Post-Crisis Challenges of Regional Economic Development in Georgia

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Abstract

The research examines the challenges of the regional economic development in Georgia in a post August 2008 war period, describes and interprets the trends and the problems that are associated with the evolving pattern of the regional economic development in Georgia. Two main questions are addressed in the research:

- How are the processes of regional economic development policy, introduced by central government few years ago, implemented?
- What are the effects of the crisis on regional economic development in Georgia?
- How can the design of existing institutional framework be modernized to ensure the improvements in regional economic development in Georgia?

The focus is on all important elements affecting the regional economic development in both pre-war and post-war periods. The research highlights the overall transformation context and common trends and challenges in the regional policy evolution in Georgia. Based on existing statistical data of regional profile the research maintains an overview of the regional policy developments, namely the existing "top-down" model (road infrastructure, transport and communications facilities, industrial sites, etc.). Particular attention is paid to the patterns of regional disparities in Georgia. The factors having particular importance in the process of regional economic development have been thoroughly examined: GDP, agriculture, industry, services, construction, public and private finances, employment and poverty. Research-based analysis, the recommendations are issued related to the institutional set-up of the regional economic governance reform. Recommendations are about the efficient approach to be applied in a near future: endogenous way of development through the "bottom-up" model is to be executed aiming at supporting the entrepreneurship, developing human capital and building local institutions capable to smooth the process of transition from exogenous to endogenous strategy of economic development in the regions. Presented assumptions on the institutional set-up of regional economic development can be applicable for decision makers of central and local governments so they can adjust the current model of regional economic management to a paradigm of European Charter of Local Self-Government.

Introduction

Georgia joined the European Charter of Local Self-Government in 2004. Based on the principles of Charter, the country undertook international obligations in the sphere of self-government and has been carrying out the process of harmonization of its legislation up to now.

In order to ensure the conformity to the principles of the Charter, following laws were adopted by the Parliament of Georgia:

- Law of Georgia on Property of Local Self-Government Unit (2005);
- Law of Georgia on Budget of Local Self-Government Unit (2006), which later was replaced by the Budget Code of Georgia (in force from January 1, 2010);
- Organic Law of Georgia on Local Self-Government (2005) which superseded the Organic Law on Local Self-Government and Administration which had been in effect since 1997.

Structural Reforms carried out from early 2005 contributed to the establishment of all necessary preconditions for the regional development in Georgia.

Since 2003, the government undertook a large number of reforms to create competitive market conditions and a business enabling environment to attract FDI as well as trade liberalisation and to eradicate corruption. During the mentioned period GDP grew significantly and new jobs were created. Real GDP growth rates exceeded 9 percent in 2005 and topped at a level of 12.3 percent in 2007. The World Bank's *Doing Business* analysis ranked Georgia as the number one economic reformer in the world in 2007, when its position improved from 112th to 18th in terms of ease of doing business.

The second phase of the Regional Development program was launched in spring 2008, when the government performed its restructuring and the position of the State Minister in Regional issues was introduced. Later on, the State Minister's office was transformed into a Ministry of Regional Development and Infrastructure hence becoming a major actor in the field of regional development in Georgia.

The strategic vision on major elements of the sustainable regional development was established at the initial phase:

- Developing strong and diversified regional economic base;
- Improving quality of life in the regions;
- Improving the quality of environment;
- Ensuring the practice of good governance.

Despite a number of activities carried out till now, still there are a lot of problems in the sphere of regional development which require urgent improvements. First of all it's about a low level of the regional economic development in Georgia.

Since Georgia has got independence, the issue of regional economic development was delegated to so-called "market forces" and to "invisible hand". Just recently this issue has been taken seriously and the concepts of institutional framework for regional policy have appeared on top of the development agenda of Georgian economy.

The aim of the research is to measure the results achieved in the process of the regional economic development and the effects of the crisis after August 2008 war. As a criteria of measurement, the simple method was selected which implies calculating how much new wealth (Gross Domestic Product) is created in a particular region in a stated period or how much income is accrued to an area's inhabitants (Gross National Income). An assessment of the increases in output and income hence applying it to regional economic development process was done, based on the method mentioned above .

It also has to be mentioned that *Data on the regional impact of the post war crisis in Georgia are limited*. Moreover, data on a municipality base are nonexistent for unemployment rates, GDP, income per capita, etc., which makes extremely difficult to carry out studies about the impact of Twin crisis[1] on the economic development in regions.

Impact of the Crisis on National and Regional Economies in Georgia

Due to inefficiencies in the economic development policy, it has become almost impossible to ensure stable economic growth in the regions and the economic disparities are the major obstacles making most of regions laggards in economic progress.

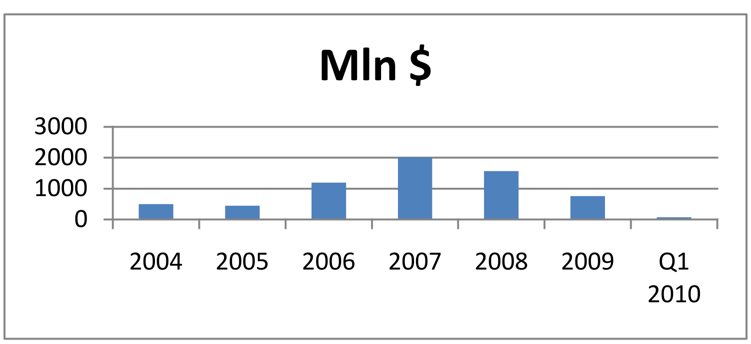
At present, there is a variety of problems to be solved in the sphere of the regional economic development. Namely, medium enterprises at regional level are decaying and there is the fewer number of small business enterprises performing at this level. The share of the small and medium size enterprises in GDP have been permanently reducing over the recent years.

It has to be mentioned about the reasons of the economic decline in the regions:

- Inefficiency of the regional institutions of economic governance;
- Insufficient amount of FDI in the regional economies;
- low performance in investment promotion activities;
- Low performance of small and medium enterprises in regions;
- High levels of unemployment in the regions;
- Lack of opportunities to update the technologies.

The August 2008 war was followed by the economic crisis that significantly hindered the regional economic development process in Georgia. By the end of August, many buildings and infrastructure were destroyed. More than 100 thousand people were displaced while the Russian army occupied South Ossetia and Upper Abkhazia (Kodiri). Post-war crisis led to a strong fall of both national and international demand and of FDI.

Chart 1. Yearly Foreign Direct Investments Inflow



[1] The term "Twin crisis" implies the effects of both August 2008 war and Global Financial Crisis.

Source: National Statistics Office of Georgia (Geostat)

In 2008 regional economies have been directly affected by downturn, notably in the trade, agriculture and the construction industries. A key concern in such regions is that the recession has been permanently reducing the number of firms and jobs in the traditional sectors which make economically weak regions drastically affected by the crisis.

