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Transfer of know-how to small and mid-size businesses in Georgia, Moldova and Ukraine. White paper: Georgia

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CASE Network Reports

Transfer of Know-how for Small and Mid-size Businesses in Georgia, Moldova and Ukraine

White Paper: Georgia

Maya Grigolia
Lasha Labadze
Pavol Minarik
Alena Zemplerova
Marek Vokoun

No. 123/2015



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List of of Acronyms and Abbreviations

| | |
|---------|---|
| BAG | Business Association of Georgia |
| BAS | Business Advisory Services |
| CASE | Centre for Social and Economic Research |
| CEVRO | Liberal Conservative Academy in Prague Czech Republic |
| CPI | Consumer Price Index |
| DB | Doing Business |
| EBRD | European Bank for Reconstruction and Development |
| ECA | Eastern Europe and Central Asia region |
| EfW | Economic Freedom of the World |
| EGP | Enterprise Growth Program for Georgia by EBRD |
| EPO | European Patent Office |
| EU | European Union |
| EU28 | European Union, 28 countries |
| FDI | Foreign Direct Investment |
| FIZ | Free Industrial Zones |
| FIZ | Fraser Institute |
| GCI/GCR | Global Competitiveness Index/Global Competitiveness Report |
| GDP | Gross Domestic Product |
| GEL | Georgian National Currency - Lari |
| GeoStat | National Statistics Office of Georgia |
| GII | Global Innovation Index |
| GMU | European Union Eastern partnership countries – Georgia, Moldova and Ukraine |
| GSMEA | Georgian Small & Medium Enterprises Association |
| HCI | Human Capital Index |
| HDI | Human Development Index |
| HF | Heritage Foundation |
| IMF | International Monetary Fund |
| IPRI | International Property Rights Index |
| IPRs | Intellectual Property Rights |
| ISET | International School of Economics at the Tbilisi State University |
| ISI | Thomson Reuters ISI, Web of Knowledge citation index, indicates high impact papers, formerly Institute for Scientific Information |
| IVF | International Visegrad Fund |
| MSMEs | Micro, Small and Medium Enterprises |
| NA | Not Available |
| R&D | Research and Development |
| SME | Small and Medium size Enterprises |
| STIs | Sexually Transmitted Infections |
| UK | United Kingdom |
| UNDP | United Nations Development Program |
| USAID | United States Agency for International Development |
| USD/\$ | United States dollar |
| USPTO | United States Patent and Trademark Office |
| VAT | Value-Added Tax |
| WB | World Bank |
| WBES/ES | Enterprise Survey of Business Managers, World Bank Enterprise Survey |
| WEF | World Economic Forum |

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Abstract

The report summarizes the conditions of the small and medium size enterprises (SME) sector in Georgia, identifies main problems in their development and provides recommendations for further interventions based on the Czech experience, research of existing literature and own survey among SME stakeholders in Georgia.

Georgia is a small open economy. Its structure has been changing during last decade dramatically what provides opportunities for start-up companies. The revealed comparative advantage is in mineral waters, nuts and wine, but the opportunity to export also encompass metals, electricity, chemicals, stone, glass and clothing. One of the fast growing industries is tourism. Exports have increased over the period, although Georgia remains to be a net importer. Georgia attracts relatively large amount of foreign direct investment (FDI), large share of FDI in flowed from the European Union (EU) countries. Georgia receives favourable evaluations of its business environment. It ranks high in indices of economic freedom and it is among the top countries with respect to ease of starting and doing business.

According to the official statistics, there is big number of small enterprises in Georgia, however as GeoStat have still not adopted the EU SME definition. Information on SME sector structure and development is unreliable and not comparable as registered SMEs are not active. As confirmed by our survey among Georgian experts, SME sector suffers from several other problems. The most serious obstacle in SMEs development is the access to credit. Another problems include low market skills of entrepreneurs, lack of education and business experience, as well as barriers for export to foreign markets, low level of activity of venture capital and political instability.

Proposed measures to assist small businesses in Georgia have been divided in generic that have impact across industries which have extensive positive spillovers (education, developing skills, training, research and development, information and competition issues) and in specific that are related to the conditions in particular sector (banking, healthcare, tourism and agriculture). In addition as the Eastern Partnership and The Deep and Comprehensive Free Trade Area (DCFTA) as a part of the Association Agreement give expectations that Georgia will become part of EU single market however the Georgian entrepreneurs will have to understand regulations and adaptation of domestic law with the EU acquis as well as SME policies adopted by the EU.

The Czech experience with programs to assist selected small and medium enterprises that aim at the discretionary support during the transition and the EU accession shows that administration can absorb big share of the available means. Less successful enterprises can be subsidised to the detriment of more successful ones. The implementation of such programs can create certain frustration and be counterproductive. On the other hand there is a good experience and possible transfer of know-how with programs which aim at generic problems and have positive externalities, especially

activities to improve information imperfections. Based on recent Czech experience creation of Contact and Information Points where all information needed to start a business, assistance and help for doing business in the European Union, funding opportunities, development of enterprises and searching for business contacts is recommended. Besides, programmes to connect entrepreneurs in Georgia with European markets and businessmen are recommended as a good way of transferring knowledge from which both sides could benefit.

1. Introduction

This report has been prepared in the framework of the project “Transfer of know-how to small and mid-size businesses” of the International Visegrad Fund (IVF) and USAID, coordinated by the Center for Social and Economic Research (CASE), Poland. The project aims to support the SME sector in the EU Eastern partnership¹ countries of Georgia, Moldova and Ukraine (GMU) because it is a major source of competition, growth, jobs, innovation, political stability and democracy. Moreover, the project contributes to the creation of a platform, a working group of governmental and non-governmental experts in the field of small and medium entrepreneurship in the GMU countries and the Visegrad countries: Czech Republic, Hungary, Poland and Slovakia. In addition, an outcome of the project is to put together a library of NGOs, think-tanks, etc., in the seven countries which are contributing to our work. A final “permanent platform” will be online. Finally a task of the project is to assist SMEs in the GMU with familiarizing themselves with EU single market rules, threats and opportunities and to share best practices and lessons learned from SME development in Central and Eastern Europe during the transition and EU accession.

This white paper is the result of the project and has three major tasks. Its outcome should not only be the research report describing the conditions of the SME sector in Georgia and identifying the main obstacles to its development, but also recommendations on how to remove or diminish obstacles for SME development, i.e. a roadmap enumerating specific actions.

The report was written in close cooperation with teams from CEVRO University Prague and two Georgian organizations: CASE-Georgia and the International School of Economics at Tbilisi State University (ISET). The members of the Czech team are Marek Vokoun and Pavol Minarik. The team is headed by Alena Zemplerova. The Georgian team is made up of Irakli Galdava and Maya Grigolia and it is headed by Lasha Labadze.

The report incorporates not only ideas and findings from existing studies but also the ideas, best practices and recommendations discussed during meetings and in-person semi-structured interviews with members of the institutions related to the SME sector. Specifically, it includes the findings from interviews carried out on February 21-22, 2014 and during the final conference organized in Tbilisi on November 14, 2015. The ISET-CEVRO team is grateful to all the experts who met in Georgia for their comments and inputs. The report also reflects the survey among stakeholders and relevant institutions for SME support in Georgia based on the questionnaire unified for all GMU countries interviewed in February-March 2014. Finally, it benefits from the multiple ideas and suggestions received from representatives from the public and private sectors in the Czech Republic and their experience with SME support during the transition to a market economy and European Union accession. We would like to thank all of these institutions and their representatives for their initiative, professionalism,

¹ Initiative which EU started in 2009.

commitment and support.

SMEs are often associated with “entrepreneurship”; sometimes the two terms are used synonymously². Societies benefit from the entrepreneurial activity of individuals who not only create jobs and income for themselves and others, but also come up with new ideas related to risk in their entrepreneurial efforts. In the report, we adopted the EU definition of SMEs which means two conditions must be fulfilled in parallel: a 1. maximum of 249 employees and a maximum turnover of EUR 50 million or a 2. balance sheet total maximum of EUR 43 million. An SME can be a legal entity (company) or a sole entrepreneur (an individual doing business on the basis of a license)³.

² Small business and entrepreneurship overlap but the concepts are different. A small-business firm is independently owned and operated, is not dominant in its field, does not necessarily engage in innovative practices, and is not strategically planning growth. An entrepreneurial venture, in contrast, is any business whose primary goals are profitability and growth and that can be characterized by innovative strategic practices.

³

| Company category | Employees | Turnover | or | Balance sheet total |
|------------------|-----------|----------|----|---------------------|
| Medium-sized | < 250 | < € 50 m | | < € 43 m |
| Small | < 50 | < € 10 m | | < € 10 m |
| Micro | < 10 | < € 2 m | | < € 2 m |

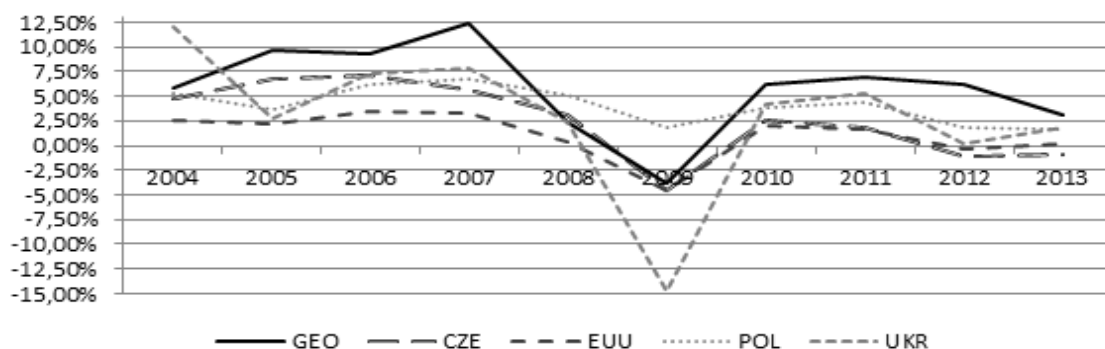
These ceilings apply to the figures for individual firms only. A firm which is part of larger grouping may need to include employee/turnover/balance sheet data from that grouping too.

2. Macroeconomic environment and development in Georgia

Georgia is small open economy similar to the Czech Republic. With an area of 70 thousand square kilometers, Georgia is slightly smaller than the Czech Republic⁴, Austria or Republic of Ireland. Its population is probably about 5 million (statistics are not reliable and migration is huge), of which about 85% are Georgians, and 12% are Azeri and Armenian.

In the early 90s, Georgia became a recipient country of international help and began its transformation from a Soviet type economy to a modern market economy. For Georgia, a country weakened by military conflicts, the role of the International Monetary Fund (IMF) and other institutions such as the World Bank and the European Union has been crucial. The IMF has helped coordinate the transformation process (Papava, 2003). After only a few years, important achievements could be noted: a new financial system with national and commercial banks was established, hyperinflation was curbed, price liberalization was started, the privatization of state banks was completed, parliament adopted a national budget, foreign trade was liberated, foreign debts were restructured, and Georgia became a country able to pay its debts. In 1993, Georgia withdrew from the rouble zone and introduced a national currency in 1995. In the same year, prices were liberalized and privatization began. Although this was an economically efficient solution, it also led to a great deal of confusion. By 1997, more than 90% of retail turnover was private and by 1998, 11,500 small businesses (with fewer than 50 employees) had been privatized, mainly by insider sales. The energy industry was unbundled and privatized in 1998, and land, water supply, ports and telecommunications followed.

Figure 1: Real GDP growth rates [%], Georgia, EU and selected EU countries 2004-2014



Data: World Bank - World Development Indicators. Note: Poland (positive) and Ukraine (negative) represent extreme GDP growth values in 2009 among GMU countries.

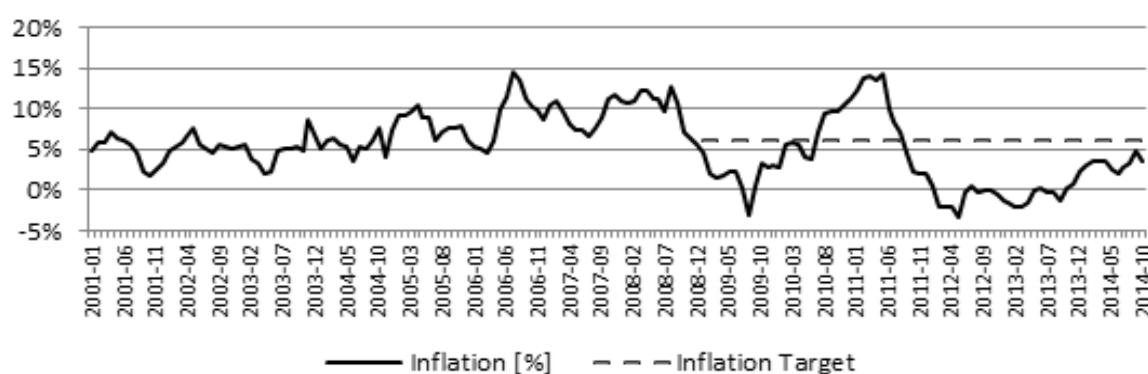
⁴ The total area of the Czech Republic is 78,866 square km.

In general, economists do not have one universal blueprint which should be applied to transform a communist economy into a competitive market economy with a limited government. Traditionally, the transformation process in post-communist countries includes the establishment of political and market competition; that is, the previous authoritarian regime is removed and the process of deregulation and trade liberalization begins, which leads to massive structural and institutional changes and a new market orientation. These reforms require country-wide support for the new regime which includes national elites and new regional leaders. Transparent cooperation without corruption and rent-seeking behavior is necessary. According to Gould and Sickner (2008), this was not the case in Georgia where corruption and rent-seeking was a common behavior among economic and political agents. The support of regional and national elites was very limited up until the Saakashvili reforms.

The Georgian economy experienced significant growth over the last decade. Starting from 2003 until the financial crises, the average growth rate was 9.3%. In 2009, growth declined to minus 4.0%. The armed conflict with Russia also harmed the Georgian economy in 2008. Figure 1 shows the benchmarking of Georgian growth. Georgian economy is an emerging economy which doubled in size during the period 2000-2005.

The Georgian economy started its recovery in 2010 and showed high positive growth. The economy started slowing down in the fourth quarter of 2012. In October 2012, the government was changed through parliamentary elections; the so-called “Georgian Dream” coalition came to power and a new wave of reforms started, which led to a long period of political uncertainty. According to a forecast of GDP growth by the ISET Policy Institute (which is in line with the IMF), the annual growth rate in 2013 will be 2.4%. This deceleration was driven by slower private investment, weak credit growth and budget underspending.

Figure 2: Inflation rate in Georgia 2001-2014, annual month to month CPI growth [%]



Data: Geostat.

The inflation rate in Georgia is measured using the consumer price index (CPI). At the current stage of economic development in Georgia, the inflation target is set at 6 percent. The monetary policy regime of the National Bank of Georgia (as of 2009) is inflation for the medium term (for the years 2011-2014)

and 3% in the long run. In June 2013, the inflation rate was 0.20%, as reported by the National Bank of Georgia (Figure 2). The average annual inflation rate in 1996-2013 was 5.52%, reaching 59.31% in 1996 and -3.30 % in May 2012 (see Figure 2 for recent development of inflation).

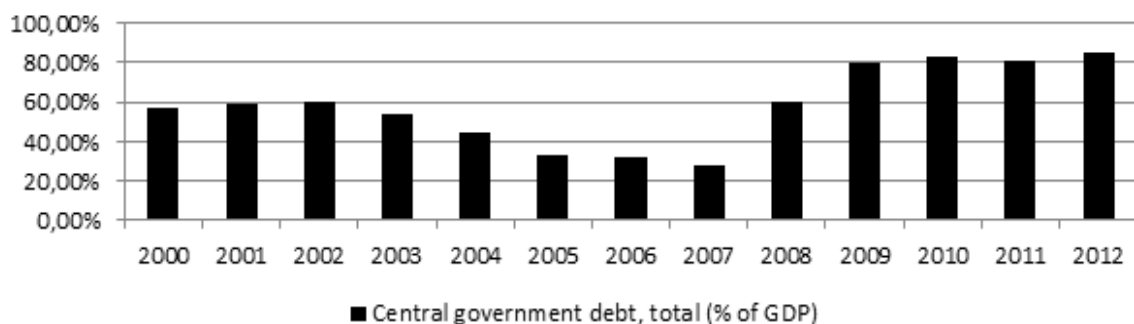
Unemployment has remained at a very high level. The official unemployment rate in 2013 was 14.6%. As expected, urban unemployment is higher; the urban unemployment rate in 2013 was 25.6%, as compared to the rural unemployment rate which was 6.5% in the same year. Most of the rural population is registered as self-employed in agricultural activities. This might mean, however, that in real life terms they are unemployed as well. The unemployment rate in the 20-24 year age group was 33.8 % in 2013.

Due to increased productivity, the labor income increased about three times in real terms over the last decade without any increase in the number of people employed. Thus, unemployment remains a constraint for economic development.

Sovereign credit ratings have long served foreign investors as the most frequently used proxy to measure the amount of credit risk linked with an economy. The external public debt situation has been one of Georgia’s key sovereign credit strengths, a fact also acknowledged by the international rating agencies.

Despite its achievements over the last decade, Georgia still remains in an unstable macroeconomic environment with major political challenges. High unemployment and low incomes affect most of its population.

Figure 3: Central government debt, Georgia 2000-2012 [%]



Data: World Bank - World Development Indicators.

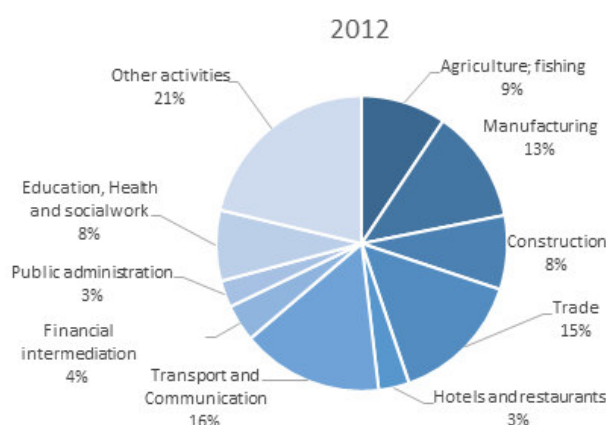
Government budget revenues started to increase in 2003. The increase was the result of improved governance and tax administration. Government expenditures also increased, with the largest shares going to education and social protection. In 2009, state budget revenues decreased by 10% due to the crisis. At the same time, an expansionary fiscal policy was implemented to stimulate aggregate demand. As a result, the budget deficit peaked at 9.3% of GDP. In 2010, the Government of Georgia pursued fiscal consolidation, resulting in a budget deficit cut down to 6.8 % of GDP. The deficit

was further cut down to 3.3% in 2011. Fiscal consolidation was mainly achieved through an increase in revenues.

In the October 2012 elections, a new government was elected which came into the power with a more left-wing program and directly implemented a social policy program. Budget underspending has resulted in an unexpected fiscal restriction, which has also contributed to the recent slowdown of the economy. According to the IMF's recent recommendation, "the priority [for Georgia] should be to allow the policies to be more accommodative in terms of spending to support demand.

The total external debt constituted about 79% of GDP in 2009. In comparison to other EU countries, the ratio of central government debt to GDP has been relatively stable and low (around 34% in 2009)⁵. Starting in 2003, both debt ratios were decreasing until 2008 when both increased due to the crisis. As for the external sector, Georgia still has a negative trade balance which makes Georgia a net borrower and contributes to its large current account deficit. Since the Rose Revolution, the new government has attracted external finance and the absolute value of external debt has increased as a result.

Figure 4: Sectors of Georgian Economy, GDP shares [%], 2012



Source: GeoStat.

