Entrepreneurship in Georgia

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Abstract

Georgia has received a fair amount of publicity as a potential investment destination in recent years. The country won praise for its bold approach to reforms and economic policy. While it is true that Georgia made tremendous progress on issues like corruption, our examination of the structure of small and mid-sized enterprises (SMEs) revealed that they face many serious problems that are not yet addressed by the government. There are also a stunning number of self-employed persons, not observed by official statistics, many of whom could be described as "entrepreneur by default" as opposed to "entrepreneur by choice". These measurement issues show that the notion of "entrepreneurship" should be considered carefully, especially in former Soviet economies like Georgia, and force observers to ask where entrepreneurship actually begins.

Introduction

Entrepreneurship is as much a social phenomenon as an economic one and as such, the shape entrepreneurship takes in Georgia opens the door to a wide range of complex issues that transition economies have to tackle. In 2010 *The Economist* concluded: "Today Georgia has reinvented itself as the star of the Caucasus. It is less corrupt than most former Soviet republics and one of the easiest places in the world to do business, according to the World Bank. Its liberalized economy has weathered Russian embargoes, and the state held together during the war with Russia. Its police do not take bribes and electricity is no longer a luxury. Most important, people are no longer surprised by such success. The biggest transformation is in their minds." While one has to acknowledge that Georgian authorities took bold steps to fight corruption and gave economic policies a clear neo-liberal direction, it is nonetheless crucial to take a critical approach to the claims that Georgia has made about its success in facilitating entrepreneurial endeavors. The methodology used by the World Bank for its "ease of doing business indicators" (EDBI) is highly controversial and Georgia's rise on the ranking took place against the background of important political concerns. To see beyond the facade, one has to look closer at the structure of the private sector.

From the regulatory, and in consequence statistical, perspective, Georgia's economy consists of two different components: The "observed" economy is described by statistics and regulated by informed bureaucrats, while the "unobserved" economy functions beyond the bounds of any regulations (such as requirements to register, observe the labor code, pay taxes, or report performance statistics) and therefore falls outside of national statistical instruments. In terms of occupational statistics, the persons active in the unobserved part of Georgia's economy are defined as "self-employed." Little is known about the mode of activity of the self-employed except that they live mainly in rural areas and that some may de facto run micro-enterprises. The workforce amounts to 1.9 million people, but only 20 percent is hired by the private sector and 12 percent by the public sector. With 16 percent of the workforce being unemployed, that leaves about half the total workforce as self-employed. Barely anything can be found about this portion of the Georgian economy in statistics. Yet self-employment amounts to about two-thirds of the total employment and, according to our estimates, generates about 18 percent of GDP.

These sharp employment differences within the population underline the sometimes overlooked side of entrepreneurship: "entrepreneurship for survival". This form of entrepreneurship is a poverty-related and social policy issue. On one hand, it can be considered as massive unemployment, which harms the economic base of the country and is the reason Fitch Ratings estimated that Georgia has a middle level of income and a narrow economic base (EPRC, 2009:8). Indeed the staggering figure of 1.9 million self-employed individuals explains the narrow base of the Georgian economy and its low level of labor productivity. Moreover, more than 800,000 of the so called self-employed (81 percent) live in rural areas.

Thus, Georgia's case illustrates very well the two-sided coin characteristic of "entrepreneurship". In other words, on one side, the unemployment point of view is linked to social policy. The average monthly income for Georgia is US$175 and about 41 percent of households were poor in 2009, if the minimum subsistence level is used as the poverty line (Gugushvili, 2011). On the other side, half of the economy relies on "entrepreneurs", and that is an economic policy concern. Moreover this combined perspective on the GDP structure allows us to deduce that self-employment generates about 18 percent of the GDP. Interestingly, we find the two sided coin problem at the heart of the definition of a self-employed person given by Geostat: It can either be equated with "entrepreneurship" or survival.

Structure of the SME Population

It is crucial to acknowledge the difficulty in defining the economic reality of small and mid-sized enterprises, which boils down to the question of where does "entrepreneurship" begin. Georgian statistics, for example, do not distinguish between micro- and small enterprises even though the tax code does so and in contrast to the other South Caucasus countries. Moreover, what is considered a firm differs from institution to institution.

