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## **Economic Regulation and State Interventions. Georgia's Move from Neoliberalism to State Managed Capitalism**

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# **Economic regulation and state interventions. Georgia's move from neoliberalism to state-managed capitalism**

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Abstract: The paper explores the dynamic interrelation between economic policy and mechanisms of power preservation in Georgia between 2003 and 2012. Focusing on the distribution effect of institutions, the study reveals how changes in the economic model significantly shape the institutional framework of power preservation strategies, and vice versa. The paper argues that the introduction of a liberal regulatory environment significantly removed formal steering instruments of benefit distribution within the society and caused an increased need of informal interventions in the economy. The result was institutional incompatibility between the political and economic agenda. At the same time, these informal interventions laid the basis for an evolving state-managed capitalism in Georgia. By intertwining already established informal intervention patterns with new formal instruments, state authorities altered their economic policy after 2008, thereby making the state a central clock generator for economic development. This finally facilitated an increasing institutional reconcilableness of the economic and political agenda.

## **A. Introduction**

Georgia's economic policy after 2003 has been perceived as an eminently consequent attempt of turning the liberal economic theory of von Mises and von Hayek into reality. The success of the extensive deregulation and administrative reforms has been acknowledged internationally, inter alia by holding the 9th position in the Doing Business Index (Doing Business 2013) or excellent ratings in categories such as labor freedom (3th), business freedom (16th) or trade freedom (6th) (Heritage Foundation 2013, pp. 219–220). As a result of the continuous improvement of the entrepreneurial environment, the World Bank honored Georgia as the global top reformer for the period 2005-2010 (World Bank 2010). In contrast to this perception of a free market economy, in-depth analyses draw a picture of massive interferences of state agencies into the economy. The monopolization of economic sectors, continuous violations of property rights and a general supremacy of the state over the economy are elements of an alternative perspective, which is manifested in local reports and worst rating results in categories such as property rights (131th) or lacking local competition (127th) (World Economic Forum 2013, p. 175). These opposing indications result from differently selected analytical perspectives. While the former perspective focuses on institutional changes, the latter primarily pays attention

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to the behavior of actors, more specifically the arbitrariness and wrongdoing of state officials. In this respect, the antagonistic findings illustrate the traditional structure-agency division and remind us of the fundamental question of how to reasonably bridge both analytical perspectives; a question that has been extensively debated within the social sciences (Dowding 2008).

The article applies a theoretical framework that is capable to reconcile the antagonistic indications towards Georgia's state-business relations. Therefore, the study makes use of a characteristic that both structure and agency share the ability to influence the distribution of benefits among various societal groups. How benefits and economic advantages are distributed within a society is crucial for maintaining power relations. For this reason, institutional rules and state action always imply a political component and present in their entirety a vital instrument to stabilize the existing power equilibrium within a society. However, the political agenda of maintaining power relations must be brought into line with other policy objectives. Adding further policies such as fighting corruption or economic development, whose implementation entails institutional reforms, may significantly affect the distribution of benefits within the given institutional setting. Responding to this, state action on the agency level might be triggered in order to re-calibrate altered benefit distribution and to balance the various policy objectives.

Using the institutional characteristic of benefit distribution as an explanatory variable, the article aims to reconstruct changes of Georgia's economic regulation vis-à-vis observable state interventions in the economy. The dynamic interrelation between both levels can be explained by the attempt to pursue two policy objectives, to promote economic development and to secure the newly reached power equilibrium. Concretely, it argues that the economic reforms after the Rose Revolution led to a massive decrease of state supervision and regulatory density including the dogma of non-intervention on part of the state, and, hence, simultaneously to a devaluation of formal institutions as instruments to shape the distribution of benefits. This in turn contributed to a relocation of distribution mechanisms from the formal to the informal sphere. The paper will show how, for this purpose, state authorities deployed various forms of informal interventions in the economy. Consequently, the introduction of neo-liberal reforms did not establish a liberal economy, but instead contributed to the evolvment of an informally state-managed capitalism, which was characterized by the above-mentioned contradiction between structure and agency.

The paper furthermore argues, that the year 2008 presented a turning point for Georgia's economic policy. Domestic protests, the ruined international reputation caused by the August war and the global financial crisis accelerated the end of the formal-liberal economic model, which would not have been permanent due to the

informal interventions. Responding to this, the government started to introduce an official state-led development agenda. The implementation of the economic agenda relied, in addition to new formal instruments, on already well-established informal means. Instruments that had earlier been applied for the pursuit of purely political interests, now appeared to be useful in promoting economic development. This change in the economic policy also allowed a partly new arrangement of both political objectives. Examining the compatibility of the political and economic agenda and the consequent dynamic interrelation between the institutional and agency level allow to bridge the antagonistic finding about Georgia's economic policy and to draw a picture of its transition from neoliberalism to state-managed capitalism.

## **B. Theoretical framework**

Economic policy in the post-communist region has significantly changed within the last decade. The 1990s were characterized by the pre-eminence of FDI-oriented neo-liberal development models, which entailed comprehensive liberalization reforms and a restriction of the state to a modest facilitator. The phenomenon of state-managed capitalism emerged in the region when resource-rich countries like Russia and Kazakhstan responded to the experienced vulnerability of their economies to external shocks (Bremmer and Johnston 2009). Deployed state interventions range from financial market support and the provision of state funds to re-privatization and greater state ownership (Kalyuzhnova and Nygaard 2011). State-managed capitalism in the post-Soviet region as a new economic paradigm (Kalyuzhnova and Nygaard 2008) is related to a worldwide process of growing state influence in the economy (Bremmer 2009), which was clearly accelerated by the recent economic crises and the decreasing persuasiveness of neoliberal ideas. In general, state influence can be exercised by direct interventions in the economy such as transfer payments, credits, fixing of market prices, tax exemptions or by own economic activities of the state. These means are capable to directly influence the outcome of specific economic processes. The exertion of state influence can also be achieved indirectly by changing the regulatory basis. By defining, for instance, rules of interaction between economic subjects by anti-monopoly legislation, regulatory policy shapes the framework in which economic processes take place.

Both interventions and regulatory policy share the common characteristic of influencing the distribution of economic advantages. This argument is obvious for interventions but needs some elaboration with regard to regulatory policy. Regulations are institutionalized rules and create predictability by constraining available options for action. A regulation may be equally valid to everybody, the specific content of the restriction, however, entails an unequal distribution of benefits

(Knight 1992). Stigler (1971) made this characteristic of regulations the central idea of his economic theory, conceptualizing regulations as an additional market good. Enterprises demand and seek to influence regulations in order to receive advantages. Contrary to such a regulatory capture on part of economic actors, regulations may also be subject to political capture as a tool to pursue the self-interest of the ruling elite (Stiglitz 1998). Both considerations share the assumption that regulations are co-produced by various actors (Offe 1984) and reflect the distribution of power within a society (Knight 1992). Formal rules are therefore not only a mirror image but also a powerful means for maintaining power relations. This is crucial when examining the effects of deregulation and the consequent abolition of formal regulations and state interventions in Georgia after 2003. Here, North (1990) correctly reminds us that the institutional environment of an economy is not limited to formal regulations but consists of formal and informal rules of economic transaction. Following Georgia's deregulation reforms, the informal institutional dimension may have compensated the potentially eroded relevance of the formal framework and official state action. This underlines the necessity to systematically include a differentiation of formal and informal institutions and interventions in the analysis.

By character, formal-state interventions are to fit into the existing regulatory structure. Therefore, state action must be legalized (by decree, judgment, law), at best legitimized by publicly communicating the pursued objective of the intervention and, above all, build upon and respect economic institutions set up by formal regulations. Deviation of formal state action from the legal framework is often very costly, which is why political elites might prefer informal interventions. Informal interventions, like their formal counterpart, constrain available options of action for economic subjects but, due to their specific nature, are more difficult to observe. However, depending on scope and frequency as well as on the respectively given enforcement capacities, informal interventions may also transform into generalized informal rules and, hence, significantly change incentive structures of economic activities in the long term.

