American Enterprise Institute for Public Policy Research

AEI

Development Policy Outlook

No. 2 • June 2009

Georgia's Search for Economic Liberty: A Blueprint for Reform in Developing Economies

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The global economic downturn is exacting a heavy toll on developing economies. The three engines of growth in the past decade—exports of consumer goods to wealthy industrialized countries, exports of commodities, and private capital inflows—have stalled. To improve their business and economic climates, developing nations should take bold actions to roll back the size and role of the state in their economies. Now, more than ever, it is important to document successful cases of reform from which they can learn. Given the breadth and scope of its reforms since 2004, Georgia is one of those test cases. Its success is due to the coherent and comprehensive nature of the reform effort, and it offers a lesson from which reform-minded leaders in other developing countries can learn.

Prior to the Rose Revolution in 2003, Georgia bore many characteristics of a failing state. It was saddled with stifling bureaucracy and widespread corruption, little foreign investment, high unemployment, and a large rural population engaged in subsistence-level agriculture. Although Georgia had high tax rates, the tax code was complex and inefficient, and tax revenue collection did not exceed 15 percent of GDP. The government was thus incapable of funding even the most basic public services or maintaining critical infrastructure. The energy sector was especially notorious for inefficiency and corruption, and blackouts were a part of everyday life. The tourist infrastructure was inadequate even for the few foreign visitors who cared to visit the country. The economy produced few competitive exports, the crime rate was high, and corruption was rampant. About a quarter of Georgian adults had voted with their feet by emigrating. The entrepreneurial energy of those who remained was squelched by the almost insurmountable bureaucratic barriers to doing business and the inability of the sleepy domestic financial sector to supply them with capital.

From this inauspicious beginning, Georgia enjoyed real GDP growth rates of 8.5 percent or higher from 2005 through the first half of 2008. Nominal GDP grew from approximately $4 billion to almost $13 billion over a five-year period, with nominal GDP per capita increasing almost 150 percent, from $1,188 in 2004 to an estimated $2,925 in 2008.[1] Virtually all key sectors of the

Key points in this *Outlook*:

- Until 2003, Georgia was mired in economic and social stagnation.
- Liberalization under President Mikheil Saakashvili has generated economic openness, high private capital inflows, and high growth rates.
- Key reforms in taxation, monetary policy, banking, privatization, free trade, trimming bureaucracy, and labor market liberalization explain the turnaround.
- Counter to what appears to be becoming conventional economic wisdom in the global downturn, developing countries should follow Georgia's lead in liberalizing and growing.

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economy have contributed to this growth, in contrast to the development of countries richer in natural resources. This suggests that President Mikheil Saakashvili's policy of increasing economic liberty was the decisive factor in Georgia's transformation.

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Growth was fueled by the increasing availability of credit and large foreign private capital inflows. The assets of the banking sector increased by a factor of nine, from approximately $600 million at the end of 2003 to almost $5.4 billion at the end of 2008. Private capital inflows reached $2.3 billion (approximately 23 percent of GDP) in 2007 and an estimated $2.15 billion (approximately 17 percent of GDP) in 2008. The diversity of foreign direct investment (FDI) has increased considerably. No single country accounts for more than 12 percent of the cumulative 2004–2008 FDI. The share of the top ten countries in the annual FDI inflows shrank from 89 to 79 percent of the total in the same period. For the first time in history, Georgian issuers were able to access Western equity and debt capital markets, with close to three hundred international portfolio investors having invested in Georgian debt and equity securities by mid-2008—a nearly unprecedented breadth of institutional investor coverage for a $13 billion economy.

Foreign currency reserves grew, from a very low base of less than $200 million in 2003 to almost $1.5 billion at year-end 2008. Tax revenue collection grew by some 400 percent since 2004 as the country rode the Laffer Curve, enabling a massive upgrade of critical infrastructure. External public debt decreased from 56 percent of GDP in 2003 to 21 percent as of year-end 2008.

Aggressive privatization was pursued, as the state retreated in virtually every sector of the economy. The energy sector was revitalized, with the country becoming a net exporter of electricity (over 80 percent of which is generated from clean, renewable sources, namely hydropower) and one of the most energy-efficient economies (measured by energy consumed per unit of GDP) among the post-Soviet countries.

