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## **Economic Regulation and State Interventions. Georgia's Move from Neoliberalism to State Managed Capitalism**

Christian Timm



## **The Author**

### **Christian Timm**

Christian Timm is a researcher at PFH Goettingen and works within the framework of the research network „Institutions and Institutional Change in Postsocialism“ funded by the Federal Ministry of Education and Research (BMBF). His research focuses on state- economy relations and economic policy in Central Asia and the Southern Caucasus. He holds a degree from European- University Viadrina and is a PhD candidate at Humboldt-University Berlin.

# **Economic Regulation and State Interventions. Georgia's Move from Neoliberalism to State-Managed Capitalism**

Christian Timm (PFH Göttingen)<sup>1</sup>

*Abstract:* This paper explores the change in the Georgian economic policy from neo-liberalism to state-managed capitalism that occurred between 2003 and 2012. Centering on the distributive effect of institutions, the analysis reveals the underlying dynamic of that policy change. The paper argues that the introduction of a radical liberal regulatory environment contributed significantly to the development of informal state interventions in the economy. However, the Russian-Georgian war in 2008 destroyed the increasingly undermined FDI-oriented liberal development model and forced the government to alter its economic policy. By relying on established informal instruments of intervention and the development of an official economic development agenda, a specific form of state-managed capitalism evolved in Georgia in the period that followed.

## **A. Introduction**

There have been two perspectives to study state-business relations in Georgia between 2003 and 2012. In the first account, Georgian politics has been perceived as an eminently consequent attempt of turning the liberal economic theory of von Mises and von Hayek into reality. The extensive deregulation policy and the restriction of the state to only provide for a neutral and minimal regulatory framework were meant to boost the Georgian economy and to leave behind the fate of a region historically known for corruption and red tape. The success of the liberal reforms has been mirrored, inter alia, by the 9th position in the Doing Business Index (Doing Business 2013) or excellent ratings in categories such as labor freedom (3th), business freedom (16th) or trade freedom (6th) (Heritage Foundation 2013, pp. 219–220) . As a result of the continuous improvement of the entrepreneurial environment, the World Bank honored Georgia as the global top reformer for the past five-year period (2005-2010) (World Bank 2010).

In contrast to this first perception, the development of government-business relations can be understood as being characterized by massive interferences of state agencies

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and state officials into the economy. The monopolization of economic sectors, continuous infringements on property rights and a general supremacy of the state over the economy are elements of an alternative perspective which is manifested in local reports and worst rating results in categories such as property rights (131th) or lacking local competition (127th) (World Economic Forum 2013, p. 175).

While the former perspective superficially focuses on institutional reforms, the latter solely pays attention to the behavior of actors, more specifically the arbitrariness and wrongdoing of the state. The objective of the paper is to combine both perspectives and to provide a framework of understanding, in which the antagonistic indications, a liberal regulatory policy and massive state interferences can be comprehended.

It will be argued that the liberal deregulation policy after 2003 was initially driven by anti-corruption and a deep-rooted suspicion towards state authorities. The consequential reforms resulted in a massive decrease of state supervision and a radical privatization of economic relations. As a consequence, formal rules forfeited their function of mirroring and perpetuating power relations. The low regulatory density and the prevailing dogma of non-intervention contributed to a relocation of the distribution of economic advantages from the formal to the informal sphere. The paper will show how state authorities by deploying various forms of informal intervention significantly shaped the distribution of economic advantages.

Furthermore, the paper argues that the August war in 2008 implied a turning point for state economic policy. Given the ruined perception of Georgia as a trustworthy investment location, the government reacted by introducing a state-driven development agenda, implemented both formally and informally. The paper will argue that the evolution of informal interventions significantly contributed to an evolving state-managed capitalism in Georgia. Instruments, which had been applied earlier for the pursuit of purely political and private interests, now appeared to be useful in promoting economic development.

The paper reveals the dynamic of Georgia's economic policy and demonstrates that the introduction of neo-liberal reforms did not establish a liberal economy, but instead led to a form of state-led capitalism in the medium term. The Georgian case can thereby contribute to the debate on state-managed capitalism, which appears to evolve as a new economic paradigm in the post-communist region (Bremmer 2009; Kalyuzhnova and Nygaard 2008).

## B. Theoretical Background

Economic policy in the post-communist region has significantly changed within the last decade. The 1990s had been characterized by the pre-eminence of FDI-oriented development models, which entailed comprehensive liberalization reforms and a restriction of the state to a silent facilitator. Regional pioneers of growing state-managed capitalism have been, first and foremost, resource-rich countries like Russia and Kazakhstan, which responded to the experienced vulnerability of their economies to external shocks (Bremmer and Johnston 2009). Deployed interventions range from financial market support and the provision of state funds to re-privatization and greater state ownership (Kalyuzhnova and Nygaard 2011). Apart from formal tools, state officials interfere and coordinate economic activities by using informal means. As a result, privately owned but politically favored companies, which enjoy tight relations with state officials, often dominate national markets. The rise of state-managed capitalism, being clearly accelerated by the recent economic crises, has not only become a common phenomenon of post-Soviet countries, but is related to a worldwide process of growing state influence in the economy (Bremmer 2009).

In order to reasonably differentiate the continuum between liberal economic policy and state-managed capitalism, this paper applies a definition of economic policy that distinguishes regulatory policy (order policy) from process policy (Tuchtfeldt 1982). Regulatory policy aims at the creation of a legal basis of economic activities. By shaping, amongst others, the forms of property rights or the constitution of enterprises as well as the rules of interaction between economic subjects, regulatory policy sets the framework in which economic processes take place. Contrary to that, process policy intends to directly influence the outcome of specific economic processes by state interventions. Process policy may comprise forms of transfer payments, credits, fixing of market prices, tax and interest regimes as well as controlling property and income distributions, e.g. by specific succession legislation. Often process policy focuses on the promotion of specific sectors (industrial policy) or superior macro-economic objectives (stability, employment rate) (Berg *et al.* 2007). The example of the East-Asian states most impressively demonstrate the effectiveness of process policy, having managed to achieve high and long-term growth rates by deploying an agenda of active state interventions (Sindzingre 2009).

The interface between regulatory and process policy is constituted by the fact that both influence the distribution of economic advantages. This argument is obvious for process policy but needs some explanations with regard to regulatory policy. Regulations create predictability by constraining available options for action. A regulation may be equally valid to everybody, the specific content of the restriction, however, entails an unequal distribution of advantages (Knight 1992). Stigler (Stigler

1971) made this characteristic of regulations central idea of his economic theory conceptualizing regulations as an additional market good. Enterprises demand and seek to influence regulations in order receive advantages. Contrary to such a regulatory capture on part of economic actors, regulations may also be subject to political capture as a tool to pursue the self-interest of the ruling elite (Stiglitz 1998). Both considerations share the assumption that regulations are co-produced by various actors (Offe 1984) and reflect the distribution of power within a society. Formal rules are therefore not only a mirror image but also a powerful means for maintaining power relations. This is crucial when examining the effects of deregulation and the consequent abolition of formal regulations and state interventions in Georgia after 2003. Here, North (1990) correctly reminds us that the institutional environment of an economy is not limited to formal regulations but consists of formal and informal rules of economic transaction. Following Georgia's deregulation reforms, the informal institutional dimension may have compensated the potentially eroded relevance of the formal framework as an arena of power competition and means of power perpetuation. This underlines the necessity to include the differentiation of formal and informal state actions in the analysis.

Informal state actions are located on the process level. They correspond to formal process policy in that informal interventions constrain the freedom of action for economic subjects. Depending on scope and frequency, these informal interventions may transform into generalized rules and, hence, significantly change incentive structures of economic activities in the long term. Official process policy differs from informal state interventions in three respects. Formally based process policy must be legalized (by decree, judgment, law), legitimized by publicly communicating the pursued objective of the intervention and, above all, build upon and respect economic institutions set up by formal regulations. Informal interventions, however, are not bound to these restrictions. Informal interventions do not need to remain within the framework of state regulatory policy. In this sense, informal interventions are unrestricted in their relation to state regulatory and process policies. They may occur *ad hoc* and ambiguously as well as strongly institutionalized and embedded in a comprehensive structure of meaning.

