

Role of Governance Infrastructure in Attracting FDI to Georgia

Ilyas CILOGLU *
Teona JIKIA **

Abstract

Many economists argue that FDI has a significant role for countries economic growth, especially, countries like Georgia. However, the question is how to attract FDI into our country. There are several factors which make economy attractive for foreigners. The purpose of this research is to focus on the role of governance infrastructure which is one of the most important for developing nations. This is a relatively new term for Georgian economy, which contains of all regulations, legislation and legal systems of the country. Thus, their importance will be investigated.

The methods used for this research are survey, interview and some other observation on the operation of Georgian economy. The interview was conducted with Georgian expert in politics. Expert in economics was also asked to answer several questions. In addition, the Survey was applied to 60 people and as a result most of them agreed on the importance of governance infrastructure, that it needs improvement and that it will definitely make Georgia more attractive country for potential investors.

In conclusion policy-makers should pay much attention to those institutions which can contribute more to the creation of stable economic environment and investment environment. Improvement of governance infrastructure will definitely decrease the risks for potential investors, increase their confidence in our country, and push them towards more investments, especially when Georgia's geographic location offers wide variety of spheres where foreigners can do business.

Keywords: foreign direct investment (FDI), governance infrastructure, government institutions, investment environment, developing country

Introduction

Georgia is doing significant increase in business environment last 10 years. According to the World Bank report Georgia is ranked number 9 in the ease of doing business. As below table shows Georgia has the best position in the region.

Table 1. Ease Of Doing Business	
Country	
Georgia	9
Turkey	71
Russia	112
Azerbaijan	67
Armenia	32

Source: World Bank, 2013

One of the main priorities for Georgian Economy is to attract Foreign Direct Investment (FDI). However, certain environment should exist in the country which will make returns on the investments more guaranteed and safe. Ministry of Economy and Sustainable Development of Georgia has carried out several reforms, like liberal and free market oriented policy, reduction of taxes, much more easier procedures to start-up businesses, introduction of laws and regulations which work best in encouraging foreigners to invest into different sectors of Georgian economy. (Table 2)

Georgia's FDI has been changing from year to year. The highest record during the last 9 years was recorded in 2007 when it reached 2014.8 million dollars. There is a dramatic decrease in 2009 due to 2008 war with Russia. In 2011 FDI was again over 1 billion level which reached 1117.2 million dollars. There is around 25 percent decrease in 2012 compared with 2011. There might be around 900 million dollars of FDI in 2013 which means almost the same as in 2012. (Figure 1)

The energy sector has attracted approximately 20% of the total FDI of Georgia in the 2012. Manufacturing 18% and Financial sector 18%. Another main indicator of FDI's contribution to Georgia's nominal GDP.

* Assoc.Prof.Dr., Faculty of Social Sciences, International Black Sea University, Tbilisi, Georgia.

E-mail: ciloglu@ibsu.edu.ge

** T.A., Faculty of Social Sciences, International Black Sea University, Tbilisi, Georgia.

E-mail:11400119@ibsu.edu.ge

Year	Total	QI	QII	QIII	QIV
2005	449.8	89.4	105.9	75.6	178.9
2006	1190.4	146.0	306.9	280.7	456.7
2007	2014.8	421.4	401.5	489.1	702.9
2008	1564.0	537.7	605.4	134.7	286.2
2009	658.4	114.0	177.2	173.2	194.0
2010	814.5	166.5	208.3	225.6	214.1
2011	1117.2	209.7	248.3	316.6	342.6
2012	911.6	261.2	217.7	199.0	233.7
2013	697.3	226.2	232.4	238.7	

