

“SOCIAL PROMOTION” OF ECONOMIC REFORM IN GEORGIA

VLADIMIR PAPAVA *

Georgia has made a significant recovery over the past year from an economic and financial crisis that brought great hardship and threatened the continued viability of civil government. With a more stable macroeconomic environment, it is possible to consider longer term measures for economic reform and revival. This paper advocates a process of ‘social promotion’ of economic reform to encourage the growth of entrepreneurship in the visible market and the emergence of the professional skills necessary to a market economy.

1. Introduction

Since independence in 1991, Georgia has been through a severe economic and financial crisis. Loss of markets in the former Soviet Union (FSU), loss of inputs from the same source, and internal civil strife were the major factors behind a fall in recorded real GDP of about 80 per cent from 1990 to 1994, with a decline in recorded industrial output of about 83 per cent and a decline in recorded agricultural output of about 63 per cent. The figures on output for the construction industry show a decline of 97 per cent, implying that the formal construction industry virtually ceased to function.

The initial reaction by the government to the dislocation of trade and industry and the consequent loss of budgetary revenue was to borrow in order to maintain government services and subsidies. At the same time, state banks and a large number of newly created banks provided credit to ailing state-owned companies. The result was an accumulation of large overseas official debt and an acceleration in the rate of inflation from around 5 per cent in 1990 to 175 per cent in 1991, 1,304 per cent in 1992, 9,040 per cent in 1993 and 8,380 per cent in 1994.

This hyperinflation not only eroded the real value of incomes in both public and private sectors (more so in government) but also that of social security payments, including pensions. Pensioners and others dependent on state welfare payments were amongst those most severely hit by the crisis.

Hyperinflation also eroded the international value of the currency. The coupon was introduced as a temporary currency in April 1993 to overcome

* Ministry of Economy of Georgia, 12 Chanturia Street, Tbilisi, 380008, Georgia.

a shortage of rouble banknotes arising from the refusal of the Russian Central Bank to supply rouble notes to Georgia. The currency was introduced at par to the rouble, but was soon trading at a large discount. In mid-1994 it depreciated to around 5 million coupons to the US dollar. Rouble and US dollar were widely used as substitute currencies in Georgia.

The recorded fall in output related essentially to the formal economy. Georgia had a substantial informal economy in Soviet times, and there is no doubt that the informal economy has since expanded during the period of crisis. The recorded fall in GDP undoubtedly exaggerates the actual contraction in economic activity. A recent study of the informal economy in Hungary [Ékes (1994)] put the extent of the informal economy at about 25 per cent of the recorded economy. In Georgia no reliable estimate of the size of the informal economy exists, but it has been suggested by the Ministry of Economy officials that it could be as large as 80 per cent of the recorded economy.

In Soviet times the informal economy operated outside the law and was linked to activities of a common criminal nature. Materials and equipment belonging to the state were sold through the informal economy. The economic crisis exacerbated the extent of criminal activity and extended its scope into all spheres of the economy. The criminal activity itself exacerbated the economic crisis. There was widespread theft of equipment and materials from state enterprises. In the financial sphere, the powers of financial institutions to direct credits were used for speculative purposes. Some state-owned companies were privatized through sales arranged by and for the advantage of criminal gangs. Many state and private enterprises were subject to extortionary demands by criminal elements. Much of the criminal activity emanated from the highest levels of government, as an offshoot of the civil unrest and of the financial needs of political factions.

The government, with the assistance of the IMF, began to take drastic measures to overcome the crisis and promote further economic reform in late 1994. The main focus of this reform programme was the restoration of financial and budgetary control. Credit emission was drastically curtailed; budget expenditure was reduced, in particular by the reduction or elimination of subsidies on bread and fuel; government employment was reduced; and measures were taken to improve the collection of government revenues. At the same time, further liberalization of prices was introduced (supplementing earlier measures of 1992 and 1993) and the privatization programme was intensified and extended. Various projects, mostly funded by external donors and financiers, were introduced to support the revival of industry and agriculture. Steps were taken to establish the legal and institutional infrastructure for a market economy.

The results of the programme have been highly encouraging. Inflation has been brought down to around 60 per cent per year—still high but on a continuing downward trend. The coupon stabilized at about 1.3 million coupons to the US dollar early in 1995 and held around that level through the first eight months of 1995. The stability of the coupon permeated the introduction of the

new currency system of 25 September 1995, the Lari and the Tetri (1 Lari = 100 Tetri). The Lari was worth one million coupons and was traded from the outset at around 1.25 Lari to the dollar.

