Investment Climate Of Georgia

Faruk GÜRSOY
Olcay KURŞUN

Abstract: *This study tries to present the current picture of investment climate of Georgia. This work, we believe, will also fill the knowledge gap in the area of foreign direct investment (FDI) research on Georgia. The analysis focuses on major obstacles faced by investors. We first identify and then quantify the major obstacles for both foreign and domestic investors using the case studies of investors in Georgia and the statistics obtained from these data. The study results indicates that the most serious problem for investors is the human factor, which comprises of corruption and unskilled local labor force. We also found that the issues such as government regulations (regulatory burden), infrastructure, or safety do not act as major deterrents of FDI inflows, especially after the successful reforms of the Saakashvili government. It was also found that most investors have been satisfied with their operation.*

Keywords: Foreign Direct Investment, Investment Climate, Georgia

Introduction

An important aspect of economic globalization is the rapid growth of foreign direct investment (FDI), specially for the developing countries to modernize their industries and support their socio-economic development. FDI by multinational companies in emerging market economies of Central Asia and Caucus region is a controversial issue. There are both critics and defenders of FDI. It was confirmed by Farrell et al (2004) that FDI unambiguously helped the receiving economy as it raises productivity and output, thereby raising productivity and production capacity, thereby raising national income and standards of living of society. Georgia is newly independent country of the former Soviet Union (FSU). Since the early 1990s, the country has received the attention of foreign investors and has started to become the subject of FDI inflows. Georgia has relatively small markets and do not have rich natural resources (e.g. oil, natural gas and rich minerals) compared to other countries in the region, such as

Faruk GÜRSOY *is an assistant professor in Economics in Faculty of Business Management and Social Sciences at International Black Sea University, Georgia*

Olcay KURŞUN *is an assistant professor in computer engineering in the Faculty of Engineering at Bahcesehir University, Turkey*

Azerbaijan, Turkmenistan, Kazakhstan and Uzbekistan. A majority of the foreign investment flows toward the region is in the form of FDI (Garibaldi et al. 2001).

After it become independent in 1991, Georgia encountered problems such as ethnic conflicts and civil war. During the 1992-1995 periods, Georgian economy was in a very poor situation. Severe economic problems coupled with grave criminal situation hindered FDI inflows to the country (Economist 1993). Starting from 1995, Georgian economy began to show development signs. But the remarkable increases in the economy occurred after the rose revaluation with the Saakashvili government, mostly due to the introduction of a political and economic stabilization program, which involved the strengthening of central authority, decline of crime rates and acceleration of privatization. These efforts had a positive impact on the economy and led to an increase in the value of FDI (Kaynak 2006).

It is obvious that any company is taking certain risks by deciding to invest in the economy of a foreign, especially less developed, country. Accordingly, in order to attract the necessary investment the recipient country must first identify and quantify the obstacles that cause these risks, which is the focus of this study.

The Questionnaire

Data were collected by means of self-administered questionnaires, each lasting for approximately 30 minutes. The questionnaire was first developed in English and then translated into Georgian for Georgian firms. Then, a business professor and a Georgian language professor who are also fluent in English proof-read the Georgian translation. A special effort was made to keep the questionnaire as simple as possible in terms of structure, wording, and scaling. Before the survey administration, a pre-test of the questionnaire was conducted with a small group of respondents, and the result was satisfactory. Surveys were based on a questionnaire consisting of three parts: the first asked a series of questions focusing on the company information; the second comprised some questions about the investment climate of Georgia, the third, and the last, part was about the overall satisfaction of the investors.

The study was conducted among 64 companies, from Tbilisi in September, October, November and December of 2006. Out of 64 companies, 52 are foreign and 12 are domestic ones. Sectoral breakdown of the companies is as follows: manufacturing (31), services (18), transport

(7), energy (5), and banking (3). Most of them were large companies (38), medium size (17) and small ones (8). 75 questionnaires were distributed and 64 of them returned and response rate was 85 percent. The response rate in our study was very high due to the first author's great effort to meet representatives face to face (55 companies) and his established relations with some of the companies as an international economic relations scholar. Moreover, the surveys were managed to be conducted with the owners or general managers of the companies.

Table 1 shows summary statistics of the responses on the obstacles. Responses (and thus, mean scores) are based on a five-point scale ranging from 0=No Obstacle to 4=Very Severe Obstacle.

