DETERMINANTS OF FOREIGN DIRECT INVESTMENT IN GEORGIA

ECONOMIC GROWTH AND STRUCTURAL TRANSFORMATION

by

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Submitted to

Central European University

Department of Political Science

In partial fulfillment of the requirements for the degree of

Master of Arts

Supervisor: Professor Carsten Q. Schneider

Budapest, Hungary

2020

Abstract

This thesis gives an overview of major developmental policies and analyses how current changes in the global economic order impacted strategies of modernization. Existing research identifies a number of factors, that constrain economic development, and advises on their improvement to ensure the unhindered flow of productive investment. This thesis applies an influential Growth Diagnostics approach to the analysis of the determinants of foreign direct investment inflows to Georgia between 2004 – 2019 and finds that human capital has become a major constraint. Georgia offers a generally attractive environment for investment, but its capacity to attract investment is underutilized. I argue that by focusing on the supply-side bottlenecks, such as, for instance, low human capital, scholarship neglects the problem of the lack of demand under uncertainty, i.e. lack of commitment to invest, which has a major negative impact on the developmental perspectives of emerging economies. First, it diverts a potentially profitable investment away from the countries. Second, the lack of demand obstructs a potential supply of tradable and non-tradable inputs, thus leading to the vicious circle of underperformance. A new analytic framework for FDI attraction that addresses these issues is proposed. State-led investment promotion is put to the forefront of the research: by attracting FDI that ensure the subsequent demand for improvement it enables countries to reinforce the benefits of structural reforms. However, Georgia's state capacity is low and, therefore, Georgia fails to fully utilize its developmental potential. This argument is derived from the analysis of the performance of Georgia’s Investment Promotion Agency. Failures, such as institutional turmoil and chronic understaffing, undermine its efficacy.

Keywords**:** economic development, binding constraints, Georgia, foreign direct investment

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List of Abbreviations

DCFTA	Deep and Comprehensive Free Trade Area
FDI	Foreign Direct Investment
FTA	Free Trade Agreements
GATS	General Agreement on Trade in Services
GDP	Gross Domestic Product
GVC	Global Value Chains
ICT	Information and Communication Technologies
IPA	Investment Promotion Agency
LEPL	Legal Entity of Public Law
MNE	Multinational Enterprise
NBG	National Bank of Georgia
RoO	Rules of Origin
TFP	Total Factor Productivity
TRIMS	Trade-Related Aspects of Intellectual Property
TRIPS	Trade-Related Investment Measures
WTO	World Trade Organization

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Introduction

Economic development is the focal point of an extensive body of scholarship. With only a handful of examples of successful and rapid developmental catch-ups, the question remains open: what viable strategies of development are available today to emerging economies?

In the 1980s, the pendulum of economic thought swung from favouring gargantuan interventionist policies towards cherishing the liberated markets and globalization. Main development theories have put trade (Frankel and Romer 1999; Alcalá and Ciccone 2004), human capital (Romer 1989, 1994), and political institutions (Acemoglu et al. 2001, 2014) at the core of economic development. During the last few decades emerging economies have greatly liberalized markets and have institutionalized their commitments by following international organizations' advice and signing multiple preferential trade agreements.

Post-2003 revolution Georgia is one of the vivid examples of a country that has embraced this approach in order to achieve rapid and sustainable economic growth (Gilauri 2017). Indeed, many reforms were conducive to growth: in the 2004 – 2019 period the economy grew at an annual average of 5.36%, and significant social progress has been achieved. "Georgia has earned a reputation of star reformer" (World Bank 2018) by offering a friendly business and investment environment, low corruption rates, high security, trade openness, and liberal tax and labour legislation (Deloitte 2016). However, the result is still far short of the miraculous transformations performed by the development record holders, such as Ireland or the Asian Tigers.

This thesis will critically evaluate Georgia's developmental challenges by putting trade-related issues at the center of the analysis. As very common in debates revolving around development, suboptimal economic results are attributed to different, sometimes mutually exclusive reasons. However, a focused look at the developed world shows that a great variety of economic arrangements can cumulate progress and well-being. The same holds for developmental policies, therefore, this research will go beyond the limitations imposed by ideological frameworks and attempt to investigate the developmental patterns of Georgia in their full complexity.

I build my thesis upon the idea that economic development is an accumulation of productive capabilities within the society, i.e. “collective know-hows” that enable it to produce more diverse and more sophisticated goods (Hausmann et al. 2005, 2007) and services. This process is undoubtedly dependent on the unquenchable entrepreneurial will, and the previous research has been mainly focused on identifying binding constraints that hinder entrepreneurial activity.

I argue, however, that by focusing on the structural determinants, like the quality of institutions and business environment, these theories neglect the transformative role of state-led (i.e. an agency) development promotion. I investigate this issue by analyzing the composition of Foreign Direct Investment (FDI) in Georgia between 2004 – 2019 and testing existing theoretical frameworks on the determinants and deterrents of FDI.

Reflections on Case Selection and Scientific Relevance

Georgia belongs to a set of developing countries that underwent profound pro-market institutional reforms (World Bank, 2016) to bolster the private sector and trigger rapid and sustainable development. It is consistently striking impressive results on numerous international economic rankings, for instance, in 2020 Georgia ranks 7^{th} out of 190 globally and first in Europe and Central Asia in the World Bank *Doing Business* ranking (up from 112^{th} in 2005). It is 12^{th} and 6^{th} respectively in the *Economic Freedom* Index, produced by the Heritage Foundation (up from 99^{th} in 2005). The country’s tax and regulatory efficiency is well above regional or world averages.

In addition to that, Georgia has secured preferential access to 2.3 billion consumers via numerous comprehensive Free Trade Agreements (FTA). Since 2008 Georgia has enjoyed an FTA with Turkey, in 2014 Georgia signed an Association Agreement with the EU, which established the Deep and Comprehensive Free Trade Area (DCFTA) between the European countries and Georgia, Ukraine, and Moldova. Figure 1 depicts the map of Georgia's preferential trade regimes. The Association Agreement offers market access to DCFTA and ensures stability and predictability of Georgia's institutional environment. In 2018, China-Georgia FTA came into force. A positive causal relationship between a market size of regional trade agreements and foreign investment inflows was confirmed in scholarship (e.g. Jaumotte 2004; Shah and Khan 2016). Greater exposure to regional trade agreements is crucial for small economies, as it compensates for the size of their market and allows them to overcome a productivity deficit.

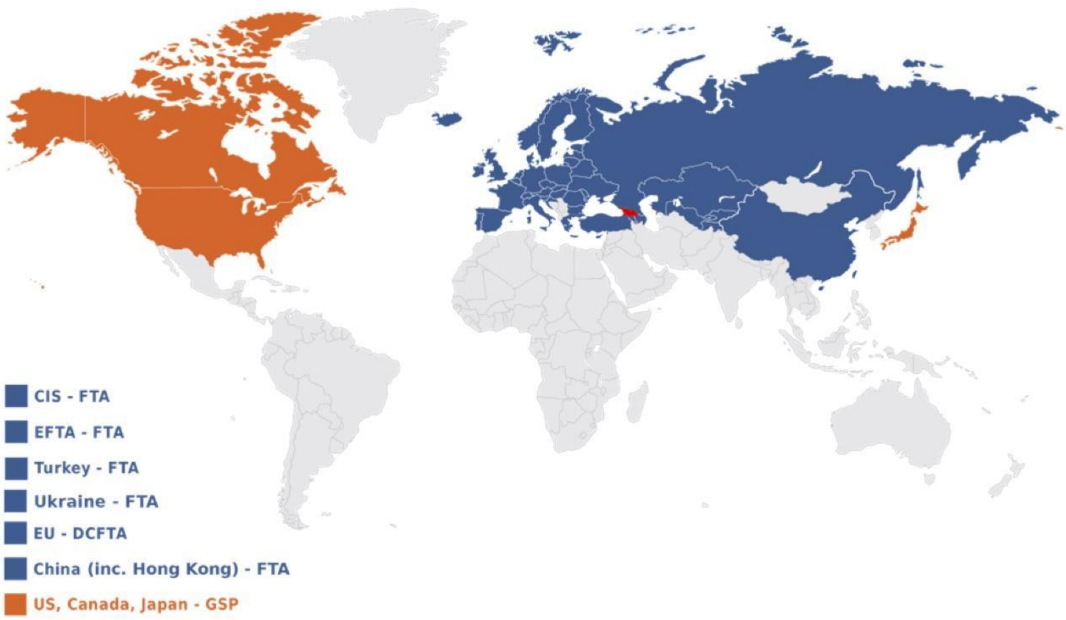


Figure 1. Map of Georgia's Preferential Trade Regimes
Source: Ministry of Economy and Sustainable Development (2020)

FTAs gravitate towards big trading gravity centers and seldomly overlap. Georgia is one of only seven countries that enjoy preferential trade regimes with both the EU and China[1] and thereby offers a unique value proposition for FDI, especially export-oriented efficiency-seeking international investment, which potentially seeks to exploit the depth and the degree of centrality of Georgia's FTAs. Overall, it is argued that countries with a higher degree of trade openness will be more able to attract international investment (Liargovas et al., 2012). Benchmarking of Georgia shows that it offers a high-value proposition with regards to economic freedom and business costs.

Factors mentioned above should have made Georgia a top destination for FDI and turned Georgia into an *export platform* for global business. Free trade regimes also increase Georgia's role as a bridge between regional markets and the potential for integration into the Global Value Chains (GVC) with the creation of upstream and downstream production linkages (Baldwin).

Georgia as a Failed Most-Likely Case

A combination of these factors should have resulted in rapid development. However, it can be argued that Georgia failed to leverage an economic transformation. Therefore, Georgia is picked by virtue of being a *failed most-likely* case. While generally being an attractive place for foreign investment, it fails to attract *efficiency-seeking* FDI.[2] According to the World Bank, in 2019 - after fifteen years of reforms - Georgia belongs to a lower range of Upper-Middle Income countries.[3]

[1] Iceland, Chile, Peru, Singapore, South Korea, Switzerland, and Georgia enjoy preferential trade regimes with both the EU and China. In comparison, Georgia has two advantages: its geographic location and lower cost of business activity.

[2] Enterprise Georgia (2019) "Foreign Direct Investment Attraction Strategy 2020 – 2021"

[3] As of July 1, 2019, Georgia belongs to Upper-Middle Income countries. The World Bank assigns countries to groups according to their GNI per capita calculated on the Atlas Method. Group thresholds are adjusted for inflation using SDR deflator. Currently, the GNI per capita range for Upper-Middle income countries is defined at 3,996 – 12,375 US dollars, Georgia's GNI/Capita/$ is 4,130. Georgia was moved from the Low-Middle income category to an Upper-Middle income category in 2016 due to an update in final results of the census conducted in 2014, which revealed a significant decline in population size.

An in-depth study of this case can shed some light on the causal story of economic development. Rohlfing (2012) argues that the choice of most-likely case analysis "rests on the intuitively plausible goal of generating surprising insights". The choice of Georgia is justified due to the puzzling outcome: Georgia is underperforming with respect to many predictors of economic growth. "A failed most-likely case is more valuable for learning something about a hypothesis than a nonsuccessful least-likely test" (Rohlfing 2012, 85). Of note is the fact that the outcome is also somewhat misleading: Georgia has been generally successful in attracting FDI relative to its market size and GDP per capita, but, as I argue, the quality of FDI is low. In this way, this case provides even greater leverage to employ exploratory process tracing.

Research Outline

I build my arguments as follows: Chapter 1 systematically reviews major debates around the issues of economic development. A growth diagnostics framework is introduced. The literature shows that economic development can only be operationalized through the lenses of structural transformation. However, that hard interventionist policies are no longer feasible, and FDI attraction is the only way through which emerging economies can kick start economic development. I present a stylized scheme of a development mechanism. Chapter 2 proceeds with the evaluation of FDI structure in Georgia. The lack of quality FDI results in economic underperformance. Chapter 3 adjusts growth diagnostics to the analysis of FDI inflows and applies it to Georgia in order to identify the deterrents of quality FDI. Chapter 4 builds on the presented findings and points to some of the deficiencies of the approach and introduces a new analytical framework that explains why active investment promotion policy is a crucial component for the attraction of quality FDI to the emerging economy. Finally, Chapter 5 tests this framework by critically evaluating Georgia's investment attraction policy, by focusing on the performance of state institutions. The research relies on descriptive statistics and a series of interviews with experts and stakeholders. I show that national investment attraction policy and *Enterprise Georgia*, investment promotion agency, lack effectiveness.

Chapter 1

Economic Development in Flux

This chapter systematically reviews major debates about economic development and gives an extensive overview of the trends in the economic development action plans. I contextualize economic development and reflect on the interdependence of economic theory, corresponding developmental policies and structural changes in the architecture of the global economy in the late XX century.

1.1 Historical Overview: Mapping the Debate on Economic Development

Terms economic growth and economic development are usually used interchangeably, however, the latter explicitly encompasses not only a quantitative dimension of the economic output but also a qualitative one. Economic development is a process of structural transformation of the economy that enables it to produce more diverse and more sophisticated goods and services. This research identifies two primary streams of development thinking, which can be summarized as States versus Markets and Markets versus States.

