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## Article

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IBSU Scientific Journal (IBSUSJ)

### Provided in Cooperation with:

International Black Sea University, Tbilisi

*Suggested Citation:* Ozsoy, Ismail; Kubetova, Maya (2006) : The development of business sector in Georgia, IBSU Scientific Journal (IBSUSJ), ISSN 1512-3731, International Black Sea University, Tbilisi, Vol. 1, Iss. 1, pp. 1-14

This Version is available at:

<https://hdl.handle.net/10419/54608>

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# LEGAL AND SOCIAL SCIENCES, ECONOMICS

## The Development of Business Sector in Georgia

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### Abstract

The article is about the development of business sector in Georgia. It consists of the wide range of information on the business environment in Georgia. Here, we would like to mention that while obtaining the information and writing this article, we focused on the importance of development of small and medium scale enterprises (SMEs) that make important contributions to economic and social development and are usually responsible for the majority of jobs created. We also indicated the steps that had been taken by the Georgian government after it became an independent republic. Actually, in Georgia many micro businesses and self-employed persons still operate outside the “formal” sector and therefore one of the major challenges to government is to encourage entrepreneurs to engage in legitimate activity.

*Key Words:* Georgia, SMSs, small business/enterprise, privatization, entrepreneurship.

### Introduction

In the period following Georgia's independence in 1991, the economy suffered dramatic setbacks. Attempts by two autonomous regions, Abkhazia and South Ossetia, to secede from Georgia resulted in civil war in those provinces and a deterioration of law and order throughout Georgia. Although the situation has somewhat stabilized since 1995, final political settlement of these internal conflicts has yet to be reached.

During the Soviet period, Georgia's economy included agribusiness, science, medicine, tourism, and aviation. Georgia had one of the highest living standards in the Soviet Union, and its people were among the best educated. The severe disruption caused by the collapse of the Soviet system has forced Georgia to reorient its economy. Georgia professes to choose open markets and the rule of law as a path to economic growth and wishes to be seen as an example of conversion from a command to a democratic and free market system. To this end, legislation aimed at creating an equitable and transparent business environment has become law.

Starting a business is a challenge anywhere, but much more so in a transition economy. The obstacle most frequently mentioned by entrepreneurs concerns access to capital. Only about one in 20 start-ups can obtain bank credit. Most entrepreneurs need to rely on the resources of family and friends. Other problems include heavy administrative burdens and related corruption. Moreover, all of these obstacles have to be confronted in a setting in which there is little experience with starting and learning to run a private business.

As for countries in transition period, no country within the former Communist Block is passing easily through the transition period that leads from

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one culture to another, and Georgia is no exception. No developing country which needs aid and assistance from the developed world can avoid being considered as an immature entity, needing not only financial assistance but also to be taught civilized behaviour, democracy and culture. When considering a more recent history, it is evident that Georgia has not rid itself of the «Soviet» business culture, etiquette and customs. It relies on the former habits, former links, former friends, former ways of demonstrating one's authority and former inclination for avoiding personal responsibilities.

As for business environment in Georgia, the general uncertainty regarding almost every aspect of business is probably the most important single characteristic of the Georgian business environment. However, this is not the only factor that makes life difficult for business operators in Georgia. Transaction and start-up costs are large because of the inadequacies of Georgian legal frameworks and frequent changes in regulations. Securing financial resources, particularly at the early stage of the project, is a daunting task. Direct assistance programs and venture capitalists are all but non-existent, while a combination of state regulations and banking policies has placed credit out of reach for small and medium-size enterprises.

The need for building strategic alliances has grown in importance, as even the most explicit contractual agreements are not enough to guarantee access to resources. In Georgia, the tradition of relying on informal arrangements and networks as an element of business has a long history, and in this period of transition, successful networking has become an even more significant factor for success.

