GEORGIA: ECONOMIC POLICY AFTER THE "REVOLUTION OF ROSES"

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In 1989, influential financial and political organizations and well-known economists agreed upon the main lines of reform in economic policy, which became known as the Washington Consensus. Its ideas had a significant impact on the way of thinking and course of action in the countries of Eastern Europe and in the Soviet Union, although initially that policy was intended not for a restructuring of the postsocialist countries, but for already functioning markets, so that in some respects it proved to be inadequate to the needs of the transition period.

The Washington Consensus stressed the importance of liberalization, privatization, the opening up of postsocialist economies, and the necessity of maintaining fiscal discipline. But that approach did not take into account a number of important elements required for systemic transformation, stabilization and growth. This includes institution building, an improvement of corporate governance in the state sector prior to privatization, and a review of the state's role in the economy, but without its complete withdrawal from economic activities (as the record of many countries shows, with excessive deregulation a society based on the principles of liberalism cannot prevent an increase in social inequity).

The assumption that emerging market forces can quickly replace the government in the field of institutional development, investment in human capital and development of the infrastructure resulted in a sharp contraction of the economy and growing social tensions. The lack of a basic market structure and financial intermediaries impeded accumulation and worsened the allocation of savings. Thus, the lack of proper control over the emerging market in the postsocialist countries and the absence of such key organizations as investment banks, stock exchanges, security and control agencies, etc., created problems which could not be resolved by liberalization or privatization. Employment in these countries fell sharply. Since their economic systems had formerly operated with a labor shortage, they had no social security system protecting against unemployment and were obliged to build up such a system from scratch.

The need to manage the institutional aspects of the transition process was recognized and taken into account only at later stages. Georgia has learned from its own experience that even a sound economic basis (i.e., a balanced budget and current account, low inflation, a steady currency, free trade and a developed private sector) cannot ensure growth unless it is supported by an appropriate institutional setup.

Much is being said today about the shortcomings of the set of measures recorded in the Washington Consensus and about the advantages of "gradualism" compared with "shock therapy." However, it is rarely taken into account that the most destructive effect on the transition economy was exerted not by these measures themselves, but by their half-hearted implementation. That is why in many countries, including Georgia we saw the emergence of an essentially corrupt and destructive combination of the private property system and a quasi-market, which means a lack of normal competition and of a level playing field for business activity. That resulted in a sharp stratification of society and large disparities in consumption levels. In Georgia, all these processes created a prerevolutionary situation.

Let us consider some of the results of the economic reforms in Georgia achieved by the end of 2003 and the changes taking place today, assessing them in accordance with the ten points of the Washington Consensus as listed by John Williamson at the time.

1. Fiscal Discipline. According to this principle, the budget deficit should be small enough to be financed without recourse to the inflation tax. In Georgia, however, fiscal policy was inconsistent with this principle from the time of the country's withdrawal from the ruble zone to the introduction of a new national currency (the lari) at the end of 1995. It was not only the state budget deficit and numerous special government programs that were financed by the state, but also private business projects. Most of these involved corruption and had nothing to do with the real economy, but were used for speculation in the foreign exchange market. The fall in the exchange rate of the national currency was both a result of such activities and their nutrient medium. Once hyperinflation had been overcome and a new currency introduced, the operation of financial mechanisms entered a relatively balanced period (1996-1997), which was once against interrupted by the negative impact of the Russian default in August 1998. The authorities associated the worsening financial problems only with these external factors, whereas in actual fact it was gradually becoming clear that the regime was in principle incapable of coping with the problems of the state budget: for five years running, actual revenues fell far short of the budget figures. Moreover, a few months into the fiscal year the authorities would announce the need to sequester or reduce the budget and would get down to restructuring budget expenditures (without meeting the proportionality requirement in reducing expenditure items), which became an important corruption scheme in the functioning of the former regime.

   Since the beginning of 2004, intensive measures have been taken to combat such chronic phenomena as inadequate administration in collecting taxes and payments into the central budget (according to experts, tax compliance did not exceed 35-40%); money offsets; use of commercial bank credits guaranteed by the Ministry of Finance on behalf of the government, of signature and other loans; conversion of debt owed by enterprises and organizations subordinate to local government bodies into domestic public debt; inordinately high inter-enterprise arrears; misuse and ineffective use of budgetary funds.

   State budget revenues in 2004 were scheduled to be 35% above the actual figure for the preceding year. But the results of the first six months have turned out to be so encouraging that, according to the government, the total increase in revenue could be close to 54%. Such optimistic forecasts in the sphere of public finance management are also based on the resumption of cooperation with the IMF, suspended about three years ago through the fault of the country's former authorities.

