Industrial Policy and Trade Regime in Georgia

Vladimer PAPAVA,
Teimuraz BERIDZE

INTRODUCTION

The main challenge facing the Georgian economy nowadays is finding the optimal way out of the crisis situation in the economy and taking appropriate measures (1). For the last year and a half, the Government of Georgia succeeded in stabilizing the exchange rate of the national currency (this achievement was instrumental in the success of the currency reform) by banning the damaging practices of overdraft used by the former state-commercial banks; balancing the 1995 and 1996 budgets without credit emission; strengthening Tax Service and Customs Department; introducing and enforcing financial discipline with the help of constant tax rates, distribution of tax revenues between the central and local budgets in line with the ratios set in advance, and eliminating tax exemptions. The State Treasury is being set up. The share of direct state ownership in the former state commercial banks has declined so as to become practically zero. The supervisory functions of the National Bank of Georgia in regard to commercial banks have been strengthened, the partnership with the participation of the National Bank of Georgia with commercial banks on the basis of market principles is now developing. All this was made possible, on the one hand, by the assistance rendered to Georgia by the international financial institutions, and, on the other hand, by the adoption of laws regulating banking and fiscal sectors.

Financial stabilization achieved on the basis of the financial assistance received from the international financial institutions (IMF and World Bank) can be considered as a positive element of the economy of Georgia. It should be noted that financial stabilization (as well as political stabilization and lower
crime rate effectively achieved in our country) is the necessary but not the sufficient condition for the industrial growth, which will - in turn - foster the process of monetary stabilization.

**AGRARIAN OR INDUSTRIAL SOCIETY?**

According to main economic indicators Georgia belongs to the category of developing countries. However, what sets Georgia apart from, for instance some African states, is its well educated population and culture, skilled manpower, high scientific and technical potential (our achievements in some sciences are internationally recognized). In the similar situation are the countries of Eastern Europe and the former Soviet Union. For this reason, these countries are grouped together as transition economies (in another words, the states in the process of transition to the market economy).

While characterizing developed countries, the economic publications widely use the notion of post-industrial society based mostly on computer technology. There are other definitions for that sort of society: "Supraindustrial" (R. Aron), "Informational" (D. Lion), "Electronical" (M. Morishima), "Programized" (A. Turen), "Third Wave Civilization" (O. Toffler), "Risk Society" (U. Bok), "Postmodernist Society" (J. Liotar).

Basic resources of the post-industrial society are human knowledge and information. Rapid development of the industry could be provided by using modern microelectronics and computer technologies, which are giving an opportunity to processing and saving enormous volume of information. Revolution in communication systems brings us to the point when internationalization of economic links will be transferred into their globalisation. Structure of the industry is changed basically. Comparably, and sometimes even absolutely (according to the volume of production and number of employees) there is industry decline in traditional branches of the processing industry. Within there is a rapid increase in the service sphere, both in productive (financial, banking, insurance, trading, scientific consulting) and in nonproductive, software (science, education, health security, culture and tourism) types (2).

The ultimate goal of economic development of Georgia is defined as creating the post-industrial society we should note that the whole hotly debated issue of whether Georgia should become an agricultural or industrial country is irrelevant. "Industrial society" is a widely recognized term which implies by definition that manual labor is replaced by machines. This process started to un-
fold at the earliest stages of capitalism. The crucial issue here is not merely deci-
ding, what should be the mainstay of Georgian economy - agriculture or in-
dustry, but rather the fact that in all the sectors of the economy (including the
growth (R. Solow) focuses on the fixed capital (technologies).

THE ROLE OF THE INDUSTRIAL-TECHNOLOGICAL POLICY IN
OVERCOMING THE ECONOMIC CRISIS:
BURDENED LEGACY AND FUTURE STRATEGY

At the stage of overcoming the economic crisis it is vital to define the coun-
try's industrial-technical policy and ways of implementation of such policy.
The paper provides the framework for the industrial-technical policy and
thus defines it. It should be noted that no industrial-technical policy can be
formulated outside policy in general. The industrial-technical policy in turn
may hinder the formulation of the new policy, if it goes against the interests of
the "industrial elite", or former Soviet directors, who by the using privatization
process managed to seize the enterprises and at the same time managed to
get into the Government structures.