Public services were improved significantly, and corruption was suppressed to one of the lowest levels in Central and Eastern Europe.[2] The efficiency of public agencies—such as the Public and Civil Registries and the vehicle registration and driver's license authority—has improved dramatically, with consumer experiences at these agencies now comparable, or in some cases superior, to those in industrialized countries.[3]

Exports grew at a cumulative annual rate exceeding 20 percent, and the export base and geography of imports broadened considerably. The number of foreign visitors grew by some 300 percent, exceeding 1 million in 2007. Many highly skilled professionals of Georgian origin returned to take leading positions in the private and public sectors. Crime is down significantly, with a significant reduction in crime rates reported every year for the past several years. Living standards have improved considerably, a new middle class has emerged, and the country has experienced an entrepreneurial boom, with more than fifty thousand new businesses being registered every year.

While a discussion of the geopolitical and territorial integrity challenges Georgia faces is beyond the scope of this *Outlook*, it is important to note for the record that the progress and development described above have been achieved despite both Georgia's continuing inability to assert control over its two breakaway provinces and its deteriorating relationship with Russia, its erstwhile principal trading partner, culminating in the armed conflict in August 2008. Although the Georgian economy has suffered a serious setback as a result of the conflict, followed by the global economic downturn, it has proven resilient to these shocks, growing at 2 percent in 2008 and forecast to grow by 1 percent in 2009. There have been no bailouts, subsidies, or other assistance involving a transfer of public funds to any private-sector firms (including the banking sector, which remains in decent shape, albeit with a reduced appetite for new lending).

The government's countercyclical policy responses have focused as much on further deep tax cuts as on new (largely donor-financed) investment in infrastructure. Rather than rolling back the progress of freedom achieved over the past few years under populist and special-interest pressure, the government has seen the economic downturn as an opportunity to consolidate liberal economic reforms.

Rising Economic Liberty and the Retreat of the State

The principal effect of these reforms has been a dramatic increase in the degree of economic liberty enjoyed by individuals and firms. In terms of having the freest economy, Georgia has moved from 112th place in 2005 to fifteenth place in 2008 in the World Bank's rankings—ahead of virtually all emerging markets and most European Union (EU) economies.[4] Georgia's progress in the Heritage Foundation's *Index of Economic Freedom* has been directionally similar, rising from ninety-ninth place in 2005 to thirty-second place in 2008.[5]

While many of the aforementioned reforms have been tried—with varying degrees of success—by many developing economies worldwide, it is rare that all have been pursued simultaneously and comprehensively, over a relatively short time, with a focus as unrelenting as Georgia's.

The rising economic liberty in Georgia has had virtuous cyclical effects, such as the massive increase in productivity due to infrastructure upgrades made affordable by rising tax revenue, itself a result of the fiscal reform. In many low-to-middle-income economies, structural impediments to economic growth are so high that similar reforms attempted in a piecemeal fashion or implemented inconclusively typically result in less impressive outcomes.

Georgia's success in defeating endemic corruption is particularly noteworthy because its approach was holistic. A "zero tolerance" policy has been in place since 2004, but—equally if not more importantly—the root causes of corruption have been addressed by adopting low, flat taxes; minimizing bureaucratic discretion; streamlining public services; and eliminating waste by switching, insofar as possible, from public funding of various institutions to funding consumers and empowering them to make their own choices, as described below.

Consolidating the Gains

Another important feature of the Georgian reform effort is the authorities' attempts to make them as succession-proof (or, in the current economic context, downturn-fueled populist sentiment–proof) as possible. While the jury is still out on how well the various critical reforms will withstand the current unprecedented adverse conditions, considerable effort has been made to codify in legislation the principal quantifiable parameters of fiscal and monetary policies. Legislation is subject to change over time, of course, but the codification of the key parameters left to the discretion of policymakers in more institutionally advanced economies makes these reforms more "sticky," as changes in the parameters are subject to public scrutiny and debate.

Another approach to achieving the same objective through means other than legislation includes the use of international commitments to make certain reforms nearly irreversible. For example, when import tariffs were largely abolished, Georgia reported these new tariff rates to the World Trade Organization (WTO) as "bound rates," thereby significantly reducing the scope of any upward revision of the tariff rates in the future.

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As the perception of the near-permanent nature of these reforms strengthens, economic agents have modified their behavior accordingly. And they have done so far more readily than if a particular reform or combination of reforms were perceived as being easy to roll back at the next election or as a result of the executive branch losing its nerve in adverse economic conditions.

Key Components of the Reform Effort

Fiscal reform and sensible monetary and exchange policy comprise the foundation of the Georgian reform effort, and I discuss them in considerable detail below. Deep structural reforms aimed at rolling back the state and increasing economic liberty have been implemented, including minimizing bureaucratic discretion through radical deregulation and liberalization of key sectors of the economy, public-sector reform, aggressive privatization, liberalization of labor markets, unilateral adoption of a free trade regime, unilateral abolition of visa requirements for citizens of most middle-to-high-income countries, education reform, health care reform, and welfare reform.

