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THE ROLE OF TRADE LIBERALIZATION AND WTO ACCESSION IN GEORGIA'S ECONOMIC TRANSITION AND DEVELOPMENT

A WTO Accession Technical Consultancy Report

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for

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THE ROLE OF TRADE LIBERALIZATION AND WTO ACCESSION IN GEORGIA'S ECONOMIC TRANSITION AND DEVELOPMENT

I. Introduction.

Economic transition involves increasing the roles of prices, markets and competition in Georgian economic development. This is most easily and efficiently accomplished by opening up the Georgian economy to international trade and capital movements. It is for this reason that Georgia's WTO accession is important. This Report examines the role which trade liberalization and WTO accession can play in Georgia's economic transition and development.

BACKGROUND.

Technical support for WTO accession is part of CEPAR's broader objective of assisting the Government of Georgia (GOG) in achieving transition to a free market economy, most particularly by WTO accession and the development of anti-monopoly policies which are consistent with liberalized markets. At present it appears that significant progress has been made by the GOG toward completing the requirements for holding the first Working Party in Geneva, tentatively scheduled for November, 1997. It appears, in light of this progress, the high quality of the Memorandum and the speed and completeness of the answers to the Questions on the Memorandum, that the WTO accession process has become a focal point for coordinating the Government's transition policy initiatives. It is, therefore, an important bell-weather of the Government's overall policy credibility.

OBJECTIVES.

This Report is intended to provide the GOG with a framework for assessing the appropriate approach to and benefits derivable from freer trade and WTO accession. It provides the theoretical and empirical underpinnings for the day to day advice given to the GOG regarding answering the questions on the Memorandum and adopting a policy stance concerning its trade regime. It aims to identify the trade policy options available to Georgia which are consistent with rapid WTO accession and transition to a market economy. Important in this is to enhance the role of prices and competition in the economy in order to achieve growth in formal sector employment and efficiently produced output. A key element of this identification process is to supplement the usual "static" analysis with dynamic considerations relating to stimulating growth in private investment, production and employment. The impact of the various trade policy options is assessed, with the aim of setting out how each policy option will affect Georgia's economy. These are used to present conclusions and recommendations regarding the trade policies best suited to maximizing Georgia's dynamic, or GDP growth and employment benefits derivable from adoption of the appropriate trade policy options.

ORGANIZATION OF THE REPORT.

Besides this Introduction, there are three main sections which set out the Analysis, Conclusions and Recommendations of the Report. The bulk of the report is contained in the Analysis section which sets out the data and analytical methods used. This is followed by a description of the current situation with respect to the trade regime and WTO accession, and an analysis of this situation in light of Georgia's transition goals of increasing efficient production and employment. A final section on the results of the analysis is a precursor to the Conclusions and Recommendations.

II. Analysis.

This section sets out the results of the analysis undertaken in the Report. The data collected for the study are identified and the analytical methods employed in the Report are described. These lead to a discussion of the current situation in Georgia, categorized under four headings, the accession process, the trade regime, the exchange rate and the investment climate. Following this, the analysis is presented, along with a short statement of the results obtained.

DATA.

The Report is based partly on general and trade-related economic theory and literature, including empirical findings from other countries. Also important were macroeconomic and trade-related papers about the Georgian economy. Specific documents relevant to WTO accession included the GOG's Memorandum of Foreign Trade Regime of Georgia ("The Memorandum", dated May, 1997), the Questions and Answers concerning it, and a UNDP-World Bank study entitled, "Georgia: Trade Policy for a Successful Transition". In addition, the findings of interviews in Georgia with Government Officials, Staff of the Donor Community and private businessmen and importers were utilized.

ANALYTICAL METHODS.

Demand & Supply (D&S) graphs are used for some of the analysis. It will be recalled that short term supply curves represent marginal rather than average costs; they indicate profit maximizing behavior at various different prices, given a specific set of factor costs, managerial practices, technologies and labor force skills, etc. The extent of profits, if any, is not discernable from this short term graph, although it is true that losses will fall or profits rise as prices move up the supply curve. Downward shifts in the supply curve represent improvements in efficiency. These can be due to managerial and operational reforms, or the introduction of new technologies and labor force skills. These are essentially the gains from the increased competition attainable through a more open trade regime. Rightward shifts in short-run supply curves represent increased investment for greater production. Although it is still not possible to ascertain the extent of profitability of operations at prevailing prices, it is easy to infer. If supply curves shift right, then profits must have been made at the old price/quantity configuration, because investment in greater productive capacity has occurred.

Two D&S graphs are used. The first concerns the likely impact of devaluations and of how greater investment, production and employment can occur without protective or restrictive trade policies. The devaluation of the Lari, in this example from 1L=1$ to 2L=1$, dramatically raises domestic prices of domestically and/or imported tradeables. Since Georgia is such a small market player, this leaves international prices unaffected. Potatoes, the example, formally imported, are exported after the devaluation. The graph also allows a discussion of the economic forces which shift supply curves downward and to the right; the representation of growth in GDP and employment. It is presumed that the devaluation causes profits to be made from the increased production and exporting, and that these profits are reinvested. As long as the trade regime is relatively open, it is most likely that newer vintages of investment will be used which, in the longer term, will shift the supply curve both downward and to the right.