In the former Soviet Union the industrial-technical policy was differed
from industrial-technical policies of world's leading countries. As a result of
the ideological confrontation, the Soviet economy emerged and developed in
isolation. Moreover, the lack of democracy did not allow for competition,
which explains the Soviet Union's falling far behind the world's leaders in the
field of the industrial-technical development.

Georgian industry as the small part of the former Soviet Union's industry
inherited the same negative features: a) obsolete technologies; b) inter-
nationally non-competitive goods. The post-communist countries remain
the only major potential market for Georgian-made industrial goods.

The Soviet megalomania left behind as its legacy such factories that can be
best described as "Soviet-style pyramids". Their size is truly amazing. Unfor-
nately, however, they do not have any practical merits. If any of them
operate at 10-20 per cent of their capacity, it is already considered remarkable
achievement, since even under the current circumstances selling expensive and
low quality goods is difficult and, in case of increasing the output, marketing

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will become even more of a urgent issue.

The collapse of the Soviet Union struck a heavy first blow to the industry. The situation was exacerbated by the economic crisis. The bulk of Georgian industrial facilities will not be competitive without seriously restructuring their capacities and introducing modern technologies. The problem of manufactured goods’ low quality is also pressing. The current technological level of fixed assets of the Georgian industry in many cases unfortunately does not leave a chance to factory managers to even think of western markets without a sizable investment. Therefore, the aforementioned state of the Georgian industry’s fixed assets pushes the majority of the “industrial elite” to deepen integration processes unfolding in the CIS countries and to entertain the illusion of restoring the old links as if the other CIS countries did not try to adopt new western technologies. In view of the above, one must recognized, that Georgia and other post-communist countries can survive only if they will opt for orientation on modern western technologies.

The viability of independent Georgia rides on the extend to which it will manage to find its place in the civilized world. This is not an easy task. If one strives for recognition by Europe as its partner, one has to meet certain European standards which imply the implementation of democratic principles in the society at large and the transition to the market economy. The transformation taking place in Georgia (laying the groundwork for the building of democratic society and expediting the transition to the market economy) provided the framework for signing a formal agreement between the European Union and Georgia in late April, 1996, which potentially opens for Georgia the door to integrate into Western Europe.

In this regard, deadlines become a very important issue, that is, whether the Georgian industry is prepared to participate in the process of European integration. The answer predicative on the aforementioned reasons are, unfortunately negative. With very few exemptions, domestic product is not competitive by Western standards.

Thus, in order to find potential customers in Europe and become integrative into European market, Georgia has to overcome objective and subjective factors. The first is the obvious lack of domestic investment, whereas the latter is manifested in the inability of the part of the “industrial elite” to adjust the way it operates to the needs of new market environment. Some directors of the industrial companies prefer to restore old “traditional linkages”, than to seek for a new partners; traditionally for producing low quality pro-
ducts (as a matter of fact they could not publicly promote this idea). Here we have to mention that these directors, in most cases, are unable to restore these "traditional linkages" and are waiting "within open mouth" and begging, (sometimes even strictly requiring) from government to solve the sales problems.

In this case, subject, what kind of industrial-technological policy and what kind of measures should state perform, to improve Georgian economy and especially industry, becomes very acute problem. All this will generate requirement on our products at the international market, which by itself will produce growth of national export potential.

For the definition of industrial technological policy, it is necessary to harmonize the ways of solving strategic and tactic goals, which will provide sustainable participation of Georgian industry in the international integration processes. Strategic goal of the Georgian industry development, as well as industries of other post-communist countries, is to integrate into Western European market. For these purposes the necessary time to attract foreign investments, as a rule, is extremely long and that may cause the final collapse of our industry. Because of that the tactical goal of industry development is to maintain its viability, for that reason the certain part of the former Soviet Union (for wine-making-Siberia and Russian Far East, for tea industry- Turkmenistan and etc.) must be used. As above mentioned other post-communist countries are trying to modify their industry according to the international standards, that is why the tactic goal of our industry is not in contradiction with strategic goal.

