

# ECONOMY, POLITICS, POLICY

## GEORGIA – FREE MARKET IDEOLOGY OR PRAGMATISM

Gia Jandieri<sup>1</sup>

### Abstract

*Georgia attempted the most radical reconstruction during the period from 2004 to 2012. There were made several pragmatic economic decisions together with implementing of state assistance programs for the most vulnerable. The assistance and subsidies had increased together with improvement of the economic performance and raise of state budgetary revenues but also strongest push of populist agenda by political rivals of the government.*

*Economic performance of Georgia in the period was remarkable. The country improved its macroeconomic and business conditions by major reforming of business climate and economic freedom. The Economic Liberty Act of 2011 was a major step for guarantying and stabilizing of this environment but the simultaneous introduction of some interventionist measures made initiated and supported by internal and foreign stakeholders limited the ability of the economy to grow faster resulted in losing of popularity and inviting to the political agenda leftist players.*

*Majority of the politicians who supported the radical reforms in the middle of 2000s found themselves in a trap of promises abandoning little-by-little small government agenda - to have chances to keep the support they had. For them so-called libertarian fashion lost its attractiveness and resulted in the shift towards left. They found a new pragmatic vision based on the belief that maybe more economic freedoms are good for business but this does not give immediate relief to poor who expect more responsibilities of the government for their living conditions.*

*This paper is an attempt to analyze if the policy of economic freedom was maintained in its full range in Georgia and to show that more economic freedom is the only pragmatic way to improve economic conditions in the long-run.*

### The Past

Current economic performance of Georgia is tied to its past – to the major tendencies in its development in the periods before Russian annexation of the country, during Russian Empire period of from early 19<sup>th</sup> century to the beginning of 20<sup>th</sup>, Soviet and post-soviet periods.

The period before 19<sup>th</sup> century has to be divided into two parts of progress before Mongol invasions in 13<sup>th</sup> century and decline after it. The first period is illustrated in development of architecture, poetry, science, government institutions etc; Georgia is proud of constructed that time church buildings and philosophy. All this needed of course good economic background which was based mostly on trade as the country was located at the crossroads of west to east and north to south.

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<sup>1</sup> Gia Jandieri is the founder and vice president of the New Economic School of Georgia in Tbilisi, Georgia. Mr. Jandieri is one of the most prominent Georgian economists and commentators who took part in the design, advocated and promoted the country's remarkably successful economic reform after 2004. The New Economic School is a combination of an economic school and a think tank that was instrumental in educating about 15 thousand young Georgian, Armenian and Azeri student in the principles of sound economics, economic policies and the basics of public choice theory.

The period started from 13<sup>th</sup> century can be characterized as permanent wars and invasions. Started with Mongols and continued by Ottoman and Persian, ended by annexation by Russian Empire; most important impact could have fall of Constantinople in 15<sup>th</sup> century which meant earthquake kind of shake of the economic and political system of the region, losing of the major strategic partner and military ally, the intellectual, cultural and religious leader and center, resulting in a major philosophical shift.

In 19<sup>th</sup> and 20<sup>th</sup> centuries Georgia was a peripheral region of Russian Empire and then Soviet one. Russian/and soviet governments made all possible to eliminate any kind of economic autonomies, despite of promises to keep them. For instance, both in the beginning of first decades of life in the Russian Empire and then in the first decade of Soviet Union, Georgia kept right of issuing and using in circulation of Georgian coins and banknotes but then they were abolished.

Pure colonial direction of policies and rules made Georgian economy (sectors, investments, supply and trade) serving strictly interests of the metropolis; moreover, Soviet Union shut opportunities international trade to Georgian producers. No direct trade was possible with foreigners and few indirect ties developed via Moscow – center. All postal or transportation services were available strictly through Moscow or by its authorization. This developed a strong dependence on the central bureaucracy, abuse of power by it, super-regulation of the economic activities, parasitical behavior and relationship between the center and the periphery.

This tendency was strengthened by soviet authorities because of their strong will to keep the political unity of the country. Georgia was among those Southern republics of the SU which, distanced from the entire world and international trade was forcefully integrated in the complete bureaucratized, centralized and protectionist economic system without private property.

### **Soviet Period**

Economy of the Soviet Union was centrally planned one. What this meant to Georgia was that central authorities needed to plan all the production and consumption, decide what was necessary to produce and where, by whom and where to be consumed, or use for future production goods.

By the idea economy of the SU was centralized to maintain full control of the economic process and try to use resources most effective ways. The central authorities were given power to distribute and redistribute resources, maintain prices, overprice one sector of the economy at the expense of underpricing of other, subsidizing production, groups and even territories, republics of the SU.

The monetary system was a part of centralized decision-making, which in fact (among the other functions) was another instrument of subsidizing of poor performing parts of the nation by better performing and wealth of natural resources.

It is uneasy to guess what would be the real quality of economic performance of different parts of the SU in the situation of market prices, if they would need any subsidies. Clear is one that central government first forced peoples (factories, agrarian production, cities, republics etc), to follow its own pricing decisions, then it was itself obliged supporting some of them who failing; then, even maybe understanding negative consequences of subsidizing, kept the system for political reasons only. Most of the agriculture goods were under-priced in exchange of overpricing of the industrial and consumption goods (like cars, TVs, etc).

Economic activities were corrupted and parasitized, resources wasted, institutes disorganized and people de-motivated. Corruption was widespread and reached greatest scales, criminalization of economic activities rose simultaneously with deficits of consumer goods, starvation and poverty. Georgia was one of the strong evidence of wrong economic system and incorrect policies. This applies to the centralized and *one size fits all*, collectivist policies against powerful individualistic nature of Georgians. In many cases they looked for private opportunities, even illegal ones, or, in

others, they instead parasitized on collectivist institutions, using common resources, receiving easier funds from Moscow authorities in exchange of bribes.

Moscow authorities heavily subsidized soviet Georgia, even well understanding of parasitizing character of this action but thinking this would strengthen uniting attitudes (in fact parasitizing) and calm down separatism. Subsidies were available for the government and industrial factories, agrarian sector (though buying lower quality production) and also culture sector.

Soviet Georgia counted around 900 industrial manufacturing companies, fabrics and factories, around 10 of them with more than 5 thousands of employees. The quality of their production was so low that in many cases buyers (obliged by the authorities) were trying to reject accepting them. Simultaneously, running for plan results Georgian authorities made possible to falsify statistics permanently and pushed falsified ways of fulfilling of the plan. This kinds of policy made further harm to the quality of goods; this tendency was also very much strengthened by lack of international trade – no direct import or export of goods was possible even from the SU's satellite countries in Eastern Europe. Consequently, quality of Georgian labor corresponded to the low quality of goods and services, despite of high level of literacy.

Very important is to mention also what real values represented by the soviet companies: these were mostly land and other real estate assets but for sure some qualifications of labor which could be still above the level of developing nations.

This was the environment in which Georgia met new life of independence.

### **Post-soviet time**

Georgian economy made a major collapse in the first few months and years of independence. The major reasons of the crash were closed economy, with no trade ties and low quality of goods made impossible to find chances for exporting goods, to keep industries to work but also to import essential consumer goods and food. For long months Georgia faced total deficit of automobile fuel. Remaining working companies were busy mostly with selling of scrap metal which staid a major export commodity for more than a decade.

