12 Georgian Economy: Main Directions and Initial Results of Reforms

From 'Shock Therapy' to 'Social Promotion'

Vladimer Papava

Georgia before 'Shock Therapy'

The question is often posed of when the economic reform started in Georgia. In my opinion the period from 1989, when the idea of national independence embraced the whole society, should be considered as its starting-point. It became a turning-point for both economists and those claiming to know economies, resulting in the creation of a number of interesting new concepts linked to the idea of economic independence (Papava, 1990). This first stage can conventionally be called *the stage of naïve comprehension.*

The second stage of economic reform started after the election of the Supreme Council in the autumn of 1990. At that time several very important laws on economic reform were issued, though they were unfortunately not implemented effectively. This stage of reform can therefore be considered *the stage of reform stagnation.*

After the coup d'état of December 1991–January 1992 there began *the stage of populist economic reform.* At that time the government transferred land and dwellings to people without compensation in order to enlist the 'easy' support of the population. These redistributive policies caused substantial damage to the agricultural sector and house-building. In particular, land privatisation was carried out mechanically and it practically ruined the necessary infrastructure for agricultural production (the system of supply of machinery, fertilisers and other resources); and without a legal basis for private ownership of land the efficiency of land tenure is very low. If differentiation of rental payments for dwellings had been made according to location and amenities, the money thus received could have been accumulated for further housing development. This became impossible because of the over-hasty, free distribution of dwellings (Papava, 1992, pp. 97–101).

During this populist stage of economic reform the method of 'shock therapy' was used in Georgia at almost at the same time as in Russia and in accordance with the Russian scenario. Was Georgia ready to apply this well-known approach to economic reform?

In order to answer this question, an important distinction of principle should be pointed out, concerning the nature of the state. Thus, it turned out to matter a great deal whether countries were with or without their own independent statehood at the beginning of their reforms. To the first type belong the countries of Eastern Europe, such as Poland, Hungary, Bulgaria, and so on, and to the second - the newly created countries following the disintegration of the former Soviet Union and Yugoslavia (and also Czechoslovakia). Among the latter countries, the legal successors of the original larger states are the only exceptions because they preserved almost all the attributes of statehood. Thus, after the disintegration of the Soviet Union, Russia was recognised as the legal successor of the USSR, retained Moscow as its capital and preserved all the attributes of statehood, inheriting the institutions of the former Soviet Union. Hence Russia can be classified with the group of post-communist countries already possessing statehood. All other countries had to build up their own state institutions, often from almost nothing (to a certain extent, Ukraine and Belorussia can be considered exceptions, since, although formally lacking independent statehood, they were already members of the United Nations). Georgia was one of the countries facing this situation. It therefore had to manage two major tasks simultaneously: the need to build up the institutions of a new state, and the process of transition from central planning to a market-type economy.

As is well known, the 'shock therapy' method of economic reform was developed and used first in West Germany after the Second World

War. New life was breathed into it in post-communist Poland with the introduction of the Balcerowicz Plan in 1990 (Balcerowicz, 1994; Schaffer, 1992). The implementation of this approach to macro-economic stabilisation requires the active involvement of several different governmental institutions. To apply the method of 'shock therapy' in the absence of these crucial institutions is impossible and any attempt to do so is doomed to failure. The experience of Georgia also supports the validity of this view. It is not difficult to demonstrate this. It is enough to elaborate what 'shock therapy' means according to the so-called 'Balcerowicz Plan' (considered today as the modern and already classical scheme of 'shock therapy') and then to study the defects in the implementation of 'shock therapy' when it was applied in Georgia, blindly imitating the reflections in the Russian 'mirror'.

The Method of 'Shock-Therapy' and its Defective Georgian Modification

The method of 'shock therapy' generally assumes that a strict fiscal policy is being implemented. It entails the simultaneous adoption of measures concerned with price liberalisation, a considerable reduction of the state budget deficit by cancelling budgetary subsidies, and stringent control over the money supply and income of the population. The plan developed by the former Polish finance minister, Leszek Balcerowicz, is considered to be an excellent, modern example of the method of 'shock therapy', and is frequently referred to favourably by other transition economies. According to this plan, the following measures were simultaneously implemented in Poland from the very start:

1. Multiple increases of all types of prices; a deliberate, though it was hoped temporary, increase in inflation aimed at ensuring and then maintaining market equilibrium;
2. Tough restrictions on the (real) incomes of the population;
3. A substantial increase in (nominal) interest rates and restrictions on the money supply in circulation;
4. Increases in the interest rates on cash and other deposits, aimed at stimulating the population to save;
5. Sharp cuts in state budget expenses by reducing government

investments and by refusing to subsidise unprofitable enterprises any longer;
6. Using issues of government bonds to help cover the state budget deficit;
7. Regulating the tax system and moving towards a more uniform, western-type tax structure;
8. Introducing a common rate of exchange of the zloty to the dollar (involving a substantial initial devaluation) and ensuring zloty convertibility in the domestic market;
9. Introducing a common customs tariff in order to restrict imports and stimulate exports;
10. Providing social assistance to the population within the limits of government possibilities;
11. The elimination of monopoly positions and a substantial withdrawal of administrative intervention in enterprise activities.

The use of the 'shock therapy' method began in Russia on 2 January 1992. A month later it began in Georgia. To explain how the 'shock therapy' approach used in Georgia deviated from the Polish approach it is helpful to compare each step taken in Georgia with the corresponding item in the 'Balcerowicz Plan' (which is a classical scheme of the 'shock therapy' approach in post-communist countries), as listed above.

1. The reform of price formation started in Georgia as early as spring 1991 when free prices on some types of goods were introduced. If in 1991 these changes were still of an exceptional character, by February 1992 (that is a month later than in Russia) there were radical changes in the price-formation system in Georgia. Thus, the prices of one group of goods and services were liberalised, while the regulated prices of another group increased considerably. All this was aimed at balancing the market. If in 1991 the consumer price index stood at 1.8, in 1992 it rose to 25. At the same time it is noteworthy that the regulated consumer prices increased 68 times in 1992 in comparison with those of 1991 (for bread, the main food product in Georgia, 100 times). We can say that the first item of the 'Balcerowicz plan' was on the whole fulfilled in Georgia.

