CHANNELING THE TIDE

Protecting Democracies Amid A Flood of Corrosive Capital

CENTER FOR INTERNATIONAL PRIVATE ENTERPRISE

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TABLE OF CONTENTS

INTRODUCTION & SUMMARY

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There is an alarming trend occurring worldwide that threatens democracy and free market principles. A growing volume of evidence indicates that many forms of capital emanating from authoritarian nations are having a corrosive effect on democratic institutions and private enterprise in recipient countries. The largest impact is seen in emerging markets and fragile economies.

China and Russia are among the most assertive donor nations offering funding and development assistance that appear to, not only exploit governance gaps in countries with weak or corrupt structures, but also make the gaps wider. In many cases, citizens in the recipient countries have no voice in the lending and spending deals, huge agreements are not well-documented, and countries have lost ownership of key resources to the donors. In short, few benefit and there is little oversight. It is also important to analyze patterns associated with foreign investment in developing democracies. China's overseas investments and funding pledges have increased by more than eleven thousand percent since 2001.[1] Foreign investments by Russia appear to be on a much smaller scale and often are not well-tracked, but seem highly strategic and typically leverage propaganda to amplify results.

The Center for International Private Enterprise (CIPE) uses the term "corrosive capital" to more clearly label financing that lacks transparency, accountability, and market orientation flowing from authoritarian regimes into new and transitioning democracies. This report by CIPE outlines top areas of concern to our experts on the

1 Charles Wolf, Xiao Wang, and Eric Warner, *China's Foreign Aid and Government-Sponsored Investment Activities*, RAND Corporation, 2013.

ground and global partners, and is supported by new proof and examples that show how "corrosive capital" is making fragile states more vulnerable to economic or political manipulation, and thus endangering democracy. The report also lays out potential actions to help mitigate the damage to foundations of democracy.

CIPE chose the term "corrosive capital" carefully, as the wording clearly reflects the wide-ranging effects opaque capital can have on developing democracies. These effects range from the relatively benign consequences associated with "high risk" capital (that may tolerate a degree of corruption) to highly corrosive government-directed investment and finance, which advances authoritarian foreign policy goals at the expense of local institutions and western geo-political interests. The term "corrosive capital," therefore, recognizes that as with chemical acidity, authoritarian capital can have its own "pH" level when it comes to its effect on democratic institutions.

CIPE's approach to combatting the effects of corrosive capital centers around identifying specific governance gaps in countries where democracy is at risk, then working with local partners to design and implement local projects to help close the gaps, as well as foster dialogue among civil society, the private sector, and lawmakers. Frequent examples of governance gaps include: uneven enforcement of local labor and environmental regulations, unreliable rule of law, insufficient checks and balances over government decision-making and expenditures, and ineffectual or inactive civil society.

In the 2017 report *Sharp Power: Rising Authoritarian Influence*, the National Endowment for Democracy (NED) identified the subtle effect of the strategic use of soft power tools by authoritarian states on democratic institutions worldwide.[2] Corrosive capital, in its higher states of "acidity," has become an effective instrument to complement these efforts. Consequently, there is a pressing need in weak democracies for local projects that reduce the disruptive effects of corrosive capital. The goal of CIPE's projects, and others, is not to stem the flow of funds, but rather to create institutional safeguards in the recipient countries that make the continued receipt of potentially corrosive capital less disruptive to democratic governance and rule of law.

Proven policy responses to the threat posed by corrosive capital do exist and can be implemented at the local level. They include improved standards of informed

2 Walker, Christopher and Jessica Ludwig, "Chapter One: From 'Soft Power' to 'Sharp Power,'" *Sharp Power: Rising Authoritarian Influence*, National Endowment for Democracy: 2017, 22.

consent by governments taking on foreign debt, greater transparency and fairness in public procurement, improved disclosure of sovereign debt, and higher standards for budget transparency. Policy advocacy by civil society, including the business community and other stakeholders, is an effective strategy for pushing governments to implement reforms that improve accountability and transparency, while creating a fair playing field for all businesses. By empowering these domestic reform constituencies to demand better governance, democracy programming can harness the positive effects of all capital, regardless of origin, and strengthen democratic institutions that safeguard the interests of citizens.

CIPE'S APPROACH TO COMBATTING THE EFFECTS OF CORROSIVE CAPITAL CENTERS AROUND IDENTIFYING SPECIFIC GOVERNANCE GAPS IN COUNTRIES WHERE DEMOCRACY IS AT RISK, THEN WORKING WITH LOCAL PARTNERS TO DESIGN AND IMPLEMENT LOCAL PROJECTS TO HELP CLOSE THE GAPS, AS WELL AS FOSTER DIALOGUE AMONG CIVIL SOCIETY, THE PRIVATE SECTOR, AND LAWMAKERS.

CHANNELING THE TIDE
Protecting Democracies Amid A Flood Of Corrosive Capital

CIPE is a core institute of the National Endowment for Democracy (NED) and is an affiliate of the U.S. Chamber of Commerce. As such, CIPE works at the intersection of economic and democracy programming, which gives CIPE unique positioning to work on issues related to high risk foreign capital and assistance offered to developing nations. CIPE coined the term "corrosive capital" to more clearly describe financing that lacks transparency, accountability, and market orientation flowing from authoritarian regimes. These financial flows into new and transitioning democracies can have an adverse effect on local governance institutions.

Corrosive capital is both an economic and democratic threat. In most countries where democracy is at risk, market institutions are weak, corruption is rampant, and there is limited capacity of policymaking processes to absorb and account for revenue. In such countries, large inflows of capital can pose challenges for local governance, regardless of where the capital comes from. For example, parliamentary review of public spending, civil society participation, and regulatory enforcement may fail to keep up with the country's needs.

When the influx of foreign capital has no accountability or transparency and is not subject to market pressure, the risks of governance failures in recipient countries are inherently greater. By exploiting gaps in governance in recipient states, such capital flows corrode the rule of law, fair market competition, and fiduciary accountability. All of these are foundational elements of democracy.

The corrosive effect of capital from authoritarian states does not depend on the type of capital. The distinction between types of financial instrument, along with the distinction between public and private capital, is often blurred. In the Balkans, for example, supposedly "private" Russian companies with direct links to the Kremlin are making multi-hundred million dollar investments. In numerous cases documented by CIPE and partners, such state-backed Russian investments in the Balkans are in strategic industries such as media and energy.[3] This blurring of public and private activity is also seen in foreign direct investment (FDI) from China. Companies directed by the Chinese government accounted for 89% of what is classified as "private" Chinese investment overseas in 2011.[4]

The line separating public and private is further blurred by the fact that the majority of loans from China to foreign governments are commercial, as opposed to concessional loans or "aid." AidData at the College of William & Mary tracked $354 billion in Chinese overseas lending from 2000 to 2014. Nearly 75% of the loans were on commercial terms, and thus are not official development assistance, despite how they are often portrayed.[5]

3 Martin Vladimirov et al., *Russian Economic Footprint in the Western Balkans: Corruption and State Capture Risks*, Center for the Study of Democracy, 2018.