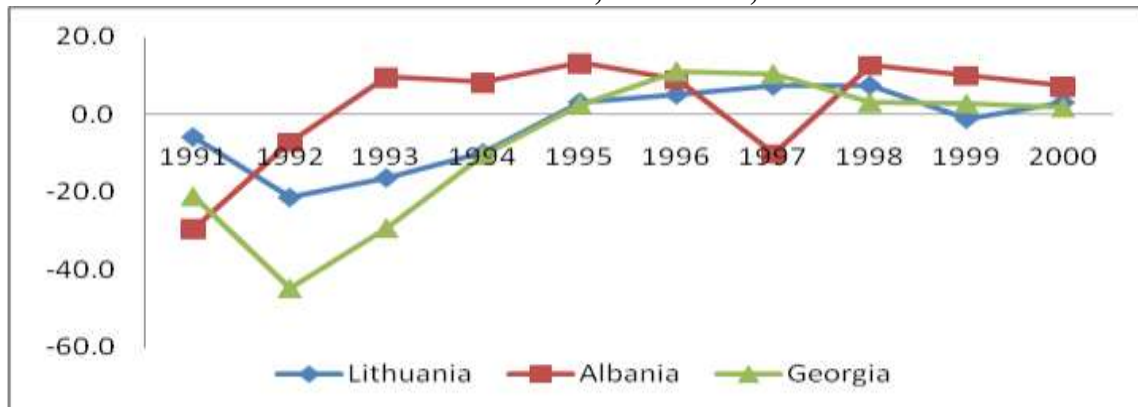
Very first year of independence was quite controversial. In parallel with very promising attempt of highest autonomy from already collapsing soviet economy, new Georgian government of the first president Gamsakhurdia made several crucial mistakes (for instance making barriers for trade with Russia and ordering price ceilings for food), which damaged first commercial attitudes for next long years.

Later, from 1993, electricity and natural gas blockade stopped operations of all remaining working industrial companies (except of those which were owned by Russian energy companies). People faced very tough winters, shortages of electricity and major food supply which lasted next several years.

First State Budget for Georgia after the collapse of the SU was only adopted in 1995 and it was less than 1/50 of the current budget arrangement.

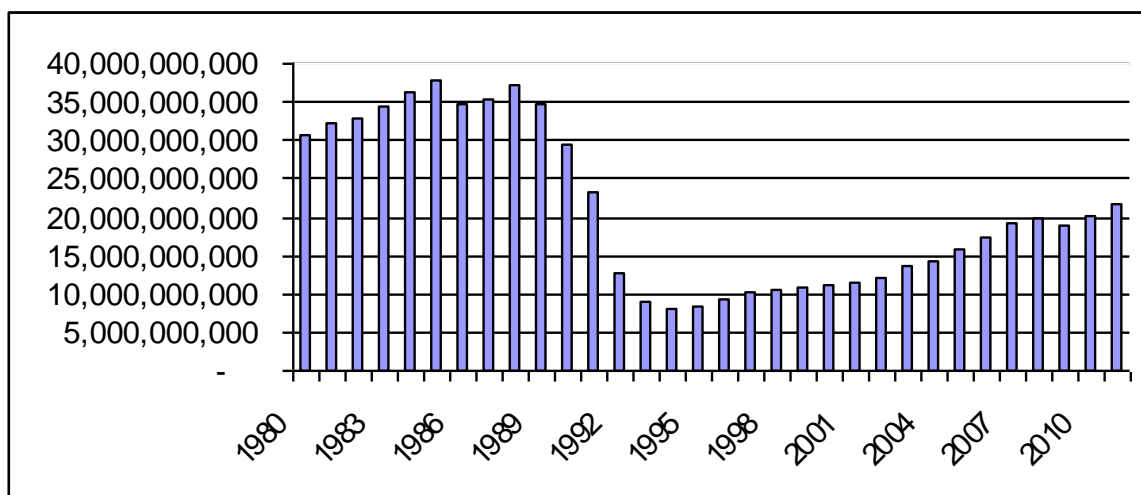
Independent Georgian economy suffered one of the worst among the ex-communist nations. In the middle of 1990s its GDP fell under 30% of the levels of 1980s and never had recovered back. The next graph illustrates the economic trends in three different nations.

**Chart 1. GDP Growth in selected countries, 1991-2000, Source: World Bank<sup>2</sup>**



Another chart shows well the deep failure of the Georgian economy after losing guaranteed soviet market.

**Chart 2. GDP in constant 2005 International dollars, 1980-2011, source: World Bank<sup>3</sup>**



**Monetary System:**

Monetary policy of first years of ex-soviet Georgia was a story of lack of experience combined with abuse of power and incompetence. In 1993 Russian Federation Central Bank decided to stop supplying Georgia with Russian rouble. In April of 1993 Georgian newborn Central Bank issued coupons to circulate in parallel of still remaining in the country roubles. This attempt was mostly connected with two major goals:

- a. create first state budget and
- b. start collecting taxes using local currency.

Unfortunately this attempt could have some other reasons which were backed by some interest groups for first increase artificially debts of public companies but also decreasing of real value of the assets for future privatization. This made acceptable inflating the Coupon t the levels of hyperinflation from initial rate of USD1=500 to USD1=1,000,000 coupons.

<sup>2</sup> <http://data.worldbank.org/>

<sup>3</sup> <http://data.worldbank.org/>

In 1995 Georgia adopted new laws on National Bank and National Currency – Lari, from the position of USD1=GEL1.3. Since that time Georgia's monetary policy went through several inflation and deflation periods, with flexible, pegged and inflation targeting experiments, which made their serious impact on the development.

### **Fiscal and Tax Policy:**

First tax laws in Georgia were adopted in 1994 in substitute of the soviet tax code which itself was implemented at the end of the SU. VAT was first implemented instead of sales tax among the other taxes on incomes, properties and consumption.

Georgian Parliament adopted state budget in 1995 in effort to cover some of the most important tasks (for instance elections) and expenditures (renovation of parliament building after it was destroyed by the civil war in 1991-1992).

The budgetary revenues collection started improving during the next years but hindered by Asian/Russian financial crisis in 1998. By that time collection of taxes reached the level USD400-500m (from almost zero in 1994) but the expenditures also increased the same speed due to implementation of several government functions and institutions.

Georgia was one of the ex-soviet nations which implemented so-called *Tax Code of the Republic of Taxastan*<sup>4</sup>, recommended by the IMF to these nations. Since 1998, local interest groups, politicians and other lobbyists organized a great press on the government and tax code was more than 100 times amended with more than 2000 minor and major changes. Every somehow powerful business was pushing its own privileges and relieves; having more than 20 kinds of taxes, most of them were using several different rates for different businesses and sectors of economy. From 1998 Georgia adopted a law freeing a farmer from taxation if the land parcel was less than one hectare. This decision made a very wrong impact on the agrarian sector.

This environment made business very unstable, impossible to fulfill obligations and rules, impossible to organize collection work. It created an informal relationship between taxpayers and authorities, paying taxes not by formal rules but by agreements making business illegal, tax collection based on bribery, lie and hiding of taxable operations.

In 2002, government, in cooperation with private experts attempted a major exercise to adopt new tax code but neither administration nor the business was ready for such a big change. This was just too late - there was a need of full shake of entire political system.

Government revenue collection declined after 1998 crisis then almost restored to the level of 1997 only in 2003. Between these years Georgia's government was sometimes unable to adopt state budget law for the year for long months, ministries and departments had huge arrears of salaries (especially to school teachers, pensioners) and liabilities to suppliers of electricity and office supplies.

The tax system contained several mistakes and loopholes, useful for powerful groups but dangerous for smaller companies. With the choice of paying up to 40% of taxes on labor most of the employees instead were hiding real volumes of salaries, but frequently paying dividends instead salaries to employees. Falsification of VAT documents was one of the ways to keep alive in the market. Meanwhile this system adapted only very risky or connected with the powerful politicians business; others tried to be distanced from the in-advance-criminal activities, the total number of registered companies was around 50,000 but only around 1/5 of this number companies were operational.

Dissolution of Soviet Union (Georgia lost its share in the Soviet pension fund) and crash of economic activities in Georgia, particularly, inability of tax collection, total unemployment created a long-run stoppage of contributions to social, health and pension funds. Restoration of the tax/social contribution collection was only possible in the second part of 1990s but in very

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<sup>4</sup> <http://www.imf.org/external/np/leg/tlaw/2000/eng/stan.htm>

limited frames. Economy was still very weak and heavy taxation made most of existing private employment hidden – major part of the contributions to the social funds were coming from public institutions, or returning amounts paid by the state budget.

