FDI IN THE SOUTH CAUCASUS: INSTITUTIONAL AND REGIONAL DEVELOPMENT CONTEXT

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Abstract. *The goal of the paper is to analyze the characteristics of institutional environment in South Caucasus countries and evaluate region-wide development opportunities of FDI. The increased importance of institutional environment for FDI in South Caucasus as a subject of study is related to the economic changes and the institutional reforms that have been going on there. Considering the new reality, the issue is also topical from EU integration point of view, as EU has promoted many institutional changes in Georgia, Armenia and Azerbaijan to ensure further approximation of its Eastern neighbors with the EU markets and institutions. The institutional context is evaluated by the rules for entry and operation, trade policy and openness, privatization policy and property rights, access to resources, governance effectiveness and corruption criteria. The research relies on statistical analysis and case study methods. Data are obtained from International organizations' databases, national statistics offices and the secondary research of the governmental and non-governmental organizations of the countries. The comparative study enables us to conclude that institutional context of FDI in South Caucasus gives a varied picture. Compared with its neighbors, Georgia is advanced by the degree of governance, corruption control and economic freedom components, while accessibility of financial resources is the field of future concern in the three countries. Differences in institutional setting can affect FDI flows targeting either of the South Caucasus Countries. Therefore in South Caucasus formation of the institutional framework for FDI should be based on region-wide development rather than location competition approach.*

Keywords: *FDI; South Caucasus; institutional determinants; institutional progress; region development.*

Introduction

Foreign direct investment (FDI) determinants can explain the process of FDI attraction by certain countries, as well as the geographical structure of FDI. The general context is that reduction in communication and transportation costs, combined with the increasing interconnectedness of markets and economies, has resulted in an increase in the number of locations where value-added activities can take place. This, according to Dunning and Lundan (2008) gives more options to the firms involved in FDI to exploit location-specific assets in any site of the world.

Due to broader cross-border opportunities for FDI, firms encounter and are influenced by different formal and informal institutions in different countries. Consequently, over the last decades institutions became very important in both micro and macro level economic literature. At the same time the effects of institutions on value-added activities have empirical support in the studies by Henisz (2000), Wei (2001), Globerman and Shapiro (2002), Jensen (2003), Anghel (2005), Al-Sadig (2009), etc.

Institutional determinants are especially important in small open economies of South Caucasus, where deep economic changes and the institutional reforms have taken place. In addition to it the significance of institutions for FDI in these countries has found some empirical support. Among the transition-specific FDI determinants identified by Kersan-Skabic and Orlic (2007) institutional factors such as openness and corruption appear to be significant in transition economies.

Except for the above, study of the institutional context of FDI in south Caucasus countries is interesting from EU integration point of view, especially for Georgia at its present stage of Association with the EU. EU has promoted many institutional changes in Georgia, Armenia and Azerbaijan to ensure further approximation of its Eastern neighbors with the EU markets and institutions. Thus EU has been an important source of institutional changes in the region.

The goal of the present paper is to analyze the institutional context for FDI in South Caucasus countries, the improvements made and weaknesses of the institutions, which affect FDI flows. Considering the long-term economic interests involved in FDI, they can have special implications for the economic and social development of the region.

South Caucasus countries have convenient location for trade with both East and West and very important resources, such as energy and water reserves. These are attractive factors for FDI. The first huge foreign capital inflow in the South Caucasus took place in the late 1990s. Due to its oil and gas resources Azerbaijan is the main recipient of foreign capital in the region, while Georgia mainly attracts FDI because of its strategic geographical location (Vacharadze, 2013, p.18). However, in 2002-2008 the majority of these flows was directed to extractive industries and was related to privatization rather than Greenfield investments. At the same time South Caucasus countries have several economic problems that affect FDI flows adversely. One of them is the low productivity, which, according to OECD (2011), was 77% below the world average calculated by the output per person despite the high growth rates before 2008 (OECD, 2011). Several experts regard that FDI flows in this region need to be improved both quantitatively and qualitatively.