The question of compatibility of economic and political agenda seeks to determine how the respectively chosen institutional setting and deployed interventions relate to each other, be they formal or informal in nature. The debate on informality provides various typologies that vary slightly within literature (Helmke and Levitzky 2004), but mainly build up on Lauth (2000), who distinguishes three basic relations that will be relevant for this paper. Firstly, institutions (as well as interventions) can be complementary and, therefore, reinforce each other. Secondly, an institution can fulfill the function of another, which presents a substitutive relation. Thirdly, institutions and interventions can compete, which means that the respectively chosen instruments of the political and economic agenda are in conflict with one another.

For the purpose of comprehending the essential changes of Georgia's regulatory policy as well as deployed formal and informal interventions, it is reasonable to examine the three basic institutions of market economies. The freedom of contract, the protection of property rights and open markets are inalienable institutions of a functioning market economy (Eucken 1952) and will provide the empirical framework for the study. Against this background, Georgia's economic policy after 2003 will be analyzed with regard to its regulatory dimension as well as formal and informal interventions.

### **C. Distributing benefits before the Rose Revolution**

Following independence in 1991, Georgia's state-building process was highly critical with regard to the establishment of a state monopoly on the use of force and, hence, the general capacity to design and implement public policies (Wheatley 2005; Koehler and Zürcher 2004). State policy at this time was primarily dominated by the political agenda of balancing different power groups. The integration of different influential societal groups into state-organized corruption pyramids was a reasonable instrument to achieve this aim (Stefes 2006) and constituted a common phenomenon of the first transition period in the post-soviet region (Darden 2001). Thus, corruption pyramids served as an important informal instrument for shaping the distribution of economic advantages (i.e. rents) among influential power groups, and in doing so, contributed to the stabilization of the political order. The scope of this political practice was mirrored in Georgia's ranking as the 7th most corrupt country according to the Corruption Perception Index (CPI) 2003 (Appendix 1).

Among the relevant power group, criminal networks presented one of the most influential groups in Georgia before the Rose Revolution. Based on the socially deep-rooted quasi-legal institution of thieves-in-law, criminals had entered into mutually beneficial partnerships with the government and its officials (Nordin and Glonti 2006). They contributed to political campaigns or even ran as candidates for office (Shelley *et al.* 2007, p. 53). These criminal groups informally controlled access to markets and were key players in some of the most important sectors of the Georgian economy—hotels, restaurants, retail trade (Shelley *et al.* 2007, p. 56). Thus, apart from corruption pyramids, thieves-in-law significantly shaped the distribution of economic advantages before the Rose Revolution by relying on own sources of power (Slade 2013).

Regulations played a decisive role in this period in two respects: Firstly, legal rules constituted the institutional prerequisites for the corruption pyramids. The vast

number, complexity or contradictoriness of existing regulations impeded rule-consistent behavior and provided respective means for coercion of bribes by state officials (Timm 2012). Around 83% of all papers requested by state officials were solely used for the purpose of extortion (Dadalaui 2005, p. 19). Secondly and at the same time, formal regulations were crucial for directly determining the distribution of advantages. A prime example for this argument is tax favoritism. 74 tax code amendments adopted between 1997 and 2003 predominantly granted hundreds of exemptions on value-added tax (VAT) and excise taxes to various sectors and companies with close connections to the ruling elite (Engvall 2008, p. 13; Dadalaui 2011, p. 160). Responding to both state-organised red tape and favoritism, large parts of the Georgian business shifted to the shadow economy (Papava 2005, p. 55). In this period, the relation between the formal and informal dimension was organized as institutionally complementary, meaning that both mutually enabled and reinforced each other. Both served the objective of stabilizing the political balance of power, which had dominated the policy agenda of the Shevardnadze regime.

Table 1

Period	Policy	Formal Dimension	Informal Dimension	
Before 2003	Balancing Power Groups	Distribution of advantages by tax exemptions, licensing etc.	Thieves In Law	Corruption pyramids

## C. Institutional Reforms after the Rose Revolution

### I. The liaison of anti-corruption and libertarianism

The implementation of an extensive deregulation policy and the elimination of an active state intervention policy after the Rose Revolution must be comprehended as a consequent answer to the experienced corruption and kleptocracy of the Shevardnadze era. The purposeful creation of red tape by state authorities had been identified as the decisive evil responsible for the economic failure of the predecessor regime. Anti-corruption and a serious suspicion towards any form of state control or regulation on part of the new policy makers (Transparency International 2008, p. 5) were consequently the crucial driving forces underlying the various institutional reforms after 2003 (World Bank 2012).

This attitude fitted well with the radical school of thoughts of libertarianism that an influential part of the new Georgian policy makers subscribed to (European Stability

Initiative 2010a). “Supporters of this anti-state school of thought want to leave as many areas of society as possible down to individual personal responsibility or market forces. They regard state intervention in the economy and the provision of public goods such as education and health care by the state as a disenfranchising and inefficient evil.” (Jobelius 2011, p. 1). Libertarian, US-based think tanks closely accompanied the reforms (European Stability Initiative 2010b) and contributed intellectually to the formulation of the ‘Georgian Model’ as an alternative model of development towards its own recent past and, of course, the political enemy Russia (Timm, forthcoming).

Consequently, regulatory reforms after 2003 were propelled by two interwoven principles. (1) Only those rules and regulations should be left in place or implemented whose enforcement can be guaranteed by the state (Interview Lejava 2012). This guarantee comprises two promises: first, the state capacity to work free of corruption and, second, the ability to enforce the existing legislation including the capability to punish wrongdoings. This approach was (2) backed by the libertarian persuasion of a free as possible market and the consequential withdrawal of the state from limiting economic activities by specific requirements.

## **II. Separating state and economy**

The retreat of the state based on the specific amalgamation of a strong anti-corruption agenda and a corresponding ideology of libertarianism achieved the desired effect, as it massively diminished market barriers and transaction costs and, first and foremost, separated state and economy. A prime example for diminished market barriers is the reform of licenses and permits. The Law on licenses and permits adopted in 2005 and its subsequent amendments dramatically reduced the number of activities subject to licensing and permit-issuance by more than 90% from 909 (Bagaudinova *et al.* 2007) to finally 45 licenses and 52 permits (Georgian National Investment Agency 2013). As for now, many economic activities do not require licenses anymore. Comparably, the number of taxes has been considerably decreased from 21 to only 6 (Transparency International 2010a, p. 2). Regarding trade barriers, the government followed a strategy to reduce customs duties gradually up to absolute abolition (Policy and Management Consulting Group 2010, p. 13). With over 80 percent of imports entering Georgia duty-free, the trade weighted tariff rate is currently still low at 0.4 percent (Heritage Foundation 2013, p. 220). With respect to starting a business, Georgia created among the most favorable regulatory conditions in the world. Only two procedures and no minimum capital are required to open a business in Georgia (Appendix 1).