This period, was characterized with total collapse of health care services – privatization of medical institutions was slow due to ongoing speculations. The pensions were flat (with some exceptions for military and police ex-officers) but never exceeded USD15 per person per month. State social funds became another big corruption sphere. Despite of very small pensions and all efforts to collect taxes funds accumulated huge arrears to pensioners, sometimes reaching several months and years.

### **Privatization and industrial structure**

First minor privatization attempts in ex-soviet Georgia were made already in the period of still alive SU, in 1991. The major success of privatization before 2004 was connected to the voucher method which woken up entrepreneurial mood among Georgians despite of rather. The major big factories stayed in state ownership mainly because of soviet type patriotic political campaigns serving the interests of the former administration leaders of those companies – the red directors. The only exception was privatization of electricity distribution company of the capital Tbilisi which suffered from shortages for long periods.

Red directors, those who participated in soviet centrally organized economy, using their powers to make money from by any possible illegal way now became organizers of strikes and manifestations in defense of their dear factories – the nation's dignity. In fact, with this way they continued use of assets, in many cases just selling them as scrap, accumulating debts at the expense of the state and avoiding paying taxes. Simultaneously, government implemented negative to liquidation bankruptcy law mainly to support dying state owned factories only for the benefits of the general managers who continuously speculated at the expense of poor employers. This had also negative impact on visions of Georgians towards entrepreneurship – for them businessman was a synonym of a thief, a liar and a falsifier.

Adoption in 1994 Law on Entrepreneurs and the Civil Code gave a strong push to entrepreneurship, but state remained the major owner of assets, including of the land. Land privatization started in early 1990s but first real effort was possible only with adopting new legislation on land ownership. Government granted small parcels of land to the farmers issuing to them registration papers but those parcels remained without surveys which remained a major problem for best use of the resource. Land ownership was limited to Georgian citizens although possible for foreign companies. But privatization was very slow due to very bureaucratized and corrupted practices. This limited very much economic progress and chances for private entrepreneurship.

### **Regulations**

Georgia of 1990s and beginning of 2000s became heavily regulated economy. First and second parliaments after adopting in 1995 new constitution made a great effort to create legislation counting totally of 900 laws and administrative acts by the executive branch. This first of all increased number of public offices and officers, especially of inspections and inspectors, all to have their strong mandate to check if all the rules, licenses and permits were used by businesses correctly, in fact collecting small to large sums as bribes. Regulatory legislation, backed by several small interest groups, made easy selection of those businesses who were ready pay bribes in exchange of getting licenses but simultaneously limiting others. Very uneasy was for instance to receive permission for constructing of new buildings, for which a company would need several permits but also bribing certain authorities of different levels – in fact impossible and/or very costly. A small business could have several different guests from different inspections sometimes for just collecting bribes – contributions for not auditing them.

Other problem of the implemented regulations was that they were adopted in a hurry to satisfy demands and recommendations of several international donors and advisers, sometimes just translated from mainly German or other EU nations. With this Georgian government tried to harmonize its legislation as close as possible to the EU without looking in its own institutional and human capacities, experience of using the democratic governance tools, responsible individuals. This created a huge opportunities of abuse and corruption but also heavy burden on the economy and business. Complicated regulations and totally corrupted bureaucracy became strong barriers to business.

### **Some other Challenges:**

#### **Property: Ethics and Protection**

Private property had been recognized by constitution but lack of experience and wrong experience of soviet past created new atmosphere where everything was allowed in parallel of lack of responsible and ethical behavior. In combination of very corrupted state institutions and especially judiciary, this made impossible of protect private property from fraud and contracts from breaching.

Government was very weak to protect individuals from robbery and stealing, moreover, criminal gangs had more power than police; they controlled smaller criminals and had very strong ties with several politicians. In many occasions police itself was acting like a criminal – robbing the small businesses, mostly during their delivery and transportation activities.

Police was one of the most corrupted institutions together with customs and some inspection services at the border. Procedure of crossing of the border for importers especially was a nightmare and impossible without direct bribery of the officers. Any effort to avoid bribe payment would cost into long delays of customs procedures, losing of market competitiveness – in comparison to those who just bribed and paid much smaller amounts as taxes, or just smuggled their goods through borders.

Apart to corruption schemes of appointment of servicemen of police, customs and tax departments (similarly to all public institutions) were paid very low salaries from 20 to 30 US dollars. This made the system working mostly for self-sustainable goals and serving the interests of powerful political groups.

In fact, several years after gaining of independence, “best” businesses in Georgia were fraud, robbery and breaching of contracts.

#### **Advantages and Disadvantages, Regional, Political, Geo-political, etc**

First separatist movement in Georgian regions of Abkhazia and S. Ossetia were organized already in the beginning of its independence. Not to fall in a discussion what and how happened, it is still very important to say that this confrontation has been only useful to Russian authorities and none of the sides gained anything from the conflict. But problem has remained and its impact on the Georgian economy is countless.

Other real influence on the economic situation in Georgia and the region has made a conflict between Georgia’s direct neighbors Azerbaijan and Armenia. This made impossible to cooperate especially in the toughest period of 1990s, trade and exchange was very limited – everybody lived for own-survival.

Fragility of the economic environment was also several times increased by bigger conflicts in the region, directly neighboring – like Chechnya, or distanced like Iraq. All the counted and other threats to peace contributed to a pessimism of investors.

In late 1990s Azerbaijan decided to change its oil industry policy, inviting western companies to develop but also cooperate with Georgia and Turkey on construction of two major pipelines to pump oil and natural gas to Europe. This revived global political interest to the region in the beginning of 2000s.

**Labor quality:**

As it was mentioned above the quality of labor in Georgia was not very competitive. It was somehow better in comparison to developing nations but looked less professional in comparison with developed nations but disoriented from global markets. Collapse of the SU and post soviet crash of the economy stopped operations of the factories, agriculture and services; this meant a long period of mass unemployment, further degradation of labor quality, no local competition, no attempts to improve skills in the times when the world continued improving, especially in the emerging markets. This made Georgians even less competitive and losing of even comparative advantage increasing importance of intensification of competition for rapid improvement of labor skills, quality and culture.

Inherited from the SU labor legislation was formally to put severe regulations to restrict employers but they almost never had any impact on the labor relations in Georgia. Even though together with heavy tax burden on labor they hindered competition and distanced potential investors for whom quality of labor in Georgia was a kind of big secret, hidden in soviet university diplomas and scientific degrees.

Another big problem with the labor market for Georgia was immigration of at least one 1/5 of population, maybe most active and skillful workers who found their business or employment opportunities up to as far as the US, living and working there mostly illegally. They worked hard in their new places sending money to support their family members back in Georgia, contributing to Georgia's economy sometimes up to 10 per cent of GDP.

**Energy Supply**

Georgia during SU was fully dependent on the soviet system then inherited by Russian Federation. This made not only very powerful the system itself but also possibility of Russian authorities to use energy supply system as a weapon for punishing rebelling neighbors. Shortages of electricity supply in winter lasted up to 2005, before it was possible to restore ordinary commercial relations in the sector instead of much politicized one. But shortages of 1990s after long decades of permanent supply during soviets brought a total shock and pessimism in Georgian cities but especially countryside where electricity was already a surprise.

Energy sector control was monopolized either by politicians or criminals who had direct corruption based ties to the suppliers in Russia. Attempt of the US owner of Tbilisi distribution company – AES, to arrange best commercial relations was also unsuccessful due to political trap they got in. Natural gas supply in Georgia was totally monopolized by Russian companies Gazprom and Itera. They dictated their policies, prices and rules but despite of this, corrupted nature of this trade made impossible provision of natural gas enough for Tbilisi until 1999 and to other places in the country even up to 2004.

**International Assistance**

International assistance started to come to Georgia immediately after its formal recognition by UN and world nations. Volumes of financial aid and loans increased especially during financial crisis of the end of 1990s. Assistance money corrupted and parasitized further government leaders. Trapped with hopes to receive as much assistance as possible they had forgotten about real life and need for improvement of business climate. Georgia's public debt reached 45-50% of GDP.

