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Policy, Advocacy, and Civil Society Development in Georgia (G-PAC)
საჯარო პოლიტიკის, ადვოკატირებისა და სამოქალაქო საზოგადოების განვითარება საქართველოში

THE ECONOMIC TRANSFORMATION OF GEORGIA IN ITS 20 YEARS OF INDEPENDENCE

SUMMARY
OF THE DISCUSSION PAPER

European Initiative
Liberal Academy Tbilisi

The Foundation "Liberal Academy - Tbilisi" was established in December 2006 as a non-governmental, non-profit organization, committed to promoting core democratic values, supporting peace-building and European and Euro-Atlantic integration and with that fostering the democratic development of Georgia and the whole Southern Caucasus region. The European Initiative - Liberal Academy Tbilisi (EI-LAT) is analytical programme which started in January 2010, builds upon LAT and embarks upon policy research and analysis with the aim to spark much needed debates on the European future of Georgia and the South Caucasus and contribute to policy agenda with its independent expertise.

On the one hand, the EI-LAT focuses upon issues pertaining to Georgia, specifically, and the South Caucasus, generally, and their relationship to the EU. On a larger scale, the EI-LAT aims to translate Europe for local stakeholders which are immediately affected by the Georgia-EU partnership frameworks and the wider public. On the other hand, it aims to reach out to the policy-makers and experts in Brussels and the European capitals in order to help them keep track of the reforms and changes within the countries and encourage a well-informed reciprocity. The EI-LAT, therefore, zooms into different stories of transition which reflect upon the dynamics of development and carry implications for the future. Its research products aim to take a fresh look and critically analyze key aspects of transition and, by that, contribute to crucial policy debates.

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This document is an assessment of the process of transformation to a market economy undertaken by Georgia. It covers the 1990-2003 and post-Rose Revolution, i.e. 2003-present, periods and describes the peculiarities of Georgia's economic and social developments, the differences these have made and the reasons for their successes and failures.

During the above periods there have always been contradictions between establishing a liberal market economy and addressing social concerns. Whereas before 2003 contradictory policies and harsh economic fluctuations were seen quite frequently, since 2003 attempts have been made to consolidate economic policy and establish a liberalised and modernised economy. However despite all the various changes of direction, phases and breakthroughs, the country still faces major challenges in terms of the tangible improvement of citizens' welfare and the provision of economic sustainability.

The reforms of the nineties served as the foundation for the formation of a market economy. In Georgia, as in the majority of post-socialist countries, the strategy of economic transformation was based on the anticipation of evolutionary development, a gradual adaptation to the market rules which were expected to cause fewer fluctuations and quakes. However, thanks to different political, economic and institutional factors, the economy has suffered market shocks and radical changes have needed to be made.

In the initial stages of Georgia's social-economic reforms two means of transformation of the economy were identified: the evolutionary and the so-called "shock" methods. Which one would be adopted would depend on the country's capacity to undertake evolutionary and revolutionary transformations respectively. Both options came with supporting arguments, and researchers into transitional economies had different opinions. Most socio-political forces supported the idea of a gradual transition to a market economy, but at the beginning of the nineties the economies of many transition countries suffered a severe shock and more radical changes had to be made. It should be noted that at this period the new economic mindset contradicted the old stereotypical mindset, and this significantly delayed the implementation of reforms.

The downfall of the Georgian economy began in 1990 and continued for another five years; this was partly the result of political conflict and ethno-political wars. During 1990-1993 Gross Domestic Product (GDP) decreased by 28% a year on average, and in terms of purchasing capacity fell from USD 4,433 to USD 1,437 per capita. By 1995 production had decreased by 78% compared to 1990, a fall three times greater than that during the "Great Depression" in the US. In addition, although the other post-socialist countries of Eastern Europe suffered the same decline, it lasted for an average of 4 years in these countries, but 7 years in specifically post-Soviet countries. Although Georgia's decline lasted for a relatively shorter time it was the deepest. Furthermore, economic activity largely moved into the shadows, the black market overtaking the official economy.