The crisis has affected economies in regions of Georgia in different ways, depending on existing strength and weaknesses of certain regions, its sectoral structure and the response of national and regional governments.

In 2008-09 some sectors have been directly affected by the post August 2008 war and post financial crisis consequences, notably agriculture, trade, financial services, construction. Regions, specialized in a narrow range of sectors, were particularly vulnerable to sectoral shocks. A key concern in such regions was that the recession could permanently reduce the number of firms and jobs in core sectors, leading to a structurally lower level of output and employment even after the downturn passed.

The limited scope of statistic activities at a regional level hinders to perform thorough exploration of the regional impact of the crisis. This is related to problems of data collection. However, the research can be considered as valid and the collected data is enough to make assumptions about the regional economies decline in Georgia at post-war period.

GDP

The 2008 August war against Russia, accompanied early September by the international crisis, led to a severe decrease of GDP in the second half of the year. Overall, GDP growth only reached 2.1 percent that year, instead of 9 percent, as forecasted earlier[2].

Table 1. GDP Growth in Georgia (2006-08).

	2006	**2007**	**2008**	**2009***
GDP at current prices, mil. GEL	13789.9	16993.8	19074.9	17948.6
GDP real growth, percent	109.4	112.3	102.3	96.1
GDP per capita (at current prices), GEL	3133.1	3866.9	4352.9	4092.8

Source; Geostat, 2010

The rates of GDP growth vary significantly between the leading regions (Tbilisi, Kvemo Kartli, Adjara) and remaining regions;

[2] IMF, April 2008.

Table 2. Gross Value Added (at current prices, GEL million).

	2007	2008
Imereti, Racha-L., Z. Svaneti	**1,670.8**	**2,034.6**
Tbilisi	**7,009.5**	**7,913.6**
Kakheti	**789.6**	**981.8**
Shida Kartli	**917.1**	**981.3**
Kvemo Kartli	**1,400.5**	**1,347.7**
Samtskhe-Javakheti	**454.8**	**526.7**
Adjara	**966.9**	**1,224.3**
Guria	**354.1**	**326.1**
Samegrelo-Z. Swaneti	**1,047.7**	**1,185.8**

Source: Geostat, 2010

Agriculture

Despite significant improvements in the business climate, companies have been becoming less competitive. As an evidence of declining competitiveness of the regional economy the poor performance of agriculture sector can be examined. Currently, 53 percent of labour force is employed in agriculture. During the last two decades agriculture's contribution to GDP has declined. In 1997, the agricultural sector accounted for 27.5 percent of the overall GDP, while in 2009 it had decreased to 9.6 percent.

Table 3. Gross Harvest of Agricultural Crops.

(thousand Tons)	**2003**	**2007**	**2008**
Potatoes	425.2	229.2	193.4
Vegetables	430.1	190.3	165
Perennial plants	130.8	8.8	30.2
Fruit	260.0	227.5	157.6
Citruses	59.2	98.9	55.2
Grapes	…	227.3	175.8
Tea leaves	25.5	7.5	5.4

Source: Statistical Yearbook of Georgia, 2009

Table 4. Production of Main Types of Animal Products

(thousand tons)	**2003**	**2007**	**2008**
Meat (slaughtered weight)	108.9	69.4	53.7
Milk	765.1	624.7	694.6
Eggs (million)	458.1	438.1	437.5
Wool	2	1.9	1.7

Source: Statistical Yearbook of Georgia, 2009

Approximately 15 percent of GDP is produced in rural areas whereas more than half of the employed population lives in rural areas. Closing of the Russian market in April 2006 resulted in decline of export of Georgian agricultural products.

Export

Some of the most evident regional impacts of the crisis are rooted in the geographical concentration of the *export-oriented* industrial firms which have suffered due to fall in international demand. Due to the crisis, total foreign trade fell to USD 5.5 billion in 2009 (a fall of 26.6 percent), with a trade Balance in 2009 decreasing by 29 percent y-o-y.

Table 5. Georgian Foreign Trade (2007-09).

(In USD million)	**2007**	**2008**	**2009**
External Trade Turnover	6,447.3	7,800.0	5,500.1
Export (FOB)	1,232.4	1,495.5	1,130.6
Import (CIF)	5,214.9	6,304.6	4,369.5
Balance	-3,982.5	-4,809.1	-3,238.9

Source: Geostat, 2010.

Industry

The impact of the recession on other industrial sector has also had significant regional effects. Food processing companies have been producing wide range of products under different brand names (meat products, packaged and fresh fish, half-fabricated products, dairy products, ice cream, soft beverages, pastry and wine). Their total output in 2008 reached GEL 901.8 million, with declining volumes following the crises. Employment has also been gradually decreasing since 2007.

Table 6. Trends in Manufacture of Food Products and Beverages.

	2006	2007	2008	2009
Output of product(In GEL million)	861.5	1033.2	901.8	
Number of employed (thsd persons)	22.4	20.2	18.9	

Source: Geostat 2010

Table 7. Turnover in Industry by Regions (GEL million, 2007-09)

Year	Georgia - total	Tbilisi	Adjara	Guria	Imereti	Kakheti	Mtskheta -Mtianeti	Racha-Lechkh umi	Samegre lo-Zemo Svaneti	Samtskhe-Javakheti	Kvemo Kartli	Shida Kartli
2007	4362.1	2100.6	120.2	59.5	348.4	112.7	98.2	12.3	76.6	72.5	888.9	431.3
2008	4637.6	2315.2	107.7	76.0	473.6	103.9	113.9	9.7	41.2	91.8	893.8	367.0
2009	4407.4	2188.6	171.5	64.4	313.3	127.2	112.2	4.1	97.3	92.0	992.7	202.4

Source: Geostat 2010

Construction

The construction sector has been particularly affected by the crisis in a number of regions, with the impacts most strongly felt in urban areas, particularly in large cities where housing market demand had been strongly increasing from 2005 to 2007.

Table 8. Turnover and Production Value of Construction.

	2007	2008	2009
Turnover(In GEL million)	1604.6	1412	1736.0
Number of employed, persons	52572	38109	43452

Source: Geostat, 2010.

Table 9. Turnover in Construction Sector by Regions (GEL, million)

Year	Georgia - total	Tbilisi	Adjara	Guria	Imereti	Kakheti	Mtskheta-Mtianeti	Racha-Lechkhumi	Samegrelo-Z. Svaneti	Samtskhe-Javakheti	Kvemo Kartli	Shida Kartli
2006	1125.3	776.3	94.1	13.5	50.1	14.2	27.2	6.2	37.5	16.6	40.1	49.3
2007	1604.6	1122.1	138.1	9.5	65.1	20.7	15.4	5.7	105.7	13.0	42.1	66.6
2008	1412.0	891.0	239.2	11.4	38.1	17.3	9.1	7.6	82.1	23.2	34.0	57.7
2009	1736.3	1266.0	184.1	2.6	46.9	25.4	16.9	10.4	87.3	7.6	37.3	51.3

Source: Geostat, 2010.