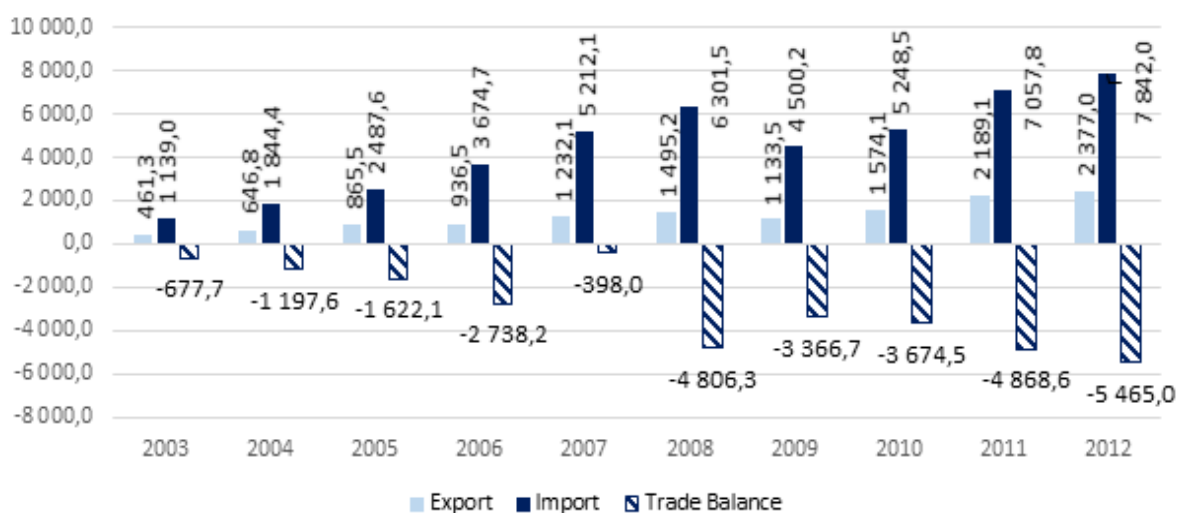
Georgia's main domestic industries are agriculture, wholesale, construction, transportation, health, education and tourism. The revealed comparative advantage is in minerals, nuts and wine, but the country also exports metals, electricity, chemicals, stone and glass and clothing. The competitive advantage will be in diversifying the export portfolio and removing obstacles to export (lack of export strategy, finances, skills of employees, and information). Georgia should especially encourage the export of high value added goods, such as ICT Services, movie production, bio-tech and pharmaceuticals, industrial design and machinery (Onugha et al., 2013).

Pro export policies and a greater exposure to the global market will lead to desirable spill-over

⁵ Source: World Bank data, total value of External debt stocks to GDP in current dollar prices. In 2009 the ratio was 79.5% and increased to 81.8% in 2010, and 85.3% in 2012. The ratio of government debt to GDP was 27.0% in 2008 and rose to 34.6% in 2009. It slightly decreased to 32.6% in 2012.

effects. Figure 4 illustrates the industrial structure of the Georgian economy in 2012. Georgia was a major agro producer of the Soviet Union, however it was relatively monocultural and it was dependent on grain and meat. The share of the agricultural sector was on average one-third of Georgian GDP during the period. After the Soviet collapse, the GDP shares of agriculture and manufacturing underwent dramatic decreases. Measured by share of GDP, Georgia was an agrarian country. However, this share declined from 38% in 1995 to 25% in 1998 to 15% in 2005 to 9% in 2012. Farmers were able to keep some of their land from the Soviet Union times and part of agricultural land has been privatized since 1998, although progress has been very slow. In agriculture there has always been private production oriented at tea, citrus fruit and wine.

Figure 5: Export, import, and trade balance, USD million, 2003-2012



Source: Geostat.

Oil and gas are important for Georgia, mainly because it is a transit country. The share of manufacturing is still very low in Georgia. During the Soviet period, Georgia was a supplier of electric locomotives and jet fighters to the Soviet Union. Rustavi was founded in 1948 to supply metallurgical products. Although Georgia enjoyed higher standards of living than the rest of the Soviet Union, the need for restructuring was huge and many industrial enterprises closed down.

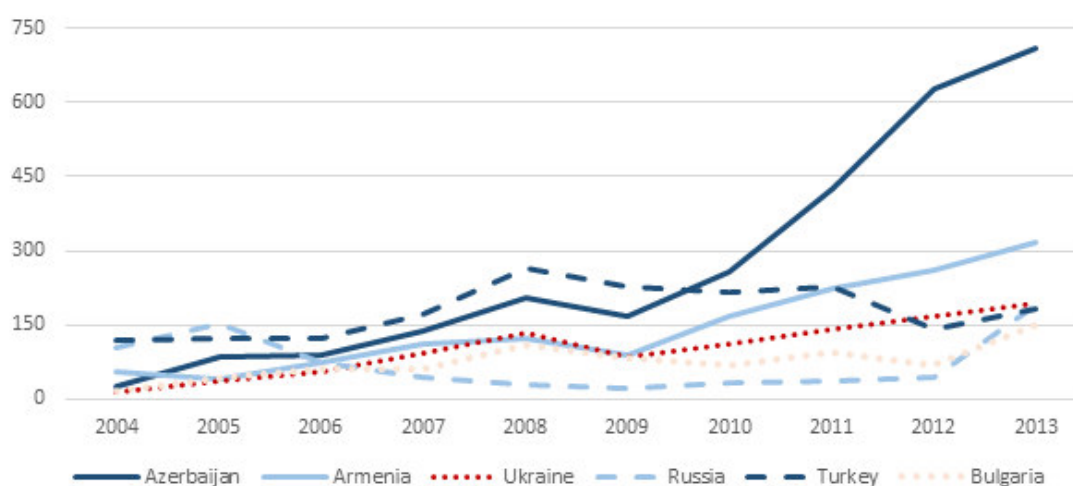
The main centers of industry as well as population lie along an east-west axis. Georgia is major wine manufacturer. Georgia has over 2000 mineral springs producing 130 million liters a day, most of which is being wasted. There are over 500 different waters, hot and cold (Borjomi, Sairme).

One of the future growing industries is tourism. During the Soviet era, four million tourists a year came to Georgia. The loss of Abkhazia coupled with the occupation of Georgia's hotels by refugees from Abkhazia and the economic crisis almost wiped out the industry. The top end of the business is overregulated (sanitary etc.) and there are plenty of rooms available informally. The number of tourists is steadily increasing.

The volume of international trade (exports + imports, see figure 5) has increased from USD 1,6bn in 2003 to USD 10,2 bn in 2012. The top six export countries in 2013 were the CIS countries, Azerbaijan, Armenia, Ukraine and Russia, as well as Turkey and Bulgaria. Annual exports to Azerbaijan decreased by 3.8 % in 2013. This was mostly due to a decrease in car re-exports, aircraft, wheat, and ferro-alloys sales. Exports to Armenia increased by 44.7% due to a significant increase in grain exports and re-export of cars. The lifting of Russia’s trade embargo (2006-2012) on Georgian agricultural goods had a positive impact on exports in 2013.

The dollar amount of wine and mineral water exports increased six times between 2012 and 2013. The significant increase in exports to Bulgaria (150.4 %) was due to increasing exports of copper ore and concentrates as well as nitrogen fertilizers (see Figure 6).

Figure 6: Export by country in Georgia, USD million, 2004-2013



Source: GeoStat.

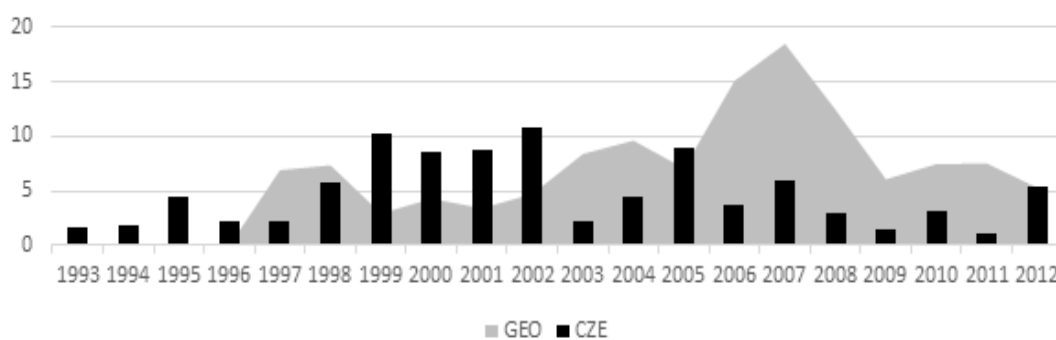
The export (re-export) of cars constituted 21% of total exports in September 2013 and it increased by 11% compared to the same period in 2012. Export of nuts and hazelnuts increased significantly, constituting 12.3% of total exports. Annual exports of nitrogenous fertilizers, natural grape wine and mineral water increased by 150%, 124.1%, and 93.7%, respectively.

Recently, a study by Onugha et al. (2013) recommended pro-export policies and greater exposure to global markets, with the hope that this will lead to desirable spill-over effects. Georgia’s main domestic industries are agriculture, wholesale, construction, transportation, health, education and tourism. The competitive advantage will be in diversifying the export portfolio and removing obstacles to export (lack of export strategy, finances, information and the low skills of employees). The revealed comparative advantage is in minerals, nuts and wine, but the quick opportunity to export also encompasses metals, electricity, chemicals, stone and glass, and clothing. Georgia has to especially encourage the export

of high value-added goods such as ICT Services, movie production, bio-tech and pharmaceuticals, industrial design and machinery (Onugha et al., 2013).

FDI was the main source of growth in Georgia, therefore GDP growth was closely related to FDI inflow during transition in Georgia (Gursoy, 2012). In the period of transition, foreign investment has become the main targeting. FDI was about 12% of GDP in 2007 and this contribution declined during and after the military conflict (Figure 7). In 2011, the same indicator was 4.6 percent, which further reduced to 3.3 percent in 2012. The last decline is associated with political uncertainty due to the government change in the fall of 2012, as mentioned above.

Figure 7: FDI inflow as % of GDP, Czech Rep. and Georgia, 1997-2012



Data: World Bank.

The 2013 FDI share as % of GDP is the same as in 2012. The main obstacle for long-term and even short-term investment is political instability. Other issues such as the regulatory burden and poor infrastructure are not deterrents since Georgia, as a developing country, offers a large portfolio of possibly high-return FDI opportunities and promising economic growth number. One of the recommendations is to promote the most promising opportunities directly to investors through FDI agencies in Europe and traditional Georgia international trade partners (Gursoy, 2012).

Almost half (48%) of FDI flowed in from the EU countries in 2012. It was 41% in 2013, and in the first two quarters of 2014, the EU countries comprised 72% of total FDI inflow. In 2013, Luxemburg, the Netherlands, the United Kingdom and the Czech Republic were the lead investors in Georgia. In 2013, FDI inflow from Germany declined significantly compared to 2012. Also, FDI inflow from Cyprus became negative in 2013, while this country was the fourth largest investor in Georgia in 2012.

Table 1: FDI inflows in Georgia by economic sector (as a share of total FDI inflows), 2007-2013

| Sectors | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 |
|----------------------------------|-------------|-----------|---------|---------|-----------|---------|---------|
| Total (in 1000 USD) | 2,014,841.6 | 1,563,962 | 658,401 | 814,497 | 1,117,244 | 911,564 | 941,902 |
| Agriculture and fishing | 0.77 % | 0.50 % | 3.39 % | 1.06 % | 1.33 % | 1.77 % | 1.3% |
| Mining | 4.28 % | 1.16 % | 2.28 % | 6.56 % | 3.60 % | 0.53 % | 4.6% |
| Manufacturing | 15.49 % | 12.04 % | 18.95 % | 21.53 % | 10.77 % | 18.42 % | 10.6% |
| Energy | 18.00 % | 18.85 % | -0.32 % | 2.69 % | 18.25 % | 19.68 % | 26.0% |
| Construction | 8.53 % | 3.63 % | 15.98 % | 0.58 % | 4.31 % | 4.59 % | 5.3% |
| Hotels and restaurants | 12.01 % | 11.63 % | 5.70 % | 2.10 % | 2.03 % | 1.94 % | -1.4% |
| Transports and communications | 20.68 % | 27.03 % | 14.95 % | 26.41 % | 11.32 % | 7.99 % | 14.9% |
| Health and social work | 0.02 % | 0.04 % | 0.04 % | 0.15 % | 1.51 % | 1.93 % | 0.1% |
| Other sectors | 12.39 % | 24.43 % | 31.48 % | 25.74 % | 31.86 % | 25.32 % | 1.3% |
| Financial sector | 7.83 % | 0.70 % | 7.54 % | 13.19 % | 15.01 % | 17.83 % | 17.7 % |

Source: National Statistics Office of Georgia (GeoStat).

3. Business environment

As mentioned above, Georgia has been undergoing continual institutional changes since the 1990s. Major institutional reforms (government, parliament, constitution, civil rights, market economy, etc.) started after the Soviet collapse and again after the Rose Revolution in 2003. At the end of 2004, the low flat tax rate of 12% was adopted. The goal was to reduce the Georgian shadow economy and to move from a relatively complex progressive tax system to a simpler flat tax system. Before 2003, taxation and tax enforcement was perceived by international institutions and by the political opposition as a major problem. The economic agents used to under-report their taxes and they also lacked the trust and credibility of the central government, which contributed to the start of the Rose Revolution (Torosyan and Filer, 2014).

Table 2: Economic Freedom of the world rankings 2013

| Countries 2013 EFoW | 1. Size of Government | 2. Legal Structure and Property Rights | 3. Freedom to own foreign currency bank accounts | 4. Freedom to trade internationally | 5. Regulation | SUMMARY INDEX | Rank |
|------------------------|--------------------------|---|---|---|---------------|------------------|------|
| Czech Rep. | 5.3 | 6.2 | 10 | 7.7 | 7.6 | 7.25 | 52 |
| Georgia | 6.9 | 5.7 | 10 | 8.5 | 7.9 | 7.61 | 25 |
| Hungary | 6.7 | 6.2 | 10 | 7.7 | 7.7 | 7.59 | 27 |
| Moldova | 7.5 | 5.5 | 5 | 6.8 | 6.9 | 6.86 | 82 |
| Poland | 5.5 | 6.4 | 10 | 7.4 | 7.2 | 7.20 | 59 |
| Slovak Rep | 6.4 | 5.8 | 10 | 8.0 | 7.4 | 7.46 | 36 |
| Ukraine | 6.8 | 5.1 | 0 | 6.6 | 6.2 | 6.16 | 126 |

Data: Fraser Institute (2014).

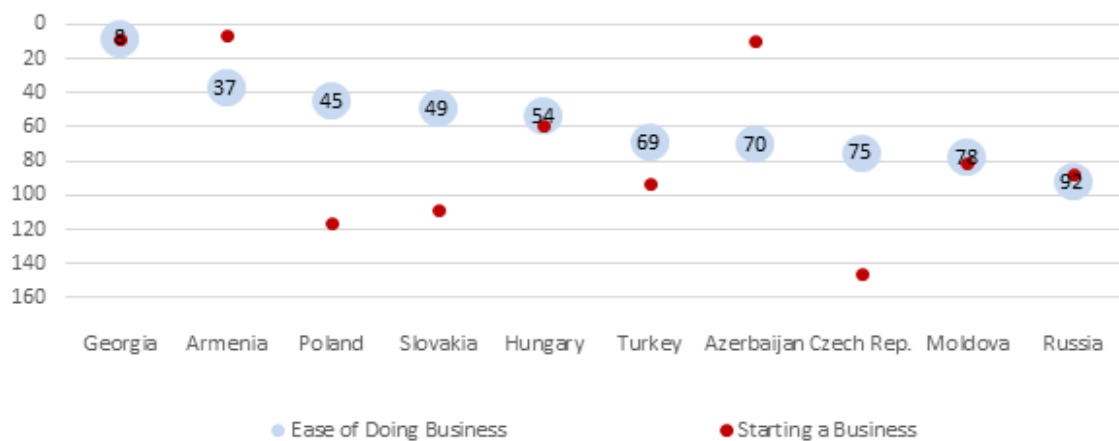
The lack of political and economic stability was problematic and resulted in many conflicts. The central government suffered from clientelism and wide spread corruption. Even the constitution was challenged and central government institutions lost their credibility between 1990 and 2003. The Rose Revolution constituted a new hope but the positive economic performance and increase in living standards was hampered by an economic crisis and the Russian-Georgian war in 2008. The unstable institutional infrastructure and constant risks of instability due to Moscow—Abkhazia—Tbilisi relations impeded the democratic process and hampered the improvement of living standards and long term investments. The low levels of civilian support, the lack of government interest and the limited experience of market economy benefits increased the role of international support. The misuse of past support was replaced with the improved cooperation of the new governments after the Rose Revolution. However, the risk of inefficient spending is still viewed as a threat (Fluri and Cole, 2005).

The institutional infrastructure is monitored by several international institutions. Since 2006, the Heritage foundation has ranked Georgia at a similar level as the Czech Republic in the “economic freedom” category. The only differences are a lower property rights sub-index for Georgia and a higher corruption sub-index for the Czech Republic. Economic Freedom of the World (EFoW), published by the Fraser Institute, measures economic freedom in five main institutional areas (see Table 2). They show the extent to which a rightly acquired property is protected and how individuals are engaged in voluntary transactions. In this respect, Georgia is ready to prosper; In the 2013 EFoW edition, Georgia outperformed even many developed countries.

After the Rose Revolution of 2003, the new administration was able to implement radical reforms in the business regulatory regime, as well as in macroeconomic management, which resulted in a much improved economic performance.

Georgia improved its Doing Business ranking between 2006 and 2010 and became one of the top countries for doing business (Figure 8). This indicator is based on regulatory rules and differs from other competitiveness indicators such as that produced by the Global Competitiveness Report. This achievement is a good advertisement for the country and helps it to attract investment. However, many observers think Georgia has climbed up the index rankings too quickly. Although changes are being implemented, the real business experience is still quite different and other institutional risks and informal institutions are still affecting the way business is done in Georgia (Schueth, 2011).

Figure 8: Ease of Doing Business, Georgia and selected countries

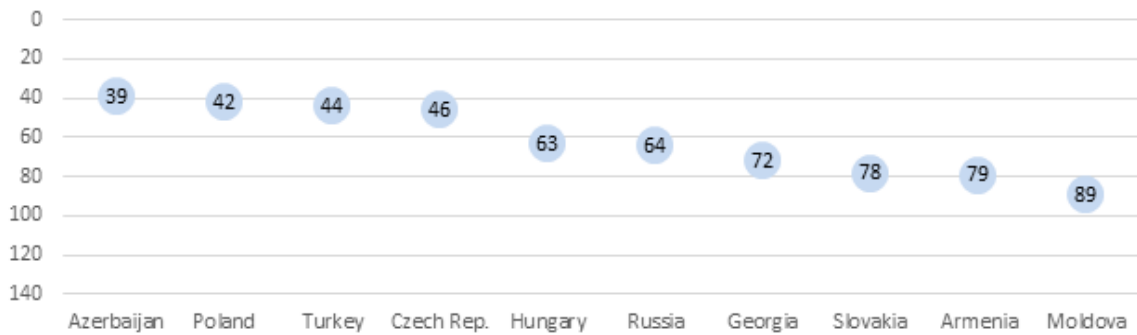


Source: World Bank, IFC, Doing Business survey.

An important survey dealing with competitiveness is the Global Competitiveness Report (GCR) prepared by Schwab, Sala-i-Martin, and Brende (2013). It contains an index that includes not only regulatory rules but also efficiency measures and for example the problematic factors for doing business. If we look at all of the countries, Georgia is in the middle (Figure 9) and that means that it should improve the efficiency of selected factors (institutions, education, macroeconomic stability, labor market

efficiency, etc.) first, and then it can focus on deepening the innovation and knowledge-driven side of the economy. The most problematic factors are lack of access to financing, lack of a skilled labor force, poor work ethic and policy/government instabilities.