4 Eve Cary, "SOEs Declining Role in China's Foreign Investment," *The Diplomat*, July 3, 2013.

5 "Global Chinese Official Finance Dataset," AidData, 2017, Version 1.0. Retrieved from *http://aiddata.org/data/chinese-global-official-finance-dataset*

CIPE COINED THE TERM "CORROSIVE CAPITAL" TO MORE CLEARLY DESCRIBE FINANCING THAT LACKS TRANSPARENCY, ACCOUNTABILITY, AND MARKET ORIENTATION FLOWING FROM AUTHORITARIAN REGIMES.

FIGURE 1: FINANCIAL INSTRUMENTS REFERENCE

TYPE OF CAPITAL	DEFINITION	EXAMPLE
Official Development Assistance (ODA)	Financial aid from one government to another country that promotes and specifically targets the economic development and welfare of the recipient country. This capital is provided by an official government agency and is concessional in form (i.e. grant or subsidized loan). ODA does not include military aid.	The World Bank loans the government of Uganda $50 million for a term of 40 years at zero percent interest. This credit facility operates at a financial loss for the lender. The Millennium Challenge Corporation (MCC) awards the government of Indonesia a $500 million grant for economic development projects.
Foreign Direct Investment (FDI)	An investment by an entity in one country in assets located in another country. Typically involves an equity position.	A cell phone provider based in France opens stores in India. General Motors purchases an auto-parts company in Thailand.
Commercial Loan	A debt-based funding arrangement in which one party borrows money from another party on market terms. The lending party typically seeks to maximize profit. Distinct from debt issuance, such as with bonds.	HSBC lends Airbus $100 million at an interest rate determined by market conditions and the credit worthiness of Airbus. HSBC seeks to earn a positive return. The Sri Lanka Ports Authority, with the Sri Lankan government as guarantor, borrows $1 billion from a Chinese state-owned bank at a floating rate tied to LIBOR.

GOVERNANCE GAPS

At a February 2018 public event at CIPE, Dr. Deborah Brautigam, a leading expert on the role of China in Sub-Saharan Africa, explained that Chinese companies tend to take advantage of "weak regulatory environments," yet weak regulations are often the source of governance gaps, and when China exploits weak regulations in a recipient country the rule of law in a country erodes.[6] Weak rule of law and uneven regulatory enforcement are present in almost every transitioning democracy. Those traits also represent some of the gaps in effective democratic governance through which corrosive capital may flow.

When huge amounts of money flow through governance gaps, the gaps widen, thereby increasing the threats to democracy in recipient countries. Therefore, when the Chinese Commerce Ministry circumvents the laws of another country, and does so with impunity, rule of law in that country erodes.

Other governance gaps include the lack of checks and balances on government actions and the lack of independent oversight of government finances. Corrosive capital flows through such gaps in governance.

CORROSIVE EFFECTS ON LOCAL GOVERNANCE

In many recipient countries, increased reliance on capital from authoritarian states has been linked with greater levels of local corruption, expansion of political patronage, reduced transparency, greater political repression, and other governance failures.

"Chinese aid projects fuel local corruption but have no observable impact on economic activity, [while data show] a more favorable pattern for World Bank aid projects, namely that they stimulate local economic activity while there is no consistent evidence of a corresponding [increase in] corruption,"[7] write economists from the University of Gothenburg and the University of Oslo.

The receipt of state-backed money from China can also promote state repression of civil society actors in countries that receive this assistance. Additionally, political violence by the state often increases with receipt of Chinese aid, as regimes are able to use aid resources to repress competition, opponents, and civilians. A working paper from the Armed Conflict Location & Event Data Project explains that, "though China isn't specifically giving official finance to

6 Deborah Brautigam, *The New Great Game? China's Investment Model in the Developing World*, Panel, CIPE, February 6, 2018.

7 Ann-Sofie Isaksson and Andreas Kotsadam, "Chinese Aid and Local Corruption," *Journal of Public Economics*, 159 (2018): 156.

'pariah states,' it is making states into pariahs through providing resources to state leaders who are not afraid to use repression as a means to quell competition."[8]

The mixture of weak institutions, rule of law, high levels of corruption, media propaganda, and geopolitical pressure from Russia and other countries has led many Western Balkan governments to adopt policies inconsistent with their national security or development interests. Russia's financial dealings in the Western Balkan region have provided more leeway for political opportunists to try to avoid implementing necessary reforms. That is especially true for reforms related to strengthening the rule of law and curbing autocratic tendencies, thus undermining civil society and the media, leading to democratic backsliding and an economic slowdown. Russia's economic presence can be linked to the cultivation of an opaque web of economic and political patronage across the region thus influencing decision-making in the critical areas of energy, security, and foreign policy.

Anecdotal evidence abounds of the political impacts of money from authoritarian states and how it crowds out civil society. For example, Chinese foreign assistance played a crucial role in President Joseph Kabila winning the 2011 election in the Democratic Republic of Congo.[9] Also, China helped finance Hugo Chavez's campaign for his third presidential term in Venezuela.[10]

In the Balkans, Russia is deploying an array of traditional soft-power instruments, including media presence, support for pro-Russian domestic civil society organizations and political parties, and high-level political visits and statements. These tools have been used to support both current governments and opposition groups, depending on what suits Russia's ends. In Macedonia, Russian soft power helped to undermine the legitimacy of anti-corruption protests in 2016, while in Montenegro, it aided the opposition in denouncing the government's Western-leaning foreign policy when the country joined NATO in 2017.[11]

In Argentina, an ongoing CIPE project documented billions of dollars in previously undisclosed loans to government ministries

8 Roudabeh Kishi and Clionadh Raleigh, *Chinese Official Finance and Africa's Pariah States*, ACLED Working Paper Series, 2016.

9 Gregory Mthembu-Salter, *Goodwill and Hard Bargains: The DRC, China and India*, Africa Portal, March 1, 2012

10 Erica S. Downs, *Inside China Inc.: China Development Bank's Cross-Border Energy Deals*, The Brookings Institution, March 21, 2011.

11 Martin Vladimirov et al., *Russian Economic Footprint in the Western Balkans: Corruption and State Capture Risks*, Center for the Study of Democracy, 2018.

from state-owned banks in China. The public works that were financed by these loans were not competitively bid, but rather were sole-sourced to state-owned companies in China. As these were commercial (not concessional) loans, this circumvented Argentine procurement laws, along with environmental and labor codes. Moreover, the fact that these sovereign loans remain "off the books" is particularly problematic in a country with Argentina's poor track record of public financial management and with Argentina's already swelling public distrust of government.