- The Ministry of Finance, which prepares the Georgian tax code, recognizes micro-business as those with an annual turnover below GEL 30,000 (approx. 18,000 USD) and small business as those with less than GEL 100,000 (approx. USD 60,000) annual turnover. From a tax perspective, micro-firms, which are not taxed, do not matter. Entrepreneurial activity begins with small firms, taxed up to 5 percent. There is no definition for medium firms.
- For GeoStat, the national statistics office, small firms are those that employ less than 20 persons with an annual turnover of less than GEL 500,000 (approx. USD 300,000). Medium enterprises are those with less than 100 persons generating a turnover of less than GEL 1,500,000 (approx. USD 900,000). Anything above that standard, in persons and turnover is considered a large enterprise.
- Commercial banks have their own standards: TBC for example does not differentiate between small and medium and considers SMEs as enterprises with an annual turnover of less than GEL 8 million and liabilities of USD 1.5 million.

Looking at the structure of enterprises, four disparities can be observed (see data p. 6 and p. 7).

1. The evidence of geographical disparity is given by the concentration of enterprises in Tbilisi. 45 percent of companies are registered in Tbilisi and they generate 73 percent of the country's turnover. There is a strong rural/urban dichotomy.
2. The disparity between the performance and employment levels of SMEs. SMEs contribute only 6 percent of the GDP, but amount to 43 percent of the private sector in terms of employment.
3. The disparity between the types of activity contributing to GDP. On the one hand, 22 percent of the GDP is generated by three activities in the enterprise sector: Industry, wholesale and retail trade (including repair of motor vehicles and personal household goods), and transport and communication. These activities constitute 70 percent of all the firms' activities. We can only guess that the self-employed layer, which by deduction, contributes approximately 18 percent of the GDP, includes farmers producing agricultural goods for subsistence living in rural areas (81 percent of the self-employed live in rural areas) and people engaged in trade in cities.

Economic Policies for SMEs in Georgia

Economic policies targeted at SMEs can be viewed in two blocks: before and after 2006. The institutional and legal framework for SMEs started to be formed in the 1990s. The "Small Enterprise Support" Special Law of 1999 defined the key parameters for SME support. To implement these programs, the Center for Small Enterprise Development and Assistance and the Small Enterprise Coordination Council were created. Even though the development of the SME sector started steadily and efficiently, it was hindered in the early 2000s by high corruption, an unfavorable tax regime, and the budget deficit. In other words, economic policy took into account the specifics of SMEs, but the institutional environment was not business friendly. The exact opposite phenomenon took place after 2006. Georgia embarked then on radical reforms to change the economic environment and as a result developed several measures that made entrepreneurial activities easier to undertake. By the same token, the level of corruption went down as well. The new course of economic policy, heavily influenced by neoliberalism, eliminated government interference in the economic sphere and abolished the law on "Small and Medium Enterprise Support" in 2006. As a result, two laws now govern SME activities. The Law on the Georgian National Investment Agency, on which GeoStat bases its definition, and the Tax Code, which uses a different definition.

The move toward neoliberalism shifted the focus toward the overall business environment thus resulting in economic reforms and a redesign of economic policy making. Support for SMEs is therefore not considered as an important element of the economic framework, which would deserve specific attention at the policy level, because the rationale is to support the economic environment in general, but not one group in particular. Thus the two considerations related to entrepreneurship—the poverty motive and the entrepreneurial motive—are difficult to reconcile in Georgia. The absence of a general non-taxed minimum amount of income, which is exceptional by international standards, does not address the poverty issue. Yet, the entrepreneurial motive is treated only partially by the tax code (Christie, 2008).

During the last 12 years the performance of SMEs has dropped, in terms of employment, turnover and share of overall production. The Russian embargo, the 2008 war and the global financial crisis all had an impact on this performance. However, one has to note that the neo-liberal policy eliminated all the SME laws, accompanying legislative acts and administrative mechanisms for SME promotion and that probably had an impact too (Japaridze, 2011). The gap between the reality of the socio-economic fabric in Georgia and the economic policy of its government reflects the dilemma of economic reforms in transition. The imperative of reform demands non-interference with the economy and therefore does not favor any particular actors, but this policy prevents the development of SMEs.

Business Environment Measures: Tactic vs Strategy

The "policy vacuum" created by the retreat of the government gave rise to numerous measures and development projects sponsored by national and international agencies and NGOs. These measures significantly enhanced the business environment, but they are of a tactical nature and cannot replace strategic and comprehensive economic policies. Liberalization and the streamlining of bureaucratic procedures lightened the administrative burden of companies. Georgia successfully implemented and enforced anti-corruption laws. The Graft Index, reflecting the number of times firms were asked or expected to pay bribes to officials, is half the level found in Eastern and Central Asia. Georgia appears to provide better infrastructure (in terms of infrastructure service delays, water and electricity provision) than its counterparts (IFC, 2008). Public-Private Consultations (PPC) emerged and the quality of the dialogue improved. Business incubator projects and support units, financed by donor organizations, do exist. Access to capital is now easier, but the progress is mostly visible for big companies.