Table 10. Number of Employed Persons in Construction by Regions (persons, 2005-09)

Year	Georgia - total	Tbilisi	Adjara	Guria	Imereti	Kakheti	Mtskhea-Mtianeti	Racha-Lechkh umi	Samegrelo -Z. Svaneti	Samtske-Javakheti	Kvemo Kartli	Shida Kartli
2005	38560	21454	2883	416	2457	748	1179	688	3317	1502	2216	1700
2007	52572	28918	4740	495	5097	990	1075	396	4874	824	2662	2454
2008	38109	20055	5351	584	3241	964	664	573	2470	980	1558	1647
2009	43452	24487	5591	182	2837	1847	1015	569	2426	525	1741	2215

The number of job cuts in the construction sector was higher in 2008 in absolute terms in the regions. The impact of this fall in employment was also more serious due to the limited availability of other employment opportunities in manufacturing and service sectors in these regions.

Services

The services sector has undergone rapid developments since early 2004. Trade, transport, financial services and public administration accounted for around 70 percent of GDP in 2008 employing over one third of labour force.

Banking Sector

As financial service sectors are usually located in the large agglomerations, the direct effect of the crises on this sector is regionally concentrated (Tbilisi, Adjara).There is factual evidence that constraints to bank lending to businesses and households and affecting regions differently. The crisis has negatively affected commercial banks' loans portfolio in the regions which is also characterised by unequal distribution among the regions.

Table 11. Total Commercial Loans to Regions (GEL million)

	As of January 1, 2008		As of January 1, 2009		As of January 1, 2010	
	in national currency	in foreign currency	in national currency	in foreign currency	in national currency	in foreign currency
Total	**1,408,405**	**3,105,335**	**1,545,328**	**4,288,306**	**1,145,149**	**3,880,385**
Tbilisi	1,062,555	2,603,653	1,127,693	3,600,824	829,903	3,274,314
Adjara	100,395	191,516	99,580	263,013	64,272	240,235
Samegrelo-Zemo Svaneti	49,811	66,355	70,202	97,057	60,527	80,467
Guria	9,681	21,181	8,053	5,838	7,971	6,640
Imereti	53,822	86,416	86,688	145,968	65,780	136,993
Racha-Lechkhumi, K. Svaneti	1,332	238	909	204	617	177
Shida Kartli	35,257	27,683	48,475	45,233	38,890	36,088
Mzkheta-Mtianeti	2,461	182	1,597	252	1,103	36
Kakheti	30,959	43,037	33,095	32,377	28,919	29,351
Kvemo Kartli	41,239	44,000	48,800	63,489	32,908	51,865
Samtskhe-Javakheti	20,892	21,073	20,235	34,050	14,259	24,218

Source: Geostat, 2010.

The fall in bank lending has particularly affected Samegrelo-ZemoSvaneti, Racha-Lechkhumi, Kvemo Kartli where firms are less capitalized and are typically characterized by shorter term borrowing. The loans of commercial banks are unequally distributed among regions, with major share of the loans falling on Tbilisi and the minor share on Samtskhe-Javakheti, Racha-Lechkumi and Guria.

Cheap Loans

Although there is no Credit Guarantee Agency operating on the basis of public funds to satisfy the needs of regional SMEs for investment, export development or leasing, some funds have been allocated over the recent three years for mentioned purposes. State program of "Cheap Credit" has allocated GEL 60 million in 2007 and GEL 20 million in 2008 for debt financing of SMEs involved in tourism, agriculture, etc. So far these are the government funded subsidized loan schemes and guarantee funds programs being extended to SMEs in recent years. These funds were distributed unequally (36 percent of the total sum was issued to SMEs in Kakheti region).

Transit, Transport, Road Infrastructure

Georgia has emerged as a strategic transit corridor for pipelines carrying Caspian oil and natural gas to world markets over the period of recent two decades. Transit function of energy resources brought certain amount of revenue in transit fees, but main consequence for Georgia is that transit function helped establish itself as a guarantor of international energy supply security.

Table 12. Turnover in Transport and Communication by Regions (GEL million)

Year	Tbilisi	Adjara	Guria	Imereti	Kakheti	Mtskheta -Mtianeti	Racha-Lechkhumi	Samegrelo-Z. Svaneti	Samtskhe-Javaketi	Kvemo Kartli	Shida Kartli
2000	366.9	127.7	0.6	36.8	3.7	1.5	0.3	71.8	1.0	6.3	22.7
2007	2335.4	158.5	1.3	14.1	4.2	6.4	0.2	220.9	3.2	19.5	2.7
2008	2585.9	131.1	0.4	16.6	4.0	1.1	0.3	239.3	3.5	19.7	2.8
2009	2858.1	127.3	0.9	9.6	0.5	0.9	0.2	287.7	1.9	26.8	1.3

Source: Geostat, 2010.

The Government of Georgia declared its following priorities in the infrastructure sector: East-West Highway from extreme eastern border (Red Bridge) to the Poti port and the Turkish Border, and the rehabilitation of selected sections of secondary and local roads. The government has committed itself to increasing funding of the road sector to stimulate the economy in a long term through improved road infrastructure and connectivity and through short-term job creation.

According to the 2009 Report of Activity of the Ministry of Regional Development and Infrastructure of Georgia, GEL 416 million were spent on road works, structured as follow: GEL 236.4 million on Road maintenance (on 680 km), GEL 169 million on Highway construction (on 48 km), GEL 108 million on existing bridges reconstruction, and GEL 10 million on New bridges building. In 2010 Georgian government allocated GEL 696.6 million for Roads Work. The modern highway crossing the country is expected to become operational from 2012. Donors' commitment remains strong to economic growth in view of the large export of transit services.

Table 13. Donors' Funding for Roads

Donor and Project Title (In USD million)	October 2008 - March 2009	March 2009 - March 2010
WB additional financing for Second East-West Highway Project (Igoeti-Sveneti, ***Shida Kartli***)	20	-

WB - Additional Financing for Secondary and Local Roads	70	-
WB- Third East-West Highway Project (Sveneti-Ruisi, ***Shida Kartli***)	-	147
WB- ***Kakheti*** Regional Roads Upgrading Project	-	30
WB- Additional Financing for the First East-West Highway Improvement Project (Rikoti Tunnel, ***Shida Kartli-Imereti***)	-	28
MCC- Javakheti Road Rehabilitation Project Additional Financing	60	-
ADB - ***Adjara*** By-Pass Roads	-	119
JICA - Rehabilitation of the Zestaponi-Kutaisi-Samtredia Section of East-West Highway (***Imereti***)	-	197
TOTAL = USD 671 million	150	521

Source: World Bank.

