A DISCUSSION PLATFORM TO PROMOTE INCLUSIVE GROWTH IN GEORGIA

Final Report by

The ISET Policy Institute
www.iset-pi.ge

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INTRODUCTION

Supported by the Swiss Development Cooperation, this project sought to pilot a discussion platform to be used for two related purposes:

- First, ISET organized and hosted a regular series of **policy dialogues** focusing on different aspects of inclusive growth in Georgia: rural development, land reforms and improvement of agriculture; creation of non-agricultural jobs by the private sector; education and vocational training bottlenecks; access to energy; and development of the tourism sector. When relevant, we organized follow up field trips and excursions to observe Georgia's development challenges from close range.
- Second, we provided a forum for discussion of **presentations** by "owners" of development-focused projects in order for them to share their project designs and/or results, and get feedback from academics, professional economists, other members of the development community and policymakers.

A total of 10 meetings (7 policy dialogues and 3 project discussions) have been organized and hosted by the ISET Policy Institute during a 14 month period. Additional 3 site visits/excursions have been organized in between the policy dialogues. Each dialog was summarized in the form of a short article for further discussion and dissemination via the ISET Economist Blog (www.iset.ge/blog), as well as other electronic and printed media.

Additionally, at the request of SDC, the ISET Policy Institute undertook two studies:

- First, in July-December 2014, the Agricultural Policy Research Center (APRC) at the ISET Policy Institute conducted a **pilot Cost-Benefit Analysis** of an SDC-funded project "Market Alliances against Poverty in Samtskhe-Javakheti Region of Georgia". The purpose was to test the application of CBA methodology to development projects.
- Second, APRC conducted a **SWOT analysis of family farming in Georgia** – its role in the sustainable development of the agriculture sector and poverty reduction in Georgia. This project was implemented in October-December 2014, concluding with a short presentation of key project results and a policy dialog involving all main stakeholders.

This paper provides an analytical summary of this dialog series, including the most important lessons learned and specific recommendations concerned with the following five "inclusive growth" sectors:

(i) Agriculture
(ii) Education
(iii) Private sector development
(iv) Tourism, and
(v) Access to water and energy resources.

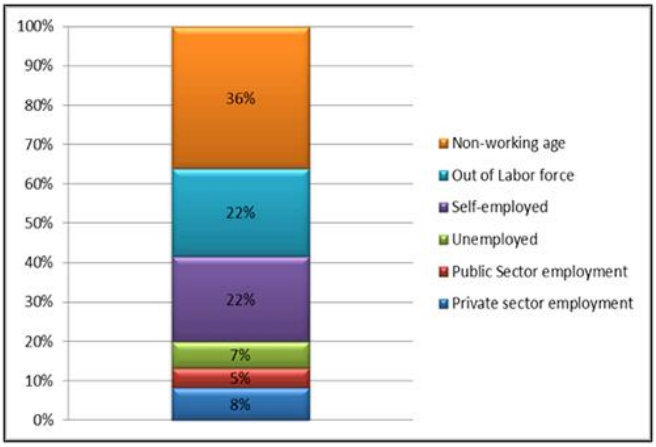
DEBATING INCLUSIVE GROWTH POLICY OPTIONS: CONTEXT

Once the wealthiest Soviet republic, Georgia has fallen far behind others (except, perhaps, Tajikistan, Kyrgyzstan and Moldova) on almost any parameter of wellbeing. Adjusted for purchasing power parity, Georgia's annual income per capita in 2012 was close to $5,900 (a little higher than in the resource-poor Armenia). Moreover, the "median" Georgian, as opposed to the "average" Georgian, is much poorer than suggested by the per capita income estimate. Like any average measure, the income per capita figure masks very large inequality in the distribution of income, and Georgia is much less equal compared to all ex-Soviet peers (with the possible exception of Russia).

Following the collapse of the Soviet Union, the Georgian nation went through a process of rapid dis-investment and de-industrialization. It was forced to shut down industrial plants, sending scrap metal abroad and workers into subsistence farming or early retirement. Thanks to moderate climate and soil conditions, hunger has never become an issue, yet inequality and associated political pressures rapidly reached catastrophic dimensions, unleashing cycles of violence, undermining the political order and prospects of economic growth.

The Rose Revolution of 2003 restarted a process of economic growth, averaging 6.6% per annum and peaking at 12% in 2007. Yet behind the glistening façade of these growth statistics, there has been a political and social uncertainty resulting from the widespread poverty and inequality. Between 2007 and 2011, the share of people living under the poverty threshold grew by 43%1[1], as reported by the National Statistics Office of Georgia. Equally alarming are the official unemployment statistics, particularly for new entrants into the labor market (people in the 20-24 age bracket). The official unemployment data, however, do not tell the whole story. In 2011, 48% of the employed were categorized as self-employed. And a very large share of these were actually subsistence farmers who should have been labeled as under-employed at best.

Figure 1: Georgian occupation structure in 2011. Only 13% are employed in the official economy.



As shown in Figure 1, Georgia has so far failed to engage the majority of its working age population in the formal sector of the economy. This has important implications for aggregate productivity, poverty, and inequality.

The growth and inequality debate. An argument is advanced by some economists that it is perfectly reasonable to expect inequality levels to increase as a country starts to develop from very low levels of productivity, as is presumably the case in Georgia. These arguments find support in a theory that was popularized by Simon Kuznets

[1] National Statistics Office of Georgia, http://www.geostat.ge/index.php?action=page&p_id=188&lang=eng

in the 1950s. Accordingly, market forces tend to bring about higher levels of income inequality at an early stage of development; yet, after a certain threshold of average income is achieved, inequality would decrease.

While perhaps logical, this theory has lost its appeal after the 1960s, not in the least because a group of countries constituting the so-called "East Asian Miracle" – Hong Kong, Indonesia, Japan, South Korea, Malaysia, Singapore, Taiwan and Thailand – demonstrated the possibility of inclusive growth. Moreover, while the East Asian Miracle demonstrates the *possibility* (and the benefits) of inclusive modernization and industrialization, what the recent Georgian experience teaches is that economic growth *must* trickle down in order to be sustained. In other words, inclusivity is a necessary condition for successful development in the political realities of the 21st century.

Near universal literacy, access to information and social networks provide the poor with political mobilization possibilities that were unthinkable in the 20th century. Even though rural development and redistribution policies come at a cost to the economy in the short run, they are essential for political stability. And without political stability, no investment, domestic or foreign, will take place.

Nevertheless, achieving inclusive growth is easier said than done. The most obvious problem is the tradeoff between economic efficiency (job creation and growth) and redistribution policies. The need to provide the poor with a minimum level of income and access to social services, such as healthcare and education, reduces the amount of resources available to the private sector. Ultimately, it is up to each society to decide how much it is willing to lose in economic efficiency in order to achieve a "fair" distribution of resources and social justice and thus ensure political stability. This is a normative choice to be made within the realm of *politics*. Science can play a role in this process by clarifying certain concepts and quantifying the impacts and outcomes of various policy scenarios. But, the choice is fundamentally a political one.

A major role for development research is indeed to help avoid costly mistakes and maximize the bang for the scarce public buck. As they try to promote inclusive growth, policymakers, donors and development practitioners may want to employ standard tools of applied economics analysis to simulate the impact of proposed policies on their immediate beneficiaries as well as assess associated costs (direct costs and efficiency losses), implementation risks and unintended consequences. While common in Europe, none of these standard tools are used in Georgia.

Yet another useful possibility is to move in small steps, conducting carefully designed development experiments before scaling up and mainstreaming policies at the national level. Donor-financed development projects can provide an ideal setup for experimentation at the local level. Well-designed rigorously evaluated experiments, often involving randomization, are increasing common in the development landscape. An excellent summary of this approach is provided in "The Experimental Approach to Development Economics" by Abhijit V. Banerjee and Esther Duflo (2007, Massachusetts Institute of Technology).

Third, unless dealing with urgent or complicated technical matters (such as Lari devaluation), Georgia's policymaking process could benefit from greater participation by all interested parties. On the one hand, by engaging in dialog with relevant stakeholders and beneficiaries, policymakers, donors and development practitioners could make sure that economic strategies and policies address actual societal needs. On the other, an inclusive and well-informed dialog among government agencies and the general public would help mitigate conflicts and facilitate broader public support for the required economic reform measures, even if costly in the short run.

I. AGRICULTURE

OWNERSHIP OF AGRICULTURAL LAND: POLITICAL STABILITY AND SOCIAL COHESION VS. ECONOMIC EFFICIENCY

Georgia embarked on land reforms in 1992, allocating small plots of land to former kolkhoz and sovkhoz members without proper registration. In total, 760,000 ha land have been distributed as part of the first wave of privatization. A large part of land remained in state ownership and was rented out.

2.4mln ownership certificates have been issued in 1998-2004 with the help of international donors. The creation of digital maps began only in 2008, and, as yet, is far from complete. We don't know exactly how much land (of different types) is in private, foreign or domestic, ownership and how it is used because data are incomplete and outdated. The latest census in agriculture was conducted in 2004! (new census data will not be available before the end of 2015). As assessed by USAID's Economic Prosperity Initiative in 2011, at most 20-30% of the total number of plots are properly registered.

SUMMARY OF ACTIVITIES

Three dialogs:

*(i) **Ownership of agricultural land**: political stability and social cohesion vs. economic efficiency;*

*(ii) **Agricultural cooperatives**: contribution to rural development in Georgia, and*

*(iii) **Family farming***

Follow up visit to agricultural cooperative Tkis Nobati ("Gifts of Forest") in Saguramo, and

Two analytical studies:

(i) Cost-Benefit Analysis and

(ii) Family farming: role in the sustainable development of the agriculture sector and poverty reduction in Georgia

One pressing issue, coming out very clearly from any agricultural policy discussion, is the **urgent need to complete the process of land registration and titling** in order to ensure individual property rights, establish an effective land market, enable land collateralization to promote agricultural lending, investment and productivity improvements. Having better information on land ownership and use patterns would also be key for effective policy making.

The main hurdles for completing land registration and titling is the fact that people are not aware of the need to register or are unable/unwilling to pay the registration fee of GEL 250-300 per ha. The 2012 policy of free primary land registration resulted in 461,256 land plots being registered, but the process is extremely costly and labor intensive and would have to be continued for several more years.

LAND FRAGMENTATION AND THE FUTURE OF GEORGIA'S AGRICULTURE

The second question concerning agricultural land - what should be done about land fragmentation? - is far more contentious because of competing ideological worldviews reinforced by different interpretations of the underlying "facts". Some participants in the debate see the root cause of all problems in Georgia's agriculture (and not only) in excessive land fragmentation. According to this view (propagated by the Saakashvili administration in 2004-2012),

too many Georgians are stuck in agriculture[2]. As the argument goes, "no developed country has more than 3-4% of its workforce in agriculture." The conclusion drawn from this (correct) observation is that, in order to develop, Georgia has to go through a rapid process of land consolidation and urbanization. Hence, projects such as Lazika (a new modern city to be established on the Black Sea shores), miniscule agricultural budgets and "active" neglect of agricultural policy during much of Saakashvili's rule (when subsidies started being thrown at rural dwellers in 2010-2012, it was done for purely political reasons).

Table 1: Over the last 20 years, land consolidation has proceeded slowly and very unevenly:

Region	Land cultivated by households		
	Average plot size (Ha)	Size distribution range (Ha)	Inequality (Gini)
Adjara	0.3	[0;1]	0.33
Imereti	0.5	[0;6]	0.41
Guria	0.7	[0;17]	0.41
Samtskhe-Javakheti	0.9	[0;5]	0.43
Samegrelo	0.6	[0;18]	0.49
Shida Kartli	0.5	[0;5]	0.56
Mtskheta Mtianeti	0.4	[0;4]	0.62
Kvemo Kartli	0.6	[0;48]	0.63
Kakheti	0.6	[0;39]	0.72

Source: own calculations based on 2011 GeoStat data

There is no arguing that land fragmentation is an obstacle for some kinds of agricultural production. Yet, there can be no consensus as to the question of whether or not Georgia should specialize in *those* kinds of scale-sensitive agricultural activities (e.g. wheat, maize and similar crops), or, rather, it should strive to carve its own market niche in smaller-scale "branded" products such as wine, cheese, or even special kinds of yogurts and churchkhela.

