The Georgian Economy: From 'Shock Therapy' to 'Social Promotion'

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Georgia has been carrying out a radical programme of economic reform designed to correct the structural defects of the economy resulting from central planning and the disequilibrium brought about by the break from the former Soviet Union and subsequent political problems. The reform is still in process, and it is necessary to look back critically, as well as forward, so that our past experience of reform can guide us in future measures. This article provides an evaluation of the early years of reform measured against a 'standard' model of economic reform, an account of recent developments under a resumed and more purposeful programme of reform, and proposals for future action to invigorate the Georgian economy. A systematic and valuable account of economic and political changes in Georgia up to the end of 1993 appeared in this journal in 1994 (Gurgenidze *et al.*, 1994).

'Shock Therapy' in Georgia

Phases of Reform

The question is often asked: 'When did economic reform start in Georgia?' The best answer is that it started in 1989, when Georgian society embraced the idea of independence. That was a turning point for economists, and anyone who claimed knowledge of economics, leading to a number of interesting proposals as to how we should handle our new economic independence (Papava, 1990). In retrospect, we might call this first stage 'the stage of naive comprehension'.

The second stage of economic reform started after the election of the Supreme Council in autumn 1990. Several important laws on economic reform were passed, though they were unfortunately not put into effect. This stage deserves a title that reflects its lost opportunities: 'the stage of movement similar to stagnation'!

After the violent change of government in December 1991–January 1992 there began 'the stage of populist economic reform'. In this stage the government transferred land and dwellings to people without payment in order to enlist the 'easy' support of the population. It caused substantial damage to the agricultural sector and to housing construction. Land privatisation was carried out without payment, and almost ruined the system of supply and utilization of machinery, fertilisers, transport and other facilities. No legal basis for the holding of private property was established

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prior to privatisation, and consequently new owners were unsure of their title to the privatised land. Privatisation of dwellings was done in a similarly impulsive manner. They were allocated free to those in possession. Payments based on the quality of dwellings and locational factors would have been more equitable, and would have established a fund that could have been used for further housing development (Papava, 1992, pp. 97–101).

This populist stage of reform was certainly a 'shock therapy' for Georgia, and it was implemented at roughly the same time as 'shock therapy' was being used to reform the Russian economy. However, the relation of this Georgian 'shock therapy' to what might be called 'classical' shock therapy is a matter of debate.

Nation States and Provinces

The first essential distinction to be made between shock therapy as it is generally understood and the process of reform in Georgia is that shock therapy was assumed to be applied in a nation state, with all the institutions of statehood. The countries of Central and Eastern Europe are the main exemplars: Poland, Hungary, Bulgaria, etc. By contrast, the new nations of the former Soviet Union and Yugoslavia, except those that inherited the state institutions of the unions, had none of the institutions of a nation state. Georgia, of course, fell into this latter category.

Russia retained the institutions of statehood of the former Soviet Union. All other countries of the FSU, including Georgia, had to build their own institutions (though the task was perhaps somewhat less in Ukraine and Belarus, since, although they lacked statehood, they were still members of the United Nations). Georgia had to build up the institutions of a nation state at the same time as it was effecting the transition from a centrally planned system to a market economy.

The origins of 'shock therapy' date back to the revival of West Germany after the Second World War, but were given new life in the present era in post-communist Poland (Schaffer, 1992; Balcerowicz, 1994). Shock therapy requires national institutions for economic and monetary management; without such institutions shock therapy is doomed to failure. Georgia's attempt to apply shock therapy similar to what was being done in Russia was doomed because of the absence of the institutions essential to carry out the process.

The necessity for such institutions can be demonstrated more clearly by attention to the essentials of shock therapy, as set out in the 'Balcerowicz Plan' (now considered the classic modern statement of the elements of a Shock Therapy programme), and their application in Georgia.

The Balcerowicz Method

'Shock therapy' generally involves the application of strict fiscal and monetary controls, including elimination of subsidies through price liberalisation, reduction of the budgetary deficit, control of the money supply through restrictions on credit emission, and short-term restraint of income growth. The plan developed by the former Polish Minister of Finance, Leszek Balcerowicz, was applied in Poland and is considered to be a model of the essentials of shock therapy. It comprised the following measures:

1. Raising prices to world market level, accepting the inflationary effects of such action.

2. Constraints on income growth in inflationary conditions.
3. Restrictions on money supply and considerable increases in interest rates.
4. Encouragement of saving, by increases in interest rates on cash and other deposits.
5. Reductions in budgetary expenditure by reduction in government investment and elimination of subsidies to unprofitable enterprises.
6. Issuing of government bonds to finance the state budget deficit.
7. Regulation of the tax system and its unification.
8. Establishing a single rate of exchange for the zloty and establishing convertibility of the zloty in the domestic market.
9. Introducing a common customs tariff in order to restrict imports and stimulate exports.
10. Providing social assistance to the population within the limits of budgetary prudence.
11. Break-up of monopolistic enterprises and rejection of state intervention in the activities of competitive enterprises.