It must be noted that while the rehabilitation and development of the central infrastructure is the top priority of the Government of Georgia, local infrastructure objects are in bad condition and in some self-governing entities they cannot be applied for providing quality services. Self-governing entities lack the funds needed to rehabilitate the electricity, road and natural gas supply infrastructure. The poor condition of the infrastructure in the regions seems to be most acute problems increasing the level of poverty and invoking economic and social problems of the population. 55 percent of village roads, for example, have no concrete surface whilst approximately 50 percent of asphalted roads are in bad or very bad repair which results in an increase of expenses for the people using these roads.[3]

Fiscal Policy

It can be said that at the current stage the legislative framework for the municipal financial governance is created and It is in full compliance with the European Charter of Local Self-Government. Management of the regional financial system consists of several elements applied in the process of financing of the regional economic and social development.

Budgetary system

The share of local budgets in the consolidated budget of Georgia is the main indicator of decentralization. The process of formation of local budget is centralized and is mainly based on the transfers received from the center.

Table 14. Share of budgets of various levels in the consolidated budget

Year	2007		2008		2009	
	GEL million	Per cent	GEL million	Per cent	GEL million	Per cent
Consolidated Budget	6,421	100	6,846	100	7,502	100
State Budget	5,237	82	5,463	80	6,274	84

[3] Regional Development In Georgia, Diagnostic Report, Tbilisi, 2009.

Local Budgets	1,184	18	1,383	20	1,228	16

Source: Ministry of Finance of Georgia

Transfers

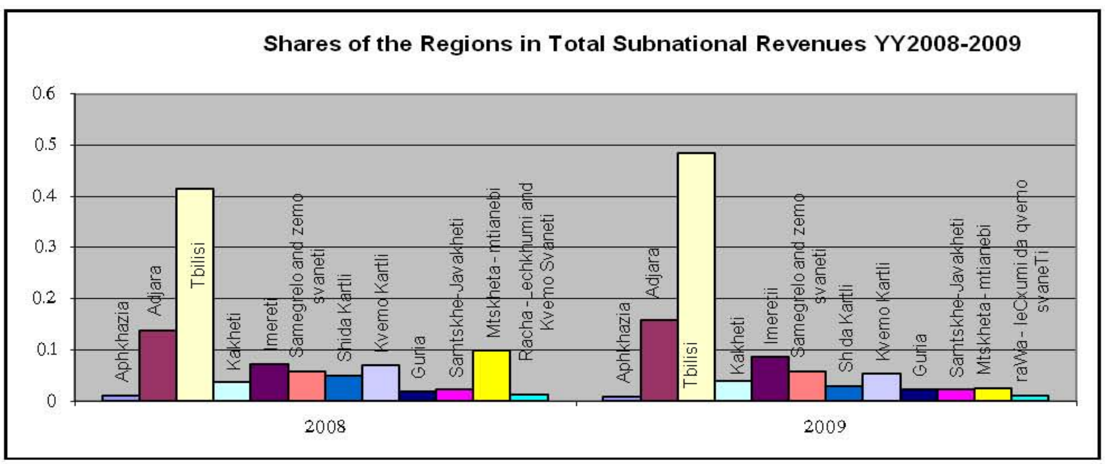
The main sources of the revenues for local budgets are the transfers from central budget. More than a half of inflows in the regional budgets come in kind of subventions from the central budget. The central budget allocates to the budgets of local self-government units three kind of transfers:

- The equalization transfer – for performance of exclusive powers;
- Purposeful transfer – for performance of delegated powers;
- Special transfer financial resources other than equalization and purposeful transfers, directed from one budget to another.

In 2009, the transfers in local budgets revenues amounted to GEL 843.0 million (68.7% in total revenue), the increase highlights the high dependence of local budgets on the intergovernmental grants.

The share of regions in the consolidated budgetary revenues is characterized by inequality. The larger share in the revenues of budget belongs to Tbilisi and Adjara.

Chart 2. Shares of the Regions in Total Subnational Revenues (2008-09)



Source: Ministry of Finance of Georgia

Subsidies

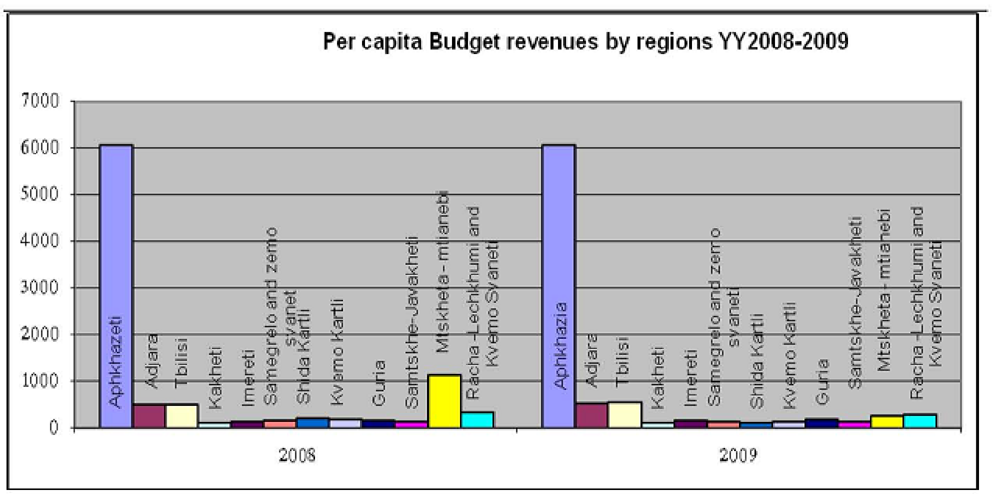
The leading role in the financing of regional development is attributed to the subsidies allocated from the state budget. During the recent years the amount of financial subsidies for regions has been growing because of channeling of the part of income tax revenues (which 2008 should be transferred to local budgets) to the state budget. As a result the own revenues of local budgets have decreased.

The amount of *program-based subsidies* from the central budget in formation of regional finances is gradually increasing. The direct state investments are supplied to regions from the ministries, departments, reserve funds of the President of Georgia and Georgian Government, from the fund for implementation of projects in regions as well as the sources of financing received from abroad (loans, grants), including the municipal development fund, Millennium Challenge for Georgia Program.

Borrowing, equalization

Self-governance bodies have been facing problems in exercising the rights of financial management stipulated by law. Namely the rights of borrowing and equalization are vague and almost impossible to exercise by existing legal mechanisms. The European Charter of Local Self-Government (Article 9, item 8) provides that the national law shall regulate the rule of activity of local self-government authorities in the capital market for the purpose of *borrowing* for capital investments. The Georgian legislation doesn't contradict the mentioned norm. However, the right of borrowing is delegated to local authorities in a way that cannot be exercised in practice. There is no legal document specifying the procedures of implementation of mentioned norm hence making its implementation impossible. So far not a single case of successful implementation of the borrowing rights and no case of issuing of any local bonds are known.

