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**The EU-Georgia Association Agreement: An Instrument To Support
The Development Of Georgia Or Lip Service? ¹**

Abstract

On 1 September 2014, the Association Agreement (AA) between the EU and Georgia partially came into force. Its main pillar is a “deep and comprehensive free trade agreement” (DCFTA). It provides for the full liberalisation of trade in industrial products and substantial reduction of barriers in agricultural trade. A significant part of the AA is devoted to the elimination of regulatory barriers to trade (e.g. technical standards). The Agreement provides for a progressive and partial liberalisation of trade in services as well as for fast and deep elimination of barriers to capital flows. The liberalisation of the movement of workers is of a very limited scope however.

Provisions of the EU–Georgia AA resemble the earlier Europe Agreements (EAs) signed by the Central and Eastern European Countries, albeit there are many differences as well. It is expected that the AA will bring about a number of advantages for Georgia, including: (a) stabilisation of its economic and legal system, thus making it more predictable for investors and more business friendly; (b) alignment of many business laws to those in the EU, which will broaden the market for Georgian products and services; (c) better

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¹ This paper is a result of research conducted by the author at the Ilja State University in Tbilisi in the framework of Erasmus Mundus Programme MID 2012.

implementation of business laws. The short term advantages resulting from trade liberalisation will be modest for Georgia, partly because it granted open access to its market before the AA entered into force. Implementation of the Agreement will involve adjustment costs, which are usually an inevitable part of the path to increasing exports to the huge EU market.

Keywords: *Association Agreement, European Neighbourhood Policy, free trade area, EU – Georgia relations*

1. Introduction

On 1 September 2014, the Association Agreement² (AA) between the EU and Georgia partially came into force (it still requires ratification by all EU Member States). We should add that similar AAs were signed on the same day (on 27 June 2014) by the EU with Moldova and Ukraine. While the general concept of these agreements is the same, the details are different.

The AAs are aimed at deepening the political and economic relations between the EU and the associated countries and at the gradual integration of these countries into the EU legal and economic system. They've been negotiated by the EU with its neighbours in recent years within the framework of the European Neighbourhood Policy, and constitute the EU's response to the democratisation processes in Eastern Europe and the Caucasus in 2003-2005, and in the Middle East in 2011.³

The EU–Georgia Agreement is centred around a “deep and comprehensive free trade agreement” (DCFTA) and a broad programme of approximation of Georgia's legislation to EU laws. The Agreement resembles the earlier Europe Agreements (EAs) signed with and by the Central and Eastern European Countries (CEECs). For the CEECs, Europe Agreements were an important instrument for stabilising their political situations and legal systems, inducing producers to upgrade the competitiveness of their products and anchoring them in the market

² Its full name is: Association Agreement between the European Union and the European Atomic Energy Community and their Member States, of the one part, and Georgia, of the other part (OJ L 261 of 30 August 2014).

³ The EU launched its European Neighbourhood Policy (ENP) after the 2004 enlargement, in order to avoid creating new borders in Europe and to enhance stability and security along its borders. DCFTAs, together with EU financial support, are the main instruments for implementation of this policy. They are currently offered by the EU to Armenia, Georgia, Jordan, Egypt, Moldova, Morocco, Tunisia and Ukraine.

economy system (Kawecka-Wyrzykowska 2014, pp. 49-52). The first research objective of this paper is to check whether this is true also in the case of the AA between Georgia and the EU. The second, related research objective is to assess the costs and benefits of the AA for the Georgian economy. When assessing the AA we concentrate on trade and trade-related matters (Title IV of the AA).

The research hypothesis is that the Association Agreement is an important instrument for making the Georgian economy more business attractive, stimulating structural changes in the economy and expanding exports to the huge EU internal market in long term.

The paper starts with short analysis of the timetable and coverage of trade liberalisation under the DCFTA. Next, the EU-Georgia Association Agreement is compared with Europe Agreements signed by the EU at the beginning of the 1990s with partners from Central and Eastern Europe. Then we try to assess the importance of the AA for Georgia itself. This part is supplemented by quantitative estimates of trade changes and non-quantitative opinions on DCFTA which are available in literature. The paper ends with concluding remarks.

2. Timetable and coverage of trade liberalisation

Before the AA entered into force, relations between the EU and Georgia were regulated by a number of agreements. The oldest, and at the same time the broadest in scope, was the Partnership and Cooperation Agreement (PCA) which was signed in 1996 and entered into force in 1999. Ten years later, in 2009, Georgia was included in the European Neighbourhood Policy (ENP), which marked a significant step forward in the EU-Georgian relations. During the period of provisional application of the new Association Agreement, some provisions of the 1996 EU-Georgia Partnership and Cooperation Agreement, which do not fall within the scope of the AA, will remain valid. The PCA will become invalid upon the full entry into force of the AA.⁴

The commercial part of the DCFTA also includes energy issues, detailed rules on the approximation of Georgian laws on sanitary and phytosanitary measures (SPS) with EU laws, as well as provisions relating to competition and transparency, intellectual property rights, technical barriers, establishment, trade in services, current payments and capital movements.