Apart from diminishing market barriers, the general suspicion toward the state stimulated the new policy makers to massively reduce the regulatory density of business legislation, and, hence, removed various state supervisions over the economy. This consequent privatization of the privity of contract can be observed, among others, in the new labor code, which was adopted in 2006. Usually intended to balance the unequal relationship between the employer and the employee, the new Labor Code abolished internationally acknowledged standards of the protection of workers (Jobelius 2011, p. 3; European Commission 2008). The withdrawal from framing and supervising this specific contractual relation is mirrored by the reduced number of articles from 250 to only 55 in the new legislation (Shvelidze 2012). A further example for the privatization of the privity of contract and the withdrawal of the state can be found in the Law on Entrepreneurship, constantly amended between 2005 and 2009. The amendments suspended a number of protective mechanisms for creditors and, thereby, obligatory supervisions of the state. The obligation of an enterprise to hold minimum capital as well as a compulsory assessment of transferred assets by an independent expert (Article 3 of the former code) were elements of the former law that guaranteed basic securities to creditors. This assessment, as well as the requirement of a minimum capital base for the foundation of a stock corporation (Article 5) or a limited liability company (Article 51) were removed by the new law. Furthermore, limitations for the use of profit have fallen victim to the liberalization of capital protection. The General Meeting or the majority shareholder now enjoys the freedom to use the profit at any time, no matter whether the remaining capital will be sufficient for the future activity of the corporation (Kikalishvili, forthcoming). The withdrawal of the state has led to a situation where creditors completely rely on private contracts in order to protect their interests (Kikalishvili, forthcoming). With respect to competition policy, the government analogically changed the fundamental direction of the legislation. The former Law on Monopolistic Activity mainly aimed at regulating the behavior of enterprises and restricted, inter alia, market dominance and monopolistic activities. The 2005 Law on Free Trade and Competition, in contrast, focused exclusively on the prohibition of state action that might limit the market. According to Article 3 (c, e) the law aims at “breaking down any discrimination barriers set up by the state or local authorities and elimination of any grounds for their appearance [and] not allowing state or local authorities to assume such international obligations which could impede free trade within and outside Georgia.” (Law on Free Trade and Competition). The new law waived any regulations with respect to agreements between companies, the abuse of a market dominant position or merger control, which present basic components of modern competition legislation. Consequently, the Georgian Anti-Monopoly Agency was replaced by the Agency for Free Trade and Competition, exclusively responsible for procurement and state aid (Transparency International 2012a, p. 11). Between 2005 and 2012, the Georgian market was open to all kinds of mergers and agreements between entrepreneurs. No

competition control mechanisms existed or were deemed necessary by Georgian policy makers (Gabrichidze 2013, p. 52).

Consequently, the regulatory policy resulted in a gradual abolition of state control bodies such as the Anti-Monopoly Agency (2005) or the Food Quality and Control Service (2006). As the closure of agencies was clearly favored over their restructuring (Di Pippo 2011), even the abolition of the National Bank as liberation from state monetary policy had been under discussion (Interview Gogolashvili 2012). Apart from abolishing administrative units, the separation of state and economy was also pursued by a number of administrative innovations. The successful introduction of One-Stop-Shops, e-governance systems for taxation or procurement, the reform of the public registry or the simplification of administrative procedures for obtaining licenses (World Bank 2012) resulted in a massive reduction of points of contact with the state. The separation of administration and economy was not primarily directed at decreasing transaction costs. The introduction of „[...] new technologies allowed managers to reduce staff interactions with the public, thereby limiting opportunities for the solicitation of bribes.“ (Bennet 2011, p. 10).

### **III. Dogma of non- intervention**

The inherent suspicion against the state found its continuation in a clearly negative attitude towards any kind of state intervention (Interviews Kovsiridze 2012, Lejava 2012). Even the promotion of small and medium enterprises was perceived as a violation of market rules (Gogolashvili 2011, p. 185). Consequently, Georgia introduced a flat tax system with unified tax rates and very rare tax exemptions. According to the last Tax Misery and Reform Index (Forbes 2009), Georgia is rated the 4th most tax friendly country in the world. Price controls exist only in areas of natural monopolies and are enforced by the National Bank in the insurance sector as well as by the Georgian National Energy Regulatory Commission and the Georgian National Communications Commission for regulating prices in the energy and telecommunication sector (Mehta 2006, pp. 385–387). Monetary policy of the National Bank of Georgia was mainly oriented on price stability (International Monetary Fund 2012, p. 13) and stuck to a “less interventionist exchange rate policy”. (European Commission 2011, p. 9). The instrument of state aid or subsidies were sparingly used and, apart from cultural and social organizations and (state- owned) public utilities, only granted to grape farmers who were most affected by the repercussions of the Russian trade embargo enforced in 2006 (Vardiashvili 2010). In sum, no serious interventions on part of the government had been conducted.

#### **IV. Results of the institutional reforms**

The obvious success of the reforms seemed to prove the government right. GDP grew between 2005 and 2007 by almost 10% annually and FDI constantly increased up to US\$ 2 billion in 2007, equivalent to approximately 20% of GDP (Appendix 1). In terms of fighting corruption, Georgia managed to climb up the CPI within four years from 127th position (2003) to 79th position (Appendix 1). This means that the formerly 7<sup>th</sup> most corrupt country Georgia became, apart from the Baltic States, the regional leader in fighting corruption. This was attributed to the success of deregulation policy in terms of abolishing red tape as a central structural characteristic of the Shevardnadze era. The consequent possibility for economic actors to adhere to rule-conform behavior contributed to an increased legalization of business in Georgia (Appendix 1). In the course of its anti-corruption policy, the government succeeded in massively reconstructing the institutional framework with positive effects on the level of corruption and economic development. Given these successes, it is not surprising that the structure-oriented analyses come to overwhelmingly positive evaluations, including placing Georgia at the 9th position in the Doing Business Index (Doing Business 2013) or at the 20th position in the Index of Economic Freedom (Heritage Foundation 2013, pp. 219–220).

The institutional and administrative reconstruction simultaneously had a side effect on the existing institutional mechanisms for the distribution of economic advantages. The new government succeeded in establishing a state monopoly on the use of force and, thereby, laid the foundation for the establishment of a minimal but capable state. As a result, the government was able to remove the main important characteristic of the Shevardnadze regime: the corruption pyramids. In the course of the state-reforms, the Saakashvili administration was also able to abolish the strong informal institution of the thieves-in-law (Slade 2012) and achieved to establish state rules as the 'only game in town'. In doing so, the government eliminated two central institutional mechanisms that formerly steered the informal distribution of advantages. Moreover, Georgia's limiting-state reforms tremendously privatized economic relations after 2003. The massive reduction of regulatory density limited the possibility to determine the distribution of advantages by means of formal rules. The less regulations exist, the less behavior is restricted and the less exemptions can be granted. This limited possibility to produce winners and losers by legislation has been backed by the negative attitude towards any form of interventions, which would provide vast chances to influence the distribution of economic advantages. As a consequence, by privatizing economic relations, the ruling elite and influential power groups gave up another powerful instrument of control.

## **D. State activism: the informalization of state interventions**

The relevance of formal state action for maintaining power relations might have been limited due to the privatization of economic relations. However, this does not imply a general abandonment of state exertion of influence. As will be demonstrated in the following, state action aimed at controlling the distribution of advantages shifted fully from formal state policy to informal means of interventions after 2003. In order to grasp the entire scope of informal state interferences, the safeguarding of property rights, openness of the economy and freedom of contract will be examined.

### **I. Protection of property rights**

Property rights are protected by the Georgian Constitution (Article 21) and the Civil Code (Art. 170-173). The legal framework governing ownership and privatization of the extractive industries, the financial sector or intellectual property are codified by separate legislation. However, international rankings point toward a significant discrepancy between legislation and its enforcement. The Global Competitive Index (World Economic Forum 2013, p. 175) ranks Georgia 131th out of 144 with regard to property rights. Georgia is also in the bottom 20 percent of 129 countries ranked in the International Property Rights Index (Property Rights Alliance 2011), standing at the 113th position. While the expropriation of property, as defined by the Georgian legislation in case of inevitable public need (Grant Thornton 2012, pp. 11–12), has not been documented, different forms of infringements of property rights as means of informal interventions are prevalent.

#### **1. De-privatization**

The ‘voluntary donation’ of property to the state by business enterprises occurred as a first type of interference in property rights and dominated the initial period after the Rose Revolution. As no law for de-privatization of unlawfully attained property existed in Georgia, coerced donation was considered a legitimate equivalent (Rimple 2012, p. 110). As an investigation of the Ombudsman on the Gori district exemplarily illustrates, all significant enterprises in the district, subsequent to the change of government, were ‘voluntarily’ transferred to the local authorities without compensation. The property was registered either on the municipality or on the head of the local administration (Public Defender of Georgia 2005, pp. 62–65). In this respect, Gori does not present an exemption, but is rather symptomatic for the approach of the government. “Businessmen were invited from different state agencies, by the ministry of interior, by financial police and were under pressure to

return their property to the state.” (Interview Papava 2012). The scheme contained a second component: a “second privatization” through property tenders, by which the acquired property was again sold. According to local observers, these transactions were often won by companies, which had been founded shortly before and that were characterized by opaque ownership (Interview Papava 2012). Often, these companies grew quickly and developed over time into potent service providers for the state (Rimple 2012, p. 113).