### **Privatization Process and Activities of Small Enterprises**

Following the collapse of the Soviet Union and the announcement of Georgia's independence, it was Zviad Gamsakluridze's government that took the first important steps in the privatization process. A Special Presidential Decree declared that Georgian householders who had forwarded the correct correspondence were now the legal owners of their flats in what were once municipal buildings. From 1992 onwards, the privatization process in Georgia gathered pace with the arrival of the Law on Privatization of State-owned Enterprises, a piece of legislation later saddled with more than 60 amendments issued to coincide with different economic swings. On 30 May 1997 the Georgian parliament adopted a new Civil Code and a new Law on Privatization of State Property (Investment Guide 1999, 2000).

According to data from the Georgian Investment Centre and the Ministry Of State Property Management, by January 1999 12,800 small enterprises were privatized. Several aspects of this privatization should be noted:

- the privatization mainly covered trade and services sectors;
- only 1 per cent of people were able to lease small enterprises such as stores, gas stations, cafes, etc;
- all entities were sold either directly or via tenders and auctions and thus only people with the appropriate financial means gained access to small-size privatization.

It was suggested that the privatization of large and medium enterprises be performed using a rather different model. Originally the idea was that the population at a large would participate in the privatization of medium and large enterprises via special voucher auctions. By 1997 approximately 87 per cent out of a total of 5,310,414 vouchers had been distributed to the Georgian population. The voucher model of privatization called for vouchers to be exchanged for securities of state-owned enterprises that were being transformed into joint-stock companies. By this process, vast segments of the population were supposed to end up owning shares in the enterprises. Formally, the procedure was declared a great success. In reality, however, the voucher model of privatization turned out to be a mass deception of the Georgian people. The vouchers and securities were accumulated in special investment funds, intended as vehicles that would later foster the creation of a secondary security market. However, these funds bought, (or exchanged via vouchers) only 0.3 per cent of shares in former state enterprises and, surprisingly enough, a significant portion of their investments went on unpromising enterprises that were waiting for the Law on Bankruptcy to be implemented. No dividends on securities had yet been paid (Terterov, 2001).

On 30 May 1997 the Georgian president declared an end to voucher privatization, at the same time as the Ministry of State Property Management launched a new wide-scale project of privatization of state-owned large enterprises. These assets were to be sold to foreign investors via international tenders prepared in close collaboration with Western advisers, such as the Barents Group (UK-USA) and Kommerzbank (Germany), among others. According to official data from the Ministry of State Property Management, by January 1999 1200 large enterprises had been transformed into joint-stock companies. Among them, 955 had been privatized.

At present, foreign capital of approximately US\$80 million is invested in more than 100 Georgian enterprises with an additional US\$180 million invested in privatization.

As for the present situation, privatization is presently one of the main components of the economic reforms that are being implemented in Georgia. The process serves the basic principles of economic development:

- the removal of the extra burden imposed on the state budget;
- demonopolization and the formation of competitive environment;
- the development of appropriate methods of management.

The first stage of mass privatization has been completed and approximately 16,000 small and medium enterprises (SMEs) are now privatized. The process has entered a new stage with the privatization of large-scale strategic enterprises in the following sectors: energy/power, telecommunications, transport, industry, health, and water supply and sewerage.

The strategy for the privatization of the above-mentioned sectors follows relevant legislative bases and is elaborated and developed according to international standards in cooperation with international organizations. Intensive cooperation with international economic and financial institutions is a main priority of the country's foreign policy, moving Georgia towards sustainable economic development. A more vivid demonstration of this is the accession of

Georgia into the World Trade Organization (WTO).

The privatization of the Georgian energy sector, which is one of the initial stages in the large-scale enterprise privatization, was conducted successfully with the assistance of the World Bank and Merrill Lynch (selected through international tender, the latter advised the Georgian government in this field). To make the country's energy sector more attractive for potential investors, the whole process of privatization has been conducted according to international standards. International financial and economic organizations are supporting the government in rehabilitating this sector through investment projects, but a crucial role is being played at the same time by the strong political will of the government. Thorough assessment by the highly skilled Tender Commission is also vital (Georgian Economic Trends, 2004).

The Independent National Energy Regulatory Commission was established to protect consumer rights and set up suitable service tariffs. The rehabilitation process of the sector supported the establishment of the wholesale market of electricity in Georgia. The selling of 75 per cent of shares in the Capital City Electricity Distribution Company, Telasi (which serves 370,000 consumers), to US Company AES Silk Road Holding BV in 2000 can be considered a first step in the large-scale privatization process in Georgia (Terterov, 2001).