The second D&S graph analyzes the impact of increases in trade restrictions, and of dumping on Georgia's welfare and growth in production. The analysis is the usual, static type which mainly shows the welfare losses from trade restrictions. However, this graph is also used to discuss whether the selective gains from trade restriction will stimulate investment, or a shift in the supply curve. This graph is used to demonstrate the fragmented and "windfall" nature of the gains, and whether they are likely to be reinvested or not. Although Georgia's trade regime is theoretically quite open, there are capriciously applied administrative barriers which fragment the revenue gains from protection. These fragmented, windfall receipts (which I will refer to, interchangeably as "rent-seeking" receipts) are not generally reinvested. The fragmented and windfall nature of these receipts and whether and how they will be reinvested and/or consumed is examined using three other analytical concepts. One concerns the marginal propensity to consume (mpc) of windfall receipts, as opposed to earned income and profits. Windfall receipts are is mainly consumed rather than saved. A second is the propensity to invest "lumps" of, rather than fragmented receipts. Fragmented receipts tend to be consumed, accumulations of retained earnings tend to be invested. The third, in another graph, is a rough depiction and application of Tobin's Q theory, which is used to provide a representation of Georgia's investment climate, compared to an international norm. This is included in order to assess whether any "push" to investment from savings accumulations is likely to be accompanied by a "pull" or attraction from Georgia's investment climate.

THE CURRENT SITUATION IN GEORGIA.

The accession process. The Georgian WTO accession process has been a good one to date; it has rapidly produced a good Memorandum, and relatively complete and appropriate answers to questions on the Memorandum. If the process continues smoothly and apace, it will result in relatively quick accession to WTO. In addition, because the process is coordinating Georgia's more general policy approach to the transition, a relatively speedy and successful accession will markedly increase the GOG's policy credibility. If maintained, greater policy credibility will have a beneficial impact on achievement of the transition and on stimulating greater investment by private Georgians, most likely in conjunction with, rather than in opposition to, foreign investors.

Is the momentum likely to be maintained, and will accession result in Georgia reaping the benefits of increased policy credibility and freer trade? It is hard to say, but there are unsettling indications. Protectionist sentiments abound in Georgia. A rent-seeking mentality is widespread, generally accepted and quite entrenched. This leads to a, "you scratch my back, I'll scratch yours" mentality; an ethic of sharing windfalls rather than earning higher income through investment and productive profits. Earning profits from higher production is still a relatively novel concept in Georgia.

There also seems to be a perception that WTO accession is a legal and political process which is mainly completed; that it will happen in two year's time no matter what economic policy signals the GOG sends out between now and then. This is reinforced by a belief that there is a significant, or at least adequate discretion period, before the agreements under the GATT become binding. It is believed that this period will be shorter or longer, depending on whether Georgia accedes as a developing or transition economy, but that in any event, it enables Georgia to experiment, without accession consequences, with all sorts of trade restrictions as long as they are labeled, "temporary".

This position is, in truth, consistent with the history of past accessions by other countries, but it is now anachronistic. Because of the past gap between WTO accession and the onset of freer trade, the prevailing sentiment applicable to the current accession process is to tighten up accession requirements. The latitudes given in the past to those acceding under developing economy status are now unattainable. In actuality, successful accession as a developing economy gives little more latitude than acceding as a transition economy. Perhaps more significant from Georgia's point of view, the accession process now relies less on promises than it used to; the Working Parties are much more concerned with actual policy behavior and enforcement of laws. If the sentiment for backsliding gains credibility and becomes actualized, probably Georgia's accession, and certainly the onset of the benefits of trade liberalization, will be delayed.

The trade regime. This is, in theory, very open. Tariffs are low; 12% for most goods and

5% for capital items and some inputs. Exemptions are granted for a handful of socially significant goods (e.g., wheat). Prohibitions on imports are rare and generally consistent with an interest in national and/or social security. On paper, therefore, tariffs and non-tariff barriers (NTBs) appear to be low. Unfortunately, there are many capricious and corrupt administrative restrictions (Capricious non-tariff barriers- CNTBs) which alter and make unpredictable the impact of the trade regime. They distort price incentives, inhibit competition, and provide rent-seeking (mostly small, fragmented) windfalls to Government Officials who are woefully underpaid. Proclivities to intervene administratively, sometimes corruptly or for rent-seeking, are intrenched and make the trade regime capriciously distorted.

It is clear from the Questions, that the onerousness and capriciousness of the application of the (relatively low and infrequent) NTBs is an issue for accession. It also has a significantly negative impact on the domestic economy, primarily through its effect on the investment climate. The examples related to me concern the application of minimum pricing and content verification rules. These were introduced to prevent the under-payment of tariffs, through under-invoicing of imports. Either the values may be under stated, and/or the content may be misrepresented, so that the values are not applicable for what is actually being imported. The Answers to the Questions suggest that the application of these procedures will be streamlined, but few believe it. From a Government revenue standpoint, there is no obvious reason for the rules. The tariffs are low anyway. Furthermore, there is a 20% VAT which is soon to be collected all the way through to the retail level. This should mean that whatever is not collected as tariff revenue is captured as a tax on value added. There seems, therefore, to be no obvious reason why importers would under-invoice.

The practice seems to persist primarily because it gives rent-seeking officials a chance to intervene and collect gratuities, which replace rather than enhance the revenue actually collected by the Government. Calculated tariff revenue to the Government should have been about 10% of official imports, or L60 million. Actual tariff receipts are L 20 m or about 3.5% or the value of official imports. Importers and producers seem not particularly upset that officials rather than the Government get this revenue. They are very inconvenienced by the delays and the haggling, and they are obsessed by the belief that others are being treated more favorably. These administrative problems and capriciousness carry through to the collection of the VAT. Collections of VAT revenue by the Government were about L 140 million, much larger than for tariffs. However, it is charged that rebates and/or reductions in calculated value added because of tariff payments are not granted. Instead, gratuities to officials can result in lower VAT assessments and less payment of taxes to the Government.