The Georgian government reviewed and simplified some procedures: Georgian State Procurement functions electronically, which adds transparency and makes the process more participatory. It reformed and digitized the cadastre system and implemented e-government/governance measures, whereby taxpayers may fill out their application online or communicate with authorities electronically. However, our interviews revealed that approximately 90 percent of land ownership in rural areas is still unregistered.

As a result of these reforms, Georgia's rise in the ranking of the World Bank's EDBI indicators is unprecedented. A USAID report (USAID, 2009) notes that the result of these fast, broad and deep reforms of the business climate in Georgia is that it is now considered an investment destination. According to the EDBI, Georgia is ahead of France, Germany, and the Netherlands when it comes to the "ease of doing business". This points to a familiar story in emergent countries where administrative barriers for local business have been simplified, but where the overall basic institutional framework is still fragile and the social (informal) barriers are still in place. Even though Georgia has undergone reforms of unprecedented breath and facilitates local business activities, its market institutions are still weak.

Thus there are still three areas of reform the country needs to address if it wants to attract international investment: Inadequate protection for property rights, low levels of judicial independence and rule of law, and a strict system of tax and customs penalties, which appears to distort business decision-making and artificially encourage imports over local production. These areas of weaknesses require more than minor technical fixes. They represent basic institutional pillars on which market economies rest and grow.

Thus it seems that Georgia demonstrates a perfect case of governance indicators' abuse (Arndt and Oman, 2006). The ranking was used to propel the country from one with a reputation as a post-Soviet failed state to one known as a "frontier-market" and this marketing campaign allowed Georgia to attract foreign investments. Its first offering of sovereign debt was a success, securing a 7.5 percent fixed interest rate which was three time oversubscribed and a B+ rating from Standard & Poor's. "Such events marked Georgia's transformation from a failed state to a neoliberal vanguard state at the leading edge of capital market expansion into the periphery of the global economy" (Schueth, 2011).

Constraints to SMEs Growth

Georgia's SME face a variety of constraints:

Institutional constraints: Many barriers to SME growth still remain. Access to finance is for SMEs in Georgia, as elsewhere, problematic. The interviews we conducted revealed, for example, that there is a law giving tax authorities the right to use the collateral of tax payers who owe money to fiscal authorities. Unsurprisingly, this provision has made banks reluctant to accept such collateral from SMEs. Similarly, the inefficiency of the bankruptcy law influences the banking sector's willingness to lend. Also, the absence of a specific arbitrage court makes it harder for business to operate. SMEs do not tend to think judicial procedures will turn out in their favor and thus prefer not to use judicial channels to resolve whatever commercial conflict they might have.

The trust component of the Georgian economic sector (interpersonal or institutional) should not be forgotten. It is very hard to isolate that element to determine its influence on access to finance and relationships within the business sector. It is nevertheless an important one for SME financing, as it goes hand to hand with the use of the unquatifiable information that is needed to build long term relationship between banks and SMEs. As former Soviet economies suffer from general distrust, one can expect that it is a factor hindering access to finance and economic cooperation.

Finally, the cultural base of what was Georgia's second economy under the Soviet regime, with its insistence on honor and trust and which encouraged risk taking behavior (Mars and Altman, 1983), influences the entrepreneurship dynamic of the Georgian economy. It is an example of the kind of entrepreneurial resources or barriers that the usual approaches used by international organizations fail to convey.

Systemic constraints: SMEs in Georgia perceive the existence of a "ceiling" to growth. There are many more business associations representing big companies than SMEs and big firms are better positioned to lobby their interests with government officials. As mentioned above, big companies are able to profit more from a simplified business environment, which makes SMEs feel that the playing field is biased in favor of large firms. The "ceiling" perception is accentuated by the ties between government and big businesses. The interviews we conducted revealed that some SMEs have the impression that they are allowed to grow only up to a certain point, beyond which further expansion becomes problematic. Despite the seemingly neoliberal orientation of the government, it recently has taken decisions that contradict liberal principles: It reinforced both the National Bank and the Tax Department with the ability to extract and gather financial information about businesses. This very intrusive move on the part of the government is expected to have repercussions on investments and was designed to bolster the government's position before the Fall 2012 parliamentary elections.