The extent of shock therapy reform in Georgia can be determined from a review of the application of each of these components.

Shock Therapy in Georgia

Item 1. The reform of prices started in Georgia as early as spring 1991 when free prices for some types of goods were introduced. In 1991 the price reforms were patchy, but in February 1992 (that is, a month after such changes had been introduced in Russia) there were more comprehensive changes: the prices of many goods and services were liberalised, while the prices of goods remaining under regulation were substantially increased. The average retail price index for 1991 was 78.5% above 1990; the average for 1992 was 913.1% above 1991. Regulated consumer prices in 1992 were 68 times prices in 1991; in the case of bread—one of the main items of consumption in Georgia—the increase was 100 times.

It can be said that Item 1 of the 'Balcerowicz Plan' was broadly fulfilled in Georgia.

Item 2. Adjustments of minimum wages and social welfare payments for inflation were increasingly made in 1992. Only one adjustment was made in 1991, but in 1992 adjustments were made six times. In 1991 the minimum and average wage of employees increased by 1.85 and 1.26 times respectively compared with the previous year. In 1992 the corresponding increases were 13.14 and 17.94 times. No strict regulating measures were taken in Georgia by means of which it might have been possible to limit increases in the wage fund (as was done in Poland, where 2% overspending on wages attracted a penalty for an enterprise of 200% of the overspending; and if the overspending was more than 2% the penalty was 300–500% of the overspending), but the increase in wages and social welfare payments fell well short of the price increases.

Thus Item 2 of the Balcerowicz Plan was more or less fulfilled in Georgia.

Items 3–4. The interest rate on deposits increased to 5% in 1992, from 2% in 1991. On 10-year deposits the interest rate increased from 9% to 80%. Such increases did not reflect the rate of inflation. Nor did they have much effect in restricting the money supply. Georgia was still utilizing the Russian ruble and had no monetary system of its own. The former USSR ruble and the newly issued Russian ruble were in circulation in Georgia.

On 25 July 1992 it was announced that cash deposits would be doubled on 1 August, but withdrawal of such doubled deposits would not be permitted for one year, except for use in the privatisation process (which was *de facto* suspended in Georgia at that time). On 1 August it was announced that the doubling would take place on 10 August, giving depositors further time to make their deposits.

In the second half of 1992 it became difficult to obtain ruble banknotes from Russia, so the banknotes deposited were used for the payment of wages and pensions. Thus the effects on the money supply of the freezing of doubled deposits was partially lost.

It can be concluded from the above that Items 3 and 4 of the Balcerowicz Plan were not carried out in Georgia.

Item 5. In 1992 the proportion of investment in total government expenditure in the state budget was not reduced. Up to 1992 it fluctuated between 20 and 25%. Subsidies in 1992 increased a little over 5 times in comparison with 1991. In spite of this increase, the proportion of the budget in 1992 attributable to subsidies declined to 30.1% compared with 47% in 1991. But it could not be said that the reduction was sufficient to claim that Item 5 of the 'Balcerowicz Plan' was realised in Georgia.

Item 6. Georgian government bonds were prepared in 1992 but only offered for sale in autumn 1993, and then mainly as a substitute for Soviet bonds. Bond issues have not yet been used in Georgia to finance the state budget deficit. Thus Item 6 of the 'Balcerowicz Plan' was not implemented.

Item 7. Reform of the tax system in accordance with the requirements of a market economy was commenced in 1991, so Item 7 of the 'Balcerowicz Plan' may be regarded as broadly fulfilled. There are, however, further developments of the tax system to be undertaken.

Item 8. In 1992 there was no national currency in Georgia, and consequently no possibility of fulfilling Item 8 of the 'Balcerowicz Plan'.

Item 9. In 1992 a blanket customs tariff of 2% was introduced for imports, and 8% for exports. These measures clearly did not restrict imports and stimulate exports, so Item 9 of the 'Balcerowicz Plan' was not fulfilled in Georgia.

Item 10. The adjustments to income in compensation for inflation in 1991 and 1992 have already been mentioned. All incomes were adjusted by the same proportionate amount, so that the poorest paid got a smaller increase than the higher paid. Since price rises were particularly heavy on basic items, such as bread, the poor suffered more than those with higher incomes. Targeted assistance to the most needy was not achieved, and consequently Item 10 of the 'Balcerowicz Plan' was not fulfilled in Georgia.

Item 11. In 1992, for the first time, legal and government resolutions to promote competition and restrict monopolistic institutions were established. Full-scale enforcement of the new laws was not, however, achieved.

A state system of centralised purchasing was retained in 1992, sustaining state interference in enterprises.

Thus Item 11 of the 'Balcerowicz Plan' was not carried out on a wide scale in Georgia in 1992.

