

Entrepreneurship as a Determinant of FDI in Case of Georgia

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Abstract

Attraction of Foreign Direct Investment (FDI) is the one of the main priorities for Georgia. Liberal investment environment and equal approach to local and foreign investors makes country as an attractive destination for FDI. The paper focuses on relation between entrepreneurship and FDI in case of Georgia, to find out the role that entrepreneurship takes as a determinant of FDI. The paper empirically proves that in order to attract FDI, development of entrepreneurship is vital.

Keywords: entrepreneurship, FDI, openness of economy

Introduction

The purpose of this paper is to investigate and empirically reveal the importance of entrepreneurship in determining FDI. Paper attempts to focus on fundamentals of economy rather than providing just financial incentives in attracting FDI in Georgia. FDI plays a vital role in the development of transition countries and Georgia is not exception. After the Rose Revolution in 2003, the economical and financial reforms followed after it, created favorable conditions for attracting FDI. However, the August war of 2008 shattered Georgia's investment image and negatively affected on the flow of FDI into Georgia, moreover the world economic crisis decreased sharply the amount of FDI flow into Georgian economy. There are different ways to increase the FDI in Georgian economy and restore the gap that appeared. The paper suggests that Georgian government should encourage and promote entrepreneurship more than it does today. So that entrepreneurship creates external economy and influences positively to the existing firms and creates suitable condition for the establishment of the new firms and indirectly increases the flow of FDI to Georgia. Being a part of world economy and member of WTO Georgia also witnessed this decrease. The war in August of 2008, made the crisis even more dangerous for the attractiveness of Georgia for Foreign Direct Investment. During this period investment in different sectors of economy decreased by 18%, and banking sector, which is the more stable and strong sector in comparison with other sectors of economy in Georgia, shrunk by 37% (Georgian Business Week, 2009). Currently situation in the Georgian economy is more stabilized and economy returns back to the positions that it had lost. National Statistics Office of Georgia (Geostat), has published verified data on foreign direct investment (FDI) in Georgia. According to the Geostat, the FDI decreased by 18.3% in 2012, comparing to

the previous year, and made up USD 912 million. This verified figure exceeds the corresponding data published by the Geostat in March 2013, showing the FDI of USD 865.2 million back.

According to the Geostat, in the first quarter of 2012, the FDI comprised USD 261 million; in the second quarter of the same year it was at USD 218 million, whilst in the third quarter it decreased to USD 199 million. The fourth quarter of 2012 saw the increase in the FDI to USD 234 million. The largest investment was made in the energy sector, comprising USD 179.4 million.

So we can assume that rehabilitation process in Georgian economy carried out successfully.

There are different advantages and that the promotion of entrepreneurship can bring and as a result take a role of locomotive in attraction of FDI. So that promotion of entrepreneurship creates quality infrastructure, competitive prices for the products as well as inputs with high quality, the access to the new technologies, and new managerial skills, in general, forming, appropriate conditions for the FDI.

Most entrepreneurship studies analyse mainly the influence of FDI on entrepreneurship ignoring the study of inverse relation. With the available data on foreign direct investment and on techniques to measure the entrepreneurship the study is intended to empirically examine the possible relationship between entrepreneurship and foreign direct investment in case of Georgia.

Taking into consideration theoretical contributions and previous empirical findings, the main hypothesis based on literary review have been developed, the second part of the work consist of methodology and results and conclusion.

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Literature Review

FDI Literature

The importance of foreign direct investment increased in the world with some exceptions after Second World War. In accordance with World Bank the growth of ownership, that is foreign-located, started in 1950's. The 80' and 90' witnessed a rapid growth in foreign direct investment from \$59 billion in 1982 to \$209 billion in 1990 and finally reached 1.8 trillion in 2007. However, the year 2008 resulted with deficit in foreign direct investment by -21.0%, the world financial crisis and falling stock market valuations were one of the main reasons (UNCTAD, 2009). There are many theories that are trying to explain the motives that are standing behind the FDI. Transitional countries, like Georgia often try to attract FDI by offering different kind of privileges for foreign investors (reduction of tax, preferential loans and etc.). The main reason for these is the fact that foreign investors will confer "technology spillovers" to local firms and companies. Caves (1974) stresses that, multinational activity should bring technology, practice of management and transfer of knowledge externalities.

