NATIONAL COMPETITIVENESS REPORT GEORGIA 2012/2013

TOWARD A MULTI-SECTOR REGIONAL HUB

ISET MA Program in Economics
Policy Institute

International School of Economics at Tbilisi State University

National Competitiveness Report
Georgia 2012/2013

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Tbilisi, Georgia

2013

ISET Policy Institute is one of the first university-based think-tanks in the South Caucasus. It is based at the International School of Economics (ISET) of Ivane Javakhishvili Tbilisi State University (TSU) in Georgia. Established in May 2011, ISET-PI builds upon ISET's academic strength and TSU's tradition of excellence and social engagement.

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Acknowledgements

This report was prepared in cooperation with the Economic Prosperity Initiative by USAID as part of a concentrated effort to promote Georgia's global competitiveness. Special thanks go to Barrie Hebb, Kevin Murphy and Alan Saffery for providing methodological guidance and training early on in the process, to Tina Mendelson for expert opinion and advice, and to Tamuna Kapianidze for helping organize public discussion and promote the competitiveness agenda. Major segments in this report follow the World Economic Forum's methodology, and we are indebted to WEF for sharing their data and knowledge. Invaluable assistance in the process of data collection was provided by Irina Kvachadze from the Business Association of Georgia, who helped organize more than 30 interviews with the CEOs of the largest Georgian companies. Naturally, we would like to thank all those who agreed to interview for the report and connecting it to the reality on the ground, including current and former Ministers Davit Narmania, Giorgi Kvirikashvili, David Kirvalidze, and Dimitri Gvindadze. The report greatly benefited from a careful review and critical comments by ISET's professors and members of its International Faculty Committee, including Yaroslava Babych, Michael Beenstock, Michael Fuenfzig, Adam Pellillo, and Robert Tchaidze. ISET Policy Institute staff took part in producing the study and bringing it to publication: Maka Chitanava, Lasha Labadze, Maya Grigolia and Nino Doghonadze. ISET's Mari Chelidze, Sopha Gujabidze, Teona Khaindrava, Nina Sukhanskaya and Liza Zhahanina helped organize interviews and the concluding conference. Last but not least, our sincere thanks go to Tamara Germanashvili, Tamuna Karosanidze, Fron Nazi, Jason Swantek, and Mari Zabakhidze from USAID's Policy Advocacy and Civil Society Development in Georgia project for generous financial support, encouragement and flexibility in extending reporting deadlines.

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Policy, Advocacy, and Civil Society Development in Georgia (G-PAC)

საჯარო პოლიტიკის, ადვოკატირებისა და სამოქალაქო საზოგადოების განვითარება საქართველოში

The report is made possible by generous support of the American people through the United States Agency for International Development (USAID). The contents do not necessarily reflect the views of USAID or the United States Government

Contents

List of figures

List of tables

List of boxes

EXECUTIVE SUMMARY

In the globalized world of today, increasing national competitiveness has become an important policy target for any country. While engaging in mutually beneficial trade, technological and cultural exchanges, countries find themselves in a race for scarce mobile resources such as financial capital and talent. Winning in this race are those locations that offer the best conditions for economic activity – skilled and disciplined labor force, high quality services and urban amenities, transparent and efficient public administration, etc. These locations – not only countries, but also regions and cities – serve as magnets for investment and people, and are able to grow and reach prosperity, the ultimate goal of economic policy.

What is it that makes some countries more competitive than others? Understandably, a lot depends on inherited conditions: cultural norms such as punctuality (not Georgia's main strength), decency and hospitality, the quality of local labor and firms, geographic location, natural resource endowment, etc. As is becoming increasingly obvious, a key role in attracting resources is played by the quality of national institutions: strength of democracy, health and education systems, rule of law, independent judiciary and protection of property rights. These institutions can be reformed, as Georgia has proven, and hence their prominence in the competitiveness debate. Finally, specific government policies are very important in ensuring security and macroeconomic stability, providing public services and infrastructure, facilitating regional collaboration, trade, travel and communication with the rest of the world.

Georgia in the Global Competitiveness Index

There are plenty of indices that purport to measure various aspects of competitiveness: ease of doing business, economic freedom, human development, democracy, political stability, travel and tourism competitiveness, to mention just a few. Our focus in the report is on Georgia's performance in the Global Competitiveness Index (GCI) produced by the World Economic Forum (WEF). This is one of the better known comprehensive international rankings, covering more than 140 countries. The GCI is based on more than a hundred indicators ("drivers of economic performance") divided, for analytical purposes, into twelve "pillars of competitiveness".

Georgia has been included in the GCI since 2005, shortly after the Rose Revolution. Reflecting the rapid growth of its economy and considerable improvements in governance, quality of institutions and infrastructure, it has since advanced in the GCI, both over time and, to a lesser extent, relative to peer countries. Last year was a breakthrough year as far as relative progress is concerned: Georgia moved from 88th to 77th position in the global ranking, above the average for CIS countries, and very close to the much larger Ukraine (73rd). Overall, considering the 2005-2012 period, Georgia has become one of the biggest improvers in GCI.

Going forward

Without any doubt, Georgia's progress on any conceivable measure of economic performance and competitiveness during the last 10 years is quite encouraging. The first wave of broad brush liberal reforms has, in many instances, cleaned the slate and created the foundations on which Bidzina Ivanishvili's administration could build the new economic and political order. While many of the early reforms produced excellent results, there remain serious gaps affecting Georgia's real and perceived competitiveness. For instance, Georgia now has one of the most liberal business environments, but it is not yet a place where doing business (as opposed to registering a business) is actually easy. Among the key problems are access to finance, qualified labor, small market size and independence of the judiciary.

The peaceful democratic transition Georgia experienced late in 2012 is likely to diffuse political risks and spark investor optimism, giving Georgia a good chance to bring growth rates back to their pre-2008 level. The change in leadership also provides Georgia with an opportunity to think through and, if necessary, reset Georgia's future strategy and policies. Our report dwells on three aspects of such a strategy: **dealing with the social and political "externality"** imposed on the economy by the persisting under-employment and growing income inequality; **assuring foreign investors** that market-friendly reforms will be deepened, not reversed; and **reducing trade and transaction costs** to enable Georgia to perform the regional hub function.

First, though quite impressive when looking at GDP statistics, Georgia's growth did not create enough jobs, leaving more than 50% of the working age population in low-productivity subsistence farming, un- or under-employment. Many former industrial workers saw their human capital depreciate over the previous decade and left the labor force. The incidence of unemployment is particularly high among youth, many of whom have spent five or more years acquiring a university degree but lack the professional skills demanded by the market. The result has been political uncertainty and risk, which, in turn, translated into unfavorable country credit ratings and high lending interest rates, further slowing down investment and job creation in the non-agricultural sector. We contend that the government should seek to resolve the vicious circle created by the social and political externality.

Second, given the lack of domestic savings, Georgia's ability to increase its capital stock remains dependent on foreign investment. Yet, FDI has decelerated considerably after 2008, in the wake of the internal political standoff, the August 2008 war with Russia, and the global financial crisis. Georgia was able to compensate for the lack of foreign investment by borrowing abroad at deeply concessionary rates, as well through technical assistance, foreign aid and remittances. The resulting capital account surplus has helped finance investment in public infrastructure and current consumption (imports of goods and services). However, while alleviating current account deficits in the short run, these capital inflows are no substitute for foreign direct investment in the manufacturing, energy, tourism or agribusiness sectors that could improve the country's technological base and boost its export potential. Attracting foreign investors should thus be another top priority for the new Georgian administration. Doing so will require strong steps to improve the administration of justice and property rights protection, on the one hand, and assure potential investors that there will be no reform reversals in such key areas as land ownership, labor code and competition law, on the other.

Finally, the racing imagery invoked by the competitiveness framework should not lead Georgian policymakers into believing that achieving competitiveness is about a zero-sum game among nations. As a small country on a crossroads between Asia and Europe, the only way in which Georgia can promote its international competitiveness is by opening up to the rest of the world and cooperating with its neighbors, Russia included. For example, Georgia is already benefiting from investment originating in the oil-rich and more "competitive" Azerbaijan. It also enjoys the opportunity to trade with Azerbaijan and serve its trade and transportation flows. Moreover, the lion's share of resources attracted by Azerbaijan is obtained in third countries, not at Georgia's expense. The general point is that one of the easiest and least costly ways for Georgia to increase its competitiveness and market size is to further reduce trade and transaction costs with its neighbors. In this way, and by prioritizing investment in essential pieces of trade and logistics infrastructure, Georgia could leverage its convenient location and "Doing Business" ranking to assume the much-coveted role of a regional hub.

1. MACROECONOMIC OVERVIEW

We start our analysis of Georgia's competitiveness with a review of the country's macroeconomic performance during the last several years. First, we take stock of Georgia's economic growth, focusing on the country's ability to effectively and efficiently deploy its scarce human resources and capital. A key consideration is the extent to which the process of economic growth was able to diffuse the social and political tensions that brought about the Rose Revolution of 2003. Second, we consider Georgia's fiscal and monetary policies in the post-Rose Revolution period. Our focus here is on the period of economic recovery following the August 2008 war with Russia and the global financial crisis. Third, we review Georgia's trade, balance of payments, and external debt position. While greater integration into the global economy is crucial for Georgia's continued growth and development, the country should exercise a lot of care in managing the concomitant risk. Fourth, we analyze the Georgian financial sector development and the ability of this sector to accumulate savings and extend credit to households and private businesses. Finally, we delve into the question of risks associated with Georgia's precarious geopolitical environment, volatile political situation, weakness of democratic checks and balances, and rule of law imperfections. These risks are a key constraint on Georgia's ability to gain trust and attract foreign investment.

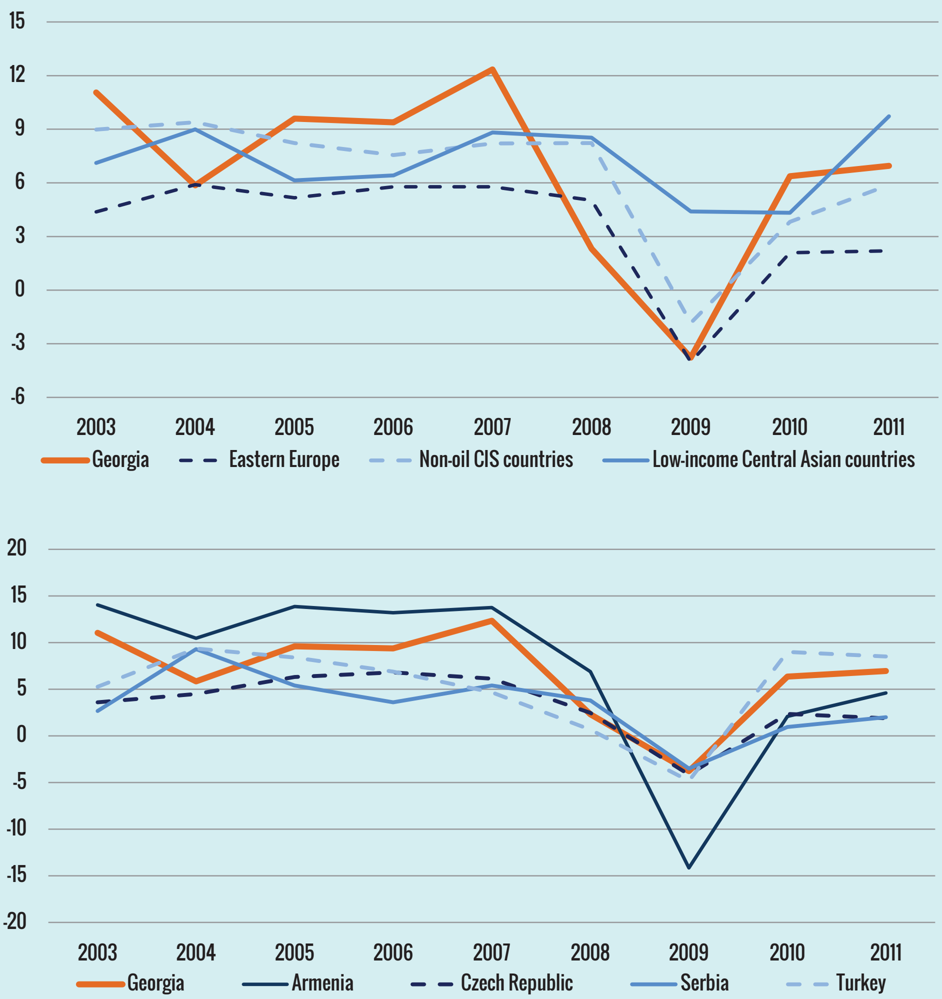
1.1 Georgia's growth performance

A "pitch document" prepared in 2012 by one of the major global consulting companies for the Georgian government describes Georgia's current strengths from the foreign investors' point of view:

- "One of the fastest growing economies in the region
- Strong economic fundamentals allow for diversified growth
- Globally recognized reformer
- Highly geo-strategic position at a regional cross-roads
- Competitive factor costs at a regional level
- Opportunities to build a multi-sector hub for the Caucasus and beyond."

Indeed, there is no arguing that during the ten years since the Rose Revolution, the Georgian economy registered an impressive growth performance, averaging 6.6% per annum (see Figures 1.1 A,B). For example, summing up Georgia's post-2004 growth experience, a recent ISET-PI study (Babych and Fuenfzig 2012), finds this performance to be "remarkable not only in light of the 5.3 percent average growth rate in the 1995-2002 period, but also considering that the average GDP growth rate for European and Central Asian developing countries was about 5.1 percent in the period between 2003-2010."

Figure 1.1 (A, B) Benchmarking Georgian growth



Source: WDI, IFS

Yet behind the glistening façade of these growth statistics there is political and social uncertainty resulting from the widespread poverty and inequality. As the 2012 parliamentary elections have shown, the majority of voters in the country do not have firm ideological views or a fixed political affiliation, and hence are for all practical purposes swing voters. This has created a perception in donor and investor circles that neglect of the inequality dimension may jeopardize some of the positive achievements of the post-2003 reforms.

In the rest of this chapter we are going to provide a high-level overview of the Georgian economy, document the benign features of the macroeconomic landscape, and point out the political risks that hinder further economic growth.

1.1.1 Labor resources utilization and fixed capital formation

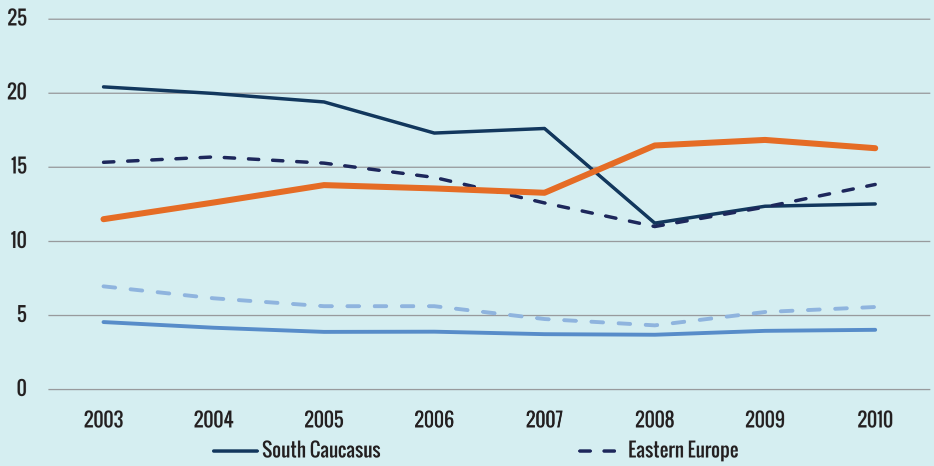
The unemployed, the underemployed, and the low-skilled. Using the traditional growth accounting method one can decompose Georgia's GDP growth rates into the sum of the growth rates of labor, capital, and the total factor productivity. The contribution of labor to economic growth is perhaps the most important given the social angle. The unemployment statistics (see Figures 1.2, 1.3) do not look too bright, but at least they are not very alarming. These statistics, however, do not tell the whole story.

In 2011, as much as 35% of the working age population were not part of the labor force. Even more importantly, 48% of the employed were categorized as self-employed. While no detailed statistics are available, a huge part of the self-employed are actually subsistence farmers. Thus it is safe to label them as underemployed at best. The picture that emerges is staggering (see Figure 1.4). It suggests that 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 high incidence of youth unemployment is also worrying (see Figure 1.5) because the jobless young of today are likely to be the less productive workers of tomorrow – negatively affecting their own lifetime income and the overall productivity of the economy.

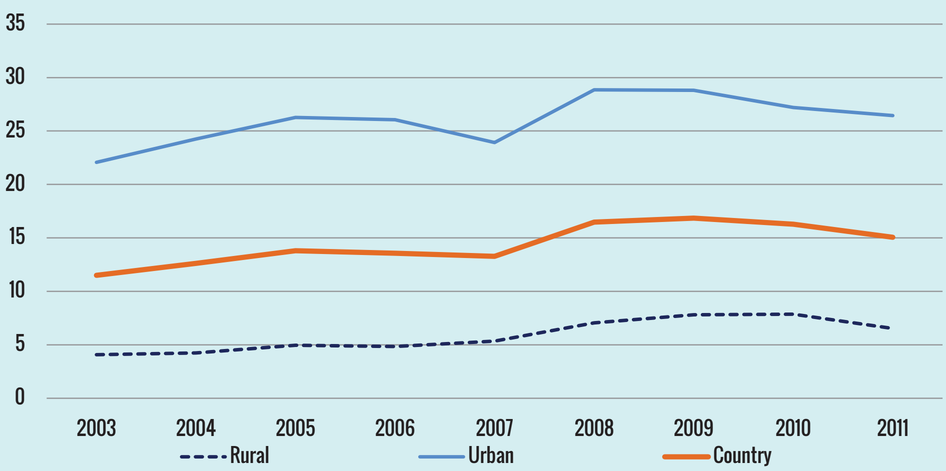
The suitability of existing skills is another concern. The UNDP Human Development

Figure 1.2 Benchmarking unemployment rate



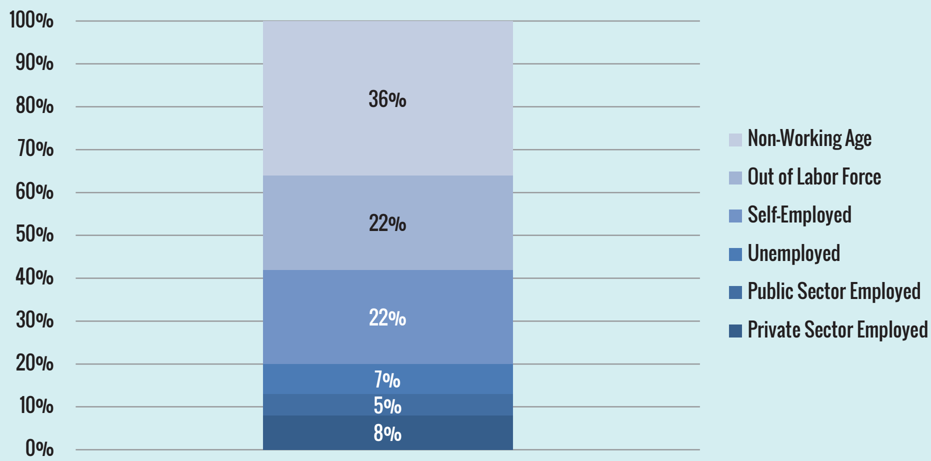
Source: WDI

Figure 1.3 Unemployment by rural-urban areas



Source: Geostat

Figure 1.4 Employment in Georgia



Source: Geostat

Report (2010) places Georgia among the leading countries of the world in terms of the formal education completion rates of the unemployed: in 2008 about 81% of all Georgian unemployed had completed secondary or higher education. This suggests that formal education has failed to give people marketable skills that would make them attractive candidates in the marketplace. We will return to this important topic in Chapter 2.

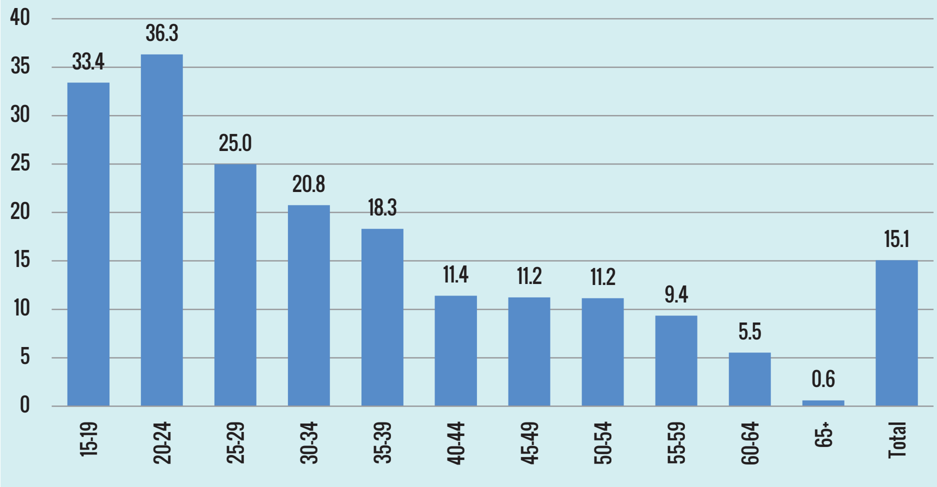
Fixed capital formation. Modern technologies are capital-intensive as a rule. Consequently, to enter the modern age, Georgia would need to constantly update and add to its capital stock. This is especially true in light of the obsolete equipment left from Soviet times. Figure 1.6 shows the evolution of private and public investment since 2003. In the years before 2008, the aggregate numbers look respectable, all the more so considering that at the outset of the reform period Georgia attracted virtually no investment from abroad. However, after 2008 the rates of capital formation have decelerated considerably. This is particularly true for private investment.

In principle, investment in capital stock can be financed by domestic savings or foreign investors. A classical paper in the literature of growth by Galor and Zeira (1993) argues that, in the early stages of economic and financial development, domestic savings cannot be a significant funding source. Below a certain threshold level of income, households live in self-imposed financial autarky. Given the interest rates available, they are not willing to either borrow money from the financial system or save. This theoretical explanation appears to be an excellent fit for the Georgian realities of recent years.

Even though international financiers have no such constraints, they too have to compare the expected rate of return on their investment in Georgia to the best alternative use (adjusted for the risk, of course). The aggregate numbers seem to suggest that the externally funded investment has been modest at best.[1]

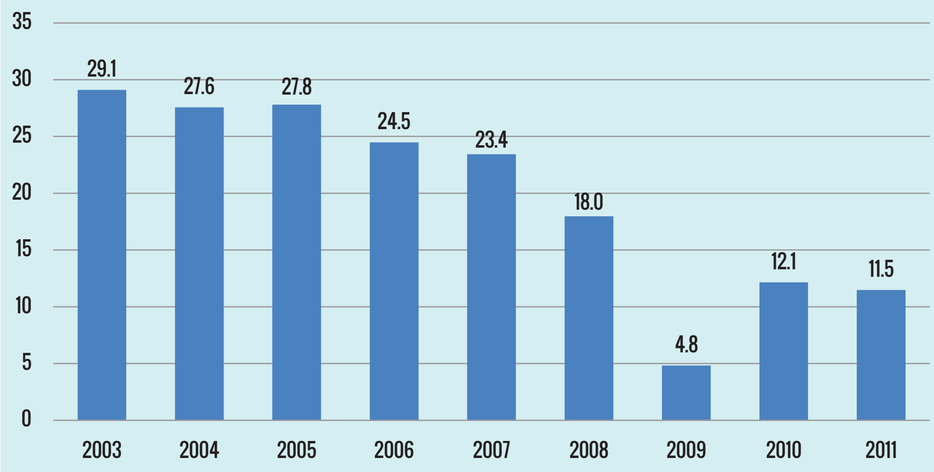
[1] The available FDI statistics does not allow for distinguishing the externally financed additions to the fixed capital stock (the proper FDI that makes part of national investment) from the stock-neutral changes of asset ownership and speculative inflows. This makes it impossible to accurately estimate how much investment came from foreign sources. Given that at the peak of the housing bubble in 2007 the inflows amounted to $2.01bln or 19.8% of GDP, a conservative estimate of the average contribution of foreign investors over the years is under 10% of GDP.

Figure 1.5 Unemployment rate (percentage, by age cohort)



Source: Geostat

Figure 1.6 Georgia: Shares of investment in GDP (%)



Source: Geostat, MoF

Total factor productivity. In the absence of sufficient investment, countries can still grow by making more efficient use of the available stocks of labor and capital, that is, by increasing so-called "Total Factor Productivity" (TFP). Countries characterized by higher TFP can produce more with the same resources. TFP growth can be triggered by reforms that eliminate corruption, reduce taxes, compliance costs and trade barriers facing businesses. Importantly, by improving TFP, an economy generates higher returns on investment, increasing its attractiveness for foreign capital.

Babych and Fuenfzig (2012) indeed find that Georgia's recent growth is largely attributable to improvements in TFP rather than an accumulation of physical capital. The high Total Factor Productivity component in overall output growth, in particular in the period after the Rose Revolution, might appear somewhat puzzling given the low levels of product innovation and new technology adoption in Georgia. The answer most likely lies in the fact that most of Georgia's productivity growth stemmed from process innovation, which is defined by the OECD as the "implementation of a new or significantly improved production or delivery method." Many of the reforms Georgia undertook in recent years focused on the removal of external constraints to businesses – such as corruption, high taxes, and unnecessary red tape – thus increasing TFP. We discuss the institutional factors contributing to high TFP and the externalities that constrain it in Chapters 2 and 3 respectively. Other prerequisites for TFP improvements, including macroeconomic, financial, and political stability, are analyzed in the rest of this chapter.

1.2 Macroeconomic policy

1.2.1 Fiscal policy

The year 2005 saw the implementation of an ambitious tax reform in Georgia (we describe this in more detail in Chapters 2 and 3). As a result of improved governance and tax administration, public revenues grew continuously before the global financial crisis. Government spending and social transfers also rose at even faster rates due to spending on police reform and infrastructure projects.

In 2009, as a result of the August 2008 war and the global financial crisis, consolidated budget revenues dropped by about 10%. Expenditures also declined, albeit at a slower rate, to provide modest fiscal stimulus. The deficit-to-GDP ratio peaked at 9.3% in 2009, triggering fiscal consolidation. The government managed to retract spending to the 2008 level, while revenues recovered due to the rebound in economic activity. As a result, the deficit stabilized at 3.3% in 2011.[2]

The government subsequently drafted “the Economic Liberty Act” intended to limit the discretion of the executive branch of government with a view to establishing a commitment to small government and low tax rates. The Liberty Act, adopted in July 2011, was promoted as a means to make reforms “immune to policy drift and reversal.”[3] It is supposed to come into force in 2014, after the 2013 presidential elections.

While there have been a few one-off socially-oriented transfer campaigns, such as the distribution of food and electricity vouchers and an increase in basic pensions[4], the fiscal authorities kept a lid on social spending and transfers, prioritizing capital spending (maintaining it at around 7.5% of GDP).

1.2.2 Monetary policy

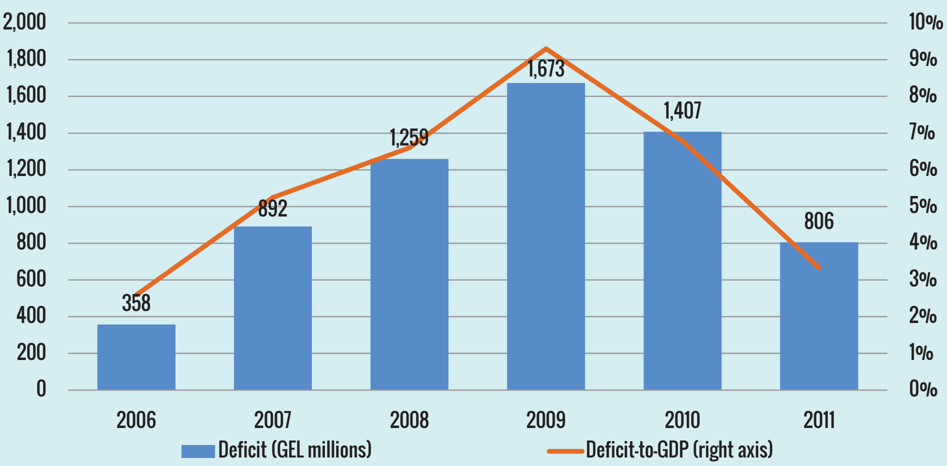
Given that the fiscal authorities avoided spending excesses throughout the reform period, there has been no trend of inflationary pressure in the economy. The National Bank of Georgia (NBG) kept an eye on currency stability, intervening whenever currency appreciation pressures were building up, for example, during the housing bubble phase that attracted a lot of hot money inflows in 2007 and, later, in 2011 when quantitative easing in the US sent inflationary ripples throughout the

[2] Source: NBG, MoF.

[3] Government of Georgia, Press Release: “Georgia adopts the Economic Liberty Act.”

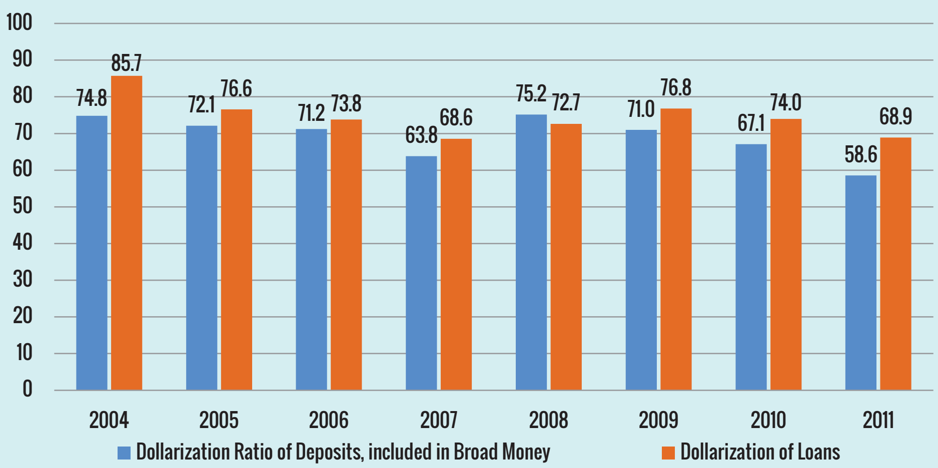
[4] One of the reforms that should reduce the budget burden in the long-term is the transition away from the state-funded pension scheme to a contribution-based occupational savings framework supplemented by means-tested social security benefits.

Figure 1.7 Government deficit



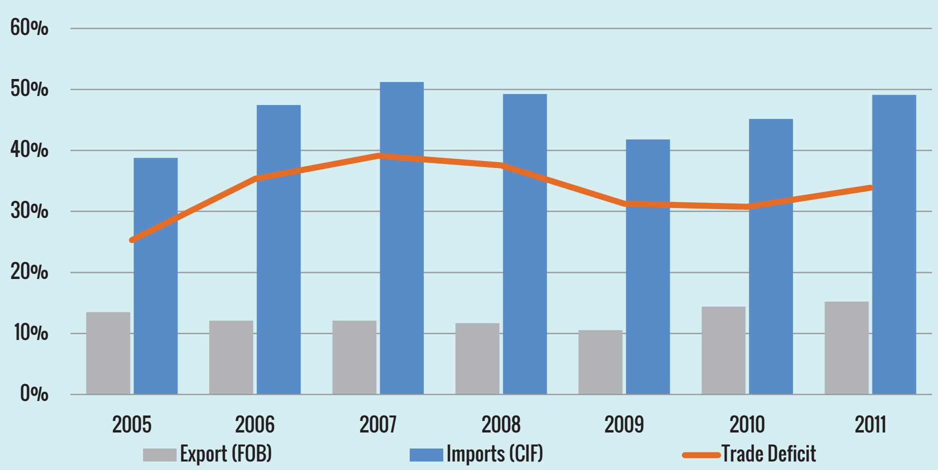
Source: NBG

Figure 1.8 Dollarization coefficient



Source: NBG

Figure 1.9 Export, import and trade deficit (% of GDP)



Source: NBG

global economy.[5] Since the spring of 2009, the NBG has officially adopted the inflation targeting approach, which in the long run will increase policy transparency and the accountability of the monetary authorities.

It should be no surprise that, despite the relatively benign recent monetary history, individuals in Georgia have resorted to using a foreign currency, the US dollar, for a substantial share of their financial transactions. Figure 1.8 tracks the evolution of this share for commercial bank deposits and loans. Dollarization rates may serve as an indicator of the general level of trust in the indigenous financial system. The financial crisis and the devaluation of the lari in 2008 have clearly dented the confidence of domestic agents. However, the modest downward trend since 2010 is indicative of both the growing resilience of the financial system and a commitment from the state not to abuse private investors and intermediaries alike.

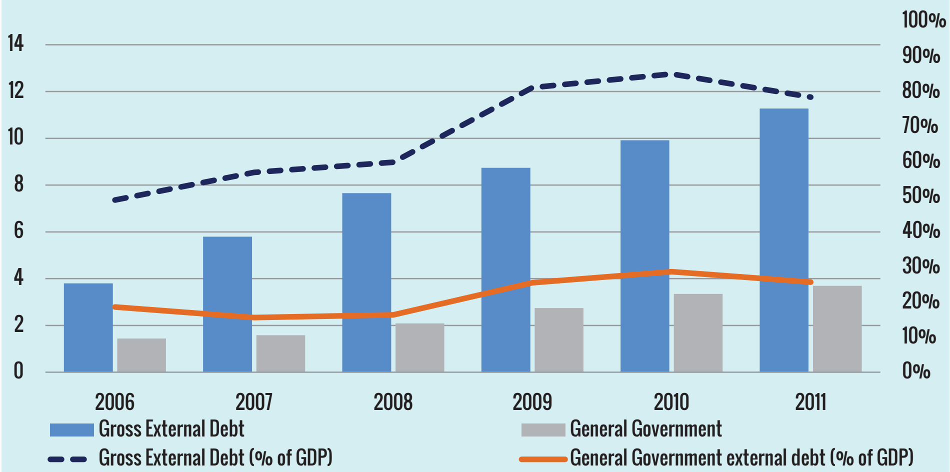
1.2.3 International trade, balance of payments, and external debt

Chapter 3 of this report is going to discuss Georgia's international trade and its potential to serve the regional hub function in detail. This section focuses on the macroeconomic implications of being a small, open, low-to-middle income economy.

Georgia is highly dependent on the rest of the world for both consumption and investment goods. The external trade turnover has been increasing over the past decade. Throughout this time Georgia has been running trade and current account deficits (see Figure 1.9), effectively borrowing[6] resources from the rest of the world to finance its ambitious investment projects.

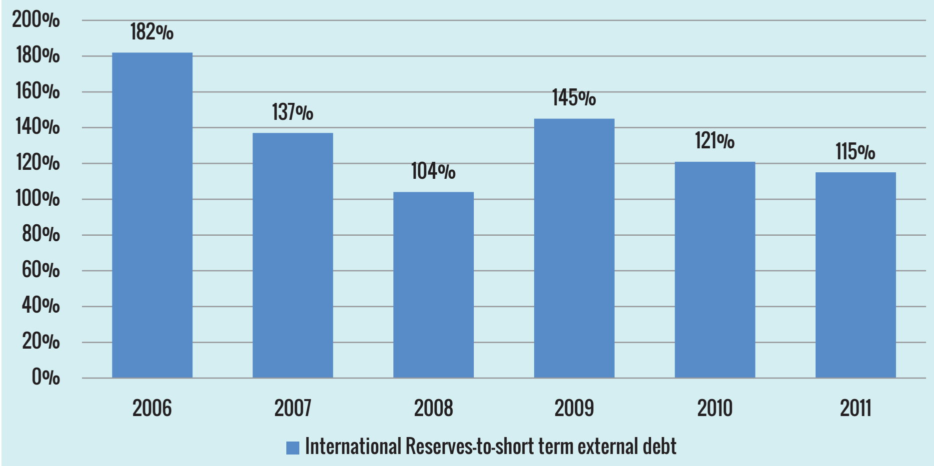
We should also note that the official reserves to short-term debt ratio, used by the IMF as a leading indicator of vulnerability to an external crisis, has stayed healthy throughout (see Figure 1.11). A careful look at the sources of financing the current account deficit may tell us more about the extent of potential vulnerabilities. Foreign purchases of domestic assets, including housing, had been a major capital account item prior to 2008. Following an abrupt drop in the aftermath of the crisis, the Georgian economy seems to have attracted financial investors with a longer horizon, who have been bringing money to the financial, transportation, energy and manufacturing sectors.