Both sides fully liberalised trade in industrial products on the day the Agreement entered into force. The elimination of all import tariffs with the entry

⁴ http://www.mfa.gov.ge/index.php?lang_id=ENG&sec_id=30&info_id=18015.

into force of the Agreement also applies to Georgian imports of EU agricultural products. Liberalisation of Georgian agricultural exports to the EU is of limited character: 1) for garlic, the EU established a duty free quota (amounting to 200 tons); 2) for a number of products (fruit and vegetables), liberalisation consists of the exemption of the *ad valorem* component of the import duty (other protective elements have not been eliminated); 3) there is a long list of processed and non-processed agricultural products which are subject to the anti-circumvention mechanism. The average annual volume of imports from Georgia into the EU for each category of those products is provided for. When those imports reach 100% of the volume established, the EU may temporarily suspend the preferential treatment for the products concerned. Most of those products are not exported from Georgia to the EU right now. Thus the liberalisation of Georgia's agricultural exports to the EU is of limited character, albeit negative implications of these provisions may appear only in the upcoming years.

No export duties or quantitative restrictions are allowed. As both partners are WTO members, the general WTO exceptions can be applied, including recourse to Articles XX and XXI of GATT 1994. Also, all WTO safeguard measures can be applied by partners (including antidumping and countervailing measures and those under Article XIX of GATT 1994).

A substantial part of the Agreement is devoted to detailed provisions on the elimination of technical barriers to trade. This will be done through gradual alignment of Georgian laws to the EU *acquis communautaire*, in line with timetables contained in Annexes. A list of the measures for approximation (21 EU New Approach and Global Approach Directives) is set out in Annex III. Concrete dates for the adoption of these measures by Georgia are listed as well. Moreover, an indicative list showing priorities in the approximation of other EU laws (mostly on marketing and standardisation of products) is enclosed in one of the Annexes. The approximation of laws will be achieved by Georgia adopting a series of laws related to standardisation, metrology, accreditation and conformity assessment. Georgia will also continue to gradually approximate its sanitary and phytosanitary, animal welfare and other legislative measures to those of the EU. The list of concrete laws in Georgia to be aligned with EU laws (including priority areas) is to be presented by Georgia not later than six months after the entry into force of the Agreement.

Apart from liberalisation of trade in goods, the objective of DCFTA is to "lay down the necessary arrangements for the progressive reciprocal liberalisation of establishment and trade in services." (Art. 76) The instruments of liberalisation are mostly national treatment and most favoured nation treatment (MFN). Both rules apply to the establishment of the Parties' subsidiaries, branches and representative offices. Both partners, however, presented long lists of economic

activities which are excluded from establishment (Arts. 78-80).⁵ Services mentioned in the AA are described in a very detailed way, and most of them contain reservations to concrete modes of supply of those services. Moreover, reservations at the EU level are supplemented by many national reservations, which reduces the access to the EU market for Georgia's service providers and makes the legal conditions of operating on the EU market extremely complex and burdensome. Besides, some sectors have been excluded from national treatment and MFN treatment by the Parties as regards the cross border supply of services (Art. 83). Due to many exceptions from general rules, the liberalisation attained of the supply of services and conduct of service suppliers seems to be modest. For the same reason, it is impossible to assess *ex ante* to what extent the provisions on improved access to the market will be implemented in practice.

The AA also contains provisions on the temporary presence of natural persons for business purposes (on the basis of mutuality). Separate provisions apply for key personnel, graduate trainees, business agents, contractual service suppliers and independent professionals (Art. 88). The objective of these provisions is to make business easier. In each case, however, there are general limitations sometimes accompanied by national (EU Members') separate reservations. For example, under Article 89 key personnel and graduate trainees have received the right to be employed in the Parties' establishments covered by the Agreement but for a limited period (usually for a period of no longer than three years, and one year for graduate trainees). Independent professionals (natural persons) are allowed to supply services in the territory of the other Party on a temporary basis. They have to obtain a service contract for a period not exceeding twelve months. Reservations at the EU level are supplemented by many national reservations. For example, residency is required for auditing services offered in Denmark. All these provisions reduce the access to the EU market for Georgia's service providers and make the legal conditions of operating on the EU market extremely complex and burdensome.

The Parties undertook to impose no restrictions on payments and transfers on the current account of mutual balance of payments (Art. 137). Also, they ensured the free movement of capital related to direct investments, including the acquisition of real estate. In addition, each Party ensured the free movement of capital related to credits for commercial transactions, to portfolio investments, financial loans and credits by the investors of the other Party, etc. It should be noted that these provisions provide for totally free access to the capital markets of the Parties, including access to the weaker market of Georgia.

⁵ The excluded activities cover, among others: mining, manufacturing and processing of nuclear materials; production of or trade in arms, munitions and war material; audio-visual services; national maritime cabotage; and some types of air transport services (Art. 78).

Chapter 8 of the AA relates to public procurement. It provides for clear and transparent minimum rules (based on EU practice) on tendering procedures for awarding public works. Over the coming years Georgia will adopt current and future EU public procurement legislation. Chapter 10 covers competition rules. Here, Parties prohibit and commit to addressing certain practices that could distort free competition and trade, e.g. cartels, abuse of a dominant position and anti-competitive mergers. The parties agree to maintain effective anti-trust and merger laws and an effectively functioning competition authority. Chapter 11 applies to trade-related energy, including electricity, crude oil and natural gas. The Parties have committed themselves not to regulate the prices of gas and electricity for industrial purposes. Also, the interruption of energy transit is prohibited.