Fiscal Reform. Prior to the Rose Revolution, the Georgian tax system did not differ materially from that of other post-Communist states at the early stages of the transition. It had a multitude of taxes, progressive taxation, and widespread exemptions and loopholes exploited by taxpayers against the background of widespread corruption.

Because of punitive tax levels, administrative complexity, and corruption, tax revenue collection had been weak, approximately 15 percent of GDP (about $600 million) in 2003.

Just as taxes are few and rates are low and flat, the administrative complexity has been reduced dramatically by the abolition of various tax exemptions, breaks, credits, rebates, and loopholes.

As a result of several waves of tax cuts (most recently in 2008) and a drastic overhaul of the tax code, the situation today is much improved. Four key taxes remain (down from twenty-one in 2004): a value-added tax of 18 percent (down from 20 percent, with financial services, health care, and pharmaceuticals exempt), a corporate profit tax of 15 percent, a flat personal income tax of 20 percent (reduced from 25 percent last year and with the further reduction to a flat 15 percent by 2012 mandated by the legislation), and a property tax of up to 1 percent. An excise tax applies to gasoline, tobacco, and alcohol.

As Georgia strives to minimize the fiscal disincentives to savings and capital formation, the tax rate on dividend and interest income was reduced last year from 10 percent to 5 percent (zero for dividends paid by publicly traded companies and interest income from bank deposits and publicly traded bonds) and will be further reduced to zero by 2012, as mandated by the legislation. Georgia does not have payroll, social insurance, inheritance, or wealth taxes, or a stamp duty or any similar transaction-based duties and levies. There is no capital gains tax, with gains taxed as part of general taxable income (individuals are exempt on gains made on assets held for more than two years). All foreign-source income is taxed at zero percent for individuals. In 2009, Georgia was ranked fourth-best performer worldwide by the *Forbes* Tax Misery and Reform Index (bested only by Qatar, the United Arab Emirates, and Hong Kong).[6] By January 2009, Georgia had evolved into a model flat-and-low-tax country, largely compliant with the four key tenets espoused by proponents of flat tax: a single flat tax rate, elimination of special preferences, no double taxation, and territorial taxation.[7]

Just as taxes are few and rates are low and flat, the administrative complexity (and thus potential for corruption and lobbying by interest groups) has been reduced dramatically by the abolition of various tax exemptions (other than those mentioned above), breaks, credits, rebates, and loopholes. As a result, the gray economy has shrunk and budget revenue, reaching $3.89 billion in 2008, exceeded 30 percent of GDP.

Whereas five years ago tax revenue did not allow the timely payment of public-sector salaries and pensions, let alone needed infrastructure upgrades and improvement of key public services, by 2008, the government's fiscal footprint had grown too big for the libertarian-leaning Georgian authorities. As a result, laws were passed in 2008 limiting the state budget expenditure to 25 percent of GDP, reducing its ability to run deficits and establishing two sovereign wealth funds to invest surpluses.[8] This legislative initiative was arguably as important than the continuing tax cuts, if not more, since it has introduced into the public discourse the notion that government spending needs to be capped and monitored.

Last but not least, fiscal management has been much improved, in many cases with assistance from the international financial institutions and other donors. The budget-writing process has been improved, with all extrabudgetary funds abolished and merged into the budget, all fiscal revenue commingled in one revenue pool,[9] centralized revenue collection implemented, a single treasury account established, and a medium-term budgetary planning framework adopted, among other reforms.

Monetary and Exchange Rate Policy. In the early transition years, the Georgian currency suffered from hyperinflation, which was curtailed in 1995. Following the introduction of the lari in 1995, Georgia enjoyed a decade of mid- to high-single-digit inflation. Yet, by early 2007, the economy exhibited the typical symptoms of overheating, and inflation started creeping up. By November 2007, inflation had crept into double digits, and it stayed high through the first half of 2008 as the commodity price cycle peaked worldwide.

In early 2008, the government initiated a legislative package that, among other things, clarified price stability as a key part of the central bank's mandate; carved out the regulatory and supervisory functions into a newly established Financial Supervision Agency (FSA), leaving the central bank to focus on macroeconomic management; and mandated the adoption of an inflation-targeting framework by 2009, requiring the target inflation rate to be set in the single digits and introducing severe penalties for under- and overshooting the target. These reforms, combined with the central bank's resolve to contain inflation by tightening monetary policy dramatically,[10] resulted in inflation dipping below 10 percent by July 2008, well ahead of the cyclical global cooling later in 2008. Inflation declined to 5.5 percent by December 2008 and 1.8 percent by April 2009, leaving the central bank ample room for loosening its monetary policy.