The countries of South Caucasus have similar economic development history and a number of common characteristics. However during the period of their independent development, many controversial processes took place there. For example, Azerbaijan has been one of the fastest growing economies in the world for the last decade, leaving behind its neighbors, Georgia and Armenia; Armenia was the most intensely influenced by the global economic crisis of 2008-2009, while Azerbaijan not only managed to overcome the economic shock, but also invested much abroad. Georgia has successfully implemented a number of important institutional, structural and economic reforms and took steps to improve the business environment by means of fiscal and administrative reforms. However, the 2008 War with Russia and government shifts in 2012 increased the unpredictability of business environment and had a negative influence on FDI flows.

Azerbaijan's GDP per capita is the largest among its neighbors. Azerbaijan has population two times, GDP four times and GDP per capita more than two times the size of those of Georgia. However, its advantages are not fully realized in the inward FDI stocks. According to the World Bank data the inward FDI stock in Azerbaijan slightly exceeds Georgia's indicator and is, $13 750 million (compared with $11 675 million in Georgia) (table 1). This can be explained by under-development of institutions and weak corruption control in Azerbaijan, in which, as we will see below, Georgia has achieved more progress. Armenia's GDP per capita is close to that of Georgia's but its inward FDI stock is half of Georgia's indicator $5 063 million (World Bank, 2013). Despite its liberal economic orientation, it is relatively isolated state. Foreign remittances play more significant role in its economy, than FDI. Because of insufficient foreign demand, its internal demand is stimulated by government expenditures and the public debt, what makes an adverse influence on FDI attraction. Until 2008, demand has been increased at the expense of loans and transfers in Georgia too. Only Azerbaijan enjoyed net export incomes.

FDI flows in the countries of South Caucasus were not stable during 2007-2013. Their trend is similar to that of the economic growth in Georgia. The lowest rate of real GDP growth (in 2009) coincides with the lowest amount of FDI inflows (table 2). This is not the case in Armenia and Azerbaijan. In Armenia FDI inflows show a downward trend annually, while Azerbaijan with lower growth rates compared with its neighbors had an upward trend of FDI inflows.

The above discussed background reveals some economic constraints for FDI, such as limited market size and insufficient local demand, unstable economic growth (figure 1), limited export potential (table 3), etc. Under the circumstances institutional determinants can play an important role in the improvement of these countries' positions as locations for FDI.

Theoretical and methodological foundations of the study

The theoretical foundation of the present study is institutional theory. We discuss *macro level institutions* and rely on the definition of North (1990) of formal and informal institutions, which comprise the institutional system. We set aside informal norms, beliefs and values and discuss *formal* "rules of the game", such as laws, financial institutions, property rights system and other regulations which can affect the relationships of foreign direct investors with the host economies. Rondinelli (2005) has explored the characteristics of seven kinds of national institutions directed to: 1. economic adjustment and stabilisation; 2. economic motivation; 3. protection of private property; 4. freedom of enterprise; 5. rule setting and corporate or societal guidance; 6. promoting competition; 7. promoting equity among the stakeholders of society, and access to opportunity. For the purpose of our analysis the study by Benassy-Quere (2005) is considerable, which covers a representative range of formal institutions and reveals that tax systems, easiness to create a company, lack of corruption, transparency, contract law, security of property rights, efficiency of justice and prudential standards are important determinants of FDI.

Institutional determinants influence FDI as they define how big the transaction and production costs will be. Low level of institutional development in a country increases the uncertainty and, therefore, the costs. Jackson (2010) argues that institutions place constraints on economic actors through various regulative, normative and cognitive pressures. Their restrictive power is expressed in that "they close off courses of action that otherwise would be available, by making them excessively costly, or reducing their value" (Dunning & Lundan, 2008, p.131). As Anghel (2005) argues, countries which are highly ranked according to various indices of the quality of institutions tend to do better in attracting FDI. We approach towards institutions as *demand-side determinants* (Azam, 2010), which can explain what countries hold to attract FDI flows from abroad.

To develop a systematized approach we rely partly on the above mentioned theoretical and empirical research and partly on the UNCTAD's (1998) grouping of FDI determinants as (1) Policy framework for FDI and (2) Business facilitation institutions. We discuss rules for entry and operation, trade policy and openness, privatization policy and property rights, access to resources, governance effectiveness and corruption as important factors in the institutional context of South Caucasus countries.