Source: Geostat.ge, 2013

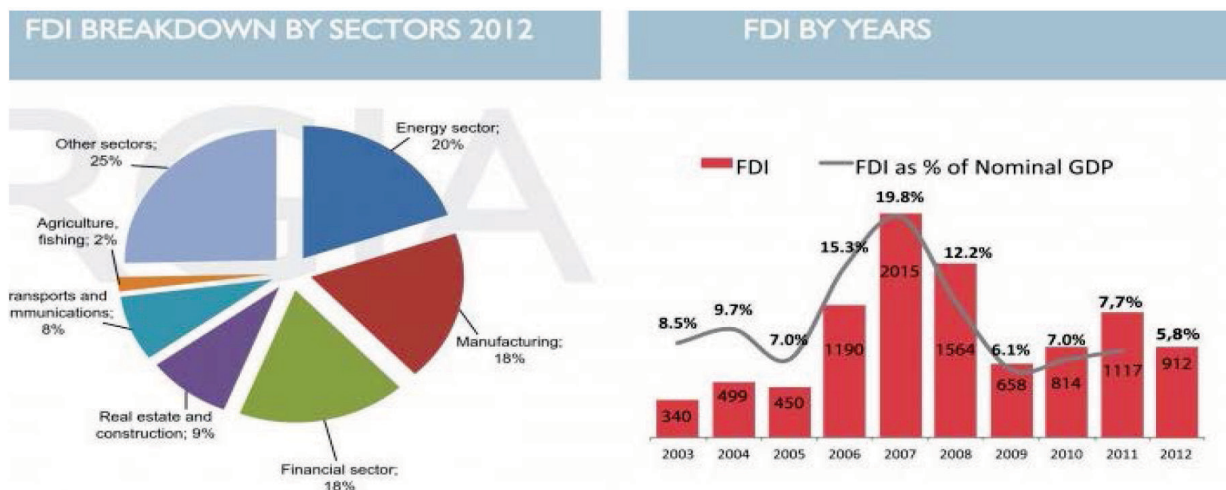


Figure 1
Source: Invest in Georgia, 2013

The highest contribution was in 2007 with 19.8%.

Above given numbers show that Georgia still needs to work towards improving investment climate in the country. And first of all it should improve governance infrastructure to support long-term results in investment field. Here, governance infrastructure includes legislation, regulation and legal systems of the country. The term “governance infrastructure” was first used by Globerman, S. and Shapiro, D. (2002) in their studies.

As Globerman, S. and Shapiro, D. (2002) found out in their studies, governance infrastructures directly influence the amount of FDI flowing into the country; however, they have also proved that this influence is much more noticeable in developing countries com-

pared to developed ones. They have developed Governance Infrastructure Index (GII) and measured it in different countries. The results of their analysis showed that second important variable in GII measurement was effective government and this variable was stronger in developing countries. To establish connection between the study conducted by Globerman, S. and Shapiro, D. (2002) and this research paper, it's enough to remind ourselves that Georgia still remains in the list of developing countries. Thus governance institutions have significant effect on FDI and much effort should be put into examination of their role and what they can do to boost FDI and thus promote economic growth.

Obvious connection can be seen between the

results of the study by Globerman, S. and Shapiro, D. (2002) and the article by Rajan, S. (2004). Rajan, S. (2004) explained that a lot of developing countries have announced new policies to encourage FDI but they have failed at the implementation stage. This implies that, in developing countries, there are usually not well-developed governance institutions which will implement the policies and strategies to attract more FDI.

It is important to carefully examine Global Competitiveness Report which is prepared annually by World Economic Forum. It will be better to summarize results of Global competitiveness Report of 2010-2011 and 2013-2014 in one table, so that it's easier to compare the announced results. 139 and 148 countries were studied in 2010-2011 Report and 2013-2014 report, respectively. This table summarizes only the indicators which are valuable to the research topic. (Table3)

Above table shows that Georgia has improved almost in most of the indicators which are important for us. However, even the two indicators mentioned in the

table which showed worse results might be quite important for investors. Also, despite the improvement, Georgia's ranking in some of the indicators is very bad (property rights, intellectual property protection, judicial independence, efficiency of legal framework); this might discourage investors and cause them to consider other countries for their businesses. Once again, this proves that there is still a lot that government has to do, and the problems which were pointed out through the table should first of all be solved through governance infrastructure, or governance institutions.