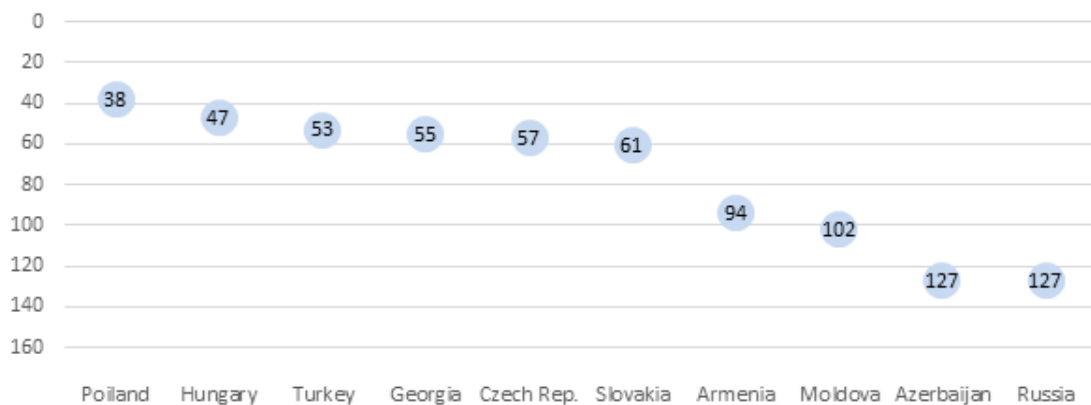
Figure 9: Global Competitiveness Index 2013/14, Georgia and selected countries



Source: World Economic Forum, Global Competitiveness Index.

The Global Competitiveness Index (GCI) “...assesses the ability of countries to provide high levels of prosperity to their citizens. This in turn depends on how productively a country uses available resources”. In the ranking provided by the World Economic Forum (WEF), Georgia is ranked 72nd⁶.

Figure 10: Corruption Perception Index 2013, Georgia and selected countries

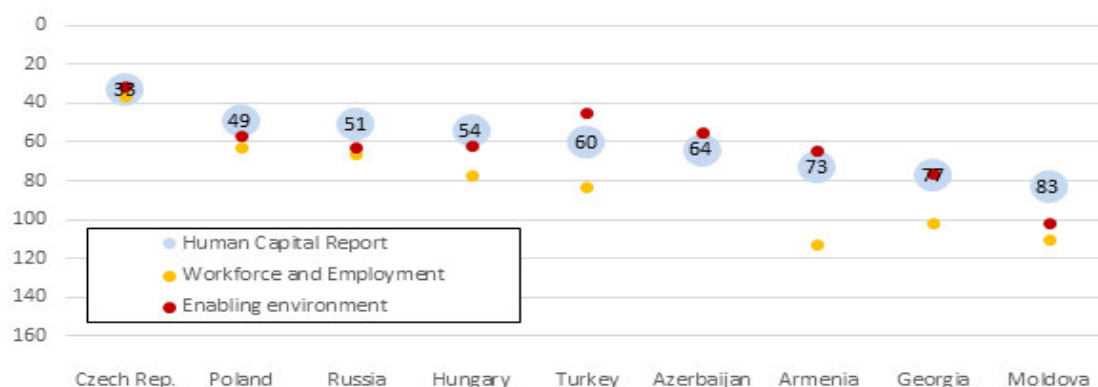


Source: Transparency International, Corruption Perception Index.

Georgia is ranked close to countries such as the Czech Republic, Turkey and Hungary in Transparency International’s Corruption Perception Index 2013. Azerbaijan and the Russian Federation are the worst performers from the reference countries. The index suggests that corruption is not a major problem in Georgia (Figure 10).

⁶ http://www3.weforum.org/docs/WEF_GlobalCompetitivenessReport_2013-14.pdf.

Figure 11: Human Capital Index 2013, Georgia and selected countries



Source: World Economic Forum, Human Capital Index.

The Human Capital Index is another ranking provided by the WEF. Similar to the GCI, the distance between the worst and the best performers is almost similar. Georgia is the second worst-performing among the reference countries in the ranking (Figure 11). Georgia ranks very low in two sub-indices of the Global index, assessing the enabling environment and employment⁷.

Georgia has significantly reduced the number of taxes and the overall tax burden since 2004 (Table 3), and this policy has resulted in improvements in tax administration and collection through the creation of a modern Revenue Service Agency. This, together with economic growth, caused government tax revenues to increase (quite dramatically) as early as 2005. They continued to grow until 2012.

Table 3: Taxes and tax rates in Georgia

| Tax indicators | 2004 | '05 | '06 | '07 | '08 | '09 | '10 | '11 | '12 | '13 |
|---------------------|--------|-----------|-----------|-----------|-----|-----|-----|-----|-----|-----|
| Number of taxes | 22 | 7 | 7 | 7 | 6 | 6 | 6 | 6 | 6 | 6 |
| VAT | 20% | 20% | 18% | 18% | 18% | 18% | 18% | 18% | 18% | 18% |
| Income tax*/ | 12-20% | 12 % flat | 12 % flat | 12 % flat | 25% | 20% | 20% | 18% | 15% | 15% |
| Social tax*/ | 33% | 20% | 20% | 20% | | | | | | |
| Corporate tax | 20% | 20% | 20% | 20% | 15% | 15% | 15% | 15% | 15% | 15% |
| Dividend income tax | 10% | 10% | 10% | 10% | 10% | 5% | 5% | 3% | 0% | 0% |

Source: The Ministry of Finance of Georgia.

The new tax code of Georgia, in force since 2011, defines two new special tax regimes for the “micro” and “small” businesses. The notion of “micro” and “small” was introduced for the first time at that time. According to the code, “micro” businesses are exempt from paying taxes, while the tax rate defined for “small” businesses is only 3 to 5% of their revenue. While they have a number

⁷ http://www3.weforum.org/docs/WEF_HumanCapitalReport_2013.pdf.

of advantages on the retail market (such as VAT exemption), they are not in a favorable position when selling goods and services to larger firms, because the VAT refunds are not redeemable for purchases from small or micro businesses. The tax code stipulates that businesses with a VAT chargeable turnover lower than GEL 100,000 are exempt from the VAT.

In general, taxes are low, but there are other problems related to the Georgian tax code. For example, a tax reduction for fixed assets investment (new machinery and equipment), first year tax benefits for first-time-entrepreneurs, and branch specific tax exemptions are recommended. Also, a tax exemption for restaurants is needed to help them pay taxes more effectively without the need to register all of the purchases from suppliers for the currently very detailed tax report. Restaurants regularly buy products from different suppliers and also buy relatively small quantities of many kinds of products. The current law makes it hard for them to register all of the purchases at the level of detail demanded by the government, because they do not have the software (supply chain management software, enterprise resource planning etc.) to help them prepare their tax reports.

Non-for-profit organizations started to pay income taxes recently, because they provide both grants and contracts. For small organizations, this is a huge change and results in a loss of income and it may lead to a reduction in the number of established and specialized national NGOs. A revision of the tax code and administrative burden related to NGOs is recommended to provide sustainable ground for the specialized not-for-profit grant institutions.

Access to finance seems to be among the most important obstacles to SME development. The World Bank (2013 – Fostering Entrepreneurship in Georgia) evaluates the financial systems in Georgia as “not conducive to business development”⁸. Particularly, high interest rates and risk-averse lending policies (requiring high levels of collateral) are cited as major problems. The World Bank 2013 Enterprise Survey shows that the financing structure of investments in Georgia is skewed towards internal sources, while bank finance and trade credit has a relatively small share. Furthermore, the risk-aversion of financial institutions leads to excessive collateral requirements. Such policies effectively limit access to credit for SMEs with insufficient assets acceptable as collateral, typically land property. Access to finance is the second most important obstacle cited by small firms in the World Bank 2013 Enterprise Survey and the third most important cited by medium firms.

According to an index based on surveying compiled by the Enterprise Survey of Business Managers (WBES), which is conducted by the World Bank Group (2013), the value of collateral needed for a loan is 222.7% on average. Specifically, it is 206.9% for large companies (1000+ employees), and it is the lowest for medium (20-99) firms, at 161.6%. The smallest companies (1-19 employees) need collateral exceeding 232.4% of the loan.

A main source of problems for SMEs in Georgia is difficult access to finance. Companies cite high interest rates and risk-averse lending policies (requiring high levels of collateral) as major hindrances

⁸ The financial market is not developed in Georgia. Bank loans and own capital are the most common sources of finance. According to the Global Competitiveness Report 2013/14, Georgia is ranked very low among 148 countries in venture capital availability (106/148).

to expansion. In addition, the risk capital is lacking. As a result, SMEs must rely on owners' capital or on retained earnings for investments, which greatly impedes their growth. The government can establish favorable financing programs for SMEs by promoting an early-stage risk capital.⁹

High lending interest rates (Table 4) are a particularly large burden for SMEs in Georgia. In light of foreign ownership of the largest commercial banks in the country, we observe a risk-averse lending policy which leaves most SMEs without access to credit.

Table 4: Annual average interest rates on commercial banks' loans [%], Georgia 1996-2013

| | Total | | | National currency | | | Foreign currency | | |
|------|-------|------------|-----------|-------------------|------------|-----------|------------------|------------|-----------|
| | Total | Short-term | Long-term | Total | Short-term | Long-term | Total | Short-term | Long-term |
| 1996 | 61.2 | 60.8 | 68.4 | 57.1 | 57.1 | 57.5 | 64.9 | 64.2 | 74.3 |
| 2000 | 27.3 | 29.4 | 21.0 | 24.5 | 25.5 | 18.6 | 28.0 | 30.4 | 21.3 |
| 2005 | 17.9 | 20.8 | 16.1 | 21.3 | 21.6 | 20.8 | 17.1 | 20.4 | 15.6 |
| 2010 | 18.6 | 22.4 | 17.3 | 22.6 | 24.9 | 21.0 | 17.2 | 20.5 | 16.4 |
| 2011 | 17.1 | 21.7 | 15.6 | 22.6 | 26.6 | 19.5 | 14.9 | 16.7 | 14.5 |
| 2012 | 16.9 | 21.6 | 15.4 | 22.1 | 26.2 | 19.4 | 14.4 | 16.2 | 14.1 |
| 2013 | 15.9 | 19.9 | 14.5 | 20.7 | 24.7 | 18.1 | 13.5 | 14.6 | 13.2 |

Source: National Bank of Georgia, interest rates are weighted.

Having no other sources of finances, SMEs depend on their owners' capital as the main source of financing. According to the 2013-2014 Global Competitiveness Index (GCI)¹⁰, affordability and availability of financial services is one of the most problematic issues for Georgian businesses. Out of 148 economies, Georgia's rank is 83 in affordability and 96 in availability of financial services (The Global Competitiveness Report 2013–2014, page 193).

According to the WB Enterprise Survey conducted in 2008, the problem of accessing finances is particularly serious for small enterprises because of the high collateral required for the loan.

With the lack of finances, it is difficult to attract and maintain a skilled and creative labor force. Most SMEs do not have enough resources to train their staff and, if some of them decide to educate their employees, there is a high probability that the newly trained workers will move to another company. Without the involvement of creative people in SMEs, no innovation is taking place. It is generally true that most innovations come from SMEs. According to the 2013-2014 Global Competitiveness Report (GCI), an inadequately educated workforce is the second largest problem (the first being access to finance) for Georgian enterprises. According to the survey, 14.2% of firms consider this issue to be the main problem for their businesses.

The Georgian banking sector can be described as monopolistically competitive, with healthier market conditions after the Rose Revolution of 2003. However, in the following years, the intensity

⁹ The World Bank, *Fostering Entrepreneurship in Georgia*, 2013.

¹⁰ More details at <http://www.weforum.org/reports/global-competitiveness-report-2013-2014>.

of competition weakened. The process of banking sector consolidation, privatization, foreign direct investments and mergers resulted in a banking sector with five dominant banks. Although no perfect collusion or collusion is observed, we can still describe the Georgian banking sector as monopolistically competitive (Mercan, 2012).

4. Labor market, skills and education

Labor market problems, especially lack of skills, structure and widespread unemployment are major problems affecting Georgia today. Most employees (almost 38.4%) are employed in the agricultural sector. This data mostly contains individuals classified as “self – employed,” with 29.6% in Tbilisi versus 8% in more distant regions¹¹.

Table 5: Average monthly nominal salary in USD in Georgia and Czech Republic, 2004-2013

| | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 |
|-----------|-------|-------|-------|--------|--------|--------|--------|--------|--------|--------|
| Georgia | 81.7 | 112.7 | 156.1 | 220.4 | 358.8 | 333.3 | 335.3 | 377.1 | 431.5 | 464.8 |
| Czech Rep | 701.4 | 761.8 | 860.5 | 1030.9 | 1324.7 | 1226.4 | 1251.5 | 1382.3 | 1281.2 | 1282.0 |

Source: Geostat and Czech Statistical Office, recomputed using average Dollar Exchange rate of the World Bank.

According to Geostat data, the highest average salaries are in financial intermediation and public administration (more than GEL 1100 and more than USD 661, using the WB average exchange rate, 2013). The lowest are in education, restaurants and agriculture (less than GEL 500; less than USD 301). The average salary for males is GEL 920,3 (USD 553.3) and GEL 585 (USD 351.7) for females (2013). There is a considerably high wage-gap (around 36%) between males and females. Almost no differences are noted in the public sector, and small differences are noted in electricity, gas, water supply and education. The highest differences (around 41%) are in financial intermediation. In the public sector, the average salary of GEL 795.1 (USD 478) per month is higher than in the business sector, which is 760.1 (USD 457) per month.

The reduction of poverty and encouragement of investments in human capital (in education and health) are the main topics of recent studies. Access to the labor and credit market is limited, especially for low-income farmer households in distant rural regions. The main sources of loans are not banks, but physical persons, especially among self-employed in agriculture and family farms (Uzagalieva and Menezes, 2009).

In the health sector, there is a lack of professionals in remote rural areas, and the overall public opinion is not positive about the skill adequacy and knowledge to deliver quality services. This situation is a result of never ending health care reforms in Georgia and limited training programs for human resources in the health sector (Djibutu et al., 2008).

A study of Bezemer et al. (2005) showed that rural households with better educated members have higher per capita incomes. Different household livelihood strategies in poorer rural areas are used,

¹¹ http://www.iset.ge/files/5._valeriane_kvartskhelia_and_nana_mukbaniani.pdf.

and this diversity is the norm among farmers. About half of the respondents also claimed to have an income from a wage-paying job.

In the first ten years after the Soviet collapse, there were many infrastructure investments which increased the well-being of households. Improvements in school infrastructure have raised school attendance and reduced health risks for school-age children, especially among the poorest households. Other infrastructural project (roads, water supply, and access to emergency services) did not have an immediate impact on the poorest households and contributed more to the general improvement of living standards. Authors have also stressed the need for better data; that is, model baseline households to assess international programs and infrastructure projects (Lokshin and Yemtsov, 2005).

Several pillars for the sustainable improvement of living standards are recommended, in particular, a stable macroeconomic environment, including a fiscally responsible government, efficient infrastructure investments and deepening financial sector stability, while lowering the costs of borrowing. Even though land holding is only weakly correlated with households' well-being, land reforms are necessary. Reforms should at least allow land rental and include a modern and precise land register institution. The authors did not conclude that there was a need for immediate state land privatization, but rather recommend the privatization of downstream industries, such as food processing, and specific marketing chains linked to agriculture. The last recommendation is aimed at social policies, which should target the most vulnerable groups. These policies should include quality education in rural poor areas, and the raising of school participation rates there since these rates strongly correlate with household welfare (Cord et al., 2004).

Table 6: Net migration rates, Georgia, 2000-2013

| | | | | | | | |
|--------------------------|-------|-------|-------|-------|------|-------|-------|
| Year 2000-2006 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 |
| Net migration, thousands | -35.2 | -32.6 | -27.8 | -27.5 | 5.5 | 76.3 | -12.1 |
| Year 2007-2013 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 |
| Net migration, thousands | -20.7 | -10.2 | 34.2 | 18.1 | 20.2 | -21.5 | -2.6 |

Source: Geostat.

Another problem in Georgia is emigration (Table 6) and the so-called “brain drain”. In 2010, several projects such as “Return to Georgia” were implemented with the aim of bringing back qualified nationals from abroad. A survey among 117 emigrants, i.e., Georgian citizens living in the Czech Republic, shows that 83% of them have a university degree and 64% intend to stay in the Czech Republic for a longer period of time. In the near future, only 23% intend to return to their homeland. The main reasons cited for emigration are poor socioeconomic conditions in Georgia and the unstable political situation. In reality, it is a complex set of causes such as unemployment, poor social policy, employment insecurities, low wages, and from a psychological point of view, the loss of hope. Respondents in Georgia with a university degree and even with employment wish to emigrate from Georgia because

of poor socioeconomic conditions (Laliashvili, 2012).

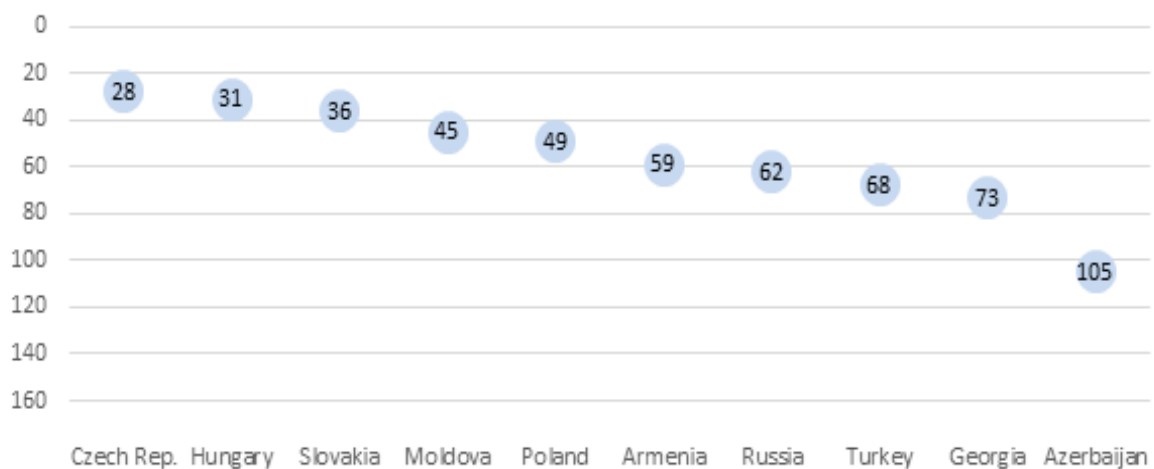
To monitor the living standards, we can use the UNDP Human Development Report, which utilizes the Human Development Index (HDI). Georgia is ranked 72nd and belongs to the second group of countries, which are in the “high human development” category.

Oxfam also dealt with health-care reform in Georgia and in 2009 identified key health issues. “Communicable diseases such as tuberculosis (TB) are increasing. The prevalence of hepatitis B and hepatitis C has dramatically increased, as has the number of sexually transmitted infections (STIs).” (Hauschild and Berkhout, 2009, p. 8). A key problem is that the primary healthcare services are supposed to be free but many patients have to pay out-of-pocket to the medical staff and many people cannot afford such payments. Other problems include low investment in healthcare diagnostic equipment and facilities renovation.

5. Research and development and innovation

Besides education and skills, another reason for innovations not to happen is poor intellectual property rights in Georgia. According to the 2013/14 Global Competitiveness Report, published by the World Economic Forum, Georgia is ranked 124th out of 148 countries.

Figure 12: Global innovation index 2013, Georgia and selected countries



Source: Global Innovation Index.

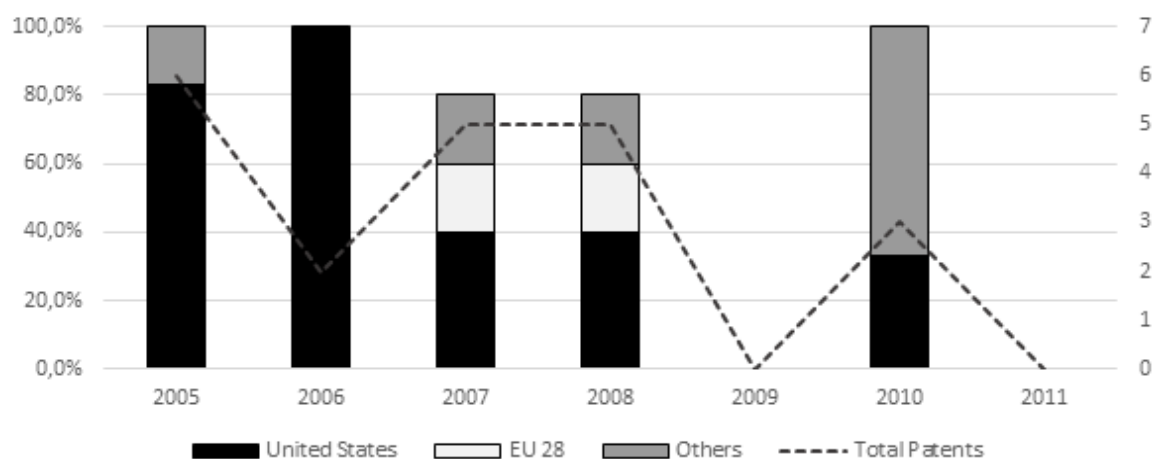
The Global innovation index 2013 ranks Georgia 73rd (out of 142 countries). The GCI also ranks Georgia among the worst countries in innovations. Figure 12 shows that all Caucasian countries rank below the Visegrad countries and Moldova¹².