State versus Market way of thinking dominated the modern developmental agenda until the end of 1970s. Based on the *balanced growth theory* pioneered by Ragnar Nurkse, one of the first challengers of "Ricardian"[4] development ideas (Kregel 2009, 53), it was believed that

[4] David Ricardo had never created a theory of economic development; however, his seminal theory of trade and comparative advantage has become a reference point for economists to come. His idea, that countries can be better

development was dependent on firm-level economies of scale and the size of the markets. Therefore, economic convergence should have become possible via a large-scale state investment in main sectors of the economy - a big push theory - that should have kicked-off the virtuous circle of productivity growth and investment. Hard industrial policies, that involved aggressive interventions and extensive protectionism, were guided by the realization of the shortcomings of the market forces and aimed at the growth acceleration. However, the importance of comparative advantage was underestimated, and state interventions created industries that failed to attain global competitiveness (Bruton 1998, 916). By the 1980s, hard industrial policies went out of fashion. However, it is worthy of note that, despite being notorious for the failures of import substitution industrialization, they still managed to produce several success stories of outward-oriented Asian Tigers (Studwell 2013), that just in three decades had undergone a miraculous transformation from economic and social laggards to the most dynamic, wealthy, and technologically advanced places in the world.

Nevertheless, the sustainability of Asian success had still been questioned (Krugman 1994)[5] as the pendulum shifted towards the *Markets versus States* mode of thinking. Economic crises of the late 1970s and beginning of 1980s had led to the macroeconomic adjustment in numerous developing countries. It became evident that large scale state interventions significantly distort price incentives, leading to suboptimal investment decisions, and the developmental agenda has become focused on government failures. In order to restore efficient allocation of resources and stimulate private investment, a set of economic policies, coined in the term the Washington consensus, pushed for minimization of the state's role in the economy through economic liberalization, privatization, and openness to trade. In addition to that a rediscovery of the importance of knowledge and innovation to economic growth, as opposed to previously popular externally enforced technological change, led to the development of the endogenous growth theory (Romer 1986, 1994) and the policy recommendations *à la*

off by trading with each other by specializing in the goods for which they have comparatively lower opportunity costs, has had a formative effect on economic theory and developmental policies.

[5] See "The Myth of Asia's Miracle". It was argued that the miracle behind "Paper tigers" was mostly dependent on an extraordinary mobilization of productive resources. An increase of inputs correspondingly results in the increase of output but a "sustained growth... can only occur if there is a *rise in output per unit of input*" (67).

Washington consensus, were augmented by the promotion of good governance and redirection of public spending from sectoral protection to the investments in human capital and education.

Thus, by the beginning of 2000s, there was a full-fledged list of policies conducive to economic development (Williamson 1989) backed by a substantial scholarship (e.g. Barro 1997): that advised, for instance, trade liberalization (Frankel and Romer 1999; Alcalá and Ciccone 2004), the improvement of institutions and promotion of good governance (Acemoglu et al. 2001, 2005), and upgrade of education (Hanushek and Kimko 2000).

These policy recommendations have also become institutionalized in various international arrangements. As a result, emerging economies are currently being subjected to stringent constraints with respect to their economic agenda. Developing countries can no longer use the same policy toolset, which was employed by Asian Tigers to upgrade industries and diversify their economies. For instance, WTO agreements on trade-related aspects of intellectual property (TRIPS), trade-related investment measures (TRIMS), and trade in services (GATS) restrict the policy field in many ways. For instance, export subsidies, a major pillar of modernization, are severely restricted. TRIPS impose strict patent and copyright protection rules on developing countries that prohibit many strategies of innovation, such as for example reverse engineering. TRIMS significantly limits the negotiating potential of local governments with respect to foreign companies' performance requirements, like usage of local content, technology transfer or export targets. GATS aims at the extension of liberalization by opening markets for trade in services. These agreements provide foreign businesses with protection, transparency and predictability, but simultaneously undermine the sovereignty of national authorities (for better or worse) over the regulation of commerce and implementation of independent economic policies.

Unsurprisingly, rules governing international trade were criticized from the perspective of the shrinking development space (Wade 2003). Many prominent mainstream economists share similar evaluation: "much of the 'law' that has developed – for instance, the WTO rules governing international trade – is grossly unfair; it has been designed to benefit the developed countries, partly at the expense of the developing countries" (Stiglitz 2008, 309). Thus, many hard industrial policies not only 'went out of fashion' but also became unfeasible, unless non-compliance is disguised and protected by market power.

The diminishing role of the WTO has not affected the world trade order.[6] The implementation of intellectual property, investment, and open trade protection became more comprehensive and migrated to numerous free trade agreements (FTA), that have drastically proliferated during the past two decades. FTAs have almost entirely substituted WTO rules and signified the next era of globalization and diffusion of market liberalization, however, negotiated now individually between the parties of the agreements.[7] The main goal of FTA is the elimination of at-the-border and behind-the-border trade barriers, therefore upgraded arrangements over intellectual property, investment protection and trade in services became an integral part of free trade areas (Baccini 2019).

Existing development literature critical of globalization perceives institutional arrangements behind free trade as a deliberate attempt to prevent emerging economies from following the developmental path of industrialized nations that had heavily relied on interventionist economic policies (e.g. Chang 2002, 2008; Reinert 2008). However, it difficult to agree with this view, since it is hard to establish an explicit intention to purposefully hinder the developmental potential of emerging economies, which, unfortunately, is also rarely fulfilled, suffice it to recall numerous developmental failures of hard industrial policies experienced in every part of the globe. Market liberalization has its winners and losers, but at the same time technological development, namely the ICT revolution, triggered structural changes in a global economy that has opened many new opportunities for developmental catch-up and welfare enhancement.[8] I discuss this topic in greater detail in Chapter 1.3.

This debate, however, points to the unintended effects of evidence-based policymaking. Economists have been increasingly employing cross-country regression analyses, which highlight the interdependence of averaged economic growth rates and GDP per capita with a

[6] However, this thesis might have been written at the commencement of a new trade paradigm, see *The return to protectionism*. (n.d.). VOX, CEPR Policy Portal.
[7] That aggravates in principle the bargaining power of developing nations even further.
[8] A clear latest success story of economic convergence through economic openness is Ireland.

number of explanatory variables, like, for instance, trade openness, quality of education, levels of corruption (Rodrik 2012). Consequently, as discussed previously, they were issuing corresponding policy advice. Rodriguez (2006) argues that such regression models assume linearity and separability of the independent variables. However, hardly anyone would agree that country-specific circumstances are separable or have a linear effect on economic growth. It had soon become evident that wholesale policy recommendations produced a mixed development track record. While being generally beneficial for the economies, the developmental potential of policy prescriptions *à la* Washington consensus was overestimated (Estevadeordal and Taylor 2013) and became frequently criticized on the grounds of "market fundamentalism" (Stiglitz 2008).

1.2 Modification of Economic Development Theory: Growth Diagnostics

This dissatisfaction with the policy outcomes has led to the re-evaluation of policy recommendations that used to focus on the maximization of reforms that increase market incentives (Rodrik 2006). 'Washington consensus' has never been an integrated theory of development, but the general idea behind can be folded in a simple motto: at any time and place, the more pro-market reforms a country has implemented, the better. Therefore, the general explanation for the lack of developmental outcomes was that the reforms that were undertaken were not comprehensive enough. However, this explanation failed to address country-specific circumstances.

It soon became evident that standard reform packages did not last long or produce a substantial effect unless there were other institutional complementarities, such as, for example, high standards of property rights (e.g. Acemoglu et al. 2001). Policy-wise, that led to the further extension of the list of recommended reforms. But the main problem with the reforms was precisely that the reforms' objectives were habitually too broad. At its core, advice on institutional reform urged developing countries to first converge with the developed countries with respect to the quality of institutions, so that later they could experience economic convergence. But such policy recommendations were ambitious to the extent of unfalsifiability.[9]

A realization that economic development is contingent on a set of country-specific factors has led Hausmann, Rodrik and Velasco (2005) to introduce *growth diagnostics*. This formative theoretical framework has responded to the shortcoming of the previous approaches and addressed the problem of heterogeneity. Growth diagnostics is a higher-order neoclassical model based on Albert Hirschman's (1958) seminal idea of unbalanced growth. Growth diagnostics "promises to apply neoclassical economics in all its flexibility" (Haberman and Padruttm 2011, 2). Building on the endogenous growth framework, growth diagnostics identifies return to investment, appropriability and cost of finance as major variables influencing economic growth. This approach presumes that economic growth can be hindered by a variety of constraints, which can be identified by tracing shadow costs. At the same time, an unbalanced growth framework explains why most of these constraints are not binding. "If agents find expected returns to be dismal, changing the availability of finance may do little to investment". (Hausmann, Klinger, and Wagner 2008, 24). Similarly, failure on one of the variables, constrains growth even if all other necessary conditions are in place.

Therefore, only the easing of *binding constraints* can boost economic growth, while other constraints, though potentially troublesome, have only a minor impact on economic growth. This intuition can be explained by comparing economic performance to a volume of barrel: a maximum volume of which is "determined by the *length* of the *shortest* slab" (ibid., 14). Policy-wise it means that the averaged improvements in a business environment have little to no effect on development. Instead, policymakers should focus on the scope and sequence of the reforms.

[9] The idea foreign aid can help developing nations to mitigate costs associated with the reforms once again gained traction in developmental thought (see Sachs 2005). Due to the lack of human and physical capital many nations are stuck in the low-level equilibrium, and targeted, reform-oriented foreign aid was aimed to help to change institutions and path a road to economic take-off. However, experience has shown that foreign aid, in fact, frequently resulted in the so-called aid curse, stimulating rent-seeking and all adjacent problems associated with the lack of accountability (Djankov et al. 2008).

An ability to reform is also a limited resource, therefore, it needs to be focused and selective (Rodrik 2006). An analytical decision tree of growth diagnostics is presented in Figure 2.

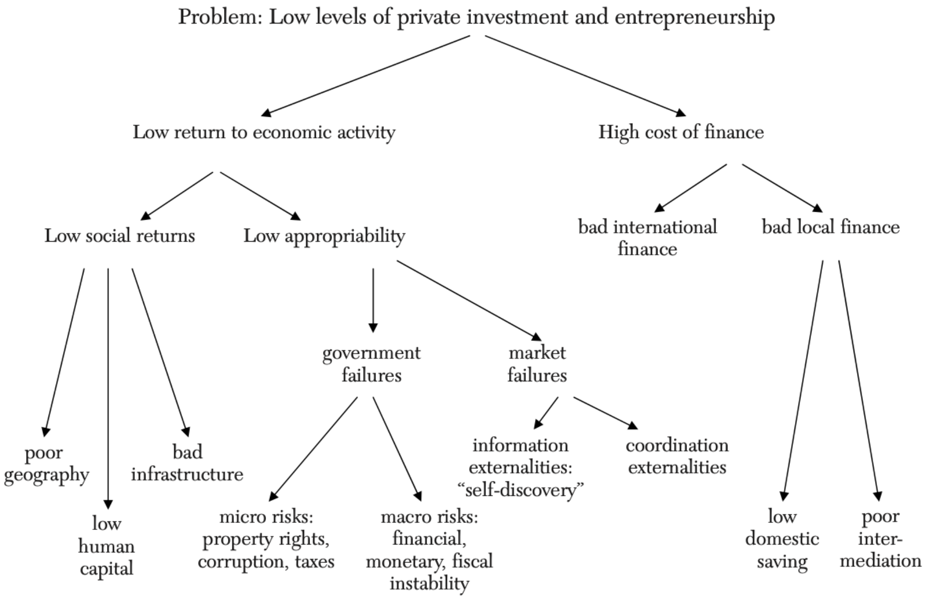


Figure 2. Growth Diagnostics Decision Tree
Source: Hausmann, Rodrik and Velasco (2005)

Another strength of this approach is that it also adds a temporal dimension to the analysis encouraging the employment of growth diagnostics at different times. Some constraints, while not binding at first, can become binging at some later stage of development. Thus, it assigns different weights to the constraints and identifies their dynamic nature. Growth diagnostics also had a significant impact on the conventional analysis of the reforms and second-best reform choice. This framework takes into account political constraints and analyzes the prioritization of the reforms from a perspective of available policy space.

Growth diagnostics is extensively employed by international organizations[10] and numerous growth studies,[11] and laid a foundation for sectoral growth diagnostics.[12] It has become a major tool for structuring an evidence-based economy assessment, country-specific aid solutions and generating policy blueprints. Although it was debated, if growth diagnostics

[10] World Bank, Asian Development Bank, Millennium Challenge Corporation (MCC), IFC Constraint diagnostics

[11] See Hausman et al. 2020, MCC Constraints Analyses, etc.

[12] IFC Country Diagnostics

was a scientific method or a disciplined art (Sartor 2007), the major strength of the framework lies precisely within its adaptability, which lays out a solid foundation for the formulation of hypotheses and 'causal stories', that can be later tested empirically (Haberman and Padruttm 2011). Besides traditional macroeconomic statistics, growth diagnostics systematically uses benchmarking and survey indices produced by international organizations, thus enhancing the quality of the research.