In 2000 the transfer of ownership to AES of units 9 and 10 of thermal power plant Gardabani, with an approximate capacity of 600 MW, was completed. The transfer of management rights for a 25-year term in hydropower plants Khrami 1 and Khrami 2 has also been completed. As a result of this privatization in the energy sector, the problems preventing the country from overcoming crisis have been solved. It is worth noting that the country acquired in the region of US\$250 million in revenues by way of the above-mentioned privatization. The successful implementation of the process in this direction gives the country potential to assimilate new credits to develop additional transmission lines and hydro resources and export the produced electricity when the country's production potential is 157 billion kW/h and consumption only cent. Work is continuing on the privatization of electricity distribution generation companies through international tenders that will be issued in due course.

Rehabilitation processes have commenced in the gas sector also. Plans to privatize the many regional gas distribution enterprises are underway. In the field of telecommunications, a consortium chaired by Kommerzbank is aiding the Georgian government in privatizing state-owned shares in two telecommunications companies, Georgian Local Lines (75 per cent) and Telecom of Georgia (51 per cent). An Informational Memorandum has been prepared and distributed using appropriate channels. The input of the Independent Telecommunication Regulatory Commission is vital for proper decision-making (Georgian Economic Trends, 2004).

The Poti seaport restructuring and modernization strategy elaborated with the cooperation of EC and USAID experts has been approved by the Georgian government, and according to which international operation standards will be established and a real investment climate created. The next stage is the long-term (ie 20-25 year) concessioning of Poti seaport berth terminals.

The goal of current reforms in the health sector that come under the World Bank umbrella is the establishment of worldwide-accepted standards. One of the main directions of this reform is the privatization of health sector companies, mainly clinics and ambulances, and at enterprises have been transferred into private ownership. Activity in this direction is moving forwards. The privatization of large-scale strategic enterprises conducted with the assistance of the USAID Privatization Support Project is another important step forward for the Georgian economy (Terterov, 2001).

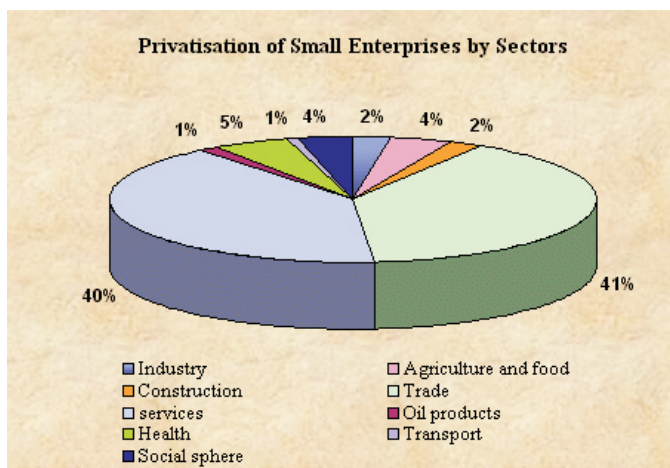
The latest phase has seen the privatization of industrial enterprises almost complete by the end of 1999. There are, however, a number of industrial companies that have not undergone this process at all. These companies include large factories that are not subject to privatization and companies that due to economic crises have lost their function and are owned by the State. In view of the above and by the recommendation of the Ministry of Industry, a number of factories will be restructured according to their individual characteristics.

After the restructuring of large industrial factories, controlling packages of shares (51 per cent) on newly emerged joint-stock companies will be sold through competition (investment bids), while the remainder of shares will be sold at auction. Controlling packages of other joint-stock companies and the total shares of minor companies will be sold on a competition basis. There is currently no plan to privatize factories and facilities owned by the military or by the industry (Terterov, 2001).

As for the privatization of small enterprises; for January 1, 1998, from 11593 small enterprises approved for privatization, only 11055 (95.4%) were privatized.