The exchange rate. In Georgia, the exchange rate is managed by the Central Bank and supported by foreign borrowing, almost exclusively from IBRD/IDA, IMF & EBRD. The currency, the Lari, is convertible. Since the banking system is crude and inefficient, it is most easy to convert small amounts at street-side vendors. For large purchases, foreign currency (The US Dollar) is preferred, and it is said, and is quite evident, that holdings of foreign currency are very significant. (One Georgian said to me, "How can we be so poor and have all this foreign exchange?"). It is my guess that, like other countries in similar situations, large currency conversions are arranged between private individuals, rather than through the banks.

BOP deficits are about $350 million a year or about 7% of GDP. This represents net additions to foreign borrowing. Virtually all of this borrowing is arranged by the Government at interest rates which are concessional, as compared to the rates generally paid for international, free market, government borrowing. The "arranged" and concessional nature of this borrowing, coupled with disarray, non-use and underdevelopment in the local baking and financial systems, means that there are no market determined interest rates in Georgia. There is, therefore, no way that interest rate policy can affect the exchange rate.

Investment and the investment climate. Current, officially estimated investment levels are low, about 5% of GDP. Since the formal economy has collapsed, one or two years of quite rapid recovery can be expected without much additional investment. Beyond two years, however, formal investment must rise rapidly to 15% to 20% of GDP if growth rates of 6% - 7% are to be sustained. There seems to be significant amounts of investment in the shadow or informal economy, but this seems to be mainly in the form of inventories of easily tradeable consumer items.

Formal investment seems to be a very risky proposition at present. It is likely that risk adjusted rates of return are very low or nil. Most saving/investment seems to be in the form of foreign exchange or easily tradable consumer commodities. A most depressing aspect of the investment climate is that formal sector investments in production for profits must compete for entrepreneurial time and attention with a host of high yielding, rent-seeking activities.

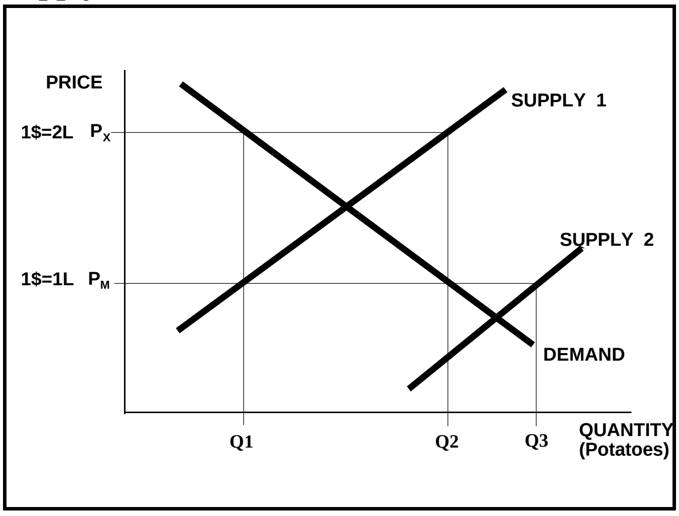
ANALYSIS.

This section examines how the current trade regime and investment climate interact. In both, expectations, institutional and market inadequacies, capricious and corrupt interventions and rent-seeking activity play important roles. Three graphical representations are presented. The first, a D&S exhibit, is utilized to examine the possible dynamic gains, in production and employment which are obtainable from a WTO accession process which coordinates policy and liberalizes trade and domestic markets. This discussion is mainly focussed on the possible benefits derivable from an open, competitive economy. The second D&S exhibit is used to represent some of the restrictions or barriers to trade which Georgia now has, or seems likely to try to adopt under the impression that they are consistent with WTO accession. A major focus of this discussion is on profits vs. rent-seeking windfalls. The third graphical exhibit is a rough representation of Georgia's investment climate compared to an international "norm". It is used to focus the analysis on how Georgia's trade policy can be used to improve the climate for formal investment.

The dynamic benefits of an open, competitive economy.

Exhibit 1 demonstrates the effects of a devaluation and possible benefits of a more open, competitive economy. At a low domestic price for potatoes, (Pm) little is supplied (Q1) and a lot is demanded (Q2) so that there are imports of Q2-Q1.In this case, consumption is large and production is small. Financial outflows for potatoes are Pm(Q2-Q1). In the extreme case, where only potatoes are traded internationally, this amount, $ (Q2-Q1) also is Georgia's net foreign borrowing. Should there be a devaluation

Exhibit 1. Market Effects of Devaluation and Supply Shift



of the Lari, to 1$=2L, the local price of potatoes will rise to Px, and the situation reverses. Domestic consumption of potatoes is dramatically curtailed, production significantly increased, and Georgia exports Q2-Q1 of potatoes, receiving foreign exchange of, or reducing foreign borrowing by, $ (Q2-Q1). It appears that devaluations are tough on consumers but helpful to producers. But is it possible that something can shift the domestic supply curve to Supply2? If so Georgian consumers, producers and exporters can all gain. Consumption could be Q2, as before, but without any foreign debt accumulation. Instead, production can increase to Q3, Georgia can export Q3-Q2, and receive foreign exchange equal to $ (Q3-Q2).