In order to grasp the entire range of informal constraints and interventions in the economy, it is reasonable to examine the implementation and safeguarding of basic institutions of market economies, as determined by the state regulatory framework. The (a) freedom of contract, (b) the protection of property rights and (c) open markets are inalienable institutions of a functioning market economy (Eucken 1952) and will provide the analytical framework for the study of informal interventions. Against this background, Georgia's economic policy after 2003 will be analyzed with regard to regulatory as well as formal and informal process policy.

## **C. The Distribution of Advantages before the Rose Revolution**

The decision to implement an extensive deregulation policy and eliminate an active process policy after 2003 is rooted in Georgia's recent history. Following independence in 1991 and the ensuing civil war, Georgia's state-building process has been described as highly critical with regard to the establishment of a state monopoly on the use of force and, hence, with regard to the capacity to design and implement public policies (Wheatley 2005; Koehler and Zürcher 2004). State policy at this time was not aimed at economic development but exclusively at balancing different power groups. Corruption and the integration of different influential societal groups into state-organized corruption pyramids was a reasonable instrument to achieve this aim (Stefes 2006) and constituted a common phenomenon of the first transition period in the post-soviet region (Darden 2001). Thus, corruption pyramids served as an important informal instrument for controlling the distribution of economic advantages (i.e. rents) among influential power groups, and in doing so, contributed to the stabilization of the social order. The scope of this political practice was mirrored in Georgia's ranking as the 7th most corrupt country in 2003 according to the Corruption Perception Index (CPI) (Appendix 1).

Within the relevant power group, criminal networks presented one of the most influential groups in Georgia before the Rose Revolution. Based on the socially deep-rooted quasi-legal institution of the thieves-in-law, criminals had entered into mutually beneficial partnership with the government and its officials (Nordin and Glonti 2006). They contributed to political campaigns or even ran as candidates for office (Shelley *et al.* 2007, p. 53). These criminal groups informally controlled access to markets and were key players in some of the most important sectors of the Georgian economy—hotels, restaurants, retail trade (Shelley *et al.* 2007, p. 56). Thus, apart from corruption pyramids, criminal groups significantly shaped the distribution of economic advantages before the Rose Revolution by relying on own sources of power.

Regulations played a decisive role in two respects in this period. Firstly, legal rules constituted the structural prerequisites for the corruption pyramids. The vast number, complexity or contradictoriness of existing regulations impeded rule-consistent behavior and provided respective means for coercion of bribes by state officials (Timm 2012). Around 83% of all papers requested by state officials were solely used for the purpose of extortion (Dadalauri 2005, p. 19). At the same time, regulations were crucial for determining the distribution of advantages. A prime example for this argument is tax favoritism. The 74 tax code amendments adopted between 1997 and 2003 predominantly granted hundreds of exemptions on value-added tax (VAT) and



excise taxes to various sectors and companies with close connections to the ruling elite (Engvall 2008, p. 13), (Dadalauri 2011, p. 160). Responding to these restrictions due to red tape and favoritism, large parts of the Georgian business shifted to the shadow economy (Papava 2005, p. 55).

Table 1

Period	Policy	Formal Dimension	Informal Dimension	
Before 2003	Balancing Power Groups	Distribution of advances by tax exemptions, licensing etc.	Thieves In Law	Corruption pyramids

## D. A Liaison of Anti-Corruption and Libertarianism

The Rose Revolution in 2003 opened a window of opportunity to break through this inherent logic. Given the kleptocracy of the Shevardnadze era, the new Georgian policy makers exhibited a serious suspicion towards any form of state control or regulation (Transparency International 2008, p. 5). State and its purposeful creation of red tape had been identified as the decisive evil responsible for the failure of the Shevardnadze regime. Economic policy was consequently based on the idea of limiting the role of the state in the economy in order to free economic activities from state corruption. In more general terms, the entire state reforms after 2003 must primarily be understood within the framework of the anti-corruption policy of the new political elite (World Bank 2012).

This attitude fitted well with the radical school of thoughts of libertarianism that an influential part of the new Georgian policy makers subscribed to (European Stability Initiative 2010a). “Supporters of this anti-state school of thought want to leave as many areas of society as possible down to individual personal responsibility or market forces. They regard state intervention in the economy and the provision of public goods such as education and health care by the state as a disenfranchising and inefficient evil.” (Jobelius 2011, p. 1). Libertarian US-think tanks closely accompanied the reforms (European Stability Initiative 2010b) and contributed intellectually to the formulation of the ‘Georgian Model’ as an alternative model of development (Timm, forthcoming). Distinguishing from its own recent past and, of course, the political enemy Russia, the imagination of a creating an own model of development and being the avant-garde for other countries in the region, contributed once more to the radicalness of the reforms.

Consequently, regulatory reforms after 2003 were driven by two interwoven principles. (1) Only those rules and regulations should be left in place or implemented whose enforcement can be guaranteed by the state (Interview Lejava 2012). This guarantee comprises two promises: first, the state capacity to work free of corruption and, second, the ability to enforce the existing legislation including punishment of wrongdoings. This approach was (2) backed by the libertarian persuasion of a free as possible market and the consequent principle that the state has to withdraw from limiting economic activities by specific requirements.

## **E. Free Economy and the Privatization of Economic Relations**

### **I. Regulatory Policy**

The specific amalgamation of a strong anti-corruption agenda and a corresponding ideology of libertarianism led to the implementation of an extraordinarily extensive liberalization policy in Georgia. The retreat of the state had immediate effects, as it massively diminished market barriers and decreased transaction costs. A prime example is the reform of licenses and permits. The Law on Licenses and Permits adopted in 2005 and its subsequent amendments dramatically reduced the number of activities subject to licensing and permit-issuance by more than 90% from 909 (Bagaudinova *et al.* 2007) to finally 45 licenses and 52 permits (Georgian National Investment Agency 2013). As for now, many economic activities do not require licenses anymore. Comparably, the number of taxes has been considerably decreased from 21 to only 6 (Transparency International 2010a, p. 2). Regarding trade barriers, the government followed a strategy to reduce customs duties gradually up to absolute abolition (Policy and Management Consulting Group 2010, p. 13). With over 80 percent of imports entering Georgia duty-free, the trade weighted tariff rate is currently still low at 0.4 percent (Heritage Foundation 2013, p. 220). With respect to starting a business, Georgia created one of most favorable regulatory conditions in the world. Only two procedures and no minimum capital are required to open a business in Georgia (Appendix 1).

Apart from diminishing market barriers, the general suspicion toward the state stimulated the new policy makers to massively decrease the regulatory density of business legislation, and, hence, decreased state supervision over the economy. This consequent privatization of the privity of contract can be observed, among others, in the labor code, the corporate law and the anti-monopoly legislation. The Labor Code adopted in 2006 is a radical example of the state's retraction from regulating economic relations. Usually intended to balance the unequal relationship between the

