ECONOMIC POLICY IN GEORGIA: LIBERALIZATION, ECONOMIC CRISIS AND CHANGES

The new Georgian government embarked on a liberal economic policy. Tax laws have been simplified, the variety of licenses and permits has been reduced and procedures were simplified. The country started a massive privatization process and investment in infrastructure. The reforms carried out by the government ensured the growth of both economic and investment streams. However, as a result of the Russian aggression in August 2008 and due to the economic crisis, economic activity in Georgia has significantly fallen back. Georgia and the EU have a contractual relationship under the European Neighborhood Policy (ENP), to re-strengthen Georgia's economy, and an Eastern Partnership Agreement has been signed this year. Similarly an Agreement on Free Trade, signed between Georgia and Turkey this year, is expected to further facilitate Georgia's economic recovery.

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Liberal Economic Policy

The new government, which came to power in 2003 as a result of the peaceful "Rose Revolution", started to carry out a liberal economic policy. This policy has brought several significant changes in Georgia: Firstly, the process of registration of businesses has been simplified with the amendments made in the Georgian "Law of Entrepreneurs". Changes have been implemented gradually: from minimizing the fixed time period for registration from 30 days to three days to the reduction of filing capital. Following these amendments, mandatory minimum filing capital for Limited Liability companies (LTD, LLC) as well as for Joint Stock Companies (JSC) was abolished. Before these amendments were made, the expected amount of payment was between 2,000 and 15,000 gel. Secondly, the numbers of taxes and their rates have been decreased. The new Tax Code was accepted at the end of 2004 and was put into action by 1 January 2005, abrogating the Tax Code of 1997. According to the new code, the number of taxes has sharply decreased from 21 to seven. Tax rates have also been decreased (for instance VAT went down from 20 percent to 18 percent, profit tax went down from 20 percent to 15 percent, etc.), which made Georgia the country with the lowest tax rates in the region.[1]

Thirdly, Liberal laws regarding customs duties were adopted. The new Customs Code of 2007 is harmonized with the consolidated Customs Code of the European Union and marks significant improvement in comparison with the former Customs Code. With the new Customs Code, custom duties have been optimized. The new Code also congregated the system for solving customs arguments and concretized possible customs violations, simplifying a number of procedural regulations and systematizing the responsibilities.[2]

Lastly, the varieties of licenses and permits have been reduced. A new law on "licenses and permits" was accepted in 2005. As a result of the reforms carried out in this field, the activities requiring licenses and permits were reduced, the procedures for granting licenses and permits were simplified, and procedures for control was strictly disciplined. For now, on the base of the new law, the activities that required licenses went down from 555 to 80, as for permits, from 423 varieties went down to 51. According to the new law a "one window" principle was established for issuing licenses or permits. In other words the administrative

[1] D. Narmania, E . Khokrishvili, Georgian Tax system (I Part), *New Economists*, Special Edition, 2006, pp-4-5.
[2] D. Narmania, K. Imerlishvili, Reforms of Tax-Customs and Budgetary Sistem in Georgia, Centre for Strategic Research and Development, *Bulletin No 98*, 2006, pp. 25-26.

department, which is responsible for issuing licenses and permits, now provides the additional documents for licenses and/or permits (connected to issuing licenses/permits) that need to be approved by other administrative department by themselves.

The above mentioned liberalization policy was followed by a massive privatization process: The legislative base of the process was prepared and enacted before the privatization process started in 1992. Up to 18,000 enterprises and other entities were already privatized by the beginning of 2009.

As a result of the liberal policy carried out by the government, the growth of three main economic indexes was achieved: Gross Domestic Product – Nominal and Real, Foreign Direct Net Investments, Total Budget and Tax Revenue. The table below indicates the main tendencies of Georgia after the Rose Revolution.