There is no simple *economic* answer to this question. One the one hand, we should indeed consider the benefits of large-scale industrial farming from the food security and efficiency point of views. On the other, by displacing smallholders, large-scale farming would cause a major disruption to traditional Georgian landscapes and ways of life, a price the Georgian nation may not be particularly happy to pay. And even from the economic point view, massive displacement of smallholders in the democratic context of the 21st century is bound to translate into major political risks to the detriment of investment (in agriculture and any other sector of the economy for that matter). Moreover, such displacement would be hard to justify even in the short run in the absence of productive urban employment options for the displaced farmers. Putting a whole generation of farmers on welfare is hardly more efficient than keeping them on their land, able to feed themselves and produce a little bit of surplus to sell in local markets.

Urban services are constituting a very large and increasing share of GDP in many developing nations, yet, as argued by Dani Rodrik, they are very unlikely to "deliver rapid growth and good jobs in the way that manufacturing once did." Rodrik's skepticism stems from two observations:

[2] The discussion of the land fragmentation question follows "Agriculture: An Engine of Inclusive Growth in Georgia?" by Adam Pellillo, Norberto Pignatti and Eric Livny (The ISET Economist, 4 December 2014).

- First, banking, finance, and other business and ICT services are certainly high-productivity activities that can help lift economies with an adequately trained work force. However, in most developing countries such internationally demanded ("tradable") services cannot absorb more than a fraction of the labor supply.
- Second, other types of locally demanded ("non-tradable") services, such as retail trade, hairdressing and taxi driving can certainly absorb excess agricultural workers, yet, jobs in these sectors do not promise a lot of productivity gains. Moreover, any growth in such low productivity services is ultimately self-limiting. Rodrik's point becomes evident if one cares to analyze the taxi service market in Tbilisi. As more and more villagers started driving taxis in Tbilisi, taxi fares went down to a level only slightly above earnings in the low-productivity agricultural jobs, therefore reducing or completely eliminating the incentives for the arrival of new drivers (and their shoddy Ladas).

The predicament in which Georgia's nascent services industry finds itself is quite consistent with Rodrik's analysis. While Georgia's urban economy is hardly advancing, agriculture is currently one of the fastest growing sectors. It is encouraged, on the one hand, by the re-opening of traditional export markets in Eurasia, the prospect of DCFTA with Europe, and, on the other, a spate of government and donor initiatives. Among these are efforts to complete land registration and start an effective land market, repair rural infrastructure, improve skills and provide cheap finance and other services.

It is certainly true that Georgia's smallholder agriculture is getting so much attention because of its political significance and because the country does not have too many other options. Yet, there are many 'positive' reasons for agriculture to serve the locomotive function.

- First, Georgia's agriculture is rife with low-hanging fruit (both figuratively and literally). In other words, productivity gains would be relatively easy to achieve in many traditional agricultural activities with very modest financial investment, organization and processes.
- Second, as improved agricultural productivity will inevitably translate into lower poverty levels, the next rural generation is likely to be better educated and, hence, better prepared for employment in the modern sector of the Georgian economy. Thus, rather than causing massive displacement of the rural population, gradual increases in smallholder agriculture productivity would feed into further investment in light manufacturing and urban services with both the 'labor push' and 'labor pull' effects going into full force.
- Third, when looking at global trends, there seems to be increasing demand for differentiated agricultural products (both primary and processed). Examples are microbrewery startups in the United States, agritourism or the slow food movement in Italy. With its multitude of soil and climate conditions, ancient culture and traditions, there is great potential for Georgia to generate unique, high value, geographically denominated products and engage in innovative agroprocessing and organic farming[3].

The latter point if worth elaborating. Greater differentiation in agricultural production and related agribusiness activities (rather than homogenization and mass production) is driving currently some of the most interesting success stories in agriculture around the world. In a globalized world, where mass products can easily be reproduced – at ever decreasing costs, driving profit margins to zero – well-trodden paths do not show much promise anymore. What matters is what cannot be easily

[3] Innovation and greater emphasis on local branding of agricultural products are discussed in Georgian Churchkhelas: Thinking Out of the Traditional Box by George Basheli and Eric Livny

reproduced or copied. Georgia and other developing countries should try new tricks, building on their own strengths and on what makes them unique.

Luckily for Georgia, the country's history, culture, biological diversity and agricultural traditions enable it to do much better than just import some "modern" high yield crop and engage in large scale (capital intensive) agricultural production of standardized agricultural products. Georgia can focus on the high value added (more labor intensive) segment of the international markets, turning its weaknesses (such as abundance of labor force in the countryside) into a strength.

Foreign Investment and Foreigners' Access to Agricultural Land[4]

Until 2012, Georgia has been encouraging foreigners to purchase land, bring modern technology and management to the country's ailing agricultural sector. On the one hand, Georgia's extremely liberal approach was a boon for investment by global food industry giants such as Ferrero (4,000ha hazelnut plantation in Samegrelo) and Hipps (growing of organic apple and production of aroma and apple concentrate in Shida Kartli). On the other, it catalyzed the creation of joint ventures in agricultural production and food processing which quickly assumed leadership in their respective market segments. Examples of the latter are:

- Marneuli Food Factory and Marneuli Agro (a cannery and 1000ha of modern vegetable production)
- Chateau Mukhrani (pioneering a business model combining grape growing, boutique winery and hospitality services)
- Georgian Wines &Spirits (GWS, the largest exporter of traditional Georgian wines)
- Nergeta ("discovering" Georgia's great potential as a kiwi producer) and
- Imereti Greenery (a 4,000m2 hydroponic greenhouse fully substituting for Georgia's imports of lettuce).

Somewhat more controversial was the arrival of foreign farmers who settled in the midst of Georgian village communities. The South African Boers were among the first to receive a warm welcome (and citizenships) in 2010; as a result, about a dozen of Boer families set up farms in Sartichala and Gardabani. In 2010-2012, Georgia's openness also triggered migration by a few scores of Panjabi families, who bought agricultural land in Kakheti, Kvemo Kartli and other regions. Towards the end of Saakashvili's rule, in 2011-2012, Georgia became an investment target for farming enterprises from the politically and economically troubled Iran and Egypt.

While good for the economy, the arrival of foreign farmers sparked popular protests across the entire country. The root cause of trouble in practically all cases was the hasty repurposing and privatization of pasture and agricultural lands around Georgian villages.

One issue was (and still is) incomplete land registration. For example, about one third of Ferrero's 4000ha landed properties was found to be owned or physically occupied by Megrelian farmers. In this particular case, a complicated compromise involving land swaps and compensation for affected smallholders was brokered by the Georgian government. Many other, less prominent and easier-to-ignore cases are still awaiting their resolution, feeding mutual hostility and simmering conflicts.

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[4] This section is based on "Moratorium on Foreign Ownership of Agricultural Land. Xenophobia, Myopia or What?" by Eric Livny (The ISET Economist, 13 Sep 2013) and "Should Georgia Sell its Agricultural Lands to Foreigners?" by Eric Livny and Salome Gelashvili (The ISET Economist, 23 February 2015).

A Punjabi farmer on the 40ha of land he purchased in the vicinity of Rustavi. An image that shook Georgia.

Second, regardless of registration status, privatization of pasture lands surrounding Georgian villages is an extremely sensitive matter. The arrival of new investors, whether foreign or domestic, reduces the amount of "free" pasture land available for the local communities. Conflicts arise the moment new investors attempt to fence and cultivate their newly acquired properties.

In most documented cases, investors were able to accommodate villagers' demands by hiring the main troublemakers (e.g. as security personnel), renovating churches, schools and roads, or by providing free machinery services, seed and training. In a number of instances, however, negotiations failed and an open conflict broke out.

Under the UNM rule, such conflicts were typically repressed through agile police and local government action. Protesters guilty of violating private property rights were arrested; some jailed. The situation changed in 2012 following the Georgian Dream coalition's rise to power. Amplified by media, the calls to stop the "foreign invasion" produced a policy shift. Police force would no longer be deployed to suppress protests and repel property invasions, effectively allowing some of the local communities to squat on investor-owned land.

In June 2013, foreign investment in Georgia's agriculture was put on hold with the introduction of a temporary one-year moratorium on the acquisition of agricultural land by foreigners. Foreign investors and any businesses with foreign shareholders, including banks, were no longer able to come into possession of agricultural land, or use it as collateral. The moratorium was lifted a year later, following a legal challenge by Transparency International. Yet, to date, transactions involving agricultural land are not registered by the Public Registry pending new legislation.

It is difficult to imagine that the Georgian government and/or parliament need to be reminded of the immediate negative implications of the law. It is universally recognized that Georgia's agriculture is in dire need of investment in physical capital and technology, all of which can only come from outside. By preventing foreigners from investing in the sector, the law will also slow down the efficiency-enhancing process of land consolidation. But are there any benefits associated with the moratorium? And, indeed, what problem does it attempt to solve?

A cynical and not particularly thoughtful interpretation is that the law was triggered by the specter of "Indians buying all of Georgia" and has no purpose other than addressing the racist sentiment of the Georgian plebs. The Indian investors are the problem, the cynical argument goes.

Yet, the problem is real. It has little to do with xenophobia. And it is not unique to Georgia. Unless carefully designed and implemented, large scale privatization of state-owned agricultural lands in immediate proximity to Georgian villages has the potential to trigger violence and social unrest of far graver consequences for investment – foreign and domestic – than the notorious moratorium. The organized protests Georgia saw in early 2013 – under the slogan ""Georgian land for Georgians" – provide a foretaste of what could follow (still) if Georgia's policymakers fail to find a solution to this fundamental problem: how to bring the much needed investment in Georgia's agriculture without threatening the livelihoods of small-scale subsistence farmers.

The (temporary) moratorium on foreign land ownership does not solve any of the above problems and poses new dilemmas. It creates a lot of uncertainty as to the future direction of Georgia's economic reforms. It does not address the foreign investors' concern for securing their property rights and investment. And it does not help increase agricultural productivity and incomes of Georgia's smallholder farmers. By imposing the moratorium, however, the Georgian government showed awareness of the challenges inherent in rapid agricultural development and attempted to gain time in order to work out an acceptable solution.

It remains to be hoped that the time thus gained will be not be wasted. Social calm and political stability that the moratorium seeks to achieve may be difficult to maintain given its negative implications for foreign and domestic investment in Georgia's agriculture. One does not go without the other, certainly not in the long run.

TOWARDS SUCCESSFUL FARMER COOPERATION[5]

There are many reasons to love the concept of farmer cooperation (and cooperation more generally). To begin with, there is a great aesthetic value in seeing people coming together, sharing resources and helping each other. After all, instinctive collectivism was the basic condition of human existence from time immemorial. But, there are also powerful economic reasons for farmer cooperation.

Smallholders are often too small to independently access markets, and can be easily exploited by middlemen and local monopolies. Service cooperatives can increase the bargaining power of smallholders versus banks, service providers, input suppliers, processors and … government. This light form of cooperation is quite effective and relatively easy to manage and sustain, which explains its prevalence in North America and Western Europe.

[5] This analytical summary is available on the ISET Economist blog http://www.iset.ge/blog/?p=3311.

A more ambitious (and far more demanding) form of cooperation is about pooling fragmented small holdings into larger farms. Examples of such production cooperatives are the Israeli kibbutz and Soviet collective farms. These are said to benefit from economies of scale in primary agricultural production.

Yet, despite its aesthetic value and compelling economic reasons, farmer cooperation (of both types) has been a spectacular failure in many transition economies, and particularly on the territory of the former USSR, including Georgia. In the words of Tim Stuart, development practitioners in the post-Soviet space are often confronted "with the reality of failed farmer groups that evaporate once the project ends, with unused equipment rusting in the corner of a field, an image, which has become a cliché of dysfunctional development in the popular press. And for many people engaged in development, farmer groups are a byword for failure."

Of course, failure and success are terms to be defined relative to expected results. For the likes of Juan Echanove, coordinator of EU's ENPARD program, the journey of a thousand miles in farmer cooperation begins with a single step. His expectation is that the dramatic changes in the legal and financial context for agricultural cooperation in Georgia will encourage the creation of bottom up farmer organizations based on traditional forms of mutual help and resource sharing that have always existed in Georgia. According to Juan, Georgian farmers have always been establishing informal groups and associations, often without any external support and on their own initiative. Such groups typically focus on a very narrow but functional scaling up of everyday economic activities including joint arrangements for pasture management and feeding, collective plowing and harvesting, etc.

WHO IS TO TAKE FARMER COOPERATION TO THE NEXT LEVEL?