Two alternative approaches to reaching these most ambitious goals may be proposed. The first is the protection for domestic producers by way of imposition of differential customs tariffs and excise taxes, whereby the domestic production will enjoy lower levels of excises, while imported raw materials and semi-finished goods (inputs) will be tax exempt (including VAT exemption). Meanwhile, the finished goods imports will be subject to higher customs tariffs (and to higher VAT). At the same time, the domestic finished goods exports shall be tax exempt, while raw materials and semifinished goods shall be taxed at a higher rate. The second approach advocates uniform excise tax levels for domestic and imported goods. Customs tariffs on all imported goods shall be at the same—relatively low-level. In the future all exports shall be tax exempt. Machinery and equipment may constitute the only—and temporary—exception.

The first scenario also implies the existence of a complicated system of ex-
port and import restrictions, quotas and licenses. The second scenario suggests the elimination of quota system. As to the restrictions, the shall be minimized, and serve the only purpose of ensuring the national security (these should apply to weapons, drugs, museum pieces).

The "industrial elite" supports the first scenario and lobbies it hard in the government. Unfortunately, some of our scholars also back this stance. Some government officials (mainly economists) are in favor of the second scenario. Their position is backed by the international financial institutions (the IMF and the World Bank) which draw from the wealth of international experience.

Some of the proponents of the protection of domestic market in Georgia, come up with such extreme proposals as the sealing off of the borders several years, prohibition of imports of specific goods (e.g. alcoholic beverages). The deepening of the domestic market with closed borders can be termed "market Stalinism".

Competition is the main driving force behind any improvement in quality of goods and any cost savings. The later can also be achieved through the introduction of new technologies. This is true not only for the domestic market but also for the world market. Any barriers put up by a country for the sake of protection for the domestic producers would limit the beneficial effects of the international competition which - in conjunction with the introduction of new technologies - impact favorably on economic incentives and cost savings.

In view of these arguments, the economic theory suggests that the best trade policy for the improvement of a country's competitiveness, is to have zero rate customs tariffs on imports and exempt exports from all taxes, and to eliminate quotas and minimize restrictions and licenses of exports and imports. Only then can the domestic become part and parcel of the international markets. Despite the obvious advantages of these trade policy, it is not fully implemented in any country of the world. Although it is true that the member states of the European Union have effectively implemented this trade policy within the Union, their policies towards non-member states include different trade barriers. This is typical and customary for nearly for all the countries. Why do all countries deviate from this ideal foreign trade policy? Why do not they use the international competition to their benefit?

"LAW OF COMPARATIVE ADVANTAGE" AND FREE TRADE

It is well known that various countries natural resources and conditions vary greatly and predetermine development of different sectors and branches and
traditions. This is a basis for government’s activity for provide protection for these traditional branches (which are only hindering the development of these vary branches).

In all states the opponents, of country’s complete integration in the international competition, are representatives of industrial sector in the government; in nearly all the countries of the world they represent the industry and lobby for preferential treatment for a particular branch on the domestic market. In some cases the lobbyists do not realize that such policy is bound to destroy the very same branch that they are trying to protect. In their demands for differential customs tariffs in Georgia the lobbyists are usually guided by the following two considerations:

1. The industry needs support for as long as domestic production costs are higher than the price of imported similar goods otherwise our goods do not sell and, therefore, manufacturing becomes meaningless. As the introduction of higher customs tariffs on some goods leads to higher prices of imports, it will make possible the sale of their own goods (of relatively poor quality) and increase their revenues.

2. Contraction and in some cases a complete shutdown of non-competitive industries will lead to higher unemployment rate which will in turn result in lower household income and purchasing power.

