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Do Economic Linkages through FDI Lead to Institutional Change? Assessing Outcomes in Kazakhstan, Azerbaijan, and Kyrgyzstan

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Abstract

Foreign Direct Investment (FDI) can deliver benefits beyond the provision of capital, such as efficiency gains. We argue that the theorised positive effects of economic linkage are reduced when linkages are based on natural resources. Domestic elite coalitions supporting reform are also weaker in countries with extensive natural resources. Kazakhstan and Azerbaijan have high-value natural resources and significant FDI, making them most likely cases for reform. Kyrgyzstan is a contrasting case as it has few natural resources. We find that the institutional reforms we would anticipate because of linkages have not occurred and those that exist are often cosmetic.

FOREIGN DIRECT INVESTMENT (FDI) IS AN IMPORTANT SOURCE OF CAPITAL IN states that have limited private and public resources. Over the past few decades, it has become apparent that FDI delivers benefits beyond just the provision of capital. FDI has been tied to constructive institutional change, efficiency gains, human capital development, and even democratisation in recipient countries (Asiedu & Lien 2011; Campos and Kinoshita 2010: Demir 2016; Johns & Wellhausen 2016). These positive benefits of FDI come through the linkages to international companies, processes, external organisations and institutions that accompany FDI. Linkages tie international corporations to local companies and actors through procurement, employment opportunities, and regulatory mechanisms. Economic linkages also give international corporations leverage over domestic actors to push changes in law and institutions that can promote a more transparent and business-friendly environment. The effects and limits of these economic linkages are the focus of our article. This question appears to be pertinent as FDI from the West is currently declining while that from other sources, including China, is projected to increase. Understanding the political effects of FDI and the specific mechanisms by which they occur may help us to understand the broader political impacts of changing investor profiles.

In order to trace the role of economic linkages in institutional change we examine three post-Soviet states: Kazakhstan, Kyrgyzstan and Azerbaijan. All three states experienced the challenges of postcommunist economic reform and state-building. Furthermore, these three countries were all closed to foreign investment before 1991, then dependent on it for economic growth and development post-1991. Kazakhstan and Azerbaijan are upper-middle-income economies with valuable oil and natural gas resources seeking to increase FDI and expand its role beyond the extractive industry. They have made institutional changes to create a business environment that is transparent and friendly to foreign investment. Despite these institutional changes, both states have had limited growth in the FDI they receive outside the extractive sector. Kyrgyzstan provides an important contrast to Kazakhstan and Azerbaijan, as it is a poor country with no significant energy resources. Kyrgyzstan has adopted fewer institutional reforms to attract foreign investment than Kazakhstan and Azerbaijan and has lower levels of foreign investment.

In this article, we argue that the type of linkage and the domestic response influences its effect. We draw on insights from the ‘resource curse’ literature and from Levitsky and Way (2010) to detail the specific mechanisms by which natural resources distort economic incentives for reform. The majority of economic linkages in Kazakhstan and Azerbaijan revolve around natural resources, which by their nature mitigate the positive effects of the linkage. In contrast, Kyrgyzstan’s fewer linkages are more diverse, involving international development assistance, military leases, and investment in natural resources. This article provides a new lens for looking at institutional effectiveness by noting that high-value natural resources limit the leverage provided by economic ties even in high linkage environments. We show the mechanisms by which elites are able to subvert what appear to be significant positive institutional changes.

The economic literature on the ‘resource curse’ suggests that high-value natural resources negatively affect a country’s GDP growth (Auty 1993; Sachs & Warner 1995; Leite & Weidmann 1999). However, there is a lack of scholarly agreement on this issue, with more recent studies arguing that the perceived GDP impacts are a diversion or simply too reductionist (Rosser 2006; Brunnschweiler & Bulte 2008). Analysis of the ‘resource curse’ by political scientists has focused on the specific ways in which high-value natural resources weaken state institutions (Shafer 1994; Karl 1997) or empower certain sectors or groups, often by fuelling civil wars (Collier & Hoeffler 1998; Ballantine 2003; Fearon 2004). In the economic literature, the dependent variable is GDP growth; by contrast, in political science literature on the 'resource curse' the dependent variable is often institutional strength. Our work engages with 'resource curse' literature indirectly through the examination of the dependent variable of institutional effectiveness. Our key independent variable is foreign investment in natural resources rather than the mere presence of natural resources. We argue that the desire for FDI should correlate with institutional effectiveness in two ways: first, FDI is a vector for institutional reform through linkages with the West; second, states seeking more FDI will improve their legal and regulatory environments. The need to attract foreign investors, who have a variety of options for where to invest, is an incentive to adopt potentially difficult institutional reforms. However, when a country has abundant high-value natural resources, multinational corporations will invest even when states fail to adopt desired reforms. Despite pressure from international institutions, 'Substantial reforms in the institutional structure of resource-rich countries are rare' (Öge 2014, p. 1482). Indeed, some scholars have argued that the lack of accountability in non-democracies may actually serve as an incentive for FDI (Asiedu & Lien 2011).

We examine the mechanisms by which natural resources distort the effects of economic linkages. We focus most intently on Kazakhstan, but also incorporate the Azerbaijani and Kyrgyzstani cases for comparison. The exposure to foreign best practices and rules through economic linkages, combined with the leverage of large multinational corporations, means that Kazakhstan and Azerbaijan are most likely to reform. Kyrgyzstan forms an important contrast as it has received significantly less foreign investment and lacks energy resources. Our particular examination of Kazakhstan is justified by its significant efforts to cultivate external linkages in multiple spheres and its increasing FDI over time. We find that despite strong economic linkages, the domestic reforms anticipated in these countries have been slow in coming and those that exist are often cosmetic.

Linkage, natural resources, and elites

The degree of international pressure on institutional reform reflects not only the strength of the linkages with the West but also the type of linkage and domestic support for reform. Linkage is 'the density of ties (economic, political, diplomatic, social, and organisational) and cross-border flows (of capital, goods and services, people, and information)' between a country and the 'West' (Levitsky & Way 2010, p. 43). While this definition may appear to be too broad, Levitsky and Way argue that the extent of linkage with the West has highly influenced the prospects for democratisation in competitive authoritarian regimes, namely those that combine elements of democracy and authoritarianism. The broad definition of linkage allows the consideration of all the potential ties between competitive authoritarian regimes and the West. There is a variety of types of linkage, including economic, intergovernmental, and information. Economic linkage involves the flow of trade and investment between a country and the United States and the European Union. In this article, we focus only on the investment side of economic linkage. Intergovernmental linkage involves membership in international organisations, such as Kazakhstan's membership in the Organisation for Security and Cooperation in Europe (OSCE) and the World Trade Organization (WTO). Information linkages, or the spread of ideas across borders, are strongly influenced by the degree of internet freedom and penetration. Levitsky and Way argue that all of these types of linkage have a 'powerful impact on actors' interests, incentives, and capabilities' and thereby help to support democratisation (Levitsky & Way 2010, p. 45).

We adapt the Levitsky and Way argument in this article to focus on the role of linkage on institutional effectiveness. If linkage serves to bring about a major change, such as democratisation, then it should also influence actors' interests, incentives and capabilities regarding other institutional reforms. Building on Levitsky and Way, economic linkages, especially the need for FDI, should increase the cost of failing to adopt international policies and procedures for investment and should help develop domestic constituencies for reform (Levitsky & Way 2010, p. 44). A potential cost for failing to adopt international standards would be low levels of foreign investment, reducing economic growth and endangering regime survival. Using the approach of Levitsky and Way should give us insight into the specific mechanisms by which the 'resource curse' can play out in countries with high-value natural resources. Other studies, such as those of Demir (2016) and Doytch, Mendoza and Siriban (2015), have examined the impact of linkages but not identified the transmission mechanisms *via* a micro-analysis to show how FDI is tied to institutional effects.