3. The Association Agreement and Europe Agreements: similarities and differences

The DCFTA and the entire AA between the EU and Georgia replicate – in general - the concepts underlying the Europe Agreements (EAs) signed by the European Communities with Central and Eastern European countries (CEECs) at the beginning of the 1990s, and later with other countries which commenced transformation of their economic and political systems. The core provisions of both types of agreements include trade liberalisation and legal alignment of the associated countries with the EU *acquis communautaire*. Nevertheless, some details differ in the two types of Agreements, which results in their differing assessment.

The CEECs negotiated their EAs with a view toward future EU accession. The first EAs were signed in December 1991 by Czechoslovakia (as the country was then named), Hungary and Poland. At that time, the European Communities were not ready to accept the prospect of future eastward enlargement.⁶ Nevertheless the EC accepted a general clause in the preamble of the Agreement negotiated with the first CEE country – Poland - which stated: “recognizing the fact that the final objective of Poland is to become a member of the Community and that this association, in the view of the Parties, will help to achieve this objective [...]” This clause became later a reference point for the four Visegrad countries (Czech Republic, Hungary, Slovakia and Poland) to repeat their strong political desire to apply for EU accession. The possibility of EU accession became more realistic only after the political decision was taken by the Copenhagen European Council Summit in June 1993. Under the pressure of

⁶ For the Community, the main function of the Europe Agreements was to stabilise the political situation in Europe after the collapse of the “iron curtain”.

CEEC, the Summit conclusions stated formally, albeit somewhat vaguely, that it was possible for those countries to join the EC if they “desire so” and “satisfy the economic and political conditions required⁷”.

In the case of Georgia there is neither a direct nor indirect reference to Georgia’s accession to the EU. There is, however, a chance that this could happen in the future. The Agreement recognizes Georgia as an Eastern European country. In addition, Georgia declared its commitment to implementing and promoting EU values. Even stronger prospects for closer future relations are declared in the paragraph of the Preamble which states that “[t]his Agreement shall not prejudice and leaves open the way for future progressive developments in EU-Georgia relations.”

As regards the coverage of both types of agreements, the following comparative remarks concerning trade and trade-related issues seem to be important (Kawecka-Wyrzykowska, Meisel 2014, pp. 35- 47). Both Agreements provide for full liberalisation of trade in non-agricultural products. Under the AA, the opening up of the market took place on the day of the entry of the Agreement into force. It might be noted that neither of the partners made substantial concessions here, as they both offered a relatively open access to their markets before the AA entered into force. For example: (a) the MFN import duties in Georgia were already very low (see more – Table 1); (b) for many years the EU had offered Georgia GSP plus status which resulted in easy access to the EU market; (c) Georgia played (and still plays) a very insignificant role in EU trade (less than 0.1% of total external EU imports and exports); and (d) there are almost no processed industrial products imported from Georgia to the EU, thus posing a very insignificant competitive threat to EU producers.

Under the EAs, the liberalisation timetable for industrial products was quite long, and in the case of several sensitive types of products it even stretched to 5-7 years. The reason, from the EU side, was that traditionally CEECs’ producers were relatively strong competitors on the EEC market (due to production cost advantages) in several sectors, mostly in textiles, clothes and metallurgical products. EEC producers wanted to have a period of several years to make adjustments to cheaper competition. From the CEECs’ side, where import duties were usually relatively high in order to protect domestic uncompetitive products (except for the above-mentioned sectors), there was a slow and gradual liberalisation, lasting in the case of the most sensitive products until 2000 (or even until 2002 in the case of cars imported to Poland). The reason for this gradual approach to the elimination of import duties was to inject competition and force domestic producers to upgrade their products on one hand, while on the other to not “kill” domestic producers.

⁷ For more on these criteria, see: http://europa.eu/legislation_summaries/glossary/accession_criteria_copenhagen_en.htm.

In the area of trade in agricultural products, Georgia immediately opened up its market for EU products. Once again this decision did not greatly increase competition as the Georgian market was relatively open earlier. The liberalisation implemented by the EU in this area was partial and selective. In the case of EAs, the liberalisation of agricultural products also applied only to some products and consisted in reduction, not full elimination, of various protective components. This reflected, on one hand, the strongly protectionist approach of the EEC towards its agricultural sector at that time, and on the other hand the comparative advantages of many agricultural products offered by CEECs.

Another difference between EAs and the AA applies to the approximation of the partners' laws to the EU *acquis communautaire*. Both types of agreements recognize the crucial role to be played by such approximation for making partners' goods and services more compatible with the EU requirements, hence increasing their export to the EU market. The Georgian AA, however, is much more detailed and comprehensive in this area. It provides for extremely detailed rules for many sectors of the Georgian economy (in particular services, technical standards for industrial goods, and sanitary and phytosanitary requirements for agricultural products) and for some areas of economic policy (e.g. public procurement).

Under the EAs, while in general limited access to the EU labour market was offered to workers from the CEECs, there was the possibility of (a) undertaking self-employment by workers from CEECs and (b) employment in the EU countries of so-called "key personnel" (persons working in CEECs' companies which operated in the EU) without the need to apply for a work permit. Under the AA, the provisions on movement of workers are more restrictive and are conditioned upon meeting numerous requirements. These reduce the practical importance of some formal facilitations of the Agreement.