All that has been mentioned above can be linked to the research paper by Georgian Institute of Public Affairs, in which it was pointed out that Georgia's legislation provided many incentives for foreign businesses however, level of FDI was still low because of unsatisfactory law enforcement, and power of individual government officials (Unanyants, et al., 2003). In 1996 Law on Investment Activity and Guarantees, in 2002 Law on the Georgian National Investment Agency (GNIA), and in 2006 Law on State promotion

Table 3. Global Competitiveness Report of 2010 - 2011 and 2013 - 2014			
Indicator	Rank/139	Rank/148	Improve/Worsening
Property Rights	120	120	+
Intellectual Property Protection	97	124	-
Irregular payments and bribes	42	28	+
Judicial Independence	104	91	+
Burden of government regulation	4	10	-
Efficiency of legal framework in settling disputes	89	92	+
Efficiency of legal framework in challenging regulations	98	105	Almost no change
Transparency in Government policymaking	33	33	+
Reliability of police services	45	37	+
Strength of investor protection	33	19	+

Note: Improvement of the indicator is shown by (+) sign, whereas worsening is shown by (-) sign.
 Source: World Economic Forum, 2013

of investments were issued. Also, there were additional laws on privatization, land ownership, permits and licensing which are important for investors. So as Unanyants, et al. (2003) explained in their research paper that existing laws on foreign business activities needed to be simplified, this was actually carried out and amendments were made to original laws after this research was published. However, the research by Unanyants, et al. (2003) still provides valuable information on importance of governance infrastructure in attracting FDI.

As already mentioned, Georgian National Investment Agency (GNIA) was established in 2002 in order to act as a mediator between foreign investors and the government of Georgia. This agency promotes and helps development of FDI in Georgia. They effectively communicate with governmental bodies and provide relevant and timely information to the investors. This is one of the types of governance infrastructure because it also cares about higher quality of goods and services; it gives advices on improvements that should be made in order to attract more FDI.

Baird, R.G. and Goertz, G. (2008) in their research paper about competition for FDI in developing countries provided link between institutions of governance infrastructure and FDI inflows. Also they showed that domestic institutions are important for attracting FDI and that political regime of the country doesn't play as big role as do the institutions of governance infrastructure. It's obvious that investors don't want to invest into the country with corrupt government officials or into the country with unstable political situation. When governance institutions do their job well, when they become primary players in attracting FDI, higher quality of governance infrastructure creates more stable economic environment and investment climate (Baird, R.G. et al, 2008, p. 12). The results of research showed that public goods due to governance infrastructure contribute a lot to country's development through FDI and public goods depend on the quality of institutions.

There is not a lot of literature addressing governance institutions as main players in attracting FDI, and especially there is not much information about this in case of Georgia. Therefore it will be timely and relevant to carry out such research in Georgia, and try to apply different countries cases to our country.

Methods

Data for the research paper was obtained through conducting survey, recording interview with expert in politics and economics. Surveys were distributed via emails, social media and hard copies. The rate of responsiveness was 83%. 50% of the participants of this survey had at least some background in business and economics; students studying in these fields, as well as professors and experts gave answers to the questions. 25% of participants had some background in political sciences, and remaining 25% were selected regardless their educational background. So

respondents were grouped according to their educational background and analysis of the data received was carried out separately for each group, as well as for all participants together. Additional and very valuable information, as well as recommendations were obtained from the interview with experts. And at last, cases of other developing countries have contributed a lot to a research. These cases are worth hearing because they can directly benefit current processes in Georgia.

Findings

In order to analyze the data received from questionnaires, SPSS 18.0 program was used. The opinion of respondents was compared with the opinion of experts in politics and economics. 58.3% of respondents regarded FDI as the most important component for economic growth of such a small country like Georgia. Others named development of agriculture, local manufacturing, local investments, tourism, political situation, increasing exports, development of different sectors as a factor that can currently contribute to Georgian economy more than FDI. Very valuable information was obtained in identifying the role of governance infrastructure (defined as legislation, regulation and legal systems by Globerman & Shapiro, 2002) in attracting FDI to Georgia. Respondents were given the choice of the factor that plays the most important role in attracting FDI, the results were quite interesting for the research. Of course, tax system does play important role but even more important for respondents appeared to be better institutions for investment law enforcement (28.33%) and Strength of investment protection (31.67%). These two are exactly regulated by the governance infrastructure; therefore its importance for Georgian economy was very noticeable here through the responses. (Figure 2)

When respondents were separated according to their background, among those with economic and business background 35% regarded tax system and 35% better institutions for investment law enforcement as equally important in attracting FDI to Georgia. Respondents with politics background regarded tax system, better institutions for investment law enforcement and transparency in government policy-making as equally important factors (11.11% for each) and 66.67% said that strength of investment protection was the most important.

Majority of respondents thought that currently institutions for regulation and law enforcements are not very good. Moreover, on the question "Do you agree that governance infrastructure in Georgia currently plays important role in attracting FDI to Georgia?" the answers were distributed like this: Figure 3.