Nevertheless, Growth Diagnostics approach suffers from a 'neoclassical' bias towards the 'supply-side'. The idea of targeting and sequencing the reforms is a major improvement of economic development theory, however, it fails to identify the 'demand-side' of economic growth, namely, a problem of the *demand under uncertainty*. Therefore, I argue that implementation of the reforms has to be complemented by an active FDI-led development promotion. I elaborate on this in greater detail in Chapters 3 and 4.

1.3 Globalization and its Effect on a Growth Paradigm

Economic history confirms that an absolute majority of successful developmental projects involved hard industrial policies focused on manufacturing (Rodrik 2011a, 2011b; Fosu 2012), however, the replicability of similar policies seem to be in question due to the fundamental changes in the global economy, production processes and, last but not least, international trade law. The impact of economic globalization on development perspectives needs further elaboration. Reduction in transportation costs and ICT revolution has moved globalization to the next stage of second unbundling (Baldwin 2006, 2011, 2012) and led to the fragmentation of production processes, parts of which are now easily outsourced or offshored. While previously in order to modernize, countries had to develop their own deep industrial bases, such was the case of South Korea for instance (Baldwin 2013, 172), at the moment they can 'simply' join global supply networks. Thus, the focus of the development has naturally shifted from the 'invention' of national industries towards the integration into global production networks (Baldwin 2011; Ozawa 2011). Therefore, I argue that hard dirigiste policies are no longer feasible today and probably unnecessary. Currently, the only viable solution for rapid modernization is integration into GVCs, FDI attraction, and multiplication of linkages within the national economy. The problems associated with linkage creation and climbing up the value chain (e.g. Wan and Wu 2017), however, are beyond the scope of this thesis.

But what constitutes economic development? Globalization has also impacted the perception and operationalization of economic development. A rapid de-industrialization of the west and a rise in the share of services in the GDPs of industrialized nations has created an illusion that developing countries can just leap-frog to the services of a post-industrial epoch. Moreover, services are becoming more and more tradable and an idea of a service-led growth is prevalent globally and in Georgia. However, the appreciation of the importance of manufacturing is reviving (see Andreoni and Gregori 2013). It is largely connected with a growing understanding of development as an upgrade in productive capabilities. And manufacturing is key to this. But, due to the rapid improvements in production technologies and increasing robotization, the share of labour in manufacturing value creation is diminishing as well as the manufacturing sectors' potential to become a solution for structural unemployment. Hence, it is becoming increasingly unrealistic for developing countries to replicate labour-intensive industrial development, a pillar of East Asia's successful modernization.

Nevertheless, manufacturing is important due to its ability to create strong forward and backward linkages. According to Hirschman's (1958) theory of unbalanced growth, production of each good or service creates 'push' and 'pull' forces in the economy, by requiring intermediate inputs and stimulating demand for other productive outputs. Linkages are not only created through supply or demand but also through knowledge aggregation and knowledge spillovers in and between the sectors. In fact, the relationship between services and manufacturing is rather coactive than interchangeable. Share of services and employment created by the upstream demand from the manufacturing sector is significant.[13] Empirical research has also identified that 70% of variations of the GDP per capita can be explained solely by the differences in manufactured export statistics (Hausmann et al. 2011). Another

[13] See Whitefoot and Valdivia (2015) "Innovation and manufacturing labor: a value-chain perspective," Brookings Institute.

important role of manufacturing is its relation to trade and trade induced positive impact on economic development. About 80% of global trade is trade in goods, out of which no less than 70% is manufactured merchandise (WTO 2018).[14]

Thus, economic development is an accumulation of productive capabilities within society. In an influential paper *What you export matters* (2005) Hausmann, Hwang and Rodrik inferred that the quality of exports is associated with future economic performance. The more diverse and sophisticated products or services a nation can produce, the bigger is the predictor of future economic growth (Hausmann et al. 2005, 2007). “Specializing in some products will bring higher growth than specializing in others” (Hausman et al. 2005, 2). It is widely appreciated that different types of exports correlate with different economic performance, therefore *growth diagnostics* suggests that reforms should target constraints that bind productivity in pivotal sectors with the largest development enhancing potential.

Two indexes were created to operationalize the knowledge intensity of an economy and a product: Economic Complexity Index (ECI)[15] and Product Complexity Index (PCI) respectively. These indexes show that countries with high ECI are associated with higher GDP per capita and Higher PCI indices, i.e. economically complex countries are richer and can produce more sophisticated products. Of note is that the latest research in the field shows that the type of production matters more than the diversity (Mealy et al. 2018). Therefore, in order to develop it is more important to specialize in more complex goods, rather than diversify the production of ubiquitous goods. It is an additional argument in favour of focusing on manufacturing due to greater developmental potential associated with knowledge-intensive activities.

Still, development debate is very much dominated by a ‘pro-consumer bias’ and hence focused on enhancing individual capabilities (Andreoni and Chang 2016, 5). This thesis, however, builds on the idea of development as a structural transformation of the economy. I put New Structural Economics framework – which emphasizes the importance of structural change in societal capabilities – at the foundation of this thesis (Lin, 2010; Lin and Monga

[14] WTO “World Trade Statistical Review” 2018

[15] Hausmann, Hidalgo et al. 2012 “The Atlas of Economic Complexity”. Puritan Press, Cambridge MA.

2017; Monga and Lin 2019). The production itself is dependent on the interrelated networks of productive capabilities: intermediate products, tradable and non-tradable inputs and knowledge (Hausmann and Hidalgo 2011; Hausmann 2016). A level of sophistication of the production is thus dependent on a level of sophistication of these networks, but how do countries upgrade their productive capabilities?

1.4 The Role of FDI and GVCs in Economic Development

For emerging economies of scarce knowledge, skills and savings, like Georgia, it has been difficult to utilize trade openness, diversify and integrate into GVCs. These and other deficiencies are believed to be easily compensated through Foreign Direct Investment (Javorcik 2008; Harding and Javorcik 2012), which is considered to be a crucial pillar of development. Thus, as described previously, the emphasis of the developmental policies has shifted from state-led industrialization towards trade openness and the attraction of FDI. FDI contributes to the country’s competitiveness in a number of ways, for instance, it increases capital accumulation and upgrades infrastructure. By attracting FDI, emerging markets also receive new technologies and a stimulus of foreign skills and expertise that helps them overcome backwardness. But quality matters. The literature distinguishes between four different types of FDI: Strategic asset-seeking, Natural resource-seeking, Market-Seeking, and Efficiency-seeking (Dunning, 1993). Out of four only efficiency-seeking FDI can be considered a *quality* investment, as it has a substantial developmental impact on the host economy.

The mechanism through which efficiency-seeking FDI can stimulate structural transformation in the host economy is threefold. Firstly, as any other investment, it reveals the underlying cost structure of economic activity, which is then spread and revealed to other economic actors. Hausmann and Rodrik (2003) conceptualized this idea in a notion of *economic development as self-discovery*. A successful FDI project diffuses information about the profitability of certain business activities, that has a formative impact on the subsequent investment decisions in the host economy. In addition to that FDI generally leads to in and between-sector knowledge spillovers, through imitation and knowledge diffusion, and by increasing demand for local inputs, leading to increased quality control and competition in other sectors of the economy (Javorcik 2004; Javorcik and Spatareanu 2008). Last, but not least, FDI "can boost a country's ability to upgrade its export basket" (Harding and Javorcik 2012, 964). By using the host country as an export platform, foreign investors not only start producing more complex goods but also generate positive externalities, beneficial for the country's export basket (ibid). Therefore, economic development is contingent on the removal of structural constraints or bottlenecks that infringe the flow of productive investment. I summarize and visualize the current paradigm of economic development in Figure 2.

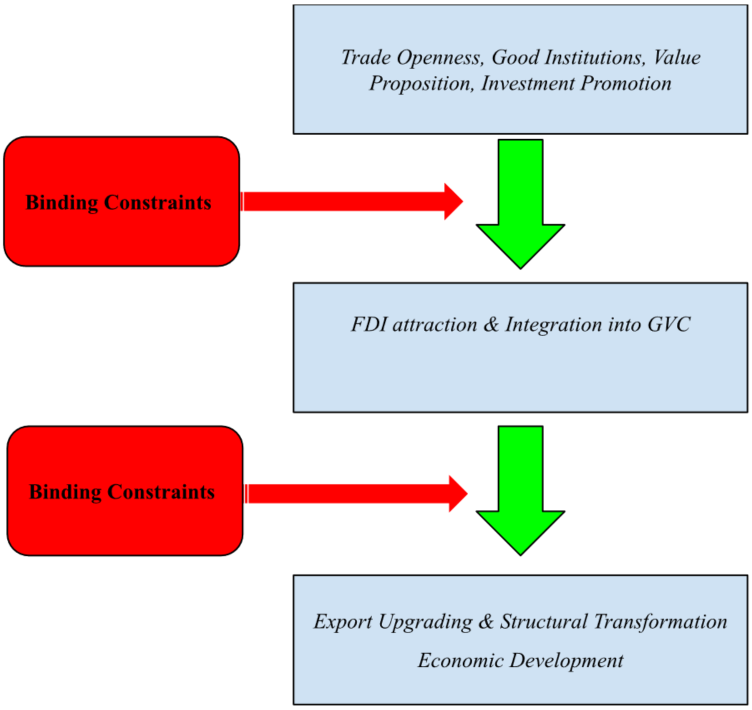


Figure 3. Stylized Mechanism of Economic Development

1.5 Summary

The takeaway of this chapter is threefold. Firstly, development theory increasingly identifies heterogeneity as a major problem of the research. Secondly, theory rightly identifies the importance of the private sector, market incentives and quality of institutions for economic convergence. Finally, it neglects the importance of state-led pro-active development promotion.

Chapter 2

Foreign Direct Investment Promotion Policy

Positive spillovers associated with FDI and their direct ability to transform the productive structure of the economy have shaped the developmental strategies and likewise predetermined the scope of this research. Research suggests that Investment Promotion Agencies (IPA) are conducive to FDI inflows to developing nations. This chapter overviews the role of investment promotion policies and analyses the structure of FDI distribution in Georgia between 2004 – 2019.

2.1 Investment Promotion

FDI-led development has come to dominate the economic agenda and the role of investment promotion has increased correspondingly. Developing countries founded numerous national and regional Investment Promotion Agencies (IPA) to ease the flow of capital to their economies. According to World Association of IPAs, 84% of world IPAs were created after 1990s (WAIPA 2018).

Despite difficulties associated with the disaggregation of the impact of multiple factors, literature captures a positive causal relationship between IPA and FDI inflows (Charlton and Nicholas 2007; Harding and Javorcik 2007, 2011). Harding and Javorcik (2011, 1445) found that sectors specifically targeted by IPAs attract more FD “relative to the pre-targeting period and non-targeted sectors”. The rationale behind the creation of IPA are the frictions created by the information failure, which hinder investment. Interestingly, authors suggest that developed countries, unlike developing, do not benefit from investment promotion (ibid, 1447). A possible explanation of this is that obtaining necessary information about a developing country is associated with much higher costs without IPA, as developing countries possess a lesser degree of predictability. Thus, IPAs of potential host economies provide assistance that reduces the costs associated with information asymmetry. Their main competences mainly include pre-investment care: country promotion and information campaigns, and assistance with handling bureaucratic barriers. However, they may also include aftercare, such as coordination with local state agencies and suppliers (OECD 2018). The efficiency of IPA is also closely related to the overall quality of the country-specific business environment (Harding and Javorcik 2007).

Georgia's national IPA 'Invest in Georgia' was founded in 2002. A year later pivotal reforms in economic liberalization began. "The World Bank had proclaimed Georgia the world's top reformer for the period from 2006 to 2011" (Gilauri 2017, 7); and FDI attraction became a priority. A new cabinet that came to power after 2012 elections continued the policy of trade openness and FDI attraction. In 2014 it had also pledged to greater assistance of economic development by creating new coordinator-and-facilitator agencies, for instance, 'Enterprise Georgia' that was focused on the business support and export promotion. In 2017, following a regional trend, 'Invest in Georgia' was merged with 'Enterprise Georgia', in order to create synergy by combining export promotion, business development and FDI attraction under one roof. I discuss the particularities of Georgia's investment promotion in more detail in Chapter 6.

2.2 Analysis of FDI Structure in Georgia between 2004 – 2019

The generated analysis is based on the available data from the World Bank and Geostat.[16] This thesis faces some limitations due to the unavailability of data,[17] such as, for instance, the number, volume and sectoral distribution of greenfield FDI in Georgia, share and volume of exports created by greenfield foreign investment, sectoral distribution of FDI prior to 2007, or

[16] National Statistics Office of Georgia

[17] Geostat collects very limited data on FDI in Georgia.

composition of FDI prior to 2013. However, the available data is still enough to generate some important inferences that support this thesis.

Georgia boasts with high relative volumes of FDI. Figure 4 depicts the comparison of FDI inflows as a percentage to GDP of Georgia and its regional counterparts. Georgia's leadership in FDI attraction can be attributed to the business-friendly environment and pro-market reforms that were conducted since 2004.