As regards the right of establishment of companies and supply of services, the main instrument for eliminating restrictions in these areas – under both agreements – is the principle of 'national treatment', i.e. the affording foreign companies and nationals no less favourable treatment than that accorded to a country's own companies and nationals. Thus, with the exceptions listed hereafter, on the day the EA entered into force each Member State of the EC accorded national treatment to the establishment of companies from the CEECs, while the CEECs offered such treatment to EC companies and nationals later (under the so-called asymmetry of concessions). Some sectors, however, were excluded from this rule (e.g. purchase of agricultural land, natural resources, air transport services, legal services). The list of sectors and modes of supply of services which are excluded from national treatment under the AA is longer than in the case of EAs.

Another area of economic activities which should make business easier is the movement of capital. The CEECs, in their EAs (i.e. on the day the EAs entered into force) accepted the unrestricted flow of payments related to the current account balance. Also, they did not have problems with the elimination of restrictions (if any) on the free movement of FDI, as they were very interested in attracting FDI in order to modernise their economies. These same solutions are repeated in the AA. The approach to other capital payments is different however. The CEECs did not agree on the free flow of some types of capital, in particular of portfolio capital (which is, at least in part, of a speculative nature) nor on the free outflow of capital (except for the types mentioned before). They feared a massive export of private capital which otherwise could be invested at home, to the benefit of the development of those countries. The deadline for liberalisation of such capital flows was not even provided for in the EAs, but it was adopted later by CEECs when their economic situation improved.

Surprisingly, Georgia did not follow this approach and accepted a much broader concept of free flow of capital once the AA came into force, including free movement of capital related to portfolio investments, financial loans, and credits by investors of the other Party. This reflects the more open approach to the movement of capital which had already existed in Georgia before the AA's implementation. There is, however, a safeguard providing for the temporary imposition of capital restrictions in exceptional circumstances, including balance of payments difficulties.

Summing up the provisions on the opening of markets, we may state that trade in goods and movement of capital in Georgia will be opened up to EU competitors faster than was the case in the CEECs on the basis of their EAs. Contrary to the situation of the CEECs, these decisions will not radically change the situation of Georgia because the pre-association situation was different. Already at that time Georgia was a very open economy, with very low import barriers to trade in goods and a relatively free flow of capital. By the same token, the advantages resulting from the elimination of border protection will be smaller in the short run. The situation is different in the case of movement of workers and supply of services, where very modest liberalisation is foreseen (by both partners). And these are the two areas where Georgia has comparative advantages. As regards legal adjustments to the EU legal system, in Georgia they seem to cover a much broader range of issues than those in the CEECs' EAs.

4. The level of external protection of Georgia's economy

An important benefit always expected from trade liberalisation is an increase in trade and a corresponding improvement in the overall welfare of the countries involved. In the case of Georgian imports, this effect is not very important as the level of protection for non-agricultural products was very low already before the implementation of the AA (Table 1). Also, the average import duties on agricultural products were not very high. Thus, liberalisation of Georgian imports (i.e. elimination of border protection) has not unduly affected the choices of Georgian consumers, at least in the short term.

Table 1. Average applied tariffs (MFN levels, %) in the EU and in Georgia in 2010

	Agriculture	Industry	All goods
EU-27	13.5	4.6	5.9
Georgia	7.7	0.3	1.3

Source: Messerlin, Emerson, Jandieri, Vernoy 2011, p. 22.

The EU market was more protected but – as already mentioned – for many years the EU has offered quite open access to its market for Georgian products under the GSP plus. Table 2 reveals that in 2013 almost 68% of Georgian exports to the EU entered duty free under the general status of MFN (which applied to all WTO members). This resulted mostly from the commodity pattern of Georgian exports to the EU, dominated by raw materials and semi-processed products subject to 0% duties (including oils and copper ores, the main export items of Georgia to the EU market). An additional 28% of Georgian products benefited in 2013 from preferential status (among others: hazelnuts and ammonium nitrate).⁸ As a result, the vast majority of Georgian products exported to the EU enjoyed easy border access. Thus, under the DCFTA the previously free access to the EU market under the GSP plus and MFN has simply been replaced in many cases by a permanent mechanism of the AA. What is probably more important, duty free access was also offered for products not currently exported, hence making the diversification of Georgian exports easier.

⁸ This was a relatively high share of Georgian exports to the EU which enjoyed a preferential access to the EU market. On average, only 13% of exports of the countries enjoying unilateral preferences (GSP, GSP plus etc.) on the EU market benefited from those preferences. The majority of their exports (68.0% in 2012) entered the EU market on duty free basis resulting from 0% duties based on most favoured nation treatment. The main reason for such proportions was the commodity pattern of beneficiaries' exports, which was dominated – as in the case of Georgia – by raw materials and semi-processed products subject to 0% MFN duties.