Figure 1.10 External debt (bln. USD)



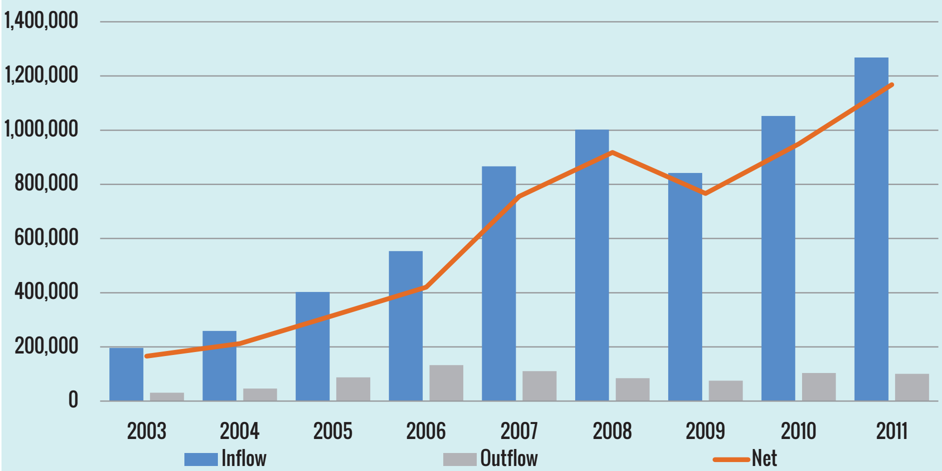
Source: NBG

Figure 1.11 Official reserves-to-short term debt (%)



Source: NBG

Figure 1.12 Remittances (mln. USD)



Source: NBG

[5] NBG, Annual Report 2011.

[6] The borrowing was made in part by private entities, banks, trading companies, and joint ventures, and in part by the state. For example, in April 2008, the government raised $500mln by issuing the first Georgian Eurobonds with 10-year maturity.

Box 1.1

Remittance inflows to Georgia - a stable source of financing trade deficits[1]

As any other labor-exporting country, Georgia faces both the costs and benefits of migration. The main costs include human capital flight – the so-called "brain drain" – and the distortion of the age and gender structure of the population. The benefits include alleviating social pressures caused by high unemployment rates, the international experience and skills returning migrants bring back to their home countries, and, very importantly, the remittances, or money transfers, that emigrants make to their families. For many households in Georgia these money transfers represent the only means of financing personal consumption expenditures, education and health care.

Remittance inflows to Georgia are as important for the whole economy as they are for the recipient households. Growing steadily since 2003, in 2011 remittances amounted to almost $1.3 billion, which is about 8.8% of Georgia's total GDP.[2]

[1] Melkadze, Givi, "Labor Migration and Remittances to Georgia".

[2] Source: Geostat.

An increasingly important source of financing Georgia's current account deficit is money transfers from abroad, mostly workers' remittances. In 2011, such money transfers accounted for 16.3 percent of imports, while exports and asset purchases accounted for 31 and 15.7 percent, respectively.[7] In addition, remittances, as opposed to volatile portfolio investment flows, are a much more stable source of foreign exchange (see Figure 1.12 and Box 1.1).

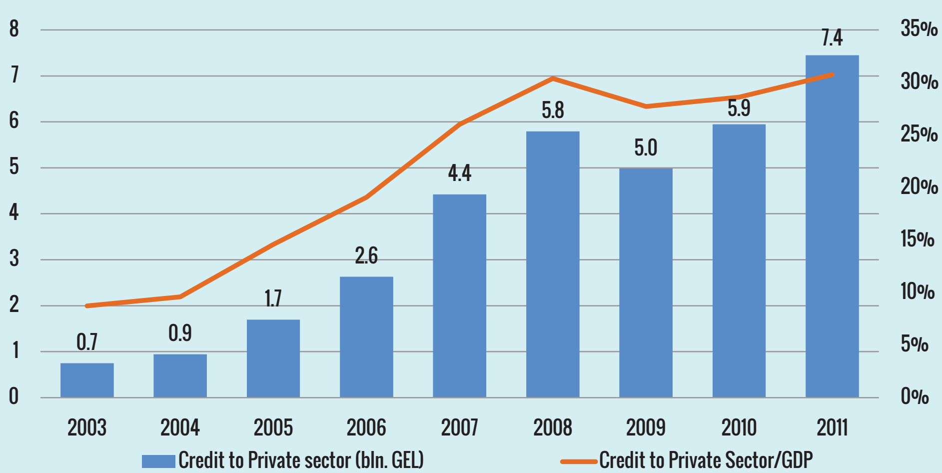
The growing reliance of the banking sector on international short term wholesale and retail funding may pose a risk to the stability of the sector and, by extension, to the whole economy. Emerging market countries like Georgia face the problem of the so-called "original sin" (as developed by Eichengreen and Hausmann (1999)) – the currency mismatch in domestic balance sheets.[8] This phenomenon may make a country vulnerable to external shocks such as, for instance, capital outflows due to margin calls elsewhere, or a sharp decline of external demand for exports, which usually leads to the depreciation of domestic currency. The banking industry would do well by opting for a more stable model of shareholder and longer term funding. At any rate, resisting temptations to leverage out on foreign loans or to participate in dubious lending campaigns should well serve the stability of the banking sector.

1.3 Financial sector

The Georgian banking sector has developed at a fast pace. One indicator of the degree of financial penetration, the ratio of banks' assets to GDP, has grown from 16% in 2003 to 50% in 2011 (see Figure 1.13). Yet, while not too out of place among the peer economies of Eastern Europe (Figure 1.14), this is still low[9] by international standards.

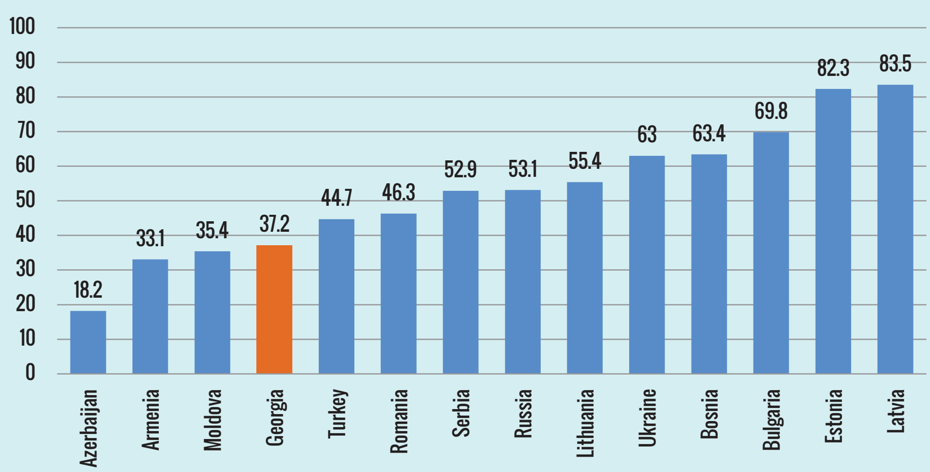
[9] The Georgian banking system is well capitalized and its inability to expand its balance sheet is probably related to the dearth of bankable investment projects. The capital adequacy ratio stood at 17% in 2011 according to the NBG methodology and at 26% according to Basel I.

Figure 1.13 Credit to private sector



Source: NBG

Figure 1.14 Loans/GDP (%), 2011



Source: WDI

[7] Source: Geostat.

[8] The exact incidence of the mismatch is not important: if Georgian banks borrowed in dollars and lent in lari, they would have been hostage to the market risk of lari depreciation; currently the banks lend in dollars, and are vulnerable to the credit risk of the same magnitude.

The same observation applies to the ratio of bank deposits to GDP (see Figure 1.15). Clearly, there is quite a long way to go until all of Georgia's citizens have access to efficient financial intermediation.

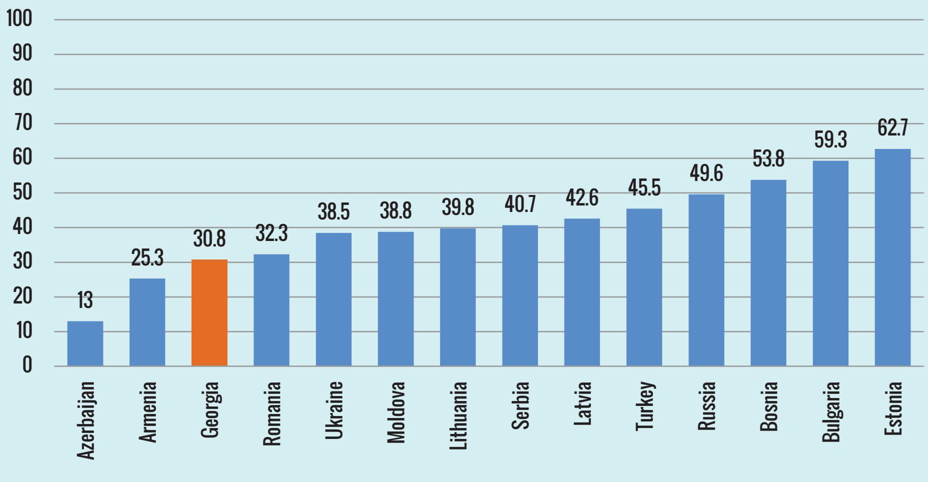
But the crucial metric that lays bare the main issue of concern for the country's entrepreneurs and self-employed is the lending rate (see Figure 1.16). Lending rates in Georgia are among the highest in the world. They are one of the main impediments to private investment. Babych and Fuenfzig (2012) discuss several potential explanations for this. Although domestic savings in Georgia are very low (one of the lowest in the region and among comparable countries in Europe) their scarcity cannot be the source of high lending rates, because, as noted in section 1.2.3, Georgian commercial banks are able to borrow from international lenders. The idea that interest rate spreads[10] are high because of low competition in the Georgian banking sector also has to be ruled out. There are quite a few banks competing for customers in Georgia, and the rivalry among them is reportedly fierce.[11] Babych and Fuenfzig (2012) find the large risk premia to be the reason behind the wide net interest margins (see Figure 1.17). The major risks that lenders face are credit events due to political and institutional instability, as well as impairments resulting from weakly enforced property rights (perhaps in part due to the lack of judiciary independence).

It is telling that the widening of the spreads started in 2007, coinciding with the first political protests that challenged the myth of the United National Movement (UNM) regime's popularity. Financial sector actors are highly attuned to the ground vibrations that an impending disaster generates. They will not be prepared to reduce the steep risk premia before they get credible assurances that there will be no major upheavals or policy reversals that may affect their assets. Political risk-related weakening of property rights translates into high credit risks and high lending rates, on the one hand, and a low share of credit in GDP and depressed private investment, on the other.

1.4 Political risks and weak property rights

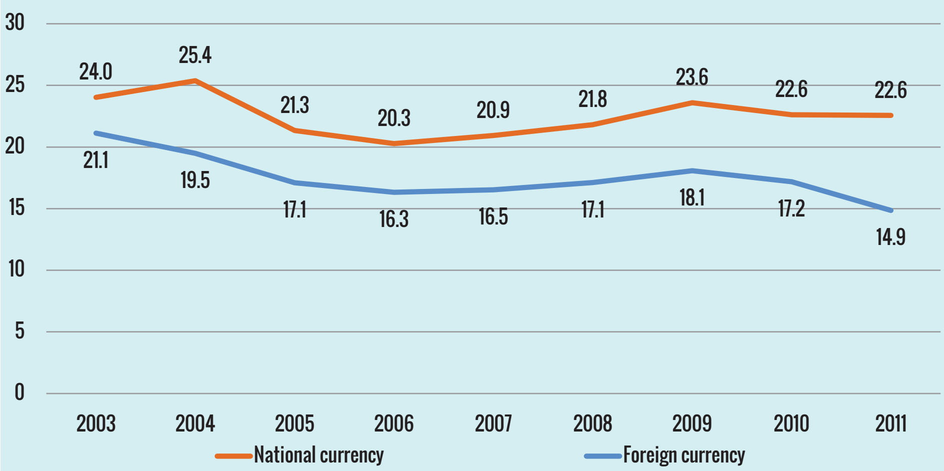
As emphasized in the previous section, one of the main constraints to the expansion

Figure 1.15 Deposits/GDP (%), 2011



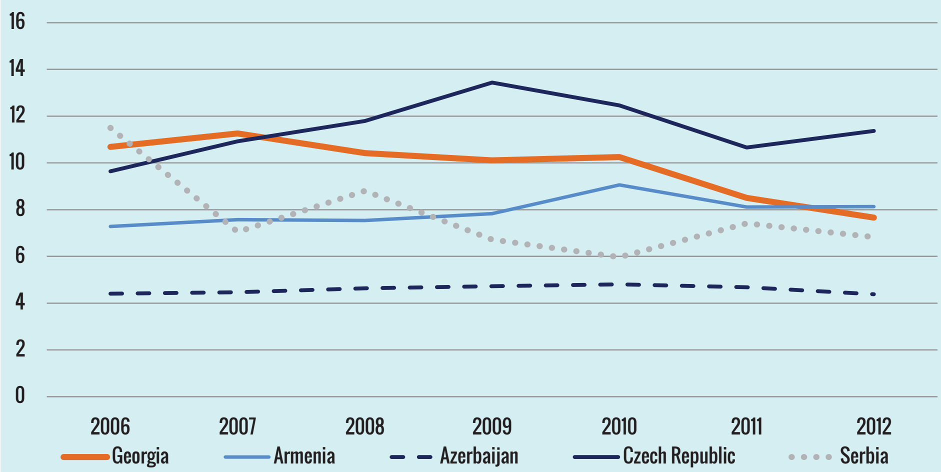
Source: WDI

Figure 1.16 Annual weighted interest rates on loans



Source: NBG

Figure 1.17 Interest rate spread



Source: IFS

[10] The spread is the difference between the deposit and the lending rate that a retail customer faces. The higher the spread, the bigger the profit margin a bank makes.

[11] Interview with Giorgi Glonti: Georgian News, "Fitch finds Georgian banking sector over-banked"

of private credit in Georgia is the political and social uncertainty resulting from poverty and inequality. Poverty rates in Georgia remain quite high. The share of the population with incomes below the subsistence minimum has been fluctuating around 9% over the last three years (Figure 1.18).[12] Likewise, income inequality has not diminished. On the contrary, the national Gini coefficient remained above 0.40 since 2006, with a big increase (from 0.41 to 0.43) occurring in 2009, the main crisis year (see Figure 1.19).

Our analysis of the situation in Georgia is consistent with the evidence marshaled by several prominent economists concerning the impact of inequality on investment and rates of economic growth (see: Persson and Tabellini 1994; Alesina and Perotti 1996). They argue that the inequality level in a country is related to the likelihood of social turmoil. The increased political and economic uncertainty negatively affects investment, and, hence, economic growth. Indeed, there is a growing perception among international donors, investors, and NGOs that Georgia has come close to tripping the wire. The social discontent in Georgia, fueled by high unemployment rates and income inequality, poses a major risk to political stability. This sends the required rate of return on investment through the roof and thereby prevents most otherwise cost-effective commercial ventures from being undertaken.

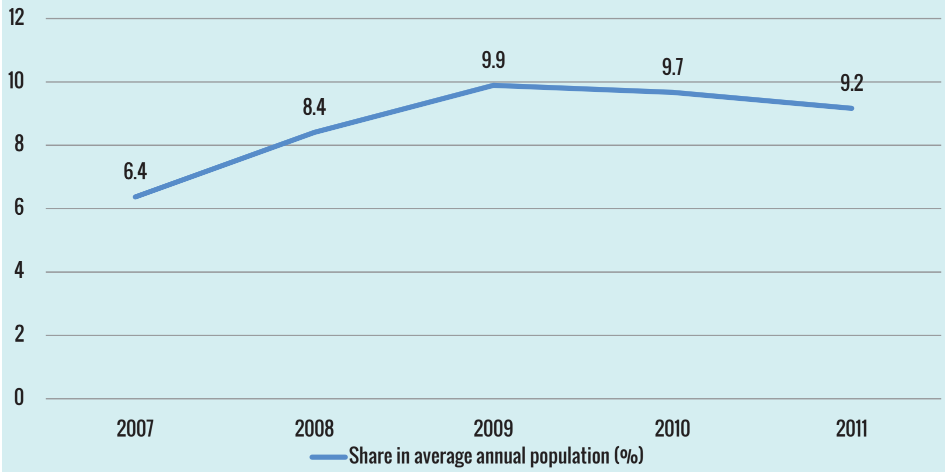
1.5 The role of democratic checks and balances[13]

Few elections in recent years were watched as carefully around the world as the Georgian parliamentary elections and few political and economic observers shunned the opportunity to interpret its stunning outcome. The majority view, or so it seems, is that Georgia passed the "litmus test for democratic governance" (Ariel Cohen of the Heritage Foundation). A few others, however, consider the victory of Bidzina Ivanishvili's coalition as the end of the "Georgian experiment" which, according

[12] A recent discussion paper by UNICEF on poverty in Georgia discusses two different poverty thresholds: a relative poverty threshold, which is 60% of median consumption, equaling to 109.2 GEL in 2011 per month Per Adult Equivalent, and an extreme poverty threshold - 71.7 GEL per month PAE. According to this study, the extreme poverty rate stood at 9.1% in 2011 (close to that reported by Geostat), while the percentage of households living below the relative poverty threshold constituted 24%.

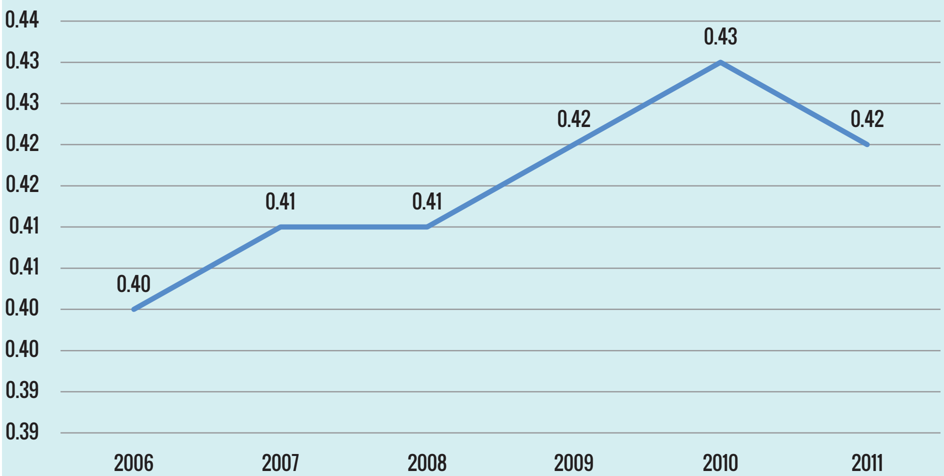
[13] This section is based on Livny, Eric, "Democracy and Economic Growth".

Figure 1.18 Population under poverty threshold (%)



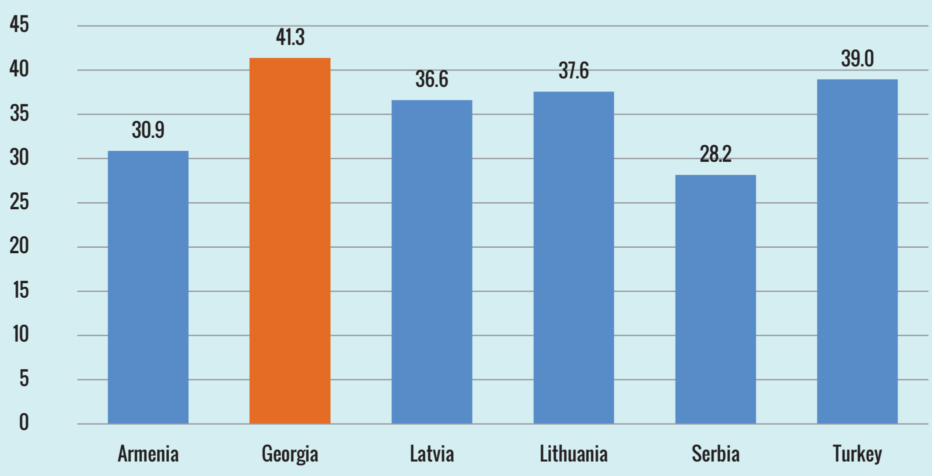
Source: Geostat

Figure 1.19 Gini index by total consumption expenditure



Source: Geostat

Figure 1.20 Benchmarking Gini index. 2008



Source: WDI

to them, was about combining radical economic reforms and universal suffrage.

The interest in Georgia and the "Georgian experiment" is not incidental. For the last 8-9 years, Georgia has been embracing a strategy of economic reforms that set it apart from all other splinters of the Soviet empire as well as most developing countries around the world. Georgia tried to grow from a very low starting point by ruthlessly eradicating cronyism and corruption while simultaneously building a democracy and liberalizing its economy. This strategy seemed to work.

Georgia's success was carefully watched and scrutinized because, over the past several decades, development and fast economic growth have become firmly associated with political authoritarianism, Chinese style. On the surface, Georgia seemed to break from the mold by achieving growth in a system based on both political and economic freedoms.

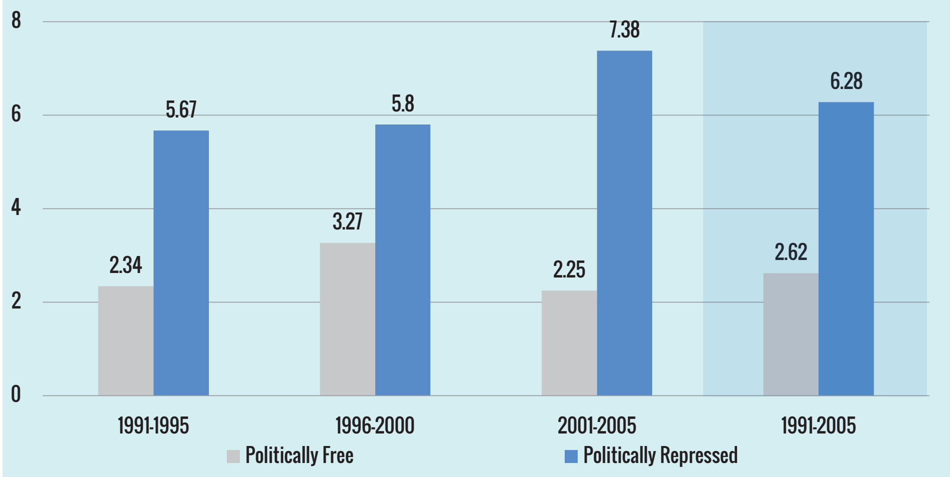
To fully appreciate Georgia's uniqueness it is worth considering this: between 1991-2005 (the first year of Saakashvili's administration) economically free countries that repressed political freedoms (e.g. China, Malaysia, Singapore and Russia) grew almost three times faster than high income Western democracies.

While Georgia's success at modernization and fast economic growth (averaging more than 6% over the past 10 years) is undeniable, it may paradoxically owe to the fact that the country was not a democracy in at least one key aspect. It seems to have lacked a system of checks and balances that limits the power of the executive branch of government and forces compromise as the main way of political and economic decision-making.

To quickly assess democratic transition in the post-Soviet states, one can employ an index similar to the Herfindahl index used by economists to study market competition. Our Political Monopolization Index (PMI) is constructed using shares of seats held by political parties in the national parliaments. If there are a lot of parties represented, the PMI is close to zero, while if a single dominant party takes most of the seats, the PMI approaches the value of 1. We selected a handful of Eastern European and former-USSR countries for comparison.

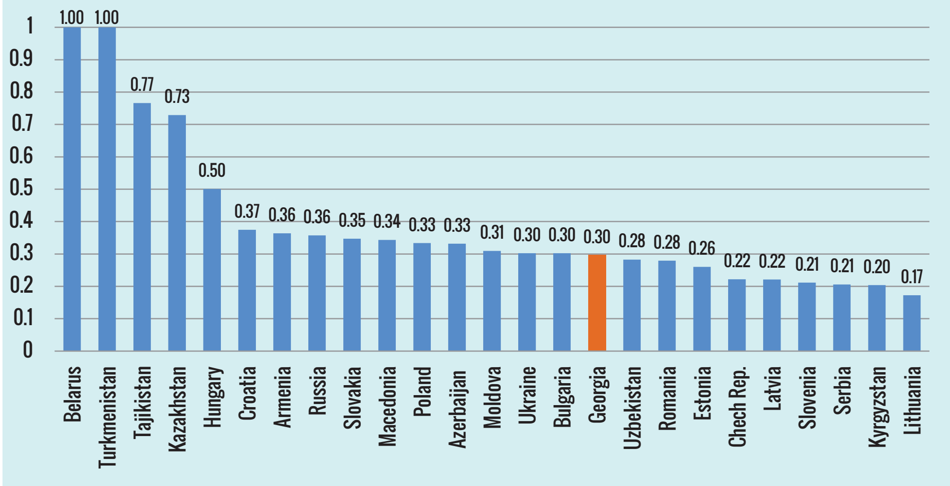
A note of caution: our index does not cover all aspects of democratic transition. In particular, it is overly flattering to such "democracies" as Uzbekistan and Russia, where a semblance of political competition

Figure 1.21 economic growth in economically free countries with and without political freedom



Source: Does Economic Success Require Democracy? By Kevin Hassett

Figure 1.22 Political Monopolization Index



Source: Own calculations

is carefully maintained by the ruling elites through the creation of zombie parties (e.g. Spravedlivaya Rossiya and the Liberal Democratic Party in Russia).

Likewise, the index ignores both the quality of Georgia's formal democratic institutions and the ability of its civil society to mobilize and generate democratic change. Yet, Georgia's 2011 position on this ranking, between Tajikistan and Belarus, is quite telling with regard to the unrestricted ability of the executive to implement reforms and get things done.

1.6 Taking stock

The development experience of Georgia since the Rose Revolution has been a mixed bag. While impressive overall, Georgia's growth was anything but inclusive. It did not create enough jobs and left more than 50% of the working age population in low-productivity subsistence farming or unemployment. Many former industrial workers saw their human capital depreciate over the previous decade and left the labor force. The incidence of unemployment is particularly high among youth, many of whom have spent five or more years acquiring a university degree but lack the professional skills demanded by the market.

Without any doubt, the last 10 years have proved quite encouraging: starting from a pathetic level in 2003, per capita income has almost quadrupled. The lion's share of this growth can be attributed to the Saakashvili regime's ability to clean up the Augean stables of corruption and incompetence. Yet, by failing to lift people out poverty and increasing inter-generational, inter-regional and inter-occupational income gaps this growth translated into an acute sense of disillusionment with the liberal economic reforms, creating a risk of political destabilization and a reform reversal.

During this period, the government pursued rather prudent monetary and fiscal policies (with the help of international donors). For instance, very significant investment in infrastructure was executed in a manner that did not jeopardize price stability or debt sustainability. However, these policies failed to bring down interest rates (and interest rate spreads). These remain quite high, limiting credit expansion and financial sector development. The share of private investment in total investment and the ratio of total investment to GDP remains low compared to benchmark countries.

Given the lack of domestic savings, Georgia's ability to increase its capital stock remains dependent on foreign investment. FDI has decelerated considerably after 2008, in the wake of the global financial crisis and the August 2008 war with Russia. Georgia was able to compensate for the lack of foreign investment by borrowing abroad at deeply concessionary rates, technical assistance, foreign aid and remittances. The resulting capital account surplus helped finance investment in public infrastructure and current consumption (imports of goods and services). However, while helping in the short run, these capital inflows are no substitute for foreign direct investment in manufacturing, energy, tourism or agribusiness sectors that could boost the country's export potential.

The parliamentary elections, held on October 1, 2012 could signify a step forward for democracy building. It was the first time in Georgia's modern history that power was passed from one party to another without revolution, peaceful or otherwise. As long as the new government pursues prudent policies, the smooth democratic transition is likely to diffuse political risks and spark investor optimism, giving Georgia a good chance to improve the country's competitiveness and bring growth rates back to their pre-2008 level.

2. GEORGIA'S COMPETITIVENESS PERFORMANCE

In today's increasingly globalized world, achieving international competitiveness has become an important policy target for any country. While engaging in mutually beneficial trade, technological and cultural exchanges, countries compete with each other for scarce mobile resources – financial capital and labor. The locations that offer access to markets and the best conditions for economic activity – a disciplined and skilled labor force; high quality services and urban amenities; transparent and efficient public administration; low taxes; safety and security; developed infrastructure; access to suppliers of raw materials and intermediate goods—are magnets for investment and people. Consequently, they are able to grow and reach prosperity, the ultimate goal of economic policy.

What is national competitiveness? The notion of competitiveness, as used by the World Economic Forum and the authors of this report, is not about trade competitiveness. Thus, it is not to be measured by, say, the Georgian ability to sell second-hand vehicles to Azerbaijan or by the size of Georgia's trade deficit vs. Turkey. The notion of competitiveness in this narrow sense is often invoked by politicians and others who try to appeal to nationalistic instinct. Paul Krugman (1994) provides an excellent account of how misplaced concerns for trade competitiveness can lead to awful lose-lose policy prescriptions resulting in trade wars, currency manipulation and wasteful "strategic" industrial policies. Moreover, as argued by Krugman, an apparent lack of trade competitiveness could imply a strength. For example, Georgia's large and growing trade deficit could be interpreted as a signal of competitiveness, not lack thereof: Georgia is able to enjoy the benefits of running a large trade deficit precisely because it is perceived as a promising country, attracting foreign credit and direct investment. These credits and investments allow Georgia to modernize large parts of its infrastructure and upgrade production capabilities, carrying a promise of higher labor and capital productivity in the future.

Another important point is that competitiveness is not necessarily about a zero-sum game among nations. There are positive spillovers from faster growing competitive nations to neighboring countries (e.g. Moreno, Trehan (1997) and Conley, Ligon (2002)). In the short run, growing regions may siphon off mobile production factors from their immediate environment, but the longer term impact could well be positive. For example, Georgia is already benefiting from investments originating in the oil-rich and more "competitive" Azerbaijan. It also enjoys the opportunity to trade with Azerbaijan and serve its trade and transportation flows, pipelines included. Moreover, the lion's share of resources attracted by Azerbaijan is obtained in third countries, not at Georgia's expense. The general point is that by increasing their competitiveness and growing faster, nations could boost economic development in their regional environment – through trade, remittances, outsourcing, cultural and technological spillovers, and the purchase of transportation and tourism services.

The concept of competitiveness, as used throughout this report finds its theoretical and empirical foundations in Delgado, Ketels, Porter and Stern (2012) - The Determinants of National Competitiveness. As put there, it is mainly about a country's ability to offer access to markets and a business-friendly environment. Understandably, this ability depends on inherited conditions: cultural norms such as punctuality (not Georgia's main strength), decency and hospitality; the quality of local labor and firms; geographic location; natural resource endowment, etc.

Additionally, a key role in promoting competitiveness is played by the quality of national institutions: the strength of democracy, rule of law and an independent judiciary; the ability to ensure equal opportunities for women, ethnic and religious minorities; and access to healthcare and education for all. These institutions can be reformed through the political process, as Georgia has proven, and hence they have prominence in the competitiveness debate.

Finally, government policies per se are crucially important in ensuring security and macroeconomic stability; affecting incentives for investment in human and physical capital; and facilitating trade, travel and communication links with the rest of the world.

How is national competitiveness to be measured? The internet is abound with indices that purport to measure various aspects of competitiveness: ease of doing business, economic freedom, human development, democracy, political stability and violence, travel and tourism competitiveness, to mention just a few. While we briefly review Georgia's performance in the entire range of available competitiveness indices, our main focus in this report is on the Global Competitiveness Index (GCI) produced by the World Economic Forum (WEF). This is one of the better known and more comprehensive international rankings, covering more than 140 countries. First, we review the GCI methodology and provide a snapshot of Georgia's progress over time and relative to benchmark countries (and regions) since it first appeared in WEF's Global Competitiveness Report in 2005. Second, we relate Georgia's progress (or lack thereof) on each aspect of competitiveness to relevant policy reforms and discuss the future reform agenda.

2.1 Georgia's position in key competitiveness indices

Georgia is included in a large number of international indices and rankings, all of which use different data and methodologies. Figure 2.1 illustrates Georgia's most recent position in some of these rankings (see Appendix 1 for a full description of each index). The country is doing particularly well in the ease of doing business, strength of government institutions, social and economic rights fulfillment, attractiveness for global brands, economic freedom and perception of (petty) corruption. Among Georgia's weaknesses are its geopolitical situation, political stability/violence, and press freedom.

Incorporating the entire wealth of global indices could theoretically add robustness to our analysis of Georgia's competitiveness. However, any attempt at combining or aggregating information from different sources would be handicapped by issues of data and methodological incompatibility. Along with more or less objective statistical data, the various rankings use hundreds of survey-based subjective indicators. Hence, indicators evaluating the same parameter or groups of parameters are likely to be inconsistent across different rankings. Inconsistency may even be an issue with indices based on official statistics (e.g. concerning macroeconomic performance), if different sub-indicators are assigned different weights.

Instead of trying to aggregate information coming from sources as diverse as, say, the World Bank's Doing Business Survey and the Global Peace Index, Figure 2.2 shows Georgia's position in all the available rankings relative to selected reference countries, including the neighboring nations (Armenia, Azerbaijan, Turkey and Ukraine), and the Czech Republic – an aspirational target.

2.2 Georgia in the Global Competitiveness Report (GCR)

Georgia has been included in the Global Competitiveness Index (GCI) since 2005, shortly after the Rose Revolution. With the exception of a minor setback during the crisis year of 2009, Georgia has been improving its ranking ever since it first appeared in the GCR in 2005. The 2012/13 GCR places Georgia in the 77th spot of the ranking, a significant improvement over the previous year (88th). Georgia is currently ranked above the average for CIS countries,

Figure 2.1 Georgia in different rankings

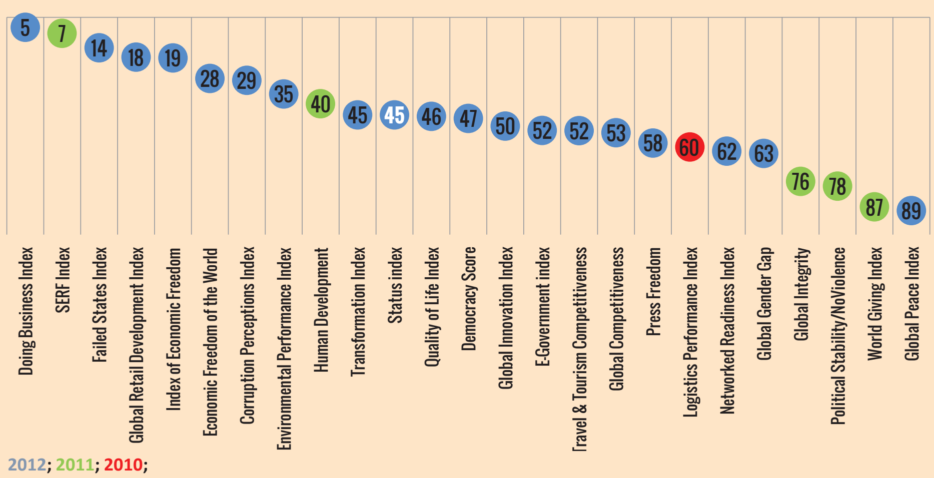
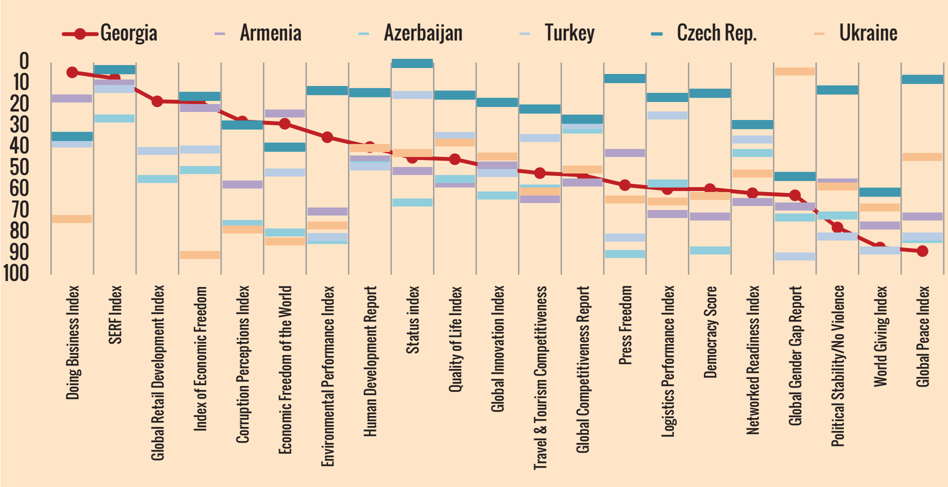


Figure 2.2 Georgia and reference countries in latest available rankings



Source: Full list of rankings are included in appendix 1 and very close to the much larger Ukraine (73rd). Moreover, based on 2011 income per capita data, Georgia has been promoted to the club of "Efficiency Driven Economies".