Given the competition to attract foreign investment, countries have powerful incentives to adopt international standards supported by the World Bank and favoured by foreign companies (Johns & Wellhausen 2016). However, the cases of Kazakhstan and Azerbaijan suggest that linkage does not always function as predicted by theory. Economic linkage based on investment in natural resources has limited effect on reform because investors are willing to accept unfavourable conditions when investing in natural resources (Asiedu & Lien 2011). International oil companies are willing to engage in 'commerce under anarchy' and even risk governments seizing property if returns from the investment are high enough (Johns & Wellhausen 2016, pp. 32–33). The investment of international oil companies in countries that lack the rule of law, have high levels of corruption, and suffer from poor governance, such as Nigeria, Angola, and Chad, supports this conclusion. In addition, multinational companies (MNC) may have less leverage once they invest in a country. Given the significant capital investments MNCs need to make when extracting natural resources, they are less willing to pull out of a country if the government reneges on agreements (Partlett 2010, p. 76), reducing their overall leverage for change. Not all economic linkages are equal; the type and form of the linkage strongly influences its effects. Rentier states—those that are dependent on natural resources rather than taxation for state revenue—are more resistant to the linkage effect. Additionally, linkages with other authoritarian states, such as Russia and China, do not bring the same sort of positive impact on institutional effectiveness (Demir 2016).

When governments with no natural resources need to attract foreign investment, there are strong incentives for elites to adopt investment-friendly reforms, such as greater transparency and support for property rights. For example, in Slovakia the importance of EU membership for attracting foreign investment increased the support for reform among elites during the undemocratic rule of Prime Minister Vladimir Mečiar and was instrumental in leveraging democratic institutional change in 1998 (Vanderhill 2014). Even after being granted EU candidate status, the Slovak government pursued investment-friendly policies, such as introducing a corporate tax rate of 19% in 2003, one of the lowest rates in Europe.[1] Attracting FDI was so important to the Slovak economy that the combination of economic linkage, EU leverage, and domestic support for reform brought about institutional change under both illiberal and democratic governments.

By contrast, when the economy and foreign investment are based on natural resources, there is likely to be less support for reform. Successful institutional reform requires linkage, leverage, and domestic support for reform, especially among elites (Levitsky & Way 2010). Domestic elites are 'gatekeepers' who shape, restrict or encourage linkages with external actors (Tolstrup 2014, p. 127). Natural resource-based economies typically produce societies in which wealth is concentrated in the hands of a relatively small elite. In these states, leaders are often able to maintain essential elite support because they control access to economic wealth; therefore, making any defections from the regime or challenges to the status quo costly for elites (Levitsky & Way 2010, pp. 66–7). Regimes with high levels of elite support are usually able to resist external pressures to reform (Brownlee 2007; Levitsky & Way 2010).

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[1] *Tax Policy Reforms in the Slovak Republic*, *OECD*, no date, available at: https://www.oecd.org/tax/tax-policy/37154700.pdf, accessed 24 February 2019.

Below, we show the specific mechanisms by which states subvert the impact of linkages. Part of that story is the influence of 'gatekeeper' political elites who actively negotiate linkages with the West, pursuing those that strengthen their positions and assist them in maintaining power, while avoiding others that might leverage reform (Tolstrup 2014, p. 129). In contrast to Levitsky and Way's argument that sees linkages helping produce domestic reform coalitions, we argue that political elites manage linkages to obtain the benefits of engaging with the global economy while hindering real reform.

Western linkages with Kazakhstan, Azerbaijan, and Kyrgyzstan

Since the establishment of an independent, modern state in 1991, the government of Kazakhstan has sought to establish linkages with the West. Kazakhstan stands out from its Central Asian neighbours through its active engagement regionally and globally. Along with seeking linkages with the West, the Kazakhstani government has actively pursued multivector diplomacy and membership in intergovernmental organisations (Kaliyeva 2011). President Nursultan A. Nazarbaev has promoted positive relations with Kazakhstan's powerful neighbours, China and Russia, as well as with the United States and European Union (Kaliyeva 1997). According to 'Kazakhstan 2050 Strategy': '[Kazakhstan's] balanced foreign policy means [it is] developing friendly and predictable relations with all states and playing a significant role in the global agenda that represents the interests of all Kazakhstan' (Nazarbaev 2012). In 1994 Kazakhstan established a Partnership and Cooperation Agreement with the European Union, hoping to develop closer economic and political ties with Europe.[2] In 2010 Kazakhstan became the first state in the region to hold the rotating chair of the OSCE and in 2015, joined the WTO as the 162nd member (Albanov 2015.[3] Kazakhstan's active memberships of the OSCE and the WTO demonstrate government support for intergovernmental linkages. However, the most significant area of linkage for Kazakhstan is economic.

Kazakhstan has taken active strategic steps to attract foreign investment. In 2003 Kazakhstan received $US5 billion in gross inflows; by 2012 that had increased to $22.5 billion.[4] Kazakhstan has the largest oil reserves in the

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[2] *EU-Kazakhstan Relations*, 2017, available at: https://eeas.europa.eu/headquarters/headquarters-homepage_en/4076/EU-Kazakhstan%20relations, accessed 24 February 2019.

[3] *Former OSCE Chairpersons-in-Office, OSCE*, 2019, available at: https://www.osce.org/chairmanship/former-chairpersons-in-office, accessed 21 February 2019.

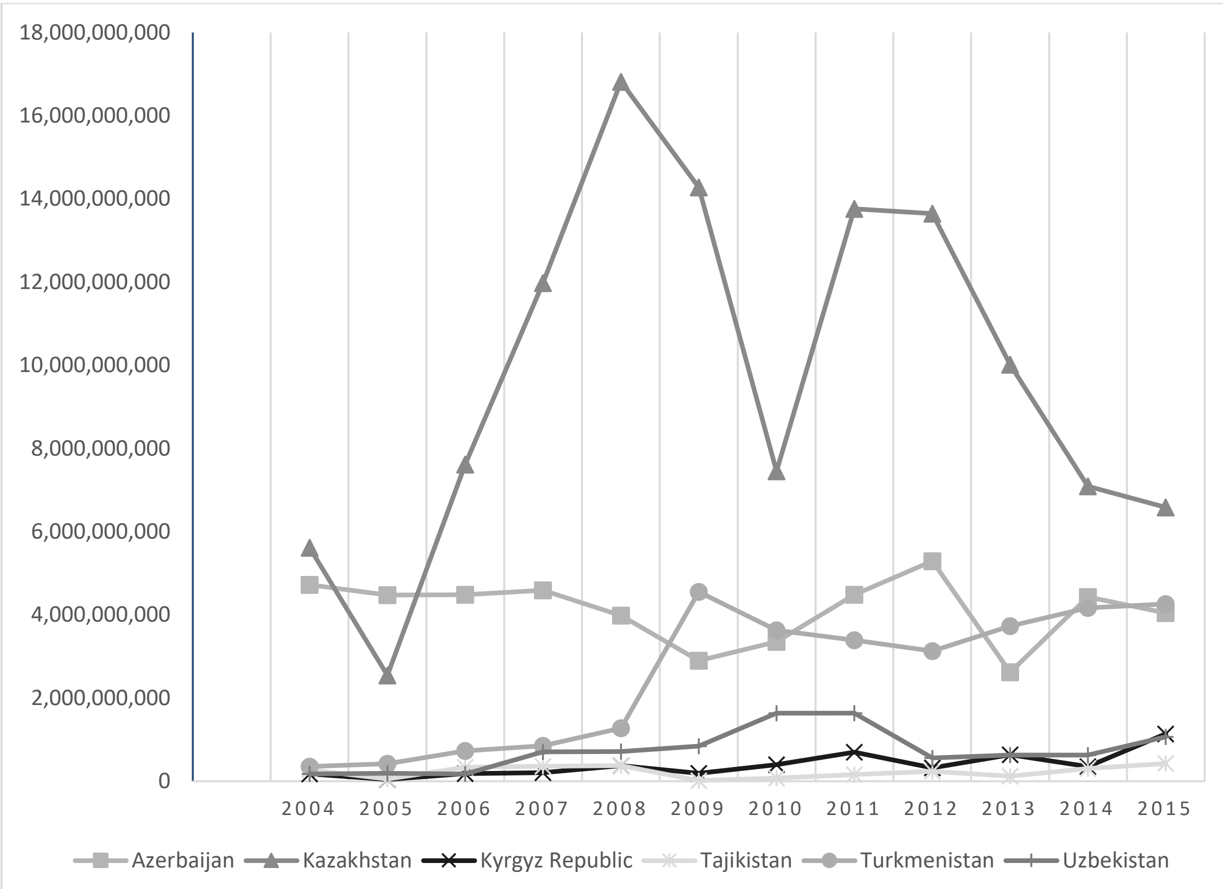
[4] *Multi-dimensional Review of Kazakhstan: Volume 1. Initial Assessment*, *OECD Development Pathways*, 2016, available at: http://dx.doi.org/10.1787/9789264246768-en, accessed 4 January 2018.