Chart 3. Budget Revenues Per Capita by Regions (GEL, 2008-09)



Here we see the horizontal misbalance. The revenues per capita are characterized by inequality according to regions. In 2009 the highest income per capita was recorded in Abkhazeti, Tbilisi and Adjara where per capita budget revenues were nearly 10 times as much as per capita income in the Regions of Kakheti, Samtkhe-javakheti and Shida and Kvemo Kartli Regions (Chart 6).

Although the Budget code of Georgia (in force from January 1, 2010) stipulated independence of the local budgets and the Local budget independence is also underpinned by the Organic Law on Local Self-Government which states that local budgets are independent from the state budget, these juridical norms are not ensuring the efficiency of financial governance at a municipality level. Because of channeling of total income tax revenues to the central budget, local budgets became more dependent on external sources, being mainly formed by the transfers received from the central budget. The local sources of revenues are just property tax and local charges channeled to the local budget which are in fact very small. In 2009, the property tax amounted to GEL 159,6 MM. (9 percent of total revenues), Tbilisi and Adjara respectively accounted 48 percent and 6 percent of total proceeds.

Foreign Financial Aid

Regional investment projects are implemented by sources and grants financed from abroad. International donor institutions (World Bank, UNDP, USAID, GTZ, Norvegian Council, Swiss Development Agency, et.) have been implementing the various projects in the socioeconomic sphere. The projects are accomplished either directly by donors or by Georgian Fund of Municipal Development (FMD). In 2009 the amount of assignments to regions from the FMD Projects reached GEL 166 million. The funds are allocated for such projects of regional development as: water supply rehabilitation, development of renewable energy, building of houses for refugees and development of infrastructure of other regions.

The important economic and infrastructure projects are financed in the framework of the US Government financed program — *Millennium Challenge for Georgia*: rehabilitation of Samtskhe-Javakheti roads, rehabilitation of energy infrastructure of regions, development of agribusiness. The program has also made long-term investments in agribusiness, tourism and food processing small and medium enterprises in regions. The overall investment portfolio of the program during recent four years was about USD 360 million.

Poverty Reduction and Employment in the Regions

Low Monthly revenues of households living in rural areas determine the high rate of Poverty and poor living conditions which are improving very slowly. Although poverty incidence diminishes over the recent years, It is still has significant influence on living conditions making most of agricultural areas as a place of poor living standards.

Table 15. Poverty level in Georgia(2007-09)

(in percent)	**2007**	**2008**	**2009**
With respect to 60 percent of the median consumption	21.3	22.1	21.0
With respect to 40 percent of the median consumption	9.2	9.5	8.8

Source: Geostat 2010

Subsistence minimum in Georgia was well below the average income in 2009 for both average consumers and households while it was above the income of average consumer in 2004. In 2007 the incidence of poverty in Georgia was 23.6 percent, while the indicator of extreme poverty was 9.3 percent[4]. Yet, poverty remains a major issue in the rural areas of Georgia.

Despite the high economic growth indicators in a pre-war period, there were no tendencies for the reduction of poverty in Georgia. In 2005-2007, the average rate of real GDP growth was 10.5 percent although the poverty level remained practically unchanged. The World Bank estimated that around 30 percent of the total population was living with less than USD 2 a day in 2005 and as much as 54.5 percent of the population was living at national poverty line in 2003 (17.1 percent even under the extreme poverty line). In H1 the poverty line equaled the subsistence minimum.

Table 16. Poverty Indicators in Georgia

	2000	2009

[4] Georgia Poverty Assessment, 2009.

Poverty gap at USD2 PPP (percent of population)	8.2	10.9*
Poverty headcount ratio at poverty line (percent of population)	52.1**	54.5**

Source: Statistical Office of Georgia
*In 2005
** In 2002 and 2003 respectively

Poverty is an especially acute problem in rural areas wherein more than 55 percent of the country's poor population resides. All indices of poverty are higher in villages than in towns, besides, contrary to urban areas, rural poverty is intensifying. Deficiency in economic resources for agricultural development is a major accelerator factor of poverty. Limited land resources are connected with the risk of becoming poor in rural areas with 55.2 percent and 35.4 percent of the incomes of individuals in the poorest first and second quintiles comprised of social assistance[5]. 36 percent of the poor population in rural areas is unable to cultivate agricultural land and 52 percent of them do not have livestock which endangers the diversification of their income. Within these circumstances, social transfers, mainly in the form of pensions, represent the main source of income for the poor population residing in the rural areas.

Table 17. Distribution of Average Monthly Incomes Per Capita by Urban and Rural Areas

	2006		2007		2008	
	Urban	Rural	Urban	Rural	Urban	Rural
Cash and non-cash inflows, total	105.6	99.9	124.9	105.1	165.4	127.7

Source: Geostat, 2010

The regional incidence of poverty is diverse, with three regions having a poverty rate above 40 percent (Table..). Shida Kartli, Kakheti and Mtskheta-Mtianeti are the regions with the highest poverty rates. Shida Kartli region had the largest number of poor people before August 2008 war (18.9%). Since both regions with high poverty rate – Shida Kartli and Mtskheta-Mtianeti were affected by the war much worse than other regions, it is expected that the poverty incidence has even augmented compared to pre-war levels. Tbilisi, the capital, has the lowest poverty rate (half the national rate), but it remains home to one of the largest groups of poor people in the country (15.6%).

Table 18. Poverty by Regions (2007)

Total poverty	Poverty headcount rate	Distribution of poor	Distribution of population
	2007	2007	2007
Kakheti	46.3	15.7	8.0
Tbilisi	12.9	15.6	28.5
Shida Karlti	59.4	18.9	7.5
Kvemo Kartli	17.3	7.6	10.4
Samtskhe-Javakheti	18.1	3.3	4.3
Adjara	27.4	9.5	8.2

[5] Regional Development in Georgia, Diagnostic Report, Tbilisi, 2009.

Guria	33.2	5.3	3.8
Samegrelo	14.4	5.7	9.3
Imereti	19.1	14.1	17.5
Mtskheta-Mtianeti	40.6	4.2	2.5

Source: World Bank, 2008.

The lower level of poverty in urban areas is conditioned by high salaried jobs and non-agricultural self-employment activities which is particularly evident in Tbilisi and Imereti regions, though there is a tendency that such activities are gradually decreasing.

Employment is a major issue in Georgia. Following the crises, unemployment rate reached 16.4 percent in 2009. In order to answer the problem, the government tried to minimise jobs in the informal sector and promote job creation in the formal sector by adopting a new Labour Code in 2006 (in compliance with ILO's standards). However, the economic crisis and August 2008 war put an end to GDP growth, and therefore to employment patterns.

