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## **After the Rose Revolution**

**Trends of economic development and  
its impact on Georgia**

**March 2007**

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## After the Rose Revolution

Trends of economic development and its impact on Georgia

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## ***Executive summary***

Since declaring independence, Georgia faced acute political turmoil resulting from civil war, ethnic conflicts, the increasing number of refugees and poverty followed by years of economic stagnation and corruption which was supposed to come to an end in November 2003, with the so-called Rose Revolution, which brought new hope to the country's population.

After the Rose Revolution the newly elected parliament and government inherited the obligations of the former elite to eradicate poverty and improve the welfare of the citizens and for that reason was forced to follow the Economic Development and Poverty Reduction Program (EDPRP), prepared and adopted by the former Georgian government under the guidance of the World Bank and the IMF in 2003. In parallel, Georgia made a commitment to integrate the Millennium Development Goals within its national development strategies, and report periodically on the status of their progress.

Overall assessment of governmental activities is at first glance, amazing. The budget of the country began to increase dramatically and laws supporting economic liberalization were quickly adopted. The process of Georgia's integration in Euro-Atlantic structures became much more visible and in 2006, the country finished its negotiations over the Georgia-EU action plan, under the EU neighborhood policy that should be implemented in 2007-2013.

The World Bank and the European Bank for Reconstruction and Development (EBRD) in their reports have declared Georgia to be one of the fastest evolving countries. But the question is: How does the actual situation in Georgia compare with the reports praising the Georgian government for its achievement of the implementation of fast track economic development and liberalization?

There are about four and a half million people in Georgia, 50 percent of who are living below the poverty line, with 17 percent in extreme poverty. Despite reducing the nutrition norms of the minimum necessary consumption basket from 2 500 **kcal** to 2 300 **kcal** per day, that significantly reduces the official number of the poverty line from more than 50 percent to about 35 percent, poverty line continues to move in a generally upward direction anyway.

Despite general praise from the banks with regard to reforms which reduced the business taxes from 21 to 7 and removed restrictions on working hours and dismissal procedures, thereby lowering firing costs to some of the lowest levels in the world, business in Georgia is still far from flourishing. While it has become easy to establish a business, running the business afterwards represents real problem for SMEs as well as for larger companies. According to entrepreneurs "If you start a business and the profit reaches around 1-2 percent in the first year it is great achievement and then step by step you can develop it. This means that a 16-18 percent loan interest rate is catastrophic not only for new businesses but for more established ones too".

The "non-budgetary funds" that flourished during 2004-2005, such as the "Law machinery development fund" under the Prosecutor General and Ministry of Interior, and the "Defence fund" controlled by the defence ministry, represent quite a headache for large and medium businesses. Officially, such funds receive injections via business sector "donations". Due to a number of recommendations from international organisations both funds have been closed, however, the incomes and expenditures of those non-budgetary funds are non-transparent.

The new Labour Code of Georgia, hailed by the government and International Financial Institutions (IFIs) as one of the brightest achievements after the Rose revolution, addressed removing restrictions on working hours and dismissal procedures, and thereby lowering firing costs to some of the lowest levels in the world, was heavily criticized by the International Confederation of Free Trade Unions (ICFTU) and the International Labour Organisation (ILO).

In 2006 the Georgian Ministry of Energy prepared and the Georgian Parliament approved in amazingly record time the document on "The Main Directions of Georgian State Energy Policy". Despite the fact that the document addresses the following positive goal: "full satisfaction of the country's electricity needs through Georgia's own hydro power resources: step by step, first to replace imported volumes and at the next stage to replace thermal power generation with hydro power generation", the main governmental priority addresses the issue of the existence of energy resources rather than the creation of a sustainable energy system.

The overall fast economic modernisation reforms, so enthusiastically supported by the World Bank, there are a number of reforms which include the liberalisation and deregulation of sectors, where through minimisation of its control functions the government risks to the health and safety of its own population and the environment. About 85 percent of licensing legislation has been abolished, including the spheres of environmental protection, food, industry and vehicle safety. As a result, a number of issues have been left without regulation.

In order to fully support Georgia the donor community should encourage the Georgian government to improve the country's business environment, safeguard and improve Georgia's environment, protect human rights and the rule of law. The assessments carried out by IFIs should be based on the realities of the implication of ongoing projects, cost efficiency of programme carried out and the actual number of people who benefit, rather than nicely written laws and programmes, where it is questionable in which direction they will be implemented.