80% of total privatized enterprises are objects of trade and service sectors, 2.5% objects of industry, 4.2% - agriculture and food, 2.3% - construction, 1.5% - oil products, 4.9% - health care, 0.9% - transport and 3.7% - social sphere (<http://www.georgia.net.ge/mospm> (Accessed on December 9, 2003)).

**Figure 1: Privatization of Small Enterprises by Sectors**

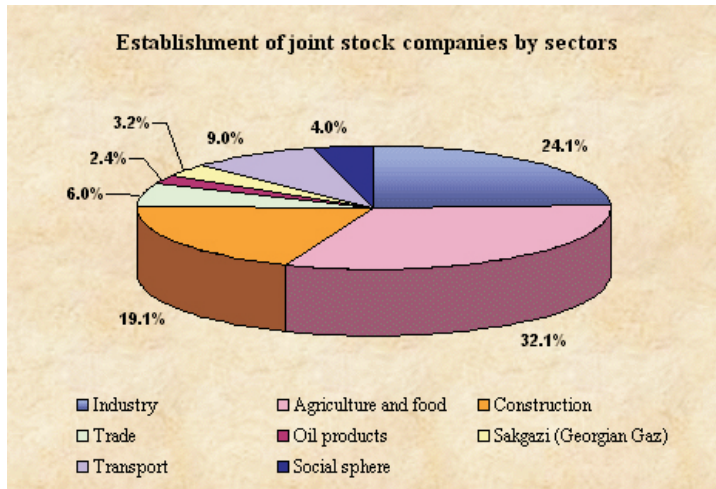


Source: State Department of Statistics, 1998.

Privatization of small enterprises is conducting at lower rate in the Autonomous Republic of Achara (37.2%), as well as in Ninotsminda (58.8%) and Sachkhere (68.1%) districts.

From 1292 enterprises to be established as a joint stock companies (JSC) only 1121 JSC are established and registered. This process is conducting at lower rate in Achara (38.4%), Ambrolauri (50.0%) and Dmanisi (33.3%) districts; lower rate is also in bread products (67.2%), oil products (55.1%), Sakgazi (63.2%) (<http://www.georgia.net.ge/mospm> (Accessed on December 9, 2003)).

**Figure 2: Establishment of Joint Stock companies by sectors**



Source: State Department of Statistics, 1998.

By January 1997 out of existing 7978 industrial enterprises 89% are small enterprises. 88% of them are functioning in non-state sector (trading and public catering enterprises 94%, industrial enterprises 83%, constructing enterprises 72%, transport enterprises 85%) (<http://www.freedomhouse.org/nit98/georgia.pdf> (Accessed on April 22, 2004)).

**Table 1: Small Enterprises by 1 January, 1998**

Small Enterprises by 1 January, 1998						
	Number of Enterprises		By forms of Property			
			State and Municipal		Non-state	
	Unit	% to result	Unit	% to result	Unit	% to result
Totally in Enterprises	7070	100	823	100	6247	100
of which:						
Industry	835	11,8	144	17,5	691	11,1
Construction	444	6,3	124	15,1	320	5,1
Transport and Communications	222	3,1	33	4,0	189	3,0
Trade and Catering	4164	58,9	262	31,8	3902	62,5
Municipal, Social and paid Services	1405	19,9	260	31,6	1145	18,3

Source: Ministry of State Property Management databases. April 1, 1998.

In Tbilisi are located 55% of all small enterprises existing today in Georgia. Their distribution according to the districts of the city is not equal: 17% of them are located in Saburtalo District, 14% - in Vake, 13% - in Didube, 11% - in Mtatsminda, 10% - in Samgori, 8% - in Isani, 7,7% in Krtsanisi, Nadzaladevi and Chugureti Districts and 6% - in Gldani.

The share of retail and whole trade (cars and household goods including repairs, hotels and restaurants) constitutes 59%, industry -12%, construction 6%, transport -3%, operation with real estate, rent and other commercial activities 9%, municipal, social and other charged service -4%.

By 1998 92 thousand people work at small enterprises. In one small enterprise about 13 people are employed.