While bottom up cooperation may indeed flourish in the new policy context, there is agreement among all analysts that for farmer cooperation to move to the next level – beyond its primitive forms – Georgian villagers have to be provided with the prerequisite skills and resources. A related question, posed by Simon Appleby, an Australian agronomist and agribusiness consultant with many years of experience in South East Asia and Georgia, is "If development agencies are the "wrong" people to be involved in farmer groups and co-ops, who are the "right" players to be involved?" To his mind, "while it may be jarring to the collectivist sensibilities of some, it is worth looking at corporations as enablers and incubators of co-ops."

Indeed, Juan Echanove sees a very wide spectrum of possibilities for private sector involvement, with or without donor assistance. For instance, some farmer groups will emerge to gain access to better and/or cheaper inputs (fertilizers, seeds, fuel) or services (mechanization, vet services, artificial insemination). In these cases the key business partners are not the buyers of the products, but

providers of services and inputs. And, importantly, donors – ENPARD, and USAID's REAP program – will target these businesses rather than farmer groups.

Juan is quick to admit that the issue becomes trickier if the goal is to create farmer groups jointly selling their primary products. Anyhow, even in this case there will be groups such as mandarin or hazelnut co-ops which will face no problem selling their products to a myriad of middlemen, processors and exporters. If these coop do things the right way, argues Juan, they will have more or better quality product to sell. The buyers are already there, and farmer groups won't need any help in engaging with the private sector.

Finally, there will be co-ops directly placing their products in the local markets, and there is nothing wrong with that, according to Juan. Producing more and/or at a lower cost in the nearby town marketplace would be an easy and realistic improvement. In many parts of Georgia there is simply no alternative, and we don't always have to be looking for complex solutions.

One problem with Juan's arguments, however, is that in none of the simple cases private sector actors would have the incentive to provide Georgian villagers with the skills and resources to do things the right way and to manage cooperation. For instance, while input providers would be quite interested in marketing their products (e.g. fertilizer) to individual farmers, there is no advantage for them in helping organize and train groups of farmers who, once organized, i) would be much tougher to negotiate with and ii) could switch to competing providers. For exactly the same reason, no single buyer of hazelnuts or mandarins would invest time and effort to help organize and train farmer co-ops even though it may be more convenient to deal with larger and more reliable growers.

Thus, while businesses may be the (only) right players to be involved in enabling and incubating farmer co-ops, special government or donors schemes would have to be developed to incentivize potentially interested corporate actors. While costly, such schemes could be justified if the resulting supply chain relationships have the potential to be sustained without additional subsidies beyond the necessary period of incubation.

As Simon Appleby explains based on his experience in South East Asia, the government could compel large food processors to take on co-ops as supply chain partners. Government (and donors) could also use carrots, such as tax holidays, low interest loans, or grants. That said, there would be no need for the government to play an active role in micromanaging farmer groups. With corporations providing suppliers with a comprehensive support package (finance, inputs, training, and guaranteed forward contracts), co-ops

PROJECT PRESENTATION:

Restoring Efficiency to Agricultural Production (REAP)

USAID's REAP is a five-year USD 19.5 mln program that aims to contribute to income and employment in rural areas by investing in agricultural businesses or service providers working with farmers.

While aiming to promote rural development, REAP is a private-sector oriented investment program delivering 120 matching grants (totalling USD 6 million) and technical assistance (farmer training and demonstrations; supply chain management and marketing; post-harvest handling; storage; processing technology, etc.). The grants are to cover 30% of total investment costs.

Three aspects of the program were debated: very high administrative cost (more than 2/3 of total program budget!) , sustainability, and actual impact on rural poverty reduction.

would pop up in response to business opportunities. Given their small size (3-5 families) and blood or friendship bonds on which they are often based, internal management issues of typical co-ops would not be very complicated. According to Simon, over time co-ops could diversify their activities from basic post-harvest treatment, storage, and logistics, to deep processing, foodstuffs trading and financial services, but this process may take many decades. Rushing the process, however, carries huge operational and financial risks.

PRIVATE SECTOR ENGAGEMENT WITH FARMER CO-OPS: THE CASE OF TKIS NOBATI[6]

The challenge of incentivizing corporations to integrate smallholder co-ops into their supply chains is not a trivial one. Mind it that corporations – e.g. large processors – have other options. They can choose to go it alone by developing own supply base or contract large farms that don't need incubation, and can be trusted to deliver on time and in consistent quality.

Yet, as one can also learn from the recent Georgian experience, there would be situations in which businesses have the incentive to engage in nurturing formal or informal farmer groups. While exceptional, these situations provide an excellent sense of the underlying economics.

In 2008, upon graduating from ISET, Gaga Abashidze has taken over a small family business which has been for years buying and processing rose hips gathered by Georgian villagers in the Shida Kartli region. The business model was extremely simple. Villagers harvested and delivered the fruit. Gaga processed and exported rose hip juice to Europe and Japan. Villagers saw no advantage in cooperation, and Gaga saw no need to engage them as a group.

Things changed when Gaga "discovered" the lucrative market of *organic* rose hip products, which required adopting a more complicated business model. First and foremost, moving to organic production required certifying all stages in the process, from harvesting to post-harvest treatment/storage, to processing. Now, as Gaga quickly understood, there was no way to certify hundreds of villagers. To acquire international organic certification, his supplier had to be a legal entity which could be trained and certified. Of course, once incorporated, his supplier could also come into possession of necessary equipment, contributing to the efficiency of harvesting, post-harvest treatment and storage, reducing processing costs and improving the quality of the final product.

Gaga had two options of re-organizing his supply chain: (i) help create, and work with, a farmer organization, or (ii) expand own business. In weighing these two options, Gaga chose the farmer organization/outsourcing alternative for two main reasons.

First, many of the startup costs could be shouldered by the village community, including labor and land. Second, while there was little to be saved in labor costs by hiring own workers, the co-op could be eligible for donor assistance to offset capital, training and certification costs.

Gaga knew that the co-op would be a reliable business partner. On the one hand, he had a long history of working with the individual members of the group and trusted its leadership. On the other, having access to a lucrative export market he could afford paying a premium for organically certified rose hips, essentially killing any incentives for the group to switch to a different buyer. As much as Gaga

[6] This section summarizes the results of the site visit to the Tkis Nobati cooperative in Saguramo, which was organized with the help of the Regional Communities Development Agency (RCDA) and Elkana.

needed the group to supply him with a certified product, the group needed him to gain access to the organic export market. Thus, both parties were to be locked into a *sustainable* win-win relationship.

This particular account of Tkis Nobati, a small Georgian cooperative in the vicinity of Saguramo is not meant to detract from the role of other players (e.g. the Regional Communities Development Agency, which channeled donor funding, and Elkana, which assisted in the bio-certification process). Rather, the point is to draw attention to the economic rationale for private sector engagement with Georgia's budding agricultural co-op movement.

The most important insight to be gained from the exceptional story of Gaga Abashidze and Tkis Nobati cooperative is that while the costs of private sector engagement in incubating smallholder "supply" co-ops could be subsidized by donors or governments in the short term, supply linkages thus created are likely to be quite fragile. In the presence of alternative suppliers, co-ops would have to be very well managed to maintain consistent quality and reliability. Otherwise, we may see many more disturbing images of donor-financed equipment "rusting in the corner of a field".

THE ISET ECONOMIST BLOG ON AGRICULTURE

LEGAL AND INSTITUTIONAL CONTEXT

Does it Make Sense to Subsidize Smallholder Georgian Agriculture, and if so How?
By Ia Katsia, Pati Mamardashvili, Salome Gelashvili and Irakli (Rati) Kochlamazashvili
What Happens When Institutions are Designed to Provide Bullet-proof Protection against Fraud?
By Eric Livny
Georgian Tangerines. By Irakli (Rati) Kochlamazashvili
The Georgian Wine Industry: Recent Past and the Way Forward. By Jacques Fleury
Save the Georgian Bazaar! By Olga Azhgibetseva and Florian Biermann

LAND OWNERSHIP

Moratorium on Foreign Ownership of Agricultural Land. Xenophobia, Myopia or What? By Eric Livny
Should Georgia Sell its Agricultural Lands to Foreigners? By Eric Livny and Salome Gelashvili
Know Thy Land or a Tale of Two Georgian Regions. By Eric Livny

FARMER COOPERATION

Agricultural Cooperatives Fishing for Competitiveness.
By Eric Livny, Adam Pellillo, Irakli Kochlamazashvili, Nino Kakulia and Nino Doghonadze
Farmer Groups: Why We Love Them, Why We Do Them and Why They Fail. By Tim Stuart
Farmer Groups: Why We Love Them, and When They are Successful. By Eric Livny

SKILLS AND INNOVATION

Agriculture: an Engine of Inclusive Growth in Georgia? By Adam Pellillo, Norberto Pignatti and Eric Livny
Georgian Churchkhela: Thinking Out of the Traditional Box. By George Busheli and Eric Livny
No Smart Farmers in Georgia. By Robizon Khubulashvili
Farmers without Verve. By Salome Gelashvili
Does Productivity Increase with Farm Size? By Eric Livny

To conclude, farmer co-ops can indeed serve many different purposes. Yet, significant productivity improvements in Georgia's agricultural sector would only be possible on the basis sustainable supply relationships between farmers and downstream processors and retailers. Only such linkages (embodied in explicit or implicit forward contracts) can provide the basis for new technology adoption and investment.

As Georgia starts exporting to new markets—to Europe under the DCFTA, for example—there will be stronger incentives for smallholder farmers to come together in order improve product quality and achieve market access. Cooperatives and farmer associations may certainly provide the organizational vehicles to take advantage of new export opportunities. Additionally, however, the Georgian parliament and government may want to consider amending the Law on Cooperatives in a manner facilitating corporate involvement in the creation of smallholder co-ops. For example, corporations could be allowed to acquire a stake in co-ops (or "smallholder partnerships") in return for investment in commonly managed storage or processing facilities.

II. EDUCATION

Despite spectacular growth performance during the past several years (averaging more than 6% since 2005), Georgia remains a poor country. In 2011, Georgia's GDP per capita reached USD 3,605[7], just below Marshall Islands in the Pacific and just above Armenia. Still worse, more than half of Georgia's population live on incomes that are much lower than this average figure. This is so because the Georgian society is plagued by a very high level of income inequality. To add insult to injury, many of the poor and extremely poor are either long-term unemployed or out of the labor force, not being able to contribute to the country's economic performance.

SUMMARY OF ACTIVITIES

Dialog:

Vocational Education and Training (VET) System.

Project presentation:

Modernization of Vocational Education and Training (VET) and Extension Systems related to Agriculture in Georgia (implemented by UNDP with funding by SDC)

A key problem with poverty is that it tends to reproduce itself through the education channel: poor people cannot afford good (and sometimes any) education for their children and, consequently, – as education is one of the main determinants of their offspring's productivity and wages – children from poor families tend to stay poor. Thus, the lack of investment in human capital has the potential to locks poor "dynasties" in a vicious circle. Moreover, if the number of such dynasties reaches a critical threshold the whole country may be trapped in poverty. **Hence the critical role of education, and the quality of public education for the poor in particular, in breaking the vicious circle of poverty and inequality.**

Very unfortunately for Georgia, the collapse of all state institutions in the early 1990s has left the country's education system in ruins. What should worry us today, however, is that judging by the 2013 level of salaries in the education sector (see chart), it hasn't even started to recover, despite a

[7] World Bank http://data.worldbank.org/indicator/NY.GDP.PCAP.CD

succession of reform efforts and many millions spent on teacher training and retraining, school boards and guards, improvement of curricula and textbooks, as well as investment in computerization and infrastructure.

In the subsequent four sections we discuss the key quality and inclusivity challenges in all segments of Georgia education system: preschools, schools, vocational colleges and universities. When possible, we will propose potential solutions, as debated in face-to-face discussions and on the ISET Economist pages in 2013-2015.

FIRST THINGS FIRST: EARLY CHILD DEVELOPMENT[8]

More than 50% of 3-5 year old Georgian children, the vast majority of whom are children from poor rural families, have been excluded from the early learning system until 2013. This is a real time bomb if only one considers the impact of preschool education on learning outcomes, labor productivity and wages.

The situation in Georgia's small towns and rural areas is far worse than in Tbilisi and large Georgian cities, which during the last 10 years have been experiencing a boom in private kindergartens. While private kindergartens cater for the needs of the emerging middle class, the outright exclusion of the rural, poor and socially disadvantaged strata of the population creates a true barrier for greater social mobility in Georgia.