Because no independent cost-benefit analysis was conducted and because local businesses were prohibited from competing for government contracts, it is impossible to gauge the true value of the sovereign debt incurred by the government of Argentina. The government is democratically elected and therefore officials have a fiduciary obligation to be stewards of the people and their money, as well as to ensure that the public benefit justifies the cost of projects. Programs that enable the business community to take part in policy making processes and monitor government expenditures, as well as policy reforms that prohibit the circumvention of procurement laws, could help address the democratic deficits observed in Argentina.

OFFICIALS HAVE A FIDUCIARY OBLIGATION TO BE STEWARDS OF THE PEOPLE AND THEIR MONEY, AS WELL AS TO ENSURE THAT THE PUBLIC BENEFIT JUSTIFIES THE COST OF PROJECTS.

STRINGS, SECRECY, AND SURPRISES

Transparency, or lack thereof, is one of the leading factors that allows corrosive capital to exploit developing democracies. The terms and details of financing coming from authoritarian states are often not revealed until it is too late to make a change, if they are disclosed at all.

There is a widely-held belief that Chinese loans come with "no strings attached" as opposed to loans from the World Bank and democratic donors that involve difficult questions about human rights and corruption. This is false. The "strings" attached to loans from China are simply different. Among the most common is the requirement that projects funded by Chinese capital be sole-sourced to Chinese firms. Other "strings" include China requiring dominant equity shares of projects, the mass importation of Chinese laborers (often in violation of local labor and immigration laws), and compulsory intelligence sharing.[12]

Because three-fourths of Chinese overseas loans are commercial, they are not subject to the various international treaties and standards that govern the provision of official development assistance (ODA).[13] In short, when one country provides ODA to another country, the donor country can require the procurement of goods and services from the donor country, even if this practice conflicts with local laws. This practice of "tied aid" is ubiquitous among bilateral donors.

On the other hand, public works financed on commercial terms, meaning the financing does not qualify as ODA, must comply with local law. For example, a commercially-funded project must follow local procurement laws, which may require competitive tenders for government contracts. If a government were to award such a project without a tender it would likely violate local law.

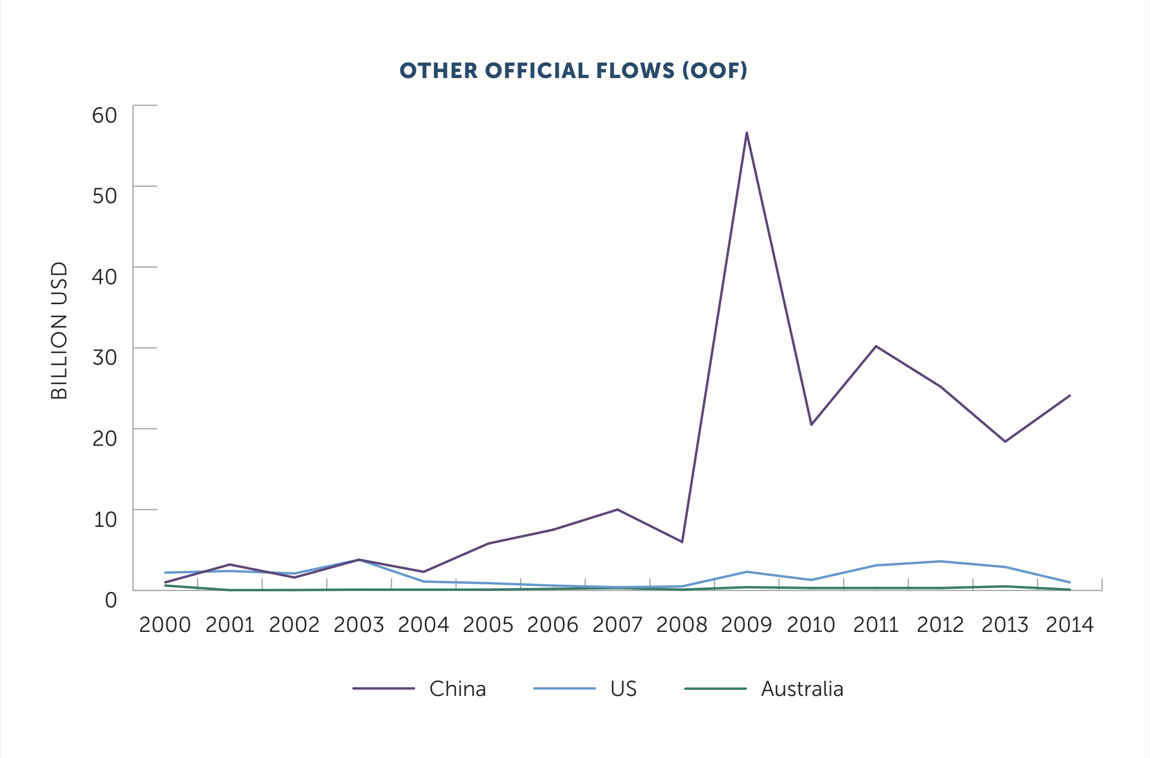
According to the Reconnecting Asia project at the Center for Strategic and International Studies, projects funded by China use Chinese contractors 89% of the time. In contrast, when projects are funded by multilateral donors, 40% of contractors are local companies, with contractors from China comprising barely 30%.[14]

12 Maria Abi-Habib, "How China Got Sri Lanka to Cough Up a Port," *The New York Times*, June 25, 2018.

13 Examples of regulations on tied aid include the OECD Arrangement/Helsinki Package, and *Ex Ante Guidance for Tied Aid*.

14 Jonathan Hillman, "China must play fair over BRI contracts," *Nikkei Asian Review*, February 6, 2018.

FIGURE 2: TWO COMPARISONS OF OVERSEAS SPENDING



SOURCE: OECD.STAT AND AIDDATA

In the Balkans, Serbia borrowed $800 million from Russia to modernize its outdated railway infrastructure.[15] At an annual interest rate of 4.1% , the Russian loan had less favorable terms than typical loans from European development financial institutions such as the European Bank for Reconstruction and Development (EBRD) or the European Investment Bank (EIB). Moreover, a second loan granted preferential status to Russian state-owned contractors for infrastructure modernization projects. According to experts in the region, many of these loan agreements were exempted from relevant Serbian laws and were not debated publicly.[16] Additionally, experts say there are indications that Serbia agreed to the terms of exclusive access for Russian contractors in violation of European Union norms on competition and transparency in public procurement.[17]

Similarly, China often attaches conditions on commercial loans that conflict with local laws in recipient countries. This highlights another problematic attribute of Chinese loans: secrecy. The terms of loans from China are rarely available to the public, especially while the terms are being negotiated.[18] This precludes any external checks and balances to hold the recipient government accountable. As these external checks and balances are already weak in most developing democracies, this is another example of authoritarian capital flowing through governance gaps in recipient countries.