## **1. Introduction**

Since declaring Independence<sup>1</sup>, Georgia has experienced a deep socio-economic crisis. However, unlike most other countries, the Caucasian Republics faced acute political turmoil resulting from civil war, ethnic conflicts, the increasing number of refugees and poverty. These years have been followed by years of economic stagnation and corruption which was supposed to come to an end in November 2003, with the so-called Rose Revolution, which brought new hope to the country's population. Among the problems the new government faced, poverty and economic development were the most acute.

The new government and parliament elected after the Rose Revolution inherited the obligations of the former elite to eradicate poverty and improve the welfare of the citizens. One of the major documents that the new government was forced to follow is the Economic Development and Poverty Reduction Program (EDPRP), prepared and adopted by the former Georgian government under the guidance of the World Bank and the IMF in 2003. The programme outlines the essential steps to be taken by the Georgian Government in the next fifteen years. The main goal of the programme is to improve the welfare of Georgia's population and support economic growth within the country.

In parallel, Georgia, as one of the co-signatories of the Millennium Declaration, made a commitment to integrate the Millennium Development Goals within its national development strategies, and report periodically on the status of their progress. Those goals, among others, include the eradication of extreme poverty and ensuring environmental sustainability.

Overall assessment of governmental activities is at first glance, amazing. The budget of the country began to increase dramatically and laws supporting economic liberalization were quickly adopted. The process of Georgia's integration in Euro-Atlantic structures became much more visible and in 2006, the country finished its negotiations over the Georgia-EU action plan, under the EU neighborhood policy that should be implemented in 2007-2013.

The World Bank and the European Bank for Reconstruction and Development (EBRD) in their reports have declared Georgia to be one of the fastest evolving countries. The EBRD's 2005 transition report<sup>2</sup> esteems enthuses about the apparent improvements in the business climate: "Georgia's indicator reflecting governance and structural reforms of enterprises rose from 2 to 2+, after the government managed to improve the business environment, tighten budget restrictions and reduce corruption". According to the World Bank, Georgia occupies first place when it comes to the speed of reforms, while it occupies 37th place with regard to the ease of doing business.

The optimism of the government and IFIs, especially the World Bank in their assessment of the country's performance is rather surprising. The government and the World Bank emphasise that the results of their collaboration are extremely positive. The words of the Georgian prime minister Z. Nogaideli that "New jobs are being created, (80 000 in the private sector in 2006) and foreign investment is increasing," were echoed by World Bank Vice-President Shigeo Katsu when he said that "Over the past three years, Georgia has become synonymous with extraordinarily rapid change and reforms. Georgia is truly open

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<sup>1</sup> Georgian Parliament declared independence in April 1991;

<sup>2</sup> <http://www.cbonds.info/eng/news/index.phtml/params/id/333466>

for business, and investors should take heed. This is a country that is pursuing the right reforms, and the World Bank is committed to supporting these efforts.”<sup>3</sup>

The question is: How does the actual situation in Georgia compare with the reports praising the Georgian government for its achievement of the implementation of fast track economic development and liberalization? And to assess its impact on poverty eradication and Millennium Development Goals (MDGs) achievement in small and medium sized enterprises (SMEs) Development, Energy and Environment.

## **2. Poverty in Georgia**

Currently, after years of transition, the Georgian population's standards of living remain far lower than they were at the start of the transition. There are about four and a half million people in Georgia, 50 percent of who are living below the poverty line, with 17 percent in extreme poverty<sup>4</sup>. According to the UNDP the Human Development index of Georgia is 97<sup>5</sup>.

To calculate the official poverty level, Georgia uses an official indicator – the so called “living minimum” which is based on a minimum consumption basket of food for a healthy adult established by the Ministry of Labour, Health and Social Protection of Georgia. The previous methodology used to calculate the minimum necessary consumption basket, was adopted in 1992. This basket was based on the consumption of **2 500 kcal** per day and was based on the nutrition norms of the Soviet period. The recommended new consumption basket<sup>6</sup> is based on the consumption of **2 300 kcal** per day. The recalculation of the poverty index in the middle of 2005 significantly reduces the official number of those below the poverty line from more than 50 percent to about 35 percent. However, despite this fact, the number of those below the poverty line continues to move in a generally upward direction (from 35,8 percent in 2004 to 39,4 percent in 2005 and 38,5 percent in the first to second quarters of 2006<sup>7</sup>).