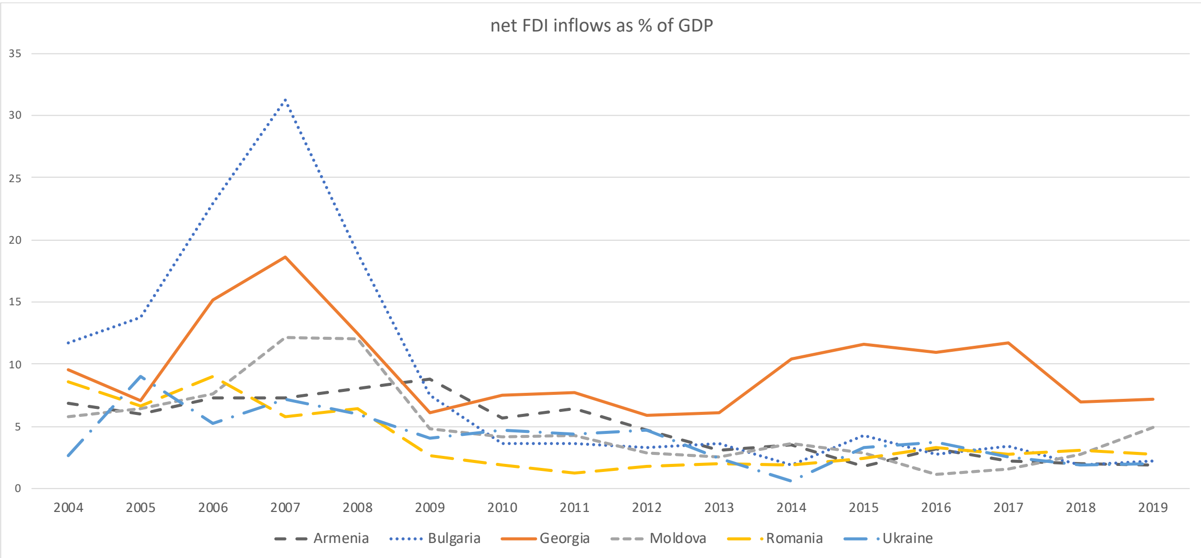


Figure 4. Foreign direct investment, net inflows (% of GDP)
Source: Own elaboration with data from World Bank

However, FDI flows are basically a Black box Nearly half of World's FDI come from offshore jurisdictions. Georgia is not an exception, as at least 30% of total FDI inflow from 2004 to 2019 came from just four offshore jurisdictions.[18] This problem severely impairs the scholarship as important economic data is might be misleading.[19]

Figure 5 depicts a sectoral distribution of FDI. Between 2007 – 2019 only 11% of FDI went into the manufacturing sector, a driver of economic transformation. Despite relatively high volumes of FDI, it is mostly distributed among non-tradable economic sectors, such as energy, real estate, construction and financial sector. The situation is a bit ambiguous given

[18] UK, Netherlands, Luxemburg and Panama. See also Appendix B.

[19] See Haldevang (2017) "Why can't we trust basic economic figures," qz.com.

Georgia's market size and GDP per capita. A possible explanation that can addresses this ambiguity is that fact that substantial volumes of investment originate in Georgia itself and then are just channeled to the country from offshore jurisdictions. A lack of developmental outcomes associated with such high levels of FDI inflows potentially confirms this explanation, as such investment does not enhance the economy with new technologies or skills.

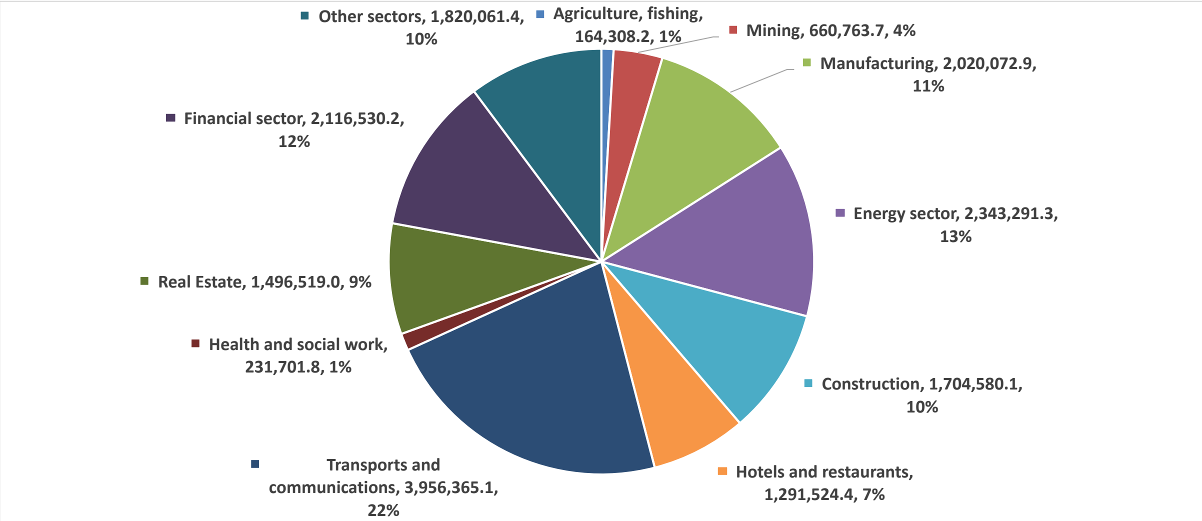


Figure 5. FDI by Economic Sectors in 2007 – 2019 Georgia
Source: Own elaboration with data from Geostat

As discussed previously, economic development depends on the quality of FDI. FDI attraction and integration in GVCs is especially important for smaller economies, like Georgia, that need to work on linkage creation and complementarities "of foreign and domestic expertise" in order to support production (Landesmann and Stöllinger 2019, 18). As discussed previously the importance of the manufacturing sector has been increasingly recognized. Empirical investigations, that analyze the impact of sectoral distribution of FDI, also confirm a stronger positive impact of FDI in the manufacturing sector and link it to the nature of the spillover effects in manufacturing (Wang 2009, 998). Interestingly, according to the author, the disaggregation of the impact shows that the effect of FDI in manufacturing on economic growth is underestimated by at least 48%, while FDI in other sectors "do not play a significant role in enhancing economic growth" (ibid., 991, 2000). Last but not least, greenfield FDI in manufacturing does not bring risks of crowding out local investment.

The reason for Georgia's underperformance seems to be the lack of a quality FDI. However, it still puzzling why, while offering a competitive value proposition for efficiency-seeking FDI and being a generally favourable location for foreign investment (Deloitte, 2016), Georgia fails to attract quality FDI in manufacturing.

The trend in FDI inflows to Georgia has also significantly changed over the past years. 2018 and 2019 are two consecutive years with a significant drop in FDI inflows. Figure 6 depicts total FDI inflows and a share of reinvested profits in total FDI. Interestingly, but the reforms conducted in that period should have positively affected the inflows. A new tax model, that exempts reinvested and taxes only distributed profits, was implemented in 2017. Furthermore, A response lag associated with the free trade agreement with China (came into force on January 1, 2018) should have been overcome as well.

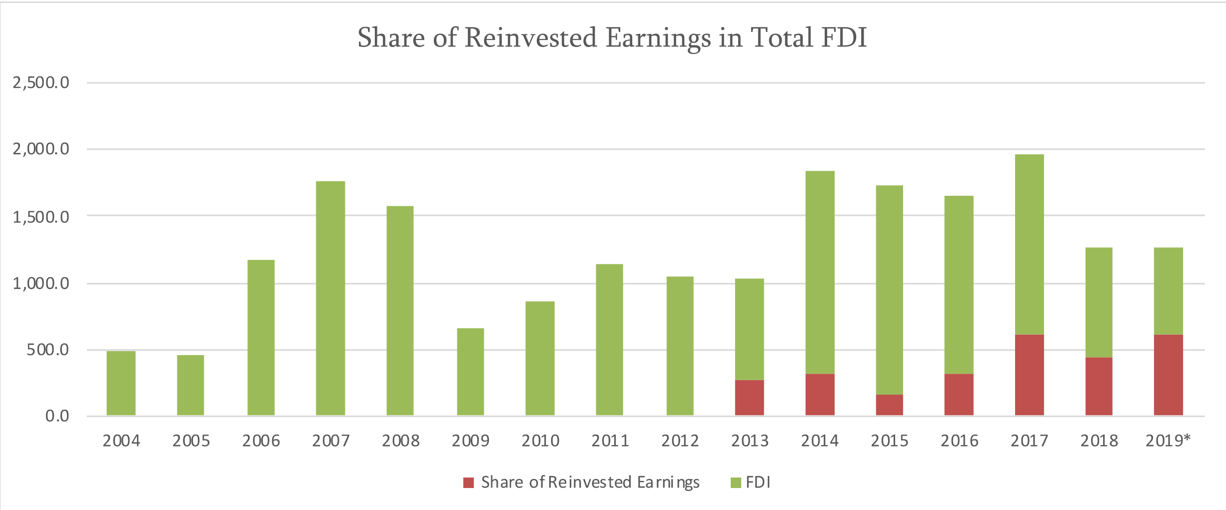


Figure 6. Total FDI in Georgia between 2004 - 2019 and share of Reinvested Earnings
Source: Own elaboration with data from Geostat

The share of reinvested profits in the total FDI increased in 2017, however, it only cushioned a sharp decline in new investments. A possible explanation for the decline in investment are exogenous factors: as the total inward FDI to the region has been decreasing,[20] however, this trend should have been compensated by the diversion of FDI.[21] Regionally aimed

[20] UNCTAD, 2019, World Investment Report
[21] Serbia, for instance, experienced +43% growth in FDI in 2019, ibid.

FDI diverts to the countries of the region that offer best environment for investment (Harding and Javorcik 2007).

Indeed, the diversion was also previously confirmed by Georgia as well: in the period from 1998 to 2018 FDI stock flowing to the countries of Eastern Partnership increased fifteen times, while Georgia has doubled its share of total regional FDI from 7% to 14%.[22] However, it is yet ambiguous whether the diversion effect will abide.

As mentioned, the majority of FDI to Georgia is market seeking as it is distributed among non-tradable sectors, such investments, despite their numerous benefits still fail to have developmental effects that are equal to the effects of quality FDI in manufacturing. Georgia's manufacturing value creation for 44% consists of food and beverages production (Enterprise Georgia 2019), and potentially it attracts a proportional amount of foreign investment. Only 1 percent of FDI received by Georgia in the years 2004 – 2017 went into machinery and equipment.[23] Moreover, Georgia has one of the lowest shares (3% compared to 13% average in a top ten) of joint domestic-foreign ventures among transition economies. These factors suggest that productive capabilities in manufacturing sector has not improved much. In the following chapters I analyze the possible deterrents of high-quality manufacturing FDI in Georgia.

[22] UNCTAD Statistics 2019

[23] UNCTAD data, based on information from the Financial Times Ltd, fDi Markets, 2019

Chapter 3

Diagnostics of FDI Deterrents

In order to explain why Georgia fails to attract quality FDI and identify and scrutinize the binding constraints, I adjust the Growth Diagnostics decision tree for the analysis of the FDI deterrents. Why is growth diagnostics adaptable to the analysis of FDI inflows? Growth diagnostics puts entrepreneurial activity and private investment at the center of the investigation. Therefore, it is also possible to analyze binding constraints of foreign investment, which is a functional equivalent of local investment, provided that it is adjusted to the influential OLI model: Ownership, Location and Internalization advantages (Dunning,1988; Denisia 2010). I disaggregate the potential deterrents of FDI in manufacturing under three branches: Cost of Production, Cost of Trading across Borders, and Appropriability. Cost of finance is excluded from the analysis as it is assumed that foreign investors (usually large multinational enterprises, MNE) have easy access to international and home credit. Each finite nod is analyzed according to three indicators: Cost, Quality, Availability.

I proceed as follows: I first identify nods of the diagnostics tree that do not represent constraints to FDI. I then elaborate on the nods that can impede FDI inflows. Finally, I identify and scrutinize binding constraints. A summary of the findings is presented in Figure 7. Green, Yellow, and Red are colours for *Not Constraints*, *Potential Constraints*, and *Binding Constraints* respectively.

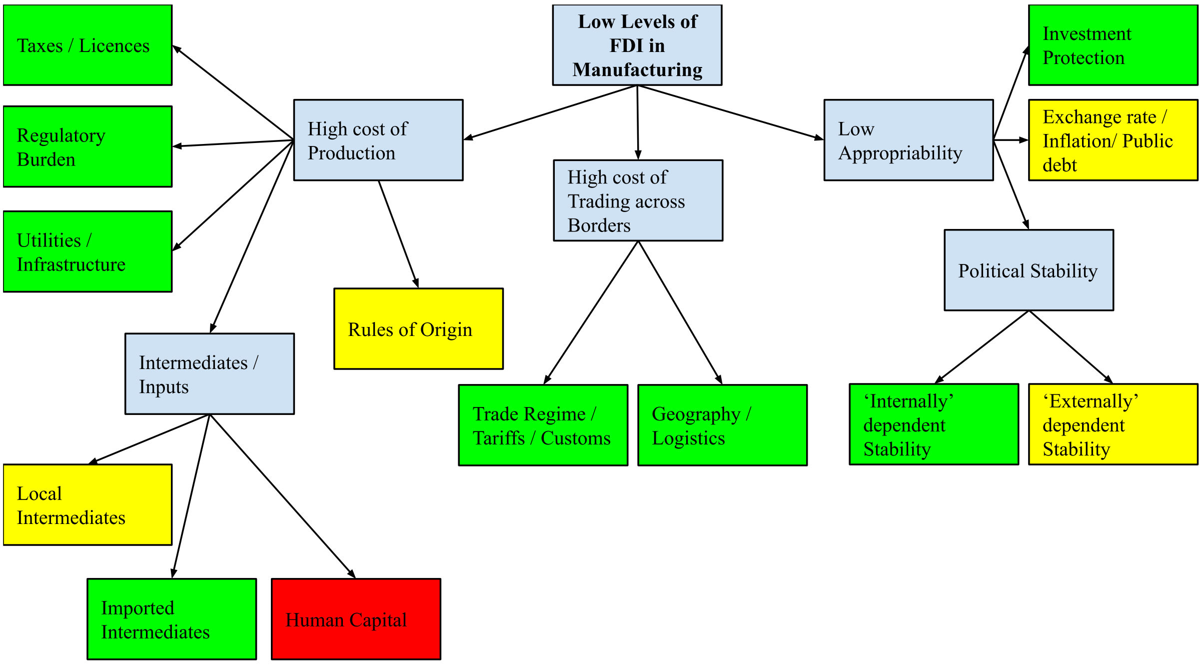


Figure 7. Growth diagnostics adjusted for the analysis of the deterrents of FDI in manufacturing
Source: Own elaboration with data from based on Hausmann, Rodrik and Velasco (2005)

3.1 Not Constraints

In terms of *regulatory burden*, Georgia is a world leader, 6th globally. Economic freedom index is 12th globally. With 77.1 Georgia scores higher than the regional average of 69.8.[24] *The tax burden* is low and simple. In addition to that companies are exempted from taxes on reinvested profits. OECD FDI Regulatory Restrictiveness Index puts Georgia among best ten countries globally. Regulatory and tax burden does not substantially diminish returns on investment, therefore further easing of a tax burden will not have a substantial impact on economic growth.

Utility costs are competitive. Establishing access to the electricity grid or other infrastructure is simple (Enterprise Georgia 2019). Georgia has a simple and low tariff system for *imported goods and intermediates*. Moreover, imports of companies registered in Free Industrial Zones are exempted from any kind of import tax. In terms of *geography*, Georgia offers an attractive geostrategic and transit location: it is close to EU markets and markets of Central Asia. *Logistics*, namely transport infrastructure, can potentially be a constraint,

[24] The Heritage Foundation (2020) Economic Freedom Report

however, at the moment, it is in the capacity to serve the current amount of output.[25] A cross-border movement, though, namely a route to and from Central Asia involves crossing multiple borders, is potentially constraining due to the quality of institutions and customs services of the involved countries.

Free Trade regimes give mostly tariff-free access to 2.3 billion consumer markets and constittute more than 40% of global GDP, thus the cost of trading should not be binding. Georgia is considered a flawed democracy, therefore *'internally dependent' political stability* can raise some questions. However, it offers a relatively stable political environment with no "anti-market" contenders. BTI transformation index gives Georgia 7/10 for the stability of democratic institutions. A great degree of involvement in international cooperation, the conditionality of international aid and cooperation with the EU under the Eastern Partnership program further ensures its stability.

Investment protection is less likely to be jeopardized by corruption,[26] but the quality of Georgia's judicial system is far less impressive[27]. The risk of investment in another country is connected with a shift in the bargaining power at the very moment of investment: FDI presupposes acquisition of factors that lack liquidity in the short run, and that naturally incentive host governments to use this disbalance to their benefit. Nevertheless, expropriation risks are at their lowest – especially for the manufacturing FDI – not only due to tremendous reputational costs but also due to the nature of a production process. A forceful change of ownership of vertically integrated FDI would immediately push the firm out of the supply chain. Therefore, long term gains associated with the investment are far preferable to immediate payoffs (Li 2009, 1105). Although governments can turn to more subtle forms of rent-seeking, that reduce profitability, investment protection is still very unlikely to be a constraint. Investment protection provisions are included in FTAs, that ensure countries

[25] Transport congestion is not observed. For instance, railroad freight volume has been falling since 2007 (Geostat).

[26] Transparency international ranks Georgia 44th/180 in 2019.

[27] According to Economic Freedom Report (2020), Property rights protection in Georgia are ranked relatively high with score of 68.6, but there from 2017 a negative trend in Judicial Effectiveness (current score 57.2) can be seen. Nevertheless, Georgia is way above world averages.

commitments towards a broader understanding of property protection and restrict arbitrary infringement (Büthe and Milner 2008). A positive causal relationship between international trade agreements FDI inflows (ibid) confirms this evaluation. Secondly, the effectiveness of the country's judiciary can be mitigated by commercial arbitration. Therefore, the national judicial system should not constitute a problem, unless the production process is heavily exposed to numerous small local intermediates. With respect to state-investor disputes, recent research conducted by Chriki (2018) has proved that any state policy that potentially contradicts the “Washington consensus” has a “45 percent higher chance of being found in violation of FET [Fair and Equitable Standard] than other cases”. Despite pervasive academic criticism of the Washington consensus, it is still very much the nuts and bolts of the global economy. Therefore, problems associated with Georgia's judicial system, most likely are not as binding.

3.2 Potential Constraints

Local intermediates that might be absent or of inferior quality potentially hinder the prospects of technologically complex production in Georgia. *Rules of origin* (RoO) provisions are potential, but a business-specific constraint. Problems associated with diagonal cumulation can increase the cost of production, as an investors have to move a larger share of value-addition to Georgia if it aims to reap benefits of FTAs. “RoO can divert exporters and importers from trading with producers in countries where it would otherwise be economically advantageous” (Garaets et al. 2015, 293). Regional potential for diagonal cumulation is limited, as Azerbaijan is not a member of DCFTA, while Armenia is a member of Russian-led Eurasian union. Georgia’s cumulation opportunities are effectively bounded to Ukraine and Turkey, but as of 2019 the procedures were not finalized.[28] Babych et al. (2019) also find that Georgia’s participation in Regional Value Chains is low. Unsurprisingly, RoO requirements are the major reason of FTAs underutilization (Garaets et al. 2015; Yi 2015).

[28]Agenda.ge (2019, December) Georgian-Turkish economic committee discusses trade relations, Georgian export potential, simplification of customs’ procedures.

Thus, a potential lack of local intermediates and RoO necessitate allocating larger shares of value-creation in Georgia, which in also increases the weight of the problems associated with the *'externally' dependent political stability*. Georgia is located in a conflict-ridden region and is an immediate target of Russia's neo-imperial aspirations. Whatever the case of real influence of regional stability on profitability, it is clear that it adversely affects the investor's perceptions. It can be suggested that a combination of these factors with high degree of probability diverts FDI that requires substantial capital investments and does not have rigid location-specific requirements.

With respect *Public debt*, Georgia boasts with prudence: as of 2019 external Government debt-to-GDP was 32.1% and total debt was 40.6%[29]. The potential impact of *the Exchange rate* and *Inflation* is, however, ambiguous. The trend for currency depreciation started in late 2014 and was accompanied by a politically motivated attack on the governance of the National Bank (NBG).[30] This reveals that the nature of the trend is rather political and determined by NBG's propensity to use its currency reserves. Even so, the depreciation rate and inflation were relatively moderate and have not directly influenced FDI inflows. Overall, the impact of inflation and currency rates can be considered a business-specific constraint, depending on the share of imported intermediates and the price elasticities of the final exports.

3.3 Binding Constraints

Thus, the inquiry shifts to the usual suspect of underperformance: *human capital*. The importance of human capital for economic growth is recognized in numerous studies (e.g. Romer 1989; Hanushek and Kimko 2000). Any production process involves non-tradable local inputs and labour skills and potential to innovate have tremendous impact on the profitability of the enterprise. The problem of quality of the labour force and skills mismatch has been

[29] Georgia Ministry of Finance
[30] GRASS (2015) The Government of Georgia Against the National Bank's Independence

identified in a number of reports.[31] Despite high unemployment, employers still struggle to find professional with right skills (Rutkowski 2013). Reforms conducted since 2004 (Gilauri 2017) and completed infrustructual projects have released most of the exogenous constraints, however improving the quality of the human capital proved to be much more challanging (see Figure 8).

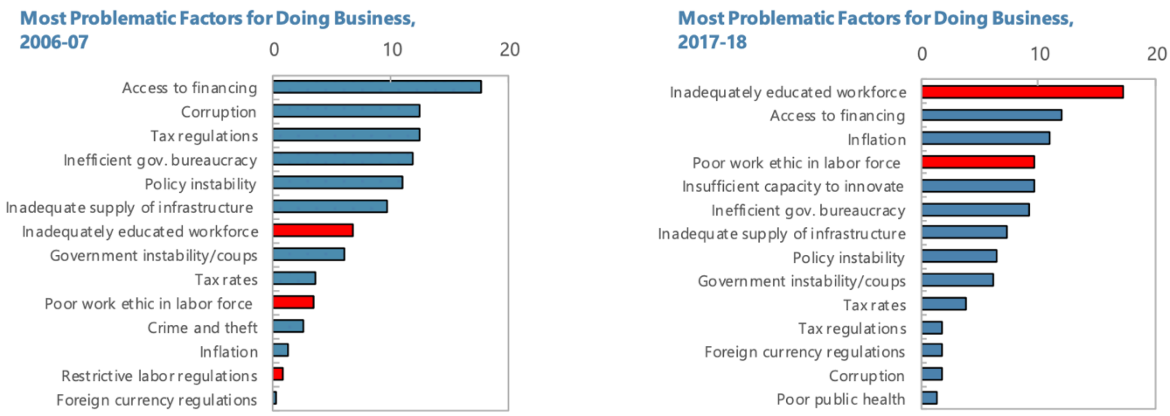


Figure 8. Most Problematic Factors for Doing Business in Georgia
Source: IMF 2018 Country Report No. 18/199

Businesses consistently identify lack of skills and poor work ethic as major problems of doing busines in Georgia. Although inferences drawn from business surveys can be easily criticized, there is ample evidence which confirms that human capital is indeed a binding constraint. First, a steady decline in the size of the workforce as the population declines and ages,[32] confirms the conjecture regarding the human capital. Further, Georgia is not the most competitive country in terms of the labour cost either. Therefore, offering a skillful labour-force is becoming increasingly important. Second, a decrease in the share of the total factor productivity (TFP) in GDP growth also signals that human capital has become a binding constraint (see Figure 9).

[31] See World Economic Forum (2020) Global Competitiveness Report; World Bank (2015) Skills Gaps and the Path to Successful Skills Development, Report No: ACS14318

[32] See Tembon, Fengler, and Kruse, (2018) Georgia's destiny will be shaped by its demography, *Brookings*.

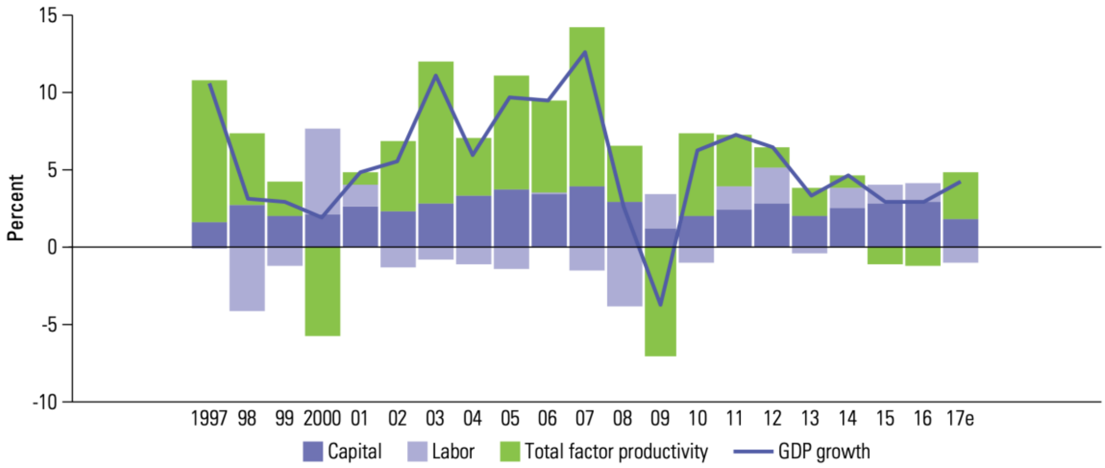


Figure 9. TFP as a share of GDP growth of Georgia
Source: World Bank (2018) A Systematic Country Diagnostic

Georgia at its current state of economic development is very unlikely to be a top performer in higher-order innovations and R&D. But for countries at different stages of economic development innovation is operationalized differently. Human capital is also important for the innovation through acquisition of new technologies (Acemoglu and Zilibotti, 2001). As discussed previously, FDI in the manufacturing sector is considered to be a key channel of technologies to the developing countries, but "...technology-skill mismatch will lead to productivity differences and to large output gaps between the North and the LDCs [Less Developed Countries] even in the absence of any barriers to technology transfer" (Ibid, 564). New skills are needed to operate modern ("skill biased") technologies. Thus, a technology skill mismatch is very likely to deter a technology-intensive manufacturing FDI.