Clamping down on the development of (excellent) private kindergartens would of course not make anyone better off. What is needed, instead, is an out-of-the-box solution for expanding preschool education options for kids in rural areas. One of the first decisions by the Georgian Dream coalition was, indeed, to make public preschools free for all children, regardless of social status. This may be a good solution for locations (mostly towns) in which public preschools exist and have the capacity to expand enrollment. **Making preschool education free does not solve the problem of very small towns and Georgian villages that suffer from a severe deficit of public preschools and qualified staff (qualified to teach, that is).**

Preschool education does indeed come first. There is considerable research evidence supporting the view that increasing the availability of early learning opportunities has the largest effect on the future of children. Early learning affects children's brain development, builds their cognitive and socio-emotional skills and improves performance at all subsequent stages of education. This, in turn, helps increase people's productivity and earnings as adults, helping to break the vicious circle of poverty, reduce crime and, as a result, increase aggregate welfare.

Much of this evidence is available on the website of an economics Nobel Prize laureate (2000) James Heckman who has made the theme of early childhood development the point of an arduous advocacy campaign. In his words: "The best way to improve the workforce in the 21st century is to invest in early childhood education, to ensure that even the most disadvantaged children have the opportunity to succeed alongside their more advantaged peers".

[8] Based on "Breaking the Vicious Circle of Poverty and Inequality" by Eric Livny (ISET Economist, 2 October, 2012)

BRINGING GENERAL EDUCATION TO GEORGIA'S DARKEST CORNERS[9]

It is hard to overestimate the impact (positive and negative) of teachers on the children's minds, their career prospects and aspirations. Despite that being so, the second half of the 20th century has seen the teaching profession going into freefall as far as its social esteem (and pay) is concerned.

This apparently global crisis in public schooling has mainly affected the poor: the rich and the educated were able to adjust by opting for the far more expensive private options, or re-discovering the "homeschooling" and "un-schooling" alternatives. The impact of this crisis is, therefore, strongest in weaker social environments where THE teacher is often the only beacon of light (and enlightenment), as well as the leading moral and intellectual authority.

Georgian classroom in Barisakhlo

While falling short of a comprehensive assessment, the Teacher Education and Development Study in Mathematics (TEDS-M), which was carried out by the National Assessment and Examination Center in 2008, speaks volumes about the low quality of Georgia's future elementary math teachers: Georgia ranked last(!) among 17 participating countries both in teaching methods and subject comprehension (mathematics).

The relative social status of Georgia's educators is surely a key factor in the country's sorrow performance in international tests that measure students' achievements in reading, math and sciences. For example, in 2006 and 2011 Georgia was ranked 37/45 and 34/45, respectively, in the Progress in International Reading Literacy Study (PIRLS), which examined the reading comprehension skills of children aging 9-10.

[9] Based on "Like Teacher, Like Son" by Eric Livny and Giorgi Tsutskiridze (ISET Economist, 22 Nov 2013) and

While only aggregate results from these and similar test are available to us at this time, it is clear that Georgia's performance in these tests is a function of the country's demographics and economic geography. Far more than half of Georgia's population – the urban poor and subsistence farmers – have their children trapped in extremely low quality public schools that fail to present them with an 'equal opportunity', let alone prepare them for the 21st century 'knowledge economy'.

ALTERNATIVE MODELS OF TEACHER RECRUITMENT AND TRAINING[10]

Georgia's education system requires new out-of-the-box solutions rather than more of the same teacher-training-curricula-reform type of medicine. First and foremost, the system urgently needs new blood. And this is mainly about two things: teachers' prestige and compensation.

The main policy question is what can bring the best and the brightest among Georgian university graduates to the country's smaller towns and villages in order to teach and contribute to a process of change. A simple but unaffordable option would be to dramatically raise teachers' salaries. A more complicated but relatively inexpensive solution would be to launch a **National Service Program** requiring (and enabling) the best university graduates – recipients of government scholarships – to give back in the form of a one or two year service as a teacher and/or community organizer in Georgia's social and economic periphery.

As argued by Simon Appleby, such a scholarship scheme was introduced after the Second World War in Australia to attract teachers to isolated rural communities. Talented school-leavers could apply to have their university fees and a modest living stipend covered by the government in exchange for a commitment to serve in public schools in remote areas for a period twice that of their scholarship.

For such a national service program to be effective, the young and inexperienced teachers have to be trained and supported. Naturally, not all of them will develop a passion for teaching and stay. But many will, particularly if the government, the schools and local communities in question will provide adequate incentives and resources.

Since 2009, Georgia has been implementing a highly successful experiment in alternative teacher recruitment as part of the **"Teach for Georgia" (TG) program**. TG's approach is rooted in the observation that Georgia's pedagogical universities are unable to attract young talent, becoming, instead, a refuge for students achieving the lowest scores on the national student examination test. The alternative provided by TG is to target university graduates and mid-career professionals who consider retiring or taking a break from their daily routines. Individuals carefully selected from a large pool of candidates (almost 300 in 2015) go through intensive pedagogical training organized by TG and get placed as teachers in remote and often desperate communities in the Georgian highlands. TG offers decent compensation (up to 1000GEL/month for teaching in isolated

> The policy debate about the quality of public schooling is very much about a country's commitment to social mobility as embodied in the 'equal opportunity' slogan.
>
> Eric Livny and Giorgi Tsutskiridze
> "Like Teacher, Like Son"
> ISET Economist, 22 Nov, 2013

[10] Based on "Like Teacher, Like Son", by Eric Livny and Giorgi Tsutskiridze, and "President Margvelashvili and Cartu-International Charity Foundation Unveil Plans to Usher a New Era in Georgia's Public Schooling", by Eric Livny

mountain locations). Far more importantly, however, it helps people find or redefine their purpose in life. Over the past 5 years, almost 550 TG teachers have gone on to serve in villages and small towns from Svaneti and Ajara to Racha and Samtskhe-Javakheti, serving as role models, teachers and community leaders.

THE PROBLEM OF STUDENTS' INCENTIVES[11]

A key problem to be tackled by any government reform or donor program is that of incentives. For many rural children, and girls in particular, attending school and completing their studies is a futile endeavor in the absence of the opportunity to continue their education. For many, the dominant strategy is early marriage and establishing a family. Very telling in this regard is the story of Dzevri, a small village in Imereti.

With close to 300 households, Dzevri is a small and utterly unremarkable village in the Terjola municipality. It would have remained utterly unremarkable, had it not been for the decision by an American couple, Roy Southworth and Cathy McLain, to settle in the village and make it the center of their philanthropic enterprise in Georgia. While Roy (World Bank's country director for Georgia in 2004-2010) was busy transforming Georgia's economy, Cathy – an educational psychologist by vocation – created a private foundation, McLain Association for Children (MAC), to take care of special needs and vulnerable children in Georgia's countryside.

As Cathy recalls, the idea of engaging with Dzevri's struggling school started after the third wedding party to which the American couple had been invited by their new village neighbors. On all three occasions, the bride was in her early teens (15-16), about to drop out of school.

The phenomenon of early marriage that Cathy and Roy thus encountered is, in fact, quite common in the Georgian countryside. According to a 2013 survey by UNICEF, about 9% of all school dropout cases are related to marriage. For many young girls, early marriage and motherhood is a strategy of dealing with a hopeless situation in which they have neither the educational background to qualify for government scholarships nor the financial resources to cover the cost of further education.

Cathy and Roy decided to respond to the early marriage problem with scholarships covering the cost of college education at a public institution. The program was launched in May 2012, a bit late for students to register for the mandatory national admissions test. As a result, only two scholarships were awarded that year, however, the program quickly gained momentum thereafter. Six students qualified for MAC Foundation's scholarships in 2013 and 11 in 2014. In 2015, the School's principal Manuchar Panchulidze expects 23 kids – the entire age cohort! – to graduate and continue to universities and professional colleges.

What is particularly gratifying is the profound impact the promise of modest scholarships (about $1,500/year) had on students' motivation. Being acutely aware of the opportunity, Dzevri kids are now doing quite well in the national student admissions tests, and many qualify for full or partial government grants, saving Cathy and Roy's funds for other important causes.

PROMOTING EQUAL OPPORTUNITY IN HIGHER EDUCATION

Judging by some of the available quantitative performance indicators, Georgia is doing very well, certainly if compared to countries at the same level of income per capita. For instance, the World

[11] Based on "Bringing Light to Georgia's Darkest Corners", by Eric Livny and Maka Chitanava

Economic Forum ranks Georgia very high according to enrolment in primary and secondary education. Moreover, the introduction, in 2005, of national tests and merit-based government scholarships was a great leap forward towards meritocracy in higher education and social mobility. Students who perform well in these tests are eligible for government scholarships that allow them to study, free of charge or at a discount, at any public or private university, contributing to social mobility and potentially ending the vicious circle of poverty and inequality.

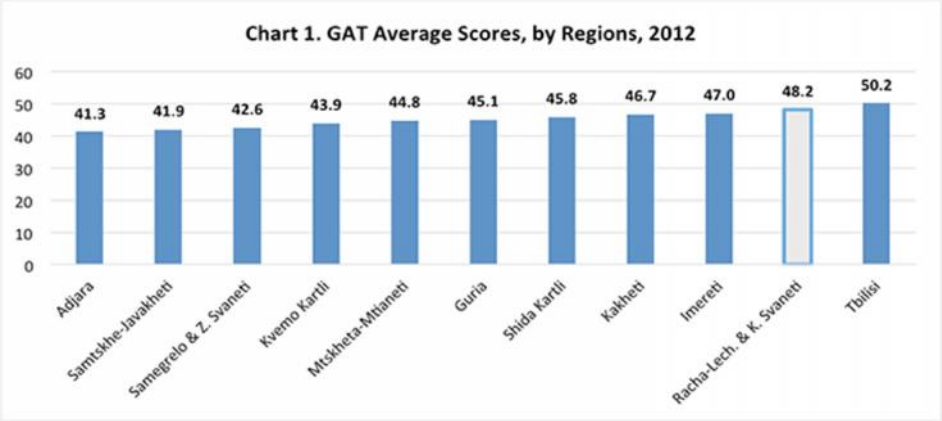
LACK OF EQUAL OPPORTUNITY IN HIGHER EDUCATION[12]

Yet, as we saw in the Dzevri example, the system is strongly biased towards children from relatively well-off urban families which have access to private tutoring (considered essential for success in the national tests) and/or can afford paying for university education. A highly disproportionate number of poor children drop out of school, do not register for the national tests, or fail them.

Another factor distorting educational choices is distance from the capital. In particular, children from Georgia's outlying regions tend to study closer to home rather than in the presumably better Tbilisi-based institutions. This bias persists even when controlling for performance in the General Ability Test (GAT) administered by the National Assessment and Examinations Center (NAEC)

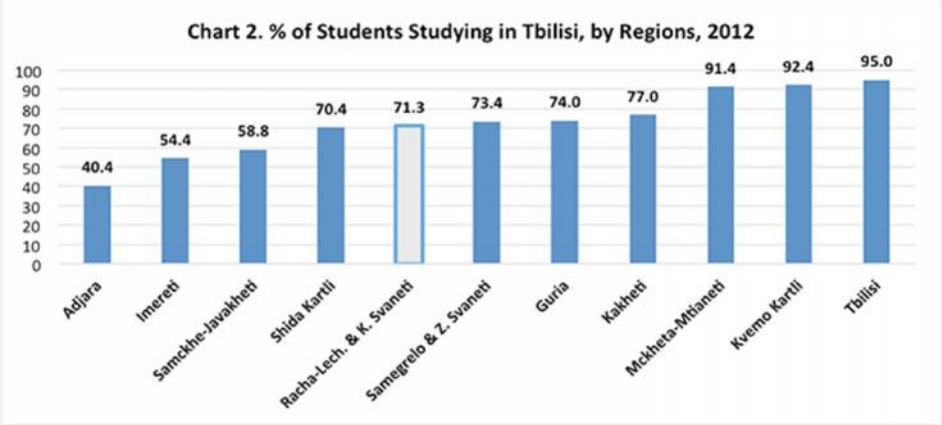
For example, in 2012, students from Racha-Lechkhumi and Kvemo Svaneti (R-L-KS) were 2nd (!) after Tbilisi on the average GAT performance (see Chart 1). Yet, as reported by Maia Changseliani (2012), not as many Rachvelis as one would expect ended up enrolling in the best Georgian universities (Chart 2). Thus, while ranked 2nd on GAT, R-L-KS was only 7th by the share of students admitted to Tbilisi-based universities. Conversely, disproportionately many Rachvelis chose to study closer to home, e.g. in Akaki Tsereteli Kutaisi State University, which is 43rd on Changseliani's ranking of Georgian higher education institutions!

