

GEORGIA'S SEARCH FOR LIBERTY

Introduction

Excellencies, ladies and gentlemen, it is a pleasure to be here with you today, and I wish to thank the Legatum Institute for convening this topical and timely event **to explore the role of economic liberty in helping to alleviate poverty.**

The Liberty Act – fundamental principles

Recently, my government submitted to Parliament a draft constitutional Law on Economic Liberty, Opportunity and Dignity (the Liberty Act), which constitutes a coherent package of bold, courageous measures **designed to constitutionally enshrine our fundamental belief what Georgia is – and should be - about: Liberty** – manifested in limited government, few, low and flat taxes, and freedom from state interference and bureaucratic discretion; **Opportunity** for all - afforded by economic liberty and clean governance, whereby upward social mobility through affordable education, hard work and playing by the rules is a realistic aspiration for our citizens; and **Dignity** – whereby means-tested, focused state assistance is available for those who are unable to fully take advantage of the opportunities, enabling our poor to live a dignified life as fully integrated members of our society.

I expect the Liberty Act and the attendant changes in our constitution to be passed by Parliament in the next few weeks.

Georgia's Economic Resilience

Why the Liberty Act and why now? For six years, since the Rose Revolution, we have worked hard to fulfill our promises. Economic success followed, with years of high growth and massive investment inflows spurred by our free-market reforms, only to be interrupted by the Russian invasion and global financial crisis. By the time of the Lehman bankruptcy, the economy of my nation, Georgia, was reeling in the aftermath of the Russian invasion. The double economic shock, the impact of which is only beginning to wear off, was particularly painful as it came after years of double-digit growth and record-breaking investment inflows spurred by our free-market reforms. Reflecting on the challenging period behind us, **our economy's surprising resilience in the face of adversity is attributed to generous help from our friends and partners worldwide, and to the one resource Georgia has in abundance – the optimistic energy, creativity and spirit of enterprise of our people, grounded in patriotic pride.**

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Where We Started From – The Georgian Economy In Ruins By 2003

Our reforms are well documented, but let me take a couple of minutes to highlight our most important achievements since 2003.

Prior to the Rose Revolution in 2003, Georgia bore many characteristics of a failing state. It was saddled with stifling bureaucracy and endemic corruption, little foreign investment, high unemployment and a large rural population engaged in subsistence-level agriculture.

Though Georgia had high tax rates, the tax code was complex and inefficient, and tax revenue collection did not exceed 15 percent of GDP. The government was thus incapable of funding even the most basic public services or maintaining critical infrastructure. The energy sector was especially notorious for inefficiency and corruption, and blackouts were a part of everyday life. The tourist infrastructure was inadequate even for the few foreign visitors who cared to visit the country. The economy produced few competitive exports, and the crime rate was high and corruption rampant. About a quarter of Georgian adults had voted with their feet by emigrating. The entrepreneurial energy of those who remained was squelched by the almost insurmountable bureaucratic barriers to doing business and the inability of the sleepy domestic financial sector to supply them with capital.

What We Have Achieved

From this inauspicious beginning, Georgia enjoyed real GDP growth rates of 8.5 percent or higher from 2005 through the first half of 2008. Nominal GDP grew from approximately \$4 billion to almost \$13 billion over the five-year period, with nominal GDP per capita increasing almost 150 percent, from \$1,188 in 2004 to an estimated \$2,925 in 2008. Virtually all key sectors of the economy have contributed to this growth, in contrast to the development of countries richer in natural resources. This suggests that our policy of increasing economic liberty was the decisive factor in Georgia's transformation.

Growth was fueled by the increasing availability of credit and large foreign private capital inflows. The assets of the banking sector increased by a factor of nine, from approximately \$600 million at the end of 2003 to almost \$5.4 billion at the end of 2008. Private capital inflows reached \$2.3 billion (approximately 23 percent of GDP) in 2007 and an estimated \$2.15 billion (approximately 17 percent of GDP) in 2008. The diversity of foreign direct investment (FDI) has increased considerably. No single country accounts for more than 12 percent of the cumulative 2004–2008 FDI. The share of the top ten countries in the annual FDI inflows shrank from 89 to 79 percent of the total in the same period. For the first time in history, Georgian issuers were able to access Western equity and debt capital markets, with close to three hundred international portfolio investors having invested in Georgian debt and equity securities by mid-2008—a nearly unprecedented breadth of institutional investor coverage for a \$13 billion economy.