2. From 1992 indexation of minimum wages and social security benefits began to be used in Georgia. In 1991 this indexation was

carried out only once, but in 1992, in the process of liberalising price formation, income indexation was performed six times. In 1991 the minimum wage and the average wage of employees increased in comparison with the previous year by 1.85 times and 1.26 times, respectively, and in 1992 compared with 1991 - by 13.14 times and 17.94 times, respectively. True, there were no strict regulatory measures in Georgia to control increases in the wage fund (as was done in Poland, when in the case of a 2 per cent overspending of the wage fund the penalty imposed on an enterprise was equal to 200 per cent of this sum; and if the overspending was more than 2 per cent the penalty was 300-500 per cent of the corresponding sum), but the increases in wages and social security benefits lagged behind price increases. Thus, it can be considered that item two of the 'Balcerowicz Plan' was also, to a certain extent, more or less fulfilled in Georgia.

3 and 4. In 1992 in comparison with 1991, the interest rate on deposits increased from 2 per cent to 5 per cent per annum and for ten-year deposits the interest rate increased from 9 per cent to 80 per cent. Such an increase of the interest rate was still far from reflecting the actual inflation rate [with the result that real interest rates remained strongly negative - Ed.]. It should also be noted that it was generally impossible to restrict the money supply in circulation in Georgia in those days by increasing the interest rate, because the country had no monetary system of its own; there were in circulation in Georgia only the rouble of the already disintegrated USSR, and the newly issued Russian rouble.

In summer 1992 it was decided to double cash deposits on a deferred withrawal basis. In particular, on 25 July the decision was taken to double cash deposits devalued by inflation on 1 August. The population immediately responded by depositing more money in cash deposits. On 1 August, a new decision was made to prolong until 10 August the time available for placing money in cash deposits for doubling. After doubling the additional money could be withdrawn after only a year, unless the money was to be used in the process of privatisation (which was, however, suspended at that period in Georgia). As it became rather difficult to receive the necessary quantity of bank-notes from Russia in a timely way in the second half of 1992, the money accumulated in this way was paid out as wages and pensions, and this practically prevented the government from restricting the money supply. As a result, we can conclude that items three and four of the 'Balcerowicz Plan' were not carried out in Georgia.

5. In 1992 the share of government investment in the total expenditure of the state budget was not reduced, and up to that year it varied in the range 20–25 per cent. The nominal amount of subsidies in 1992 compared with 1991 increased by about 5.1 times. However, in 1991 the share of subsidies in budget expenditure amounted to the remarkably high level of 47 per cent, and in 1992 this was cut back to 30.1 per cent. Even so, this does not enable us to suggest that item five of the 'Balcerowicz Plan' was realised in Georgia.

6. Government internal bonds were formally issued in 1992. But they were offered for sale only in autumn 1993 and mainly in order to convert bonds of the former Soviet Union into new Georgian bonds. As for the use of government bonds to meet the state budget deficit, it should be noted that this has not yet proved feasible in Georgia. It is clear that item six of the 'Balcerowicz Plan' was not implemented either.

7. Comprehensive reform of the tax system in accordance with the requirements of a market economy started as early as the spring of 1991. For this reason item seven of the 'Balcerowicz Plan' should mainly be considered as fulfilled in Georgia at that time, although it should also be noted that further reform of the tax system is continuing constantly, as in many other countries of the world.

8. In 1992 there was no national currency in Georgia, and so it was practically impossible to fulfil item eight of the 'Balcerowicz Plan'.

9. In 1992, general customs tariffs were introduced at rates of 2 per cent on imports and 8 per cent on exports. Obviously, this policy did not favour either import restrictions or export stimulation, so that item nine of the 'Balcerowicz Plan' was clearly not fulfilled in Georgia either.

10. It was already mentioned above that in 1992, as in 1991, there was income indexation, albeit imperfectly applied, and subject to lags. At that time any type of assistance to families with small incomes was disregarded. That is to say, the social protection system did not differentiate by income level in a way that supported those with low real incomes. As a result, the real minimum wage in 1992 amounted to only 86 per cent of that of 1991. Since, despite the income indexation in

1992, targeted assistance to the families most in need was inadequate, item ten of the 'Balcerowicz Plan' was unfortunately not fulfilled.

11. In 1992, for the first time in Georgia, legal and government resolutions and decrees restricting monopolistic institutions and practices and promoting competition were issued, although their effective implementation was significantly delayed. True, as early as 1991, the Soviet procedures for the centralised supply of resources to enterprises and final customers were disrupted and gradually abandoned, but many elements of the system of state administrative interference in enterprise activity were still preserved. For instance, the mechanism of state orders continued to be widely used. Hence item eleven of the 'Balcerowicz Plan' was also not carried out at that time.

Thus, in 1992 in Georgia eight out of eleven items of the 'Balcerowicz Plan' (that is, all except items one, two and seven) were not fulfilled.

Also neglected were such important measures as the cancelling or at least serious restriction of budgetary subsidies and tough restriction of the money supply. Many of those items were actually doomed to failure, above all because there was no independent monetary system at that time in Georgia.[1] In these conditions, implementing a defective variant of the 'shock therapy' method based only on price liberalisation could hardly be expected to succeed. In other words, in the absence of corresponding governmental institutions, the transition to a market economy using the 'shock therapy' approach was practically impossible. In this situation it might have been much more effective to choose the step-by-step approach to the transition to a market economy, which could have been based on the successive creation of the various institutions necessary both for pursuing reforms and for constructing the Georgian state.

The populist stage of economic reform ended with the inevitable failure of the defective Georgian modification of the 'shock therapy' approach, and this then gave rise to serious delays to economic reform process.

1. It is not clear that such a negative conclusion is justifed in principle, since the Georgian authorities could have imposed far more extensive and effective monetary control than they chose to do. However, one effect of the lack of an independent currency might well have been an absence of clarity concerning the real locus of responsibility for monetary control, together with serious lack of experience regarding the means for exercising such control [Editor's note].