The utter lack of transparency surrounding Chinese capital makes it unsurprising that such funding is disproportionately funneled to the home regions of the leaders of recipient countries.[19] In Argentina, commercial loans from Chinese state-owned banks financed the construction of dams in the home province of then-President Cristina Fernández de Kirchner.[20] In Sri Lanka, then-President Mahinda Rajapaksa secured loans on commercial terms from a state-owned Chinese bank for a port in Rajapaksa's home district. The construction of the port was sole-sourced to a state-owned firm from China, and was implemented despite feasibility studies that questioned the economic viability of such a port.[21]

15 Vladimirov et al, *Russian Economic Footprint in the Western Balkans*," 2018.

16 Ibid

17 Ibid

18 *Governance of International Financial Aid in State-Owned Infrastructure Companies – Argentina*, CIPPEC (2018): 34.

19 Axel Dreher, et al., *Aid on Demand: African Leaders and the Geography of china's Foreign Assistance*, AidData Working Paper, October 2016.

20 *Governance of International Financial Aid in State-Owned Infrastructure Companies*, CIPPEC (2018) 34.

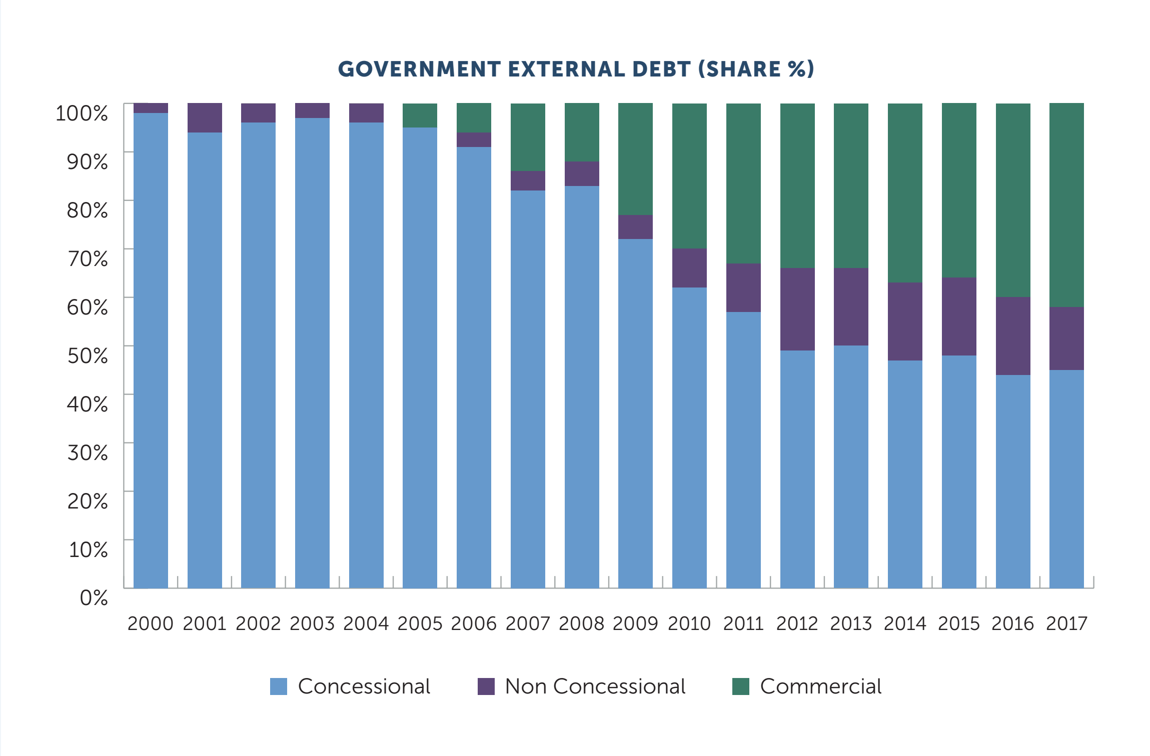
21 Abi-Habib, "How China Got Sri Lanka to Cough Up a Port."

The Rajapaksa government agreed to several loan revisions sought by China, such as higher interest rates, and the Chinese construction company gave several million dollars to Rajapaksa's political campaigns.[22] The pessimistic projections for the port proved correct. In fact, they were not pessimistic enough. When the debt burden become untenable for Sri Lanka, the government acquiesced to China's demands that the Hambantota port and 15,000 acres of adjoining land be ceded to China. Imagine the surprise of many Sri Lankans when they awoke one morning in December 2017 to the news that a corner of their country was now part of China.

Such governance failures in countries where democracy is fragile, at best, pose an existential threat to democracy itself. In these countries, local business associations can play a unique role in pressing for transparency in public expenditures in order to ensure that their member companies can compete for public works contracts. Good governance NGOs need training on how to monitor public tenders, and policy reforms are needed to enable public requests for government information.

22 Ibid

FIGURE 3: SRI LANKA'S INCREASED RELIANCE ON COMMERCIAL LOANS (SHARE OF CONCESSIONAL FUNDING IS DECLINING)



SOURCE: VERITÉ RESEARCH

NOT A TREND THAT BENEFITS U.S. BUSINESS

Of course, not all Chinese or Russian capital is corrosive, nor are corruption and malfeasance unique to China or Russia. Corruption cases involving Western companies are numerous. However, when a company from the United States engages in corruption overseas, not only does it risk running afoul of local laws, it is also subject to the U.S. Foreign Corrupt Practices Act (FCPA). Such laws are common in democracies, from the U.K. Anti-Bribery Act to the Act on Combating International Bribery in Germany. Conversely, firms from Russia, China and other authoritarian states face no such risk back home.

The explosive growth of corrosive capital flowing into emerging markets, and the resultant degradation of transparency and rule of law, puts companies that are held to higher compliance standards at a disadvantage. When the FCPA was amended in 1998 and its enforcement made more aggressive, it was partly at the urging of American businesses clamoring for assistance in competing against companies from countries with far lower standards of corporate governance.