Georgia has had full currency convertibility with no currency or capital controls since 1997, the first among the Commonwealth of Independent States (CIS) members to have done so. (Georgia has since left the CIS.) Unlike the knee-jerk policy responses of some of its post-Soviet peers to the adverse conditions of late 2008, Georgia has refrained from imposing any currency or capital controls or limits on bank deposit withdrawals or transfers, preserving these crucial economic freedoms and confidence in its financial sector in the process. Since 2004, the lari has appreciated considerably, both in nominal and real terms, against the U.S. dollar and other major currencies. The authorities intervened in the foreign exchange market to support exchange rate stability for the three months following the August 2008 armed conflict, which was seen as crucial for preserving confidence in the financial sector. The foreign currency reserves were bolstered by a $750 million standby arrangement from the International Monetary Fund, which was requested as soon as the hostilities ceased in mid-August and was approved by mid-September 2008. In November 2008, the lari depreciated against the U.S. dollar by 15 percent over the course of several days and appears to have found a new short-term equilibrium.

Like many of its peers in Central and Eastern Europe, Georgia has been running a large current account deficit (22.6 percent of GDP in 2008), which, until recently, had been comfortably financed (indeed, largely driven) by massive FDI inflows. Unless the FDI inflows reach preconflict levels, exchange rate flexibility may be expected in the medium term to affect the macroeconomic adjustment and reduce the current account deficit. In the meantime, the reduced level of private inflows is compensated by donor-led inflows, with a $4.5 billion economic aid and reconstruction package pledged by donors in October 2008.

Under current global conditions, the currencies of many developing countries with large current account imbalances have come under severe pressure. In some cases, despite the governments' best efforts, the pressure may be so extreme as to justify extraordinary measures. In this context, in the aftermath of the August 2008 conflict, Georgian authorities considered but ultimately did not pursue the option of dollarization, whereby the U.S. dollar (and perhaps the euro and the pound sterling) would have been allowed to circulate freely and to be used as legal tender. While this move would have had advantages, the drawbacks were considerable. At times of significant macroeconomic challenges, it behooves authorities to consider even drastic measures in a dispassionate and pragmatic manner.

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Financial Services Sector Growth. By 2008, financial intermediation comprised 2.1 percent of GDP, up from 1.5 percent of GDP in 2003, as banking assets grew from approximately 16 percent of GDP in 2003 to an estimated 42 percent of GDP at the end of 2008. The number of individuals with bank accounts grew from an estimated 200,000 in 2003 to well over 2.2 million in 2008. Banks have invested heavily in their distribution channels, trying to reach those without accounts and sell modern products to their clients. Hundreds of thousands of individual and small-business borrowers have availed themselves of bank credit, with the attendant benefits of growth of consumer-oriented businesses, home ownership, and entrepreneurship.

Unique in the CIS, Georgia completed the privatization of its banking sector in 1995 and has maintained since then no restrictions whatsoever on foreign ownership of banks. The withdrawal of the state led to the development of the banking sector without the distortions and inefficiencies that state-owned banks inevitably create. Foreign investment poured into the banking sector, as both strategic and portfolio investors sought leveraged exposure to the rapidly growing Georgian economy, best attained through investing in Georgian banks. As a result of the further sweeping liberalization of access to the financial services market for foreigners, any financial institution licensed in any Organisation for Economic Co-operation and Development (OECD) country may establish a presence in Georgia by opening one or more branches and notifying the regulator, with no prior approval required. Reputable financial institutions wishing to establish a presence through the creation of a wholly owned local subsidiary face minimal hurdles from the FSA.

The risk-weighting of foreign currency assets in the context of bank capital adequacy requirements has been so high as to make it impossible for the Georgian banks to achieve greater than six times leverage—helping them absorb the shocks since August 2008.

This liberal approach applies to banks as well as insurance companies and broker-dealers. The recent amendments to the securities law allowed the "demutualization" of the stock exchange and remote membership by broker-dealers licensed in OECD countries (without the need to establish a local presence) to promote the deepening of the liquidity in the market. Competition is promoted with simplified procedures for the establishment of new organized securities exchanges and clearing and settlement institutions. Securities may be quoted in any currency, and it is easy and straightforward to admit to trading in Georgia securities listed or admitted to trading on more than one hundred qualified stock exchanges worldwide. By 2008, an estimated fifty international institutional investors and hundreds of nonresident high-net-worth individuals had opened brokerage and custodial accounts in Georgia, despite the absence of major global custodians, providing much-needed liquidity and depth to the nascent securities market. In 2006–2008, several local companies and listed private equity vehicles raised equity capital through first-ever initial public offerings and rights issues on the local stock exchange.