The Stage of Delayed Economic Reform

The stage of delayed economic reform includes 1993 and the first half of 1994 (Georgia, 1995). One factor resulting in delayed reforms was outside the economic sphere, while another factor explained delays in terms of basic mistakes of economic policy. The economy of Georgia (and not only the economy) was not prepared for the full-scale military operations that started in Abkhazia in summer 1992, nor for the civil war that intensified in autumn 1993. These events seriously strained the state budget, and in 1993–94 it proved impossible to get the budget approved in advance in the normal manner. To cover the resulting deficits, the only possible source was money emissions. The gap between state expenditures and revenues was 1.118 billion coupons in 1993, and in 1994 the corresponding deficit amounted to 28.293 billion coupons.

Both in consequence of a general amnesty announced in the winter of 1992, and later on through its participation in military operations (as a country without an army), the crime situation in Georgia worsened so much that it became too dangerous to conduct most economic activity. As a result, many businessmen left their native land, and this accelerated the outflow of capital. At the same time undisguised robbery was replaced by racketeering, which is also not conducive to successful business development. These criminal elements could not usually manage to accumulate wealth (had they done so, it might in the future have put them in a position where they needed a stable situation to protect their new wealth). The reason for this is that the overwhelming majority of these people were drug addicts or had links with the drug trade, and so there was substantial leakage of stolen property to the neighbouring countries from where the drugs illegally penetrated into Georgia.

In late 1992 and early 1993 the most important policy mistake occurred. The government, for some reason, did not expect that it would receive additional banknotes from Moscow, and it therefore brought into circulation the temporary banknotes of Georgia – the coupon of the National Bank of the Republic of Georgia. Unfortunately, representatives of the different levels of authority in Georgia were unable to take the new currency seriously, sometimes revealing contemptuous attitudes towards it. This had a decisive impact on the already serious devaluation process under way. Basically, the nature of the mistake was the illusion that it was economically expedient for Georgia to remain temporarily or even permanently within the proposed 'rouble zone'. As a result of this unfortunate illusion, the coupon became the sole legal tender of payment only in July-August 1993, when Russia carried out a partial currency reform of its own and withdrew the rouble of the former Soviet Union from circulation. This act made it clear that Georgia would be obliged to introduce its own currency.

Uncontrolled credit emissions were the foundation of the inflationary process in Georgia. Attempts to solve agricultural problems (for example, the procurement of agricultural products in autumn 1993 and carrying out essential agricultural work in spring 1994), from a budget that had been practically non-existent since the autumn of 1993, resulted in initially unreported budgetary emissions which finally ruined the financial system of the country. Georgia developed a hyperinflationary spiral, with the inflation rate from 1993 until autumn 1994 proceeding at some 60-70 per cent per month. In the long run this money was not, unfortunately, used for agricultural purposes. In conditions of such high inflation, the coupon could not perform the normal function of sustaining commercial turnover, because the real value of the coupon supply was constantly falling. Other things being equal, this promoted wider use of the rouble instead of the coupon as means of payment.

In 1991-92 the foundations of the system of informal relations which is characteristic of low-income counries were laid down in Georgia (Adams and Fitchett, 1992).

The incorrect policy of the National Bank towards restricting cash circulation (which gave rise, contrary to common sense, to restrictions on the withdrawal of coupons from the banking system) resulted in sunstantial discrepancies between cash and non-cash monetary values. This further restricted the circulation of the coupon. Also, state commercial banks tolerated excessive overdrafts, which promoted hidden credit emission. Subsidised prices on bread, gas, electricity and transport gave the budget an additional 'loading' and also promoted budgetary emissions.

A serious error was perpertrated in Georgia's foreign trade policy, which allowed the 'unique Georgian' clearing system to be consolidated. Barter was considered the only way to receive gas from

Turkmenistan. The prices of both Turkmen gas and a lot of poor-quality goods produced in Georgia were artificially overcharged. According to the 'innovators' of such an approach, this would result in the creation of an environment for Georgian enterprises that stimulated their activity. It should be mentioned that such an environment for producing goods of poor quality has really been created. At the same time this production had to be purchased by government. In the absence of a proper budget, however, this operation could be only partially carried out, and even then only by means of money emission (which also promoted inflation). Most of this production was taken from enterprises by the government using a form of the state order system,[2] with guarantees to pay the corresponding price in the future. Needless to say, this put these enterprises in a difficult financial situation and resulted in the formation of a non-payment 'network' within the country, which was difficult to stop. For the government it became impossible to collect the full volume of goods within the country to fulfil the barter commodity exchange agreed with Turkmenistan. In recent years the existing difficulties with the Azerbaijan transport route, first the blocking of the railway line passing through Abkhazia and then through Chechnya, at first complicated and then made impossible the normal transportation of goods, assembled by the government, to Turkmenistan. As a result of these difficulties and mistakes, Georgia's debt to Turkmenistan amounted to about half a billion US dollars over two years. The country's total external debt rose to one billion US dollars.

Ignoring the interests of enterprise workers and employees effectively impeded the privatisation process in 1992–93 and held up the restructuring of enterprises into joint-stock companies.

Much of this lay behind the energy crisis, associated with the use of credits for purposes other than the intended ones; non-payment of the real cost of power resources (in other words, absurdly low domestic prices); chronic irresponsibility in regard to technical norms that made it impossible to carry out not only capital renewal, but even routine repairs and maintenance; constant theft of power equipment containing

2. Using the system of state orders required a complicated system of quotas and licensing. When receiving debts from different foreign countries and international organisations, in some cases the interest rates and prices on goods bought with the help of credits were artificially increased, and the credits received were partly used in less important directions.

copper (including wire) to sell in Turkey. All the above-mentioned factors, including the energy crisis, gave rise to an unprecendented collapse of production.

Moreover, given the general state of disarray in both national and enterprise-level accounting, it became impossible to obtain full information on firms and their activities. This, in its turn, artificially exaggerated the already apparent decline in the major macro-economic indicators and, at enterprise level, facilitated firms' efforts to hide their tax liabilities.