Moreover, it is notable that overall prices are rising more rapidly than the official living minimum which is not usual in normal economic development. Additionally, in August 2006 the inflation rate rose to 14 percent, and despite the government's efforts to bring it down towards 9 percent; in reality, prices of basic commodities are still very high. Furthermore, according to information from the Department of Statistics of Georgia<sup>8</sup>, unemployment increased from 11,5 percent in 2003 to 13,8 percent in 2005.

## **3. Economic development**

Business in Georgia is still far from flourishing. This is despite general praise from the banks with regard to reforms which reduced the business taxes from 21 to 7 and removed restrictions on working hours and dismissal procedures, thereby lowering firing costs to some of the lowest levels in the world. While it has become easy to establish a business, running the business afterwards represents a real problem for SMEs as well as for larger companies.

Small businesses that are forced to function under the same tax and administration rules as larger ones, have clear problems with accessing the start up funds from commercial banks or from micro financial organizations<sup>9</sup>. Another problem is the interest rates on loans are too high, (around 16-18 percent annually). According to entrepreneurs “If you start a business and the profit reaches around 1-2 percent in the first year it is great achievement and then step by step you can develop it. This means that a 16-18 percent loan interest rate is catastrophic not only for new businesses but for more established ones too”<sup>10</sup>.

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<sup>3</sup> Georgian prime minister spotlights investment climate reforms

<sup>4</sup> By the decree # 111/N of the Minister of Labor, Health and Social Protection, established a new recommended consumption basket;

<sup>5</sup> Georgia ranks 97th in UNDP's Human Development Index 2006, The Messenger, Monday, November 13, 2006, #215 (1235) By M. Alkhazashvili;

<sup>6</sup> By the decree # 111/N of the Minister of Labor, Health and Social Protection, established a new recommended consumption basket;

<sup>7</sup> <http://www.statistics.ge/files/georgian/Quarterly%20Bulletin%20II%202006.pdf>

<sup>8</sup> [www.statistics.ge](http://www.statistics.ge)

<sup>9</sup> All of them conditioning the loan with at least 4 month activity period;

<sup>10</sup> Georgian newspaper “Rezonansi” March 23, 2006;

The only businesses that can survive in this situation are those which import goods from abroad (mainly from China and Turkey) and sell them within the country. However, based on Georgia's balance of imports and exports, this type of business activity can hardly be counted as development of the local economy.

While the number of specific corruption cases with regard to the bribing of officials has decreased in recent times, there are a growing number of cases where local and regional governors compel SMEs to hand over shares in their businesses. Nino Mamukelashvili, the president of "Comersant" association<sup>11</sup>, states: "If you want to start and run your business successfully you need firstly to find a lobby in governmental circles otherwise either your business will go bankrupt or local or regional governors will compel you to hand over shares in your business".

Along with the above mentioned, the new Tax Code does not stimulate employment, as entrepreneurs are exempt from income and social tax, if they do not employ additional labour, which means that the code does not serve the stimulating of employment thus does not decrease the poverty level. Meanwhile, entrepreneurs are obliged to pay 18 percent as VAT for objects of leasing<sup>12</sup>. For the improvement of the quality of Georgian products, it is necessary to replace outdated machinery with machinery which is modern and energy efficient, which is impossible without long-term financing. In almost all countries leasing is a financial service, but not in Georgia. So leasing objects taxed with VAT and interest rates make leasing services uncompetitive thus hampering the modernisation of machinery stipulating quality improvement and the development of SMEs..

It should be underlined that foreign companies face the same problems as Georgian ones. In 2005 the Austrian company "Schirrhofer" announced plans to construct a meat processing factory in Georgia, involving a EUR 14m investment and the creation of 1 400 jobs. However, in March 2006, during the Georgian-Austrian Business Forum in Vienna, company representatives made a statement about the obstacles they faced when trying to invest in Georgia. For three months, a number of trailers with products that Schirrhofer was importing into Georgia were held, without explanation, at Georgian customs<sup>13</sup>. As a result the company decided to invest in Kazakhstan and develop its activities there.

