

Georgian Dream Meets Reality:

The Coalition's First Term and Future Reform Prospects

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Executive Summary

Concluding its first four years in power, the Georgian Dream coalition government has reformed and changed many aspects of Georgia's public life. The coalition has not only continued along the path toward reforms initiated by Mikheil Saakashvili's team, but has successfully furthered the fight against corruption, furthered initiatives in the healthcare, education and justice sectors, overhauled the tax and welfare systems, and amended the labor code. This has made healthcare more accessible to the average citizen, rendered the tax system more attractive for entrepreneurship and the welfare system more just, enabled the school system to better meet the needs of employers, and improved the protection of workers' rights. In addition, an Association Agreement was signed and a free-trade area with the European Union established, further integrating Georgia with the West.

As a result of these efforts, since 2012 Georgia has enjoyed stable and increasingly inclusive economic growth, and seen a substantial decrease in the poverty rate. Since 2014, foreign direct investment continued to flow into the country, making Georgia an attractive regional hub for foreign capital.

Georgia is on track to overcome its Soviet past and prosper. It is now, therefore, crucial that the U.S. and the EU ensure that Tbilisi maintains the momentum of the reforms. Despite its success to date, the prospects for further Georgian progress are still fragile, and much depends on continued foreign assistance. The U.S. Government should contribute to ensuring that the achievements of Georgia's past four years become a stable and integral part of Georgian society. In particular, the U.S. Government should:

- Pursue a free trade agreement between the U.S. and Georgia
- Support more academic exchanges and legislative visits
- Promote visa liberalization with Western countries
- Assist Georgia in reaching out to occupied Abkhazia and South Ossetia
- Further support the fight against corruption
- Support English language education
- Combat the influence of anti-Western voices and Russian anti-Western propaganda in Georgia
- Further invest in Georgian NGOs and training for Georgian journalists
- Increase funding for the Overseas Private Investment Corporation (OPIC) to facilitate U.S. foreign direct investment (FDI) in Georgia
- Support the independent business dispute resolution system

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Introduction

The Georgian Dream coalition decisively won the 2012 parliamentary election in Georgia and, in October 2016; will conclude its first four-year term in power. The coalition, launched by charismatic billionaire and philanthropist Bidzina Ivanishvili, gained popularity amidst the crises of security and confidence that marked the concluding years of President Mikheil Saakashvili's administration (2003–2013). Despite a number of successful reforms that were implemented under Saakashvili, by 2012 the country was in a precarious situation, with an economy that was failing to address high poverty and unemployment rates and a restive civil society complaining about the regime's heavy-handed tactics. Georgia possessed an improved but still underdeveloped infrastructure, an unaffordable healthcare system, and an obsolete education system. The country was—and still is—suffering from two unresolved military conflicts and Russian occupation. It is also located in a volatile region in which centuries-old ethnic conflicts still smolder.

This report maps the progress of the government of Georgia in the last four years and formulates recommendations for how the U.S. Government can assist Georgia in becoming a modern democratic country with a vibrant economy and stable political institutions.

Background: the 2012 elections and the overall Georgian Dream strategy

In October 2012, Georgia saw its first peaceful democratic transition of power since its modern independence. The ruling United National Movement (UNM), led by then-President Mikheil Saakashvili, lost the elections to the newly formed Georgia Dream coalition led by the billionaire and philanthropist Bidzina Ivanishvili. This happened despite various attempts by the UNM to derail Ivanishvili's efforts by stripping him of his Georgian citizenship and passing a law that de facto prohibited his financing of the Georgian Dream coalition.

The grounds for the reforms carried out by Georgian Dream in 2012–2016 were laid in part by Saakashvili and his team during the previous decade. UNM substantially lowered the rampant level of corruption in most spheres of public life, simplified regulations, reformed the law enforcement agencies, and the educational, and healthcare systems as well as the military. However, in 2012, problems still persisted. The UNM government failed to provide adequate employment or reduce the widespread poverty and vast income inequalities. In other words, the UNM fell short of sufficiently impressing the population with its reforms to re-elect it smoothly for a third term. Instead, the discontent with President Saakashvili and the UNM eventually grew into street protests in several cities in Georgia, with protesters demanding Saakashvili's resignation.

In 2013, when the Georgian Dream was in power but Saakashvili was still president, popular discontent culminated with protesters physically stopping Saakashvili from delivering his state of the presidential address to the nation in the National Library—after he failed to do so in Parliament.¹

¹ "Protesters in Georgia harry Saakashvili over speech," *BBC News*, February 8, 2013, <http://www.bbc.com/news/world-europe-21385546> (accessed September 10, 2016).