employer and the employee, the new Labor Code abolished internationally acknowledged standards of the protection of workers (Jobelius 2011, p. 3; European Commission 2008). The withdrawal from framing and supervising this specific contractual relation is mirrored by the reduced number of articles from 250 of the former Labor Code to only 55 in the new legislation (Shvelidze 2012). A particularly decreased regulatory density can be found in the Law on Entrepreneurship, constantly amended between 2005 and 2009. The amendments, which were to the clear detriment of creditors, abolished, inter alia, the minimum capital for the foundation of a stock corporation or a limited liability company (Article 5, 51). It also removed the assessment of transferred assets by an independent expert (Article 3). The liberalization of capital protection (minimum capital, capital preservation, profit distribution) provides the possibility for the General Meeting or the majority shareholder to use the profit at any time no matter whether the remaining capital will be sufficient for the future activity of the corporation (Kikalishvili, forthcoming). Due to lacking state regulations, creditors completely rely on private contracts in order to protect their interests (Kikalishvili, forthcoming). With respect to competition policy, the Georgian parliament analogically changed the direction of the legislation. The former Law on Monopolistic Activity still restricted market dominance and monopolistic activities. The 2005 Law on Free Trade and Competition, in contrast, was directed exclusively on the prohibition of state action, which might limit the market. According to Article 3 (c, e) the law aims at „breaking down any discrimination barriers set up by the state or local authorities and elimination of any grounds for their appearance [and] not allowing state or local authorities to assume such international obligations which could impede free trade within and outside Georgia.“ (Law on Free Trade and Competition). The new law did not provide any regulations with respect to agreements between companies, the abuse of a market dominant position or merger control, which present basic components of modern competition legislation. Consequently, the Georgian Anti-Monopoly Agency was replaced by the Agency for Free Trade and Competition, exclusively responsible for procurement and state aid (Transparency International 2012a, p. 11). Between 2005 and 2012 the Georgian market was open to all kinds of mergers and agreements between entrepreneurs, both on the horizontal and vertical level. No competition control mechanisms existed or were deemed necessary by Georgian policy makers. (Gabrichidze 2013, p. 52)

Consequently, this limiting-state policy resulted in a gradual abolition of state control bodies such as the Anti-Monopoly Agency (2005) or the Food Quality and Control Service (2006). As the closure of agencies was clearly favored over their restructuring (Di Puppò 2011), even the abolition of the National Bank as liberation from state monetary policy had been discussed (Interview Gogolashvili 2012).

The regulatory dismantling was accompanied by simplifying administrative procedures. The introduction of One-Stop-Shops, e-governance for taxation or procurement, the reform of the public registry or the simplification of administrative procedures for obtaining licenses contributed to a further decrease in transaction costs and points of contact with the state. The administrative restructuring had been the second most important component in the framework of the anti-corruption policy.

## **II. Process Policy**

The inherent suspicion against the state guiding regulatory reforms found its continuation in a clearly negative attitude towards any kind of intervention, the prioritization of certain sectors or the promotion of an industrial policy (Interviews Kovsiridze 2012, Lejava 2012). Even the promotion of small and medium enterprises was perceived as a violation of market rules (Gogolashvili 2011, p. 185). Consequently, Georgia introduced a flat tax system with unified tax rates and very rare tax exemptions. According to the last Tax Misery and Reform Index (Forbes 2009), Georgia has the lowest tax rate in the post-communist region and is rated the 4th most tax friendly country in the world. Price controls exist only in areas of natural monopolies and are enforced by the National Bank in the insurance sector as well as by the Georgian National Energy Regulatory Commission and the Georgian National Communications Commission for regulating prices in the energy and telecommunication sector (Mehta 2006, pp. 385–387) . Monetary policy of the National Bank of Georgia was mainly objected on price stability (International Monetary Fund 2012, p. 13) and stuck to a “less interventionist exchange rate policy”. (European Commission 2011, p. 9). The instrument of state aid or subsidies were sparingly used and apart from cultural and social organizations and (state- owned) public utilities only granted to grape farmers who were most affected by the Russian trade embargo since 2006 (Vardiashvili 2010). To conclude, given the fact that no serious interventions on part of the government were conducted, a process policy between 2003 and 2008 was clearly absent.

## **III. Results of a Limiting-State Policy**

The obvious success of the reforms seemed to prove the government right. GDP grew between 2005 and 2007 by almost 10% annually and FDI constantly increased up to US\$ 2 billion in 2007, equivalent to approximately 20% of GDP (Appendix 1). In terms of fighting corruption, Georgia managed to climb up the CPI within four years from 127th position (2003) to 79th position (Appendix 1). This means that starting from one of the worst positions, Georgia became, apart from the Baltic States, the

regional leader in fighting corruption. This had been attributed to the success of deregulation policy in terms of abolishing red tape as a central structural characteristic of the Shevardnadze era. Simplifying regulatory requirements and administrative procedures decreased the capacity for extensively extorting bribes. The consequent possibility for economic actors to adhere to rule-conform behavior contributed to an increased legalization of business in Georgia (Appendix 1). Due to the implemented radical regulatory reforms, Georgia managed to become a leader in the Doing Business Index, currently ranked at 9th position (Doing Business 2013) and holding the 20th position in the Index of Economic Freedom (Heritage Foundation 2013, pp. 219–220) .

By reorganizing state administration and security structures, the new government also managed to lay the foundation for the establishment of a minimal but capable state. It succeeded in establishing a state monopoly on the use of force and, apart from Abkhazia and South Ossetia, to reestablish a unified state territory. As a result of the anticorruption reforms, the government removed the main important integration instrument of the Shevardnadze regime: corruption pyramids. In the course of the state-reforms, the Saakashvili administration was also able to abolish the strong informal institution of the thieves-in-law and achieved to establish state rules as the 'only game in town'. In doing so, the government eliminated two central institutional elements that formerly steered the informal distribution of advantages during the Shevardnadze era.

Moreover, Georgia's limiting-state reforms tremendously privatized economic relations after 2003. The massive reduction of regulatory density limited the possibility to determine the distribution of advantages by means of formal rules. The less regulations exist, the less behavior is restricted and the less exemptions can be granted. This limited possibility to produce winners and losers by legislation has been backed by the negative attitude towards any form of process policy, which would provide vast chances to influence the distribution of economic advantages. As a consequence, by privatizing economic relations, the ruling elite and influential power groups gave up another powerful instrument of control by state regulatory and process policy.

## **F. State Activism: The Informalization of State Interventions**

Evans (Evans 1995) defined the characteristic of an ideal state as “embedded autonomy”, emphasizing the needed balance between the autonomy of the state as an independent actor and its embeddedness in social networks. Thus, state actions (the creation of rules, interventions etc.) are at best co-produced (Offe 1984) and expressions of self-interest of state elites and reflect power relations within a given society. In Georgia, the relevance of formal state action for expressing interest and power relations might have been limited due to the privatization of economic relations. However, this does not imply an automatic loss of relevance of the state. As will be demonstrated in the following, state action aimed at influencing the distribution of advantages shifted from formal state policy to informal means of interventions. In order to grasp the entire scope of informal state interferences, the safeguarding of property rights, openness of the economy and freedom of contract will be examined.

### **I. Protection of Property Rights**

Property rights are protected by the Georgian Constitution (Article 21) and codified by the Civil Code (Art. 170-173). The legal framework governing ownership and privatization of the extractive industries, the financial sector or intellectual property are codified by separate legislation. However, international rankings point toward a significant discrepancy between legislation and its enforcement. The Global Competitive Index (World Economic Forum 2013, p. 175) ranks Georgia 131th out of 144 with regard to property rights. Georgia is also in the bottom 20 percent of 129 countries ranked in the International Property Rights Index (Property Rights Alliance 2011), standing at the 113th position. While the expropriation of property, as defined by the Georgian legislation in case of inevitable public need (Grant Thornton 2012, pp. 11–12) , has not been documented, different forms of infringements of property rights as means of informal interventions are prevalent.

#### **1. De-privatization**

The ‘voluntary donation’ of property to the state by business enterprises, mostly for its subsequent re-privatization, occurred as a first type of interference in property rights and dominated the initial period after the Rose Revolution. As no law for de-privatization of unlawfully attained property existed in Georgia, coerced donation was considered a legitimate equivalent (Rimple 2012, p. 110). As an investigation of the Ombudsman on the Gori district exemplarily illustrates, all significant enterprises in

the district, subsequent to the change of government, were 'voluntarily' transferred to the local authorities without compensation. The property was registered either on the municipality or on the head of the local administration (Public Defender of Georgia 2005, pp. 62–65) . Gori presents not an exemption in this respect but is rather symptomatic for the approach of the government. "Businessmen were invited from different state agencies, by the ministry of interior, by financial police and were under pressure to return their property to the state." (Interview Papava 2012). The scheme contained a second component: a "second privatization" through property tenders, by which the acquired property was again sold. According to local observers, these transactions were often won by companies, which had been founded shortly before and characterized by opaque ownership (Interview Papava 2012). Often, these companies grew quickly and developed over time into potent service providers for the state (Rimple 2012, p. 113).