All together, therefore, in Georgia in 1992 eight out of 11 items of the 'Balcerowicz Plan', the classic scheme of shock therapy for post-communist countries, were not fulfilled. Perhaps most importantly, budget subsidies were not eliminated and money supply went unrestricted. The only items fulfilled (though not altogether satisfactorily) were Item 1, price de-control, Item 2, adjustment of minimum wages and social welfare payments, and Item 7, reform of the tax system. In part the process failed because of the absence of the necessary institutions to carry it out. Shock therapy based on price liberalisation alone was probably doomed to failure. It might have been better to take a more measured approach, starting with the establishment of the essential institutions of statehood and economic management.

'The populist stage of economic reform' ended inevitably with the failure of the Georgian version of 'shock therapy', and resulted in a delay of further reform.

Suspension of Reforms

Basic Features

The 'stage of delay' in economic reforms includes 1993 and the first half of 1994 (Georgia, 1995). The delay was partly due to non-economic factors and partly the result of mistaken economic policy.

In summer 1992 full-scale military operations commenced in Abkhazeti, with the conflict continuing in 1993. The economy of Georgia was severely disrupted, including the economic functions of the government. No proper state budgets were approved for 1993 or 1994.

The only possible source of finance to cover substantial government deficits was money emission. In 1993 state expenditure exceeded tax revenues by 1118 billion coupons, and in 1994 the deficit was 28 293 billion coupons.

Criminal Situation

Non-economic factors delaying reform included a serious upsurge in criminal behaviour in Georgia. The granting of an amnesty for prisoners in winter 1992, and the subsequent arming of a large section of the population in the civil war, were the major factors behind this upsurge. The conduct of any form of economic activity became dangerous. Many businessmen left Georgia, taking capital with them. Armed robbery gave way to racketeering. Many of those involved were addicted to drugs, and much of the income derived from criminal activity is thought to have gone overseas in payment for drugs. This criminal activity deepened and prolonged the agony of the civil war and impeded the resumption of economic activity and reform.

Currency and Credit

Reforms were also delayed as a result of mistakes in economic management, relating in particular to currency issue, credit management and fiscal control.

In late 1992 and early 1993 a serious shortage of ruble banknotes developed in Georgia. To meet this problem, the government introduced a national currency, the coupon, in April 1993. This measure gave rise to dissension between those who wished to remain within the ruble zone and those who supported the introduction of the coupon. The supporters of the ruble zone option were sufficiently prominent to contribute to erosion of confidence in the coupon and mismanagement of the issue of the currency. The coupon was declared the only legal tender in Georgia not when it was issued, but only when Russia carried out partial currency reform in July–

August 1993 and withdrew from circulation the ruble of the disintegrated Soviet Union.

Uncontrolled credit emission laid the foundation of the inflationary process in Georgia. Part of this credit was provided outside budget controls for agricultural rehabilitation in 1993 and 1994—rehabilitation that did not, in the end, take place. The extent of credit emission, uncontrolled and largely unforeseen, took Georgia into a state of hyperinflation in 1993 and 1994, with rates around 60 to 70% per month. Extensive substitution of rubles for coupons took place in trading.

Most of the formal part of the economy failed in this period, and an informal economy grew up, characteristic of low-income countries (Adams & Fitchett, 1992).

Inexperience of the National Bank of Georgia in currency and credit management led to restrictions on the availability of cash, including restrictions on withdrawal of cash coupons from the banking system. A considerable discrepancy developed between the value of cash and non-cash money. At the same time the provision of easy overdraft facilities by the state banks promoted hidden credit emission.

Continued subsidies for bread, gas, electricity and transport further extended the budget deficit and the requirement for credit.

Foreign Trade and Payments

A serious mistake was also made in foreign trade, with the consolidation of a 'unique Georgian clearing system'. Barter was considered to be the only way to obtain gas from Turkmenistan. The prices of both Turkmenistan gas and many poor quality goods produced in Georgia were artificially inflated. According to the proponents of the scheme, it was supposed to stimulate production by Georgian enterprises.

It is true that production of poor quality goods was stimulated. However, the products had to be purchased by government, and with no budget established, only partial purchases were made. Most production was acquired compulsorily by government, with promises of future payment. This put the producers in an impossible financial situation, and established a chain of defaults through the economy.

On top of this, the trouble in Abkhazeti blocked the rail link to Russia; unrest in Azerbaijan impeded transport through that country; and later the war in Chechnya blocked access to Russia by that route. These problems made it first difficult and then impossible to deliver goods to Turkmenistan. Georgia's debt to Turkmenistan over two years amounted to about half a billion US dollars.

To provide the barter goods a system of state ordering was instituted, which required a complex system of quotas and licensing to ensure the availability of goods to government. In some cases prices of goods obtained from overseas, including consignments from international organisations, were inflated, and the credits provided to pay for these goods were used in part for other purposes. By these means the foreign debt of Georgia rose to one billion US dollars in total.

Other Aspects of the Period of Suspension

A number of other factors related to key reforms, key sectors or administrative functions also contributed to the suspension of reforms in this period.

The restructuring of enterprises into joint stock companies, and further privatisation, was held up owing to failure to take proper account of the interests of the employees of enterprises.

The energy sector was particularly affected by economic and other problems.