Table 1 Transitional recession and the "Great Depression"

Countries	Length of production decline (post 1990) in years	Cumulative reduction in production (%)	Real GDP, 2000 (1990=100)
Central and Eastern European countries and Baltic States	4	23	107
Post-Soviet countries	7	51	63
Armenia	4	63	67
Azerbaijan	6	60	55
Belarus	6	35	88
Georgia	**5**	**78**	**29**
Kazakhstan	6	41	90
Kyrgyzstan	6	50	66
Moldova	7	63	35
Russia	7	40	64
Tajikistan	7	50	48
Ukraine	10	59	43
Uzbekistan	6	18	95

Source: Transition (2002), January-February, World Bank.

Georgia was the last post-Soviet country to begin to peacefully construct its state and transform its economy. Not until 1995 did the Georgian economy begin to recover from crisis, supported by institutional transformation. The peak of economic growth was seen in 1997, when GDP grew by 10.7%, the highest rate prior to the “Rose Revolution”. But the growth rate then deteriorated dramatically, and the Russian financial crisis of 1998 significantly handicapped economic development, leading to inflation.

This first catastrophic inflation caused an increase in the value of foreign currency in Georgia, in particular the US dollar, and in the size of the shadow economy, which as a coefficient of dollarisation reached its height by the end of 2003 – at 86% of the whole economy. If fact a two-currency zone existed in Georgia: local currency was used to cover immediate expenses, small business transactions and consumer costs, and the US dollar was used for large business transactions, larger consumer expenditures and making investments.

In fact, the newly established state failed to ensure the functionality of state funds or to collect taxes. The share of the state budget in gross domestic product was insignificant. In 1995 it was only 5% of GDP; later it increased, but never exceeded 12%. Until 2004 this was the lowest index in the whole post-Soviet space. Thus, the state’s financial, economic and institutional capacities were too weak to enable it to make dramatic changes on the economic and social fronts.

During 1994-1998 a series of reforms aimed at stabilising and liberalising the economy were implemented. Changes were made to the banking system and to the national currency – the LARI was introduced. The privatisation of small and medium-sized enterprises began, trade was liberalised. This economic stabilisation and structural change was designed to end hyperinflation, balance the country’s economy and establish the institutional capacity to construct a market economy.

After the severe decline of 1990-1994, 1995-1998 saw a small improvement in the economy. People’s incomes, salaries and pensions increased in relative terms; small and medium-sized businesses became more productive; unemployment decreased. However from 1998-1999, against the background of the global financial crisis, the growth rate fell again until in 2004 Georgia was developing at a slow pace.

The biggest problems in the Georgian economy were the hyperinflation from the beginning of the nineties, low revenues accruing to the state budget and the financial crisis of 1998. In addition, Georgia had the fundamental problems characteristic of an underdeveloped economy: a budget deficit, increasing state debt, low monetisation, a weak banking system and insufficient progress on institutional and structural reforms.

Transformation progressed slowly; market mechanisms operated in a poor and weak manner. Strong administrative interference in the activities of market institutions prevented the development of a private sector and stimulated corruption and the formation of a new state oligarchy. To this can be added the immovability and stagnation in the attitude of the state; the level of monetisation was very low, and this indicated the limited role banks were playing. Due to the low levels of savings, the preponderance of cash transactions and the high dollarisation coefficient, the development of banks took place within a limited, closed environment.

The low level of investment also contributed to the instability of the economy, and the high dollarisation increased Georgia’s dependence on external factors, which, in case of the devaluation of the dollar, had a negative impact on the growth of the national economy and the value of goods produced in Georgia. These and other indicators demonstrated the generally weak financial condition of Georgia, but the dynamics were slowly improving.

The development of the Georgian economy could not be described as a homogenous process. After the notorious financial crisis of 1998, structural reforms were delayed and the rate of economic growth declined. A period of “immobility” began in Georgia and lasted almost until the Rose Revolution, although country was still developing, at the moderately low tempo of 3-3.5% on average. Socio-economic analysis of this period has indicated that the previous expectation of social-economic and political change had given way to conservative inactivity on the part of the authorities. No actual changes were in fact made.

As a result, social differentiation within the population became even stronger and the illegal economy increased in scope. Pensions and salaries were frozen, and therefore the wealth of a small group of people increased. These people constituted the political-economic elite of the country. The average salary was only 60-70% of the subsistence level, and pensions just 1/10 of it. During 1998-2003 the actual size of pensions even decreased.