([http://www.passlivelikelihoods.org.uk/site\\_files%5Cfiles%5Creports%5Cproject\\_id\\_14%5CRural%20Non\\_farm%20Economy%20in%20Georgia,%20A%20Pilot%20Research%20Report\\_W0050.pdf](http://www.passlivelikelihoods.org.uk/site_files%5Cfiles%5Creports%5Cproject_id_14%5CRural%20Non_farm%20Economy%20in%20Georgia,%20A%20Pilot%20Research%20Report_W0050.pdf) (Accessed on February 27, 2004)).

**Table 2: Quantity of employees at the small enterprises by 1 January, 1998**

Quantity of Employees at the small enterprises by 1 January, 1998						
	Average quantity		By forms of Property		Share of employees in different branches to the total number	
	Employee	% to result	State	Non-state	State	Non-state
Totally in Enterprises	91745	100,0	11383	80362	100,0	100,0
of which:						
Industry	11772	12,8	2871	8901	25,2	11,0
Construction	6177	6,7	2262	3915	19,9	4,9
Transport and Communications	2087	2,2	503	1584	4,4	2,0
Trade and Catering	58416	63,7	2301	56115	20,2	69,8
Municipal, Social and paid Services	13233	14,6	3446	9847	30,3	12,3

*Source:* Ministry of State Property Management databases. April 1, 1998.

64% of employed in small business fall on retail and whole trade, 13% - industry, 7% - constructing works, 15% - other branches.

15-15% of the employees at small enterprises work in Vake and Saburtalo districts, 14% - Samgori, 11% - Didube District.

The share of the employees working in small business non-state sector constitutes 87% of the whole employed population (in industry -10%, trade -70%, other fields -20%).

9,4 thousand people occupied in small business work at the same time somewhere else (52% - field of education)

In 1997 in Tbilisi small enterprises produced 324 mln.GEL equal volume of production and service (not including VAT and excise).



**Table 3: Profit of the small enterprises by 1 January, 1998 (GEL thousand)**

Profit of the small enterprises by 1 January, 1998 (GEL thousand)			
	Total Profit	of which:	
		State enterprises	Non-state enterprises
Totally in Enterprises	324165	33633	290532
of which:			
Industry	39400	8334	31066
Construction	77242	8270	68972
Transport and Communications	20429	3596	16833
Trade and Catering	148654	3005	145649
Municipal, Social and paid Services	38440	10428	28012

*Source:* Ministry of State Property Management databases. April 1, 1998

46% of the whole production volume falls on trading entities, 12% - industry, 24% - on construction works

([http://www.passlivelikelihoods.org.uk/site\\_files%5Cfiles%5Creports%5Cproject\\_id\\_14%5CRral%20Non\\_farm%20Economy%20in%20Georgia,%20A%20Pilot%20Research%20Report\\_W0050.pdf](http://www.passlivelikelihoods.org.uk/site_files%5Cfiles%5Creports%5Cproject_id_14%5CRral%20Non_farm%20Economy%20in%20Georgia,%20A%20Pilot%20Research%20Report_W0050.pdf) (Accessed on February 27, 2004)).

Up to 100 important kinds of products are manufactured by Georgian industrial sector. There are traditions and technical possibilities of such complicated and high-technology output, as: planes, trains, cars, boats, machinery for agriculture and food industry, cutting machines, altitude cranes, microelectronics, computing machinery and other technical and household goods. The industrial sector has quite big potential, though currently functions on small scale. The following indices witness the above-mentioned: the 1999 output as compared to 1990 made 14% in machine engineering, 3% - in light industry, 1.5% - woodworking, 14-40% - chemical industry. The average annual output of huge metallurgical plant - JSC Rustavi Metallurgical Plant - was as follows prior to 1990: open-hearth steel - 1,425 thou t, cast iron - 670 thou t, finished rolled metal - 1,225 thou t, pipes - 516 thou t, agglomerate - 1340 thou t and coke - 300 thou t. According to the 1999 indices, steel - 7.1 thou t, finished rolled metal - 7.2 thou t and pipes - 1.1 thou t (Shatberashvili, 2003).

The real total amount of production in 2001 was by 1.1% less than in 2000. The output has increased in extractive industry and mine *development* (6.9%); *decreased in process industry* (2.3%) and electricity generation and distribution and gas and water supply (10.6%).