The programme entails the provision of credits by the IMF to the government to cover the continuing budget deficits. The measures introduced to curb expenditure and to raise revenue have successfully reduced the deficits to a stable level, given continued good management. A first purchase of SDR 27.75 million under a Systemic Transformation Facility was made in December 1994 and a second in July 1995. A first purchase under a 12-month stand-by arrangement totaling SDR 72.15 million was made in July 1995, and a second in October 1995. The IMF Enhanced Structural Adjustment Facility credit of SDR 166.5 million is being received over three years and the World Bank Structural Adjustment Credit of SDR 41.3 million was received in Spring 1996.

These changes suggest that the major threat of economic collapse is now in the past. Given the stabilizing macroeconomic environment, it is possible to think more constructively and usefully about the rebuilding of the Georgian economy and society. Sound initiatives have been taken to revive the economy, including projects for the reform of the financial sector, the development of local energy resources, the revival of agriculture and industry, the rehabilitation of infrastructure, the improvement of communications and the intensification of training. Building on a stable base, these projects will promote the growth of the Georgian economy.

This paper concentrates on some particular features of the recovery process under the general heading of "social promotion" of reform. It is argued that, in order to determine how best to pursue reforms for a country like Georgia, the fundamental reference point must be the *human* being, who creates and for whom the market system is created. It is the human dimension that must be the focus of attention. The paper thus considers various implications of this focus for social policy and the role of government.

2. "Social promotion" of economic reform

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

In the final period of the USSR, namely under 'Perestroika', 'homo sovieticus' was a popular characterization of Soviet man. This is a frightened man, oppressed by the state machine and dependent on the goodwill of the powerful for his welfare. 'Homo sovieticus' is also an abstract notion, but it expresses with some realism the type of man created by decades of communist power.

At the present stage of economic reform, however, there is a type of man who, on the one hand, tries to act on his own initiative and in his own interests,

and, on the other hand, still looks at government in fear and with the hope of charity and protection.

Voucher privatization might be looked upon as a manifestation of the existence of this type of man. Vouchers valid for the acquisition of shares in the privatization auctions were distributed to the whole population of Georgia and, also, they could be traded privately. Such a distribution of property rights meant that the principles of social justice were introduced as a foreign body into the economic sphere of privatization [Papava (1995, pp. 34–37)].

Another example of this dualism is the depositors' compensation demands by the government for the loss of their deposits following the bankruptcies of commercial and industrial trust companies operating 'pyramid' schemes. The government had made no prior commitment to guarantee people's deposits, but it found the social and political pressures so overwhelming that it had to exempt all companies that were reestablished on the foundations of pyramid schemes from all taxes for one year and to give depositors vouchers—each depositor was given a block of vouchers with a nominal price of US\$ 200.

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

To achieve our transformation into a market economy, we need to transform 'homo transformativus' into 'homo oeconomicus'—the faster we do so, the faster we shall achieve a market economy.

This gives us an indication of how we should proceed in the next stage of Georgian reform. Stratification of society in accordance with the requirements of a market economy is bound to take place. What is meant is the whole spectrum of social stratification, i.e. covering economic, political and professional stratifications [Sorokin (1959)].

The central objective is to create a social stratum of entrepreneurs, strongly supported both politically and professionally. This objective implies the improvement of the economic conditions of the 'middle stratum'—representatives of middle and small businesses, and physicians, teachers, scientists etc.

From this point of view, the democratic system can be seen as strengthening the institutions of political support for entrepreneurs, while the creation of a strong stratum of entrepreneurs is a guarantor itself for the existence of a democratic society.

It is also necessary to create practitioners of the new professions (managers, brokers, dealers etc.) during the transition process. They are essential to a market economy and to the phenomenon of entrepreneurship.

At the same time, social policy requires focusing attention on the poor, so as to target them for assistance. Targeting, in turn, requires the identification of the stratum of population whose income does not provide a minimum standard of living.

To summarize, Georgia is at the beginning of a new phase of economic reform, which could be called a '*stage of target-oriented market sociogenesis*'.

During this process of market sociogenesis, special attention has to be paid to target-orientation, because if the process is allowed to take place naturally, the period of transformation of 'homo transformaticus' into 'homo oeconomicus' will be considerably prolonged. If the delay is long, we will neither develop an entrepreneurial stratum, nor national wealth, and we will not be able to provide social assistance to the poor.