The research relies on statistical analysis and case study methods. The data are obtained from the World Bank World Governance Indicators, World Economic Forum Global Competitiveness indicators, Heritage Foundation and Fraser Institute Databases, as well as EU Commission evaluations, data of national statistics offices and the secondary research data of the governmental and non-governmental organizations.

The institutional determinants of FDI in South Caucasus

Rules for entry and operation. According to the World Bank Investing Across Sectors by all foreign business entry and operation indicators Georgia is completely open to foreign capital and there are not any restrictions for foreign companies. 4 days are sufficient to start a business in Georgia [1]. There are not any perceived difficulties in obtaining any required operating licenses. However, in the local business environment foreign investors currently regard the inefficiency of courts directly discriminatory factor, what generally tends to favor local business agents. Another problem is the easiness for local firms than for foreign firms to evade taxes.

In Armenia direct ownership restrictions on foreign capital exist in a number of key sectors of the economy, such as air transportation, airport operation and railway transportation, forestry, oil and gas sectors.

Azerbaijan presents above average restrictions on foreign equity ownership. The state retains a controlling stake in companies operating in certain sectors. Foreign ownership in the media sectors is

[1] see http://iab.worldbank.org/data/exploreeconomies/georgia.

strictly limited. Financial services sectors are also subject to certain limits for total foreign capital participation.

The dynamics of Heritage Foundation Index of Economic Freedom illustrates (Figure 2) that Georgia and Armenia stand almost at the same level, above the world average (60). In 2014, Armenia's indicator slightly deteriorated mainly due to business freedom, fiscal freedom and investment freedom components. Although Azerbaijan is below them, it step-by step improves its position. In 2014, it moved into the group of "moderately free countries" for the first time.

Trade policy and openness. Georgia and Armenia have somewhat similar trade structures, with low exports and great dependence on imports. Azerbaijan is the most export oriented due to its natural gas and oil reserves (with export to GDP ratio 54% in 2012). During 2005-2012 there was 5-fold increase in Azerbaijan, 3-fold increase in Georgia and 1.5-fold increase in Armenia of trade volumes. Georgia's export to GDP ratio in 2005-2012 increased slightly from 34% to 38%. The indicator decreased from 29% to 25% in Armenia in the same period. Azerbaijan, with its current account surplus, represents an export revenue dependent country with low internal demand. Current account deficits of Georgia and Armenia indicate to low savings and large share of consumption expenditures in their disposable incomes.

Georgia has liberal trade regime; there are no quantitative restrictions, restrictive licensee requirements and other non-tariff barriers. Under Georgian legislation, foreign investors enjoy the non-discriminatory and not the least favorable conditions for their activities. Foreign investors can make their independent choice with regard to the size, amount and conditions of their financial involvement; they are guaranteed an immediate and safe repatriation of profit, financial resources and facilities.

Fraser Institute world economic freedom indicators also confirm the above: Georgia is not only a regional, but also one of the world leaders according to trade openness and takes the 8th position among 152 countries. Armenia and Azerbaijan take the 62th and the 110th places, respectively. Georgia is advanced by the regulation component (the 27th position). At the same time, business is freer from regulation than labor and capital markets. By the aggregated Index Georgia leads among the neighboring countries (table 4).

Trade policy reforms in the three countries were to a considerable extent driven by harmonization and cooperation with the EU. Georgia successfully concluded DCFTA. In Armenia and Azerbaijan some progress has been made regarding the improvement of the business climate and reduction of technical barriers to trade.

Governance effectiveness and corruption. Since institutions shape the incentive structure within a society, the quality of governance determines whether or not the formulation, implementation and enforcement of reforms will be effective. Good governance is related to low uncertainty and high expected return on FDI. Weak institutions bring additional costs for foreign investors. The threat of this kind is corruption. Because FDI is characterized by a high level of sunk costs, uncertainties, such as unexpected political changes, unrealizable property right, etc. are reflected especially negatively on FDI flows.

Analyzing the figures 3, 4 and 5 data, we conclude, that Georgia is the most progressive among the three countries by its degree of governance. Azerbaijan is the least successful. It is noteworthy that there is obvious annual progress in Georgia and Armenia, while in Azerbaijan there is almost no improvement.