As formal employment grew—thanks to the low flat taxes, a more flexible labor market, and effective abolition of the payroll tax in 2007—hundreds of thousands were enrolled in health insurance plans sponsored by private employers. Rising home and car ownership, fueled by the retail banking boom, resulted in rapid growth in the property and casualty insurance sectors.

Effective prudential regulation of the banking sector contributed greatly to its rapid growth. For over a decade, Georgia has maintained a simple bank licensing regime, whereby only one type of bank license exists, allowing licensed banks to engage in all banking activities. This has prevented the excessive and arbitrary fragmentation of the sector typically observed in developing countries with several types of banking licenses.

There has been much discussion of the benefits of dynamic provisioning (that is, banks overprovisioning during booms and releasing these reserves in lean times, as practiced, for instance, in Spain) and the "twin peaks" approach (the separation of prudential and conduct-of-business regulation, as in Australia). These approaches have merit for developing as well as industrialized economies. However, a simpler (and admittedly cruder) approach has served Georgia well. Since 1998, the risk-weighting of foreign currency assets in the context of bank capital adequacy requirements has been so high as to make it arithmetically impossible for the Georgian banks to achieve greater than six times leverage (total assets to equity). The excess capital carried by the banks as a result of this conservative approach has played a crucial role in helping them absorb the shocks since August 2008.

Crucially, given the limited size of the Georgian market, the banks were allowed to pursue a universal banking model, with the leading banks becoming involved, through acquisitions and organic development, in insurance, broker-dealer activities, wealth management, pensions, card processing, and other related activities. This has allowed the banks to scale their earnings more rapidly and compensate somewhat for the implicit cap on their return on equity due to the limited leverage they have been allowed to maintain. Innovation and creativity flourished, as the leading banks struck up symbiotic relationships with real estate developers and expanded their distribution networks in a cost-effective manner by establishing synergistic relationships with, and in some cases investing in, various retail chains. As the leading banks reached critical mass, they have found themselves in a position to access international debt and equity markets, benefiting from the benign conditions of the bull market of 2004–2007.

Domestic consolidation was allowed and, in fact, encouraged, resulting by 2008 in a concentrated yet intensely competitive banking sector, with the top five banks accounting for nearly 80 percent of the sector assets but experiencing competitive pressure from sixteen smaller banks. By 2007, the leading Georgian banks began establishing beachheads in nearby regional markets, such as Azerbaijan, Belarus, and Ukraine.

Even under the best of circumstances, it is not easy to strike the right balance between central bank independence; effective principles- and risk-based regulation of the financial services sector; and effective communication among the government, central bank, and the regulator to ensure the preemption of and coherent policy responses to various shocks. Many industrialized countries are currently reexamining their regulatory and policy arrangements. So far, Georgia has avoided following their lead. While there is always room for improvement, coordination among the government, central bank, and the FSA has proved effective in the aftermath of the August 2008 armed conflict.

Predictably, the liberalization of labor market access has not created any social dislocations—low-to-middle-income countries have nothing to fear by opening their labor markets.

By choice, Georgia remains one of the very few countries worldwide without any state-sponsored bank deposit insurance arrangements whatsoever. Nonetheless, thanks to years of rapid but largely disciplined growth and effective (rather than excessively tight) risk-based supervision, the confidence in the banking sector has been such that, while client deposits dipped by about 15 percent in the immediate aftermath of the August 2008 conflict, by the end of 2008, deposits returned to the July 2008 level. This experience reinforces the notion—long held by Georgian authorities—that it is possible to establish and preserve confidence in the banking sector without incurring the costs and distortions and moral hazard issues inherent in state-issued guarantees for bank deposits.

Georgia's banking sector remains sound and liquid, despite the extreme stress of the August 2008 conflict and the spreading contagion of the global financial crisis. There is thus no case for the further tightening of the regulatory regime.

Aggressive Privatization. Private ownership of land and privatization of the legacy housing stock were among the few early reforms implemented in the 1990s, but those efforts stalled. Since 2004, however, the government has stepped up its privatization efforts, generating annual privatization proceeds of approximately $200 million per year. Many large state-owned companies were privatized in 2004–2006 (including the existing telecommunications operator, most remaining power generation and distribution assets, and significant transportation infrastructure assets), alongside thousands of smaller state-owned assets, including land and real estate. In 2008, despite the worsening market conditions, privatization proceeds reached $450 million, as several large companies, such as Poti seaport and the water utility in Tbilisi, were privatized. Small-scale privatization auctions continued apace.