So, under market sociogenesis, target-orientation has special importance. The process cannot be carried out by means of 'natural selection' which might entail a long process of formation of a stratum of entrepreneurs. The government must participate in this process of formation and in the whole process of stratification of society in accordance with market requirements.

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

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

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

These three elements are closely linked. A difficult criminal situation prevents the development of entrepreneurial activity; new goods are not produced;

it is impossible to assist the poor; and the poor join the criminal world because of the hardships they experience.

There have been improvements in the criminal situation, as mentioned above. It is thus necessary to complete the fight waged by the government against the criminal world.

To develop entrepreneurship, it is necessary to create an environment in which it is safe for the entrepreneur to move out of the 'shadow economy' and into legal status, and reinvest for the expansion of his business.

At the same time, it is necessary to create an environment in which savings are encouraged and made available to entrepreneurs for investment.

It is necessary to use the full potential of the state budget in order to provide social protection. At the same time, the principle of 'state of social insurance' mentioned above (according to which poverty is only eliminated through accumulation of wealth by the government) must be adhered to. The state budget should be used to target assistance to the most needy [Tanzi (1993, ch. 14, 15)] rather than increasing the sums spent on social protection (i.e. that the expenditure should be of a productive nature [Papava (1993, pp. 58–60; 1994, pp. 39–40)] must determine the directions of its usage).

To achieve this, it is necessary to remove the 'superfluous' burden from the budget. Today, much of the population of Georgia employed in the public sector is engaged in private activities. While it is true that the wage received by each citizen is very small, the total does nevertheless amount to a heavy burden on the state budget. It is thus necessary to remove from the public payroll those people earning their living in non-government activities. The problem can be solved by reorganizing health-care, education, science, culture and state management. The funds released will thence permit more reasonable incomes for those continuing to work solely in government.

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

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

3. Role of the government

3.1. Withdrawal from business enterprise

The transition from command to market economy involves a fundamental change in the role of government. Central to the transition is the withdrawal of government from direct involvement in business enterprise and trade, and its adoption of an enabling, or supportive, role. It is also required that the

government drop its pre-eminent role in the intellectual and social life of the nation.

The withdrawal of government from business enterprise is exemplified in the programme of privatization pursued by the government since 1991 but especially intensified in 1994. This privatization programme opens up former state enterprises to private initiative and presents opportunities for the exercise of entrepreneurial skills that are the core concern of the 'social promotion' of reform. It is frequently pointed out that it is not sufficient simply to privatize state enterprise unless the new owners run the newly privatized enterprises efficiently.

Urban housing was privatized in 1992 under legislation passed in February 1992. Land privatization proceeded under a decree of January 1992. By mid-1995 about 51 per cent of tree-crop land and 38 per cent of arable land were privatized; yet, in total, only about 20 per cent of agricultural land were privatized due to the existence of large tracts of pasture land of which only 5 per cent had passed to private ownership.

For the privatization of industrial and agro-processing ventures, a law permitting workers or their nominees to acquire 51 per cent of the stock of their enterprises was passed in August 1991, just four months after independence. Two decrees governing auction sales were adopted in May 1992. In April 1993 a government resolution converted all industrial enterprises with assets valued in excess of 30 million roubles into joint stock companies with tradable shares. Under this legislation, however, privatization proceeded slowly. In May 1994 the process was accelerated by the introduction of legislation that gave employees the right to buy 100 per cent of the shares of small scale enterprises and 51 per cent of the shares of medium and large scale enterprises. Under this legislation the privatization process has proceeded more rapidly. The target privatization of 6,500 small companies by the end of 1995 was nearly achieved. Small scale privatization should be completed by the end of April 1996. Auctions of medium and large scale enterprises began in June 1995 and will proceed for about 18 months. About 700 enterprises are being offered for sale, with 35 per cent of their shares offered through the voucher auctions. Vouchers have been distributed to the whole population of Georgia.

The mass privatization programmes give the priority to the transfer of a large number of enterprises out of the public sector and into private ownership in a short period of time. It is recognized that many of the companies will be acquired by persons who are unable to provide the entrepreneurial and other skills necessary to rebuild the enterprises now facing market competition. The support of the 'social promotion' programme for entrepreneurs is in part directed at encouraging and giving incentives to the new owners of these enterprises to prepare these latter effectively for the market.

In order to increase the chances of efficient performance of some privatized enterprises, the government has selected a number of them to be privatized by international tender. In these enterprises, employees may take only a minority

shareholding. While the immediate impact of this measure may be to substitute foreign entrepreneurial expertise for Georgian, it is anticipated that the skill transfer from foreign entrepreneurs will induce the formation of Georgian 'homo oeconomicus'.