Credit that should have been used for energy development was diverted to other purposes. The real costs of power resources were not fully reflected in prices, and insufficient efforts were made to enforce payment of energy accounts. An irresponsible failure to observe technical norms meant that routine maintenance of energy installations was not carried out, and repair of subsequent breakdowns was often impossible. On top of all this, continual theft of electrical equipment and machinery for its copper content, for sale overseas, aggravated the deficiencies of electricity supply. Against this background, there was inevitably a steep decline in production in all sectors.

Accounting systems at this time fell into serious disorder, so that it was impossible for government to obtain information on the activities and earnings of companies. This inevitably led to problems in the collection of tax.

In addition to the above, there was at this stage a virtual cessation of activity in the customs office; defective recording of foreign economic relations; loss of state property overseas; a growing contempt for the earning of an honest wage; expansion of the shadow economy; and use of humanitarian aid for purposes other than those for which it was intended.

Reform Resumed

Political Developments

At the beginning of 1994 the Head of State of the Republic of Georgia, Eduard Shevardnadze, initiated a new programme to combat the economic crisis through macroeconomic stabilisation and to pursue further structural reforms. This programme was put into effect in spring 1994 and marked the beginning of a 'stage of correcting of errors'.

This new stage of economic reform was, unfortunately, also accompanied by problems of a non-economic nature.

By the start of 1994 hostilities had been stopped. This had a markedly beneficial effect on the economy, but was not without its own problems. The protection and social support of refugees and displaced persons placed a heavy new burden on the state budget. The problem will not be solved until the refugees and displaced persons are able to return to their homes.

The fight by law enforcement agencies against criminals was also strengthened. Results have been positive, but it has to be acknowledged that a complete solution to the problem has not so far been found. A number of enterprises still do not dare to work at full stretch, for fear of being robbed by criminal elements. Government is giving this problem high priority and trends clearly indicate that an orderly social environment for the conduct of business is emerging.

Coupons and Rubles

Starting in spring 1994, the government gradually changed its attitude towards the coupon. This was partially the result of the involvement of the IMF, which seemed more ready to assist Georgia if it had its own national currency and was seeking to resolve problems with the management of the currency. This factor tended to reduce the influence of those arguing that Georgia should remain within the ruble zone and advocating the declaration of the ruble as legal tender in Georgia. Conversely, it assisted those in power who saw, from the very beginning, that there was little prospect for the Georgian economy without its own currency. It is worth noting here that a noble but possibly, from the start, hopeless effort was made in 1994 by the city authorities in Kutaisi to sustain the coupon—the only region in Georgia to do so.

The coupon was also taken more seriously as it stabilised, while the Russian ruble depreciated. The stabilisation of the coupon was the result of elimination of credit emission thanks to tight control imposed by the National Bank of Georgia (NBG). In autumn 1994 the NBG also cancelled restrictions on the withdrawal of cash from the banks, on advice from the IMF, resulting in a major reduction in the premium paid for cash.

Following the recommendations of the IMF, at the end of 1994 the NBG started regulating the banking system in accordance with conventional Western methods of control. Amongst other measures, it restricted the provision of overdrafts by the state banks. Corporatisation of the state banks began in the second half of 1994.

Budgetary Stabilisation

As part of a programme of reform worked out with the IMF in September 1994 prices for gas and electricity have been raised to world levels, the price of bread has been increased 285 times, and metro fares and tariffs for municipal services have also been substantially increased. Wages for those paid from the budget were increased, as also were pensions and social welfare payments, but these increases lagged considerably behind the price increases. These changes brought about a substantial reduction in subsidies.

The changes were followed by strengthening of the Georgian coupon. Before the rise in the bread price one dollar was 5.3 million coupons; after the price rise it was 2.4 million coupons. At the end of 1994 the price of bread was increased by a further 40% and the coupon exchange rate moved to 1.3 million to the dollar. The coupon has remained at around this rate since then.

Unfortunately it was not possible to collect full payments for gas and electricity, or even for bread, from enterprises and the population. A large part of the problem was the withholding from government of sums received in payment for these items. Trade organisations, enterprises and banks delayed transfers, speculating instead on the further decline of the coupon. Many of them incurred considerable losses in this way as the coupon stabilised. Even after the stabilisation of the coupon in 1995, collection of these payments was delayed by inefficiency in the banks and by the use of such sums by some local authorities for temporary settlement of outstanding budget debts.

Efforts to make good collection of payments by stopping services were not successful, partly because some representatives of government chose to 'protect' certain enterprises. Gas delivery to the population of Tbilisi was finally stopped in January 1995. Bread payments were improved by stricter policy in the first and second quarters of 1995.

Owing to formal commitments on the reform programme, the inability to collect full payments for gas and electricity meant that the government could not revise the prices of these items. This was a problem, because the strengthening of the coupon meant that dollar prices of gas and electricity were increasing unnecessarily. The adverse effect of this was felt particularly by industrial enterprises. A review of the formal commitments enabled government to revise prices downwards in coupon terms.