Georgia institutional progress is primarily related to the reduction of corruption, which has been a serious FDI constraint for years. Since 2004 Georgia had significant success in fighting various forms of corruption. As International Transparency reveals, that the anti-corruption laws have been improved and the transparency of government activities increased in a number of fields. However there are still problems with the private sector transparency and accountability, especially with regard to ownership of major companies as off-shore shell companies control these firms[2]. In 2013 Georgia took 55th position among 174 countries by the Corruption Perception index. Armenia and Azerbaijan took 94th and 127th position, respectively. The study of CRRC is also noteworthy, which reveals that in Armenia and Azerbaijan corruption was named as the most acute problems by 5% and 7% of the population, respectively, while in Georgia by 0% [3].

Another important source of data to evaluate the degree of economic and legal institution development is Global Competitiveness Index (GCI). In GCI 2014-2015 Georgia ranks 69th position out of 144 countries, as opposed by 85th and 38th ranks of Armenia and Azerbaijan, respectively. The most problematic areas for doing business in Georgia are access to financing, protection of intellectual property rights, intensity of local competition, effectiveness of competition policy (WEF, 2013).

Corruption is the most problematic area for doing business in Azerbaijan and Armenia according to the GCI. Despite the high ranking of Azerbaijan, more detailed analysis of indicators shows that the weakest areas in are the spread of corruption (irregular payments and bribes) and low progress in education quality. The country adopted the National Anti-Corruption Plan 2012-2015 (NACP) to address this problem.

Armenia faces the problems of corruption as well. It is mainly manifested in non-transparence and non-observation of tax, customs and regulatory rules. Global Corruption Barometer 2013 shows that in the view of one-fifth of respondents corruption has decreased in Armenia for the last two years. However international surveys on Armenia, such as by Bureau of Economic and Business Affaires (2013) reveal that the instances of unfair tender processes and preferential treatment are pervasive in Armenian procurement system.

Privatization policy and property rights. The process of privatization estimated by timing and scale has seen more progress in both Georgia and Armenia than in Azerbaijan, as shown by the EBRD transition indicators (table 6). The measurement scale for the indicators ranges from 1 to 4+, where 1 represents little or no change from a rigid centrally planned economy and 4+ represents the standards of an industrialized market economy. The performance of competition policy is almost equal in Azerbaijan and Georgia, while Armenia is more advanced in this area of reforms.

The field of property rights remains problematic in South Caucasus countries. They were excluded from the Property Right Alliance Index in 2014, because of critical difficulties related to the availability of data. The positions of Georgia are especially weak, what is also confirmed by empirical evidence. During 2010-2011 many businesses complained that government interfered in their activities. Nowadays there are many complaints filed with the Prosecutors Office against the previous authorities, concerning property right violations. According to the surveys of domestic NGOs, property and land appears to have been particularly affected. The statistics is that the Prosecutor's Office has received approximately 1 289 complaints related to alleged violations of property rights[4].

Over the period 2010-2014 Armenia's IPRI score has increased by +2.9% to 4.7 points. The index has not changed (4.5 points) in Azerbaijan, while there has been deterioration in Georgia's IPRI score, which has shown a decrease of -3.6%.

Access to resources. Lack of access to finance represents one of the impediments for business in the countries of South Caucasus. We rely on the GCR indicators to evaluate the degree of financial market development, which enables us to make comparisons. Data in table 7 reveal that the financial environment is unfavorable in the whole region. In some areas Azerbaijan manifests slightly better indicators of financial market development compared with its neighbors.

[2] see http://www.transparency.org/country#GEO.
[3] see http://caucasusbarometer.org/en/cb2013/IMPISS1/
[4] See http://eeas.europa.eu/delegations/georgia/documents/virtual_library/cooperation_sectors/georgia_in_transition-hammarberg.pdf.

Georgian financial sector is dominated by banks and is characterized by a primitive model, comprising only a narrow range (deposits, loans, settlement and cash operations) of banking activities. (Khishtovani, 2010). Despite this, bank soundness shows a better development in Georgia. Banks are mainly represented in Armenia's financial sector, too. OECD estimates, that financial markets in Armenia are under-developed, both technologically and in terms of other institutional characteristics. In Azerbaijan access to capital is problematic and there is low trust to the bank sector. At the same time, protection of private investors represents a future objective.