Despite all this, certain institutional changes did take place; these were in conflict with one another, but still paved the way to the development of a liberal market economy.

The process of privatisation, which began in Georgia in 1992, aimed, besides other targets, at liberating those enterprises the state was unable to effectively manage. However, despite their liberation from state ownership their growth was still insignificant, and they suffered from a lack of financing and personnel. Private owners had no experience of running independent enterprises, and consequently the majority of these enterprises ceased trading, as they could not operate under the principles of a market economy. Those which remained open could only do so by taking on debts structured by the state, and remained uncompetitive. Thus, privatisation failed to ensure the competitiveness of the economy, but did create the institutional foundation for the introduction of a market economy.

From the 1990s onwards the preconditions for a liberal economy were slowly but steadily established in Georgia. In 1992-1996 import restrictions were gradually removed, and in 1995 the system of quotas was abolished. The list of non-exportable goods, drawn up during the Soviet period, grew shorter.

The institutional basis for the development of a liberal trade policy was established in 2000 by the accession of Georgia to membership of the World Trade Organisation (WTO). The basic obstacle handicapping the growth of the Georgian economy was the low level of investment and unfavourable investment environment, a product of the high level of corruption, instability resulting from ethno-political conflicts, existence of a shadow economy and other factors.

The social policies of the state had an insignificant impact on the number of jobs available, social security provision or inequalities of income, and as a result the unemployment rate increased. There was a mass transfer of employment from highly productive sectors to minor productive sectors – specifically to the agriculture sector, where added value per employee was 5 times less than in industry. The number of people employed in the agriculture sector, which in 1990 had been 26 %, had risen to 51% by 2003. This increase was caused by an allocation of agricultural land parcels to the people, which dramatically raised the level of self-employment. The ostensible social consequence of the low productivity of the rural areas and their routine manual labour was a lower level of unemployment, but in reality they were a clear manifestation of mass poverty.

Here it must also be noted that during this period the self-employed, who could barely manage to support themselves and their families, comprised almost 70% of the total workforce, and this index remained unchanged for years. The number of those hired to salaried jobs also decreased, partly as a result of the intense migration which began in the 1990s. During the same period the official unemployment rate was 11-14%, and 4 times higher in urban areas than in rural ones. 52.3 % of the population lived in urban areas, meaning that almost 4/5 of the unemployed were concentrated in the urban areas. In addition, the highest incidence of unemployment was amongst those with a higher education.

The state was unable to take radical measures to increase the effectiveness of social security provision, and as a result every second citizen of Georgia lived in poverty. Despite the moderate economic growth, the state social security system failed to get people out of poverty and ensure stable living conditions. It was supplanted by the generosity of neighbours and relatives, humanitarian support, charity – all these provided for the physical survival of the poor for some period of time.

The social problems of Georgia, including poverty, general social conditions and the quality of life, were mainly the product of the low effectiveness of the social services available in the country. During this period, three main problems were identified in the system of social infrastructure development: a) the minimal size of the tax base, caused by low wages and the small number of people employed in formal sectors, b) demographic changes – the aging and migration of the population, and c) incomplete coverage of social payments. One of the major problems was the minimal effect of social security on the population. In 2002 the share of state social payments (pensions, stipends, allowances) in the total income of a household was 3.8%; private (received from friends and family) cash transfers amounted to 10%.

In general, the transitional period provoked a contradiction between the illegally enriched and impoverished parts of the population. Between these there was no middle class, only the authorities. Government policy did not support the formation and growth of a middle class, which was supposed to serve as the driver of the country's development. The economic basis of such a class is the development of small and medium-sized businesses, intellectuals playing a significant role in the economy and community and the use of knowledge and education, but these phenomena did not exist.

Georgia could break out of its immobility by enhancing its democratic level, but this required a radical change of state institutions and the political adoption of a new democratic course as well as the strengthening of economic liberalisation. These serious challenges, failed statehood and severe social-economic conditions led to a change of government occurring via peaceful revolution in November 2003. In order to prevent the possible continuation of the immobility, people supported the radical "Rose Revolution" by protesting in the streets after another fraudulent election and demanding fresh governance and overarching reforms.