The processes of de-privatization and second privatization, predominantly in 2004 and 2005, led to massive re-distribution of property with a clear objective: "[...] the infringement of the property right aimed at distributing this property amongst the so-called elite businessmen standing close to the government." (Papava 2009b, p. 24). In addition, the state benefited directly from this re-distribution of property as revenues from the "second privatization" went into the budget. This was especially important after the Rose Revolution when the state was in need of collecting revenues. Although this form of intervention occurred selectively in later years (Radio Commersant 2012b), in time it was increasingly replaced by another mode of operation.

## **2. Coerced Sale**

The second form of infringement perpetuated the process of re-distribution of property, but circumvented the intermediate step of de-privatization. Instead of a second privatization, ownership was directly transferred or sold to other individuals or companies. The transfer of entire enterprises was carried out by acquiring shares, with the objective of profit sharing or holding majority control. Enterprises and shares were again transferred without compensation or for a price lower than the actual value.

One prime example is "Senta Petroleum", a locally owned petrol station network, which was targeted by state authorities in 2011. The Georgian gasoline market underwent a process of market oligopolization between 2003 and 2012 (Transparency International 2012a, pp. 17–31) and was supervised informally by the former Minister of Defense. When a new competitor, registered to a close friend of the former Minister Kezerashvili (Todadze 2012), entered the market in 2011, the owners

of Senta were forced to sell the company to him. During the negotiations, not only the price decreased from initially GEL 28 million to 23 million (Radio Commersant 2012d), the owners were also put under pressure by the tax authorities resulting in a plea bargain agreement of GEL 6 million to settle the case (Interview Kakulia 2012).<sup>2</sup>

Due to its regularity and persistence over a longer period of time, the transfer of shares or entire companies has by now become an expectable procedure for Georgian entrepreneurs. If a company reaches a critical size, it runs the risk of being placed under the control of state or party officials. A turnover of more than 100.000 Lari, a level from which companies are categorized as medium business, is mentioned as a critical size (Interview Papava 2012, Interview Tvalchrelidze 2012). This form of re-distribution of property is more discretionary as no intermediate registration on state bodies is needed.

After the defeat of the United National Movement in the parliamentary elections in 2012, the scope of this form of infringements has been becoming increasingly visible. In rare incidents property has been already returned (Radio Commersant 2012f), but thousands of applications are still waiting at the Public Prosecution Office for their revision in order to have property returned (Radio Commersant 2013a).

### **3. Coerced Bankruptcy**

Coerced bankruptcy as form of infringement of property rights is the most subtle and most difficult to prove by data. The purposeful bringing about of a companies' bankruptcy without sound reason can be done by excessive tax claims on part of the Revenue Service (Interview Shergelashvili 2012) or by informally restricting access to markets, resources or bids on state contracts.<sup>3</sup> While excessive tax claims often led to the confiscation of property by the state (Radio Commersant 2012a), informally restricting economic activities resulted rather in a creeping bankruptcy of the company or the devaluation of property.

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<sup>2</sup> For a more comprehensive illustrations of the changes of ownership in key sectors of the Georgian economy see Rimple (2012).

<sup>3</sup> See next section.



## II. Open Markets and Competition

Officially, the regulatory reforms after 2003 focused exclusively on an *ex ante*-promotion of competition by guaranteeing openness i.e. equal access to markets and low transaction costs. Thereby, the government neglected the possibility of an *ex post*- promotion of competition by controlling the potential abuse of market dominance. Admittedly, competition policy is considered an instrument of ensuring a functioning price mechanism by controlling or preventing monopolies and, thereby, a basic requirement of liberal market economies (Eucken 1952).

Georgia's bad rankings in the "intensity of local competition" (128/ 144) or the "extent of market dominance" (112/144) (World Economic Forum 2013) suggest a massively lacking competition on the Georgian market. The crucial question is, whether this situation is caused by abused market power of dominant companies due to the absence of competition policy or actively influenced by state authorities. Different forms of infringement suggest that lacking competition has been decisively stimulated by (a) informal regulation of access to markets and (b) forms of favoritism, which both had significant influence on the distribution of benefits and resources within the Georgian economy.

Some main mechanisms of regulating market access can be demonstrated by the case of Arti Group case, which had been the general importer for products of Procter & Gamble, Gillete, Uni, Dilmah, Sara Lee in the Southern Caucasus until 2007 (Civil Georgia 2007). Signing (and adhering to) exclusive import contracts are usual business practices and clearly advantageous for producers. Simultaneously, they significantly contribute to market concentrations because import contracts create dominant positions in the local markets. These dominant market positions can further be strengthened by limiting the import of alternative products, e.g., by state registration- lists for specific products, such as drugs (Transparency International 2012d, pp. 12–13) . For the Arti Group such formal restrictions did not exist. However, the founder and majority stakeholder of the Arti Group, Kibar Khalvashi, had not been seriously challenged by competitors due to his close relationship to Irakli Okruashvili, the Minister of Defense. However, when Okruashvili went into opposition in 2006, the fate of Khalvashi also changed. On the basis of investigations of the Revenue Service and extensive Tax claims, the Arti Group was finally closed (Civil Georgia 2007).

Saakashvili openly admits the existence of informal restrictions for competitors: "This one company was importing products ranging from toothpaste to nappies. [...] When another company tried to enter the same market, our precious defense ministry [...] prevented it from entering the market by practically using battle tanks. And it happened while we were in power, my brothers." (Civil Georgia 2007). According to

other analyses, like on the above mentioned fuel market, informal access restrictions were no singular phenomenon: “despite the absence of legal barriers to entry, an economic agent wishing to enter to the retail segment of the fuel market faces informal barriers. Otherwise stated, it appears that it is impossible for a new player to enter the fuel market.” (Transparency International 2012a, p. 19). Reports on other commodity markets confirm these findings (Petrosyan 2007; The Messenger 2011).

Analogous to markets, the regulation of the access to state resources appeared to be crucial for the distribution of economic advantages. Despite the reforms of the procurement system and its integration into the e-governance strategy of the government procurements used to remain susceptible to governmental influence as the case of the public bidding process on public transport in Tbilisi illustrates. Conducted in 2010 in a competitive procedure with participation of several companies, the process was won by four companies. The companies were newcomers in the market and registered only shortly before by the same notary with an interval of a few minutes, each with a capital charter of 100 Lari (Putkaradze and Kvira 2011). All companies share addresses with restaurants owned by the GMC Group, which is owned by Merab and Revaz Sharangia. The brothers, belonging to an influential Georgian business family (Rimple 2012, p. 74) are close allies of the president (Putkaradze and Kvira 2011), and the Tbilisi City Mayor (Radio Commersant 2012g). Although the four companies did not officially merge, they started to operate under the common umbrella of the newly founded “Tbilisi Microbus” company (Radio Commersant 2012g).

Apparently, also within a minimal regulatory environment, advantages may be distributed by selective enforcement of rules or granting exemptions. The tax amnesty for politically related media is a widely discussed example (Transparency International 2013a) . According to other reports, up to 100 large companies were not reviewed at all by the tax authorities under the previous government. To secure these advantages, the presidential team wished to subsequently legalize this informal practice by implementing a financial amnesty (Radio Commersant 2013b). The government also violated the principle of equal treatment licensing by granting privileges and better conditions to certain companies in licensing (Radio Commersant 2012a).