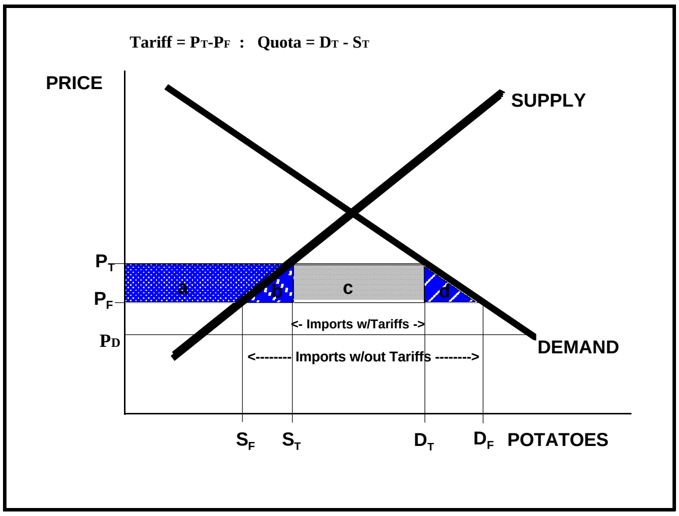
The shifting of the supply curve to Supply 2 is a major goal of a successful transition. The devaluation, or any short term price movements, need not be an integral requirement of achieving the shift. It is possible, for instance, that a devaluation raises other prices and producer profits to a greater extent than for potatoes, so that increased investment in potatoes doesn't occur. More important to achieving a beneficial shift are Georgia's overall investment climate and whether, at the prevailing price, say Pm, producers are making profits or not. If producers are making profits at Pm, and the investment atmosphere is good, then the favorable supply shift will occur. Furthermore, the acquisition of newer vintage capital means that the shift is more than likely to be both rightward and downward, with the latter reflecting increased efficiency and productivity.

It is most likely that in Georgia, as in other CIS countries, considerable investment will be required to achieve growth in production and employment. However, given the past high levels of investment in inefficient production, it will be the cost cutting and efficiency increasing investments which will have the highest yields. These would be represented by significant downward as well as rightward shifts, signifying the utilization of new technologies and labor force skills. It is greater competition rather than government policies which induce these efficiency gains.

The disadvantages of tariffs and quotas.

The above description of the advantages of open competition were dealt with first in order to make the point that simply raising prices, especially artificially and temporarily, need not result in favorable shifts in supply curves. This point is reinforced through an examination of Exhibit 2, along with the application of economic principles regarding uncertainty and the receipt of windfalls. Exhibit 2 represents the results of imposing (an increase in) tariffs or quotas. It shows the welfare and revenue effects of a tariff (increase) of Pt-Pf or of a quota (increase) of Dt-St. Since Pf, the world price, will not be affected, domestic prices rise to Pt, cutting consumption by Df-Dt, but expanding production in the short run by St-Sf. Consumers lose and existing marketers/producers gain. It is assumed that existing marketers/producers receive extra revenue equal to the revenue blocks a+b and that the Government receives the revenue block c if the restriction is a tariff. If the restriction is a quota or NTB, theory says that marketers/producers, rather than the Government, receive the

Exhibit 2. Market Effects of Tariffs and Quotas



revenue block c, in addition to a+b. In any event, consumers lose; consumption is cut from Df to Dt and prices are higher. This loss is represented by the triangle d.

Will the imposition of a tariff or quota (NTB) restriction stimulate a rightward/downward shift in supply so as to give more efficient growth in production and employment? As with Exhibit 1, it is important to realize that the higher prices don't necessarily stimulate supply shifts. In fact, there are significant reasons to believe that these artificially increased prices, due to tariff or quota or NTB restrictions, will not stimulate investment in expanded, more efficient production. One reason, relating to Georgia's investment climate is discussed in a separate section below. However, there are two other reasons, relating to the nature and capriciousness of windfall receipts, which can be discussed using Exhibit 2. The increase in the price, to Pt, is due to interventions, e.g., by Parliament, rather than to market forces. The restrictions represent the granting of monopoly powers to existing marketers/producers who earn extra receipts because of the restrictions rather than because of increases in production. The extra receipts are, therefore, windfalls rather than production related profits. Expansion of production and marketed output will reduce or remove these windfalls. Artificial or Government granted restrictions, therefore, prevent rather than stimulate a greater supply response. It could be argued that windfalls enable producers to amass savings which can be used to expand investment. Unfortunately, this does not occur. Windfall receipts, such as from corruption and/or Government favors, are not saved and invested. Rather, they are almost always spent on conspicuous consumption and/or sent abroad. A major lesson of Exhibit 2 is that tariffs and quotas and other NTBs artificially raise domestic prices, but these price increases do not result in greater investment, production or employment.

<u>The capriciousness of Georgia's NTBs</u>

Exhibit 2 is not a very accurate representation of Georgia's relatively slight trade restrictions because tariff assessments are selectively or capriciously enforced. This enables Officials to extract a share of the Government's revenue and/or producers' windfalls for themselves. In essence, capricious enforcement of tariffs means that Officials get portions of the revenue boxes, b and c. I have already mentioned the 40 million Lari discrepancy in Georgia between the theoretical size of the revenue box, c, (60 million Lari) and actual tariff collections (20 million Lari). In the extreme case, Officials could rake off the whole 40 million Lari, and producers would be able to charge Pt and collect the revenue boxes a & b. However, it is also possible that Officials extract part of a&b, or that they allow producers to pay lower tariffs so that a market price below Pt, but above Pf, allows the passage of some of the benefits of corruption back to consumers.

In the longer term, the division of the windfall receipts is less important than the restrictions themselves, and the capriciousness of their application. Together, these insure that peoples' income is derived in the form of windfall or rent-seeking receipts rather than from production related profits. Saving and investment related behavior is directly reduced because the receipts are from rent-seeking, while the capriciousness of enforcement makes further productive investment extremely risky.