Table 2. EU imports from Georgia by type of market access (2004-2013)

Year	Pattern of imports by type of market access (%)									Total imports (ths EUR)	Preferential imports (ths EUR)	Share of preferential imports in total import (%)	Rate of utilisation of preferences (%)
	Imports on MFN basis			Imports potentially preferential					Other imports not classified by preferences				
				Imports on MFN basis		Imports on preferential basis							
	MFN =0	MFN >0	Unknown customs duty	MFN=0	MFN >0	pref.=0	pref.>0	Unknown customs duty					
1	2	3	4	5	6	7	8	9	10=1 to 9	11=6+7+8	11/10	11/ (4+5+11)	
2004	73.0	0.5	0.0	0.0	2.7	10.9	10.1	2.1	0.6	289,460	67,014	23.2	89.4
2005	45.5	1.0	0.0	0.0	7.8	32.2	8.0	3.5	1.9	237,907	104,096	43.8	84.8
2006	74.7	1.2	0.0	0.0	1.9	17.4	0.0	3.1	1.8	440,163	89,959	20.4	91.4
2007	68.5	5.3	0.0	0.0	3.2	18.1	0.0	3.8	1.0	455,089	99,592	21.9	87.2
2008	76.4	5.0	0.0	0.0	3.1	14.3	0.0	0.4	0.8	734,919	108,314	14.7	82.7
2009	76.4	3.5	0.0	0.0	3.8	15.2	0.0	0.7	0.4	517,344	82,117	15.9	80.6
2010	79.4	1.0	0.0	0.0	2.1	15.5	0.0	1.4	0.5	564,894	95,515	16.9	88.9
2011	72.1	1.8	0.0	0.0	2.2	23.2	0.0	0.2	0.4	611,918	143,577	23.5	91.3
2012	71.2	3.8	0.0	0.0	2.8	21.8	0.0	0.0	0.4	580,983	126,690	21.8	88.5
2013	67.5	4.3	0.0	0.0	4.4	23.5	0.0	0.0	0.3	661,872	155,931	23.6	84.4

Source: Eurostat-Comext (calculations were prepared by Dr. Łukasz Ambroziak, Institute for Market, Consumption and Business Cycles Research; The Institute of Agricultural and Food Economics - National Research Institute, Warsaw.

Moreover, positive trade-creating effects resulting from the elimination of non-tariff barriers (among them, technical and sanitary barriers) may only appear in the next several years.

5. Importance of the AA for Georgia

On the basis of the above analysis one might come to the conclusion that the AA is neither advantageous nor necessary for Georgia. However, such a conclusion is not justified. The AA offers a number of advantages for Georgia, although some of them are of an unquantifiable character and some will appear only in the longer term.

First of all, the implementation of the AA will stabilise the internal economic and legal systems in Georgia, making domestic laws more predictable and more difficult to reverse, thereby contributing positively to the long term development of the country. As stressed before, many changes in Georgia's legislation will be the result of international contractual commitments and thus new laws will be difficult to withdraw or relax in the case of the change of government or under the pressure of domestic lobbies (international obligations are usually more binding than domestically-based reforms). To put it differently, an AA with a major partner such as the EU is a signal to investors both at home and abroad that economic reforms will not be reversed, as they are guaranteed by a legally binding international agreement. This will increase the attractiveness of Georgia as an economic partner for foreign investors.

Moreover, regular monitoring of the EU-adjusted laws (by association institutions which are provided for in the AA) will ensure a better implementation of business regulations, which so far have been characterised by poor implementation in Georgia (e.g. on competition policy). Economic operators will be able to prepare their strategies based on the agreed-upon calendar of regulatory approximation of Georgian laws with EU laws. Thus the AA – if properly implemented – should become a strong external anchor for the reform process of Georgia's economy. Such benefits, albeit of a general character, are very important, especially for the country which is not yet very attractive for FDI.

In the long term, better alignment with EU technical and sanitary standards and the improved competitiveness of Georgian products should result in broader exploitation of duty free access to the huge EU market, with over 500 million high income consumers, and lead to an increase of Georgia's exports to this market. The present lack of compatibility of Georgian agricultural products with the EU SPS system severely restricts the capabilities of the majority of Georgian food

products to be exported to the EU market. Only such products as wine, hazelnuts and mineral water, which do not require official health certification or for which the exporting industries in Georgia could ensure that they meet EU food safety criteria, are currently exported to the EU. Most products of an animal origin require health certificates and their export into the EU is not possible at this time.

The involvement of foreign companies will be of crucial importance. Without their investments, the Georgian economy will not be able to upgrade and/or create many competitive products and services, to find money to finance new ideas and investments, etc. FDI is also required in order to create new specializations, including those in the food processing industry, which carries considerable potential. This cannot be done exclusively by domestic capital as the needs and challenges are so vast. Thus, promotion of and incentives for FDI inflow should become the priority of both the Georgian government as well as of the EU and its Member States. Foreign investors themselves may not “notice” that Georgia as a good place for establishment due to, *inter alia*: the small size of the domestic market; the relatively long distance from the EU for the most active companies investing abroad; a geopolitical position which includes unsettled conflicts with Russia; a limited number of highly skilled workers; an unstable (so far) legal environment; an unclear legal situation as regards purchase of land (both for agricultural and business use), etc. As already mentioned, the Association Agreement should help in this respect, making the legal environment both more stable and more business friendly. Also, Georgia has an advantage not often found in other countries – a substantial reduction of corruption and high degree of compliance with tax rules (even very small enterprises use cash registers to record their turnover and profits for tax purposes). Of course fraud has not been eliminated completely, but it has definitely been reduced in recent years.

