

# BTI 2008 | Georgia Country Report

|                         |      |             |             |   |
|-------------------------|------|-------------|-------------|---|
| <b>Status Index</b>     | 1-10 | <b>6.60</b> | # 38 of 125 |   |
| Democracy               | 1-10 | 6.85        | # 42 of 125 | ↗ |
| Market Economy          | 1-10 | 6.36        | # 48 of 125 | ↑ |
| <b>Management Index</b> | 1-10 | <b>6.36</b> | # 23 of 125 |   |

scale: 1 (lowest) to 10 (highest)    score    rank    trend

This report is part of the Bertelsmann Transformation Index (BTI) 2008. The BTI is a global ranking of transition processes in which the state of democracy and market economic systems as well as the quality of political management in 125 transformation and developing countries are evaluated.

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## Key Indicators

|                          |        |      |                              |      |                      |    |       |
|--------------------------|--------|------|------------------------------|------|----------------------|----|-------|
| Population               | mn.    | 4.5  | HDI                          | 0.74 | GDP p.c.             | \$ | 2,994 |
| Pop. growth <sup>1</sup> | % p.a. | -1.0 | HDI rank of 177              | 97   | Gini Index           |    | 40.4  |
| Life expectancy          | years  | 71   | UN Education Index           | 0.91 | Poverty <sup>3</sup> | %  | 25.3  |
| Urban population         | %      | 52.2 | Gender equality <sup>2</sup> | 0.41 | Aid per capita       | \$ | 69.4  |

Sources: UNDP, Human Development Report 2006 | The World Bank, World Development Indicators 2007 | OECD Development Assistance Committee 2006. Footnotes: (1) Average annual growth rate 1990-2005. (2) Gender Empowerment Measure (GEM). (3) Percentage of population living on less than \$2 a day.

## Executive Summary

During the period under review, Georgia has continued its accelerated path toward strengthening weak and corrupt state structures. It has achieved impressive results in terms of fighting corruption, enhancing the efficiency of administrative structures and stimulating economic growth by overdue public investment in a decaying infrastructure. The government has adopted a vast range of laws, strengthened property rights and simplified the issuing of licenses and tax payment procedures – all of which have contributed to a radical improvement of the business climate. So far, success was partly achieved at the expense of consolidating democratic power-sharing. Executive interference with the judiciary's independence has become a common phenomenon. Due to the structural weakness of the opposition, the parliament has almost ceased to exercise its oversight function. From time to time independent media outlets still suffer from bureaucratic harassment. The consolidation of democracy is, moreover, still hampered by a deep-rooted culture of distrust and clientelism. There is no party system in place capable of articulating and aggregating social interests. Even the United National Movement, the ruling party that clearly dominates all branches of power, does not have much appeal at the local level. The NGO sector, which has been weakened by a dramatic brain drain underway since the Rose Revolution, does not offer a viable alternative. It consists primarily of donor-driven advocacy groups that are not socially embedded.

## History and Characteristics of Transformation

Political and economic transformation in Georgia clearly lacks a linear dynamic toward the consolidation of democracy and a market economy. Regaining independence after the dissolution of the Soviet Union, the country faced the difficult task of managing a quadruple transition involving not only democratization and the institutionalization of a market economy, but state-building and nation-building as well. The development of the country, which was from the onset hampered by the heavy burden of two unresolved ethnic conflicts and a sharp economic decline aggravated by pervasive corruption, can be roughly divided into three different phases.

The first breakthrough to a democratic political regime in Georgia was accomplished with the parliamentary elections of October 1990, won by a heterogeneous umbrella movement under the leadership of the former dissident Zvia Gamsachurdia. Despite his landslide victory in the May 1991 presidential elections, he failed to consolidate his rule. As he missed the opportunity to build up a coherent political organization, his power rested mainly on charismatic mobilization. As a result, he was easily driven from office by a violent coup d'état at the beginning of 1992.

The brief interlude of chaos that ensued after the ouster of Gamsachurdia was terminated with the return of former party head Eduard Shevardnadze, who assumed the newly created position as head of state in March 1992. In the first three years of his rule, Shevardnadze was mainly occupied with the restoration of public order. He tried hard to get rid of competing gangs of criminals that had originally placed him in power. The adoption of a constitution and the successful organization of elections signaled a fragile consolidation. Notwithstanding quite impressive achievement in terms of ending violence and introducing the formal requisites of democratic statehood, and despite massive international assistance, Shevardnadze did not succeed in basing his rule on stable institutions. His political survival depended heavily on the application of two strategies, both of which placed heavy constraints on the consolidation of democracy.

Firstly, he used access to administrative resources and to international development funds as a means to consolidate fluid clientelistic networks. The government thus never acted as a coherent team. Severely weakened by frequent reshuffles, it gained notoriety for the fierce competition between different ministries over the distribution of spoils. Secondly, Shevardnadze manipulated and frequently changed procedural norms regulating access to power. The only continuous feature was a clear dominance of the executive, which was firmly controlled by Shevardnadze. In contrast, the shape of the parliament was adapted to varying needs. Until 1995, the abolishment of any kind of threshold ensured a highly fragmented legislature. After the creation of the Citizen's Union of Georgia (CUG) in 1993, which was designed to serve as Shevardnadze's

party of power, the introduction of a barrier bestowed a stable majority on the CUG. Pluralism was thus mainly confined to intra-elite competition inside the ruling party, which was composed of former Soviet apparatchiks and a group of young reformers.

These two strategies ceased to function effectively after 2001. The distribution of official fiefdoms among the different cliques of the elite severely hampered economic growth and thus gave rise to popular unrest. As the international donor community became aware of the increasing gap between legal fiction and corrupt practices, it demonstrated a growing reluctance to continue funding assistance programs. Confronted with a decline in its authority, the ruling party was compelled to adopt authoritarian measures, a move that provoked an internal split. The attempt to crack down on the independent TV station Rustavi 2 in October 2001 became a turning point. Prominent representatives of the wing of young reformers inside the CUG, headed by Saakashvili, Zhvania and Burjanadze, formed a new opposition that assumed power in the aftermath of popular protests against the rigging of parliamentary elections in November 2003.