According to the GCI rankings and the country profile (see chapter 2), Georgia is only starting to be an innovation driven country. To achieve this goal, the country has to increase its efficiency and productivity and needs to exploit all the untapped opportunities. In innovation activities, the cooperation (Figure 13, see a decrease in cooperation ensures participation and the transfer of knowledge to individuals and then back to the national Georgian innovation laboratory.

In Georgia, protecting an idea is a problem. One of the channels of ideas leak is through banks, which assess start-ups. In general, intellectual property rights (IPRs, mostly copyrights or patents) are not respected. Even with a well-prepared disclosure agreement, actual enforcement is not easy because it is not very efficient. It usually takes 2-5 years with a very good attorney, which is expensive and by the time the case is won, the SME might cease to exist. A quicker solution might be an arbitrage and increasing public awareness of these practices being a crime.

¹² <http://www.globalinnovationindex.org/content.aspx?page=gii-full-report-2013..>

Figure 13: Patent cooperation, Georgia, 2005-2011



Source: data OECD.

Table 7: Total granted European Patent Office patents, 2004-2010

| Country | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2010 Population | 2010 Patents/mil. inhabitants |
|------------|-------|-------|-------|-------|-------|-------|-------|-----------------|-------------------------------|
| Czech Rep. | 112.7 | 109.6 | 153.2 | 189.1 | 207.6 | 175.2 | 195.3 | 10.50 | 18.6 |
| Georgia | 1.8 | 2.1 | 1.4 | 4.1 | 2.2 | 0.0 | 1.8 | 4.44 | 0.4 |
| Hungary | 154.4 | 134.4 | 167.0 | 190.8 | 179.6 | 186.1 | 192.6 | 10.00 | 19.3 |
| Moldova | 1.7 | 4.0 | 0.3 | 2.2 | 1.0 | 0.3 | 0.3 | 3.56 | 0.1 |
| Poland | 125.9 | 128.0 | 143.4 | 203.5 | 228.7 | 286.7 | 357.1 | 38.52 | 9.3 |
| Slovakia | 20.6 | 31.3 | 40.6 | 37.6 | 36.0 | 29.9 | 44.5 | 5.39 | 8.3 |
| Ukraine | 24.2 | 27.5 | 32.8 | 28.8 | 26.0 | 22.1 | 38.8 | 45.96 | 0.8 |

Data: stats.oecd.org Note: Inventors country, priority date, fractional count, EPO applications.

6. SMEs enterprises in Georgia

Georgian official statistics have still not adopted the EU SME definition. In the official statistics provided by the National Statistics Office of Georgia (Geostat), the SME definition is based on turnover (volume of sales of goods or services made by the entity) and number of employees,

- Small enterprises: less than 20 employees and a turnover of GEL 500 thousand;
- Medium enterprise: 21-100 employees and a turnover of GEL 1500 thousand;
- Large enterprises are those in which the number of employees exceeds 100 persons and annual turnover is more than GEL 1500 thousand.

Table 8: Number of registered enterprises in Georgia, 2008-2012

| 2008 | 2009 | 2010 | 2011 | 2012 |
|--------|--------|--------|--------|--------|
| 374440 | 412856 | 459077 | 511177 | 553692 |

Source: Geostat (Section: Annual publications - Entrepreneurship in Georgia, 2013).

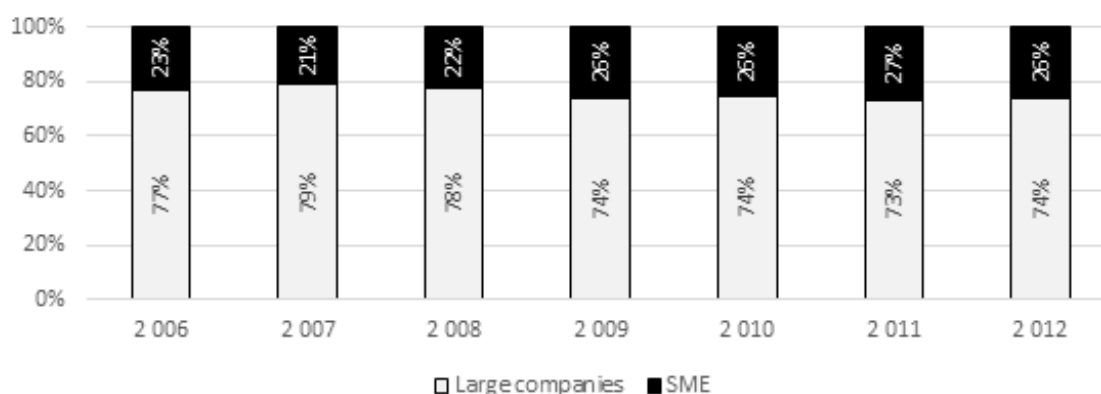
As shown in Table 8, the number of officially registered SMEs is very high but according to surveys, only a small share (about 15%) are active. Comparing those numbers, one may conclude that while business registration is very simple, the same does not apply for closing a business.

One reason that so many companies are being registered could be the benefits for SMEs and particularly for small companies. According to the Tax Code of Georgia, companies with a VAT applicable turnover of below 100,000 Georgian Lari (GEL) are exempt from VAT. Once a firm crosses this threshold, it has an incentive to restart its business. As there is no branding in place, the newly established company is likely to be as successful as its predecessor under the same management.

In the EU, the SME sector is economically significant in terms of employment, turnover, productivity, output, value added, etc. In Georgia the situation is different and at least by official statistics, larger companies (i.e. those with more than 100 employees) are more significant. A paper by Papiashvili and Chiloglu (2012, p. 22) shows that "...there is a set of macro factors (for example, unstable legal environment, low purchasing power of the population, lack of qualified human resources, lack of market information, etc.) and micro factors (such as low coordination between organizations supporting SMEs, lack of proper marketing and managerial skills, uncompetitive products, etc.) that still hinder the development of the SME sector in Georgia."

From the figures below, it follows that the share of SMEs in terms of value added per employee was growing however slowly along with a decrease in employment, which is relatively low when compared with the Czech Republic or the EU.

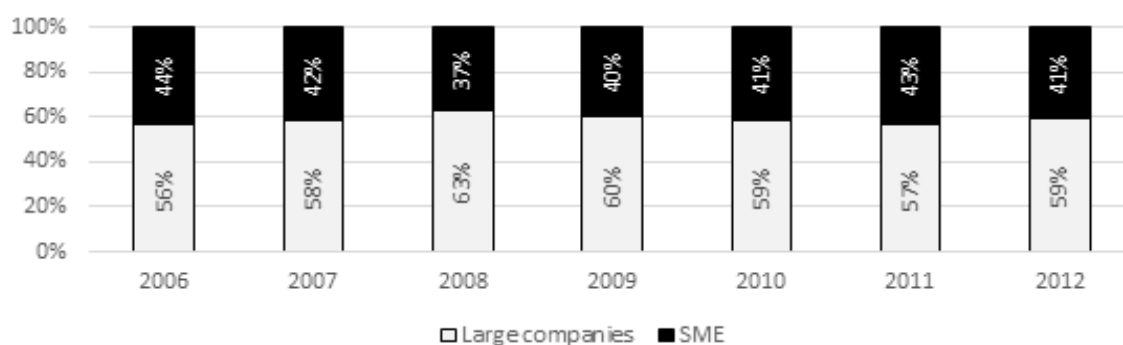
Figure 14: Value Added per employee, Georgia between 2006 and 2012



Data: GeoStat.

Note: Large enterprises are those with more than 100 employees and an annual turnover of more than GEL 1500 thousand.

Figure 15: Employment shares, Georgia, 2006-2012



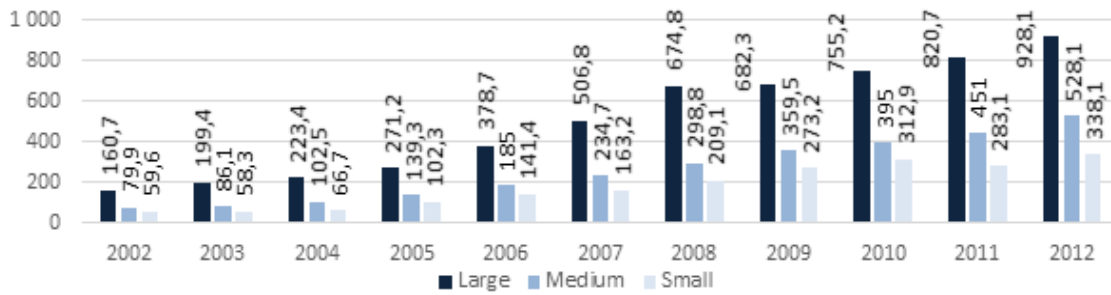
Data: GeoStat.

Note: Large enterprises are those with more than 100 employees and an annual turnover of more than GEL 1500 thousand.

When analyzing developing countries, we have to account both for the SME contribution to the official as well as the informal economy. Ayyagari et al. (2007) observed in a sample of 76 countries, including Georgia, that reducing the costs of market entry and property rights protection, i.e., fostering a competitive business environment, along with efficient credit information sharing, results in a larger employment share of SMEs in manufacturing.

While talking about problems of existing SMEs or of those about to register, we should note that there is almost no bureaucratic burden for registering a company. The ease of business registration is reflected in the World Bank's Doing Business survey, where Georgia is ranked 8th in terms of registering a company.

Figure 16: Average monthly remuneration¹³ of employed persons by enterprise size¹⁴, GEL, 2002-2012



Source: GeoStat.

Note: Large enterprises are those with more than 100 employees and an annual turnover of more than GEL 1500 thousand.

All of these factors make it difficult to invest in more risky innovative activities. Investors, risking their own capital, prefer to undertake an activity that they observe to be profitable by duplicating the idea of another business in the field. As a result, we see a high concentration of SMEs, and particularly small enterprises, in limited areas of activities, where all firms produce homogeneous products and services.

¹³ Salary, supplement, bonus, vacation assistance, compensation benefits, etc.

¹⁴ A large enterprise is an enterprise in which the average annual number of employees exceeds 100 and/or the value of the average annual turnover exceeds GEL 1.5 million. Small enterprises are those in which the average annual number of employees does not exceed 20 persons and the average annual turnover is lower than 0.5 million GEL. Medium sized enterprises employ 20-100 persons and their average annual turnover is 0.5-1.5 million GEL.

7. SME policies, institutions and projects in Georgia

There is no particular and straightforward government strategy or approach to support SMEs in Georgia. Since the Georgian law on supporting small enterprise was abolished in 2006, there has been no legal act regulating SME support mechanisms and attaching any specific responsibilities to government institutions.

SMEs policies are dispersed among independent projects and entities. A platform is needed to connect the stakeholders. The role of the government in supporting SMEs in Georgia is of crucial importance. The Ministry of Economic Development is supposed to elaborate an SME development policy. While support for SMEs was announced as one of the priorities of the current government, no concrete steps have been taken yet.

Recently, the Ministry of Economy and sustainable development of Georgia started a public entity to support SMEs in capacity building and access to finance. But it is fairly new and there is no experience. The monitoring of this entity is recommended.

The “Cheap Agro Credit Program,” implemented by the Ministry of Agriculture, aims to improve access to finances for already established companies as well as for new establishments¹⁵. The project consists of several components: (1) interest free credit for small farmers for buying production inputs; (2) cheap credit for medium and large farmers, producers, exporters; and (3) cheap agro leasing.

There are several business associations and chambers which aim to assist and protect the interests of business representatives in Georgia: the Georgian Small & Medium Enterprises Association (GSMEA), the Business Association of Georgia (BAG) and the International Chamber of Commerce of Georgia.

Members of almost all business associations are medium or large, the only exception being Georgian Small & Medium Enterprises Association (GSMEA)¹⁶, which is a non-political non-profit organization advocating the common interests of the business community. It aims to improve the business environment and increase the competitiveness and productivity of Georgia’s private sector, to protect the interests of small and medium businesses, promote the creation of healthy competitive conditions, as well as to establish active communications among the SMEs on one side and the public agencies, financial institutions, and international organizations at the other side. The Georgian Small & Medium Enterprises Association (GSMEA) projects aim to increase the involvement of SMEs in the public procurement process and run advocacy campaigns for a sustainable procurement system. Other GSMEA goals are linked with the Friendly Legal Framework in Georgia.

¹⁵ See the geographic distribution and the number of financed companies at <http://moa.gov.ge/map/>.

¹⁶ <http://www.gsmea.ge/>.

The following projects are already implemented or are being implemented by the GMSEA:

- “Supporting the Development of Business Friendly Legal Framework in Georgia.” The purpose of this project is to prepare recommendations in order to improve business environment in Georgia.
- “Small Business and Sustainable Public Procurement: Advocacy for Transparency and Increased Accessibility.” This project aims to increase the involvement of small and medium businesses in public procurement processes and to run an advocacy campaign for a sustainable procurement system.

The Business Association of Georgia (BAG)¹⁷ is an independent, non-governmental, apolitical and non-profit organization founded in October 2009. Today, the BAG is one of the largest unions of businesses in Georgia whose members represent large and midsize business organizations. Its mission is to help businesses operating in Georgia create more benefits for themselves and for society based on joint cooperation.

The International Chamber of Commerce of Georgia¹⁸ is one of the most influential business associations which unites more than a hundred small, medium and large business organizations operating successfully in Georgia. The Chamber was officially established in 2002. Today it unites leading companies and business associations within Georgia. It helps businesses to develop policy positions and ensures those positions are heard at the national and international levels. The services provided by the Chamber are the following: Dispute resolution services, Publications, Research foundation, Training and conferences and World Chambers Federation.

While there is no special support mechanism for SMEs from the government, donor organizations are more actively involved in the development of entrepreneurship in Georgia. The European Bank for Reconstruction and Development supports small and medium sized businesses in Georgia¹⁹. There is a program called Energocredit, provided by the EBRD through Georgian banks which aimed to increase energy efficiency in SMEs operating in Georgia and thereby reduce their costs. SME loans starting at USD 50,000 enable SMEs to acquire equipment. The program also provides Energy Audits to help companies choose the best options for investment.

Business Advisory Services²⁰ (BAS, since 2003) and the Enterprise Growth Program (EGP²¹, since 1997) have been improving the competitiveness and level of sophistication of the micro, small and medium enterprises (MSMEs)²² sector in Georgia. Both programs are expected to be continued in the future. BAS, initiating 698 projects with the MSME in Georgia, received a total of €6 million in donor funding from the European Union (EU), the EBRD Shareholder Special Fund, the Early Transition Countries Fund, Canada and Taipei China. Engaging 225 consultants, the project aimed to improve management effectiveness and market performance of the MSMEs. Moreover, the BAS

¹⁷ <http://www.bag.ge/>.

¹⁸ <http://www.icc.ge/>.

¹⁹ <http://www.ebrd.com/pages/workingwithus/sbs/where/georgia.shtml>.

²⁰ EBRD, Strategy For Georgia, approved by the Board of Directors at its meeting on 4 September 2013, <http://www.ebrd.com/downloads/country/strategy/georgia.pdf>.

²¹ EBRD, Strategy For Georgia, approved by the Board of Directors at its meeting on 4 September 2013 <http://www.ebrd.com/downloads/country/strategy/georgia.pdf>.

²² MSMEs = Micro, Small, Medium Enterprises. (EBRD definition) see the list of abbreviations.

has implemented a number of market development activities, including trainings. The industry spread of enterprises assisted included agribusiness, construction, and wholesale and retail distribution sectors. About 47% of the BAS-funded projects were assessed as successful or highly successful.

EGP accounts for 31 completed projects and 7 that are in progress in Georgia, with 2.86 million euro from the EU, Taipei China, Netherlands, Canada, Japan, Italy, Switzerland, and UK and other BAS and EGP donors. Twenty-one projects have been evaluated after completion: 48% of them were rated “highly successful” and 48% were rated “successful”. Furthermore, 77% of assisted enterprises reported increases in turnover, 44% reported increases in pre-tax profits, 60% reported increases in employment, 69% reported productivity growth, and 3% reported increases in their profit margins.

In addition, there are three free industrial zones in Georgia. Two of them are located in the western part of Georgia, in Poti and in Kutaisi. Also, a part of Tbilisi is a free industrial zone. Kutaisi free industrial zone Georgian International Holdings, serving as Administrator of the Free Industrial Zones, created Kutaisi FIZ in 2009. The Egyptian firm Fresh, operating in Kutaisi FIZ invested USD 55.8 million during 2009 and the investment is expected to reach USD 396 million. The Kutaisi FIZ will focus on several types of businesses, including trading and services, heavy industries, warehousing and storage, and manufacturing.

Poti free industrial zone Since June 2008, Poti FIZ (RAKIA Georgia FIZ), near the existing port of Poti, has been operating in Georgia. Poti FIZ is the first in the south Caucasus region and it lies on the historic “silk route,” linking the east to the west. RAKIA has 300 hectares of land around the port to be used for a state-of-the-art FIZ. According to the development project plan, the Poti Free Industrial Zone will be spread over 3.0 million m² for industrial and logistics parks and business centers. Infrastructure is being developed to form the backbone of the zone. Poti FIZ expects to attract close to USD 1 billion to Georgia, and RAKIA will invest USD 200 million to develop the project. The FIZ will employ approximately 5,000-10,000 people.

Tbilisi free industrial zone (Tbilisi FIZ) is laid on an 11 hectare area, 13 km from the city center and is equipped with all available transportation and communications, including rail, road and air. It provides a tax-free environment for businesses. The FIZ is designed for multi-use facilities, including commercial and office buildings, university campuses, hotel facilities, residential areas, customs warehousing and logistics centers.

Georgia, as a developing country, has been participating in many international programs. This cooperation and international involvement began to be very intense after the Rose Revolution. Since 2004, Georgia began to climb the international rankings and indices which provided interesting research ground for all kinds of social scientists. Participation in different types of projects and close cooperation with international institutions such as USAID, World Bank and many European institutions and foundations also resulted in a regular and most importantly, credible, monitoring.

The USAID Projects have been helping reform the Georgian economy for a long time. There are also SME programs, which aim to reduce poverty and boost employment. One of the goals

is to strengthen the capacity of Georgia's agricultural sector. Entrepreneurs in this sector have to be able to respond to export opportunities.

8. Czech experience with SME policies

There are relatively good SME statistics in the CR. The number of SMEs in the Czech Republic (2013) was 1,126,880 legal and natural persons together, of which, 869,279 are individuals and 255,631 are legal entities. SMEs' share on the total number of active enterprises is 99%, the share on the total number of employees is 60% and share on the total added value is 55% (MPO, 2014). The SME sector, however, developed from scratch after the Velvet revolution in 1989.

During communist times, a complete liquidation of small and medium enterprises was carried out in the Czech Republic. After the velvet revolution in 1989 however, the private sector, the small and medium businesses, expanded with unprecedented speed. Even though the official estimates confirm their booming development, on the one hand, a significant part of private activities have not been recorded and have escaped the statistics. On the other hand, as shown below, a considerable number of firms remains in the business register (BR) despite never having started operations, having interrupted their activities or having been liquidated. Thus the official information on the number of firms is distorted and so are the estimates made based on the business register related to the small business sector²³. Recently, there is a similar situation in Georgia.

In the Czech Republic, the SME sector grew rapidly through new start-ups, restitution, small scale privatization and the division of big state enterprises into smaller units during the first years of the transition in 1990-1993. The old monopolistic structure provided numerous niches and opportunities for SME activities. There were underdeveloped industries with great potential for growth in the Czech economy (Zemplerova, 1993).