<u>Dumping and Subsidies</u>

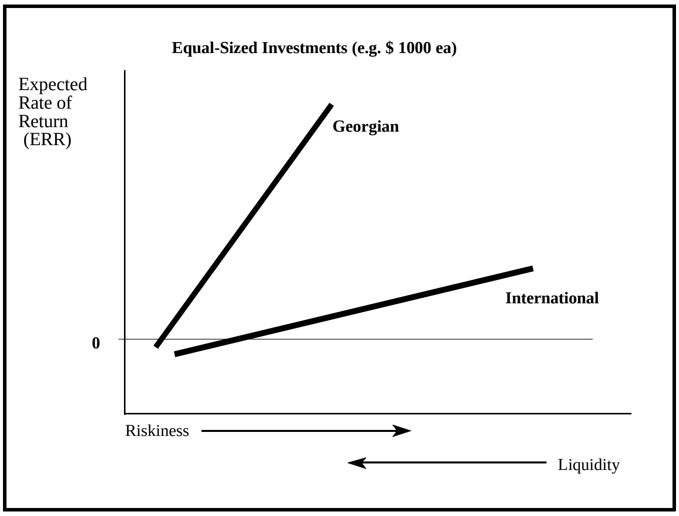
Exhibits 1 & 2 can be used to demonstrate dumping and how it can come about with subsidies. Pd in Exhibit 2 is assumed to be the (dumping) import price in, say, Georgia. It is called dumping because it is below the free market price Pf. However, "the" free market price is very difficult to determine. As a result, dumping is defined, in conjunction with subsidies, with reference to prices in the country of origin, or the exporting country. The simplest case is one where the price to importers in the importing country, say, Georgia, is below the price in the exporting country. In a relatively open market, this will only be possible if the Government of the exporting country is giving some sort of subsidy. In this example, it will be assumed that the subsidy is given per unit, and in domestic currency. Exhibit 1 represents the country of origin, and Exhibit 2 the importing country. Suppose that Pm in Exhibit 1 is equal to Pd in Exhibit 2. That is, Pm = Pd, where both are the dumping price in the importing country. The country of origin agrees to pay exporters 1L per unit for an export volume = Q2-Q1 (which, although it doesn't look like it, is assumed to be the same volume as imports at Pd in Exhibit 2). The result will be that the price in the dumping country will be Px, or 2 L (the amount of potatoes supplied to the domestic market is restricted to Q1) while the price in the importing country will be 1 L. This is clearly dumping; it is accomplished by giving a 1L per unit subsidy to an export volume of Q2-Q1. This sort of export subsidy used to be a quite frequently used export promotion technique, when foreign exchange was not easily convertible. It was accomplished by giving a more favorable exchange rate to exports.

Investment and the investment climate.

Countries with favorable investment climates can assume that investment of 15% to 20% of GDP occurs annually without the need for changes to Government interventions into the trade regime and/or the domestic economy. In such situations, the basic policy approach should be to **do no harm**. In particular, interventions (restrictions) to the trade regime should be avoided; they can do great harm. Consumers can be harmed in the short run and, if the additional interventions are viewed as credible by producers, they can sift investment into areas where efficiency losses will cause too rapid depletion of a country's natural resources.

Currently Georgia's formal investment level is very low, estimated at 5% of GDP. One possible explanation for this is that the investment climate and the trade regime are generally appropriate, but that potential investors require time, following Georgia's massive economic shock, to adjust to the new incentives. This is consistent with a view that the transition has essentially occurred, but entrepreneurs need time to realize it. A alternative explanation is that formal sector investment levels are low because the investment climate is poor; that formal sector investment is so risky and low yielding so as to be an economically unattractive thing to do. Exhibit 3 presents a representation of investment climates roughly based on James Tobin's "Q" theory of saving and investment. (The reader is warned that this is not a presentation of Tobin's theory.) Either line in the graph represents an array of equi-cost investments, ranked by expected rate of return (ERR) and riskiness (increasing to the right) or, in reverse, liquidity (increasing to the left). The left end of either line represents saving/investment in cash, the currency of choice (which may be foreign exchange). Moving rightward and upward along a line represents equi-cost investments first in increasingly risky financial instruments and then in increasingly risky real investments. Each line conveys information regarding how anticipated rates of return must rise in a country as savers/investors purchase increasingly risky, less liquid investments. The higher and steeper the curve, the less accommodating the investment climate.

Exhibit 3. Comparison of Georgian and International Investment Climates



The international “norm” represents a vast array of investment opportunities and well developed, smoothly functioning primary and secondary asset markets. By comparison, investment in Georgia has a much steeper “Q” curve, which is also, for its relevant range, above and to the left of the international norm. An important question is, will anything other than the passage of time and increased familiarity cause Georgia’s “Q” curve to slide downward and rotate clockwise? Devaluations and administrative and institutional reforms can drop the curve and rotate it favorably.

In Georgia there seem to be three different views regarding solutions to Georgia’s unfavorable “Q” curve. One, is a “do nothing” view. Georgia’s Q curve will naturally drop and rotate favorably over time, with out any further Government action, as savers/investors become familiar with market principles. This is a view which is consistent with a contention that the transition has already happened, but investors don’t realize it yet. A second view is that further Government action is needed, but that this should entail market interventions only. This “market friendly” view would mainly involve a significant devaluation of the Lari and a significant decrease, or a cessation of public foreign borrowing, but little else. Initially, this would drop Georgia’s Q curve. The third view is a “hands on” one involving Government financing, with continued but targeted foreign borrowing, of economic and administrative reforms and institutional developments. Initially, this would rotate the Q curve. For each of these latter two, secondary effects would rotate (“market friendly) or drop (“hands on”) the Q curve.