Implications for the Region Development

Based on the above discussed institutional determinants, we conclude that South Caucasus as FDI location gives a varied picture. Georgia explicitly outperforms its neighbors by the rules of entry and operation, degree of governance, economic openness and corruption control. Better accessibility of financial resources is the field of future concern in the three countries.

It is obvious that there is still room for further institutional improvements in these countries. FDI constraints related to their limited market sizes and low internal demand can be compensated by means of improved institutional determinants of FDI location.

Well-functioning institutions are necessary not only to reduce direct and indirect costs for investors, but also to ensure FDI benefits for the host countries. In the absence of strong institutions "foreign investors may neither be able to meet their objectives of profit maximization and market expansion nor would their operations promote development objectives of host countries". (OECD, 2002. p.2). There are several forces behind South Caucasus countries' institutional divergence.

One of the strongest points of Georgia's institutional context for FDI is the DCFTA with the EU. The Agreement creates grounds for predictable institutional environment, reduces uncertainty and increases the trust among investors what is an incentive for FDI inflows. Another source of gains from the Agreement is the reduction of trade costs, which positively affects the FDI.

Preferential trade agreements are a strategic instrument in the international competition for foreign direct investment (Buge, 2014). However membership in Customs Union does not offer Armenia the best model for institutional development as it was the reason behind the withheld of the Association Agreement with the EU, which was expected to improve economic governance as well as Armenia's ability to attract investments from abroad. In addition the Customs Union common external tariffs are rather high. DCFTA goes much further than mere free trade agreements and involves wide-spread approximation of regulations and institutions to the EU legal frame [[5]]. Georgia's more institutional approximation with the EU in the areas of technical barriers to trade, food safety, intellectual property rights and competition policy can reduce institutional distance to the largest single market in the world, while implementation of the rules and changes envisaged by the Customs Union Agreement may reduce Armenia's institutional distance from its member states. The experience of Central and Eastern European transitional economies shows that greater integration with the European production networks through FDI led them to the development of more capital intensive rather than unskilled-intensive production. At the same time the benefits from FDI were greater in the countries with better legal, regulatory and political institutions (OECD, 2011). As for Azerbaijan, despite its multi-aspect development agenda (economic diversification, deeper cooperation with the EU), low progress in WTO accession, as well as weaknesses in ENP implementation (it needs further efforts to meet its commitments on democracy, protection of human rights and reduction in corruption) represent impediments for its institutional progress.

Institutional competition is one of the key elements of locational competition, which involves competition for mobile factors of production of the world (Siebert, 2007). Countries compete on the basis of good legislation, internal and external security, quality of the educational system, thereby

[5] see http://www.berlin-economics.com/download/policypapers/Moldova_PP_03_2013_en.pdf.

attracting mobile factors of production. Because of their limited market sizes South Caucasus countries may become attractive for the specific type of FDI known as export-platform FDI. The advantage of this type of FDI flows is that choice of any of these countries as a location may bring benefits others as well in terms of increased and diversified exports and developed linkages with local companies. Favorable geo-strategic location, opportunities for free trade with the countries in the region and low trade costs create grounds for such FDI inflows. However differences in institutional development can affect FDI flows targeting either of South Caucasus Countries. Therefore formation of the institutional framework in South Caucasus countries should be based on region-wide development rather than location competition approach towards FDI.