Contrary to these at first sight well-founded arguments, it is clear that a protectionism policy of this nature will be extremely detrimental to our industry:

First of all, it is impossible in practice to select one particular industry worthy of support by way of providing preferential customs treatment it, while nearly all the industries are in equally bad “technical” and “financial” shape. For instance, as soon as the tea industry manages to obtain customs privileges, it opens the door for the wine-making industry’s lobby: as a result the process will spin out of control. The light industry’s lobby will manage to obtain the same concessions, followed by chemical industry and so on, and so forth. In the end, we will find out that our entire industrial sector enjoys full protection. Then the other sectors of the economy would strive to achieve the same treatment as the industry, and we, therefore, will cut our economy from the rest of the world (the best example was the extension of the coverage of provisions of the draft law on concessions to tea industry submitted to the Parliament to the entire industrial sector in a matter of one session, which was abolished very soon.) In the process, we will cause so much damage to the budget that
the Government will not be able to cover expenditures on defense and law enforcement and may very well fail to meet the needs of pensioners and socially vulnerable groups of population. And if our Government will try to meet these needs with the help of credit emission by the National Bank of Georgia, we will find ourselves in a situation of not such a long time ago.

Secondly, let us assume that we will be able to limit spreading of customs privileges to only several branches. This will undermine any economic incentives for them to lower their production costs and improve quality of their goods. This process will snowball like "chain reaction" to the industries supplying these privileged branches with raw materials, semi-finished products, etc. While the employment in these branches will increase, the low quality of the output of these enterprises will not allow them to pay higher salaries to their workers. An increase of employment of such a nature serves as the most spectacular example of the country's backwardness. It must not be supported in any way, shape or form. Apart from the above, granting concessions to one of several subbranches of the industry will distort the profile of investment.

Thirdly, one cannot ignore the fact, that the losses incurred in the course of consuming domestic goods of poor quality which become more expensive will simultaneously adversely affect the welfare of the population. A borne out by international experience the decline in the overall welfare of the country using customs protection varies from one to ten per cent of the GDP (6). The negative impact of these brand of customs protection has been evidenced not only in theory but also in international practice.

In this case, the introduction by the Government of Georgia of protectionist policies based on differential customs tariffs would do a disservice to our industry. What kind of approach should we then adopt in regard to customs tariffs?

Zero-rated customs tariff on imports would not be justified from the fiscal problems perspective. We would then lose a certain part of budgetary revenues which otherwise should grow as the Customs Service improves enforcement.

In theory it is proven that the optimal rate of customs tariffs as the part of costs paid by foreign supplier is the reverse function of the elasticity of import supply (7). However, this indicator of elasticity is extremely volatile, therefore, introducing corresponding changes to the customs tariffs would undermine the stability of our taxation system. This would be a highly undesirable outcome. Moreover, frequent determination of the elasticity indicator on all imported
goods is labor-consuming, thus the cost of it would not be recovered by customs receipts resulting from this exercise.

As shown by international practice, the best system of import tariffs comprises a uniform tariff applied to imported goods across the board, which should not be excessively high (8). In the case, every sector of national economy is competing internationally on equal footing without causing any distortions in the beneficial impact of competition on the competitiveness of domestic manufacturing outlined earlier. The non-zero-rated import tariffs are means of protecting of domestic entrepreneurs from the outside world and one of the sources of income for the budget. Does all this mean that protecting our industry and other sectors should be completely ruled out? Certainly not.

In 1992-1996 regulation of the export-import by the Georgian Government once more proved it. First significant document on export-import was presented by Government of Georgia in August of 1992 about temporary regulations of quotation and licensing of export-import.

Broad assortment of the raw materials and goods were subjected to this resolution (25 items, among them were presented as one of the items, food products, ferrous metal products and all kinds of natural recourses), import licensing was spread on six items of goods (medical appliances, drugs, chemical means of plant protection, industrial wastes, narcotics, weapons and ammunitions) and thirteen items of goods were prohibited.

The next stage of export-import regulation was resolution of the Cabinet of Ministers of the Republic of Georgia in March of 1993. According to this regulation the list of goods taking quotation and licensing still included 25 items (there were some changes in the former list, e.g. food products were taken out of the list), licensing of import was still unchanged, though the list of prohibitions was not only changed, but grew up to 15 items.