In many cases reports showed a total abuse and wasteful spending of the financial assistance and loans. Foreign experts, following to the aid resources frequently advocated policies which created further misuse of the resources, in many occasions granted finances were used for hiring individual or group advisors from abroad whose advices were just to increase public spending and regulatory burdens on businesses.



The IMF and World Bank, together with other donors made an effort to create anti-corruption and poverty reduction programs for the government. Georgian agreed with donors a reducing poverty with economic growth direction but implementation of this way was already late and rather impossible.

### **Short Conclusion**

Post-soviet economy in Georgia was a total chaos, corruption, waste of time and resources, incompetence and inability to arranging of business friendly institutional framework. Economy was growing slowly despite of huge barriers created by government. Georgia was fluctuating in between of 90<sup>th</sup> and 102<sup>nd</sup> places in the Index of Economic Freedom of the Heritage Foundation, held lower than 130<sup>th</sup> position in Transparency International Corruption Perception Index and among autocratic nations in the Freedom House surveys.

At the end of 2003 people were very exhausted with corruption, poverty and stagnation, demanded a major change which then converted into the Revolution of Roses a great hope.

### **After the Revolution of Roses**

Revolution of Roses – public peaceful revolt against falsified results of the elections in November 2003 brought a new reality to Georgia. Power was taken in its hands by young politicians in effort to modernize the country, finish with corruption, abuse of power and improve economic conditions of life for people.

From the very beginning of revolutionary era government has very unclear understanding and visions what was needed to restart economy. Most of the efforts were directed towards fighting corrupted officials, illegally or wrongly privatized assets and other violations of legislation. Only from the summer of 2004 the government announced about some of the new ideas to decrease of tax and regulatory burden, reform totally the police and other enforcement agencies, improve the quality of judiciary and public institutions.

Reforms of 2004-2012. The core foundations for the reform which sometimes were called Singaporisation<sup>5</sup> - were De-bureaucratization, Liberalization and Privatization, that meant:

- Decreasing of taxes and government size
- High speed of Privatization
- Deregulation of economic activities
- Anti-corruption measures
- Decriminalization measures
- Openness

### **Tax reform**

As it was mentioned above the tax system in Georgia before the Revolution of Roses was both disorganized and bureaucratized. The tax audits were organized by five different offices, some of the independent from the Revenue Service office (Social Taxes) and even from the Ministry of Finance (Road Tax). Therefore, a taxpayer could have been attacked by any of these offices (including VAT, Excise and Big Taxpayers Divisions). One of the main tasks government announced in 2004 was to allow only one institution to have inspection/auditing,

This kind of change first of all needed to reorganize the tax code and the revenue service itself. After long-run discussions it was decided to eliminate all secondary and special taxes (except social tax which was abolished later in 2007).

One of the directions of Tax Reform was decrease of rates for all remaining taxes after. Some of the rates decreased gradually and some had decreased in one step:

1. Personal Income tax decreased from 20% top rate to flat 12%, from 2005

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<sup>5</sup> For instance: Thomas de Waal in his *Georgia's Choices* actively advocated for Georgia to take Europeanization instead of looking for making Georgia another Singapore.

2. Social Tax from 31% - to 20%, from 2005
3. VAT from 20% to 18% later, in the second part of 2005
4. Corporation/profit Tax from 20% to 15%, 2005
5. Dividend and Interest Tax (part of the Personal Income Tax) from 10% to 5%
6. Social Tax merged into Personal Income Tax, in 2007 with rate of 25%, which decreased to 20% (flat) from 2008, becoming on of the first nations abolished social/wages taxes, meaning stoppage of social contributions and government liabilities to population.

Total number of taxes in 6, including of Import Tax

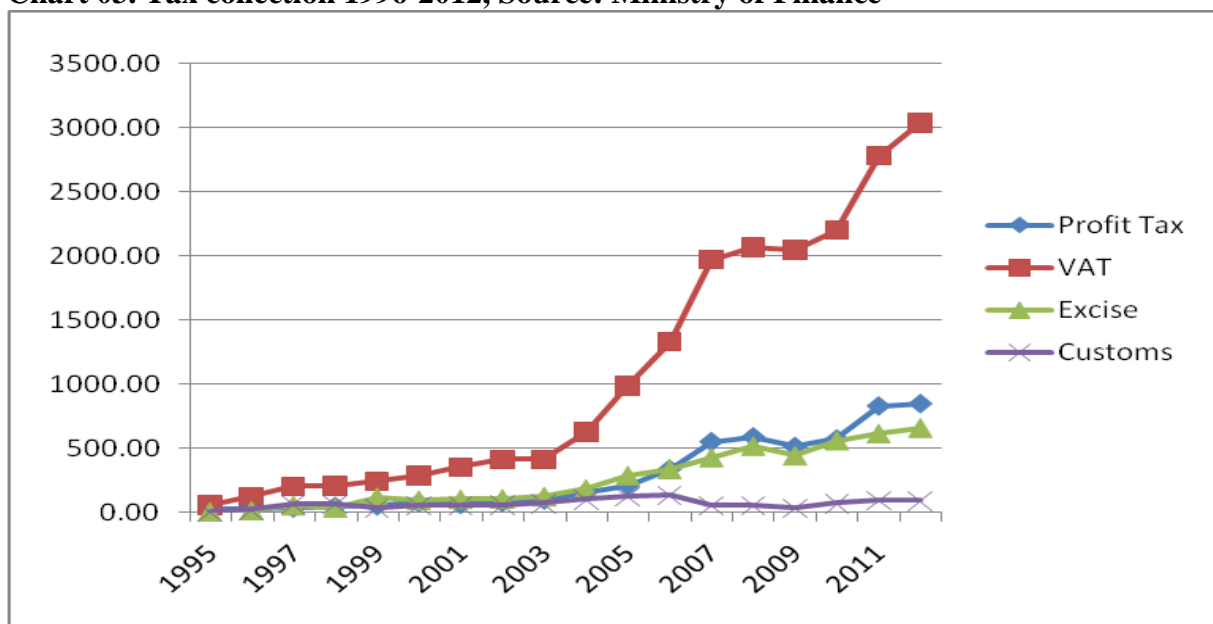
It would be uneasy to calculate what impact made the Tax Reform on the economy because of several other factors – reforms in many other spheres. But indirect positive impact can be observed in the dynamics of tax revenue growth:

*“The growth in nominal tax collection between 2003 and 2011 was remarkable across all taxes, with the largest increases in the profit tax (up by a factor of six), VAT and excise tax (up by a factor of more than five), and income and property tax (up by a factor of three). This expansion of the tax base was particularly striking given the sharp reduction in tax rates.”*

(Fighting Corruption in Public Services, Chronicling Georgia’s Reform, WB, 2012)

The first chart below demonstrates absolute positive trend of tax collections – a supply-side effect of the tax reduction (please note: customs tax rates have been radically reduced in 2007).

**Chart 03. Tax collection 1996-2012, Source: Ministry of Finance**



Very impressive was the reform of customs. First of all, simplified customs procedures are allowing importers to cross the border in few hours. But most effective news was elimination of customs duties to most of the imported goods from 2007 and decreasing the top rates of up to 32 % down to 12%. Here is the table to visualize Georgia’s trade policy openness in comparison to other nations in transition and the EU average:

**Chart 04. Border Protection in the EU and partner nations 2009 (Source: An Appraisal of the EU's Trade Policy Towards Its Eastern Neighbors: The Case of Georgia (Groupe D'Economie Mondiale, Sciences Po, Center for European Policy Studies, 2011)**

	Applied tariffs (%)		
	All goods	Agriculture	Industry
European Union	5.9 <sup>a</sup>	13.5 <sup>a</sup>	4.6
Countries under accession negotiations			
Croatia	4.9	10.7	4.0
Turkey	9.7	42.9	4.8
Macedonia	7.3	13.4	6.4
Countries with signed or ongoing DCFTA negotiations			
Korea	12.1	48.6	6.6
Ukraine	4.6	9.7	3.8
Countries willing to open DCFTA negotiations			
Armenia	2.8	6.8	2.2
Georgia	1.3	7.7	0.3
Moldova	4.6	10.7	3.7

It is also important to mention total improvement of tax and customs services. All tax procedures including of declaring and payment of taxes now are made through internet based software - taxpayers have no direct contact with the tax administration personnel. Very important was also to maintain very tight monitoring for the customs department offices which are now done with several special displays at the offices of Ministry of Finance and Revenue Service.

