Key factors in attracting foreign direct investments in oil and gas industry of Kazakhstan

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Abstract. This article is devoted to the study of major determinants in attracting foreign direct investment. The article presents an overview of academic literature on the factors that determine foreign direct investment inflows, as well as the analysis of the foreign direct investment in Kazakhstan. The conclusions emphasize that despite the presence of various motives of transnational corporations' investment decisions, foreign direct investment to Kazakhstan is mainly directed to the resource sector of the economy.
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Introduction

Nowadays attraction of foreign direct investment (FDI) is one of the most important factors of economic growth and competitiveness of a country. The inward FDI in a host country's economy has an impact on the acceleration of enterprises development, improvement of human capital quality, creation of new jobs and advanced technologies development. FDI inflows also help to speed up integration of a country to the global economy.

The last two decades were characterized by increased volumes of global flows of FDI and higher competition. In 2013 global FDI flows are estimated to be almost US $1.5 trillion [1]. This volume was substantially increased from the beginning of the current age. The increased level of FDI challenged governments to develop and implement comprehensive measures and economic policies aimed at increasing investment attractiveness.

Also, the geographical structure of FDI flows changed significantly. Thus, in the beginning of the current age the prevailing share of FDI was directed to developed countries, developing countries received only a small part of FDI. Thus, the OECD countries received on average 75% of the total global FDI [2].

Today the share of developing and transition countries in global FDI flows increased to approximately 61% [1].

The increased competition for FDI has also led to a growing interest in the academic and scientific literature to study of the key (determining) factors, investment decisions and the best measures to attract FDI.

However, analysis of the key factors of FDI attraction shows that there is no unified formula of success. That is caused by a variety of economic and political context in countries and sectors of economy.

Main part

According to the Dunning's theory [3], investment motives of transnational companies (TNCs) can be roughly divided into four categories:

1) «search for new markets» that is focused on the search for new markets for a particular product;

2) «the search for new resources» that involves the search for resources that are not available in the firm's home country (minerals, hydrocarbons, agricultural raw materials, cheap labor);

3) «search for new opportunities» that is oriented toward improving the efficiency and contribution to the efficient use of assets of TNCs;

4) «search for new information» that is aimed at strengthening the competitiveness of TNCs in the market, for example, by acquiring new technology base.

The most common motives of companies to invest abroad are the first two categories which are often called horizontal (market-seeking) and vertical (resource-seeking) FDI.

Horizontal FDI is preferred when products distribution to foreign markets is too expensive because of transportation costs and trade barriers [4, 5]. Horizontal investment implies production of almost the same products and services abroad that are produced at home country. Companies can also decide to set up a branch abroad in order to avoid tariffs and quotas on imports, or if the local content requirements of the host country restrict exports of goods produced by TNC [6].

The purpose of vertical FDI in a foreign country is to benefit from the use of local natural resources or from the low prices of factors of production such as cheap labor [7]. Term «resources» in this context implies not only natural but also labor, technological and managerial resources.

FDI motives are categorized in accordance with the provisions of the Dunning eclectic paradigm [8, 9], known as OLI paradigm (O - Organizational advantage, L - Locational advantage, I - Internalization advantage). In accordance with this theory, the firm invests abroad in order to benefit from the following advantages:

1) specific advantages of particular organization (company) over other companies in another country. Those benefits are often called company's competitive advantages in the market. This category includes such intangible assets as a trademark, proprietary technology, know-how and reputation on the market that allow the company to stand out from the competition;

2) benefits from localization that assume lower costs of the production factors use due to differences in the internal market conditions of a country. The advantage of localization means possible benefits of investment: access to large markets, cheap labor and other favorable business conditions;

3) benefits from internalization mean a significant benefit from the firm's involvement in international operations in comparison with other forms of expansion into foreign markets (export, licensing, etc.). The advantage of internalization allows TNC to increase the company's profitability from the sale of products, by reducing the costs of licensing and export costs and avoid high import tariffs or other entry barriers imposed on foreign goods.

The Dunning theory establishes the existence of certain company's advantages from the interaction with the country that should be taken into account before investment decision by the company. The Dunning model was criticized because of the inability to illustrate why some factors are more important than others during making a decision [10]. However, this model is recognized as the most overarching theory of the determinants of FDI. Theory and empirical data allocate political and economic factors as two basic groups of factors affecting these benefits.