This analysis shows that human capital severely aggravates Georgia's potential to attract quality FDI, thus leading to economic underperformance. Furthermore, I argue that the continuation of institutional reforms and the acquisition of greater access to foreign markets via FTAs have started to produce diminishing results, that confirms that a human capital is becoming increasingly binding.

Chapter 4

Critical Analysis of the Findings. New Framework for Growth Acceleration

Educational attainment is high in Georgia, but the employers are generally dissatisfied with the quality of graduates (Rutkowski 2013). The overall quality of schooling is low, which is confirmed by PISA tests where Georgia is consistently scoring in the last third of the list (OECD 2019). Skills mismatch is another identified problem; however, I argue that this problem is ubiquitous,[33] and is especially common for developing countries, and therefore is not binding. Education is important as it increases countries' capacity to acquire "collective know-hows". The prescription that comes from these findings is that public resources should aim at the improvements in education system.

While cautiously agreeing with the recommendation to invest in the education system, it is yet ambiguous how to operationalize the effect of human capital and labour force skillset with respect to the attraction of FDI in manufacturing. It is worth pointing to the argument which theoretically undermines this finding of growth diagnostics.

Previously in order to modernize and upgrade their industrial output[34] nations had to widen their labour skill-pool and develop deep industrial bases. However, now the fragmentation of the production enables countries to specialize in the very narrow parts of the production process, thus, basically helping them to elude the constraints associated with the lack of competences (Baldwin 2012, 2013). Moreover, demand for skills is usually business-

[33] See European Economic and Social Committee (2018) Skills mismatches: EU businesses are losing millions and will be losing even more!
[34] Before 'second unbundling' of globalization (Baldwin 2011).

specific and, thus, is generalizable only to a certain extent. An informed guess – contrary to the expectations – would suggest that countries nearly always possess a sufficient amount of a quality workforce – or at least it can be easily trained – necessary for attracting parts of GVC production, provided a high level of coordination on the labour market. Therefore, the limitations imposed by the low quality of human capital can be overcome by an increase in specialization. This, however, reveals some bigger implications of a coordination problem that impede economic development: the lack of demand and a vicious circle of underperformance.

4.1 Demand under Uncertainty

The effects of the binding constraints, as previously mentioned, are generalizable only to a certain extent. Most constraints are business-specific and thus investment decisions are dependent on what I conceptualize as *constraint complementarities*, i.e. an aggregate of constraints that magnify the deterrence effect. The mechanism of deterrence is not merely a cost-benefit analysis in which the existence of a constraint (or constraint complementarities) increases the cost of production or lowers approbiability, but a cost-benefit analysis multiplied on *uncertainty*.

Most of economic analyses, including growth diagnostics, focuses on supply-side bottlenecks and fails to analyze the demand side of development, specifically the *lack of demand under uncertainty*. A decision to invest at its core is a commitment to allocate resources for production purposes and substantial parts of this commitments are irrevocable (Chang and Andreoni 2020, 4). Many capital investments, for instance, are illiquid, as they are designed to perform a particular productive task and are hardly movable.[35]

It seems that there is an innate tendency to evaluate country's comparative advantage with respect to FDI hosting similar to the evaluation of a country-level comparative advantages with respect to the production of goods. To elaborate on this point, I disentangle the Ricardian model of comparative advantage from the perspective of GVC production.

[35] A vivid exception is a garment industry.

Ricardian model describes the production of final goods and the model's integrity is jeopardized by addition of exogenous factors or intermediate products, an irreplaceable component of current, globalized, production process (Deardorff 2005a). A dependency on exogenous factors complicate Ricardian model to the extent that it becomes not applicable to the analysis of modern GVC-led production process, as it fails to deliver robust results (Deardorff 2005b). Similar conclusions can be applied to the analysis of a country-specific advantages with respect to hosting FDI. Modern production is contingent on multiple networks of intermediate inputs, business-specific constraints and circumstances. Moreover, extensive outsourcing of the parts of production narrows ownership exposure and competences of foreign investors and increases the importance of local intermediates (Dunning and Lundan 2008, 118). Therefore, the modeling of future profits is becoming increasingly complicated. The entanglement of these factors affects the demand-side, i.e. the propensity of an investor to invest, narrows down the range of possible investments, and ultimately deters potentially profitable investment.[36]

Neoclassical models, such as growth diagnostics, assume the existence of demand and focus on the supply-side bottlenecks that impede channeling of productive inputs. Removing such bottlenecks would result in growth acceleration. However, I argue that uncertainty associated with country-specific circumstances eliminates demand, i.e. commitment to invest, in the first place and thus deters potentially profitable investment. The absence of demand, in turn, leads to a low-level equilibrium problem. The discussion of this issue follows below.

4.2 Vicious Circle of Underperformance

The problem of commitment also arises with respect to human capital, workers have to commit themselves to training specific skills that, like physical capital, are potentially non-transferable (Chang and Andreoni 2020). Some skills can be easily moved from sector to sector, but workers inevitably lose productivity (or job perspectives), before new skills are not acquired. However,

[36] Econlife (2020) The impact of economic uncertainty on economic growth

hard skills are much less transferable across sectors.[37] This also correlates with the problem of the transfer of know-hows, as transfer and acquisition of knowledge is extremely challenging (Hausmann 2016).

Then how do countries improve their knowledge capacities? While education improvements are generally beneficial from multiple perspectives, still no kind of education provides skills that can be acquired only on-the-job. In fact, the breach between what can be learned 'at school' and in production is in a way perpetual. The major fault of the neoclassical approach is that human capital is considered as something exogenous to production (Andreoni 2014). However, human capital, as well as specific skills, are linked to the actual production process and are hardly transferable (Hausmann 2016, 13). Human capital is upgraded through production as learning itself is embedded in the production process (Andreoni 2014; Andreoni and Chang 2020). Thus, the absence of production corresponds to the absence of skills that at the same time cannot be acquired otherwise but in production. Even if the argument on inability to learn outside of the production is discarded, the problem arises at a different level: the deficit of skills, necessary for particular FDI, diverts the investment away from the country, which correspondingly *impedes* worker's *commitments to learning*. "Industrial competencies are demanded by industry, so if there is not industry, there is no demand, and thus no supply of competencies" (Baldwin 2013, 191). Absence of demand hinders the generation of supply in the first place, thus leading to a vicious circle of underperformance.

The mechanism of this problem is similar to the low-level equilibrium trap (or "poverty trap"). It is two-fold: first, lack of demand weakens the commitment to learn skills necessary (for instance, for manufacturing). Second, learning is impossible if separated from the production process, as tacit knowledge is hardly transferable (Hausmann 2016, 13).

This state of affairs impedes potential local investment in the development of human capital, as well as other types of investments, that as a result are channeled to less risky but also less growth-enhancing activities. The evaluation of the policies in education has also

[37] Publications Office of the European Union, (2011) Transferability of skills across economic sectors: role and importance for employment at European level, Luxembourg.

shown that a public investment in education systems, if not concurred with an upgrade in production, is not conducive to growth (see Hausmann 2015).

This theoretical framework can, in fact, be extrapolated to other activities and intermediate inputs as well. Some higher-order constraints, such as rule of law, government efficiency or political stability, also can be improved solely by doing – or following the analogy – in 'production'. For instance, it was found that integration into GVCs creates strong alliances that promote property rights protection in the host countries with weak institutions (Johns and Wellhausen 2016). Similarly to 'push' and 'pull' forces, economic demand for 'inputs' that are non-tradable in their nature, such as for instance good governance and rule of law, will generate political pressure for them and create alliances against vested interests. Overall, this kind of demand generates pressure for an upgrade in state capacity, a necessary condition of a successful economic policy (Evans 1995). Bruszt and Campos (2019) identify the mechanism through which political and business coalitions, created by integrational processes (induced by the EU), have positively impacted the building up of state capacities in Central and Eastern Europe. Economic development is also an upgrade in state capacities, that is done through experimentation and contestation, and generation of solutions to the challenges. It seems, however, that an intentional push should be made in order to get the countries out from low-level equilibrium of underperformance and upgrade the nexus of policy and economy.

This analysis shows that binding constraints or constraints that have a binding potential are not only supply-side bottlenecks, that can be easily treated, but they also undermine demand for investment. A lack of demand under uncertainty reinforces the vicious circle of underperformance. Therefore, development promotion strategies should ensure commitments for productive activities, but due to their neoclassical bias towards supply-side, they frequently fail to address this issue.

4.3 New Framework for Growth Acceleration: States with Markets

In order to augment the supply-side approach to economic development, manifested in growth diagnostics, and address the demand-side, I propose an analytic framework that describes a mechanism of a successful FDI attraction. This framework builds on the notions of reform sequence and policy space. Literature mainly analyzes FDI promotion through the lenses of information asymmetry and popularization of the potential host economy. However, this seems insufficient for the commencement of an accelerated structural transformation.

I argue that more active and even heterodox policies, like subsidizing technology and knowledge intensive FDI, can deliver greater outcomes in promoting FDI-led development, provided that FDI promotion is supported by reforms and linkage-creation within the host economy. Such FDI would play the role of an 'icebreaker.' It will send signals on profitability and stability of doing business in a host country and generate 'pull' and 'push' forces that can articulate latent demand on local intermediate products, services and inputs into market incentives. Overall, it should also create pressure for policy improvement. The framework is depicted in Figure 10.

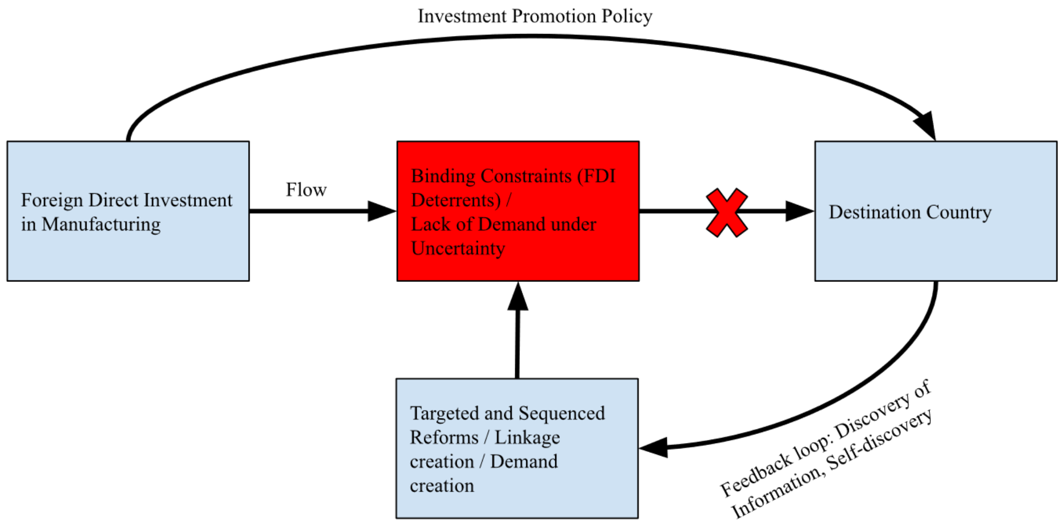


Figure 10. Stylized Mechanism of FDI-led Structural Transformation

According to the theory, FDI inflows are impeded by constraints that decline the profitability of the enterprise or have an adverse impact on appropriability. However, as I elaborate in Chapter 4, developing countries suffer from numerous dynamic constraints that create 'constraint complementarities' that deter investment not only by reducing its profitability or approabiability, but also by complicating a cost-benefit analysis to that extent, when the decision *not* to invest is the only possible outcome. This problem is conceptualized as a lack of demand under uncertainty, as it diverts a potentially profitable investment away from the country. The lack of quality FDI in turn triggers economic underperformance and impedes the implementation of growth-enhancing reforms. Improvements in regulatory burden and improvements in human capital or rule of law proved to be objectives of different levels of complexity. Lack of demand, lack of commitment to productivity-enhancing investments (both, investment in production and investment in learning) and lack of political pressure for better governance reinforce a vicious circle of underperformance.

The proposed framework addresses these issues by employing a notion of a feedback loop that represents a potential of self-discovery and encompasses the idea of sequencing the reforms. Such an approach allows to reap the benefits of the economies of scope and modularity. Promoting one investment not only creates upstream and downstream demand, but also increases the profitability in the adjacent industry. Unlike 'big push' models, this approach implies small and sequenced nudges – building blocks of economic modernization – that contribute to an upgrade in productive capabilities.