The processes of de-privatization and second privatization, predominantly in 2004 and 2005, led to massive re-distribution of property with a clear objective: “[...] the infringement of the property right aimed at distributing this property amongst the so-called elite businessmen standing close to the government.” (Papava 2009b, p. 24). In addition, the state benefited directly from this re-distribution of property as revenues from the “second privatization” went into the budget. This was especially important after the Rose Revolution when the state was in need of collecting revenues. Although this form of intervention occurred selectively in later years (Radio Commersant 2012b), in time it was increasingly replaced by another mode of operation.

## **2. Coerced sale**

The second form of infringement perpetuated the process of politically motivated re-distribution of property. However, this form circumvented the intermediate step of de-privatization, since ownership was directly transferred or sold to other individuals or companies. The transfer of entire enterprises was carried out by acquiring shares with the objective of profit sharing or holding majority control.

A prime example is “Senta Petroleum”, a locally owned petrol station network, which was targeted by state authorities in 2011. The Georgian gasoline market underwent a process of market oligopolization between 2003 and 2012 (Transparency International 2012a, pp. 17–31), supervised informally by the former Minister of Defense. When a new competitor, registered to a close friend of the former Minister Kezerashvili (Todadze 2012), entered the market in 2011, the owners of Senta were forced to sell the company to him. During the negotiations, apart from decreasing the price from initially GEL 28 million to 23 million (Radio Commersant 2012d), the owners were also put under pressure by the tax authorities resulting in a plea bargain agreement of GEL 6 million to settle the case (Interview Kakulia 2012). A comprehensive documentation of various ownership changes in key sectors of the Georgian economy is provided by Rimple (2012).

Due to its regularity and persistence over a longer period of time, the informal practice of transferring shares or entire companies has become an expectable procedure and, hence, an informal rule for Georgian entrepreneurs. If a company reaches a critical size, it runs the risk of being placed under the control of state or party officials. A turnover of more than 100.000 Lari, a level from which companies are categorized as medium business, is mentioned as a critical size (Interview Papava 2012, Interview Tvalchrelidze 2012). This form of re-distribution of property appeared to be more discretionary as no intermediate registration on state bodies is needed. After the defeat of the ruling United National Movement in the parliamentary elections in 2012, the scope of this form of infringements has become increasingly visible. In rare incidents property has already been returned (Radio Commersant 2012f), but thousands of applications are still waiting at the Public Prosecution Office for their revision in order to have property returned (Radio Commersant 2013a).

### **3. Coerced Bankruptcy**

Coerced bankruptcy as form of infringement of property rights is the most subtle and most difficult to prove by data. The purposeful bringing about of a companies' bankruptcy without sound reason can be done by excessive tax claims on part of the Revenue Service (Interview Shergelashvili 2012) or by informally restricting access to markets, resources or bids on state contracts (next section). While excessive tax claims often led to the confiscation of property by the state (Radio Commersant 2012a), informally restricting economic activities resulted rather in a creeping bankruptcy of the company or the devaluation of property.

## **II. Open markets and competition**

Officially, the regulatory reforms after 2003 focused solely on an *ex ante*- promotion of competition by guaranteeing openness i.e. equal access to markets and low transaction costs. Thereby, the government neglected the possibility of an *ex post*- promotion of competition by controlling the potential abuse of market dominance. Admittedly, competition policy is considered an instrument of ensuring a functioning price mechanism by controlling or preventing monopolies and, thereby, a basic requirement of liberal market economies (Eucken 1952).

Georgia's bad rankings in the "intensity of local competition" (128/ 144) or the "extent of market dominance" (112/144) (World Economic Forum 2013) suggest a massively lacking competition on the Georgian market. The crucial question is whether this situation is naturally caused by abused market power of dominant companies due to

the absence of competition policy, or actively influenced by state authorities. Different forms of infringement suggest that lacking competition was decisively stimulated by (a) informal regulation of access to markets and (b) forms of favoritism, which both significantly influenced the distribution of benefits and resources within the Georgian economy.

Markets that strongly depend on the import of goods have a natural tendency to create import monopolies. Signing (and adhering to) exclusive import contracts are usual business practices in developing countries like Georgia and due to stable business relations clearly advantageous for producers. However, import contracts simultaneously contribute to market concentrations and create dominant positions in the local markets. These natural dominant market positions can, furthermore, be strengthened by artificially limiting the import of alternative products. Such formal limitation existed in Georgia, inter alia, in the pharmacy sector, where state-released registration-lists state which specific products may be imported (Transparency International 2012d, pp. 12–13). A more effective approach, however, turned out to be the informal limitation of market entrance. The case of Arti Group, which had been the general importer for products of Procter & Gamble, Gillete, Uni, Dilmah and Sara Lee in the entire Southern Caucasus until 2007 (Civil Georgia 2007) illustrates this paradigmatically. Kibar Khalvashi, the founder and majority stakeholder of the Arti Group had not been seriously challenged by competitors since 2004, thanks to his close relationship to the Minister of Defense Irakli Okruashvili. However, when Okruashvili left the government in 2006, the fate of Khalvashi's enterprise changed too. On the basis of investigations of the Revenue Service and extensive tax claims, the Arti Group came increasingly under pressure and was finally closed (Civil Georgia 2007). Saakashvili openly commented the existence of informal restrictions for competitors as follows: "This one company was importing products ranging from toothpaste to nappies. [...] When another company tried to enter the same market, our precious defense ministry [...] prevented it from entering the market by practically using battle tanks. And it happened while we were in power, my brothers." (Civil Georgia 2007). According to other analyses, for instance on the above mentioned fuel market, informal access restrictions were no singular phenomenon: "despite the absence of legal barriers to entry, an economic agent wishing to enter to the retail segment of the fuel market faces informal barriers. Otherwise stated, it appears that it is impossible for a new player to enter the fuel market." (Transparency International 2012a, p. 19). Reports on other commodity markets confirm these findings (Petrosyan 2007; The Messenger 2011).

Analogous to markets, the regulation of the access to state resources appeared to be crucial for the targeted distribution of economic advantages (Interview Papava 2012). State orders and procurements used to remain susceptible to governmental influence

as the case of public transport in Tbilisi illustrates. Conducted in 2010 in a competitive procedure with participation of several companies, the bidding process was won by four companies. The companies were newcomers in the market and registered only shortly before by the same notary with an interval of a few minutes, each with a capital charter of 100 Lari (Putkaradze and Kvira 2011). All companies share addresses with restaurants owned by the GMC Group, which is the property of Merab and Revaz Sharangia. The brothers, belonging to an influential Georgian business family (Rimple 2012, p. 74) are close allies of the president (Putkaradze and Kvira 2011), and the Tbilisi City Mayor (Radio Commersant 2012g). Although the four companies did not officially merge, they started to operate under the common umbrella of the newly founded "Tbilisi Microbus" company (Radio Commersant 2012g). State procurement is a prime example for the two-sided policy of formally establishing sound and transparent structures and informally restraining the usage of them. So, while Georgia established „the most efficient, transparent and competitive [procurement] system that we have identified internationally“ (Transparency International 2013c, p. 4), this was ultimately torpedoed by letting only one bidder participate in a tender. In 60,2% of all successfully conducted tenders (total number: 20016) between the introduction of the E-procurement platform in 2010 and the change of government in 2012, only one bidder submitted a bid (own calculation based on data from Transparency International 2013d). This number clearly indicates an informal restriction of local competition. Moreover, the efficiency of the platform has been formally limited by a provision according to which contracts approved by the president or government can bypass the unified electronic system. In 2012, the government spent GEL 800 million via the president/government clause (Transparency International 2013c, p. 4).

