

BRENTHURST DISCUSSION PAPER

**ECONOMIC REFORMS
IN GEORGIA**

Their Relevance for Africa?

Gia Jandieri



STRENGTHENING AFRICA'S ECONOMIC PERFORMANCE



Strengthening Africa's Economic Performance

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EXECUTIVE SUMMARY

Of all the former Soviet republics, Georgia suffered most severely from the collapse of the Soviet Union. During the early 1990s the country's gross domestic product (GDP) had fallen to 15–20% of what it had been under Soviet rule. Several political revolutions and a tough geopolitical situation prolonged the economic crisis, and by 2003 the country had sunk to its lowest level – political, economic and social – in modern times. After years of stagnation and political cataclysms, Georgia tried to turn itself around by launching a radical economic and political reform programme starting in 2004. The main goal of the reforms was to establish an environment in the country that would grow the economy, return a sense of dignity to the citizens of Georgia and give the country an opportunity to achieve sustainable development. The reforms covered all sectors of life and have generally satisfied both the population and international monitors, and the results of the reforms have been significant, although a great deal still remains to be done.

Radical reforms required radical and rapid decisions that could not be made if lengthy debates first had to take place, so the government gave itself extensive decision-making powers that allowed the reforms to be put in place, but caused certain mistakes to be made and resulted in the abuse of power in some areas.

In the economic sector, the main aim of the government was to change the business climate to make it much friendlier for Georgian entrepreneurs and foreign investments. The increased economic activity and higher inflows of capital that this brought resulted in higher economic growth and a dramatic reduction in poverty levels.

The results of the reforms have been impressive. The country's GDP has increased more than two-fold; the total volume of bank deposits has increased more than five times; and, after years of serious energy shortage, the whole country has a reliable electricity supply and Georgia has become a net exporter of electricity. Key international indices have reflected the success of the reforms: on the Doing Business Index Georgia is in 15th place; on the Economic Freedom Index it is in 32nd place (from 93rd in 2005); and on the Corruption Perception Index it is in 67th place (from 130th in 2005).

However, Georgia needs further reforms to become more entrepreneur friendly, secure property rights, establish a proper system of checks and balances in the political system, limit the power of government, make state expenditure more transparent, and make individual rights and freedoms a top priority.

INTRODUCTION

Although Georgia lies on the border between Europe and Asia, its experience is similar to Africa's in some respects. Like most of Africa, it underwent a long period of colonial rule. Then, on finally achieving independence in 1991, it found that radical reforms of its economy and political system were necessary but, nonetheless, endured a decade of stagnation.

In 2004 the Georgian government succeeded in carrying out radical political and economic reforms that resulted in high growth and widespread political changes. Georgia achieved success in several areas of both the private and public sectors, introducing changes that affected all areas of life. Economic growth was accompanied by improvements to public sector services and an increase in the number of companies operating in the country. The liberalisation and deregulation of the economy motivated businesses to pay taxes, legalise most of their previously hidden operations and initiate new ones. It is this process, and its significance for countries in Africa, that this paper will map out.

GEORGIA BEFORE THE REFORMS

Early history

Georgia, whose unique culture survives from antiquity, was annexed by Russia in the early 19th century. Its stormy relationship with Russia, whether in the form of the old Imperial Russia or the later Soviet Union, defined the country's development until 1990. After the collapse of the Soviet Union, the first free elections were held in Georgia in October 1990 and independence was declared on 9 April 1991.

The Soviet period

Georgia was one of the richest republics in the Soviet Union, mainly due to the widespread unofficial or underground economy. It was a typical colonial economy, with all production and services produced solely for the Soviet Union's market. Georgia produced 90% of tea consumed in the Soviet Union, 98% of citrus fruits, 60% of wines, and a large share of fruits and vegetables. Georgian industries also produced machinery and chemicals only for the Soviet market. All the production was of low quality and the main goal was to produce quantity.

The underground economy flourished at this time, including all industries and services, even those, like medical care, that were officially supposed to be supplied free by the state.

The tradition of planning the economy in combination with the underground economy made Georgia's economy incompatible with both socialism and a market economy. This

tradition, however, made it difficult for most of the old economic players to adopt market rules when reform came after independence from the Soviet Union, while it took time for a new generation of business people, who were familiar with the workings of a market economy, to appear on the scene.

Georgia after the Soviet Union

The collapse of the Soviet Union resulted in a very difficult period for the economies of the various entities that had made up the former Soviet Union. The disintegration of economic entities, whole territorial units and former Soviet republics caused hundreds of thousands of factories to cease their operations and millions of people to lose their jobs resulting in huge numbers of people having to change their professions and places of work, and to develop new skills. The still-functioning economic institutions of the different territorial units and republics of the former Soviet Union, such as energy supply companies, tried to avoid co-operation and develop more exports instead of continuing to supply one another. The economic system was also shaken by hyperinflation, which caused both individuals and many small and medium-sized factories to go bankrupt.