Since April 1995 the price of gas has been reduced by 35% and the price of electricity by 25%. The government also ceased to purchase gas from June 1995. Purchasing was left to Sakenergo (the state energy company), big industrial enterprises and municipalities.

Barter and State Purchase

Steps are also being taken to eliminate the 'Georgian clearing' system for overseas trade, along with the associated system of quotas and licences. Quotas were abolished from 1 June 1995, and licensing has been retained only for a limited list of goods. As noted above, this system has been a significant impediment to the introduction of reforms in foreign trade.

International Credits

The budgetary stabilisation measures have enabled the government to obtain credits from the World Bank and the IMF to sustain the process of reform. In December 1994 Georgia received the first tranche of a Systemic Transformation Facility (STF) from the IMF, amounting to approximately US$39 million.

In July 1994 Georgia received an Institution Building Credit from the World Bank of approximately US$10 million; in November 1994 it received a Rehabilitation Loan for Municipal Infrastructure of approximately US$18 million; and in March 1995 it received an Economic Rehabilitation Credit of about US$75 million.

The STF is available to the National Bank for purposes of currency stabilisation. The Institution Building Credit is used to improve the material and technical base of government organisations. The Rehabilitation Credit is used to finance part of budget expenditures.

Budget 1995

The approval of a budget by the parliament at the beginning of 1995 marked a very significant step forward in establishing order in the financial system of Georgia, coming as it did after a break of two years in the formal budgetary process. The budget was also significant in that it did not involve the issue of currency to cover the budget deficit. While the 1995 budget provided for only 47% of expenditure to be covered by taxation, the remaining 53% was to be financed by monetisation of food aid.

Financial results for the first two quarters of 1995 indicate that targets were not reached, but the trends are favourable. With the help of the IMF, it has been possible to reschedule much of Georgia's US$1 billion outstanding overseas debt. With this achieved, the IMF agreed at the end of June to allocate the second tranche of the STF, amounting to approximately US$44 million, and provide a Stand-By Agreement to the value of approximately US$113 million. These credits will enable Georgia to sustain its new-found financial stability and issue a new currency, the Lari, without the mistakes that marked the introduction of the coupon.

The exchange rate of the coupon was expected to remain stable through to the end of 1995. The inflation rate in the first half of 1995 was an average 2–3% per month. In the second half it was expected to average perhaps 1% per month. In the autumn of 1995 it was planned to liberalise the price of bread, and the government monopoly providing bread would be put into liquidation.

Wages in the government service remain very low. On 1 July 1995 the lowest monthly wage paid in the budget sector was the equivalent of US$2.69, while the highest was US$12.69. These represent, however, substantial increases on September 1994, when the lowest wage was less than 10 cents, and the highest little more than one dollar.

Health Care

The reforms have impinged most heavily on the health care system. The reform programme has been developed in close cooperation with experts from the World Bank. Much of the provision of health care will be passed to the private sector, and a system of medical insurance will be introduced.

Privatisation and Production

The process of privatisation, central to economic reform, was given renewed impetus by a decree of the Head of State in May 1994 giving preference to the existing staff of an enterprise in the corporatisation and privatisation process. By this decree the process of privatisation was markedly speeded up. Privatisation has also been advanced through provision of opportunities for direct purchase. In 1995 Georgia, like many ex-communist countries, started using vouchers for privatisation. It means, in effect, that shares in enterprises are distributed to people free of charge (Papava, 1992, pp. 92–97).

Further requirements for the revival of production include improvements in the energy sector and the relief of rail routes through Abkhazeti and Chechnya. It can be said that the 'stage of correction of errors' in economic reform will have been completed in 1995. Georgia will now be able to press ahead with the structural reforms necessary to bring success as a market economy.

Method of 'Social Promotion' of Economic Reform

Social Change by 'Social Promotion'

With the errors corrected, the complicated question arises as to how and by what method the reforms in Georgia should be continued. Unfortunately, there is no satisfactory and comprehensive answer to this question in economic theory. It is not rare for economists to argue over how the transition from a centrally planned economy to a market economy should be achieved—by 'shock therapy' or by graduated reform. But it is easy to forget that we are not at the beginning of the transition period. The choice has already been made. To speak of graduated reform (as in, for example, communist Hungary in its final period, or in China, which is still a communist regime) is, at least, late.

To establish how best to pursue reforms for a country in the situation of Georgia, it is necessary to determine the main indicator for assessing progress under a market system. It is the *human* being, who creates and for whom the market system is created, who is the best reference point for the measurement of progress.

In the classical market system, the notion of *Homo oeconomicus* was developed to describe the essential nature of man in business. This is man guided by private interests in his activity, in order to gain maximum profit. Of course, *Homo oeconomicus* is an abstract notion, but it still describes quite realistically the behaviour of a manufacturer.

In the final period of the existence of the USSR, *Perestroika, Homo sovieticus* was a popular characterisation of Soviet man. This is a man frightened and oppressed by the state machine, who depends on the good will of the powerful for his well-being. *Homo sovieticus* is also an abstract notion, but it expresses with some realism the type of man created by decades of communist power.