Apart from the positive effects, there will also be costs for Georgia related to the implementation of the AA. Some of them will be borne by central authorities (translation of documents, new offices to monitor functioning of new laws, training of new staff etc.) and will be partly supported by EU financial aid. There will also be much higher costs borne by private operators connected with the implementation of new technologies of production which are compatible with EU laws. It should be kept in mind however that: (1) such adjustments are a part of transformation costs of any economy which is on the path to a market economy system and aims at improved competitiveness; (2) taking into account the very limited diversification of Georgian exports (in particular in the industrial sector), the costs of legal adjustments in many cases apply not so much to the existing domestic producers but to the new establishments to be started in the future; and (3) such adjustment costs are an inevitable way to

increase exports to the huge EU market. Unless they meet EU technical and sanitary requirements, Georgian producers will not be able to enter the EU market. Given the present situation in Georgia it is probable that in the first period of association producers will bear adjustment costs rather than enjoy benefits. Some time has to elapse before most producers will be able to exploit the opportunities created by the AA. The experience of the CEECs with their transformations demonstrates that without painful adjustments an uncompetitive economy is not able to record rapid economic growth. This experience also shows that the hard economic constraints induced by EU competitive pressures have proved to be important pro-efficiency instruments, more important than any domestically-motivated policies.

In these circumstances, in order to fully use the opportunities created by the AA a lot of support is needed to improve the competitiveness of Georgian producers and, in many cases, assist them to start production of new products. The aforementioned support should involve public authorities and cover technical support, cheap credits, creation of a business friendly legal environment, and convenient and easy access to information, including detailed information on cooperation opportunities created by the AA.⁹ This support should also be the focus of EU financial and technical assistance.

6. Quantitative estimates of trade changes

To the best of our knowledge, there is only one quantitative study on the likely impact of the DCFTA on Georgia's economy (ECORYS & CASE 2012).¹⁰ The study projected Georgia's exports to the EU to increase by 9% and 12% in the short and long term, with imports going up by 4.4% and 7.5%, respectively. Georgia's GDP could increase by 4.3%, or 292 million euro, in the long term, provided that the DCFTA is implemented and its effects sustained (based on the CGE model, with a baseline scenario that assumes no DCFTA in place). Other main conclusions were the following: "... DCFTA is expected to improve the trade balance for Georgia in relative terms, although in absolute terms the trade deficit

⁹ For example, the list of provisions (and annexes to them) on commitments relating to establishment and trade in services is so long and complicated that probably no single person knows exactly all the privileges and reservations. From the business point of view, it would be desirable to prepare a detailed list of activities (and modes of their supply) where liberalisation has been offered.

¹⁰ The study was commissioned by the EU prior to the conclusion of the negotiations. There is an earlier quantitative study, coordinated by CASE, but it is not relevant today as it was prepared in a period when the content of the AA was not known (in 2008) and projected scenarios were purely theoretical. See: Maliszewska 2008.

may still grow, given that exports expand from a much lower baseline than imports. The DCFTA-related effects on the EU trade are negligible. Average wages in Georgia are projected to increase 3.6% over the long run. Meanwhile, the overall consumer price index is expected to decrease by about 0.6 percent. This implies that – on average – purchasing power of Georgian citizens increases because of the DCFTA, especially in the long run. For the EU, changes in wages and prices are again *negligible*.” (ECORYS & CASE 2012, p. A14). The study also mentioned the costs related to the implementation of the AA: “DCFTA will lead to approximately four percent of the Georgian labour force needing to change their sector of employment.” The authors suggest that the costs could be higher for the less skilled workers. Thus, the ease of labour adjustments in practice will be crucial for actual gains from the DCFTA. Given Georgia’s size and modest share in the EU’s total trade with the world (0.1%) - the overall effects of the Agreement for the EU should be negligible.

In view of the earlier information on the low level of protection, these calculations seem to be overestimated in the short term. One explanation for these relatively optimistic estimates is that they were done a few years ago, when the level of tariff protection in Georgia was higher¹¹ (thus its elimination was assumed to result in the creation of bigger trade flows). In the long term, the export increase should be higher due to better adjustment of Georgian products to the EU technical and sanitary requirements. Georgian imports will depend mostly on the demand and purchasing power of Georgian society, which can improve due to expanded exports to the EU.

7. Review of non-quantitative opinions on DCFTA EU-Georgia¹²

The above formulated assessment of the AA and its comparison with the EAs can be compared to other non-quantitative opinions presented in the literature. There are two comprehensive studies available which reflect on the DCFTA from the point of view of the Georgian economy. Both are very critical and stress the high costs involved in DCFTA’s implementation.

The older study was prepared by P. Messerlin et. al. (in 2011). The authors argue that the Commission’s approach in the form of a DCFTA between EU and Georgia is bad from three perspectives. Firstly, it is deemed to be “bad

¹¹ The authors of the study assumed that the applied tariffs in Georgia were 12% for the majority of products (ECORYS & CASE 2012, Table 7.3).

¹² We skip here the Commissions’ opinions which are “by definition” very positive and usually refer to the estimates of the above-mentioned study prepared by ECORYS and CASE.

development policy for Georgia. It requires Georgia to adopt and implement an enormous amount of imprecisely identified EU internal market regulations that go way beyond strictly trade-related matters, with no attempt to identify those that make sound economic sense for Georgia. (...) The burdensome regulatory changes imposed on Georgia are equivalent to taxing Georgian production—endangering its growth and the sustainability of its reforms” (Messerlin, Emerson, Jandieri, Vernoy 2011, p. I - iii). The authors calculated that the adoption of EU sanitary and phytosanitary (SPS) standards by Georgia could raise food prices by 90% (Messerlin, Emerson, Jandieri, Vernoy 2011, p. 72).

