PRIVATE SECTOR ASSESSMENT (SUMMARY)[1]

A. The Private Sector in Georgia

1. In 2013, Georgia had 557,379 registered businesses, but only 112,937 (20%) of them were active. Of these, 87% were small, 7% were medium-sized, and 5% were large. Georgia's small businesses are largely owner-operated, employing an average of 1.3 people per firm. The largest sectors are wholesale and retail trade (17% of gross domestic product [GDP]), manufacturing (11%), agriculture (9%), transport (8%), and construction (7%). Nontradeable activities, including wholesale and retail trade, largely comprising small retail outlets and large import companies, have been the fastest growth area since 2004. Tradeable activities, especially agriculture, which has experienced real output declines, have fared worse. Agriculture accounted for nearly 52% of employment in 2013, but only 9% of GDP. Most rural enterprises are owner-operated and suffer from seasonal underemployment.

2. Georgia’s weak competitiveness in tradeable activities poses a challenge for sustainable growth and export potential. Georgia's exports are less diverse and sophisticated than the country’s level of development suggests, and the survival rate of exporting firms has declined over time, in part due to sustained real effective exchange rate appreciation. Exports grew from $2.5 billion in 2008 to $4.4 billion in 2013, mostly due to mining, agrochemicals (fertilizers), metal products, food processing (such as wine, mineral water, and nuts), construction materials and equipment, and refurbished passenger vehicles.

3. Georgia’s cultural and historic assets provide a robust base for tourism development, which is an important source of service exports. Tourism development has the potential to boost the productive capabilities of agro-processing activities, which Georgia is naturally set to exploit. Less than 15% of the nation's hydropower has been tapped. If generated competitively, hydropower could become an important source of export revenue. Service inflows, in the form of tourism earnings, fees on transit trade in oil and gas, insurance payments, and remittances from overseas employment increased from $1.3 billion in 2009 to $3.0 billion in 2013.

4. Since 2004, Georgia has implemented a significant program of market liberalization and has taken steps to combat corruption. The government passed a simplified tax code, abolished requirements for many business licenses and permits, reduced the size of and scope for rent-seeking activities by the civil service, liberalized international trade, and implemented a large-scale privatization program. The privatization program included large-scale privatizations of public utilities such as the electricity distribution network and the Tbilisi water distribution network. Many public lands and buildings were also sold; and foreign investment in nontradeable sectors, such as telecommunications, was liberalized. Foreign direct investment has averaged nearly 10% of GDP annually since 2006. Together with substantial debt inflows to the domestic banking sector, capital inflow recorded in the 2000s shaped the speed and pattern of private sector development since 2004. These dynamics have moderated since the crisis and slowdown of 2008–2009.

5. Georgia requires improvements to the regulatory environment and policies to support innovation and the enhancement of human resources in key tradeable activities to increase exports in existing products and diversify private sector production and exports.[2] Successive

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[1] This assessment is based on a staff consultant’s study on the private sector in 2013. National Statistics Office of Georgia, World Bank, and IMF sources have also been relied upon in this assessment, together with structured interviews with private sector representatives and government officials.

[2] World Bank. 2013. *Developing a Competitiveness Strategic Roadmap for Georgia*. Tbilisi.

improvements in transport and energy infrastructure support this objective. As a result of an extensive road repair program, 77% of Georgia's international roads were considered to be in good condition in 2013, up from 34% in 2004. Electricity supply, which was largely unreliable across the entire country following the collapse of the Soviet Union, has been reestablished. Water supply, which was also a serious problem before 2004, has been restored in the capital, and is slowly improving across the country, particularly in urban areas.

B. Constraints to Private Sector Development

6. **Infrastructure.** Gaps in essential infrastructure, particularly for connectivity and trade, continue to constrain private sector development in lagging regions. While infrastructure is improving nationwide, some 38% of secondary roads and 54% of local roads are in poor or very poor condition because of years of inadequate maintenance funding. This is particularly problematic as Georgia's mountainous terrain isolates its regions from key markets. Beyond agricultural production and seasonal tourism, opportunities for business in these regions are limited. The fragility of the energy system is another major constraint to regional development. Key assets in the power system were developed decades ago, and will require replacement in the coming years. As energy production from hydropower increases, infrastructure limitations and bottlenecks could disrupt domestic supply. In addition, large parts of the country do not have access to reliable water supply, sanitation, or solid waste disposal facilities, leading to rising environmental costs as economic activity increases.