42.9% of production (in current costs) fell to state sector, while 57.1% - to private sector.

Several tens of enterprises (each with production volume GEL 3 mln and more) materially affected country's industrial growth in 2001, their production made 73.5%. The output decreased by 30.1% in 26 of them in comparison with 2000.

In accordance with the studies carried out by the State Department for Statistics of Georgia small enterprises make the majority of entrepreneurship sphere. Their number increases quite rapidly, especially during the recent years. 10,373 (by 3,180 more than in 2000) small enterprises were registered in 2001,

mainly due to the increase of number of individual enterprises. It should be mentioned that this situation demonstrates big entrepreneurial capabilities and potential of the population. Simplification and cheapening of individual enterprise registration rules greatly promoted to this. At the same time, it should be mentioned that there is a big variance between registered and acting enterprises (Shatberashvili, 2003).

**Table 4: Share of small enterprises in major macroeconomic indices (Enterprises which activities were studied in 2000)**

	Entrepreneurship, total	Of which small enterprises	
		Total	%
Number of enterprises, units	28,547	26,150	91.6
Output, GEL mln	1,888.9	493.7	20.7
Number of employed, men	378,055	125,807	33.3
Value Added Tax, GEL mln	961.9	214.9	18.3
Capital assets, GEL mln	3,486.3	461.6	11.7
Export, USD mln	329.9	234	6.5

*Source:* State Department for Statistics, 2001.

Quality indices of small enterprises (up to 20 employees and with annual turnover - up to GEL 500 thou), in spite of being inadequate in comparison with quantitative parameters, become far better. This demonstrates the increasing role of small enterprises in the establishment of new economic relations. Namely, more than 20% of goods produced within the country and almost one fifth of VAT falls to small entrepreneurship. The small entrepreneurship encompasses one third of the employed in this sphere of activities (Shatberashvili, 2003).

**Table 5: Small enterprises sector structure, %**

Kinds of activity	Number of enterprises	Number of employers	Production	Capital stock
Agriculture, hunting, forestry	0.9	1.8	0.8	15.2
Mining industry	0.3	0.7	0.9	1.1
Manufacturing industry	10.4	17.1	38.3	34.1
Electric power, gas, water production and distribution	0.4	1.5	1.6	6.3
Construction	1.4	3.1	7.0	2.8
Trade, reconditioning	71.1	54.7	21.3	8.8
Hotels and restaurants	6.6	6.4	5.1	3.2
Transport, warehousing, communication	1.8	3.0	14.8	6.8
Real property business, lease and public service	3.6	4.2	6.4	17.1
Education	1.1	2.9	1.0	0.5
Health care and social service	1.0	2.5	1.0	1.7
Public, social and personal	1.2	1.8	1.4	2.0
Other activities	0.2	0.3	0.5	0.5

*Source:* State Department for Statistics, 2001.

As for the recent changes, the government has launched a new phase of reforms and privatization. Major trends of the current privatization policy are a quick transfer of the remaining enterprises into private ownership and a radical deregulation of the economy to mobilize private investments. The government is planning to attract foreign investors and create a more favorable environment for business in the country. In 2005, Georgia became a more attractive country both

for domestic and international investors due to the parameters of the new Tax Code. The Ministry of Economic Development has published a list of 372 enterprises where the state is offering its share for sale by auction.

Privatization of medium and large enterprises (MLE) that are still in state ownership remains a problematic issue. The experience of recent years showed that the ways used for privatizing large Georgian enterprises are not bringing results. The enterprises are oversized. The assets are in poor condition. Indebtedness, overstaffing, and influence from different interest groups has also aggravated the situation. It is obvious that in terms of privatization of the MLEs some serious steps and measures need to be taken. So the government has to be more decisive in restructuring the enterprises and implementing liquidation/bankruptcy procedures to make these enterprises attractive for foreign investors. Bankruptcy procedures lead to reorganisation/rehabilitation or liquidation of an insolvent enterprise. Although in some MLEs liquidation/bankruptcy procedures have been started, none of the largest enterprises has been liquidated yet. In some of them rehabilitation programmes were under way. If rehabilitation is successfully implemented, the enterprises will be able to service their debts, improve overall performance and become efficient. Privatization of efficient enterprises will be much easier (Georgian Economic Trends, 2005).