This stage of economic reform was characterised by extremely imperfect recording of foreign economic activities, inefficient customs procedures, extensive waste of commodity stocks, uncontrolled transfers of state property to foreign countries, a decline in the economic role of normal wages, unrecorded expansion of the shadow economy, and uses of humanitarian aid for purposes other than those intended. Overall, the picture of the Georgian economy was exceedingly bleak.

The Stage of Correction of Errors

At the beginning of 1994 the head of state of the Republic of Georgia, Eduard Shevardnadze, initiated the preparation of an anti-crisis programme of macro-economic stabilisation and systemic change. In spring 1994 the programme was initiated, and this made a good start to *the stage of correction of errors* committed during the earlier stages of the process of economic reforms.

This new stage of economic reform was also characterised by problems of a non-economic nature. By spring 1994 the hostilities in Abkhazia had already come to an end. True, this fact had a positive influence on the economy as a whole, but it also gave rise to a new problem: social protection of refugees and displaced people, which was a heavy burden on the government budget. Until the refugees and displaced people return to their homes these social (and not only social) problems will not be solved.

Law-enforcment institutions intensified the fight against criminals in order to improve the situation. Definite positive results were achieved, but the country still has a long way to go to solve the problem. Many enterprises, for instance, are afraid to undertake high levels of production for fear of being robbed by organised (including semi-official) and other criminal elements.

From spring 1994 the government gradually changed its attitude towards the coupon. According to the standard policy of the International Monetary Fund (IMF) it is ready to assist any country that has its own currency and whose government does its best to strengthen it. If Georgia stayed within the 'rouble zone' the IMF would undoubtedly prefer to work with Russia – the country issuing the rouble. This fact undermined the positions of those in power supporting the 'rouble zone' since they would have had to advocate openly the requirement to regard the Russian rouble as the sole legal tender. Conversely, it assisted those in power who, from the very beginning, realised that the Georgian economy had no prospects without its own national currency. Interestingly, in 1994 a noble but perhaps hopeless experiment was already going on in Kutaisi, where the city authorities were supporting the coupon – the one region of Georgia to do so. All this, together with the relative stabilisation of the Georgian coupon and worsening depreciation of the rouble, encouraged the population to take the coupon more seriously.

Uncontrolled monetary emissions became impossible owing to the increasing firmness of the authorities of the national bank of Georgia. In autumn 1994 the Bank cancelled the prevailing restrictions on the withdrawal of cash from the banks, under obvious pressure of the IMF. As a result cash and non-cash money values drew considerably closer to each other.

From late 1994, on the advice of the IMF, the national bank started regulating the banking system using the classical methods widely used elsewhere in the world. Apart from solving other problems, this prevented the state-commercial banks from continuing to work in overdraft conditions. Also, from the second half of 1994 the process of corporatisation of the state-commercial banks started.

According to the programme worked out with the IMF in September 1994, the prices of gas and electricity were raised to world levels, the price of bread increased 285 times (!), metro fares increased greatly, and so did tariffs on other municipal services. There was a wage increase for those employed in activities financed by the budget, pensions and social welfare payments were also increased, but these increases lagged considerably behind the price rises. This enabled a great reduction in the budgetary subsidies needed to cover the discrepancies between consumer and producer prices or between producer prices and actual costs. It was followed by a substantial strengthening of the rate of the Georgian coupon. If before the price rise on bread one dollar was worth 5.3 million coupons, after the price rise one dollar was already valued at 2.4 million coupons. This process continued; at the end of 1994 the price of bread increased again by 40 per cent and as a result a stable coupon exchange rate was established (at one dollar = 1.3 million coupons).

Unfortunately, Georgia could not manage a full recovery of money either for gas and electricity, or even for bread. However, if enterprises and the population did not pay for their gas and electricity supplies, or paid only negligible sums, the price of bread was almost fully paid by the population. Delays in enforcing these payments encouraged a more sceptical attitude to the coupon by economic agents: trade organisations, enterprises and banks delayed corresponding money transfers and conducted speculative operations in the currency market, sustaining significant losses in the process. Starting from 1995, when the coupon rate became stable, timely withdrawal of these sums was prevented not only by the sluggishness of the banks, but also by some local authorities using these sums temporarily in order to settle the problems of their local budgets.

Also, the pseudo-protection of enterprises by some representatives of government, and the often groundless fears of the population about interruptions of supply, meant that enforcement of payments by cessation of deliveries - the normal method in market-type economies - was not achieved. Gas supply to the population of Tbilisi stopped only in January 1995. Carrying out a stricter policy to recover the cost of bread was achieved step by step in the first and second quarters of 1995.

The impossibility of collecting the full cost of gas and electricity also meant that the government could not revise the corresponding prices, because of the general commitments on reform. The dollar prices of gas and electricity increased every month as a result of the strengthening of the coupon. This led to an artificial increase in the product cost, having an adverse affect, first of all, on industrial enterprises. Following a review of its commitments to the IMF, the Georgian government revised coupon prices downwards. In particular, since April 1995 the cost of gas was reduced by 35 per cent and the cost of electricity by 25 per cent. At the same time, the government of Georgia refused to purchase gas after June 1995. Instead, purchases had to be undertaken by the immediate consumers, namely by 'Sakenergo' (Georgian state energy company), big industrial enterprises and municipalities. To enable these direct purchases of gas by consumers to take place, the above-mentioned Georgian clearing system was, in effect, annulled.

All this put on the agenda the requirement to terminate quotas and simplify licensing. This process soon started: the system of quotas was completely annulled with effect from 1 June 1995, and licensing was preserved for only a limited list of goods. Order was also re-established in borrowing and using debts, building on the practices established in connection with Georgia's first loans from the IMF and the World Bank. In December 1994, Georgia received from the IMF the first tranche of a Systemic Transformation Facility (STF) (approximately 39 million US dollars). In July and November 1994 and March 1995, Georgia received an Institutional Building Loan from the World Bank (approximately 10 million US dollars), a Rehabilitation Loan on Municipal Infrastructure (approximately 18 million US dollars) and an Economic Rehabilitation Loan (75 million US dollars). The STF is used by the national bank to stabilise the rate of the Georgian coupon by means of credit allocation to support particular approved activities. The Institutional Building Loan is used to improve the material and technical base of government structures. As for the Rehabilitation Loan, it is used to finance a part of budget expenditures on a temporary basis.