The next resolution "On Perfection of State Regulation on Export-Import of Goods (jobs, services)" was adopted by the Cabinet of Ministers of the Republic of Georgia in January of 1995. Serious changes were included in it. Specifically, goods which were subjected to licensing and quotation were separated from goods subjected only to the licensing. Eight items of goods remained in the list subjected to quotation and licensing, but another eight items subjected only to licensing. According to this resolution prohibited list was diminished to twelve items. The enumeration: "list of goods import and export of which are performed by licensing" was adopted instead of import licensing
and it included eight items (medical appliances were removed, but wild animals and birds, gunpowder, explosive and nuclear materials, technologies and mechanisms were added). It is remarkable that all items included in this list correspond to the international standards and it is still in force.

In February 1995 the resolution, which was adopted by the month before was modified. Specifically, tea and coal were removed from the list of goods under quotation. From prohibition list copper production was moved to licensing. In February wood was moved from licensing to prohibition, but "unwashed wool" was added to licensing.

The most important stage of export-import processing liberalization was resolution in April of 1995 by Head of Georgian Republic, according to which the quoting system of goods was canceled from June, 1995. That caused necessary changes: the new list of goods subjected to licensing, which included only 9 items have been adopted.

The last document, which modifies the rule of export licensing and the list of licensing export prohibited goods, which is still in force, is resolution adopted in November of 1995 by the Cabinet of Ministers.

According to the above mentioned resolution to licensing are subjected: different materials for collections, wood logs, raw materials for drugs originated from animals and plants and the substances received from the human body, Caucasian Sochi seeds (Silver fir). The list of export prohibited goods was sufficiently diminished. Nowadays valuable it is prohibited to export from Georgia only valuable museum arts specimens, antiques, weapons and ammunitions, black and ferrous metals scraps (three items in all).

Besides licensing and non-tariff barriers of prohibition the obligatory registration regulation on contracts was in the processing in Georgia, until November of 1996. At first it was extended on the contracts made on all kinds of state enterprise produced goods. From November of 1995 there were made amendments in the obligatory registration regulation on contract; each enterprise and organization (despite of their form of ownership) contracts on the following exports: black metal and its products, manganese and copper concentrations, leather and its raw materials, tobacco and its products, alcoholic beverages, mineral waters, tea, tinned fruit and vegetables and food concentrates, tourist service (nine items in all) were subjected to the regulation of registration. Besides this there was excepted import contract registration on alcoholic beverages, tobacco products, toning non-alcoholic beverages and original juices.
The obligatory registration regulation on contracts was changed in February of 1996 according to the joint decree of the Ministries of Economy and Trade and Foreign Economic Relations. Due to this decree export contracts registration was extended on: black metals and its products, manganese and its copper concentrations, alcoholic beverages, mineral waters, tea and tourist services (leather and its raw materials, tobacco and its products, tinned fruits and vegetables and food concentrations are removed), as for import contracts registration there were annulled. The obligatory registration regulation on contracts was abolished by the resolution of President in November of 1996.

Besides above mentioned due to the President’s resolution in June of 1996 the right on licensing the import of medicines was referred to the Ministry of Health and licensing on import of medical-technical goods was determined, which was not foreseen in the main lists at all.

The instruction improved by the Ministry of Culture and Customs Department there was proceeded decree in January of 1995 the regulation on movement of the cultural values inside the Georgian boarders. This regulation includes rather broad list of articles and goods, carrying out of which are prohibited or special permission is required.

As for the customs duties, for the first time in Georgia, due to the Georgian Government resolution in May of 1992, there were fixed export-import taxes (on export - contract value 8%, on import - contract value 2%, on barter - contract value 20%). According to the resolution in November of 1994, the mentioned temporary system was changed: export was exempted from taxes, common 12% taxes customs duty on imports was fixed, on barter operations - 20 %. According to the law on “Georgian State Budget 1996” on barter operations as well as on import 12% tax was fixed.

Protectionism, from one point of view, must be consisted from: exports should be entirely tax exempt, which should provide an important impetus for export-oriented production (that is the current situation in Georgia apart from the export to the CIS countries which levy the VAT on goods in the source and not the destination country). This has to change as soon as possible, whatever it takes. One should also note that in the Soviet times Georgian economists with the interests of the Georgian budget in mind-argued with their Russian collecting the VAT’s predecessor, turnover tax, in the republic of production rather then the republic of consumption which would have boosted the revenue side of the Georgian budget, mostly due to alcoholic beverages and tea (the turnover tax accounted for an important part of the total tax liability).
In the case of a uniform relatively low import tariff, the exporters should be reimbursed the amount paid as import tariff on imported inputs used in production for export. This measure has been also effectively implemented in Georgia.