For the reasons described above, and because of the colonial nature of the economy and its industries, the Russian embargo on energy supplies, and the bad economic policies implemented by the Georgian government after independence, the Georgian economy suffered more than the other former Soviet republics that became independent states in 1991. This had various economic and political results.

Civil wars

The first years of Georgia's independence from 1991 to 1993 were marked by controversy. Georgia's first elected president was dismissed by the military and a military junta took power. This government decided to implement police control over the whole territory, which resulted in civil war and the establishment of separatist governments in two regions, with the support of the Russian security service.

The civil wars in 1992–3 resulted in the Georgian government losing control over large amounts of territory and displaced more than 300 000 refugees of Georgian ethnicity. These wars also resulted in the economy shrinking to only 10–15% of its size in the Soviet period. As a result, during the first years of independence, Georgia lost 30% of its total population, which dropped from 5.4 million to 4 million, as people emigrated for economic reasons to various countries in Europe, to the United States and to Russia.

INEFFECTIVE ATTEMPTS AT ECONOMIC RECOVERY BEFORE 2003

After a long period of recovery from the total collapse of both the economy and law and order in the country, a new constitution was adopted in 1995 and a new Georgian currency – the lari – was introduced. 1996 was the first year in which Georgia's government was able to adopt a central government budget.

The new constitution consolidated political freedoms that already had quite a strong presence in the country. Even though the government tried to attack the media several times without any success, many new TV and radio stations and newspapers started operating in all parts of Georgia. Religious freedom was also enshrined, although the Orthodox Church dominated in this area.

Alongside these successes there were also several failures, such as widespread corruption and abuse of power, which caused the country to stagnate. Economic reforms produced no results and business was frightened, and dominated by political favouritism. Trust in public institutions fell to its lowest level.

Georgia adopted a tax code in 1997 that introduced the kind of system recommended to many developing countries by donor organisations. This system did not work well – it made the lives of entrepreneurs very difficult, forcing them to hide their business activities and evade taxes. Bribery of tax collectors was rife. The complicated rules and large number of taxes with high rates made business virtually impossible without governmental/political backing. Only those companies with political support could survive, and then only by making direct cash payments to the powerful families or political organisations backing them.

The same kind of process happened with customs, which presented the largest problem for import-based businesses. Customs procedures were both very slow and very corrupt, many companies tried to avoid paying customs by bribing high- and lower-level officers, and those who couldn't find patrons or people to bribe simply abandoned their businesses. Because of the taxation and customs systems the number of companies actually operating was about 10 000–12 000, compared to the 40 000 officially registered in 2002.

The number of permissions and licences applied to business exceeded a thousand, and establishing even a simple business wasted huge amounts of time and required a huge amount of documentation, which inevitably also meant that bribes had to be paid. Running an official company without political backing became almost impossible and economically unrealistic. Anti-trust regulations gave power to government agencies to effectively terrorise small businesses for many petty reasons, thus allowing the officials of these agencies to extort bribes.

The privatisation process started in 1990 continued with partial success after 1993, and achieved a certain level of breakthrough after 1998. Most of the big factories (up to 1 800 plants and factories that had almost never worked after the collapse of the Soviet Union) remained in the ownership of the government, which tried unsuccessfully to sell some of them, but then stopped after criticism from local media and politicians. The bankruptcy law adopted in 1997 did not work, as it was designed only to defend management. This had the result of prolonging the life of the state factories with a devastating effect on the economy. The managers of these companies were only concerned with stealing what could be stolen, and organising illegal/hidden companies on the premises of state factories. At the end of the 1990s the government had failed totally to privatise state-owned industrial companies.

Rural land was only partially privatised, affecting only 30% of the land, while all urban land remained under state ownership. Private property rights continued to develop, but unsatisfactorily: Georgia had fewer restrictions on land ownership – even by foreigners – than any neighbouring nation, but simultaneously paid almost no attention to institutional

issues like securing title deeds to properties. The institution responsible for the real estate register was dysfunctional with very low levels of efficiency, lots of paper work, long queues and no security. Nobody could be sure that the building or land parcel that they were buying had not already been sold to someone else several times over. In this situation, Georgian small businesses, especially in the agricultural sector, were unable to find financing for their activities because without secure possession of their properties they could not use them as collateral for loans. In other cases, people simply tried to take possession illegally of parcels of land or empty buildings.

The increase of governmental functions and responsibilities resulted in high levels of bribery. Corruption was rife among high-level officials, while most of the low-level bureaucracy was also involved in petty corruption. All public expenditure was based on the non-transparent and ineffective waste of resources, and most of the money available to government was simply stolen. Despite both internal and external criticism, the government did not establish or apply any rules for fiscal discipline and transparency.

Paying taxes therefore became absolutely irrational. Expert evaluation of the shadow economy put its extent at up to 70–80% of all economic activity, but definitely not less than the 55% given by official statistics. The total official tax burden imposed was around 45%, and up to 70% in some areas. Nonetheless, tax revenues never exceeded 20% of gross domestic product (GDP); for instance, in 2003 (the year in which economic growth reached its highest level of 13%) total tax revenue was estimated at 700 million laris, while GDP was 8.4 billion laris.

International donor organisations tried to support the establishment of a new state in Georgia with advice, consultations, staff training, capacity-building efforts, loans and grants. External financial assistance to Georgia was an important part of government revenues, including financing the budget deficits, and the country became one of the highest recipients of foreign financial assistance in the world. Unfortunately, however, this assistance was as ineffective as government itself: firstly, the money was spent ineffectively, and secondly, most of it was simply wasted or stolen. This international assistance corrupted the minds of most of the population, the media and politicians, who thought that the most significant achievement of the government was to get as many loans and grants from foreign sources as possible. In some periods, external financing of government activities reached 30–50%. This made the Georgian government think mainly in terms of how to get more money from foreign donors, and gave no incentive to it and the civil service to be accountable, transparent and effective. In 2003 international donors lost all confidence in Georgia because of its stagnant economy and corrupt politics.

Political problems

The constitution did not create a system of checks and balances and failed to impose limitations on the power of the central government. Decentralisation did not find support in central political circles.

The executive held all the power and elections became more and more ineffective, making the population feel frustrated. Participation in the elections held from 1999 to 2003 fell

to 30–40% of the electorate, down from 70% in 1995. Opposition parties and the media accused the governing majority of falsifying the election results.

The economic situation did not improve, especially after the East Asian financial crisis of 1998, when the economy shrank again and experienced no positive movement until 2003. GDP per capita was at its lowest level of US\$600–800, tax revenues hardly reached US\$300 million. The people of Georgia started demanding change.

External economic and security problems

Internal mistakes and mismanagement were accompanied by external problems.

Georgia's neighbourhood is definitely not the best in economic terms. The most developed nation near Georgia is Turkey, which had very hostile economic policies over the pre-2003 period. All the other economies in the region were in the same kind of critical state as Georgia; GDP per capita in neighbouring countries was no higher than US\$1 000, and economic policies were also not pro-business. These nations also had very corrupt governments and even less-developed civil societies, their business practices were no better than those of Georgia, and the competitiveness of their business and public sectors was at a low level, so Georgia had nothing to learn from them.

Georgia has always been a meeting place of different civilisations, with competition among them always affecting the situation in the country. It has always been a strategic goal of various powers to control the corridor between Europe and Asia; and the importance of the country increased due to oil and gas supplies passing through it from the Caspian Sea area. This caused changes in the status quo of the region, and it became increasingly important, especially after the establishment of the Baku–Tbilisi–Ceikhan and Baku–Supsa oil pipelines.

Furthermore, Georgia is located on the Black Sea, which makes its territory vital to some of its neighbouring nations and very important for others in the Central Asian region, particularly in terms of their trade with the rest of the world. Georgia's railways, roads and ports are the best means of transport for these nations' exports and imports. This applies to both oil and gas, and to other cargo. Russia's aim seems to be to extend its control once more over the territories of the former Soviet Union and regain its superpower status. If the Russian Federation were to regain control over Georgia, it would effectively control the key transport route that allows the region to trade with the rest of the world. After several provocations, in 2006 Russia announced an economic embargo on Georgian production; cut transport and postal services; and, after the war in August 2008, occupied 20% of the country's territory. This makes the policies of the Russian Federation a vital problem for Georgia's security, since they discourage investment and reduce growth.

Last, but not least, the region in which Georgia is located has suffered from many conflicts and wars over the last few decades, including those in Iraq, Azerbaijan and Chechnya. Not only are none of these conflicts resolved, but the appearance of new ones is quite possible.

THE 2003 ROSE REVOLUTION

In 2003 Georgia found itself in a permanent political crisis that was not ended by the general elections, the results of which had failed to satisfy any of the participating political parties. After lengthy peaceful protests, President Shevardnadze resigned and new presidential and parliamentary elections were announced. This event was called the 'Rose Revolution,' because the thousands of protesting Georgian citizens were armed only with roses, not guns.

The revolution had both positive and negative results.

Most government institutions collapsed and therefore the need for constitutional changes was seen as increasingly important in order to concentrate power in the hands of the executive branch to enable quick responses to the new challenges facing the country.

The revolutionary government made many populist promises, and although many of them were simply rejected later and never implemented, they had a negative impact on the government's actions.

After some months had gone by, the government realised that the position of the country was very fragile and that there was almost no chance of moving the economy forward except by using extraordinary measures. Georgia was at rock bottom, and there was nowhere to go but up. The most important idea to surface was the need to attempt a radical reform of the business environment. The main questions that had to be answered were how to make the country more attractive to investors, how to achieve economic growth and how to reduce corruption. The major answers to these questions appeared to be to liberalise, to deregulate, and to decrease the functions and power of the government.