Another case that highlights the attitude of the state towards business was the incident with Georgian-Italian Company Badagoni, where the financial police, in front of TV cameras, removed the wine from some tanks and poured it into the sewer. According to the Ministry of Agriculture, the tests showed that the wine did not comply with standards: one of the wines contained synthetic dye; the other had low alcohol content. The financial police have brought a charge of "forgery" against the company. Meanwhile, Badagoni openly stated that the main cause of the raid was unfair competition and that company is going to appeal to the court against the decision of the financial police. According to the company every week they send their wines for examination to Italy and no forgery or low quality is possible.

A few days later the prime minister of Georgia visited the Badagoni Factory and officially apologised for the 'misunderstanding'. According to the prime minister, officials that seek promotion overstep their authority. It should be underlined that a few weeks ago during the Badagoni opening ceremony, President Saakashvili praised the opening of factory, which invested EUR 12m, as a "symbolic step for Georgia"<sup>14</sup>. However, it is not financial policy to organise raids without any court decision.

The problems with private property are one of the most acute issues in today's Georgia. Incidents of different official bodies expropriating and/or forcing people to give private property to the state are not rare. In this situation the fact that business in Georgia develops very slowly should not be surprising<sup>15</sup>.

While foreign direct investment (FDI) in Georgia in recent years constitutes up to USD 500m per year, a significant amount comes from China to support the opening of retail shops and businesses in Georgia. This type of FDI could be considered as important in countries which are already developed but not in countries whose export–import balance is so imbalanced<sup>16</sup>.

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<sup>11</sup> Georgian newspaper "Rezonansi" March 23, 2006;

<sup>12</sup> Newspaper "Rezonansi": "Small and medium sized businesses are in a severe condition"; January 21, 2005;

<sup>13</sup> Sarke March 21, 2006;

<sup>14</sup> <http://eng.primenewsonline.com/?c=121&a=10541>, October 27, 2006, 9:14 pm;

<sup>15</sup> Politics Ombudsman against Tbilisi city hall, [www.rustavi2.com](http://www.rustavi2.com) 2007.01.18 21:46;

<sup>16</sup> According to the Department of Statistics of Georgia in 2005 exports were USD 866,7m, while imports were USD 2490,9m;

#### **4. Non-budgetary funds**

The “non-budgetary funds” that flourished during 2004-2005, such as the “Law machinery development fund” under the Prosecutor General and Ministry of Interior, and the “Defence fund” controlled by the defence ministry, represent quite a headache for large and medium businesses. Officially, such funds receive injections via business sector “donations”. In 2006 Badri Patarkashvili, the Chair of the Business Federation of Georgia, openly criticised the accepted practice of forced donation to such funds, observing that in 2005 alone the cash flows into the “law machinery development fund” amounted to GEL 160m (USD 87m), while it is impossible to actually control how the government is using such sums. Due to a number of recommendations from international organisations both funds have been closed, however, the incomes and expenditures of those non-budgetary funds are non-transparent. With continued enormous strains on the Georgian budget (pensioners receive USD 18 per month), it is difficult to avoid the suspicion that influential pockets are being lined at the expense of Georgians struggling at the sharp end.<sup>17</sup>

High interest rates on loans for business development also create obstacles for the economy. Despite the positive tendency of decreasing rates on loans and deposits and increasing the level of confidence in banks, the government and parliament rejected the idea for a deposit insurance system calling it something from Soviet times. Meanwhile insecurity forces the private banks to increase interest rates over the credit lines, including those coming from IFIs, sometimes up to 24 percent annually.

Furthermore, the Georgian government, rather than investing money in SMEs development in the agricultural or tourism sector, supports the development of entertainment parks from city and national budgets in Tbilisi and surroundings. These parks are free of charge. An interesting case happened in the Black Sea Coast resort of Ureki, where an entertainment park was opened in the summer through private investment. However, during the opening the president of Georgia promised that services would be free of charge during the summer season and this was implemented. It is not clear who in reality covered the costs of the investment (city or national budget), but the fact itself of making entertainment in a resort full of foreign tourists free of charge, raises lots of the questions with regard to the incentives to develop local economies.

Also, before local elections in Autumn 2006, the president presented another idea of how to develop the economy and increase employment opportunities. Around 50 000 people were to work in positions declared by local business entities. The salaries of the people were supposed to be financed from the budget and each of the participant’s salaries was supposed to be GEL 150 per month for three months. What took place was that small restaurants got around 20 people for free in the positions of trainee waitresses or cleaners for three months. A significant number of the employees clearly stated that they were requested by business owners not to even show up at the place of employment.<sup>18</sup> It is clear that no real positive impact can be achieved by this programme. According to some opposition parties, the real “positive” impact of the programme was on the local elections where the National Movement of Georgia, chaired by the President, got more than 50 percent.