There is consensus among the governmental bodies that SMEs deserve assistance in order to multiply their positive roles in the economy and in all of society²⁴. There is less agreement on how to implement the policy towards small businesses, i.e. which institutions and instruments of SME assistance to employ in order to meet the objectives of an economic policy towards SMEs.

Government policy, legislation and bank policy were favorable for SME development after the revolution in 1989. The barriers to entry have been gradually removed, the approval process has become less bureaucratic and the state began to provide tax advantages for small businesses with less than 25 people. It was not difficult to obtain credit during the second half of 1990, 1991 and the first half of 1992.²⁵ Banks did not require collateral other than the assets on which the credit

²³ The quality of BR has been tested in the framework of the PECO PANEL project (all CEECs involved), which allowed for new estimations of performing non-agricultural firms and thus for more reliable estimations of the role of SMEs in the economy. According to the PANEL 1995 (only CR) only 64.1% of 970,000 nonagricultural and non-profit units (sectors 6 and 7 according to the SNA) registered in BR in 1995 were economically active. In the case of legal units, it is 65% and in the case of natural persons, it is 64%.

²⁴ The ministry responsible for executive activities regarding small and medium -sized companies and businesses is the Ministry of the Economy.

²⁵ The relatively liberal credit policy was caused by the fact that the Central bank provided large amounts to re-finance credits, and the existing state banks did not consider the risk of providing credits to SMEs.

was provided, did not ask for credit histories, and the required business plans were simple, often elaborated by bank officials themselves. In addition, the state did not have a strong and sophisticated internal revenue service, which provided the possibility of tax avoidance.

There were numerous local activities for SME support financed by local governments and other sources during the transition and the EU accession of the Czech Republic. The most important ones are briefly described below:

The Czech American Enterprise Fund was established in March 1991 by the US Government, as the Czech and Slovak American Enterprise Fund. It received its funds through the US Agency for International Development (USAID); the total grant from USAID over the life-time of the Fund was supposed to be at least \$60 million plus \$5 million for Technical Cooperation. This fund had a staff of 17 people in Prague and about 30 in Washington. Credits have been provided for manufacturing (no construction or services), for projects that would increase exports or technology import (preferably from the USA) and create new jobs creation, The credits are worth a minimum of 10-50 mil. crowns, and 20-40% ownership participation of the Fund has been required as well as a 1-3 month procedure of evaluating the business plan. The Fund charged interest and fees on loans and also took collateral. For equity investments, the fund took a percentage of ownership related to the amount invested but did not seek to retain a majority voting position. All revenues and profits made by the Fund have been re-invested in the Fund. The Fund preferred to bring additional local banks into the investment process for joint investments. The Fund negotiated with local banks about providing small credits without collateral (from 500,000-3,000,000 crowns) with 50% of participation of the Fund and 50% by a local bank (Komerčni banka). To our knowledge, in more than two years of existence, only 21 projects have been financed (of this, 10 new starts-up, 3 JVs, 2 privatizing enterprises and 6 growing existing enterprises). The sum provided totals 10.5 mil. USD.

Japanese support through credit to Komerčni Banka: 20,000 USD to 10 mil. USD up to 70% of the value of business plan, min. 30% own money required, in DEM, USD or YEN, 10-11 % interest, instalments in foreign currency, manufacturing preferred, security and occupancy are a criterion of financing, export support, direct financing possible.

The Czech and Moravian Guarantee and Development Bank (CMZRB) was founded in 1992 to support the development and growth of small and medium sized enterprises in the Czech Republic. The establishment of the Bank was initiated by the Czech Ministry of Economic Policy and Development, which had 30% of the share capital.²⁶ During the 90s, the CMZRB offered loan guarantees through different programs of up to 70% of the value of a loan. If the entrepreneur defaults (i.e. cannot repay the loan), the CMZRB takes over the repayment of the loan to the commercial bank up to a maximum of 70 % of the total value of the loan.

The CMZRB also offered interest payment reductions on medium-term loans. In order to apply

²⁶ Other shareholders are: Agrobanka, Ceska Sportelna, Ceskoslovenska Obchodni Banka, Investicni Banka and Komerčni Banka. The Bank has a universal banking license with limited foreign exchange activities. The Bank's total capital is 1.1 billion Kr. (305 million subscribed capital and 800 million reserve).

for programs offered, a detailed business plan, cash flow analysis and loan repayment forecasts are required, using the formatted application forms. Basically the criteria for a loan guarantee are the same criteria for the loan itself, and the information materials developed to apply for a guarantee can be used to apply for the loan itself.

Numerous programs of the CMZRB have been operational: Start, Rozvoj (Development), Region, Aeskulap, Regenerace Pamatek (Restoration of Historical Monuments), Consult, Transfer, Park and Garant²⁷. The Bank cooperates with numerous commercial banks, having numerous network branch-offices. The Bank worked with a network of consultants which could help entrepreneurs in formulating their business plans and applying for support from the Bank²⁸.

The CMZRB is the only development bank in the Czech Republic currently entrusted with the mission to facilitate the implementation of the Government nation-wide economic strategy, as well as the regional policy related to economic sectors which require the support of public finance. According to this mission, the main business of the Bank consists in providing assistance to small and medium sized enterprises with the aim of helping them get access to financial capital and to share their business risk. The assistance to support SME development is implemented through a scheme of bank guarantees, preferential loans and specific subsidy programs.

The Bank also participates actively in the realization of state policy in the field of financing municipal development, housing construction and reconstruction, and infrastructure-oriented projects (construction of main roads, water sector schemes).

There was also a European Union financed preaccession program for the Czech Republic. The total amount agreed by the Commission of the EC for the SME program for the Czech Republic was 12.83m ECU for the period 1990-1994. This amount represented 9% of the total budget of the PHARE program for the Czech Republic. The SME program has the following three main components: 1) Policy and Program Development, 2) Information, Counselling and Training and 3) Credit and Guarantee Schemes. The Credit and Guarantee Schemes involve:

- Micro-loan scheme - administered by Banka BOHEMIA, which had 19 branches. As of March 1993, the bank received 376 applications, of which 186 have been approved (all businesses with the total

²⁷ Three of them are important for manufacturing and services development: "Start" is a loan guarantee and interest payment assistance program targeted at small businesses during the start-up phase. It offers loan guarantees up to 70% of the value of a loan and/or interest payment reductions. For service companies, the maximum amount of a loan guarantee is 5 million Kr., for industrial start-ups it is 10 million Kr. Any entrepreneurial activity that is based in the Czech Republic and has been in operation for less than 1 year (since the day of registration) and that has no more than 10 employees (including owner/manager) if in service or 25 employees if in manufacturing business. "Rozvoj" is a loan guarantee and interest reduction program targeted at industrial or construction companies. The maximum amount of the interest subsidy is 10 million Kr. over a period of 4 years. Small and medium sized businesses legally seated in the Czech Republic with a maximum of 500 employees, in the manufacturing or building industry. "Region" is a loan guarantee and interest payment assistance program targeted at companies that are creating new jobs in certain preferred regions, with inadequate infrastructure or weak economy. The maximum loan guarantee is 70 % of the value of the loan and the maximum interest payment assistance is 10 million Kr. over a period of 3 years. A list of targeted regions can be acquired at the CMDGB or any of its cooperating banks. Small or medium sized businesses with a maximum of 200 employees, or starting entrepreneurs based in the Czech Republic and wishing to carry out their business development plans in certain preferred regions.

²⁸ An entrepreneur who uses the services of one of the selected consultants and who, with the help of these consultants, successfully applies for one of the programs of the CMDGB, can get a subsidy of up to 40% of the fees charged by the consultant.

number of employees being 731);

- Credit guarantee scheme - administered by CMZRB²⁹. As of March 1993, during 3.5 months, 16 guarantees having a cumulative value of ECU 540,000 were provided (maximum was ECU 70,000, minimum was ECU 2,000). Business classifications were not favorable: in manufacturing only 3 guarantees were provided. This represents 5% of the theoretical maximum. Only 3 out of 20 banks eligible to take guarantees from the fund have participated in the scheme so far;
- A newly created sub-program “seed capital” - venture capital.

During the accession period (1994-2004), there were numerous programs and grants (from EU structural and investment funds, from the state budget, regional budgets etc.), revolving financial instruments (loans, guarantees, venture capital), indirect financial incentives (tax deduction) as well as other services related to SME infrastructure (business incubators, science and technology parks, innovation centers), advisory (help in solving specific situations, business development, export), training and information service (training courses, internship, web sites, brochures).

Up until 1996, the responsible Ministry for the SME program elaboration, proposals and implementation was the Ministry of Economy. Since November 1996, the responsibility for implementing laws and legal rules for SMEs has been transferred to the Ministry of Industry and Trade and for regional support to the Ministry of Regional Development according to Law 272/1996 Coll. on the Competences of Governmental Bodies.

Ministry of Industry and Trade (MIT)

Recent programs to promote entrepreneurship, funded by European Union structural funds and from the state budget of the Czech Republic (Figure 17, Figure 6 in annex), involve:

- Bank Guarantees for SMEs after floods and other natural disasters
- Bank loan guarantees for start-up innovative entrepreneurs
- Support for presentations or exhibitions in foreign countries
- Cooperation with universities. Funding Publications like “Barriers to business: The Conception of support for small and medium-sized enterprises 2007-2013 (http://www.mpo.cz/default_en.html)

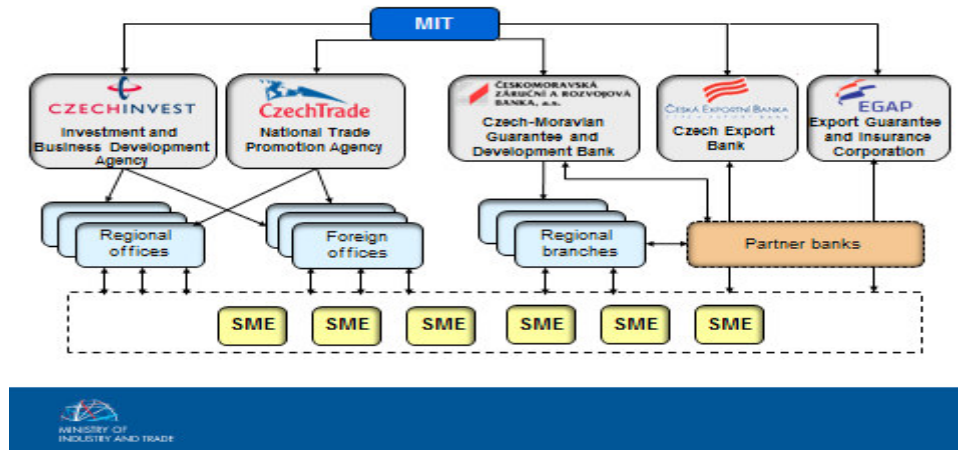
Ministry of Regional development

This ministry plays important role in matters of: Regional policy, Housing policy, Development of dwelling and housing stock, spatial planning, building rules, investment policy and tourism (Czech-

²⁹ CMRZB realizes the Garant program, which is a loan guarantee targeted at small businesses during the start-up phase (first two years of operations). It offers loan guarantees of up to 70% of the value of the loan. The loan can have a maturity of maximum years and can be maximum 4 million Kr. The GARANT program is similar to the START program. However, the GARANT program is financed by PHARE and implemented by the CMZRB, while the START program is financed by the Ministry of Economy.

Moravian Guarantee and Development Bank, or CMZR Bank). CMZR is the most important SME financial institution of SME support. The CMZR Bank's long-term goals and primary businesses are focused on providing assistance to small and medium-sized enterprises (SMEs) with the aim of enabling them easier access to financial capital, sharing their business risk and reducing their project costs through different types of support tools such as bank guarantees, preferential loans and financial subsidies.

Figure 17: Institutions involved in SME support programs



Source: Ministry of Industry and Trade.

Programs or plans addressing the problems of obstacles to doing business, in particular bureaucracy, red tape and corruption:

Projects addressing the problems of obstacles to doing business:

- Czechpoint – listing from several registers, assisted state administration operations, expansion of Czechpoints to the post office and city authorities (EU financed program);
- Contact Points - All information needed to start a business and assistance and help with doing business in the European Union and the Czech Republic (financed by the state budget, Act 222/2009, Trade Office);
- Information points for entrepreneurs - starting a business, business operations and regulatory information, funding opportunities, development of enterprises, searching for business contacts (Ministry of Industry and Trade + Czech Chamber of Commerce).

In addition there are two major issues that are a focus of the government A) anti-corruption strategy, B) reduction of red tape and bureaucracy. The Justice, Interior, Finance and other Ministries strive to reduce corruption opportunities. They are numerous sets of goals and deadlines with expected impact on corruption. As for red tape, the 2008-10 Standard Cost Model (SCM) Government program targeted various resorts and offices in order to reduce or abolish administrative work (obligation to inform). The plan was a 20 % reduction, but in reality it was 15.6 %. In 2010, the Law no. 155/2010 & Amendment to the Trade Licensing Act aimed at the removal of some regulation and red tape

(according to the government) and better trade licensing for foreign persons from third countries. A uniform place for collecting taxes and facilitating the communication of taxpayers with relevant public authorities (Government Bill, Public finance reform) are under discussion. The following official committees (parliamentary commissions, working groups) are working to address the above questions:

- Parliamentary Economic Committee – impact of changes in legislation (taxes, insurance), impact on self-employed
- Senate Committee on National Economy, Agriculture and Transport – deals with international treaties on double taxation and international investment protection

Pro-business NGOs working in the Czech Republic are, in general, country-wide, general purpose organizations focused on improving the legal environment, industry-specific organizations focused on improving conditions in a particular field of business, or regional organizations (specialized or not) focusing on business growth in a particular region, interacting with local administration (state or self-governance).

Any of these organizations may either lobby for legislative changes that benefit either all businesses or a specific group. In the first group, there are pro-market, libertarian or conservative think-tanks and educational organizations (e.g. Liberalni institut, Obcansky institut, Cevro, Laissez Faire). These organizations focus on educating the population and the decision-makers and spreading pro-market ideas.

Business associations and industry specific associations (e.g. Unie zaměstnavatelských svazů ČR, Sdružení podnikatelů a živnostníků ČR) also seek to improve the institutional environment for businesses. However, some organizations may lobby for industry-specific legal norms that do not benefit firms in other industries (or may be even harmful to them).

Regional and local organizations have usually little impact on the general legal structure, the quality of property rights and the extent of state interventions. They may, however, try to improve local governance in favor of businesses in the area.

The Czech Chamber of Commerce (CCC) is a major organization that represents entrepreneurs in the Czech Republic. It protects the interests of its members – small, medium and large enterprises associated via a network of regional chambers and trade associations. Its major tasks include (<http://www.komoracz.eu/>) support of private enterprise, consulting for entrepreneurs, commenting legislature, and establishing business contacts abroad.

The Czech Business Representation to the EU in Brussels (CEBRE) was founded by three important cross-sectoral Czech entrepreneurial and employers organizations –the Confederation of Employers' and Entrepreneurs' Associations of the Czech Republic, the Confederation of Industry of the Czech Republic and the Czech Chamber of Commerce. The Ministry of Industry and Trade of the Czech Republic together with its trade promotion agency CzechTrade provided support to this joint effort. (<http://www.cebrecz/en/>)

The experience of programs to assist SMEs showed the tendency of applying global theory

supported solutions along with looking at the concrete problems of the businesses in the country. It also became clear that administration can absorb a big share of the available means. Less successful enterprises can be subsidized to the detriment of more successful ones. Programs are often lacking flexibility. In addition, the allocation of the funds was not transparent enough. The implementation of such programs has created certain frustration.

The best government policies on how to support SMEs and the theory as well as the experience from the transformation in the Czech Republic confirm it is A) fiscal policy oriented towards dismantling state paternalism towards enterprises by abolishing all kinds of regulations and subsidies, introducing a balanced budget and decreasing taxes, and B) a prudential monetary policy checking the danger of inflation and currency stability.

Besides a stable business environment and transparent legislation, low taxation is the best way the Government can support SMEs. In the CR, income tax is divided into the income tax of natural persons (sole proprietorship) which most small businesses are, and the income tax of legal entities, with different tax rates. The income tax of natural persons has a flat rate of 15%. The rate is the same for wage earners and self-employed people. The current income tax of legal entities is 19%.

9. Support of SMEs at the European level

In the European Union, SMEs account for 99.8 percent of all active enterprises. They provide two out of three of the jobs and contribute to more than half (precisely 58.1 percent) of the total value added created by businesses in the EU. Micro-enterprises account for 92.4 percent of active businesses. The value added is roughly equally divided between micro, small and medium enterprises.

Five key economic sectors account for approximately 78 percent of all SMEs and 71 percent of employment in the EU28. They are “manufacturing”, “construction”, “professional, scientific and technical activities”, “accommodation and food” and “wholesale and retail trade, repair of motor vehicles and motorcycles”. (Muller et al. 2014)

The Eastern Partnership and The Deep and Comprehensive Free Trade Area (DCFTA), as a part of the Association Agreement, set high expectations that Georgia will soon become a member of the EU. This includes energy, services and traditional flanking measures such as rules of origin, customs, and trade facilitation, together with anti-fraud provisions as well as trade defense instruments. These rules aim to ensure that trade is liberalized to the fullest extent possible while providing the necessary precautions to ensure that only eligible goods qualify for preferential treatment. A bilateral dispute settlement procedure is envisaged to solve issues in an expeditious manner.

The DCFTA also tackles the ‘comprehensive’ elements of an FTA, designed for Eastern Partnership countries. These include regulatory disciplines that aim to ensure a stable and growth-oriented policy framework that will boost competitiveness. They include competition and transparency provisions, intellectual property rights, and the adaptation of domestic laws with the EU *acquis* in selected services areas and public procurement.

Furthermore, Georgia strives to bring its legislation closer to that of the EU to modernize its export capacity in agricultural and industrial goods, as well as to enhance consumer safety. Of notable concern are sanitary and phytosanitary standards. Georgia aims to create a food safety environment similar to the EU’s, allowing it to export products of animal origin to the EU. Moreover, Georgia will adapt several laws concerning industrial goods, focusing on domestic safety and consumer protection aspects³⁰.

The hope is that the EU might help resolve the territorial conflicts in Georgia and restore the country’s territorial integrity. However, people working in agriculture, viticulture and protected industries may not benefit from EU entry. Centuries of shared history have forged social and economic ties with Russia. Georgians would also like to have friendly relations with Moscow. The EU, however, can help them build political stability, deepen democracy processes, encourage economic development and provide infrastructural improvement (Müller, 2011).

³⁰ http://europa.eu/rapid/press-release_MEMO-13-705_en.htm.

Entrepreneurship 2020 Action Plan

DG Enterprise and Industry carries out a regular monitoring of the implementation of the SME definition. Building on the results of evaluations performed in 2006 and 2009, an independent study was carried out in 2012, focusing on how the SME definition works in practice in the implementation phase.

The Entrepreneurship 2020 Action Plan is a blueprint for decisive action that aims to unleash Europe's entrepreneurial potential, to remove existing obstacles and to revolutionize the culture of entrepreneurship in Europe. Investments in changing the public perception of entrepreneurs, in entrepreneurship education and to support groups that are underrepresented among entrepreneurs are indispensable if we want to create enduring change.

Only if a large number of Europeans recognize an entrepreneurial career as a rewarding and attractive option will entrepreneurial activity in Europe thrive in the long term.

The Entrepreneurship 2020 Action Plan is built on three main pillars:

1. Entrepreneurial education and training
2. Creation of an environment where entrepreneurs can flourish and grow, and
3. Developing role models and reaching out to specific groups whose entrepreneurial potential is not being tapped to its fullest extent or who are not reached by traditional outreach for business support.

The Action Plan and its key actions will be followed up by the Commission through the competitiveness and industrial policy and the Small Business Act governance mechanisms.

The European Commission is ready to help the Member States' administrations implement the Entrepreneurship 2020 Action Plan by providing its own know-how and fostering peer learning and exchange of good practices with other Member States. At the national level, it is the SME envoy, appointed by the respective national government, who is responsible for driving the implementation of the Action Plan.