The relative ease with which Shevardnadze was overthrown during what was to be called the Rose Revolution can be explained partly by the existence of democratic facades erected under his rule. A dense network of NGOs, which had mushroomed during the 1990s, carried out parallel vote counts and organized public protests. Independent media outlets, which had never experienced serious threats to their existence, supported popular mobilization by providing uncensored information. An independent judiciary, established under the influence of the young reformers, canceled the officially announced results.

After the accomplishment of the peaceful revolution, the victorious triumvirate of Saakashvili, Burjanadze and Zhvania rushed to stabilize the situation. They joined forces with the creation of a new party named the United National Movement – Democrats and thus put an end to early speculations concerning internal rivalry. With more than 96% of the popular vote, the charismatic leader Saakashvili gained an overwhelming victory in the presidential elections in January 2004. The newly created party won more than two-thirds of the mandates in the parliamentary elections of March 2004.

The new elite was thus awarded with a more than comfortable starting point. Control over the executive and legislative branch of the government made the implementation of a far-reaching structural reform agenda a much easier job. As a result, outstanding achievements were realized in terms of curbing corruption, streamlining an inefficient administration, improving the extraction capabilities of the Georgian state and providing public goods for an economy that experienced a significant upsurge. Despite these impressive results, critics of the new elite point at serious deficits and even setbacks in terms of institutionalizing checks and balances. Firstly, the adoption of far reaching amendments to the constitution further weakened a legislative body, which

due to the stable majority for the ruling party is hardly able to exercise its oversight functions. Secondly, the new government stopped short of respecting the independence of the judiciary and is constantly suspected of exercising undue influence over judges. Thirdly, many concerns were raised with regard to state interventions into the independence of the media. As a result, the record is rather mixed: Clear gains in efficiency were obviously achieved at the expense of the separation of powers. Sustainable economic recovery is moreover still complicated by permanent tensions caused by the unresolved conflicts with the breakaway region of Abkhazia and South Ossetia on the one hand, and strained relations with neighboring Russia on the other hand.

## Transformation Status

### I. Democracy

#### 1 | Stateness

Despite impressive achievements in terms of dissolving paramilitary units operating on the territory controlled by the current government of Georgia, the restoration of a nationwide state monopoly on the use of force could not be accomplished. Control over the separatist territories of Abkhazia and South Ossetia could not be restored. They still represent a kind of safe haven for all sorts of criminal gangs. To date, all efforts to achieve a resolution to these conflicts have failed. At the same time, the significant gains that were made in the course of the successful removal of the autocratic and semi-independent regime of Abashidze in the autonomous Republic of Adzhara in May 2004 could have been further consolidated. The integration of Adzhara, which now enjoys some rather limited but constitutionally recognized privileges, into the Georgian State is completed. Further improvements refer to the effective implementation of anti-smuggling measures. Whereas government-led crackdowns on smugglers have still triggered some violent reactions in the Shida Kartli region bordering South Ossetia in January 2005, the situation seems to be more or less under the firm control of rule-enforcement agencies now.

Monopoly on the use of force

In the territory controlled by the Georgian state, all citizens share the same civic rights. There is no legal provision for the discrimination of ethnic minorities, which represent 16% of the population. At the same time, the significant Armenian and Azeri minorities are still heavily underrepresented in state structures at all levels. The recent decision of the Georgian government to increase investment in the rehabilitation of the transport infrastructure in the areas of minority settlement can be regarded as a crucial improvement, but does not mark a breakthrough in terms of overcoming the legacy of their exclusion from the political and cultural life of the republic. Due to the low level of political organization on behalf of the ethnic minorities, this situation did not translate into an active questioning of the legitimacy of the Georgian State.

State identity

Though the Orthodox Church of Georgia still enjoys some special privileges, the legal situation of other religious communities was significantly improved. On the one hand, an amendment to the Civil Code adopted in April 2005 removed obstacles to their activities by allowing them to register as legal nonprofit organizations. On the other hand, radical representatives of the Orthodox Church, who gained prominence for organizing violent attacks against protestant sects, were sentenced to prison terms.

No interference of religious dogmas

The efficiency of administrative structure was significantly improved due to determined anti-corruption measures, an impressive increase in the tax collection rate and crucial rises in salaries for a wide range of state officials from police officers and judges to university teachers. In some Georgian regions, the picture seems to be less clear-cut. Here, efficiency gaps are still to be observed as a result of a clearly felt lack of reliable cadres.

Basic administration

## 2 | Political Participation

There are almost no restrictions on free and fair elections. Election administration has been significantly improved since the numerous violations that were a common phenomenon under Shevardnadze's rule. During the parliamentary elections in 2004 and again in the local elections in 2006, there have been minor infringements with regard to the use of state resources to the advantage of candidates from the ruling party. Irregularities in voter registration remain a problem, despite crucial improvements.

Free and fair elections

Due to highly successful efforts at curbing pervasive corruption the ability of elected officials to exercise effective power is no longer constrained.

Effective power to govern

Freedom of association and assembly is guaranteed by law and not constrained in practice.

Association / assembly rights

Legal restrictions that have constrained the freedom of the media under Shevardnadze have been successfully removed. According to an amendment to the law on the freedom of speech adopted in 2004, libel has been abolished as a criminal offense. It is now to be treated under civil law. Despite these legal guarantees, the media continues to be quite vulnerable to state pressure. This is to be explained mainly by the very limited scope of the market for advertisement. Whereas state agencies used to intervene quite frequently in the internal affairs of independent TV stations, as evinced by the charge of tax frauds in 2004 that led to the closure of two channels and leadership changes in two other channels, the situation seems to be much more relaxed nowadays. The year 2006 witnessed the re-emergence of political talk shows that had been taken off the air in the summer of 2005. Nevertheless, some concerns were raised with regard to the arrest of the

Freedom of expression

independent TV station 202's anchorman, who was accused of having accepted bribes by a member of the ruling party. Critics stated that he was convicted on flimsy evidence.