And the acquisition of small enterprises by insiders is still widespread, which in many cases diminishes government revenues and retards efficient operation of the small enterprises. However, the existing resale market seems to be effective enough to ensure the acquisition of assets by more capable owners and increasing competition puts pressure on companies to increase efficiency. Most small enterprises are in the trade and service sectors - 32 and 46 per cent respectively. Almost half of whole SMEs operate and 60% of products are produced in Tbilisi (Georgian Economic Trends, 2005).

Table 6 shows the number of individual enterprises existing in Georgia.

**Table 6: Individual Enterprises, Units**

2000	2001	2002	2003	
18134	17927	15170	15179	<b>Total</b>
15	46	55	49	<b>By kind of activity:</b>
-	-	1	-	Agriculture, hunting & forestry
2	3	3	8	Fishing
1076	1121	1162	1165	Mining & quarrying
1	1	-	1	Manufacturing
2	11	14	19	Electricity, gas & water supply
15756	15799	13085	13087	Construction
1258	780	574	531	Wholesale & retail trade; repair of vehicles, personal & household goods
2	10	23	27	Hotels & restaurants
1	10	8	8	Transport, storage & communications
9	63	92	95	Financial intermediation
3	4	8	7	Real estate, renting & business activity
				Education

2	19	27	31	Health & social work
7	60	118	151	Other municipal, social & personal service
<b>By administrative-territorial units:</b>				
3416	5244	4025	3742	The city of Tbilisi
...	...	...	...	Abkhazeti Autonomous Republic
2588	1634	1407	1317	Adjara Autonomous Republic
804	727	651	645	Guria region
				Racha-Lechkhumi & Kvemo Svaneti region
394	418	416	415	Samegrelo-Zemo Svaneti region
1781	1537	1340	1392	Imereti region
2598	2741	2818	2884	Kakheti region
1785	1824	1342	1396	Mtskheta-Mtianeti region
717	570	624	635	Samtskhe-Javakheti region
540	578	508	683	Kvemo Kartli region
2173	1525	1206	1240	Shida Kartli region
1338	1129	833	830	

*Source:* State Department for Statistics, 2004.

As for industry in Georgia, it is one of the main branches of the national economy and plays an important role in developing the country. Although the difficult process of transformation to a market economy, and the coincidence of the political and economic cataclysms in 1990s had a negative influence on the general economy as well as on the industry sector. Industrial decline reached a critical point in 1993 and 1994. Due to the structural reforms in the economy and institutional reforms in the state, such as the start of a process of privatization, stabilization of the monetary and fiscal systems, price and trade liberalization, strengthening of the state institutions and rule of law, industry began to recover since 1996. The analysis of last years shows that the important elements of market economy have been established, the great number of industrial enterprises were privatized or transferred to joint-stock companies, the new macroeconomic and judicial environment were created. Among the recent reforms undertaken after the 'Rose Revolution' the crucial ones were the reduction of the administrative corruption, the new wave of the privatization, and adoption of the new Tax Code that is considered more liberal by the experts. The transparency of the current policy-making process, the participation of the stakeholders in creating a new liberal business environment (e.g. a series of consultations between the government and industrial entrepreneurs in the process of drafting the new tax code), and the establishment of new rules that put lobbying by interest groups into the frames of legality, together created the necessary preconditions for fair competition and minimized non-economic factors of risk and unpredictability (Georgian Economic Trends, 2005).

Despite the improvements there remain a number of the persistent problems in the sector. The restructuring of industrial enterprises is being carried out weakly. The deficiencies in the bankruptcy mechanisms and bad debt situation hinder the identification of viable enterprises. Most of industrial enterprises are privatized, but many of them stand idle. Serious impediments of investments are the large arrears of the companies towards the budget, poor management, outdated

material-technical base and underdeveloped infrastructure. Unstable electricity supply often causes the interruption of the enterprises' activity and the high cost of energy in Georgia compared with neighboring countries, undermines the competitiveness of the Georgian enterprises. Access to finance is one of the biggest obstacles to the development of industry; however the interest rates on commercial bank loans are gradually reducing. Unfavourable business environment leads to a large-scale shadow economy. The share of unregistered output in the total production remains still high 30 per cent (Georgian Economic Trends, 2005).