region, estimated by British Petroleum at 30 billion barrels (Kosolapova 2016). Research on what determines foreign investment in postcommunist states has found that the presence of natural resources is one of the most important factors (Deichmann *et al*. 2003). This is the case with Kazakhstan, as its oil and gas resources are the main drivers of FDI, although declining as a percentage of overall foreign investment: 'The share of inflows of FDI into activities related to natural resources stood at around 50–60% in Kazakhstan over 2010–14, down from 70–80% before the global economic downturn in 2008.'[5] The main investors in Kazakhstan's natural resources are major global energy companies, including Royal Dutch Shell (The Netherlands and UK), Gazprom (Russia), British Gas (UK), Chevron (US), the Chinese National Petroleum Company (China), and Mobil (US).

Kazakhstan's government aspires to convert its economic success into worldwide recognition of its role as an important regional actor, reliable diplomatic partner and model multi-ethnic society. In his 2012 address to the nation, President Nazarbaev announced: 'Kazakhstan must become the regional magnet for investment. Our country must become the most attractive place in Eurasia for investments and technology transfer. This is crucially important. To do this we must demonstrate to investors our advantages' (Nazarbaev 2012). At first glance, Kazakhstan has been extraordinarily successful in its ability to obtain FDI. Many other countries aspire to this sort of investment portfolio. The Kazakhstani government's ambitious future plans are dependent on more, and diversified, foreign investment in terms of recipient sector and country of origin. So far, however, Kazakhstan's non-energy sectors attracted limited investment, in areas including telecommunications (AT&T) and commercial banking (ABN-Amro). As research on other natural resource-rich countries such as Gulf Countries Saudi Arabia and Qatar has found, FDI focused on oil and gas in Kazakhstan has crowded out investment in other sectors such as agriculture and manufacturing (Elheddad 2016). Moreover, FDI is falling as a share of GDP, as noted in Figure 1.

[5] *Multi-dimensional Review of Kazakhstan: Volume 1. Initial Assessment, OECD Development Pathways*, 2016, available at: http://dx.doi.org/10.1787/9789264246768-en, accessed 4 January 2018.

FIGURE 1. FDI Inflows (BoP, current US$)



Source: World Bank Data. International Monetary Fund, Balance of Payments database, supplemented by data from the United Nations Conference on Trade and Development and official national sources https://data.worldbank.org/

In 2015, because of a fall in global oil prices and the economic recession in Russia, a major trading partner, Kazakhstan's economy faced significant challenges, including a devaluation of the currency and a projected recession. As a result, the Kazakhstani government announced a bold plan to privatise its biggest enterprises, including the state oil and gas company, the state nuclear company, the railroad company and the national postal service. Kazakhstani officials hoped that privatisation would bring tens of billions of dollars into the Kazakhstani economy (Pannier 2016). The 'Kazakhstan 2050 Strategy' is designed to make Kazakhstan one of the top 30 economies in the world through the diversification of the economy, public-private partnerships and a favourable investment climate. Its rhetoric suggests a commitment to attracting foreign investment (Nazarbaev 2012).

Like Kazakhstan, Azerbaijan also became independent in 1991. Smaller in size and population than Kazakhstan, Azerbaijan receives most of its export revenue from oil and gas. As its reserves are not as extensive as those of Kazakhstan, Azerbaijan has tried to diversify its economy so as to expand FDI into other sectors, including construction and tourism. In 2005, Azerbaijan had net FDI inflows of $4.5 billion. However, rather than increasing significantly, like that of Kazakhstan, Azerbaijani FDI flow in 2015 was lower at $4 billion (see Figure 1). President Ilham Aliyev has made public statements about attracting more FDI, particularly to the non-extractive sectors of the economy.[6] Azerbaijan has established a single-window system, whereby all regulatory documents go through one entity rather than multiple government agencies, to decrease the costs of starting a new business in the country, along with legislative changes, such as changing the customs code, to make the country more investment-friendly. However, Azerbaijan has not yet joined the WTO. Among the issues that need to be resolved first are the application of discriminatory tax exemptions, production-sharing agreements, local content requirements, and investment incentives.[7]

Despite being the first post-Soviet state to join the WTO in 1998, Kyrgyzstan has had limited success in attracting foreign investment, as Figure 1 illustrates. The largest source of foreign investment in Kyrgyzstan is the Canadian investment in the Kumtor gold mine, which in 2014 accounted for 28% of all foreign investment in Kyrgyzstan.[8] Production at the Kumtor gold mine accounts for up to 12% of Kyrgyzstan's GDP and 50% of all of its exports.[9] China, the second-largest investor in Kyrgyzstan, has invested in mining operations and the building of an oil refinery in the city of Kara-Balta (Lelik 2016). International development assistance represented an additional form

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[6] 'Aliyev targets Azeri diversification and FDI in non-oil industries', *Azernews* 12 January 2016, available at:http://www.eurasianbusinessbriefing.com/aliyev-targets-azeri-diversification-and-fdi-in-non-oil-industries/, accessed 8 January 2018.

[7] *Azerbaijan: Investment Climate Statement, 2015*, available at: https://www.state.gov/documents/organization/241680.pdf, accessed 15 January 2017.

[8] *Kyrgyzstan Investment Climate Statement*, 2016, available at: http://www.state.gov/e/eb/rls/othr/ics/investmentclimatestatements/index.htm?year=2016&dlid=254483, accessed 12 June 2017.

[9] 'Mining in Kyrgyzstan Gold in the Hills', *The Economist*, 16 March 2013.

of linkage in Kyrgyzstan. The United States has given over $900 million in democracy, economic, and health assistance since 1992.[10] During the period 2002–2014, the European Union offered development assistance for a total €226 million.[11] In a country where the GNI per capita was only $1,170 in 2015, combined US and EU aid is significant.[12] During the years 2002–2014, the United States leased the Manas Air Base as a military transit point for NATO operations in Afghanistan, paying $40–60 million per year to the Kyrgyzstani government (Cooley 2008, p. 1177).

In recent years, there has been a diversification of investors in the post-Soviet states. Most notably, China's ambitious 'One Belt, One Road' initiative is pouring resources into Central Asian states in order to create new markets and finding an investment home for China's immense foreign exchange holdings. These infrastructural investments are meant to be profitable; so far, China is having a difficult time identifying investment opportunities that meet this goal.[13] As China's investment increases in Central Asia, we do not expect to see institutional change. Quantitative studies have shown that South–South FDI flows have a negative impact on institutional development in resource rich countries (Demir 2016). As China is an authoritarian state, increased linkages do not entail the adoption of accountability, transparency and international best practices that are, usually, part of increased linkages with the West.