It is not the purpose of this Report to select from amongst these three strategies, which may not, in any event, be mutually exclusive. What is of interest is how WTO accession and/or changes in trade policy might or might not contribute to one or the other strategy and to improve Georgia’s Q curve. Speculation regarding this is set out in the <u>RESULTS</u> section below.

<u>RESULTS.</u>

The analysis raises questions concerning whether Georgia’s current trade and accession policies can be sustained, and concerning whether there is need to adjust them in order to gain all possible development and employment advantages from a hastened transition. The present, theoretical openness of the Georgian trade regime, coupled with an energetic, well coordinated effort by the WTO Accession Task Force have put Georgia on a relatively rapid schedule which could result in accession in 18-24 months from now. However, the current trade regime is, in actuality not as open as it seems because of capriciously administered barriers to trade. These enable Officials to rake off gratuities or windfalls via what is commonly called “rent-seeking” behavior. This behavior is extensive and entrenched and it results in reductions in receipts of both Government and producer revenue. There is also a generalized sentiment in Georgia to increase protective and/or administrative interventions. The capriciousness of these, along with the extensiveness of rent-seeking behavior, have an adverse impact on formal investment and on the investment climate.

The analysis demonstrates that more open trade, and enhanced domestic competition are consistent with improved prospects for growth in production and employment. Greater tariff, quota and NTB protection, restrictions and interventions, on the other hand, are not compatible with increases in welfare, production and employment. The analysis of the causes of Georgia’s low levels of formal, estimated investment suggest that the investment climate is poor; that there are few investment opportunities and asset markets here, and that Georgians are risk avoiders. The question is posed concerning how investment levels can be raised and what role the Government and its trade policy can have in this.

Three, not necessarily mutually exclusive policy strategies are identified. One, a “do nothing” policy, assumes that the current openness and price incentives are generally adequate, so that the

Government needs to initiate little more in the way of trade reform. Regarding trade and WTO accession this would entail maintaining pressure to accede to WTO while resisting pressures and initiatives to increase, even temporarily, protectionist and interventionist trade policies. This involves a risk that the accession process will be slowed because of WTO concerns regarding the existence and capriciousness of administrative barriers to trade.

The second and third strategies emanate from a position that further, pro-active policy and/or procedural changes are needed to hasten the transition and improve the investment atmosphere. Both would be consistent with the current, fairly rapid pace of WTO accession and both would reduce the risk that accession would be delayed due to concerns about the extent of capriciously administered NTBs in Georgia. The second strategy is a "market friendly" one involving a significant devaluation of the Lari and markedly reduced foreign borrowing by the Government (which currently supports the exchange rate). The final, or third strategy, a "hands on" one, would entail continuing with the present price incentive structure and the foreign borrowing, but to better target the borrowing toward administrative reforms and institutional and market development. This could be supplemented by using some of the concessional borrowing to provide production related, lump-sum subsidies in situations where the targeted sector is or will become open and competitive.

III. Conclusions.

In Georgia the greatest likelihood is that the investment atmosphere is poor, either because price incentives are **in**adequate and distorted, and/or because administratively capricious interventions and institutional inadequacies prevent the price incentives from stimulating investment, and through that, growth in the production needed to close the BOP deficits. Although investment incentives are not adequate, it is difficult to determine whether this is due mainly to inadequate price incentives and distortions or mainly to capricious administrative interventions and institutional inadequacies. The crucial issue from a development point of view seems to be whether expected, risk adjusted profits from production related investments can exceed the present, very significant windfalls available from rent-seeking activity. The existence of a vibrant informal sector, and of significant rent-seeking windfalls, suggest the capricious administrative interventions and institutional inadequacies, rather than inadequate or distorted price incentives are the binding constraint. Given the present theoretical openness of the trade regime, this appears to reduce the importance of further trade reforms, in favor of administrative reforms and institutional development.

This does not mean that Georgia need pay no further attention to trade policy and WTO accession. On the contrary. The pervasiveness of protective and interventionist sentiments suggests that a continuing battle must be fought to keep the trade regime theoretically open, and to fight to reduce the capricious interventions fueled by rent-seeking behavior. Simultaneously, it is necessary to increase the extent to which this openness percolates into the domestic economy so as to increase competition in domestic markets. There is a tendency, particularly amongst interventionists and rent seekers, to reason that economies of scale mandate that domestic markets be supplied by a few, large suppliers, and that, therefore, regulated monopolies are more efficient for small economies than fragmented competition. This has not proved to be borne out in practice. Besides, it assigns to the many the subservient role of workers while it reserves for the privileged few, the role of manager/master. Given the vibrancy of the informal sector in Georgia, it seems unlikely that so many budding entrepreneurs will accept this subservience willingly.