Approval of the republican budget by parliament at the beginning of 1995, after a two-year interval, can be considered a very important step towards establishing order in the financial system of Georgia. The real significance of this budget is that emissions of credit and also monetary emissions themselves were not used to balance budgetary income and expenditure. In 1995, only 47 per cent of the expenditures of the state budget were covered by taxes and the remaining 53 per cent had to be covered through the monetisation of wheat and flour received as humanitarian aid (mobilising proceeds of sales in the state budget). In that way, an unbalanced budget could be balanced without monetary emission. It was achieved through the help of donor countries and organisations promoting reforms in Georgia. Unfortunately, the planned financial indicators for the first two quarters were not achieved, though the actual results were improving considerably month by month.

With the support and efforts of the IMF, the majority of the countries to which Georgia's debt of approximately one billion US dollars was owed agreed to debt rescheduling. This allowed the IMF to allocate the second credit tranche of the STF at the end of June 1995 (approximately 44 million US dollars) and the stand-by credit (approximately 113 million US dollars). All this was expected to create the conditions for Georgia to preserve financial stability, to carry out currency reform and to place the *lari* (national currency) into circulation, avoiding the errors previously commited by the government in connection with the coupon.

The exchange rate of the national currency was expected to remain unaltered until the end of 1995. If the inflation rate in the first half of 1995 averaged 2-3 per cent per month, then in the second half of 1995 it was expected to fall to just 1 per cent per month [in the event, Georgia's consumer prices rose by 65 per cent in 1995 as a whole - Ed.]. In fact, after July 1995 the price of bread increased by 7 per cent on average, while the wages of budget sector employees increased by 50 per cent on average. In autumn 1995 the liberalisation of bread prices was planned. This was expected to become possible as a result of the planned dissolution of the government monopoly in this sphere.

From 1 July 1995 the minimum monthly wage of those employed in the budget sector was just US$2.69 and the maximum US$12.69. These figures are, of course, very low, though one should recall that at the beginning of September 1994 the minimum wage was less than ten cents, and the maximum a little more than a dollar (all evaluated using the then prevailing exchange rate, without adjustment for purchasing power parity).

From the point of view of sectoral development, the reforms in Georgia are being implemented most vigorously in the health-care system, where the project for reform was elaborated in close co-operation with experts of the World Bank. In the health-care sphere there is a gradual transition to paid medical service and establishing a system of medical insurance. Reforms in the education sphere are also making gradual progress.

In May 1994 the head of state issued a decree according to which enterprise personnel were given precedence in the process of corporatisation. This speeded up the process. At the same time the process of privatisation, by means of direct purchases, was also encouraged. In 1995 in Georgia, as in many other former communist countries, the process of using vouchers in privatisation began: part of the social property is distributed to people free of charge. The approach is justified by the necessity to give everyone a fair chance to acquire assets in the course of privatisation (Papava, 1992, pp. 92–7).

Method of 'Social Promotion' of Economic Reform

Putting right the mistakes made due to the deficient modification of 'shock therapy' as applied in Georgia and those due to delayed or blocked economic reforms will be difficult enough. This then places on the agenda the rather complicated question of how, and using what methods, the reforms in Georgia should be continued.

Unfortunately, there is no satisfactory or comprehensive answer to this question in economic theory. It is not uncommon for economists to continue to debate how the transition to the market economy should be carried out - by means of 'shock therapy' or by more gradual reform. At this time, however, they forget that we are no longer at the start of the transition period to the market economy: the choice has already been made, which is why to speak about gradual reform (striking examples of which are provided by the experience of communist Hungary in its final period, and China, which is still under a communist regime) is, at least, rather late.

To learn how best to continue reforms for a country in Georgia's situation, it is useful to determine the *main indicator* for assessing the maturity of the market system. A human being who himself creates the market system and for whom it is created can be considered as the best indicator of this kind.

In the classical market system, in order to describe a man working successfully, the notion *homo economicus* was long ago defined in economic theory. This is the person whose activity is guided by his or her private interests to gain the maximum profit. Of course, *homo economicus* is an abstract notion, but still, in a sense, it captures well the typical behaviour of a private-sector manufacturer.

During the last period of the existence of the USSR, referred to as *perestroika*, *homo sovieticus* was a rather popular notion to describe a Soviet man. This is a person afraid of and subordinated to the state 'machinery', who depends on the good will of the powerful to improve his or her well-being. Naturally, *homo sovieticus* is also an abstract notion, but it also reflects the type of person created for decades by communist power.

At the present stage of economic reform, there are many who, on the one hand, try to act on their own initiative and according to their own interests, and on the other still regard the government with fear, but also in the hope of charity and expecting to be protected. Voucher privatisation might be considered as an instance of such confused thinking, when principles of social justice are introduced as a foreign body into the economic interests associated with privatisation (Papava, 1992, pp. 92–7; 1995, pp. 34–7). Another example to illustrate the above characterisation is given by the urgent pleas from depositors in bankrupt commercial and industrial trust companies which functioned on the principle of a 'pyramid' (when to cover old debts new debts at high interest are taken on). They begged the government to provide them with financial assistance. True, the government had not undertaken any preliminary obligations with respect to those companies or corresponding depositors, but the social and political pressure was so great that the government of Georgia had to intervene as requested. For a period of one year it exempted from all taxes all stock companies set up on the basis of these bankrupt ones, and the depositors were also given vouchers as compensation (each depositor was provided with a block of vouchers, with nominal price of US$200).