The negative assessment of the “effectiveness of the anti-monopoly policy“ (135/144) (World Economic Forum 2013, p. 175) is clearly caused by the formal absence of an effective competition legislation and its administration. However, the range of informal intervention in market institutions makes the redundancy of an official competition policy in Georgia obvious. *Ex-post* interventions with respect to the abuse of market dominance require *ex- ante* free and fair competition, protected property rights and

the freedom of contract. Against the background of the above-discussed infringements, it can be strongly assumed that informal state interventions decisively contributed to the distortion of competition and the subsequent monopolization of markets. Analyses of main sectors of the Georgian economy exemplarily prove that, despite diminished formal barriers, a monopolization or oligopolization of the respective sectors between 2003 and 2012 took place. This is mirrored, amongst others, in sharply decreased market shares of small and medium enterprises, in high retailer prices and low price elasticity (Transparency International 2012a). An official *ex-post* competition control is not only needless considering the informal *ex-ante* infringements; it would have been an obstacle to the discretionary informal process policy of the government.

### **III. Freedom of Contract and Corporate Political Responsibility**

The freedom of contract is guaranteed by the Georgian Civil Code (Article 319) and contains, inter alia, the freedom to conduct (and to rescind from) a contract and to determine its content (Articles 319, 327). Generally, the freedom of contract is mainly tested *ex post* with respect to the enforceability of contracts between private persons. Whether *ex ante* a person wants to make use, in this case of the formally enhanced freedom of contract, and voluntarily decides for its content, however, thereby remains neglected.

Khishtovani and Pirveli (Khishtovani and Pirveli 2012) implicitly take up this question in describing a phenomenon called “Corporate Political Responsibility” (CPR). This cautiously chosen term points toward a practice of Georgian enterprises to act politically sensitive and satisfy particular needs of the state and the ruling party. Corporate Political Responsibility “[...] can be seen when an ordinary private player on the market faces a necessity to complete a “political-economical” activity, usually financially harmful, ruled by the government.” (Khishtovani and Pirveli 2012, p. 3). Different forms of involuntarily conducted political-economical activities as infringements in the freedom of contract such as so-called donations and the repeal of market mechanisms can be found.

#### **1. Donations**

Supporting election campaigns or financing cultural events by the business community are usual phenomena in many countries aimed at maintaining good relations to politics, having good public relations for the company or spending for

charity reasons. The crucial question is whether the spending was made on a voluntary basis.

CPR-related spending can be assumed with respect to financing election campaigns. The ruling party United National Movement received GEL 12.5 million in 2008 as donations from individuals and legal entities. The lion's share of approximately GEL 11.6 million was donated by 454 companies. As no company contributed to the election campaigns of any other party, the Christ-Democratic Party ranked second with only GEL 58,000 donated by individuals (Transparency International 2011a, pp. 12–13) . Reports of pressure exerted on business representatives back the suggested limited voluntariness of electoral support (US Department of State 2011, pp. 1, 59).

Examples of financing cultural events, the investment of GEL 1.9 million into renovating a state library (Radio Commersant 2012d) or the purchase of official cars for the Ministry of Defence (Radio Commersant 2012e) are only the tip of the iceberg of known “voluntary donations of money for certain state and party activities” (Interview Papava 2012). This form of infringement in the freedom of contract did not directly affect economic processes, but has extracted a huge amount of capital to be invested more efficiently in economic activities. Respectively long list of donation from 2004 until 2012 have currently become available as the Ministry of Economy registered donations to the state (Transparency International 2013b). Nevertheless, the entire volume of this specific infringement in the freedom of contract remains difficult to quantify, as no data on donations to local authorities or targeted donations for party activities exist.

## **2. Repeal of Market Mechanisms**

The second form of infringement affects economic processes as the government directly intervenes in market mechanisms. The coerced purchase of grapes and wine in great quantities by various companies in order to prevent economic difficulties for winegrowers due to Russian trade barriers in 2006 (Vardiashvili 2010) presents a first example of repealed market mechanisms. Other instances point on similar short-term measures, for instance to fight high prices in certain sectors of the economy. In one case the Ministry of Interior bought 800 tons of salt to be sold subsequently for half the retail price. This measure aimed at breaking high prices in existing import monopolies (Leigh 2007). In another instance, prices on basic drugs were decreased following an official announcement of the president to fight monopolies in the pharmaceutical sector (Interview Papava 2012). Politically motivated intervention in consumer prices could also be observed prior to elections as an analysis on the

wheat market suggests (Livny and Labadze 2012). Finally, similar to the increased number of staff in the district councils and administrations in the run-up to elections (Transparency International 2010b, p. 9), state authorities also requested companies to increase their number of employees (Interview Papava 2012). The companies were often financially compensated through special state programs set up prior to elections. Examples are the 'national employment programme' covering 50.000 people in 2006 and 100,000 people in 2007/2008 (Papava 2009a, pp. 201–202) as well as specific employment programs for students (Natroshvili 2012). In doing so, a first sign of consideration on part of the state for CPR- related activities becomes apparent.

This form of interventions had an immediate influence on economic processes, because companies, assuming their Corporate Political Responsibility (CPR), ignored existing market mechanisms and acted according to government requests. However, the mentioned examples are not to be classified as informal sector policy, hidden competition policy or unofficial labor policy, as they mostly lack any mid- or long-term strategy, in which these interventions would be embedded. Creating a Corporate Political Responsible business community is a powerful tool for the political elite to please large parts of the electorate and achieve good public relations for the ruling party. As will be shown, CPR can also help the state authorities to steer economic development. The crucial condition for the establishment of CPR, however, is the control of property and use rights.

#### **IV. Constituting an Informal Process Policy**

The above-mentioned informal interventions of state authorities implied deep interferences in the fundamental institutions of the Georgian economy and, in doing so, significantly shaped economic processes and their outcomes. Although partly directed on improving economic shortcomings, this informal process policy pursued clearly political and not economic goals.

The re-distribution of property must be considered an initial step for the objective of creating a financially strong support base for the ruling party. The governmental interventions in property rights (Appendix 2) laid only the foundation for the second element of an informal process policy: Corporate Political Responsibility. The coerced donation of money or employment of workers as violations of the freedom of contract appeared as well-calculated engagements of business. The engagement was stimulated on the one side by the transfer of property to loyal supporters and,

respectively, by the very possibility of informal expropriation and exclusive access to market, resources and state orders on the other side.

Based on these state interventions, a specific pattern of interaction between business and the state emerged that is more characteristic for state-managed capitalism than for a liberal economy. "The government thought that if a company is under political control, this is better for [the state] and also for the company." (Interview Narmania 2012). From a theoretical perspective, it is evident that within a 'symbiotic relationship' between business and the state a monopolization and the formation of "national champions" (Bremmer 2009) is highly advantageous for the ruling elite. Firstly, monopolization reduces the number of market participants to be controlled, leads, secondly, to a higher accumulation of capital, which allows, thirdly, national champions to fulfill political needs. Creating a Corporate Political Responsible business community is a powerful tool for the political elite to please large parts of the electorate and achieve positive public relations for the ruling party. Apart from financial support for the ruling party or populist means to compensate for socio-economic deficits, this may also comprise the possibility of strategic investments in the economy as can be seen in the following.

Table 2

Period	Policy	Formal Dimension	Informal Dimension
2003- 2008	Anticorruption State-building Limiting-state	Libertarian State Deregulation FDI-oriented development model	Property re-distribution Regulating market access Corporate Political Responsibility

## **G. State Activism: An Evolving Development Agenda**

The official economic policy of deregulation and non-intervention 2003-2008 showed the desired effect of abolishing red tape, liberating business from endemic administrative corruption and contributing to an increased attractiveness of Georgia as an investment spot.

At the same time, however, the liberal reforms added to a proliferation of discretionary policy. The privatization of economic relations reduced the role of formal rules as mirror image and means of perpetuation of societal power relations. This function was shifted to the informal arena already firmly established under Shevardnadze. As a result, the distribution of advantages after the Rose Revolution appeared to be organized predominantly through informal interventions by state authorities.