2. Public Expenditure Priorities. Postrevolutionary financial policy provides that expenditure should be redirected from socially and politically sensitive areas toward fields with high economic returns and the potential to improve income distribution. The chronic budget deficit and the state's complete withdrawal from economic activity under the former regime (not counting widespread "racketeering" by government officials or their business activities and unfair lobbying practices) made it impossible to carry out measures designed to regulate public spending. Moreover, pervasive corruption in this area gave occasion to the institution in early 2004 of criminal proceedings against the former head of the State Control Chamber, the country's main watchdog agency in the field of financial control.

3. Tax Reform. Such reform involves broadening the tax base and cutting marginal tax rates in order to improve horizontal equity conducive to economic growth. One should note that tax

reform in Georgia is just beginning. The new Tax Code will probably be adopted by the end of the year. The tax base is to be expanded through a resolute improvement in tax administration, suppression of smuggling and abolition of numerous tax benefits which nominally take the form of social assistance but in actual fact have a corruption content.

4. Financial Liberalization. Its main objective—market-determined interest rates—has in principle already been achieved. But given the lack of confidence (and also in view of interest rate inertia as inflation falls), these rates have turned out to be so high as to threaten the financial solvency of enterprises and make it impossible for them to obtain credits, especially long-term credits. In the conditions of high dollarization of the economy and flight of savings abroad, the banking system cannot pursue a flexible monetary policy and in effect remains on the sidelines of production processes. Today the country's authorities are taking resolute measures to improve the investment environment, enhance the protection of property rights and promote mutual confidence between economic agents, which will help to mobilize national and to attract foreign financial resources and will thus serve to improve the operation of the banking sector.

5. Exchange Rates. The country today has a liberalized foreign exchange regime. Exchange rates are established as the result of trading on the Interbank Currency Exchange. For several years now the National Bank has not carried out any interventions in support of the exchange rate of the lari, which became possible owing to a very tight monetary policy and stringently controlled money supply. In the view of many experts, the country's currency today is excessively overvalued in relation to the key world currencies, which impedes the development of export production. The level of capital concentration and monopolization in the banking sector is very high, creating the danger of collusion for the purpose of economically unjustified currency speculation. People sense this danger and are in no hurry to part with the foreign currency they hold even in the conditions of an overvalued lari. On the whole, the banking system (despite its relative independence) did not escape the impact of the former corrupt regime. The National Bank is accountable to parliament, but until recently this accountability was only nominal. However, the newly elected parliament, which started work in April 2004, has been trying to establish proper relations with the banking system.

6. Trade Liberalization. In 2001, Georgia joined the World Trade Organization. At the same time, influential industrial circles have expressed dissatisfaction over the country's inability to protect its domestic market and to organize import-substituting production. The republic's leadership is fully committed to WTO membership and intends to stimulate export production, which meets Georgia's long-term interests.

7. Foreign Direct Investment. Barriers impeding the entry of foreign firms have been abolished. Foreign and domestic companies can compete on equal terms. But the territorial disintegration of the country (about 30% of its territory is outside its jurisdiction, which creates the danger of a renewal of the conflict) and the high level of corruption and "shadow" economic activity did little to enhance Georgia's investment attractiveness. Today there are promising signs of improvement in the investment climate, both from the standpoint of territorial integrity and in the drive to curb corruption. An immense role here could be played by targeted funding of programs for the development of the republic's economy currently undertaken by the international community.

8. Privatization. Under the former regime, there was a massive sell-off (at giveaway prices) of state-owned enterprises, which fell into the hands of former "red directors" and their patrons. Most of the plants and factories privatized in that way are still standing idle, while their owners have been selling land and other fixed assets. In spite of just criticism of the state of affairs and numerous offenses committed in this area, privatization (especially under the new authorities) is on the whole entering its final stage, which should result in the emergence of a robust equity market. This stage has generated particularly heated debates in society, which center on the privatization of so-called "strategic facilities," especially by foreign buyers. As a manifestation of the old mentality, people often argue that the new owners of alienated facilities can harm

national interests, forgetting the harm that has already been done by the state to the facilities it used to control (or still controls). On the other hand, these debates show the growing maturity of the public consciousness, with people expressing progressive views on the economic security of the state in the conditions of globalization of the world economy. At the same time, it is gradually becoming clear that changes in corporate governance are very important—alongside and to some extent in contrast to the indiscriminate transfer of ownership (just as long as state property is sold off), something that has now been recognized even by keen supporters of rapid mass privatization.