So, most of the respondents agreed that currently role of governance infrastructure plays important role. Even more, 96.67% said that improving governance infrastructure will make Georgia more attractive country for investors, experts also agreed on this. Let's see how opinions were distributed among different groups

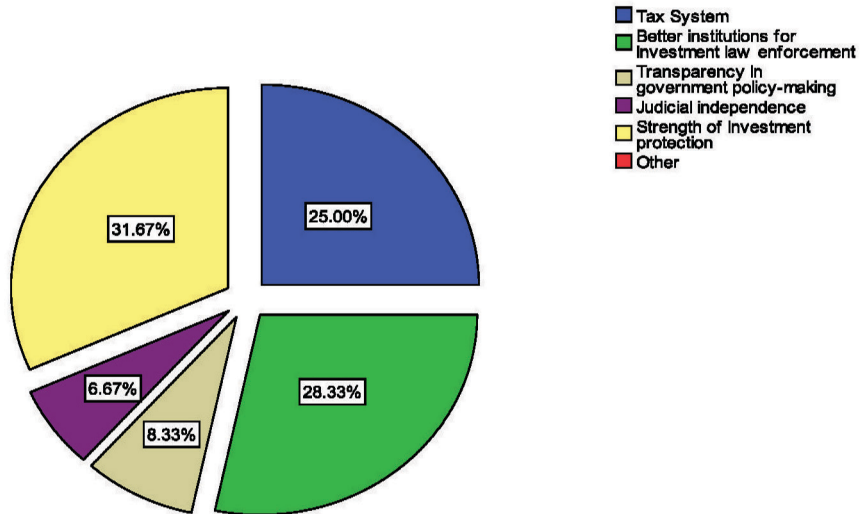


Figure 2: Most important factor in attaching FDI to Georgia
Source: own calculations

Table 4. Respondents with economic and business background naming the importance of factors.

Answer Choices	Responses
Tax System	35%
Better institutions for investment law enforcement	35%
Transparency in government policy-making	0%
Judicial independence	5%
Strength of investment protection	25%

Source: own calculations

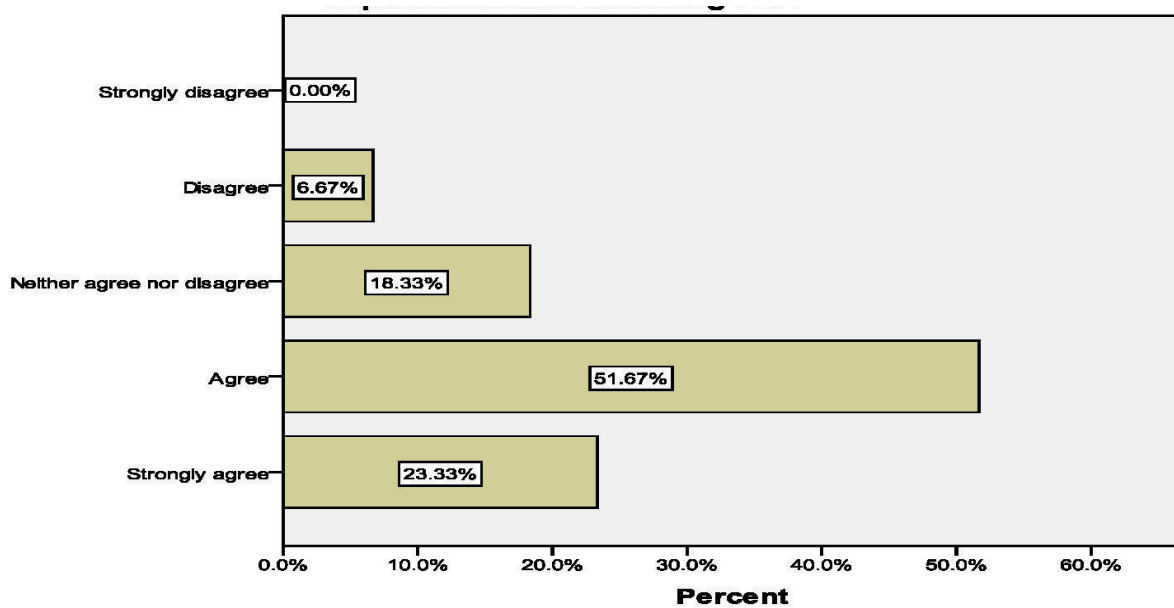


Figure 3. Do you agree that governance infrastructure in Georgia currently plays Important role in attracting FDI?
Source: own calculations