Researchers have not reached a consensus as to which of the factors has the greatest influence on the choice of the host country. On the one hand, some authors [11, 12, 13] concluded that market factors are more closely connected with the choice of the investment sphere, rather than political factors. Traditional view is that economic variables are considered as the main factors determining FDI [9, 14]. Garibaldi defines the macroeconomic situation in the country as a key factor of investment [15].

On the other hand, Laurie and Guisinger [16] emphasize the importance of political factors in attracting FDI. In particular, in recent years a number of authors emphasize the special role of public investment policies [17, 18] and indicate that in the modern world the public sector plays an increasingly important role in attracting FDI.

Economic factors

Size of the market is considered as a major factor of FDI attraction that is motivated by «search for markets». The importance of market size (actual and potential) is emphasized in the works of Holland [19] and Tsai [20]. China is the most common example of a country's attractiveness to investors by the presence of a large consumer market and cheap labor.

The macroeconomic instability in the country increases the risk for foreign investors reducing their desire to invest or reinvest capital. In particular, the volatility of the exchange rate and inflation rate is the most obvious indicator of macroeconomic instability [21].

Some researchers pointed that developed infrastructure is one of the key factors of investment, especially for developing countries. The researches Mengistu and Adams [22] and Zhang [23] emphasized the positive impact of infrastructure on FDI. In contrast, the analysis of Nadozie Osili [24] of American investments in Africa shows an insignificant dependence of infrastructure development on the size of the investments in countries of the region.

One of the most common ways of attracting FDI is the application of tax incentives to foreign investors. The tax incentives mean facilities that reduce tax burden of enterprises in order to encourage them to invest in specific projects or sectors. Therefore the tax incentives represent exceptions from the general tax regime.

Tax benefits may include, for example, reducing the income tax rate, the tax «holidays» (i.e. full or partial exemption from taxation for a certain period), the adoption of tax accounting rules that accelerate depreciation and replenishment of losses from previous years and also the reduction of tariffs on imported equipment, components and raw materials.

On the example of investigation of developing countries in Africa Cleeve [25] concludes that fiscal incentives are one of the most important factors that influence on the investment decisions of TNCs.

Political factors

Empirical researches have shown that political stability of the state-recipient of investment is one of the most important factors in promoting of investment climate.

Risk assessment of events that may have a negative impact on the political regime in a country-recipient of investments is conducted during consideration of the country's political stability. Change of regime entails renegotiations, nationalization of industry or revision of tax rates.

Another important political factor is efficiency of institutions. Daude and Stein [26] described a positive correlation between institutions and FDI flows. Institutions include legislation, mechanisms of property rights protection, inviolability of contracts, corruption indicators and efficiency of governance institutions. The role of institutions is particularly important for attracting FDI in developing countries.

In countries with undeveloped legal institutions there are additional risks related to weak protection of investors' property rights. Overall it reduces country's investment attractiveness.

The level of state institutions development is factor that difficult to measure. However, many scholars focused attention on the level of corruption as the main indicator of the institutional capacity of the country. Corruption hampers FDI inflows into the country [27]. The analysis of data from 117 countries around the world from 1984 to 2004 conducted by Al-Sadig [28] almost proved that the high level of corruption significantly reduces FDI inflows.

Public policy is an important catalyst of FDI inflows in most countries. In particular, in countries with transition economies, one of which is Kazakhstan, government reforms play a pivotal role in the economic restructuring.

The researchers [29, 30] highlighted the importance of public policies of attracting FDI. In the 1990s, after the introduction of reforms aimed to improve the investment attractiveness, China reached the second position in the world by volume of attracted FDI.

Market openness is another indicator that determines FDI inflows. Open market policy may include liberalization of foreign ownership regulation and privatization of some industries. Nevertheless some scientists reject the market openness as a factor in which increases the flow of investment into the country.

This judgment is based on the example of South Asian countries that have achieved impressive growth without adhering to a strict policy of market liberalization.

The effectiveness of creating special economic zones in attracting FDI is highlighted to be an efficient measure. Scientists Chen and Kwan [18] exemplify the People's Republic of China as a vivid example of the use of such policy.

There are many other political factors that may affect the potential investors. They include financial incentives (subsidies, loans, etc.), the flexibility of the regulatory framework, international and bilateral agreements on investment activity.