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Foreign currency reserves grew, from a very low base of less than \$200 million in 2003 to almost \$1.5 billion at year-end 2008. Tax revenue collection grew by some 400 percent since 2004 as the country rode the Laffer curve, enabling a massive upgrade of critical infrastructure. External public debt decreased from 56 percent of GDP in 2003 to 21 percent as of the year-end 2008.

Aggressive privatisation was pursued, as the state retreated in virtually every sector of the economy. The energy sector was revitalized, with the country becoming a net exporter of electricity (over 80 percent of which is generated from clean, renewable sources, namely hydropower) and one of the most energy-efficient economies (measured by energy consumed per unit of GDP) among the post-Soviet countries.

Public services were improved significantly and corruption was suppressed to one of the lowest levels in Central and Eastern Europe.ⁱ The efficiency of the public agencies, such as the Public and Civil Registries and the vehicle and driver's license authority, has improved dramatically, with consumer experiences at these agencies now comparable, or in some cases superior to those in industrialized countries such as the United Kingdom or the United States.ⁱⁱ

Exports grew at a cumulative annual rate exceeding 20 percent, and the export base and geography of imports broadened considerably. The number of foreign visitors grew by some 300 percent, exceeding 1 million in 2007. Many highly skilled professionals of Georgian origin returned to take leading positions in the private and public sectors. Crime is down significantly, with a significant reduction in crime rates reported every year for the past several years. Living standards have improved considerably, a new middle class has emerged, and the country has experienced an entrepreneurial boom, with more than 50,000 new businesses being registered every year.¹

Rising Economic Liberty and the Retreat of the State

The principal effect of our reforms has been a dramatic increase in the degree of economic liberty enjoyed by individuals and firms. In terms of having the freest economy, Georgia has moved from 112th place in 2005 to the **11th place** last year in the World Bank's rankings—ahead of virtually all emerging markets and most European Union (EU) economies. Georgia's progress in the Heritage Foundation's *Index of Economic Freedom* has been directionally similar, rising from 99th place in 2005 to **26th place** last year.

While many of the aforementioned reforms have been tried—with varying degrees of success—by many developing economies worldwide, **it is rare that all have been pursued**

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simultaneously and comprehensively, over a relatively short time, with a focus as unrelenting as Georgia's.

The rising economic liberty in Georgia has had virtuous cyclical effects, such as the **massive increase in productivity due to infrastructure upgrades made affordable by rising tax revenue**, itself a result of the fiscal reform. In many low-to-middle-income economies, structural impediments to economic growth are so high that **similar reforms attempted in a piecemeal fashion or implemented inconclusively typically result in less impressive outcomes**.

Georgia's success in defeating endemic corruption is particularly noteworthy because its approach was holistic. A **"zero tolerance" policy** has been in place since 2004, but—equally if not more importantly—the **root causes of corruption have been addressed by adopting low, flat taxes; minimizing bureaucratic discretion; streamlining public services; and eliminating waste** by switching, insofar as possible, from public funding of various institutions to funding consumers and empowering them to make their own choices.

How Did We Do It? Our Key Economic Reforms

Fiscal Reform. I have already touched upon the lamentable state of our fiscal affairs prior in 2003. Back then, we had a multitude of taxes, progressive taxation, and widespread exemptions and loopholes exploited by taxpayers against the background of widespread corruption. Because of punitive tax levels, administrative complexity and corruption tax revenue collection had been weak, approximately 15 percent of GDP (or approximately \$600 million) in 2003.

As a result of **several waves of tax cuts** (most recently in 2008, and scheduled to continue in the next couple of years) and a **drastic overhaul of the tax code**, the situation today is much improved. **Four key taxes remain (down from twenty-one in 2004)**: a value-added tax (VAT) of 18 percent (down from 20 percent, with financial services, health care, and pharmaceuticals exempt), a corporate profit tax of 15 percent, a flat personal income tax of 20 percent (with the further reduction to a flat 15 percent by 2012 mandated by the legislation), and a property tax of up to 1 percent of the property value. An excise tax applies to gasoline, tobacco, and alcohol.

As Georgia strives to minimize the fiscal disincentives to savings and capital formation, the tax rate on dividend and interest income has been reduced last year from 10 percent to 5 percent and will be further reduced to zero by 2012, as mandated by the legislation.