Racha-Lechkhumi &Kvemo Svaneti region is 2nd after Tbilisi on the General Ability Test…



[12] Based on "If You Are So Smart, Why Are You Stuck in Kutaisi?" by Eric Livny and Giorgi Kelbakiani

But 7th on the share of students admitted to Tbilisi-based universities



One may discount the significance of Chanqseliani's ranking and Rachvelis' educational choices given that many of the programs offered by Kutaisi State University are of rather decent quality, at least by Georgian standards. Yet, what her ranking does capture is the quality of *peer and network effects* in education, which research shows to be an extremely important factor in determining learning outcomes and future earnings. In other words, the quality of human environment in which students find themselves early in their life – not what they study, but who they study with! – has a tremendous impacts on their future success. Essentially, by choosing, or being forced, to study in Kutaisi, Rachvelis diminish their chances of moving up the social ladder.

The distance and cost-of-living factors reinforce existing regional disparities while generating welfare losses for the individuals involved and the economy as whole. To reduce these losses, state scholarships should include a ***living stipend*** *component to encourage the (perhaps) slow but smart Rachvelis to study in the better human environment offered by the more prestigious Tbilisi-based universities.*

Eric Livny and Giorgi Kelbakiani
"If you are so smart, why are you stuck in Kutaisi"
ISET Economist, 22 Nov, 2013

The reason distance plays an important role in determining educational choices has to do with the fact that government scholarships do not cover the cost of housing and living expenses for out-of-town students. The higher costs of living in the capital may prevent students from Racha and other rural locations from studying in Tbilisi regardless of their GAT performance.

To sum up, the quality of, say, mathematics or engineering education at some of the provincial universities may not be inferior to that offered by Tbilisi State Technical University. However, the sorting of students according to distance and cost-of living factors significantly affects educational outcomes, occupations and, consequently, social mobility.

CASH TRANSFERS: IMPACT ON EDUCATIONAL OUTCOMES[13]

While government scholarships are, unfortunately, biased towards the urban elites, other policy tools, such as targeted cash transfers, may be available to government to fight poverty and create a level field in education.

Importantly, the rationale for cash transfers goes beyond relieving short-run poverty, as explained by eminent development economists Abhijit Banerjee and Esther Duflo in their 2011 book Poor Economics: A Radical Rethinking of the Way to Fight Global Poverty: people are poor because of all kinds of detrimental factors, such as family, geography, and just bad luck. Yet they are unable to get out of poverty because they are trapped. Living barely above subsistence level, it is very difficult for them to become more productive because they spend most of their scarce on food consumption. Unable to invest in skills and education and, therefore lacking in professional qualifications, the poor remain poor. And, to add insult to injury, so do their children.

If one subscribes to this reasoning, then the availability of financial resources is crucial for getting people out of this vicious cycle. Yet, this policy position is not uncontroversial. The opposing view is that cash transfers reduce people's incentives to solve their own problems, being largely spent on conspicuous consumption (ceremonial activities, movies, television and DVD players) instead of education, health, and other long-term investments.

Thus, in the end, the effectiveness of such transfer programs depends on what recipients do with the money. Do they spend it on useless blink or on education and investment in own skills?

To answer this question in the Georgian context, Zura Abashidze and Lasha Lanchava look at the impact of the Georgian State Social Assistance Program (SSAP) on university enrollment. The program was introduced in 2005 and runs to this day. By using sophisticated regression discontinuity analysis which compares applicants who are just above and just below the cutoff point for receiving social assistance Abashidze and Lanchava are able to show that cash transfers increases the chance of university enrollment by 0.8 percentage points – not a minor improvement considering that university enrolment rate in the sample is 12.7%!. The effect is stronger for males (1.7 percentage points), possibly reflecting gender-specific preferences (bias towards males) by parents in the South Caucasian countries. The treatment effect is also stronger – 1.1 percentage points – for cities dwellers (as compared to inhabitants of rural areas). Accordingly, it is strongest (2.4 percentage points) for male children in urban families.

The study by Abashidze and Lanchava provides support for the effectiveness of the SSAP program in improving educational outcomes for the poor. In essence, they find that SSAP increases university enrollment for the poor by anywhere between 5 (for rural girls) and 20% (for urban boys). Now, if unconditional transfers have such a strong impact on university enrollment of the poor, the government may consider other, complementary approaches to nudge the poor to invest in skills and education. In particular, it might go for conditional transfer programs, such as need-based university scholarships, that would encourage students from poor family backgrounds to continue their education. Such measures would reduce the pressure to leave the educational system and start working early with low education and correspondingly low productivity and income levels.

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[13] Based on "Education for the Poor" by Zura Abashidze and Lasha Lanchava, The ISET Economist, 20 Feb 2015.

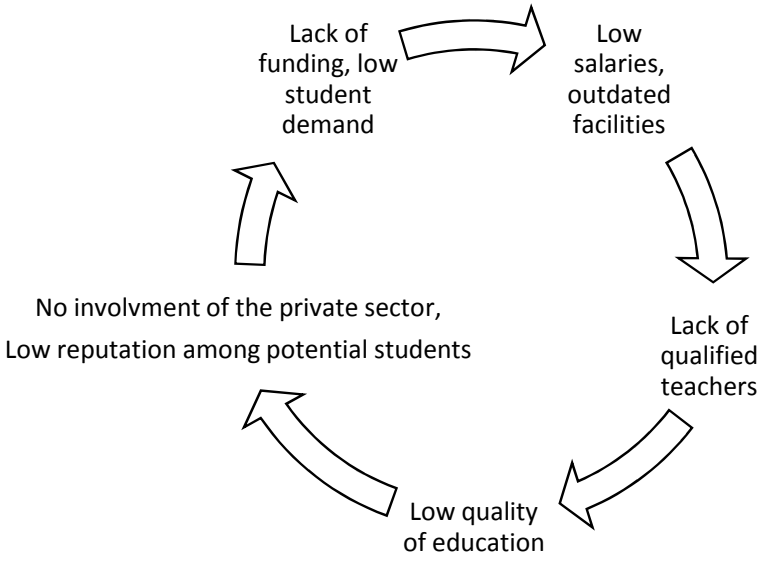
RESETTING THE SYSTEM OF VOCATIONAL EDUCATION AND TRAINING

It is well documented that Georgia's labor market is plagued by a skills mismatch: the supply of labor does not properly reflect employers' demand in terms of both professional qualifications and work ethic (see, for example, the 2013 Global Competitiveness Report). This results, on the one hand, in very high unemployment (particularly among Georgian young) and low capital productivity, on the other.

If modernized, VET institutions could serve as a key mechanism for aligning workers' skills/specializations with labor market needs. At present, however, the Georgian VET system is failing to perform this critical role: inadequately financed and unreformed, it is unable to provide high quality training in relevant disciplines, and hence is not an attractive option for Georgian youth. Moreover, VET training carries a social stigma, further detracting from its labor market value from the point of view of would-be-students and employers alike.

Regrettably, the situation in the VET sector represents yet another vicious circle. Most public VET colleges lack vision and leadership. Their human resources (faculty and management) have been depleted by many years of neglect and negative selection (all good people left). While any reform must start with a gradual renewal of faculty, the level of compensation in the VET system makes it nigh on impossible to attract high quality teachers. The training programs, professional literature and equipment available to most public VET colleges belong to the Soviet era with little chance of upgrading given the absence of industry linkages that are essential for keeping abreast of changes in technology and relevant pedagogical methods. Not surprisingly, the quality of VET students leaves much to be desired resulting in a "garbage in, garbage out" modus operandi, with almost no light at the end of the tunnel. Neither teachers nor students at VET colleges have any idea about the kind of skills that are demanded by the labor market. Career planning, an aspect of decision-making that is very important for future students, is simply unknown in Georgia.

The vicious circle in the public VET system can be schematically described as follows:



All stakeholders agree that the system is broken beyond repair through standard administrative interventions such as teacher training, curriculum reform and rigorous evaluation/certification of teaching programs.

From this follows that to be successful, any reform of the VET system requires *external* institutional anchors – in both government and the private sector – to provide (i) the resources (human and material) and (ii) the individual and institutional incentives for change (positive, such as bonuses and extra funding, and negative, such as revocation of licenses and accreditation).

Furthermore, institutions performing the role of "external anchors" have to be directly involved in the governance of public VET colleges. Only in this way will they be able to exert influence on the process of strategic planning, budgeting and key appointments, on the one hand, and monitor the progress of organizational restructuring, on the other.

An example of successful transformation is provided by the solid public-private partnership involving VET college Spektri and Knauf, one of the world's leading manufacturers of modern insulation materials, paints, floor systems, construction equipment and tools. Given Knauf's interest in promoting its products on the Georgian market, the company partners with Spektri in a variety of ways, including supply of sophisticated training equipment (simulators), construction materials and tools, improvement of the general teaching infrastructure, training of Spektri instructors by Knauf professionals, and provision of internships and employment opportunities for Spektri graduates.

Unfortunately, this kind of win-win approach represents an exception to the general rule whereby the businesses limit their involvement to participation in discussions and ceremonial meetings organized from time to time by the Ministry of Education and Science.

The difficulties of matching demand and supply in the VET "market" are understandable. Investing in poorly governed and managed public VET colleges represents such a formidable challenge that, while facing severe shortages of qualified technical personnel, large international companies operating in Georgia would rather go it alone.

Given this "market failure", one major conclusion emerging from the discussion is that government and donors may want to play the role of catalysts in bringing private businesses and VET colleges to work together. One the one hand, this may entail participation by the Ministry of Education and Science in pushing through necessary governance reforms and otherwise supporting the process of organizational change at selected VET colleges. On

PROJECT PRESENTATION:

"Modernization of Vocational Education and Training (VET) and Extension Systems related to Agriculture in Georgia" (implemented by UNDP with funding from SDC)

UNDP's presentation focused on the general challenges of developing viable VET programs in Georgia; the main lessons learned from previous donor-financed VET initiatives; UNDP's specific approach with a focus on private sector engagement (in terms of financing, determination of content, recruitment of trainers and trainees and job placement) and coordination with the Georgian government, other donors and VET providers.

Given that one of the project's objectives was to inform future reform efforts, it appeared to have missed the opportunity to experiment with, and evaluate, specific models of private sector engagement.

the other, given the social value and inherently sustainable nature of public-private partnership in the field of VET, there could also be a role for international donors in financing the startup costs of such

THE ISET ECONOMIST BLOG ON EDUCATION

QUALITY OF PRESCHOOLS AND GENERAL EDUCATION IN RURAL AREAS

President Margvelashvili and Cartu-International Charity Foundation Unveil Plans to Usher a New Era in Georgia's Public Schooling. By Eric Livny
Bringing Light to Georgia's Darkest Corners. By Eric Livny and Maka Chitanava
Common Language, Education, and Nation Building. By Eric Livny and Elene Grdzelidze
"Invisible Hand" in the Georgian Preschool Education Sector. Nino Doghonadze

QUALITY OF HIGHER EDUCATION

The Roots of Education are Bitter… is its Fruit all that Sweet? By Nino Doghonadze and Eric Livny
Removing Educational Bottlenecks. By Giorgi Tsutskiridze
Education That Matters. By Nino Abashidze
Can Georgia Develop a Knowledge-Based Economy? By Florian Biermann and Ia Vardishvili

VALUES

American Dream vs. Georgian Dream, By Nino Doghonadze

GOVERNMENT SCHOLARSHIPS AND ACCESS TO HIGH QUALITY EDUCATION

If You Are So Smart, Why Are You Stuck in Kutaisi? By Giorgi Kelbakiani and Eric Livny
Education for the Poor. By Lasha Lanchava and Zurab Abramishvili

POOR EDUCATIONAL CHOICES AND LABOR MARKET MISMATCH

The Educational Choices We Make… By Eric Livny
Math Education – an Engine of Economic Growth in the 21st Century. By Givi Melkadze
Career Guidance for Unemployed Georgians. By Florian Biermann
Georgia's New Immigration Law: Many Losers and no Winners. By Florian Biermann and Eric Livny
The "Over-Education" Trap. By Eric Livny

collaborative undertakings as well as facilitating professional linkages and information sharing between Georgian VET colleges and similar institutions in other countries.