On this basis it should be noted that the theoretical foundations which can be applied to most of the economic sectors are not always the same for all industries. Factors of investment attractiveness in certain sectors can vary significantly depending on the specifics of a particular industry. Thus, determining indicators of investments in the oil and gas industry do not always coincide with the determinants of other industries.

Oil and gas sector of Kazakhstan

The decisive factor in attracting investments in oil and gas industry is the existence of rich hydrocarbon reserves. Research data from 22 African countries from 1984 to 2000 indicate that natural resources are a competitive advantage in the struggle for foreign capital [31].

The analysis of the oil and gas sector in Kazakhstan confirms the importance of this factor for attracting investment.

It should be mentioned that after the breakup of the Soviet Union in 1991, Kazakhstan became independent and adopted an «open door policy» with respect to FDI. The Government undertook a number of reforms to transfer the country from a planned to a market economy.

In the mid-1990s it was an active process of privatization and the most important state-owned enterprises were transferred to private hands [32]. Further reforms included the de-monopolization, price liberalization, debt restructuring, tax reform and the reform of the banking system.

Between 1993 and 2012 Kazakhstan attracted more than US $180 billion of FDI. Most of it came to the raw materials sector, mainly in oil and gas. The largest volume of investments into the Kazakhstan economy were carried by the Netherlands ($43 billion or 25.3% of the total), the U.S. ($24.2 billion or 14.1%), the UK ($11.7 billion or 6.8%), France ($ 10 billion or 5.9%) and China ($7.9 billion or 5%) [33].

Today, Kazakhstan is among the ten largest countries of explored oil reserves and one of the twenty countries with proven natural gas reserves. Proved oil reserves in Kazakhstan are estimated about 30 billion barrels or nearly 2% of world reserves and 45.7 trillion cubic feet of natural gas or approximately 1% of world reserves [34].

As of December 31, 2012, the largest foreign direct investments were directed to professional, scientific and technical sphere (mainly on geological exploration and research) – 66.4 billion dollars (38.8 %), mining – 51.7 billion (30.2%), manufacturing – 17.4 billion (10.2%) [33].

Growth of oil and gas production in the country was mainly achieved by attracting FDI. About 70% of the total oil production in Kazakhstan is the contribution by foreign investors [35]. Major international oil companies that produce hydrocarbons in Kazakhstan are Chevron, ExxonMobil, Shell, Total, Eni, CNPC, PetroChina and LUKOIL.

It should be noted that the tax climate in the oil and gas industry of Kazakhstan has been simplified for investors. The customs duty on crude oil exports was not applied prior to 2008. The oil export duty was first introduced in 2008, but was abolished in 2009 when there was a sharp decline in oil prices. Again the duty was re-introduced in 2010 together with the increase in oil prices [36].

During the last two decades, Kazakhstan has become one of the fastest growing countries in the region. This relies largely on the success of FDI attracting into the country's economy.

Nevertheless, most of the FDI activities in Kazakhstan are directed to the resource sector of the economy. The mining sector, in particular Kazakh oil and gas industry, has attracted the largest share of investment.

Conclusions

During the first two decades of independence, a number of economical and political factors have played a decisive role in attracting FDI in Kazakhstan's economy.

Firstly, there are advantages of the localization, in particular the availability of natural resources. The sharp oil prices rise in the early 2000s stimulated interest for inward FDI.

Secondly, there are a favorable investment climate, which includes an open market, tax incentives and other measures to support investors.

Third, there are political stability in the country, due to the absence of significant fluctuations in domestic and foreign policy.

Search for new markets is one of the most important motives of FDI attraction. However, the size and development of the Kazakhstan market were not the key factors that determined FDI inflows.

The most important motives were directed to «resources finding» and played a significant role in attracting FDI. Considerable size of the resources had a paramount importance for investment decisions as well as support from the government. In the early stages, the government introduced a number of measures that promoted to high levels of FDI attraction.

As the result, Kazakhstan has made impressive progress in the development of the economy which to a greater extent was made possible by investments in the oil and gas sector.

Today when the economy and industry in Kazakhstan has reached a certain maturity stage it is expected that the country will refocus on the quality of investments, rather than their volume. Investments with a high level of «quality» suggest a high added value with a positive side effect for the recipient country's economy.

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