Summary Economic Indicators of Georgia, 2003-2008

Indicator	2003	2004	2005	2006	2007	2008
Nominal GDP (mln GEL)	8564.1	9824.3	11620.9	13789.9	16938.0	19069.6
Real GDP (mln GEL, 2003=100)	8564.1	9065.9	9935.6	10868.0	12208.8	12460.7
Real GDP growth (%)	11.1	5.9	9.6	9.4	12.3	2.1
Real GDP per capita (GEL, 2003=100)	1972.1	2100.9	2299.1	2469.3	2778.1	2843.5
Annual Inflation (%)	4.8	5.7	8.2	9.2	9.2	10.0
Trade Balance (mln USD)	-576.8	-845.9	-1130.7	-1861.3	-2734.5	-3810.4
Foreign Direct Net Investments	330.9	432.8	449.7	1190.4	2014.8	1563.9
Total Import (mln USD)	1141.2	1847.9	2490.9	3677.7	5214.9	6304.6
Total Export (mln USD)	461.4	646.9	866.2	936.2	1232.9	1496.1
Total Budget Revenue (mln GEL)	1272.7	2102.0	3152.7	4235.6	5915.6	6578.2
Total Tax Revenue (mln GEL)	1186.6	1827.6	2411.5	3149.4	4391.1	4752.7
Total Tax Revenue (% of nominal GDP)	13.9	18.6	20.8	22.9	25.8	24.9
Employment rate (ths.)	297.8	322.8	388.9	361.0	361.2	330.5
Unemployment rate (%)	11.5	12.6	13.8	13.6	13.3	16.5

Source:
1. State Department of Statistics of Georgia, www.statistics.ge
2. Georgian Economic Trends, GEPLAC, www.geplac.org

GDP rose in market value prices between 2003 and 2008 and compiled 222.7 percent in comparison with 2003, and the real indicator was 145.5 percent. The analysis of main GDP categories shows that the added value created in economy increased by 81 percent during the last four years, while administrative tax rate increased by 424 percent.[3] The analysis of GDP usage according to the main categories shows that there were no new powerful segments presented recently and despite the economy has been growing, it was on account of three to four developed fields (building-construction works, real estate, trade, intermediary services).

The tendency of growth in investment streams was observed after the Rose Revolution. The main stipulating factor for the growth was the more or less stable fiscal policy, liberal economic policy and the massive PR campaigns carried out at the international level by the government of Georgia. Liberal tax policy should have been followed by tax rate reduction, but in fact contradictory results were faced: Tax income ratio to GDP has the tendency of growth. For example, whereas this index for the year 2003 was 13.9 percent, it increased to 24.9 percent by the end of 2008. In other words despite the liberal economic policy carried out by the government of Georgia, tax rate increased and the government made businesses pay one gel from every four gels profit last year.

Despite this policy by the government, Georgia still could not recover in the human poverty index and decrease its level of unemployment. One-fourth of the employed population work in the public sector (347,200 for 2008) and this is 7.9 percent of the total population. Less people are employed in small and medium-sized enterprises than in any single public sector. More than 50 percent of the population is engaged in agribusiness (self-employed according to ILO standards). If they are considered "employed", the decrease in the number of those considered "unemployment" will be only an artificial drop. Despite this fact, in comparison with 2003, the level of unemployment for 2008 has increased by five percent and become 16.5. The number of population under the poverty level is up to one million and is almost one-fourth of the total population.[4]

In total, the following results have been achieved as a result of the economic policy carried out in Georgia: Firstly, the Georgian economy still depends on foreign involvement. The economic system was not formed as a dynamic one

[3] State Department of Statistics of Georgia, www.statistics.ge
[4] Georgian Economic Trends, GEPLAC, www.geplac.org

based on market mechanisms that are productivity-oriented and effective in growing usage of resources.

Secondly, growth in budgetary incomes did not match growth of effectiveness and adequateness of public expenditures. This played a hindering role on economic development, since resources were drawn from the more effective private sector and were moved to the less effective budgetary priorities. Thirdly, economic policies were not oriented towards the growth of long-term manufacturing factors, including capital equipments, technological developments and/or human resource development. Accordingly economic development had less of an impact on economic capacity to produce more product and services. Lastly, the formation of the three fundamental principles for market economy; secured private property, secured private arrangements and equal and free competition was not maintained.