This caused serious implications for the chosen liberal economic model, which was effectively FDI- but not competition-oriented. As liberal market economies are based on guaranteeing the basic institutions (freedom of contract, property rights, free trade), the above-mentioned massive infringements tended to undermine this model in the long term. Thus, the institutional requirements of the chosen development model were in conflict with the given political rationality. The “mixture of Neo-Liberal rhetoric and the Neo-Bolshevik essence“ (Papava 2011) of the economic policy, which became increasingly apparent, would have damaged the attractiveness of Georgia to foreign investors in the long run.

The August War 2008 shortened this process and entailed a radical decrease of FDI (Appendix 1). The subsequent world economic crisis accelerated this process and forced the government to act. Authorities responded by an adjustment of already established formal and informal instruments and their interlocking and shifted to a far more active economic policy.

### **I. Continuation of a Liberal Regulatory Policy**

Along with the destruction of the liberal development model, a deeper economic integration with the EU became increasingly attractive for Georgian policy makers (Interview Gogolashvili 2012, (Transparency International 2009, p. 9). A Deep and Comprehensive Free Trade Agreement (DCFTA) promised a restoration of Georgia's international reputation and far-reaching economic advantages such as unrestricted access to the European market. In order to sign a DCFTA with the EU, Georgia had to implement extensive legislative approximations towards EU standards. Yet

resistance against the regulatory requirements of the EU remained strong. The government firmly insisted on preserving the liberal regulatory environment, partly due to the belief in the importance of this comparative advantage to attract FDI, partly due to its facilitation of discretionary policy. For both the EU and the Georgian government, competition policy was the most critical field for discussion.

After long consultations with the EU, the new Law on Free Trade and Competition was finally adopted in 2012. Although the law prohibited the illegal restriction of competition between enterprises and the abuse of dominant market power as firm objectives of the new legislation (Article 2), no sufficient incentives for a changed behavior of market participants or an efficient state supervision had been created. Firstly, incentives for changing behavior were circumvented by setting the definition of the relevant market too wide and vague and penalties too small. In addition, registrations of mergers are considered only on a voluntary basis for which no *ex ante*- examination is provided (Gabrichidze 2013, pp. 104–106) . Secondly, the law continued the dominant idea of state non-interference and exclusive responsibility of private subjects for the protection of their rights. No *ex officio* control and, hence, no duty of the state to supervise competition was provided by the law. This means, according to the legislation, competition control can only be enforced on the basis of a private initiative (Articles 20-22). To initiate action by the Competition Agency, the complainant has to pay a fee, which even in case of a successful proceeding will not be refunded.<sup>4</sup> More importantly, however, the burden of proof is fully on the complainant (Article 22). As the provision of sufficient documentation is even more difficult for a private person than for a state investigation agency, this legislation constitutes very high barriers. Consequently, the legislative incentives for an effective supervision are very limited. This regulatory analysis is backed by the fact that the agency is not established as an independent state body, protected from governmental influence. It is provided with only 11 employees including a very limited budget on the basis of which an effective supervision of competition is hardly possible (Gabrichidze 2013, p. 163).

A similar picture emerges in the field of food safety, where inspections had also been suspended for years. Although the government started to develop a new food safety strategy in 2010 to meet EU requirements (Jobelius 2011, p. 12) and the European Commission reported progress in this respect (European Commission 2012), new legislation adopted in 2012 puts undue burden on Georgian consumers to protect their rights. In order to initiate an unplanned inspection by the National Food Agency, the consumer has to provide, amongst others, results of a laboratory analysis of the product and a doctor's note confirming the correlation between the disease and the

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<sup>4</sup> The amount of the fee is not regulated by the law but has to be defined by statutory order, which has not been released by the new government.



consumed product (Eurasia Partnership Foundation 2011). Similar to competition policy, the legislator introduced new regulations approximated to EU standards but simultaneously privatized their enforcement. The reforms of the regulatory framework were obviously concessions to the EU but continued the initial regulatory policy of privatizing economic relations.

## **II. An Evolving Official Process Policy**

While the core of the regulatory policy was preserved, signs of an evolving process policy emerged after the August war. The first deviation from former policy can be found in the 2008 Law on Free Industrial Zones, which created the basis for the establishment of free economic zones, first in Poti and later on in Kutaisi. The law provided even more business-friendly regulations and a more favorable tax and customs system than in the rest of the country. Apart from income tax, companies in the Free Economic Zones were completely exempted from taxation (Ministry of Economic Development of Georgia 2013). This approach was continued by the establishment of Free Tourism Zones, enabled by the amendment to the Law on Tourism in December 2010. Investors who made an investment of at least GEL 1 million (\$562,000) in Kobuleti on the Black Sea coast were exempted from profit and property taxes for 15 years (Civil Georgia 2010). Similar conditions were introduced for Anaklia, located next to the Abkhaz border (News.az 2011). As a consequent continuation of the Free Industrial and Tourism Zones, the government also considered the establishment of an offshore financial system under British business law attractive for international financial institutes, which was, however, not realized under the former government (Mellow 2011). The Free Industrial and Tourism Zones still perpetuated and even strengthened the idea of a state, which only provides a minimalist regulatory environment. In 2010, however, the government started to promote specific sector developments and shifted the economic policy from the former dogma of non-intervention towards an active process policy.

A first example for this changed approach is the Georgian Agriculture Corporation (GAC), which was founded in March 2010. GAC is a 100% state-owned company and started to fully operate in 2011. The budget of the Ministry of Agriculture correspondingly grew from 30.6 million GEL in 2010 to almost 120 million GEL in 2011, a large proportion of which was channeled to the GAC (Boivin 2012). GAC supports the agricultural sector, providing a variety of needed agriculture services (USAID 2011, p. 49). Apart from trainings and advice on improving production practices, farm service centers and machinery service centers have been developed to provide farmers with high quality seeds, pesticides, fertilizers and veterinary supplies. New farming techniques and modern technologies were also made

available through a diverse range of projects (USAID 2011, pp. 46,51). So far, GAC helped to cultivate 25 thousand ha of land in 2010, and increased that to 49 thousand ha in 2011 (Boivin 2012).

A new instrument of the Georgian government to promote economic development was established with the Partnership Fund in June 2011. A 100% government-owned shareholding company, the fund is mandated to extend guarantees for projects in the energy sector and develop cooperation between the private and public sector to promote investments in agriculture, manufacturing and the real estate sector (Khurtsia 2012). Projects should be financed by loans from international financial institutions, co-financed by the private sector as well as by revenues from privatization and dividends from state-owned enterprises (SOE) (Transparency International 2011b). The current asset base of the Partnership Fund exceeds 4.3 billion USD due to transferred government stakes in major state-owned enterprises, including Georgian Railway, Georgian Oil and Gas Corporation, Georgian State Electrosystem and others (Partnership Fund 2013). Dividends and revenues from privatization amounted to approx. 120 Mio US\$ in 2011 (Transparency International 2011b). According to one expert, three projects have been realized, one in the hydropower sector and two in agriculture (Interview Tvalchrelidze 2012).

Tourism is another sector where the active promotion of economic development on part of the GoG can be observed. In 2011, the Georgian government invested more than 170 Mio US\$ in the prioritized Black Sea region of Adjara, mainly in infrastructural modernization (German Trade and Invest 2011). The implementation of development projects in the tourism sector by SOE like Sairme LLC played only a minor role, because private investors became increasingly interested in the region. Between 2008 and 2011, more than 566 Mio US\$ were invested in Adjara, 70% of which came from foreign investors and 40% were put into tourism (German Trade and Invest 2012). However, in order to achieve the ambitious goal of the government to establish competitive tourism clusters at 20 places until 2020, the government focuses on strengthened cooperation in the framework of public-private partnerships (German Trade and Invest 2012).