7. **Regulatory frameworks and logistics.** Hydropower and agriculture face a number of sector-specific challenges. In hydropower, there is lack of clarity about the basis upon which new projects will access newly completed transmission lines, and through them, the Turkish market. There are also concerns over the amount of power that companies would be required to sell to the local grid and the off-take tariffs. In agriculture, there are considerable public–private coordination failures. Increasing farm productivity and output will require a combination of land consolidation, better logistics, improved seed technology, agro-processing and farming knowhow support services, and better access to finance.

8. **Access to finance.** The high cost and limited availability of external finance also constrains private sector development. The banking sector comprises 21 commercial banks, 20 of which have a majority of foreign ownership.[3] The sector is highly concentrated with the Bank of Georgia and TBC Bank holding more than 60% of total assets and the five largest banks controlling more than 80%. Outstanding bank lending represented about 35% of GDP in 2013, up from less than 20% in 2006.[4] Lending has increased since 2010 but remains far from reach for specific economic activities and smaller firms. There is also limited financial outreach to rural areas. Just 1% of total lending goes to agriculture. Deposits have likewise been increasing, but they remain low at 27.5% of GDP in 2013, in part because of the absence of a deposit insurance system.[5] Financial dollarization is high, with the share of foreign currency loans at 56.2% and deposits at 56.3% as of the end of 2013. Dollarization may cause financial stability concern as it hinders monetary policy from being sufficiently responsive, hampering its effectiveness. This also constrains maturity transformation in the banking sector, keeping average loan tenors short. This reduces the ability of the private sector to take on investment

[3] More than 85% of all paid-in capital is foreign-owned. Nonresident shareholders control 95% of total banking assets. Regional banking institutions, European banks, and international financial institutions are shareholders.
[4] International Monetary Fund. Financial Access Indicators database. http://fas.imf.org/ (accessed 10 October 2014).
[5] The average ratio of deposits to GDP for low-middle-income countries is 49%, and 141% for Organisation for Economic Co-operation and Development (OECD) countries. Within the region, Armenia (22%), Azerbaijan (16%), and Tajikistan (17%) have lower figures.

opportunities that have longer payback and gestation periods. Intermediation spreads also remain high, indicative of high risks and inefficiencies in financial intermediation.

9. To support the development of micro, small, and medium-sized enterprises, two new agencies—the Entrepreneurship Development Agency and the Innovation and Technology Agency—were established under the Ministry of Economy and Sustainable Development in 2014. They seek to promote entrepreneurship by improving access to finance, entrepreneurial learning, consultancy services, and export promotion and innovation, and by supporting adaptation to Deep and Comprehensive Free Trade Area requirements. The Produce in Georgia Program, also launched in 2014, aims to enhance business competitiveness by providing access to commercial finance, consultancy, and new technologies.

10. **Capital markets.** Banking sector development can be complemented and further enhanced by capital market institutions that enable the financing of long-term public and private capital investment. Private pension funds are, concomitantly, also underdeveloped. In 2013, there were five licensed nonstate pension institutions, of which only two were active. The aggregate pension liabilities of these pension schemes equaled just GEL12.7 million. Insurance penetration in Georgia is low, with total assets representing 2.4% of GDP in 2012, and a limited number of insurance products (mainly nonlife).[6] Georgia's securities market is in the early stages of development. Stock market capitalization to GDP was 7.8% in 2013 (down from 9.2% in 2010).[7] The government securities market is nascent at an estimated 3.2% of GDP in 2013. Securities market development is hampered by (i) the absence of short-term debt markets; (ii) weak information underpinnings, such as the quality of financial information, corporate governance, and the reliability of credit information sharing; and (iii) the absence of the institutional players that are crucial in price-discovery and liquidity management.