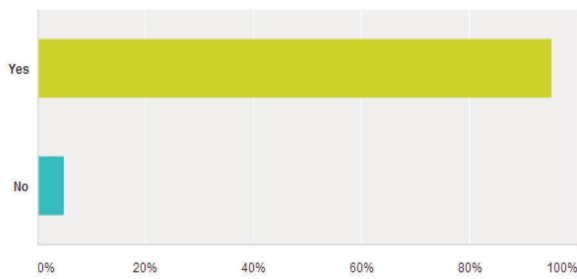


Figure 4: Do you think that improving governance in infrastructure will make Georgia more attractive country for investors?

Source: own calculations

(Graph of economics and business background on the left, and graph of respondents with political background on the right): Figure 4. 95% of respondents

with economic and business background said yes, and 100% of respondents with political background said yes. This gives a solid ground to conclude that institutions are not so well-developed, but public views them as very important and believes that their improvement will benefit our economy.

However, when asked about whether Law on Investment should be simplified even more, the results were not so unanimous: only 5% strongly agreed, 35% agreed, 43.33% neither agreed nor disagreed, 15.00% disagreed and 1.67% strongly disagreed. This might be connected to some fear in the society which is very often formed through media, or anti-campaigns of giving equal legal rights to foreign investors as Georgian citizens. This initial assumption was actually proved. (Figure 5)

And in fact, when the respondents were asked if for any reason they had any kind of fear if FDI increased in Georgia, 25% answered yes, 36.7% said no, and 38.3% were not sure. (Figure 6)

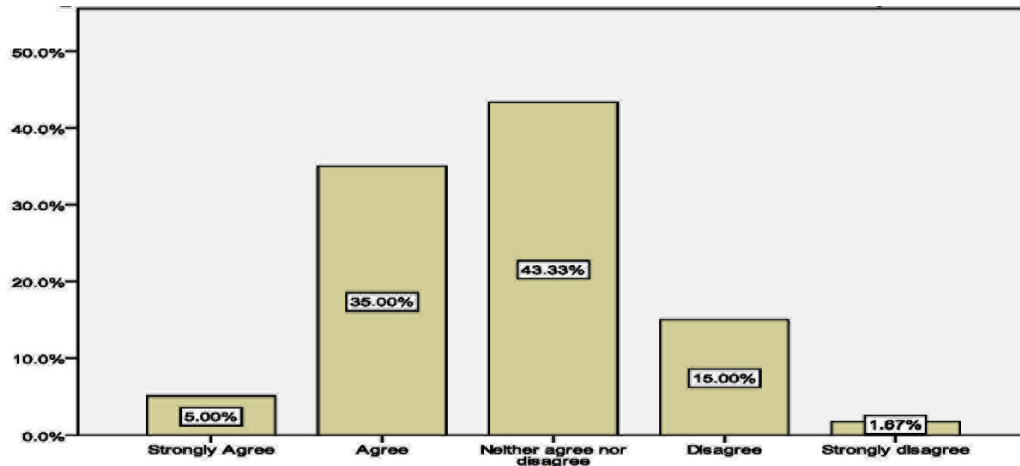


Figure 5: Whether Law on Investment should be even more simplified
Source: own calculations