Other recommendations were as follows:

- Students' educational choices as well as VET curricula and programs should be informed by regular employer surveys and labor market performance data. Given the "public good" nature of such data and information, their production should be financed by the government.
- Both state and non-state VET institutions are currently eligible for government funding through government vouchers provided their courses are certified (to be eligible, students must successfully pass a NAEC-administered test). The aim is to cover operational costs, but

not e.g. infrastructure investment. Private VET colleges may also be considered for targeted program financing provided these address agreed upon social objectives.

- At present, VET education standards are established by a government agency. This is suboptimal given that government agencies are almost by definition not very well informed about changes in technology and labor demand conditions. It would be essential to privatize the "standard setting" function and let professional business associations or guilds define standards and priorities in VET education (as is the common practice in leading industrial countries, such as Germany and Switzerland).
- Large companies, such as BP, major retail chains, banks and hotel networks are able to systematically meet their demands through in-house training programs. It is the small and medium companies that are mainly affected by the weakness of the public VET system. One way to harness SME resources to the reform effort might be to engage SME associations or interested groups of SMEs in the governance and management of selected VET colleges.
- Finally, while the public VET system may take years to be thoroughly reformed, quick results may be achieved by redeploying public resources from some of the dysfunctional professional colleges to alternative training modalities such as apprenticeship programs administered by interested private companies. **Business internships or apprenticeships** – jointly financed and regulated by the government and professional business associations – could go a long way in generating demand for vocational training and technical education, quickly and efficiently addressing any gaps in knowledge and skills, and better matching unemployed or underemployed workers to productive jobs. Very importantly, such programs would also help buy the time that is necessary to restructure the entire public VET system and bring it in line with the technological demands of the 21st century.

III. PRIVATE SECTOR DEVELOPMENT

It is often argued that small- and medium-sized enterprises (SMEs) can serve as an engine for inclusive economic growth. Yet the Georgian SME sector currently exhibits relatively low labor productivity, especially among the smallest firms. Is it really the case, and if so, why?

The importance of SMEs for economic development cannot be understated: most successful large firms in developing countries have graduated up from the SME category. The breadth of the SME category itself reflects, and helps create, a strong and deep entrepreneurial culture. It is also well documented that SMEs tend to dominate a country's new/fast growing industries, therefore it is important to ensure the economic and legislative settings are conducive to SME development, so that the dominance of old and large firms does prevent the economy from quickly responding to a dynamically changing environment. At the same time a well-developed SME sector is often said to be a source of price-reducing and quality-improving competition – which is particularly important for small-size markets like in Georgia, which are prone to monopolization or oligopolization. All in all, the SME sector can be crucial in the long-term economic development of Georgia.

SUMMARY OF ACTIVITIES

Dialog:

Small and Medium Enterprises (SME) and Their Importance for Georgia's economic development.

SMALL OR LARGE?

For the moment, SMEs are relatively small players in the Georgian economy, even though their numbers are large. In 2012, the share of SMEs in total business turnover was only about 17%. Their share in total production value in the business sector was only slightly higher, at about 18%. Lastly, the share of SMEs in total value added in the business sector was about 20%.

Thus, contrary to the established theory, it is the large Georgian firms that are mainly responsible for the creation of jobs, production of economic value, and, most certainly, exports. Moreover, size and degree of vertical integration achieved by Georgian manufacturers turn out to be crucial for their ability to withstand competition from very large (and often subsidized) Turkish and other international businesses in the absence of any significant tariff or non-tariff protection.

An excellent case in point is **Chirina LTD**, currently one of the largest poultry producers in the country. Chirina represents a unique greenfield investment initiated, financed and managed a prominent member of the Georgian Russian diaspora. Having earned his personal wealth in the Russian chemical industry, Mr. Revaz Vashakidze chose to repatriate a part of his fortune to Georgia in order to invest in a modern, fully integrated poultry production plant able to compete with cheap imports of frozen meat products, which had dominated the Georgian market until 2013. Designed and built as a turnkey project by Israel's Agrotop in 2011-2013, Chirina is a unique vertically integrated complex. Its products – fresh and frozen chicken meat sold under the BiuBiu brand – already account for about 1/6 of Georgia's total consumption of poultry. With the planned doubling of its processing capacity by the end of 2014, Chirina become a major food industry player in Georgia, integrating Georgian agricultural producers into its supply base, applying downward pressure on prices, and expanding the range and quality of products available to Georgian consumers.

According to Keti Vashakidze, Quality Manager and Organizational Structure Developer at Chirina, the company currently employs around 250 workers in its farming and food processing activities located in outside Tbilisi. It expects to double production and significantly increase employment when additional broiler farms become operational in early 2015. Furthermore, Chirina contributes to the creation of many additional jobs by its retail partner (operating its distribution fleet and mobile retail network) and suppliers of agricultural inputs, all of which happen to be SMEs. Finally, Chirina contributed to the wellbeing of Georgian consumers by bringing to the market affordable, high quality and fresh poultry meat substituting for low-quality, mass-produced frozen products imported from Turkey and Brazil.

The current policy is to support smallholders, who are 50% of the population. While I understand the political significance of doing so, training and subsidizing such a large mass of subsistence farmers will inevitably lead to a waste of resources. In my opinion, the emphasis should be on medium and large business, which would integrate smaller businesses and smallholders into their supply chains or provide alternative employment in processing and services. It is unfortunate that the EU and other donors are supporting such a wrong approach.

Interview with Rezo Vashakidze
in Competitiveness of Georgian Agriculture: Investment Case Studies,
by Simon Appleby and Eric Livny,
September 2014

Chirina's example suggests that, contrary to the established 'Worldbankese' mythology, the key to Georgia's success in technological upgrading, job creation and SME development may be held by large, well-invested food processing and manufacturing businesses. The notion that Georgia should prioritize SME development (at the expense of large enterprises) is akin to putting to cart before the horse. Rezo Vashakidze, the owner of Chirina is quite blunt on this point. In his view, the Georgian government is using agrarian policy to achieve social policy objectives, which is a mistake.

IMPROVING ACCESS TO FINANCE AND PROMOTING AN ENTREPRENEURIAL CULTURE

There is wall-to-wall agreement among analysts that access to finance is a key constraint for the development of Georgian businesses. On the one hand, there is the problem of cost: bank loans and, even more so, credits provided by microfinance organizations (MFOs) are exorbitantly expensive. On the other, businesses (and individuals) are constrained in their borrowing by very high collateral requirements set by the banks, forcing them to borrow – at even higher rates – from MFOs and pawnshops.

According to Archil Bakuradze, chair of the Georgian of Microfinance Association, MFOs remain the main source of finance for SMEs, and, in particular, startups. He indicated that 350,000 individuals (including 75,000 farmers) are financed by microfinance organizations. Excessive collateral requirements are also a key concern for Kakha Kohrekidze, head of the Georgian SME association.

As argued by Angela Prigozhina, WB Country Sector Coordinator in the South Caucasus, Georgian SMEs suffer from the fact Georgian banks provide real estate-based access to finance. Agricultural SMEs are most vulnerable in this regard given the low price of agricultural land in the Georgian periphery.

Both international donors and the Georgian government are attempting to address the financial bottleneck for SMEs and businesses operating in the agricultural sector. The government launched ambitious programs of subsidized agricultural loans and vouchers (to buy seed, chemicals and implements). However, both programs suffered from poor targeting and monitoring, resulting in quite a bit of waste.

According to Giorgi Tsikolia, the recently established Entrepreneurship Development Agency has been mandated by the Georgian government to help start-up entrepreneurs gain access to information, education and finance. Angela Prigozhina emphasized the importance of providing medium term support (incubation, funding or loan guarantees) for **high-risk innovative projects** which are unlikely to be financed by more conservative commercial banks and microfinance organizations.

Tsikolia outlined the main parameters of "Produce in Georgia" – a recent government initiative aiming to help manufacturing startups get off the ground. "Produce in Georgia" would provide selected startups with access to land and infrastructure as well as reduce the collateral requirements required by commercial banks by arranging for insurance and technical assistance. Additionally, during the first two years of a project, "Produce in Georgia" would subsidize the interest rate on commercial loans.

An interested experiment was conducted by USAID's Economic Prosperity Initiative (EPI), as reported by Giorgi Darchia. Commodity loans, provided by EPI through microfinance organizations and agriculture input providers, allowed farmers (organized in informal coops) to gain access to key inputs (at a discount), helping offset operational costs. EPI's approach included a capacity building/advising component helping farmers develop better funding proposals and business plans.

While dealing with its symptoms (high interest rates), none of these interventions can address the fundamental problem of high risks plaguing the Georgian economy. These risks are related Georgia's geopolitical situation – between the European rock and Russian hard place, as writes Eric Livny; commercial risks of operating in small market; currency risks related to limited domestic savings and the high degree of dollarization; underdevelopment of insurance, long-term supply contracts and/or forward markets for agricultural products; and shortage of entrepreneurial and managerial skills reflected in the poor quality of projects.

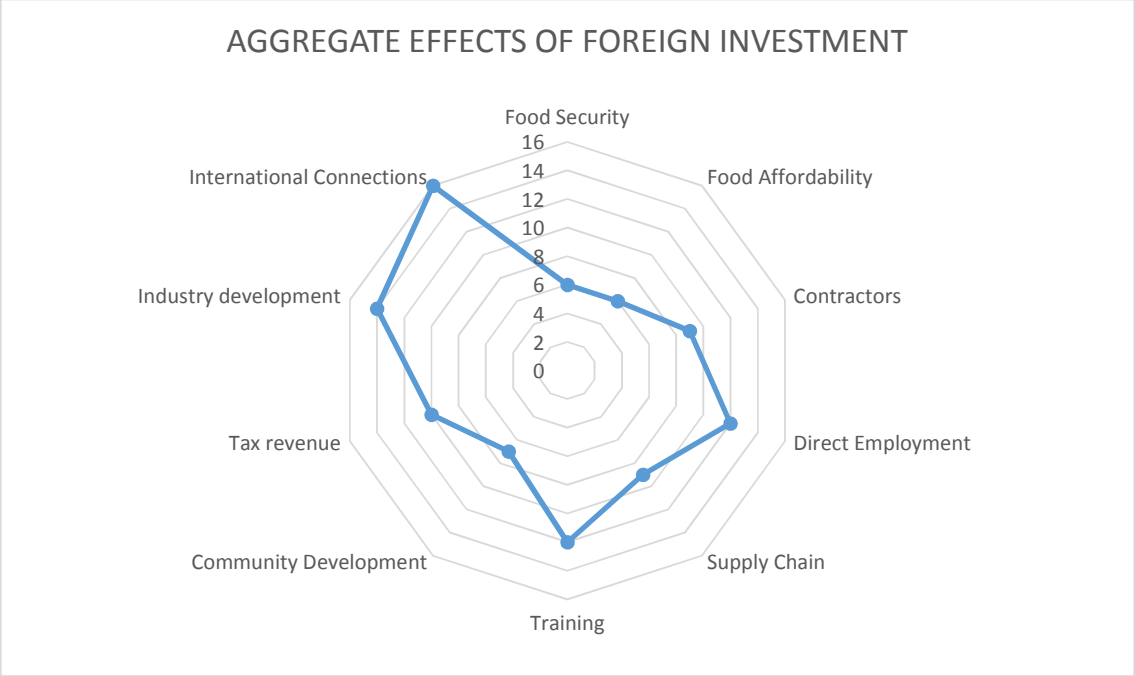
The good news is that Georgia's country risk goes down over time, bringing about a gradual reduction in interest rates for both loans and deposits. MFO and banking institutions are also learning how to operate more efficiently, reducing operational costs and learning to more accurately assess commercial risks related to agricultural and other SME projects. The skill level in the private sector is also growing over time – as a result of accumulated experience and spillovers from international activities in the Georgian economy. Given all the above, Georgian businesses, of all sizes, are likely to see their access to finance improved in future years.

FACILITATING INVESTMENT BY FOREIGN AND DIASPORA ENTREPRENEURS

The role of foreign and diaspora investment in promoting the competitiveness of Georgian agriculture has been the subject of a study conducted by Simon Appleby and Eric Livny over the course of 2014 with support from USAID's EPI project. Specifically, Appleby and Livny look at the impact of foreign-invested businesses on job creation and workforce development, product and process innovation (including technology spillovers affecting suppliers, competing agribusinesses and smallholders), expansion in the range and quality of products available to Georgian consumers, import substitution and improvement in access to international markets, and last but not least, work ethic and the general

culture of doing business in Georgia (a total of 10 dimensions). Figure 1 below depicts the cumulative scores of the eight enterprises included in the study along each of these dimensions. The aggregate impact along each dimension runs from 0 (no impact) to 16 (strong impact).

