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KEY FACTORS IN ATTRACTING FOREIGN DIRECT INVESTMENTS IN THE OIL AND GAS INDUSTRY OF KAZAKHSTAN

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

Keywords: *foreign direct investment (FDI); investment inflows; Kazakhstan; oil & gas sector.*

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КЛЮЧОВІ ФАКТОРИ В ЗАЛУЧЕННІ ПРЯМИХ ІНОЗЕМНИХ ІНВЕСТИЦІЙ В НАФТОВІЙ І ГАЗОВІЙ ПРОМИСЛОВОСТІ РЕСПУБЛІКИ КАЗАХСТАН

У статті розглянуто основні фактори залучення прямих іноземних інвестицій. Зроблено огляд наукової літератури щодо факторів, які визначають приплив прямих іноземних інвестицій, а також аналіз прямих іноземних інвестицій в Казахстан. Результати показали, що незважаючи на наявність різних мотивів прийняття інвестиційних рішень транснаціональними корпораціями, прямі іноземні інвестиції в Казахстан спрямовані переважно у сировинний сектор економіки.

Ключові слова: *прямі іноземні інвестиції; приплив інвестицій; Казахстан; нафтогазовий сектор.*

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КЛЮЧЕВЫЕ ФАКТОРЫ В ПРИВЛЕЧЕНИИ ПРЯМЫХ ИНОСТРАННЫХ ИНВЕСТИЦИЙ В НЕФТЯНОЙ И ГАЗОВОЙ ПРОМЫШЛЕННОСТИ РЕСПУБЛИКИ КАЗАХСТАН

В статье изучены основные факторы привлечения прямых иностранных инвестиций. Сделан обзор научной литературы по факторам, определяющим приток прямых иностранных инвестиций, а также анализ прямых иностранных инвестиций в Казахстан. Результаты показали, что, несмотря на наличие различных мотивов в принятии инвестиционных решений транснациональными корпорациями, прямые иностранные инвестиции в Казахстан в основном направлены в сырьевой сектор экономики.

Ключевые слова: *прямые иностранные инвестиции; приток инвестиций; Казахстан; нефтегазовый сектор.*

Problem setting. Nowadays attraction of foreign direct investment (FDI) is one of the most important factors for economic growth and country's competitiveness. Inward FDI into a host country's economy has impact on the acceleration of enterprises development, improvement of human capital quality, creation of new jobs and advanced technologies development. FDI inflows also help speed up the integration of a country into 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 have been estimated to be

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almost 1.5 trln USD (UNCTAD, 2014). 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, at the beginning of the current age the prevailing share of FDI was directed to developed countries, while developing countries received only a small part of FDI. Thus, the OECD countries received on average 75% of the total global FDI (Agiomirgianakis et al., 2003).

Today the share of developing and transition countries in global FDI flows increased to approximately 61% (UNCTAD, 2014).

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

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

Latest research and publications analysis. According to (Dunning, 2000) investment motives of transnational companies (TNCs) can be roughly divided into 4 categories:

1) "search for new markets" focused on new markets for a particular product;

2) "search for new resources" involving the search for resources not available in a firm's home country (minerals, hydrocarbons, agricultural raw materials, cheap labor etc.);

3) "search for new opportunities" focused on improving the efficiency and contribution to the efficient use of TNCs assets;

4) "search for new information" aimed at strengthening the competitiveness of TNCs at a 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.

1. Horizontal FDI is preferred when products distribution to foreign markets is too expensive because of transportation costs and trade barriers (Brainard, 1997; Markusen, 1984). Horizontal investment implies the production of almost same products and services abroad that are produced in a home country. Companies can also decide to set up a branch abroad to avoid tariffs and quotas on imports, or if the local content requirements of a host country restrict exports of goods produced by TNC (Anderson and Wincoop, 2004).

2. The purpose of vertical FDI in a foreign country is to benefit from the use of local natural resources or from low prices for production factors such as cheap labor (Anderson and Wincoop, 2004). 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 (Anderson and Wincoop, 2004; Slaughter, 2003), known as OLI paradigm (O – organizational advantage, L – locational advantage, I – internalization advantage). In accordance with this theory, a firm invests abroad in order to benefit from the following advantages:

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

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

3) benefits from internalization mean a significant benefit from 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 increase company's profitability from sales, by reducing the costs of licensing and export costs and avoiding 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 decisions. The Dunning model was criticized because of the inability to illustrate why some factors are more important than others during decision-making (Dunning, 1977). However, this model is recognized as the most overarching theory of FDI determinants. Theory and empirical data allocate political and economic factors as the two basic groups of factors affecting these benefits.

Researchers have not reached the consensus as to which of the factors has the greatest influence on the choice of a host country. On the one hand, some authors (Dunning, 1993; Harinder and Kwang, 1995; Caves, 1996) 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 (Slaughter, 2003; Villela and Barreix, 2002). Garibaldi defines the macroeconomic situation in a country as the key factor for investment (Globerman and Shapiro, 2001).

On the other hand, Laurie and Guisinger 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 (Garibaldi et al., 2001; Loree and Guisinger, 1995) and indicate that in today's world the public sector plays an increasingly important role in attracting FDI.

Methodology and key research findings.

Economic factors. Market size is considered as the major factor in FDI attraction that is motivated by "search for markets". The importance of market size (actual and potential) is emphasized in (Holland et al., 2000; Tsai, 1994).