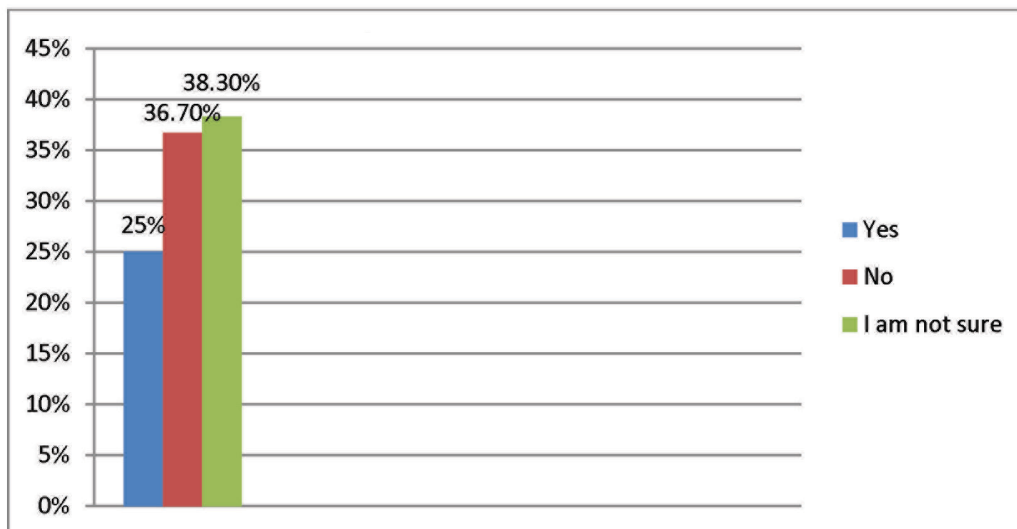


Figure 6. Do you fear any possible increase in FDI in Georgia?
Source: own calculations

Number of respondents who didn't have any fear was definitely not that much. And even more, respondents named different reasons for their fear. Some said that they don't want to see illegal enrichment and appropriation of Georgian property; some fear that not local population but workers brought by investor will be employed; others claim that Georgia is too small to have high index of FDI development, and that it will be better to increase number of domestic manufacturers and increase exports of local goods to international markets.

The results were not so pleasing when respondents were asked if they have ever heard about Georgian National Investment Agency (GNIA). Only 33.33% of all said yes, and 66.67% answered no. Even worse results were shown when 75% of respondents with economic and business background said that they haven't heard about GNIA when 55.56% of respondents with political background actually have heard about such agency. (Table 4, Table 5)

This way, the role of this organization currently can be doubtful. To be more precise, not the role but their activities are undermined and hopefully the only rea-

son is that it's not often reported by the media. Maybe other political processes are often put higher above on the scale, and this causes lack of public awareness about this agency.

And at last, respondents were also asked about their expectations of FDI for next several years. Here are the results: Figure 7.

These results are shown not in percentage but in number of people who chose this or that answer. In other words, 60% marked increase, 11.667% - decrease, 11.667% - no change, and 16.667% considered that they don't have enough information to answer this question. Interesting is the opinion of Professor Teimuraz Beridze, Doctor of Economic Sciences who thinks that there will be no change in FDI for the next few years.

The results of the survey can be combined with the interview conducted with expert in politics, Nika Chitadze. He explains about marketing environment of the country which is largely determined by political processes. He identified that political environment, economic and legal environment are most important in attracting FDI to Georgia. He thinks that the authori-

Table 4. Respondents with economic and business background: Have you ever heard about Georgian National Investment Agency (GNIA)?

Answer Choices	Responses
Yes	25%
No	75%

Source: own calculations

Table 5. Respondents with politics background: Have you ever heard about Georgian National Investment Agency (GNIA)?

Answer Choices	Responses
Yes	55.56%
No	44.44%

Source: own calculations

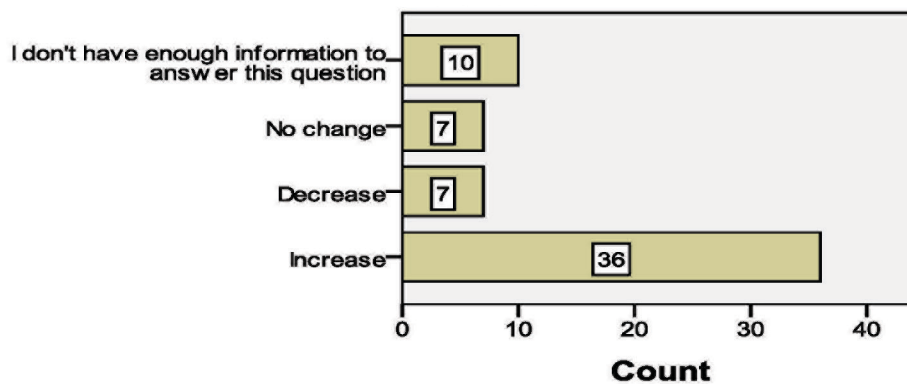


Figure 7. Expetations of Georgian citizens about FDI level

Source: own calculations

ties of Georgia, society of Georgia should create appropriate environment in Georgia and give the opportunity to potential foreign investors to avoid potential risks, which could have political, legal, economic, cultural or other types of character and at the same time it is important to organize different types of international forums for the foreign investors and to implement the advertisement of Georgia in general.