Figure 1: The impact of the foreign investment on the Georgian economy



According to Appleby and Livny, foreign-invested businesses play an extremely important role in helping bring industry standards to the global level and promote international linkages (14/16 and 16/16, respectively). They have a moderate effect on direct employment and general workforce development (10/16), and moderate-to-weak impact on tax revenue[14], community development and other aspects of the business environment.

Importantly, many successful foreign-invested enterprises involve **Georgian diaspora entrepreneurs**. An excellent case in point is Rezo Vashakidze's investment of more than 80mln USD in Chirina LTD. This project was found to be truly exceptional in its ambitious design and faultless implementation. The sheer visuals of the company's modern facilities are a testimony to the fact that Georgia is on a path towards economic revival.

Vashakidze's investment was conceived in the post-Rose Revolution years, and, indeed, it would not have been possible in the corrupt and crime-infested Georgia of the 1990s. It is perhaps rather symbolic that some of Chirina's facilities are located in Gamarjveba, on a spot that witnessed a much earlier attempt to build a modern poultry plant using the same technology and the help of the same Israeli consultants. That attempt had failed miserably because back in 1996 Georgia lacked the basic law and order conditions for doing business and ensuring investors' property rights.

Chirina LTD, as well as other major investment projects by international Georgian entrepreneurs, should remind us that the Georgian diaspora, in Russia and elsewhere, is as a goldmine of financial

[14] Many enterprises report positive EBIDTA, but are yet to turn a profit given the amount of upfront investment they had to undertake

resources and entrepreneurial talent that Georgia can potentially harness. Georgia should be actively courting dozens of Rezo Vashakidzes, creating the conditions for them to come back and invest their financial and human capital in Georgia's young economy. There may be many policy tools to achieve this objective (as could be learned from the experience of Israel and, perhaps, also China), but first and foremost, the country should make this a top priority.

Appleby and Livny conclude their study as follows:

> "It is within the power of the Georgian government to improve the food security, employment, and general economic situation in the Georgian countryside through a careful revision of the policy context and operational activity. A mixture of smallholders, farmer co-operatives, SMEs, and foreign-invested large commercial enterprises are likely to be the beneficiaries of sound policy.
>
> For domestic and foreign investors to risk their capital in Georgia's agricultural sector, a stable regulatory environment is required and concrete steps must be taken to enhance investor confidence.
>
> In some cases this involves **repealing policies that damage the business climate**, such as the moratorium on farmland purchase by foreign-invested entities, draconian visa restrictions upon existing farmland investors from abroad, and harsh administration of welfare payments discouraging rural dwellers from taking seasonal work when it is available. Issues identified as inhibiting the Georgian business enabling environment must be addressed as a matter of urgency, in particular infringement of private property rights
>
> In other cases would require **introducing new initiatives**, such as a mechanism to swiftly review and react to complaints about inefficiencies in inter-agency coordination, local government, and tax administration; PPPs or tax concessions to encourage food processors to invest in their smallholder supply chain; reforming the VAT administration system; and financing workfare programs to encourage under-employed smallholders to develop modern small-scale orchards to support their families."

THE ISET ECONOMIST BLOG ON PRIVATE SECTOR DEVELOPMENT

Georgian Churchkhelas: Thinking out of the Traditional Box. By Eric Livny and George Basheli
Can Georgia Develop a Knowledge-Based Economy? By Ia Vardishvili and Florian Biermann
The Ethics of Empty Stomachs. By Nikoloz Pkhakhadze and Florian Biermann
The Washington Consensus and Georgia. By Ia Vardishvili
Georgia Caught Between the Russian Rock and the EU Hard Place. By Nikoloz Pkhakhadze and Eric Livny

IV. TOURISM[15]

Tourism has been for long considered one of the few economic options available to Georgia. Yet, given that the country's attraction may lie in its very lack of development, tourism presents both opportunities and threats. In Georgia, it's often said that *tavisupleba mxolod mtebshia* – freedom is only in the mountains. Indeed, the mountains have long shielded the small Georgian nation from much larger invaders, helping it maintain its freedom, as well as its unique culture, language and faith. Even today, getting into Georgia's mountains is no easy task. Separated from the 'mainland' by the 3,000m high Abano pass, Tusheti, is an excellent case in point. The sheer 'outworldliness' of Tusheti, as well as its well-preserved indigenous traditions and architecture, are a powerful motivator for many Georgians and international visitors alike to undertake the bumpy excursion to Omalo (and beyond).

SUMMARY OF ACTIVITIES

Dialog:

The Role of Tourism Sector in promoting Inclusive Growth in Georgia

Follow up visit:

Site visit to the Kazbegi Municipality, Kazbegi Rooms Hotel, and Stepantsminda village

The number of visitors to Tusheti has been growing quite rapidly in recent years, raising an important policy dilemma: what is the "optimal" level of development for this wild region of Georgia? On the one hand, tourism is strengthening the local economy by providing locals with an additional source of income. On the other hand, the arrival of 21 century invaders (in the shape of tourist 'armies') will undoubtedly strain the local infrastructure, requiring significant investment in roads, water supply and other utilities. Too much investment may strip Tusheti of its uniqueness. Too little of it may carry risks for health and the environment.

The policy challenge is therefore to anticipate such risks and plan ahead. If managed well – in the sense of preserving the pristine landscapes and environment, on the one hand, and ensuring that some of the benefits flow to the affected communities, on the other – tourism can be a great boon, outweighing any costs associated with "crowding out" community-based hospitality services or straining the environment.

In particular, the arrival of modern tourism operators, such as the new Kazbegi Rooms Hotel, can help create four-season jobs and additional opportunities for local SMEs specialized in hospitality services (tour guiding, transportation, family-based hotels and restaurants), primary agricultural production, arts and crafts. Additionally, and very importantly, modern hotels may act development agents, filling the coffers of local government with tax revenues and engaging in charitable giving to local schools, hospitals and churches.

While having a positive short-to-medium term impact on incomes, tourism is not known to be a driver of long-term productivity growth. Certainly not to the same extent as manufacturing or IT sectors. Still, it allows to improve the lot of local communities in the economic and cultural sense, changing the children's approach to personal development, their work ethic and attitude to the environment.

[15] Based on "Tourism and Rural Development: The Case of Tusheti" by Adam Pellillo and Irakli Kochlamazashvili, October 2014

TOURISM AND LOCAL DEVELOPMENT: THE CASE OF KAZBEGI ROOMS HOTEL[16]

The complex love-hate relationship between the new Kazbegi Rooms Hotel and the local community in Stepantsminda village was in the focus of a debate on the role of high end tourism in promoting inclusive growth in Georgia which ISET hosted in July 2014. A follow up excursion to the Kazbegi municipality, meetings with local farmers, service providers and Rooms Hotel management helped clarify some of the issues and raise many more questions.

Kazbegi Rooms Hotel offers a spectacular view over the Gergeti Trinity Church and the Kazbegi mountain. Its story also offers a great perspective on the failure of government to promote win-win public-private development partnerships.

ROOMS KAZBEGI: POSITIVE IMPACTS

Kazbegi is a touristic heaven in the picturesque Tergi (Terek) river valley offering many attractions such as bird watching, alpinism, castles and towers. Located some 10km south of the Georgian-Russian border, Kazbegi boasts a spectacular view of Mount Kazbek and Gergeti Trinity Church. As a gateway to Russia, it serves traffic flows and tourism (heli ski and casino). www.iset.ge

The result of a $15mln investment project, Rooms opened a little over two years ago, in July 2012, providing a major boost to the meager hotel capacity in the region. The property was privatized in 2010 (at no cost) with the investors –Tbilisi Holiday Inn shareholders – taking upon themselves the obligation to build a modern hotel. As Rooms management knows to tell, the first year was not an easy one, but since then Rooms has seen a doubling in the number of arrivals, including a 23% increase in the first 6 months of 2014 relative to 2013.

Rooms is by far the largest employer in Kazbegi. And it is the company's explicit strategy to train and employ as many villagers as possible. The logic is straightforward: if available, locals are cheaper, don't need housing, and are less likely to leave. At present, about 60% (100 of 170) of staff are, indeed, local hires, most of whom went through a 6-month in-house training program in language and hospitality services. A major constraint for hiring more locals, however, is the proud uplands culture (translating into the client-is-always-wrong approach to service) and language skills. Thus, only one local woman is employed in the front part of the operation (as a waiter) while others are doing the back office work,

[16] Based on Kazbegi Rooms: with a View to Improvement of Regional Development Policies, By Eric Livny

maintenance, kitchen, cleaning and security. The most senior local hire is … head of security.

Not only is Rooms a boon for local employment, but also, as all stakeholders agree, its arrival did not have any negative impact on homestay owners who continued catering to backpackers and budget travelers. There is no displacement or competition among them and Rooms. In fact, the city has generally become a much more popular tourist destination, which benefits everybody, including the Alexandre Kazbegi museum, souvenir shops, and restaurants.

People always used to come to Kazbegi from Gudauri, but did not stay given the lack of hotel capacity. Now, they tend to stay overnight, which is a great boost for the local economy. Locals and expats living in Georgia account for about 30-32% of total visitors, and according to Valeri Chekheria, Rooms CEO, this is indeed a fast growing segment. Internal weekend tourism can be seen as a great (voluntary and non-distortionary!) way to redistribute income from Vera and Vake to the Georgian periphery.

There are also specific activities which Rooms leaves to the locals, such as Georgian traditional cuisine (e.g. khinkali, a local specialty), horse riding, local guiding and transportation services. Providers of transportation services and local guides are in fact under contract with Rooms. And there are many products that Rooms sources from local farmers (many of whom are supported the New Economic Opportunities project of the US Agency for International Development), such as cheese, salad leaves, broccoli, potato, and trout. What could go wrong then?

INFRASTRUCTURE BOTTLENECKS

While most local infrastructure bottlenecks – public toilets, safe road crossings, intermittent electricity supply and road quality – are equally damaging for businesses and households, **insufficient water supply** created a *zero sum game* situation between Rooms and the entire Kazbegi community, becoming a major source of conflict in winter 2012/13, soon after Rooms started operating.

Water supply in Kazbegi and much of rural Georgia is the responsibility of the United Water Supply Company of Georgia – an LLC in 100%-ownership by the state. While having at least two years to prepare for the launch of Rooms, the company took no steps to upgrade the water infrastructure in anticipation of increased demand, subjecting the entire town to seasonal outbursts of anger and misery. Ironically, since consumption by Georgian households is not metered, Rooms is the water company's only (sic!) paying client in Kazbegi – about $10-15,000/month. Yet, to date, it has been unable to allocate sufficient resources to deal with the root cause of the problem: the size of water reservoirs. Instead, the company has been tinkering with holes and leakages in the water collection system and piping.

As far as the **environment** is concerned, Rooms would like to promote its green image and qualify for an eco-certificate by encouraging guests to reduce electricity and water consumption and by sorting its waste. However, there is no local recycling option – at the end of the day a single truck collects the entire load of garbage and dumps it not far from the river. The only thing the company could do is involve its staff in regular cleaning actions (e.g. in the nearby forest) but it has been extremely frustrating to see that in just a few weeks the place gets littered again by the locals.

Road infrastructure is also an issue. The government has invested large resources in improving the main Gudauri-Kazbegi road, but the "last mile" from the village center to the hotel has not be repaved despite an explicit commitment by the government to do so as part of the privatization deal. Until now, Rooms could not (and did not want to) invest its own resources (estimated at GEL 100,000) in paving the road.

GREATER ROLE FOR (LOCAL) GOVERNMENT

So far, the role of ***local* government** in developing the tourism infrastructure or helping local businesses in Georgia's periphery has been quite limited. For instance, at present, tourism is the responsibility of one person in the Kazbegi municipality, with no budget and limited capacity to coordinate. Large private businesses, such as Rooms, can certainly help with ideas, skills and resources. However, they cannot be expected to fix all the infrastructure problems such as waste management, sewage and water supply systems. Businesses would be more than willing to pay a part of their taxes to the *local* government, providing it with the incentives and resources to invest in tourist-friendly infrastructure and public goods. Georgia's tax administration system is, however, overly centralized, weakening the fiscal incentives of local government. Incidentally, the casino operated by Rooms is potentially a major contributor to the local budget (approximately $200,000/year, depending on the number and types of tables operated), however, the Kazbegi municipality has not been authorized to use the money for local needs. Instead, these funds (and about GEL 30-50,000 in monthly VAT payments made by Rooms) are finding their way to the national government's coffers.