Today, the only significant assets in state ownership are the railway, which is profitable and reasonably well-managed and may well be privatized; the national postal system and power transmission grid, which require significant restructuring before they appeal to investors; the highway and road system; municipal water and sanitation assets in the regions; and the seemingly inexhaustible supply of real estate owned by the central and local governments.

Deregulation and Minimizing Bureaucratic Discretion. Since 2004, dozens of laws have been simplified or repealed altogether, and hundreds of licenses and permits previously regulating all sorts of economic activities have been abolished.[11] The new licensing law establishes clear parameters and procedures for the remaining licenses and permits, thereby making it difficult to reregulate the economic activities that have been liberalized.

In areas in which issuance of permits is unavoidable, such as construction, the bureaucratic discretion has been minimized by adopting the "single window" (or one-stop shop) system; streamlining procedures; and introducing the "silence is consent" principle, which imposes rigid deadlines for civil servants to respond to citizens' and companies' queries. If an official reply is not provided within the specified time frame, the permit, certificate, or license in question is automatically granted. According to the World Bank rankings, Georgia is among the top ten countries globally in terms of ease of obtaining construction permits.[12]

Georgian policymakers realized early on the limitations that a poor, developing country faces in building up its regulatory capacity, due to low wages and a critical shortage of human capital. A realistic and pragmatic view has prevailed, recognizing that in most instances it would take a generation (at least) for the locally nurtured regulatory sophistication and capabilities to equal those of industrialized economies. Consequently, Georgia has embraced the concept of regulatory outsourcing where possible. The near-automatic admission of OECD-licensed financial institutions was discussed above. Other examples of this approach include no local certification of consumer goods (including processed foodstuffs) that have been deemed or certified as safe for consumption in any one OECD member country. The technical standards and codes adopted by the EU, other OECD members, and CIS countries have been adopted for use in Georgia in parallel with any local standards and codes, thereby facilitating activities of economic agents and minimizing the bureaucracy that tends to become entrenched around the need to develop, refine, monitor, and enforce the use of the local standards. A law has been initiated by the government (and is currently being debated by parliament) that would abolish local licensing requirements for any pharmaceuticals licensed for consumption in the EU and other eligible industrialized countries. This approach, predictably, has resulted in more investment and trade, fewer market distortions, greater diversification of exports and imports, significantly less corruption, and more growth.

The energy and utilities sectors have been liberalized under a modern regulatory framework with an independent regulator. Ownership of power generation and distribution assets by the same company were allowed, resulting in increased foreign investor interest. The electricity and gas markets for industrial users were liberalized in 2006 and 2008, respectively; third-party infrastructure access rights have been guaranteed; and a timeline has been adopted for the complete liberalization of electricity rates.[13] In addition, in 2008 the government initiated a streamlined, first-come-first-served procedure for attracting investors in the dozens of large and small greenfield hydropower plant sites (primarily in western Georgia).[14]

In the transportation sector, transit fees, quotas, and other barriers have been abolished. Railway tariffs have been liberalized. In aviation, "open skies" policies have been adopted. All of these have resulted in the rapid growth and development of the transportation and logistics sector, which plays a particularly important role given Georgia's role as a transit zone for Caspian basin hydrocarbons and a trade gateway to the Caucasus and Central Asia.

Public-Sector Reform. Since 2004, Georgia has undertaken a radical reform of the public sector. The number of ministries and state agencies has been reduced considerably, and the headcount of public-sector employees has been reduced by about 50 percent. Public-sector salaries have risen markedly, reducing corruption and enabling public-sector institutions to compete for senior talent with the private sector.

Free Trade. Georgia has been a member of the WTO since 2000. In 2006, Georgia unilaterally set bound import tariffs of zero on approximately 95 percent of categories of goods and abolished all nontariff barriers on virtually all goods and services.[15] The procedures and paperwork required for both exports and imports have been streamlined considerably, reducing the typical time for processing exports and imports from several weeks to a few days. Currently, the weighted-average import tariff in Georgia does not exceed 1.5 percent. Customs revenue has decreased from approximately 1 percent of GDP in 2004 to approximately 0.26 percent of GDP in 2008. As a result, foreign trade turnover has quadrupled since 2003, investment and imports of capital goods have been encouraged, costly distortions and inefficiencies in the consumer market have been avoided, diversification of exports and imports has been achieved, and endemic corruption at customs has been eradicated.