At the present stage of economic reform there is a type of man who, on the one hand, tries to act on his own initiative and in his own interests, and on the other hand, still looks at government in fear and in hope of charity and protection. Voucher privatisation might be seen as a manifestation of the existence of this type of man. Here, principles of social justice are introduced as a foreign body into the economic interest of privatisation (Papava, 1992, pp. 92–97; 1995, pp. 34–37).

Another example of this dualism is the demand of depositors to be compensated by government for the loss of their deposits as a result of the bankruptcy of commercial and industrial trust companies operating pyramid schemes (when to cover old debts new debts with high interest are taken). The government made no prior commitment to guarantee the deposits of these people, but it found the social and political pressures so great that it was obliged to exempt from all taxes for one year all the companies that were re-established on the foundations of the bankrupt victims of the pyramid schemes, and to give depositors vouchers—each depositor was given a block of vouchers with a nominal value of US$200.

Thus, at the present stage of transition to a market economy, there is a type of man in whom the qualities of *Homo oeconomicus* are steadily developing, but who has not yet liberated himself from the qualities characteristic of *Homo sovieticus*. This type we could perhaps call *Homo transformaticus*, which is about as close to reality as the abstractions discussed above. Many contemporary entrepreneurs can be considered as striking examples of *Homo transformaticus*. They make their enterprises function at the minimum capacity necessary to satisfy personal and family needs, and the needs of the small number of workers employed at the enterprise. This type of entrepreneur has no interest in expanding his enterprise, because *Homo oeconomicus* has not been fully awoken in him.

To achieve our transformation to a market economy, we need to transform *Homo transformaticus* into *Homo oeconomicus*—the faster we do so, the faster we shall achieve a market economy.

This gives us an indication of how we should proceed in the coming stage of Georgian reform. Stratification of society in accordance with the requirements of a market economy is bound to take place. The whole spectrum of social stratification is meant here, which includes economic, political and professional stratification (Sorokin, 1959).

The central objective is to create a social stratum of entrepreneurs, strongly supported both politically and professionally. It implies improvement of the economic situation of the 'middle stratum'—representatives of middle and small business, and physicians, teachers, scientists etc. From this point of view, the democratic system can be seen as strengthening the institutions of political support for entrepreneurs, while the creation of a strong stratum of entrepreneurs is a guarantor itself for the existence of a democratic society.

In the transition process, it is necessary to create practitioners of the new professions (managers, brokers, dealers etc.) that are essential to a market economy and the phenomenon of the entrepreneur. At the same time, it is necessary to focus attention on the poor, so as to render them targeted assistance. For this, it is necessary to identify the stratum of population whose income does not provide a basic minimum standard of living.

To summarise, Georgia will enter a new phase of economic reform in 1996; a new 'stage of target-oriented market sociogenesis' has to be started.

During this process of market sociogenesis, special attention has to be paid to target orientation, because if the process is allowed to take place naturally, the time of transformation of *Homo transformaticus* into *Homo oeconomicus* will be considerably prolonged. If there is long delay, Georgia will not develop an entrepreneurial stratum, will not develop national wealth, and will not be able to provide social assistance to the poor. So in market sociogenesis, target orientation has special importance. The process cannot be carried out by means of 'natural selection', by which a stratum of entrepreneurs is formed during a long process of development. The government must participate in the process of formation of the entrepreneurial stratum and in the whole process of stratification of society in accordance with market requirements.

In other words, to continue economic reforms in Georgia (and in other post-communist countries in a similar situation) we offer the system of 'social selection', or what might be called the method of 'social promotion' of economic reform. The essence of the method is that the government should create the conditions promoting quick formation of the stratum of entrepreneurs. At the same time, it is necessary to render target-oriented assistance to that stratum which is most in need, so that the poor do not prevent the process of reform.

The method of 'social promotion' of economic reform involves three essential measures:

1. Improvement in the criminal situation, to relieve the fear of formal or partially formal military formations. Without settlement of this problem, it will be a serious obstacle to the activities of both domestic and foreign entrepreneurs, and prevent the arrival of foreign investors in Georgia.
2. Promotion of the development of entrepreneurial activity. Without this, the entrepreneurial stratum will continue to be developed in the shadow economy, which is fertile soil for the consolidation of illegal activities and prevents the creation of legal entrepreneurial activity.
3. Carrying out purpose-oriented social assistance to the most needy stratum of society, so that they are able to overcome difficulties which arise in the reform process. This targeted social policy would be the guarantor of support for the reform process.

These three elements are closely linked. A difficult criminal situation prevents the development of entrepreneurial activity; new goods are not produced; it is impossible to assist the poor; and the poor join the criminal world, because of the hardships they experience.

There have been improvements in the criminal situation, as mentioned above, but it is still necessary to complete the fight waged by the government against the criminal world. To develop entrepreneurship, it is necessary to create an environment in which it is safe for the entrepreneur to move out of the shadow economy into legal status and reinvest for the expansion of his business. At the same time, it is necessary to create an environment in which savings are encouraged and made available to entrepreneurs for investment.