### Social System Reform

The initiative of the government to eliminate social tax or contributions was both long- and short-run practical decision. For the long run Georgia avoids huge liabilities of the government that makes its fiscal future very stabile. But for the short-run this attempt had a very pragmatic reason – government tried to avoid any fiscal difficulties but simultaneously stopped any speculations on the theme – who deserves more. The last was very important because any attempt to find a fair way to pay pensions and for medical services would be trapped in miscalculations and political accusations.

Therefore government's decision on keep flat pension system, gradually increasing the rate, according to the fiscal capacities was the only correct solution. The same time means-tasted social assistance program was also implemented to support the families with no or low incomes, with the medical insurance vouchers for pension age people.

### Deregulation

The Revolution Government promised to eliminate any kinds of barriers and obstacles to for making business in Georgia. In spring of 2004 it announced about lifting off the burden of inspections and checking of the fulfillment of regulatory requirements. It was clearly understood that this kind of functions of the government offices had no positive impact but simply making business difficult – many businesses were shutting down just because impossibility of following the rules and paying bribes.

After a year long discussions government in 2005 adopted new legislation regarding licensing, competition, labor, electricity production and supply. 800 licenses (85% of all<sup>6</sup>) and permits out of almost a thousand were just abolished. New rules of competition (Fair Trade) prohibited any

<sup>6</sup> <http://issuu.com/freedominstitute/docs/20120227-dis-fins-why-georgia-has-succeeded>

governmental intervention which could result in artificial monopolizing in the market – instead of investigating and punishing of the businesses. Legislation in energy sector allowed vertical integration, unregulated pricing and exporting opportunities.

Deregulation and commercialization brought total improvement of the situation in the energy market which after a decade of shortage nightmare became in 2007 exporting sector. The next table illustrates trend of electricity export and import during the last decade:

**Table 1. Georgia’s Electricity Export-Import Trends, Source: Ministry of Energy Web-Site<sup>7</sup>**

YEARS	2007	2008	2009	2010	2011	2012
Export	633.9	679.4	749.4	1,524.3	930.6	528.2
Import	433.5	649.2	255.0	222.1	471.0	614.6
Balance	200.4	30.2	494.4	1,302.2	459.6	-86.4

Very effective was the deregulation in the sector of pharmacy sector. Here, government made three important steps: 1) eliminating most of the licenses, 2) total opening of the market to the medicines produced and licensed in OSCD nations, and 3) allowing vertical integration. Production of medicines was also deregulated that supported the sector’s development and competition. In the result of the reform total number of acting in this sector companies increased 10 times, number of chain pharmacies increased from three to six, eight new producing companies were created, all these resulted into: “In 2012 standard treatment price is 50%-60% less compared to 2009” (Curatio International Foundation survey, 2012).

Another strong effort for supporting business environment was made in eliminating obstacles to start business. By new rules starting of business procedures decreased to two within maximum two days.

The deregulation story in Georgia would not be full (although there were countless other improvements) without major labor reform. In 2005 government adopted new labor code of Georgia which made employment relationship based totally on contracts. This measure was very essential for Georgia because of a long stagnation period and before disoriented by artificial economic system labor force the country needed a very free labor environment with highest degree of competition.

Together with the decrease of labor costs (taxes on labor) this reform made the country one of the leaders in labor freedom (evaluations of the World Bank, Fraser Institute and Heritage Foundation).

The labor freedom and decrease of tax burden on the labor, together with the government downsizing measures resulted in a great shift in the employment:

### **The Reform of the Police**

The police system in Georgia was a direct successor of soviet militia. Its main real function was to serve the interests of the authorities but not of the people. Simultaneously it was the most corrupted public institution in the country, taking bribes in any situation, robbing drivers in the streets, and it was also the most violent – having a big number of kidnapping, robbery, theft and victims every year.

The revolutionary government decided to finish with this problem using several different tools: a) firing all corrupted policemen. b) hiring new, well trained policemen, c) reorganizing of the system, implementing transparency and openness, d) implementing civilized methods of functioning, respecting individuals but strictly fulfilling their legal obligations. Most effective step was made was firing all the traffic police in one day – this eliminated bribing robbery of

<sup>7</sup> <http://www.minenergy.gov.ge/en/Statistic>

drivers at once. The other very effective measure was building of new offices of the police – all made of glass, transparent and friendly. But major step for fighting crime was zero tolerance low – or stopping any kind of cooperation with criminals (higher rank criminals to control the lower.) Announced by the government zero tolerance to crime policy together with the police reform made Georgia one of the safest nations in the world. The following table illustrates a big success of the police reform.

**Table 2. Victimization over last five years, per cent of the population, 2011; Source: Georgian Crime Trends in an International Perspective<sup>8</sup>, Jan Van Dijk and Tea Chanturia**

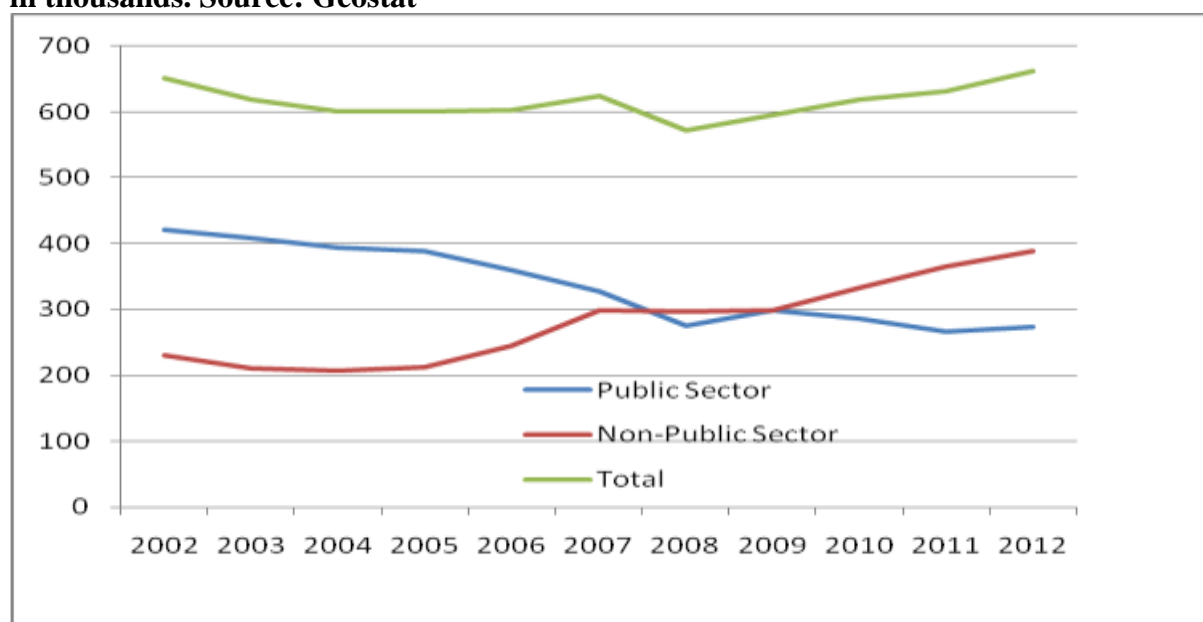
Crime types	0.2	1.2	2.2	0.4	1	0.1	1.1
Car Theft							
Theft from and out of cars							
Burglary							
Robbery/Armed Robbery							
Theft of other personal property							
Sexual incidents against women							
Assaults and threat of violence							

**Anti-corruption reform**

Anti-corruption agenda of Revolutionary government included first of all a campaign against bribery practices, including of firing hundreds of public servants. From the beginning everyday news was full of investigation and arrest stories of former government officers.