Secondly, they concluded that “the Commission’s approach is also bad *commercial* policy for the EU since it would lead to an expansion of the trade between Georgia and non-EU countries, rather than between Georgia and the EU. Georgian consumers would be induced to import what Georgian producers could no longer sell because of EU norms; and their low incomes would induce them to turn to imports from non-EU sources that are less expensive than those from the EU. Meanwhile, in order to survive the vast majority of Georgian producers who would not be able to sell their products anymore on Georgian markets under EU norms would try to sell them to foreign markets not observing EU norms, thereby artificially boosting Georgia’s exports to non-EU countries.” (Messerlin, Emerson, Jandieri, Vernoy 2011, p. I - iii).

Thirdly, the authors argue that “the Commission’s approach is bad *foreign* policy for the EU.” The reason is that “preconditions are being imposed on a country that is granted no EU membership perspective (...) They would make EU DCFTA partners appear like EU member state clones, but i) without full access to the EU markets in agriculture and services, ii) without EU aid and iii) without a voice in the future EU decisions - clearly an unacceptable proposition.” (Messerlin, Emerson, Jandieri, Vernoy 2011, p. ii).

A recent paper by I. Dreyer (2012) also contains a number of reservations with regard to the Georgian DCFTA. The author’s assessment echoes Messerlin’s critical arguments as she calls into question certain political conditionalities and the overestimation of the benefits in EU documents assessing the AA, and criticises the very demanding legal alignments expected from Georgia, in particular in the field of technical and sanitary standards. Furthermore, she contrasts the lack of a prospect of EU accession with the adjustment costs: “The EU continues to push for regulatory alignment. Yet this is problematic. The EU is dealing with economies that are much poorer than the EU’s poorest member states. For them [those economies - EKW], integrating EU standards into their legislation, and in particular putting them into practice, will be costly and will probably fail.” (Dreyer 2012).

One should probably agree with the argument contained in both studies about the demanding and costly nature of EU requirements regarding regulatory adjustments of Georgian products. However, such strong criticism does not seem justified. It is not clear why P. Messerlin et al, estimated that agricultural prices would go up by 90% (!) as a result of the adoption by Georgia of EU SPS measures. Of course, certain price increases will appear following the changes of methodologies of production and adoption of new standards (e.g. relating to the microbes content in milk or cheese). They will affect, however, only some – not all – groups of products. Even more importantly, the list of compulsory alignment of SPS standards (and the product groups affected) will be presented by the Georgian Government only after the entry of the Agreement into force (Article 55, point 4). Therefore, it is too early to make any reliable estimates as to the price increases. Next, meeting the EU standards for products is a *sine qua non* of exporting to this market. The more producers apply those standards, the more of them will be able to take advantage of the opportunities of the huge EU market. Last but not least, while some price increases will appear, perhaps the higher health standards will lead to lower costs of the health services, a smaller number of early deaths, etc. Modernisation involves costs, but it offers benefits as well.

With regard to the point on “bad foreign policy” of the EU – let us repeat that the CEECs at the very beginning of their negotiations concerning their EAs were not offered any prospect of EU membership. The Europe Agreements themselves did not guarantee it either (see more in subchapter 2).

8. Concluding remarks

Our analysis has revealed that the positive effects from the simple elimination of tariffs and other border-crossing barriers under the DCFTA will be limited. This assessment applies both to the liberalisation of Georgia’s imports and EU imports from Georgia. The reason for this is that Georgia was a very open economy already before the AA entered into force and enjoyed preferential access to the EU market (under GSP plus). Therefore, the deeper DCFTA, providing for the elimination of numerous non-tariff barriers, reforms of the legal system and institutions, stabilisation of laws and increased credibility of the country for foreign investors, is more promising than any simple free trade agreement. Its benefits also include support for strengthening domestic institutions to help achieve the desired outcomes. Thus, the main benefits of the DCFTA will stem from making Georgia a better place to conduct business and invest in.

Modernisation of the economy is a pre-condition for improvement of competitiveness (with or without association), and this cannot be done without FDI. Therefore, increasing Georgia's credibility as a good place for locating FDI is of crucial importance, and the DCFTA is an instrument to help achieve this goal.

Taken as a whole, the AA is an instrument which has the potential to enhance Georgia's position as a country on the path to a full market economy, based on democratic values, strong and stable domestic institutions, and on EU-related legislation. In this way the Agreement should anchor Georgia into the western economic and political system.

It is equally true, however, that in order to reap the benefits offered by the DCFTA, deep domestic reforms are necessary. They include not only changes in the law, which are necessary, but also adjustments of the technical and sanitary standards of goods and related restructuring of the pattern of production. Clearly such adjustments will involve significant costs. Thus, additional funds are necessary to implement these reforms. Domestic funds are scarce, so greater financial involvement on the part of the EU is required. The EU should provide both expertise and financial assistance for the adoption of the provisions of the DCFTA and the entire Association Agreement. The DCFTA itself is not sufficient to achieve the expected benefits (Athukorala, Waglé 2013). The association process requires accompanying measures in order to mitigate the difficult transition. In this regard, the right domestic policies implementing the AA and supporting adjustments are of crucial importance. Also, the above-mentioned EU assistance and expertise to Georgian decision-makers would help greatly. In particular, assistance and expertise offered by EU Members from Central and Eastern Europe would be most useful, as these countries have gathered plenty of their own experiences with economic and political transformation.