The government should mobilize foreign investment in line with the priority status of any particular branch of industry (the best example in our case is the energy sector). If the budget had sufficient funds, it would be preferable to subsidize a particular industry with the aim of strengthening it. (Unfortunately, there are no available funds in our budget). The uniformity of such measures of protection creates level playing field for the implementation of industrial technological policy. When the Georgian economy will become western-oriented, it will lay the groundwork for participation in the western integration, while not ruling out access to the CIS market (provided our entrepreneurs will be interested).

At the same time, one should note that the 12 per cent import tariff currently in force in Georgia provides our entrepreneurs with a 23 per cent cushion compared with their foreign competitors. The production costs of our entrepreneurs can be 23 per cent higher than those of their foreign competitors. As the goods are brought in Georgia, they are subject to 12 per cent taxes, thus becoming more expensive by 23 per cent. The Georgian domestic market is, therefore, enjoying a 23 per cent protection without even factoring in any transportation costs. This protection would have been sufficient, were our Customs Service able to effectively collect taxes and ensure law enforcement at the borders. If we take into account the fact that excise taxes are levied on imported goods inclusive of import duties, it becomes obvious that this category of goods enjoys an even higher degree of protection on the domestic market that the aforementioned figure suggests.

The demand for differential excise taxes on imported and domestic products often voiced by our “industrial elite” does not carry much weight, since they ignore that the nature of goods hazardous to human health or that of luxury items does not change regardless of whether they are manufactured domestically or abroad. At the same time, it should be noted that the excise taxes need some fine tuning (i.e., rate of excise on beer must come down.)

The legislative framework for intensive is very important for proper implementation of industrial-technological policy, as it should create level playing field for domestic and foreign investors. Bureaucratic procedures that the investment projects have to comply with must be reduced to a minimum. Tem-
porary tax concessions of any kind granted to foreign investors become a breed-
ing ground for proliferation of shady firms and weak companies. Bona fide
tirms with international reputation are not in the habit of asking for tax breaks.
A matter of primary concern for them is the issue of unrestricted profit repatriciation and privatization of land which the proposed investment project is
going to be locate, so that they will not be exposed to any arbitrary actions on
behalf of the State which would exacerbate the syndrome of the volatility al-
ways affecting foreign investors in transition countries. As borne out by in-
ternational experience, the environment created by temporaty tax concessions
for foreign investors is such that majority of these investors leave the country
immediately after the expiration of tax holidays, while domestic investors are
left with even less to show for this period then at the outset. Protection, as Ja-
panese experience shows, gives a certain fiscal effect to the state, and pro-
vides some profit for national producers, but it does not make significant con-
tribution in the economic growth. Whatever it lies as a heavy burden on the
consumers budget (9).

Good work of the Customs Service should be the mainstay of protection
from the imports entering the country illegally. The demand voiced by some of
our compatriots to introduce higher tax rates unacceptable not only for the
aforementioned reasons but also because it will encourage tax evasion by way
of exploiting the "bribe effect". The Parliament's decision revoking tax con-
cessions granted to individual firms was important in our quest for imp-
rovements in the Customs Service and development of our market.

In regard to protection of consumers from the so called "faked" goods (be it
from fakes produced domestically or imported), it should be done on the basis
of the "Law on Consumer Rights Protection" adopted by our Parliament of
Georgia in Spring of 1996).

We would not want to leave our reader with the erroneous impression that
our legal framework for taxation and customs does not leave anything to be
desired. We would like to see the suggestion formulated in this paper taken
into account in the course of implementation of these pieces of legislation, al-
though most of them have been already introduced in Georgia.

At the end we want to note, that the differences between countries (de-
veloped, developing and on the transition period), according to the content
and the scale of the liberalization on one hand and state intervention on the
other hand, many "structural differences" which still exist will disappear. After
this the subject of the discussion will be two types of macroeconomic policy:
good or bad.
FOOTNOTES:


