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Georgia's Macroeconomic Situation Before and After the Rose Revolution

ABSTRACT: *The fall of 2003 appeared to be a turning point in the history of independent Georgia: during November 22–23, Georgia witnessed a Rose Revolution. This event was caused by the harmful social consequences of a number of negative factors, including economic ones. Relatively high level of corruption in the Georgian government stalled reforms in almost all spheres of public life, leading inter alia to serious macroeconomic problems. This article demonstrates that the main macroeconomic component of the Rose Revolution (late fall of 2003) was the budget crisis. The postrevolutionary government is wishes to show the people positive outcomes of the revolution as soon as possible, but this will not be easy to achieve in the face of ongoing imperfect tax legislation—the background of the budget crisis.*

Economic and inflationary components of the Rose Revolution

The monetary system was the only part of the pre-revolutionary Georgian economy in which macroeconomic indicators pointed to some stability (Beridze and Papava, 2003). Over the previous years, as a result of

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the National Bank of Georgia's (NBG) tight monetary policy, the exchange rate remained stable and inflation was fairly moderate (see, e.g., Kakulia, 2001; Papava and Chocheli, 2003, pp. 10–17). The only significant devaluation of the lari (by 70 percent), which took place in late 1998, was due to external factors—namely, the Russian default in August 1998. For the whole period from 1996 onward, only in 1998–99 was inflation slightly higher than 11 percent (yet another negative effect of the above-mentioned Russian default), whereas in all other years it never exceeded a threshold of 7 percent a year.[1] By contrast, in 1993–94, inflation reached 50–70 percent a month; however, in 1995, the rate dropped to 57 percent a year (Gurgenidze, Lobzhanidze, Onoprishvili, 1994; Papava, 1995, 1996, 1999; Wang, 1998; Wellisz, 1996) (see Table 1).

In addition to relative monetary stability, a consistent economic recovery has been observed since 1995. In contrast to the economic collapse of 1989–94, annual GDP growth reached 11.2 percent and 10.5 percent in 1996–97, respectively (see, e.g., Papava, 1998). Although annual GDP growth was relatively modest in 1998–2000 (3.1 percent, 2.9 percent, and 1.8 percent, respectively), in 2001–2 it increased again (to 4.8 percent and 5.5 percent, respectively). Special emphasis should be placed on the year 2003, when, because of the commencement of the Baku–Tbilisi–Ceyhan oil pipeline project, GDP growth reached 11.1 percent. It must also be noted that growth in almost all sectors of the Georgian economy is affected by "shadow" activities: according to one estimate, the share of Georgia's *untaxed economy* reached 65–70 percent of GDP (Chocheli, 2003).

GDP growth in the first half of 2003 remained strong at 9.5 percent, suggesting that the Rose Revolution had no impact on economic growth. Because of its short-term nature, the Rose Revolution did not have a negative impact on the Baku–Tbilisi–Ceyhan international pipeline project. Likewise, the so-called inflationary component of the Rose Revolution was not as serious as it could have been: from January to October 2003, the actual inflation rate was only 1.9 percent. In November, in the period of one month, during revolutionary conditions, prices rose 4.8 percent. This reflected not only political instability, but also some provocative statements made by government officials about diminished supply on the Georgian market and the inevitable growth of prices of consumer goods because of the revolution. No doubt, such statements intensified inflationary expectations.

Nonetheless, because the new postrevolutionary government under the

Table 1

Annual Growth of GDP and Inflation in Georgia, 1995–2003 (%)

	1995	1996	1997	1998	1999	2000	2001	2002	2003
Annual GDP growth rate	3.1	10.5	11.2	2.9	1.8	4.8	4.8	5.5	11.1
Consumer price index*	57.4	13.8	7.3	10.7	10.9	4.6	3.4	5.4	7.0

*December to December of the previous year.

leadership of the main revolutionary hero, Mikhail Saakashvili, received full credit from the Georgian people, and the NBG continued to pursue its tight monetary policy, the actual inflation rate for 2003 was never higher than 7 percent, that is, it never exceeded the expected upper threshold projected in the 2003 Indicative Plan of Georgia's Economic and Social Development (IPGESD). The revolution actually managed to "squeeze" itself into the projected limits of inflation, and, therefore, it did not cost the Georgian people too much.

Toward a Georgian "budget crisis" phenomenon

If economic growth was more or less satisfactory and inflation was moderate, what was the "macroeconomic component" of the Rose Revolution? Many economists and politicians in Georgia have argues that an *economic crisis* (see, e.g., Gotsiridze and Kandelaki, 2001) in Georgia was one of the key causes of the Rose Revolution. Although this explanation may seem quite attractive at first glance (because of its simplicity), it does not accurately describe the prerevolutionary situation in Georgia's economy. Such a conclusion appears logical if one recalls that economic theory knows just two types of economic crisis—those of *overproduction* and *underproduction*. When crisis is due to overproduction, supply far exceeds demand and the amount of unsold products keeps mounting, causing prices to drop drastically. Companies go out of business and the unemployment rate keeps growing. In the case of a crisis of underproduction, demand is greater than supply, causing prices to rise, in the long run stimulating increased supply. As was noted above, recent years saw relatively stable economic growth and moderate inflation, a clear indication that there were no symptoms of overproduction or underproduction.