Thus, at the present stage of transition to a market economy, the type of a person in whom the qualities of *homo economicus* are steadily developing is formed, although he is not yet liberated from qualities more characteristic of *homo sovieticus*. Such an individual can conventionally be called *homo transformaticus*, which is the same abstraction as the similar notions mentioned above. Many entrepreneurs today can be considered as striking examples of *homo transformaticus*. They operate their enterprises sufficiently to satisfy their personal needs, the needs of their family members and a small number of workers employed at their enterprises. This type of entrepreneur is not interested in operating his enterprise at a higher level, because *homo economicus* has only partly developed in him.

Proceeding from such an approach to contemporary man, we can conclude that the sooner *homo transformaticus* is transformed into *homo economicus* the sooner and more completely the market economy will become firmly established. It determines the specificity of a new stage of economic reform (due to start in Georgia in 1996). In particular, the market stratification of society is bound to take place, that is the formation of social strata corresponding to the market system. The whole spectrum of social stratification is meant here, including economic, political and professional stratification (Sorokin, 1959).

All this seeks to create a stratum of entrepreneurs strongly supported both politically and professionally, and to provide the basis for improving the economic situation of the 'middle stratum' (representatives of middle and small business, physicians, teachers, scientists, and so on). From this point of view, the formation of democratic society helps to strengthen the institutions of political support to entrepreneurs; and the creation of a strong stratum of entrepreneurs is itself a guarantor of the existence of democratic society.

One aspect of the transition to a market economy is the urgent need for new professions (managers, brokers, dealers, and the like), which are especially necessary in post-communist countries for the development and formation of entrepreneurship and its supporting institutional framework. At the same time, it is important to provide targeted assistance to the poorer segments of society, especially those losing badly in the early stages of transition. To do this, it is necessary to identify the stratum of the population whose income does not meet the living standards and subsistence minimum.

To summarise the above, we can conclude that in 1996 Georgia was entering a new phase of economic reform, that is, the *stage of target-oriented social market formation.*

During the process of social market formation, special attention is paid to the aspect of target-orientation, because otherwise the period of time needed to bring about the transformation of *homo transformaticus* into *homo economicus* will be greatly extended. And this, in its turn, will create a situation where we would have neither a developed stratum of entrepreneurs nor the means to improve social assistance to the poor. So in the process of social market formation, the aspect of target-orientation acquires a special meaning. In order to avoid a very sluggish transition to a market economy, the government must participate in the process of formation of entrepreneurs and in the process of market stratification of the society as a whole. In other words, to continue economic reforms in Georgia (and in other post-communist countries in a similar situation) we suggest that the government should adopt the method of 'social selection', which can be called the method of *'social promotion'* of economic reform. The essence of the approach is that the government should create conditions to promote the rapid expansion of a strong stratum of entrepreneurs. At the same time, it is necessary to render targeted assistance to the most needy social groups so that they should not block the reforms.

The method of social promotion of economic reform includes three types of measures:

- considerable improvements in the crime situation, to relieve widespread fears associated with various types of military group, including bandit-type militias. If this problem is not settled, it will place serious obstacles in the path of both domestic and foreign entrepreneurs. In particular, few foreign investors would come to Georgia;
- stimulating the development of entrepreneurial activity, without which the process of creating a solid layer of entrepreneurs mostly takes place in the 'shadow economy'; this also creates fertile soil for reinforcing illegal actions, and thus impedes the process of creating sound, legally-based entrepreneurial activity;
- directing social assistance towards the most needy strata in society, in a targeted manner, enabling them to overcome the difficulties brought about by the reforms. At the same time this targeted social policy facilitates the reform process by widening the social basis of support for reforms.

These three problem areas are closely interwoven. The difficult crime situation prevents the development of entrepreneurial activity, new goods are not produced and this in turn makes it impossible to assist the poor social stratum; and the representatives of the poor, other things being equal, are drawn into the criminal world because of this hardship. An initial improvement in the crime situation was already mentioned above. It is necessary, however, to continue the struggle being waged by the government against the criminal world.

To develop entrepreneurship it is necessary to create a social environment in which the entrepreneur can have the possibility of free choice. In such an environment he or she will have an interest in transferring from the 'shadow economy' into a legal state, and will also direct part of his or her profits to support the expansion of production. At the same time, against a background of financial stabilisation, once there is a reduction of interest rates, it will be important to promote the wider use of savings to expand production; that is, a favourable investment environment must be created. In other words, it is necessary to stimulate the domestic supply side. In general, during the period of transition to a market economy, special attention must be paid to the problems of supply (see Tanzi, 1993, Ch.1).

Early discussions of supply-side economics focused on the need for a liberal system of taxation (Canto, Joines and Laffer, 1988). One of the theory's proponents, Laffer, gave his name to the *Laffer curve*, which shows the connection between average (effective) tax rates and budget revenues. According to the Laffer curve, at low tax rates an increase in taxes increases the budget revenues, but after a definite limit any further increase in average tax rates leads to a reduction in budget revenues. Thus, with comparatively low tax rates, one group of entrepreneurs would be encouraged to start production, a second group would transfer from illegal activity into legal production, and a third group would even expand production considerably.

These findings of the theory have been applied more or less successfully in some of the developing countries. Generally, in these countries arguments based on the Laffer curve were used to justify reducing income tax rates (Gandhi, 1987). However, in present-day Georgia the maximum income tax rate is just 20 per cent. Nevertheless, a further reduction in this tax is not out of the question, although it is not at present under consideration. Much more important is the reduction of tax rates associated with corporate activity. According to supply-side economics, in order to stimulate production, the total amount of taxes should not normally exceed one-third of the income of entrepreneurs and the general population. In that case, as indicated by empirical work on developed countries, tax revenues into the state budget would reach their maximum level. Various tax allowances should be avoided where possible, since they complicate the tax system and reduce its efficiency (Tanzi, 1993, Ch.5). It is more effective to use a general approach based on supply-side economics.