Overall, considering the 2005-2012 period, Georgia has become one of the best improvers in the GCI.

In what follows, we review the GCI methodology and analyze Georgia's performance over time and in 2011 (the year on which the 2012/13 GCR is based).

2.2.1 The Global Competitiveness Report: an overview

According to WEF, the GCI "...assesses the ability of countries to provide high levels of prosperity to their citizens. This in turn depends on how productively a country uses available resources. Therefore, the GCI measures the set of institutions, policies, and factors that set the current and medium-term levels of economic prosperity."[14]

The GCI is made up of over 110 variables/ competitiveness indicators coming partly (two-thirds) from the Executive Opinion Survey and partly (one-third) from publicly available sources (such as the United Nations). These 110 indicators are grouped into twelve pillars, which, in turn, are combined into three sub-indices:

- Basic Requirements;
- Efficiency Enhancers;
- Innovation and Sophistication Factors.

The latest GCR (2012/2013) covers 148 major and emerging economies divided into five categories (see Tables 2.1, 2.2 and Appendix 2), depending on their stage of economic development.[15]

The categories are important insofar the weight of each sub-index and each competitiveness pillar in the GCI is different for each country category (see Table 2.3). In particular, the weight of **Basic Requirements** is higher for the poorer countries, whereas the I**nnovation and Sophistication Factors** are more important for the more advanced nations.

Table 2.1 Categories in GCI

1. FACTOR-DRIVEN ECONOMIES: per-capita GDP less than USD 2,000

Countries compete based on their factor endowments, primarily unskilled labor and natural resources. Companies compete on the basis of prices and sell basic products or commodities, with their low productivity reflected in low wages. Competitiveness on this stage hinges mainly on well-functioning public and private institutions, appropriate infrastructure, a stable macroeconomic framework, and good health and primary education (pillars 1-4).

Transition Stage 1-2: per-capita GDP between USD 2,000-3,000

2. EFFICIENCY DRIVEN ECONOMIES- per-capita GDP between USD 3,000-9,000

With wages rising due to advancing development, the countries must begin to develop more efficient production processes and increase product quality. At this point, factors like higher education and training, efficient goods markets, efficient labor markets, developed financial markets, the ability to harness the benefits of existing technologies and its market size, both domestic and international (pillars 5-10) become more important.

Transition Stage 2-3: per-capita GDP between USD 9,000-17,000

3. INNOVATION-DRIVEN ECONOMIES- per-capita GDP more than USD 17,000

At this stage, the countries are only able to sustain higher wages and a higher standard of living if their businesses are able to compete by providing new or unique products. At this stage, companies must compete by using the most sophisticated production processes and innovation (pillars 11-12).

Table 2.2 Economies by category

Factor-driven Per-capita GDP less than USD 2,000	Transition Stage Per-capita GDP between USD 2,000-3,000	Efficiency-driven Per-capita GDP between USD 3,000-9,000	Transition Stage Per-capita GDP between USD 9,000-17,000	Innovation-driven Per-capita GDP more than USD 17,000
Côte d'Ivoire	Algeria	Albania	Argentina	Australia
Ethiopia	Azerbaijan	Armenia	Bahrain	Austria
Gambia, The	Bolivia	BiH	Brazil	Belgium
Ghana	Botswana	Bulgaria	Chile	Canada
Guinea	Brunei Darussalam	Cape Verde	Croatia	Cyprus
Haiti	Egypt	China	Estonia	Czech Rep
India	Gabon	Colombia	Hungary	Denmark
Kenya	Honduras	Costa Rica	Kazakhstan	Germany
Kyrgyz Rep	Iran, Islamic Rep	Georgia	Latvia	Greece
Lesotho	Kuwait	Indonesia	Lithuania	New Zealand
Liberia	Libya	Romania	Mexico	Norway
Madagascar	Mongolia	Serbia	Poland	Portugal
Moldova	Philippines	South Africa	Russian Federation	Puerto Rico
Tajikistan	Qatar	Ukraine	Turkey	Slovak Rep

Source: WEF, GCI

[14] "Global Competitiveness Network: Frequently Asked Questions". Retrieved 2009-04-17

[15] Countries are grouped based on two main criteria. The basic criterion is the level of GDP per capita at market exchange rate. However, an adjustment is made for countries that are wealthy, but where prosperity is based on the extraction of resources (measured by the share of exports of mineral goods in total exports of goods and services). This adjustment is based on the assumption that countries exporting more than 70 percent of mineral products (measured using a five-year average) are factor-driven. Azerbaijan, to take one obvious example, has been affected by this adjustment.

2.2.2 Georgia's progress in the GCR: 2005-2012

With the exception of the crisis year of 2009, Georgia has been improving its score every year since it first appeared in the GCR in 2005. Georgia's ranking, however, was not particularly sensitive to this progress until the last couple of years (Figure 2.3). This should not come as a surprise: to advance in the GCI rankings, countries have to improve faster than others.

Having exceeded the $3,000 threshold in per capita income ($3,210 in 2011), Georgia has been upgraded from Transition Stage 1-2 to the Efficiency Driven Economy category in the 2012/13 GCR. An immediate implication of this upgrade was an increase in the weight of pillars comprising the **Efficiency Enhancers** sub-index (Higher education and training, Goods market efficiency, Labor market efficiency, Financial market development, Technological readiness, and Market size).

Since competitiveness is both an absolute and relative notion, Figure 2.4 (A-F) presents data on the 2005-2012 changes in Georgia's overall GCI score and rank relative to other nations and "clubs" of nations, including Georgia's immediate neighbors, CIS[16], non-oil CIS countries, the three Baltic nations and Eastern Europe.

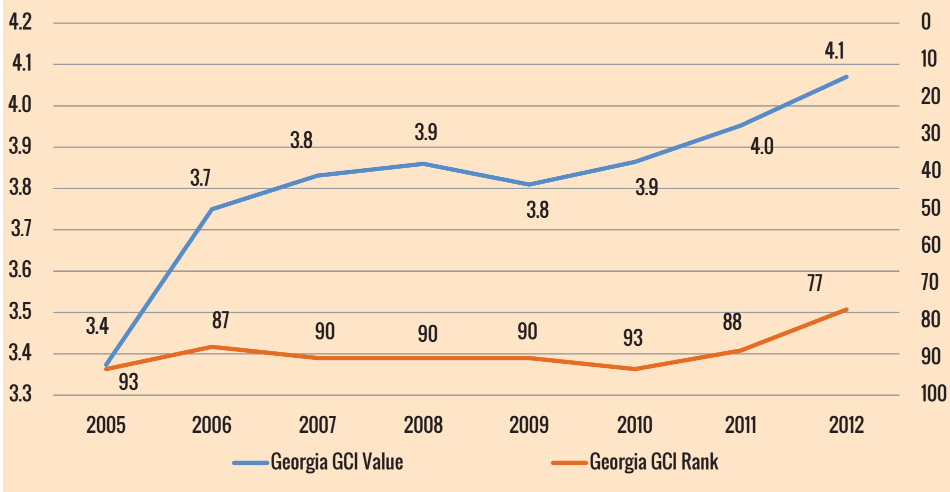
Georgia's recent progress in the ranking is closely related to its relative resilience to the global financial crisis. Partially as a result of the massive international assistance effort in the aftermath of the August 2008 war with Russia, Georgia was one of the first nations to emerge from the 2009 recession. Being well behind all its neighbors in 2005, Georgia is currently ahead of Armenia and quite close to Ukraine and Russia. Unlike Georgia, Armenia and Ukraine took much longer to recover. While Armenia was severely hit by a reduction in the inflow of remittances, Ukraine's economy was affected by a protracted political crisis and the post-2008 slump in the global market for many of its export commodities such as ferrous metals and steel products. Russia's stagnation and decline in the ranking is mostly related to a reduction in oil prices, as well as growing concerns about the quality of bureaucracy, corruption and property rights protection.

Table 2.3 Sub-indices and pillars in GCI: Their weight for different categories

		1 Factor-driven	Transition Stage 1-2	2 Efficiency-Driven	Transition Stage 2-3	3 Innovation-Driven	
BASIC REQUIREMENTS		60%	40-60%	40%	20-40%	20%	Key for FACTOR-DRIVEN economies
1	Institutions	25%	25%	25%	25%	25%	
2	Infrastructure	25%	25%	25%	25%	25%	
3	Macroeconomic environment	25%	25%	25%	25%	25%	
4	Health and primary education	25%	25%	25%	25%	25%	
EFFICIENCY ENHANCERS		35%	35-50%	50%	50%	50%	Key for EFFICIENCY-DRIVEN economies
5	Higher education and training	17%	17%	17%	17%	17%	
6	Goods market efficiency	17%	17%	17%	17%	17%	
7	Labor market efficiency	17%	17%	17%	17%	17%	
8	Financial market development	17%	17%	17%	17%	17%	
9	Technological readiness	17%	17%	17%	17%	17%	
10	Market size	17%	17%	17%	17%	17%	
INNOVATION AND SOPHISTICATION FACTORS		5%	5-10%	10%	10-30%	30%	Key for INNOVATION-DRIVEN economies
11	Business sophistication	50%	50%	50%	50%	50%	
12	Innovation	50%	50%	50%	50%	50%	

Source: Full list of ranking are included in appendix 2.1

Figure 2.3 Georgia's dynamics in the GCI



Source: WEF, GCI

Although impressive, Georgia's relative progress pales in comparison with the very strong competitive performance of Azerbaijan and, particularly, Turkey. Starting out far behind Russia and Ukraine, Turkey is currently ranked 43rd in GCI, a little below Estonia (34th), the Czech Republic (39th) and Poland (41st). Azerbaijan (46th) was able to leverage its oil and gas resources in order to catch up with the leading East European nations.

Compared to the regional averages[17], Georgia is now slightly ahead of the CIS average and on a trend of catching up

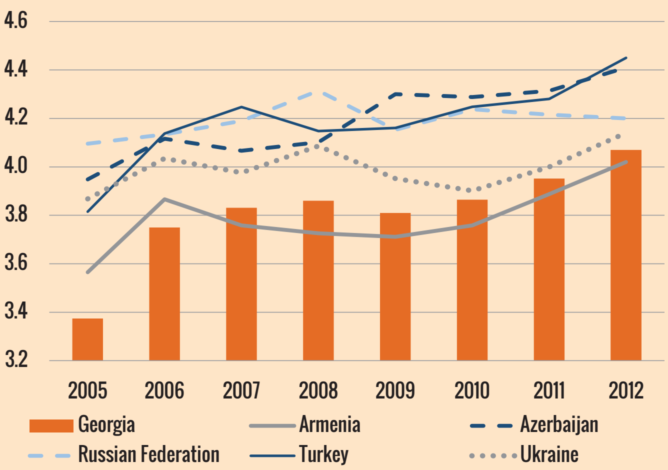
[16] The CIS group excludes the Baltic countries given that they are now part of the EU. Belarus, Uzbekistan and Turkmenistan are excluded for lack of data. Moldova has appeared in the GCI only since 2010. On the other hand, we included Mongolia, since this country is often considered in the same category as the CIS countries from Central Asia.

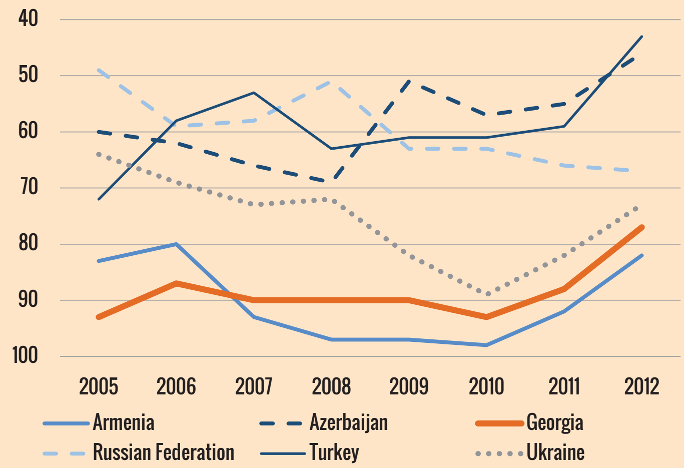
[17] These figures also include the Czech Republic, which is an interesting case policy-wise. On the one hand, the Czech Republic was better able to cope with the 2008/9 crisis compared to other successful reformers in the Baltic region. It is also quite interesting to compare the Czech Republic to Slovakia: back in 2005 these two nations were separated by only 10 places in the GCI ranking. By 2012/13, Slovakia fell behind by a staggering 32 places.

Figure 2.4 (A-F) Georgia's overall competitiveness performance vs. peer nations and regional clubs

2.4 (A, B).GEORGIA VS. ITS NEIGHBORS:

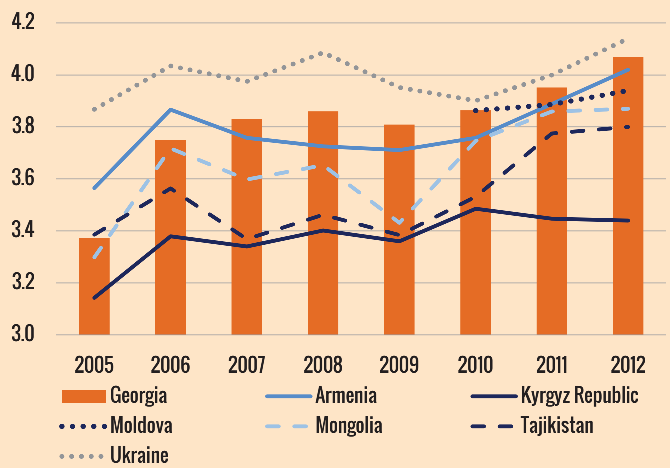
In the three years since the global financial crisis, Georgia overtook Armenia and closed the gap with Ukraine and Russia. Turkey and Azerbaijan remain far ahead

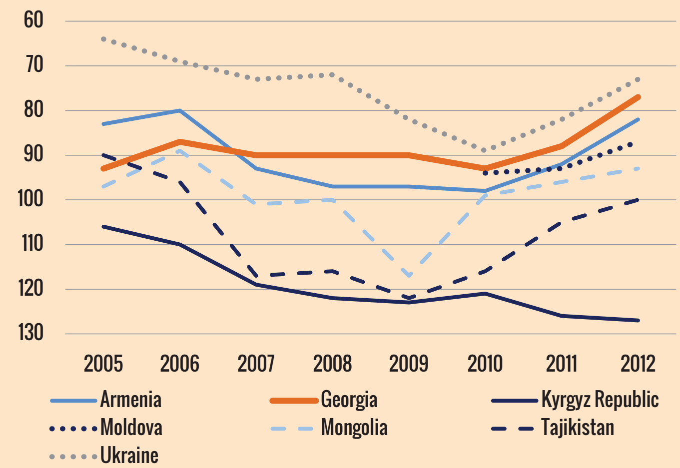




2.4. (C-D): GEORGIA VS. NON-OIL CIS COUNTRIES.

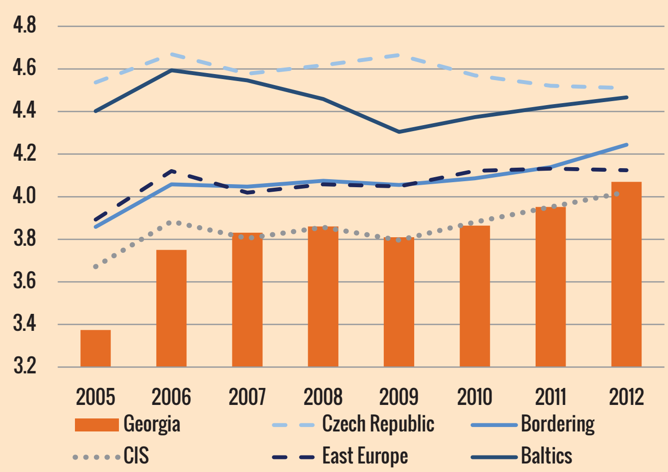
"The last shall be first". Georgia has made a lot of progress since 2005 and is currently one of the most competitive nations among non-oil CIS countries.

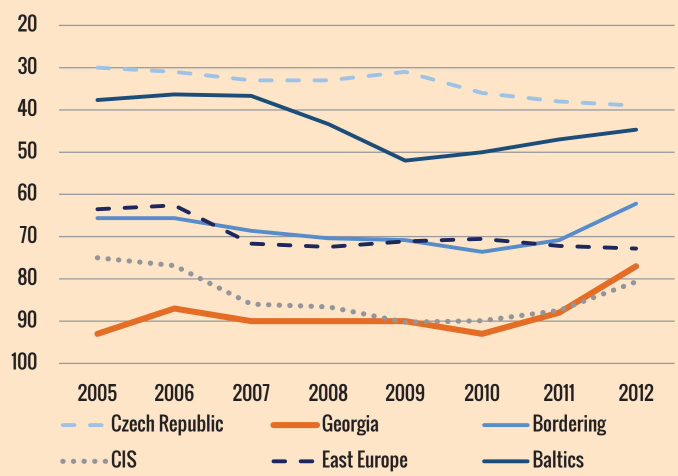




2.4 (E-F). GEORGIA VS. REGIONAL CLUBS.

Exceeding the CIS average and closing the gap with Eastern Europe, Georgia remains far behind the leading European reformers such as the Baltic countries and the Czech Republic.





with its immediate neighbors and Eastern Europe. The latter region suffered a setback in the wake of the 2008 global financial crisis and is still affected by the sovereign debt crisis plaguing the Eurozone (which peaked in late 2011 and early 2012). As a result, Georgia has been able to catch up with and outperform some of the Balkan nations (Bosnia and Herzegovina, Croatia, Macedonia, and, most recently, Romania (see Figures 2.5.A and 2.5.B).

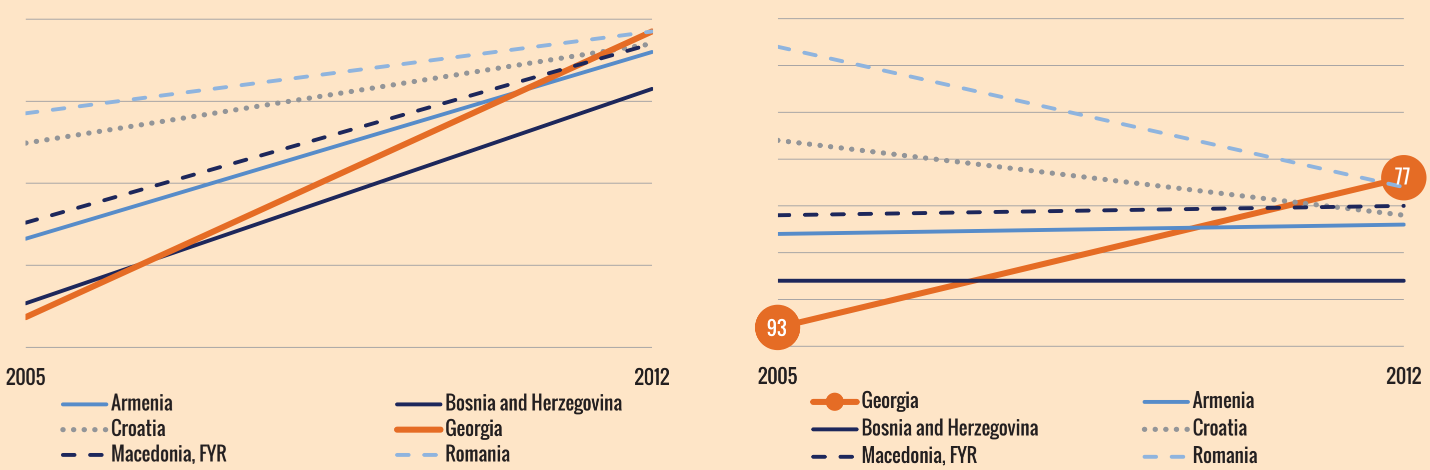
Looking at other transition economies included in the GCR, Georgia tops the list as far as improvement in GCI value is concerned, and is second (behind Turkey) in GCI rank improvement (See Figures 2.6 A,B for more detail). Georgia's performance in the 2005-2012 period is in fact impressive on a global scale: considering all nations included in the GCR, Georgia was the 3rd best improver in GCI value (0.7 points), and the 6th best improver in ranking, gaining 16 places.

While impressive, Georgia's progress was very uneven across the different areas ("pillars") of competitiveness. Figure 2.7 illustrates how Georgia's scores in the three dimensions of competitiveness changed over time. In general, Georgia's has been scoring relatively well in the **Basic Requirements** sub-index (BR), including such pillars as infrastructure, health and primary education, institutions, and the macroeconomic environment. The value of this sub-index has exceeded the scores received by other two sub-indices (Efficiency Enhancers and Innovation and Sophistication Factors), pulling the overall GCI score up (which is calculated as a weighted average of the three sub-indices).

It is also eminently clear that almost the entire improvement in Georgia's 2012 ranking can be attributed to progress in the Basic Requirements sub-index. The **Innovation and Sophistication Factors** (ISF) sub-index has remained flat at a very low level of competitiveness throughout the period. Moreover, because many other countries experienced progress in this sub-index, its stagnation leads to a relative deterioration in Georgia's competitiveness position. The situation is not much better concerning the **Efficiency Enhancers** (EE) sub-index. Georgia's scores on Efficiency Enhancers were going up until 2008, reflecting the outcomes of major reforms which were taking place in the early period of Saakashvili's administration. After 2008, we observe almost no progress in the EE sub-index, suggesting that, similar to ISF, it has become a drag on future progress in and of itself, and relative to other nations.

Georgia's progress is also very uneven if

Figure 2.5 (A, B) Swapping places



Source: WEF, GCI

Figure 2.6 (A, B): Change in GCI value and rank (2005-2012) for the 23 transition nations included in the GCR, and Turkey and Cyprus

Countries are ordered by size of improvement (From 2005 to 2012) in competitiveness as measured by GCI value (2.6-A) and rank (2.6-B). Positive changes (improvement in GCI) are shown by blue bars, negative changes are in red.

Source: WEF, GCI

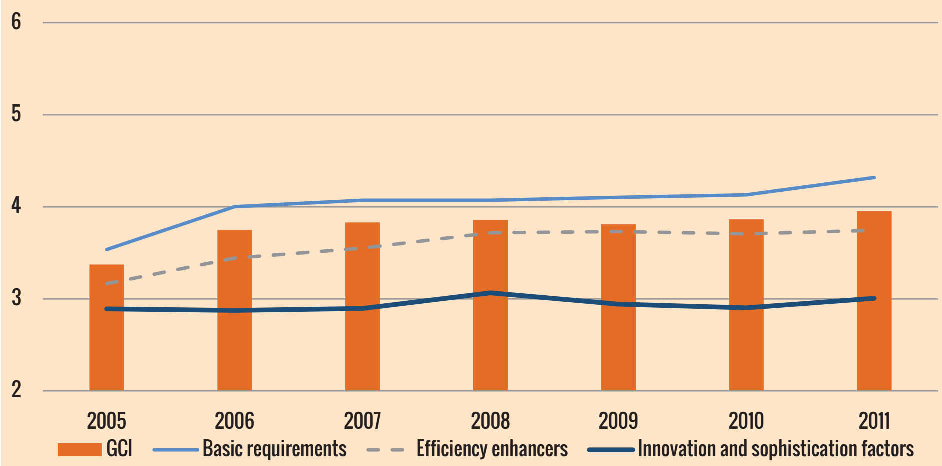
we look within each competitiveness sub-index. Of the four **BR** pillars (Figure 2.8), Georgia receives the highest scores on the **Health and Primary Education** pillar.[18] This is not surprising given that, like other former and current socialist countries, Georgia inherited very strong health and primary education institutions. What stands out, however, is that Georgia has made no progress in this pillar since 2006, after the first wave of reforms were implemented. Additional progress may require costly measures, such as an expansion of preschool education (currently covering less than 50% of the pre-school aged population) and universal healthcare insurance.

Conversely, Georgia has been experiencing consistent improvement in the **Institutions** and **Infrastructure** pillars. The Institutions pillar recorded very strong gains early on in the reform process (up until 2008), reflecting achievements in deregulating the economy and cleaning up the state bureaucracy. The Infrastructure pillar took off in 2007, staying on an upward trajectory through 2012. Finally, the **Macroeconomic Environment** pillar has been subject to very strong fluctuations, being largely responsible for the big hit Georgia's overall GCI ranking took in 2008, 2009 and 2010, and its recovery in 2011 and 2012.

There is quite a lot of variance within the **Efficiency Enhancers** (EE) sub-index as well (Figure 2.9). On the one hand, this sub-index is propped up by Georgia's outstanding performance in **Labor Market Efficiency**.[19] On the other, the **Market Size** pillar is a major drag on Georgia's attractiveness for investment and, consequently, its competitiveness.

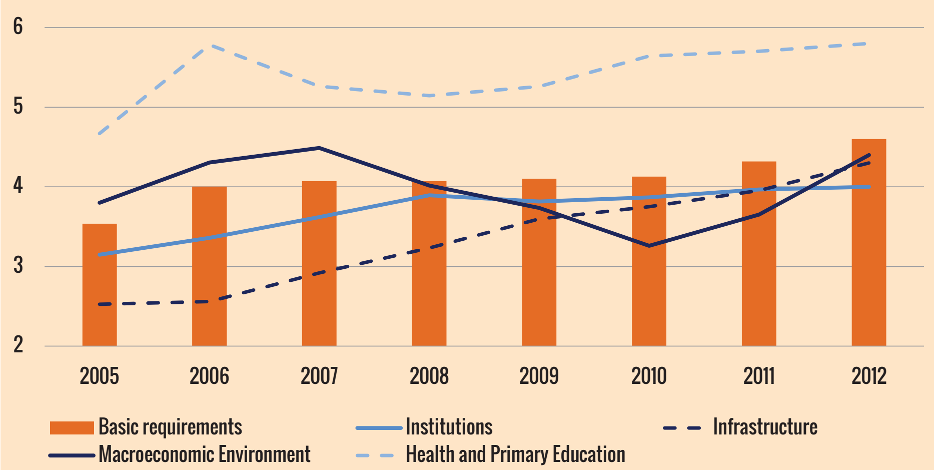
While there have been some ups and downs in the **Financial Market Development** pillar (related to the August 2008 war and the global financial crisis), other EE pillars experienced consistent, albeit modest improvements. This is the case with **Higher Education and Training**, **Technological Readiness** (on the back of improvements in ICT service quality and prices) and **Goods Market Efficiency** (as a result of lower taxes and improvements in tax administration, low export and import barriers, and formal easiness of doing business). The latter pillar is a subject of careful attention for the new Georgian administration[20], which seeks to move beyond formalities (such as

Figure 2.7 GCI vs. sub-indices (values)



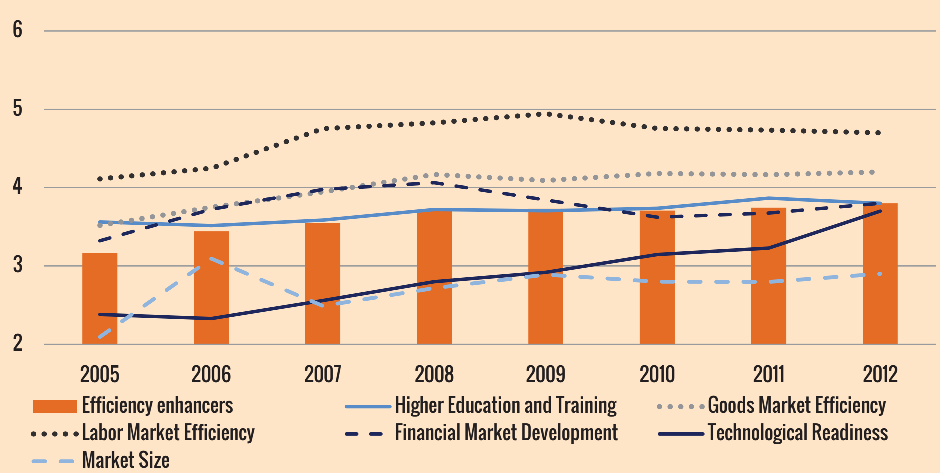
Source: WEF, GCI

Figure 2.8 Basic Requirements (values)



Source: WEF, GCI

Figure 2.9 Efficiency Enhancers (values)



Source: WEF, GCI

[18] The GCI ranking may in fact be flattering to Georgia's actual performance in these areas considering the low quality of primary schooling and a lack of universal healthcare insurance. Reforms in both areas are being currently debated within Georgian policy circles.

[19] This may be another instance of a GCI indicator being flattering to Georgia's actual competitiveness given that the country's extremely liberal labor market legislation is a sore point in its trade negotiations with the European Union, and a source of internal political tensions.

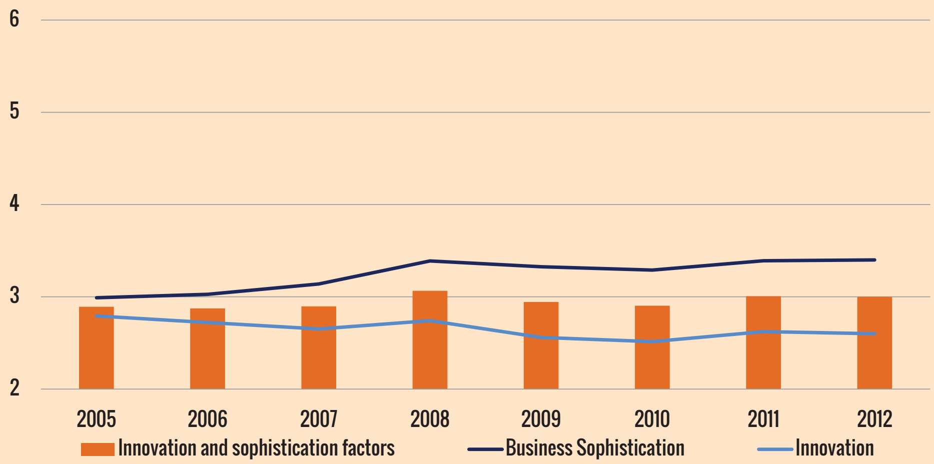
[20] Interview with Giorgi Kvirikashvili.

the number of days it takes to register a business) to creating a level playing field for Georgian businesses by: i) preventing government from harassing businesses; ii) introducing a new competition law providing for more effective monopoly regulation; and iii) strengthening the autonomy and professional capacity within the Georgian judiciary to deal with civil disputes and tax appeals.[21]

Georgia's performance on the **Innovation and Sophistication** (ISF) sub-index remains dismal, with almost no improvement since 2005. The two ISF pillars had very similar scores in 2005, but have significantly diverged since (Figure 2.10). While **Business Sophistication** has somewhat improved, there appears to be no progress with **Innovation**. The overall result is stagnation, particularly after 2008.

One piece of "good" news is that the **Innovation and Sophistication** sub-index has little weight in the overall GCI (10%) for Georgia and other countries at a similar level of development as their competitiveness is deemed to be mostly a function of **Basic Conditions** and (above per capita income of $3,000) **Efficiency Enhancers**. Another piece of good news is that, at least as far as manufacturing is concerned, productivity growth may come from sources other than technological innovation (see Box 2.1). For instance, low productivity firms that can catch up with industry leaders by copying and emulating existing technologies. Additionally, Georgia's manufacturing sector appears to be receiving a large productivity boost from the improvements in infrastructure and the institutional environment induced by the Rose Revolution of 2003.

Figure 2.10 Innovation and Sophistication Factors (values)



Source: WEF, GCI

[21] Tea Tsulukiani, Georgia's Minister of Justice, speaking with AmCham members in December 2012: "Previously, business registration was easy. However, what followed registration was often quite ugly. A few businessmen were jailed. Some are still behind bars. The Fuchs case [Israeli businessman accused of bribing a deputy minister] is well known." (Notes taken during the meeting by the authors).

Box 2.1

Innovation, reforms and manufacturing productivity in Georgia

As far as innovation and business sophistication is concerned, Georgia is occupying one of the lowest positions in the GCI, even if we only look at its place among developing economies. What can one infer from the growth of Georgia's productivity in manufacturing?

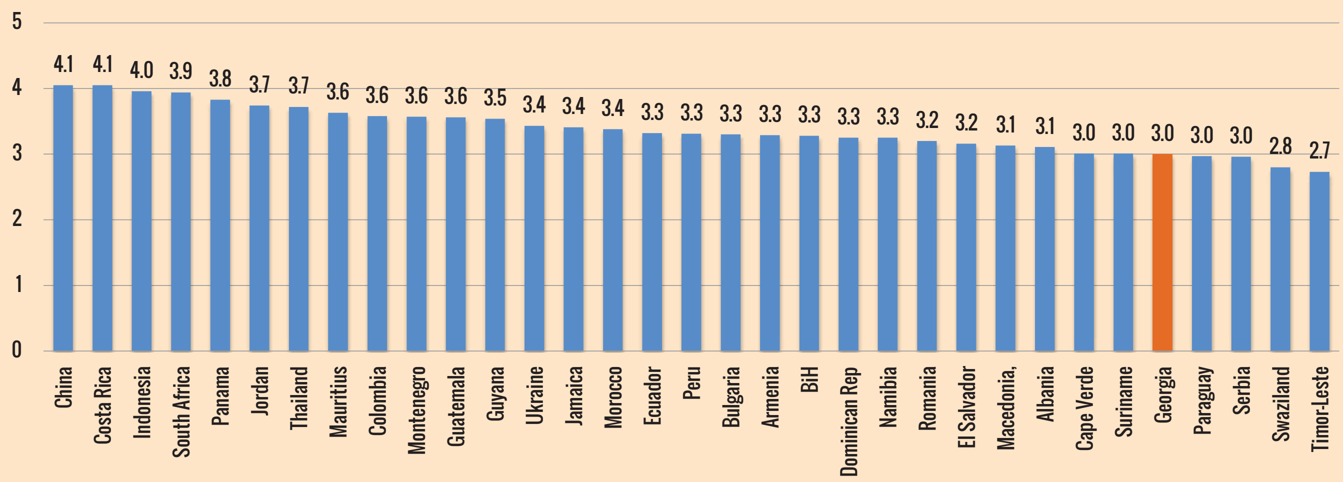
As discussed in a blog post[1] by Michael Fuenfzig, a recent paper by Dani Rodrik (2011) estimates the productivity growth rates of manufacturing firms, based on a UNIDO dataset covering 72 countries, and finds that growth rates are negatively related to productivity levels. In other words, low productivity firms feature high productivity growth rates, and high productivity firms feature low productivity growth rates. The logic is very simple: it is hard to innovate, but easy to copy and emulate, the productivity leaders in the industry, suggesting a process of convergence in productivity levels. Importantly, Rodrik's result only holds for manufacturing industries. Not for agriculture and not for non-tradable services, where technology may not be as easy to transfer. Given this, what should you do as a poor country? You should move into those industries that offer you high productivity growth rates – manufacturing essentially. Rodrik calls these industries escalator activities – you step on the escalator and quickly, almost automatically, move up.