Table 19. Unemployement Rate in Georgia (percent)

	2000	2009
Unemployment	10.3	16.4

Sources: IMF and Statistical Office of Georgia

In 2009, the number of unemployed amounted to 335.6 thousand persons[6]. Unemployment in urban areas accounts for 75.3 percent of the country's total unemployment. Tbilisi, Adjara and Shida Kartli are especially distinguished by their unemployment growth rates. About 30 percent of the total unemployment is in Tbilisi and is followed by the Adjara (22.1 percent) and Imereti Regions (12.8 percent). A reduction in the number of unemployed persons in 2005-2008 was observed only in Kvemo Kartli and Guria.

Table 20. Distribution of Population Age of 15 and Older by Economic Status and Regions (2009, percent)

	Kakheti	Tbilisi	Shida kartli	Kvemo Kartli	Adjara	Samegrelo -Z. Svaneti	Imereti	The remaining regions[7]	Georgia
Unemployment rate (percent)	11.0	29.6	16.6	10.7	22.1	13.1	13.2	8.3	16.9
Employment rate (percent)	62.7	37.5	51.6	58.1	50.4	59.5	57.8	67.0	52.9

Source: Geostat, 2010.

Regional Disparities in Georgia

[6] Geostat, 2010

[7] Samtskhe-Javakheti, Guria, Mtskheta-Mtianeti

The disparities are seen as a major impediment in the regional economic development in Georgia. One of the major indicators of the regions' performance in economic development is the volume of the FDIs. Up to present moment there is no statistical data available describing the regional distribution of FDI. Due to the mentioned reason we apply indirect method while carrying out regions' investment performance, namely investments in fixed assets in various sectors. Distribution of private investments in fixed assets according to regions is following:

Table 21. Investments in Fixed Assets in Industry in Regions (GEL million)

	Tbilisi	Adjara	Guria	Imereti	Kakheti	Mckheta -Mtianeti	Racha–Lechkh.	Samegrelo Z. Svaneti	Samtskh. Javakhei	Qvemo Kartli	Shida Kartli
2008	222.3	5.3	0.3	4.2	1.5	0.0	0.0	4.9	0.3	2.1	0.6
2009	247.6	2.2	0.1	3.6	2.2	0.0	0.0	1.3	0.8	1.2	1.4

Source: Geostat, 2010

Table 22. Investment in Fixed assets in Transport and Communication by Regions (GEL million)

	Tbilisi	Adjara	Guria	Imereti	Kakheti	Mtskheta-Mtianeti	Racha-Lechkhumi	Samegrelo-Z. Svaneti	Samtskhe-Javakheti	Kvemo Kartli	Shida Kartli
2007	853.6	22.7	-	0.9	0.1	1.2	0.3	14.0	0.1	2.8	0.3
2008	505.0	24.4	0.1	4.1	0.0	0.1	-	13.9	0.1	2.4	0.3
2009	896.5	17.5	0.0	0.8	0.0	0.0	_-	50.4	0.0	6.5	0.0

Source: Geostat, 2010

Table 23. Investments in Fixed Assets in hotels and Restaurants by Regions (GEL million)

	Tbilisi	Adjara	Guria	Imereti	Kakheti	Mtskheta-Mtianeti	Racha-Lechkhumi	Samegrelo -Z. Svaneti	Samtskhe-Javakheti	Kvemo Kartli	Shida Kartli
2007	64.3	3.9	0.5	0.2	-	11.6	0.1	0.1	0.2	0.1	0.1
2008	18.6	30.0	0.1	2.9	-	0.9	0.0	0.1	2.1	0.0	-
2009	130.3	9.8	0.1	0.0	0.1	0.2	-	0.7	0.2	0.0	0.3

Source: Geostat, 2010

Most of the investments in fixed assets of industry, transport, communications and tourism sectors are made in Tbilisi and Adjara. The disparities in investments are increasing in all given sectors hence making the capital increase process in other regions almost nonexistent.

Conclusions

As is clear from the foregoing, Georgia faces the regional development challenges. The dichotomy between urban and rural areas in Georgia is high: they are in fact much differentiated. The mountanious topography and small territory of the country imply that plain territories are far removed from mountainous area in economic development.

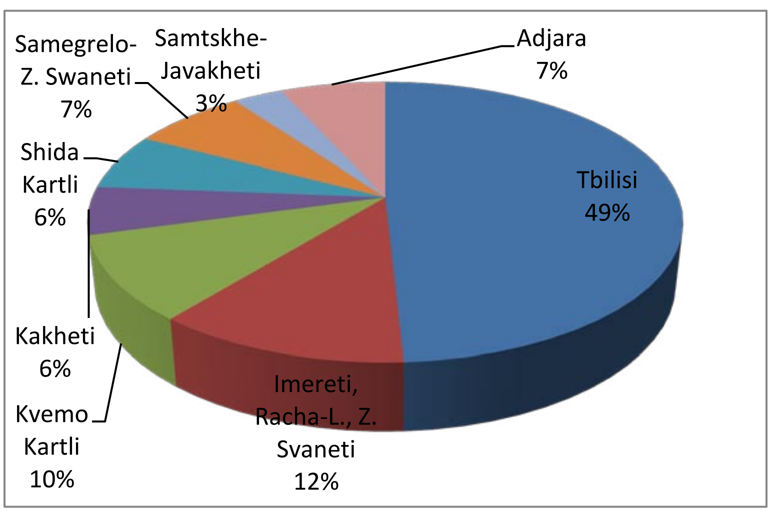
The impact of the crisis on regions in Georgia has been mixed. Every region has been affected by the August 2008 war and economic crisis in one way or another. The early phases of the crisis seem to have had the heaviest impacts on the regions neighbouring to conflict zone (Shida Kartli, Mtkheta-Mtianeti). It is difficult to make precise assessment of the crisis effects on the regional economic development in Georgia because of nonexistent regional and municipal economic data. However, the secondary data obtained in the research process makes possible to conclude that the regional economic development processes in Georgia faces an enormous difficulties. Growing disparities are observed in the regions' economic development. The influence of the "Twin Crisis" was particularly vulnerable for national economy. The August 2008 war gave birth to a downward trend in the economic sphere and speed down the progress that country made in a pre-war period. The regions neighbouring the conflict zone were affected severely by the military activities. Kodori (Abkhazeti), Shida Kartli and Mtskheta-Mtianeti regions were damaged in a worst manner.

Global financial crisis also deeply affected economic development processes in regions. Commercial banks' loan portfolios were reduced and access to financial resources become almost impossible for small enterprises in the regions.

Economic development in the regions has a significant spatial impact. There is growing regional differentiation between the leaders and laggards, with a number of factors including labour market difficulties (including high unemployment) and lagging GDP levels affecting poorer regions – often located in the mountainous periphery of Georgia.