Apparently, also a minimal regulatory environment allows distributing advantages by selectively enforcing rules or granting exemptions. The tax amnesty for politically related media is a widely discussed example (Transparency International 2013a). According to other reports, up to 100 large companies were not reviewed at all by the tax authorities under the previous government. To secure these advantages, the presidential team wished to subsequently legalize this informal practice by implementing a financial amnesty (Radio Commersant 2013b). The government also violated the principle of equal treatment licensing by granting privileges and better conditions to certain companies in licensing (Radio Commersant 2012a).

The negative assessment of the “effectiveness of the anti-monopoly policy“ (135/144) (World Economic Forum 2013, p. 175) is primarily a result of the formal absence of competition legislation and its respective administration. However, given the scope of informal intervention in market institutions, a formal competition policy is redundant. There is no interest for political elites to correct market distortion *ex post*, which has

been *ex ante* produced by themselves. Moreover, an official *ex-post* competition control is not only obsolete considering the informal *ex-ante* infringements; it would have been an obstacle to the discretionary informal interventions of the government.

### **III. Freedom of contract and corporate political responsibility**

The freedom of contract is guaranteed by the Georgian Civil Code (Article 319) and contains, *inter alia*, the freedom to conduct (and to rescind) a contract and to determine its content (Articles 319, 327). The freedom of contract is generally tested *ex post* with respect to the enforceability of contracts between private persons. Whether a person wishes to make use of the – in this case – formally enhanced freedom of contract *ex ante* and voluntarily decides to determine its content, however, remains neglected.

Khishtovani and Pirveli (2012) implicitly take up this question in describing a phenomenon called “Corporate Political Responsibility” (CPR). This cautiously chosen term points toward a practice of Georgian enterprises to act politically sensitive and satisfy particular needs of the state and the ruling party. Corporate Political Responsibility “[...] can be seen when an ordinary private player on the market faces a necessity to complete a “political-economical” activity, usually financially harmful, ruled by the government.” (Khishtovani and Pirveli 2012, p. 3). Different forms of involuntary political-economical activities as infringements in the freedom of contract can be found.

#### **1. Donations**

Supporting election campaigns or financing cultural events by the business community are usual phenomena in many countries often aimed at maintaining good relationships to politics or the general public. The crucial question is whether the spending was made on a voluntary basis or due to Corporate Political Responsibility (CPR).

CPR-related spending can be assumed with respect to financing election campaigns. The ruling party United National Movement received GEL 12.5 million in 2008 as donations from individuals and legal entities. The lion’s share of approximately GEL 11.6 million was donated by 454 companies. As no company contributed to the election campaigns of any other party, the Christ-Democratic Party ranked second with only GEL 58,000 donated by individuals (Transparency International 2011a, pp. 12–13). Reports of pressure exerted on business representatives back the

suggested limited voluntariness of electoral support (US Department of State 2011, pp. 1, 59).

Examples of financing cultural events, such as the investment of GEL 1.9 million into renovating a state library (Radio Commersant 2012d), or the purchase of official cars for various ministries (Radio Commersant 2012e), are only the “tip of the iceberg of voluntary donations of money and goods for certain state and party activities” (Interview Papava 2012). According to data of the Ministry of Economy, donations worth more than GEL 137,8 million were made to the state between 2004 and 2012 (Transparency International 2013b). However, this number reflects only a small part of the given donations, because it neither includes direct payments to the budget nor provisions of services (for instance renovation of a library) or donations to local and regional authorities. These infringements in the freedom of contract did not directly affect economic processes, but extracted a huge amount of capital to be invested more efficiently in economic activities. Donations were used as an additional financial source to carry out state duties and, in doing so, to demonstrate the managerial capability of the ruling party and the government.

## **2. Repeal of market Mechanisms**

The second form of a limited freedom of contract can be defined as direct state interventions in market mechanisms. These informal interventions may have been aimed at correcting market distortions, though not in order to generate a healthy economic development but to create political legitimation by targeted populist social policy.

The coerced purchase of grapes and wine in great quantities by various companies in order to prevent economic difficulties for winegrowers after the Russian trade barriers in 2006 (Vardiashvili 2010) presents a first example of repealed market mechanisms. Other instances point at similar short-term measures. In order to fight high prices in the food sector, the Ministry of Interior bought 800 tons of salt to be sold subsequently for half the retail price. According to the Ministry, this measure aimed at breaking an existing import monopoly in this specific sector of the economy (Leigh 2007). In another instance, prices on basic drugs were decreased following an official announcement of the president to fight monopolies in the pharmaceutical sector (Interview Papava 2012). Politically motivated intervention in consumer prices could also be observed prior to elections, as an analysis of the wheat market suggests (Livny and Labadze 2012). Finally, similar to the artificially increased number of staff in the district councils and administrations in the run-up to elections (Transparency International 2010b, p. 9), state authorities also requested companies to increase

their number of employees (Interview Papava 2012). The companies were often financially compensated through special state programs set up prior to elections. Examples are the 'national employment programme' covering 50,000 people in 2006 and 100,000 people in 2007/2008 (Papava 2009a, pp. 201–202) as well as specific employment programs for students (Natroshvili 2012). In doing so, a first sign of consideration on part of the state for CPR- related activities becomes apparent.

Similar to donations, the repeal of market mechanisms served the government to pursue its political agenda of power preservation. Creating a Corporate Political Responsible business community turned out to be a powerful tool to please large parts of the electorate, achieve good reputation for the ruling party and, in doing so, create legitimation of the government for remaining in office.

#### **IV. Informal intervention policy**

Informal interventions of state authorities implied deep interferences in the fundamental institutions of the Georgian economy. The re-distribution of property must be considered an initial step for the objective of creating a financially strong support base of the ruling party. Moreover, weak rights of use and ownership laid the foundation for the characteristic of Georgia's state-business relations: Corporate Political Responsibility. The emergence of CPR points on a specific pattern of interaction between business and the state that is more characteristic for state-managed capitalism than for a liberal economy. "The government thought that if a company is under political control, this is better for [the state] and also for the company." (Interview Narmania 2012). Corporate Political Responsible was a powerful political tool to finance state duties, to ease socio-economic deficits and, in doing so, to increase the legitimacy of the government.

Contrary to Shevardnadze, the Saakashvili government pursued not only a political but also an anti-corruption based economic agenda. The policy of deregulation and non-intervention showed the desired effect of abolishing red tape and endemic corruption and resulted in an increased attractiveness of Georgia's business environment. At the same time, however, these liberal reforms added to a proliferation of discretionary policy. The extensive privatization of economic relations reduced the role of formal rules and state supervision as means for maintaining power relations. After 2003, this function shifted fully to the informal arena. As a consequence of the liberal economic policy, the politically important distribution of advantages appeared to be steered exclusively through informal interventions.

Balancing various objectives is always challenging for policy makers. In the Georgian case, opting for a radical liberal economic model resulted unintentionally in an incongruence of the economic and political agenda. As argued above, the reforms led to a functional separation between the formal and informal dimension, which respectively provided means for either the economic or political agenda. The relation between both dimensions, however, was not complementary but competing. As liberal market economies are based on safeguarding basic institutions of freedom of contract, property rights and free trade, the above-mentioned massive informal infringements tended to undermine this model. State policy was not a “mixture of Neo-Liberal rhetoric and the Neo-Bolshevik essence” (Papava 2011), but constituted by contradicting *modi operandi* of the economic and political agenda. These inherent institutional contradictions ran risk of damaging the attractiveness of Georgia to foreign investors in the long term and, hence, to undermine the FDI-oriented development model.

Table 2

Period	Policy	Formal Dimension	Informal Dimension
2004- 2008	Anticorruption State-building Limiting-state	Libertarian State Deregulation FDI-oriented development model	Property re-distribution Regulating market access Corporate Political Responsibility

## G. State activism: an evolving development agenda

This scenario was overtaken by three incidents, which forced the government to adjust its economic policy. Recurring protests on part of the population against the persisting poverty pressurized the Saakashvili administration since 2007. More decisive, however, was the downturn of FDI in the first half of 2008, caused by the emerging global financial crisis and, of course, Georgia’s damaged reputation as a result of to the August war. As the imagination of a self-regulated, FDI-driven development became obviously obsolete, state authorities started to increasingly develop state intervention, as well as interlocking them with already established informal instruments of influence. In doing so, the government, notwithstanding the preserved general regulatory framework, shifted to a far more active economic policy.