The Georgian Dream, led by Ivanishvili, took advantage of the rising discontent with Saakashvili and won the 2012 election. To his credit, President Saakashvili and his team peacefully handed power over to the opposition, an unprecedented move in the country since its independence in 1991. However, the state of the country that the Georgian Dream inherited was far from ideal, and much needed to be done. Reforms were overdue in a whole range of sectors, especially healthcare, education, and infrastructure.

As the first term of the Georgian Dream Cabinet is coming to an end, the coalition has achieved progress in a wide range of areas. It started reforms in the education sector, overhauled the healthcare system, adjusted taxes to boost investments, and improved the welfare system. The Cabinet's efforts are reflected in improved rankings in a number of international indexes, as will be demonstrated below.

In 2014, the Georgian government adopted the Social-economic Development Strategy of Georgia, also known as Georgia 2020.² The strategy is the primary guiding document for the country's reforms in economic and social affairs. The strategy is centered on three main pillars:

- (1) Competitiveness of the private sector
- (2) Development of human capital
- (3) Access to finance

Under the competitiveness pillar, the government seeks to ensure the transparency of public administration, provide equal opportunities in terms of starting and doing business, and protect property rights. It strives to create an attractive and stable tax environment for the private sector, develop entrepreneurial skills to boost startups and small businesses, strengthen mechanisms for the efficient resolution of commercial disputes, enhance investment legislation, improve the conditions for free market competition, amend bankruptcy regulations, and enhance the transparency of public administration.

Under the second pillar, the government aims to improve the general education system, develop better vocational training programs, further improve the accessibility of healthcare, and lower poverty through better-funded and better-targeted social assistance programs.

Under the third pillar, the government wants to improve fiscal consolidation, introduce deposit insurance for retail banking, establish a mandatory pension saving scheme, and gradually de-dollarize the financial system.

The strategy contains a set of particular milestones for 2017 and targets for 2020. Some of these milestones have already been or are likely to be reached. For instance, Georgia has already almost reached the target rate of total investments of 30 percent of the GDP (28.5 percent in

² "Social-economic Development Strategy of Georgia "GEORGIA 2020"," *Asian Development Bank*, 2014, <https://www.adb.org/sites/default/files/linked-documents/cps-geo-2014-2018-sd-01.pdf> (accessed September 10, 2016).

2015)³ and an unemployment rate of 12 percent or less (although this is only the official statistic that also counts land parcel owners as “employed” even if they do not generate any income from those parcels, as discussed later in this paper). On the other hand, the Doing Business rank in electricity coverage of 45 is unlikely to be reached next year (62nd place in 2016), but the effort to expand electricity production from hydro and natural gas is on its way.

Another significant milestone was the conclusion of the Association Agreement with the European Union (AA), signed on June 27, 2014, which also includes the creation of a Deep and Comprehensive Free Trade Area (DCFTA). The AA entered into force on July 1, 2016. In this document, the EU provides Georgia with unequivocal recognition of its territorial integrity and offers cooperation in security and other spheres; on the other hand, Georgia is required to conduct a series of reforms aimed at improving its market. Thus, falling behind on the reforms might put Georgia’s security at risk and leave it more under the influence of Russia, which has already waged two wars with Georgia and continues to occupy around 20 percent of its territory. Moreover, unlike other free trade agreements, the AA aims to harmonize Georgian national legislation with EU law, which will facilitate mutual economic integration and improve Georgia’s attractiveness to investors. The AA is a motivation for Georgia to continue pursuing its reforms and is a political guarantee to the EU that Tbilisi will continue to do so. A Free Trade Area will motivate Georgia to increase added value for its good services and become more competitive in the EU market.