Social constraints: The lack of managerial staff, professional accountants and financial managers is also considered a limit to growth. Banks generally do not trust a firm's accountants and examine their books directly, thus helping SMEs with financial statements. The availability of managerial resources is particularly important if entrepreneurial activity is expected to be a regular economic activity. The notion of an enterprise, in its Western conception, supposes stable, repetitive activity. One-shot deals can be the expression of "entrepreneurial spirit", but do not necessarily create "enterprises". The availability of high-skilled labor is an important resource required for Georgia to evolve from "entrepreneurship" to enterprise.

Conclusion

In light of the labor and enterprise statistics presented here, the controversial uses of the EDBI described above, and the institutional problems Georgia faces, concluding that the country is an example of market liberalism seems a bit hasty. The famous EDBI kept the historical, institutional and social contexts (maybe even the economical) out of the picture. Georgia has indeed made huge progress since the Rose Revolution, but property rights are still not respected. The fact that half of the work force is self-employed does not mean that "entrepreneurship" suddenly emerged, for it might well mirror the necessity of survival. The over-optimistic advertising campaign Georgia pursued in recent years reflects the complexity of building market economies.

How can market institutions emerge from the old, rotten socio-economic tissue? Foreign investment becomes a crucial element for countries with very limited resources like Georgia to get out of the "virtual economy" (Gaddy and Ickes, 1999), the ugly cross-breed of the two systems, as Yeltsin put it. Multinational companies with their international capital, know-how and best practices can transfer knowledge to Georgia that would indeed help Georgia develop from the top–down. But do entrepreneurs come from the observed or unobserved part of the economy? Is the self-employed segment of the Georgian economy a stumbling block or a building block for economic development? How does one go from a social transformation to "entrepreneurship"? These questions refer to the possible option of a bottom-up rescue out of the economic purgatory that some transition countries are in.

About the Author

Philippe Rudaz is a PhD student in Economics at the University of Fribourg, Switzerland. His dissertation focuses on the links between financial development and economic development in emerging economies. He worked for the past 4 years a consultant for financial institutions in Russia and South-Eastern Europe

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DATA

Structure of the Georgian Private Enterprises Sector, 2010

Table 1: Firm Population

Number of registered enterprises (thousands)	321.20
Number of active enterprises	42.530
% of registered firm	*13.2%*
Small firm, as % of total registered	88%
Medium firm, as % of total registered	8%
Large firm, as % of total registered	4%

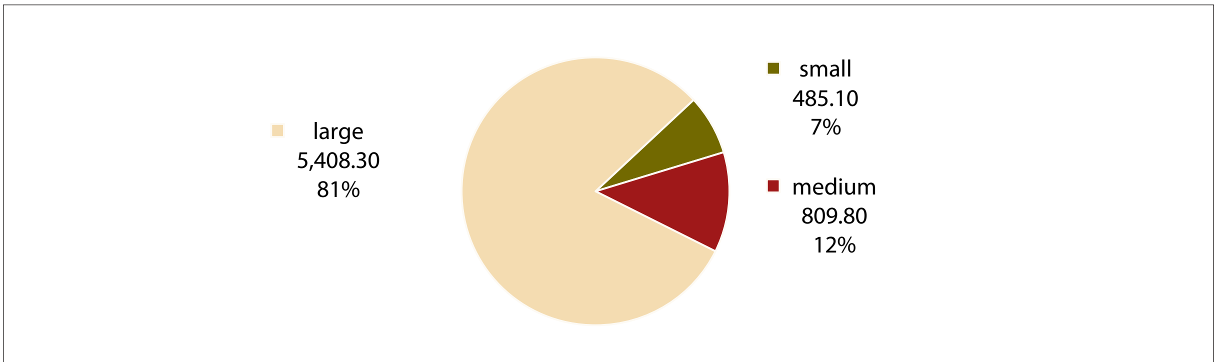
Compiled by Philippe Rudaz; source of data: Geostat

Table 2: Firm Performance

Firm contribution to GDP, mln. GEL	6,703.20
As % of GDP	32%
Contribution of SMEs to GDP generated by private sector	19%

Compiled by Philippe Rudaz; source of data: Geostat

Figure 1: Performance of the Private Sector (Value Added By Enterprise Size in Mln. GEL)



Compiled by Philippe Rudaz; source of data: Geostat