Failure of linkage

The foundation for attracting foreign investment in any country is the legal environment, specifically, laws protecting foreign investment from expropriation. Similarly, provisions for dispute settlement through arbitration are appealing to investors because they demonstrate a credible commitment by the government to resolve conflicts in a clear and predictable manner through 'neutral' external conflict resolution mechanisms. Another, less obvious way that governments can protect the assets of foreign investors is through stabilisation clauses, which ensure that no public

[10] 'Overview of USAID Projects in the Kyrgyz Republic as of March, 2014', available at: https://www.usaid.gov/kyrgyz-republic/key-documents, accessed 12 June 2017.

[11] *European Union–Kyrgyz Republic Cooperation for Development*, available at: https://eeas.europa.eu/sites/eeas/files/brochure_2015_en.pdf, accessed 12 June 2017.

[12] *World Bank Data*, 2016, available at: http://data.worldbank.org/country, accessed 15 January 2017.

[13] 'What is China's belt and road initiative?', *The Economist*, 15 May 2017, available at: https://www.economist.com/blogs/economist-explains/2017/05/economist-explains-11, accessed 21 January 2018.

policy changes, such as a rise in taxation, will affect the value of the investment. For example, in a typical stabilisation clause, the government might exempt foreign companies from a rise in export taxes on oil and gas for ten years in an effort to make the revenue streams of those companies more predictable. These are all guarantees of a predictable institutional environment—a key component of any clear property rights regime and a foundation for a well-functioning economy (North & Thomas 1970; De Alessi 2003). Daude and Stein (2007) show that government commitment as well as the predictability of law and policy significantly influence the amount of foreign direct investment received by a country. Indeed, a cross-national study of FDI flows over a nearly 30-year period shows that credible commitments to protect investments results in more FDI (Büthe & Milner 2014).

On this basis, the combination of high levels of linkage, the importance of FDI for Kazakhstan and Azerbaijan, and the value placed on a strong legal environment by international investors should result in both countries having institutions supportive of investment. Kazakhstan has the two factors that we posited would correlate FDI with institutional effectiveness: the desire for FDI and high levels of linkage with the West. Azerbaijan has an expressed desire for FDI, but its linkages with the West are fewer as a result of its lower natural resource endowments and less ambitious government outreach. However, foreign businesses currently face several challenges when doing business in Kazakhstan, Azerbaijan, and Kyrgyzstan. The three main difficulties in Kazakhstan are: the repeated changes in laws; the lack of enforceability of arbitration decisions; and the regulatory framework. In Azerbaijan foreign investors struggle with the lack of the rule of law and the practice of using regulations to protect the economic interests of elites at the expense of foreign investors. In Kyrgyzstan, investors also face challenges with the lack of the rule of law, high levels of corruption, and repeated political interference with existing investment. The apparent failure of leverage here arises from the specific character of natural resource investment and the lack of strong elite support for institutional reform.

Legal and institutional structures in Kazakhstan

A stable legal and institutional environment encourages foreign investment. We would expect that, with increased linkages with the West, there would be growing transparency and rule of law, coupled with a diminishing uncertainty for investors. Superficially, this has happened in Kazakhstan. The government has joined the WTO and has sought to promote policies, such as property rights protections and arbitration, that protect foreign economic interests in the country.[14] Kazakhstan is also rated relatively well in terms of having a business-friendly environment.[15]

TABLE 1 Economic and Institutional Indicators

	WB *Doing Business 2017*	**Global Competitiveness Index 2017**	**Index of Economic Freedom**	**WTO membership**	**2015 FDI inflows (US$ billions)**
Kazakhstan	35	57	66	Yes	6.2
Azerbaijan	65	35	114	No	4
Kyrgyz Republic	75	102	80	Yes	1.1

Sources: Gwartney *et al*. (2017); *Global Competitiveness Report 2017–2018, World Economic Forum*, available at: https://www.weforum.org/reports/the-global-competitiveness-report-2017-2018, accessed 8 January 2018; *World Bank Data*, 2017, available at: https://data.worldbank.org/country/kazakhstan?view=chart, accessed 15 January 2017; *Doing Business*, *2017*, World Bank, available at: http://www.doingbusiness.org/reports/global-reports/doing-business-2017, accessed 3 January 2018.

[14] *Kazakhstan and the WTO*, 2015, available at: https://www.wto.org/english/thewto_e/countries_e/kazakhstan_e.htm, accessed 24 February 2019.

[15] Kazakhstan is ranked 35 in the World Bank report, *Doing Business 2017*, 50 in the *Global Competitiveness Report*, and 68 in the Index of Economic Freedom. (*Doing Business*, *2017*, World Bank, available at: http://www.doingbusiness.org/reports/global-reports/doing-business-2017, accessed 3 January 2018).

The World Bank's *Doing Business 2017* shows Kazakhstan as one of the countries that has most improved its ranking—to 35—because of significant reforms in business regulation.[16] However, repeated criticisms of the World Bank's methodology raise some concerns about the validity of its assessment of contract enforcement in Kazakhstan.[17] Moreover, the reported experiences of investors are more relevant. One concern for investors is the uncertainty created by repeated changes to legislation and the realignments of the governmental institutions involved in investment regulation. The appearance of institutional change is present, but the substance is lacking.

Since independence, the legislation around foreign investment has changed several times. Two early important pieces of legislation were the 1994 Investment Law[18] and the 1997 Law on State Support for Direct Investment.[19] The 1994 Investment Law contained a stabilisation clause to ensure consistency in the country's investment environment. That same law prohibited the nationalisation of foreign investments except for cases of 'paramount public interest' appearing to offer solid protection to the property rights of foreign firms. However, changes to tax laws in 1997 rescinded the stabilisation clause for export taxes: 'Since July 1997, guarantees to foreign investors do not apply to changes which amend the procedure and conditions (including taxation and state regulations) on import, production and/or selling of excisable goods as well as the import of excisable goods intended for sale

[16] *Doing Business*, 2017, World Bank, available at: http://www.doingbusiness.org/reports/global-reports/doing-business-2017, accessed 3 January 2018.

[17] The World Bank's process of assessment involves reviewing the relevant laws and asking lawyers. One criticism of this approach is that it fails to capture the complexity of the situation and is only based on the experience of selected firms (Davis & Kruse 2007; Besley 2015). There is also concern that there may be significant 'divergence between the stylised legal practices assumed in the DB [*Doing Business*] project's scenario and actual legal practice … We are concerned about the reliability of responses to questions about relatively uncommon hypothetical scenarios' (Davis & Kruse 2007, p. 1107).

[18] *Law No. 266-XIII of 27th December 1994 of the Republic of Kazakhstan Concerning Foreign Investments*, available at https://online.zakon.kz/document/?doc_id=1030647#pos=0;224 accessed 21 February 2019.

[19] *KAZ-1997-L-51292 Law on State Support for Direct Investments*, 1997 *Adoption: 1997-02-28.*

without processing.'[20] Since most of the investments at this time were in the oil and gas sector, this was a step backwards in terms of protections for foreign investors. Property interests were protected, but the export duties could change and foreign investors could not claim protection using the stabilisation clause.

The 1994 Investment Law and the 1994 Law on State Support for Direct Investment were replaced by the 2003 Investment Law, which further eroded certainty. The law had no stabilisation clause and explicitly omitted contracts concluded with the state prior to 2003. There was no provision for 'grandfathering' former investments that were either initiated or concluded under the old investment laws of 1994 and 1997. As a result, 'Many foreign companies say they must vigilantly defend their investments from a steady stream of decrees and legislative changes'.[21]

Moreover, the 2003 Investment Law was vague concerning the role of international arbitration mechanisms: 'Investors have also expressed concerns about the narrow definition of investment disputes which did not cover disputes between private entities, the lack of clear mechanisms for access to international arbitration and uncertainty concerning the binding nature of international arbitration judgements.'[22] Given that the extraction processes for oil and gas require considerable upfront investment in infrastructure, such as the building of rigs, before any returns are seen, the protection of the large capital inputs is always important in attracting foreign investment to these sectors.