Since 2003 a rotation of neo-liberalisation, poverty reduction and "social economy" policies has taken place. Important institutional reforms, based on the principles of economic freedom, deregulation and economic modernisation, have ensured a high rate of economic growth and had a substantial effect on the growth of foreign direct investment. However, poor property protection, incomplete implementation of economic policy and lack of attention to the social sector have once again turned unemployment and poverty into severe problems. The Georgian economy has been recast as a demand-oriented and import-dependent economy, which has increased foreign liabilities and inflation. The idea of modernisation has not acquired strategic meaning in the economic policy of the government.

After the "Rose Revolution" new President Mikheil Saakashvili initiated radical changes in the social-institutional and economic fields. In fact, Georgia began the process of forming a new state. The post-revolutionary period may be conditionally divided into three stages: 1) the first months after the revolution, when the primary tasks were the establishment of fiscal order and coverage of budgetary, including salary and pension, debts and fulfillment of liabilities, whilst severe problems in energy supply, etcetera still needed to be resolved, 2) from the second half of 2004 till the end of 2007, when radical liberal (often call libertarian by analysts) elements first appeared in the policy and rhetoric of the Government of Georgia, and 3) that which commenced in 2008 following the political crisis at the end of 2007, encompassing the war of August 2008 and the global financial crisis, in which social goals were prioritised.

Initially, the supreme objective identified by the new government was the establishment of financial discipline and the restoration of the legal rules of the economic game. This implied the destruction of the shadow economy and clan structures and the seizure of property illegally misappropriated by key actors and its redistribution to the poorer classes.

At the same time, the following policies were being implemented: improving the industrial environment, changing the economy's legislative basis (by taking measures including the introduction of a liberal tax code) and reducing the number of control bodies and limiting their authority. The number of taxes was reduced from 20 to 6. Tax rates were also changed; some decreased. However these legislative changes had an insignificant impact on the reduction of the tax burden, and as a counterpart to the liberalisation of the laws the state tax authorities oppressed businesses to obtain revenue.

After 2004 changes were made to how the tax revenue was allocated to different level budgets. Centralisation was enhanced. In the Autonomous Republic of Adjara, all tax revenues apart from income tax and property tax were directed into the state budget, but in other local government budgets only an average of 5-10% was made up of local revenue. The local authorities received most of their income from equalisation, meeting targets and special and capital transfers from the state budget.

After the Rose Revolution the privatisation of state-owned property was particularly intensive. One of the cornerstones of the new government's liberal policy was accelerated privatisation, with no restrictions on the alienation of so called “strategic” objects. In addition, no limits were placed on the transfer of property to offshore companies and state-owned companies from other countries. Large scale concerns as well as small enterprises and land were privatised.

During the process of privatisation the primary accent was placed on fiscal effect, i.e. the accumulation of budget revenues via privatisation. One of the key effects of this was to increase the inflow and growth of foreign direct investment, as this derived from the purchase and further operation of objects of privatisation. From the macroeconomic viewpoint, privatisation and the associated inflow of foreign direct investment played an important role in both GDP growth and the growth of the state budget.

After the Rose Revolution the abolition or minimisation of different regulatory systems became one of the basic policy directions of the government. This was based on three arguments: 1. such systems are ineffective and cannot fulfill their functions; 2. the corruption level at regulatory institutions is high, and therefore under an anticorruption policy such institutions are unacceptable; 3. liberalisation of the economy implies a reduction in the areas and forms of regulation, including the complete rejection of certain types of regulation. On the basis of these arguments the anti-monopoly service was abolished and the “agency of free competitiveness”, with restricted functions, established in its place, on the basis that antimonopoly regulation by the state is not required as it should be ensured by the market.

Food safety control systems and institutions, and the structures in charge of technical regulation, standardisation, licensing and certification were also abolished. The number of licenses and permits required for trading was reduced by 84%. Nowadays, licenses and permits are still required for trading in high risk products and services, the use of natural resources and specific operations. In addition to the above, the procedures for granting such licenses and permits were simplified; the principles of a “one-stop-shop” and “silence is consent” were introduced. As a result of these reforms, the country adopted a system of voluntary standards and the regulatory role of the state decreased, moves which were supposed to support entrepreneurial activity.