Then government decided to completely reorganize public services by downsizing, decreasing of the number of institutions and employees of remaining offices. This wave of downsizing of the government decreased number of employees from 400 thousands to 280 thousands, including of Ministry of Agriculture in which number of working public servants was diminished from almost six thousands to 400 (the number of employed doesn't include self-employed).

**Chart 5. Number of Employed in Georgia, 2002-2012, total, public and non-public sectors, in thousands. Source: Geostat**



<sup>8</sup> Remarkable Case of Georgia, Georgian Crime Trends in an International Perspective, Secondary Analysis of the 2010/2011 Crime and Security Surveys in Georgia, Jan Van Dijk and Tea Chanturia, (Ministry of Justice publication)

Government made a special effort also for moving public institutions from their huge buildings in to smaller outside of the center of the capital. Some of those buildings were privatized to international hotel chains (Intercontinental, Kempinski)

Another anti-corruption direction was establishment of fair payment for the employees (average salaries increased 10 times and more) with the more open and transparent hiring rules it was already possible to invite honest and well-trained individuals to the public service.

One of the most important anti-corruption directions was indeed the implementation of new procurement system. The new system took full control (except of some state secret purchases) of all government tenders and contracts but also fully changed to methods of purchasing. Now, since 2010 all procurement (including of municipal) is based on the Internet based software and all procedures are done via this system of the State Procurement Agency ([www.spa.ge](http://www.spa.ge)). Any user, registered in the system can observe the process and the results. Worth to mention also the dispute mechanism of the SPA: it is a group of individuals selected from non-government organizations and business associations. EBRD recognized Georgian public procurement (both the legislation and the system) as “A model for improving public procurement regulation”.<sup>9</sup>

It is not very big surprise globally now, but still, for the country with soviet past, implementation of e-government, electronization of the public services and procedures, using Internet-based services in several spheres like: taxation, civil registration, real estate registration, vehicle registration, national exams, etc. In the Justice House – individuals can obtain all kinds of documents, buy, sell and register properties, etc – in a very short time, with the principle of one window. No more lines and bureaucratic problems or bribes.

## **PRIVATIZATION**

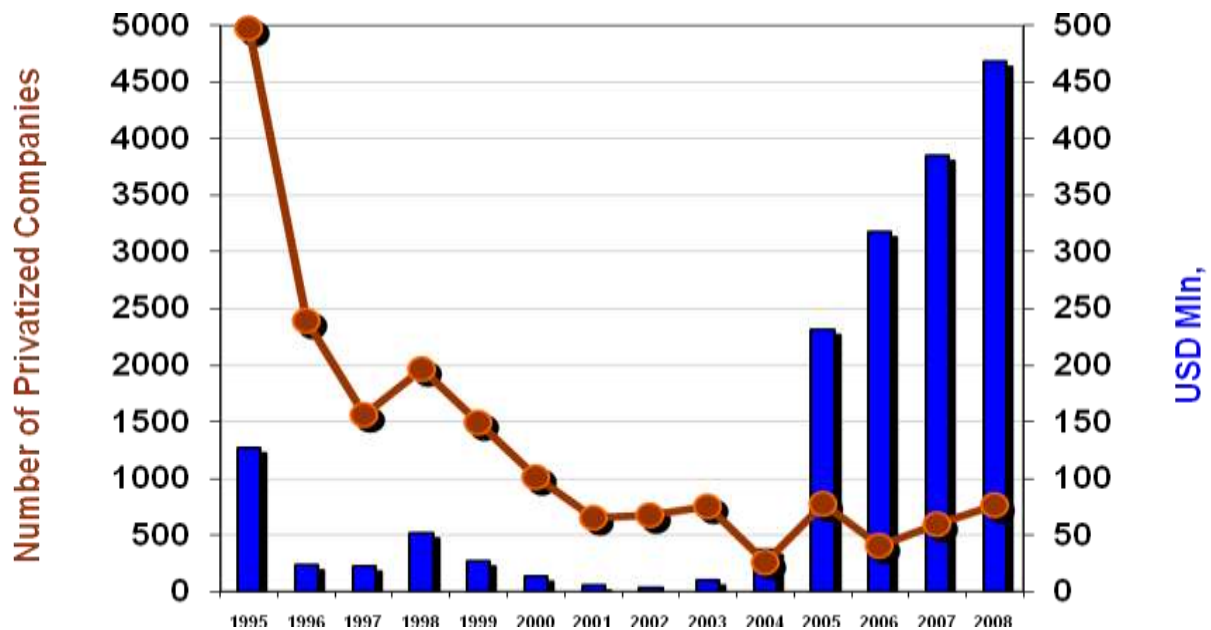
After long years of efforts to privatize state owned factories and land 2004 Georgian government met with a huge task to make major steps forward. The Voucher Privatization in the middle of 1990s was successful in the meaning of involving millions of population into privatization process, understanding that private ownership of former state property was normal event.

In 2004 new government, and particularly Minister of Economy (in future – State Minister of Reforms coordination - the major intellectual figure of economic reforms in Georgia) Mr. Kakha Bendukidze announced about full scale privatization “we are going to sell everything except of our honesty”. The agenda of the government included privatization of thousands of state owned factories as well as to restart privatization of the land. Very important was the second wave of the land privatization – in 2005 government adopted amendments to the legislation which eliminated some discriminations of farming land ownership. Major privatization efforts included the sectors of electricity generation and distribution and natural gas distribution, sea ports and heavy industries like metallurgy.

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<sup>9</sup> Seventh Regional Public Procurement Forum May 16-19, 2011, pg. 10-17

**Chart 6. Privatization of state owned factories (Left, line pattern, number of factories privatized; Right, columns, revenues from privatization in mln USD) Source: Why Georgia Succeeded, Larisa Burakova, OOO United Press, Moscow, 2011)**



From the same Source we learn that: “The European Bank for Reconstruction and Development (EBRD) noted a significant improvement in privatization of large enterprises in Georgia, raising the associated indicator from 3.3 in 2003 to 4 in 2007.”

### Openness

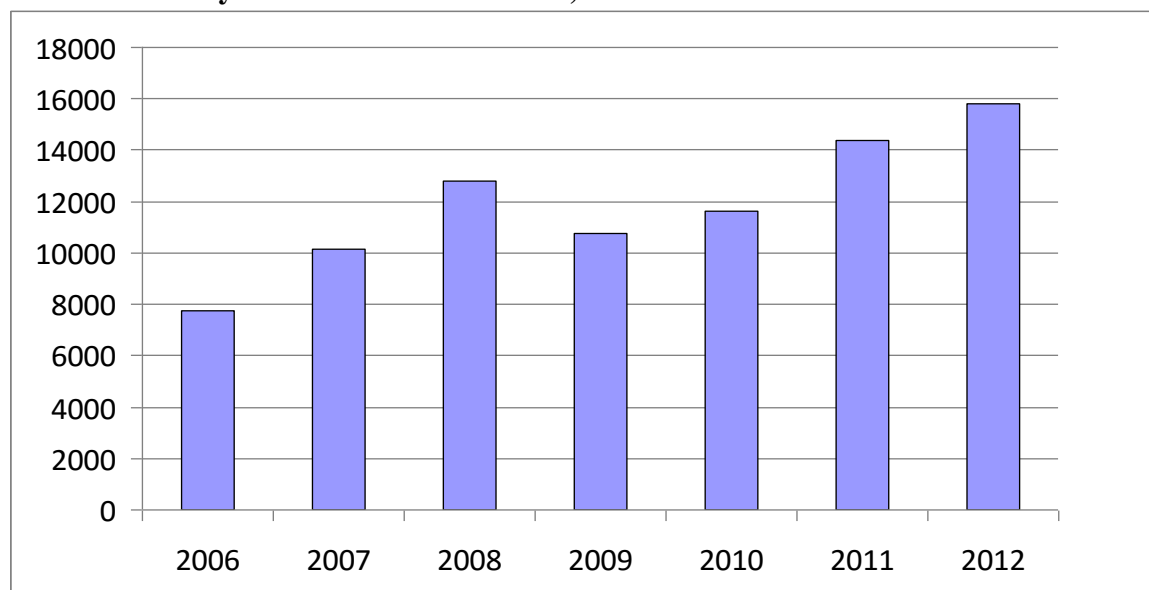
Georgian government made a very special effort for opening the country to any foreign economic activities and people. If looked at the four general freedoms from which European integration started in 20<sup>th</sup> century - freedom of movement of human and financial resources, investments, goods and services, Georgia can be recognized one of the world champions. A member of the WTO from 2000, Georgia from 2007 opened its borders to any goods – most of them are not taxed when imported, but the tariffs are kept at maximum of 5% and 12% for other goods. Georgia also has no quotas and any other limitations for imports.