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Appendix

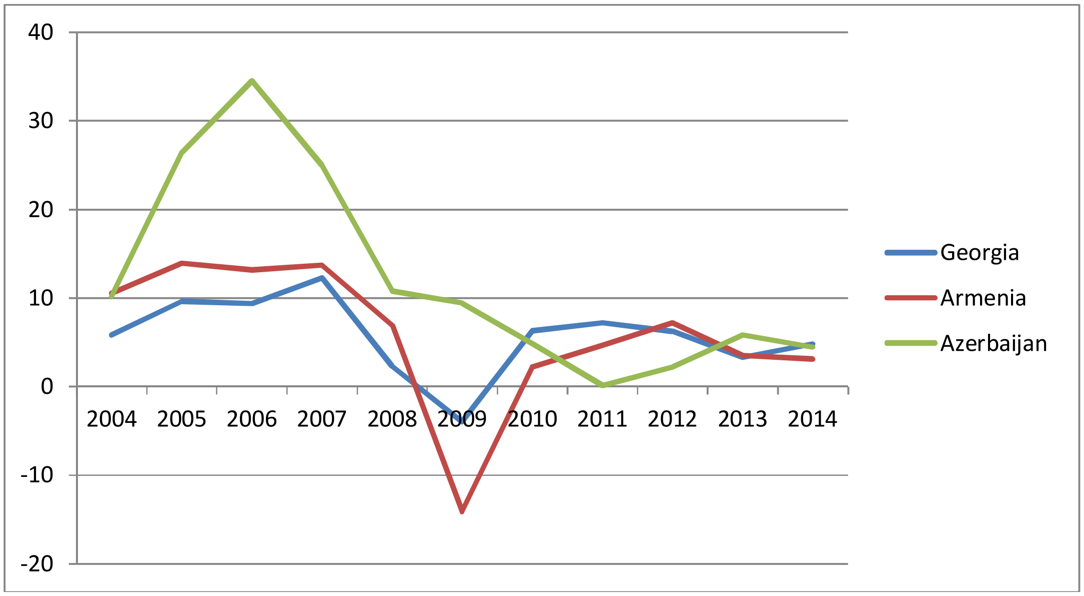

Figure 1. Economic Growth in South Caucasus (real GDP percentage change)
Sources: www.geostat.ge, www.armstat.am, http://www.stat.gov.az

Table 1. Market Size and FDI Stock in South Caucasus Countries, 2013

Country	Population million people	GDP billion $	GDP per capita $	Inward FDI stock (millions of dollars)	Inward FDI stock (% to GDP)
Georgia	4.5	15 380	3508	11 675,6	72,2
Armenia	2,9	9 950	3337	5 448,1	51,7
Azerbaijan	9,2	67,2	7227	13 750,0	18,7

Sources: http://databank.worldbank.org/data/views/reports/tableview.aspx
UNCTAD, FDI/TNC database (www.unctad.org/fdistatistics).

Table 2. FDI Inflows in South Caucasus Countries 2007-2013

Country	Inward FDI inflows (million $) and Share in GDP (%)													
	2007		2008		2009		2010		2011		2012		2013	
Georgia	1 750	18.5	1 564	12.4	659	6.1	814	7.5	1 048	7.5	866	5.3	1010	5,9
Armenia	699	7.6	935	8.0	778	9.0	570	6.2	525	6.5	489	4.9	370	3,5
Azerbaijan	- 4 749	13.9	14	8.2	473	6.5	563	6.3	1 467	6.8	2 005	7.9	2 632	3,6

Sources: World Investment Report, 2014. p.220
http://data.worldbank.org/indicator/BX.KLT.DINV.WD.GD.ZS

Table 3. Current Account to GDP ratio (%) in South Caucasus Countries

Country	Current Account (% to GDP)								
	2005	2006	2007	2008	2009	2010	2011	2012	2013
Georgia	-6,9	-11,06	-15,17	-19,75	-22,07	-10,5	-10,2	-12,7	-11,5
Armenia	-0,55	-0,1	-1,83	-6,4	-11,85	-15,83	-14,83	-11,05	-10,6
Azerbaijan	-29,83	1,26	17,67	27,29	33,68	23	28,4	25,7	21,4