This takes us into issues of supply-side economics: during the period of transition to a market economy it will be necessary to pay special attention to problems of supply (Tanzi, 1993, ch. 1).

Supply-side Economics in Georgia and 'Laffer–Keynesian Synthesis'

The initial statement on supply-side economics concerned the liberal system of taxation (Canto, Joines & Laffer, 1988). One of the authors of the theory was Laffer, and it was after him that the curve linking rates of taxation and budget revenues was named. According to the 'Laffer curve', in the early stages of rising tax rates, budget revenues increase, but after a certain critical limit, a further increase in tax rates leads to a reduction in budget revenues, because of a reduction in levels of activity brought about by high tax rates.

Thus, with comparatively low rates of tax, some entrepreneurs might be motivated to start production; another group might be motivated to move their activities from an illegal situation to legality; and a third group might be motivated to expand production considerably. These applications of the theory were used more or less successfully in the developing countries. It should be noted here that, as a rule, in those countries the Laffer theory was implemented mainly through the reduction of income tax rates (Gandhi, 1987).

In present day Georgia the maximum income tax is equal to 20%. There are no plans at present to reduce this rate, though it is not out of the question. More important is the reduction of tax rates applying to corporate activity. According to supply-side economics, in order to stimulate production, the total amount of taxes should not exceed one-third of the income of entrepreneurs. At this rate, tax revenues into the state budget reach their maximum. Tax allowances should not in general be used, since they complicate the tax system and reduce its efficiency (Tanzi, 1993, ch. 5). The establishment of appropriate tax rates, based on supply-side economics, is more effective.

A well known model of the practical implementation of supply-side theory is 'reaganomics', where the reduction of rates of taxes is not limited only to income tax but affects the vital interests of corporations. On the one hand, it is impossible for Georgia to adopt the principles of reaganomics on a full scale, and on the other hand, it is also unjustified. 'Reaganomics', together with reduction of rates of taxes, assumed an increase in military expenditure and cuts in budget financing of social programmes. The third group of measures in the social promotion of economic reform pays special attention to social protection of the population, so that it is impossible and unjustifiable in Georgian conditions to adopt the system of 'reaganomics' without alterations.

Supply-side economists also argue that governments should take on a completely new role, creating a 'state of social insurance' in which market forces are able to generate expansion of production and economic growth without restriction. Poverty is conceived, in this context, not as a relative state, but as an absolute state. It is to be overcome by increasing the wealth accumulated by the society, an objective to be achieved by stimulus to the supply side.

It is not, however, sufficient to rely on supply-side economics, which is mainly concerned with taxation. High levels of inflation necessarily imply high levels of interest rates. This restricts the use of commercial credit for working capital. Strict financial policy is therefore necessary to reduce the inflation rate and improve the banking system. With that achieved, the interest rate can be brought down. The reduction in rates of taxation will itself help companies accumulate the finance necessary for working capital. Excluding barter from foreign trade, and substituting normal currency transactions, will also provide a supply-side stimulus.

Reduction in rates of taxation not only stimulates expansion of supply, but also stimulates demand. Money saved from taxation increases disposable income, and can be used for both consumption and investment. It is true that, according to the Keynesian approach, stimulation of demand requires attention to government expenditure, but this does not exclude reduction in taxation to stimulate demand. It is notable that this approach to demand stimulation is less popular in Keynesian theory.

For a country in the position of Georgia, increasing government expenditure as a means of stimulating demand is not practicable. The state budget is balanced only with the assistance of humanitarian aid, and an increase in expenditure would make it impossible to preserve financial stability. Tax reductions are thus the favoured method for promotion or stimulation of demand, to reduce unemployment and resolve other social problems.

Reduction of taxes in any case raises consumption. This may have a negative effect in a developed market system. In particular, in the case of existing stocks of productive assets, output capacity is fixed and with no change in public expenditure growth in consumption will cause a reduction in saving and an increase in the interest rate. This will decrease investment and production in future (e.g. Mankiw, 1992, ch. 3, 16). This unfavourable effect is not present in the countries in transition, as the real stocks of productive assets, in the situation of reduced production (often significantly reduced), are not being used completely. This gives incentives for production growth in the situation of consumption growth, while saving is not reduced either (and in some cases may actually be raised).

Thus a 'Laffer–Keynesian synthesis' provides the theoretical basis for the method of 'social promotion' advocated here. This synthesis, described mathematically in Appendix A, demonstrates compatibility between optimal supply-side management of taxation and Keynesian principles.

As noted above, a liberal tax policy stimulates both supply and demand. In these conditions, the entrepreneur, and society as a whole, are being 'medically treated' with both supply and demand stimulus. Let us call this economic policy based on the 'Laffer-Keynesian synthesis' the 'tax therapy' treatment.