Inequality between regions is significant. The contribution of individual regions to GDP creation in 2009 was also highly differentiated. Four regions (Tbilisi, Adjara, Imereti, Kvemo Kartli) contributed about 75 percent of Georgia's GDP. The bottom three regions (Guria, Racha-Lechkhumi and Samtskhe Javakheti) produce just less than 7 percent of country's GDP.

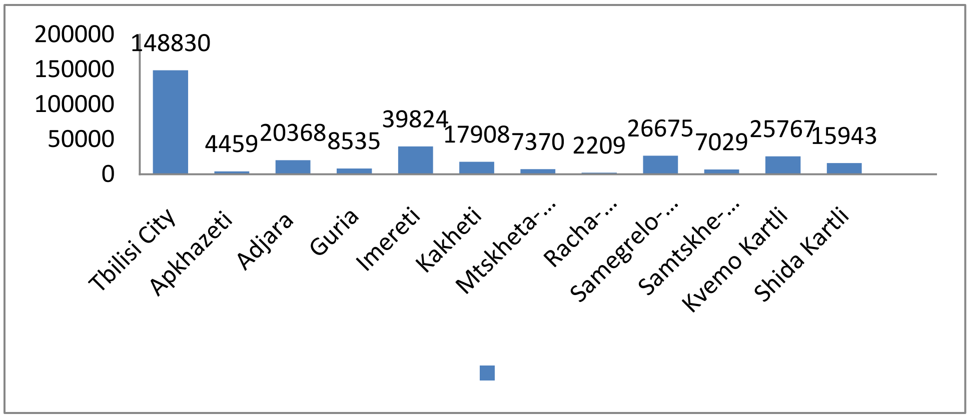
Chart 4. Distribution of Gross Value Added by Region (percent, 2008)



Source: Geostat, 2010.

Enterprises' competitiveness is considered as a most important factor of regional economic development which is also affected by the degree of concentration of the companies on the territory of a given region:

Chart 5. Number of Enterprises in the Regions (2009)



Source: Geostat, 2010.

Above presented chart gives clear evidences of the important disparities in geographical concentration of active enterprises across the regions: 45 percent of companies are registered in Tbilisi, whichi is dominant in economic terms in the country as a whole and is explicitly accepted as the engine of national economic growth.

This polarization in economic development caused problems in terms of stagnation in certain rural or peripheral areas. This in turn entails significant changes in regional differentiation of the economic development, particularly between potential "growth poles" (Tbilisi and Adjara) and stagnating regions (Guria, Racha-Lechkhumi).

The results of this study make possible to present the key negative factors having effects on the regional development process flow:

Legislative Factor

- At present there is *no special law on regional development* and the existing governance system is inefficient. Accordingly, two-layer system is applied in the country: central and municipal. Existing model disagrees with the regional development concept and makes impossible to build the competitive economies in the regions.

- There is *no established formal definition of the Region* that makes all related official documents inconsistent and obscure from the point of view of their mandate.

- Generally, strong *centralisation and poor deconcentration of power* is inherent in Georgian legislation and practice.

Institutional Factor

– Currently, the Central Government has overall responsibility for the development and implementation of regional policy, and proposing the budget allocation for regional policy for ratification by Parliament. Accordingly, *the role of Governor is very limited in the elaboration of regional socio-economic development strategies*, goals, instruments and tasks. They seldom rely on the support of donor institutions in preparing the regional development strategies.

- The present legislative basis makes the development and implementation of the plans defining the priorities and trends of the socio-economic development of the region rather vague.

- The sub-national institutional infrastructure is still largely inadequate for many economic development functions, and *regions are heavily reliant on central government intervention and administratio*n in so many aspects of regional and local development.

- Financial Governance System at regional level comprises of several main elements which are used to fulfill a funding function of the economic and social development in the regions. The existing model of financial governance doesn't allow carrying out regional economic development funding by the regional and local institutions. This authority is fully concentrated on the central level, where the discretionary decisions are taken in which capacities can be planned and applied financial management instruments: transfers, subsidies, equalization, etc. The only tax left under the discretion of the local governance - property tax is so small that no economic effect can be obtained by it.

- *The insignificant role and practice of local and regional authorities in developing regional investment projects and attracting foreign investments* substantially hinders the promotion and stimulation of economic processes in the regions of Georgia. Presently, these *sub-national administrations possess neither the necessary resources nor a well-formulated non-ambiguous legal mandate for the implementation of the abovementioned activities*. The qualifications of the public servants at local levels are not sufficient to ensure the attraction of the international financial flows and provoke the interest of foreign investors by the business opportunities in the regions. *Increasing direct foreign investments into the local economy represents one of the most important factors for regional economic growth.*

- Georgian National Investment Agency (GNIA) doesn't have any branches in the regions and the sphere of its competencies does not give an opportunity to perform a proactive role in attracting foreign investments and innovative projects at the regional level. As an evidence of its ineffectiveness could be given the example that for the time being the *agency does not maintain the statistics of the foreign investments in regions*. *Neither is collected the statistical data on the municipal level.*

- *Existing Model of the Investment Policy is not favourable for the purposes of regional economic development.* GNIA has the mandate to work exclusively for the country's investment attractiveness. The theme of the regional economy's Investment Promotion is almost ignored. As a result, there is a very low level of investment activities and lack of investment flows in the regions. Regional economies are stagnating due to shortage in investment flows (except for Adjara): companies operating in Agricultural, industrial, service and other sectors have not been modernizing their technologies which are almost amortized hence being unproductive.

- Lack of *cluster-based* development formal initiatives. At this stage, the possibility of cluster development as the instrument for the successful introduction of an innovation system and the use of competitive advantages of the regions is only being considered at the level of a few private organisations.

- Ignorance of *a regional innovation system,* as a new model of regional development. The issue of regional innovation systems has only recently become pressing in Georgia; so far it has been deliberated at the level of few nongovernmental organizations and the innovation component was not taken into consideration in the course of developing and implementing regional policy. Despite the fact that the State Universities have been functioning almost in all regions, for the time being there is no communication between investors, knowledge institutions, business entities, research & development organizations and innovation brokers.

- *Weak role of financial institutions in supporting small businesses and innovative activities***.** One of the major obstacles to innovations development appears to be the gap between the existing demand for new technologies and innovations from entrepreneurs and the lack of financing of this demand. Currently, the Georgian banking sector does not seem ready to significantly contribute to the development of innovation oriented entrepreneurship and small business in the regions.

Recommendations

In order to promote the regional economic development at present stage, it is recommended to focus attention on the following spheres:

Legislation

- *Adoption of Law on Regional Development* would encourage the process of the elaboration and implementation of the regional strategic development plans.

- The law should clearly *define the status of a region,* as of functional - planning unit. It is also recommended that Tbilisi and the Autonomous Republics to be considered as a region.

- Consequently, it is recommended that *the law on regional development determine the function and powers of the Governor*.