On 1 January 2016 a new Entrepreneurial Code came into force, which consolidated six laws into one document, thus unifying and systematising the existing legislation regulating entrepreneurial relations, including investment activities.[23] As a result, more than a hundred laws needed to be amended (Abdrahmanova 2015). While the new code also brought many changes that appear to benefit investors, including strengthening of the institute of

[20] *OECD Investment Guides: Kazakhstan 1998*, available at: http://www.oecd-ilibrary.org/finance-and-investment/investment-guides-kazakhstan-1998_9789264163546-en, accessed 10 December 2015.

[21] *U.S. Department of State Kazakhstan Investment Climate Statement*, 2015, available at: http://www.state.gov/e/eb/rls/othr/ics/2015/241613.htm, accessed 16 May 2016.

[22] *OECD Investment Policy Review: Kazakhstan. 2012*, available at: http://www.oecd-ilibrary.org/finance-and-investment/oecd-investment-policy-reviews-kazakhstan-2012_9789264121812-en, accessed 8 January 2018.

[23] The following laws were replaced by the Entrepreneurial Code of Kazakhstan: Law No. 214 'On Homestead or Commercial Farming', 31 March 1998; Law No. 373 'On Investments', 8 January 2003; Law No. 124 'On Private Entrepreneurship', 31 January 2006; Law No. 112-IV 'On Competition', 25 December 2008; Law No. 377-IV 'On State Control and Monitoring in the Republic of Kazakhstan', 6 January 2011; Law No. 534-IV 'On State Support for Industrial and Innovation Activities', 9 January 2012 (Tanasheva *et al*. 2016).

investment ombudsman and providing better mechanism for protecting investors' rights,[24] there remains a lack of clarity around certain issues, such as the grandfathering of investments made prior to the code's enactment.

Overall, the situation for FDI in Kazakhstan remains uncertain. Some investors complain of 'vague and contradictory legal provisions that are often arbitrarily enforced, these negative tendencies feed the perception that Kazakhstan's investment environment is subpar';[25] others that the environment is characterised by regulatory instability and threats to investments that emanate from the unpredictability of government actions[26] (Soldatkin & Gordeyeva 2013).

Enforceability of decisions in Kazakhstan

While the repeated changes in laws and institutions create uncertainty for investors, a key factor in the predictability of a foreign investment climate is the process for resolving disputes. If national courts appear biased or corrupt, then arbitration mechanisms and the enforceability of arbitration decisions are critical. Arbitration is the preferred option for dispute settlement among businesses investing in developing countries, as it removes the enforcement of contracts or the resolution of disputes from national courts. The existence of reliable arbitration mechanisms demonstrates a credible commitment by a state to creating an institutional environment friendly to FDI (Büthe & Milner 2014). It may also be a more rapid means for dispute resolution. International arbitration mechanisms are supranational; they typically operate in commercial hubs—New York, London, Stockholm—using recognised international standards such as the UN Commission on International Trade Law Arbitration Rules.[27] However, while arbitration offers the

[24] *Doing Business Guide Kazakhstan 2017*, prepared by PricewaterhouseCoopers Tax and Advisory LLP, 2017, available at: https://www.pwc.de/de/internationale-maerkte/doing-business-in-kazakhstan-2017.pdf, accessed 25 February 2019.

[25] *U.S. Department of State Kazakhstan Investment Climate Statement*, 2015, available at: http://www.state.gov/e/eb/rls/othr/ics/2015/241613.htm, accessed 16 May 2016.

[26] *КАЗАХСТАН - В поисках новой модели роста: срочная необходимость экономической трансформации*, Доклад об экономике, this report was prepared by the World Bank, Spring 2018, available at: *http://documents.vsemirnyjbank.org/curated/ru/443681527664626790/pdf/126685-WP-PUBLIC-RUSSIAN-KAZ-CEU-Spring-2018-final-final-rus-corrected-002.pdf*, accessed 26 February 2019.

[27] *UNCITRAL Arbitration Rules*, adopted in 1976 and revised in 2010 and 2013, available at: https://uncitral.un.org/en/texts/arbitration/contractualtexts/arbitration, accessed 26 February 2019.

opportunity for a relatively quick and unbiased settlement of business disputes, the enforcement of arbitration decisions is still in the hands of the government of the state in which the foreign investment is located.

Kazakhstan's 2003 Law on Investments allows dispute resolution for investors through three processes: negotiation; use of Kazakh courts; and international arbitration. The EBRD's Assessment "Commercial Laws of Kazakhstan"[28] described the impartiality of Kazakh courts as 'questionable': 'In their judgments, courts are believed to show particular deference to the government and entities in which the state has a substantial interest.'[29] Thus, Kazakhstan fits the profile of a state in which foreign investors look to arbitration rather than the court system as a mechanism for dispute resolution. Kazakhstan ratified the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards in 1995 and is legally obliged to enforce arbitration decisions. However, there have been complaints about the arbitration mechanisms in Kazakhstani law; specifically: the limited scope of what sort of dispute can go to arbitration and the willingness of the government to enforce arbitration decisions.). As of 2018 there have been 60 different arbitration cases with Kazakhstan named as respondent, of these cases 17 have been made public. [30] Not all of them have been resolved satisfactorily from the perspective of the investors. For example, when an AIG-funded apartment complex project in Almaty was confiscated by the municipal government, AIG sought arbitration and was awarded damages of nearly $10 million. Yet, AIG was unable to have the decision enforced and the damages paid, as the state invoked its right to sovereign immunity (Shmatenko 2013, p. 29). The Moldovan Tristan Oil and its partners won an arbitration decision heard in Stockholm against the government of Kazakhstan in 2014 after the government seized their oil and gas businesses. The arbitrator found that 'Kazakhstan violated its international obligation to treat claimants' investments fairly and equitably'.[31] The government refused to pay and instead took the

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[28] *Commercial Laws of Kazakhstan, an Assessment by EBRD*, 2014, available at: https://webcache.googleusercontent.com/search?q=cache:AstNcMUwb6sJ:https://www.ebrd.com/documents/legal-reform/kazakhstan-country-law-assessment.pdf+&cd=2&hl=en&ct=clnk&gl=us, accessed 26 February 2019.

[29] *Multi-dimensional Review of Kazakhstan: Volume 1. Initial Assessment, OECD Development Pathways*, 2016, available at: http://dx.doi.org/10.1787/9789264246768-en, accessed 4 January 2018.

[30] "*Kazakhstan as Respondent State,*" United Nations Conference on Trade and Development, 2018, available at: https://investmentpolicyhub.unctad.org/ISDS/CountryCases/107?partyRole=2, accessed 26 February 2019.

[31] 'Tristan Oil Announces $506 Million Arbitration Award Against Republic of Kazakhstan', *Reuters*, 8 January 2014.

case to the Kazakhstan High Court.[32] In both cases, the government refused to comply with arbitration decisions not in its favour and chose to support the interests of the state and municipal governments when they were in conflict with those of foreign investors.