9. Deregulation. The country's new leadership accords top priority to deregulation and denationalization of the economy, notably by expanding the rights of autonomous entities and enhancing the role of local self-government, and also to the development of fiscal federalism. The dialectics of the completion of the transition period in our republic is such that it is first of all necessary to reduce the state's role to a minimum, to close all the loopholes for rent-seeking bureaucratic supervision, to enable the economy to develop in accordance with its own laws, and then, with due regard for the changing internal and external conditions, to think about the methods and extent of government intervention, which is an indispensable part of economic life in any country. Further democratization of political and economic life is an equally significant factor, which will make it possible to go over from reforms imposed "from above" to political activity by free enterprise and local self-government.

10. Property Rights. In the conditions of a sprawling shadow economy (informal sector) and widespread corruption, the official legal system had to accommodate itself to "shadow" illegal law and illegal courts (or courts that were "legal" for participants in organized economic crime). In the past few years, the country's law enforcement agencies did nothing to suppress illegal business. In fact, these agencies themselves often colluded in corruption and bureaucratic abuses, so expanding the scope of illegal law. That situation was one of the main causes of the revolutionary expression of popular discontent. From its very first days in power, the country's new leadership began to put things in order within the law enforcement system. The president has announced a tax amnesty, which provides that criminal proceedings will not be instituted against businessmen for concealment of income under the former regime, with the result that many of them are now moving out of the shadow into the sphere of legal business. In June 2004, the chairman of the republic's Supreme Court was removed from office, and work is underway to overhaul the judiciary. The country's parliament pays close attention to the development of legislation designed to protect property rights, to contract law and an improvement of the institutional foundations of the economy. The newly elected parliament has deemed it necessary to set up a parliamentary Committee for European Integration, one of whose tasks is to harmonize legislation in the field of protection of property rights.

Representatives of the new authorities have repeatedly declared that institutional measures are the key to further development. If a country's government neglects institutional arrangement and leaves it to spontaneous processes, giving full play to liberalized market forces, the systemic vacuum will be filled with informal institutionalization, as Georgia has learned from its own bitter experience. The Bretton Woods organizations should change their policies towards transition economies in order to direct them towards institution building, the creation of a full-fledged securities market and appropriate price support. The liberalization of capital and its transfer from the "shadow" to the legal economy should be brought under the control of the country's financial and monetary authorities with the support of international financial institutions.

Georgia's present policy-makers are probably quite right in thinking that government composition is less important than the quality of policy and the means of its implementation and that political conservatives should give way to reformers. However, the critics of such an approach are displeased with the fact that the average age of government members in the republic is much lower than in any other postcommunist country.

Meanwhile, Georgia's young head of state, as indicated by his speeches, takes into account that institution building is by its very nature a gradual process with its own internal logic ruling out both frequent change of tack and hasty extremist decisions. At present, the next item on the agenda is to restructure and modernize the judicial system and to transfer some of the central government's powers and authority to local government bodies, which is necessary to reduce government intervention in the postsocialist economy.

In June 2004, the government published its program for 2004-2009, entitled "For a Unified and Strong Georgia on the Path of Economic Growth, Long-Term Stabilization and European Integration." In the field of institutional reform, this program formulates the following tasks: to increase saving by maintaining fiscal discipline through a significant improvement in the work of financial control agencies; to reorient public expenditure toward more rational social spending with a simultaneous increase in the role of the budget as an instrument for stimulating priority lines of development; to restructure the tax system so as to maximize incentives to economic growth; to tighten banking supervision, and to maintain a competitive exchange rate of the national currency, both stable and flexible. The program also provides for trade liberalization, creation of a single national market and of conditions for extending the general principles of market regulation to the country's entire territory; completion of the privatization process, deregulation of the economy; establishment of well-defined property rights accessible to all, and also of political and economic institutions that would help to minimize transaction costs and ensure contract implementation; and an increase in spending on education, especially primary and secondary education.

Observers and economic experts accentuate the weaknesses of Georgia's institutional structure to which the new authorities should pay special attention. These include: an undeveloped organizational infrastructure required to create a liberal market economy; insufficiently competent financial intermediaries incapable of efficient allocation of privatized assets; inadequate commercialization and liquidity of state enterprises (prior to privatization); lack of managerial experience and skills for exercising corporate governance in the conditions of a deregulated economy; a weak institutional infrastructure for political competition, especially in connection with the coming 2005 elections to local self-government bodies; weak and corrupt judicial agencies unable to enforce the Tax Code and business contracts; low professional standards and inadequate funding of the local authorities, which makes them incapable of addressing regional development problems; the small size and poor financial standing of nongovernmental organizations supporting the operation of the emerging market economy and civil society.