POST-2003 REFORMS IN GEORGIA

In January 2004 Mikheil Saakashvili was elected president of Georgia. Constitutional amendments in February of that year gave him considerable power to reorganise the country and launch economic reforms. The population understood and supported this initiative and demanded rapid changes. In response, the government offered a plan of action to rehabilitate the economy, support business and attract foreign investments.

President Saakashvili concentrated all his efforts on making public policy as effective as possible in order to immediately re-establish public confidence and used his popularity to take decisive measures. One of his most effective steps was his invitation, in the spring of 2004, to Georgian professionals abroad to return home and assist with the reforms, a plan that worked most effectively, as those invited have played an important role in the reform process.

The government announced its priorities for economic recovery and reform, which included liberalising the tax system, deregulation, making the process of starting a business much easier and privatisation, along with public sector reforms that included eliminating corruption, decreasing the number of government agencies and downsizing those that remained.

Tax reforms

Taxation had been a major problem for Georgia before 2003. As mentioned above, it affected not only the market and businesses in Georgia, but also the political system itself. Taxpayers, instead of being the major stakeholders in, and monitors of, the government and its policies were hiding not only from taxes, but also from any political and civic responsibilities. As a consequence, the system needed not simply a cosmetic change, but radical reform. After the Rose Revolution, the government committed itself to reducing the burden both of tax and administrative abuse and, after a year of discussions and debates, reduced the number of taxes and their rates to the lowest levels in the region at the end of 2004. The new tax code radically changed the structure and approach of taxation.

- The number of taxes was reduced from 22 to seven (and then to six after 2008). All the fiscally ineffective taxes were eliminated, and those taxes that resulted only in corruption were abolished. The taxes remaining after the tax reform were those that had the most positive fiscal effects and were the easiest to calculate and pay.
- A flat income tax rate of 12% was implemented, which was then merged with the social tax (which was a flat 20%) in 2006 to make a total of 25%, which was subsequently reduced to 20% (flat) in 2009.
- Social (insurance) tax was first decreased from 31% to 20% and then eliminated in 2006; all other special taxes were also abolished, including road tax, and special funds were to be financed directly from the budget (by revenues from other taxes).
- The corporate tax rate was decreased from 20% to 15%.
- The value added tax (VAT) rate was reduced from 20% to 18%.
- A 100% depreciation rule was implemented from 2004, which means that any company can write off equipment bought in the same year. This is an incentive not to hide incomes, and also to innovate and introduce new technology as fast as possible.
- Customs duties were removed. Export duty had been eliminated previously, but from 2006 the government started decreasing import duties, and by the end of 2007 the actual rate of duties was close to 0%.
- Privileges and special rates were done away with: the new tax code eliminated all remaining privileges and applied the same rates of income tax and VAT to all business activities.
- Online tax declarations (returns) and payment were implemented from 2007, allowing companies or people with access to the Internet to submit their returns and pay taxes from their offices or homes, thus avoiding frequent visits to the tax office and long queues.

Despite the reduction in the number and rates of taxes, fiscal revenues increased impressively. The table below shows the best results.

Tax revenues after the 2004 reforms

	Year	2004	2005	Increase/ decrease
Personal income tax (PIT)	PIT rate	Progressive up to 20%	Flat 12%	-8%
	Revenues from PIT	268 649	290 690	+8%
	Tax base	1 343 245	2 422 417	+80%
Social insurance tax rate (SIT)	SIT rate	Flat 31%	Flat 20%	-11%
	Revenues from SIT	296 354	428 786	+45%
	Tax base	955 981	2 143 930	+124%
		1st half 2005	2nd half 2005	
Value added tax (VAT)	VAT rate	Flat 20%	Flat 18%	-2%
	Revenues from VAT	367 000	560 000	+53%
	Tax base	2 202 000	3 671 000	+67%

Recent tax developments: new initiatives

At the beginning of 2008 the Georgian government announced a new initiative contained in the Financial Sector Act, which, along with other initiatives for developing the financial market, included a further liberalisation of tax rates that included:

- the reduction of income tax from 25% to 20% from 2009
- the elimination of capital gains tax from 2009
- the reduction of tax on dividends and interest to 5% from 2009, and
- the elimination of tax on dividends/interest from 2012.

Deregulation

After the tax reforms, the government understood that the business/investment climate would not improve quickly if only taxation were reformed. All the surveys showed that the second-largest problem involved in starting and running a business in Georgia was over regulation. The government therefore decided to radically deregulate the economy, which included various measures.

- In 2005 Parliament adopted a new law on licences and permissions related to business that decreased their number from 944 to 150, and implemented a system of entrepreneurs having to visit only one window at the relevant government department to carry out all the procedures required to start a business in the quickest time possible (the number of procedures was also reduced).
- Deregulation in the sphere of the environment/use of natural resources included institutional strengthening of controlling functions, but also allowed the government to issue long-term (up to 89 years) licences for the exploitation of natural resources (including forests and minerals) that could be sold or granted to other persons/companies. In addition, the relevant ministry changed its approach completely, making its work extremely open and transparent.