In Table 1, the average scores for environmental impact statements used in the study are listed. The statements in Table 1 have been arranged in order of the magnitude of their mean score. The highest mean score (2.3) was for the statement that the biggest obstacle for investing in Georgia is skills and education of available workers. This is the major obstacle for the investor to operate and grow their business. Specially, most managers indicated that they have lack of skillful workers in technical jobs and some also complaint about the honesty and trustworthiness of the workers. When Georgian roads and building were adjudicated, there were only foreign companies ready to compete. This is a good indicator that in Georgia there is lack of skillful worker, especially in technical jobs.

Although crime, theft, and disorder levels decrease recently, investors still do not feel completely safe (1.97). They think that economic and regulatory policy uncertainty is moderate obstacle (1.92). According to most of the managers, it is a great success of the Saakashvili government that this has become only a moderate issue, which was among the severe obstacles.

Cost of finance (interest rate) is another difficulty to operate and grow business (1.66). Some respondents argue that interest rate is reasonable when we compare it with the risk factor. Some of international investors even stated that because of high interest rates, they get credits from banks in Europe. Electricity is no longer a major problem (1.53). Most of the investors who indicated electricity as an obstacle have branches in different regions of Georgia. That is to say, it is mostly a regional problem. An anti-competitive or informal practice seems to be a problem that we have to fight with (1.44).

Another issue for foreign investor for importation or production of different goods in the country is the problem of poor performance of the official at the customs (1.36), which also corresponds to the findings of the other researches. Some investors suffer from the officials who are not experienced enough at their fields and they waste time at the borders. Tax administrations (1.35) another serious issue stays on the table, especially finance police makes it difficult to operate business.

Most of the comments made by our respondents show that macroeconomic instability (inflation, exchange rate) is a minor obstacle (1.34), they are stable. Tax rates (1.32) are reasonable after the enacted new tax code in 2005 that significantly reduced tax types and rates.

Previous studies showed that corruption used to be the number one problem of Georgia (1.20). It refers to the lack of transparency in government decisions, the extent to which government officials ask and are willing to accept informal payments, and the extent to which government contracts are offered to those with political connections. Thanks to the Saakashvili government's considerable efforts against corrupted officials, it is no more very severe obstacle.

Investors do not think that it is difficult to “access to finance” (1.04). But some of them stated that it is difficult to get the amount of money that they demand. That is why; they have to work with several banks to collect the amount that they have need of. As we see from their average scores, transportation (0.97), and labor regulations (0.79) are not serious issues for the country anymore.

Access to land (0.64) and telecommunication (0.45) scores, according to our correspondents, are very close to be an obstacle no more; however, infrastructure in Georgia can still be considered an obstacle, even smaller than ever, compared to more advanced economies.

The number of business activities subject to licensing and permitting regimes has been reported to be reduced by 84% by the government officials of Ministry of Economic Development of Georgia (Investor's Guide to Georgia, 2006). Thus, due to successful reforms in “business licensing and operating permits” (0.68), today, Georgia owns a more favorable investment climate for business.

Table 1. Basic Summary Statistics for Investment Climate in Georgia

Obstacle	Mean Score	Number of Responses (out of 64)
Skills and Education of available workers	2.30	61
Crime, theft, and disorder	1.97	62
Economic and Regulatory Policy Uncertainty	1.92	64
Cost of Finance (interest rate)	1.66	56
Electricity	1.53	64
Anti-competitive or informal practices	1.44	39
Customs and Trade regulations	1.36	59
Tax administrations	1.35	62
Macroeconomic instability (inflation, exchange rate)	1.34	64
Tax rates	1.32	63
Corruption	1.20	61
Access to Finance	1.04	45
Transportation	0.97	64
Labor Regulations	0.79	63
Business Licensing and Operating Permits	0.68	53
Access to Land	0.64	55
Telecommunication	0.45	64

We also applied *factor analysis* to discover if the measured variables can be explained to a large degree in terms of a much smaller number of variables (*factors*).