There is still the problem of what, if anything, Government should do about the capricious, administrative interventions or NTBs. It is conceivable, though very risky that these can be overlooked, and not compromise relatively rapid WTO accession. However, it is certain that these problems will reduce the openness of the Georgian economy and the possible gains from freer trade. In addition to fighting off protectionist and interventionist initiatives, the Government should address these administrative and institutional problems. To do this, it can adopt either the “market friendly” or the “hands on” strategy, or some combination of both. Currently the “hands on” approach appears to be favored by the Government and the Donors. Market friendly interventions are quiescent; the exchange rate is being supported at a relatively high (Lari/$) rate, and significant amounts of foreign borrowing are being arranged. Some budget support and external funding is being reallocated for legal and administrative reforms, and for institutional development. Unfortunately, this “hands on” approach is, in itself an administrative one which can be inconsistent with the development of free, competitive markets. Furthermore, it is one which has not worked well, nor inexpensively elsewhere. It is still possible that further price reforms, notably a further, significant devaluation or raising the Lari/$ price ratio, is the quickest, least costly, free-market-friendly way of rising expected, production-related profits relative to rent-seeking windfalls.

IV **Recommendations.**

There are four main recommendations regarding Georgia’s trade policy, and a fifth regarding dealing with the problem of dumping. The first concerns a “hands on” policy of making administrative interventions into the trade regime less onerous and capricious and more transparent. The second, relating to a “market friendly” strategy, deals with Georgia’s exchange rate and closely related, foreign borrowing policies. Thirdly, another “hands on” policy, this time relating to granting production relevant, WTO consistent subsidies is discussed. This recommendation also covers export promotion. Following this is a fourth recommendation regarding maintaining the theoretical openness of the present trade regime by refusing to grant special tariff, quota or NTB favors, even temporarily. Finally, because it engendered so many inquiries in interviews, some information/recommendations on anti-dumping are included. These are fully consistent with the subsection above covering subsidies and dumping.

REDUCE ONEROUS AND CAPRICIOUS TRADE INTERVENTIONS--APPLY REASONABLE ADMINISTRATIVE INTERVENTIONS, TRANSPARENTLY & CONSISTENTLY (FAIRLY).

Problems regarding the capriciousness and onerousness of administrative procedures in the trade regime draw the most frequent complaints in Georgia. They are also the most likely problem to compromise relatively rapid WTO accession. The Government must effectively reform and repress them if the benefits of freer trade are to percolate back into domestic markets. A most frequent and flagrant problem involves the application of minimum or reference pricing and content verification. Detailed recommendations regarding how the Government can alleviate these particular problems serves as an example of how the broader problem could be solved.

Georgia’s reference/minimum/customs evaluation and content verification procedures are intended to prevent under-invoicing of imports. However, they are administratively difficult to apply and they allow Customs to be capricious and to collect gratuities for lenient enforcement. The procedures are unevenly applied, expensive and time-consuming for importers, and they will not likely increase customs revenue collections appreciably. Georgia should not be concerned about under-invoicing of imports anyway; tariffs are low and there is a 20% VAT which will capture any (of the likely very few) attempts to avoid 12% tariffs. In light of this the Government should consider reforming these practices as follows:

(1) The existing Minimum Customs Evaluations procedures should be abolished (apparently this is about to be done).
(2) Import invoices should be the major instrument of import evaluation.
(3) Any applications of price/content verification procedures should be transparently, consistently and simply applied. This should mean: (a), that the price/content verification exercises be applied only to a scientific sample of shipments and; (b), that many of the sample of inspections be undertaken as pre-shipment verifications, by independent examiners.

USE A DEVALUATION OF THE LARI TO IMPROVE PRICE INCENTIVES AND LOWER FOREIGN BORROWING

Some of the current clamoring for differentially higher protective tariffs is based on GOG cost studies which suggest that import border prices provide inadequate rates of return. This is consistent with Georgians' belief in the pervasiveness of dumping. There is general admission that the cost studies show tremendous inefficiencies, but it is argued, correctly, that improving efficiency requires significant investment and new technologies and labor force skills, and that higher prices, via selectively raised, temporary tariffs, will stimulate such investment. The analysis of this paper shows that attaining greater efficiency requires more openness and competitiveness, not protection. The issue would not be important if the affected productive endeavors were an insignificant portion of GDP. Unfortunately, the items being discussed in Georgia as needing this extra protection constitute a large portion of GDP and are thought to be those items in which Georgia's comparative advantage lie. If such a large portion of the economy is similarly affected by this "low price" phenomenon, it may be that the best strategy is to devalue the Lari, so as to raise all producer prices of tradeables. Since the exchange rate is currently being supported by foreign borrowing from the IBRD/IDA, IMF and EBRD, the devaluation could be accompanied by reductions in such borrowing. This could also be beneficial in other ways. Arranged, concessional borrowing can cause distortions to, and delays in the development of Georgia's budding financial markets.

TRANSPARENTLY GIVE LUMP-SUM (NON-RECURRENT) SUBSIDIES TO STIMULATE COMPETITION

An alternative to devaluation, in addressing problems of inadequate investment incentives, if the problems are not widespread, is to give subsidies. Subsidies can be dangerous if they stimulate rent-seeking behavior or lead to dumping. However, they can be a very effective developmental and anti-monopoly tool, if used carefully and in conformity with the GATT. Relatively small, well targeted subsidies can stimulate investment in new technologies and labor force skills, thus lowering supply curves and expanding efficient production and competition. Effective subsidy programs are usually designed specifically to accomplish certain goals, such as introducing new technologies and labor force skills into particular industries, or subsidizing competitors in a monopolized industry. The subsidies must be in conformity with the GATT, which generally means that they must not subsidize recurrent costs. A recent, apparently quite successful subsidy example, which conformed to the spirit of the GATT, is European subsidization of Airbus.