- Only three years after the reform of the energy supply system, which included liberalising the market and attracting foreign investments, Georgia became a net exporter of electricity, producing a surplus after many years of shortages. Several sound management practices were employed: no state regulations for new energy companies, and no regulation of energy exports and imports. The private companies involved were very successful in improving rates of payment for services by consumers, which had always been a problem while the government owned the energy distribution and generation companies.
- Georgia lifted visa requirements for citizens of 45 nations (including the US, EU and Japan) with citizens of all other countries only having to fill in a simple form at the border that takes three minutes to complete.
- The country adopted an open-door policy for foreign labour, with no real restrictions on entry, especially for the citizens of Organisation for Economic Cooperation and Development (OECD) countries.
- In 2005 Georgia eliminated all anti-trust regulations, together with the responsible agency inside the Ministry of Economic Development. The Fair Trade Law that replaced them prohibited any government activities that presented obstacles to competition and free trade.
- The reform and deregulation of the financial sector announced in 2008 is designed to make Georgia a low-tax jurisdiction from 2011. This includes not only the new tax regulations mentioned above, but also free participation in the securities and credits market for any Georgian, or OECD citizen or company. It also includes free banking in Georgia, which allows OECD banks to open affiliates and/or branches without the need for additional licensing by the Georgian authorities.
- The new labour code of 2006 established a new labour relationship between employer and employee. No cost of hiring and a very low cost of firing employees made business more flexible and decreased labour costs. All relations between employer and employee – working hours, number of holidays, vacation time, and so on – are based on a contract. The elimination of the social (wages) tax continued the process that made Georgia a leader in this area.
- Georgia cancelled special restrictions governing food safety, which immediately eliminated corruption in this sphere.

Aggressive privatisation

The government launched the fastest privatisation programme since independence, with no restrictions or limitations in any area.

- Major ports were rented out for 49 or more years to private companies, which have the right to sell this contract. A free economic zone was established, which included permission to construct a new port close to the port of Poti.
- All communications companies and systems are now private, because all public entities in the sector have been privatised.
- Most of the energy generation and distribution companies have also been privatised.
- Hospitals have been privatised or are in the process of being privatised. Very few hospitals will remain in government hands. Despite widespread poverty and the population generally not using health insurance, people are starting to adopt insurance-based health care.

- Government has made new efforts to privatise publicly-owned buildings, including those belonging to members of the cabinet, and government ministries.
- Privatisation of government land has entered a new stage, which means that only 35% of all land will remain in public ownership after the reforms have been completed.

New bankruptcy legislation

The new law on bankruptcy has eliminated all barriers in the process, supported creditors and brought more order to the process. It also places government-owned factories outside government protection.

Public sector reforms

Reforms in the public sector are intended to make government activities and expenditures more effective, and to privatise some government functions. Beginning in 2004, the government started eliminating and privatising several functions, downsizing, and minimising the number of government offices and civil servants, with the aim of improving services in all areas of government. Specific examples of reforms include the following.

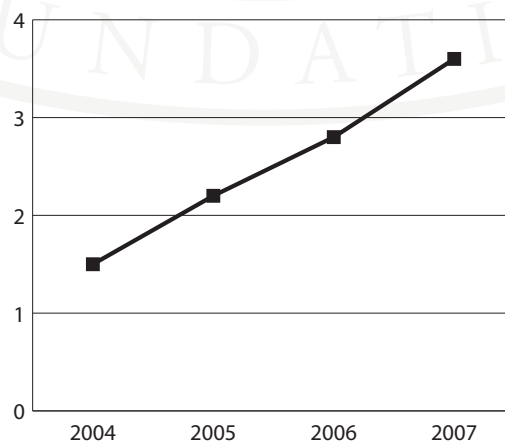
- The number of government employees was decreased by up to 35% at government ministries and by up to 65% in the lower-level agencies. For example, the number of employees at the Ministry of Agriculture was 5 800, and is now 350, while the number of police has been reduced from 40 000 to 15 000 (see below).
- The new real estate public register has become trustworthy and effective. Most of the operations are done over the Internet and are carried out by private operators with special permission to access the register server.
- The new citizens register is a vast improvement on the old one: now any citizen can get his/her passport/ID card in a designated number of days, without corruption and delays.
- Most hospitals are privatised or in the process of being privatised. Special targeted programmes have been implemented to assist the disabled and the most vulnerable.
- No new system of contributions to the public pension system has been implemented, and the system is moving towards privately funded and operated pensions and voluntary contributions.
- Regarding education, measures have been taken to increase competition among the various educational institutions, which have become accountable to their students and the students' parents, and not only to the Ministry of Education.
- Up to 40 000 policemen were fired and 15 000 new, young, well-trained personnel hired in their place. The road police, the most corrupt branch of the police force, were eliminated, and patrolling police introduced instead. Public trust in the police has improved dramatically; after receiving almost zero public support before the reforms, the police now have the almost total support of the population.
- A zero deficit rule for public budgeting was implemented from 2008.
- Reducing corruption was made possible by eliminating wasteful agencies, programmes and functions of government, and by punishing several senior government employees. An important role was also played by the new strategy for remunerating public employees: salaries increased ten, and in some cases 20, times according to an individual's level of responsibility and job description.