The first factor found, which we called "Regulations", seems to stand for an overall effect of regulatory burden on the investors. This factor is composed of "Macroeconomic instability (inflation, exchange rate)", "Economic and Regulatory Policy Uncertainty", "Tax administrations", "Tax rates", "Labor Regulations", "Business Licensing and Operating Permits", "Customs and Trade regulations", and "Anti-competitive or informal practices", "Customs and Trade regulations", "Anti-competitive or informal practices" obstacles.

We called the second factor "Infrastructure" because the obstacles that contribute to it are related to the definition of infrastructure. Infrastructure can be defined as the facilities that must be in place in order for a country to function as an economy, including the means for transportation (reflected in the survey by "Transportation"), communication (reflected in the survey by "Telecommunication"), power (reflected in the survey by "Electricity"), access to land (reflected in the survey by "Access to Land"), security (reflected in the survey by "Crime, theft, and disorder" and "Corruption"), health (not reflected in this study), schools (not reflected in this study), and financial institutions (reflected in this study by "Access to Finance" and "Cost of Finance").

Last factor found comprises of "Corruption" and "Skills and Education of available workers". We called this factor the "Human" factor. It should be noted that in response to the labor obstacle, the investors also evaluated the workers in trustworthiness as well in addition to skills and education.

As another important summary statistics, we also measured the cumulative response to all obstacles combined for each respondent. This factor is an indicator of overall dissatisfaction or hardness of investment in Georgia. Table 2 gives descriptive statistics and Figure 1 shows histograms (probability distributions and the normal curves) of these factors.

In view of global negative impression of business climate in Georgia, it was unexpected to find out that 57 out of 64 respondents answered positively when asked whether they consider their investment in Georgia successful. Many of them stated that the reason for their positive responses is due to the successful reforms of the Saakashvili government.

We also analyzed which factors were most serious for the dissatisfied investors. The averages of the three factors for these seven dissatisfied investors along with the averages for the satisfied investors are shown in Table 3. This shows, once again, that the Human factor is among the most critical factors in satisfying investors.

Table 2. Descriptive statistics for the factors

FACTOR	Min	Max	Mean	Std. Dev.
Regulations	0.00	3.50	1.27	0.72
Infrastructure	0.00	2.86	1.19	0.63
Human	0.00	4.00	1.72	1.12
Cumulative	0.00	3.12	1.29	0.58

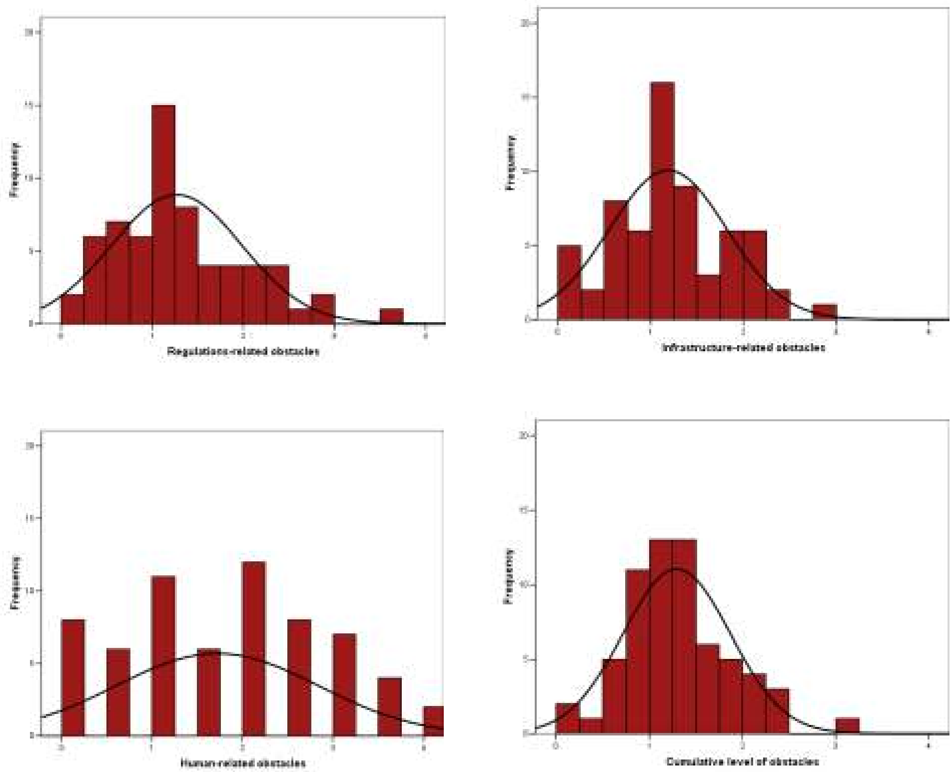

Figure 1. Histograms of the factor scores. Among the 64 respondents, only infrastructure-factor was never rated more than a score of 3 and only human-factor was rated 4.