Where does Georgia stand? Dani Rodrik's figure has Georgia in an interesting position. The productivity of Georgian manufacturing firms is the lowest or one of the lowest among the 72 countries covered. At the same time productivity growth rates in Georgian manufacturing are among the highest, if not the highest, compared to all other 72 countries.

This is, of course, fully in line with the theory that it is easier to copy and emulate than to innovate. However, Georgia is far above the regression line, indicating that more is going on than just what this simple theory can explain. A potential explanation is that Georgian manufacturing firms experienced a productivity boost not so much as a result of technological innovation or technology transfer, but on the back of reforms implemented after the Rose Revolution. Firms became more productive because they had to spend less on dealing with a corrupt bureaucracy, could quickly move goods in and out of Georgia, and had access to reliable electricity, better roads and communications infrastructure. The resulting boost in productivity was so large, at least according to Rodrik's analysis, that Georgia appears to be not only the World's number one reformer, but also the World's number one performer in manufacturing firm productivity growth!

[1] Fuenfzig, Michael, "The Catching-up Game"

Figure: Innovation and Business Sophistication



Source: WEF, GCI

2.2.3 Georgia in the 2012/13 Global Competitiveness Report

The 2012/13 Global Competitiveness Report is a source of very good news for Georgia. Based on 2011 data, Georgia advanced to the 77th position in the global ranking and, based on its GDP per capita level, was upgraded to the Efficiency-Driven economies category. Georgia's latest competitiveness score exceeds the averages for CIS and other Efficiency-Driven economies. Finally, the country's one year progress in the GCI places it among the top twenty value improvers in the world and among the best five in Europe. In terms of rank improvement, Georgia is among the top 10 worldwide and the top 5 in Europe.

Yet, none of this should justify complacency. In fact, much of the most recent improvement could be attributed to one factor: a revaluation of Georgia's **Macroeconomic Environment** pillar (from a dismal and totally unrealistic rank of 137th in 2011/12 to 88th in 2012/2013). Georgia's real progress in competitiveness in 2011 (which the latest, 2012/2013 GCR is supposedly measuring) has been quite modest, as reflected in declining levels of foreign direct investment in 2012 (primarily related to rising political risks).

The extent to which Georgia's competitiveness performance has been a mixed bag is well illustrated in Figure 2.12, which shows the degree of variance in the ranking of all competitiveness indicators within each pillar. A case of extreme divergence is the **Goods Market Efficiency** pillar, which includes both very strong indicators ("number of days to start a business" (2), "total tax rate" (11), and "burden of customs procedures" (13)) and indicators on which Georgia is trailing far behind, such as "quality of anti-monopoly regulation" (141) and "intensity of local competition" (127). Another example of extreme variance is the **Institutions** pillar. Here we find Georgia among the world leaders on the "burden of government regulation" (9) and an outsider on "property rights protection" (131), the latter being a critical determinant of both foreign and domestic investment.

Not incidentally, these two pillars were the subject of signature reforms by the Saakashvili administration. While Georgia's reform efforts propelled it close to the top of the GCI ranking on a subset of directly affected competitiveness indicators, the country continues to lag behind on indicators that were beyond the government's direct control, such as "degree of local competition" (ultimately restricted by Georgia's small market size). On the other hand, the outgoing government's poor record on anti-trust policy and property rights protection is reflected in Georgia's very poor performance on these competitiveness indicators.

2.2.4 Global Competitiveness Indicators: What do they actually measure?

In this section, we offer a brief discussion of what we consider to be problematic issues with the GCI methodology, with an emphasis on those that had direct implications for the measurement of Georgia's competitive performance in the 2012/13 GCR.

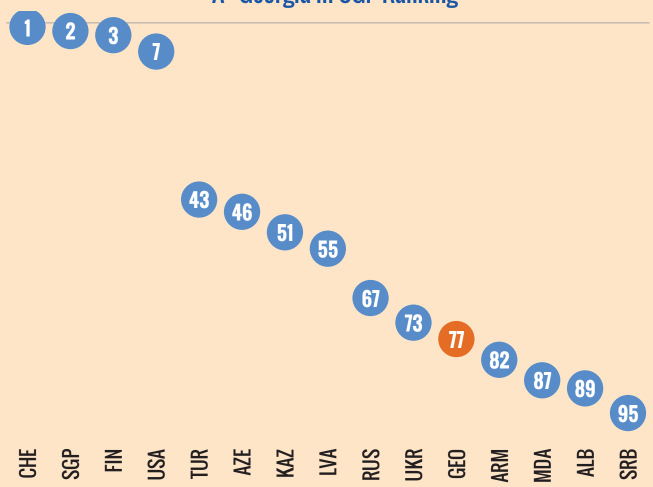
First, the GCI is based on a combination of objective statistics and subjective data coming from interviews with the national business community (WEF Executive Opinion Survey) in each country. Based on a robustness test conducted by the WEF, the 2012 Survey data collected in Georgia and three other countries (Ecuador, Rwanda, and Sri Lanka) "deviate significantly from the 2011 results." According to the GCR 2012/13 (p.77): "The subsequent analysis revealed that this departure was not accompanied by a similar trend in indicators taken from other sources, and the recent developments in these countries do not seem to provide enough justification for the large swings observed." For this reason, the GCR 2012/2013 uses only the 2011 Survey data in the computation of Georgia's GCI. Next year report, in line with GCR policy, will be based on a weighted average of the Georgian survey data of 2011 and 2013, providing for a smoother transition.

The large swings in the GCR Executive Opinion Survey are indicative of a fundamental weakness of the GCR: survey results may be biased upwards through vigorous campaigning by government agencies and technical assistance projects interested in promoting their countries' position in this or that international ranking. The problem may be particularly acute in small developing and transition countries, such as Georgia, where such "vigorous campaigning" may in fact be effective.

Second, the set of countries in the GCR changes almost every year, potentially complicating year-on-year comparisons: a country's ranking may change only because of a change in the sample of countries. More importantly, the set of GCI indicators is also not stable over time. For example, the **interest rate spread** indicator, a key parameter in the **Macroeconomic Environment** pillar, was excluded from the 2012/13 report "because of limitations in the international comparability of these data" (GCR 2012/13, p. 10). Conversely, **mobile**

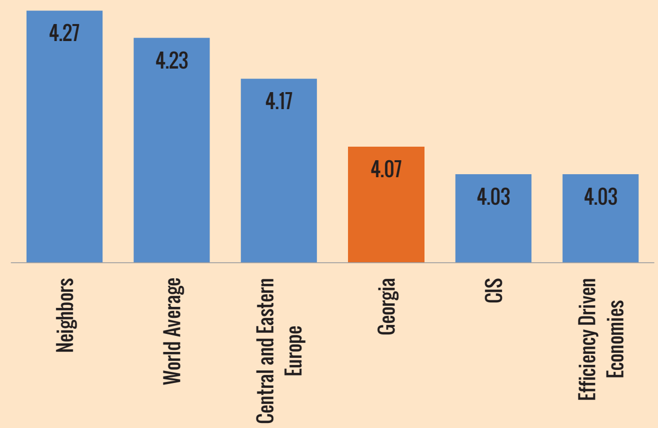
Figure 2.11 (A-F): Georgia's competitiveness performance in the 2012/13 GCR

A - Georgia in CGI: Ranking



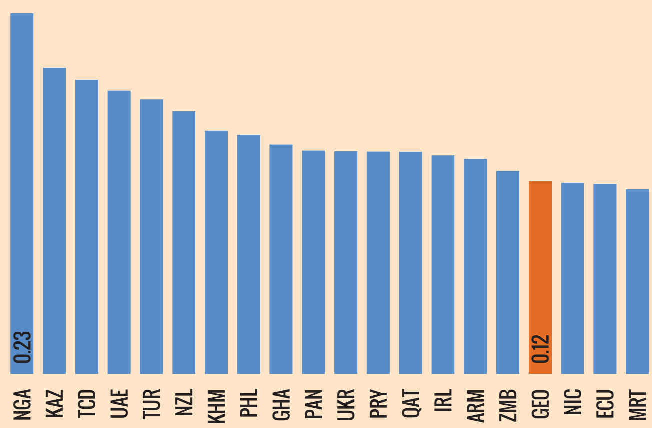
Georgia is ranked 77th in Global Competitiveness

B - Georgia in CGI: Valures



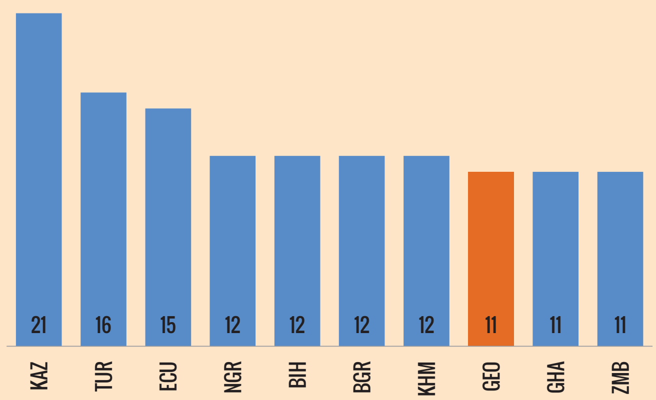
Above average for CIS and efficiency-driven economies

C - The best improvers in the world: change in value



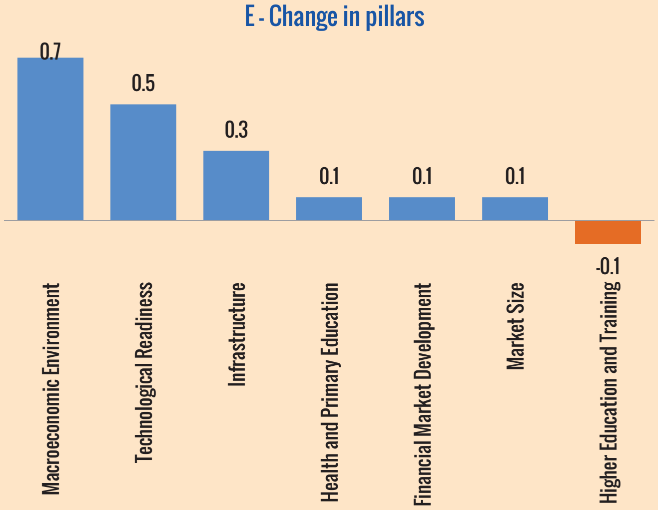
Among the top twenty **value** improvers in the world and among the best five in Europe

D - The best improver in the world: change in ranking



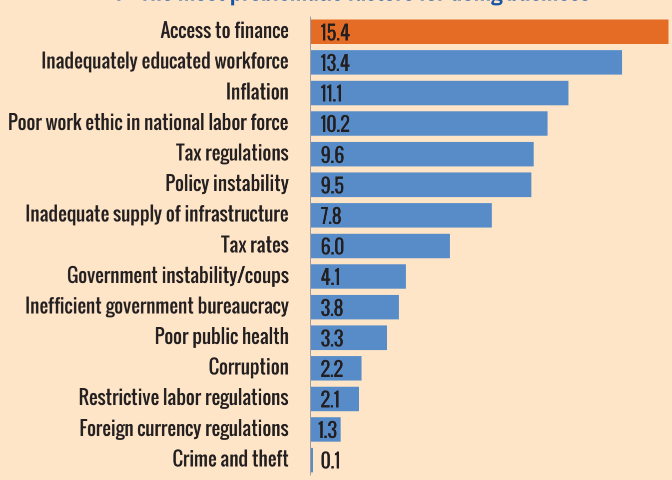
Among the best ten **rank** improvers in the world, and the top five in Europe

E - Change in pillars



Major improvements in macroeconomic environment, technological readiness and infrastructure

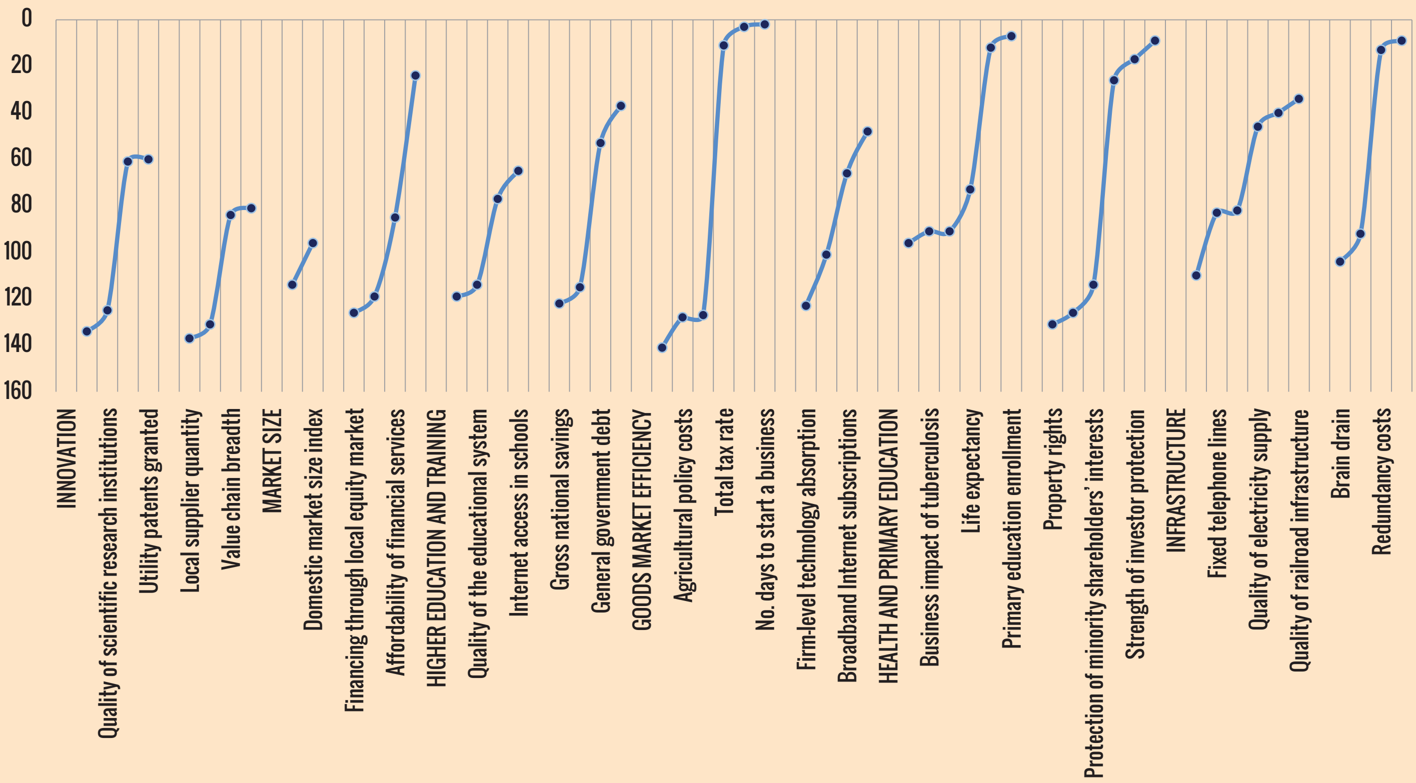
F - The most problematic factors for doing business



Access to finance is the main bottleneck for doing business

Source: WEF, GCI

Figure 2.12 Major strengths and weaknesses of each pillar



Source: WEF, GCI

broadband subscriptions/100 population was added to GCR's **Technological Readiness** pillar "in order to take into account the rapidly expanding access to the Internet via mobile devices."

Incidentally, while not reflecting any real progress in Georgia's competitiveness, both technical changes were extremely beneficial for Georgia's ranking in the GCR. Bear in mind that, with an interest rate spread of 15 percentage points (!), Georgia has been a world leader in this domain (ranked 129th out of 142 countries) in GCR 2011/12.

Third, the methodology for calculating some of the competitiveness indicators is at odds with what the index is purporting to measure: a country's ability to make the efficient use of available resources and thus serve as a magnet for investment and skilled labor. One source of bias is the simplistic "the-more-the-better" assumption behind competitiveness indicators such as "**tertiary education enrolment, gross %**." The folly of this assumption becomes evident if one inspects the data on university enrollments, youth unemployment and labor market mismatch. The sheer pace and extent of higher education expansion in many transition nations is suggestive of eroding educational standards and degree inflation, bringing about great efficiency losses and no benefits for the economies and societies involved.

Now, Georgia is unique among all transition countries in that, beginning in 2004-5, it had the political will to combat corruption in higher education and raise the quality bar for both students and universities. As a direct consequence of its education policies, Georgia is the only transition country in Europe that managed to bring higher education enrollment from the peak of almost 47% in 2004 down to 28% in 2010 (below the 1999 level of 35%). Of course, weeding out weak universities solves only a part of the problem. Georgia is yet to offer its younger generation a viable option of vocational training and productive jobs.

Paradoxically, given its methodology, the GCI has punished Georgia for implementing this key reform. In 2006, Georgia had an enrolment rate of about 41%, and was ranked 40th on "tertiary education enrolment, gross %." In 2012, Georgia brought university enrolment down to 28%, and … fell in the GCI ranking to the much less respectable 77th position.

Finally, some of the survey-based GCI indicators are often at odds with other international rankings. A good case in point are such indicators under the Institutions pillar as **Judicial Independence, Intellectual Property Protection** and **Property Rights**. For instance, two other international rankings – Nations in Transit and the Bertelsmann Transformation Index – evaluate the independence of Georgia's judiciary based on a different set of subjective indicators (see Figure 2.13[22]) and come to starkly different conclusions. According to Nations in Transit, Georgia and its neighbors, including Ukraine, are much further away from the Czech Republic in terms of judicial independence than what is suggested by the GCI and the Bertelsmann Transformation Index. Second, the dynamics and relative rankings of Georgia and its neighbors in the different rankings are utterly inconsistent.

Finally, it is often the case that one international ranking is based on objective statistics while another uses subjective survey data to estimate the same competitiveness parameter. Which is better? For example, the UNICEF Human Development Index (HDI) evaluates educational systems based on expected years of schooling, while GCI measures the quality of education using subjective survey data. Figure 2.14[23] provides a side-by-side comparison of education system rankings for Georgia and its reference countries. According to the HDI, the educational

[22] Values of the indices have been monotonically transformed for better visualization.

[23] Values of the indices have been monotonically transformed for better visualization.

Box 2.2

Georgia opts out of the "Over-Education" Trap?[1]

For approximately 10 years (from 1999 until 2010) higher education enrollment increased by 64% in Central and Eastern Europe, 27% in Central Asia and the South Caucasus, and 19% in Western Europe. There is no arguing that increasing higher educational enrollments may be a very positive development for most transition countries aiming for the "knowledge era". However, the sheer pace and extent of higher education expansion in many transition nations is suggestive of an uncontrolled explosion, bringing about great efficiency losses and costs for the societies involved. Georgia is the only transition country in Europe that managed to bring higher education enrollment from the peak of almost 47% in 2004 down to 28% in 2010 (that is even below the 1999 level of 35%). The question of whether or not Georgia managed to get out of the over-education trap is discussed by Eric Livny on the ISET Economist Blog.

[1] Livny, Eric, "The 'Over-Education' Trap."

systems of all countries move in parallel and basically stagnate. In contrast, the GCI reports (unreasonably) sharp fluctuations and changes in relative rankings.

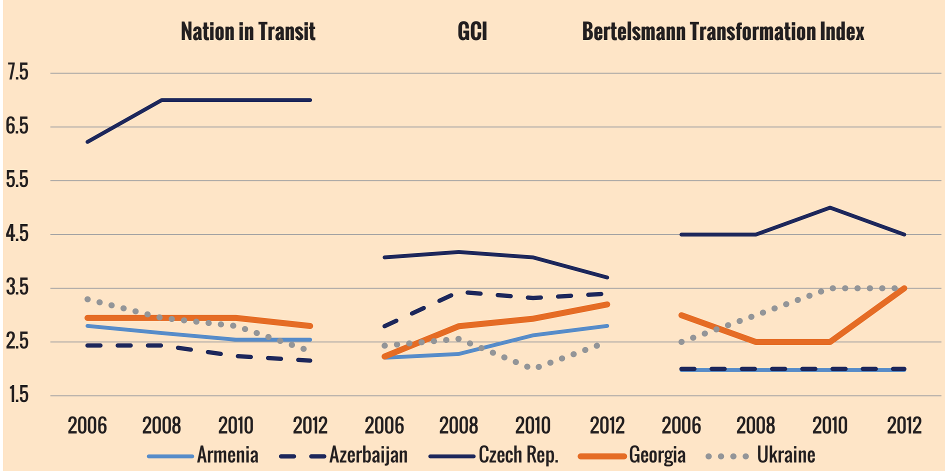
2.3 Taking stock

Georgia may be proud of its progress in the Global Competitiveness Index and many other rankings since the Rose Revolution. The country is currently ranked 77th in the GCI, a respectable position above most non-oil CIS countries, and above the average for countries in the $3,000-9,000 per capita income bracket. Moreover, the 2012/2013 report places Georgia among the top improvers worldwide.

Of course, there are many issues with the GCI rankings, including the accuracy of the underlying Executive Opinion Survey data, the simplistic (the-more-the-better) approach to calculating some of the indices, and an unstable set of indicators and countries complicating inter-temporal comparisons. Yet, even if we take the GCI data at face value, there is a lot to be learned if one cares to analyze them objectively.

One key fact to note is that, barring a dramatic correction in Georgia's performance on the **Macroeconomic Environment** pillar (from the totally unrealistic rank of 137th in 2011/12 to 88th in 2012/2013), Georgia stopped progressing in the GCI rankings with the completion of the first round of major reforms in 2008. Whatever progress has been achieved after 2008 was almost exclusively related to improvements in **Infrastructure**. Progress on **Institutions** (a source of pride for the Saakashvili administration) – another key element of **the Basic Requirements** pillar

Figure 2.13 Judicial independence assessed by different indices



Source: Nation in Transit, GCI, Transformation Index

– stalled in 2008. There has been no real progress in the **Efficiency Enhancers** pillar during the past three years. Furthermore, much of the progress achieved in this pillar prior to 2009 is attributable to extreme labor market liberalization – in reality a major source of political tension and a bone of contention with the EU (which makes a more balanced approach to labor market regulation a condition for deeper trade integration with Georgia). Goods market efficiency, a key indicator in this pillar, has actually deteriorated since 2009.

As discussed in the first chapter of this report, foreign direct investment (FDI) – an objective barometer of Georgia's international competitiveness – collapsed in the aftermath of the August 2008 war with Russia, and has never recovered to its pre-2008 levels. Moreover, FDI all but fizzled out in the course of 2012 as a result of foreign (and domestic) investors' nervousness about political uncertainty, reports of government meddling with property rights, and "elite" corruption.

2.4 Promoting the competitiveness agenda

The first wave of broad brush liberal reforms has, in many instances, cleaned the slate and created the foundations on which the new administration can build the new economic and political order. While many of the early reforms brought excellent results, there remain serious gaps affecting Georgia's real and perceived competitiveness. For instance, Georgia now has one of the most liberal business environments, but it is not yet a place where doing business (as opposed to registering a business) is actually easy. In the remaining part of this chapter, we discuss each pillar of competitiveness, focusing on progress to date and the outstanding challenges.

2.4.1 The Institutions Pillar

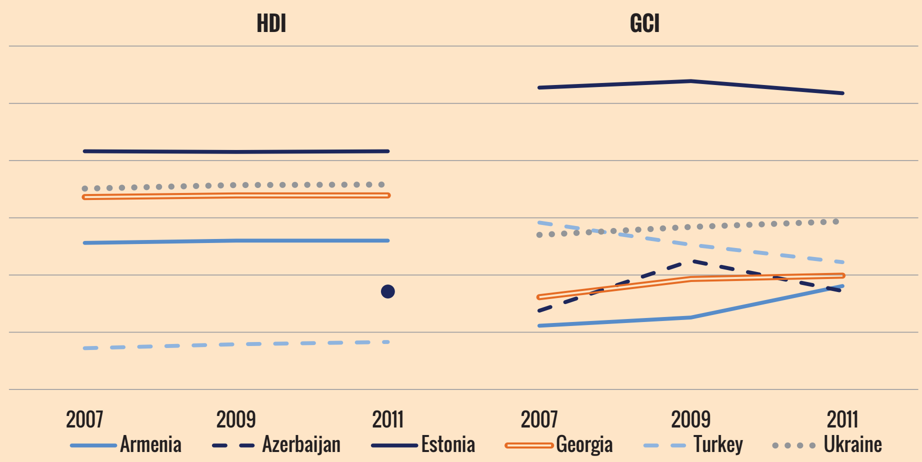
Georgia achieved considerable progress in the **Institutions Pillar** between 2004 and 2008. Using a political window of opportunity brought about by the landslide (96.2%) victory in the repeat parliamentary elections of January 4, 2004, the Saakashvili administration used the "guillotine method" to reform all branches of government: "through [the] aggressive use of the 'guillotine,' reformers shut down entire government agencies that were not providing value and merely extracting bribes from the population."[24] The "old guard" were removed from public office. Better trained, new personnel were offered higher remuneration, but also face severe sanctions in order to reduce the incentives for corruption. This method was applied while transforming the police, tax and customs administration, the judiciary, and other systems considered to be plagued by endemic corruption. Figure 2.15 documents Georgia's progress on "Fighting Corruption in Public Services" (the title of a recent World Bank publication on this subject).

Law enforcement was the area most clearly affected by the guillotine method. Almost the entire Road Police force – "thugs with a franchise from the government,"[25] a total of 25,000 to 30,000 people – were fired in 2004 and 2005. The new Patrol Police was equipped with new vehicles, American-style uniforms, radios, badges and other equipment. While largely symbolic, these changes helped break from the past and improve the police force's prestige and its attractiveness from the recruitment point of view.

As a result of police reforms, the level of crime, considered a serious problem before 2003, has dramatically decreased (Figure 2.16.A). The impact of police reform is fully reflected in both the official crime statistics and Georgia's GCI indicators "**reliability of police services**" and "**total crimes recorded**" (see Figure 2.16.B).

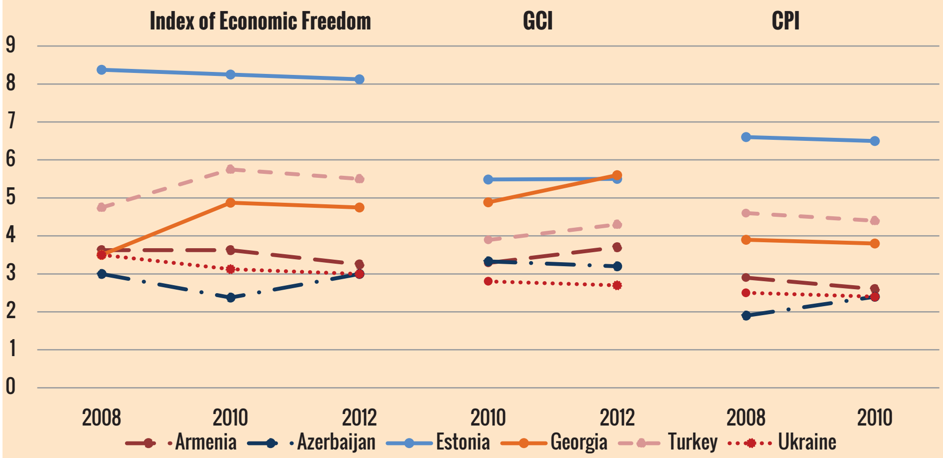
In addition to employing the guillotine, the Georgian government quickly moved to reduce bureaucracy and improve citizen services. The introduction of Public Service Halls, operating according to the One-Stop-Shop principle, provided a full gamut of services to private citizens and businesses. An increasing number of services are available online through government web portals (for example, www.house.gov.ge). In addition to the Public Service Hall, additional agencies have been established under the Ministry of Justice to improve the efficiency of citizen services, including the Civil Registry Agency, the National Agency of Public Registry, the National Archives of Georgia, the National Bureau of Enforcement, and the Notary Chamber of Georgia.

Figure 2.14 Education system assessed by different indices



Source: WEF, UNICEF

Figure 2.15 Corruption, taking bribes: Assessment of different indices



Source: WEF, TI, the Heritage Foundation

Going forward, Georgia faces two main challenges: first, ensuring the independence, professionalism and efficiency of the Georgian judiciary and, second, strengthening property rights protection.

Georgia ranks very poorly on "**Judicial independence**" (95) and "**Efficiency of the legal framework in challenging the legality of government actions and/or regulations**" (106) in the GCI. In particular, as Figure 2.17 illustrates, there has been no progress on this count between 2005 and 2012. The GCI scores are consistent with reports from independent international observers. For instance, evaluating the early phase of Georgia's judicial reforms, the American Bar Association's report[26] found "notable improvements ... in the increased availability of financial resources... infrastructure and working conditions of judges."

However, the report also notes important shortcomings concerning judicial independence:

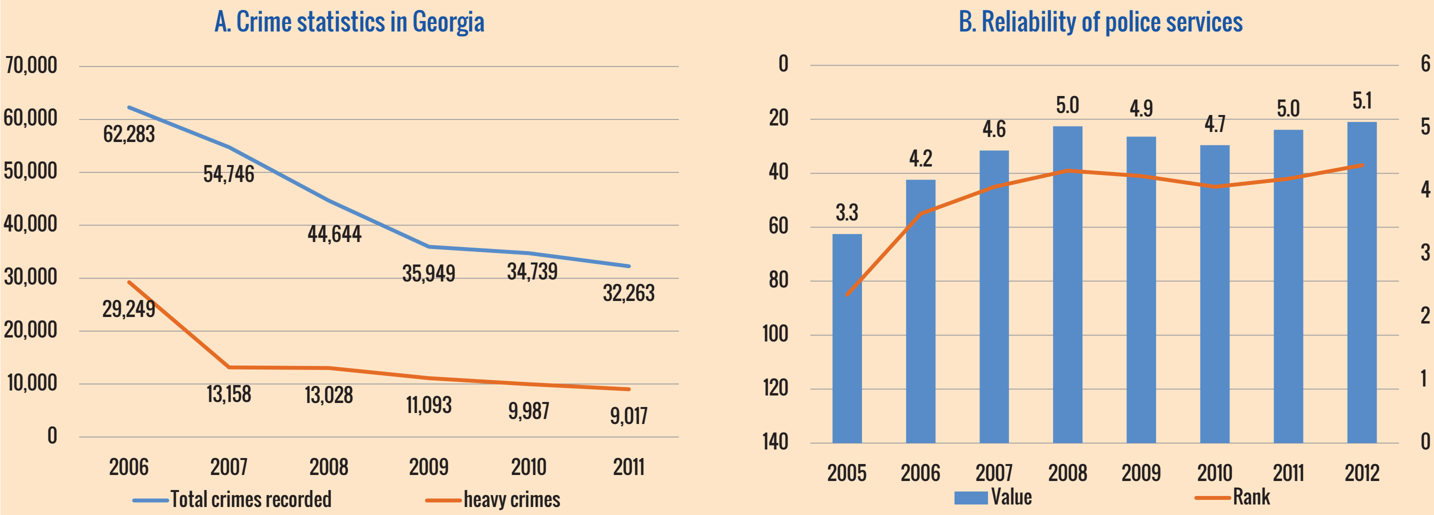
- "...judges are generally independent when deciding civil cases, but ... improper influence by the executive branch and the procuracy reportedly still exist in administrative and criminal cases. In the latter instance, independence is seen the exception rather than the rule, and

[24] The World Bank. "Fighting Corruption in Public Services: Chronicling Georgia's Reforms."

[25] npr.org. "Georgia's National Police Corruption Project."

[26] American Bar Association. "Judicial reform index for Georgia." (p. 1)

Figure 2.16 (A, B) Police reliability and crime rate

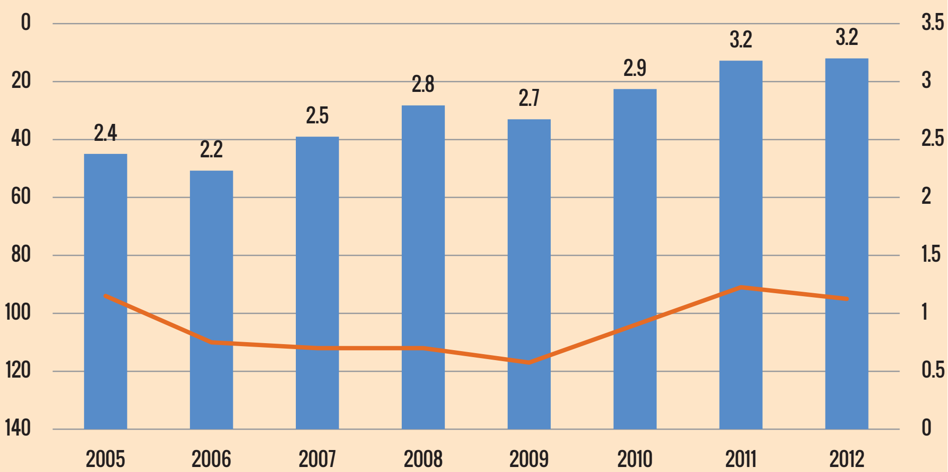


Source: A- GeoStat, B - WEF, GCI

prosecutors are said to exert significant influence over judges, as evidenced by the extreme rarity of acquittals and by sentences that are usually in line with prosecutors' requests.

- The common disposition of criminal cases by what is referred to as 'plea bargaining' raises significant concerns regarding both criminal justice and judicial independence. Despite procedural requirements to the contrary, in practice such arrangements are typically negotiated without the defendant's lawyer and require payment of substantial sums of money in return for having charges dropped. Interviewees referred to the practice as legalized bribery and characterized judges acting like notaries who merely rubberstamp such dispositions without independent review.
- Although the Constitution guarantees an impressive array of civil rights and liberties, including the right to apply directly to court to protect one's rights and freedoms, in practice, the judicial role in protection of human rights remains inadequate. Although some judges have been able to resist the government pressure in politically sensitive cases, most victims of civil and human rights violations reportedly feel that it would be futile to seek recourse from the courts."

Figure 2.17 Judicial Independence (GCI values and rank)



Source: WEF, GCI

Current problems with the Georgian judiciary were a matter of discussion between the new Minister of Justice Tea Tsulukiani and the American Chamber of Commerce in December 2012. In her remarks, Tsulukiani emphasized the need to protect the independence of Georgia's judiciary. Rather than replacing all the judges, the new government's intent is, according to Tsulukiani, to create the conditions for them to work professionally and independently. Proposed measures include:

- Depoliticization of the High Council of Justice (HCOJ) to include independent members representing civil society organizations (CSO) rather than members of parliament.
- Separating the powers of the Chief Prosecutor and the Minister of Justice.
- Not allowing judges to sit on the disciplinary committee to ensure it has real teeth.
- Providing the conference of judges will real self-governance functions. Today only the Supreme Court president can propose members and the ballot is open. The intent is to have a secret ballot and give all judges the right to propose candidates.
- Opening the Ministry of Justice to the outside world, including the Georgian media and CSOs.

Property rights are clearly another area for improvement. Georgia's current rank on this count is among the poorest in the world, 131st out of 144. For instance, "Stripped Property Rights", a recent report by a coalition of Georgian NGOs[27], documents multiple instances of property rights violations in newly developed tourist regions (Samegrelo-Zemo Svaneti

[27] Transparency International Georgia. "Stripped Property Rights in Georgia." The third Report. (p. 3)

and Adjara). The infringement of private property is said to take various forms, including [a] "mass abandonment and citizens giving property to the state as a gift;" and the "arbitrary registration of the state's title to the real property already registered by the owners."