THE REFORMS OF 2004–8: SOME POSITIVE RESULTS

Georgia improved many economic indicators and improved its place on many indices measuring comparative economic activity.

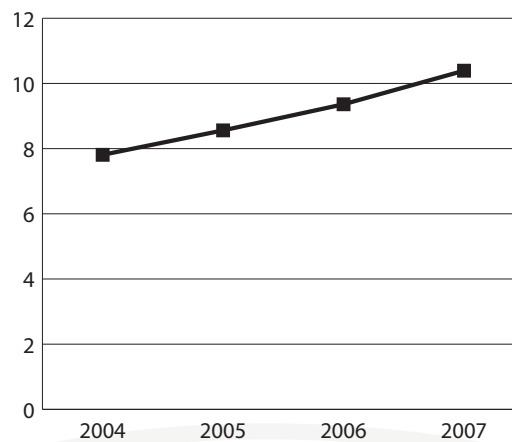
- Legalising most of the country's businesses resulted in an increase in the number of businesses, which currently stand at more than 200 000 per 4 million of population – one of the highest rates in the world (the total number of companies was around 40 000 in 2002). This increase reflects the success of legalisation, but also the new ease of opening a business, and the reduced tax burden among other things.
- The inflow of foreign direct investments has increased (more than US\$2 billion in 2007, or US\$500 per capita) and real economic growth has averaged 8%, which is one of the best results for a country with no mineral resources.
- The volume of bank deposits has been increasing (more than an eight-fold increase in the four years since the reforms were introduced). This reflects not only the success of legalisation, but also improved trust in financial institutions and increased earning levels.
- After tax rates and the number of taxes were reduced, tax revenues increased *ten times* in the period from 2003-8 (from US\$300 million to US\$3 billion), most probably as a result of the tax reforms, which resulted in many people deciding to pay taxes to avoid penalties.
- Georgia's position on the Heritage Foundation's Economic Freedom Index went from 93rd in 2005 to 32nd in 2008. The best score in the factors that make up the index is for labour freedom, while the worst is for property rights.
- The *Doing Business* report of the World Bank placed Georgia 15th in September 2008, indicating how much the Bank values the new business environment in Georgia.
- Georgia's position on Transparency International's Corruption Perception Index improved from 130th in 2005 to 67th in 2008.

Tax revenues of the government of Georgia 2004–7
(billions of laris)



Source: Ministry of Finance of Georgia

GDP in billions of laris 2004–07
(constant 2000 prices)



Source: International Monetary Fund

MISTAKES AND FAILURES

It is no surprise that not all government attempts at reform achieved success. The government's most challenging problem was to try to use methods that would guarantee quick decisions and their effective implementation. As a result, the government had very few opportunities to make both the markets and the democratic institutions function in the most effective way possible.

Reforms and policy implementation took place very quickly; the government was designing and adopting new rules and institutions that were unfamiliar to most of the population, the media, civil institutions and politicians, and thus many of the policies did not receive direct and strong support from society.

Higher government expenditures

Government reforms produced high growth rates for the economy, but even higher growth rates for government expenditure, which increased from 15% to 35% of GDP. The general perception of the population regarding government expenditure is better than it was four years ago, but in this situation it is very important to ensure that fiscal discipline, accountability and limitations on government spending are firmly in place.

Unbalanced and unlimited power

One of the real problems visible in Georgia after the revolution is the constitutional imbalance after the amendments of February 2004, which have made the judiciary weaker and the executive more powerful. The result of the reform was efficient government agencies, but a politicised judiciary.

Centralised government

The centralisation of government power resulted in a weakening of local governments, but simultaneously ensured more effective ways of controlling the implementation of new policies. The election of local governments was formalised, but their efficiency and effectiveness did not improve. Local governments become more dependent on the central government, especially in the fiscal sphere, but remained almost completely unaccountable to the local population that they were meant to serve.

Mistakes of privatisation

Despite the fact that privatisation was one of the major achievements of the government, several problems accompanied the process. Of course, in essence, privatisation can only be a positive thing for any country with a long history of totalitarian governance, such as Georgia. The main goals of the process are decreasing the power of the state, increasing that of individuals, and finding more effective owners and managers of businesses. But reckless or badly thought out policies can discredit the idea itself and make politicians think about re-privatisation or nationalisation. Some of these mistakes are discussed below.

Firstly, after announcing the privatisation plans, major attention was directed towards their fiscal effects. With this approach, (a) any sale of state property that does not visibly benefit government revenue can be seen as undesirable and harmful and to be stopped; and (b) politicians can find it disadvantageous for their careers to support individual instances of privatisation that do not produce visible benefits. This can result in properties remaining in the hands of the government, despite very low levels of efficiency and the consequent costs to the public.