The Georgian government also decided to develop a state wine industry. The wine-producing sector has been faced with tree shock since 2006: a lose of 80% of its market due to the Russian trade barrier, the Russian-Georgian war and the devaluation of the Ukrainian currency by approximately 60%, the country where 50% of the wine export went to in 2008 (Fleury 2013). The state authorities responded to the crisis by introducing a minimum price for wine grapes and the foundation of the state-owned winery Gruzvinprom, which subsequently acquired large quantities of surplus grapes for distillation. Initially founded to support Georgian winegrowers, in

2011 Gruzvinprom started to strongly compete with established private companies by opening a new factory for the production of wine (Anderson, p. 22). In relation, it is estimated that Gruzvinprom has secured more than 20,000 tons of grapes (Fleury 2013) – nearly ¼ of the entire harvest of 85,000 tons in 2012 (Georgia Today 2012). This economic strategy resulted in an increase of 40% to 70% to the price private wineries had to pay when purchasing grapes (Fleury 2013). Given the fact that, simultaneously, Gruzvinprom started to sell wine, at prices 40% below the prices of the main Georgian private winerie (Fleury 2013), this move suggests to present an aggressive strategy not in order to support the existing private wine-making industry but to rapidly increase the state's share on the Georgian wine market (Anderson, p. 22; Fleury 2013) . Given the announcement of the Prime Minister Ivanishvili to establish 60-100 state-owned food-processing factories in the regions, the new government obviously tends to continue the new economic development approach of the previous government (Guria News 2013).

Increased state activity in managing economic development is also reflected at the document level. The peak stage of the liberal regulatory reforms (2004-2008) was, according to self-declaration, exclusively managed by compiling power-point presentations, drafting laws (Interview Lejava 2012) and characterized by the conscious abandonment of any guiding plan (Ministry of Economic Development of Georgia 2011). The Basic Data and Directions (BDD) document, released in 2008 following the request of the international financial institutions, was the first comprehensive policy document, still emphasizing the 'small government' concept (Gogolashvili 2011, p. 188). The deviation from the non-intervention policy started in 2010 was accompanied by the release of new documents. The "10-Point Plan for Modernization and Employment (2011-2015)" marks the first comprehensive strategy of the government to promote economic development in Georgia (Ministry of Corrections and Legal Assistance of Georgia 2011). This strategy was supplemented by sector specific development plans issued since 2010 (USAID 2011, p. 54), (Government of the Autonomous Republic of Adjara 2011).

The mentioned examples clearly indicate an evolving state agenda to manage economic development in Georgia since 2008. At latest since 2010, the Georgian government increasingly deviated from its dogma of non-intervention and discovered the potentials of a state-led development. By discovering the advantages of an official process policy, the government could also fall back on already widely established informal instruments of influencing economic processes. As a result, the former division between a formal regulatory policy and an informal process policy ceased, leading to initial approaches of linking together formal and informal means of state process policy.

## 1. Strategic 'Expropriations'

The coerced transfer of property, i.e. land and real estate assets, to the state, in areas of strategic interests of the government had taken place from the very beginning of Saakashvili's presidency. First incidents of this form of property right infringements could be observed at the territory of today's recreational park Rikhe in Tbilisi. The owners of restaurants formerly located in this area were massively targeted by state agencies (Public Defender of Georgia 2005, pp. 62–65) , resulting finally in a collective property transfer to the state (Rimple 2012, p. 72). A similar development took place in Signaghi in 2007, a touristic spot in the Khakheti region, which the state decided to rehabilitate (Mtvlishvili 2008).

After this form of property rights infringement temporarily subsided, the president's declaration of priorities towards tourism development on the Black Sea coast and in the Svaneti region resulted in a resurgence of the phenomenon in 2009 (Transparency International 2012b, p. 4). Two different strategies were applied to acquire property: firstly, by abandonment or by gift and, secondly, by changing registration.

The Georgian legislation differentiates between abandonment and giving a gift.<sup>5</sup> In both cases, the owner voluntarily waives his right to his property. A detailed documentation on two tourism development projects shows how the state received a huge quantity of land plots from the local population in Sairme. "In these specific cases it was peculiar that such valuable property (and a significant source of income) was given to the state as a gift, especially when the state's intention to develop the land where this property was located had already been announced. Equally murky was how these gift contracts were executed en mass, under time constraints, and were usually certified by one notary." (Transparency International 2012b, p. 4). A similar development could be observed in Bakhmaro, where 79 abandonments by private persons were registered within a few days. According to the Public registry, there was a total of 1563 abandonments until January 2011 (Transparency International 2012b, p. 4). Data showing how often land and real estate were given as a gift to the state has been kept confidential.

The second strategy of acquiring property from the local population was to register land plots or real estate electronically on the state. This obviously led to a conflict between the registration by hard copies of cadaster drawings and the electronic registration. "The Public Registry is unable to compare drawings developed through the application of two different systems (hard and electronic versions of cadastre

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<sup>5</sup> For details see Transparency International (2012b, p. 5).

drawings) allowed under Georgian law.” (Transparency International 2012b, p. 23). Obviously, courts have often failed to protect the victims from this form of governmental property right infringement. As the report about the Free Economic Zone of Anaklia reveals, the Public Registry registered 150 formally privately owned land plots to the state (Transparency International 2012b, p. 9).

The fact, that state acquired property was often sold to locally owned private companies, which shortly afterwards re-sold this property for high profits to foreign investors (Rimple 2012, pp. 79–84) , served obviously the distribution of advantages among the ruling elite. However, the exclusive view on private gain leaves aside the initial purpose of the infringement on property rights, which is the touristic development agenda of the government.

## **2. Coerced Investments in Strategic Sectors**

The second type of informal intervention complementary to the new state development agenda relies on the Corporate Political Responsibility of companies. By requesting investments of private capital in specific sectors of the economy, the government intervenes in business’ decisions and steers specific sector developments.

The main Georgian insurance companies present one example for coerced investments. Within the framework of the hospital privatization program, the insurance companies were requested to concertedly invest a significant amount of capital in the hospital market (Khishtovani and Pirveli 2012). According to the apparent official miscalculation of profits of the insurance companies (Transparency International 2012c, pp. 15–16) , the state agencies considered the companies sufficiently solvent for this kind of investment. Although the state found a way to re-compensate the companies for their involuntary engagement by regionally dividing up the state insurance market among them, the strain on the insurers was massive (Khishtovani and Pirveli 2012).

Further prime examples for coerced investments are the privatization of hotels and investment in touristic zones. After selling his company, the former owner of “Senta Petroleum” was forced to invest GEL 4 million in the rehabilitation of the Akhtala resort (Radio Commersant 2012d). The Lebanese Businessman Joseph Kay also claims that he was forced to invest 200 million in various government development projects, among others in the Rustavi metallurgical factory (Radio Commersant 2012c). However, arguably the most telling example for the combination of coerced

investments and tourism development presents the rehabilitation of Akhaltsikhe, an ancient city close to the Turkish border. Between 2011 and 2012, eleven premises on the territory of the Akhaltsikhe municipality were brought to auction and sold off at ten or more times above the actual market value (Tchokhanelidze 11.03.2013, p. 7). A total of GEL 9 632 000 was earned by the state in the course of the privatization of the property, whereas the initial price of the real estate was only GEL 161 000 (International Society for Fair Elections and Democracy 2013, pp. 38–39) . In most of the cases, only one bidder took part in the auction and, in two cases, the bidder even transferred the property purchased free of charge back to the state (International Society for Fair Elections and Democracy 2013, pp. 38–39) . With over GEL 26 million, the government spent on the renewal of Akhaltsikhe (Tchokhanelidze 11.03.2013, p. 7), the coerced private engagement in Akhaltsikhe presented an efficient source of co-financing state’s development agenda. “The pattern does not come as a big surprise to many, especially those who understand that such deals have been endemic in recent years.” (Tchokhanelidze 11.03.2013, p. 7).

Obviously, the government implemented its development agenda not only by formal means of Free Tourism Zones or Public-Private-Partnerships, but also relied on established informal instruments of intervention in economic processes. While Corporate Political Responsibility had formerly stimulated companies to donate for state and party activities, the shift towards an active state-development agenda led to projects capital of which remained within the economic sphere and, depending on the conditions, may even prove profitable for the investor in the long term. However, the projection, steering and final implementation of economic development projects has been first and foremost supervised by state authorities. In doing so, the Georgian state became a central clock generator for economic development in Georgia. Even given the fact that the period between 2010 and the defeat of the ruling party UNM in 2012 was rather short to develop a coherent new economic policy, various indications point on a growing state-managed economy in Georgia comprising formal and informal means.