The Stephan Hymer's (1976) dissertation work, published in 1976, was the first attempt to find out the motives behind the FDI. In his analysis of multinational enterprises (MNE), he first distinguishes between portfolio and direct investment based upon industrial organization theory. In his work Hymer analyzes the firms that are crosses the national boundaries and faces extra costs. Those costs include culture differences, different business ethics, language differences and etc. Hymer suggests for a firm to overcome this issues posed by the extra costs, to poses internal, firm-specific advantages over its rivals. He argues that such advantages as firm-specific likely to take the form of managerial and entrepreneurial advantages, as well as, economies of scale, and privileged access to the raw materials and resources of that country). Until Hymer there was not any work explaining why multinational enterprises transfer intermediate products while retaining rights over the assets. Another early work was done by John Dunning (1993), whose work was based on testing manufacturing operations of US firms operating in United Kingdom. In his work Dunning found that the labor productivity is higher in US-based firms that are operating in UK than the domestic UK controlled firms, at the same time differences in wages and in creation of new innovations. Even though the Hymer and Dunning worked independently but both of them specify firm-specific ownership advantages that drive FDI. In 1966 Raymond Vernon explained FDI based on product cycle. In his work Vernon found the relation between product life cycle in technology and changes in behavior of US firms from export oriented to direct investment. Being a microeconomic theory Vernon transformed it into the theory of international division of labor. According to Vernon theory, the production should stay in rich country and firms should not invest into the other low-in-

come countries because of low-elasticity of the product. However as the products starts to mature, the price elasticity grows and firms will be looking for low-cost production locations and creating FDI. According to Vernon, firms start to invest into foreign countries as they products start to mature and as they start to fear of losing markets.

Javorchik (2004) found positive relation between FDI productivity spillovers and their local suppliers, another evidence is from the Kugler (2005) work that found the same result.

Entrepreneurship Literature

A huge body of analysis has focused on entrepreneurship, entrepreneur and entrepreneurial activity. However, these researches mainly focus on developed countries rather than on developing countries due to lack of statistical data in that countries. The entrepreneurship as a terminology has a wide range of definitions. The meaning of Entrepreneur in dictionaries is defined as a person who organizes, manages, and assumes the risks of business enterprise. The definition takes root from the French word, meaning "to undertake". According to Carl Menger (1870), an Austrian economist, entrepreneurship emerge as people who seek out and take advantage of opportunities for profit, creating goods that previously did not exist and finding new ways to create existing goods. Another Austrian economist Schumpeter's *The Theory of Economic Development* (1912) places the entrepreneur at the center of the process of capitalist development. Entrepreneurs are responsible for the innovations (new products, new sources of supply, new production methods, and new forms of organization) that open up opportunities for profit, disturbing the system. Successful entrepreneurs will earn high profits and will attract imitators. Over time, imitation will eliminate the profits earned by the original innovator and the system will settle down to a new equilibrium until it, in its turn, is disturbed by another innovation. Schumpeter's vision of capitalism was thus one of a system in continuous motion, the impetus for change coming from the entrepreneur. Entrepreneurship has been defined as the "purposeful and successful activity to initiate, maintain, or develop a profit-oriented business" (Livesay H., 1982, p.10). More recent definitions have explicitly incorporated the notions of risk and personal satisfaction as well. In lieu of a conclusive definition, it can be said that entrepreneurship is a type of behavior that includes: (a) initiative taking, (b) the innovative organizing and reorganizing of social/economic mechanisms to create greater value from resources and/or situations, and (c) risk-taking Hisrich and Peters (1992). It is important to note that the commonly accepted definitions of entrepreneurship have been developed in relatively advanced market economies. According to Kirzner (1973), entrepreneurship is not so much the ability to break away from routine as the ability to perceive new opportunities which others have not yet noticed. Entrepreneurs historically in Georgia often do exhibit the types of behavior described