The Communication on the Action Plan was preceded by a public consultation. The consultation did not target any specific group as all citizens and organizations were welcome to participate. However, contributions from public administrations, private sector organizations and individuals who support entrepreneurs in starting businesses as well as individual entrepreneurs and businesses were of particular interest.³¹

A "Small Business Act" for Europe

The "Think Small First," or "A 'Small Business Act' for Europe," is an initiative of the European Commission aimed at supporting SMEs. It is a set of relatively ambitious principles which should guide

³¹ http://ec.europa.eu/enterprise/policies/sme/entrepreneurship-2020/index_en.htm.

the design and implementation of policies both at the EU and national levels. The document adopted in June 2008 reflects the Commission's political will to recognize the central role of SMEs in the EU economy and for the first time puts into place a comprehensive SME policy framework for the EU and its member states.

The idea of a "Small Business Act" has raised many expectations. While it is widely supported at the government level, by the European Parliament and by the SME community, it needs to be implemented by individual actors. This requires the full political commitment of both the Commission and the Member States.

The "Small Business Act" contains a set of ten principles to guide the conception and implementation of policies both at the EU and at the member state level. These principles intend to bring added value at the EU level, create a level playing field for SMEs and improve the legal and administrative environment throughout the EU. Individual principles are then elaborated in particular policy steps. The following principles are included:

1. Create an environment in which entrepreneurs and family businesses can thrive and entrepreneurship is rewarded.
2. Ensure that honest entrepreneurs who have faced bankruptcy quickly get a second chance.
3. Design rules according to the "Think Small First" principle.
4. Make public administrations responsive to SMEs' needs.
5. Adapt public policy tools to SME needs: facilitate SMEs' participation in public procurement and use State Aid possibilities for SMEs better.
6. Facilitate SMEs' access to finance and develop a legal and business environment supportive to timely payments in commercial transactions.
7. Help SMEs benefit more from the opportunities offered by the Single Market.
8. Promote the upgrading of skills in SMEs and all forms of innovation.
9. Enable SMEs to turn environmental challenges into opportunities.
10. Encourage and support SMEs to benefit from the growth of markets.

The set of new legislative proposals at the EU level which are guided by the "Think Small First" principle include the following:

1. General Block Exemption Regulation on State Aids (GBER) exempts from prior notification categories of state aid already covered by existing regulations in the field of aid to SMEs, for training, employment, R&D and regional aid and possibly also for new categories of aid.
2. Regulation providing for a Statute for a European Private Company (SPE) provides for a Statute for. This Regulation provides for a Statute for an SPE that could be created and operate according to the same uniform principles in all Member States.

3. Directive on reduced VAT rates should offer member states the option of applying reduced VAT rates principally for locally supplied services, which are mainly provided by SMEs.
4. Other measures that include, for instance, a legislative proposal to further modernize, simplify and harmonize the existing rules on VAT invoicing to alleviate the burden on businesses, or an amendment to the directive on late payments with a view to ensuring that SMEs are paid on time for any commercial transaction.

The “Small Business Act” document formulates particular recommendations for the member states guided by the 10 basic principles. These include, among others, the promotion of entrepreneurial attitudes, mentoring, the removal of the regulatory burden on entrepreneurs, improvements in the procurement system, state aid directed towards facilitating access to finance, etc. The document indeed provides a catalogue of sensible pro-SME policies that could also be followed by countries outside the EU and membership candidates³².

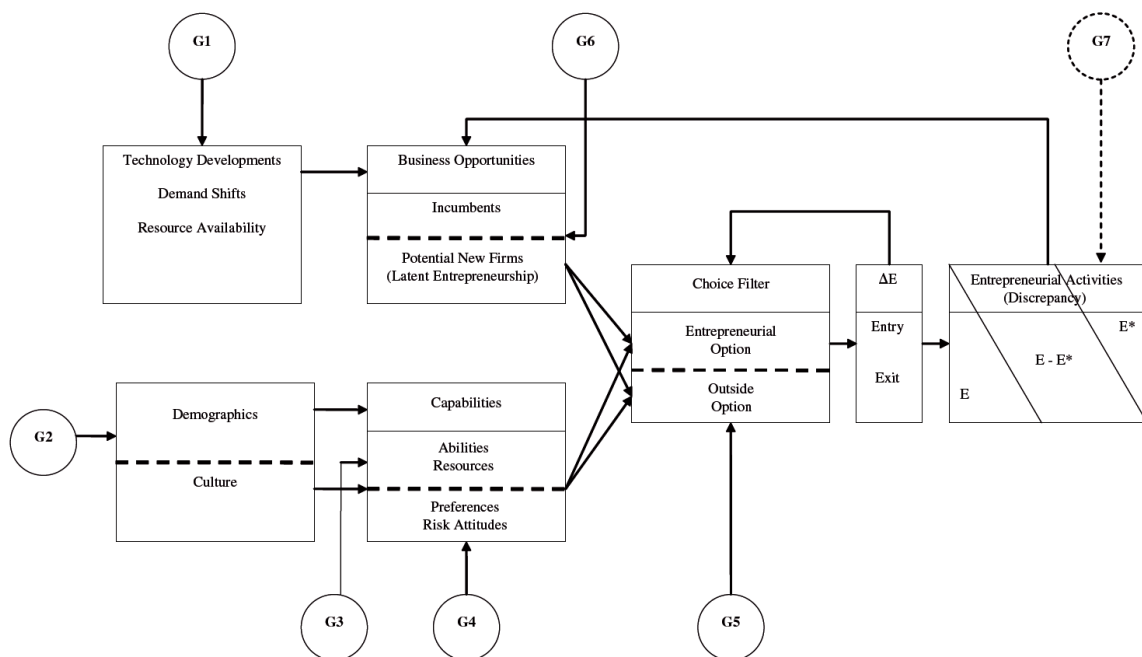
³² <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2008:0394:FIN:EN:PDF>.

10. Determinants of entrepreneurship and policy interventions

This part deals with SME issues and transfer of knowledge in a more theoretical way; that is, entrepreneurship, technological transfer, skills and demand shifts are described to provide universal recommendations in the area of SMEs, job creation and sustainable economic development.

There are different ways to approach entrepreneurship and its determinants. One possible analysis framework is authored by the World Bank and OECD (the scheme is shown in Figure 7 in the Annex). It identifies several determinants affecting entrepreneurship, particularly the regulatory framework, access to finance, market conditions, skills and education, research and development and culture (Kuriakose, 2013). All these factors affect entrepreneurial performance and ultimately the economic well-being of a country.

Figure 18: Entrepreneurship and its determinants: Detailed analysis framework



Source: Audretsch, Grilo and Thurik (2007, p. 5).

More nuanced frameworks can be found in the theoretical literature. Audretsch, Grilo and Thurik (2007) develop a scheme (Figure 18) that distinguishes the demand for entrepreneurship and the supply of entrepreneurship. On the demand side, technology developments demand shifts and resource availability creates business opportunities. These are either seized by incumbent businesses or potential new firms (latent entrepreneurs). The supply side is characterized by capabilities specified as abilities, resources, preferences and attitudes. These are determined by demographics and culture. The intersection

of supply and demand is represented by the choice of individuals between entrepreneurial and outside options (employment or unemployment).

Of course, the two frameworks described above are not incompatible or mutually exclusive. Each of the determinants identified in the World Bank/OECD approach could be placed within the framework of Audretsch, Grilo and Thurik (2007). Any decomposition of individual factors allows for searching for interventions that would affect the particular determinants of entrepreneurship.

The framework of Audretsch, Grilo and Thurik (2007) also identifies possible channels of public intervention as presented in Figure 18. First, public interventions (G1 in the scheme) may influence the demand side, the type, number and accessibility of entrepreneurial opportunities. These interventions may address, for instance, research and development that produces technological advancements. Second, the supply side may be affected by population policies, including those related to migration (G2).

The supply of entrepreneurship may further be enhanced by interventions on capabilities. Primarily, public interventions (G3) may improve abilities and resources available to potential entrepreneurs. These include both material resources, typically understood as access to finance or financial capital, and knowledge and skills (or human capital). Further interventions (G4) may be directed towards changing the attitudes regarding entrepreneurship as an alternative to employment. Although these attitudes as well as risk preferences are embedded in culture and thus are difficult to change, they might be affected by education and media coverage on the topic of entrepreneurship.

Another set of public interventions affect the choice between entrepreneurship and (un)employment. Different policies including taxation, regulation of businesses and the labor market, unemployment benefits, bankruptcy laws, etc., may have a crucial impact on individuals' choices (G5). On the demand side, public policy also affects the possibility that new market opportunities would be used by new entrepreneurs rather than incumbents (G6). Competition policy plays an important role in this respect, as well as protection of intellectual property and regulation of business establishment. Finally, we could identify other different elements "shaping the government perceived 'optimal' or target entrepreneurship" (denoted as G7).

We may produce yet another classification of problems and obstacles to SME development based on the problems' sources. The two principal sources would be an inadequate environment for entrepreneurs and inadequate resources, both material and immaterial. The environment is composed of many different aspects. It is comprised of political stability, a legal framework for entrepreneurship (particularly property rights and contract law), taxation, regulation and law enforcement (including impartial judiciary and corruption).

The availability of resources may limit entrepreneurship even when the environment is perfect. Regarding material resources, the chief limitation is typically access to finance and the cost of credit, if accessible. Further limitations are related to the availability of required skills, both of the entrepreneur and the necessary workforce. Finally, inadequate information might restrict entrepreneurship – information on market opportunities (domestic and foreign), financing options, the regulatory environment,

etc. Ignorance of market opportunities or insufficient skills to expand into new markets decreases the de facto size of the market.

The different shortcomings of the environment and markets call for different interventions. The general policy regarding the environment should be that the government provide a “level playing field” for entrepreneurship, that is, equal conditions for all entrepreneurs. Further measures should address particular market failures. In line with the “level playing field” idea, competition policy should attempt to prevent excessive market power. Asymmetry of information is another source of market failure; it is particularly pronounced in the credit market. Finally, various positive externalities are connected to entrepreneurship, especially their contribution to innovation, productivity growth, product diversity and jobs creation. Without public intervention, the production connected with such externalities will be suboptimal.

11. Recommendations of measures to support SMEs development

This chapter summarizes and introduces recommendations of measures to support SME development. Recommendations are formed on the basis of the ideas of Georgian experts dealing with the SME sector who are influential entities shaping the Georgian economy as well as those of local stakeholders that were generated during the interviews and workshops³³. The views and recommendations are strictly our interpretations of the interviews we conducted in cooperation with the ISET in February 2014.

In addition to the survey and interviews with experts, two sources were used for the recommendations: first, the theoretical foundations and literature on entrepreneurship policy and second the Czech experience and know-how in the field of SME sector. These recommendations may overlap in some parts, but they differ in others. To justify this approach, some interventions may be country-specific (thus ignored by the theory) and some others may have escaped the attention of locals. The recommendations target problems identified in the field of SME development.

We divided the measures into generic - related to a particular determinant of business environment and having an impact across industries (education, skills training, skills mismatch, R&D, innovation, export strategy, start-up, competition issues) and activities which are measures that are sector-specific such as banking, health, tourism and agriculture. Both generic as well sector-specific measures to support SMEs can be further divided into financial and non-financial.

Among the non-financial determinants, political stability is important for the business environment. However, achieving political stability, the chief problem in Georgia, is beyond the scope of possible interventions. Reputation problems, especially among potential foreign partners, that follow from the past political situation could be corrected through an intervention promoting Georgia as a secure and valuable trade partner. Generally, the government should contribute to raising awareness about the benefits from entrepreneurial activities.

Different reports agree on the high quality of the institutional environment in Georgia. However, they also point to certain weaknesses. Major shortcomings are seen in the area of weak protection of property rights (Economic Freedom of the World - Fraser Institute, 2014; Heritage Foundation, 2014). On the other hand, business regulation and labor market regulation are evaluated positively. Indeed, Georgia's ranking in the World Bank's Doing Business Report locates the country among the most pro-business economies. These evaluations have been confirmed by our survey.

The red tape and bureaucracy domain is considered to be the least important problem for Georgian SMEs. Similarly, the taxation system does not seem to be a major source of difficulties, although, some point to frequent changes and certain ambiguities (Fostering Entrepreneurship in Georgia;

³³ The detailed results of our survey of experts and evaluations of institutional environment in Georgia are in the Annex II.

also, a survey respondent mentioned this). Regarding the rule of law, survey respondents cited weak property rights and weak judiciary as rather problematic areas. Help in the area of institutional differences with the European Union is required.

The situation in the banking sector is very problematic. Nowadays, an entrepreneur with a traditional business like a bakery or even a well-documented project with a very good idea will not be financed by a Georgian bank. Collateral and a relatively high interest rate are preventing entrepreneurial activity. Government guarantees on loans or leasings are one of several possible economic policies. New relatively stable jobs would be created, because those who repay the loan would be ready to survive on their own, and would possibly generate their own funds for further development.

Imperfections of the credit market stem from an asymmetry of information and seem to be aggravated by the risk-aversion of financial institutions and the market concentration in the banking industry of Georgia. A standard measure to overcome the issue of the high collateral requirement is to provide a program of public guarantees for loans. The program must be developed to screen out projects that are too risky but the level of acceptable risk must be higher than in banks. At the same time, administrative requirements should not be too complicated in order not to discourage entrepreneurs from applying for a guarantee.

The high cost of credit may also stem from risk-aversion and market concentration in the financial sector. Again, a standard measure would be a public subsidy of interest rates. Subsidizing privately provided credit should be much preferred to public lending. First, it is less demanding of resources since the finance comes from private sources; second, private banks are typically better equipped to screen out problematic projects.

Our survey confirmed that access to finance is an important domain to be addressed by public interventions. Respondents pointed to difficulties in accessing financial services and the high cost of credit.

The Low market skills of entrepreneurs, i.e. the lack of business experience and low availability of high skilled workers, also require an intervention. Help is needed the most in the area of EU trade and regulations.

The market domain is the most important and help is required in two cases which are rather important: in overcoming the lack of information about the public and foreign support and also in the area of strengthening the influence of professional SME organizations. The factors which most impede entrepreneurs are the weak market position of SMEs, which might be linked with the excessive market power of some of the companies and also to unfair competition and weak SME organizations, and barriers to exports.

An important factor in the entrepreneurship environment is political stability. This may be especially important for foreign trade partners and potential investors. In this respect, recent history does not provide a very optimistic picture of Georgia. Political instability is cited as the main obstacle by representatives of small, medium and large firms in Georgia (World Bank/Enterprise Survey 2013). However,

the political situation and international relations can hardly be seen as a possible target of SME policies. Anyway, we shall be mindful of these limitations within the environment for the activities of the SMEs. Also, the image of a country vis-à-vis (potential) foreign business partners can be improved in a planned and coordinated manner.

Unlike the institutional environment, the availability of resources is not very favorable for entrepreneurship. This is true both for material and immaterial resources. The existing literature as well as our survey point to problematic access to finance, inadequate skills of the entrepreneurs and the labor force and insufficient information among SMEs.

Inadequate skills are also cited as a problem both in previous studies and our survey. The World Bank (2013 – *Fostering Entrepreneurship in Georgia*) lists “difficulty recruiting highly skilled employees” among the most frequently cited obstacles to SMEs development and recommends reforms in the education system. The World Economic Forum’s 2013 *Global Competitiveness Report* ranks this issue as the second most important (access to finance being the first). In our survey, respondents point to low skills or lack of education of entrepreneurs, lack of experience as well as low availability of high skilled workers. Low labor market flexibility and the lack of language skills are also rated as rather significant.

Finally, there is a major issue concerning information on business opportunities, especially concerning foreign trade. The size of the market is assessed as one of the weakest points of the Georgian economy in the World Economic Forum’s 2013 *Global Competitiveness Report*. The expansion of exports requires specific skills and information on potential foreign partners that are obviously scarce in Georgia. In our survey, the lack of experience in foreign trade, particularly with the EU, and the lack of knowledge of EU regulations (coupled with institutional differences with the EU) is marked as a significant problem that requires intervention. The lack of language skills and contacts abroad is also considered a somewhat serious problem among our respondents, as well as foreign barriers to trade (although these are not specified). Finally, our respondents point to lack of open communication channels with the EU.

The low market skills of entrepreneurs are the most important factor. The lack of availability of high skilled workers is related to a sector. These obstacles are also considered requiring an intervention. Help is needed mostly in the area of EU trade and regulations. There is also a need to improve business and labor ethics, the number of high skilled workers, and the insufficiency of market and business skills. Help is needed in overcoming the lack of information about public and foreign support and also in the area of strengthening the influence of professional SME organizations.

Relatively minor problems in taxation and regulation can further be eliminated by government policy. However, stable rules may be preferable to continuous reforms in these areas. Improvements in policy advocacy of SME organizations could help in this respect; it might help the SMEs to shape the environment more effectively.

Recommendations for sector-specific policies

Healthcare sector privatization in Georgia is suffering from constant changes in the system. New political representatives are constantly reversing everything that was done by the previous government and ministry. This creates uncertainty for the private sector, which deters private and foreign direct investment. This situation prevents firms from engaging in long-term business strategies.

In recent Georgian history, we observe the limited government capacity to manage public funds related to the healthcare system. The private insurance companies seemed to handle it better for a limited time, however lacked managing capacity. Along with deteriorating healthcare infrastructure and the low perceived quality of services, this sector remains one of the most critical.

The majority of total health expenditures come from the pockets of the people. The money does not officially end up in the system and the poorest suffer because of this. The healthcare sector is a big part of a national economy and at the end of the day it affects both the SME sector and general health of the population. The current situation, in which the government is paying for past mistakes, leaving the system unstable and unpredictable, could continue forever. One recommendation is that the Georgian government focuses on gradual rather than rapid reform. This will control for the limited managing experience of private insurance companies, and will safeguard the private sector's long-term involvement (investments, strategies).

The agricultural sector is recognized by many institutions and the Georgian government as one of the most strategic for the positive economic development in the country. The recommendation is to monitor and analyze the many projects being implemented. Their effectiveness has already been recognized in projects dealing with training and access to finance. The next step is to continue with best practices and further increase the efficiency of the projects and as well as the on-project participation of farmers in distant areas.

The rural sector readiness for the Single European Market is another related topic. The necessary knowledge dealing with European regulations and export opportunities is recognized as challenging and possibly discouraging. Georgia has the potential to develop good market relationships and deepen current business links. This sector also reflects the Georgian economy in general and we have to consider the bigger picture, which includes current economic policies and regulations that shape the Georgian economic and institutional environment. Transformation and evolution to a modern technology-driven country is going to depend on sustainable and rapid development in this area.

Culture and tourism are also among the areas that need to be further developed and more connected. It would be better to present Georgia as a country with a rich history and culture, not only as one having good traditional agricultural products. There are still barriers, however. The towns have to become pedestrian friendly and historical buildings need to be reconstructed, repaired and re-opened.

12. Roadmap of concrete activities

In this part we list the most urgent activities and measures which reflect important problems faced by SMEs in Georgia. Several generic measures can be outlined to improve conditions for entrepreneurs in Georgia. These measures target recommendations to enhance entrepreneurship listed above. Specifically, they should aim at improvements in access to credit and its costs, and the availability of necessary skills and information. Intervention is required from both public and non-profit organizations.

12.1 Access to finance and cost of credit

Several options are available in these areas. First, interventions may aim to improve the availability of equity investments of start-up and developing firms. Second, interventions may address the imperfections of credit markets to improve access to external finance. As a general rule, selective or sectoral support should be avoided to prevent distortions of the industrial structure. Direct public financing is excessively demanding on resources and typically leads to inefficient results. Loan schemes are expected to help SMEs to have access to credit. Loans are supposed to be designed to help SMEs become more competitive and profitable, boosting economic growth across Georgia.

Start-up entrepreneurs and owners of developing businesses are often short on financial resources. Business angels and venture capital funds can provide the resources needed to set up a company or expand the business. Business angels can also provide skills and experience that may often be missing in the SMEs.

Public interventions could support equity investments by business angels and venture capital in various ways. First, they could enhance matching between the willing investors and the entrepreneurs requiring finance, both increasing information for investors about available investment opportunities and improving the awareness of such financing options among entrepreneurs. Second, preferential treatment in taxation may induce this kind of investment; the basic scheme could be a tax exemption in the first years of a firm's operation. Subsidizing or co-financing are yet another option; however, these are potentially costly and demanding on public administration. Such preferential treatment would favor start-ups to existing businesses. Measures to attract foreign venture capital may be an interesting complement (or even alternative) to standard policies aimed at direct foreign investments.