## I. Continuation of a liberal regulatory policy

After the August war of 2008, a deeper economic integration with the EU became attractive for Georgian policy makers (Interview Gogolashvili 2012, Transparency International 2009, p. 9). First and foremost, a Deep and Comprehensive Free Trade Agreement (DCFTA) promised a restoration of Georgia's international reputation and far-reaching economic advantages such as unrestricted access to the European market. Although Georgia was therefore encouraged to implement extensive legislative approximations towards EU standards, the government firmly insisted on preserving a less restricted economic environment. This was certainly due to the belief in its importance to attract FDI, but not less relevant for the facilitation of discretionary policy. Two reforms exemplify how the government continued to evade its obligatory supervision.

After long consultations with the EU, the new Law on Free Trade and Competition was adopted in 2012, which states both the prohibition of illegal restriction of competition and the abuse of dominant market power as firm objectives of the new legislation (Art. 2). However, the new legislation exclusively imposes responsibility on private subjects for the protection of their rights. No *ex officio* control and, hence, no duty of the state to supervise competition was provided by the law. It also included that registrations of mergers are considered only on a voluntary basis for which no *ex ante*-examination was provided (Gabrichidze 2013, pp. 104–106). According to the legislation, competition control can be enforced solely on the basis of a private initiative (Art. 20-22). To initiate action by the Competition Agency, the complainant has to pay a fee, which even in case of a successful proceeding will not be refunded. More importantly, however, is that the burden of proof lies fully on the side of the complainant (Art. 22). Moreover, the incentives to start a proceeding are furthermore limited as the provided definitions are too wide and vague and penalties are too small (Gabrichidze 2013, pp. 104–106). On the organizational level, these findings are backed by the fact that the agency is not established as an independent state body, which would be protected from governmental influence. It is endowed with only 11 employees including a very limited budget, on the basis of which an effective supervision of competition is hardly possible (Gabrichidze 2013, p. 163).

The field of food safety shows a similar picture, where inspections had also been suspended for years. Although the government started to develop a new food safety strategy in 2010 to meet EU requirements (Jobelius 2011, p. 12), the progress of which was positively highlighted by the European Commission (2012), the new legislation adopted in 2012 puts undue burden on Georgian consumers to protect their rights. In order to initiate an unplanned inspection by the National Food Agency, the consumer has to provide, amongst others, results of a laboratory analysis of the

product and a doctor's note confirming the correlation between the disease and the consumed product (Eurasia Partnership Foundation 2011). Similar to competition policy, the legislator introduced new regulations approximated to EU standards, but simultaneously privatized their enforcement. The reforms of the regulatory framework were obviously concessions to the EU, but were implemented in a way that prevented any serious impetus towards changing market participants' behavior.

## **II. Evolving state interventions**

While the core of the regulatory policy was preserved, signs of evolving state interventions emerged after the August war. The first deviation from former economic policy can be found in the 2008 Law on Free Industrial Zones, which created the basis for the establishment of free economic zones, first in Poti and later in Kutaisi. Apart from income tax, companies residing in the Free Economic Zones were completely exempted from taxation (Ministry of Economic Development of Georgia 2013). This approach was continued by the establishment of Free Tourism Zones, enabled by the amendment to the Law on Tourism in December 2010. Investors who made an investment of at least GEL 1 million (\$562,000) in Kobuleti on the Black Sea coast were exempted from profit and property taxes for 15 years (Civil Georgia 2010). As a consequent continuation of the Free Industrial and Tourism Zones, the government also considered the establishment of an offshore financial zone under British business law attractive for international financial institutes, which, however, did not come into life under the former government (Mellow 2011). The Free Industrial and Tourism Zones still perpetuated the concept of a state that is only responsible for creating a business-friendly regulatory framework and a favorable tax and customs system. In 2010, however, the government ultimately broke with the former dogma of non-intervention and shifted towards active state engagement in the economy.

A first example is presented by the Georgian Agriculture Corporation (GAC), which was founded in March 2010. GAC is a 100% state-owned company and started to fully operate in 2011. The budget of the Ministry of Agriculture correspondingly grew from 30.6 million GEL in 2010 to almost 120 million GEL in 2011, a large proportion of which was channeled to the GAC (Boivin 2012). GAC supports the agricultural sector, providing a variety of needed agriculture services (USAID 2011, p. 49). Apart from trainings and advice on improving production practices, farm service centers and machinery service centers have been developed to provide farmers with high quality seeds, pesticides, fertilizers and veterinary supplies (USAID 2011, pp. 46,51). So far, GAC helped to cultivate 25 thousand ha of land in 2010, and increased that to 49 thousand ha in 2011 (Boivin 2012).

A second instrument of the Georgian government to promote economic development was established with the Partnership Fund in June 2011. A 100% government-owned shareholding company, the fund is mandated to extend guarantees for projects in the energy sector and develop cooperation between the private and public sector to promote investments in agriculture, manufacturing and the real estate sector (Khurtsia 2012). Projects should be financed by loans from international financial institutions, co-financed by the private sector as well as by revenues from privatization and dividends from state-owned enterprises (SOE) (Transparency International 2011b). The current asset base of the Partnership Fund exceeds 4.3 billion USD due to transferred government stakes in major state-owned enterprises, including Georgian Railway, Georgian Oil and Gas Corporation, Georgian State Electrosystem and others (Partnership Fund 2013). Dividends and revenues from privatization amounted to approx. 120 Mio US\$ in 2011 (Transparency International 2011b). According to one expert, three projects have been realized, one in the hydropower sector and two in agriculture (Interview Tvalchrelidze 2012).

Tourism is another sector where the active promotion of economic development on part of the GoG can be observed. In 2011, the Georgian government invested more than 170 Mio US\$ in the prioritized Black Sea region of Adjara, mainly in infrastructural modernization (German Trade and Invest 2011). The implementation of development projects in the tourism sector by SOE like Sairme LLC played only a minor role, because private investors became increasingly interested in the region. Between 2008 and 2011, more than 566 Mio US\$ were invested in Adjara, 70% of which came from foreign investors and 40% of which were put into tourism (German Trade and Invest 2012). However, in order to achieve the ambitious goal of the government to establish competitive tourism clusters at 20 places until 2020, the government started to focus on strengthened cooperation in the framework of public-private partnerships (German Trade and Invest 2012).

The most extensive intervention of the Georgia government, however, was conducted in the wine-producing sector by establishing a state-owned wine industry. The wine-producing sector has faced three shocks since 2006: a loss of 80% of its market due to the Russian trade barrier, the August war 2008 war, and the devaluation of the Ukrainian currency by approximately 60%, the country where 50% of the wine export went to in 2008 (Fleury 2013). The state authorities responded to the crisis by introducing a minimum price for wine grapes and the foundation of the state-owned winery Gruzvinprom, which subsequently acquired large quantities of surplus grapes for distillation. Initially founded to support Georgian winegrowers, in 2011 Gruzvinprom started to strongly compete with established private companies by opening a new factory for the production of wine (Anderson, p. 22). In relation, it is estimated that Gruzvinprom has secured more than 20,000 tons of grapes (Fleury

2013) – nearly ¼ of the entire harvest of 85,000 tons in 2012 (Georgia Today 2012). This economic strategy resulted in an increase of 40% to 70% to the price private wineries had to pay when purchasing grapes (Fleury 2013). Given the fact that, simultaneously, Gruzvinprom started to sell wine, at prices 40% below the prices of the main Georgian private wineries (Fleury 2013), this move suggests an aggressive strategy not to support the existing private wine-making industry, but rather to rapidly increase the state's share of the Georgian wine market (Anderson, p. 22; Fleury 2013). According to the announcement of the Prime Minister Ivanishvili to establish 60-100 state-owned food-processing factories in the regions (Guria News 2013), the new government obviously tends to continue this state-ownership based development approach of the previous government.