Product space analysis (Hidalgo et al. 2007), a rigorous method of identifying the network structures of product creation, seems to be a powerful tool that can enhance policymaking and help to avoid the common mistakes of hard industrial policies. Private-public partnership in the discovery of a 'comparative intermediate production advantages' (Baldwin and Lopez-Gonzalez 2015) is another source for growth acceleration and integration into GVCs.

Economic development and human capital are both modular in their nature, meaning that higher order capabilities are dependent on lower level capabilities. This approach potentially allows for kick-starting the economy and stimulating market forces through positive externalities of economies of scope and agglomeration (Dunning 1993, 594), that will reinforce the virtues circle of economic growth. Historical analysis shows that in all catch-up projects an activist government was a key to success (Storm 2017). But intentions to compensate for the embedded uncertainty of development and ensure investment commitments should nevertheless be complemented by high state capacity (Evans 1995). Otherwise it would be virtually impossible to avoid rent seeking and policy captures, that caused most of the developmental disasters (Studwell 2013). The next chapter tests this framework through the analysis of Georgia's investment promotion policy.

Chapter 5

Scrutinizing Georgia's FDI Promotion Policy

This chapter analyses the efficacy of investment promotion in Georgia. I focus on the role of national IPA, Enterprise Georgia. An evaluation of the IPA's quality plays a role of a *hoop test* (Collier 2011; Ricks and Liu 2018), which can affirm potential veracity of the framework for FDI attraction to developing economies, presented in Chapter 4. The logic behind this chapter's exploratory process tracing is the following: if the analysis reveals information that confirms the efficacy of Investment Promotion in Georgia, the above-mentioned framework fails, and the 'burden' of development shifts 'back' to the improvement of structural constraints and verifies the validity of supply-side approaches, e.g. growth diagnostics. If, however, the framework passes the hoop test, i.e. drawbacks in the functioning of IPA are identified, the veracity of a framework becomes somewhat more plausible, but it will still need further empirical confirmation.

Due to the scarcity of available data and an innate deficit of quantitative information about investment attraction projects, the primary source for evaluation is anecdotal evidence collected through 9 semi-structured interviews with experts and stakeholders conducted between May and July 2020. Interviews include: current heads of Investment promotion departments at Enterprise Georgia and Ministry of Economy, Kristine Meparishvili and Giorgi Edilashvili; head of Investors' council of Georgia and former Minister of Economy Giorgi Cherkezishvili; lead economist in EBRD and a former president of Tbilisi International School of Economics Eric Livny; and Aleksandre Papiashvili, director of international relations department at Georgian Chamber of Commerce and Industry with a particular experience in the FDI attraction. A full list of interviewees can be found in Appendix A.

These interviews give an illustrative answer to the trends of Georgia's investment promotion policy and its institutional organization. Interviews validate the finding presented in Chapters 3 and 4, and also provide an extended elaboration of challenges regarding a manufacturing-led economic growth. Several grave failures of the investment promotion were identified, such as institutional turmoil and serious understaffing, meaning that the mechanism of FDI attraction and structural transformation (Chapter 4.3) passed the hoop test. Information received during interviews was contextualized and where possible verified.

5.1 Overview of Georgian Investment Attraction Policy

In 2002, following a regional trend, a Legal Entity of Public Law (LEPL) national investment agency 'Invest in Georgia' was founded. However, a first active phase of FDI attraction started in 2005 with aggressive privatization that lasted until the middle of 2008. During this period major property, state-owned companies and infrastructure were privatized, however, without any conditionality on improvement, which seriously undermined developmental outcomes of privatization (Interview 11).

Nevertheless, the volume of FDI inflows had reached record highs during these years (see Figure 6). Significant changes of ownership also explain the spikes in TFP (see Figure 9). Improvements in business environment and new trade opportunities with the EU opened under GSP+ scheme in 2005 have spurred international investment in the real sector of the economy (Interview 1).

The Russian invasion of Georgia in 2008 severely undermined Georgia's aspirations of becoming a top destination for FDI. The Great Recession had also delayed a recovery. Given that major state-owned property was already privatized, a need for a new investment strategy became evident and the importance of national IPA started to grow (Interview 11). Previously, most of the investment negotiations were conducted at a higher political level or by the National Agency for State Property and Invest in Georgia's role was reduced to the organization of meetings and site visits. But starting from 2009, IPA began working on its international outreach and image-building. IPA began to target markets of interest, for instance Gulf states' markets, but, ignoring gravity models of FDI, it also targeted Western Europe and the USA (ibid). Overall investment promotion policy lacked consistency. The USAID report (2011, 14) characterized Georgia's investment promotion in that period as *ad hoc* and suggested that IPA had a limited mandate, small leverage in independent decision making and a "lack of high-level political support". The problems, which, I found, are still persistent. Georgia's IPA had changed its position in institutional hierarchy several times. A summary of the changes is presented below.

Table 1. Invest in Georgia's Institutional Reshuffling between 2002 – Present

LEPL subordinated to the Supervision of the Ministry of Economy and Sustainable development	LEPL subordinated to JSC Partnership Fund, a state-owned investment fund	LEPL subordinated to the Prime Minister of Georgia	Part of LEPL Enterprise Georgia
2002 – 2012	2012 – 2015	2015 – 2017	2017 – Present

As Papiashvili noted, working under the PM's direct supervision had substantially improved IPA's efficiency, as it came with greater leverage – "acting on behalf of the Prime Minister" – for conducting negotiations with foreign investors and eased the coordination with other state agencies (Interview 11). 2014 – 2016 were characterized by stable and high FDI inflows (see Figure 6). Considering favouring macroeconomic conditions and a positive impact of DCFTA, the success of this period can also be attributed to the improvement in IPA quality and sectoral targeting. Business process outsourcing, a new direction for efficiency-seeking service FDI, became IPA's priority and created more than 3500 jobs in the following years (Interviews 8, 9).

In 2017, Georgia experienced a significant drop in FDI, but, as was explained in Chapter 2.2, large shares of reinvested profits cushioned the decline. Between 2018 – 2019, the trend continued: a growing share of reinvested profits in FDI[38] meant that new investment projects stopped flowing to Georgia.[39] The decline was paralleled by a merger of Invest in Georgia and Enterprise Georgia. Interviewees have evaluated the rationale behind the merger differently (Interviews 5, 7, 9), but with one accord noted the immediate negative effects on its capacity (Interviews 5, 8, 9). A decline in FDI became evident and bore high political costs. This led the government to re-evaluate its approach (and probably put pro-active FDI promotion back on the agenda). A new 'Investment Attraction Strategy 2020 – 2021' was presented in December 2019. The Strategy[40] summaries IPA's future plans and deliverables. It also gives grounds for interesting inferences, as it reveals some implied failures of the Georgia's investment promotion policy.[41]

5.2 Identified Problems

The Strategy acknowledges the lack of efficiency-seeking FDI as a major challenge and puts benchmarks for 2020 – 2021 action plan. These benchmarks, however, represent some basic requirements of a successful investment promotion: such as, for instance, "identifying 450 potential investor companies, increasing the number of employees in the Investment Promotion Department to 10, improving the quality of a LinkedIn page, and acquiring access to international databases". This suggests that the 2017 merger had significantly worsened the functioning of the IPA. Interviewees have confirmed this conclusion and identified some other problems that had hampered FDI promotion policy. I organize the findings in three main groups: policy consistency and institutional stability, international outreach, and political and financial leverage.

[38] Geostat
[39] As of now FDI in Georgia is at record lows.
[40] Received from Enterprise Georgia.
[41] Of note is that it is the first official strategy of FDI attraction. Previously, IPA's activities were governed by smaller (but of similar content) internal documents (Interviewee 8, 9) that are not available publicly.

Policy Consistency and Institutional Stability

According to Skhiereli, Invest in Georgia (currently a department of Investment Promotion in Enterprise Georgia) has been experiencing a relatively high employee turnover and a chronic understaffing (Interview 2). As a result, the capacity building proved to be difficult (Interview 5). After the 2017 merger, IPA's budget was sequestered and only four investment specialists continued working in Enterprise Georgia. At some point after the merger the foreign investment desk – approximately for one year – was reduced to only two (*sic!*) specialists (Interviews 8, 9). Several respondents hinted that the merger was politically motivated. At any event, it had even negatively affected the quality of a website maintenance (Interview 9), another predictor of the IPA's efficiency (Harding and Javorcik 2012).

Apart from this narrow institutional instability, frequent changes in the Ministry of Economy[42] has also been negatively affecting the functioning of IPA (Interview 8). Papiashvili notes that IPA's mandate is too dependent on political support and recalls how the agency' efficiency grew, when the investment promotion was backed by the higher-level politicians, and declined, when it was neglected. A current head of investment promotion at 'Enterprise Georgia' Meparishvili explained that understaffing was a serious problem that hindered a greater outreach. She notes that the number of employees should be at least doubled in order to achieve any significant change the efficacy of investment promotion (Interview 8). While acknowledging that the size of an agency is not directly proportional to its efficacy, a comparison of 'Enterprise Georgia' with two hierarchically equal LEPLs can shed some light on this issue. Table 2 compares the number of staff members in IPA and Tourism Administration and Wine Agency.

Table 2. Number of Employees in Selected State Agencies

Investment Promotion Department, Enterprise Georgia	Georgian National Tourism Administration	Georgian National Wine Agency
10 specialists out of 48 employees in total	85 employees	81 employees

[42] From 2014 to the present the Ministry of Economy was reshuffled seven times.

Such distribution of state priorities can potentially be explained by a public choice theory: Georgia has a revealed comparative advantage in hospitality and in wine production and it is much easier to derive political dividends from success stories, whereas pushing a long-term development agenda and overcoming structural constraints is usually much less rewarding for the politicians focus on short-term re-election cycles. Overall, narrow and broader institutional instability hampers FDI attraction, as the MNE decision-making process spans over the years (Interview 8).

International Outreach

Scholarship identifies that IPA's foreign desks have a positive impact on its ability to increase FDI inflows (Lim 2008; Volpe and Sztajerowska 2019). However, a former Minister of Economy Cherkezishvili notes that in Georgia's case international outreach has been minimal (Interview 5). In order to improve this limitation, the position of Commercial Attaché was created in Georgian diplomatic service in the end of 2016. The importance of embassies in FDI attraction is widely recognized (Moons and Bergeijk 2011; Pajtinka 2016) and commercial attachés, subordinated to the Minister of Economy but assigned to Georgia's diplomatic missions, were supposed to strengthen the embassies in export promotion and FDI attraction. In July 2017 the then Minister of Economy, now Prime Minister Gakharia officially endorsed the project and announced first six target markets. However, the contest for the positions was announced only in March 2018, but eventually had never been filled (Factcheck 2019). Thus, the inefficiency of state agencies over commercial attachés has led to nearly four years of stalemate.

Georgia's ability to attract FDI is still seriously undermined as most embassies have a limited capacity to improve their performance with respect to FDI attraction (Interview 5). Anecdotal evidence collected for this research suggests that the Commercial Attachés' project was obstructed by an interagency competition between the Ministry of Economy and the Ministry of Foreign Affairs.[43]

Political and Financial Leverage

FDI attraction is supported by effective coordination within state agencies, however, as respondents 6 and 9 claim, coordination has been rather ineffective. For instance, IPA has had limited leverage on decisions of the National Agency for State Property and thus was losing potential investors (Interview 9).

At the same time, IPA lacks financial resources to incentivize investors (Interview 8). It is getting increasingly hard to compete for investment as many more countries start providing an investment friendly environment (Interview 1, 8). Anonyms interviewee noted that public-private partnership potential is underutilized, not least due to the problem that investors decline the investment opportunity in Georgia already at the initial phase of decision-making (Interview 3). This confirms that the *lack of demand under uncertainty* has a tremendous negative impact on the potential of developing countries to attract FDI.

As this research found out, Georgian IPA has constrained finances and lacks budgets to implement efficiency-enhancing approaches. For instance, IPA does not collect data on FDI and relies on Geostat.[44] Access to international databases until recently also used to be a problem (Interview 8). Despite the high-value proposition of Georgia's business environment, Georgia frequently was not included even in the long lists of potential host countries of FDIs, as many databases that were used by location advisors and international consultancies contained minimal or sometimes faulty information about the costs of doing business in Georgia (ibid). This analysis sheds light on problems faced by the Georgia's IPA. Its

[43] On July 17th, 2020 Georgian Parliament has revoked the position of a commercial attaché and introduced a position of Counsellor for Economic Affairs appointed by and accounted to the Ministry of Foreign Affairs (BMG 2020).
[44] Of note is the fact that GeoStat collects very limited data on FDI. For instance, important data on greenfield FDI is absent.

functioning is characterized by frequent turmoil, but the new Strategy[45] lays a solid foundation for institutional sustainability and future effectiveness.