Rather than investing money in entertainment and unusual employment programmes it would seem advisable for the government to easily establish a start up fund for SMEs (this could be done easily), to develop or give incentives to finance small and medium sized businesses with much lower risks and therefore lower the interest rates. It should be mentioned that Tbilisi Municipality introduced a GEL 500 000 programme in the run up to the elections, but it looks like the exception rather than the rule and in comparison to other funds is a very low amount.

#### **5. Labour code**

The development of the new Labour Code of Georgia was hailed by the government and International Financial Institutions (IFIs) as one of the brightest achievements after the Rose revolution. Lobbied for intensively by the State Chancellery, not by the business entities, the major reforms addressed removing

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<sup>17</sup> Interview with D.Gamkrelidze, newspaper Asaval-Dasavali, 1-7 May, 2006;

<sup>18</sup> “USD 26m the Employment programme has been withdrawn from social programmes”, 28th of September, 2006 Resonansi;

restrictions on working hours and dismissal procedures, and thereby lowering firing costs to some of the lowest levels in the world. Furthermore, the code undermines the freedom of association and has been heavily criticized by the International Confederation of Free Trade Unions (ICFTU) and the International Labour Organisation (ILO). According to ICFTU secretary general Guy Ryder, “countries such as Colombia, Georgia, Moldova, El Salvador, Costa Rica and Guatemala are notorious for violations of basic workers' rights, yet they seem to have been judged by the European Commission to be in full compliance with international standards”. Even more, in Georgia, “the authorities have engaged in systematic efforts to undermine legitimate and democratic trade unions,” said WCL<sup>19</sup> general secretary, Willy Thys<sup>20</sup>.

How poverty eradication has been supported by the fact that Georgia has been scored zero for the rigidity to fire employees is dubious. The Labour Code itself does not bring lots of gains to employers (e.g. social taxes are still high), while it creates high instability for employees, that would directly impact their productivity. For a poor country, where unions do not exist and workers lack basic rights, the effect of reducing firing costs can be a step back in evolution instead of a leap ahead.

## **6. Macroeconomic stability**

According to EDPRP<sup>21</sup>, the major priority of macroeconomic policy is to attain fast and sustainable economic growth, maintain price stability, promote a favorable business and investment climate, increase budgetary revenue, decrease the budget deficit, secure debt sustainability, promote exports and reduce the current account deficit.

One of the most acute problems for the population of Georgia is inflation. There are several factors influencing inflation. One of the factors is increasing overall demand, which is caused by the money supply, including government expenditures. In August of 2006 the IMF praised the fact that “Georgia's economic growth performance continues to be strong,” however recognised the fact that “the economy is now characterized by significant inflationary pressure”. It underlines that “whereas twelve-month inflation was about 6 percent as of the end of April 2006, by the end of July inflation had accelerated to 14,5 percent”. The IMF urged the authorities “to tighten the current fiscal and monetary stances. The combination of expenditure restraint, a smaller deficit and slower growth of reserve and broad money would help reduce demand pressures. To this end, understandings were reached that would limit the overall fiscal deficit to 1,8 percent of GDP. Taken together, these measures should reduce inflationary pressure during the remaining months of 2006 and improve the prospects of achieving end of 2006 inflation of around 10 percent. For 2007, efforts to reduce inflation will be intensified.”<sup>22</sup> At the end of the year 2006, despite the creation of strange entertainment parks and employment programmes, the inflation rate was brought towards 9 percent, however, the prices of basic commodities and medication rose significantly.

Another factor negatively influencing macroeconomic stability was the price of energy in the world market. As a result of the non-existence of anti-monopolistic regulation, its influence on economy was more severe, as prices did not follow fluctuation on the world market and subsequently once raised stayed there for a longer period.

## **7. Energy sector**

The energy sector is a key factor in the development of the economy and the eradication of poverty. At present, there is still a problem of access to energy as well as affordability of energy services for Georgian citizens, especially in rural areas.

The reforms in the energy sector in Georgia before and after the “Rose Revolution” can be said to be almost completely a product of the government. In the initial stage of their design the government consulted with the IMF, the World Bank and other donor organizations. However, elaboration of any document and its implementation was in the hands of the Ministry of Energy, and the other stakeholders were left in the dark, without any public consultation or hearings.