Significant deregulation of the labour market also took place. A new Labour Code was adopted in 2006, which minimised the areas of regulation but contradicted the principles of the International Labour Organisation, European standards and the European Social Charter.

As a result of the institutional changes Georgia’s trade borders opened up: import-export procedures were simplified; tax rates and types were decreased; tariff and non-tariff regulation was simplified; trade relations were diversified via the conclusion of free trade agreements with regional and key trade partners and the investment environment improved. As a result, from 2006 Georgia’s rating in the Index of Economic Freedom began to improve.

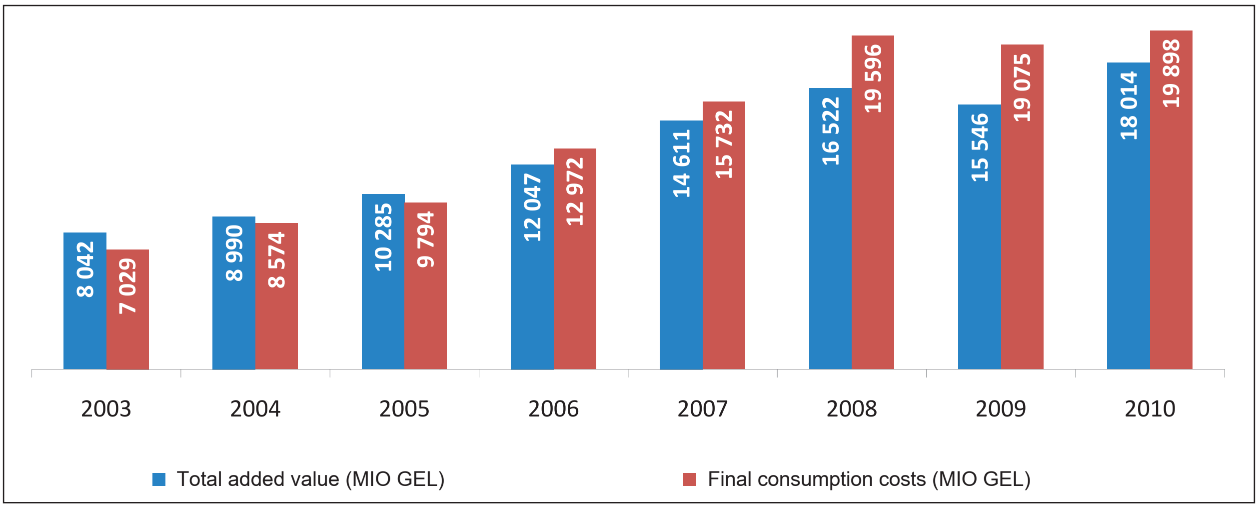
Year	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**
Position	96	83	79	93	43	31	32	32	26	26

Source: http://www.heritage.org/index/visualize

According to World Bank’s Ease of Doing Business rating Georgia made sharp progress in 2006-2007, as it moved from 112th to 37th position. In 2008 its rating improved even more, to 21st, and in 2009 to 5th. In 2010 it fell slightly, to 12th, and in 2011 it was 13th. However in the Report on Global Competitiveness Georgia was in 90th place during 2008-2009, 93rd in 2010-2011 and 88th, out of 142 countries and territories, in 2011-2012.

Until 2008 the main drivers of the economy were foreign direct investment and the development of the banking system. However, the Georgian economy was consumption-oriented (see the diagram below) and its productive capacity was underdeveloped. This was one of the main reasons for prioritising inflation in 2008-2010.