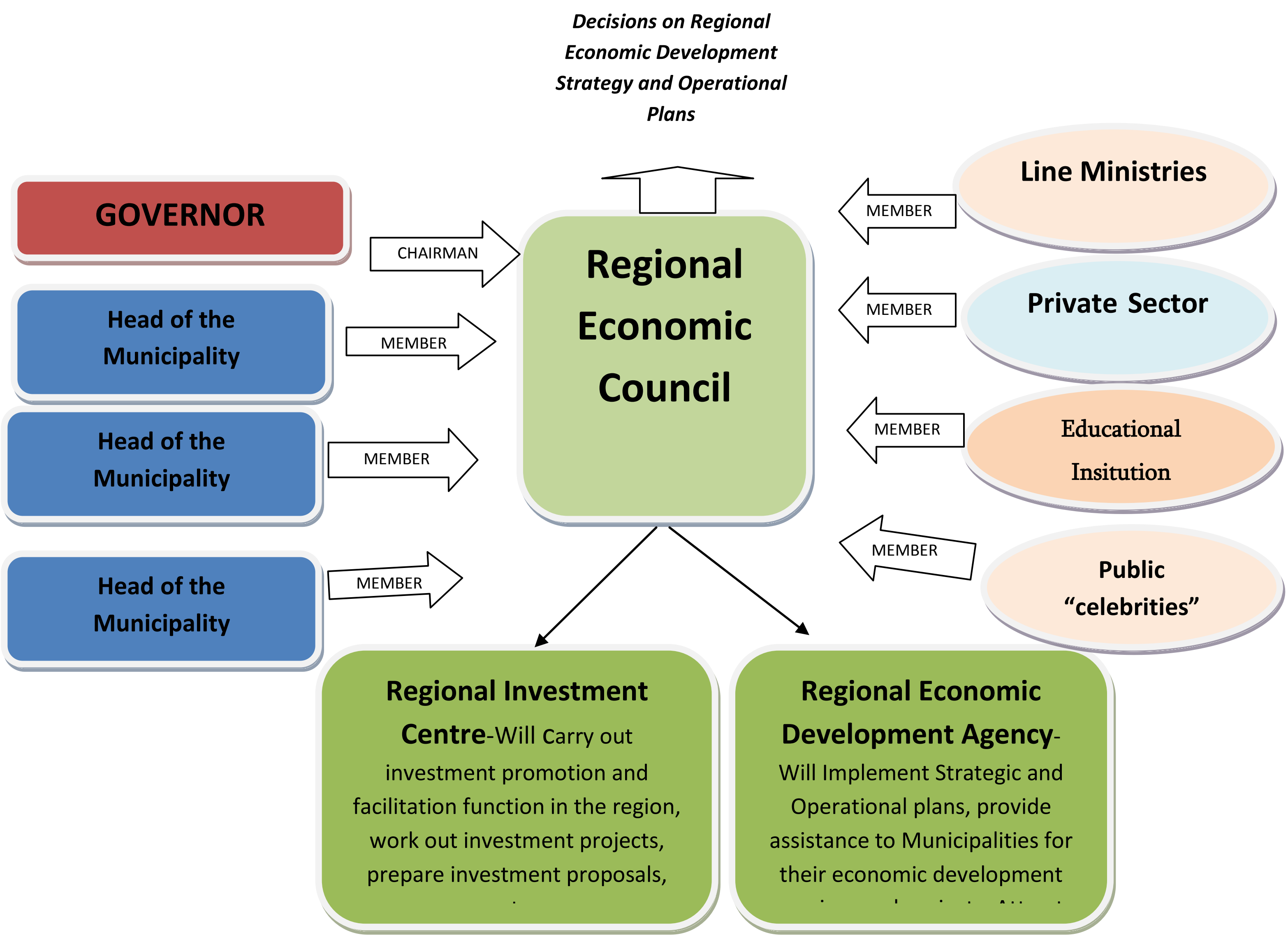
Institutional Needs and Challenges

- In order to improve the management practice of the regional economic development, it is necessary to *change the institutional model for policy development and implementation*. The present model is highly centralized and less fits to the regional specificity. It is needed that procedures of the elaboration and planning of economic policy directly correspond to the regional structures and address all challenges of the regional developments.

- The ability to deal with the above challenges depends *on resolving the question of an 'intermediate tier' of governance.* With weak municipalities, the creation of a regional tier is an urgent issue to enable the decentralisation of government administration through deconcentration to the State offices of central government or devolution to regional authorities.

Regional Development Council – According to the Organic Law on Local Self-Government, communication with the local population is ensured by the governor, but there is no legal requirement for establishing consultative bodies which would encourage public participation in the decision-making process. *Regional Development Council (RDC)* will fill out the existing gap in decision making process when elaborating the main economic priorities and strategic development plan of the region. Many different public and social representatives will be involved in regional development policy through the RDC. The public members are to be representatives of the following institutions: Governor, Heads of municipalities, line ministries. The social actors will be: private sector, NGOs, Trade Unions, region-based high educational institutions. This type of membership model will bring to RDC higher degree of trust and cooperation from the side of population.

Diagram 1. Institutional Frame for Regional Economic Development.



The RDC is expected to define elaborate regional economic development strategy and add value to economic policy implemented by central government. Establishment of the RDC will help to generate enough competencies when dealing with the economic problems at a regional level. RDC has to provide a forum for integrated approach to economic policy delivery in which all possible instruments are combined to ensure maximum effectiveness of the model.

- *Regional Economic Development Agency (REDA*) – the agency will develop and implement the programs that are approved by the Regional Development Council. REDA's function also implies to provide assistance to municipalities in elaboration and implementation of the municipal economic development programs and projects.

- *Regional Investment Center (RIC)* – the center will perform a function of attraction of foreign investments, encouragement of regional investment strategy preparation and implementation of regional investment projects, search for potential foreign investors.

Policy Instruments

- Georgia has to transform the strategic approach of its extremely centralized policy *to a place-based policy* by focusing more on the *competitiveness of regions*. This will be resulted in different policy and investment priorities. This is an important model, implying the best conditions for strong regions in Georgia to exploit their comparative advantages on a global scale, while at the same time, benefiting weaker regions through functional links with the stronger regions.

- *Regional economic development strategies* – each region has to design and develop a clear regional economic strategy, identifying areas for particular attention. Regional economic strategy has to correct the errors of free market economy, expressed in wrong spatial consequences and disparities.

- *Operational structures*: Regional Development Agency (RDA) and the Regional Investment Centres (RIC) are operational structures. They have to be employed with the aim to deliver the economic development policy and coordinate the intervention measures of the local, regional and central governments.

- *Actions*: Operational structures in cooperation with the municipal departments of economic profile have been carrying out the functions stimulating the economic growth. Namely, they provide assistance to improve the company competitiveness and exports, stimulate creation of new businesses and their retention, attracting foreign investments, improving skills and knowledge, etc.

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