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<sup>19</sup> World Confederation of Labour (WCL);

<sup>20</sup> World unions concerned over EU GSP offer <http://www.dailynews.lk/2005/12/29/bus01.htm>

<sup>21</sup> Economic Development and Poverty Reduction Program (EDPRP);

<sup>22</sup> Statement by an IMF Mission to Georgia Press Release No. 06/181 August 18, 2006;

The process of elaboration of a number of the documents<sup>23</sup> drawn up by the Georgian government in 2004-2006, including the “Main Directions of Georgian State Energy Policy”, is a good illustration of the above mentioned. Since 2004 Association “Green Alternative” has applied several times to the Georgian government and the Ministry of Energy and requested that the public be included in the decision making process, unfortunately with no success<sup>24</sup>.

In 2006 the Georgian Ministry of Energy prepared and the Georgian Parliament approved in amazingly record time the document on “The Main Directions of Georgian State Energy Policy”. Despite the fact that the document addresses the following positive goal: “full satisfaction of the country’s electricity needs through Georgia’s own hydro power resources: step by step, first to replace imported volumes and at the next stage to replace thermal power generation with hydro power generation”, the main governmental priority addresses the issue of the existence of energy resources rather than the creation of a sustainable energy system.

In this regard the policy document clearly showed that it does not intend to establish a basis for the creation of a sustainable energy system in Georgia. For example, according to the document, “the use of traditional and alternative energy sources should be regulated under the same conditions”. This statement clearly excludes incentives for the development of renewables. Furthermore, energy efficiency, one of the major components of a sustainable energy system, is almost ignored within the priorities of the policy paper and does not represent a strategic direction for the government. Meanwhile, according to experts, crude calculations suggest, the energy efficiency measure could reduce Georgia’s dependence on the gas supply by at least 20 percent.<sup>25</sup>

It should be mentioned that the policy document fails to comply with the Economic Development and Poverty Reduction Program (EDPRP) prepared by the Georgian government with the support of the World Bank and the International Monetary Fund in 2003. The EDPRP document underlines the fact that energy efficiency and use of alternative and renewable energy resources “are especially important” for guaranteeing the country’s energy security. However, in the policy document everything is narrowed down to rehabilitation of energy units and diversification of imported energy sources.

The lack of public participation during the decision making process is a characteristic of all sectors of economy, including the energy sector. The privatisation process, currently being conducted, planned that all energy generation units and electricity distribution companies should be become private in the near future.

However, before the privatisation of the companies an environmental audit was not carried out and consequently the enterprises were not asked to present and observe environmental management plans according to the preliminarily agreed schedule.

According to the experts, the recent privatisation that took place does not comply with the statement presented in the document on the Main Directions of Georgian Energy Policy: “ensure transparency of the privatisation process in the power and natural gas sectors”<sup>26</sup>. The experts believe that the privatisation will increase the tariff and that this will affect the population’s welfare, and bring disastrous results, both politically and socially<sup>27</sup>. The fact that lack of transparency during the privatisation process hinders the development of a friendly investment climate in the country is also noteworthy. Privatisation of the so-called strategic sites, for example the Enguri hydro power station (which generates 40 percent of all electricity generated in Georgia) or the gas pipeline from Russia to Armenia is also a problematic issue. Most experts believe that in order to guarantee the country’s energy security the state should retain its control over such sites.

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<sup>23</sup> Energy Sector Policies, 2004, 2005, 2006 Energy Sector Strategic Action Plan, 2005-2008 Energy Sector Strategic Action Plan;

<sup>24</sup> Visit: [www.greenalt.wanex.net](http://www.greenalt.wanex.net)

<sup>25</sup> “Crude calculations suggest that the increase of energy efficiency in supply and consumption sides by just 10 percent, will lower the dependence of the country on imported energy resources by approximately 20 percent.” Georgia in the context of EU energy policy, Teimuraz Gochitashvili, Professor,; Mindaugas Krakauskas, GEPLAC expert on energy issues, George Abulashvili, GEPLAC expert on energy issues Georgia Economic Trends, June 2006 [www.geplac.org](http://www.geplac.org)

<sup>26</sup> According to the government, the Czech company “Energo Pro” purchased 2 distribution companies (Unified Georgian Energy Distribution Company and Adjara Power Company) and 6 hydro power stations: “Atshesi”, “Dzevrulhesi”, Lajanurhesi”, “Rionhesi”, Shaorhesi” and “Gumbathesi” for USD 312m. However, experts and some MPs believe that the privatisation process was not transparent;