### 3 | Rule of Law

A certain disregard on behalf of the ruling elite for the institutionalization of a proper functioning system of checks and balances seems to mark the most serious deviation from the principles of democratic governance in Georgia since the Rose Revolution. Crucial problems are to be observed on two distinct levels. Firstly, an amendment to the constitution adopted in February 2004 has significantly enhanced the authority of the executive. The president is now granted the right to dissolve parliament if legislators fail to approve the state budget in three successive votes. Secondly, the stable majority of the pro-presidential party in parliament acts as a constraint on the legislature's ability to exercise its oversight functions. Whereas the ruling elite cannot be blamed for the emergence of this situation, critics have pointed to the undue hastiness with which laws were adopted without sufficient deliberation in parliament.

Separation of powers

Whereas legal and institutional guarantees for the independence of the judiciary ranged among the uncontested achievements of the Shevardnadze regime, the new elite that arose in the course of the Rose Revolution gained sad prominence for serious setbacks in the implementation of legal reforms. A number of highly contested measures raised fundamental concerns among local NGOs and the international donor community with regard to rising pressure on judges and severe interference in court affairs by the executive. From the beginning, the Saakashvili administration pursued the aim of getting rid of judges appointed under Shevardnadze. Initially, it tried to induce judges to resign with the help of material rewards. After the partial failure of this strategy, the judicial discipline commission under the supreme council of justice was charged with prosecuting and firing judges in cases of so-called "disciplinary abuses." As a result, the number of disciplinary proceedings against judges jumped from 48 in 2003 to 130 in 2005. The threat of filing disciplinary complaints against judges thus became a common practice of exercising undue influence on their decisions. In June 2005, the reduction of the number of first instance courts from 75 to 17 and the placement of many judges on a reserve list further increased their job insecurity and their vulnerability to manipulation by interested state agencies. As a result, courts as a rule agree to demands by the prosecutors – especially when it comes to pretrial detention. Additionally, the reduction of the number of active judges has severely exacerbated the problem of vacancies and led to delays in hearing cases.

Independent judiciary



The current government demonstrates a serious commitment to addressing the problem of pervasive corruption. A number of high profile arrests serve as a proof to its firmness. However, the fact, that only very few of those who had been imprisoned in 2004 have been brought to court has raised concerns with regard to the transparency of these measures. Several suspects have been released in exchange for money on the bases of a new law allowing for plea bargains.

Prosecution of  
office abuse

Especially in the immediate aftermath of the Rose Revolution, civil liberties have been negatively affected by the revolutionary style of implementing far-reaching reforms. Particularly in the context of the struggle against corruption, violations of human rights were criticized by the public defender. After all, the government has at least taken some measures to improve the situation. Since 2004, 10 police officers have been convicted on charges of torture and inhuman treatment. No progress has, however, been made in terms the less-than-transparent imposition of pretrial detention.

Civil rights

#### 4 | Stability of Democratic Institutions

With regard to institutional consolidation, the record of the new elites who rose to power after the Rose Revolution is rather mixed. Undisputed efficiency gains in terms of curbing corruption, improving the implementation of political decisions by the administration and overcoming internal frictions between different ministries are to a certain extent circumscribed by some setbacks in terms of assuring for a proper functioning of the system of checks and balances. This is on the one hand a consequence of the extreme weakness of opposition parties in parliament which has almost lost the capability of exercising its oversight function. On the other hand, the government can be blamed for undermining the independence of the judiciary, a move which might be legitimated in terms of combating corruption but nevertheless puts into question the commitment of the new powerholders to the principle of power-sharing. Additionally, a clearly felt lack of reliable cadres, especially in the provinces, has contributed to the persistence of the problem of permanent rotation of administrative personnel. A focus on capacity building would be needed to allow for reducing rotation. At the same time, a clear tendency towards the consolidation of central power structures can be observed. The practice of moving members from the core elite from one ministry to the other which has indicated a certain lack of predictability in the first year after the revolution has slowed down albeit not completely come to an end.

Performance of  
democratic  
institutions

Democratic institutions are mainly accepted by all relevant social and political players as the legitimate rules of the game. In 2005, some opposition parties partly deviated from that principle by lending their support to dubious figures from the shadow economy who had been sentenced for violations of the law.

Commitment to  
democratic  
institutions

Since these strategies did not gain any significant popular support, they did not really pose any substantial threat. The only relevant threat to the consolidation of democracy comes from the growing apathy among broad segments of the society who have been negatively affected by the downsizing of state agencies, price rises and the struggle against corruption. But to date these frustrations did not translate into support for anti-democratic forces.

## 5 | Political and Social Integration

Democratic consolidation in Georgia is still hampered primarily by a weak party system, which is characterized simultaneously by a high level of fluidity on the one hand and a low level of competitiveness and social entrenchment on the other hand. Representative bodies at the national and local level are clearly dominated by the United National Movement – Democrats, the ruling party of President Saakashvili, which has emerged only in the wake of the highly contested elections in November 2003 and still lacks reliable nationwide structures. Similar to the CUG, which has dominated the political scene between 1993 and 2003 but has vanished without leaving any trace in the course of the Rose Revolution, the new party of power is mainly a vehicle for the promotion of bureaucratic careers, but unable to represent authentic social interests. At the same time, there is no single opposition party capable of aggregating and articulating the interests of the socially marginalized population. Only two parties managed to overcome the high 7% threshold in the 2004 elections. The Georgian party system still fails to serve as a reliable mediator between state and society. The superficial impression of stability, which is produced by a very low level of fragmentation, is thus rather a consequence of its lack of representativeness and competitiveness. Since parties as a rule still emerge rather top down as a result of internal splits and not bottom-up as a consequence of political activities on the ground, there is no chance that this situation will change much in the near future.

Party system

The influence of social interest groups is close to zero. Trade unions do exist, but they are hardly visible. This is primarily due to high rates of unemployment and self-employment but it is also a legacy of the servile tradition of the state-sponsored Soviet trade unions. Big enterprises in which trade unions could form are still the exception. As the few bigger businesses still prefer informal bargaining to promote their interests, organizations representing business interests are of no real significance. Civil society organizations in contrast form a dense network. However, their capability to act as mediators between state and society is severely constrained by their lack of social roots. Moreover, since the Rose Revolution and the appointment of many of their most active members to government positions, they have experienced a kind of brain drain. Another phenomenon can be observed: as many of these NGOs ceased to be critical

Interest groups

towards the new government, they contributed to an emerging situation that the civil sector is in danger of being split into allies and enemies of the government.