11. **Skills mismatch.** Another constraint to private sector development arises from skills mismatches in the labor market. The education system reaches most of the population, and a relatively high proportion of the youth is educated at the tertiary level. However, the quality of education is relatively low and the subjects provided often do not address labor market needs.[8] Despite recent investment in physical facilities, gaps remain in the quality of technical training. Engineers and skilled technical staff are in particularly short supply, constraining skill-intensive economic activities, particularly in manufacturing.[9]

12. **Tax administration.** There have been significant improvements in tax administration, partly in response to concerns over dispute resolution and tax collection procedures. The government's efforts to combat tax evasion, while contributing to higher voluntary compliance, sometimes lead to more frequent tax inspections and a greater risk of arbitrary payments. Gaps in the capacity of the judicial system, along with confusion over tax code provisions, raised concerns in the business community. However, recent reforms in tax administration have responded to business concerns (e.g., excessively harsh penalties have been removed and dispute resolution has been made more transparent and inclusive).

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[6] The average volume of assets to GDP is 8.1% for OECD and 2.6% for Central and Eastern Europe.

[7] This indicator is well below the 33% in developing Europe and Central Asia, 45% in lower-middle-income countries, and 73% in OECD countries. Indicators of market activity and liquidity also compare poorly.

[8] Improvements in professional standards are underway; the Ministry of Education and Science is surveying employers for needed skills and competencies and rationalizing financing for vocational education.

[9] The government secured grant support in 2013 from the Millennium Challenge Corporation to promote higher and vocational education. Efforts are underway to introduce educational programs in natural sciences, technology and engineering, and to enhance the capacity of higher education public institutions.

C. Possible ADB Contributions to Private Sector Development

13. Past ADB support for private sector development (PSD) in Georgia focused on addressing critical infrastructure constraints and providing countercyclical budget finance after the 2008 armed conflict with the Russian Federation and the global financial crisis. Assistance to the transport sector helped develop Georgia's section of the Eurasian Transport Corridor, and improved trade facilitation. Engagement in the energy sector has contributed to developing the infrastructure needed for a cross-border energy market. ADB assistance has also been important in developing urban areas into viable centers of commerce by addressing the serious deterioration of urban water supply and sanitation, solid waste management, and urban transport systems. ADB's Private Sector Operations Department has also provided support for financing small and medium-sized enterprises. The European Bank for Reconstruction and Development, International Finance Corporation, and the World Bank provide extensive advisory support for PSD through support for business environment reforms and financial market development, and catalytic private sector investments. The United States Agency for International Development engages in policy advisory, capacity building, private sector surveys, and pilot programs for small businesses and rural development. German development cooperation through KfW supports the financing of economic infrastructure, a regional small business fund, and the development of value chains for agribusinesses and rural finance.

14. ADB support for PSD will be harmonized with assistance provided by other development partners, and will build on ADB's ongoing support for economic infrastructure and improving urban service delivery. Diversifying the economy and trade remains key to boosting Georgia's trade flows, not only with the EU but also with its partners in the region. The Deep and Comprehensive Free Trade Area provisions of the Association Agreement with the EU, signed in June 2014, requires the deepening of regulatory and institutional reforms to improve trade and the trade environment in Georgia. This will be crucial to further attract foreign investments in tradeable activities, strengthen economic competitiveness, and diversify exports. ADB support for measures aimed at enhancing the competitiveness of existing and new tradeable activities could position Georgia to take advantage of EU markets.

15. Future support for PSD could be fostered by (i) addressing major infrastructure constraints and skills gaps through public and private service provision, (ii) improving the regulatory setting, (iii) enhancing capacities for public–private partnerships (PPPs) and private sector investment, and (iv) providing transaction advisory services to develop PPP projects. To complement public sector infrastructure operations, support could be provided for developing a framework and suitable legislative and regulatory arrangements for PPPs. This support would provide a basis for more intensive collaboration between ADB's public and private sector operations. To boost domestic savings and long-term investment, ADB could assist in the use of international financial reporting standards, improving transparency and corporate governance, and drawing up a road map for capital market development. ADB could also support increased access to financial services in rural areas and among small and medium-sized enterprises.

16. There is scope for catalytic private sector operations. If viable projects are forthcoming, ADB could support trade finance; rural finance; and micro, small, and medium-sized enterprises through extending loan and guarantee facilities to qualified banks for on-lending. ADB could also explore private sector investment in hydropower, energy, logistics, agribusiness and food-processing, and PPP projects. Private sector and nonsovereign financing of projects could involve a wide range of financing instruments, which should be deployed in ways that are most relevant to each operation.