China is the most common example of country's attractiveness to investors by the presence of a large consumer market and cheap labor.

Macroeconomic instability in a country increases the risk for foreign investors reducing their desire to invest or reinvest capital. In particular, exchange rate volatility and inflation rate are the most obvious indicators of macroeconomic instability (Holland et al., 2000).

Some researchers pointed out that developed infrastructure is one of the key factors for investment, especially in developing countries. B. Mengistu and S. Adams (2007) and K.H. Zhang (2001) emphasized the positive impact of infrastructure on FDI. In contrast, E. Nadozie and U.O. Osili (2004) regarding American investments in Africa show the insignificant dependence of infrastructure development on investments volume in the region.

One of the most common ways of attracting FDI is tax incentives for foreign investors. Tax incentives reduce tax burden on enterprises in order to encourage them invest in specific projects or sectors. Therefore, tax incentives represent exceptions from the general tax regime.

Tax benefits may include, for example, reducing the income tax rate, 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 tariffs reduction on imported equipment, components and raw materials.

On the example of developing countries in Africa (Zhang, 2001) concludes that fiscal incentives are one of the most important factors that influence the investment decisions of TNCs.

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

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

Another important political factor is the efficiency of institutions (Cleeve, 2008) described as a positive correlation between institutions and FDI flows. Institutions include legislation, mechanisms of property rights protection, inviolability of contracts, corruption indicators and efficiency of public institutions. The role of institutions is particularly important in attracting FDI for developing countries.

In the 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 the factor which difficult to measure. However, many scholars focus their attention on the level of corruption as the main indicator of institutional capacity of a country. Corruption hampers FDI inflows into a country (Cleeve, 2008). The analysis of data from 117 countries around the world from 1984 to 2004 conducted by (Daude and Stein, 2007) proved that high level of corruption significantly reduces FDI inflows.

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

J.H. Zhao, S.H. Kim and J. Du (2003) and A. Al-Sadig (2009) highlighted the importance of public policies in attracting FDI. In the 1990s, after the reforms aimed at improving investment attractiveness, China reached the second position in the world by the volume of attracted FDI.

Market openness is another indicator that determines FDI inflows. Open market policy may include the liberalization of foreign ownership regulation and privatization of some industries. Nevertheless some scientists reject market openness as the factor increasing investment flows 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 as an efficient measure. L.K. Cheng and Y.K. Kwan (1999) exemplify the People's Republic of China as a vivid example of such policy use.

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

On this basis it should be noted that the theoretical foundations which can be applied to most of 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 & gas industry do not always coincide with the determinants for other industries.

Oil & gas sector of Kazakhstan. The decisive factor in attracting investments in the oil & 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 (Kumar, 2002).

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

It should be mentioned that after the split of the Soviet Union in 1991, Kazakhstan became independent and adopted an "open door policy" regarding FDI. The government undertook a number of reforms to transfer the country from planned to market economy.

In mid-1990s there was an active process of privatization and the most important state-owned enterprises were transferred to private hands (Morrissey and Rai, 1995). Further reforms included demonopolization, price liberalization, debt restructuring, tax reform and reforms in banking.

Between 1993 and 2012 Kazakhstan attracted more than 180 bln USD of FDI. Most of it came to the raw materials sector, mainly oil & gas. The largest volume of investments into Kazakhstan economy were carried by the Netherlands (43 bln USD, or 25.3% of the total), the US (24.2 bln USD, or 14.1%), the UK (11.7 bln USD, or 6.8%), France (10 bln USD, or 5.9%) and China (7.9 bln USD, or 5%) (Asiedu, 2006).

Today, Kazakhstan is among the 10 largest countries with explored oil reserves and one of the 20 countries with proven natural gas reserves. Proved oil reserves in Kazakhstan are estimated for about 30 bln barrels or nearly 2% of the world reserves and 45.7 tln cubic feet of natural gas or approximately 1% of the world reserves (Pomfret, 2005).

As of December 31, 2012, the largest foreign direct investments were directed to professional, scientific and technical sphere (mainly geological exploration and research) – 66.4 bln USD (38.8%), mining – 51.7 bln USD (30.2%), manufacturing

– 17.4 bln USD (10.2%) (National Bank of the Republic of Kazakhstan. Date Views, 2014).

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 of foreign investors (Energy Charter, 2013). Major international oil companies that produce hydrocarbons in Kazakhstan are Chevron, ExxonMobil, Shell, Total, Eni, CNPC, PetroChina and LUKOIL.

It should be noted that 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 until 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 (Sarsenbayev, 2011).

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 FDI activities in Kazakhstan are directed to the resource sector of the economy. 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 economic and political factors have played a decisive role in attracting FDI in Kazakhstan's economy.

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

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

Third, there is political stability in the country, due to the absence of radical changes in domestic and foreign policy.

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

The most important motives were related to "resources finding" and played a significant role in attracting FDI. Considerable size of the resources was of paramount importance for investment decisions as well as government support. At the early stages, the government introduced a number of measures that promoted FDI attraction.

As the result, Kazakhstan has made impressive progress in the development of the economy which to a greater extent had been enhanced 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 on their volume. Investments with high "quality" suggest a high added value with a positive side effect for the recipient country's economy.

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