General support for democracy seems to be quite high in Georgia. Even the rate of approval for the incumbent president is amazingly high. Although it dropped by more than 25% between 2004 and 2006, still 61% of the respondents of a recent public opinion poll were satisfied with his job. Only a closer look at the results raises a certain concern. Actually, Saakashvili enjoys support for only two issues: his achievements in the fight against corruption and his pro-Western course in foreign policy. At the same time, more than 80% of the respondents assessed his policies in combating poverty and unemployment as poor.

Consent to democratic norms

Due to a deep-rooted culture of clientelism, vertical bonds of dependence are still regarded as the most effective means of pushing through one's interests. Despite official efforts at fighting networks of patronage, the emergence of authentic forms of social self-organization is thus severely impeded by widespread distrust. The existence of NGOs does not in and of itself dispel this common perception as their emergence is mainly donor-driven. Moreover, most NGOs resemble advocacy groups staffed by urban intellectuals whose bonds to the interests of those they claim to represent are quite loose.

Associational activities

## II. Market Economy

### 6 | Level of Socioeconomic Development

Despite significant progress made since the Rose Revolution with a GDP at around \$2994 per capita (PPP), Georgia still remains among the poorest countries in the region. After independence, the country suffered especially hard from the implosion of the Soviet command economy, the economic consequences of two unresolved secessionist conflicts and pervasive corruption. Altogether, these factors resulted in a 70% drop in output. Meanwhile, a wide range of structural reforms launched since 2004 has significantly improved the situation and led to impressive growth rates. The World Bank has rated Georgia as one of the fastest improving business climates in the last two years. However, a poor infrastructure with extremely bad roads and unreliable energy supplies as well as a pronounced lack of confidence in the rule of law still continue to pose significant obstacles to sustainable economic growth. Whereas progress is mainly due to rapid development in the oil transit industry, communication, construction, financial services and trade, sectors like agriculture, tourism and manufacturing, which

Socioeconomic barriers

once accounted for the lion share of exports and employment experienced only modest recovery. As a result, more than 39% of the population still lives below the national poverty line and approximately 15-17% is extremely poor. The poorly developed social safety net is far from being able to cope with this situation. Poverty distribution is moreover highly uneven throughout the country. Especially in rural areas it strongly correlates with limited connectivity to markets and public infrastructure. The recent increase in public welfare spending is partly neutralized by a sharp rise of consumer prices especially for energy and water supplies.

| Economic indicators       |          | 2002    | 2003    | 2004    | 2005           |
|---------------------------|----------|---------|---------|---------|----------------|
| GDP                       | \$ mn.   | 3,396   | 3,991   | 5,126   | <b>6,395</b>   |
| Growth of GDP             | %        | 5.5     | 11.1    | 5.8     | <b>9.3</b>     |
| Inflation (CPI)           | %        | 5.6     | 4.8     | 5.7     | <b>8.2</b>     |
| Unemployment              | %        | 12.6    | 11.5    | 12.6    | -              |
| Foreign direct investment | % of GDP | 4.9     | 8.5     | 9.7     | <b>7.0</b>     |
| Export growth             | %        | 5.7     | 4.8     | 4.6     | <b>4.8</b>     |
| Import growth             | %        | 4.2     | 3.6     | 8.3     | <b>5</b>       |
| Current account balance   | \$ mn.   | -210.5  | -374.5  | -346.7  | <b>-690.0</b>  |
| Public debt               | \$ mn.   | 1,444.9 | 1,564.0 | 1,593.1 | <b>1,494.4</b> |
| External debt             | \$ mn.   | 1,838.7 | 1,934.7 | 2,064.3 | <b>1,910.7</b> |
| External debt service     | % of GNI | 3.8     | 4.5     | 4.5     | <b>2.9</b>     |
| Cash surplus or deficit   | % of GDP | -1.8    | -0.9    | 0.5     | <b>1.5</b>     |
| Tax Revenue               | % of GDP | 7.6     | 7       | 9.9     | <b>12.1</b>    |
| Government consumption    | % of GDP | 9.8     | 9.2     | 14.0    | <b>18.5</b>    |
| Public expnd. on edu.     | % of GDP | 2.2     | 2.2     | 2.9     | -              |
| Public expnd. on health   | % of GDP | 1.6     | 1.4     | 1.5     | -              |
| R&D expenditure           | % of GDP | 0.3     | -       | -       | -              |
| Military expenditure      | % of GDP | 1.0     | 1.1     | 1.4     | <b>3.5</b>     |

Sources: The World Bank, World Development Indicators 2007 | UNESCO Institute for Statistics | Stockholm International Peace Research Institute (SIPRI), Yearbook: Armaments, Disarmament and International Security

## 7 | Organization of the Market and Competition

The legal foundations of a market economy were already established in the 1990s. The price system is fully liberalized, subsidies to state enterprises have been abolished and restrictions to foreign trade were removed with the introduction of uniform custom duties before Georgia joined the WTO in 2000. Whereas under Shevardnadze, pervasive corruption has ensured a highly selective application of ostensibly uniform rules, since the Rose Revolution the new elite has taken a number of decisive steps to narrow the gap between formal rules and informal practice. Tolerance toward tax arrears and overdue payments to state owned utilities, which once granted enormous privileges to a close circle of politically influential entrepreneurs and thus contributed to a massive distortion of competition, has come to an end. A wide range of structural reforms from the adoption of a simplified tax code to recently enacted amendments to laws dealing with the registration of immovable property, the status of state-owned land and ownership enforcement proceedings have led to a significant improvement of the business climate. As a result, the share of the informal economy, which surpassed 67% until recently, is constantly shrinking. The legalization of formerly unregistered business activity is very much facilitated by a liberal policy of issuing licenses. Despite these impressive achievements, the country still faces considerable challenges. Corruption and a lack of professionalism on behalf of the administration remains a serious problem. The implementation of legal standards especially outside the capital is far from being guaranteed.