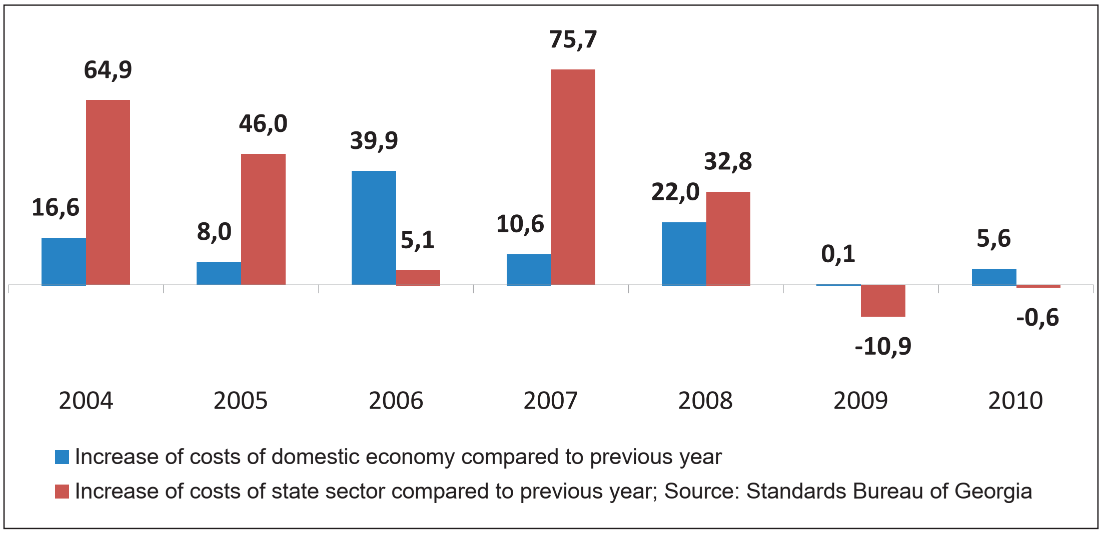
Diagram 1



Source: Standards Bureau of Georgia)

Consumption in the state sector significantly increased compared to the private sector. The costs of the state sector, and its share of GDP growth, were more dynamic than those of the private sector.

Diagram 2



Sectoral analysis of GDP clearly reveals a high rate of growth in those areas relating to the financial sector: real estate, construction and trade, which was directly connected to the expansion of the banking sector and partly to foreign direct investment. However, the important role of state expenditures in GDP growth was expressed in the development of the education, healthcare, social security and communal service sectors.

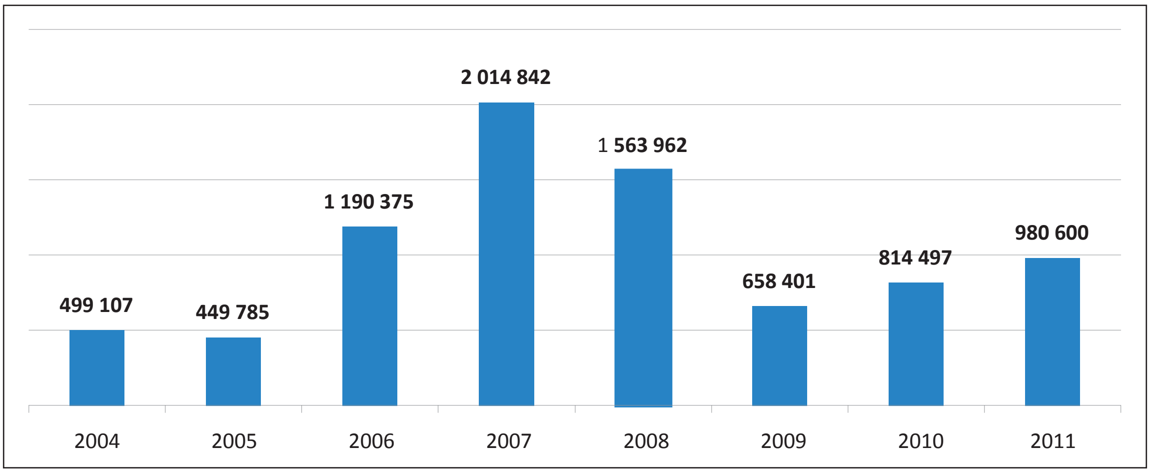
The Georgian economy was characterised by the small proportion of domestic savings in its GDP. Despite the growing dynamic of foreign direct investment (plus instability), the Georgian economy did not have a high proportion of savings or investments in its GDP. In this regard, and especially in regard to savings, Georgia lagged behind other post-Soviet republics.