In 2007–2008, legislation was enacted to allow the establishment of free industrial zones (FIZs) with additional tax and customs benefits. A low barrier to entry has been set, allowing any firm or individual with as little as ten hectares of owned or leased land to apply for FIZ status. In an attempt to reinforce Georgia's nascent status as the regional trade and financial hub, legislation created the Free Warehouse Company and International Financial Company regimes, which have appealing tax and customs benefits for businesses wishing to use the Georgian jurisdiction to engage in international trade and finance activities.

Labor Market Liberalization. A new labor code was adopted in 2006, replacing the multitude of regulations and liberalizing the labor market dramatically while complying with all essential International Labour Organization conventions. Restrictions on the duration of the term of employment contracts and overtime work have been largely abolished, leaving it to the employer and employee to agree on these and other terms, while complex and onerous severance procedures have been streamlined into a simple procedure whereby the law requires one month's severance pay and little else. There is no minimum wage legislation. Individual and collective contracts are now treated similarly, and collective bargaining is allowed by any group comprising two or more individuals (rather than only by formally established trade unions). As a result of these changes, by 2008, Georgia was ranked by the World Bank as the fifth-easiest country in which to employ workers.[16] Combined with tax reform, labor market flexibility has played a crucial role in the rise of formal employment.

> Seizing the opportunity presented by the current economic downturn to initiate deep and comprehensive reforms, courageous leaders can transform their countries in the process.

Labor market access has been fully liberalized for noncitizens. An individual of any nationality can seek formal employment and become employed in Georgia without any work permits or other restrictions. Signing an employment contract is sufficient for receiving an individual residency (should an expatriate worker wish to obtain one, since even this is not required). This policy has helped address the shortage of critical skills in finance, law, accounting, and senior management. Predictably, the liberalization of labor market access has not created any social dislocations—low-to-middle-income countries have nothing to fear by opening their labor markets, as the probability of menial labor pouring in and competing with the indigenous workforce is negligible.

Liberalizing Tourism. During the Soviet era, Georgia was an important tourist destination, hosting more than 3 million (mostly Soviet) visitors per year in the 1980s. The tourist infrastructure had degraded significantly and fallen into disrepair by the beginning of this century, and the instability of the early 1990s in Georgia and discovery by Russian and other post-Soviet tourists of destinations such as Cyprus, Turkey, Israel, and Egypt had effectively erased Georgia from the regional tourist map. By 2003, barely 300,000 visitors a year were reported.

After the Rose Revolution, Georgia unilaterally liberalized access to the country, granting citizens of all EU countries and OECD member states full, visa-free access for visits lasting up to ninety days.[17] Access for citizens of many other countries has been simplified, with visas obtainable at the point of entry. This reform—combined with massive improvements in transportation, hospitality, and communications infrastructure; the rapidly improving image of the country; and limited promotion efforts by the government—resulted in the tripling of annual visitors to 1 million by 2007. In 2008, the government initiated legislation—recently passed by parliament—to extend visa-free access to citizens of an additional thirty countries with GDP per capita of $10,000 or higher and to extend the duration of visa-free visits for all eligible visitors from ninety to 360 days.

Education Reform. Alongside the continuing upgrades of the decrepit school infrastructure, important structural reforms were initiated in 2005–2006. A national unified exam system has been created for school graduates, eliminating the endemic corruption in the university admissions system. Day-to-day decision-making has been devolved to the boards of trustees established at all state schools and universities. The most important and successful reform was the radical change in the way state schools are funded, with vouchers issued nationwide to all households with school-age children, enabling parents to use the vouchers at any school—state or private—of their choice. In addition to creating competition among state schools, this measure has fostered the development of private schools, and, by 2008, enrollment in private schools was approximately 7 percent of the total (up from nearly zero five years ago).

Health Care Reform. The government initiated an ambitious and elegant reform aimed at the eventual replacement of all state-owned hospitals with privately owned, newly built facilities. Private investors and consortia were invited to bid for several lots comprising the existing health care facilities (in many cases, located in downtown business and residential districts and occupying real estate that is valuable but unsuitable without expensive modernization for the provision of quality health care services). Investors bid for these lots not in cash but in firm commitments to build by a specified deadline—in Tbilisi and other locations specified in the bid documentation—modern health care facilities satisfying the established requirements and comprising the minimum number (and composition) of hospital beds contained in their bids. If and when they complete the construction of these new facilities, the investors are free to do what they wish with the legacy health care facilities they have so "purchased." The typical scenario involves the demolition of the legacy facilities and redevelopment of the valuable land. This reform, while highly complex in terms of implementation and impeded by worsening access to capital, will, when completed, result in the state's near-complete withdrawal from the provision of health care.