The general situation in the industrial sector still depends heavily on the activity of a small number of enterprises. The development of small and medium enterprises is hindered by unfavourable legislation and widespread corruption. In previous years, the practice of "state capture" and unfair competition was still in place. As a result, the most economically viable are those enterprises that are lobbied by illicit means. In such a business environment, small and medium enterprises have little chance for survival and further development. It is worth mentioning that in the small and medium industrial enterprises only less than 20 per cent of general industrial output was produced, while in the most developed countries the share of such firms is 50-60 per cent.

Registered output of industrial enterprises in Q1 2005 increased by 7.12 per cent compared with the corresponding period of the previous year (Georgian Economic Trends, 2005).

**Table 7: Registered Output of Industrial Enterprises**

	Number of enterprises	Number of employees (thousands)	Output (GEL million)	Q1 2005 vs. Q2 2004 (Q2 2004=100)
Industry:	2572	75.4	412.5	107.1
Large enterprises	147	52.0	342.8	102.7
Medium enterprise	340	12.2	40.9	133.6
Small enterprises	2085	11.2	28.8	136.5

*Source:* State Department for Statistics, 2005.

## Conclusion and Recommendations

The development of small business sector in Georgia should become one of the main priorities of the Government's economic policy because small businesses can play crucial role in establishing market economy and in solving economic, political and social problems in the country. Small businesses support the development of the competition and free entrepreneurship in a country. But in less attractive entrepreneurial environment SMEs are developing with great difficulties. In promotion of this field Georgia are far behind developed countries. Small business generate more than half of GDP in these countries and they create 55-60% of employment.

New and small firms are more effective in creating new work places than

old and large companies. New jobs created by small enterprises make it less painful to restructure the giant factories inherited from the Soviet Union and this in the end will help the business in Georgia to reflect local market conjecture. It is also to be mentioned that stable economy, which is made up of small and medium enterprises, can put significant contribution in accelerating democratic reforms and in establishing political stability in a country.

The development of small business sector is one of the best means for reducing the outflow of foreign currency from the country. As a rule small businesses play relatively insignificant role in expanding the volume of export from the country but they help us to economize on foreign currency reserves. Small firms mainly act as producers of those goods and services that are imported into the country and they will help to restrict import and correspondingly the outflow of foreign currency from the country.

The development of small business in the country will help to reduce the size of shadow economy. One of the reasons for separating small business from the rest is for the government to provide certain support and assistance for them. The establishment of a favorable infrastructure for small business development will help the government reduce the size of shadow economy to certain degree. Nowadays, many small businessmen run their businesses illegally and create difficulties for themselves as well as for the society as a whole. Therefore the promotion of the small businesses will help to bring small firms operating underground to the surface.

As we mentioned above small and medium scale enterprises (SMEs) make important contributions to economic and social development. And one of the main challenges to governments is to encourage entrepreneurs to engage in legitimate activity. In other words, Georgian government should improve the regulatory environment. An improved regulatory environment and more favorable business climate would increase FDI rates. Also Custom system reform should guarantee sufficient legislation and limit minimum contraband in Georgia. Another obstacle for the entrepreneurs is the low guarantee of commercial information confidentiality. It's necessary to simplify entrepreneurship legislation and interpret laws exactly and understandable for creation favourable environment of competitiveness. The financial sphere should be improved as well, which means decreasing budget deficit, inflation and etc. Also attention should be paid to credit guarantee system for SMEs. It increases enterprise credit ability and enterprise can access bank credit. Georgian government should eliminate bureaucratise burdens, which artificially increase enterprise costs and decrease their ability of competitiveness. In Georgia cost share concerning to the bureaucracy are high in SME operating costs. So the important way of improving entrepreneur environment is to regulate above mentioned activities and cancel administrative burdens.

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