Economic and business development: Prospects look encouraging

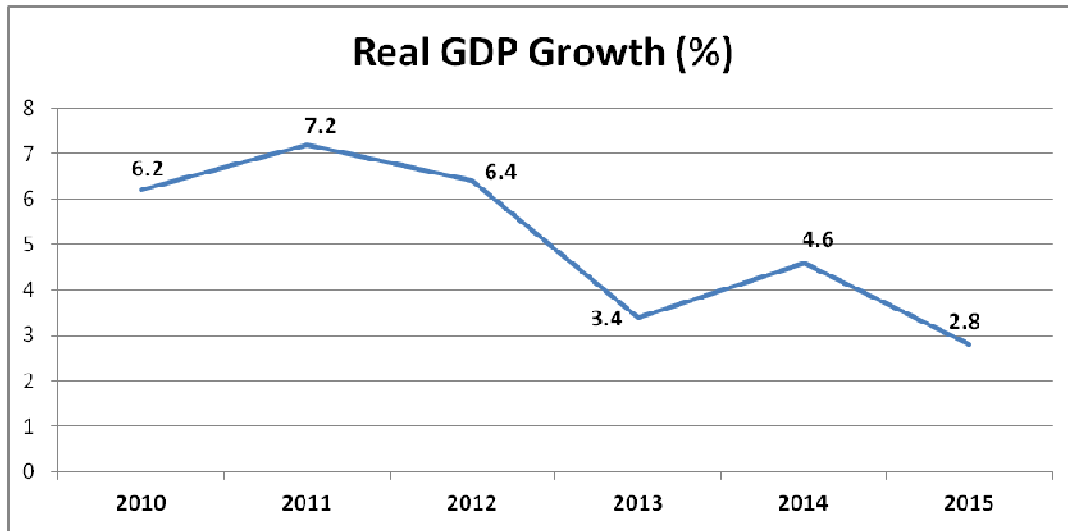
Overall economic progress

Georgia’s GDP growth since 2012 has been lower than during the last years under the UNM rule. This decrease can be explained in part by the drop in GDP in Russia and the former Soviet area between 2014 and 2016 due to the war in Ukraine and weak energy prices. In fact, Georgia is a growth leader in the region of shrinking economies.⁴ In 2013, the GDP grew 3.4 percent as opposed to 6.4 percent in 2012.⁵ In 2014 and 2015, the economy grew 4.6 and 2.8 percent, respectively. The International Monetary Fund expects Georgia’s growth to accelerate in the coming years and reach 4.5 and 5.0 percent in 2017 and 2018, respectively.

³ “Gross fixed capital formation (% of GDP),” *The World Bank*, <http://api.worldbank.org/v2/en/indicator/NE.GDI.FTOT.ZS?downloadformat=excel> (accessed September 10, 2016).

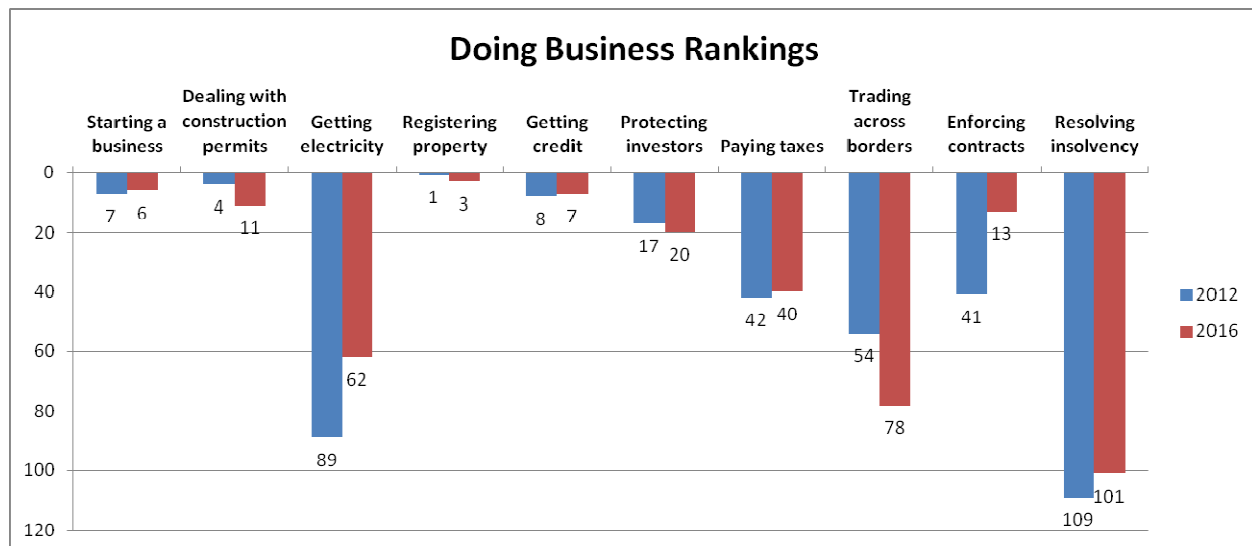
⁴ “Economic Snapshot for the CIS Countries,” *Focus Economics*, September 7, 2016, <http://www.focus-economics.com/regions/cis-countries> (accessed September 20, 2016).