Market-based  
competition

There is a quite solid anti-monopoly legislation in place. Whereas in former times implementation was hampered by the widespread practice of granting all sorts of privileges to politically influential entrepreneurs, the emergence of monopolies is nowadays no longer a real problem for the Georgian economy with its high degree of openness to international trade and business.

Anti-monopoly  
policy

As a result of recent trade policies reforms, Georgia has one of the most open trade regimes in the world. Import tariffs have been significantly simplified with the adoption of a new customs law in 2006, which envisages only three different rates at zero, five and twelve percent. Almost 90% of imported goods are zero-rated. With these measures the heavy-handed policy of granting exemptions from the payment of custom duties to individual companies, which were thus endowed with enormous rent-seeking opportunities, has come to an end. At the same time, the new government has taken decisive steps to combat smuggling. Despite these impressive achievements, there are still some problems concerning the internal procedures of the custom department. Current problems mainly concern refunding of VAT and the exchange of information with the tax inspections. But plans for unifying both bodies under the roof of the ministry of Finance are already in the making.

Liberalization of  
foreign trade

Although the reform of the banking system began as early as 1995 and the National bank has successfully assumed a supervisory role involving the imposition of stringent reporting standards and the introduction of gradually increased capital requirements, the banking system and the capital market remain quite small. Despite a significant growth of the credit market – the share of domestic credit to the private sector in GDP rose from 8.7% in 2003 to 14.8% in 2005 – the access to capital is still fairly limited given the enormous demand in infrastructural investment. Moreover, the banking sector still contains a number of weak and undercapitalized banks, whose risk management is far from sufficient. However, the new government shows a clear commitment to improving the situation further and is currently preparing to remove restrictions on the inflow of foreign capital.

Banking system

## 8 | Currency and Price Stability

Inflation, which had been kept under firm control by a prudent monetary policy and stringent interventions by the National Bank since the middle of the 1990s, has resurfaced as a problem in 2005. Due to capital inflows related to the construction of the BTC-pipeline, increased fiscal spending and a significant rise in energy prices, the annual inflation rate increased to 8.0% in 2005 and reached even 14.6% in July 2006. However, since this development is partly caused by external factors and partly rooted in necessary and overdue investments into the rehabilitation of a rotten public infrastructure, this situation might be regarded to be of a temporary nature. The restructuring and service of external debts whose ratio to GDP has decreased from 36% in 2004 to 27% in 2005 shows clear tendencies of further improvement.

Anti-inflation /  
forex policy

Fiscal policy is probably the realm where the new elite which took power during the Rose Revolution, achieved its most outstanding success. Prudent anti-corruption measures, the adoption of a simplified tax code in 2005 and significant progress in enhancing the efficiency of tax and customs administration contributed to a dramatic increase in budget revenues, whose share in GDP rose from 16.2% in 2003 to 23.4% in 2005. At the same time, institutional safeguards like the introduction of a single treasury account prepared the ground for a more transparent and rational execution of the budget.

Macrostability

## 9 | Private Property

The legal protection of property rights witnessed a clear improvement since the Rose Revolution. Recently adopted amendments to the laws on the registration of immovable property, the status of state owned land and ownership enforcement procedures closed important gaps in the legal environment. However, there are

Property rights

still some shortcomings with regard to legal safeguards for transparent corporate government. Moreover, the reduction in the number of courts and political pressure exercised on judges raises some concerns with regard to timely and neutral implementation of these rules.

Launched in the first half of the 1990s, the privatization process had been stalled under Shevardnadze for a long time due to intransparent procedures and a severe lack of investment capital. As a result, until recently the state had claimed ownership rights to more than 1,800 enterprises, employing more than 180,000 people, which equaled nearly one quarter of the workforce. Meanwhile, the large-scale privatization program launched by the new government in 2004 is starting to bear fruits. Privatization is now almost completed. Among the enterprises already sold are a shipping company, a metallurgical plant, two telecom companies and two hydropower plants. Moreover, the government has increasingly used the possibilities of leasing out state owned enterprises and utilities like the Batumi Sea port under management contracts to international firms. The progress achieved thus far is mainly due to improved standards of transparency. However, there are still some problems with regard to the equal treatment of competitive offers. To name just one prominent and highly disputed case – there have been some rumors concerning the involvement of personal interests in the sale of management rights for the Tbilisi airport to an international consortium in May 2005, which was expected to invest into the construction of a new terminal in exchange. In the meantime, the contract was abolished and the government signed a new agreement with a Turkish company. Some critics moreover raised concerns over the priority given to liquidation without restructuring. At least some of these problems may be solved with the adoption of a new insolvency law, which is currently under discussion.

Private  
enterprise

## 10 | Welfare Regime

Despite significant improvements, which were achieved due to the dramatic increase in tax revenues in recent years and which mainly involve the doubling of pensions and the timely payment of social transfers, the social safety nets in Georgia are far from being sufficient to cope with widespread poverty. The dramatic increase in consumer prices especially for housing and energy supplies may have even contributed to a worsening of the situation – at least with regard to those, who did not benefit from the economic upswing or the salary rises for some categories of public officials. Besides the scarcity of resources the lack of proper targeting procedures remains a serious problem. In view of the overall dramatic picture, the maintenance of uniform rates for pensions and for the allowances paid to the 247,000 internally displaced persons appears to be rather dysfunctional as it hampers the attempt to reach the most vulnerable segments of the population.

Social safety nets

Equality of opportunity is far from assured. Typical high-risk groups traditionally include the elderly, families with a large number of children, orphans and persons with chronic illnesses, who depend on meager social transfers. Moreover, poverty in Georgia highly correlates with geographic isolation. People living in remote areas with weak or no access to public infrastructure and basic services are among the poorest and most vulnerable groups. Outside the capital, which has now attracted more than 1.5 million people, that is, more than a third of the population, there are quite a number of places completely cut off from energy supplies during winter with almost no prospects for economic recovery. In recent times, we can observe the emergence of a split along generational lines in the Georgian society. Whereas well-educated young people with a solid knowledge of Western languages and computer skills benefit from the current reforms, those older than 35 who have great difficulties in finding jobs are hardly affected by the recent improvement of the overall economic situation.