Georgia does not have payroll, social insurance, inheritance, or wealth taxes, or a stamp duty or any similar transaction-based duties and levies. There is no capital gains tax, with gains taxed as part of general taxable income (individuals are exempt on gains made on

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assets held for more than two years). **All foreign-source income is taxed at zero percent for individuals.**

In 2009, Georgia was ranked as the fourth-best performer worldwide by the *Forbes Tax Misery & Reform Index* (bested only by Qatar, the United Arab Emirates, and Hong Kong).

By January 2009, Georgia had evolved into a model flat-and-low-tax country, largely compliant with the key four tenets espoused by proponents of flat tax: a single flat tax rate, elimination of special preferences, no double taxation, and territorial taxation.

The administrative complexity (and thus potential for corruption and lobbying by interest groups) **has been reduced dramatically by the abolition of various tax exemptions, breaks, credits, rebates, and loopholes.** As a result, the gray economy has shrunk and budget revenue, reaching \$3.89 billion in 2008, exceeded 30 percent of GDP.

Last but not least, **fiscal management has been much improved**, in many cases with assistance from the international financial institutions and other donors. The budget-writing process has been improved, with **all extra budgetary funds abolished and merged into the budget, all fiscal revenue commingled in one revenue pool, centralized revenue collection implemented, single treasury account established and medium-term budgetary planning framework adopted**, among other reforms.

Sound Financial Sector. Unique among the post-Soviet countries, Georgia completed the privatization of its banking sector early and has maintained since then no restrictions whatsoever on foreign ownership of banks. The withdrawal of the state led to the development of the banking sector without the distortions and inefficiencies state-owned banks inevitably create. Foreign investment poured into the banking sector. By 2008, the leading Georgian banks began establishing beachheads in nearby regional markets, such as Azerbaijan, Belarus, and Ukraine.

Georgia has had **full currency convertibility with no currency or capital controls** for a while, the first among the Commonwealth of Independent States (CIS) members to have done so. Unlike the knee-jerk policy responses of some of its post-Soviet peers to the adverse conditions of late 2008, **Georgia has refrained from imposing any currency or capital controls or limits on bank deposit withdrawals** or transfers, preserving these crucial economic freedoms and confidence in its financial sector in the process.

By choice, **Georgia remains one of the very few countries worldwide without any state-sponsored bank deposit insurance arrangements whatsoever.** Nonetheless, the confidence in the banking sector has been such that, while client deposits dipped in the immediate aftermath of the Russian invasion in August 2008, **by the end of 2008 deposits returned to their pre-war level.**

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Georgia's banking sector remains sound and liquid, despite the extreme stress of the August 2008 war and the spreading contagion of the global financial crisis. We have seen a new wave of foreign investment in our banks starting last fall.

Aggressive Privatization. Since 2004, however, the government has stepped up its privatization efforts, generating annual privatization proceeds of approximately **\$200 million per year**. Many large state-owned companies were privatized in 2004–2006, alongside thousands of smaller state-owned assets, including land and real estate. **In 2008, despite the worsening market conditions, privatization proceeds reached \$450 million**, as several large companies, such as Poti seaport and the water utility in Tbilisi, were privatized. Small-scale privatization auctions continued apace.

Today, the only significant assets in state ownership are the railway, which is profitable and reasonably well managed and may well be privatized; the national postal system and power transmission grid, which require significant restructuring before they appeal to investors.

Deregulation and Minimizing Bureaucratic Discretion. Since 2004, **dozens of laws have been simplified or abolished altogether, and hundreds of licenses and permits previously regulating all sorts of economic activities have been abolished**. The new licensing law establishes clear parameters and procedures for the remaining licenses and permits, thereby making it difficult to reregulate the economic activities that have been liberalized.

In areas in which issuance of permits is unavoidable, such as construction, the bureaucratic discretion has been minimized by adopting of the **“single window”** (or one-stop shop) system, streamlining procedures, and introducing the **“silence is consent”** principle, which imposes rigid deadlines for civil servants to respond to citizens' and companies' queries.ⁱⁱⁱ According to the Doing Business rankings, Georgia is among the top ten countries globally in terms of ease of obtaining construction permits.^{iv}

The energy and utilities sectors have been liberalized under a modern regulatory framework with an independent regulator. In the transportation sector, transit fees, quotas, and other barriers have been abolished. Railway tariffs have been liberalized. In aviation, “open skies” policies have been adopted. All of these have resulted in the rapid growth and development of the transportation and logistics sector, which plays a particularly important role given Georgia's role as a transit zone for Caspian basin hydrocarbons and a trade gateway to the Caucasus and Central Asia.