⁵ “Gross Domestic Product (GDP),” *National Statistics Office of Georgia*, http://geostat.ge/index.php?action=page&p_id=119&lang=eng (accessed September 10, 2016).



Source: National Statistics Office of Georgia (GeoStat)

Despite the lower economic growth than in the several preceding years, the Georgian Dream-led Cabinet has continued to build a free economy. Whereas the 2012 Doing Business report ranked Georgia 16th,⁶ its 2016 edition moved Georgia 8 positions down to 24th.⁷ The country fell in trading across borders (down from 54th to 78th) and dealing with construction permits (down from 4th to 11th), despite undertaking reforms in this area. On the other hand, it moved up significantly in enforcing contracts, from 41st to 13th—a noticeable improvement.

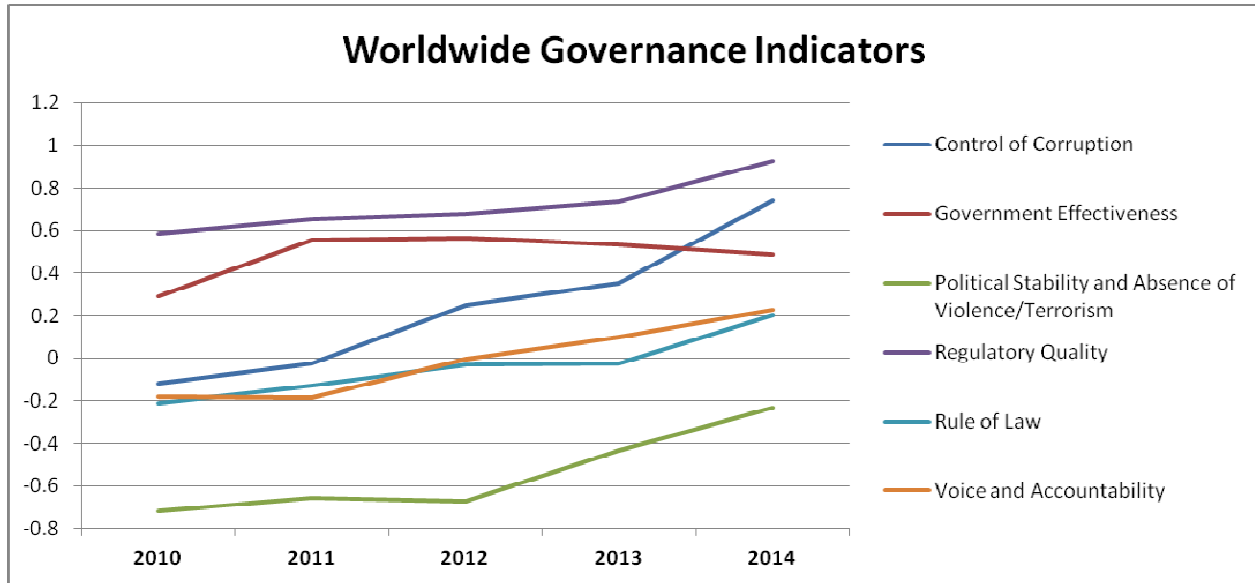


Source: The World Bank

⁶ “Doing Business 2012,” *The World Bank*, <http://www.doingbusiness.org/~media/FPDKM/Doing%20Business/Documents/Annual-Reports/English/DB12-FullReport.pdf>, p. 97 (accessed September 10, 2016).

⁷ “Doing Business 2016,” *The World Bank*, <http://www.doingbusiness.org/~media/GIAWB/Doing%20Business/Documents/Annual-Reports/English/DB16-Full-Report.pdf>, p. 203 (accessed September 10, 2016).

Georgia also achieved progress in 5 out of 6 Worldwide Governance Indicators (WGI) from 2012 to 2014 (latest data available), demonstrating the fruits of the government’s resolve.⁸ The most notable progress occurred in the indicators of control of corruption (increase by 0.49) and political stability (increase by 0.44). The only indicator in which Georgia worsened in the period is government effectiveness (decrease by 0.08).