Equal opportunity

## 11 | Economic Performance

Since the Rose Revolution economic performance is marked by a number of outstanding achievements. Due to coherent reform strategies, budget revenues sharply increased by more than 200% between 2003 and 2005. GDP growth continued with growth rates between 6% and 9%. The expansion of domestic credit to the private sector, which alone in 2005 rose by more than 70%, stimulated an economic boom – especially in the construction and manufacturing sectors. Rising prices for metal, the single most important commodity for export, further improved the trade balance. But despite these dramatic changes to the better, the Georgian economy is still struggling with the legacies and burdens left over by a 15-year period of pervasive corruption and delayed reforms. The rehabilitation of a public infrastructure that had been totally neglected under Shevardnadze will demand enormous investment in the near future. Unreliable energy supplies and poor roads still act as an obstacle to further economic growth. Recent developments have moreover clearly indicated the vulnerability of the Georgian economy to external shocks. In 2006 the trade balance deteriorated due to a sharp increase in prices for Russian energy supplies and a Russian ban on the import of Georgian wine, the second most important export good. The ban has already resulted in a loss of \$35-40 million in export revenues.

Output strength

## 12 | Sustainability

Environmental concerns are formally considered in legal documents. NGOs have, however, criticized the government for paying too little attention to the negative impact big international projects like the construction of the BTC oil pipeline have exercised on natural reserves. The heavy dependence of the Georgian

Environmental  
policy



economy on international investment in its transit infrastructure clearly makes environmental aspects an issue of secondary importance for the government although Georgia faces serious environmental problems such as deforestation, erosion, the contamination of the Black Sea and the degradation of landscapes.

Due to many years of neglect and under-financing, the education system Georgia inherited from the Soviet Union was, until recently, at the verge of breaking down. State run schools and universities did not only suffer from a deteriorating physical infrastructure, but from widespread corruption caused by extremely low salaries for the teaching staff as well. Bribery and the outright sale of diplomas had become a norm. In recent times, efforts at curbing corruption in the system of higher education promise, however, a radical turnaround. Measures taken so far include a re-examination of university teachers, a significant rise in salaries and a dramatic reduction in the number of private universities, which had to renew their licenses. The effectiveness of these steps is highly disputed. Among the positive outcomes, one could probably name the promotion of young specialists who had obtained part of their professional training predominantly in Western countries and who are expected to guarantee for an increase in quality standards. Less than transparent and rule-guided selection procedures are cited among the weak sides of the reform process.

Education policy  
/ R&D

## Transformation Management

### I. Level of Difficulty

The level of structural difficulties faced by the political leadership is comparatively high. The ordinary Soviet legacies, which include an unbalanced economy poorly adapted to the pressures of globalization, the lack of autonomous social organizations, a weak civil society and a longstanding tradition of authoritarian rule are, in Georgia's case, further complicated by the burden of two unresolved ethnic conflicts, difficult relations with neighboring Russia and the heritage of pervasive corruption, which had contributed to a weakening of state structures and a significant delay of structural reforms under Shevardnadze. Two of the few advantages, a comfortable geographical location at the crossroads of important energy transport lines and the presence of a well-educated labor force, did not pay off until recently but have the potential of triggering economic recovery in the near future. However, without a resolution of ethnic conflict and without an effective rapprochement with Russia, all future plans at sustainable development still hang in the air.

Structural  
constraints

Notwithstanding the existence of a great number of NGOs, there is no authentic tradition of civil society. A high degree of distrust in public institutions, which has resulted from a long history of foreign domination and a deeply entrenched culture of clientelism, acts as a severe constraint on the emergence of effective governance.

Civil society  
traditions

The explosion of ethnic conflicts in the immediate aftermath of regaining independence in 1990 has produced a difficult legacy of two frozen conflicts with the breakaway regions of Abkhazia and South Ossetia, which do not lead to massive violence at present, but pose a permanent threat to a further consolidation of statehood. In contrast, the level of social conflict is surprisingly low – despite dramatic processes of impoverishment that accompanied the restoration of independence and transition. This is mainly to be explained by the total lack of stable and clear-cut cleavages and the amorphous state of the social structure. There are no organizations capable of mobilizing broader constituencies. At the same time, the marginalization of broad and unorganized segments of the population, can give rise to massive destabilization at any time.

Conflict intensity

## II. Management Performance

### 14 | Steering Capability

The stable majority the ruling elite currently enjoys in representative bodies at all levels and the absence of any serious opposition force, have significantly enhanced the authorities ability to set and maintain strategic priorities. The new leadership has made prudent use of these favorable starting conditions in terms of pursuing a coherent reform strategy. Important aims, which are given a clear priority since the Rose Revolution, include a strengthening of governance structures by a fierce struggle against corruption and smuggling, the improvement of the business climate by introducing the rule of law and privatization of state-owned enterprises. In the course of these structural reform measures, the institutionalization of power-sharing was regarded as an issue of secondary importance. A certain neglect for the build-up of a proper functioning system of checks and balances on behalf of the ruling elite is thereby legitimated in terms of the need for a powerful executive capable in order to push through necessary reforms that had been delayed in former times. Whereas the authorities have given ample proof for the seriousness of their commitment to an economic development agenda, which mainly corresponds to the prescriptions of the international donor community, certain setbacks with regard to laying the foundation for a sound democratic system and respect for human rights have nevertheless raised some concerns. It remains to be seen whether the new elite will be able to manage problems that may arise with the growing need of including broader segments of the population into the reform process. This would obviously require the development of a sound party system, which is still in status nascendi. Even the ruling party, which clearly dominates the political arena, does not have a full-fledged structure covering all districts of the country.