3.2. Budget considerations in the role of government

The government's role is currently very sharply constrained by budgetary considerations, to such an extent that it is unable to perform many of its nominal functions. In recent months it has been necessary to scale down very significantly the provision of government services. The most notable change has been in the provision of health services. The comprehensive service provided through the budget of the Soviet Union could not be sustained and has been replaced by a service that aims to provide basic health services. More sophisticated services are left to private initiative. Similarly, it has been necessary to modify the education system to guarantee a free basic nine years of education, rather than the full educational service of the old regime. Further reductions in the size of government are planned as part of the programme of recovery and reform agreed with the IMF.

Budget management is a central part of the role of any government, and tax policy is a major component of budget management. The programme of 'social promotion' of economic reform stresses the importance of maintaining incentives for entrepreneurs to take risk and invest, and maintain their operations in the legal, tax-paying sector of the economy. A low tax regime is essential to the pursuit of the economic revival and growth.

3.3. Role of government in 'social promotion'

The programme of 'social promotion' of reform has further implications for the role of the government. Firstly, it proposes a positive role for the government in the social restructuring or the targeted sociogenesis of society. This restructuring would aim, in particular, at creating an effective entrepreneurial stratum of society, and a professional stratum, including lawyers, accountants, financiers etc., who would provide essential support services to industry and commerce in a market economy. It would be necessary for the government to define its targets in this regard and the means for reaching them.

'Social promotion' of reform also requires a concerted drive against criminal elements, particularly those that threaten the activities of legitimate entrepreneurs. As noted in the introduction, criminal activity has been widespread in the country and has reached high levels in government. Recent changes, and the outcome of elections in November 1995, have substantially improved the situation, though there remains much to be done for the development of an effective police and security service.

'Social promotion' of reform also implies programmes for the support of the poor. People dependent on state support, through age, infirmity, or other reasons, have been particularly hard hit by the economic crisis. It is this group that is most likely to become disenchanted with the reform process, and give support to political factions that would like to see the clock turned back. The elections of November 1995 gave a clear mandate for reform, but it would be unwise to expect this support to continue without clear benefits from reform being spread through the community. An effective social safety net has to be established.

4. Conclusion

The challenges facing the government and people of Georgia remain daunting. The most severe part of the economic crisis is probably surmounted, but the task of rebuilding the economy in a new shape has still to be achieved.

Success in this rebuilding will be determined most critically by success in social regeneration—the changes in thoughts and attitudes that are necessary to make a democracy and market economy function successfully. This paper suggests that the government has a major role to play through 'social promotion' to make these changes a reality. Entrepreneurs and other essential protagonists in a market economy have to be given encouragement to play their part in full.

One important aspect of this social promotion is the establishment of a tax system that provides incentives for risk-taking and encourages entrepreneurs to conduct their businesses in accordance with the law. The programme also envisages a continued drive to enforce law and order, and budgetary expenditure to establish an effective social security net.

References

- Ékes, Ildikó, "The hidden economy and income: The Hungarian experience", *Economic Systems*, 18, 4, December 1994, pp. 309–334.
- Papava, Vladimer, "A new view of the economic ability of the government, egalitarian goods and GNP", *International Journal of Social Economics*, 20, 8, 1993, pp. 56–62.
- Papava, Vladimer, "The role of the state in the modern economic system", *Problems of Economic Transition*, 37, 5, 1994, pp. 35–48.
- Papava, Vladimer, "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*, 22, 6, 1995, pp. 29–37.
- Sorokin, Pitirim A., *Social and Cultural Mobility*, New York, 1959.
- Tanzi, Vito (ed.), *Transition to Market: Studies in Fiscal Reform*, Washington, D.C., IMF, 1993.

Zusammenfassung

Georgien hat während des letzten Jahres eine ökonomische und finanzielle Krise überwunden, die große soziale Not gebracht und die Überlebensfähigkeit der zivilen Regierung ernsthaft bedroht hatte. Die stabilere makroökonomische Situation ermöglicht es nun, langfristige Maßnahmen zu wirtschaftlicher Reform und Erneuerung anzugehen. Dieser Beitrag befürwortet eine 'soziale Förderung' wirtschaftlicher Reform, um das Anwachsen einer Unternehmerschaft am Markt und die Entstehung der für eine Marktwirtschaft notwendigen professionellen Fertigkeiten zu unterstützen.