LOCATION ADVANTAGE AND GEORGIA'S POTENTIAL TO ATTRACT FOREIGN DIRECT INVESTMENT

David Sikharulidze, Associate Prof.
Vasil Kikutadze, Associate Prof.
Grigol Robakidze University, Georgia

Abstract

This paper reviews one of the elements of Dunning's eclectic paradigm to explain the role of location-specific (L) advantages as determinants of foreign direct investment location. OLI paradigm is a general framework which explains that foreign direct investment (FDI) takes place according to three factors: ownership advantage, location advantage and internalization advantage. Location advantages try to explain why a firm should want to locate in a foreign country. Multinational enterprise will typically engage its foreign production when they find it to be in their best interest to combine their ownership advantages and certain internalization gains with production in foreign country. This paper analyzes the location advantages of Georgia to explain the inflow of FDI to Georgia's economy. It also analyzes the motive behind FDI in Georgia. These motivations serve to determine what policies the host country should pursue in order to facilitate the location of FDI in Georgia's economy.

Keywords: Location advantage, foreign direct investment, resource seeking FDI, market-seeking FDI, efficiency-seeking FDI

Introduction

The growth interest in Multinational Enterprises (MNE) activities through Foreign Direct Investment (FDI) in Georgia can only be matched with the high expectation of what FDI can achieve in terms of its contribution to economic and social development. Most politicians and analysts agree that developing countries have to rely primarily on FDI as a source of external finance. They argue that for several reasons, FDI stimulates economic growth more than other types of capital inflows. Indeed MNEs own superior technological and managerial capabilities that may spill over affecting the production function of local firms but the effect of FDI and its quality depend significantly on domestic policies, especially measures to develop human capital, and social, physical and institutional infrastructures.

Policy application of location theory has examined ways in which different countries, states and regions can actively compete to be production location for FDI. Location theory is frequently applied by researchers wanting to understand the factors that influence the choice of multinational firms where to locate their foreign operations. Foreign investment location decisions are thought to be influenced by number of country-specific variables. The location advantages need to be present if a firm should want to locate in a foreign country; if not, it will be better for a firm to produce in the home country and only make export to foreign market. Multinational enterprises will typically engage foreign production when they find in their best interest to combine their competitive or ownership advantage which may derive from number of sources and certain internalization gains with production in another country. The specific choice of location production abroad will depend on the presence of location advantage in a country or countries abroad, including economic determinants (e.g. market size, natural resources, and created assets), policy framework, business facilitation measures and business conditions. Differences between location advantages of different countries are important determinants of the international location pattern of FDI or other types of TNC activity.

Over the last few years, the Georgian Government has taken considerable efforts to improve the country's business environment. The new tax code, passed in 2005, reduces tax rates and the number of types of taxes imposed on business and individuals. The customs code, passed in 2006, reduces the impediments to trade by decreasing the number of customs categories and overall tariff levels for exports and imports. Similar liberalization has been undertaken in the areas of licensing and permits and labor regulations. In many of these areas, most notably the labor regulations and the trade regime, Georgia has now one of the most liberal policy frameworks in the world. Georgia has good transportation links with CIS countries, Europe and Asia, free trade agreement with Turkey and CIS countries. Georgia has also GSP+ with EU, GSP with US, Canada, Japan, Norway and Switzerland. Some important questions therefore need to be born in mind when assessing the location advantage of Georgia? Why has Georgia not become favorable destination for investment? What policies should the host country pursue in order to facilitate the location of FDI in its economy?

The choice of FDI should depend on the motivation for undertaking the investment activity. These motivations serve to determine what policies the host country should pursue in order to facilitate the location of FDI in its economy. To attract FDI and multinational enterprises (MNE) activities, different types of policies (or incentives) are needed to attract the different modes of FDI. Cleeve, Behrman and Dunning suggest that from the perspective of home economies, FDI determinants can be related to different motivations for investment. Based on OLI eclectic paradigm FDI determinants, Dunning points out that the relative attractiveness of FDI locations is determined by investment motivations, which he classifies into four categories: resource-seeking, (horizontal) market-seeking, (vertical) efficiency-seeking and strategic asset-seeking. Different kinds of investment incentives are needed to attract inbound MNC activity of natural resource-seeking, c.f. that of a market or efficiency seeking. Export-oriented FDI is likely to be less influenced by the size of local markets than is import substituting FDI. Investment in R&D facilities requires a different kind of human and physical infrastructure than investment in assembling or marketing, etc. (Dunning 2009).