The Influence of Economic Crisis on Investment Environment

The speed of investment activities that existed after the Rose evolution has changed since 2007 and investment streams started to gradually decrease. In the third quarter of 2008 investment activities in Georgia slowed down, direct investment streams in particular. For the first and second quarter of the same year, the characteristic investment was about 430.2 and 525.2 million dollars respectively, in the third quarter it was 150 million. The indicator of the third quarter lags behind the same indicator of the last year by 339.1 million dollars and is making up only 30 percent of the previous amount.[5]

As part of the global economy, Georgia was eventually affected negatively by the world crisis. After the events of August 2008, the investment environment of Georgia significantly worsened, led by the tendency of decreasing investments caused by the financial crisis of 2009. In 2008, Georgia has attracted investments that amount to 2.17 billion dollars, for 2009 investments of only 1.7 billion dollars are to be expected. There are cases of several large-scaled investors refusing to make investment due to the circumstances. For example after the Russian aggression in Georgia in August 2008, the company Kazmunaigaz from Kazakhstan refused to invest 1 billion dollars; so did the American company "Clear Stream Holding", by canceling the already announced investment. The company

[5] State Department of Statistics of Georgia, www.statistics.ge

had brought "WI max" frequency for 9 million 3 thousand gels and had planned to provide wireless internet service.[6]

The total volume of investments of the first three quarters of 2008 is twice less in comparison with the total investments of 2007. In the third quarter of 2008 the volume of investments decreased from all investor countries. Investments of the following countries dropped significantly: Denmark, the Virgin Islands, the Netherlands, the Czech Republic and Russia. In other words Western investors were the first to be cautious. Despite the events of 2008, United Arab Emirates and Turkey are still leading investors and have invested more money in Georgia than in the previous years.

No doubt, a country which has unresolved territorial issues is less attractive, but in addition to this the global economic crisis caused a very deep depression in the country's economy. Credit and deposit organizations observe a high risk in exploring their economic activities, which also hinders direct investments. At the same time, as the calculation of revenues shows, the main source of the growing credit portfolio were portfolio investments, which will fall back considerably as soon as the country loses its attractiveness, also capital flow has decreased on international markets. The amount of deposits was slightly more than three billion gels for 2008, and the amount of loans exceeded six billion gels. The difference was balanced by the portfolio investments accumulated from the banks, but in today's reality, most probably it will not be possible to implement them full scale and availability of recourses on credits on the credit market will retrench back significantly. These recourses will lack sectoral economics, as a consequence of the fact that Georgia is a consumer economy. Hence, we may conclude that the consumer sector will suffer the most.[7] According to the stimulating package planned by the government of Georgia, through investment in infrastructure, the percentage of the consumption in GDP and state procurement will significantly increase, but the component of investment will decrease. This will finally lead to disadvantageous distribution. Impediments in production will increase the negative balance between export and import; accordingly the negative index of net export will increase even further.

[6] D. Narmania, World Financil Crisis and Challenges for Georgia, *Georgian Economics* No:1, 2009, pp. 4-5.
[7] The National Bank of Georgia, www.nbg.ge

Changes in Foreign Economic Relations

Recent foreign economic relations of Georgia can be discussed in three main sections: Firstly, trade-economic relations with the European Union have expanded and striving for integration in the European Union has become ever-more important. Secondly, the effects of the Russian embargo broke off the trade/economic relations with Russia and hence a need of searching for new markets arose. Thirdly, trade-economic relations have been extended to the neighboring countries (i.e. Turkey) and also the trading barriers have been lowered.

In order to get closer with the European Union, the European Commission and Georgian Cooperation Council endorsed the European Neighborhood Policy Action Plan in November 2006. By endorsing this plan, the EU offers Georgia close collaboration on politics and security, economy and culture, as well as other issues.[8] The European Neighborhood Policy Action Plan (ENP) enhances the sustainable development of business environment and improvement of investment climate. It also included modernizing and simplifying tax administration, developing strategies for fiscal control, audit and research methods, cooperation with tax payers and execution of tax warrant.[9]

The realization of the European Neighborhood Policy Action Plan was followed by signing of the Eastern Partnership Agreement in 2009, which opened many perspectives for Georgia towards the EU. Eastern Partnership (EaP), as the EU's new form of cooperation with eastern neighboring countries (Ukraine, Moldova, Georgia, Azerbaijan, Armenia, Belarus) supports deeper integration of partner countries in the European Union, spreading mutual values, security reinforcement in the region and economic development by regional and bilateral cooperation.[10]

Europe recognizes potential or current energy security challenges and devotes much attention to alternative energy resources. Thus, Caspian energy source and Georgia, as potential transit countries of the energy to Europe, are of growing interest to the EU. This interest became more vivid after the construction of the Baku-Tbilisi-Ceyhan and South Caucasian oil-pipe projects.[11]