Since 2008, the Georgian government increasingly discovered the potential of a state-led development. In elaborating a state strategy to manage economic processes, the government fell also back on already established informal instruments. Apart from the new state-centered economic model that evolved, this also opened up the possibility to lessen the former contradiction between state economic policy and informal interventions, leading to initial approaches of linking together formal and informal means of state economic policy.

## **1. Strategic 'expropriations'**

The involuntary transfer of land and real estate assets to the state in areas of strategic interests occurred from the very beginning of Saakashvili's presidency. First incidents of this form of property right infringements could be observed in the territory of today's recreational park Rikhe in Tbilisi. The owners of restaurants formerly located in this area were targeted by state agencies (Public Defender of Georgia 2005, pp. 62–65), resulting finally in a collective property transfer to the state (Rimple 2012, p. 72). A similar development took place in Signaghi in 2007, a touristic spot in the Khakheti region, which the state decided to rehabilitate (Mtvlishvili 2008).

After this form of property rights infringement had temporarily subsided, the president's declaration of shifting priorities towards tourism development on the Black Sea coast and in the Svaneti region caused a resurgence of the phenomenon in 2009 (Transparency International 2012b, p. 4). Two different strategies were applied to acquire property: firstly, by abandonment or by gift and, secondly, by changing registration.

The Georgian legislation differentiates between abandonment and giving a gift (Transparency International 2012b, p. 5). In both cases, the owner voluntarily waives his right to his property. A detailed documentation on two tourism development projects shows how the state received a huge quantity of land plots from the local population in Sairme. "In these specific cases it was peculiar that such valuable property (and a significant source of income) was given to the state as a gift, especially when the state's intention to develop the land where this property was located had already been announced. Equally murky was how these gift contracts were executed en mass, under time constraints, and were usually certified by one notary." (Transparency International 2012b, p. 4). A similar development could be observed in Bakhmaro, where 79 abandonments by private persons were registered within a few days. According to the Public registry, there was a total of 1563 abandonments until January 2011 (Transparency International 2012b, p. 4). Data on how often land and real estate were given as a gift to the state has been kept confidential until now.

The second strategy of acquiring property from the local population was to register land plots or real estate in the electronic database on the state. Obviously, this led to a conflict between the registration by hard copies of cadastre drawings and the electronic registration. "The Public Registry is unable to compare drawings developed through the application of two different systems (hard and electronic versions of cadastre drawings) allowed under Georgian law." (Transparency International 2012b, p. 23). To file a suit against this informal expropriation lacked promise as courts have often failed to protect the victims from this form of property right infringement. As a report about the Free Economic Zone of Anaklia reveals, the Public Registry registered 150 formally privately owned land plots to the state (Transparency International 2012b, p. 9).

These infringements on property rights were primarily used as strategic expropriations in the course of the government's touristic development agenda. State acquired property was often sold to locally owned private companies, which shortly afterwards re-sold this property for high profits to foreign investors (Rimple 2012, pp. 79–84). This obviously served the distribution of advantages among the ruling elite and illustrates that, firstly, informal property rights infringements had been used for the purpose of the new economic policy but also, secondly, that the active state engagement in the economy provided new opportunities for a renewed formally based distribution of benefits.

## 2. Coerced investments in strategic sectors

The second form of informal interventions complementary to the new economic agenda relies on Corporate Political Responsibility. By forcing private entrepreneurs to invest in the economy, the government holds a powerful tool to steer the development of specific sectors.

The Georgian insurance industry presents a telling example for coerced investments. In the course of the hospital privatization program, the insurance companies were requested to concertedly invest a significant amount of capital in the hospital market. Given the official miscalculation of profits of the insurance companies (Transparency International 2012c, pp. 15–16), state agencies considered the companies sufficiently solvent to make investments of estimated GEL 125 million (Khishtovani and Pirveli 2012, p. 9). Here again, the symbiotic relationship between state and business becomes apparent as the state attempted to re-compensate for the involuntary engagement by regionally dividing up the state insurance market among the companies. Nevertheless, the strain on the insurers' performance caused by this investment was massive (Khishtovani and Pirveli 2012).

Other examples for coerced investments are the privatization of hotels and investment in touristic zones. After selling his company, the former owner of “Senta Petroleum” was forced to invest GEL 4 million in the rehabilitation of the Akhtala resort (Radio Commersant 2012d). The Lebanese Businessman Joseph Kay also claims that he was forced to invest GEL 200 million in various government development projects, among others in the Rustavi metallurgical factory (Radio Commersant 2012c). However, arguably the most telling example for the combination of coerced investments and tourism development is presented by the rehabilitation of Akhaltsikhe, an ancient city close to the Turkish border. Between 2011 and 2012, eleven premises on the territory of the Akhaltsikhe municipality were brought to auction and sold off at ten or more times above the actual market value (Tchokhanelidze 2013, p. 7). A total of GEL 9 632 000 was earned by the state in the course of the privatization of the property, whereas the initial price of the real estate was only GEL 161 000 (International Society for Fair Elections and Democracy 2013, pp. 38–39). In most of the cases, only one bidder took part in the auction and, in two cases, the bidder even transferred the property purchased free of charge back to the state (International Society for Fair Elections and Democracy 2013, pp. 38–39). With over GEL 26 million that the government spent on the renewal of Akhaltsikhe (Tchokhanelidze 2013, p. 7), the coerced private engagement in Akhaltsikhe presented an efficient source of co-financing state's economic projects. “The pattern does not come as a big surprise to many, especially those who understand that such deals have been endemic in recent years.” (Tchokhanelidze 2013, p. 7).

The implementation of the new development agenda was not only pursued by formal means of Free Tourism Zones or Public-Private-Partnerships, but also relied on well-established informal instruments of intervention in economic processes. While Corporate Political Responsibility had formerly stimulated companies to donate for state and party activities, the shift towards an active state-development agenda led to projects capital of which remained within the economic sphere. Depending on the conditions, this engagement may even prove profitable for the investor. However, the projection, steering and final implementation of economic development projects was, first and foremost, supervised by state authorities. In doing so, the Georgian state turned into a central clock generator for economic development in Georgia. Even given the fact that the period between 2010 and the defeat of the ruling party UNM in 2012 was rather short to develop a new coherent economic policy, various indications point toward a growing state-managed economy in Georgia comprising formal and informal means.

Table 3

Period	Policy	Formal Dimension		Informal Dimension
2008- 2012	Legitimation through Performance i.e. economic development	Liberal regulations	State process policy	Continuation of informal state interventions

## H. Conclusion

The present article aimed at analyzing Georgia’s economic policy between 2004 and 2012. According to the main argument of the study, the dynamic changes of the regulatory policy as well as the formal and informal interventions can be explained by the interaction between economic and political objectives and, specifically, their instruments of implementation. The interdependence arises from the fact that the respectively chosen instruments, i.e. regulative reforms as well as formal and informal interventions equally influence the distribution of economic advantages, which are essential for stabilizing the given power equilibrium. Using the distributive effect of institutions as explanatory variable, the paper distinguishes three periods (Appendix 3).

The political agenda before the Rose Revolution was solely dominated by the objective of stabilizing the reached power equilibrium. This monolithic focus may have

been due to the precarious political circumstances, however, it allowed for orientating and intertwining all available instruments towards this objective. The result was an institutionally complementary setting of formal and informal institutions through which the distribution of advantages was controlled in order to balance various existing power groups. The regulatory framework served directly (by tax exemptions etc.) to allocate rents among these powerful groups as well as indirectly (by red tape, low salaries etc.) as prerequisites for the creation and perpetuation of corruption pyramids. Corruption pyramids were the central informal mean for the integration of different societal groups. The complementary and intertwined organization of the formal and informal dimension led also to an institutionalization of the informal dimension. Informality, hence, should not be understood as short-term interventions undermining the formal sphere but as rule obeying behavior. This institutionalization contributed to the attempts of creating strong incentives structures in order to increase the likeability of corresponding behavior under the condition of Shevardnadze's precarious power. Yet, a system that extensively bases on corruption can hardly be economically sustainable. The institutional setting of the Shevardnadze era may have been effective with respect to the political agenda; economically, however, the regime failed and broke down once the external resource flow was cut. The subsequent radical reforms after the Rose Revolution are, hence, to be understood as a response to the disastrous economic failure of the Shevardnadze regime.