5.3 Human Capital as FDI Deterrent and Manufacturing Potential of Georgia

Interviewees confirm that human capital has become a binding constraint (Interview 7, 8, 9). A number of state programs have been employed to counter the situation. However, their effectiveness has been evaluated very differently. Such difference in the evaluation might derive from the fact that the programs are evaluated from two perspectives: from a policy perspective and from a results perspective, that are either minimal or still lagging. Interviewee 6, a director of a VET program, emphasized that the education system can only provide skills that are required on the market. This confirms the elaboration on the demand on skills presented in Chapter 4. Hence VET programs train skills that are necessary for the hospitality sector, retail or customer relations. Interviewees 7 and 9 note that Georgia does not have resources for cheap massive production, therefore that cannot be a driver for investment, instead, Georgia should be focused on quality. It still proved to be challenging to jump out of a vicious circle of underperformance (Interview 7, 8).

Respondents have noted some challenges of manufacturing-led growth in Georgia that so far were underestimated in this thesis. Overall economic openness and FTAs have significantly increased Georgia's potential to attract export-oriented manufacturing FDI. But manufacturing investment flew solely to the industries with a revealed comparative advantage. For instance, GSP+ preferences turned out to be a necessary condition for efficiency-seeking FDI in the production of ferroalloys[46] or steel and nitrogen fertilizer plants in Rustavi, that were historically linked to resources of the Caspian basin through a soviet-era railroad and a pipeline (Interview 1). DCFTA and FTA with China have induced diversification of Georgia’s exports

[45] As one of the interviewees noted, the Strategy was created and confirmed publicly also in order empower the institution and ensure its stability against potential future turmoil (Interview 8).
[46] Georgia has significant manganese ore reserves, necessary for production of ferroalloys.

from both product diversity and destination diversity perspectives (Interview 4) and spurred FDI in the production of *final goods* in Georgian Free Industrial Zones (FIZ). For instance, German *AE Solar* Panel Plant and French producer of heaters, *Atlantic Georgia,* opened their factories in Georgia to enjoy preferential access to the European market, cheap labour costs and FIZ benefits (Interview 7). But Georgia has a low starting position with regards to integration in GVCs through the production of *intermediate goods*.

Georgia is neither labour abundant, nor resources rich and this implies that the potential to produce resource-intensive or labour-intensive intermediates is low. Therefore, the value-added margin in such case would be razor-thin (see Babych et al. 2019). The problem is further aggravated by stringent RoO rules and competing regional organizations that disintegrate the South Caucasus and eliminate any opportunity for diagonal cumulation. "Debates about sectoral priorities arise every other year" (Interview 8) and it seems that these structural constraints inevitably push economic agenda from manufacturing towards a service-led development model.

5.4 Synopsis

This chapter gave an illustrative answer to the challenges of foreign investment promotion in Georgia. Respondents have confirmed the findings presented in Chapter 4. Reforms in the business environment and trade liberalization, achieved through FTAs, have had a significant positive impact on the economy and FDI attraction. But overall, it can be inferred that Georgia's potential for FDI attraction, after the initial ease stage, has become exhausted, as FDI has acquired the majority of enterprises with a revealed comparative advantage. Diminishing developmental returns are hard to operationalize, but it seems that a problem will soon become evident. The sustainability of Georgia's initial economic success is under question, as human capital constraint becomes more and more binding.

This chapter has revealed some grave failures and inefficacy of national IPA, that were induced by the lack of political support and a concurrent institutional turmoil. Georgia's IPA fails on all three predictors of effectiveness (Lim 2008): age (Georgia's IPA has been operating for eighteen years already, but it lacks institutional memory due to frequent staff transitions); overseas staff intensity (failures to assign six commercial attachés is a striking example of government inefficiency) and a number of employees (eighteen years later after its foundation Georgia's IPA has a staff of only 10 investment specialists). Respondents have also identified a persistent lack of higher-level political support. For comparison, a major engine of Irish economic transformation, Industrial Development Agency (IDA), which in 1969 was transformed into a national IPA, just in a couple of months after the reform boasted with six overseas offices and 230 employees.[47] By 1984, it was "probably the most powerful governmental agency in Ireland. It acts as both coordinator and lobbyist for all matters relating to manufacturing and service industries as well as the industrial infrastructure ... If the I.D.A. supports a particular investment, other officials rarely withhold their approval or consent" (Fanning 1984 as cited in Barry and Fathartaigh 2015, 460).

Interviews have shown that information regarding the best investment promotion practices is diffused, however, the problem arises at the implementation stage, which is to a great extent dependent on the quality of higher-level statesmanship. This research shows that the capacity of the civil service is underutilized. Collected evidence suggests that there is significant room for improvement, mainly through empowerment of the national IPA.

Georgia's economic policy has had a substantial positive impact but has not proved to be sufficient for turning Georgia into a full-scale international export platform. Efficiency-seeking FDI has been flowing only into the companies with revealed comparative advantages. But isn't economic development precisely a movement towards new areas of competitiveness? For that reason, this chapter also makes a case for more active and heterodox investment promotion along the lines of the framework presented in Chapter 5.

[47] IDA Ireland 2019 "Marking 70 Years of IDA Ireland."

Conclusion

This research overviewed possible constraints of FDI attraction to Georgia. While most studies employ neoclassical growth models and mainly focus on the structural deterrents of FDI, this research identifies the problem of the demand under uncertainty as a potential deterrent of FDI. The contribution of this research is that it analyses the role of the agency, i.e. state, as a determinant of the FDI volume and quality. To this, I propose an analytical framework that explains why a state-led pro-active investment promotion is necessary for overcoming the 'demand-side' problem and kick-starting economic development. I test my hypothesis by evaluating the quality of state investment promotion policy and find that it lacks efficacy. Therefore, the contribution of this research is two-fold. Firstly, it explains the mechanism of FDI-led development and shows that the volume of quality FDI to Georgia has not been high, and thereby Georgia's structural transformation and GVC integration are characterized by low speed. Secondly, it proposes a novel framework for an analysis of FDI attraction and applies it to the Georgian case.

The novelty of this thesis is that it puts the role of an agency to the forefront. It is argued that existing explanations for the deficit of a quality FDI fail to identify the transformative role of state-led active investment promotion. I argue that FDI promotion not only mitigates countries' structural deficiencies and ensures commitment for investment but is also the necessary condition for achieving and sustaining the improvements of the institutional and business environment.

This research was challenged by the lack of readily available quantitative data, however existing statistical information was sufficient to identify major failures of Georgia's investment promotion. Role of the higher-level political leadership needs further examination, as it not only plays a significant direct role in the FDI attraction, but also ensures that the capabilities of the civil service would be fulfilled. Current latent political crisis, that has been unfolding since the beginning of 2019, badly affected Georgia's international reputation and revealed serious drawbacks in governance. Such deterioration of first-order institutional conditions confirms the argument regarding 'push' and 'pull' forces in the economy that create demand for political transformation towards good governance. Considering Georgia's diminishing potential for investment attraction, such problems would further aggravate its investment attractiveness. Nevertheless, arguments regarding the transformative role of the state would still remain valid.

This thesis focuses mainly on the problems associated with FDI attraction. However, it does not discuss how countries upgrade their national economies and climb up the value chains. It can be suggested, though, that the same type of policies that enable countries to attract quality FDI in the first place, would potentially enable them to climb up on the value chain. It is argued, however, that FDI-led economic development is the only viable option for catching-up. Again, development is contingent on country-specific factors, and is not a single stop process, and deserves greater inquiry.

A closer look at the problems associated with the enforcement of free trade agreements and RoO is necessary. RoO are especially interesting in the case of Georgia as the region is divided between competing trading centers, and deriving legal incompatibilities narrow the space of economic cooperation within the South Caucasus. In fact, the idea that developmental outcomes are rather a function of legal structures than the economy *per se* seems to be a plausible extension of the research.

Afterword

This thesis might suffer from a partiality towards the role of an agency in development promotion. Duncan Green, a professor in practice at LSE, wittily noted that "often a person's views about poverty and development are shaped by the first region of the developing world that he or she gets to know".[48] My first significant exposure to the topic were studies on the economic history of the Asian tigers, and thus state-led augmentation of market forces seems to be the wanted "Golden Fleece" of economic development. Skepticism towards the possibility of good governance is outbid by the appreciation of a classical republican idea of a state as a most ambitious project of common living, where virtues of its citizens made great achievements of civilization possible. An implicit tendency towards larger discretion with respect to economic policies is comparable to the reflections upon the benefits of judicial law-making when qualified judges overturn the rigidity of a one-size-fits-all approach and amend framework rules that are at risk of delivering outcomes opposite to fair and optimal. Needless to say, such an approach carries with it tremendous risks.

This thesis perceives the virtue of development as an increase in complexity and diversity of skills and thus inclined towards – what is known in political philosophy as – perfectionism, as the ability to competitively produce complex objects seems to be innately good and an aim to aspire to. This intuition reveals perhaps a greater difference of this thesis' perspective.

It seems the 'logical' direction of development thought needs to be turned from *development due to* to *development in spite of*. Underdevelopment seems to be a 'feature' of the global economy and not a 'bug', hence the notion of binding constraints is somewhat

[48] The economist (2020) "Listening to the Voices of the Hungry."

misleading, as ‘underperformance’ is a global norm. Therefore, the contradictions that arise between theory and empirics can be attributed to the basic misunderstanding of the development process. Modernization is not a spontaneous process, and there is never an optimal economic environment for a take-off, therefore all developmental catch-ups involve an explicit intention to transform and an active and purposeful policy, a continuous and constant effort to achieve excellence. A solely rules-based approach, which implies a very general or no understanding of the developmental objective, innately fails to deliver. The exact objectives, though, ought to lie within individual freedoms and entrepreneurship but unless the society acquires versatile productive capabilities, the entrepreneurial will most likely will be channeled to less sophisticated activities, thus undermining future economic performance.

Appendix A: List of Interviews

Interviewee 1. 2020 Personal Interview with Eric Livny, Regional Lead Economist, Central Asia - European Bank for Reconstruction and Development, May

Interviewee 2. 2020. Personal Interview with Mikheil Skhiereli, Associated Consultant in Governance, Innovation and Investment Policy at Policy and Management Consulting Group, May

Interviewee 3. 2020. Personal Interview with a Senior Economic Adviser (Anonymous), June

Interviewee 4. 2020. Personal Interview with Giorgi Chitadze, Deputy Director General at Georgian Accreditation Center, 2016 – 2018 Head of trade negotiation and DCFTA implementation coordination division at the Ministry of Economy of Georgia, June

Interviewee 5. 2020. Personal Interview with Giorgi Cherkezishvili, Head of Secretariat at Investors Council of Georgia, former Minister of Economy, July

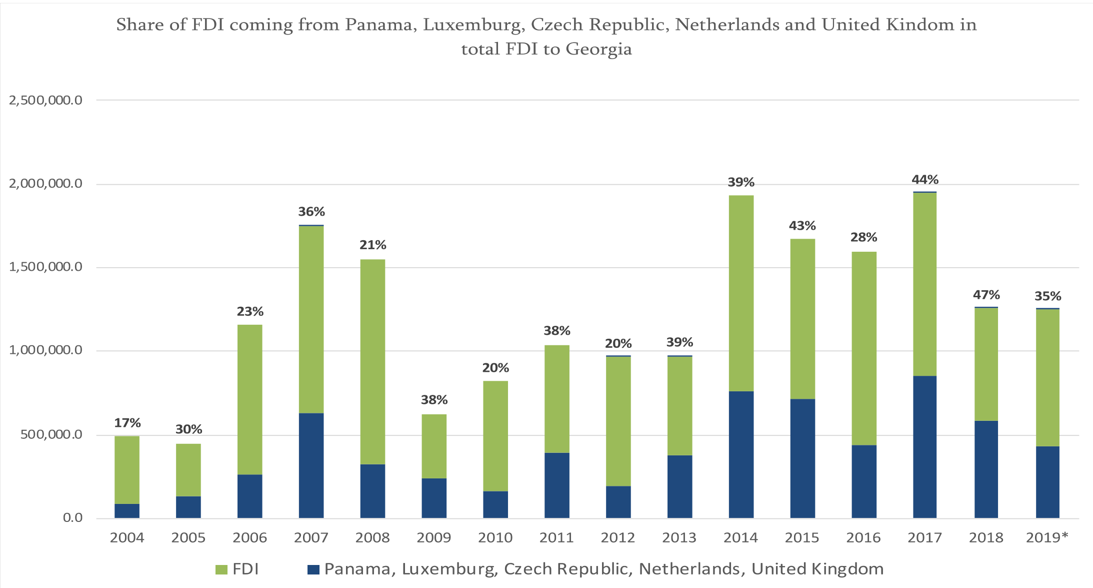
Interviewee 6. 2020 Personal Interview with Irina Tserodze, Head of the Technical and Vocational Education and Training Department at the Ministry of Education and Science of Georgia, July

Interviewee 7. 2020 Personal Interview with Giorgi Edilashvili, Head of Investment policy and support department at the Ministry of Economy and Sustainable Development of Georgia, July

Interviewee 8. 2020 Personal Interview with Kristine Meparishvili, Head of Investment Support Department at Enterprise Georgia, July

Interviewee 9. 2020 Personal Interview with Aleksandre Papiashvili, Director of International Relations and Project Management Department at Georgian Chamber of Commerce & Industry, July

Appendix B



Share of FDI coming from five allegedly offshore jurisdictions to Georgia
Source: Own Elaboration based on Geostat

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