The basic WTO position is that subsidizing exports, either explicitly or implicitly, constitutes dumping and contravenes the GATT. However, subsidies are both very difficult to identify, and an important policy tool for the Government vis-a-vis the domestic economy. For instance, certain tax abatements, considered a subsidy domestically, are allowed for exports under the GATT. In addition, GATT would allow, or its members would overlook, an anti-monopoly policy involving capital (lump-sum) subsidies to other domestic producers so as to stimulate competing production against a monopoly -- even if the result was some (slight) spill-over into exports. This is essentially the logic used by the EU in subsidizing Airbus. Subsidies for R&D and for production-relevant-learning by labor are also accepted, even though they might spill over into exports, because they can be so beneficial to Georgia. Export credit subsidies ("EXIM" credit subsidies) are generally acceptable as long as the lending governments associate with the Berne Union and abide by members' agreements, regarding the extent of allowable subsidization of export credits. EXIM credits are not a good idea for Georgia at this time, however.

With respect to trade and development, export promotion is a frequently adopted subsidy program. The Government must not simply subsidize certain exports so their export prices are lower than their domestic equivalents; that's dumping. For this reason, most export promotion is really tantamount to stimulating more efficient domestic production so that both domestic and export prices fall. It has become fashionable, and sensible, for Governments to use an "arm's length" approach to export promotion. This usually involves hiring an international, export promotion company, which then promotes exports in ways which conform to the GATT. As mentioned, one focus of these companies is the efficiency of domestic production. Another is to make very small grants to fund international marketing efforts by specific producers. It is ironic but true that successful export promotion or subsidization, usually conveys tremendous benefits to domestic consumers, both by lowering domestic prices and by raising the quality of domestic output to international standards.

Lack of financing is not an appropriate reason for not giving appropriate subsidies in Georgia. The Government is currently borrowing relatively large amounts of concessional money, all of which is subsidizing something. It would be much better to appropriately target and deliver these subsidies to production and employment, than to have the subsidies spill over into consumption.

DON'T GIVE SPECIAL TARIFF OR QUOTA (NTB) PROTECTION, EVEN TEMPORARILY.

It is a major thrust of this Report that Governments which grant special (differential) tariff or quota (NTB) protection, even temporarily, harm their economies. If Georgia begins to grant these special favors before accession, it will compromise the WTO accession process. It is certain that a few gain windfalls, sometimes huge ones, from these favors, but this comes at the expense of more-than-offsetting-welfare-losses for society as a whole. It doesn't stop there. Special trade restrictions inhibit growth in production and employment and prevent the efficiency gains which free and fair competition bring to every productive endeavor. The nation's destruction of natural resources will occur at a much faster than necessary rate.

It has not proved possible, in practice to give these special favors temporarily. The windfalls received stimulate further requests for favors; rent-seeking, or the pursuit of income earned from someone else's investments. This behavior becomes endemic. As this Report has shown, the fundamental logic of granting such temporary protection is flawed. It is based on two false premises. One, that investment is savings constrained, that if there were more savings (credit) at lower interest rates, investment would take off. Second, that windfall receipts, garnered via rent-seeking will stimulate accumulations of savings. The first, regarding a savings (credit) constraint on investment is not true for Georgia; the investment climate is poor and, therefore, the demand for savings (credit) for investment is low. Regarding the second, it is unlikely that Georgians are any different than nationals of other countries; those who receive windfalls through rent-seeking will not accumulate them for investment, but will spend them on consumption or send them abroad.

APPROPRIATE ANTI-DUMPING MEASURES FOR GEORGIA

Many Georgians feel that imports are being dumped here. They feel that it is virtually impossible for others to produce certain imported items so much more cheaply than Georgians. It is conceivable that they are correct, but it is also possible that this incredulity is a measure of how out of touch with modern technologies and production procedures Georgian producers are. Whatever the case, accession to WTO should be accompanied by regularization of the Government's handling of suspected dumping.

Under the GATT, it is not expected that the Government will unilaterally impose anti-dumping sanctions. Instead, it is expected that dumping complaint(s) originate with Georgian private producers/traders who are adversely affected. They are advised to inform the Government, which can, in turn inform the GATT. Because of this, the Government usually adopts and publicizes internal procedures, for use by its citizens, in handling suspected dumping. Although these procedures are not directly relevant to the WTO accession process, it is important for the Government to have anti-dumping procedures and institutions in place shortly after accession. The institutional arrangements and anti-dumping procedures are frequently the responsibility of Ministries of Trade. It is not expected that the Government, or a State Owned Enterprise, or a regulated monopoly initiate dumping charges.

If Georgians feel victims of dumping, following WTO accession, they will have to abide by GATT anti-dumping procedures. One of the most generally applicable of these is that there should not be capricious, unilateral, Government action against the suspected country of origin, for example in the form of special tariffs, quotas, administrative restrictions, etc. Instead, Georgia will have agreed to press charges of dumping with WTO and let the GATT adjudicate the case(s) and suggest the imposition of sanctions. This is a very cumbersome, time consuming process, although GATT has speeded up its anti-dumping approach somewhat, mainly be agreeing to apply more standard definitions of dumping. These involve comparing export with adjusted domestic prices for the same item(s), with a presumption that markedly higher domestic prices in the exporting country indicate dumping. In spite of this, and of the anti-dumping agreements with in the GATT, capricious, unilateral anti-dumping actions are sometimes taken by non-governmental, commercial, labor union, business, etc. interests. The Georgian Government should not defend the right of these interests to act unilaterally. However, sometimes actions by affected parties can cause the GATT to deliberate with greater speed. In practice, once the transition is more complete and Georgia accedes to WTO, solutions to these trade irregularities frequently involve settlements and agreements between non-governmental parties, of course with the acquiescence of GATT.