More impressive can be visa regime and even more labor requirements for foreigners in Georgia. First of all, nationalities of 88 countries do not need visa to enter and stay in Georgia for a quarter of the year, all others can obtain a visa while crossing border with a simple procedures.

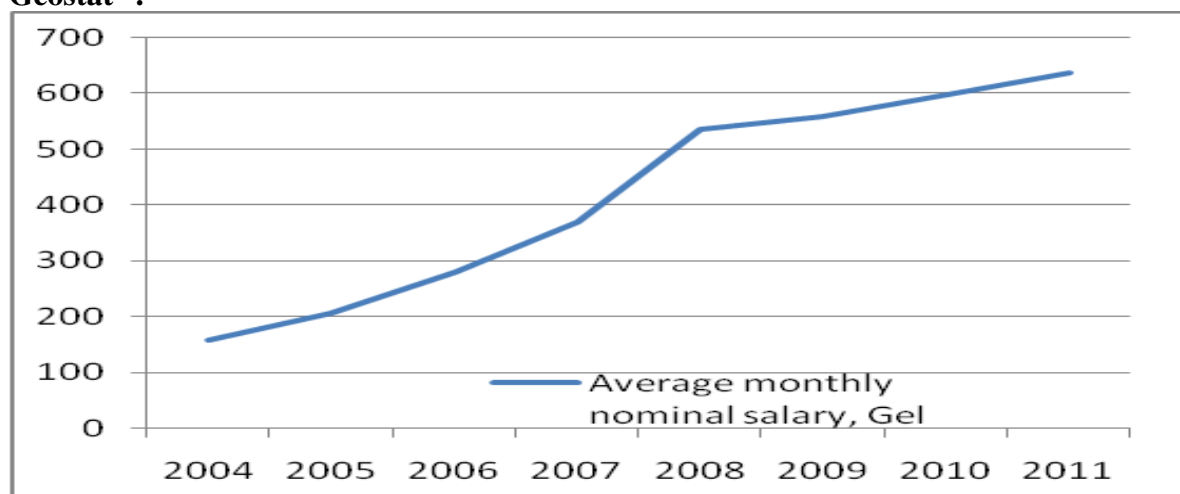
Employment rule is as primitive as having just a permanent legalization in the country.

### RESULTS OF THE REFORMS:

There are several facts to illustrate the positive impact of the reforms. Let’s look first at economic growth. In real current US dollars GDP of Georgia during the years of reforms from 2004 to 2012 more than doubled (it is worth to remind this growth happened despite of several tough challenges like: economic, energy supply and trade blockade by Russian Federation from 2006, the War with RF in 2008, Global Economic Crisis from 2008, etc):

**Chart 7. GDP by millions of current USD, Source: Geostat<sup>10</sup>**

Average salaries in Georgia increased four times – reasons can be various: economic growth, legalization of labor costs, increase of salaries especially in the public sector and inflation but all of them were the results of the reforms.

**Chart 8. Dynamics of average monthly nominal salaries, Georgian lari, 2004-2011, Geostat<sup>11</sup>.**

Another strong witness of well-performance of the economy during the reform period is for instance increase of volume of bank operations – the next table shows that it boosted eight times:

**Table 3. Revenues of Commercial Banks 2003-2012, Source: web-site of the National Bank of Georgia**

YEARS	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Bank Revenues	251,400	276,338	395,970	575,327	949,335	1,555,232	1,377,283	1,553,053	2,037,738	2,143,095

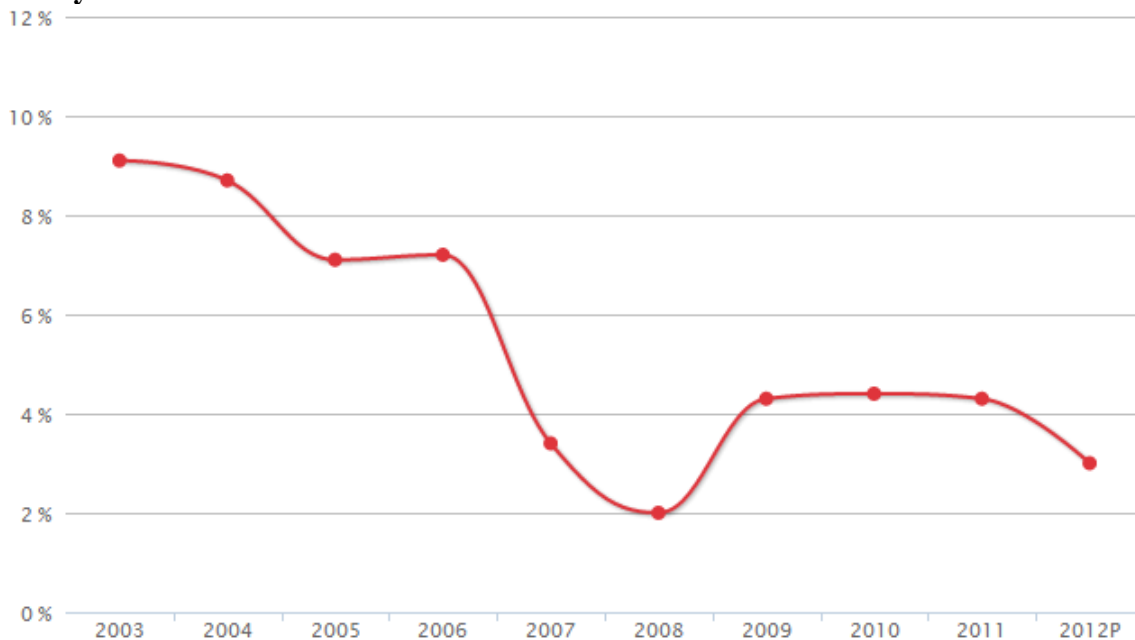
<sup>10</sup> [http://geostat.ge/index.php?action=page&p\\_id=119&lang=eng](http://geostat.ge/index.php?action=page&p_id=119&lang=eng)

<sup>11</sup> [http://geostat.ge/index.php?action=page&p\\_id=149&lang=eng](http://geostat.ge/index.php?action=page&p_id=149&lang=eng)



Very important for the economy and country was a decline of public foreign debt ratio to the GDP - from 40% to 25% but more important was a sharp decline of ratio of the annual payments from the state budget for the foreign debts. It decreased from 9% to below 3% level despite of the War in 2008 and global crisis.

**Chart 9. Ratio of repayments for the foreign debt to state budget, 2003-2013, Source: Ministry of Finance Webs-site<sup>12</sup>**



With high speed of growth and declining of need in borrowing Georgian government made very good steps to take whole responsibility over the economic situation and growth. In the Spring of 2008 major projects of the World Bank were finishing their activities in Georgia, and in May the office of the IMF was closed down. Only War with Russia in August after few months made it turning towards international borrowing and assistance.

Very spectacular is the number of registered companies which increased from 50 thousands in 2003 to 400 thousands in 2012.

Georgia became one of the leaders of economic reforms (WB, Doing Business) and kept this recognition for years. Different studies of economic and business liberties found Georgia as one of the best in the region and world. By now Georgia is:

- 21<sup>st</sup> in the Economic Freedom of the World, by Heritage Foundation evaluation
- 42<sup>nd</sup> Index of Economic Freedom, by Fraser Institute study
- 9<sup>th</sup> In Doing Business, World Bank survey.