Following this, we had discussion about legal environment currently in Georgia, and the sphere of interest for this research was, as already pointed out by questions in the survey, whether experts also agree that institutions to enforce and implement all the laws and procedures affecting this legal environment, legislation and regulations are well-established and well-developed in Georgia. Expert Nika Chitadze states that such institutions are more or less established. Specifically, appropriate environment in Georgia has been created with regard to tax code. Taxes have decreased a lot and number of taxes overall have been reduced as well which is very convenient for foreign investors. Although there is an improvement about tax code, but the problem still lies in other influential spheres. Professor Teimuraz Beridze, responded that currently institutions for regulation and law enforcement are not so good.

Nika Chitadze sees the problems interrelated with political risks. Corruption has decreased a lot but there are still issues should be developed justice system, transparency of government's actions etc. He sees solution in necessary clear explanations to foreign investors, to establish better contacts with them. Thus commercial sectors of specific Embassies should connect investors to our country. He believes that activation of Embassies of the Georgian diplomatic representation is important together with economic and commercial sectors which will establish more contacts with potential investors increasing their awareness, level of international competition related to economic, business situation in Georgia.

Analysis/Discussion

Governance was not defined as a pure single term and concept until 1990s (Baird, 2008). It consists of several different types of institutions. The World Bank now defines the term governance as following: "traditions and institutions by which authority in a country is exercised" (Kaufmann, Kraay, and Zoido-Lobaton, 1999). So institutions are important because they have influence on economic relations between nations. Each country needs to develop institutions which will be able to support its goals and objectives of attracting FDI. Georgia is no exception. Quality of governance institutions in the countries directly is related to the growth of their economies, and this might even be one explanation why poor countries find it hard to catch up with richer ones (Barro, 1991). Of course developed countries have contributed much to development of crucial institutions while in developing countries this is still a serious problem, because

of difficulty to collect necessary financial resources to support such development. Particularly, this is a problem for the post-Soviet countries with transition economies, just like Georgia. It is hard to establish the institutions which will support smooth transition, and besides work toward direct goals, like attracting FDI.

The study in this research which was conducted through surveys and interviews showed the importance of governance infrastructure in attracting more FDI to Georgia. We should not forget that Georgia is post-Soviet country which has incurred many internal conflicts and even a war with neighbor in 2008. Of course, it's difficult to persuade investor to invest into the country where political situation is unstable. Institutions should do their best in giving explicit, clear information to all the desired parties to create clean picture of the country and not to allow foreign rumors to affect Georgia's image internationally.

Of course more investors will be willing to start their businesses in Georgia once they see solid base for investment law enforcement, once they believe in the transparency of government policy-making, once they are assured that their rights will be protected and court will be independent in resolving disputes. Well-developed institutions also make sure that economic situation in the country is stable and investment climate is improved.

In 2005 SWOT analysis was conducted by different groups of economists about investment environment in Georgia. Among the weaknesses main factors listed were the following: weak institutions, weak court system, unclear separation of power between legislation, execution and judiciary, inadequate law enforcement, poor protection of property rights, weak contract enforcement, etc (Unanyants, et al., 2003). There is no doubt that much improvement was made in these areas but there still remains much that needs to be done.

Conclusion

The purpose of this research was to identify the role of governance infrastructure which is one of the most important for developing nations. And the results clearly have shown that general public with different backgrounds, and also experts believe in importance of governance infrastructure in attracting FDI to Georgia. Opinion of public and experts might diverge on what is more important factor that needs most attention, but all the factors that they listed in the form of better institutions for investment law enforcement, transparency in government policy-making, judicial independence, strength of investment protection, tax system are the ones which are regulated by exactly those governance infrastructure. Even if different segments of population believe that one factor is more important than another one, inevitably developing more qualitative governance infrastructure in Georgia will eliminate potential risks for the investors.

Well-developed governance infrastructure is a premise and solid ground for investor confidence,

and therefore their development is crucial for such a small economy, like Georgia. FDI can contribute a lot to economic growth of this country, and much should be done to improve business environment and attract more investors into the country.

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