The fears expressed that adjustment costs will be massive and will result in the bankruptcy of many Georgian producers seem to be exaggerated. Most of the DCFTA-related adjustments are necessary for Georgian producers themselves to have a level-playing field with competitors, both domestically and in the EU. In particular, if Georgian producers want to gain easier access to be competitive on the huge EU market (as well as the markets of other developed countries) they have no other choice than to meet partners' requirements. Without such adjustments, no substantial improvement of the competitiveness of the economy will be feasible.

Public support is necessary in order to speed up the appearance of economic benefits. Without them, "integration for its own sake or the adoption of the "EU model" will not necessarily be beneficial" (Hoekman 2007, p. 18). Formal implementation of the AA alone, not followed by a visible increase in exports of goods and of other types of economic cooperation, will be a failure. In such a case,

the additional costs involved will not be compensated for by extra advantages. Even more dangerously, the present quite positive approach to EU integration may turn into a high scepticism which later will be difficult to reverse.

The first thing that should be done to address this challenge is to precede the implementation of the DCFTA in Georgia with a broad information campaign. As of now, very few “average” people know exactly what the AA is about. They usually think that the Agreement will be “good” for Georgia, but without knowledge of the details and not being prepared for tough adjustment burdens. Therefore, many Georgian officials and members of the political elite argue that offering Georgia a free visa regime would be a crucial step towards making the AA more people-friendly and assuring citizens that the EU actually supports Georgia’s European aspirations. Such a decision has been taken recently (in April 2014) vis-à-vis Moldova. The Georgian people claim that their country meets all the formal EU requirements for a visa waiver to a greater extent than (or at least to the same extent as) Moldova, and they do not understand why the EU is still depriving them of a similar solution.

Also, greater EU support for education of young Georgians would be invaluable. Educated people are the greatest asset of every country. Wider access to the EU Erasmus higher education programmes and to academic staff exchanges would greatly improve the growth potential of the country. Thus, the main conclusion is that the DCFTA is a good starting point to make the country more business attractive and to stimulate structural changes in the economy.

At present, the economic, social, institutional and legal distance between Georgia and EU countries is vast, and EU membership seems unrealistic.¹³ However, that may change over time. As D. S. Hamilton correctly maintains: “The Baltic states provide a tremendously positive example. They, too, were burdened by the legacy of being a “former Soviet Republic.” They, too, were rebuffed initially for their “unrealistic” dreams of EU and NATO membership. Although they started two years later than the Visegrad countries and from a lower economic base, they launched such a determined and vigorous set of reforms that within just five years they had caught up with the leading membership candidates in Central and Eastern Europe.” (Hamilton 2005, p. 31). Thus the evolution of the situation in the upcoming years depends greatly on Georgia itself, on broad public support and the right choices of the political elites.

¹³ An additional barrier is the geographical location of Georgia, in that long border with Russia which is difficult to control (mostly along the crest of the Greater Caucasus mountains), and having no border with any of the EU Member States.

The next step might be deeper integration of Georgia into the four freedoms of the EU internal market. In this respect, the possibility of Georgia's membership in the European Economic Area might be considered.

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Streszczenie

UKŁAD STOWARZYSZENIOWY UE – GRUZJA: INSTRUMENT WSPARCIA ROZWOJU GRUZJI CZY DEKLARACJA BEZ POKRYCIA?

1 września 2014 r. wszedł w życie (częściowo) układ stowarzyszeniowy między UE i Gruzją. Jego główną część stanowi „Umowa o pogłębionej i całościowej strefie wolnego handlu”, która przewiduje pełną liberalizację handlu wyrobami przemysłowymi i znaczącą redukcję barier w handlu rolnym. Istotną część umowy jest poświęcona eliminacji regulacyjnych barier dla handlu (np. standardów technicznych). Umowa przewiduje też stopniową i częściową liberalizację handlu usługami, jak też szybką i głęboką eliminację barier w zakresie przepływów kapitałowych. Liberalizacja przepływu pracowników ma bardzo ograniczony zakres.

Postanowienia układu stowarzyszeniowego UE–Gruzja są podobne do Układów europejskich podpisanych wcześniej przez państwa Europy Środkowej i Wschodniej, jakkolwiek istotne są też różnice.

Oczekuje się, że układ stowarzyszeniowy przyniesie wiele korzyści Gruzji, w tym (a) stabilizację jej systemu ekonomicznego i prawnego, czyniąc go w efekcie bardziej przewidywalnym dla inwestorów oraz bardziej przyjaznym dla przedsiębiorców; (b) zbliżenie wielu przepisów do tych, które obowiązują w UE, co rozszerzy rynek dla gruzińskich towarów i usług; (c) lepsze wdrożenie przepisów ważnych dla biznesu. Krótkookresowe korzyści wynikające z liberalizacji handlu będą skromne dla Gruzji, częściowo z uwagi na otwarty dostęp do jej rynku już przed wejściem Układu w życie. Implementacja Układu będzie się też wiązać z kosztami dostosowawczymi, które są zazwyczaj nieuniknioną metodą wzrostu eksportu na wielki rynek UE.

Słowa kluczowe: układ stowarzyszeniowy, Europejska Polityka Sąsiedztwa, strefa wolnego handlu, stosunki UE-Gruzja