<sup>27</sup> “Why is the agreement still not signed?! The results of the destructive processes taking place in the energy sector will be evident in the forthcoming year” newspaper “Resonance”, #233, Tuesday, August 29, 2006;

It should also be mentioned that a friendly investment environment in the energy sector has not been created. Therefore investment in the energy sector is scarce, which creates significant barriers for the development of the country's economy. Furthermore, the decision makers are mainly focusing their attention on large and expensive projects such as the construction of new high-capacity hydro power stations and power transmission lines.

A good example of the above mentioned is the Khudoni hydro power station construction project that is under preparation by the WB and the Georgian government. According to the WB, the project aims at the development of new hydropower resources, which would be able to generate an amount of electricity, which would be able to satisfy more than 10 percent of Georgia's needs in electricity annually and will represent 20 percent of existing energy resources; According to the Bank, this will strengthen Georgian energy security. In addition, the project is oriented towards exporting electricity to neighboring countries<sup>28</sup>.

Decision makers often try to represent these type of activities as another step towards ensuring the country's energy security; however, they tend to forget the problem of energy accessibility, as the construction of Khudoni and other high-capacity hydro power stations have the potential to increase the electricity tariff in a way that the local industry that is still based on old energy intensive technologies may become totally uncompetitive<sup>29</sup>.

On the positive side we should mention, the rehabilitation works on small and medium size hydros carried out by the Georgian government in 2004-2006, that have played a positive role in the reduction of the energy deficit. This tendency (rehabilitation of hydro power stations with state money) must be preserved in the future, if private investors are not interested. It is important as the energy deficit and problems with regard to energy accessibility pose a direct threat to the Georgian economy's further growth. Taking into account the potential of Georgia's power sector, the growth of energy consumption and the energy balance structure should be planned based on the use of local, mainly hydro resources, which should be based on the principles of sustainable development.

## **8. Environment**

Since the Rose revolution the government's policy of, so called "fast economic modernization practice" which envisages fully minimising state intervention through complete deregulation and liberalization in a number of the sectors could bring more harm than benefits. Unfortunately, within the overall fast economic modernisation reforms, so enthusiastically supported by the World Bank, there are a number of reforms which include the liberalisation and deregulation of sectors, where through minimisation of its control functions the government risks to the health and safety of its own population and the environment.<sup>30</sup> About 85 percent of licensing legislation has been abolished, including the spheres of environmental protection, food, industry and vehicle safety; which is a good example of above mentioned. Correspondingly, a number of controlling bodies have been abolished or their functions have been transferred to other organizations. As a result, a number of issues have been left without regulation<sup>31</sup>. The above-mentioned approach is shared by almost all the members of the government; however, there are pro-European forces as well that require gradual harmonisation.

According to one Georgian expert, the logic behind the idea of fast economic modernisation is as follows: "Since the prospect of EU accession is not looming at all, we can't postpone fast economic reforms. When the people are fed, we will take care of the environment and consumer protection issues.

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<sup>28</sup> WB believes that it can provide partial financing for Khudoni hydro power station (up to USD 50m) through IBRD if the loan will be guaranteed with an electricity export contract. The ownership issue of the hydro power station should be defined by that time;

<sup>29</sup> There are no credits or state programmes to assist local industry in carrying out activities directed towards energy efficiency;

<sup>30</sup> "Over the past three years, Georgia has become synonymous with extraordinarily rapid change and reforms," said World Bank Vice-President Shigeo Katsu. "Georgia is truly open for business, and investors should take heed. This is a country that is pursuing the right reforms and the World Bank is committed to supporting these efforts." World Bank Press Release No: 2007/176/ECA Georgian prime minister spotlights investment climate reforms, [www.worldbank.org](http://www.worldbank.org)

<sup>31</sup> For example nobody controls the selling of expired food products in the trading network. The Law on Food Safety and Quality (approved in December 2005) completely restructured the food control system; as a result, these functions were transferred to the Ministry of Agriculture (except for border control) and the National Service of Food, Safety, Veterinary Medicine and Plant Protection (part of Ministry of Agriculture) was created. Experts hope that the Service will carry out effective control from 2007 when its regulations are approved and it's able to operate;