Kazakhstani local content law

The third major challenge for foreign investors in Kazakhstan is the fluctuating regulatory environment. In Kazakhstan, the requirement for local content highlights the difficulties for investors. There are several laws that define the local content requirements for companies. The 2009 and 2010 amendments to Kazakhstan's Law on Government Procurement established new, higher percentages for local content in government procurement and in purchases by state-owned or controlled businesses.[33] In addition, the 2010 Subsoil Law, governing natural gas, oil, and mineral extraction, included strict local content requirements. The initial targets were for 50% of products and 90% of services to come from Kazakhstani suppliers by 2012 (Ospanova 2010, p. 6). A Kazakhstan certificate of origin (CT-KZ) is required to fulfil local content requirements. If there is no CT-KZ, then the product does not count towards local content requirements. Companies in violation of the requirements face the potential termination of their mineral contracts.[34] The rationale behind instituting local content rules is to help diversify economies away from natural resources, create jobs, enhance the competitiveness of local businesses, and improve the capacity and skills of local workers (Arthur & Arthur 2014, p. 61).

Although the motivations and reasons behind Kazakhstan's local content requirements are understandable, there have been several problems with the implementation of the rules. Foreign investors have complained about the difficulty of complying with the law because of the lack of local goods that conform to international standards and

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[32] *ASCOM Case: Allegation of fraud in arbitration between Moldovan investors and Kazakhstan will go to trial*, Swann Bigot, Eurasia Business News, 12 May 2018, available at: *https://eurasiabusinessnews.com/2018/05/12/ascom-case-allegation-of-fraud-in-arbitration-between-moldovan-investors-and-kazakhstan-will-go-to-trial, accessed 27 February 2019.*

[33] 'National Trade Estimate Report on Foreign Trade Barriers, Kazakhstan', 2014, Office of the United States Trade Representative, available at: https://ustr.gov/about-us/policy-offices/press-office/reports-and-publications/2014-NTE-Report, accessed 4 January 2018.

[34] 'Over 30 Cos. May Lose Mineral Development Licenses, Including Kazatomprom', *Central Asia & Caucasus Business Weekly*, 24 April 2012.

that the enforcement of the law is uneven, irregular, and non-transparent.[35] There are also concerns about the introduction of changes to existing contracts to incorporate compliance with new local content laws. As noted above, the lack of 'grandfathering in' existing contracts is a problem for foreign investors, especially as the resources and overhead required for complying with local content laws are significant, and place mid-size and small companies at a disadvantage relative to larger companies (Ospanova 2010, p. 4). In addition, in the oil and gas industries there is a lack of Kazakhstani suppliers able to produce the specialised products needed and an overall lack of technological capacity (Ospanova 2010, p. 5). Furthermore, the monitoring and enforcement of local content law is complex, involving multiple government agencies, such as the Ministry of Oil and Gas, the Ministry of Finance, the Ministry of Investments and Development, the National Agency on Development of Local Content (NADLoC), and other specialised government agencies. Foreign investors find local administrators inflexible and overly harsh in their enforcement of the law.[36]

The development of the local content requirements after Kazakhstan had already increased its economic linkages demonstrates a lack of foreign investor leverage on government policy. Although Kazakhstan's November 2015 membership of the WTO reduced barriers for foreign investors in subsoil contracts, existing rules will apply until 2021, so there is continuing uncertainty about whether the government will comply with WTO requirements, considering also that WTO rules do not apply to government procurement (Albanov 2015).

In summary, despite significant economic and intergovernmental linkages, elements of Kazakhstan's legal and governmental structure often do not comply with international requirements or serve the interests of foreign investors. The frequent changes in government legislation and institutions combined with the lack of 'grandfathering' results in a degree of unpredictability. The repeated failure to enforce arbitration decisions raises questions about the government's commitment to the rule of law. Local content requirements cause logistical difficulties for companies. All of these issues demonstrate a lack of real support for foreign investment in recent legal and institutional changes.

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[35] *OECD Investment Policy Review: Kazakhstan. 2012*, available at: http://www.oecd-ilibrary.org/finance-and-investment/oecd-investment-policy-reviews-kazakhstan-2012_9789264121812-en, accessed 8 January 2018; *U.S Department of State Kazakhstan Investment Climate Statement*, 2015, available at: http://www.state.gov/e/eb/rls/othr/ics/2015/241613.htm, accessed 16 May 2016.

[36] 'Doing Business in Kazakhstan: 2012 Commercial Guide for US Companies', 2012, US Commercial Service, Department of Commerce.

Foreign investment challenges in Azerbaijan

In Azerbaijan legal protections for foreign investors are at least the same as those enjoyed by local investors and are sometimes more extensive. The 1992 Foreign Investment Law, the 1995 Law on Investment Activity, and the 2010 Investment Fund Law are all investor-friendly. Foreign investors were protected under the 1992 law against major policy changes by a ten-year moratorium on any legal changes in most economic areas outside of national security. Under the 1995 Law on Investment Activity this ten-year protection was extended to the life of the.[37] Most recently, the 2016 Decree on Additional Measures to Promote Investment gives special tax and custom incentives to investors.[38] Disputes between foreign investors and other parties can be heard in the national courts, or resolved *via* arbitration through the International Centre for Settlement of Investment Disputes or another mutually acceptable arbitrator. Azerbaijan's openness to arbitration is observable in clauses within the various bilateral investment treaties of which it is a signatory.[39] That said, it is not always possible to have arbitration awards against the state enforced. One 2006 arbitration case ended up in the US courts as the company tried to pursue enforcement of the arbitration decision blocked by the Azerbaijani government.[40] In another case, a US firm, despite an arbitration ruling in its favour, 'has been unable to collect a monetary settlement to resolve a contract dispute'.[41]

The World Bank report *Doing Business 2017* ranks Azerbaijan at 65 out of 190 countries, well below the 35 rank maintained by Kazakhstan, a drop of four since the 2016 report. While it is very easy to register and start a business in Azerbaijan, the quality of judicial processes for contract enforcement is poor, well below the regional average. In addition, there are serious problems with the lack of transparency and fairness in the design and enforcement of government regulations.

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[37] Law of the Azerbaijan Republic On Investment Activity, Law № 952, https://investmentpolicyhub.unctad.org/InvestmentLaws/laws/186, accessed 26 February 2019.

[38] "Favorable Tax Environment for Foreign investors in Azerbaijan," http://www.taxes.gov.az/modul.php?name=pages&page=231, accessed 26 February 2019

[39] For a list of the 51 bilateral investment treaties please see https://investmentpolicyhub.unctad.org/IIA/CountryBits/13#iiaInnerMenu.

[40] 'Frontera Resources Azerbaijan Corporation v. State Oil Company of the Azerbaijan Republic', 2009, available at: http://caselaw.findlaw.com/us-2nd-circuit/1352726.html, accessed 8 January 2018.

[41] 'Azerbaijan 2013 Country Report', *Political Risk Services* 2014, available at: https://www.ebsco.com/products/research-databases/business-source-complete, accessed 8 January 2018.

> Politically connected businesses benefit from government regulatory and other decisions to achieve effective control over lucrative sectors of the economy … Powerful state-owned enterprises, such as the Azerbaijan State Caspian Shipping Company (CASPAR) and Azerbaijan Airlines (AZAL), have regulatory authority that they can exploit to block new entrants into the market—a clear conflict of interest.[42]

Furthermore, economic elites use their often monopolistic positions and political relationships in a way that ‘discriminates against or unfairly burdens foreign investors or foreign-owned investments’.[43]

Foreign investment challenges in Kyrgyzstan

As Levitsky and Way’s theory predicts, Kyrgyzstan’s weaker economic linkages correspond to its lack of institutional reform and continuing problems with weak rule of law and corruption. In addition, as previous research predicts, the lack of political stability and high levels of corruption deter FDI in Kyrgyzstan (Elheddad 2016, p. 17). The World Bank’s *Doing Business 2017* report ranks Kyrgyzstan at 75, significantly below Kazakhstan’s position at 35. The US Department of State report on the Investment Climate in Kyrgyzstan in 2016 states that ‘investors should be aware that an estimated 60% or more of the economic activity in the country occurs in the unregulated gray’.[44] The World Bank’s International Finance Corporation survey of several hundred foreign investors in Kyrgyzstan found that 80% of investors said the high level of corruption, the low level of transparency, and the unpredictability of government actions were major constraints on doing business in the country.[45] Furthermore, 58% of investors had considered

[42] ‘Azerbaijan 2013 Country Report’, 2014, p. 2, available at: https://www.ebsco.com/products/research-databases/business-source-complete, accessed 8 January 2018.