This problem is, of course, closely related to the perceived lack of judicial independence in dealing with administrative cases. The "Stripped Property Rights" report concludes: "The courts are supposed to ensure that the laws adopted in the country and their interpretation by the state do not infringe or restrict fundamental human rights and freedoms. ... Unfortunately, the Georgian court system still fails to protect citizens' rights. It is crucial that the courts use the rights conferred to them by law and examine/investigate cases fully, objectively, and impartially. It is equally crucial that the courts be committed to the protection of property rights safeguarded by the Constitution and not submissive to the technical arguments of administrative agencies."

It is hard to underestimate the importance of property rights protection for Georgia's real and perceived competitiveness. Babych and Fuenfzig (2012) identify weak property rights, broadly defined, as the major bottleneck for Georgia's economic growth. According to them: "weak property rights and political instability have several effects. Firms and entrepreneurs are less likely to invest, and if they invest will focus on the short-term. Bank and other financial institutions providing loans to firm and entrepreneurs are likewise less likely to lend. Following Bae and Goyal (2009) and Qian and Strahan (2007) banks will charge higher real lending rates, are more likely to require collaterals, and will shorten the maturity of the loan".

While Babych and Fuenfzig operate with theoretical concepts, one can learn about the practical implications of property rights infringements from the emotional reaction of Georgian and international businesses to the peaceful democratic transition following the recent parliamentary elections. "We hope that a new era of optimism for Georgian business has been brought by Mr. Ivanishvili", wrote Fady Asly, Chairman of the International Chamber of Commerce (ICC-Georgia) in a comment to *The Financial* (October 19, 2012), "an era when all businesses are given equal opportunities, when there will be no more harassment, an era when businesses will not be considered milking cows anymore."

2.4.2 The Infrastructure Pillar

Bolstered by improved tax collection, grants and concessionary loans, the Georgian government implemented a very ambitious infrastructure development program, resulting in very fast and sustained improvement in the GCI. Georgia's overall infrastructure rank improved from 93rd to 53rd in just seven years. The most dramatic improvement was achieved in the quality of electricity supply (from 111th to 46th), but other elements of essential infrastructure – road, rail, and air – received a significant upgrade (see Figure 2.18). Several major road construction and rehabilitation projects have been implemented with the generous assistance of the international donor community and concessionary funding by international financial institutions (IFIs)[28] since 2005, including the new East-West Highway, the Samtskhe-Javakheti and Zugdidi-Mestia roads. Roads have also been improved throughout rural Georgia, significantly reducing travel time and cost, while improving safety and comfort.

Importantly, the Georgian government's own investment in public infrastructure sparked a round of private investment through the mechanism of privatization and concessions. For example, built and operated by TAV Urban Georgia LLC (TAV Georgia[29]), Tbilisi's new state of the art passenger terminal opened in early 2007, improving service quality and leading to almost a doubling in passenger traffic from 2005 to 2011. Two international airports, in Batumi and Kutaisi (since September 2012), and a smaller airport in Mestia (since early 2011) are significant additions to Georgia's tourism infrastructure.

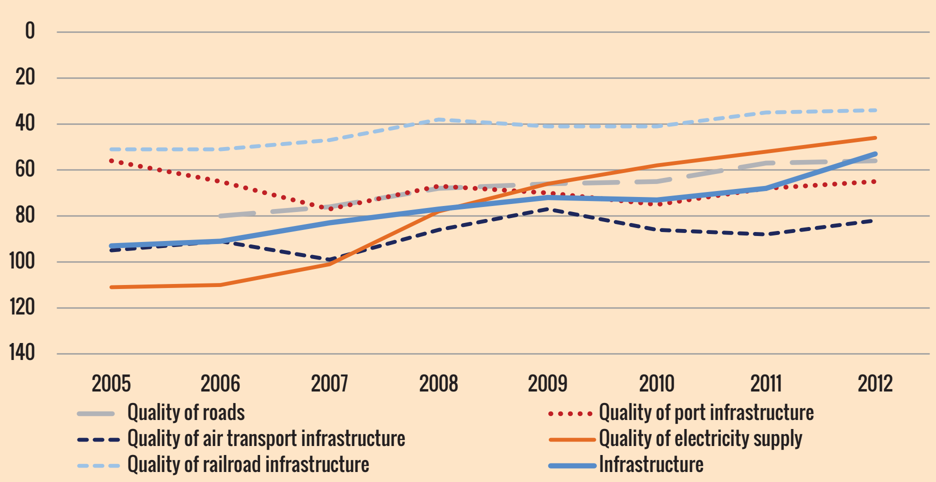
Similarly, Georgia's sea port infrastructure has been developed through privatization and concessions awarded to international companies. Thus, KazTransOil (a subsidiary of KazMunayGas) acquired the rights for the long-term management of Batumi Sea Port and purchased the Batumi Oil Terminal in early 2008. A leader in global port management, ICTSI, took over the Batumi Container Terminal, as well as the ferry and dry bulk handling facility. APM Terminals Poti, a unit of Denmark's A.P. Moller-Maersk, operates Poti Port after acquiring an 80% stake from Rakia in 2011. Poti port is the largest dry cargo handler in the Caucasus, making Georgia a corridor for shipments destined for Central Asia. Finally, the Kulevi oil terminal near Poti was purchased by Azerbaijan's SOCAR in 2006. Following the completion of construction work in 2008, Kulevi oil terminal and port became SOCAR's most important investment in Georgia, designed to receive oil and petroleum products and store and load them onto tankers.

The Georgian government played a key role in reforming and developing the electricity sector. Reforms covered all the essential elements of the system, including generation, transmission and distribution, ending an era of long and frequent blackouts. Privatization of Georgia's generation and distribution capacities led to a badly needed infusion of private funds and ended the non-payment debacle.

[28] These include the Asian Development Bank, the Millennium Challenge Corporation (USAID), the World Bank, and the Japanese International Cooperation Agency, among others.

[29] Detailed data related to air transport infrastructure are available from TAV annual reports, http://www.tavhavalimanlari.com.tr/en-EN/Publications/Pages/AnnualReport.aspx and the Georgian Civil Aviation Agency http://gcaa.ge/eng/.

Figure 2.18 Quality of Infrastructure in Georgia (GCI rank)



Source: WEF, GCI

While remaining in state ownership, transmission capacities were renovated using concessionary international funding. In 2007, following renovation of existing capacities and the construction of new generation utilities, Georgia became a net electricity exporter. While investment in additional transmission and hydro-generation capacities may allow Georgia to increase its exports to Turkey and other countries of the region, the risks associated with access to the Turkish market are a drag on the private sector's willingness to commit its own funds on a sufficiently large scale.[30] With hydro-generation volumes stagnating and domestic demand steadily growing, Georgia has once again become a net importer of electricity. Moreover, according to our interview[31] and the World Bank Doing Business survey (Figure 2.24), connection to electricity is still considered to be one of the most problematic aspects for Georgian businesses.

The construction of a new Black Sea Transmission Line (500kV) and the back-to-back station connecting Georgia to the Turkish market is an excellent example of how a strategic public investment in infrastructure could be used as a means of coordinating private investment in the sector. The same model – using public investment along with tax benefits and/or subsidies – has been tried, with various degrees of success, to coordinate the actions of private players in a few other key sectors of the Georgian economy, including **agriculture, tourism** (in Kakheti, Imereti, Svaneti and Adjara), **trade, transport and logistics services** along the corridor connecting Europe to Caucasus and Central Asia (TRACECA). The government's role in developing Georgia's potential as a regional trade hub is the focus of Chapter 3 of this report.

2.4.3 The Macroeconomic Environment Pillar

As discussed in the first chapter of this report, Georgia's macroeconomic outlook is quite positive. Georgia's progress in the 2012/13 GCI rankings is largely attributable to improvement in this pillar (See Figure 2.19).

[30] Given the small size of the Georgian electricity market, the degree of regional market integration is key for new investment in Georgia's generation capacity. There are currently several (internationally, not locally) bankable HPP projects under consideration, however, to be realized these projects need 10-year power purchase agreements upfront and a reliable scheme of connection (interview with Natia Turnava, Georgian Industrial Group, GIG).

[31] Interview with Natia Turnava.

Box 2.3

Road Infrastructure in Georgia

In 2011, a Gallup survey[1] measured people's satisfaction with the road infrastructure in their countries. Only 36 percent of respondents from the Former Soviet Union (FSU) countries gave a positive answer to the question "In the city or area where you live, are you satisfied or dissatisfied with the roads and highway?" As a result, the FSU shared last place with Sub-Saharan Africa in the regional ranking. Interestingly, with 69 percent of Georgians happy with the quality of the country's roads, Georgia not only tops the FSU region in the ranking, but also stands above all regional averages.

Global and Regional averages	% satisfied
Global Average	59
Asia	66
Europe	61
Middle East and North Africa	49
Sub-Saharan Africa	36
Former Soviet Union	36
Country Averages	**% satisfied**
Georgia	69
Uzbekistan	64
Turkmenistan	58
Belarus	52
Azerbaijan	51
Tajikistan	50
Kazakhstan	39
Armenia	37
Kyrgyzstan	35
Russian Fed.	30
Ukraine	27
Moldova	17

[1] Gallup.com. "Former Soviet Nations Aren't Banking on the Dollar."

Georgia emerged relatively unscathed from the global financial crisis and the August 2008 war with Russia. The government was able to stimulate the economy while keeping the budget deficit (ranked 37th in GCI) and inflation under control. Georgia's foreign debt is considered to be sustainable under most realistic scenarios (ranked 53rd).

The Economic Liberty Act, expected to come into force in 2014, is an interesting policy innovation, seeking, according to former Prime Minister Nika Gilauri, "to limit the discretion of the executive branch of government and ensure that the government remains small and limited, and taxes remain low and flat (other than through the sovereign will of the people).[32]" The Liberty Act sets constitutional limits on budget expenditure (at 30% of GDP), budget deficit (at 3% of GDP), and public debt (at 60% of GDP).

Despite these developments, Georgia's country credit rating, BB-, remains three notches below investment grade, which implies that only a tiny percent of global investors are looking at Georgia as a potential target. This also implies that the cost of capital remains high, driving up interest rates.[33] The low credit rating also pulls Georgia down in the GCI ranking (91st). Other challenges related to the macroeconomic environment pillar have to do with the abysmally low gross national saving rate (less than 11% of GDP in 2011, ranked 122nd in the GCI). The low savings rate forces banks to borrow abroad, exposing Georgia to the so-called currency mismatch risk.

There is no simple way for Georgia to increase savings in the short to medium run given the current levels of income and its highly unequal distribution. Based on data from ISET's Consumer Confidence Index survey, the vast majority of Georgia's population is barely able to make ends meet, and the outlook is not necessarily very positive. Given that about 50% of the Georgian population is self-employed or underemployed in seasonal subsistence agriculture, the best strategy to improve income distribution (and, maybe, savings) would be to create higher productivity jobs in the urban sector, while simultaneously promoting cooperation and raising the efficiency of small-scale agricultural

[32] Government of Georgia, Press Release: "Georgia adopts the economic liberty act."

[33] Interview with Dimitri Gvindadze.

production. The greater income equality resulting from such a strategy may also contribute to political stability, thus reducing Georgia's country risk and further improving the macroeconomic environment.

2.4.4 The Healthcare and Primary Education Pillar

The healthcare indices included in this GCI pillar have little relevance for the actual competitiveness of the Georgian economy. In particular, the practical impact on Georgian business of diseases such as HIV, malaria, and tuberculosis is negligible. Life expectancy and child mortality indicators, on the other hand, place Georgia close to the global average, without saying much about the actual state of public health.

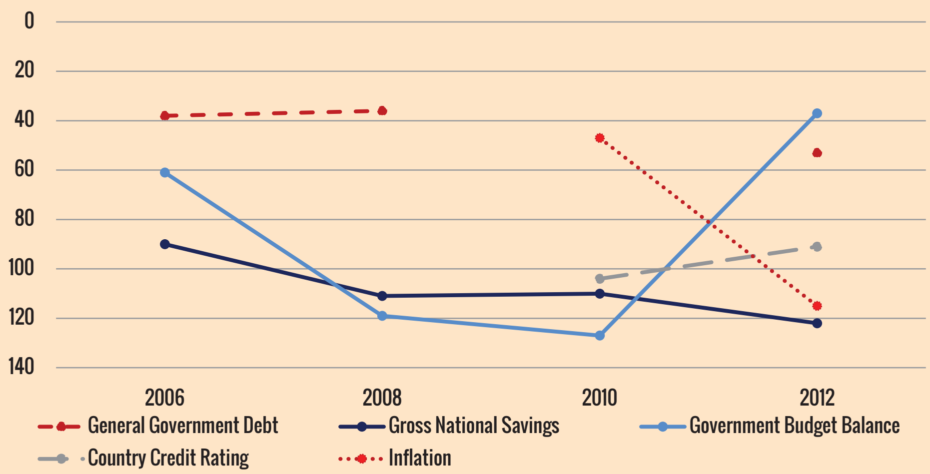
Georgia is yet to reach an institutional optimum as far the healthcare sector is concerned. Sweeping healthcare reforms have been announced and implemented almost every year since 2004. According to the Oxford Policy Management Introduction to Primary Healthcare in Georgia (2008), the initial wave of reforms lacked an integrated approach. For instance, as far as reform of the hospital sector is concerned, "an optimization plan was prepared twice with the support of the World Bank, but has never been fully implemented. Instead of optimizing, the GoG was investing in the rehabilitation of medical institutions. [...] In most cases, some units or departments of separate hospitals were renovated, in fact changing very little overall for the patients, who received part of the service in old buildings without equipment and laboratories, and part better equipped and cleaned parts of the same facilities."[34]

A new government strategy was implemented beginning in 2007, seeking to "to achieve affordability, quality, access and increased efficiency". In practice, the new Hospital Master Plan led to a near complete privatization of health service provision, including the hospital sector, while partially subsidizing health insurance premia and providing additional compensation for the socially vulnerable. The 2010 Hospital Master Plan obliged every insurance company participating in state insurance schemes to be involved in the building and operation of hospitals throughout the country.

According to independent international assessments, e.g. by Oxfam and the World

[34] Oxford Policy Management. "Introduction to Primary Health Care in Georgia - Volume 1."

Figure 2.19 Macroeconomic Environment (GCI rank)



Source: WEF, GCI

Health Organization (WHO), access and affordability remain huge challenges. The state provides insurance coverage for a very small category of the poorest citizens, leaving the lion's share of the low-income population with no coverage and poor access to essential healthcare services. The reforms also created a non-competitive environment, leading to the emergence of a small number of vertically integrated companies that could abuse their market position given the lax regulatory environment.

An assessment conducted by the WHO in 2009 (Chanturidze et al. 2009, p. 102), shares the same concerns while emphasizing the issue of quality:"... MoLHSA [the Ministry of Labor, Health and Social Affairs] currently lacks sufficient regulatory capacity to ensure that even the minimum quality standards are met and there is no policy on the quality of medical services... In addition, there is also a lack of reliable data with which to benchmark or assess the quality of care."

Primary and secondary[35] school education. Like all other post-Soviet states, Georgia maintained almost universal coverage[36] in the primary education sector (99.6%, 7th in the GCI ranking. See Figure 2.20). Post-Rose Revolution reforms triggered considerable investment in school infrastructure, with a focus on the introduction of modern IT technologies (Georgia's current GCI rank on **Internet access in schools** is 65th). However, impressive enrollment rates and improved infrastructure did translate into quality. Georgian children[37] perform worse than their international peers.[38] Out of 74 countries examined, Georgia ranked in the 60-70 range according to various indicators, with math and science performance being particularly weak.[39] These results are consistent with the GCI ranking (91st for **Quality of primary education.** See Figure 2.21).

The thinking behind the first wave of institutional reforms in the education sector was that the quality of education is best enhanced through a voucher system (that induces competition among schools) and greater accountability of school management to school boards. The latter mechanism seems to work in large schools located in the capital, but not further away from Tbilisi. Likewise, the voucher system is unable to induce student mobility in rural areas and smaller towns, where students face higher switching costs due to larger distances between schools. Lump sum subsidies have been introduced in 2010 to compensate small rural schools for higher per student costs. Further out-of-the-box measures, however, would be

[35] Secondary education is actually included in the Higher Education and Training pillar of the GCI, but, given the similarity of the challenges and policy prescriptions for primary and secondary education, we chose to discuss it in this section.

[36] A drop in enrolment rate in primary and secondary education (figure 2.21) was observed in 2012 after hundreds of schools were merged as part of a school optimization program. The impact of this program on the quality of education has yet to estimated, however, it had a negative effect on enrolment rates and the ranking.

[37] Interestingly, Georgian girls are outperforming boys in scientific literacy by a statistically significant margin.

[38] ACER. "ACER releases results of PISA 2009+ participant economies." ACER. "ACER releases results of PISA 2009+ participant economies."

[39] Georgia ranked 65th in Math; 69th in Sciences and 67th in Reading. Unfortunately, the Georgian government reacted to the results of the PISA assessment by opting out of PISA.

Box 2.4

The "PISA Shock" affecting Germany [1]

	PISA 2000 Main Score	PISA 2003 Main Score	PISA 2006 Main Score	PISA 2009 Main Score
Reading	484	491	495	497
Mathematics		503	504	513
Science			516	520

For many years, the German public and policy makers assumed that their county had one of the world's most effective, fair and efficient school systems. They were shocked when the PISA 2000 rankings revealed that Germany stood below the average. The "PISA shock" prompted a series of reforms in the sector. By now, 11 years later, Germany's mean scores and ranking have improved quite a bit.

Germany implemented multidimensional and complex education reforms, targeting the general, primary, and the preschool education sectors. At the preschool level, the reforms focused on children from poor families, ethnic minorities and migrants. The country reformed the preschool education sector to minimize the influence of a student's socio-economic background on his or her achievement. Actions undertaken at preschool level included:

- Supervised by the state and run by municipalities or charities, special programs were developed to increase the level of organized, high quality, affordable language training for preschool age children whose families do not speak German fluently at home;
- A series of legislative changes were introduced to ensure that every child had a place in a kindergarten from the age of three until she or he enrolls in an elementary school;
- The availability of preschools for children under the age of three was improved.

The "PISA shock" is good example how a country may adjust its education system as a result of international benchmarking and how complex reforms targeting the primary and preschool sectors may lead to improved educational achievements.

[1] Livny, Eric, Chitanava, Maka and Doghonadze, Nino. (2012).

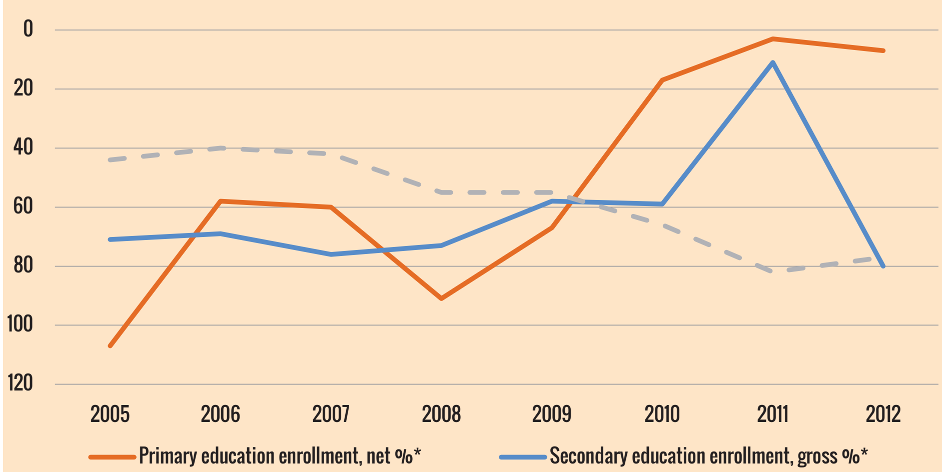
required to bring higher quality education opportunities to rural Georgia.

Additionally, any future reform seeking to upgrade the quality of schooling should include a strong emphasis on improving the quality and coverage of early learning (EL), especially in the smaller towns, rural areas and regions with higher child poverty and large ethnic minority populations. The lack of a uniform approach created problems of inclusion and quality in many Georgian municipalities.[40] Focusing on disadvantaged groups will help achieve the fastest possible progress since they are further away from the national "mean" in terms of learning outcomes. This recommendation is consistent with evidence from international studies, e.g. (Boocock, Spence, 1995). Accordingly, "preschool experience appears to be a stronger force in the lives of low-income … children"[41] and tends to narrow the achievement gap between them and children from better off families by providing equal opportunities for everybody from the very beginning. Importantly, the positive impact of preschool education goes far beyond school performance. Economic research provides ample evidence that investment in EL has one of the highest economic returns to society affecting social skills, educational attainment, including university attendance, professional advancement and earnings (Heckman and Masterov, 2007).

[40] Livny, Eric, Chitanava, Maka and Doghonadze, Nino. (2012).

[41] Boocock, Spence (1995), p.96.

Figure 2.20 Enrolment rates (GCI rank)



Source: WEF, GCI

2.4.5 The higher education and training pillar

Georgia's relatively low ranking (93rd) on this pillar is a key weakness in the country's competitiveness. This finding is further corroborated by the most recent WEF-sponsored Executive Opinion Survey, according to which an "**inadequately trained labor force**" comes second (after "**access to finance**") on the list of problems faced by Georgian businesses. The problem of "inadequate training" is not so much about access to education per se as it is about access to the right kind of education and high quality vocational training.

Prima facie, Georgia's employment outcomes (65% of the working age population is employed) are close to the

EU average, but, in fact, they are far from satisfactory given that a very large share of the workforce is underemployed in low-skill and low-productivity subsistence farming. According to a recent study by the World Bank (Rutkowski, November 2011), Georgia suffers from very high unemployment (16.2% in 2010; 18.8% if discouraged workers are included). Very importantly, unemployment is concentrated in urban areas and among the youth with tertiary education:

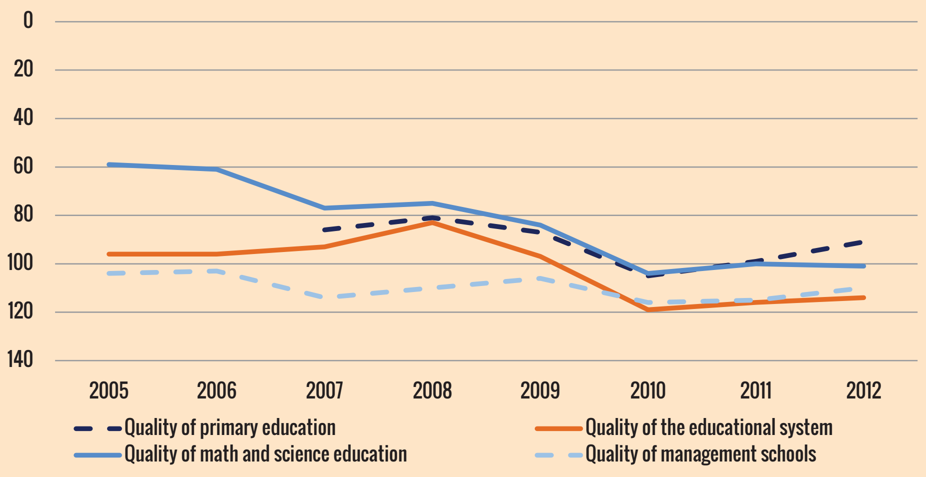
- Urban unemployment – 28.4% | Rural – 9.2%
- Unemployment among people with tertiary education – 22.2% | vocational education – 13.4%
- Youth unemployment – 36.4% | Prime age – 17.4%[42]

The high unemployment figures reflect both a shortage of high productivity jobs and a skills mismatch: a surplus of workers with tertiary and secondary education, and a shortage of people with technical skills. Many of the unemployed have college diplomas, but lack the skills demanded by the labor market.

These outcomes seem to be particularly disappointing if one considers the amount of attention education reforms have received since 2004. The new laws on higher and general education (2004 and 2005) aimed to clean the system from endemic corruption, and improve access and quality. While quality remains a challenge, the first two aims appear to have been fully achieved in a very short timeframe. For instance, the independent National Centre of Education Accreditation, created in 2005, conducted a "quick and dirty" institutional accreditation process, reducing the number of higher education institutions from more than 240[43] to 43. Many of the "institutions" thus shut down were in fact village-based diploma mills, "orghobis universitetebi", as they were called in Georgian.

To eliminate corruption in the university admissions system, the government implemented a rapid admissions reform process in 2005 (see the recent book from the World Bank (2012) chronicling Georgia's reforms for more details). The key element of the reforms was the establishment of the National Accreditation and Examination Center (NAEC) to be placed in charge of conducting a single, centralized, secure and

Figure 2.21 Quality of educational system (GCI rank)



Source: WEF, GCI

transparent entrance examination. In 2009, NAEC was authorized to conduct a similar entrance exam for master's-level studies. The highly successful accreditation and admissions reforms resulted in a reduction of **Tertiary education enrolment** from the peak of 46.6% in 2005 to 28.2% in 2011. Ironically, the GCI punished Georgia for implementing this reform by downgrading it from 44th (in the 2005/6 GCR) to 77th (in 2012/13) on this indicator.

The quality-enhancing aspects of the reform included i) an ambitious institutional accreditation process to eliminate low-quality institutions (see above); ii) introducing competition among universities by adopting the principle of "the money follows the student"; and iii) allowing students to apply to multiple universities in a single academic year.

Despite the success of the early reforms in eradicating corruption and establishing a transparent system of university admissions, the system has been much more resilient to change as far as the quality of teaching is concerned. The new higher education accreditation rules guaranteed that institutions fulfilled minimum standards, but it did not guarantee quality (World Bank 2012). The new, famously liberal, labor code allowed university management to (repeatedly) fire and rehire the entire academic staff, beginning in 2006 and 2007. However, the result was staff retrenchment and public outrage. Some of the better instructors, e.g. in fields such as mathematics, decided not to go through what they considered to be a humiliating process of reapplication. Tbilisi State University tried to attract better instructors by introducing a highly differentiated faculty compensation structure in 2008, but ended up paying more for the same quality of teaching.

The general problems of quality are compounded by a very significant lag with which changes in labor market conditions affect demand and supply in the education sector. To this date, universities continue to produce unreasonably large numbers of diploma holders in business, law, economics, social sciences, humanities, and medicine, resulting in high unemployment among university graduates and efficiency losses for the economy. In 2010/11, the government reacted to the evident labor market mismatch by targeting higher education grants towards technical education, privatizing the agricultural university, and negotiating a major grant with the Millennium Challenge Corporation to upgrade the quality of technical education and the system of vocational training. These latter reforms are yet to bear fruit.

The weakness of technical education and training implies that sophisticated businesses are bearing a higher cost of training, reducing Georgia's attractiveness as a possible destination for investment. Very telling in this regard is our interview with BP's Gia Gvaladze: BP is forced to make a massive investment in training its own staff. According to Gvaladze "Georgians are definitely capable of mastering the necessary skills, however training is expensive. It takes two years to bring a technician up to speed."

2.4.6 The goods market efficiency pillar

Georgia is characterized by a huge variance in its performance on this competitiveness pillar. On the one hand, Georgia is one

[42] Rutkowski, World Bank, November 2011.

[43] Following a botched attempt to reform the system, the number of higher education institutions skyrocketed in 2002. It rose from 26 public institutions (plus 18 branches) to 235: 209 new licenses for private universities were granted in 2002 alone! (World Bank 2012)

of the global leaders on trade openness, tax regime, and formal "easiness of doing business" indicators, such as the time and number of procedures required to register a business. On the other hand, Georgian businesses are operating in a very difficult market environment plagued by a lack of competition and lax regulations allowing for market power abuse (Georgia ranks **141st out of 144** in the 2012/13 GCI on **Effectiveness of anti-monopoly policy**, Georgia's worst performing indicator in this year's report).

Trade liberalization. Georgia scores very well on indicators of trade liberalization: **Trade tariffs, % duty (33rd), Prevalence of trade barriers (21st), and Burden of customs procedures (13th).** Bureaucratic red tape and corruption created significant obstacles for cross-border trading until 2004. Between 2005 and 2012, Georgia implemented a series of aggressive reforms to open up to the rest of the world, as was appropriate for a country aspiring to serve the trade corridor function in the region. Georgia replaced its entire customs personnel; simplified customs procedures; lowered tariffs; modernized border crossings and Customs Clearance Zones (CCZ), equipping them with efficient modern technologies; and created a unified electronic database to allow for random checks (the ASYCUDA system). As a result, crossing borders and clearing customs became easier, safer and faster, reducing the costs for trade and transit operations. Commenting on Georgia's relative advantage in serving trade flows, Nikoloz Gogoli, MAERSK-Georgia General Director, noted that "it takes three days to trans-ship cargo in Turkey because of inefficient customs procedures. The same customs clearance procedure takes minutes in Poti."

Before 2005, 54 documents were required to complete an import procedure; this number was reduced to four in 2009-2010, and only two in 2012. Customs clearance currently requires going through only two procedures taking on average less than one hour, as compared to nine procedures taking a few days prior to the introduction of modern CCZs.[44] In 2012, there were three Custom Clearance Zones with five regional offices throughout Georgia. A special VAT regime, golden lists, certificates of origin, unified personal tax and customs liability accounts are additional services provided for the better functioning of the system. Importing has also become cheaper. Instead of 16 different import tax rates before 2007,

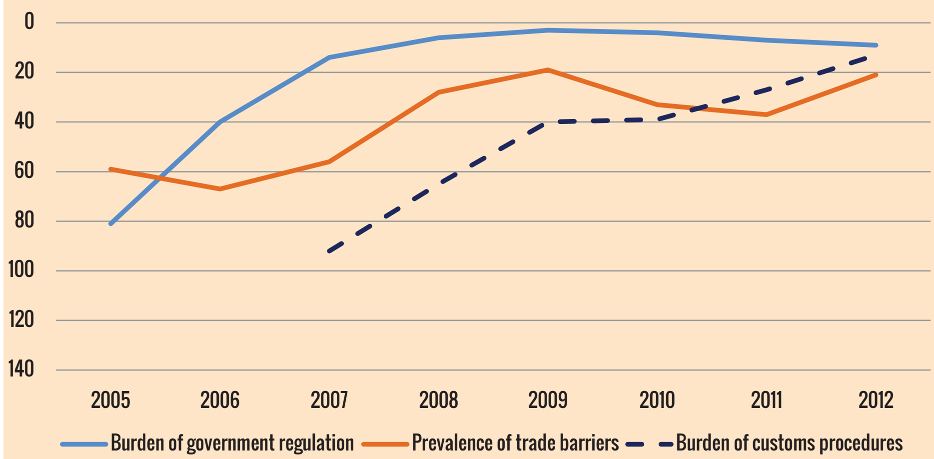
[44] Revenue Service of Georgia, Annual Reports (2010, 2011).

Table 2.4 Reduction of tax burden, 2004-2009

Type of tax	2004	2005	2006	2007	2008	2009
Number of taxes	21	7	7	7	6	6
VAT rate	20%	20%	18%	18%	18%	18%
Personal income tax rate	12-20%	12%	12%	12%	25%	20%
Social tax	33%	20%	20%	20%	0	0
Corporate profit tax	20%	20%	20%	20%	15%	15%
Dividend and interest income tax	10%	10%	10%	10%	10%	5%

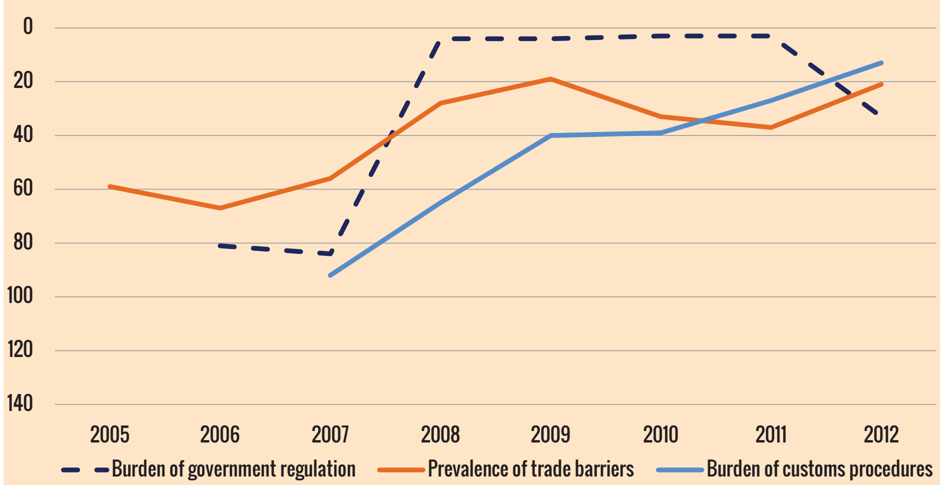
Source: Ministry of Finance of Georgia (MOF)

Figure 2.22 Burden for business (GCI rank)



Source: WEF, GCI

Figure 2.23 Customs reforms in GCI (GCI rank)



Source: WEF, GCI

Georgia currently levies a zero customs rate for 80 percent of imports; other imports are subject to 5% and 12% customs rates.

Taxation. Georgia axed the number of taxes and the overall tax burden after 2004. This did not result in a loss of revenue. Just the opposite: improvements in tax administration and collection, through the creation of a modern Revenue Service Agency, as well as economic growth ensured that government tax revenues increased (quite dramatically) in 2005, and continued going up till 2011, averaging 23.4% growth per year.

Tax and customs codes have been streamlined and merged in 2011, further simplifying business regulations. **Easiness of Doing Business**. The two GCI indicators assessing the easiness of doing business (**Number of days** and **Number of procedures to start a business**) are measured by the World Bank Doing Business index, in which Georgia currently occupies a very respectable 9th position. Georgia is performing exceptionally well on almost all indicators of the Doing Business index, except access to electricity and resolving insolvency, though the latter hardly has any impact on Georgia's actual competitiveness. Table 2.5 below provides a timetable of the major reforms affecting various aspects of the "doing business" environment.

Many of these reforms were associated with the creation of the Public Registry (a one-stop-shop for all matters pertaining to business and property registration), the introduction of e-government services, including tax administration via the Revenue Service webpage, and the creation of the National Bureau of Enforcement under the Ministry of Justice.

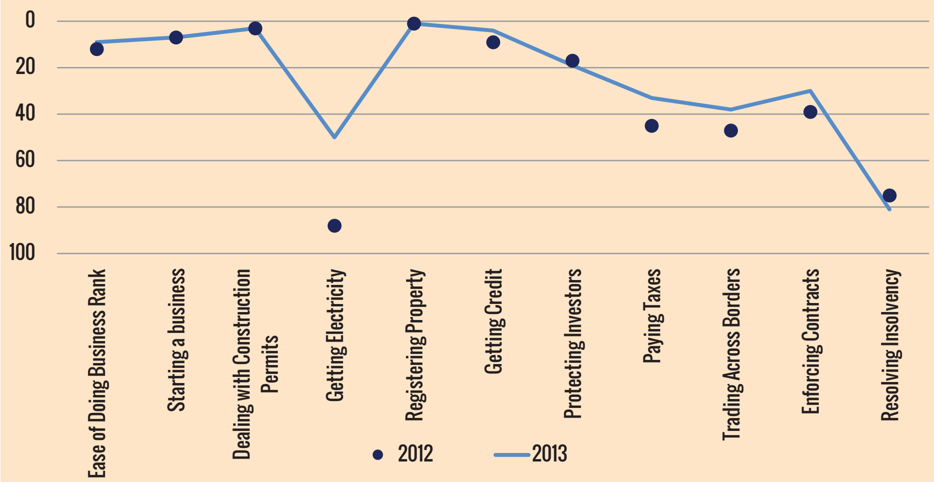
What seems to matter most from the businesses' point of view is captured by two recent surveys conducted by the International Financial Corporation (see Figure 2.25) and the World Economic Forum (see Figure 2.11.F). Both surveys indicate **Access to finance** to be the major bottleneck for Georgian businesses (we come back to this problem later in this section). Both surveys agree that problems with customs and tax administration, trade barriers and corruption have been successfully resolved.