Compliance with the EU *acquis* is not a priority now<sup>32</sup>. As a result, environmental protection, which has been recognised only as a last priority by the Georgian government, has been overridden by the exploitation of the natural resources and their privatisation, without regard to the environmental and social consequences of those measures. It was during the EU-Georgia Action Plan negotiations, under the ENP framework, when the Georgian government in the first proposed draft, despite the clear requirement from the EU, did not even mention environmental protection.<sup>33</sup>

The legislative changes undertaken by the government fully ignore the preventive role of environmental protection. For example, one of the most important changes introduced through the new licensing law is the fact that the government, with regard to certain A category projects, such as oil and gold extraction, or farming, is no longer required to carry out and does not require any environmental and social assessment, while the Ministry of Environment is obliged to give an applicant an environmental permit within 20 days of the application being received.

## **Conclusion**

While the government and IFIs report optimistically about the creation of a friendly investment climate for foreign and domestic investments, the fact is that all Georgian businesses, regardless of size and longevity, are experiencing difficulties, while the poverty level is still significant. Moreover, since the Rose Revolution government has been oriented towards short-term measures (which on the one hand can be understood with regard to the amount of the problem that needs to be solved fast, and on the other from the fact that they still try to prove to the electorate how efficient they are) whilst long term perspectives have been lost sight of.

In order to fully support Georgia the donor community should encourage the Georgian government to improve the country's business environment, safeguard and improve Georgia's environment, protect human rights and the rule of law. The assessments carried out by IFIs should be based on the realities of the implication of ongoing projects, cost efficiency of programme carried out and the actual number of people who benefit, rather than nicely written laws and programmes, where it is questionable in which direction they will be implemented.

Almost all recent strategic papers, adopted by the government and different international institutions (including the EU-Georgia Action plan,<sup>34</sup>) clearly underline the transit potential of Georgia in the transport and energy spheres, which implies enlargement of trans-European networks, construction of strategic power industry sites and high-voltage power lines. At the same time the Council of the European Union adopted the new external mandate of the European Investment Bank (EIB). In 2007-2013 based on its new mandate the EIB will invest about USD 3,2 bn in Russia and the South Caucasus for the development of the sectors that are of most interest to the EU, such as transport (enlargement of trans-European highways), energy (strategic energy projects), telecommunications and development of environmental infrastructure<sup>35</sup>.

Theoretically, the European Neighborhood policy opens new prospects for Georgia for more active participation in European integration processes, gradual harmonization of legislation and encouragement of improving the living standards in the country. It should encourage the growth of Georgia's and other South Caucasus country's shares of the EU's internal market and strengthen stability and security. While horizontal instruments of environmental and social security are not working in the country, there is not a sustainable development strategy and the protection of the environment is of the lowest priority; the development of the transit potential of the country may cause further degradation of the environment, violation of human rights and increased poverty.

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<sup>32</sup> Georgia in the Wider European Context: Bridging Divergent Interpretations; Archil Gegeshidze, Georgian Foundation for Strategic and International Studies, Tbilisi 2006;

<sup>33</sup> N291 decree of Georgian government, about approved priorities of EU-Georgia action plan, under ENP framework", July 11, 2005;

<sup>34</sup> Adopted by EU Parliament;

<sup>35</sup> Council agrees on renewed mandate for external lending by the European Investment Bank, Brussels, 28 November 2006, 15787/06 (Presse 339), The Council of the European Union.

**This paper was prepared by CEE Bankwatch Network**

**CEE Bankwatch Network** is an association of non-governmental and non-profit civic organisations from Central and Eastern European countries.

**The CEE Bankwatch Network's mission** is to prevent environmentally and socially harmful impacts of international development finance, and to promote alternative solutions and public participation.

**The goals of the CEE Bankwatch Network** are:

- To create public awareness about the activities of International Financial Institutions in Central and Eastern European countries and their social and environmental impacts.
- To promote public participation in the decision making process about policies and projects of International Financial Institutions, on the local, national and regional levels.
- To help non-governmental environmental organisations and citizen groups monitor what the International Financial Institutions are doing in Central and Eastern Europe.
- To change or stop environmentally and socially destructive policies and projects of International Financial Institutions in Central and Eastern Europe, and to promote alternatives.
- To cooperate with environmental citizen organisations in stopping destructive activities of Transnational Corporations and to limit their overall impacts on the environment in Central and Eastern Europe.



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