Table. Savings and investments as a proportion of GDP in post-Soviet countries

Country	Savings as a proportion of GDP in 2004-2011 (average in %)	Investments as a proportion of GDP in 2004-2011 (average in %)
Armenia	25.0	32.9
Azerbaijan	44.3	28.5
Belarus	27.5	35.7
Georgia	12.7	26.0
Kazakhstan	30.8	31.0
Kyrgyzstan	20.4	22.6
Latvia	21.6	30.4
Lithuania	16.0	22.1
Moldova	20.0	29.9
Russia	28.4	21.3
Tajikistan	13.6	17.6
Ukraine	22.1	22.9
Uzbekistan	36.6	29.5

After the Rose Revolution the inflow of investments dramatically increased, due largely to privatisation and the post-privatisation financial injections made into certain objects/facilities.

Diagram3: Foreign direct investment in Georgia (in thousands of US dollars)



After the Rose Revolution a significant expansion of the banking system also commenced. In this regard a breakthrough was made in 2004-2006, when the share of loans in GDP increased from 9.2% to 19.4%. This indicated that the economy was developing by means of resources issued by the banks. The significance of the banks, and their participation in the growth of GDP, was increasing. This trend continued until 2008. The growth rate of the banking system was much higher than that of other sectors of the economy. In addition, loan accessibility was also expanded.

During this period commercial banks attracted foreign credit resources, which were supported by the favourable conditions on the global financial markets just prior to the global financial crisis. In this way too the banking sector played a significant role in the growth of Georgia's GDP.

The growth of the Georgian economy was also affected by foreign financial resources, which flowed in in the form of increased foreign debt and monetary transfers from abroad. Total foreign debt almost tripled in 2006-2010, and grew from 3,800,535.3 thousand US dollars in 2006 to 9,817,145.1 thousand US dollars in 2010.

In the second half of 2008 the country entered recession. The Russian-Georgian war of 2008 had dramatic consequences. The country suffered direct economic loss, which resulted in a radical reduction in its growth. In 2008 GDP grew just 2.1%, whereas in 2007 it had grown 12.3%. The war created severe ecological damage and other problems. The number of internally displaced persons increased by 160,000, and all these needed temporary shelter and social support.

The global economic crisis was the fourth reason for the decline of the economy. Western companies stopped giving credits to Georgian banks; as a result, the banks cut the number of loans they gave. This was followed by a reduction in the inflow of foreign direct investment. In 2009 foreign direct investment was only half that of the previous year; the fiscal and debt positions of the country aggravated.

At a conference in Brussels in October 2008 the leaders of 38 countries and 15 international organisations allocated 4.5 billion dollars worth of assistance to Georgia; of this, 2.0 billion was in the form of grants and 2.550 billion loans. This assistance was meant to rehabilitate the post-conflict economy during 2008-2010. It also mitigated the impact of the global financial crisis on Georgia, and consequently the economic decline was less painful for the country than it might otherwise have been.

Another serious challenge was the current account deficit. The increasing trade deficit of Georgia had previously been balanced by foreign direct investment and transfers. From the second half of 2008 onwards the reduction of these aggravated the current account deficit. The Georgian economy is basically import-oriented, and the growth in imports was one of the reasons for the increased trade deficit.

Changes also occurred in the social sector. After the Rose Revolution several steps were taken to institutionalise the social security sector. In order to provide social support for those living below the poverty line a state programme for families in such circumstances was instituted; they were identified, assessed and registered on a unified database. Targeted social support, in the form of a subsistence allowance, was distributed. As a result of economic growth and social reforms, the poverty rate slightly reduced, but at the same time social inequality increased and the profile of poverty changed within certain social groups. Poverty remains one of the most significant problems in Georgia.

According to the social service agency, on January 12 2012, 36.7% of the Georgian population was registered as vulnerable. The government has not proposed any significant innovations in relation to employment.

Since the Rose Revolution the government's economic policy has lacked consistency. During 2004-2007 little attention was paid to agriculture or social problems, the reduction of poverty or employment. After 2008 the government focused on these issues, though without tangible results. Economic growth was not reflected in a decrease in unemployment. The idea of modernisation, which drove the economic policy of the government, was not clearly defined or formulated as a concept or strategy. The resulting shallow understanding of modernisation ensured that no changes occurred in the deep structural elements (sectoral, labour market, technology, trade) driving the economy. Infrastructure has been improved and emphasis redistributed between the various sectors periodically, but the government policy of "modernisation" is not clearly identified, result-oriented or based on steady economic calculations.