Businesses would be more than willing to pay a part of their taxes to the local government, providing it with the incentives and resources to invest in tourist-friendly infrastructure and public goods. Georgia's tax administration system is, however, overly centralized, weakening the fiscal incentives of local government.

Eric Livny
Kazbegi Rooms: with a View to Improvement of Regional Development Policies.
ISET Economist Blog, September 2013

Another issue for large businesses operating in the periphery is the fact that 99% of local service providers are operating in the shadow economy. Rooms has a hard time to do business with locals unless they are legally registered. An appropriate (budget neutral) policy response to this bottleneck could be a blanket **tax exemption for small businesses and individual entrepreneurs operating in remote** regions in order for them to officially register, receive support and grow.

Finally, there is a role for government in managing the negative impacts of tourism on the **environment** by installing sewage and waste management systems, protecting rare animal species, on the one hand, and promoting people's awareness of these environmental issues, on the other. After all, it should not be too difficult to explain to Georgia's youth that good citizenship and patriotism are not only about rooting for the national rugby team, but also about not polluting the Motherland.

THE ISET ECONOMIST BLOG ON TOURISM

TOURISM AND RURAL DEVELOPMENT

Kazbegi Rooms: with a View to Improvement of Regional Development Policies. By Eric Livny
Travel and Tourism to Georgia: Making Sense of Definitions and Numbers.
By Giorgi Bregadze and Revaz Geradze
Tourism and rural development: the case of Tusheti. By Adam Pellillo and Irakli Kochlamazashvili

V. WATER AND ENERGY RESOURCES

USE AND GENERATION OF ENERGY

Georgia is very rich in hydro power resources, and yet, rather paradoxically, it is characterized by very significant energy poverty. The same is true for Georgia's immediate neighbors. Per capita electricity consumption in the South Caucasus region is only about ¼th of the OECD average.

SUMMARY OF ACTIVITIES

Dialog:

Access to Energy and Water Supply in Georgia

Follow up visit:

Aragvi HPP and Gudauri

Project presentation:

Renewable Energy and Energy Efficiency" projects by BP

On the one hand, this reflects a lengthy period of de-industrialization (until well into 2000s, Georgia's main export was scrap metal!). On the other, most Georgians simply cannot afford the use of energy for air-conditioning, heating, or powering energy-intensive equipment, such as washing machines.

Firewood is the most common source of heating energy in Georgia's regions. Unfortunately, as shown by a number of studies, it is used very inefficiently, causing environmental damages.

While most Georgian households are connected to the electricity grid (only 28 villages are yet to be connected, almost 30% do not have access to natural gas. According to a survey conducted by the Association of Young Professionals in Georgia's Energy Sector, firewood is used for heating by around 96% and 26% of rural and urban households, respectively. Facing energy poverty, come winter time, many Georgian households move into a single heated room and minimize the use of energy-intensive equipment.

Achieving energy efficiency is also a major challenge for Georgia. On the one hand, this is a matter of firms and households being liquidity constrained –modern insulation and energy efficient technologies require costly investment which Georgians cannot afford. On the other, this is a matter of awareness. Businesses and individuals could borrow to invest in energy efficient technologies or better insulation that would save them money in the medium term. Except that they don't.

HYDROPOWER DEVELOPMENT, ECONOMIC GROWTH AND POVERTY

As discussed in the Georgian National Competitiveness Report (ISET, 2013), "Georgia became a net electricity exporter in 2007, however, export levels are modest due to growing domestic demand and limited transmission capabilities. There is an obvious coordination problem in the sector: investment in HPPs will not happen without guaranteed access to regional markets, and, private investment in transmission infrastructure is conditioned on a guarantee of sufficiently large volumes of traded electricity. In economists' jargon, the sector is characterized by an externality in investment decisions.

The cornerstone of the chosen government approach is public investment into the transmission infrastructure connecting the Georgian and Turkish grids. This involves building new and improving existing power lines and back-to-back stations at the total expense of 220mln Euros. The funds are provided by the European Bank for Reconstruction and Development, the European Investment Bank, the European Union Neighbourhood Investment Facilities, and Kreditanstalt fur Wiederaufbau.

The Government of Georgia has allocated the land plots and liaised with the Turkish authorities to ensure the connection to the main grid across the border. According to the blueprint, the new lines will motivate investor interest in the construction of HPPs on a concessionary Build-Operate-Own (BOO) basis. More than 36 HPPs (including six large, 100-702 MW plants) are currently under memoranda of understanding (MoUs) with foreign investors, though about 50% are in need of additional investment."

> Georgia could do a lot more to promote its competitiveness – and job creation at home – if it were to use its hydro resources to reduce the costs of local producers and households, and spur investment in energy-intensive industries with the potential to export higher value-added and more sophisticated products..
>
> Georgian National Competitiveness Report,

Located in Georgia's outlying regions, hydropower projects are likely to generate considerable local employment during the capital intensive construction phase. Furthermore, new power generation facilities are frequently the reason for improvements in local infrastructure such as roads, electricity transmission equipment and even water supply. Once operational, generation of hydro and other renewable energy resources (e.g. wind and solar) could furnish off-grid energy solutions for remote mountainous regions or and/or supply existing and new electricity-intensive industries – boosting employment and contributing to local budgets.

But there are tradeoffs to consider.

New hydropower plants rarely have any impact on *local* employment or public revenue beyond the construction phase. The new state-of-the-art Aragvi HPP, to take one example, employs only three local technicians and sells its electricity to the national grid rather than to the nearby Gudauri resort (the initial rationale for this HPP, conceived by the Austrian owners of the Gudauri Marco Polo Hotel back in late 1980s). Likewise, the ongoing development of Georgia's hydropower potential does not translate into lower electricity prices for Georgian households or industrial consumers. This is so because, according to the government's policy blueprint, instead of flowing into the domestic market – and applying downward pressure on prices – any surplus electricity is supposed to be siphoned off by the Turkish grid.

Thus, it may be worthwhile to take a step back and consider the power industry and the above policy blueprint in the broader context of the Georgian economy. Would the economy as a whole benefit from an increase in electricity exports? What would be the spillovers from this activity to other sectors of the Georgian economy? Figuratively speaking, does the investment into new Turkey-oriented transmission lines provide the best bang for the Georgian lari? The answer is far from certain. Also consider that, under the BOO concession model, the lion's share of economic rents accruing from the use of natural resources will be pocketed by foreign investors.

The public revenue, raised in the form of the transmission tariff, seems a modest return on the massive capital outlays and environmental impacts. Georgia could do a lot more to promote its competitiveness – and job creation at home – if it were to use its hydro resources to reduce the costs of local producers and households, and spur investment in energy-intensive industries with the potential to export higher value-added and more sophisticated products.

WATER SUPPLY AND ECONOMIC DEVELOPMENT

Despite being abundant in water resources, Georgia faces enormous challenges in irrigation and water supply for both residential and commercial use. For one thing, dilapidated sewage, wastewater management, and water supply systems are a cause of frequent interruptions and supply schedules, and a source of risk for human health and the environment. This problem has no solution other than sustained investment over the next several years.

> In Georgia, unless you are an honest guy by nature, it makes no sense not to steal water".
>
> Participant in the debate

Another major issue is that tariffs for tap water, set by the Georgian National Energy and Water Supply Regulatory Commission (GNERC), has been designed to perform social policy functions: much of the residential sector is not metered and the flat fees charged for water consumption are ridiculously low. The entire cost of maintaining tap water supply is thus shouldered by the Georgian private sector and taxpayers. This is not only a problem of fairness, but also of economic efficiency. At present, Georgian households enjoy the luxury of using free tap water for washing their cars and watering their gardens, while businesses (e.g. food processing companies) are facing very stiff tariffs, reducing the amount of resources they have available for investment and affecting product prices.

Georgia's **residential water distribution sector** involves two main actors. In the Tbilisi metropolitan area (Tbilisi, Rustavi and Mtskheta), water distribution system is owned and managed by the private Georgian Water and Power Ltd (which also owns several water reservoirs and nearby hydropower plants). In all other municipal centers (towns and large villages), except Adjara and the conflict zones,, water supply and distribution is in the hands of United Water Supply Company of Georgia (UWSCG), owned by the Georgian Ministry of Regional Development and Infrastructure (MRDI).

UWSCG is at the forefront of investment water supply infrastructure using government funds and loans from international donor organizations such as ADB, EIB and World Bank. To improve tariff collection and reduce waste, UWSCG installs water metering systems in all locations in which it performs infrastructure investments. Unfortunately, little improvement is happening in all other locations (defined by law) in which water infrastructure is the responsibility of local governments. While perhaps not obvious, another negative implication from the lack of metering concerns the company's ability to accurately forecast water supply needs and plan ahead, exposing customers to supply shortages, particularly in winter time (see Kazbegi Rooms: with a View to Improvement of Regional Development Policies, by Eric Livny).

Georgia's **irrigation sector** is currently managed by the United Amelioration Systems Company of Georgia (UASCG), an Ltd under the Georgian Ministry of Agriculture. Old soviet irrigation and amelioration infrastructure is one issue directly affecting agricultural productivity. Another major problem is that the company does not operate as business. The flat per hectare tariff (GEL 75) does not even cover basic maintenance costs. While existing irrigation infrastructure allows to supply water to 88,000 hectares of land, UASCG has contracts covering only half of this land from which only 30% of fees are collected. As a result, UASCG has to be heavily subsidized by the government and cannot undertake investment without borrowing or support from international donor organizations.

Simon Appleby from the YFN Georgia and Jean-Frederic Paulsen from Wellington LLC – industrial consumers of Georgian energy and water supply utilities – noted some improvement in irrigation after

the establishment of the UASCG with overall responsibility for the sector. One major issue yet to be tackled is damage to existing networks and theft of water by Georgian smallholders.

Another problem is the lack of a civilized "protocol" in communication with customers. According Jean-Frederic Paulsen, Georgian utilities do not provide early prior to suspending energy and water supply. If at all, notice is given just hours before terminating supply (of electricity and water) which badly impacts the business. Due to the frequent brownouts, especially in Georgia's regions, businesses have to invest in expensive stabilizers and UPS units.

Finally, Mr. Paulsen noted the excessive amount of paperwork and time required of businesses at the initial stage of getting connected to the electricity grid and water supply network. He warmly welcomed GNERC's intent to prepare and launch grid codes regulating supply and service quality standards and establishing stricter monitoring requirements.

GOING FORWARD

Georgia's Association Agreement with the EU, signed in June 2014, includes a number of provisions requiring the Georgian government to comply with EU energy efficiency regulations and standards. One opportunity to improve energy efficiency in the residential sector would involve smart metering, nudging consumption away from peak load time. The government may also subsidize the interest on loans to help offset the cost of modern insulation, solar panels and energy efficient bulbs in residential buildings. The AA thus provides an opportunity to develop and implement a sound strategy to achieve energy efficiency and develop renewable energy resources.

All stakeholders agree that the use energy and water supply polices to achieve social policy or political objectives leads to enormous waste of resources without necessarily achieving its stated objectives. It would be far more efficient to charge consumers for the real cost of tap or irrigation water while providing direct subsidies to those in need. This, for instance, is the essence of recent reforms implemented by the Ukrainian government in the country's highly corrupt and inefficient gas distribution system.

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Electricity Generation in Georgia I: The Seasonality Problem. By Norberto Pignatti and Giorgi Kelbakiani
Electricity Generation in Georgia II: Blowing Wind into the System.

Perhaps most importantly, the use of energy and water supply policy to achieve social and political objectives also creates an excuse not develop competitive markets in these sectors. And this directly influences the quality of services provided by utility companies. Facing no competition, they are in no rush to connect new clients to the grid and don't see excessive paperwork as a problem for their own business. Lack of competition is also behind the frequent brownouts, failure to plan ahead and communicate with clients. Finally, a tariff system which forces businesses to pay not only for their own

consumption of water (or any other resource) but also for that of their residential neighbors ultimately limits the ability of businesses to expand, create jobs and employ those very neighbors. Such a system therefore fails to achieve those very social policy objectives it is supposed to achieve.