Business experts testified in the FCPA hearings, including Stuart E. Eizenstat, Undersecretary of State for Economic, Business and Agricultural Affairs; Paul V. Gerlach, Associate Director of the SEC Division of Enforcement; Andrew J. Pincus, General Counsel of the Department of Commerce; and Fritz F. Heimann, Chairman of Transparency International-USA. In his testimony, Heimann stated that "the U.S. Department of Commerce estimates that 139 international commercial contracts valued at $64 billion may have involved bribery by foreign firms" to the direct detriment of U.S. firms.[23]

CORROSIVE CAPITAL AND NEGATIVE NORM TRANSMISSION

U.S. businesses are disadvantaged in both the short and long-term when foreign competitors are able to hammer out unethical deals. The presence of corrosive capital often leads to "negative norm transmission." For example, surveys of communities in Africa located near Chinese-funded projects show that "individuals living near active project sites are indeed less likely to report that media need to [investigate and report on corruption], possibly

23 H. Lowell Brown, "Extraterritorial Jurisdiction under the 1998 Amendments to the Foreign Corrupt Practices Act: Does the Government's Reach Now Exceed its Grasp," *North Carolina Journal of International Law and Commercial Regulation*, 26:2, UNC School of Law, 286.

revealing more accepting attitudes towards corruption." That finding differs from results from communities not near active sites.[24]

Recipient countries not only receive funding from investors, but also import the business practices of the investor countries. When investment originates from countries defined by rule of law, regulatory enforcement, and sound corporate governance, it can help improve the institutional environment in the recipient country. Corrosive capital typically has the opposite effect, creating conditions in emerging markets that disadvantage companies subject to anti-bribery laws such as the FCPA.

This is intuitive, as American businesses rely on the rule of law to protect the value of their foreign investments. Consequently, there is an inherent incentive to advance the rule of law in markets where they operate. Leading expert Claude G.B. Fontheim, who advises the world's largest companies on global strategy and social responsibility, explains that "a growing number of business leaders understand not only that their organizations have responsibilities to the broader society, but also that changing their strategies and performance in this way will greatly strengthen their businesses."

STRENGTHEN DEMOCRATIC DEFENSES BY CLOSING GOVERNANCE GAPS

The goal of CIPE's work on corrosive capital is to make this money less disruptive to governance and democracy in recipient countries. CIPE's approach is to implement projects in specific countries that can help close the governance gaps that corrosive capital exploits, thereby reducing the disruptive effects of such capital. By translating this enormous global trend into specific projects that address specific governance gaps in specific countries, CIPE's approach is to think globally and act locally.

Through strategic investments by the Bureau of Democracy, Human Rights, and Labor (DRL) at the U.S. Department of State and by the NED, CIPE is piloting efforts in select countries. The first key step in most of these efforts is to partner with members of the private sector and civil society to identify governance gaps that high-risk capital can exploit via lack of transparency, accountability, or market orientation. The next step is to design and implement projects that close the governance gaps, while also fostering dialogue among civil society, the private sector, and lawmakers. Successful examples are cited later in this document.

24 Isaksson and Kotsdam, "Chinese Aid and Local Corruption," (155).

The goal of such projects is not to dissuade any country from spending or receiving money. Given the exponential growth of foreign spending by authoritarian governments, stopping such capital flows is not possible. Nor would it be desirable. Asia, for example, has a multi-trillion dollar infrastructure deficit.[25] Investments in infrastructure are surely needed. Furthermore, foreign investment in emerging markets and trade with developing countries can minimize shortfalls, help reduce poverty, and spur economic development.

But when huge amounts of high-risk capital flow into an emerging market, the governance distortions can outweigh economic benefits. Consequently, there is an acute need in the world's emerging democracies for local projects that address local governance gaps, so that the continued receipt of Chinese and Russian capital becomes less disruptive to weak democracies. For example, advocacy projects can help ensure that public works projects are transparent and competitively tendered.

As CIPE shares lessons learned from the implementation of project methodologies, it is CIPE's hope that DRL, NED, and U.S. policymakers will further support and replicate CIPE's project models through their global networks of partners. This would scale up the targeted investments in CIPE's ongoing programs to achieve greater global results and make markets and democracies more resilient in the face of capital flows from nondemocratic countries.

25 Chris Heathcote, *Forecasting infrastructure investment needs for 50 countries, 7 sectors through 2040*, World Bank Group, August 10, 2017.

CIPE'S APPROACH IS TO THINK GLOBALLY AND ACT LOCALLY.

REGIONAL EXAMPLES
Africa

Democratic governance is still taking root in many African countries. Often the mechanisms and institutions of accountability are not yet fully-functioning, if they exist at all. In countries across the continent, China is solidifying financial relationships with governments, especially in resource-rich countries such as Angola.[26] As mentioned above, the vast majority of lending from Beijing to African governments is on commercial terms, and the vast majority of ostensibly "private" investment from China is from companies owned by the Chinese government. The public works projects funded by Chinese capital are negotiated in near-complete secrecy, and do not involve the governance and human rights standards that are required by the World Bank and democratic donors.

As the following examples illustrate, the secrecy of China's spending in Africa all but prohibits the ability of civil society, the business community, and the media to monitor government finances or hold the government accountable. In addition to enabling Chinese parastatal enterprises to ignore environmental regulations and local labor codes, this also involves the circumvention of competitive bidding and local content requirements for government contracts.

In dozens of cases across the continent, African governments were overcharged by China for public works projects. As a result, these governments incurred far more debt (owed to Chinese state-owned banks) than was justified by the service provided by the Chinese contractors.

26 "Data: Chinese Loans to Africa," China-Africa Research Initiative, 2018, retrieved from: *http://www.sais-cari.org/data-chinese-loans-and-aid-to-africa/*

EXPLOITING GOVERNANCE GAPS

GHANA: As part of an ongoing initiative with a Ghanaian think tank, a CIPE project investigated a $3 billion commercial loan agreement between the government of Ghana and the China Development Bank. This 2011 loan was the largest in Ghana's history, and it was collateralized by Ghanaian cocoa revenues that were deposited in an escrow account with the Export-Import Bank of China. Chinese state-owned conglomerates, including Sinopec and Huawei, were among the primary beneficiaries of the ensuing contracts with the Ghanaian government.