Competition policy. As has been noted above, a perception of market domination by large players[45] and the absence of any anti-monopoly regulation has been Georgia's weakest link both in this competitiveness pillar and overall (GCI rank 141st out of 144). Reacting to criticism from all quarters, the government passed a new law on free trade and competition in 2012 and merged the Free Trade and Competition Agency with the State Procurement Agency. These changes, however, are yet to impact the reality on the ground.

As Livny and Shelegia note, "having less regulation can certainly be a virtue, especially if the regulatory bodies are

[45] See, for instance, Transparency International's Report on Competition Policy in Georgia. The report has been criticized for a lack of methodological rigor (Fuenfzig, Michael, "Competition in the Georgian Retail Gasoline Market"), however, it did reflect a common perception among businesses and Georgian civil society groups at the time of publication.

Figure 2.24 Georgia in Doing Business Survey



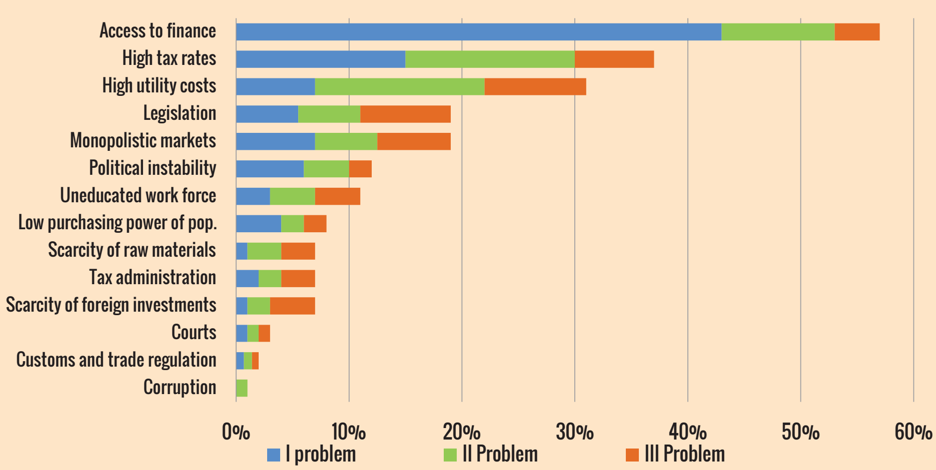
Source: WB Doing Business Survey

Table 2.5: Timetable of "Doing Business" reforms in Georgia

Type of reform	2008	2009	2010	2011	2012	2013
Starting a business	√	√			√	
Dealing with construction permits	√		√			
Getting electricity						√
Registering property	√	√				
Getting credit easier	√	√		√	√	√
Strengthened investor protections	√			√	√	
Paying taxes		√			√	√
Trading across borders			√			√
Enforcing contracts				√		√
Resolving insolvency	√			√		√

Source: The World Bank Doing Business

Figure 2.25 Problems faced by businesses in Georgia



Source: IFC, 2012

Box 2.5

The sale of Tbilisi city's underground wired network to a private company in 2007 is a telling example of an unconstrained monopolist using his position to expand to downstream markets.

The underground wired network of any city falls under the "essential facility" definition since fixed-line telephony and internet companies must have access to the network in order to operate. Moreover, it cannot be replicated at a reasonable cost, and any attempt to do so would constitute a wasteful duplication of existing infrastructure. As could be expected, the company continued to expand downstream, by purchasing the lion's share of the formerly state run fixed line telephony company of Tbilisi and entering the internet service provision (ISP) business. The next step was to dramatically increase the usage fees for competitors in the ISP sector, triggering consolidation and near monopolization of this industry.

incompetent, inefficient and corrupt."[46] As part of the "deregulation" blitz in 2005, the Georgian government abolished the antitrust and consumer protection agencies for their notoriously incompetent and corrupt conduct. Only two sectors remained closely regulated after 2005: telecoms (by the Georgian National Communications Committee) and energy (by the Georgian National Energy and Water Supply Regulatory Commission). The Free Trade and Competition Agency, which was created in 2005, had the goal of preventing government agencies from meddling with competition, i.e. performing a deregulation function.

Having no regulatory mechanisms in place could eventually slow down economic development, leaving small private firms vulnerable to unfair competition, and forcing individual consumers to pay higher prices for lower quality goods and services. Two competition policy-related challenges seem to be facing Georgia in the near term. The first one is restricted access to "essential facilities" that have been privatized in recent years without adequate regulatory constraints on future pricing and access strategy. Examples of such essential infrastructure facilities are underground communications (in large cities such as Tbilisi), air[47] and sea ports. An unconstrained monopolist in possession of an essential facility is very likely to drive out its competitors in the "downstream" markets by charging inappropriate access fees, harming competition and, subsequently, consumers.

The second major issue is uncompetitive behavior of large firms in potentially competitive markets, resulting in consumer abuse. Suspicions of such anti-competitive practices have been widely debated in the Georgian media in recent years, e.g. concerning the pharmaceuticals and gasoline markets. The pharmaceuticals market had been shielded until 2009 by an unnecessary import licensing requirement, leading to the creation of an oligopolistic situation with three vertically integrated companies dominating the market. The licensing requirement was lifted in 2009, facilitating entry by a fourth company and a reduction in consumer prices. At present, while the largest three companies (Aversi, PSP and GPC) admit to cooperating on the import of drugs (to get larger discounts from international producers[48]), there has been no evidence, structural or behavioral, for any anti-competitive practices such as price collusion in this market. The pharmaceuticals market example should serve a reminder that regulation should be approached with a lot of caution. Overzealous regulation of a budding industry, such as pharmaceuticals, can do more harm than good.

The question of future competition policy is currently being debated by the Georgian parliament and stakeholders. According to Michael Fuenfzig, "Georgian competition authorities can rely on two strategies. One, to give incentives to cartel members to whistle blow, and incentives for cartels to break up by themselves. Second, to not focus on detecting cartels or monopolies but to create an environment that reduces the probability of successful and stable cartels or monopolies."[49]

As argued by Fuenfzig, the first strategy is based on an acknowledgment of the fact that "virtually all cartels that have been detected have so because criminal evidence has surfaced. Here sticks and carrots can do the trick: competition law should provide immunity to whistleblowers and those who cooperate with the competition authority, and should provide substantial penalties to those whose misconduct has been identified." The second strategy is much broader, involving not just competition authorities, but also other institutions and policymakers. "In a narrow sense competition authorities have to ensure that existing firms, in particular those with a dominant market position are not abusing their market power. This in particular includes restrictions on anticompetitive practices and merger controls. In a broader sense, the likelihood of cartels and monopolies can also be reduced by creating a market framework that encourages competition. For a small economy such as Georgia this means open borders and free trade, ensuring that Georgian firms face competition from abroad. It also means low entry barriers for new firms, raising the likelihood that sectors with excessive profits will attract new firms and new competitors."

To reiterate, to further advance Georgia's competitiveness on the **Goods market efficiency** pillar, the new Georgian administration would have to move beyond formalities (such as the number of days to register a business) to creating a level playing field for Georgian businesses. In particular, this would require restricting the possibility for government agencies to harass private businesses, ensuring that unregulated state-owned monopolies, such as Georgian Railway and Georgian Post, crowd out private competitors[50], introducing effective (but not overly draconic) competition laws and, last but not least, strengthening the autonomy and professional capacity within the Georgian judiciary.

2.4.7 The Labor Market Efficiency Pillar

Georgia's current GCI rank in the ease of "hiring and firing practices" and "redundancy costs" (weeks of salary an employer is required to pay a dismissed

[46] Livny, Eric and Shelegia, Sandro, "Under-regulation in Georgian economy", ISET Policy Brief, 2008.

[47] A possible monopolistic bottleneck was reported to us in an interview with John Braeckeveldt (Gosselin Group) concerning ground handling services in Tbilisi International Airport.

[48] Interviews with Irakli Purtseladze and David Khiladze.

[49] Georgia Today, "A new competition policy for Georgia."

[50] A blog post by Transparency International-Georgia alleges that: "With the help of the Finance Minister's order the Georgian Post has assumed an advantageous position on the market". A similar concern was shared by John Braeckeveldt (Gosselin Group). According to him, Georgian Post's trucking service was allowed privileged access to Customs Clearance Zones (CCZ), resulting in loss of business for private freight movers.

worker) are 9th and 13th, respectively. Considered a major achievement by the previous Georgian administration, liberal labor regulation has become a major bone of contention between the UNM and its many critics, including local labor unions, the International Labor Organization (ILO), the European Union (EU) and the US. A common concern is that the current labor code strengthens employers' positions while undermining the rights of employees. The fact that Georgia's "flexible" labor market has failed to create jobs in recent years strengthens the pro-labor voices in the ongoing public debate.

As argued by Alexandre Bluashvili, "It took independent Georgia six years to make the first amendments to the Soviet labor code. However, even after the 1997 amendments, the core of the code remained intact with communist-style provisions directly contradicting the free market spirit and principles. The labor code has been finally revamped after the 'Rose Revolution'. In 2006, the new government abolished almost all of the regulations concerning the labor market. Containing only 55 paragraphs, the Georgian labor code appeared to be among the world's shortest and most liberal. Ignoring recommendations from the European Commission and ILO standards, the Georgian government chose to stick to the more market-oriented US model. The labor code adopted in 2006 (which is still in force) gives employers the freedom to dismiss employees without supplying any explanation. Georgian employers are only obliged to provide a one month severance pay, something which presents no significant relief to those who have lost their jobs."[51]

As reported by Bluashvili, "while not introducing a minimum wage requirement, the new draft labor code which has been presented to the public by the new Georgian government in February 2013 does include stricter non-wage regulations, making the life of Georgian employers more difficult." A detailed analysis of the recently proposed amendments has also been furnished by Transparency International Georgia.[52] Accordingly, the most important changes concern employment agreements, less flexibility to keep employees at work beyond normal working hours, and stricter rules for dismissal.[53] Although providing greater job security, these changes will increase the rigidity of the labor market and push up labor costs.

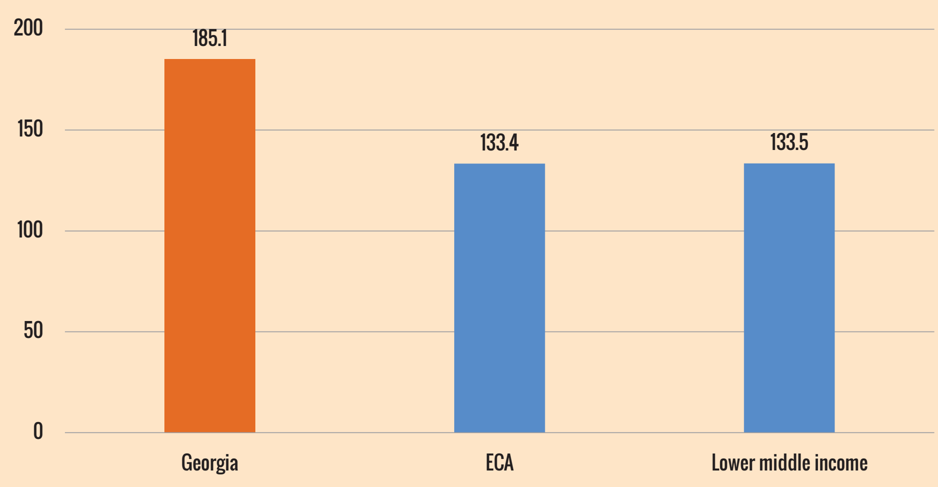
The new labor code has also been the subject of analysis by ISET-PI's Maka Chitanava. According to her, the main goal of the proposed amendment "is to make it more difficult for employers to fire staff without reason or for a wrong reason (e.g. discrimination on the basis of gender, ethnicity and/or political preferences). Yet – and this is a crucial point – it will also make more it more difficult for employers to dismiss workers for other, legitimate reasons. This will be particularly the case since the new draft law provides a restricted list of specific violations that are recognized as valid causes for contract termination, therefore further limiting employers' capability to fire employees.[54]"

On the one hand, at least in theory, excessive ease of firing might reduce the incentives for workers to invest in firm-specific human capital, leading to a lack of loyalty, low morale, and low productivity. Yet, as Chitanava argues, in the fast-paced modern business environment, firms have to have the ability to swiftly and flexibly react to changes in market conditions, and any tightening of the firing procedures lowers the flexibility of employers to react to such changes. Another justification for light regulation is that hiring is done in a situation of "information asymmetry". Employers can never be sure that a person is really suitable for the job. If, unfortunately, this turns out to not be the case, employers would like to be able to fire staff as easily as possible.

It is also crucially important to understand that some of the proposals currently on the table are not entirely positive, even from the workers' point of view. For example, an issue that is often overlooked is that tighter regulation of labor relations and employment contract dissolution may result in the division of the labor market between the segments of permanently employed and relatively well-protected "insiders" and a group of disadvantaged "outsiders". The reason for this is that a tightening of dismissal procedures may have a negative effect on the creation of new employment opportunities. Thus, the job security of insiders will be achieved at the expense of outsiders not being able to enter the labor market. This, according to Rutkowski (2003), was the case of Croatia, where "low hiring is a mirror image of low firing and considerable job stability enjoyed by the insiders. The high level of protection of the interests of those who have jobs substantially raises implicit labor costs and, consequently, makes employers reluctant to hire new workers. Those who pay the price are the outsiders: new entrants to the labor market (mainly youth) and job losers."

At the aggregate (macroeconomic) level, existing evidence suggests that stronger employment protection does lead to less job reallocation – an important condition for effective structural change and modernization (Haltiwanger, J., Scarpetta, S. and Schweiger, H. 2010). However, the extent to which it slows down economic growth is not certain. So, while it is certainly

Figure 2.26 Value of collateral needed for a loan (% of the loan amount)



Source: Enterprise Survey, 2008

[51] Bluashvili, Aleqsandre, "Thou Shall Work or Thou Shall not Eat."

[52] Transparency International Georgia. "Planned changes to the Labor Code."

[53] According to TI-Georgia's analysis, "The notorious Article 37, which regulates termination of contracts, has changed to a great extent. The main change is that the concept of 'annulment of contract' (which implied termination of contract on the initiative of one of the parties) has completely disappeared, and it no longer constitutes grounds for terminating a contract. Therefore, the employer is no longer entitled to dismiss an employee without indicating the grounds (it should be noted that an employee may leave the job without naming a cause), and these grounds must be envisaged in this code. Article 37 contains a list of the causes of terminating a contract."

[54] Chitanava, Maka. "The Georgian Labor Code: Real Challenges and False Myths"

true that tighter labor regulation will affect the managerial practices and the relative strength of employers and employees, the final outcomes for employees, firms and for the entire economy, are far from clear.

In the end, job security, better working conditions and decent wages are best secured in a fast growing, competitive environment in which employers hunt for talent and seek to nurture and retain it. If unreasonably stringent and excessively "well" enforced by the courts, tighter labor market regulation may lead to a lose-lose situation, preventing Georgia from creating such an environment and moving up the ladder of economic and human development. Thus, it would be best for the country to avoid moving from one extreme to another by basing labor market regulations on the careful monitoring and evaluation of the effects of implemented policy changes, rather than on ideology or pre-existing beliefs.

2.4.8 The Financial Market Efficiency Pillar

Georgia's current GCI rank on the **Financial market efficiency** pillar (93rd) is among the three lowest in the "Efficiency Enhancers" sub-index, along with **Higher education and training** and **Market size**. This is not at all surprising given that Georgia currently offers a limited range financial services, does not have an equity market, and venture capital is nowhere in sight. In this regard, Georgia's situation is not much different from most other small nations.

As discussed in the first chapter of this report, Georgia's banking sector is actually quite healthy, though this is not reflected in the country's rank (92nd) on the **soundness of banks** GCI indicator. This view is confirmed by Fitch's James Watson, according to whom, "most of the country's lenders have relatively strong foreign owners, and smaller, less profitable institutions are for the most part under limited near-term pressure to deliver improved performance."[55]

Two major issues for Georgian businesses (and households) are **Ease of access to loans** and **Affordability of loans**. To reduce lending risks, Georgian banks started cooperating on the creation of a private credit bureau in 2008 in order to track borrowers' credit history. According to the World Bank's Doing Business Survey, this measure reduced the number of defaults, lowered borrowing risks and, accordingly, interest rates. In addition, a central collateral registry equipped with an electronic database was created in 2010, further reducing transaction costs and default risks for the banks. The new regulations guarantee the right of borrowers to inspect the data registered in the private credit bureau, helping to improve the quality and accuracy of credit information in Georgia.

Additional amendments to the Civil Code were introduced in 2011 in order to improve access to loans. In particular, Georgia expanded the range of assets that could be used as collateral and allowed parties to agree to out-of-court enforcement of the creditor's security rights. While indeed helping lower interest rates since 2010, these measures could not overcome the fundamental factors that negatively affect financial sector development in Georgia. First and foremost among these factors are the lack of domestic savings and Georgia's country credit rating (three notches below investment grade), as discussed earlier.

Contrary to recent allegations, the persistence of high lending interest rates cannot be attributed to a lack of competition or collusion among the largest actors in the banking sector. If anything, Georgia may be over-banked for a small economy, with 18 credit institutions currently registered. "Putting it simply", says Watson, "there is just not enough banking business in the country to sustain so many banks." A similar opinion has been recently expressed by Michael Fuenfzig: the "Georgian banking sector might almost be too competitive, as too much competition discourages long-term lending relationships between clients and banks."[56] Our interview with George Glonti, Kor Standard Bank's CEO, offers strong support to this view. According to Glonti, "the cost of financing is still very high in Georgia, one of the highest in the world. Banks are ready to pay for term deposits about 9-10%. Considering the NBG reserve requirements, the effective cost of this funding is 1 or 1.5% higher. The Bank of Georgia was able to issue Eurobonds at 7.5% and thus faces lesser reserve requirements, however it also needs time to process new loans, which implies an additional cost. Interest rates on loans are in the 14-18% because of cut-throat competition among banks. Margins are very low and decreasing, not consistent with the existing level of risk – we are far from investment grade."

2.4.9 The Technological Readiness Pillar

From 2005 to 2012, Georgia experienced consistent, albeit modest, improvements in the **Technological Readiness** pillar, mostly on the back of improvements in ICT service quality and prices. Progress was particularly impressive in 2012/13 – jumping from the 100th to the 76th position in just one year. Improvement in the GCI score was also quite strong (0.5 points), second highest after the **Macroeconomic Environment** pillar (0.7 points).

Much of this progress, however, resulted from a technical change in the composition of this pillar. The 2012/13 GCR added **Mobile broadband subscriptions/100 population** to the **Technological Readiness** pillar, on which Georgia ranked 48th given the relatively high penetration of mobile internet services. Changes in all other indicators cancelled each other out, with **firm level technology absorption** going down from the 115th rank to the 123rd, and **Individuals using internet**, % moving up from the 85th to the 75th position.

Thus far, Georgia's progress on the technological readiness pillar has been mainly a story of internet and mobile telephony penetration. Foreign direct investment into the Georgian economy was growing very fast prior to the August 2008 war with Russia, however it was not targeted towards the more technologically advanced sectors of the economy and did little to promote productivity and technology transfer. The real estate bubble – the main target for FDI prior to 2008 – burst in 2008. The FDI level fell dramatically in 2009, and has never fully recovered since. Moreover, FDI has been declining throughout 2012, in the run up to the parliamentary elections and in their aftermath, given the high level of political and policy uncertainty. Our interview with Fadi Asly, Chairman of the International Chamber of Commerce, reaffirms this point. According to Mr. Asly, foreign and domestic investors continue to be worried by what he referred to as "booby traps planted by the previous government", such as loan guarantees used to finance ambitious investment programs, as well as the political vulnerability of the incoming government which could translate into populist policies and macroeconomic destabilization in the face of rising labor protests.[57]

To some extent, the problems of low firm-level technology absorption and technology transfer through FDI are closely related to the shortage of experienced technical

[55] Georgianews.ge, "Fitch Finds Georgian Banking Sector Over-banked."

[56] Georgia Today, "A new competition policy for Georgia."

[57] Interview with Fadi Asly.

personnel. Investment in relevant kinds of human capital is preconditioned by the existence of technology-intensive jobs. In other words, progress on the **Technological Readiness** pillar requires investment in both capital and high skilled labor. A vicious circle. The second contract the Georgian government signed with the Millennium Challenge Corporation has been designed to cut this Gordian Knot by using $100mln of US Government funding to upgrade technical education and vocational training. However, this investment may only prove effective if the private sector quickly reacts to this initiative by investing in skill- and technology-intensive manufacturing. If this happens quickly enough, the Georgian labor market will be able to absorb new workers, creating a virtuous circle of sustained demand for, and supply of, technical education and training.

For now, however, FDI and technology transfer is limited to a very narrow segment of the Georgian economy – the energy sector, trade/transport logistics and light manufacturing. The former two sectors are developing thanks to Georgia's hydropower potential and strategic location on the trade and energy transport route from Central Asia and Azerbaijan to Turkey and Europe. Investment in the energy sector happens despite Georgia's human capital deficiencies; companies are willing to invest considerable amounts of money in specialized training.[58] BP, to take one example, is currently in the process of implementing a major expansion of the South Caucasus Pipeline (SCP) transporting gas from the Shah Deniz field in Azerbaijan to Turkey. In addition to massive investments on the Caspian end of the pipeline, BP plans to invest more than $2bln in pipelines and two new modern compression stations in Gardabani and Tsalka, creating more than 2,000 jobs in these two regions.

Georgia has also been able to attract FDI into light industries, such as food processing and apparel. While not exactly "cutting edge" from the technology absorption point of view, these industries take advantage of Georgia's unique agricultural products (a good example is Hipp Georgia[59]), as well as cheap labor and EU export quotas. For instance, Turkish firms started investing in Georgia's textiles (producing for global brands such as Nike and Puma), thus adding to their own EU quota.

[58] Interview with Gia Gvaladze.

[59] According to information on Hipp Georgia Ltd's website, the company had begun as an organic agriculture business in Meskheti and Racha-Lechkhumi. Since 2009 it has been producing organic and conventional apple clear juice concentrates at its own processing factory, which are exported to Europe.

2.4.10 The Market Size, Business Sophistication and Innovation Pillars

Georgia's performance in the last three pillars in the GCI stagnated at a very low level ever since joining the WEF in 2005. We discuss the market size pillar in the next chapter of this report in the context of promoting Georgia's potential as a regional trade hub. Indeed, reducing trade and transaction costs and developing relevant infrastructure seem to be the best ways to quickly advance on the **external market size** indicator of the GCI.

The last two pillars are part of the third, **Innovation and Business Sophistication**, GCI sub-index. Given the current state of Georgian economic development (per capital income level), this sub-index is assigned a very low weight of 10% in the overall GCI ranking. Competitiveness on the **Business Sophistication** pillar could, in principle, be promoted through coordinated, public-private investment in budding industry clusters, such as electricity generation, and downstream electricity intensive sectors; trade and logistics; tourism and hospitality industries; light industry (apparel); and agribusiness. The latter is a clear priority of the new government, supported by the EU, USAID, Sida and other bilateral donors. Hence, we are likely to see improvements in the institutional foundations of the agricultural sector, including the strengthening of farmers' cooperatives[60], sophisticated "aggregators" linking farmers to processing plants and large retail chains. Similar developments are to be expected in the trade and logistics industry – the subject of the third section of this report.

2.5 Conclusions and policy recommendations

Taking power in 2003, Saakashvili and the United National Movement (UNM) faced an empty treasury, an inept and corrupt bureaucracy, a lack of basic infrastructure, poverty and inequality. That same year, Transparency International ranked Georgia next to Azerbaijan on its Corruption Perceptions index, behind Ukraine and Armenia. Within the span of two years, in 2006, Georgia was named the number one reformer in the world by the World Bank Doing Business survey.[61] Reforms implemented by the Saakashvili administration during this period targeted all spheres of public policy: establishing a professional police force and military; cleaning up the judiciary; reducing taxes and simplifying tax administration; liberalizing trade policy; slashing business regulations and licensing requirements; developing critical infrastructure; and improving healthcare, education and social security. Within a very small number of years, these reforms "transformed Georgia ... into an emerging middle-income, market-oriented economy".[62]

[60] Strengthening farmers' cooperation is a specific objective of the EU's 5-year ENPARD program.

As our analysis shows, the first wave of law and order, anti-corruption, liberalization and deregulation reforms cleaned the slate for future development. However, barring very recent improvement in the **Macroeconomic environment** pillar, Georgia's reforms and its progress in the overall GCI rank stalled after 2008. While infrastructure continued to improve in later years, there was a regress or stagnation in most other indicators, including the **Institutions** pillar, progress on which was the main early achievement of the Saakashvili administration.

Georgia may by now have a relatively effective and lean state apparatus, but its economy is anything but modern. Further gains in productivity are not conceivable without improvement in human capital and massive private investment, foreign and domestic. Only in this way will Georgia be able to create better employment opportunities for the country's rural population and youth. Yet, the low level of physical and human capital (per capita) are not a problem in and of itself. If all other factors were there, one would predict large inflows of capital goods and a high level of training (financed by foreign borrowing), because returns to investment would be high. **The reason we do not observe an investment rally in Georgia is the same as in many other developing economies: low Total Factor Productivity (TFP).** What TFP measures is a country's ability to make efficient use of production factors, capital, land and labor. Countries characterized by high TFP can produce more with the same resources, and are therefore able to provide higher returns on investment and grow faster.

[61] Djankov, Simeon (2006).

[62] The World Bank. "Fighting Corruption in Public Services: Chronicling Georgia's Reforms."

Doing business in Georgia is difficult for objective reasons such as small market size and a lack of reliable suppliers. On top of that, until recently, these objective problems have been compounded by (perceptions of) anti-competitive practices, favoritism in decisions of government officials, and overly compliant judiciary. Reflecting these widely shared concerns with the rule of law and property rights protection, FDI fizzled out in the course of 2012. Finally, the government's failure to guarantee property rights and promote social justice has led to a disillusionment with liberal reforms, feeding into political uncertainties, another major factor in investors' decision-making.

To reignite investment and economic growth, the new Georgian government faces a very challenging reform agenda:

INSTITUTIONS: progress on this pillar stalled after 2008. Key weaknesses are judicial independence (current rank 95th), efficiency of the legal framework in challenging the legality of government actions and/or regulations (106th), and property rights protection (131st). Georgia's GCI ranking on these crucial indicators is consistent with the self-assessment by Minister of Justice Tea Tsulukiani, recent reports by the American Bar Association, and ISET-PI own analysis (see Babych and Fuenfzig, 2012).

INFRASTRUCTURE: Georgia achieved very impressive and uninterrupted improvement under this pillar (93th to 53th), particularly as far as electricity supply is concerned (111th to 46th). The new government remains committed to completing ongoing investment projects in transport and logistics infrastructure which has spillovers to all sectors of the economy. Georgia's strategic location justifies continued public and private investment in pipelines and electricity transmission infrastructure.

MACROECONOMICS: Georgia's fiscal and monetary policies have been prudent in the past, contributing to Georgia's progress on this pillar. Strikes and labor protests in late 2012 presented a grave threat to macroeconomic stability and Georgia's competitiveness. On the one hand, the new government has to manage expectations and resist populist measures aiming to achieve quick political results. On the other, it has to target the cost of financing by improving Georgia's country credit ratings (91st) and implementing banking sector reforms. Promoting productivity in the rural economy might be considered a low hanging fruit as far as progress on investment risks and demand conditions is concerned. For instance, a relatively minor investment in streamlining and organizing primary agricultural production and processing would pull significant human resources from subsistence farming into official employment, raising labor and land productivity, and inducing a more equitable income distribution. Higher incomes will translate into improved demand conditions (domestic market size - 96th) and savings (122th).

HEALTHCARE AND PRIMARY EDUCATION. Riding on its Soviet heritage (high percent of doctors in the population, universal schooling), Georgia is ranked relatively high on this pillar, however, no progress has been achieved on this pillar since 2005. In particular, a very high share of the population is exposed to catastrophic health risks (only the "very poor" are insured). While primary education coverage is near 100%, Georgia's new education strategy should consider out-of-the-box solutions to improve the quality of primary schooling outside Tbilisi and expand access to pre-school education for rural households and ethnic minorities.

HIGHER EDUCATION AND TRAINING: Georgia implemented very successful anti-corruption reforms in higher education by linking admissions and financial aid decisions to rigorous national tests; launching a crackdown on flagrant diploma mills; and allowing for easier firing and hiring of academic personnel. However, these reforms did not produce any notable improvements in the quality of higher education. General university education remains oversubscribed, resulting in labor market mismatch and youth unemployment. On the one hand, the new education strategy should employ public funding to prioritize technical education and vocational training. On the other hand, the government should admit to its inability to mandate quality improvements through the accreditation mechanism and, instead, promote public-private partnerships involving university departments and future employers.

GOODS MARKET EFFICIENCY: Georgia made excellent progress on trade liberalization, reduction of the tax burden and compliance costs for businesses. Despite these achievements, Georgia is notorious for the quality of its anti-monopoly policy (current rank 141st). There might be a natural temptation for the new administration to copy-paste European competition laws and institutions. Yet the government should be aware of concomitant costs and corruption risks and exercise great caution in reforming the liberal legal framework. While competition (127th) is likely to remain a limiting factor for Georgia given its small market size, the best way to achieve progress on this indicator would be for the government to avoid competing with the private sector through the creation of state (or state-sponsored) monopolies and thus ensure level playing field among businesses (extent of market dominance currently 121st).

LABOR MARKET EFFICIENCY: Georgia is a global leader in the ease of hiring and firing practices and redundancy costs (9th and 13th). The new government has to safeguard these achievements while amending the labor code. Measures like minimum wage requirement and very strict firing regulations may backfire by hurting the poorest. The best approach would be to advance in small steps and evaluate impact on job creation and wages.

FINANCIAL MARKET EFFICIENCY: The cost of financing is a major bottleneck for the Georgian economy. And yet, the Georgian banking system is sound, reasonably competitive and well capitalized. The new government must improve access to loans (93th), reduce lending interest rates, and expand the range of available services, however, achieving progress on these indicators is easier said than done. Lacking in domestic savings, Georgia is forced to borrow abroad and is thus facing a grave currency mismatch problem. This problem, in turn, translates into exchange risks for Georgian firms (which mainly borrow in foreign currency) and credit risk for domestic lenders. These risks are particularly grave given the large external imbalances facing the country. The government and the National Bank could target these risks by building trust in the local currency and encouraging the accumulation of GEL-denominated liabilities by Georgian banks. If these measures prove ineffective, the government could consider the option of establishing a currency board or adopting the USD or the euro as the official legal tender.

MARKET SIZE, BUSINESS SOPHISTICATION AND INNOVATION: Starting from low levels of development, Georgia has not been able achieved much progress on these pillars of competitiveness. While increasing domestic market size will objectively require time, Georgia could gain in access to external markets by improving transport, trade and communication links to its immediate neighbors (particularly, Russia), promoting trade integration with the EU, and developing its potential as a regional hub economy – the topic of the last chapter in our report!

3. TOWARD A MULTI-SECTOR REGIONAL HUB

The gains in Total Factor Productivity (TFP) Georgia experienced following the Rose Revolution can be largely attributed to rapid improvements in basic competitiveness conditions such as infrastructure, the institutional and macroeconomic environment. However, further progress may stall for genuine reasons, even with the best institutions and enviable macroeconomic stability. One of these is "external economies" or "productivity spillovers" that cannot be internalized by private agents and may require government intervention. For example, the productivity of investment in hydropower generation depends on the availability of trained personnel, road access, transmission infrastructure and access to markets. Thus, investment in hydropower plants (HPPs) will only happen if other, "external" pieces of the puzzle are guaranteed to fall into place at the right time. Understandably, the presence of external economies calls for an effort by the national, and in some cases regional governments, to solve the coordination problem.

This chapter investigates the policy options available to a benevolent social planner aspiring to exploit Georgia's strategic location on the crossroads between Europe and Central Asia. The idea of transforming Georgia into "a multi-sector hub for the Caucasus and beyond"[63] has recently gained a lot of currency in the policy circles. Yet, as we argue in this chapter, implementing the "hub" strategy will require a sustained coordination effort and significant public investment to overcome very strong external economies. While our primary focus is on trade and logistics, the same logic applies to other sectors of the Georgian economy, such as, hydropower, tourism, agribusiness and light industry.

[63] Invest in Georgia, National Investment Agency, October 2012.

3.1 Lean and hungry: social planning on a shoestring

3.1.1 Low TFP, spillovers and coordination failures

Economic externalities have been long known as a chief reason for market failure and a legitimate cause for policy intervention. Of particular interest to us are economies of scale that are external to individual economic actors. It has been observed that many industries are characterized by complementarities. This means that the productivity of an individual enterprise improves when other players in the industry increase economic activity.

Illustrating his point about the interaction of economies of scale and trade, Krugman (2011) cites the example of the incredible geographic concentration of production. It is mind-boggling to imagine how the Chinese town of Qiaotou produces 60% of the world's supply of garment buttons. It is not only China that offers such incredible examples of industry concentration. Italian firms in the "chair triangle" in Udine manufacture 30% of the world's chairs.

It is important to realize that for every example of a successful industry there may have been many potential industries that just never started. There is an obvious coordination problem when private entrepreneurs are left alone. If my business can only flourish in combination with your business and vice versa, one of us must start business first in order to make the other one profitable. If both of us are reluctant to risk our fortunes and reputation, and there is no way for us to coordinate on a mutually beneficial outcome, no investment may occur.

Another example of great relevance for Georgia is provided by Acemoglu (1996). If the total productivity of a business depends on the quality of equipment (e.g., IT) and the competence of its personnel, the business owner is likely to invest in better equipment if there are reasonable chances of employing skilled workers. But the entrepreneur may have a hard time hiring skilled workers if they are few and far between. This makes the profitability of investment in expensive equipment dependent on the average human capital of the labor force. On the other side of the labor market there are potential entrants whose decision to invest in skills depends on the likelihood of being able to utilize them and get rewarded by a high productivity job. There is an obvious coordination problem. If enough workers decide to train, it makes sense for entrepreneurs to upgrade their capital stock, and vice versa. However, if entrepreneurs do not upgrade their equipment, the workers will choose not to invest as well. Both a vicious and a virtuous circle are possible in this situation.

Coordination problems can be resolved, for example, by private local associations or chambers of commerce, if the externalities are sufficiently local or specific to a particular sector. In the above example of the two mutually-dependent investment projects, a private association may facilitate communication about the nature of the problem and enforce mutual commitments, thus causing both businesses to start at the same time. This is referred to as internalizing the externality. It may well be that the externalities are spread over such large swathes of firms or territories that it is nigh on impossible to bring all the beneficiaries to the same negotiation table. In these cases the government may need to step in. Coordination can be helped by targeted subsidies or public investments. Cooper and John (1988) have categorized coordination failures on the macroeconomic scale and discussed the ways to achieve coordination.

The external effects are far from being an obscure theoretical concept. They may well be the main determinant of the pace of global economic growth. As argued by Rivera-Batiz and Romer (1991), the importance of coordination rises in

Box 3.1

Social planning in the presence of productivity spillovers[1]

Related economic activities can have a mutually reinforcing effect on each other. Economists say that these activities have "positive externalities." The classical example is Silicon Valley in California. Because there are so many companies working on software and computer technology in what was previously known as Santa Clara Valley, it is a highly attractive place for new companies that are active in the same fields. You need a programmer specialized in 3D graphics programming? He or she can be found in Silicon Valley. You are searching for a company that provides a highly specialized software solution for an electronic commerce application? No problem, they are in Silicon Valley. You are looking for cooperation partners for technology projects and companies with expertise that complements your own? Guess where you can find them...

Ever since Silicon Valley so overwhelmingly succeeded as an information technology hub, countries all over the world have tried the same approach. Some, like Israel, did very well, while others are now left with empty industrial parks and lots of wasted subsidies. Nonetheless, it is clear that government policies may play an important role in promoting private investment, as there is an obvious coordination problem when private entrepreneurs are left alone. If my business can only flourish in combination with your business and vice versa, one of us must start his business first in order to make the other one profitable. If the government coordinates these efforts, for example by providing a tax incentive or investing in essential infrastructure and/or basic research, it may cause both businesses to start at the same time, thus solving the coordination problem.