above, Although the term entrepreneurship does not necessarily was carrying the positive connotations in Soviet Georgia, that it does in most developed market economies, and may even be viewed negatively. The fact that many entrepreneurial ventures have developed, what was commonly referred to under communism as the “unofficial economy”, reinforced view of entrepreneurship as a “shady” activity. Since such activities often were considered illegal. It would be an oversimplification, however, to imply that entrepreneurship remains a “dirty word” after the collapse of Soviet Union. The 1990s brought dramatic changes to the region and, despite an ignominious past, attitudes toward entrepreneurship have also changed a great deal. As private sector development becomes increasingly important to economic growth, entrepreneurs are coming to be viewed in more capitalistic sense. That is they are viewed as one of the key “driving forces” in powering the transition from a planned to a market economy.

Unfortunately there is growing concern among the researchers that the term definition takes the central role in works and debates are focusing on terminology itself rather than developing a distinctive theory on entrepreneurship. In our analysis we defined entrepreneurship as an important factor in creation of firms and in our work we consider it as a creator of new private business.

The formation of attractive business climate for entrepreneurship and for entrepreneurial activity exerts pressure on government to create comfortable business atmosphere to functioning of business sector in proper way. Thus, the great number of firms and companies dealing with entrepreneurship signals to investors that appropriate conditions and infrastructure is formed to operate in a specific market. This is our main argument to test the relationship between entrepreneurship as determinant of FDI in Georgia.

Hypothesis

Based on the literary review and previous findings the general hypothesis to be tested is to determine does the entrepreneurship determinant of foreign direct investment in Georgia. Entrepreneurship is vital for such countries in transition such as Georgia. The development of entrepreneurial skills that ones have been pressured and mislead is one of the major challenges for countries in transition like Georgia. Adjusting the legislation and business environment to entrepreneurial activities gives the impulse not only for domestic entrepreneurs but also signals to foreign direct investors about the suitable business climate for occupations. Furthermore, entrepreneurs form social networks where reputation becomes an important mechanism that prevents opportunistic behaviors. For the investors such economies having dynamic entrepreneurs and superior industries represents efficient. Thus, entrepreneurship tends to an increase the FDI inflow to the domestic country.

H1. There is positive relation between entrepreneurship and foreign direct investment in Georgia.

One of the main factor, that the influence on the decision of investors about the country, is how free or liberal is the host country economy. Investors tend to avoid the investment in such countries where government tightly regulates the economy. The business should be free in order to grow, the level of liberalization of economy have an enormous influence on the entrepreneurial activity and on entrepreneurship inside the country too. It is considered in the research that the level of freedom leads to and development of entrepreneurship, thus it has a powerful effect on inflow of foreign direct investment. As a result it is expected that:

H2. Higher the economic freedom will be in Georgia the more foreign direct investment inflow will be.

The research tends to test the interaction effects between entrepreneurship and FDI inflow in free economic condition.

There have been applied explanatory variables that will assist to go into more details on this issue, while previous literature were applied such variables as: growth, openness of the economy, location, tax rates, natural resources exchange rate, wage rate, corruption, Infrastructure and etc. it is difficult to use all this variables.

Depending on the country specification of Georgia we considered in this paper such factors as: Market Size, Economic Growth, Number of registered entrepreneurs, Political and Economic Stability, Openness of Economy, and the Level of Corruption, interest rate.

Methodology

Multiple linear regression method of analyses has been applied in this paper to reveal absolute and relative effect of entrepreneurship on foreign direct investment in case of Georgia. Yearly panel data from 2000 through 2012 were used based on statistical data provided by World Bank and Georgian Statistical Department. The reason for choosing panel data is the possibility of panel data to present a large set of observations and thereby increasing the number of degrees of freedom as well as decreasing the collinearity between the independent variables. Another reason for choosing panel data is limitless of the study to Georgian economy and it does not cover countries of different development characteristics. The main idea of using panel data is that: given the observed explanatory variables the effect of all omitted variables are driven by individual time-varying variables. Taking into account explanatory variables the basic full formulation looks as follow:

FDI = (Entrepreneurship, Interest Rate, Market Size, Growth Rate, Infrastructure, Openness of the Economy, Corruption)