Secondly, the need to produce revenue from the privatisation process motivates government to sell to the highest bidders. These bidders pay for the assets they are bidding on, but also for the privileges that go with the assets, namely a monopolistic position in the market and exclusive access to special rights and regulations. This creates artificial monopolies that cannot be prevented by ordinary market rules, which alarms the public and undermines support for the privatisation process. It also forces the other players to employ the same methods and attempt to gain artificially created advantages.

Thirdly, the high amounts paid by investors for these state-owned businesses limit their new owners' ability to invest further in, for example, the latest technologies. Instead, by paying such high prices, they effectively use their capital to finance public sector budgets.

A solution to this problem was the no-cost privatisation plan for the hospitals, which allowed people to invest the money that they would have used to buy old hospitals in the construction of new ones or the purchase of up-to-date technology and equipment for the older ones. This avoided the above-mentioned problem giving private investors the chance to use their resources in the most effective way and at the same time improve the healthcare system.

Unclear political processes and procedures

Political processes and procedures became clearer, but much stricter for the small players. Most of the complaints came from the opposition, while the media criticised the monopolistic attitude of the governing party, which leads it to ignore the existence of opinions that differ from its own, and to maintain procedures for political competition that give little chance to the opposition. The opposition and dissatisfied members of the public have tried to make the leadership of the governing party aware of the problematic nature of the political situation. But the leaders of the ruling party have ignored this and have put their energies into ensuring the effective continuation of the reforms.

The systemic crisis of governance in Georgia has placed a key political question on the agenda: reforms or democracy? On the one hand, it can be argued that economic growth and increasing wealth make up the only foundation on which a sound political system can be based. Democratic rules with proper political competition and seemingly endless discussions and negotiations cannot contribute much to the needs of the country in a situation of economic stagnation. On the other hand, governance, if it is not based on the rules of fair competition, cannot avoid the misuse of power, monopolistic activities and abuse.

Weak judiciary

The second most frequently used argument against the government is the weak position of the judiciary and its dependence on the executive and the ruling party. The constitutional amendments of 2004 and the behaviour of the leadership of the ruling party have been recognised as the major reasons for this problem. The problem is exacerbated by the lack of human resources, namely competent and honest judges and lawyers. The implementation of the jury system in courts of law seems to have at least partially filled the gap in this sector, but further significant measures to strengthen the independence of the judiciary appear to be very important, if not vital.

Poorly protected property rights

The weak position of the judiciary increases the problem of property rights. The Georgian people, including politicians, the media and especially executive officers, do not have a good understanding of the ethics of private property. This deficiency can only come from long experience of living in a country without property. Following the Soviet collapse, these ethics have been developing quite rapidly, but still have a long way to go to achieve Western standards.

Low levels of understanding of these ethics have caused the major failure of the government to implement generally accepted best practices and it has used very questionable methods to deal with the property issue. There are many examples of abuse and controversial decisions on property, which sometimes contradict both the Georgian constitution and international agreements.

Despite this, the reform of the real estate register has significantly decreased the problems faced by private property owners, as mentioned earlier in this paper. Many thousands of Georgians have found that their ownership of properties is much more secure, and in

general the property rights situation has improved, although there is a great deal of work to do in this area.

TO DO LIST

It is obvious that the reforms already carried out in Georgia are a very important step forward to encourage business and decrease the power of the state. Some of the reforms and their results are truly amazing, even though they were obviously a first step and more work is needed to strengthen what has been achieved, to develop the country further, and to rectify failures and push forward with new ideas.

Most of the failures come from the population's lack of experience of living in a civilised, market-oriented, democratic environment. This has made the task more complicated: some tried and tested institutions that have worked well in the West have failed because of a lack of well-established habits and traditions of accountability and transparency among public institutions and politicians, and, on the other hand, less demand for exercising control over government and a lack of personal responsibility on the part of citizens. For this reason, the main direction of reforms in the near future has to be towards limiting the powers and functions of the government, and restricting its area of activities and spending. Georgia must re-establish and secure checks and balances among the different branches of government, make the judiciary independent, decentralise and ensure political competition.