Location decision for natural resource seeking FDI is thought to be influenced by number of country-specific variables including the availability, cost and quality of natural resources and their development (i.e. processing and marketing); infrastructural development necessary for the exploitation of these resources and availability of joint-venture partners. Investment incentives are also important in resource seeking FDI (Caves, 1996), (Dunning, 2001). Historically, the most important host country determinant of FDI has been the availability of natural resources, e.g. minerals, raw materials and agricultural products.

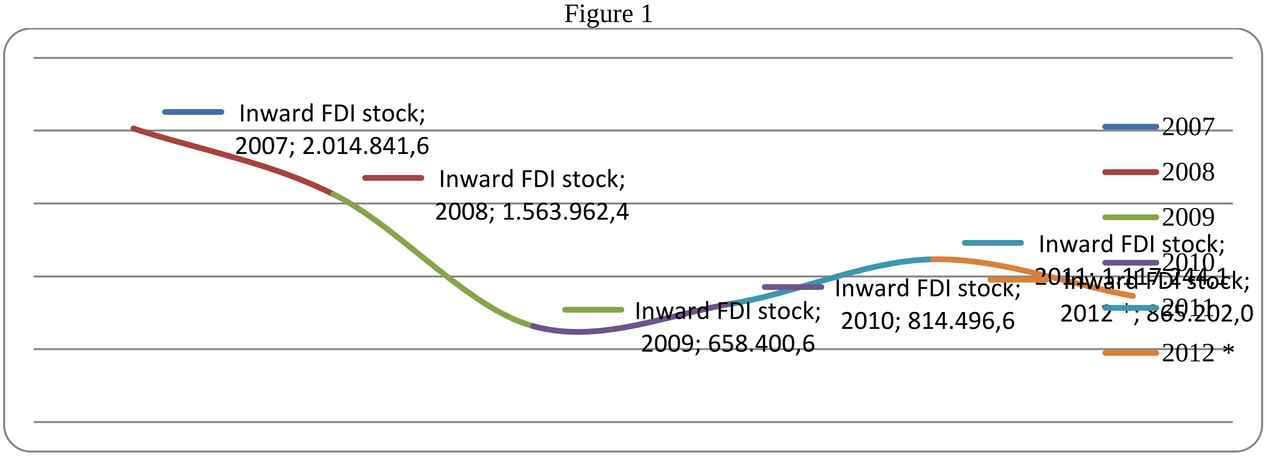
Dunning also emphasized that large and growing domestic markets, availability and price of skilled and professional labor, quality of national and local infrastructure and institutional competence, macroeconomic and macro-organizational policies and growing importance of promotional activities by regional and local development agencies influence market-seeking FDI (Dunning, 2009). In case of efficiency-seeking FDI, the most significant determining factors are mainly production cast related (e.g., labor, materials, machinery, etc.), freedom to engage in trade in intermediate and final products, investment incentives.

The motivations and driving forces for FDI vary from country to country and between industries. Generally, FDI into countries that are more advanced in the transition process has been more often efficiency-seeking i.e., oriented toward export processing. For example, CEE is becoming increasingly targeted by higher value added production in industries such as electronics and the automobile industry. SEE and Turkey are targets for market-seeking investments and more dispersed industries such as textiles and food-processing but also the service sector. However, in South-East Europe, manufacturing FDI increased in 2011 because of competitive production costs and open access to EU markets, while in the CIS, resource-based economies benefited from continued natural-resource-seeking FDI (UNCTAD, 2012). In case of CIS countries, one of the most important determinants has been the abundance of natural resources. The inflows of FDI stock in the CIS up to the early 2000 were related to the extraction of natural resources to the construction of pipelines transporting these energy resources and large privatization (Shiells, November 2003).

Georgia is becoming an unattractive location for investments based on the decreased volume of investments over the last three years. Foreign direct investments (FDI) in Georgia amounted to USD 865 million in 2012, 23 percent less from the data for 2011 and up to 6 percent from the adjusted data for 2010.