Long Linear model:

$$\text{LogFDI} = (\alpha + \alpha_2 \log \text{En} + \alpha_3 \text{Ir} + \alpha_4 \text{LogGDP} + \alpha_5 \text{G} + \alpha_6 \text{Infr} + \alpha_7 \text{Corr} + \alpha_8 \text{Open} + u) \quad (1)$$

$$\text{LogFDI} = (\alpha + \alpha_2 \log \text{En} + \alpha_3 \text{Ir} + \alpha_4 \text{LogGDP} + \alpha_5 \text{G} + \alpha_6 \text{Infr} + \alpha_7 \text{Corr} + \alpha_8 \text{Open} + u) \quad (2)$$

Where:

FDI= Foreign Direct Investment (measured by FDI inflow)

En=Entrepreneurship (Number of registered entrepreneurs)

Ir= Interest rate in a given year

GDP= Market size measured by GDP

G= Growth rate measured by changes in real GDP

Infr= measured by length of roads built

Corr= Corruption measured by corruption Index

Open= Openness of the economy measured as fraction of change in Net import divided by GDP

u=Stochastic error term.

In the paper, due to delays in the decisions of investors and transnational corporations, entrepreneurship may have little immediate impact to FDI. However, this impact can be corrected after a lag of three four years. The model will be tested between various time lags in order to check simultaneous relationship between entrepreneurship and FDI.

Results and Analysis

This part of the paper presents main empirical findings relating to the effect of entrepreneurship on FDI inflows. In order to test our hypothesis, regression long-linear model have been applied. Dependent variable LogFDI have been regressed with independent variables such as logEn, Log of GDP, Interest rate, Growth, infrastructure, corruption and openness rate. Log-Linear model (Table 1).

In accordance to our regression analysis results the overall model is significant=68.09, $p=0.000 < 0.1$, and

$R^2=85.6\%$. We found out that LogGDP ($p=0.000 < 0.1$), log of Entrepreneurship ($0.000 < 0.3$), while Interest rate ($p=0.087 < 0.1$) and Corruption ($p=0.075 < 0.1$) are marginally significant while Infrastructure and GDP growth rate are not significant. ($p=0.243 > 0.1$) and ($p=0.978 > 0.1$). The overall analysis and findings provides the support of our hypothesis (1) and hypothesis (2).

Conclusion

The study found out the relationship between entrepreneurship and foreign direct investment inflow in Georgian Republic. The findings revealed the entrepreneurship as an important determinant of foreign direct investment. The study empirically proved that development of entrepreneurship is key element in attracting FDI inflow. For such countries as Georgia, which is inherited a command type economy and trying to reform and transform its economic system the attraction of FDI inflow is very important. It is very difficult to attract FDI inflow to the countries in transformation so that there is high risk for investment. The one of the ways to attract such investment is to encourage them by different methods like tax holidays or subsidies, spending millions of dollars for this purpose. While, alternative method can be promoting and encouraging entrepreneurship and by doing so indirectly stimulating FDI to domestic country. To flourish entrepreneurship, government should dismantle all barriers to competition, decrease bureaucratic burdens and regulate tax system. The more successful will be the entrepreneurship the more attractive the market will be for FDI, because the main requirements fit to both of the variables FDI and entrepreneurship. Besides of such variables, as openness of the economy and corruption, has the same effect as it has on entrepre-

Table 1. Log-Linear model

Variables	REGRESSION RESULTS
Dependent Variable	LogFDI
Constant	-1.925
LogEn(Entrepreneurship)	0.338***
IR(Interest rate)	-0.665**
LogGDP(Market Size)	0.227***
LogG(GDP growth rate)	0.645
Infr(Infrastructure)	0.865
Corr(Corruption)	-0.432**
Open(Openness)	0.321***
F-Value	68.09
R ²	85.6

***Significance at the 0.01 Level; **Significance at the 0.05 Level

Source: Own calculations

neurship and to FDI, as results show the more corruption and the closer the economy is the less FDI and entrepreneurial activity is in the domestic economy. As entrepreneurship develops it opens new frontiers to research and development, so business grows and becomes more populated with the talented people. The findings are consistent with the arguments presented in the literature.

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