Prioritization

The effectiveness of reform measures in the above described areas of priority is undisputed. A vast range of reform laws has been pushed through parliament, the fiscal capacity of a once terribly weakened state has been successfully enhanced, important steps toward strengthening the efficiency a formerly overstuffed and underpaid public administration that had gained sad prominence for corruption and idleness have been taken, and the World Bank has named Georgia among the countries which have excelled in improving its business climate. Moreover, the leadership has obviously overcome problems that marked the first year after the Rose Revolution. Whereas the strongly felt lack of reliable cadres still

Implementation

produced frequent reshuffles in government agencies in 2004, the situation is now more or less stabilized. Recent events like the adoption of a second amendment to the constitution, which has weakened the president's influence on the judiciary, indicate a certain willingness to take into consideration international concerns with regard to meeting standards of democratic governance. The dismissal of the Minister of Justice, who was criticized by the NGO community for his failure to improve the human rights situation in the prison system, and the criminal conviction of 10 police officers accused of torture point into the same direction. Main shortcomings nowadays mainly pertain to the ability to spread the impact of reforms evenly throughout the country. The efficiency of regional administrations, which are far from stabilized, remains a problem.

Without doubt, the current leadership has demonstrated an impressive ability to draw the necessary lessons from the failure of state-building efforts under Shevardnadze. Recent reform measures have successfully addressed former shortcomings that had been heavily criticized by the donor community. Even a certain ability to correct policy mistakes the new authorities have committed is out of question. This is evinced not only by the above cited adoption of new principles that are now to be applied with regard to the judiciary, but by a certain change in the foreign policy as well. Whereas in 2004, the former minister of defense launched an aggressive attack against the breakaway region of South Ossetia, the leadership demonstrated a certain restraint in the years to follow. Recently the war-minded minister of defense was forced into retirement and the president has more than once underlined his commitment to a peaceful resolution of the conflict. In its difficult relations with Russia, the leadership has acted with clear-sightedness and prudence. Although the imposition of a ban on Georgian imports was provoked by the expulsion of Russian officers suspected of spying, the government rushed to prevent a further escalation of the conflict and has paved the ground for the return of the Russian ambassador, who had been withdrawn at the height of the scandal. One may however raise the question, in how far these course corrections were a result of genuine learning or a reaction to growing international pressure – especially from the United States as the most important donor. With regard to policy innovation, one may rightfully blame the new leadership of having simply copied the old formula of giving priority to the strengthening of executive capacity while neglecting the task of developing the conflict processing features of the political system.

Policy learning

## 15 | Resource Efficiency

There have been significant improvements in the efficient use of resources, but scarce resources clearly distinguish the administration of president Saakashvili

Efficient use of assets

from all his predecessors. This refers first of all to the reform of an overstuffed and underpaid administration. A civil service reform launched in 2004 led not only to the dismissal of more than 30,000 public officials with savings invested in crucial salary increases, but to the introduction of meritocratic recruitment procedures as well. As a consequence, positions in the public administration that underwent a radical rejuvenation for the first time became attractive for a stratum of young and well-educated professionals without ties to corrupt clans. With some reservation, one may criticize the new government for its too outspoken and exclusive reliance on young cadres, a move which, especially outside the capital, led to some unfortunate decisions. When it comes to budget revenues, the picture is a bit more mixed. On the one hand, the dramatic rise in fiscal revenues counts among the new government's achievements. Moreover, the introduction of a single treasury bill paved the way for a more rational and transparent execution of the budget. The recent abolishment of most extra-budgetary funds, whose existence had raised a wave of strong criticism in 2004, is without doubt a step in the right direction. Remaining concerns pertain, however, to disputed priorities in budget spending. Thus, two-thirds of the supplementary budget that was adopted in June 2006 in response to privatization gains above expectation were spent on defense. In a situation in which the government was not able to clear all the arrears in social transfer payments, this may be regarded as a wrong signal. Likewise, one could have wished for more investments into the decayed public infrastructure. Decentralization marks another weak spot in the record of all Georgian governments. After the Rose Revolution, the adoption of a new law on local government and the holding of local elections were delayed several times. The new law, which passed parliament in December 2005, stopped short of meeting expectations. The separation of functions between different levels of administration is still not sufficient. The abolishment of local administration at the level of communities was heavily criticized by the opposition and some NGOs. The budget revenues of district administrations were further limited. The legal status of regional administration and governors, who exercised several functions in former times, was not addressed at all.

Internal divisions and some disputes between different members of the government on the question of privatization and strategic policies towards the breakaway regions of South Ossetia and Abkhazia, which had plagued the new authorities in the initial period after the Rose Revolution, are mainly issues of the past. However, this is less an achievement of improved mechanisms of coordination, but rather an outcome of a further strengthening of President Saakashvili. The still mysterious death of former Prime Minister Zurab Zhvania, the ousting of foreign minister Zourabishvili and just recently the retirement of the hawkish Minister of Defense Okruashvili do play a major role in this process. One may rightfully raise the question, whether the unchallenged

Policy coordination

position of power Saakashvili has secured for himself can lead to a dangerous immunization against any kind of critique and will thus weaken the learning capabilities of the current powerholders. In view of the tremendous tasks that still lay ahead, this might be quite dysfunctional.

The fight against corruption represents the single most undisputed success story since the Rose Revolution. Measures taken thus far do read as a textbook example of prudence and coherence. A skillful combination of different strategies led not only to a significant enhancement of the state's ability to impose sanctions on unlawful behavior, but to a dramatic reduction of incentives structures which have reliably reproduced corruption under Shevardnadze as well. Publicly announced high profile arrests of officials charged with corruption and the abuse of office have instilled a new level of credibility into the law enforcement agencies. Significant pay rises for police officers, judges and university teachers, financed partly by staff reduction and partly by increased budget revenues, decreased the vulnerability of public servants to bribes. The adoption of a simplified tax code and the abolishment of dozens of licenses have reduced the necessity to engage in corrupt transactions with representatives of the state. In view of these impressive achievements, one can point to only one missing link. Performance efficiency could have benefited from the inclusion of broader segments of the society, such as watchdog NGOs.

Anti-corruption  
policy

## 16 | Consensus-Building

In their public statements, all major political actors are committed to the cause of building democracy and a market economy. The current government was able to build a broad coalition of support for its reform drive. In the future, a possible threat may result from poverty-ridden segments, which are, to date, generally excluded from the political process, but may, in view of further social hardship, decide to lend support to radical political actors. Beneath the surface of an overall consensus, one can feel the gradual emergence of strong anti-Western feelings among the socially marginalized layers of the society.