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[8] D. Narmania, Sh. Murgulia, O. Zedelashvili, M. Nanitashvili, G. Khutsishvili, EU, European Neighbour Policy and Georgia, Centre for Strategic Research and Development, *Bulletin No. 102*, 2007, pp. 7-12.
[9] *Georgia and European Neighbouring Policy, Perspectives and Challenges*, Open Society Georgia Foundation and the NGO coalition For Transparency of Public Finances Tbilisi, 2007, p. 7.
[10] State Minister office of Georgia on European and Euro-Atlantic Integration, www.eu-integration.gov.ge
[11] *Georgia and European Neighbouring Policy, Perspectives and Challenges*, Open Society Georgia Foundation and the NGO coalition For Transparency of Public Finances Tbilisi, 2007, p. 10.

Despite the low index of export-import ratio, diversification of export is one of the most challenging factors for the Georgian economy. For implementing this task the country should fully make use of the advantages offered by the Generalized System for Preferences (GSP+). Although this system is less related to Georgian wine exports, it gives real opportunities for expanding the export to mineral water, nuts, chemical and light industry, etc. to the EU.

Georgia has a small domestic market and therefore its economic growth largely depends on foreign demand. Russia traditionally has always been a big market for exporting Georgian products, with its 17.8 percent share of exports to Georgia in 2005. The Russian trade embargo of 2006, which prohibited the import of Georgian wine, mineral water and agricultural products, had a negative effect on Georgian economy. In 2006 Russian's share in Georgian export decreased down to 7.6 percent, but despite the blockade from the biggest trade partner, Russian import to the country has increased by 14.7 percent in comparison to 2005. One of the problems, which might hinder Georgian economic growth is rise in prices of imported natural gas, which is also connected with tense relationships with Russia. Russian gas monopolist Gazprom controlled by the Russian government, has increased the price from 110 dollars per on 1,000 cubic meters to 235 dollars after January 2007. In other words there has been a 114 percent rise in the price. If we consider the fact that the Georgian economy is energy effective, and producing energy mainly depends on the imported gas, it is not difficult to conclude that the rise in price is connected to serious microeconomic risks. Thus, diversification of energy supplier sources is a crucially important task for the Georgian economy. Certain activities have already been implemented in this respect. According to the agreement with Azerbaijan and Turkey, Georgia will get sufficient natural gas from the newly built south Caucasian gas-pipe from the Shakh Deniz gas field. It is also worth mentioning that the price of this gas is cheaper then the Russian gas – 120 dollars per 1,000 cubic meters. Moreover, there is one more challenge for economic growth – increase in energy-efficiency. According to the EU, a strategy should be drawn up for energy efficiency in the country through reforms of the energy sector.[12]

Turkey is the main trading partner of Georgia. According to the agreement on free trade, the chances for expanding trade and other relations with Turkey are quite high. The free trade agreement between Georgia and Turkey entered into

[12] Young economists association of Georgia, *Reforms in business regulations and assessment of business environment in Georgia*, Tbilisi, 2007. pp. 130-31.

force on 1 November 2008. According to the agreement, tax rates were abolished for the import of industrial products. Exception is made only for a certain limited quantity of agricultural products. Preferences under the agreement on free trade cooperation do not include the import of some agricultural products from Turkey to Georgia or the import of some agricultural products from Georgia to Turkey, though some products are listed as preferred and the Secretariat for Foreign Trade of the Republic of Turkey is responsible for the distribution of quotas.[13]

Development of trade-economical relations with Turkey, as one of the biggest neighboring country, has a significant importance for Georgia. After the Russian embargo, Turkey remains as the largest trading partner. For 2008, the share of ten largest trading countries in Georgia's foreign trade turnover was 67.4 percent and Turkey comprised 15.9 percent. In the first and the second quarter of 2009, 23.3 percent (120 million dollars) of Georgian export (515 million dollars) were delivered to Turkey in return of the import, 18.9 percent (337 million dollar) from the total import (1992 million dollars) were also delivered to Turkey.[14]

[13] Ministry of Economic Development of Georgia, www.economy.ge
[14] State Department of Statistics of Georgia, www.statistics.ge