In all likelihood, Georgia won't become an information technology hub as Georgia's contribution to the global computer industry has so far been limited to a failed attempt to establish a government-subsidized computer assembly industry. If Georgia wants to go for a hub strategy, it has to take advantage of its unique strengths, for instance Georgia's geographic position at the heart of the South Caucasus.

[1] Biermann, Florian, Livny, Eric, Mekerishvili, Giorgi, "On Social Planning, Symphonies and Cacophonies."

proportion with specialization and trade. One the one hand, the more countries trade and specialize, the higher the returns to innovations and, hence, growth. On the other hand, however, specialization poses coordination challenges on a global scale. One of the major coordination failures the world has yet to address is the North-South technology gap and biased innovation (Acemoglu and Zilibotti 2001).[64]

3.1.2 Policy responses to coordination failures

It seems obvious that a benevolent social planner should subsidize or otherwise promote economic activity subject to external economies so as to provide the necessary spark to a virtuous circle of mutually reinforcing investments. However, this policy prescription, as any medicine, comes with a list of precautions. The strongest one applies to heeding lobbying requests.

For example, consider the desirability of export promotion policies. It is safe to say that clamoring for state assistance in expanding the market size and other arguments advocating the need for the government to provide infant industry protection are pervasive. However, Ruffin and Ethier (2011) caution us that protectionism may do more harm than good, even in the case of an industry subject to external effects.

Another reason why interventionism may backfire is rent-seeking by private firms who would attempt to manipulate the government's choice of policy. As shown by Grossman and Maggi (1998), it is beneficial for a government to commit to not interfering with market outcomes, for example, by joining a Free Trade Agreement (FTA).

There may be other seemingly attractive reasons to intervene, for example, high fixed costs of entry into exporting. However, Bernard and Jensen (2004) show that state export promotion expenditures have no significant effect on the probability of exporting. Görg, Henry, and Strobl (2008) also find that, while export grants may encourage already exporting firms to produce more for the international market, there is little evidence that they encourage non-exporters to start exporting.

The net welfare impact of state intervention may very well be negative, even in the absence of rent-seeking. Considering that the bureaucrat has no informational advantage over the private players, large subsidies could artificially create sizeable industries at a higher cost than the gains they create. If government coffers were infinitely deep, one would be less apprehensive about subsidizing all industries and providing training at all levels. However, the reality is that public funding is scarce and may support only a very topical application of the medicine. Even if credit is available to the state, the accumulation of public debt would lead to deteriorating credit ratings and higher capital costs for the private sector (never mind the risk of a currency crisis).

3.1.3 Georgia's liberalization reforms: fighting externalities on the cheap

So what should a frugal social planner do in the face of external economies? Start with general reforms that cost no or little money, but have the potential to trigger investment and produce economy-wide spillovers, e.g. reducing the tax burden and transaction costs. Indeed, picking this low hanging fruit was one of the main policy objectives of the Georgian government early on in the reform process.

Reducing the tax burden. The tax code enacted in 2005 simplified the tax structure by reducing the number of taxes and fees that taxpayers were liable for from 21 to seven[65], as well as making various exemptions. In 2008 the gambling tax was

[64] The authors argue that many technologies used by less developed countries (LDCs) originate in the OECD economies and are primarily suited for the skills of their workforces. "Differences in the supply of skills create a mismatch between the requirements of these technologies and the skills of LDC workers, and lead to low productivity in the LDCs. Even when all countries have equal access to new technologies, this technology-skill mismatch can lead to sizable differences in total factor productivity and output per worker."

[65] Income tax, profit tax, social tax, value-added tax (VAT), excise tax, property tax, and gambling tax.

scrapped. Tax rates were substantially lowered across the board. A unified Revenue Service of Georgia was created in 2007, bringing the tax and tariff collection functions under one roof.

Reducing tariffs and non-tariff trade barriers. Import tariffs were lifted on most categories of goods, with 5% and 12% rates applicable only to agricultural products and construction materials, respectively.

Establishing Free Industrial Zones. Free Industrial Zones were introduced in 2007 as a policy measure to provide further incentives for startups and global corporations to locate production facilities in Georgia. Registered enterprises in each of the three zones (Tbilisi, Poti, and Kutaisi) are exempt from property tax, payroll tax, VAT, profit tax, as well as all customs duties. Of course, they also benefit from unrestricted access to the global markets granted by the GSP and GSP+ status.

Providing Free Warehouse Company status. This preferential fiscal status has been devised to attract entry by international cargo companies, regional network distributors and, indeed, any company set up to transport goods from Central Asia to global markets. Free Warehouse Companies are exempt from the profit tax accruing on earnings from re-exporting activities as well as from VAT on the supply of goods to a Georgian VAT taxpayer.

Reducing compliance and transaction costs. No matter how low the official tax rates were, businesses could still be discouraged from entry and operations in Georgia by high compliance costs related to red tape, kickbacks, bribes, etc. Compliance costs were targeted through the deployment, in 2008-09, of an electronic filing system allowing all tax liabilities and rebates to be settled online and providing the ultimate one stop shop for resolving all compliance issues at a substantially reduced cost.

Simplifying customs clearance procedures. Customs Clearance Zones (CCZ) were introduced in 2011 to facilitate compliance with customs regulations. The CCZ infrastructure, including parking for hundreds of cargo trucks, is capable of accommodating a high flow rate of applications. No intermediaries, such as brokers, are needed.[66] The time and money it takes to arrange transit of goods through Georgia is, in an order of magnitude, less than in all neighboring countries.

Improving external market access. Georgia has been enjoying Most Favored Nation (MFN) status with most of its trade partners thanks to its accession to the WTO in 2000. This means that Georgia's exports to all WTO members may not be treated less advantageously than those from any other country with MFN status.

Furthermore, in 2005, Georgia became a beneficiary of the Generalized System of Preferences (GSP) scheme with the US, Japan, Canada, Switzerland and Norway, and the enhanced GSP+ scheme with the European Union. In theory, this allows Georgia to export, free of duty, 7,200 varieties of goods to the EU and 3,448 varieties to the other GSP grantors (in reality, Georgia presently exports only nine categories of goods to the US, for example).

Additionally, Georgia has concluded Free Trade Agreements with CIS countries and Turkey[67], which exempts many categories of goods and services from customs duties on a bilateral basis. Georgia is currently negotiating the Deep and Comprehensive Free Trade Agreement (DCFTA) with the EU, which will further improve market access by abolishing quotas and other non-tariff barriers.

Despite these early achievements, there may be scope for further progress on certain aspects of tax and customs procedures, as reported by some of the business executives we interviewed for this report. For example, we received suggestions to improve the administration of CCZ, to clarify the rules on refunding VAT on imported goods, and reconsider the 10% VAT tax that is levied on services procured from non-resident companies.

3.1.4 Deriving the criteria for public spending

Businesses always appreciate tariff cuts and low levels of bureaucratic red tape. Yet, the key issue here is whether the beneficial effects of business-friendly reforms act on the extensive or the intensive margin. So far, Georgia has used the opportunities brought about by improvements in the tax environment and lower compliance costs to churn out more of the same stuff (as suggested by low rates of product innovation, see Chapter 2). Productivity improvements mainly resulted from process innovation, not investment in high value added activities. The desirable outcome, however, is a chain reaction of investment that boosts Total Factor Productivity (TFP) and makes further investment profitable at the same time. So far, general liberalization measures have triggered a rapid increase in trade flows, as documented below, but failed to set off a process of investment in low-risk-low-return activities, such as manufacturing, that are key for further productivity improvements.

To the extent that further progress is handicapped by coordination failures and scale economies, the frugal social planner may want to undertake additional, more costly actions, beginning with measures addressing externalities at the broadest national level, such as the cost of financing public health, applied research, education and training, or providing essential public infrastructure (particularly transport). If deemed necessary, the state could also coordinate the actions of private investors in key sectors of the economy. In doing so, however, it must weigh the perceived magnitude of the externality in a specific industry against the risk of failure because of government incompetence, the inherent inability of the industry to be viable in the long run, or external shocks.

In the remaining part of this chapter we will use the above criterion to review the potential for state intervention in key export-oriented industries such as agriculture and agribusiness, tourism, hydroelectric power, transport and trade logistics. Examples of successes and failure will be provided along the way.

3.2 Agriculture and the agribusiness sector

Any future reform of the Georgian agricultural sector would have to take account of the fact that, in addition to production, the sector performs an important social function: it provides a social safety net to a very large part of the population that have lost their jobs and whose qualifications are a poor match for current market needs. As mentioned in Chapter 1, many of those "employed" in agriculture are treated in the national statistics as "self-employed" (about 800,000 people, i.e. about 41% of the total Georgian workforce).[68] The share of agricultural output in total GDP, on the other hand,

[66] According to John Braeckevaeld (Gosselin-Georgia CEO), the creation of Customs Clearance Zones (CCZ) eliminated the institution of private customs brokerage, resulting in the loss of relevant independent expertise. At CCZ the same expert fills in the declaration and verifies it. The client, who has no expertise, has to sign the declaration and is held legally responsible for any omissions and classifications mistakes in the declaration.

[67] The lifting of tariffs is partially negated by non-tariff restrictions that are reportedly employed by Turkey, such as food safety standards and licensing rules.

[68] Rudaz, Philippe, "Entrepreneurship in Georgia"

stands at a meager 12%.

Given this dual role of agriculture, productivity in the sector is almost a moot point. As noted by Adam Pellillo (2012), it is remarkable "that Georgia seems to be the only former Soviet republic in which agricultural productivity hasn't returned to or exceeded its level in 1992. As of 2010, agricultural productivity stood at only 77 percent of where it was at nearly two decades ago."[69] This finding is even more puzzling if we consider that during the same period agricultural productivity has grown by nearly 200 percent in the neighboring Armenia.

A major issue for Georgia's future agricultural development is fragmentation. This has several aspects: highly fragmented land ownership, as a result of the land privatization of the 1990s; and weak links, if any, between different actors in the various value chains. The result is depreciated or inexistent machinery; obsolete and inefficient cultivation techniques; poor storage, packaging and transportation, leading to very low agricultural output.

3.2.1 Private sector capacity to resolve coordination failures in agriculture

From an economist's perspective, the persistence of fragmentation reflects two types of market failures:

- Failure to achieve coordination among small farmers, and
- Failure to coordinate between smallholder farmers and other market players (aggregators, processing plants, large retailers, hotel chains, etc.).

However, the truth is that in quite a number of cases the market has been able to fully "internalize" the coordination externalities plaguing the Georgian agricultural sector. The most prominent examples of recent successes in overcoming the fragmentation bottleneck are associated with major international brands such as Hipp, Carrefour, and Ferrero Rocher. Launched in 2007, Hipp's plant in Gori makes organic apple juices for world distribution from Georgian apples. By acting as an integrator it has drastically improved quality standards and yields in organic agriculture. Similarly, having entered the Georgian market in 2012, the French hypermarket chain Carrefour is already procuring most of the fresh produce for its store locally, imposing its rigorous quality standards on the Georgian producers.

Aggregators such as Hipp and Carrefour provide guarantees of long-term demand, offer technical assistance with the choice of crops, growing and post-harvest treatment methods. This gives farmers stronger incentives to learn (i.e. invest in their own human capital), to invest in improved facilities and machinery (i.e. physical capital), and very importantly, to cooperate. Cooperation allows the exploitation of economies of scale in the procurement of inputs, cultivation, storage, transportation, etc. The presence of guaranteed demand reduces the market risk for related investment projects, lowers the cost of finance and speeds up the process of technological upgrading in agriculture.

3.2.2 Social risk as an externality

If the market is able to internalize coordination externalities in agriculture, are there any reasons for the social planner (government and foreign donors) to "meddle" with free market dynamics to try and speed up the (inevitable) process of consolidation in Georgian agriculture?

The primary reason for intervention, in our view, has to do with the buffer nature of the agricultural sector, which poses an important socio-political externality. The slow pace of productivity growth in agriculture has left large swathes of Georgia's rural population far behind the urban middle class, often in poverty and with no or limited access to high quality education and healthcare. The result has been political uncertainty and risk through protest voting or worse, as reflected by Georgia's performance in the GCI, country risk ratings, and FDI dynamics. Political risks, in turn, translated into high lending interest rates, which affected the entire economy (see Chapter 1). On the one hand, they slowed down investment and job creation in the non-agricultural sector (limiting its ability to absorb surplus agricultural labor). On the other hand, these risks limited smallholder farmers' access to credit, stalling their productivity and disenfranchising them even further. We contend that the social planner should attempt to resolve this vicious circle.

Endorsed and supported by the international donor community, the new Georgian government's general strategy – to promote rural development and agriculture – is, indeed, consistent with our analysis. In the remaining part of this section we consider the choice of policy tools that the social planner could employ to achieve his or her goal.

3.2.3 The role of government in addressing the social risk externality

In considering potential interventions we adhere to our general approach that, first, the government should spend its scarce resources in ways that address market failures and coordination externalities across the entire economy. One obvious example is negotiation of **free trade agreements** and the use of WTO arbitration mechanisms to improve market access to the EU, Russia and other neighbor countries. Another example is investment in **strategic transportation infrastructure** which has positive repercussion for the entire economy. As discussed in Eric Livny's "Roads and Rural Development: the Case of Samtskhe Javakheti,"a new road connecting the Samtskhe-Javakheti region to the Tbilisi market has dramatically improved labor productivity and income per household in the region: "in just two years, this – until recently isolated – region registered a cumulative income growth of 66% (well more than twice the average rate of income growth (29%) for all other regions!) and went from 5th to 1st in the household income ranking of the Georgian regions."[70]

To take another example, while facilitating the entry of budget airlines and adding to Georgia's existing air freight capacity, the new Kutaisi airport will also have agriculture-specific effects. According to YFN's Simon Appleby, the airport will link Western Georgia to new markets, e.g. through Dubai and Qatar, creating opportunities for cut flowers, citrus, fresh herbs, and other high-value horticultural exports.[71]

Next in the order of priority are interventions that address the cost of entry and market failures that are specific to the agricultural sector and yet are broad in nature. Examples are **vaccination programs, prevention, monitoring and control of animal and plant diseases**.[72] While already in place, relevant programs could be further strengthened to boost productivity and to meet the requirements for the Deep

[69] Pellillo, Adam. "The Puzzle of Agricultural Productivity in Georgia (and Armenia)."

[70] Livny, Eric, "Roads and Rural Development: the Case of Samtskhe Javakheti."

[71] http://yfngeorgia.wordpress.com/2012/09/27/president-opens-kutaisi-international-airport/

[72] These fall under the definition of market failures because individual farmers may not fully internalize the negative external effect of contagious diseases and spend less than is socially optimal on disease prevention and control.

Box 3.2

Georgia's wine making industry in search of new markets

Despite significant downsizing, the Georgian wine industry has been able to restructure and find new markets following the loss of Russia in 2006. If up until 2006 Georgia exported 60mln bottles, of which 90% went to Russia, in 2011, exports totaled 21mln bottles. The number of registered exporting companies went down from 150 to about 50 (of which only 12 are active today), however major new companies joined the industry after 2006, including Chateau Mukhrani, Badagoni, and Kindzmarauli Marani. The major industry players coordinate through the Georgian Wine Association (GWA) and the Business Association of Georgia, which engage in advocacy on behalf of their constituents and assist in brand building in the global marketplace.

As argued by Tbilvino's president, George Margvelashvili, the clumsy attempts of the government to provide price support by buying grapes without proper quality control spoiled small farmers who started harvesting too early. By establishing a very high floor price (75 tetri for one kg of Rkatsiteli white grapes in September 2012, as opposed to the record market price of 45 tetri observed in 2006) the government was trying to win favors with the rural voters at the expense of wine producers. This was pure politics, according to Margvelashvili. Moreover, the government did not allow wine producers to approach larger farmers (above 10 ha) before the smallholder market cleared. As a result, many owners of larger vineyards could not sell and were forced to bear the cost of processing and storage.

At present, the industry is eagerly expecting to re-enter the Russian market, which has significantly improved during the past six years. While returning to 60mln bottles a year will not be possible immediately, the prospect of capturing a respectable share of the Russian market is real. Thus, while boosting the cachet of Georgian wine may carry a positive externality for the tourism and hospitality industry (and vice versa), it's hard to think of productivity spillovers which could not be internalized through collective action at the industry level and would thus require government interference. The comparative advantage that Georgia possesses in wine-making is sure to manifest itself as long as it is not faced with artificial trade barriers and price support measures.

and Comprehensive Free Trade Agreement with the EU.

Another type of broad measures concerns **research, education and vocational training**[73] in relevant fields. Government-provided scholarships and the new Millennium Challenge Corporation multi-year agreement with the Georgian government, both targeting technical education, are excellent examples of the latter type of intervention. The agricultural education component is also included in the EU's new ENPARD program that seeks to support Georgia's rural development, including agriculture.

Third, to complement investment in education, **extension centers** could help increase the general level of expertise available to the agricultural sector, facilitating the introduction of new crops, thus improving yields and incomes. Extension services could be particularly effective if delivered through a public-private partnership such as the recent alliance between USAID's Economic Prosperity Initiative and the maker of Nutella and Ferrero Rocher chocolates.[74] A web of government-subsidized agricultural extension centers – providing farmers with essential know-how and training – could be thought of as the application of the same medicine on a broader, national scale.

Fourth, investment in **irrigation and drainage** systems would increase the supply and quality of arable land. While the "last mile" of irrigation infrastructure could be undertaken by individual farmers (or farmer cooperatives), the construction of dams and irrigation canals are clearly a matter for government (or donor) attention.

Last, but not least, the government and donors could choose to address the **cost of financing** bottleneck affecting Georgia's agriculture. Lending interest rates and collateral requirements are generally very high in Georgia. On top of that, given the very small volume of lending to the agricultural sector, the financial sector – banks and insurance companies – do not have the skills to properly assess agricultural risks (ProCredit bank may be the only Georgian institution with a history of lending to agribusinesses; crop insurance is extremely rare in Georgia). In the absence of relevant skills, financial sector players seek to over-insure themselves against market risks, charging above optimal interest rates and insurance premia, or withholding credit and insurance from worthy projects. The social planner could try addressing this bottleneck by supporting relevant training and research to establish proper criteria for judging the agricultural risks that are specific to Georgia, the different branches of Georgian agriculture, soils and climate zones.

As far as the subsectors of Georgia's agribusiness are concerned, the frugal social planner may be well advised to spend his or her energy and public money elsewhere. On the one hand, there is sufficient evidence of the private actors' ability to internalize sector-specific coordination externalities. On the other hand, this is perhaps the main lesson learned from the ham-fisted attempts of the outgoing Georgian government to introduce price support for grape growers, improve crop varieties, or promote citrus exports to Ukraine. While there may be great business opportunities related to export promotion activities, such as those attempted by the state-owned Fruit and Vegetable Company prior to the recent parliamentary elections[75], these opportunities are best left to private entrepreneurs and business associations.

We now come to one of the most debated issues concerning Georgia's smallholder agriculture – the possibility for the social

[73] As a rule, education markets are extremely slow to react to signals coming from the labor market. For instance, the Georgian education system is still churning out medicine, business, and law degrees, thus aggravating the labor market mismatch and youth unemployment problems.

[74] Ferrero's €21mln investment has created more than 400 jobs and supported a large network of small suppliers. Leveraging $1.5mln of Ferrero's funding, EPI delivers training for farmers at Ferrero's 4,000 hectare hazelnut plantation in Samegrelo, helping them "learn new farming practices to boost their yields and improve their incomes." See: http://georgia.usaid.gov/news/usaid-news/2012/10/24/1147.

[75] According to media reports, in early August 2012 former PM Vano Merabishvili announced that the company will establish modern collection centers to sort, package and store fruits and vegetables all over Georgia, and assist with transportation to a storage terminal to be created in Ukraine, http://en.trend.az/regions/scaucasus/georgia/2053158.html.

planner to promote **farmer cooperation** as a means of overcoming fragmentation at the level of primary agricultural producer. Indeed, farmer organizations could exploit economies of scale by undertaking joint investment in machinery and equipment, procurement of inputs (seed, fertilizer, etc.), processing, branding, bargaining and marketing. Yet, successful farmer organizations are almost nowhere to be found in Georgia because cooperation requires a common vision, mutual trust and excellent management skills. All of these can only be developed over time. Additionally, an argument is sometimes made that Georgian village communities are inherently individualistic, a tendency only made worse by the memory of forced Soviet collectivization.[76]

Top-down approach. A dispiriting example of what might happen when the state tries to babysit farmers is offered by the Nikozi cooperative experiment.[77] This quasi-cooperative was established on the South Ossetian border following the August 2008 war with Russia with extensive assistance from the Agricultural Development Fund (ADF). The government built and rehabilitated irrigation systems and consolidated a patchwork of land strips into a single 140ha holding (among the largest in Georgia). A highly concessionary 1.2mln GEL loan from the ADF covered the costs of a pump station and pipes to supply modern drip irrigation to the entire farm. Annual agreements were signed with the ADF-controlled Mechanizatori Ltd. to provide the much needed agricultural machinery. Seedlings and relevant agricultural know-how were furnished by other ADF daughter companies. Most importantly, the demand for Nikozi's produce was assured by advance purchase agreements with the new Fruit and Vegetable Refrigeration plant (a public-private partnership) in Natakhtari.

And yet, all this investment has not led to sustainable outcomes due to the top-down nature of the experiment. The small management team installed by ADF realizes that without continuing state support the organization is going to unravel. Their planning horizon is limited to three years, within which the ADF loan is supposed to be repaid; the land lease agreements with individual cooperative members will expire at roughly the same time. As a result, hardly any investment is made by the cooperative that would maximize its long-term value. Little care is exercised concerning the choice of crops and their suitability for soil conditions, resulting in low productivity and poor quality. Makeshift plywood boxes are used for transportation purposes, resulting in a significant portion of the produce – and the cooperative's reputation – perishing en route.

Pushing money out of the door. Even less effective are donor programs that support organizations that are a) cooperatives in name, but lack significant grassroots membership; and b) not linked to private sector actors in the relevant value chain. Donors and the international NGOs, through which such support is often channeled, cannot substitute for the private sector in linking farmers to the market. An honest evaluation of cooperation support programs that do not involve private sector partners as integrators (processing plants, retailers, hotel chains) would reveal that they are hugely ineffective. Organizations thus supported are very likely to pick the wrong products, and/or fail to bring them to the market in the right quality and at the right time. On the other hand, cooperatives-without-members (effectively small businesses disguised as cooperatives) often end up not utilizing donated equipment (such as milk collection centers, slaughterhouses, storage). Treated as a "free lunch", this equipment often sits idle or is heavily underutilized, potentially adding to Georgia's exports of scrap metals.

To sum up, in promoting farmer cooperation the social planner should bear in mind the following three lessons learned:

- Farmers could be encouraged to form service cooperatives – e.g. through assistance with the relevant information, legal and managerial aspects of cooperation – however, the initiative should come from the ground-up and not be imposed top-down.
- Selection criteria for farmer organizations should include the existence of a genuine membership base and proper governance and management arrangements ensuring effective management and member buy-in.
- The best way to ensure sustainable outcomes is to use public or donor funds to facilitate and incentivize the creation of institutional links between farmer organizations and private sector actors performing the aggregator function in the relevant value chains.

3.3 Tourism and the hospitality industry

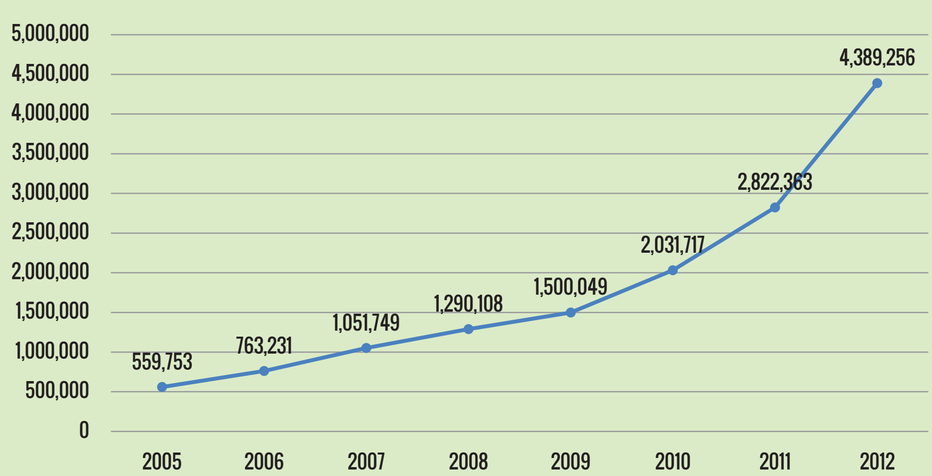
Georgia has a wealth of historical sites, a variety of natural tourist attractions, and an agreeable climate. It used to be a tourist destination in the USSR era, and there is no reason why today it could not appeal to sun seekers, nature lovers, skiers, extreme sport enthusiasts, and other holidaymakers from around the globe.

3.3.1 Basic facts and analysis

The efforts to develop Georgia as a major tourist destination in recent years seem to have paid off. The number of international arrivals to Georgia has been growing rapidly, reaching 2,822,363 in 2011. In 2012, the number of visitors increased by another 56%, exceeded 4.3mln.

But how much of this increase in international arrivals represents an actual growth in tourism? While there is no precise

Figure 3.1 International arrivals to Georgia: 2005-2012



Source: Georgian National Tourism Agency

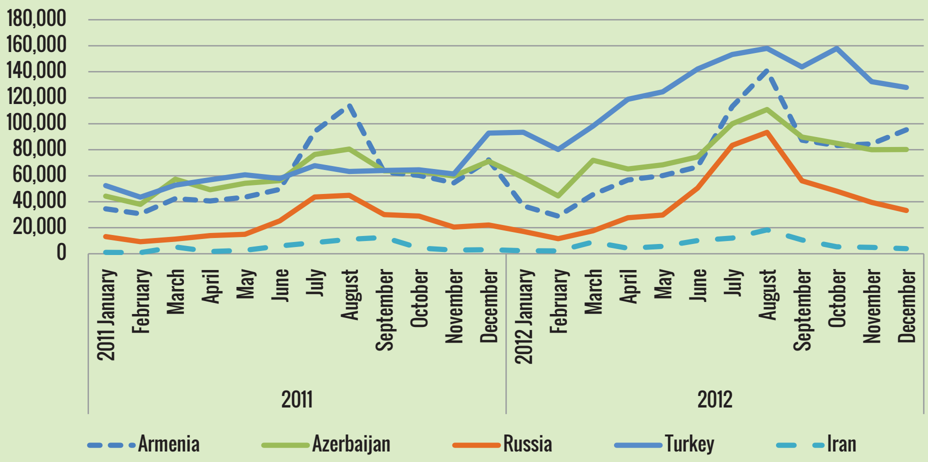
[76] Livny, Eric, "Are Georgian Village Communities able to Organize Themselves?."

[77] Livny, Eric, "Farmer Cooperation: The Nikozi Experiment Assessed."

data to answer this question, several points are worth emphasizing.

- First, Georgia has done a lot to lift restrictions on travel to and through the country. In particular, it has no visa regime with almost 90 nations; citizens of most other countries can be issued visas (and, until recently, also bottles of wine!) at the border. Still, these measures did little to boost the number of arrivals from destinations farther away. To date, 86% of all arrivals are from neighboring countries: Armenia, Azerbaijan, Russia and Turkey.
- Second, and related to the above, Georgia remains a rather expensive and hard-to-reach destination. The opening of Kutaisi airport and the entry of Wizz Air are steps in the right direction, however, at present most foreign visitors enter Georgia by land.
- Third, with the notable exception of Turkey (see below), foreign arrivals are extremely concentrated in a very short period around July and August. This highly pronounced seasonal pattern negatively affects the entire hospitality industry (by reducing incentives to invest in physical capital and skills), strains the environment, and creates congestion.
- Fourth, three countries stand out as far as growth in the number of foreign arrivals is concerned: Turkey (up 117% in the first 11 months of 2012); Russia (up 85%) and Iran (up more than 45%). Georgia's unilateral move to abolish visas, the opening and modernization of the border crossing point in Larsi, and the reinstatement of flights have all played a role as far as Russia is concerned. However, Russian tourism remains way below its potential, which in 2013 may jump to double or triple the current level.
- Iran is a very special case: the economic sanctions imposed on Iran by the international community are pushing many Iranians to seek work and study opportunities abroad. Georgia is one of only 37 countries around the world that have no visa regime with Iran, making it an attractive destination for Iranian students, workers and business people.
- Finally, what about Turkey? The more than doubling of the number of foreign arrivals from Turkey apparently has to do with Georgia's growing importance as an East-West transportation corridor. International sanctions are beginning to come to bear on Iran, and more and more of Azerbaijani and even Iranian trade is being diverted from Iranian ports to Turkey and Georgia. Thus, many of the Azeri, Turkish and Iranian "tourists" are in fact truck drivers who transit through Georgia. This is consistent with the results of a recent survey carried out by the Georgian National Tourism Agency (GNTA) from April 2011 to May 2012: 27% of all international visitors don't spend a single night in Georgia; the median visitor spends less than two days, which is the maximum allowed transit period; 78% are repeat visitors.

Figure 3.2 International arrivals to Georgia: 2011-2012



Source: Georgian National Tourism Agency

The current trend implies that in a year or two Georgia will have more than 5mln foreigners crossing or visiting its territory. While creating jobs in the hospitality industry and bringing foreign currency, mass tourism carries many negative externalities, including congestion and damage to unique ecosystems. Thus, the Georgian government should be advised to worry not about the sheer number of tourists, but rather about the amount of money they spend in the country.

As argued by Eric Livny, "Georgia should strive to increase the share of relatively wealthy tourists from Western Europe and North America who currently account for less than 5% of total border crossings by foreigners. It would be of particular importance to increase the number of tourists visiting the country in the offseason period. This would help attract additional investment in human and physical capital, bringing the quality of services to a level appropriate for high-end tourism. A shift to high-end tourism would also help boost incomes and productivity."[78] Yet there are several serious obstacles to overcome before more discerning crowds come to discover Georgia. These relate to the limited supply of accommodation and amenities, service standards, and transport.

A number of international chains have already opened hotels in Tbilisi (Tbilisi Marriott, Radisson Blu Iveria, Sheraton Metekhi Palace, Courtyard Marriot, Holiday Inn) and Batumi (Sheraton and Radisson Blu). Radisson Blu is currently building new hotels in Gudauri and Kakheti (Tsinandali). However, hotel capacity and tourist amenities are still insufficient to accommodate high season demand.

The level of service delivery in Georgia is often very modest. Because the hospitality industry is highly seasonal, the professional workforce is in short supply. Our interview with the Gudauri Marco Polo Hotel's marketing director indicated that the problem is particularly acute outside of Tbilisi, e.g. in ski resorts such as Gudauri and along the Black Sea coast, where temporary positions are filled by people who do not speak foreign languages and are often unwilling to learn.

Affordable, frequent and direct flights are of the utmost importance for the development of tourism. Until recently, Georgia had two international airports, located in Tbilisi and Batumi (both operated on a concessionary basis by the Turkish firm TAV), serving approximately 1mln passengers per year.[79] Another airport opened last year in Kutaisi. It is designated primarily for budget airlines and is operated independently. Tbilisi airport currently offers direct flights to just 34 destinations, while the corresponding numbers for Batumi and Kutaisi airports are a woefully low five and two destinations,

[78] Livny, Eric, "5 Million tourists in Georgia by 2015 - a myth or nightmarish reality?"

[79] Interview with Ketevan Aleksidze.

Box 3.3

Georgian ski resorts receive a major upgrade[1]

Considering the small number of international ski visits and the limited local demand, the Georgian market is simply too small for large international investors. Given this, and the fact that ski resorts are very capital intensive, the social planner's role is to bring the industry to the point where it becomes attractive from the international investor's point of view.

There are several options to develop Georgia's potential as a regional ski destination:

- Popularize skiing in Georgia, beginning with school education.
- Bring visitors from Ukraine, Russia, Belarus, the Baltic countries and Poland for "mass ski tourism".
- Bring visitors from Western Europe (Austria, Switzerland, Germany) for niche (heli) skiing: cheaper, less regulated, more attractive landscapes.

In addition to two traditional resorts in Bakuriani and Gudauri, the Georgian government has started developing two new resorts in Mestia and Adjara.

Financially, investment in ski resorts may not be commercially viable at this stage, especially not at the going interest rates, but there is an important rural development externality to consider. The industry is very labor intensive: at the "4-star" level, the number of beds is equal to the number of people providing hospitality services.

An important way to improve capacity utilization and thus increase productivity of private investment in ski resorts is to enhance summer tourism. **Bakuriani** and, particularly, **Mestia**, have the four season destination potential, but need additional investment in summer infrastructure, including international airports within the radius of 120km.

The case of Gudauri

Located on the sunny side of the mountain, Gudauri has a very low risk of avalanches and lots of sunny days. Yet, coordination among individual investors is essential for Gudauri to become an attractive international destination. Construction on the mountain takes time, the landscape is difficult, and the construction season is very short. At present, Gudauri has only 800-1,000 commercial beds, whereas the international benchmark for a commercially viable ski resort is about 5,000 visitors a day.

The Gudauri Development Fund was created in 2011 to coordinate public and private investments in road access, ski lifts, grooming equipment and a modern pedestrian alpine village providing retail, night life, and hotels. The Fund undertook investment in water, electricity, sewage, internet, and roads. It also built new ski runs and a gondola lift bringing the total lift capacity from 2,700 to 5,600 people an hour. It is now up to private investors to build new hotels according to available designs. Three private hotels are already under construction (investments of $5-10mln each), including by Radisson Blu. The total planned capacity is 1,500 beds.

The Fund also rehabilitated all major installations to avoid lift accidents, installed generators and trained rescue personnel. Additionally, it improved queue management and increased the number of ticketing booths.

As a result of these improvements and the opening of the Larsi border crossing with Russia, the 2011/2012 season saw a 65% increase in ski visits compared to 2010/11 (both tourists and locals).

[1] Information in this section is based on our interview with Nika Grdzelidze, former director of the Gudauri Development Fund and Gudauri Maro Polo Hotel management.

respectively. In addition, a smaller Mestia airport provides services to Tbilisi.

3.3.2 Coordination externalities and role of government

There are many aspects of the hospitality and tourism industry that create scale effects and threshold effects. For example, a minimum number of daily users is needed to justify investment in a modern ski lift; a resort location must have at least 800 beds to be able to engage a major travel agency; a minimum number of regular passengers is required for a commercial airline to offer a new route.[80]

Staff training programs are costly and take time. For investors to commit to providing employee training, they must be reasonably assured of their continued employment. Given the sharp seasonal fluctuations in the number of tourists (particularly outside Tbilisi), long-term employment is a rarity, reducing the incentives for both employees and employers to invest in training.

Finally, private investment in hotels and other tourist amenities must be synchronized with public investment in infrastructure such as air and ground transportation, and water and sewage systems that provide important public goods such as potable water.

All this suggests that the industry is indeed suffering from a classical coordination failure, justifying intervention by the social planner. According to our methodology, at least initially, social planners should target spillover sources with the broadest possible footprint. The national transport infrastructure – Kutaisi airport, upgrading the railway system and the East-West highway – clearly falls into this category. Next in the order of priority should be externalities affecting particular regions, such as the local road networks (and signs!) in Kakheti and Imereti. Finally, there may be scope for coordinating the actions of individual investors – through planning and infrastructure development – in key tourist sites, such as Georgia's ski resorts in Mestia, Gudauri and Bakuriani.

[80] For instance, Georgia does not have direct flights to/from the US because, in addition to requiring longer runways, the country must be able to fill at least two flights per week, i.e. a minimum of 500 passengers.