Inward FDI stock in Georgia[5]
(Thousands of US dollars)

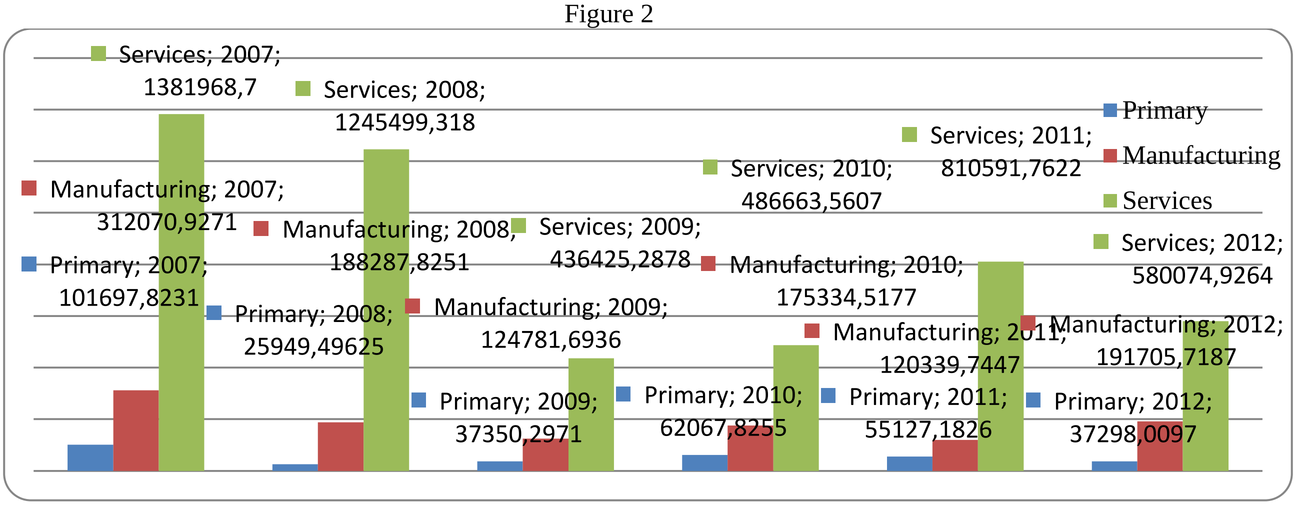
Figure 1



Compared with the same period, in 2011, the value of FDI in the primary sector decreased by 32 percent; FDI in manufacturing rose by 59 percent, while FDI in services remained lower compared with 2011. However, the services sector by far has been the dominant choice of investment from within the broad composition of foreign investments.

FDI in Georgia by Economic Sectors[6]

Figure 2



---

[5] National statistics office of Georgia. **Inward FDI stock in Georgia.**
[6] National statistics office of Georgia. FDI by Economics Sectors.

Predominant motives for investing in Georgia has been resource-seeking up-to 2006 that was related to the extraction of the natural resources, to the construction of the BTC pipelines and more recently, the construction of the gas pipeline transporting these energy resources and basic industries or resource extraction (ferrous metals, magnetite, fertilizers, copper, cement). In particular, high inward flows in 1997 and 1998 were attributable to the construction of the Baku-Supsa pipeline and terminal Supsa. Unsurprisingly, the availability of natural resources, such as oil appears to be the dominant motive for undertaking resource-seeking FDI (Nunnenkamp, 2004).

The second important reason is market seeking. For example, when analyzing the structure of investments in Georgia, it is the fact that they are driven by privatizations in network industries (telecom, energy generation and distribution, ports, oil terminal, media), real estate (hotels).

Investment in real estate and network industries positively impact on the infrastructure of the country but contribute little in terms of production and exports (Shmidt M., 2007). This type of investment is less involved in foreign markets, because, by definition, they mainly have a domestic market orientation. For these reasons, a non-significant result is expected. Moreover, in the long run, the host countries' balance of payments is likely to deteriorate through the repatriation of funds, since market-seeking FDI often does not generate export revenues, especially if the protection of local markets discriminates against exports. Hence, the growth impact of this type of FDI should be weaker than the growth impact of efficiency-seeking FDI.