The loan financed the purchase of helicopters from a Chinese state-owned company and other items. This contract was awarded without competing bids or independent review, despite the fact that such processes are required by Ghanaian law. Approximately two years later, a parliamentary review documented that the Chinese firm inflated the price of the helicopters by 300%. To date, the helicopters have not been delivered.[27]

SIERRA LEONE: China is among the largest sources of foreign funds for infrastructure projects in Sierra Leone. While such investment is sorely needed, it is exacerbating weaknesses in public governance and regulatory oversight in Sierra Leone. For example, the Wilkinson Road project in Sierra Leone was financed by a commercial loan from a Chinese state-owned bank. There was no competitive tender for the construction, and no independent price analysis was conducted. As a result, the government of Sierra Leone paid $4 million per kilometer for the Wilkinson Road project, compared with the average expenditure for similar projects of $600,000 per kilometer. The Deputy Speaker of the Sierra Leonean Parliament and Chairman of the Public Accounts Committee, Sengepor Solomon Thomas, called this the "most expensive road in the world."[28]

KENYA: Democratic norms are starting to take root in Kenya with the rise of more active governance institutions and civil society. Yet the government

27 William Yaw Owusu, "Ghana Gas Helicopters Missing," *Modern Ghana*, May 24, 2017.

28 Hassan Gbassay Koroma, "'Le2.47bn for Wilkinson Road rehabilitation is waste,'" *Sierra Leone Concord Times*, November 24, 2014.

departed from its democratic leanings in negotiating the standard gauge rail project.

The Kenyan government obtained a loan of $3.6 billion for the Mombasa-Nairobi Standard Gauge Railway (SGR) project from the Export-Import Bank of China on the condition that the contract would go to the China Road and Bridge Corporation (CRBC) without a competitive bidding process. Since the SGR was launched in May 2017, it has been running at a loss of almost $1 million a month with multiple pending legal cases asserting environmental and labor rights violations. Bypassing the regular order of public procurement meant that a project of this magnitude did not receive the necessary oversight and scrutiny that traditional lenders require in the regular order of public project financing. For instance, there were allegations of corruption involving procurement, many of which were not investigated. The deal was cleared by the Supreme Court after being challenged for violating procurement laws. But it is costing the country more in terms of socioeconomic losses than anticipated.

Kenya's private sector felt the brunt of the secretly negotiated agreement when CRBC exercised its duty-free right to import materials that could have been purchased locally. There was no environment and social impact assessment, despite legal requirements that they be conducted, and there have been many labor law violations that could have been managed properly on the front end of the deal.

THE PUBLIC WORKS PROJECTS FUNDED BY CHINESE CAPITAL ARE NEGOTIATED IN NEAR-COMPLETE SECRECY, AND DO NOT INVOLVE THE GOVERNANCE AND HUMAN RIGHTS STANDARDS THAT ARE REQUIRED BY THE WORLD BANK AND DEMOCRATIC DONORS.

REGIONAL EXAMPLES
Europe

Russia is reasserting its influence in the Western Balkans. While Serbia, Montenegro, Macedonia, and Bosnia and Herzegovina have chosen to integrate with the European Union (EU) both politically and economically, Russia has been exploiting their still-weak governance to sway them away from Western integration. In the last decade, Russia has grown from a peripheral economic power to a significant player in the region. Although the share of Russian economic investment is small, ranging between 6.5% and 10% of the region's GDP, Russia's influence is disproportionate, due to high concentration in strategic sectors such as energy, banking, mining, infrastructure, and real estate.[29] Moreover, Russia exerts indirect control over the recipient countries, who depend on the import of Russian raw materials and owe debt to Russian banks.

An over-reliance on Russian energy imports and investments has made the governments of the Western Balkans particularly susceptible to pressure on strategic decisions. Examples include energy market diversification, economic liberalization, NATO and EU expansion, and Russian sanctions.

Balkan and international actors have underestimated the importance of Russia's economic footprint, resulting in a failure to recognize the extent of the associated risks. Russian FDI channeled through offshore zones and tax havens such as Cyprus remains largely hidden, which means that countries on the receiving side are not necessarily prepared for the potentially negative effects on governance. The Russian government's ability to use FDI as a foreign policy tool has been overlooked. Western investors cannot

29 Vladimirov et al, *Russian Economic Footprint in the Western Balkans*," 2018.

compete with Russia, which maintains control over its corporate citizenry. Also, while Western countries invest in diverse assets, Russian companies focus primarily on strategic and more vulnerable sectors.

In partnership with the Center for the Study of Democracy from Bulgaria, CIPE has begun working with civil society and business leaders throughout the Balkans to document the extent of Russian economic and political influence. CIPE has also identified governance gaps that Russian capital exploits. Moving forward, CIPE will work with stakeholders in the region to help engage in a systemic dialogue with respective governments to close these governance gaps. Such gaps are linked to both legislation and implementation of anti-corruption laws, competition policy, public procurement laws, and anti-monopoly laws.

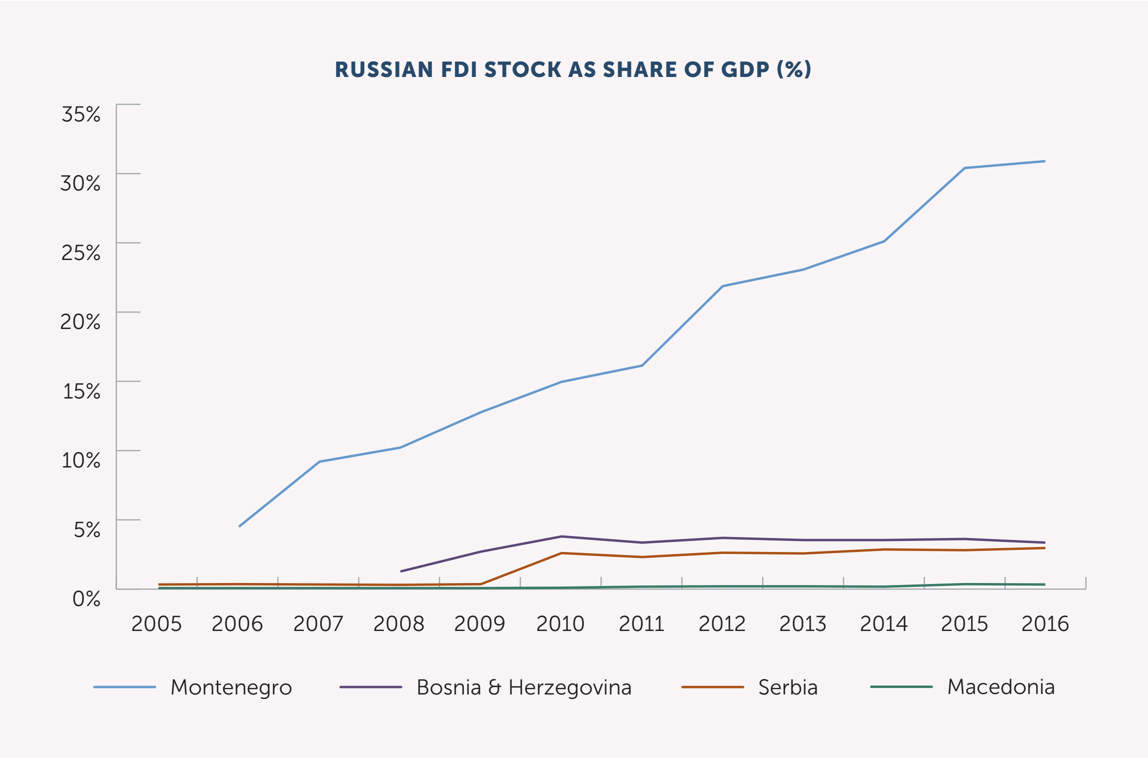
EXPLOITING GOVERNANCE GAPS

Russia's economic footprint in the four Western Balkan countries has visibly expanded over the past decade. Russian companies have invested close to $3 billion[30] in the four countries, half of which has gone to Montenegro, a hub for Russian investment in real estate and tourism. Russian FDI stock in Montenegro accounts for nearly 30% of the recipient country's annual GDP.