In order to properly understand the macroeconomic preconditions of the Rose Revolution, it is necessary to focus on the country's budget problems. Specifically, the focus should be on the year 1998, which was marked by both the devaluation of the lari (as noted above, this was an immediate effect of the Russian default in August 1998), and the appearance of major gaps in the state budget, leading actual revenues to be considerably below projected ones. The year 1999 was particularly illustrative in this respect: the budget deficit reached as much as US$150 million, or about 30 percent of projected total tax revenues.

We believe that the term "budget crisis" is the most accurate description of this long drawn-out process that stretched into late 2003. Specific elements of the government's overall failure to fully collect projected revenues were:

- failure to fully collect projected tax revenues;
- failure to fully collect projected nontax revenues, such as those resulting from the privatization of state-owned property; and
- failure to fully receive favorable loans and grants from international financial institutions and donor countries.

While each of these elements had a number of specific causes, the first (i.e., the failure to fully collect projected tax revenues) had an immense influence on the other two. As was mentioned above, in almost all years from 1998 onward, major gaps in budget revenues appeared in the tax component of the state budget. A new tax code was adopted by the Georgian parliament in late 1997, which led many politicians and economists in Georgia to believe, quite correctly, that the new tax legislation was the immediate cause that prompted the budget crisis to emerge (Papava, 2003a, pp. 31–40; 2003b, pp. 13–21). The draft tax code was proposed to the government of Georgia by International Monetary Fund (IMF) experts. It was based on a model tax code that IMF specialists had developed taking into account both theory and international practice of taxation. Among other things, this "ideal" tax law was based on the assumption that the entirety of Georgia's national borders were under the control of national border and customs authorities. This was not consistent with Georgian reality: the territories of Abkhazia and South Ossetia, which function as major channels of smuggled goods coming from Russia to Georgia, have been beyond the Georgian government's control since the early 1990s.

Apart from this very important shortcoming, the IMF-imported tax code contained some other substantive and linguistic weaknesses that made tax administration even more problematic. Under the traditional IMF procedures that have to be followed in order to be eligible for another tranche from this financial institution, the government of Georgia was compelled to adopt new tax legislation that was incompatible with the country's context and the key inadequacies of which were apparent from the very beginning. The government in turn contributed significantly toward worsening an already bad tax code: in a few years it introduced thousands of amendments and additions, which ultimately transformed the tax code into a totally confusing document without addressing its core weaknesses. This paved the way for unbridled corruption in the taxation system. Repeated attempts to persuade the IMF to allow the government of Georgia to fundamentally change tax legislation were unsuccessful: so-called *institutional patriotism* prevented the IMF from acknowledging its own mistakes (Papava, 2003a, p. 43; 2003b, p. 22). Such an ineffective tax law made the realistic planning of state tax revenues virtually impossible. The personal interests of corrupt government officials and numerous lacunae in the tax code that were quite easy to conceal made the gap between actual and projected tax revenues even larger.

A remarkable peculiarity of the Georgian budget crisis was the so-called *war of budgets* between the central budget and that of the Autonomous Republic of Ajaria, which has been waged for about a decade. This conflict was marked by the autonomous republic's refusal to contribute fiscal revenues to the central budget (Papava, 2001). The Ajarian leaders justified this practice by referring to the alleged failure of the central government to transfer resources from the central budget to the autonomous republic. Such circumstances further aggravated Georgia's budget crisis.

In addition to the above, corrupt government officials resorted to various fraudulent machinations to present the fictitious implementation of state budget revenues. Compelling companies to pay taxes in advance, "winding" budgetary resources back and forth from one budget line to another, paying back collected taxes to taxpayers by means of forged documents, filing fictitious offsets, and raising prices artificially for the purpose of public procurements were particularly widespread practices. To fill the gaps in the planning of anticipated tax revenues, the government sought to offset missing tax revenues with fictitious increases in the planned nontax revenues, by artificially raising anticipated privatization earnings. In practice, however, such increases rarely panned out, shortfalls in actual nontax revenues as the result.

Failures to receive favorable loans and grants from international financial institutions and donors were caused primarily by the government's post-1998 inability to implement its IMF programs in a timely fashion. This problem became especially painful in 2002 when the IMF suspended its programs in Georgia. In addition to blocking financial assistance from other international financial institutions, this suspension aggravated Georgia's foreign debt burden, which by then totaled about 50 percent of GDP. The suspension of the IMF program was an immediate result of both the government's inability to adopt and implement a realistic state budget and the deferment of almost all reforms oriented toward democratization and a free market.