Access to finance is an important growth constraint for the SMEs. Innovative financing instruments could help facilitate SMEs' access to finance even in the absence of strong institutions. Without well-developed financial markets and legal systems, subsidizing SMEs may be at best ineffective and at worst, counterproductive. "Factoring is an example of a technology that is particularly promising in the absence of developer institutions, as it relies on them to a lesser extent. Others, such as credit-scoring and leasing, can also be useful and be more effective with the development of institutions over

time.” (Beck and Demircuc-Kunt, 2006, p. 2941-2942).

In any case, interventions aimed at improving access to credit must be formulated as generally as possible. That is, they should leave little space for the discretion of public or private officials, as discretion always produces opportunities for corruption and clientelism. Selective sectoral support is also problematic as it is difficult to predict the future needs of the economy. Also, selective support policies may create rent-seeking opportunities for various pressure groups.

12.2 Information and skills

Leaving aside education reform, which is a much broader issue than improving the situation of SMEs, there are several other limited interventions available. First, informal education and increasing the awareness of entrepreneurship as an alternative to employment could create a more pro-business environment in the country. Second, the provision of information and consultancy for SMEs could help to overcome certain information barriers that prevent them from further developing.

In standard settings, a firm uses the services of consultants to obtain necessary information when expanding to a new market. However, this option may be too costly for a start-up or an SME contemplating expansion to foreign countries. A potential entrepreneur might be discouraged by his own ignorance of procedures to start a business. A small firm might be discouraged from expansion because it lacks information on available resources or potential business partners. These problems are even more pronounced when a firm plans to expand abroad. The need for external consultancy is even more urgent the less experience entrepreneurs have, the lower their knowledge of foreign countries is and the greater the difference in the business environment in the target country is.

Provision of information, transfer of experience and aid in communication with potential partners are other areas for intervention. Of course, consultants could operate on a commercial basis. However, their services would not be available to many SMEs. The non-commercial (public or private) provision of consultancy could enhance development in many ways, including a better organization of firms, improved hiring, better access to finance, and expanded opportunities to trade with foreign partners.

It is hoped that the outlined interventions would lead to improved access to finance and lower cost of credit, thereby enabling new investments, the expansion of productive capacity and, especially with increased equity investments, innovation. Better information on market opportunities and the development of entrepreneurial skills would enhance productivity and efficiency. All of these measures would advance the entrepreneurial performance of SMEs and bring them closer to the level of EU countries, which in turn would increase the credibility of the Georgian economy and would strengthen the ties of foreign trade between the EU countries and Georgia.

12.3 Further recommendations addressing particular problems

Foreign direct investments

So far, it is necessary and important to promote investment opportunities in Georgia. The goal is principally not to discourage the current ongoing investments. Recently there was a massive FDI inflow between 2005 and 2007. The promotion and strategic attraction policies should be oriented at high and medium tech industries where Georgia can benefit from the technological transfer. Georgia needs diversification and investments in manufacturing and services, not only in primary sectors such as agriculture. To protect investments, Georgia needs a good law enforcement environment as well as a modern antitrust agency to protect it from unfair competition, to monitor possible cases of monopoly power misuse, and to remove all barriers of entry.

Business sector awareness and information

Many firms and family companies are not aware of all the grants and programs they can benefit from. Information is scattered and the transaction cost can be too high. A unified portal concentrating information on public programs and grant opportunities would increase the spending efficiency of public money and ensure a better grant competition.

University graduates

The younger generation coming out of business schools is capable of doing essential feasibility studies and business plans. Graduates are the only ones able to start a new dynamic company and they are likely to have a more sophisticated growth strategy and business plan than the members of older generation. The younger generation can also help their parents overcome problems with business administration issues. University graduates are the national investment in human capital, which is essential for sustainable economic growth. There is a high risk of emigration if the political stability decreases. Making access to business and technical universities easier and increasing the quality in the education sector are important conditions for future national prosperity. This group of young people is essential for moving family businesses to a new level (pro-export, new technologies, specialization, and cooperation) and creating new start-ups.

To reduce the generation gap, trainings for the older generation are recommended. Projects like Third Age Universities can be a useful policy. The aim would be to help older adults understand basic market economy principles and communication technologies (software options for businesses). For currently established small and family businesses, the aim would be, for example, to learn the best practices of running a business, to show business growth opportunities and to encourage them to participate in procurements.

Procurement

Even with the transparent and relatively bureaucracy-free procurement in Georgia, SMEs are afraid of government contracts, which they perceive as too risky for them. For that reason, SMEs prefer to contract large companies. It is common that the government does not pay. This creates a kind of corruption practice in this area. Larger companies have a better negotiating position, political power, attorneys, etc., and the SMEs do not. The recommendation in this area is to undertake an analysis of past procurements leading to a revision of the system, which would result in the increased participation of the SME sector.

R&D and innovation

High tech companies often patent their inventions in cooperation. They sell them, for example, to a company in the Silicon Valley and patent them through international partners. Generally, patent output is not high if we look at a regional patent office, such as EPO and USPTO. The existing funds for R&D support are mostly used for conferences. Few projects end up with patents. Cooperation in R&D depends on the own activities of universities and businesses, which have to find partners and compete for grants.

European experts

Programs that connect entrepreneurs in developing countries with developed European markets and with business managers are a good way of transferring knowledge. These programs offer local expertise and practical assistance, which offers the Georgian clients a unique combination of experienced long-term local presence, technical assistance, business intelligence and entrepreneurial mentality. Another way to connect is for younger Georgian entrepreneurs to travel to the EU to a particular market or a selected participating firm (a brewery, bio-farm, etc.) to learn about how to deal with EU regulations and successfully establish a medium company on the market.

Overlapping ministry policies

Georgian green goods production policies (export of wine, nuts, silk, eco-tourism, etc.) and other environmentally friendly policies in general (ecological standards, banned chemicals, national parks) are controlled by the ministries (energy, economy...). Since this is one of the crucial pro-export sectors, the competency and policies of ministries has to be analyzed and precisely divided.

There is also no particular and straightforward government strategy or approach to support SMEs. SME policies are fragmented among many independent projects and entities. A platform is needed to prevent further fragmentation. Recently, the Ministry of Economy and Sustainable Development started a public entity to support SMEs in capacity building and access to finance. The monitoring of this new entity is recommended.

12.4 Selected interventions

The following topics and problematic issues have been identified and we recommend addressing them in order for the country to be efficient in the promotion of entrepreneurship, technological transfer, skills in the area of SMEs, job creation and sustainable economic development in Georgia. All actions are subject to discussion and future planning.

12.4.1 Innovative financial mechanisms

Access to finance seems to be among the most important obstacles in SME development. The situation in the banking sector is very problematic. An innovative financial mechanism could provide an alternative, or at least a complement, to ill-functioning traditional sources of finance.

Workshop sessions (pilot training, implications for policy proposals to be submitted to the authorities, assistance initiatives to business organizations)

(1) Innovative financial mechanisms

Description: The presentation will outline some of the innovative mechanisms providing finance for start-ups and expanding SMEs. These mechanisms, such as microfinance, peer-to-peer lending and crowdfunding, present an alternative to the practice of the banking system and traditional financial institutions. Some attention shall be given to equity investors (business angels) as well. Examples from European countries shall be presented as an inspiration for the Georgian economy.

Expected outcomes: Innovative financial mechanisms can provide an alternative to the banking system even if the government is not willing to support SMEs directly. Awareness of innovative (alternative) financial mechanisms that could improve SMEs' access to finance.

12.4.2 Research, development, innovation and venture capital

Georgia is only starting to be an innovation-driven country. To achieve this goal, the country needs to increase its efficiency and productivity and exploit all of the untapped opportunities. In innovation activities, cooperation ensures participation and the transfer of knowledge to individuals and then back to the national Georgian innovation laboratory.

In Georgia, protecting an idea is a problem. One of the channels of ideas leak is through banks, which assess start-ups. In general, intellectual property rights (IPRs, mostly copyrights or patents) are not respected. Even with a well-prepared disclosure agreement, actual enforcement is not an easy thing because it is not very efficient. It usually takes 2-5 years with a very good attorney, which

is expensive and by the time the case is won, the SME might cease to exist. A quicker solution might be an arbitrage and making public awareness of these practices a crime.

Workshop sessions (pilot training, implications for policy proposals to be submitted to the authorities, assistance initiatives to business organizations)

(2) Intellectual property rights

Description: The presentation will explain the role of intellectual property rights (IPRs), and their essential role in the sustainable long term development of Georgia. The presentation will indicate what kind of protection is advisable in the Georgian context. There will be examples from the Czech transition period, during which respect for IPRs was of a similar nature.

Expected outcomes: Suitable methods and practices to protect ideas, inventions, and other kinds of innovations in the Georgian context with examples and good practices from the Czech industry.

(3) Innovation and venture capital

Description: The presentation will explain the role of high-risk investment projects, and the essential role they play in rapid economic growth. The presenter will outline the possibilities which are suitable for the Georgian context. For example, expansion capital is a way to support the already established Georgian SMEs which generates high value-added products and struggle to approach new markets. The start-up venture capital in Georgia should flow into projects devoted to prototyping and product development with a potential for high added value. The supported SMEs should exhibit a high level of expertise, and the venture capitalist has to be able to provide IPR protection and assess viability (stop failing projects) on daily basis.

Outcomes: Awareness of venture capital projects and their high-risk nature. Examples from the Czech economy, the possibility to attract international venture capital, and government options to provide venture capital through public funds will be presented.

12.4.3 Start-up grants for entrepreneurs from distant and under-developed areas

Start-up grants tailored for under-developed regions are a great tool to fight poverty. These grants should encompass not only the access to finance but also the viability study of market opportunities, business plans and strategy.

Transfer of know-how from the field of support of venture capital

- Survey of applicable EU state aid rules
- EU funds and support of venture capital
- Experience with the seed fund project preparation in the Czech Republic

Workshop session

(4) Start-ups and distant underdeveloped areas

Description: The presentation will outline viable start-up strategies for Georgia. In general, start-up projects can fight rural poverty. But there are already plenty of registered entrepreneurs in Georgia. They most likely operate their firm from one of the core areas (Tbilisi, Kutaisi, Batumi, Rustavi, Zugdidi, and Gori). These entrepreneurs can benefit from seed-fund-like projects which are usually oriented towards the development of market ideas and long term business plans. These firms will therefore rather benefit from “start-over” projects and they can mobilize local small producers and benefit from the relatively low cost labor force and access to more developed city infrastructure. In a similar way, this is suitable for established rural family firms.

Outcomes: Understanding of start-ups and “start-overs” as a way to increase learning-by-doing process in Georgia; Importance of a business plan, managerial skills and a long term strategy which can be “imported” (foreign presence) or learned by doing and imitating (in a good way).

12.4.4 European regulations and export opportunities

The readiness of the rural sector for the Single European Market is a topic currently under discussion. The necessary knowledge dealing with European regulations and export opportunities is recognized as challenging and possibly discouraging. Georgia has the potential to develop good market relationships and deepen current business links. This sector also reflects the Georgian economy in general and we have to consider the bigger picture, which includes current economic policies and regulations that shape the Georgian economic and institutional environment. Transformation and the evolution to a modern, technology driven country is going to depend on sustainable and rapid development in this area.

12.4.5 Business sector awareness about grants and programs in Georgia and the EU

Many firms and family companies are not aware of all of the grant opportunities and programs they can benefit from. Information is scattered and the transaction cost can be too high. A unified portal concentrating public programs and grant opportunities from different foundations would increase the efficiency of spending public money and ensure a better grant competition. Regional meetings or packages sent via post intended for farms, hotel and accommodation unit owners could be potentially beneficial. These groups need to know that the government agencies are their “friends” and that there are opportunities and resources (hand-books, business portals, chamber memberships, etc.) for them when they stay in touch. Georgian government agencies could learn from the best practices in the EU and its member states.

Workshop session

(5) SME support in the EU under the Small Business Act

Description: The presentation will outline the approach taken by the European Union in the recent period. A special focus shall be given to the “Think Small First” principle and the specific measures adopted in the “Small Business Act” and the particular ways of applying these policies in individual countries.

Outcomes: Understanding of the EU strategy is necessary for Georgia to successfully join the Union. Even before the EU accession, the Georgian government can draw inspiration from the best practice of European states.

12.4.6 Entrepreneurship skills

The younger generation coming out of business schools is capable of doing business, while the rest of the population is not well equipped for entrepreneurship. To reduce the generation gap, training for the older generation is recommended. The aim should be to teach them basic market economy principles and information and communication technologies (software options for businesses). For currently established small and family businesses, the aim would be, for example, to learn the best practices of running a business, to show business growth opportunities and to encourage them to participate in procurements.

12.4.7 Competition policy: removal of barriers to market entry

The SME sector is crucial in the long-term economic development of each economy in general and especially in a transition economy such as Georgia. Large firms usually grow out of small firms that had a successful strategy. Small and medium size firms are interrelated with large firms in the economy as suppliers or customers.

Small firms however are not all the same – some are and remain local and fulfil certain roles, others grow fast, some even go bankrupt (which is the case of about one third of start-ups). A small firm in manufacturing is different from a small firm in services or agriculture etc. Incumbent firms in industries which have been de-regulated or/and privatized might attempt to create barriers to entry for new competitors, hence a competition policy is needed which prevents large firms from abusing their dominant positions, colluding or establishing links to political and administrative bodies. A competition policy is particularly important for small markets like in Georgia, which are prone to monopolization or oligopolization. The Czech Republic has a lot of relevant experience with this.

Even with the transparent and relatively bureaucracy-free procurement system in Georgia, SMEs are afraid of government contracts, which seem too risky to them. Larger companies have a better negotiating position, i.e., political power and attorneys, which the SMEs do not have. The recommendation in this area is to undertake an analysis of past procurements leading to a revision of the system, which would

result in an increased participation of the SME sector. For example, more categories should be included to ensure quality, or some of the usual repeatedly procured products and services should be well defined by a suited template.

Conclusion

The Czech experience shows that the know-how in implementation of the policies towards SME is important. Proper control and transparency of allocated funds is necessary in order to meet the objectives of a SME policy. The Czech experience of programs to assist selected SMEs also shows that administration can absorb big share of the available means, less successful enterprises can be subsidized to the detriment of more successful ones, and that programs might lack flexibility. The implementation of such programs can create certain frustration and be counter-productive.

The different shortcomings in the environment and markets call for different interventions. The general policy regarding the environment is that it shall provide a “level playing field” for entrepreneurship; that is, equal conditions for all entrepreneurs. Further measures shall address particular market failures. In line with the “level playing field” idea, competition policy attempts to prevent excessive market power. Asymmetry of information is another source of market failure; it is particularly pronounced in the credit market. Finally, various positive externalities are connected to entrepreneurship, especially their contribution to innovation, productivity growth, product diversity and job creation. Without public intervention, the production connected with such externalities will be suboptimal.

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Annex I

Table 1: Real GDP growth rates [%], Georgia, EU and selected EU countries 2004-2014

| Real GDP Growth | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 |
|-----------------|--------|-------|-------|--------|-------|---------|-------|-------|--------|--------|
| GEO | 5.86% | 9.60% | 9.38% | 12.34% | 2.31% | -3.78% | 6.25% | 6.95% | 6.18% | 3.18% |
| MDA | 7.41% | 7.50% | 4.78% | 3.07% | 7.76% | -5.99% | 7.09% | 6.80% | -0.70% | 8.90% |
| CZE | 4.74% | 6.75% | 7.02% | 5.74% | 3.10% | -4.51% | 2.47% | 1.82% | -1.02% | -0.93% |
| HUN | 4.80% | 3.96% | 3.90% | 0.11% | 0.89% | -6.80% | 1.26% | 1.39% | -1.66% | 1.10% |
| POL | 5.34% | 3.62% | 6.23% | 6.79% | 5.13% | 1.79% | 3.88% | 4.45% | 1.91% | 1.57% |
| SVK | 5.06% | 6.66% | 8.35% | 10.49% | 5.75% | -4.94% | 4.43% | 2.98% | 1.80% | 0.94% |
| UKR | 12.10% | 2.70% | 7.30% | 7.90% | 2.30% | -14.80% | 4.20% | 5.20% | 0.20% | 1.88% |
| EUU | 2.61% | 2.19% | 3.38% | 3.20% | 0.36% | -4.53% | 2.05% | 1.64% | -0.37% | 0.11% |

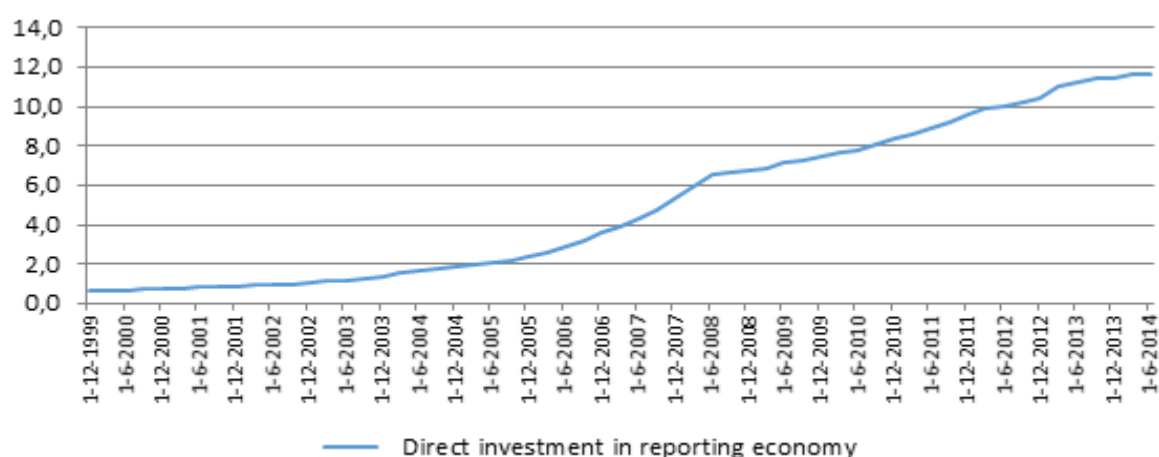
Data: World Bank - World Development Indicators.

Table 2: FDI stock, Georgia [USD, 10⁹], 2004-2013

| Year | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 |
|-------------------|------|------|------|------|------|------|------|------|-------|-------|
| IIP of FDI inflow | 1.91 | 2.37 | 3.56 | 5.37 | 6.79 | 7.47 | 8.35 | 9.55 | 10.39 | 11.41 |

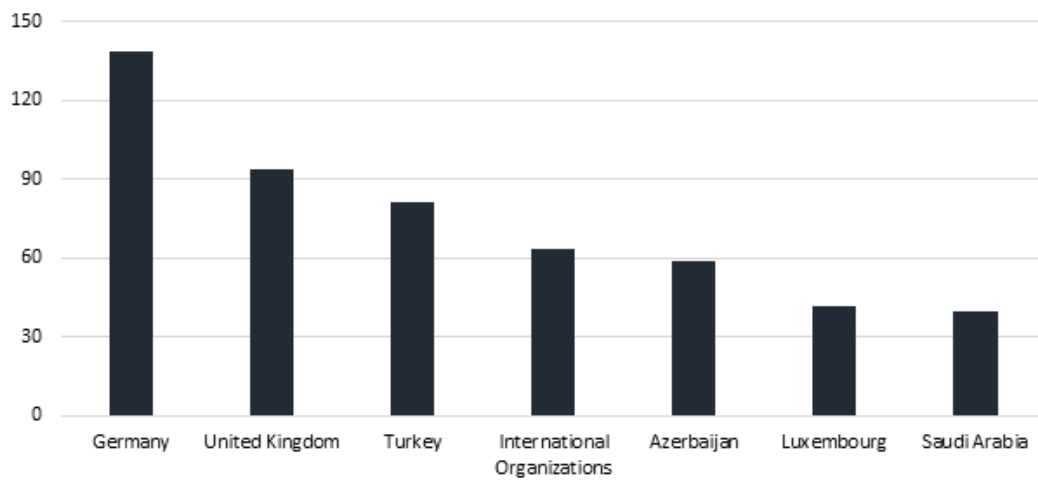
Note: International Investment Position (IIP) is the balance sheet of the stock of external financial assets and liabilities. IIP comprises of claims on nonresidents and liabilities to nonresidents. IIP consists of the following sectors: monetary authority, government, banking and other sectors.