Consensus on goals

To date, the reformers dominate the political arena to such an extent that they are not faced with the challenge of excluding or co-opting anti-democratic veto actors. However, this comfortable situation may change some time. Despite a significant drop between 2005 and 2006, Saakashvili still enjoys a comparatively high rate of approval with more than 60% of the population supporting his policy. A closer look at the results of public opinion polls does however reveal that he mainly enjoys support for two issues: fighting corruption and foreign policy. At the same time, 80% assessed his achievements in combating poverty and unemployment as poor. To date this dissatisfaction does not find public expression.

Anti-democratic veto  
actors

Due to the comfortable majority they enjoy in all branches of power and in view of the structural weakness of any kind of opposition, the new authorities do not really feel a need to engage in the management of political cleavages. What appears to be a short-term advantage, the absence of politicized cleavages, may turn out to be a long-term risk. In the absence of institutional channels for the expression and reconciliation of conflicting interests, growing popular dissatisfaction can easily lead to destabilization – especially in times of externally induced crisis.

Cleavage / conflict  
management

With Saakashvili's rise to power, the once vibrant NGO sector has been severely weakened by a kind of brain drain. NGOs have become an important pool for the recruitment of government personal. At the same time, especially in the initial stage after the Rose Revolution, the new authorities have to some extent ignored concerns raised by some NGOs with regard to the hasty adoption of constitutional amendments, bureaucratic harassment of independent media outlets or human right violations. Meanwhile, the government's attitude towards civil society organizations has become much more differentiated. Whereas some ministries, like the Ministries of Justice and Education do take their advice into consideration and have established regular contacts, others like the Ministry of Interior or the president himself demonstrate a certain reluctance toward close cooperation.

Civil society  
participation

The reconciliation process between Georgian society and its former opponents in the secessionist wars with Abkhazia and South Ossetia is still a task of the future. Since the Rose Revolution, a wave of nationalism has even contributed to a certain rigidification of stereotypes. Reflective opinions as articulated in the medium of literature and films by isolated intellectuals do not reach a wider public. The same holds true for the civil war in the early 1990s. There is still no coherent version of the events, which permanently gives rise to much in the way of myth-building.

Reconciliation

## 17 | International Cooperation

Impressive progress in re-launching stalled reforms in accordance with international policy recommendations in recent years were rewarded with massive financial aid. Multilateral and bilateral donors active in supporting the government's reform agenda include the European Union, the World Bank, the IMF, the United States and Germany as key players. Donor money is mainly and prudently used for the rehabilitation of the energy and road infrastructure, credits to small- and medium-sized enterprises and the implementation of far-reaching rule of law programs. Western powers, however, are cautious about Georgian authorities' current aspirations to join NATO and the European Union. Georgia nonetheless achieved a highly significant success by initiating the Intensified

Effective use of  
support

Dialogue with NATO in September 2006 and the Membership Action Plan (MAP), which is the gateway to NATO membership. With the adoption of the Action Plan outlining the cooperation between the European Union and Georgia for the next five years, another milestone was reached after its participation in the European Neighborhood Policy (ENP). These steps constitute an important stimulus for internal reforms in Georgia.

In general, the new Georgian government has given clear proof of its reliability in cooperation with the international donor community. There are, however, significant differences with regard to the implementation of economic and political reforms. The World Bank and the IMF have frequently cited Georgia as a positive example in terms of fulfilling its requirements. Soft criticism was articulated recently with regard to rising rates of inflation, which were caused primarily by external effects. However, they were aggravated by high government spending and the National Bank of Georgia's intervention, which aimed at strengthening the national currency that had under pressure from the inflow of international capital. However, an agreement on counter measures was reached soon thereafter. Objections against the violation of human rights norms came mainly from the Council of Europe. They have been only partly addressed by the criminal conviction of police officers accused of torture. Concerns about undue political pressure on judges – raised among others by the American Bar Association – remained, however, unanswered.

Credibility

The readiness of the Georgian government to cooperate with neighboring countries in regional organizations like the CIS or GUAM did not help it, to find a solution to strained relations with Russia, which clearly have the potential of threatening further progress in political consolidation and economic recovery. Whereas Russia is primarily to blame for its determination in exercising its influence on the breakaway regions of Abkhazia and South Ossetia as a means of preventing the stabilization of pro-Western Georgia, Georgian authorities' engaged in provocative acts that further complicated things. In the aftermath of a recent crisis, caused by a Russian ban on Georgian imports, a significant rise of prices on Russian Energy supplies, the deportation of Georgian migrants and the closure of transport links, the Georgian government demonstrated, however, prudent restraint and utmost flexibility. Firstly, it reached an agreement with Azerbaijan and Turkey on additional gas supplies and secondly, it abstained from further provocations against Moscow thus preparing the way for a return of the Russian ambassador, who had been withdrawn in the midst of the confrontation.

Regional cooperation



## Strategic Outlook

Georgia clearly stands at a crossroads. During the period under review, impressive achievements have been reached in terms of strengthening weak and corrupt state structures, institutionalizing the rule of law and giving a fresh stimulus to economic recovery. The country has enjoyed massive donor support on its road to stabilization and normalization. However, much remains to be done – especially with regard to promoting power-sharing, the establishment of viable structures of local government, laying the foundations for an active participation of broad segments of the population in the reform process and combating poverty. External actors are highly recommended to keep an eye on the government's readiness to sacrifice democratic standards for the sake of effectiveness. Measures to be taken should include programs for the strengthening of embryonic party structures, support for representative bodies at all levels, assistance for the development of local self-governance and increased funding for the NGO sector. The recent trend among international donors of cutting spending on civil society organizations sends a wrong signal to the Georgian authorities. The total lack of institutional channels for the articulation and representation of social interests remains a severe weakness of the political system and can give easily rise to sudden policy changes in times of crisis. The Georgian government should give more priority to fighting unemployment. This would involve more attention to rural districts and agriculture, which still employs more than 50% of the active workforce. State-sponsored credits for the development of food-processing enterprises in rural districts would be a measure of utmost importance. A rethinking of the current strategy of privatization, which prefers liquidation before restructuring, should be considered. In summary, to date, the future of the reform project depends primarily on the successful handling of two tasks: the development of stable structures for participation and effective efforts at reducing poverty and unemployment.