[43] ‘Azerbaijan 2013 Country Report’, 2014, p. 2, available at: https://www.ebsco.com/products/research-databases/business-source-complete, accessed 8 January 2018.

[44] *Investment Climate Statements for 2016: Kyrgyz Republic*, 2016, United States Department of State, available at:http://www.state.gov/e/eb/rls/othr/ics/investmentclimatestatements/index.htm?year=2016&dlid=254483, accessed 8 June 2017.

[45] *Investment Climate in Kyrgyz Republic: Views of Foreign Investor*s, 2015 (Washington, DC, World Bank), available at: http://documents.worldbank.org/curated/en/259411467997285741/Investment-climate-in-Kyrgyz-Republic-views-of-foreign-investors-results-of-the-survey-of-foreign-investors-operating-and-non-operating, accessed 8 June 2017.

closing their investment in Kyrgyzstan because of government actions.[46] The corruption and the weak judicial system negatively affect contract enforcement in Kyrgyzstan. *Doing Business 2017* ranks Kyrgyzstan particularly low on the enforcement of contracts: 141.[47] According to a US State Department report, because of political interference, 'There is no known example in which the final verdict on an investment dispute between an investor and the government has favoured the investor'

Political interference in investment decisions is illustrated by the multiple, repeated disputes over the Kumtor gold mine. Kumtor is owned and operated by Centerra, a Canadian company. The Kyrgyzstani government owns a 32.7% share of Centerra. In 2013, the government demanded an increase of its stake in the gold mine to 67% and several members of parliament threatened to nationalise the gold mine. While negotiations between the government and Centerra continued, then president Almazbek Atambayev made the unsupported accusation that Centerra had engaged in corrupt practices and 'looted' the mine.[48] In 2016 tensions increased when the government delayed issuing necessary permits; the police raided Centerra's offices and the government prevented mine officials from leaving the country (Koven 2016b). Given that Kumtor employs over 2500 Kyrgyzstanis, provides significant tax revenue, and often accounts for 50% of the country's exports, these repeated government attacks on the company demonstrate the limited influence of the economic linkages on institutional reform and elite behaviour in Kyrgyzstan (Koven 2013).[49] The almost two-decades-long relationship with Canadian investors in the Kumtor mine has not produced any improvements in the legal or regulatory environment, an outcome that parallels the limited influence of investors in

[46] *Investment Climate in Kyrgyz Republic: Views of Foreign Investor*s, 2015 (Washington, DC, World Bank), available at: http://documents.worldbank.org/curated/en/259411467997285741/Investment-climate-in-Kyrgyz-Republic-views-of-foreign-investors-results-of-the-survey-of-foreign-investors-operating-and-non-operating, accessed 8 June 2017.

[47] *Doing Business*, *2017*, World Bank, available at: http://www.doingbusiness.org/reports/global-reports/doing-business-2017, accessed 3 January 2018.

[48] 'Kyrgyz Leader Vows "Tough" Measures Over Gold Mine Dispute with Canada', *BBC Monitoring Central Asia Unit*, 27 October 2014, available at: http://0-www.lexisnexis.com.library.wofford.edu/hottopics/lnacademic/, accessed 4 January 2018.

[49] 'Centerra and Kyrgyzstan to Reach Agreement on Kumter Gold Mine (Part 1)', *The Times of Central Asia*, 21 August 2013.

Kazakhstan and Azerbaijan. Furthermore, the willingness of Kyrgyzstani elites to persistently challenge and undermine the legal agreements with Centerra further erodes foreign investor interest in the country.[50]

Despite extensive foreign investment we do not see institutional changes favouring investors in any of these countries. In Kazakhstan, reforms are complex and iterative; in Azerbaijan, the laws are clear but implementation is uneven and subject to arbitrary government regulation. In Kyrgyzstan, there have been relatively fewer attempts at reform and repeated government interference in major foreign investment.

Why the failure? Natural resources and elites

Despite significant economic linkages, reform has been limited in both Kazakhstan and Azerbaijan as foreign investors tend not to apply leverage and elites are often resistant to reform. As noted above, elites are able to facilitate or constrain linkage and, in the cases of Kazakhstan and Azerbaijan, actively sought to constrain the influence of linkage, despite the pro-investment rhetoric and the appearance of change. Although the lack of reform in Kyrgyzstan is partially due to the lower levels of linkage, Kyrgyzstani elites also have actively prevented institutional reform.

If we track over time the changes in Kazakhstan's investment law, there are repeated examples of the government enacting laws that worsen conditions for investors despite receiving high levels of FDI. For example, the 2003 Investment Law removed the pro-investor stabilisation clause that existed in the 1994 investment law. Burdensome local content requirements increased in 2005, 2009 and 2010. What is most remarkable about these repeated changes in the laws governing foreign investment is that there has been little response from foreign investors. Although they may have expressed their views privately, we have seen no corresponding reduction in investment, threats to challenge the legal changes, or efforts to delay future investment. Quite the opposite: in 2008 Eni, Shell, Total, ExxonMobil, ConocoPhillips, and Inpex all agreed to renegotiate production-sharing agreements to increase the shares of the Kazakhstani national oil company (Pomfret 2011). Investors also appear willing to repeatedly pay

[50] 'Centerra and Kyrgyzstan to Reach Agreement on Kumter Gold Mine (Part 1)', *The Times of Central Asia*, 21 August 2013.

fines for violating the local content requirements: in 2012 alone, companies involved in natural resource extraction paid a total of $2.3 million in fines.[51]

Foreign investors do not appear to apply any significant leverage over the Kazakhstani government. Once multinational companies commit a large amount of resources to develop a mine, oil field, or natural gas field it is very costly to end their relationship with the government or pull out of the venture (Partlett 2010). Moreover, unlike FDI in manufacturing, international energy companies are very limited in their options for moving production as resources such as oil are only available in a few countries. It is also possible that international energy companies have not applied leverage because the problems presented by the lack of reform or the enforcement of arbitration decisions in Kazakhstan and Azerbaijan do not warrant risking their valuable relationships with these governments. Neither government has reneged on contracts or sought to renationalise energy assets. If they did, then international energy companies might well take more significant action. However, the case of the Kumtor gold mine in Kyrgyzstan presents evidence that, even in such circumstances, international investors may continue to work with governments. Centerra has not pulled out of Kumtor despite repeated changes to the agreement, threats of nationalisation, arbitrary fines, and the harassment of company executives. In the midst of the most recent crisis, a financial reporter made the following analysis: ‘Investors and analysts doubt the political tensions in Kyrgyzstan will ever go away completely. They have become accustomed to the occasional flare-ups, which are simply the cost investors have to pay to get exposure to Kumtor, an extremely rich and profitable gold mine’ (Koven 2016).

The lack of pressure from foreign investors enables Kazakhstani and Azerbaijani elites to continue resisting reform. Elites currently face few incentives to support change. For example, Kazakhstani business elites benefit from the local content laws as these rules eliminate their need to compete with foreign businesses. Stable regimes share the profits of FDI with a range of elites in order to maintain their support. The members of this profit-sharing coalition have no interest in risking future benefits by disrupting the current arrangements (Bak & Moon 2016). In Kazakhstan, political and economic elites are intertwined, preventing a strong reform coalition from developing: ‘Top companies in the private sector—namely media, energy, construction, mining and finance—are either directly controlled by the political elite, owned by trusted allies and family members, or represent the interests of elites through proxies or

[51] ‘National Trade Estimate Report on Foreign Trade Barriers, Kazakhstan’, 2014, Office of the United States Trade Representative, available at: https://ustr.gov/about-us/policy-offices/press-office/reports-and-publications/2014-NTE-Report, accessed 4 January 2018

nominees' (Mesquita 2016, p. 379). For example, in the financial industry, ten out of the 24 domestic banks are owned by government officials or their family members (Mesquita 2016, p. 389).