30 Vladimirov et al, *Russian Economic Footprint in the Western Balkans*, 2018.

AN OVER-RELIANCE ON RUSSIAN ENERGY IMPORTS AND INVESTMENTS HAS MADE THE GOVERNMENTS OF THE WESTERN BALKANS PARTICULARLY SUSCEPTIBLE TO PRESSURE ON STRATEGIC DECISIONS.

FIGURE 4: RUSSIAN INVESTMENT IN BALKAN COUNTRIES AND CORRESPONDING GDP ESTIMATES



SOURCE: CSD CALCULATIONS BASED ON NATIONAL CENTRAL BANKS AND UNCTAD COUNTRY STATISTICS

Moreover, Russian state-owned and private energy companies dominate the region's oil and gas sectors. These firms gained influence through a series of privatization deals for lucrative assets, such as Serbian companies Naftna Industrija Srbije (NIS) and Beopetrol, as well as the Bosnian firms Rafinerija Nafte Brod (oil refinery) and the Modrica motor oil processing facility. These countries remain almost entirely dependent on supplies of Russian natural gas, allowing the Russian state-owned company Gazprom to charge some of the highest prices for gas in Europe. Russian companies also have taken advantage of the closed nature of regional oil and gas markets to solidify their dominant position, successfully exploiting delays in market liberalization and an unwillingness to advance diversification projects. These are among the governance deficits Russian companies have exploited to their benefit. Further, Russia has attempted to lock regional governments into large scale energy projects that exceed their administrative capacities, such as the recently cancelled South Stream pipeline.[31] These projects

31 Ibid

not only sidelined efforts by regional governments to diversify, but exposed them to significant financial risk.

Non-transparent privatization procedures, in which asset valuations did not stem from objective economic assessments, have enabled Russian businesses to expand their economic presence in key industries. In most cases, these companies have not complied with the terms of privatization agreements, leading to losses for taxpayers and state budgets alike. Meanwhile, preferential regulatory treatment, including tax regimes and energy subsidies, allows Russian companies to register enormous profits, expand their market share and minimize tax payments.

To exploit these governance loopholes, Russia has attracted local power brokers by offering government-sponsored business opportunities at premium returns.[32] These intermediaries in turn have benefitted from further business opportunities or Russian support for their political objectives. Ultimately, the concentration of power in small, influential economic-political networks creates vulnerabilities that Russia can exploit to sway decision-making.

Finally, to amplify the effect of its economic footprint, Russia has deployed an array of traditional soft power instruments, including media presence, support for pro-Russian domestic civil society and political parties, and high-level political visits and statements. These tools have been used to support both current governments and opposition groups, depending on what suits Russia's ends. In Bosnia and Herzegovina, Russian political support has exacerbated internal divisions on both the economic and political fronts, successfully diverting the country from its path toward NATO and EU accession.

SERBIA: Serbia is the most visible manifestation of Russia's economic footprint in the Balkans. Russian entities have gradually taken over the Serbian energy sector. Russian entities, directly or indirectly, affect as much as 10% of the economy, where corporate presence is measured by volume of revenues and assets controlled by Russian companies in Serbia.

There are two main interconnected factors in Russo-Serbian relations that have laid the foundations for Russia's expanded power in the country. One is Russian support for Serbia's non-recognition of Kosovo's declaration of independence, and the second is a 2008 energy agreement that included Gazprom's takeover of Serbia's largest state-owned company, oil and gas firm NIS. The indirect Russian influence has different forms,

32 Ibid

including local companies' dependence on Russian raw material imports such as natural gas; debts accumulated for gas supply; and domestic companies' dependence on exports to Russia and Russian-controlled bank loans.

The Russian economic footprint is most obvious in the energy sector, where Gazprom and Lukoil dominate the oil and fuels markets. Serbia is almost fully dependent on natural gas imports from Russia, and local politically-connected intermediaries prevent supply diversification and market liberalization.

MONTENEGRO: The last decade has seen a significant level of economic engagement by Russian companies and individuals in Montenegro. Vital economic ties have been sustained despite the fact that bilateral political relations worsened as this small Adriatic country stepped up its efforts to complete the NATO accession process. The deterioration of political relations between the two countries culminated in an alleged failed coup attempt in 2016 and the Russian backing of the opposition Democratic Front (DF) party. Even so, Russian investment flows never dropped below 10% of total FDI and accounted for almost 30% of Montenegro's GDP, as noted earlier.[33]

Russia has exploited governance gaps to take advantage of Montenegro's lucrative privatization opportunities and to extract state subsidies in Montenegro. In addition, Russia has assertively tried to meddle in Montenegro's domestic politics. Russia supports political parties, launches media attacks against Montenegro's government and allegedly organized street protests and attempted a coup d'état before the country joined NATO.

Montenegro's largest company, the Podgorica Aluminum Plant (KAP), was once part of the metal empire of an influential Russian private investor who is reported to have close ties to the Russian government. In 2014, bankruptcy procedures were initiated after KAP accrued more than $300 million in debt.[34] The aluminum plant, which used to contribute approximately 15% of Montenegro's GDP, 51% of exports, and employed 2.3% of the population, has shrunk significantly since then. A court claim involving hundreds of millions of USD was launched in late 2016 by the Russian businessman against the government of Montenegro and could put the country at serious financial risk.[35]

33 Ibid

34 Dusica Tomovic, "Montenegro Sells Bankrupt Aluminum Plant," *Balkan Insight*, June 11, 2014.

35 "Russia's Deripaska sues Montenegro for lost aluminum investment," *Reuters*, December 7, 2016.

REGIONAL EXAMPLES
Latin America

CIPE is partnering with CIPPEC, an Argentinian think tank, to identify governance gaps related to foreign investment in infrastructure in "low intensity democracies." These are countries that hold elections but lack basic civil liberties and whose citizens can't be certain who actually governs their country. This ongoing project documented that public works funded by foreign states, principally China, circumvent Argentinian regulations regarding labor, procurement, and environmental measures. In more than a half-dozen documented cases, state-owned construction companies from China were awarded public works contracts by the Argentinian government with no public tender or competitive bidding, even though these projects were financed on commercial terms.