Figure 1: FDI stock in Georgia [USD, 10⁹], 2004-2013



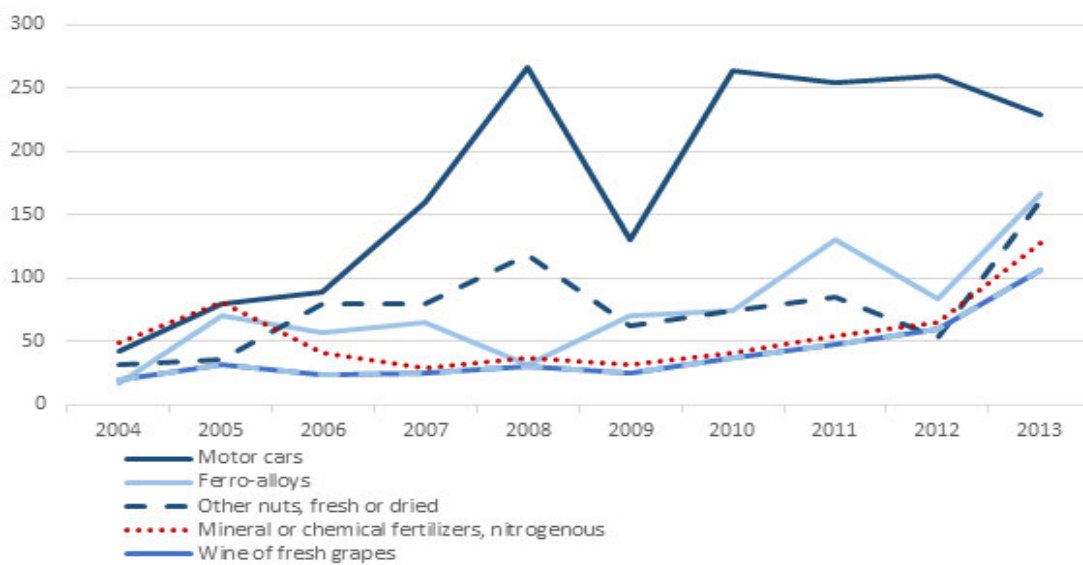
Note: International Investment Position (IIP) is the balance sheet of the stock of external financial assets and liabilities. IIP comprises of claims on nonresidents and liabilities to nonresidents. IIP consists of the following sectors: monetary authority, government, banking and other sectors.

Figure 2: FDI in Georgia by country, USD million, 2012



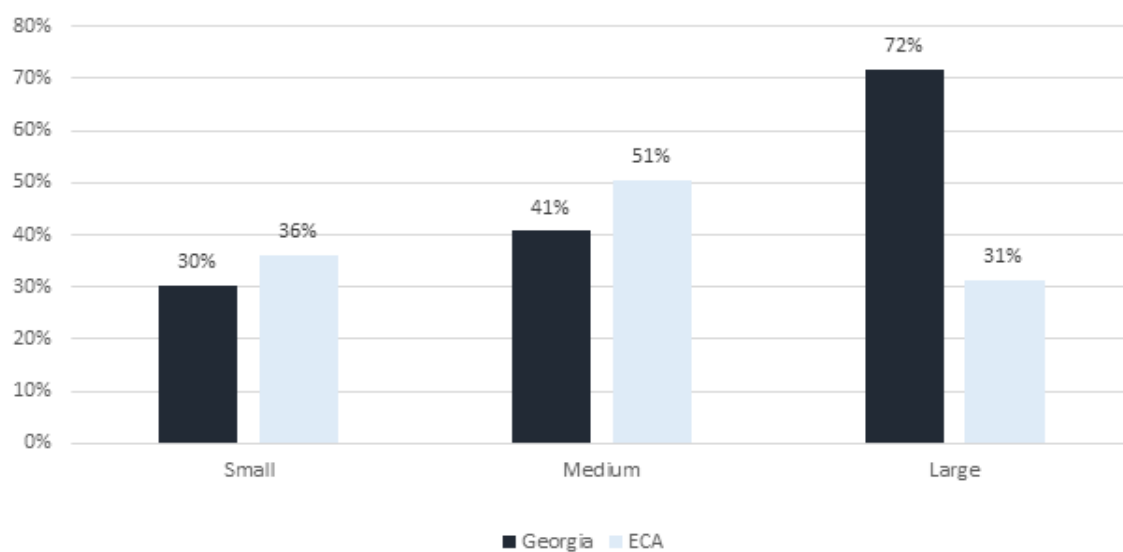
Source: GeoStat.

Figure 3: Georgian export by commodity, USD million, 2004-13



Source: GeoStat.

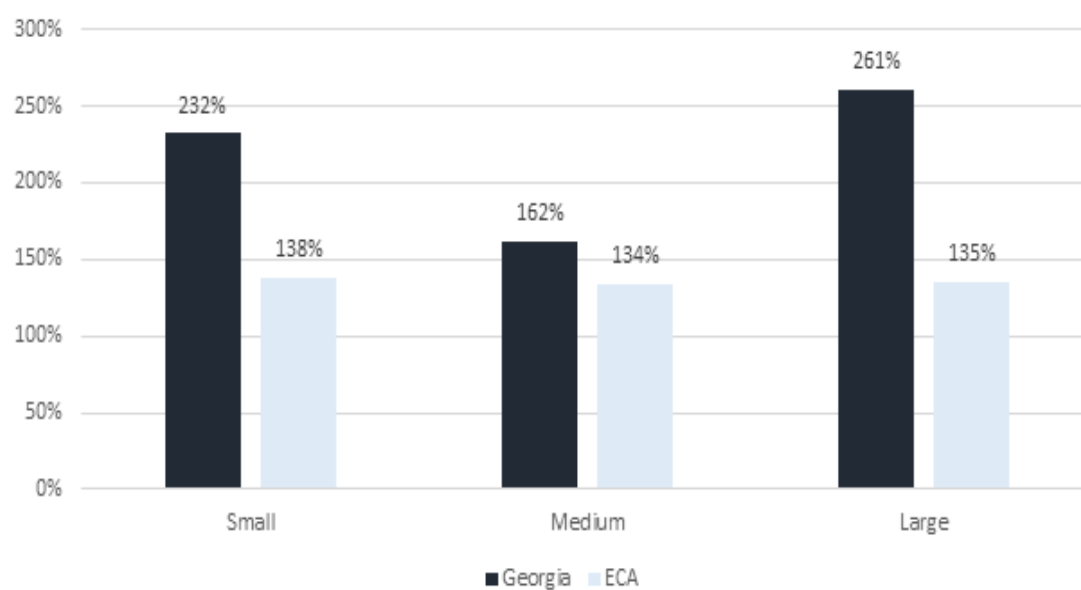
Figure 4: Percent of firms with a bank loan/line of credit in 2013



Source: World Bank, IFC. Enterprise Survey (2013).

Note: ECA - Eastern Europe and Central Asia region.

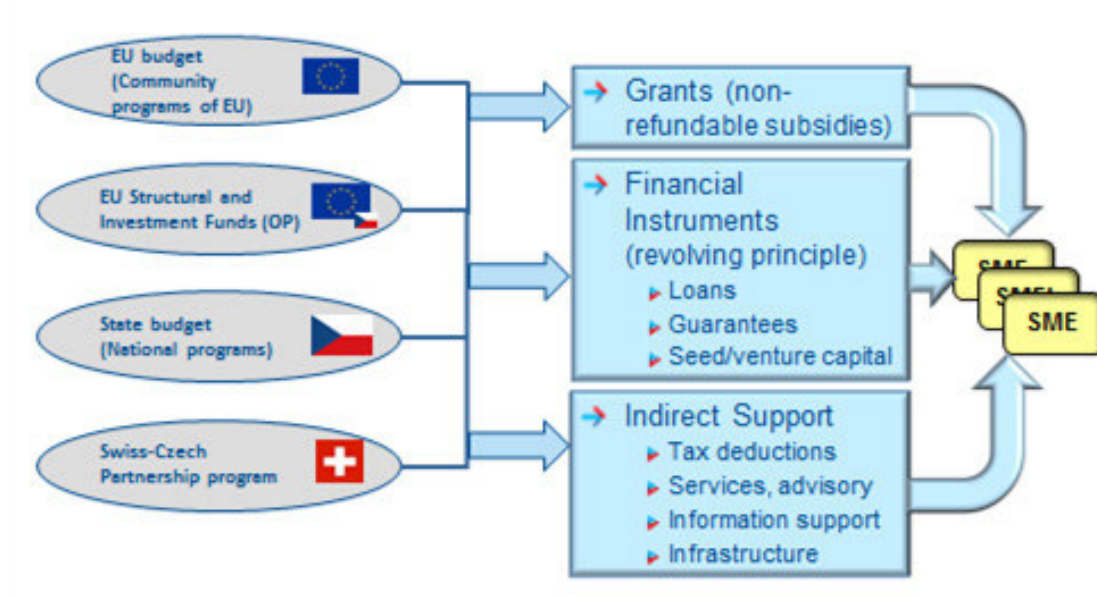
Figure 5: Value of collateral needed for a loan, percent of the loan amount in 2013



Source: World Bank, IFC. Enterprise Survey (2013).

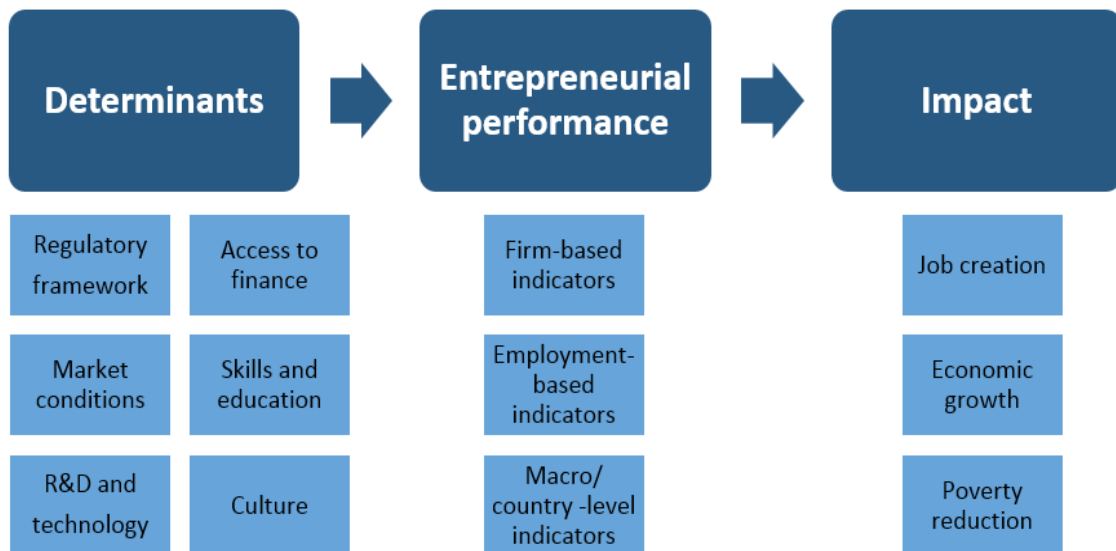
Note: ECA - Eastern Europe and Central Asia region.

Figure 6: Public sources and enterprise support forms, Czech Republic, 2014



Source: Ministry of Industry and Trade.

Figure 7: Entrepreneurship and its determinants: Analysis framework



Source: World Bank 2013, Fostering entrepreneurship in Georgia (Kuriakose, 2013).

Annex II Results of the survey

As part of the project, a uniform questionnaire was prepared and sent out to various stakeholders and experts. More than 50 persons/organizations were targeted, including ministries and other policy actors, SME organizations, agricultural associations, think tanks and expert groups, universities, banks dealing with SME financing and local representatives of international organizations. Hereby, we analyze the results of the replies. To help the respondents, the questionnaire was translated and distributed both in the English and Georgian languages. The target group was also reminded via phone calls to fill out the questionnaire.

In the first part of the questionnaire template, respondents were asked to evaluate, to what extent the factors listed were impeding the development and activities of the SMEs in the country. On a 1-4 scale, 1 represented “not at all”, 2 represented “somewhat”, 3 stood for “significantly”, and 4 meant “very significantly”. The NA option was provided in case the respondent did not know.

Parallel to this exercise, respondents were asked to mark “help” in case they thought that an intervention by the GMU Project would be advised and welcomed. Some respondents marked (or did not mark) “help” parallel to giving a number from 1-4 signaling the importance of the given topic. However, some others understood “help” as the means to signal “most important, very significant,” not giving a value from 1-4 but expressing that this issue is of crucial importance and policy recommendations and knowledge transfer are most welcome regarding the given obstacle.

For methodological/technical reasons, in all of those cases where the respondent did NOT give a number value but marked “help” for a given topic, we understood that they considered the topic as a major obstacle to SME development in the country and calculated it in the database with a number 4. We analyze the “help” answers separately.

The questions targeted six domains relevant to the development and daily activities of SMEs. The main domains were: Labor and skills, red tape/bureaucracy, tax burdens, law and order, market specificities, finance and other issues. the following tables present the results of the survey.

Table 1: Labor and skills domain, Georgian experts' survey results, 2014

| 1 | Domain/Obstacle | Help | Mean value | SE | Obs. |
|---|--|------|------------|-------|------|
| A | Low market skills of entrepreneurs / Inadequate business education | 1 | 3.31 | 0.21* | 13 |
| B | Lack of business experience | 0 | 3.00 | 0.28 | 13 |
| C | Lack of experience in foreign trade, in EU in particular | 3 | 2.54 | 0.18* | 13 |
| D | Lack of knowledge of EU regulations | 3 | 2.69 | 0.24* | 13 |
| E | Lack of language skills and contacts abroad | 0 | 2.69 | 0.24* | 13 |
| F | Low availability of high skill workers | 1 | 3.00 | 0.25 | 13 |
| G | Low availability of low-skill workers | 0 | 2.08 | 0.14* | 13 |
| H | Demographics / low number of young labor market entrants | 0 | 2.15 | 0.25* | 13 |
| I | High emigration | 0 | 2.54 | 0.24* | 13 |
| J | Expensive labor / Mismatch between labor cost and productivity | 0 | 2.31 | 0.29 | 13 |
| K | Employer-employee conflicts | 0 | 2.00 | 0.25 | 13 |
| L | Low labor market flexibility | 0 | 2.77 | 0.23* | 13 |
| M | High syndicalization / Excessive power of labor unions | 0 | 1.62 | 0.31 | 13 |
| N | Low labor ethics | 1 | 2.54 | 0.18* | 13 |
| O | Low business ethics | 1 | 2.85 | 0.19* | 13 |
| 1 | Labour & Skills | 10 | 2.54 | 0.23* | 13 |

Note: *) Mean value significant at 5%.

Table 2: Red Tape and Bureaucracy domain, Georgian experts' survey results, 2014

| 2 | Domain/Obstacle | Help | Mean value | SE | Obs. |
|---|---|------|------------|-------|-------|
| A | Difficulties in registering company | 0 | 1.25 | 0.25 | 12 |
| B | High cost of market entry | 0 | 2.18 | 0.30 | 11 |
| C | Difficulties to expand business activities / bureaucratic obstacles | 0 | 1.75 | 0.25 | 12 |
| D | Non-transparent / inconsistent regulations | 1 | 2.00 | 0.16* | 13 |
| E | Poor overall regulatory framework / Excessive burden of regulations | 0 | 1.92 | 0.19* | 12 |
| F | Foreign trade barriers | 0 | 2.92 | 0.23* | 12 |
| G | Institutional differences with EU | 3 | 2.83 | 0.30 | 12 |
| 2 | Red Tape /Bureaucracy | 4 | 2.12 | 0.24 | 12.00 |

Note: *) Mean value significant at 5%.

Table 3: Tax burden domain, Georgian experts' survey results, 2014

| 3 | Domain/Obstacle | Help | Mean value | SE | Obs. |
|---|--|------|------------|-------|-------|
| A | Unstable and non-transparent tax rules and/or their applications | 0 | 2.33 | 0.22* | 12 |
| B | High cost of compliance | 0 | 2.25 | 0.18* | 12 |
| C | High effective SME presumptive tax rates | 0 | 2.11 | 0.11* | 9 |
| D | High effective personal income tax rates | 0 | 2.33 | 0.26 | 12 |
| E | High effective corporate income tax rates | 0 | 1.90 | 0.28 | 10 |
| F | High effective value added tax / trade tax rates | 0 | 2.36 | 0.31 | 11 |
| G | High custom charges | 0 | 1.91 | 0.25 | 11 |
| H | Other high taxes and fiscal fees/charges | 0 | 1.89 | 0.35 | 9 |
| 3 | Tax burden | 0 | 2.14 | 0.25 | 10.75 |

Note: *) Mean value significant at 5%.

Table 4: Law and order domain, Georgian experts' survey results, 2014

| 4 | Domain/Obstacle | Help | Mean value | SE | Obs. |
|---|--|------|------------|-------|------|
| A | Weak property rights / weak contract enforcement | 1 | 2.69 | 0.26 | 13 |
| B | Crime and violence (low safety) | 0 | 1.58 | 0.23* | 12 |
| C | Corruption / Clientelism / Favoritism | 0 | 1.83 | 0.27 | 12 |
| D | Weak judiciary | 1 | 2.77 | 0.26 | 13 |
| 4 | Law and order | 2 | 2.22 | 0.25 | 12.5 |

Note: *) Mean value significant at 5%.

Table 5: Market conditions, Georgian experts' survey results, 2014

| 5 | Domain/Obstacle | Help | Mean value | SE | Obs. |
|---|---|------|------------|-------|------|
| A | Small market size / Weak demand | 0 | 3.23 | 0.28 | 13 |
| B | Barriers for exports to foreign markets | 0 | 3.15 | 0.19* | 13 |
| C | Unfair competition / Uneven playing field / Informal economy | 0 | 2.58 | 0.19* | 12 |
| D | Monopolization / Excessive market power of some participants | 0 | 3.00 | 0.23* | 13 |
| E | Weak market position of SMEs | 0 | 3.38 | 0.14* | 13 |
| F | Weak professional organizations of SMEs | 1 | 2.92 | 0.18* | 13 |
| G | Weak analytical and policy advocacy of SME organizations | 0 | 3.25 | 0.13* | 12 |
| H | Discriminatory practices of authorities | 0 | 2.00 | 0.17* | 12 |
| I | Unfair privileges for foreign investors | 0 | 1.75 | 0.18* | 12 |
| J | Macroeconomic instability (demand, inflation, exchange rate) | 0 | 2.92 | 0.21* | 13 |
| K | Political instability | 0 | 3.00 | 0.23* | 13 |
| L | Insufficient market information/governmental support for SMEs | 1 | 2.92 | 0.23* | 12 |
| M | Weak support/lack of support by international organizations | 1 | 2.42 | 0.19* | 12 |
| N | Low level of activities of venture capital | 0 | 3.25 | 0.25 | 12 |
| 5 | Market | 3 | 3.03 | 0.20* | 12.5 |

Note: *) Mean value significant at 5%.

Table 6: Finance and Other domain, Georgian experts' survey results, 2014

| 6 | Domain/Obstacle | Help | Mean value | SE | Obs. |
|---|---|------|------------|-------|------|
| A | Difficulties in accessing financial services | 1 | 3.15 | 0.27 | 13 |
| B | High cost of credit | 1 | 3.31 | 0.24* | 13 |
| C | Inappropriate infrastructure | 0 | 2.45 | 0.25 | 11 |
| D | Weak professional organizations of SMEs | 1 | 2.75 | 0.18* | 12 |
| E | Difficult access to internet / Lack or low quality of business websites | 0 | 2.50 | 0.23* | 12 |
| F | Lack of open communication channels with EU | 1 | 3.00 | 0.19* | 11 |
| 6 | Finance and other | 4 | 2.86 | 0.23* | 12 |

Note: *) Mean value significant at 5%.