In contrast to the previous government, the Saakashvili administration pursued an additional policy objective, namely economic development by means of eliminating corruption. The extensive liberal reforms and the emphatically pursued separation between state and economy should contribute to this superordinate policy objective. However, by introducing a radical liberal economic model the new government simultaneously removed all formerly established instruments of advantage distribution. Firstly, the fundamental reduction of regulatory density and state supervision as well as the policy of non-intervention limited the possibility to steer the allocation of benefits by formal means. Secondly, the state reforms also managed to remove the institutions of corruption pyramids and thieves-in-law as the main elements of informal advantage distribution. Therefore, the reforms caused the unintended side effect of losing effective instruments for stabilizing the political equilibrium. Given the withdrawal of the state, an unrestricted economic environment would have naturally led to a strengthening of already powerful market participants. As these enterprises were politically close to the former regime, this would have posed a significant risk to the new government. In order to limit this risk and to distribute economic advantages among the new power groups for establishing a solvent supportive base of the ruling party, the government massively interfered informally in property rights, freedom of contract as well as restricted access to

markets and resources. Ironically, the state-limiting policy, intended as a strategy to fight corruption, turned into an accelerant of discretionary policy. As a result, the phenomenon of Corporate Political Responsibility became a dominant attribute of business in Georgia, which is rather characteristic of state-led than of liberal economies. This informal feature appeared to be helpful later on to facilitate the implementation of the new economic agenda after 2008.

As a consequence of the radical reforms, the formerly intertwined formal and informal dimension has been separated. The informally pursued political agenda of power preservation was in a competing relation to the attempt of establishing an FDI-oriented development model. The informal organization of advantage distribution was not compatible with the formal prerequisites of a liberal economy. This contradictory institutional setting would have led inevitably towards undermining the economic model, which could only last as long as the government manages to preserve Georgia's reputation as a trustworthy investment location.

The global financial crisis and more decisively the August War prematurely terminated the FDI-based development model and, along with the social protests, forced the government to respond. The state interventions that took place after that and the active development agenda of the government were absolutely inconceivable before 2008. The government started to develop new instruments of promoting sectorial development, which incrementally increased state involvement in economic processes, as well as relied on already established informal instruments to accelerate economic development. Here, an intertwining of the informal Corporate Political Responsibility and official economic policy can be found. Regardless of the pursued liberal economic model, Georgia before 2008 was already a state-managed economy, though as an unintended side effect of the political agenda. Only in the aftermath of 2008, this informal management capacity was used for the objective of economic development, complemented by formal state programs and interventions. In doing so, Georgia also officially made the leap from a libertarian idea of state economy to an increasingly state-led economic approach.

Furthermore, this policy shift helped to some extent to ease the contradiction between the political and economic agenda, since the increasing state activities extended the possibilities for allocating advantages back to the formal sphere. However, the question of a possible synchronization of the political and economic agenda remains. Resource-rich countries can waive the liberal economic model and its institutional prerequisites. They can afford a fully state-managed capitalism, as they can rely on own resources to bring economic development about as well as to manage the appropriate distribution of advantages. Under the condition of a globalized economy, Georgia as a resource-poor country highly depends on the inflow of foreign capital,

which requires certain institutional standards. For this reason, Georgia remains reliant on continuing a liberal regulatory policy appropriate to attract FDI. This means, regardless of the improvements due to the new development agenda, that the basic conflict between the economic and political agenda persists. The question how the political agenda of power preservation and the agenda of economic development can be compatibly organized remains one of the central challenges for resource-poor, non-democratic countries.

The paper reveals two conclusions. It demonstrates that the focus on the distributive effect of institutions presents a reasonable approach to analyze the dynamic interrelation between the political agenda of power stabilization and the agenda of economic development. In doing so, the above-mentioned perspectives, the successful regulatory reforms and state arbitrariness can be analyzed in a common framework of understanding. Furthermore, the paper explains the changes in Georgia's economic policy from neoliberalism towards state-managed capitalism. So far, the phenomenon of state-managed capitalism has been mostly discussed with respect to resource-rich countries (Bremmer and Johnston 2009; Kalyuzhnova and Nygaard 2011). The Georgian case adds a new form, which operates in a highly liberalized regulatory framework. To include the Georgian case into the studies of state-managed capitalism may significantly extend our understanding of state-business relations in non-democratic regimes.

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### **Laws**

Georgian Civil Code  
Georgian Constitution  
Law on Licenses and Permits  
Law on Entrepreneurship,  
Law on Monopolistic Activity  
Law on Free Trade and Competition  
Law on Free Industrial Zones  
Law on Tourism

### **Interviews**

Christian Timm (14/11/2012). Interview with Vladimir Papava, economist, former Minister of Economy. Tbilisi

Christian Timm (15/11/2012). Interview with Tamar Kovsiridze. economist, former Deputy Minister of Economy and chief advisor to the Prime Minister. Tbilisi.

Christian Timm (16/11/2012). Interview with Alexander Tvalchrelidze. economist, director of the International Foundation of Sustainable Development. Tbilisi.

Christian Timm (19/11/2012). Interview with Kakha Gogolashvili, economist, director of the Georgian - European Policy and Legal Advice Centre (GEPLAC). Tbilisi.

Christian Timm (19/11/2012). Interview with Vato Lejava, former economic advisor to the Prime Minister. Tbilisi.

Christian Timm (20/11/2012). Interview with Merab Kakulia, economist, former vice-governor of the National Bank of Georgia. Tbilisi.

Christian Timm (21/11/2012). Interview with David Narmania, economist, Minister of Economy. Tbilisi.

Christian Timm (23/11/2012). Interview with Tengiz Shergelashvili, economist, Deputy Minister of Economy. Tbilisi.

## Appendix 1

	2003	2004	2005	2006	2007	2008	2009	2010	2011	1012
CPI Rank	127 (133)	136 (145)	133 (158)	99 (163)	79 (179)	67 (180)	66 (180)	68 (178)	64 (182)	51 (174)
Real GDP Growth	11.1	5,9	9,6	9,4	12,3	2.3	-3.8	6.3	7,0	6,5 - 7,5
FDI as % of GDP	8,4	9,6	7,1	15,1	18,5	12,4	6,1	7,5	8,0	
New business registered		3231	3958	5698	6898	8537	7779	11107	13935	
Procedures to register business	9	9	8	7	5	3	3	3	2	2
Time (d) to register business	25	25	21	16	11	3	3	3	2	2

(Source: World Bank 2013, Transparency International 2013)

## Appendix 2

### Matrix of infringements on property rights

Type of infringement	Gift	Sale	Bankruptcy	Registration Change
Objects of Property				
Goods/ Money	Library renovation			
Enterprises/ Assets	Gori District	Senta		
Land/ Real Estate	Sairme/ Bakhmaro			Anaklia / Grigoleti

### Appendix 3

Period	Content of Policy	Formal Dimension		Informal Dimension		Dimension Relation
<b>Before 2004</b>	Balancing Power Groups	Distribution of advantages by tax exemptions, licensing etc.		Thieves In Law	Corruption pyramids	Complementary
<b>2004-2008</b>	State-building Anticorruption Limiting-state Vs. establ. strong power base	Libertarian State Deregulation FDI-oriented development model		Property re-distribution Regulating market access Corporate Political Responsibility		Competing
<b>2008-2012</b>	Legitimation through Performance i.e. economic development	Liberal regulations	State process policy	Continuation of informal state interventions		Complementary/ Competing





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Turkmenistan after Turkmenbashi.
- 2009/01 **Spechler, Martin and Spechler, Dina**  
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