In order to address the health care needs of the poorest strata of the population, the state issues health insurance vouchers with which patients can purchase basic health coverage from any of the dozen or so private insurance companies active in Georgia.[18]

Welfare Reform. A nationwide targeted social assistance program has been launched to replace the complex and inefficient legacy social programs prone to manipulation and corruption. Poverty assessment of some 550,000 households has been carried out by social agents, and, based on multifactor proxy means-testing technology, more than 400,000 households (or one-third of the total) have been identified as socially vulnerable. These households receive monthly cash payments on request to supplement their private incomes (if any), as well as state-issued health insurance vouchers. As a result, available social assistance has been targeted and delivered to those most in need of it.

There Is No Better Time to Reform Than Now

Georgia's economic achievements and rapid progress since 2003 resonate with reform-minded policymakers in low-to-middle-income economies. The starting conditions for the sustained reform effort were broadly similar, and many challenges Georgia faces are familiar. Seizing the opportunity presented by the current economic downturn to initiate deep and comprehensive reforms, these courageous leaders can transform their countries in the process.

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Notes

1. Unless otherwise noted, all economic data and figures cited in this *Outlook* are drawn from Statistics Georgia (www.statistics.ge/index.php?plang=1), the Georgian Ministry of Finance (www.mof.ge/default.aspx?sec_id=2537&lang=2), and the National Bank of Georgia (www.nbg.gov.ge/?lng=eng).

2. In 2008, Georgia was ranked the sixty-seventh least corrupt country in the Transparency International Corruption Perception Index, up from 133rd place in 2004. In a poll conducted semiannually by international and local polling organizations under the auspices of the International Republican Institute, more than 96 percent have consistently answered that they have not had to pay a bribe in the previous twelve months.

3. Georgia ranks fifteenth out of 181 in the World Bank's 2009 rankings; it outranks the United States in ease of starting a business, getting construction permits, and registering property. See World Bank, *Doing Business 2009* (Washington, DC: World Bank, 2008), available through www.doingbusiness.org (accessed May 19, 2009).

4. Ibid.

5. Heritage Foundation, *2009 Index of Economic Freedom* (Washington, DC: Heritage Foundation, 2009), available through www.heritage.org/index (accessed May 19, 2009).

6. Jack Anderson, "The Forbes Tax Misery Index," *Forbes*, April 7, 2008, available at www.forbes.com/global/2008/0407/060.html (accessed May 19, 2009).

7. For a discussion of these four key principles, see Daniel J. Mitchell, "The Global Flat Tax Revolution: Lessons for Policy Makers," *Prosperitas* 8, no. 1 (February 2008), available at www.freedomandprosperity.org/Papers/flattax/flattax.shtml (accessed May 28, 2009).

8. Unfortunately, the $350 million accumulated in the sovereign wealth funds by August 2008 has been fully drawn down in the aftermath of the August 2008 conflict to address urgent reconstruction needs.

9. The single revenue pool is used instead of having certain programs or agencies funded directly by a particular fiscal revenue source. When specific programs or agencies are identifiably dependent on a particular tax, the vested interests expend considerable lobbying effort to protect the revenue source in question, resisting any cut in the tax rate in question.

10. Between November 2007 and July 2008, the main rate was raised by five hundred basis points cumulatively, peaking at 12 percent in July 2008.

11. It has been estimated that the overall number of licenses and permits has been reduced from approximately three hundred to ninety-two and from approximately six hundred to fifty-two, respectively, with the scope for further streamlining and reduction.

12. World Bank, *Doing Business 2009*.

13. This deregulatory initiative applies to legacy privatized generation assets. New-build generation assets and gas distribution networks already enjoy a deregulated tariff environment.

14. More information is available at www.minenergy.gov.ge/?lang=eng.

15. As a result of a political compromise reached when this law was passed, low tariffs not exceeding 12 percent apply to several food staples and some construction materials. Currently, there are only three tariff bands—of zero percent, 5 percent, and 12 percent—down from sixteen different tariff bands prior to the trade reform.

16. World Bank, *Doing Business 2009*.

17. Citizens of Commonwealth of Independent States members other than Russia have historically enjoyed visa-free travel on a reciprocal basis; Russian citizens can obtain Georgian visas easily at the point of entry.

18. These vouchers are currently issued to approximately 1 million individuals below the poverty line.