Public Sector Reform. Since 2004, Georgia has undertaken a radical reform of the public sector. The number of ministries and state agencies has been reduced considerably, and **the headcount of public-sector employees has been reduced by about 50 percent. Public-sector salaries have risen fifteen fold**, reducing corruption and enabling public-sector institutions to compete for senior talent with the private sector.

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Free Trade. Georgia has been a member of the WTO since 2000. In 2006, Georgia unilaterally set bound import tariffs of zero on approximately 95 percent of categories of goods and abolished all nontariff barriers on virtually all goods and services. The procedures and paperwork required for both exports and imports have been streamlined considerably, **reducing the typical time for processing exports and imports from several weeks to a few days.** As a result, **foreign trade turnover has quadrupled since 2003**, investment and imports of capital goods have been encouraged, costly distortions and inefficiencies in the consumer market have been avoided, diversification of exports and imports has been achieved, and endemic corruption at customs has been eradicated.

Labor Market Liberalization. A new labor code was adopted in 2006, replacing the multitude of regulations and liberalizing dramatically the labor market while complying with all essential International Labour Organization conventions. Restrictions on the duration of the term of employment contracts and overtime work have been largely abolished, leaving it to the employer and employee to agree on these and other terms, while complex and onerous severance procedures have been streamlined into a simple procedure whereby the law requires one month's severance pay and little else. There is no minimum wage legislation. Individual and collective contracts are now treated similarly, and collective bargaining is allowed by any group comprising two or more individuals (rather than only by formally established trade unions). As a result of these changes, by 2008, Georgia was ranked by the World Bank as **the fifth-easiest country in which to employ workers.** Combined with the tax reform, labor market flexibility has played a crucial role in the rise of formal employment.

Labor market access has been fully liberalized for noncitizens. An individual of any nationality can seek formal employment and become employed in Georgia without any work permits or other restrictions.

Liberalizing Tourism. During the Soviet era, Georgia was an important tourist destination, hosting more than 3 million (mostly Soviet) visitors per year in the 1980s. However, by 2003, barely 300,000 visitors a year were reported.

After the Rose Revolution, Georgia unilaterally liberalized access to the country, granting citizens of all EU countries and OECD member states full, visa-free access for visits lasting up to ninety days. Access for citizens of several other countries has been simplified, with visas obtainable at the point of entry. This reform—combined with massive improvements in transport, hospitality, and communications infrastructure; the rapidly improving image of the country; and limited promotion efforts by the government—resulted in the tripling of annual visitors to **1 million** by 2007. In 2008, legislation was passed to extend visa-free access to citizens of additional thirty countries with GDP per capita of \$10,000 or higher and extend the duration of visa-free visits for all eligible visitors from ninety to 360 days.

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Education Reform. Alongside the continuing upgrades of the decrepit school infrastructure, important structural reforms were initiated in 2005–2006. A national unified exam system has been created for school graduates, eliminating the endemic corruption in the university admissions system. Day-to-day decision-making has been devolved to the boards of trustees established at all state schools and universities. The most important and successful reform was the radical change in the way state schools are funded, with vouchers issued nationwide to all households with school-age children, enabling parents to use the vouchers at any school—state or private—of their choice. In addition to creating a measure of competition among state schools, this measure has fostered the development of private schools, and, by 2008, enrolment in private schools was approximately 7 percent of the total (up from nearly zero five years ago).

Health Care Reform. The government initiated an ambitious and elegant reform aimed at the eventual replacement of all state-owned hospitals with privately owned, newly built facilities.

In order to address the health care needs of the poorest strata of the population, the state issues health insurance vouchers with which patients can purchase basic health coverage from any of the dozen or so private insurance companies active in Georgia.

Welfare Reform. A nationwide targeted social assistance program has been launched to replace the complex and inefficient legacy social programs prone to manipulation and corruption. Poverty assessment of some 550,000 households has been carried out by social agents and, based on multifactor proxy means-testing technology, more than 400,000 households (1/3 of the total) have been identified as socially vulnerable. These households receive monthly cash payments to supplement their private incomes (if any), as well as state-issued health insurance vouchers. As a result, available social assistance has been targeted and delivered to those in most need of it.

Democratic Consensus

So, as you can see, by 2009 we had much to protect and preserve. And our economic achievements were obvious to many, if not all, as were the policies responsible for our success.