Here is a short list of things that Georgia still has to do:

- *Fiscal discipline legislation* needs to be adopted, requiring results-oriented planning and execution of public budgets. Government spending should be limited to less than 20% of GDP.
- *Monetary discipline* needs to be firmly established through either a currency board or dollarisation. Georgia is not rich in financial and monetary policy specialists/experts, and the lack of understanding that the central bank is not a political institution makes it very vulnerable. These two factors make economic stability vulnerable and investments in Georgia more risky. Therefore, Georgia needs either to completely eliminate its monetary unit by means of dollarisation or euro-isation, or entrench monetary policy by appointing a fully independent currency board. This kind of decision could increase monetary discipline to levels that are among the highest in the world. In the case of the currency board, it is vital to have a very high level of fiscal discipline in the country. Whatever the policy that is adopted, Georgia needs the public budgeting and budget execution process to be based on key principles: (a) zero deficit planning; (b) results-oriented budgeting; and (c) limited government spending ceilings, namely lower than 20% of GDP.
- *Tax administration reforms*: Despite great success in tax reforms, there are certain concerns about tax administration rules, especially the rules for auditing and enforcement. In many cases, these rules violate the constitution of Georgia.
- *Lower tax rates*: The total burden of taxes on business has to be reduced to 20% of a product's price. A decrease of the personal income tax rates to 10% and VAT to the same level could make the Georgian economy grow faster. Tax administration rules

must not use confiscation as a tool, especially without a court decision. Tax disputes should be solved via private arbitration.

- *Fiscal decentralisation:* Local government needs to have its own sources of finance to allow it to fulfil its functions and tasks. There is no need to invent new taxes; instead, a portion of existing taxes could be given to local authorities.
- *Property rights:* To secure property rights, firstly the constitution needs to eliminate all the articles granting the government special property privileges and the rights of some individuals or their groups to attack the properties of others. Secondly, the constitution needs to state that private property is inviolable, namely that the state has no right to appropriate such property. (Seizure of stolen property, however, should not be seen as confiscation.)
- *Keeping the public informed:* Government has been most ineffective in keeping the public informed about its reforms – most of the population hardly understands what has happened and why it has happened. They demand more jobs, which cannot be created overnight in a country with weak market traditions. Government must work very hard to inform the population about the reforms, their meaning and importance, its future plans and the results it expects to achieve from the reforms.

GEORGIA'S REFORMS: THE AFRICAN CONNECTION

While Georgia is in many ways very different to most African countries, there are similarities between its position, both pre- and post-1990, and that of many African countries. Since the circumstances of each country are different, however, policy makers in particular African countries will have to identify the specific features of Georgia's experience that might offer insight into their own unique dilemmas. But there are, nevertheless, some key lessons that are of value to all countries attempting thoroughgoing reform:

- Recognise the value of crises as powerful catalysts of reform. Make the most of them by advancing the fundamental reform measures that may otherwise appear to be too controversial.
- The risks of bold, even 'crazy', actions are lower than they appear.
- Sometimes it is better to do everything at once, rather than in steps.
- You will be questioned or opposed by donors. However, the costs of defying the donors are lower than they appear to be.
- Similarly, foreign experts do not necessarily understand your problems better than you do. It is important to have the confidence to disagree with them and to find solutions that work for your country. You know your country best.
- When a reform policy fails to achieve the desired result, it does not mean that reform in general is a failure. Learn the policy lesson, adapt, and keep moving forward.
- Countries concerned with reducing public corruption would do well to adopt such reforms as their first-line strategy. If you do not deal first with corruption, no other reforms will work properly. However, when you reduce the number of vectors for corruption by reducing the role of the state in private enterprise, corruption will decrease. Eliminate the functions of government that make corruption possible.
- Increasing your own country's capacity to generate wealth makes you truly independent, not just independent in name only. Use this to create and sustain the domestic political

consensus that is required to support the reform and competitiveness agenda over the long term.

- When the state's role in economic life is reduced to its proper level, democratic politics has a greater chance of success, because irrational forms of political patronage are less available to political leaders. Seen in this light, true business climate reform is an indispensable step in the process of democratisation. Therefore, privatise radically to decrease the power of the government, but do not seek high profits from privatisation.
- Make individuals freer and more responsible for their own lives: government is not a solution for all the problems of life.
- Tax at levels that people can afford; these levels should be as low as possible, to give people the capital to invest in the country, for the good of all.

CONCLUSION

The 2004–8 reforms in Georgia are mostly a success story. The government made a huge effort and showed itself to be both courageous and smart. The important decisions were made very quickly and had a real impact on the life of Georgia's citizens. This success has encouraged Georgia's neighbours to learn from the Georgian experience (for instance, the improvement of Azerbaijan's position in the Economic Freedom Index in 2008 was very impressive). Several delegations from Central Asian countries have visited Georgia over the last few years to find out more about the reforms and study Georgia's stories of both successes and failures.

At the same time, poorly working democratic institutions, especially the judiciary, have provoked the public and the opposition to organise mass protests. Even though it has achieved visible results for its programme of reform, the government needs to find more opportunities to work with the public, and find more political will and courage to establish a balance of market-oriented reforms and democratic rule, which together can guarantee the high growth of the economy. Without this high growth rate, any government will simply fail to survive, but in the same way that the monopolisation of power can be effective for a short period of time, but can generate major obstacles in the future, failure to push ahead with reforms can be used by the political opposition as a good reason for attacking even the best performing government.

The reforms have shown that a poor nation can achieve good results if it is confident, smart, courageous, pragmatic, has a responsible government and supports key free market values.