At the Georgia Donors' Conference held in Brussels on 16-17 June, 2004, the country's leadership presented a report entitled "Georgia: The Government's Strategic Vision and Urgent Financing Priorities in 2004-2006." The conference itself became possible as a result of the latest changes in the republic, whose new legitimate authorities have started an uncompromising struggle against corruption. The outcome of the conference was unexpected for Georgia: it received three times more donor assistance (850 million euro for three years) than it had requested.

The government listed its priorities as follows: governance, rehabilitation of the energy sector, social protection of the population, private sector development, sustainable and regional development. The report emphasizes that, according to the estimates of Transparency International, only six of the 133 countries surveyed in 2003 had a worse corruption perception index than Georgia. Compared with other CIS countries, Georgia scored lower on regulatory quality, rule of law and political stability. Since January 2004, criminal proceedings on charges of corruption have been initiated against 19 high-ranking officials, as a result of which the state has recovered $23.4 million. The latest public opinion polls show that, owing to such measures, public confidence in the authorities today is three times as high as it was before the revolution. The government believes that the level of civil society participation in anticorruption activities will markedly increase, because all these measures are to be widely discussed in advance. It is planned to separate the powers and to determine the strategies of various law enforcement agencies in their fight against corruption. Steps are to be taken to introduce new criminal procedures that would ensure equal rights for all defendants and prosecutors. Investigative procedures in corruption cases are to be simplified, the role of legislative bodies in the fight against corruption is to be enhanced, national legislation in this area is to be harmonized with EU documents, and the law enforcement agencies themselves are to be modernized.

In the field of administrative reform, the authorities have launched a long-term program to restructure the civil service, which will make it possible to eliminate all corruption sources. The government is soon to put before parliament a draft package of legal and structural reforms aimed at creating a meritbased professional civil service, including competitive recruitment. Work is in progress on a code of ethics for public servants. A salary reform is already underway, and methods of providing new employment for former public servants are being developed.

As regards fiscal and public finance reform, it is planned to simplify tax legislation, with a considerable reduction in the overall number of payments. There will be seven basic taxes: VAT, personal income tax, corporate income tax, excise tax, property tax, social tax and land tax. The tax reform is to be continued, notably by improving customs administration and by creating a single customs information system, including a border service (since Georgia is a transit country, it is necessary to rule out the possibility of customs clearance of import goods as transit goods not liable to tax). In the immediate perspective, it is planned to develop a program for random sampling and auditing of taxpayers, to markedly improve the organizational and material status of the financial police, to link the budget process even closer to the Economic Development and Poverty Reduction Program (EDPRP), to increase transparency in budget planning and spending, to reform the treasury, and to implement international accounting standards.

In the energy sector, the tasks for the next three years have been designated as follows: to raise the collection rate for electricity charges by 20%, to reduce transmission losses by 1%, to launch a large-scale public campaign against energy theft by the population (the authorities are even considering the possibility of criminal penalties for such actions), and to improve the financial monitoring of energy enterprises. A long-term investment program is to be drawn up by April 2005.

In the field of social protection of the population, the main tasks are to reduce poverty under the EDPRP program and to improve health care. With this aim in view, it is planned to tighten control of the health care system, restructure hospital and primary health care services, improve the targeting of medical assistance to the poorest strata of the population and to rural areas, and enhance maternal and child care. It is also planned to rationalize the pension and social security systems, raise pensions, set up a system for monitoring poverty indicators, and strengthen the targeting of social assistance benefits.

In order to promote the development of the private sector, the government intends to simplify the rules of company registration, acquisition of building permits, tax and customs administration, and product standardization and certification. The general purpose of these measures is to reduce the costs of doing business. It is also planned to improve the VAT refund system, introduce new customs legislation based on an anti-smuggling strategy, and take measures to enhance banking supervision.

In the sphere of sustainable and regional development, there are plans to give agricultural producers greater access to credit and insurance, create conditions for upgrading the rural infrastructure, increase agrobiodiversity, and introduce standardization, certification and quality control systems for agricultural products.

The main tasks in the field of trade and transport include a removal of procedural obstacles to transit of goods through the country's territory, a reduction in transportation costs, and creation of favorable conditions for trade and investment.

In the sphere of infrastructure, the government is planning to transfer the Road Fund to the Finance Ministry, to restructure railroads and ports with the adoption of modern management methods, to restructure and privatize the water supply and sewage system, to develop a social housing program and create conditions for public-private partnerships in housing construction, and to rationalize the urban development strategy.

Finally, it is necessary to link environmental protection and management measures to socioeconomic development plans, to work out the economic and institutional principles for protecting the country's coastal zone, and to minimize the environmental impact of such key projects as the development of sea ports, tourism and hydraulic power construction.