*Georgia has emerged as a global leader in deregulating businesses and improving its business environment*<sup>13</sup>. By DB 2013 Georgia is No 1 in the World in Registering Property, 3<sup>rd</sup> - Getting Construction permits, 7<sup>th</sup> – Starting Business.

Very inspiring was as it was mentioned above, the anti-corruption reform after which Georgia improved its position of 124<sup>th</sup> in the world (out of 133) in 2003 to 51<sup>st</sup> (out of 176 nations) in 2013. Surveys like *Life in Transition* by EBRD found that: “77% of citizens agreed that corruption has fallen last four years. 87% of population assessed police performance as good or fairly good; 0.4% of cars were stolen last five years (Crime and Security Survey, GORBI, EU, 2011).

<sup>12</sup> <http://www.mof.ge/en/DebtFinance>

<sup>13</sup> Fighting Corruption in Public Services, Chronicles of Georgian Reforms, 2012, IBRD/WB

### **Economic Liberty Act**

In 2011, after long discussions Georgian government adopted constitutional Law: Economic Liberty Act. It prohibits government to have:

- Public spending over 30% of the GDP,
- State budget deficit upper than 3% of the GDP, and
- Public Debt more than 60% of the GDP.

The Economic Liberty Act also restricts government to impose a new tax or increase tax rates without public consent by referendum. The law came in force in 2013 for the time when all the requirements of it were already kept. This law has very important meaning in the situation when Georgia already has new government which is limited with the Liberty Act, though had promised lots of spending initiatives.

Another significant recognition of the reforms was a great number of visitors to Georgia to observe and study why country was so successful and how it happened. These were delegations from neighboring Azerbaijan, Armenia, Ukraine, Moldova, Kyrgyzstan, Kazakhstan, even from as distanced as

### **Problems Remained and Some Controversy:**

After a very strong free market push – President Saakashvili declared that Georgia’s way was “Not by closing the economy, but by giving it maximum transparency and by implementing free market principles.”<sup>14</sup>, from 2007 Government made its approach more moderate. Though most of the pillars of the reform were kept political leadership made some important decisions to try to calm down the rising political opposition and some disappointment of population (maybe mainly because of increase of competition). From 2008 government started implementing social programs of more assistance to poor, to unemployed, health care insurance for pensioners etc. The table below describes the fast growing social expenditures (and this is without education spending and subsidies to farmers).

**Table 4. Public Social Spending in Georgia, Millions of Lari, Information: Ministry of Finance of Georgia**

YEARS	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Social Expenditures	382.99	434.04	558.10	762.40	851.00	1378.60	1505.90	1623.60	1655.57	1857.57

Volume of Subsidies in the state budget increased five times from 105 m lari in 2003 to GEL514 in 2012. Among the subsidies, only after 2008 appeared support to farmers article, in 2012 government made one of the biggest mistakes during all post-revolutionary times: bought all the harvested grapes from farmers.

Backing of these new policies they thought could have found permanent support from the population, especially during the election periods. The same affair with grape purchasing was a simple attempt to keep engaged by opposition (political opposition strongly demanded direct budgetary support of the agrarian sector and farmers) farmers at least neutral in their political choice.

The faith into free market solutions was also strongly shaken by several international institutions demanding from Georgian government to implement more restrictive regulations especially in the labor, food safety, and competition policies. ILO, EU Commission, USTR and many other international institutions were directly involved not only recommending but also dictating to Georgian authorities to change their liberalizing attitudes (for example EU Commission’s prolonged pre-negotiations about the Free Trade Agreement, described in a study by Science Po

<sup>14</sup> From the President M. Saakashvili’s speech to the Parliament of Georgia, October 6, 2009

and CEPS<sup>15</sup>). Still, nothing said in this text can discredit the chosen by the government, very brave path to improve Georgia's economic situation with free market rules.

One of the challenges to economic improvement was the monetary policy. In 2010-2011 inflation again reached double digit size. Here, it is very important to note in favor of the Georgian National Bank leadership that after the high inflation they maintained more careful monetary policy which reduced the inflation to zero levels in 2012. But the experience of most successful in monetary policy nations in transition like Estonia and Bulgaria shows that implementation of the system of Currency Board would be better solution both for economic and political reasons. In fact Georgia was very close to this decision in 2007 when after Dr. S. Hanke visited Georgia and convinced many decision-makers about benefits of the Currency Board. (This is especially essential now when Currency Board could be another strong limiting instrument for the new government).

There were several criticisms for slow process of improvement of judiciary in Georgia. In fact there were many steps to improve judiciary independence: there were 76.4 % surveyed in the country in 2012 who believed that bribes were not taken by judges, and up to 84% trusted the courts, and quality of services by the courts was evaluated 4.5 out of 5<sup>16</sup>. But, still, it seems that to achieve more confidence, there should be harder work but lifting out political mentorship (maybe somehow needed at the first stage to ensure implementation of reforms but also avoiding corruption.)

This good result and very best and safe system of property registration had a very weak influence on the situation with property right in Georgia. This applies especially the eminent domain cases where government abused its confiscatory powers. The Heritage Foundation Economic freedom 2013 Index also states slight improvement of the property freedom in Georgia from by 5% to 45%, remaining the lowest rate among 10 subcomponents of the Index for Georgia<sup>17</sup>.

Some other problems the reformist government was not able to improve were decreasing of budgetary deficit and stabilizing the business legislation. Some government leaders were also too much excited by the success, forgot about their support to the small government idea. Very important was also to ensure that revenue service rules would not make a taxpayer automatically guilty and the rules to fit the constitutional requirements. A problem of low quality of the labor will remain a challenging press on the next generations of the decision-makers.

## Conclusion

The economic reforms of Georgia of 2004-2012 was one of the greatest attempts to improve economic situation and take responsibility on economic policy and development. Despite of the several warnings from abroad and opposition in the political scene in Georgia free market direction was chosen as a major engine of the reforms. The hesitations and political pragmatism after 2008 made impact on the decisions by which it was never achieved the level of double digit growth of 2007, and or level of investments of the same year of USD2 billion.

Government tried its best to walk between free market ideology and political pragmatism but rising dissatisfaction with results made possible softening of the reforms character and moving towards more socialized spending. Government simultaneously made a greatest step to ensure sustainability of the reforms by the Economic Liberty Act but hesitated to fulfill its promise to decrease further tax rates and soften administrative burdens. International organizations hailing Georgian reforms the same time pushed to the agenda some spending initiatives and regulatory obligations which have never helped country's business and economy. But political pragmatism dictated to be involved or to lose their potential support if needed.

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<sup>15</sup> An Appraisal of the EU's Trade Policy Towards Its Eastern Neighbors: The Case of Georgia (Groupe D'Economie Mondiale, Sciences Po, Center for European Policy Studies, 2011)

<sup>16</sup> Court Services' Quality Survey 2012, Applied Research Company, Council of Europe, and others

<sup>17</sup> <http://www.heritage.org/index/country/georgia>

It is very uneasy to anticipate what situation Georgian people would have if not the War with Russian Federation in 2008. But if implementing the Currency Board and keeping all the free market reforms, Georgia could very much count on foreign direct investments and double-digit growth. This could increase GDP to the rather higher level than it happened to have in the reality and bring this growth to every individual and family. This is exactly the major lesson from the Georgian experience: the political and international environment puts a government of a transition nation in front of the choice: either self-responsible policy or obeying to global powers, accepting their rules and assistance, pushing short-sight based huge social programs to satisfy current needs of population, instead of ensuring of quick development and sustainable future. Georgia's experience was a good lesson to the politicians in Georgia and in the World; the success of the reforms was a very good reason for following them in the direction of more liberalization. There was a need to decrease further tax rates, eliminate remaining custom duties and reorganize further tax rules, maintain strict fiscal and monetary discipline and at last, implement inviolability of private property environment.

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