A well-known model for the practical implementation of the supply-side theory is 'Reaganomics' (named after its popularity during the presidency of US President Reagan), when the reduction of tax rates is not confined to the income tax, and spending cuts go far enough to threaten the vital interests of large corporations. Together with the reduction of tax rates, 'Reaganomics' assumed an increase in military expenditure and accompanying sharp reductions in the budget financing of social programmes. In Georgia, it is clearly impossible to adopt fully the principles of 'Reaganomics', and in any case it could not be justified because of the unfavourable distributional impact of such a programme. The third group of measures to implement the method of social promotion of economic reform pays special attention to the social protection of the population, and this makes it impossible and unjustifiable in Georgian conditions to adopt the system of 'Reaganomics' without alteration.

According to supply-side economics, the government should assume a completely new role. In particular, 'a state based on social welfare and insurance principles' should be formed, which will not restrict the impact of market forces on the expansion of production and the creation of the basis for economic growth (Kristol, 1979). In this case, poverty is perceived not as a relative value but as an absolutely low level of welfare. And it implies that to overcome poverty it is necessary to increase the total wealth accumulated by the society, which is achieved by stimulating the supply.

Until a transition from 'galloping' to 'creeping' inflation is achieved in Georgia the bank interest rate is bound to be high. This also limits the possibility of using commercial credit in order to establish the current assets of enterprises. That is why, in order to stimulate the supply, it is not enough to be guided by the recommendations of supply-side economics alone, since these are mainly derived from the principles of liberal taxation. Alongside the latter it is necessary to conduct a strict financial policy to reduce inflation and to improve the banking system. It will then be possible to reduce the bank rate. At the same time it should be borne in mind that the reduction in tax rates will then make it possible for enterprises to use accumulated funds to restore their current assets.

Eliminating barter from the normal practice of foreign trade and using straightforward currency transactions will also contribute to the stimulation of supply. The reduction of tax rates not only stimulates an expansion of supply, but it also creates an indispensable condition for stimulating demand; this results from the fact that lower taxes result in incresed disposable income which can then be spent on consumer goods and investments. True, according to the Keynesian approach, in order to stimulate demand attention must be paid to government expenditure, but this approach does not exclude reducing taxes in order to stimulate demand. However, this indirect way of stimulating demand is usually less popular in the Keynesian theory.

For a country in Georgia's situation, increasing government expenditures in order to stimulate demand is practically impossible, since the state budget can be balanced only with difficulty, with the help of external aid. Additional spending would disturb the balance and, consequently, it would be impossible to preserve financial stability.

By reducing tax rates, the stimulation of demand should seek to contribute to the solution of social problems as far as possible, notably the problem of employment. Reducing taxes in any case raises consumption, which can have a negative effect in a developed market system. In particular, with existing stocks of productive assets, output capacity is essentially fixed in the short run, and with no change in public expenditure a growth in consumption will be accompanied by a fall in savings and an increase in the interest rate. This will decrease investment and production in the future (see, for example, Mankiw, 1992, Ch.3). This unfavourable effect is not present in the countries in transition, as the real stocks of productive assets are far from fully utilised in a situation where production has already declined markedly. This gives incentives for expanding production as consumption grows, while saving is not reduced either (and in some cases may actually be raised).

Thus, the theoretical foundations for the method of 'social promotion', proceeding from the above, lead to a form of *Laffer–Keynesian synthesis*, which might seem contradictory. To illustrate this Laffer-Keynesian synthesis let us consider a relatively simple version of the integration of the Laffer curve and the Keynesian expenditure multiplier. Let the 'Laffer curve' be described by the function:

$$T = N.t.lnt \quad (1)$$

where

T is the total tax revenue of government;

N *is* the value of gross national product (GNP), corresponding to maximum total tax revenues;

and t is the tax rate $(0<<t<<1)$.

Clearly, $T = 0$, when $t = 0$ and $t=1$.

If we take into consideration that the link between the total tax revenues (T) and the actual volume of GNP (Y) is:

$$T = tY \quad (2)$$

the dependence between Y and t on the basis of (1) will be:

$$Y = N.lnt \quad (3)$$

Graphically (1) and (3) can be described by the following curves (Figure 12.1):

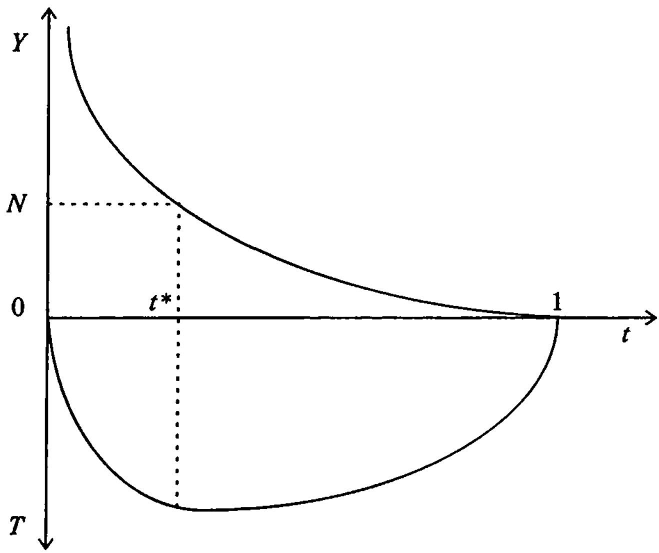

Figure 12.1 The Laffer curve and relation of tax rates to output

Figure 12.1 reflects the notion of the Laffer curve, roughly corresponding to similar curves by writers on supply-side economics (Canto, Joines and Laffer, 1983, p.76). t^* is the tax rate which corresponds to the maximum value of total tax revenue, T. Equating the derivative of the function T to zero and solving the resulting equation for t, we find that $t^* = 1/e$ (where e is the base of natural logarithms). According to (3), while t grows, the Y is reduced. This statement fully corresponds to the Keynesian views (for example, Stoleru, 1969, Ch.5).

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

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

where

c is marginal propensity to consume $(0 < c < 1)$;

G is government expenditure;

I is private investment;

X is exports; and

M is imports.

Under conditions of market equilibrium the total supply (3) is equal to the total demand (4), that is

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

In (5), equations (1) and (2) are taken into account. Now we solve (5) for N. According to the 'Laffer curve', $Y=N$, when $t=1/e$. Using this in (5) we find that:

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

Thus, under the 'Laffer-Keynesian synthesis' the volume of GNP when total tax revenues reach their maximum level is determined using equation (6).