Source: http://www.tradingeconomics.com

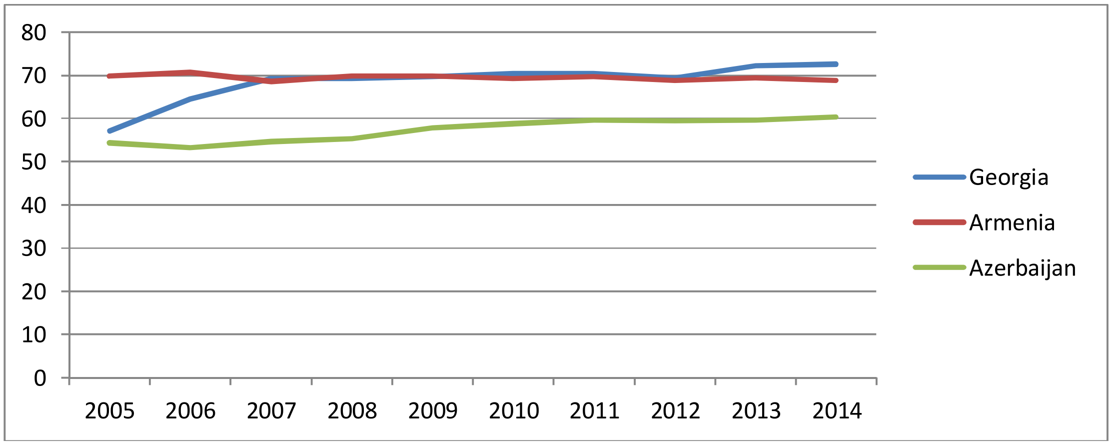

Figure 2. Index of Economic Freedom (2005-2014)

Source: Index of Economic Freedom,
http://www.heritage.org/index/visualize?countries=armenia|azerbaijan&src=country

Table 4. Fraser Institute Economic Freedom Index in South Caucasus Countries

Country	2005 Point (rank)	2010 Point (rank)	2011 Point (rank)	2012 Point (rank)
Armenia	7.31 (47)	7.53 (23)	7.63 (19)	7.72 (17)
Azerbaijan	6.05 (106)	6.01 (130)	6.19 (126)	6.39 (115)
Georgia	7.42 (37)	7.25 (53)	7.61 (21)	7.73 (16)