Table 3. A Comparison of Satisfied and Dissatisfied Investments

Average Scores	Regulations	Infrastructure	Human
Satisfied	1.28	1.17	1.67
Dissatisfied	1.16	1.33	2.14

Conclusions

Starting from 1995, Georgian economy began to show development signs. Nevertheless, the remarkable increases in the economy occurred after the rose revaluation with the Saakashvili government, mostly due to the introduction of a political and economic stabilization program, which involved the strengthening of central authority, decline of crime rates and acceleration of privatization. These efforts had a positive impact on the economy and led to an increase in the value of Foreign Direct Investment (FDI).

According to our survey results, there are still some obstacles to be cleared out for successful investments to attract more investors. These include business climate reforms that reduce the costs of doing business, offering a variety of incentives such as tax preferences or government financed infrastructure development to serve particular investors, and targeting and recruiting investors from promising sectors. Another important issue is that investors in Georgia can not find skilled and educated workers. This shows more attention must be paid to the education system, particularly technical training schools. It is another problem that still some foreign investors do not feel safe in the environment. Some still do not trust much in Georgian judicial system. Some other suggestions on what measures can be taken to encourage investment in Georgia includes state guaranties, tax holidays, political stability, and improvement of infrastructure and advertisement of the country.

Moreover, factionalism within Georgia further raises economic costs. Abkhazia and South Ossetia problems also affect the Caucasus component of the EU-led TRACECA transport project linking Europe, Caucasus and Asia. TRACECA (the Transport Corridor Europe – Caucasus – Asia or the "New Silk Road") is expected to contribute a lot to Georgian economy in the near future.

It is obvious that Georgia's population, estimated at about 4.2 million, is too small to be attractive to many foreign investors. However, its unique geographic location and its trade agreements with neighboring countries make it attractive as a platform from which to serve other markets, particularly the EU and Turkey. In longer term, if relations with Russia improve, Georgia could also become an important platform to serve that market, too. Besides empty market is another attractive feature of business climate of Georgia.

While this study has tried to fill the existing knowledge gap with regard to FDI issues in this relatively under-researched part of the world, further research is definitely called for in order to gain deeper understanding of the issues confronting both foreign investors and domestic firms when forming strategic business alliances and partnerships. Another line of research would be to investigate the factors influencing foreign investors' choice of alternative modes of investment when operating in these regions. As the survey utilized in this study was undertaken more from the perspective of foreign investors, a survey utilizing the perspectives of both foreign and domestic firms equally well would be another valuable contribution to the extant literature.

References

1. Economist. 1993. "Just Awful." 326, Issue 7798, (February 13, 1993): 56.

2. Farrell, Diana; Jaana K. Remes, and Heiner Schulz. 2004 "The Truth About Foreign Direct Investment in Emerging Markets," The McKinsey Quarterly, (1): 25-35.

3. Foreign Business in Georgia, "Investment", Winter / 2007, Tbilisi, 2007.

4. Garibaldi, P.; N. Mora; R. Sahay and J. Zettelmeyer. 2001. "What Moves Capital to Transition Economies?" IMF Staff Papers, International Monetary Fund 48 (Special Issue): 109-145.

5. Georgian Business Week, "Liberalization of Customs Tariffs Increases Investment Attraction of Georgia", Weekly Bulletin of News and Analysis, September 4-10, Tbilisi, 2006.

6. Invest in Georgia, Georgian National Investment and Export Promotion Agency, Tbilisi, 2006.

7. Investor's Guide to Georgia, Ministry of Economic Development of Georgia, Tbilisi, 2006.

8. Kaynak, E., Tatoglu E., Yalcin S., "A Comparative Study of Foreign Direct Investment Activities in Georgia and Kyrgyz Republic", 2006.

9. USAID, Business Climate Reform, "Attracting Foreign Direct Investment", Tbilisi, May 2006.