One of the main ways of promoting an expansion of production is the provision of accelerated depreciation allowances on fixed capital investment. The sums released in this way are frequently used for investment. Hence, the method of accelerated depreciation is an integral part of 'tax therapy'.

Reductions in tax rates should be followed by simplification of the system. The aim must be to create a culture of acceptance of taxation in society—payment of taxes must come more naturally than evasion. It will create in the public an important set or readiness (Uznadze, 1966) for timely and complete payment of taxes, which *Homo transformaticus* notably lacks.

When using tax therapy, it is necessary to use the state budget to the maximum extent possible to provide social protection. At the same time, the principle mentioned above of the 'state of social insurance', by which poverty is only eliminated through the accumulation of wealth by the government, must be adhered to. The state budget should be used to target assistance to the most needy (Tanzi, 1993, ch. 14, 15), rather than increasing the sums spent on social protection (the expenditure should be of a productive nature (Papava, 1993, pp. 58–60; 1994, pp. 39–40), which must be taken into account in determining the areas in which it is used).

To achieve this, it is necessary to remove the 'superfluous' burden from the budgetary sector. Today, much of the population of Georgia employed in the budgetary sector is engaged in private activities. It is true that the wage received by each citizen from the budget is very small, but the total nevertheless amounts to a heavy burden on state budget expenditure. It is necessary to remove from the budgetary sector those people who in reality earn their living in non-government activities. The problem can be solved by reorganising health care, education, science, culture and state management. The funds released will permit more reasonable incomes for those remaining, who will receive their incomes only from the budget.

One of the most important tasks of a 'state of social insurance' is to create the conditions for the establishment and development of private institutions of social protection, for example, private pension and insurance funds.

Finally, it is suggested that there is no alternative to the continuation of economic reform by means of 'social promotion', since there is no sharper or more effective way to implement market sociogenesis. 'Tax therapy' is the means by which promotion or stimulation of supply and demand can be achieved simultaneously.

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Appendix A: Laffer–Keynesian Synthesis

To illustrate the 'Laffer–Keynesian synthesis', consider a relatively simple version of the 'Laffer curve' and the Keynesian multiplier.

Let the Laffer curve be described by the function:

$$T = -Nt \ln t, \tag{1}$$

where:

T—the total tax revenue of government;
N—the Gross National Product (GNP) corresponding to maximum total tax revenues
t—the tax rate ($0 < t > 1$).

It is clear that $T = 0$ when $t = 0$ and $t = 1$.
The link between total tax revenues (T) and the actual volume of GNP (Y) is:

$$T = tY \tag{2}$$

The dependence of Y on t is derived with equation (1):

$$Y = -N \ln t. \tag{3}$$

Equations (1) and (3) can be described by the curves in Figure A1.

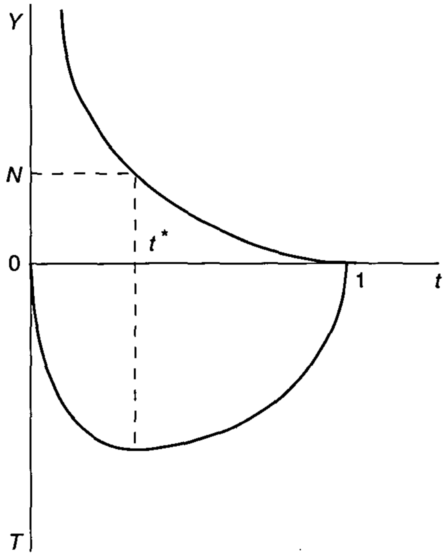

Figure A1. The 'Laffer Curve' and relation of tax rates to output.

It should be noted that Figure A1 adequately reflects the idea of the Laffer curve, and corresponds approximately to similar curves used by the authors of supply-side economics (Canto, Joines & Laffer, 1983, p 76).

t^* is the tax rate that corresponds to the maximum value of the total tax revenues.

Equating the derivative of function T in equation (1) to zero and solving for t, we derive that:

$$t^* = 1/e,$$

where: $e = 2.718282 \ldots$

According to (3), as t rises, Y falls. This corresponds to the Keynesian view (e.g. Stoleru, 1969, ch. 5).

In order to aggregate the Laffer curve and the Keynesian multiplier, consider the Keynesian formula of aggregate demand:

$$Y = c(Y - T) + G + I + X - M \tag{4}$$

where:

c—marginal propensity to consume ($0 < c < 1$);
G—government expenditures;
I—private investment;
X—exports;
M—imports.

In conditions of market equilibrium, the total supply (3) is equal to total demand (4), so that, using (1) and (2):

$$-N \ln t - c\ (-N \ln t) = G + I + X + M \tag{5}$$

According to the Laffer curve, $Y = N$ when $t = l/e$. Thus from (5) were derive:

$$N = \frac{G + I + X - M}{1 - (1 - (1/e))c} = \frac{G + I - X - M}{1 - 0.632c} \tag{6}$$

Thus under the 'Laffer–Keynesian' synthesis, the volume of GNP when the total tax revenues reach maximum level is given by formula (6).