Table 3

Period	Policy	Formal Dimension		Informal Dimension	
2008- 2012	Legitimation through Performance i.e. economic development	Liberal regulations	State process policy	Continuation of informal interventions	of state

## H. Conclusion

The paper aimed at analyzing the evolutionary change of economic policy in Georgia between 2003 and 2012. It emphasizes the role of institutions and their impact on the distribution of advantages as an explanatory factor for the underlying dynamic. The paper distinguishes different periods of regulatory and process policy and corresponding modes of distribution of advantages (Appendix 3).

Before the Rose Revolution, the distribution of advantages had been organized both formally and informally. The regulatory framework served directly to allocate rents among powerful societal groups as well as indirectly as prerequisites for the perpetuation of corruption pyramids. Both the formal regulatory and informal distributive policy aimed at balancing various power groups. Consequently, the constellation between the formal and informal dimension can be defined as complementary.<sup>6</sup> The constellation between formal and informal institutions tells us about the existing endogenous incentives for actors and hence the likeability of corresponding behavior. The Shevardnadze regime depended on a complementary linkage between the formal and informal institutional dimension in order to set strong incentives for the integration of various power groups. This perspective leaves aside exogenous factors like economic crisis or presidential elections. The institutional setting of the Shevardnadze era may have been strong due to its complementary nature; however, it had failed to be economically sustainable.

After 2003, the implementation of radical liberal reforms - comprehended as an explicit response to the endemic corruption of the Shevardnadze era - simultaneously removed all formerly established instruments of advantage distribution. The massive decrease of regulatory density and state supervision and a policy of non-intervention limited the possibility to control the allocation of benefits by formal means. The state reforms also removed the institutions of corruption pyramids and thieves-in-law as informal elements of advantage distribution. The exclusive implementation of a deregulation policy would have led to a strengthening of large companies and already powerful market participants who were politically close to the former regime and, hence, posed a risk to the new government. In order to limit this risk and to distribute economic advantages among the new power groups (and to establish a solvent supportive base for the ruling party), the government massively interfered informally in property rights, freedom of contract as well as restricted access to markets and

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<sup>6</sup> Helmke and Levitzky (2004) developed a matrix of possible constellations between formal and informal institutions according to their outcome (convergent, divergent) and the effectiveness of formal institutions. The four types are complementary, accomodation, substitutive and competing.

resources. To some extent, the government took up practices of the thieves-in-law but relied on state sources of power for its implementation (tax inspection, financial police etc.). Ironically, this state-limiting policy, intended as an instrument to fight corruption, turned into an accelerant of discretionary economic policy. As a result, the phenomenon of Corporate Political Responsibility became a dominant attribute of business in Georgia, which is rather characteristic of state-led than of liberal economies. The relation between the formal and informal dimension can be defined as substituting. With regard to the distribution of advantages, formal means had been replaced by informal. Concerning the policy goal of establishing an FDI-based liberal development model, the relation is rather competing. The informal mode of advantage distribution is not compatible with the establishment of a liberal economy.

The August War prematurely terminated the FDI-based development model and forced the government to respond. The active process policy and the clear development agenda that suddenly emerged had been inconceivable before 2008. The government not only started to develop new instruments of promoting sectorial development, but also relied on already established informal instruments to accelerate economic development. Here, an intertwining of Corporate Political Responsibility and official economic policy can be found. Furthermore, the evolving state process policy extended the distribution of advantages back to the formal sphere - as the example of reselling of 'donated' property in state tourism projects demonstrates. Here, an again increasing complementary relationship becomes evident. However, as the government continued to stick to the goal of keeping Georgia attractive for FDI, the relation between the formal and informal institutional dimension remained competing.

The constellation of formal and informal incentives is relevant for actor's behavior but does not give answers to the influence of the given institutional setting on economic development. It is beyond the scope of this paper to give an answer on this question. Some considerations about the relation of the institutional framework and economic development in Georgia will be made in another paper (Timm, forthcoming).

This paper reveals two findings. It demonstrates that the focus on the distributive effect of institutions presents a reasonable approach to analyze the dynamic interrelation between the formal and informal institutional dimension as well as between institutions and the behavior of actors. In doing so, the above-mentioned perspectives, firstly, on the regulatory reforms and, secondly, on state arbitrariness can be analyzed in a common framework of understanding.

Furthermore, the paper traces the changes in Georgia's economic policy from neoliberalism to a form of state-managed capitalism. So far, state-managed



capitalism has been mostly discussed with respect to resource-rich countries, which typically deploy an officially state-centered economic policy (Bremmer and Johnston 2009; Kalyuzhnova and Nygaard 2011). The Georgian case adds a new form of state-managed capitalism, which operates in a still highly liberalized regulatory framework. To include the Georgian case in the studies of state-managed capitalism may significantly extend our understanding of this specific state-business relation.

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## **Laws**

Georgian Civil Code  
Georgian Constitution  
Law on Licenses and Permits  
Law on Entrepreneurship,  
Law on Monopolistic Activity  
Law on Free Trade and Competition  
Law on Free Industrial Zones  
Law on Tourism

## **Interviews**

Christian Timm (14/11/2012). Interview with Vladimir Papava. Tbilisi.  
Christian Timm (15/11/2012). Interview with Tamar Kovsiridze. Tbilisi.  
Christian Timm (16/11/2012). Interview with Alexander Tvalchrelidze. Tbilisi.  
Christian Timm (19/11/2012). Interview with Kakha Gogolashvili. Tbilisi.  
Christian Timm (19/11/2012). Interview with Vato Lejava. Tbilisi.  
Christian Timm (20/11/2012). Interview with Merab Kakulia. Tbilisi.  
Christian Timm (21/11/2012). Interview with David Narmania. Tbilisi.  
Christian Timm (23/11/2012). Interview with Tengiz Shergelashvili. Tbilisi.

## Appendix 1

	2003	2004	2005	2006	2007	2008	2009	2010	2011	1012
CPI Score	1,8	2,0	2,3	2,8	3,4	3,9	4,1	3,8	4,1	52
CPI Rank	127 (133)	136 (145)	133 (158)	99 (163)	79 (179)	67 (180)	66 (180)	68 (178)	64 (182)	51 (174)
Real GDP Growth	11.1	5,9	9,6	9,4	12,3	2.3	-3.8	6.3	7,0	6,5 - 7,5
FDI as % of GDP	8,4	9,6	7,1	15,1	18,5	12,4	6,1	7,5	8,0	
New business registered		3231	3958	5698	6898	8537	7779	11107	13935	
Procedures to register business	9	9	8	7	5	3	3	3	2	2
Time (d) to register business	25	25	21	16	11	3	3	3	2	2


(Source: World Bank 2013, Transparency International 2013)

## Appendix 2

**Matrix of infringements on property rights**

Type of infringement	Gift	Sale	Bankruptcy	Registration Change
Objects of Property				
Goods/ Money	Library renovation			
Enterprises/ Assets	Gori District	Senta		
Land/ Real Estate	Sairme/ Bakhmaro			Anaklia / Grigoleti

## Appendix 3

Period	Content of Policy	Formal Dimension		Informal Dimension		Dimension Relation
<b>Before 2003</b>	Balancing Power Groups	Distribution of advanges by tax exemptions, licensing etc.		Thieves In Law	Corruption pyramids	Complementary
<b>2003-2008</b>	State-building Anticorruption Limiting-state Vs. establ. strong power base	Libertarian State Deregulation FDI-oriented development model		Property re-distribution Regulating market access Corporate Political Responsibility		Competing
<b>2008-2012</b>	Legitimation through Performance i.e. economic development	Liberal regulations	State process policy	 Continuation of informal state interventions		Complementary/ Competing





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