Thinking and acting locally. Addressing coordination failures should not be the exclusive concern of Georgia's national government. Georgia's regions, such as Adjara, Imereti, Kakheti and Svaneti could give thought to a very modest investment in local public goods – better signs, environmental cleanup operations, fairs and festivals – to bring potential visitors and convince them to stay overnight. Adjara, for example, has all the attributes of a tourism hub (in addition to transport and trade logistics): an excellent location close to the Turkish border, Black Sea resorts, beautiful landscapes, a train connection to Tbilisi, Batumi sea port and airport. Very importantly, it has an autonomous status, allowing its government to pursue a consistent strategy, allocate funds for public investment, coordinate (and bargain) with the national government over overarching initiatives that affect the region. The Kobuleti bypass road, to be completed in 2013, is an excellent example of the latter. The new road will promote Kobuleti's tourist potential by diverting through traffic from the sea resort area. Likewise, the decision by the regional government to abolish the license fees for gambling establishments created a minor boom in casino tourism[81], which is of importance during the long low season period.

3.4 Hydroelectric power generation

The government of Georgia has been devoting a lot of energy to the promotion of its hydroelectric power generation industry. It undertook a detailed survey of potential plant locations and came up with a blueprint for the future export-oriented development of the sector. The vision is to promote regional energy market integration by means of coordinated investments in transmission lines and the building of new Hydro Power Plants (HPP).

3.4.1 Externalities in investment decisions

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.

Some of the outstanding issues from the point of view of private investors were summarized in a recent World Bank presentation.[82] These include regulatory and market uncertainties around future energy prices, transmission tariffs and volumes, and the need for further investment in improving the regional grid infrastructure. A similar note is struck by Natia Turnava[83], a former deputy minister of economic development and a senior executive with the Georgian Industrial Group: "many (internationally, not locally) bankable HPP projects are currently under consideration, however, these projects need 10-year power purchase agreements upfront and a reliable scheme of connection. The regional market would have to be more fully integrated to attract investment in Georgia's generation and transmission capacity. Georgia's national market is simply too small. The market has disintegrated in the aftermath of USSR collapse and connections to neighboring countries remain poor. For instance, Armenia is isolated from the major parts of the regional market due to political reasons. Likewise, transmitting grids are investment projects that should have a guarantee of sufficient volumes. Investors would be attracted by the prospect of a larger market including Iran, Russia and Turkey."

3.4.2 Back to the drawing board?

Stepping back, it is worthwhile to 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 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 exports higher value-added and more sophisticated products.

3.5 Transport and trade logistics

Georgia has a strategic location on the crossroads between Europe, Central Asia and the Far East. The shortest routes from Turkey to Russia and from Iran to the Black Sea also pass through the country. For the landlocked Central Asian region Georgia is the closest access point to maritime trade routes. This suggests that Georgia could serve as a hub for both regional and interregional goods transit. The likelihood of this is further helped by the political situation in the region. Georgia is the only country in the Caucasus that may act as an intermediary between Azerbaijan and Armenia, or Armenia and Turkey. Georgia's diplomatic and economic relations with Russia have been strained for nearly a decade due to territorial disputes and geopolitical considerations, yet there are reasons to expect a thaw in the aftermath of the 2012 parliamentary elections.

Most economic historians attribute a large role to transport infrastructure in explaining the take-off of global growth after 1820. Angus Maddison, the pre-eminent authority in the field, cites railways and steam

[81] Licensing fees for large gambling establishments were abolished in 2010 triggering a 70% increase in the number of visitors to Batumi.

[82] Melitauri J., and Rivera S., November 2012.

[83] Interview with Natia Turnava.

shipping as "particularly important in creating new elements of dynamism."[84] The technology has changed considerably since the 19th century, but the fact that a major railway construction and upgrade project is currently proceeding at full steam in Georgia is very encouraging indeed. The new Baku-Tbilisi-Kars (BTK) railway is going to become a central link in the so-called TRACECA ("Transport Corridor Europe-Caucasus-Asia"), a major international transport program involving the European Union and 14 member states of the Eastern European, Caucasian and Central Asian regions.[85]

It is also encouraging that since 2009 the program has been financed by the member countries without the use of EU funds. Examining the reasoning behind this large financial commitment can reveal the extent and direction of the Georgian economy's growth potential. This section will therefore take a look at a number of new investment undertakings in the country while applying insights from the economics of spillovers.

3.5.1 TRACECA and the Caucasus Transit Corridor

Recent data on exports (see IMF Direction of Trade Statistics Database) between selected countries of the Caucasian and Central Asian regions and the European Union suggest that this trade is already generating a lot of goods transit in the region. That said, trade still constitutes a very modest fraction of the GDP (see Table 3.1), so there are reasons to expect significant further expansion of trade.

3.5.2 The Caucasus Transit Corridor and its competitors

The part of TRACECA that runs through the three Trans-Caucasian countries forms the Caucasus Transit Corridor (CTC, see map below). It is important to remember that the expansion in the transit of goods through Georgia is conditional on the existence of essential infrastructure and quality of logistics services. At the moment, given CTC limitations, significant volumes of non-oil cargo transit between Europe and Central Asia bypass the CTC. In 2011, just 8.5 million tons of cargo was transported along the route (8,010 TEU's[86] by road and 8,457 TEU's by rail).

At present there are three major goods highways that link Central Asia, via a maritime port and onwards, to Western Europe. The main competitor to CTC is the route via Russia and the Baltic ports. Due to better infrastructure and service quality it currently offers cost advantages to the CTC, even though the latter is shorter. This implies, however, that CTC has the potential to become a preferred route once the cost issues are ironed out.

Table 3.2 juxtaposes the transit costs and times via three different routes from Taraz (Kazakhstan) to Hamburg. One has to also keep in mind that several issues in the various jurisdictions along the CTC route currently contribute to uncertainty about the transit times and costs.

There are currently several opportunities to increase Georgia's share in regional trade flows:

First, Iran used to serve as a gateway to the landlocked Central Asian economies, Azerbaijan and Armenia. With many international transport companies leaving Iran, the Bandar Abbas port is no longer able to perform the critical function of supplying the Azerbaijani and Armenian markets, creating an opportunity for Georgia. Azerbaijan used to export through Poti and import though Iran. Now both Azeri imports and exports go through Poti.

Second, provided a regular schedule is established for the Caspian ferries and corruption problems are addressed at Baku Port, a portion of the 0.5 million tons of Central Asian traffic, now being served by the Baltic ports, could move to the CTC. Also, another potential for increasing freight volumes via CTC is to shift a portion

Table 3.1 Trade/GDP ratios.

Trade/GDP of CCA Countries in 2011 (%)	
Armenia	53.5
Azerbaijan	71.3
Georgia	64.4
Kazakhstan	67.1
Kyrgyzstan	105.1
Turkmenistan	65.2
Uzbekistan	51.2
Trade/GDP of a selection of countries for comparison 2011 (%)	
Bulgaria	112.3
Czech Republic	144.6
Estonia	155
Latvia	103
Lithuania	139.5

Source: World Bank.

Source: TRACECA webpage

[84] Maddison, 2008 (p. 6)

[85] The TRACECA program members are: Armenia, Azerbaijan, Bulgaria, Georgia, Kazakhstan, Kyrgyzstan, Iran, Moldova, Romania, Turkey, Ukraine, Uzbekistan, Tajikistan, and Turkmenistan.

[86] Twenty-Foot Equivalent Unit (TEU) is a unit of cargo capacity used to measure the capacity of container terminals and container ships.

of the 200 TEU a month traffic cargo from China-Istanbul-Central Asia to the China-Poti-Central Asia route.

Third, there is strong interest in linking up the CTC with other transit corridors. For instance, the company providing the services of the Viking container train between Klaipeda and Odessa, Plask, is considering expanding the service beyond Odessa, via the Black Sea, to Poti and onwards to Baku and Central Asia.

3.5.3 Caucasus Transit Corridor: current bottlenecks and ongoing investment projects

At present, Georgia's transit and logistics facilities consist of pipeline infrastructure, roads, railways, free industrial zones, ports and warehouses.

Railways. Georgian Railway, a joint-stock company, is the monopoly railway operator in Georgia. It owns rolling stock, tracks, terminals and other infrastructure. Currently, the total length of the Georgian railway is 2,344 km. In Soviet times, Georgian Railway handled over 50 million tons of freight and 13 million passengers annually. Most of the traffic on the railway was transit traffic, thus Georgia played the role of a transportation hub for the Caucasus and Central Asia (CCA) region. At present, only 11 million tons of cargo is transported, of which 7 million is transit. The main bottleneck for increasing non-oil cargo volumes is the shortage of railroad cars, and in particular, refrigerator cars.[87] This causes delays and affects prices. For oil products, the deficit of tank cars is the problem.

The Baku-Tbilisi-Kars railway project, which is due to be completed in 2013, will connect the Azerbaijani, Georgian and Turkish railways. The railway route will provide a shorter and safer means of transit from Europe via Turkey to Central Asia and China, compared to other alternative routes. The project's implementation began in 2007. Its goal is to rehabilitate parts of the existing tracks and construct a new portion of the railway linking Georgia to Turkey. The Georgian section of the BTK railway is financed by a $775mln loan from the Azeri government. The decision to conspicuously stake so much money outside of their own jurisdiction suggests that the creditors' expectations of the project must be very high.

Elsewhere in the Georgian railway system,

[87] Interview with Nikoloz Gogoli.

Table 3.2 Transport costs and transit times between Taraz and Hamburg via alternative routes.

Route	Cost/TEU	Transit Time
Via Poti	$6,896	40-42 days
Via Ukraine	$7,474	34-37 days
Via Riga	$6,220	33-36 days

Source: Comprehensive Logistics Solutions, Almaty

roughly 13% of the tracks are in need of upgrade or repair. The most critical section is the 40km mountainous gorge region in the central part of the country. A major modernization project aims to increase passenger train speeds to 80 km/h on this section and to 120 km/h on the rest of the mainline. Georgian Railway has also commenced work on the Tbilisi bypass project, constructing a new line (27km of double electrified track) passing through the Tbilisi Logistics Center (see below), thus strengthening the logistical capacity of Tbilisi. Funding for this project comes from the EBRD and EIB.

Sea ports. Georgia has two operational cargo ports: Poti and Batumi. At present, Poti primarily serves feeder vessels linking the Black Sea to the Mediterranean. There are constraints on expanding the throughput of cargo. The shallow draft at the entrance channel to Poti port is 8.4 meters. This restricts vessel sizes in the container terminal and prevents operation of direct routes from Poti to Asia and North America. Larger mother vessels use other ports on the Black Sea (Romania, Turkey and even Ukraine), detracting from Georgia's competitiveness as a transit route. Another infrastructural bottleneck is low off-dock capacity for container storage in Poti port. Currently cargo has to be trucked 5km away from the port, adding to costs. There is also a lack of industry-specific warehousing (e.g. for cotton).

Batumi port has no refrigerated storage facilities and poor transportation links. Currently it serves as a destination for overflow cargo. However, the town of Batumi is a tourist destination with the potential to grow. Thus there may be reasons to keep/convert it to a passenger port.

The ports of Aktau in Kazakhstan, Turkmenbashi in Turkmenistan, and Baku in Azerbaijan are the termination points of the CTC on the Caspian Sea. Currently, there are many infrastructural, regulatory and logistical issues with regard to those ports. One of the main obstacles to an increased use of the CTC is the shortage of feeder vessels between Aktau and Baku, resulting in delays of up to five days. The main reason for the vessel shortage is the monopolistic position of the Azerbaijani State Caspian Sea Shipping Company.

Corruption is another serious problem. Users of Baku port complain about unfairly high customs charges and the absence of transparency. There are problems with obsolete infrastructure in all three ports. In addition, the "last mile" rail connection from the Aktau port to the main rail grid is privately owned and charges a monopoly rate.[88]

The problem with the shallow draft in Poti port can be alleviated by dredging. This will allow vessels of up to 34,000 DWT to enter the port making it possible for freight liners to provide direct services linking Georgia to every continent. Between the years 2012 and 2014 APM, the private port operator, is investing more than $100mln in constructing new container and bulk cargo terminals. These improvements are expected to increase the port's capacity by 50%. This will also reduce the total cost of the maritime portion of the route by 40-50%.[89]

Liberalized entry into the shipping industry in the Caspian Sea and a stringent regulation of the private rail link to Aktau should boost service levels and make the route more attractive.

Less certain prospects face Lazika, a new city-port on the Georgian Black Sea coast originally envisaged to be built from scratch by the previous government. The current government's attitude to the ambitious project is much more tepid. The advantage of this would be port is the deep sea shore that would allow the handling of all types and sizes of vessels. Its disadvantage is a construction bill in the region of $600mln to $900mln.

Logistics. Because transporting goods is very different from a homogeneous flow that can be stopped, reduced, or increased at will, logistics is an important determinant

[88] Interview with John Braeckeveldt.

[89] Invest in Georgia, Annual report 2012

of the total cost of transportation in the supply chain. In 2012, logistics accounted for about 7% of Georgia's GDP and 3% of its employment. Current logistics infrastructure consists of a mix of old Soviet-era and new privately-owned storage facilities built by retailers, manufacturers and wholesalers. Only a few warehouses are mechanized. Warehouse management systems are virtually unknown. A lack of cold storage facilities is one of the most severe bottlenecks for most companies operating in agriculture. This causes an estimated 30% waste of Georgia's produce.

Besides infrastructure problems, there is lack of skilled human resources in supply chain management. This causes order management and inventory problems for companies, resulting in heavy losses. Firms which have seasonal merchandise are most vulnerable – they often run out of warehouse space because of inappropriate stock planning.

One more obstacle to increasing transit container traffic to the Caucasus and Central Asia is the reluctance of container owners to allow their containers to move to the region. This mainly happens because of little backhaul traffic, implying that container shipments to the region should take into account the cost of returning an empty container to its owner, which makes shipments more costly. For example, annually, 72,000 empty containers leave Georgian ports. This inflates shipping costs, making imports more expensive.

Extrapolating demand for logistics services in line with GDP, Tbilisi will have to handle 50% of the total logistics market, which is estimated at 2.25 million tons of cargo annually. The Tbilisi Logistics Center (TLC) project, which will be completed by the end of 2013, is expected, along with the Tbilisi Railway Bypass Project, to form a hub for multi-modal cargo handling in the region. The TLC will be directly connected to Poti/Batumi ports, Azerbaijan and Armenia by railway, and to the East-West highway. In total, $26-38mln will be invested in the project by a consortium of private investors, led by Swiss Global Investment Group.

A competing logistics project is being currently implemented by an offshoot of the automobile trading company Tegeta Motors in partnership with Gebrüder Weiss near Tbilisi airport.[90] The project envisages the building of A-level warehouse to function as a local and regional distribution hub, capable of handling all types of cargo, including industry-specific facilities. The first phase of investment is financed by a €8mln loan from the EBRD.[91]

3.5.4 Georgia's potential as a trade logistics hub

A great opportunity for Georgia's economy is to leverage its central location on the CTC and the general business environment in order to develop its potential as a trade logistics hub.

Car trade logistics. One may be surprised to learn that Georgia manufactures no cars, yet car exports accounted for 25% of its total exports in 2012. Since 2005, car imports and exports have been growing by leaps and bounds, in value and as a share of total exports. Indeed what Georgia does is re-export the cars it imports from Japan, USA and Europe. Observing the annual growth rate in car re-exporting activity (98% in 2011) one may wonder whether this trade is subject to a version of the famous Moore's law. In fact, however, this rapid expansion is easy to explain. Early 2011 saw the announcement of impending changes in the customs code of Kazakhstan, raising tariffs on imported cars. While creating a temporary spike in demand, this announcement had a permanent effect on demand from other countries given that Georgia used the opportunity to upgrade its car trade logistics infrastructure. The new car trade center in Rustavi offered foreign buyers a convenient, corruption free and efficient platform to conduct trade in cars. The serendipity of tighter international sanctions on Iran further strengthened Georgia's position as a regional transport and trade hub, explaining both the large increase in the volume of cargo going through Georgia in 2012 and the country's attractiveness as a car trade hub for buyers from Azerbaijan and Armenia.

It is important to understand that, fundamentally, the reasons for such phenomenal growth in the car re-export activity is the combination of Georgia's general business environment (efficient customs administration and low compliance costs) and the national government's effort to coordinate the creation of a modern car trade facility in Rustavi. Otherwise it is hard to think of any particular advantage that Georgia may have in this activity other than a central location. There is no superior technology involved or specialized factors of production. Indeed, Georgia does not yet even have a well-developed network of service centers. Yet, it became a regional hub for automobiles simply because it acted strategically when the opportunity presented itself. When neighboring states liberalize car imports to an equal measure, Georgia will lose this artificial aspect of comparative advantage. Yet, it may be able to maintain its role as a regional car trade hub if it reaches sufficient scale in terms of the number and variety of cars available for foreign buyers, on the one hand, and develops value adding services such as repairs and stocking of spare parts, on the other.

Trade in pharmaceuticals. Unlike cars, Georgia does manufacture (generic) medical drugs for export, although there is also quite a bit of retail repackaging of bulk imported drugs. Over the past six years, the average annual growth amounted to 35% in production and 55% average annual growth in exports. In relative terms, by 2012, pharmaceutical products made up 3% of total imports and 2.2% of total exports.

Light regulation makes it easy for wholesalers to import and export this category of goods to and from Georgia. The pharmaceuticals regulator does not require additional certification for new drugs that have already been certified in developed countries. Further, the 2009 fiscal reform eliminated VAT or customs duties on most pharmaceutical products.

Currently, the main export markets are Kazakhstan, Ukraine, Azerbaijan and Armenia. There are three major players in the industry, two of which have made modest investments in production and logistical infrastructure, such as warehousing. This is because tight expiry dates mandate an effective inventory management system. Whilst no substantial investment in R&D capacity or production of proprietary drugs has been made so far, one of the operators, Aversi Pharma is planning to make a GEL 7mln investment in a new laboratory[92].

The large specialized warehouses providing tight control over temperature and humidity conditions are likely to contribute to the future prominence of Georgia as a hub for the regional distribution of pharmaceuticals. It is, however, doubtful that the generics-driven industry can achieve substantial returns to scale here. And since the share of transportation costs is low there is no rationale in locating production units closer to the markets. Given that about 80% of the world's pharmaceutical manufacturing takes place in China, large international investors are unlikely to set up production in Georgia.

[90] The center has own rail connection (500m) to the new rail bypass; it is located 800m from the airport; 2 km from Customs Clearance Zone; and 2km from the Tbilisi ring road.

[91] Interview with Sandro Kharlamov

[92] Interviews with Irakli Purtseladze and David Kiladze.

Hualing International Economic Zone. A new city with a population of up to 200 000 people is currently in construction on the shores of Tbilisi lake based on agreement between Chinese investors and the previous Georgian government. The driving force behind the Hualing investment is the option of using Tbilisi as a trade logistics hub servicing Chinese manufacturing and exports to the Caucasus, Turkey, and the European market.

According to YFN's Simon Appleby, "both logistics and manufacturing are very desirable industries to encourage in Georgia, as they have the potential to employ many tens of thousands of semi-skilled laborers who have not had regular employment in the past two decades. The Deep and Comprehensive Free Trade Agreement with the EU, likely to be fully ratified in 2015, may prove very attractive to Chinese TCF (textile-clothing-footwear) manufacturers to locate here instead of Bulgaria or Romania, where labor and power are more expensive."[93]

3.5.5 TAKING STOCK

Once the rail tunnel under the Bosporus Strait in Istanbul is completed, the Baku-Tbilisi-Kars railway segment will become a part of a new rail corridor from the Caspian Sea to Europe. This rail corridor will diminish the need for sea and road transportation, reducing costs and the environmental footprint.[94]

Additionally, assuming future improvement in Georgia's economic relations with Russia, the Baku-Tbilisi-Kars project would help re-open the North-South rail corridor linking Russia and Turkey. Because of international sanctions on Iran, by 2015, the North-South corridor via Georgia has the potential to serve over two million tons of additional cargo.

Once the corridor allows goods delivery in a cost and time-efficient manner, it is estimated that about 25% of the traffic between Turkey and Asia will shift to the Baku-Tbilisi-Kars line. This will lead to total annual throughput of 30 million tons on the line. As the current total throughput of Georgian Rail is 11 million tons annually, this would imply a substantial increase on the Baku-Tbilisi-Kars route alone.

[93] Comment on "Riding the Dragon" http://www.iset.ge/blog/?p=1889

[94] As Georgia also has plans to increase electricity production, it will make sense to shift bulk cargo from road to rail. This will be both cost efficient and environmentally justified.

Since Georgia is only a part of CTC, for this rosy scenario to materialize, the Georgian government should continuously engage in coordination efforts with other countries along TRACECA. A top priority is to resolve the infrastructure bottlenecks in Azerbaijan and Kazakhstan. Given the expected completion of the BTK project, Georgia and Azerbaijan should coordinate to add ferries on the Black and Caspian Sea routes. The current network of ferries and ports is constrained by the capacity of about 2 million tons per annum, which will not be enough given expected increases in trade volumes.

To maximize the use of the new transport corridor, and to provide benefits to a wider set of regional parties, the project's planners should contemplate linking up with other Central Asian countries to the eastern coast of the Caspian Sea as part of the "Navoi-Turkmenbashi-Baku-Tbilisi-Kars" project. And, as is apparent from recent statements by the political leadership in Turkmenistan and Uzbekistan, the door for cooperation is wide open.

3.6 Conclusions and policy recommendations

With TFP growth largely exhausting itself by 2008, Georgia is currently in the process of figuring out its future strategy. As argued throughout this chapter, given the presence of strong external economies there could be a role for the benevolent social planner in promoting coordination among independent actors – investors, banks, business associations, individual producers and farmer communities, local governments, employers, educational establishments and students (future entrants into the labor market). Such coordination can take various forms: for example, international agreements on trade and cross-border collaboration; investment in public infrastructure (such as roads, airports, transmission lines); coordination of investment decisions, sector-specific tax breaks and subsidies (e.g. hydropower). The aim is in any case the same – to trigger a virtuous circle of investment in capital and skills.

Like any medicine, interventionism comes with a long list of precautions. Moreover, given that government attention span and public funding are inherently scarce, only a very topical application of the medicine is conceivable. It seems logical to start with reforms that have economy-wide effects, such as law and order, improvements in general infrastructure and broad liberalization measures implemented by Georgia in 2004-2006. Yet, while further fine-tuning of the business environment is certainly feasible (particularly as far as rule of law and property rights are concerned), these first generation reforms appear to have exhausted their potential. As argued above, improvements in the general business environment allowed Georgian businesses to churn out more of the same stuff (as indicated by low rates of product innovation). The aim of the new Georgian administration should be to create the conditions for investment in low-risk-low-return activities, such as manufacturing, in order to take productivity improvements and economic growth to new levels.

Our aim in this chapter was to review the potential for state interventions in key export-oriented industries such as agriculture and agribusiness, tourism, hydroelectric power, transport and trade logistics. In all these sectors, Georgia has the potential to leverage its business-friendly environment and inherited conditions (central location, abundance in water resources, soft climate and rich soils). So far, however, progress has been handicapped by coordination failures and scale economies. While massive investment and training could potentially create viable industries in all these sectors, public resources are ultimately limited, calling for careful prioritization, experimentation, monitoring and evaluation.

Georgia's agriculture stands out on the above list of potential priority sectors given its social and political significance. While there is evidence for private sector's ability to internalize coordination externalities, we see strong justification for government action targeting untapped agricultural land and labor resources. Such action is justified given the urgent need to reduce social and political risks stemming from rural un- and under-employment. In designing interventions, the government should be fully cognizant of the recent experience with ill-conceived, disruptive and wasteful interventions at the micro-level (e.g. politically motivated price support for grape growers, the creation of Gruzvinprom). The main lesson learned from this experience is that instead of ignoring private sector interests and competing with private agribusinesses, the government should promote, and work with, business associations and large businesses that have the ability to resolve coordination failures plaguing Georgia's agriculture.

As a matter of principle, desirable interventions fall into three categories:

- Interventions affecting the entire economy such as free trade agreements that improve market access for all Georgian businesses; investment in strategic transportation infrastructure (road, rail, sea and air communications);
- Interventions targeting externalities that are specific to the agricultural sector and yet are broad in nature such as improved control of animal and plant diseases; research, education and vocational training; extension services that make professional expertise available to smallholder farmers and farmer organizations; irrigation and drainage systems increasing the supply of arable land; and, last but not least, measures to decrease the cost of agricultural lending.
- Promotion of farmer organizations and cooperatives to directly address the social and political risk externality. To avoid past mistakes, the government should not engage in Soviet-style collectivization. Instead, it should develop an appropriate legal and tax environment and encourage the creation of farmer organizations by helping with the managerial aspects of cooperation and integration into relevant value chains through a period of incubation.

Tourism and the hospitality industry. Despite what seems like phenomenal growth in the number of foreign arrivals to Georgia (about 30% per annum), the tourism industry suffers from classical coordination failures related to threshold and scale effects. To inject significant capital into the sector, private investors have to be assured of minimum demand, which Georgia's major touristic destinations cannot guarantee. The result is a vicious circle which the previous administration tried to undo by investing in public infrastructure, such as, water, rail, road and air communications; creating special touristic zones along the Black Sea shore, establishing the Gudauri Development Fund, and engaging international donors and businesses in the development of Batumi, Mestia, Tskhaldubo and other touristic sites.

While the tourism sector is unlikely to be a driver of productivity growth in the long run, its development addresses the social and political risk externality by promoting rural development and creating jobs in the periphery. The sector's contribution to job creation is likely to increase with the further development of four season destinations such as Svaneti and Tskhaldubo, the entry of budget airlines, and the full opening of the Russian borders, including re-establishment of the rail connection to Russia via Abkhazia.

Hydroelectric energy. Georgia does have significant hydropower potential, however it is not at all clear that the outgoing government's strategy of gearing this potential towards exports to Turkey justifies massive capital outlays and environmental impacts. This is particularly so given that under the Build-Own-Operate concession model currently proposed to foreign investors, the lion's share of economic rents accruing from the use of Georgia's water resources will not stay in the country. Georgia can benefit from increased hydrogenation capacity and cross-border trade in energy, yet it should also make sure that at least some of these gains are passed onto domestic consumers and producers. By lowering the domestic price of energy Georgia's will create the incentives for private investment in energy-intensive export-oriented manufacturing activities – a far more promising avenue for future productivity growth and competitiveness.

Transport and trade logistics. The currently observed levels of public and private investment in the BTK rail project and many other pieces of transport, trade and logistics infrastructure are indicative of the great promise of this sector for Georgia as a gateway to and from the vast landlocked Central Asian region. Georgia is of course only a small part of the cargo route connecting Central Asia, Azerbaijan and Armenia to the Black Sea, Turkey and the EU market. Spanning many natural and artificial (political) barriers, this route is in need of coordinated investments by all the parties involved.

As far as Georgia is concerned, public investment in transport infrastructure and policies that reduce trade and transaction costs carry very large spillover effects for the entire economy. For one things, they translate into a drastic increase in the **external market size** accessible for Georgia-based firms and agricultural businesses. Strong positive spillovers are also associated with the development of Georgia's trade logistics and warehousing capacities since they provide domestic producers and consumers with improved access to a wider choice of intermediate inputs and consumption goods (a key indicator in the **goods market efficiency** pillar in the GCI). The extra advantage of greater international exposure is the opportunity for domestic enterprises to interact with foreign industries, fostering technology adoption and innovation.

Measures reducing trade costs have all the attributes of a desirable policy: opening up to trade sends correct price signals to domestic producers and allows them to enjoy spillovers generated by the transport sector. And, as we have seen above, the trade and logistics sector is a magnet for foreign and domestic investors, generating value added and jobs.

There is no doubt that the sector is in need of public capital investment (financed by the Partnership Fund or concessionary loans). However, in light of tight budget constraints, the public investment must be just sufficient to spark a round of private investment. Moreover, it is important to outsource the financing and the actual operation of the trade logistics sector to the private investors, domestic and foreign.

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APPENDIX 1. List of indices referred to in the report

World Giving Index – The index is calculated from 2010 by the Charities Aid Foundation (CAD) based on the data from Gallup's World View World Poll covering 153 countries. The final index/percentage is an average of three indicators: Percentage of population giving money, Percentage of population volunteering time, and Percentage of population helping stranger.

https://www.cafonline.org/pdf/World_Giving_Index_2011_191211.pdf

Global Peace Index – Prepared by the Institute for Economics and Peace, incorporating 158 countries (in 2012), is a measure of national peacefulness. The index is based on 23 indicators on the 'absence of violence'. The index was first released in 2007.

http://www.visionofhumanity.org/gpi-data/

Global Gender Gap Report – Published by the World Economic Forum. The report quantifies gender-based disparity based on economic participation/opportunity, educational attainment, health & survival, and political empowerment and evaluates its dynamics over time. In 2012 the report covered 135 countries.

http://www.weforum.org/reports/global-gender-gap-report-2012

Global Innovation Index – Prepared by INSEAD, the Business School for the World. The index covers several sub-indices: the Global Innovation Index 2012, Innovation Input Sub-Index, Innovation Output Sub-Index, Institutions, Human capital and research, Infrastructure, Market sophistication, Business sophistication, Knowledge and technology outputs, and Creative outputs. The 2012 index covered 141 countries.

http://www.globalinnovationindex.org/gii/main/2012rankings.html

Travel and Tourism Competitiveness Report – Prepared by the World Economic Forum, the Travel and Tourism Competitiveness Report measures indicators of T&T competitiveness around the world. 139 countries were covered in the latest (2011) report.

http://gcr.weforum.org/ttci2011/

Quality of Life Index – Prepared by International Living. The 2011 Quality of Life Index covered 192 countries. The index is calculated on the basis of Cost of Living, Leisure & Culture, Economy, Environment, Freedom, Health, Infrastructure, Risk & Safety and Climate.

http://www1.internationalliving.com/qofl2011/

Human Development Index (HDI) – Evaluated by ENDP and covering 187 countries, the HDI is a measure of development. It is calculated on the basis of health, education and living standards.

http://hdr.undp.org/en/reports/global/hdr2011/

Corruption Perceptions Index – Ranks countries by their perceived levels of corruption. The index is calculated by Transparency International. In 2011 the index covered 182 countries.

http://cpi.transparency.org/cpi2011/results/

Failed States Index – Is a project of the Fund for Peace and Foreign Policy Magazine. The ranking is produced on the basis of data/report analyses and forming social, economic and political & military indicators. The 2012 report covers 59 countries.

http://www.foreignpolicy.com/failed_states_index_2012_interactive

Economic Freedom of the World - Is a product of the Fraser Institute and measures the degree to which the policies and institutions of countries are supportive of economic freedom. It evaluates economic freedom throughout the world on the basis of five parameters: Size of Government, Legal System and Property Rights, Sound Money, Freedom to Trade Internationally, and Regulation. The latest (2012) report covered 144 countries.

http://www.freetheworld.com/release.html

Social and Economic Rights Fulfillment Index (SERF) – Is a product of the Economic and Social Rights Empowerment Initiative. The latest (2011) report covers 195 countries.

http://www.serfindex.org/2011-international-serf-index-downloads/

Logistics Performance Index (LPI) – Produced by the World Bank, the index is the weighted average of six indicators: Efficiency of the clearance process by border control agencies (including Customs); Quality of trade and transport related infrastructure; Ease of arranging competitively priced shipments; Competence and quality of logistics services; Ability to track and trace consignments; and Timeliness of shipments in reaching destination within the scheduled or expected delivery time. The latest (2010) report covers 155 countries.

http://www1.worldbank.org/PREM/LPI/tradesurvey/mode1b.asp

Transformation Index – Is a product of Bertelsmann Stiftung. The index analyzes the quality of democracy, the market economy and political management in 128 developing and transition countries.

http://www.bti-project.org/index/

Environmental Performance Index – Environmental health and Ecosystem Vitality is used to build the index. Yale University covers 132 countries for environmental issues.

http://epi.yale.edu/epi2012/rankings

Index of Economic Freedom – The Heritage Foundation, in partnership with the Wall Street Journal, calculates the index for 179 countries (2012 report). The global index is calculated on the basis of rule of law, limited government, regulatory efficiency and open markets.

http://www.heritage.org/index/ranking?src=home

Global Retail Development Index - The Global Retail Development Index is an annual study by A.T.Kearney that ranks the top 30 developing countries for retail expansion worldwide. The Index analyzes 25 macroeconomic and retail-specific variables.

http://www.atkearney.com/consumer-products-retail/global-retail-development-index

Doing Business Index – The index ranks economies on their ease of doing business. The index covers 185 countries (2012 report) and is produced by the World Bank and the International Financial Corporation.

http://www.doingbusiness.org/rankings

Networked Readiness Index – The index is produced by the World Economic Forum and measures the propensity for countries to exploit the opportunities offered by information and communication technology.

http://reports.weforum.org/global-information-technology-2012/

Status index – The index developed by Bertelsmann Stiftung is a combination of two indices: political transformation and economic transformation. 128 countries are covered by the index.

http://www.bti-project.org/index/status-index/

Global Integrity Report – The index is developed by Global Integrity and covered 100 countries in its latest (2011) ranking. The report analyses the transparency of the public procurement process, media freedom, asset disclosure requirements, conflicts of interest, regulations, etc.

http://www.globalintegrity.org/report

Democracy Score - Is an average of ratings for Electoral Process, Civil Society, Independent Media, National Democratic Governance, Local Democratic Governance, Judicial Framework and Independence, and Corruption. It is developed by Freedom House and the latest (2012) ranking evaluates 29 countries.

http://www.freedomhouse.org/report/nations-transit/nations-transit-2012

Political Stability/No Violence – Being a part of the Worldwide Governance Indicators (WGI), the index reflects perceptions of the likelihood that a government will be destabilized or overthrown by unconstitutional or violent means, including politically-motivated violence and terrorism. In total, 213 countries are included in the ranking.

http://info.worldbank.org/governance/wgi/sc_country.asp

APPENDIX 2. Countries in different GCI categories

Factor Driven	1-2	Efficiency-driven	2-3	Innovation-driven
Bangladesh	Algeria	Albania	Argentina	Australia
Benin	Azerbaijan	Armenia	Bahrain	Austria
Burkina Faso	Bolivia	BiH	Barbados	Belgium
Burundi	Botswana	Bulgaria	Brazil	Canada
Cambodia	Brunei Darussalam	Cape Verde	Chile	Cyprus
Cameroon	Egypt	China	Croatia	Czech Rep
Chad	Gabon	Colombia	Estonia	Denmark
Côte d'Ivoire	Honduras	Costa Rica	Hungary	Finland
Ethiopia	Iran, Islamic Rep	Dominican Rep	Kazakhstan	France
Gambia, The	Kuwait	Ecuador	Latvia	Germany
Ghana	Libya	El Salvador	Lebanon	Greece
Guinea	Mongolia	Georgia	Lithuania	Hong Kong SAR
Haiti	Philippines	Guatemala	Malaysia	Iceland
India	Qatar	Guyana	Mexico	Ireland
Kenya	Saudi Arabia	Indonesia	Oman	Israel
Kyrgyz Rep	Sri Lanka	Jamaica	Poland	Italy
Lesotho	Venezuela	Jordan	Russian Fed	Japan
Liberia		Macedonia,	Seychelles	Korea, Rep
Madagascar		Mauritius	Trinidad and Tobago	Luxembourg
Malawi		Montenegro	Turkey	Malta
Mali		Morocco	Uruguay	Netherlands
Mauritania		Namibia		New Zealand
Moldova		Panama		Norway
Mozambique		Paraguay		Portugal
Nepal		Peru		Puerto Rico
Nicaragua		Romania		Singapore
Nigeria		Serbia		Slovak Rep
Pakistan		South Africa		Africa
Rwanda		Suriname		Slovenia
Senegal		Swaziland		Spain
Sierra Leone		Thailand		Sweden
Tajikistan		Timor-Leste		Switzerland
Tanzania		Ukraine		Taiwan, China
Uganda				UAE
Vietnam				UK
Yemen				USA
Zambia				
Zimbabwe				

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