The Azerbaijani government has passed from father to son in the short time since the country's post-Soviet independence. Heydar Aliyev, chairman of the Supreme Soviet of Azerbaijan under the communist system in Azerbaijan, became president through an electoral process in 1993. When he died in 2003, his son Ilhan Aliyev became president and has remained in power since. Aliyev and his family have personal ties to the oil industry and have been accused of benefitting from international oil deals (Franke *et al*. 2009, p. 124). The Aliyev family heads up a tight circle of elites, many of whom, such as the state oil company president and the executive director of the state oil fund, have their roots in the Nakchivani region.[52] The ruling family has sought to punish those who publicly document their interests, most notably journalist Khadija Ismayilova, who was imprisoned for her work exposing their economic interests.[53] Her revelations were substantiated by documents revealed in the Panama Papers in 2016 (Fitzgibbon *et al*. 2016). Throughout Azerbaijan, elite personal economic interests touch upon investment in multiple spheres: 'While the laws on the books promote foreign investment, in practice investment disputes can arise when a foreign investor or trader's success threatens well connected or favoured local interests.'[54] The case of the Turkish company Barmek highlights the importance of maintaining strong local elite and business connections for foreign investors. The Azerbaijani government contracted with Barmek to manage the electric grid in the capital city of Baku. However, when Barmek's supporters within the Azerbaijani elite fell out of favour with Aliyev, the government arrested 30 employees and then froze the company's assets (Johns & Wellhausen 2016). Thus, the bureaucratic processes put in place to woo foreign investment and protect it are contingent on elite interests in Azerbaijan.

As noted above, Kyrgyzstan has weaker economic linkages than Kazakhstan and Azerbaijan, producing less externally driven pressure for institutional reform. In this sense, Kyrgyzstan fits well with Levitsky and Way's theory as less linkage has produced less reform. Furthermore, the main source of economic linkage is either based on natural resources (such as the Kumtor gold mine) or with China, which has shown little interest in promoting institutional

[52] 'Azerbaijan Anonymous: Azerbaijan's State Oil Company and Why the Extractive Industries Transparency Initiative Needs to Go Further', Global Witness, December 2013, available at: https://www.globalwitness.org/sites/default/files/library/azerbaijan_anonymous_lr.pdf, accessed 8 January 2018.

[53] 'The First Lady and a Jailed Journalist', *The New York Times*, 6 May 2016.

[54] 'Azerbaijan 2015 Country Report', Political Risk Services, 2016, p. 6, available at: https://www.ebsco.com/products/research-databases/business-source-complete, accessed 8 January 2018.

reform. In these aspects, counter to expectations, Kyrgyzstan is similar to the Kazakhstani and Azerbaijani cases as the type of economic linkage again reduces its support for reform.

Politics and economics are deeply interconnected in Kyrgyzstan. Elites benefit from the lack of transparency and weak rule of law. Under former president Kurmanbek Bakiyev, corruption and nepotism were widespread and often connected to foreign money. For example, when negotiating the lease for the Manas Air Base, the US government agreed to give a $315 million multi-year jet fuel deal to companies linked to Bakiyev's son (Landler 2010). Furthermore, Bakiyev appointed his son Maksim as the chief of the Agency for Investment and Economic Development, the government agency overseeing most foreign investment in Kyrgyzstan.[55] According to a recent *Freedom House* report, there are multiple reports of corrupt relationships between government officials and Chinese investors.[56] The combination of Centerra's continued willingness to work in Kyrgyzstan and the clear benefits gained by elites from the lack of transparency produce few incentives for Kyrgyzstani elites to support institutional reform.

Kyrgyzstan does differ from Kazakhstan and Azerbaijan in its higher levels of pluralism and stronger civil society. It is possible that other forms of linkage, especially international development assistance, have helped to support the development of civil society in Kyrgyzstan and encouraged greater pluralism. However, most analysts argue that the primary causes of Kyrgyzstan's greater pluralism are domestic: state weakness and elite divisions (Radnitz 2010; Way 2015). Even if linkage with Western countries has had a positive impact on civil society, its continued influence remains questionable, as the Kyrgyzstani government is strengthening its relationship with Russia. Kyrgyzstan has joined the Russian-led Eurasian Economic Union (EEU) and under Russian pressure refused to renew the US lease on the Manas Air Base, which expired in 2014 (Cooley 2008). Since 2003 Kyrgyzstan also hosts a Russian air base in Kant, outside of Bishkek (Putz 2018). These closer ties with Russia will further reduce international incentives for reform.

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[55] *The Truth Behind The Recent Unrest in Kyrgyzstan*, 14 April 2010, *Business Insider*, available at: https://www.businessinsider.com/causes-of-unrest-in-kyrgyzstan-2010-4, accessed 27 February 2019.

[56] *Nations in Transit 2017: Kyrgyzstan*, 2017, available at: https://freedomhouse.org/report/nations-transit/2017/kyrgyzstan, accessed 8 June 2017.

Conclusions

While we did not seek to replicate or argue for the ‘resource curse’ in this paper, our findings complement its conclusions. We carried out a micro-analysis of the role of FDI on institutional effectiveness in countries with high-value natural resources, positing that linkages with the West through FDI should increase the leverage of Western companies and investors, with positive effects on the institutional environment. In general, we did not find this to be true in Kazakhstan and Azerbaijan. Instead, analysis of institutional reforms in Kazakhstan showed that, although superficial changes were made, these had little impact on the overall investment climate. While both countries expressed a desire for FDI and embarked on institutional changes designed to make the country friendlier to foreign investment, neither country was willing (or able) to adopt reforms that challenged elite interests. Despite the significantly lower level of foreign investment in Kyrgyzstan, its situation bore some surprising similarities to Kazakhstan and Azerbaijan. Investment in Kyrgyzstan, again, focused on natural resources and had minimal effect on institutional reform. Therefore, in Kyrgyzstan the nature of the economic linkage limited its capacity to motivate reform.

The large investments required by extractive industry may reduce the likelihood of those companies exerting leverage on the government to obtain favourable policies or enforce contracts. This dynamic is unlikely to occur in other industries with lower capital investments. Thus, as both Kazakhstan and Azerbaijan seek investment beyond their extractive sectors, we predict that they will attract less FDI or that the leverage of foreign investors on the state and elites will increase. Lower oil prices and rapidly developing technologies that reduce dependence on natural resources make large investments in the extractive sector less desirable. An unpredictable institutional environment will likely seem a larger barrier to investment when the potential returns are smaller than those historically associated with oil and gas.[57] Research by Doytch and Eren (2012) demonstrates that institutional quality matters for attracting investment in manufacturing, a stated desire of the Kazakhstani government. We posit that the decline in oil prices over the last few years may reduce the amount multinational companies are willing to invest in states that have not made the necessary institutional changes to support transparency, protect investments, and adhere to international business standards. The question is whether these economic pressures will motivate Kazakhstan and Azerbaijan to introduce further institutional reforms and increase transparency. The experience of Kyrgyzstan, where the

[57] Deichmann *et al*. (2003) find that economic reforms and stability are an important factor in attracting foreign investment in postcommunist states.

government has failed to adopt essential reforms despite strong incentives to attract foreign investment to improve economic development, suggests that Kazakhstan and Azerbaijan may continue to struggle to reform. Furthermore, if China's investments in Central Asia become as substantial as anticipated, we would also expect less transparency and a movement away from a strong legal and regulatory environment in countries where it has the largest investments.

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