In June 2003, the Georgian president, Eduard Shevardnadze, issued an ordinance approving the Economic Development and Poverty Reduction Program of Georgia (EDPRP) in Georgia for 2003–15 (EDPRP, 2003). The program was developed with close cooperation between the public authorities, on the one hand, and nongovernmental organizations and academic circles, on the other. At a later stage, they were joined by experts from international financial institutions and donors. Unfortunately, because of its traditional lack of political will, the Shevardnadze government never even attempted to embark on the implementation of this program, which precipitated the deterioration of Georgia's relationship with the IMF and other international donors.

In 2003, as a result of the government's numerous failures in the budgeting process, the state budget deficit reached US$90 million, 15 percent of projected budget revenues. By the end of 2003, the aggregate internal debt accumulated, as unpaid salaries and pensions to public sector employees and pensioners during the years of budget crisis reached around US$120 million, of which unpaid pensions totaled US$70 million (even though monthly pensions in Georgia are as low as US$7). Unsurprisingly, the poverty rate in Georgia reached 52 percent. Deteriorating social conditions and overall dissatisfaction with the Shevardnadze regime in Georgian society created a revolutionary situation in Georgia, the logical consequence of which was the Rose Revolution.

Key macroeconomic tasks in the postrevolutionary period

As the initial postrevolutionary months have shown, in early 2004, all key positive macroeconomic trends were still in place. For example, GDP growth for the first quarter of 2004 was 9.5 percent, whereas inflation remained at 1 percent. As early as February 2004, the parliament of Georgia supported the president's initiative to change the country's constitutional model and introduced a cabinet of ministers. Therefore, the government was engaged in purely organizational matters during the first couple of months of the postrevolutionary period. Despite this, based on the extensive efforts of the Ministry of Finance, the government of

Georgia took its first important steps toward establishing financial order. Almost all mechanisms that could be used for the above-described machinations associated with the fictitious implementation of the state budget revenues were abolished.

Immediately after the Rose Revolution there was the impression that the relationship between the government of Georgia and the Ajarian leadership could be improved and that the "war of budgets" would end. Later developments proved that such an impression was illusory, and not only with respect to the budget issue (Tsereteli, 2004). However, since the revolution of May 6, 2004, in the Autonomous Republic of Ajaria, new opportunities are emerging for the arrangement of normal budget processes between the central government and this region. As a result, state budget revenues are likely to grow significantly.

The new government based the draft 2004 state budget on forecasts of 6 percent GDP growth and 5 percent inflation. This GDP growth rate is lower than the one anticipated in the EDPRP's optimistic scenario (8 percent). This fact deserves particular attention since, as was noted above, GDP growth for the first quarter of 2004 was 9.5 percent. (Government growth forecasts are not as optimistic as one might expect.) Against this background, the government's forecast of a 26 percent increase in total tax revenue collected in 2004 compared with 2003 looks excessively optimistic. In the first quarter of 2004, the government managed to collect no more than 21 percent of annual tax revenues called for in the state budget for 2004, although under the budget law this indicator should not have been less than 23 percent. (Since the revolution of May 6, 2004, tax revenues paid to the state budget by the Autonomous Republic of Ajaria are likely to grow significantly.)

The adoption of a new tax code that would be based on generally accepted principles for lightening the tax burden and simplifying the taxation system is particularly important (Chappell, 1990). This is what many international experts suggested immediately after the Rose Revolution (Phillips, 2004). Remarkably, President Saakashvili was the first to advocate such an attitude long before the revolution. Later, this proposal was in general upheld by the IMF. As a result, a special governmental commission of experts was established that started working on the draft of new tax legislation. As the parliament was not expected to adopt this law before the fall of 2004, the new tax code would not become effective before 2005. Under such circumstances, the government's excessive *budgetary optimism* may still return to haunt it. Accelerating the implementation of the EDPRP is a task of primary importance. This will allow the government to seek more extensive international financial assistance for strengthening Georgia's economic reforms.

The postrevolutionary period is especially remarkable for the government's initiation of effective combat against corruption. Criminal charges were filed against numerous former high-ranking government officials and their relatives suspected of having been involved in corrupt practices. Many of them have already returned to the state some of the funds that they had "earned" by illegal means. These nontax revenues of the state budget enhance the government's capacity to pay off some of its debts to the people of this country. However, such incomes of the state budget are of a temporary nature and that the government will not be able to rely on such returns in the future (Papava, 2000).

In conclusion, although the government of Georgia faces a postrevolutionary "temptation" to show the people of this country positive outcomes of the revolution as soon as possible, in dealing with many problems, including budget-related ones, it must apply sober approaches. The economy can be extremely harsh in its revenge for precipitate decisions.

Note

1. Here and hereinafter, all statistical information is based on that of the State Department for Statistics and Ministry of Finance of Georgia.

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