Source: http://www.freetheworld.com/2014/EFW2014-POST.pdf

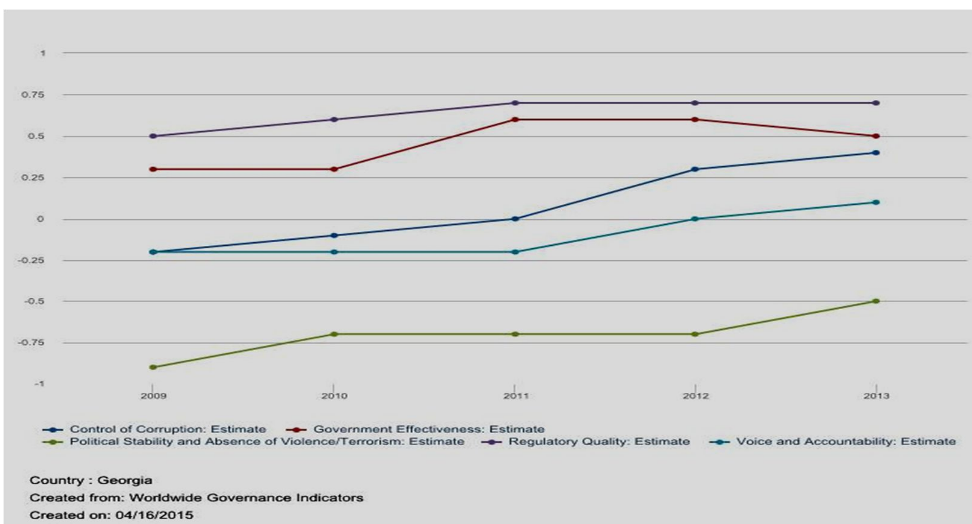

Figure 3. Georgia WGIs in 2013

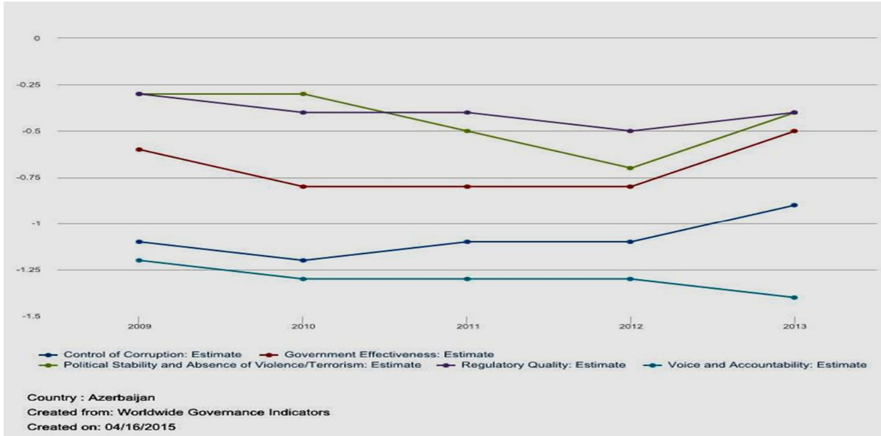

Figure 4. Azerbaijan WGIs. in 2013

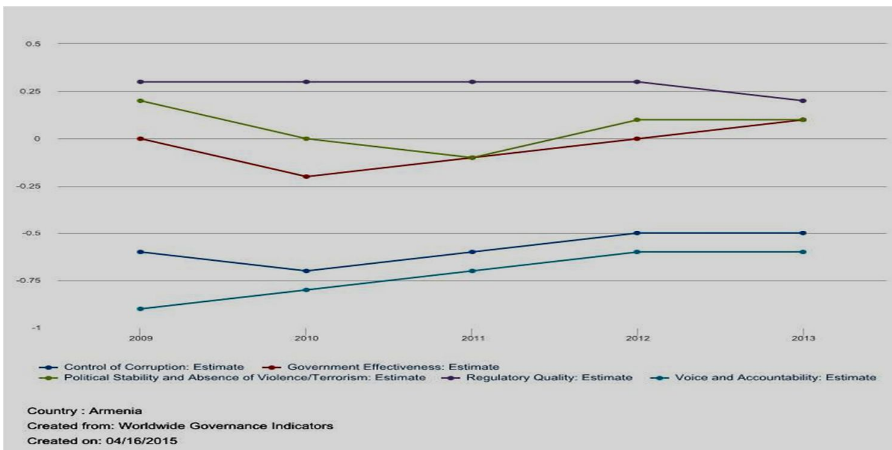

Figure 5. Armenia WGIs. in 2013

Table 5. EIU Democracy Index in South Caucasus Countries

Country	2010 Point (rank)	2011 Point (rank)	2012 Point (rank)	2013 Point (rank)	2014 Point (rank)
Armenia	4.09 (109)	4.09 (111)	4.09 (114)	4.02 (116)	4.13 (113)
Azerbaijan	3.15 (135)	3.15 (140)	3.15 (139)	3.06 (140)	2.83 (148)
Georgia	4.59 (103)	4.74 (102)	5.53 (93)	5.95 (78)	5.81 (81)

Source: http://www.eiu.com/Handlers/WhitepaperHandler.ashx?fi=Democracy-index-2014.pdf&mode=wp&campaignid=Democracy0115

Table 6. Transition Indicators in South Caucasus Countries

Country	Indicator	2007	2008	2009	2010	2011	2012
Georgia	Large scale privatisation	4,0	4,0	4,0	4,0	4,0	4,0
	Small scale privatisation	4,0	4,0	4,0	4,0	4,0	4,0
	Price liberalisation	4,3	4,3	4,3	4,3	4,3	4,3
	Competition Policy	2,0	2,0	2,0	2,0	2,0	2,0
Armenia	Large scale privatisation	3,7	3,7	3,7	3,7	3,7	3,7
	Small scale privatisation	4,0	4,0	4,0	4,0	4,0	4,0
	Price liberalisation	4,3	4,3	4,3	4,3	4,0	4,0
	Competition Policy	2,3	2,3	2,3	2,3	2,3	2,3
Azerbaijan	Large scale privatisation	2,0	2,0	2,0	2,0	2,0	2,0
	Small scale privatisation	3,7	3,7	3,7	3,7	3,7	3,7
	Price liberalisation	4,0	4,0	4,0	4,0	4,0	4,0
	Competition Policy	2,0	2,0	2,0	2,0	1,7	1,7

Source: http://www.ebrd.com/what-we-do/economic-research-and-data/data/forecasts-macro-data-transition-indicators.html

Table 7. Financial Market Development Ranks in South Caucasus Countries

Country	Financial Market Development	Availability of financial services	Access to loans	Funding from local equity markets	Availability of venture capital	Soundness of Banks
Georgia	76	89	110	126	118	67
Armenia	97	75	97	112	96	66
Azerbaijan	89	92	79	90	64	100

Source: World Economic Forum (2014)