As mentioned above, a liberal tax policy not only stimulates supply, but also demand. Given this, the whole society, including entrepreneurs, are being 'medically treated' with both supply and demand stimuli. The resulting economic policy based on the 'Laffer-Keynesian synthesis' can be referred to as *tax therapy* for short.

One of the main ways of stimulating an expansion of production is through the accelerated depreciation of fixed capital. In this case, depreciation allowances reduce the portion of profit liable to taxation, and hence reduce taxation. The sums released in that way, as a rule, are used for investment. Thus, the method of accelerated depreciation is an integral part of 'tax therapy'.

After the decrease of tax rates the simplification of the system itself should follow, which will have to promote the formation of a culture of taxation in the society. Disbursement of taxation must be easier and more convenient than attempts to avoid it. This will create in the public a very important and necessary attitude (or 'set', to use the terminology of Uznadze, 1966) towards the due and complete payment of taxes, seriously deficient in early forms of *homo transformaticus*.

When carrying out *tax therapy* it is necessary to use maximum possibilities of the state budget to solve the problems of social protection. At the same time, the above-mentioned principle of the 'state of social insurance' must be protected, whereby the problem of poverty can be addressed most effectively using the collective resources accumulated by the government. Thus, sums from the state budget should be targeted to render assistance to those most in need (Tanzi, 1993, Chs 14,15), rather than increasing the total amount of state budget expenditure allocated for social protection (these sums are of a productive nature [see Papava, 1993, pp. 58–60; 1994, pp. 39–40), which must be taken into account in determining the directions of their usage).

To achieve this, it is first of all necessary to free the budgetary sector from 'superfluous' burdens. For instance, today, that part of the population of Georgia employed in the budgetary sector is, in many cases, engaged in private activities. True, the wage received by each citizen from the budgetary sources is extremely small, but on the whole it is nevertheless a heavy burden for the budget. Hence those people who earn their living in the non-budgetary sphere, and who in reality are not occupied in their state offices, should no longer be employed in the budgetary sphere. It is possible to solve this problem by reorganising the health care, education, science, culture and state management spheres. The budgetary resources released in this way will be of greater value to those who receive money only from the budget.

One of the most important tasks of the 'state of social insurance' is to create the most encouraging conditions for setting up and developing private institutions of social protection (for example, private pension and insurance funds). [Experience elsewhere, however, suggests that this is extremely difficult, since it requires parallel developments in the financial structure of private sector firms, the market for government debt, and the development of a variety of financial institutions - Ed.]

The 'Laffer-Keynesian synthesis' provides a perfect opportunity to apply different (but not incompatible or mutually exclusive) approaches to macro-economic regulation which stimulate economic growth and further develop the country. Let us take, for example, programmes for the renovation of cities in the US, justified by the Keynesian approach, according to which, in particular, for every dollar invested by the US federal government, private investments of 5-7 dollars would follow (Hansen, 1964, pp. 643-4). For Georgia, given its objective of developing a federalised state model, this type of effect could assume great importance, for instance in connection with regional budgets used to help develop regional city capitals. It should also be mentioned here that, in the process of federalisation of Georgia, other countries' extensive practical experience with budgetary federalism (Tanzi, 1993, Ch.16) should be taken into consideration.

And finally, there is no real alternative to the continuation of economic reform by means of the *social stimulation* method, as there is no shorter or more effective way to implement the market socio-genesis. At the same time, *tax therapy* creates all the conditions for the simultaneous stimulation of supply and demand in the Georgian economy.

References

Adams, D. W. and D. A. Fitchett (eds) (1992), *Informal Finance in Low-Income Countries* (Boulder, CO: Westview).

Balcerowicz, Leszek (1994), 'Poland, 1989-92', in *Political Economy of Economic Reform* (Washington, DC: Institute for International Economics).

Canto, V. A., D. H. Joines and A. B. Laffer (1983), *Foundations of Supply-Side Economics, Theory and Evidence* (New York: Academic Press.

Gandhi, V.P. et al. (1987), *Supply-Side Tax Policy: Its Relevance to*

Developing Contries (Washington, DC: International Monetary Fund).
'Georgia' (1995), *IMF Economic Reviews*, 1994, No. 15 (March), (Washington, DC: International Monetary Fund).
Hansen, A. (1964), *Business Cycles and National Income* (New York).
Kristol, I. (1979), 'Confession of a True, Self-Confessed - Perhaps the Only - 'Neoconservative', *Public Opinion*, October–November.
Mankiw, N. G. (1992), *Macroeconomics* (New York: Worth).
Papava V. (1990), 'On the Concepts of Economic Reform in the USSR', *Ekonomika i matematicheskie metody*, Vol. 26, No. 6.
—— (1992), 'Privatisation of Major Production Factors', *Fair Play, Problems of Management*, No. 3.
—— (1993), 'A New View of the Economic Ability of the Government, Egalitarian Goods and GNP', *International Journal of Social Economics*, Vol. 20, No. 8, pp. 56–62.
—— (1994), 'The Role of the State in the Modern Economic System', *Problems of Economic Transition*, Vol. 37, No. 5, pp. 35–48.
—— (1995), 'Marxist Points of View on the Soviet Communist Economic System and the Manifestation of Egalitarianism in Post-Communist Economic Reform', *International Journal of Social Economics*, Vol. 22, No. 6, pp. 29–37.
Schaffer, M. (1992), *The Economy of Poland*, Centre for Economic Performance, Working Paper No. 67 (London: London School of Economics).
Sorokin, P. A. (1959), *Social and Cultural Mobility* (New York).
Stoleru, L. (1969), *L'equilibre et la croissance economiques* (Paris: Dunod).
Tanzi, V. (1993), *Fiscal Policies in Economies in Transition* (Washington, DC: International Monetary Fund).
Uznadze, D. N. (1966), *The Psychology of Set* (New York: Consultants Bureau).