A vibrant political debate is a factor of our daily life, yet one little-noticed fact is worth pointing out. None of my critics among the diverse Georgian opposition question the premise that the only path to prosperous democratic future is to embrace free enterprise, responsible governance and protecting the freedom of our citizens from bureaucratic tyranny. **Our society has displayed a remarkable level of maturity in the face of adversity, for the Georgians understand that, as Frederic Bastiat pointed out, when people are free, they are also responsible to bear the consequences of their actions.**

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We have begun work on further steps to enhance the Georgian democracy. **As George Washington said, “government is not reason, it is not eloquence, it is force! Like fire, a troublesome servant and a fearful master. Never for a moment should it be left to irresponsible action.”** And we are hard at work to get right the system of checks and balances, implement judicial and electoral reform and advance free speech.

However, **I would be failing our citizens if I did not pay equal attention to the re-building and advancement of our economy, for it is naive and unrealistic to expect that the highest possible quality of democracy is sustainable in a nation trapped in poverty, where confidence and optimism are scarce.**

Ensuring Sound Economic Governance Through The Liberty Act

Governments of developing nations (often deservedly) suffer in investors' perceptions from a credibility deficit, whereby basic economic policies are all too often subject to drift or even sudden reversal. **Our Liberty Act, if passed, will constitutionally enshrine strict and transparent rules, limiting severely the power of the executive to deviate from sound economic governance.**

Rarely in modern history has the notion that the size of government ought to be capped, monitored and controlled been introduced into the public discourse by the government itself, let alone be constitutionally enshrined – yet we have done just that. Our Liberty Act caps the size of the budget expenditure at 30% of GDP.

We believe that fiscal responsibility is a fundamental obligation of democratic governance. Our Liberty Act proposes that the size of budget deficit be capped at 3% of GDP, and the overall size of government debt be capped at 60% of GDP.

It further proposes a ban on earmarks and protected budget items, thus reinforcing the integrity and transparency of our fiscal framework.

Our currency has been freely convertible since 1995 – a rare achievement among the post-Soviet nations, and we have a twelve-year track record of not limiting or restricting the repatriation of profits and capital in any way. Our Liberty Act puts this responsible policy into law, removing any risk of reversal in the years to come.

Much has been done since the Rose Revolution to free entrepreneurs from excessive regulation and unwarranted bureaucratic interference. **Our Liberty Act proposes a ban on any increase in the number of licenses and permits that exist in our economy, and bans the establishment of new state or public regulatory bodies** in addition to the existing independent regulators in the areas of financial services, communications and utilities.

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In Georgia, there have been no state-owned banks since 1995, and no price controls [whatsoever] since the mid-1990s. The Liberty Act reinforces these policies by prohibiting state ownership of banks and imposition of any price controls (including on interest rates).

We are proud of the success of our approach to healthcare and education, whereby the poor are issued health insurance vouchers they are free to use at any private insurance company, and parents are free to use the state school vouchers at any school of their choice – public or private. **Recognising the fact that the state is intrinsically bad at providing high-quality affordable service to citizens, the Liberty Act reinforces the notion that fiscal funds ought to be used to empower our citizens by giving them choice where possible, rather than be used for directly funding the public service providers.**

Georgia has ridden the Laffer Curve in recent years, whereby, as we simplified our tax code, reduced tax rates dramatically and adopted flat taxes, our tax base broadened and our tax receipts grew from 15 percent of GDP in 2003 to about 30% of GDP in 2008, triggering economic growth. While our taxes are few, low and flat, we believe it is our duty to ensure that this achievement is immune to any policy shifts or, worse, reversals. Furthermore, **we strongly believe that the power to tax – misused and abused all too often in human history – must not be used by the state without the consent of the people. Which is why perhaps the most important principle that the Liberty Act seeks to enshrine is that a nationwide referendum will be required for any tax rates to be increased or any new taxes imposed.**

Conclusion

For far too long, efforts to eradicate poverty in the world focused on merely re-distributing wealth, rather than on establishing the conditions for creating it, while focusing state assistance on those who need it the most. Despite the challenges my nation faces, I am certain that peaceful, democratic and prosperous future is well within our reach. Our path to economic success through liberty may be a challenging one, but there is much to be excited about in observing – let alone in participating in this process. On behalf of Georgia, I am delighted to invite investors from all over the world to join us on our journey to economic success through liberty.