The governments of China and Argentina formalized a bilateral economic agreement in 2015. This agreement was ratified by the Argentinian Congress. This Chinese-Argentine partnership called for Chinese banks to provide commercial loans to the government of Argentina to finance specific projects: the rehabilitation of the Belgrano Cargas Network (transportation), the construction of two hydroelectric power plants in the Santa Cruz River, and the construction of two nuclear power plants.

This agreement established a policy relationship between the governments of China and Argentina, but it did not specify the terms of subsequent loans that would actually fund the projects. In other words, while there was nothing secret about Argentina borrowing money from China, the credit facilities themselves were negotiated on a project-by-project basis, and they were negotiated in secret. None of these loans were publicly communicated by the government of Argentina. Additionally, there is no evidence of independent price analyses. Each loan involved the sole-sourcing of public contracts to Chinese state-owned construction companies, and these loans are excluded from the government of Argentina's balance sheet.

At the time of this writing, all of the aforementioned projects are still underway, and the Chinese banks have dispersed approximately $20 billion to date. Although the various projects have different loan terms, all of the funding comes from government-controlled banks in China and involves floating interest rates tied to LIBOR.

CIPPEC concludes that in Argentina, Chinese funds have avoided adequate procedures and have consequently yielded questionable infrastructure strategies, overcharging and overpricing. Furthermore, the increased opacity in project execution allows unclear project terms and non-strategic ventures to take place. To protect democracy, countries need better monitoring mechanisms for foreign funds.

Argentina shows no signs of backing away from bilateral agreements and foreign capital, particularly through public-private partnerships (PPP) under the current government. However, opacity can be averted to transform foreign capital into an effective, non-threatening mechanism for investment in infrastructure. CIPPEC determined that if agreements were to be submitted to the National Congress' parliamentary monitoring and control division, significant improvements would be made to fund accountability and transparency.

Furthermore, the adoption of Organization for Economic Cooperation and Development recommendations for public procurement would allow Argentina to continue to meet its demand for infrastructure, while also maintaining adequate standards of due diligence.

EXPLOITING GOVERNANCE GAPS

BELGRANO CARGAS RAILWAY: The Belgrano Cargas Railway is a $2.5 billion rehabilitation project seeking to increase the railway's cargo capacity. This was one of the projects identified in the Chinese-Argentine bilateral agreement. All project materials were procured from Chinese suppliers without public notification, competitive tenders, or price analyses. While this loan is backed by a sovereign guarantee by the government of Argentina, it is not reflected in the government's debt ledger.

SANTA CRUZ RIVER DAM: In 2006, a National Plan for Hydroelectric Works of 2025 was devised in order to rank the priority of 30 hydroelectric power dams. The Santa Cruz River Hydroelectric Dam and its subsequent hydroelectric plants were ranked eighth in project priority. The project was funded by a commercial loan from Chinese government-owned banks. The public works were sole-sourced to Chinese construction firms, and the project bypassed seven other potential projects that had been prioritized ahead of it.

SAN MARTIN RAILWAY: During the construction of the San Martin railway line, the purchase of goods and services did not follow appropriate price analyses, leading to higher payments of financial commissions and higher prices for goods and services by up to 21%. The San Martin railway remains underutilized as a result of the lack of adequate adjustments and planning provisions prior to its construction.[36]

36 *Governance of International Financial Aid in State-Owned Infrastructure Companies*, CIPPEC (2018)

IN ARGENTINA, CHINESE FUNDS HAVE AVOIDED ADEQUATE PROCEDURES AND HAVE CONSEQUENTLY YIELDED QUESTIONABLE INFRASTRUCTURE STRATEGIES, OVERCHARGING AND OVERPRICING.

HOW TO RESPOND TO CORROSIVE CAPITAL

Through a series of projects in select countries, CIPE is piloting efforts to build up the internal defenses of emerging democracies. By closing the gaps in governance that corrosive capital can and often does exploit, recipient countries may absorb funding with less risk to democratic governance. CIPE's various pilot initiatives on this issue are at different stages of implementation. Examples of objectives for projects that can reduce the disruptive effects of corrosive capital in recipient countries include, but are not limited to:

- Increase transparency of public budgets through democratic oversight, including civil society monitoring and public awareness raising
- Build the capacity of local civil society and businesses to craft and advocate policy reforms that systematize how their government receives, budgets, and disperses donor funds (regardless of what country the funds are from)
- Increase democratic oversight of procurement
- Reform state-owned enterprises in transitioning and vulnerable democracies
- Increase participation of local businesses in foreign-funded public works
- Identify problems with procurement laws
    - Determine whether existing laws are not aligned with international regulation and best practices, whether the problem is implementation and enforcement of existing laws, or whether the international guidance does not provide the necessary safeguards
- Enable investigative journalism to illuminate the negative effects of corrosive capital and promote the

importance of good democratic and economic governance

- Institute policy reforms that help ensure informed consent
  - Guarantee that loans used to finance public works projects are in line with actual project costs
  - Ensure that recipient governments require an independent cost-benefit assessment of projects that are funded through sovereign debt

Corrosive capital is not the only factor underlying the strategic threats facing democracy today. But there is considerable evidence that the negative impacts of corrosive capital in new and struggling democracies exacerbates these strategic threats by undermining government accountability and contributes to citizens' alienation from government.

If democracy programs can address specific public governance breakdowns, negative political decisions, and harmful policy outcomes caused by corrosive capital, this would help improve the resiliency of democratic governments everywhere.

BY CLOSING THE GAPS IN GOVERNANCE THAT CORROSIVE CAPITAL CAN AND OFTEN DOES EXPLOIT, RECIPIENT COUNTRIES MAY ABSORB FUNDING WITH LESS RISK TO DEMOCRATIC GOVERNANCE.

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ABOUT CIPE

The Center for International Private Enterprise (CIPE) is a non-profit affiliate of the U.S. Chamber of Commerce and a core institute of the National Endowment for Democracy. CIPE's mission is to strengthen democracy around the globe through private enterprise and market-oriented reform, fulfilling a vision of a world where democracy delivers the freedom and opportunity for all to prosper. Founded in 1983, CIPE partners with local business associations, chambers of commerce, universities, think tanks, and advocacy groups to advance democratic and economic reforms worldwide. Headquartered in Washington, DC, CIPE teams are active in over a dozen countries through field offices and representatives. In addition, CIPE maintains a network of more than 130 organizations spanning over 70 countries. A wide range of donors directly support CIPE's work, and CIPE regularly collaborates with other international development and democracy organizations to carry out joint projects.

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