In case of resource-seeking, FDI is often concentrated on enclaves dominated by foreign affiliates with few linkages to the local product and labor markets for this reason; the level of knowledge transfer may be lower as well.

The current investment inflows to Georgia are probably not sustainable. Access to country's research and development and export-generating manufacturing (machinery and electrical equipment) can be assessed as the less important factor to invest in Georgia which shows that investors do not yet seek efficiency in Georgia. Efficiency-seeking FDI plays an increasingly important role in manufacturing and openness to trade and institutional development is crucial for host economies to attract this type of FDI. According to the "Global Competitive Report", Georgia ranks 61st place in terms of institutional development with 4.0 scores. It means that Georgia has some kind of problems in this way. It is not favorable in terms of Property rights, Intellectual property protection, Efficiency of legal framework in settling disputes, judicial independence.

There are positive developments in industries such as food processing (wine, hazelnut, and mineral waters/glass production) and isolated cases of export processing investments in the textile sector.

Conclusion

To summarize, the challenge faced by Georgia is how to ensure that the ownership advantages possessed by TNCs can best contribute to the wider economy.

When designing strategies in respect of FDI participation, host countries need to distinguish between different types of such investment. Each type of FDI has particular impacts on the host country and may therefore require different host country policy responses. It is important to analyse the dynamics and structure of FDI flows and the potential of attracting investments to understand its possible impact on the domestic economy. Georgia needs to clarify in which industries and regions FDI is most needed. Georgia has to identify traditional resources of the country. It is possible to determine tree traditional resources: First – strategic location of country; second - agriculture and food industries with the unusual combination of good soils, water and sun; third - broad tourist potential from sea-side to alpine tourism and also using green, trekking and cultural tourisms (Sumson I., 2008). And finally, Georgia has to build its comparative advantages by forming human capital as a result of strong vocational and general education policies because the availability of complementary human capital in the host economies is important for FDI so stimulate economic growth (Borensztein, 1998).

References:

Behrman J. N. The Role of International Companies in Latin America: Autos and Petrochemicals. Lexington, MA: Lexington Books, 1972.

Borensztein Eduardo R., Jose De Gregorio and Jong-Wha Lee. How does foreign direct investment affect economic growth? Journal of International Economics, 1998. - pp. 115-135.

Caves R. Multinational Corporations and Spillovers. Journal. Cambridge: Cambridge University Press, 1996.

Cleeve E. The eclectic Paradigm and Foregn Direct Inevstment [Conference] // Repositioning African Business Developlment for 21st Centery. IAABD, 2009. - pp. 241-242.

Dunning J. H. Multinational, Enterprises and the Global Economy. Journal. Wokingham:Addison-Wesley, 1993.

Dunning J. H. Location and the multinational enterprises: a neglected factor? [Journal]. Journal of International Business Studies, Vol. 29(1). 2008. - pp. 45–66.

Dunning J.H. Location and the multinationl enterprise: A neglected factor? Jurnal of INternational business Studies, Vols. 40, 5-19. 2009. - pp. 10-11.

Nachum L. and Zaheer S. The persistence of distance? The impact of technology on MNE motivations for foreign investment. Strategic Management Journal, Vols. 41, 2005. 673–690.

Nunnenkamp P., Spatz, J. FDI and economic growth in developing economies: how relevant are host-economy and industry characteristics? // Transnational Corporations. Vol. 13. New York and Geneva: United Nations, 2004. - pp. 51-86.

Shiells C. FDI and Investment Climate in the CIS Countries. // IMF Policy Discussion Paper. November 2003.

Shmidt M. Foreign Direct Investment to georgia: Can Active Investment Promotion Policies make a Difference? // Georgian-European Policy and Legal Advice Centre (GEPLAC). Tbiilisi, 2007. - pp. 65-70.

Sumson I. Medium-Term Prospects for the Georgian Economy // Georgian Economic Trends (Quarterly Review). Georgian-European Policy and Legal Advice Centre (GEPLAC), February 2008. - pp. 76-77.

UNCTAD World Investment Report 2012: Towards a New Generation of Investment Policies [Conference]. - New York and Jeneva : United Nations Publication, 2012. - pp. 56-60.