Source: The World Bank

In the Index of Economic Freedom prepared by the Heritage Foundation, Georgia progressed from 34th place in 2012 to 23rd place in 2016. Similar to the WGI, Georgia demonstrated the biggest improvement in freedom from corruption (14-point increase), government spending (19.5-point increase), and investment freedom (10-point increase). Although some corruption, especially petty issues, was successfully fought under Saakashvili, disrespect for institutions and bad governance remained. It is slowly being tackled by the incumbent Georgian Dream government.

The government is also able to maintain a relatively low (by Western standards) public debt, at around 35 percent of the GDP (32.5 percent in 2012 and 41 percent in 2015).⁹ However, the overall external debt of the country (the public and private sector combined) amounted to 107.1 percent of the GDP at the end of 2015.¹⁰ The average import tariff rate of the country is 0.7 percent, making it an attractive place for investors with goals of exporting to other countries in the region as well as the EU.

⁸ “Worldwide Governance Indicators,” *The World Bank*, http://databank.worldbank.org/data/download/WGI_excel.zip (accessed September 10, 2016).

⁹ “Central government debt, total (% of GDP),” *The World Bank*, <http://api.worldbank.org/v2/en/indicator/GC.DOD.TOTL.GD.ZS?downloadformat=excel> (accessed September 10, 2016).

¹⁰ “Gross External Debt of Georgia,” *National Bank of Georgia*, June 30, 2016, <https://www.nbg.gov.ge/index.php?m=340&newsid=2897&lng=eng> (accessed September 10, 2016).

On the Global Competitiveness Index, Georgia moved up from 77th place in 2012–2013¹¹ to 66th place in 2015–2016.¹² The greatest progress occurred in the macroeconomic environment (the 3rd pillar, up by 0.6 points) and institutions category (the 1st pillar, up by 0.4 points).

Tax reforms

Since 2012, the government has improved the tax system and made it more business friendly. In May 2016, the Georgian Parliament approved a tax reform law to provide for the taxation of only distributed profits, as opposed to undistributed profits that will remain in the company or be reinvested.¹³ This rule will enter into force starting January 2017 as it might have been problematic to apply the new regulations in the middle of the tax year. However, the rule will apply to banks, insurance companies, microfinance institutions, and pawn brokerages starting in 2019. This measure is aimed at motivating entrepreneurs to reinvest their profits instead of using them for consumption, thereby increasing the overall investment level and economic growth in the country. The authorities estimate that the state budget will receive around 600 million lari less in 2017 as a result of the measure, but the budget losses in the subsequent years should be lower due to higher economic growth.

In 2013, 2014, and 2015, the government gradually increased excise taxes on alcohol and cigarettes. In December 2014, it increased the excise tax on a pack of filtered cigarettes from 0.15 to 0.90 lari and on unfiltered cigarettes from 0.20 to 0.25 lari.¹⁴ Similarly, the excise tax on beer increased from 0.40 to 0.60 lari per liter and was doubled on other alcoholic beverages. The law also introduced a 5 percent retail sales tax on tobacco products starting in July 2015. In November 2015, the government further increased the excise tax on a pack of filtered cigarettes from 0.90 to 1.10 lari and on unfiltered cigarettes to 0.30 lari, as of January 2016.¹⁵ The announced government intention behind the increased taxes on cigarettes was to lower the percentage of smokers in the population, which in 1999 (latest official data available) stood at 60 percent for men and 15 percent for women aged 40 to 65.¹⁶ Such measures will have beneficial fiscal and health outcomes.

In order to lower harmful emissions and improve traffic security, the government reformed the taxes on importing used cars.¹⁷ The tax decreased from 1.5 lari per ccm of engine capacity to 0.7

¹¹ “Global Competitiveness Report 2012–2013,” *World Economic Forum*, 2013, http://www3.weforum.org/docs/WEF_GlobalCompetitivenessReport_2012-13.pdf, p. 174 (accessed September 10, 2016).

¹² “Georgia,” *World Economic Forum*, 2016, <http://reports.weforum.org/global-competitiveness-report-2015-2016/economies/#indexId=GCI&economy=GEO> (accessed September 10, 2016).

¹³ “Parliament Adopts Corporate Income Tax Reform Bill,” *Civil Georgia*, May 14, 2016, <http://www.civil.ge/eng/article.php?id=29150> (accessed September 10, 2016).

¹⁴ “Tobacco, Alcohol Excise Tax Increase Endorsed,” *Civil Georgia*, December 12, 2014, <http://www.civil.ge/eng/article.php?id=27905> (accessed September 10, 2016).

¹⁵ “Tobacco, Alcohol Excise Tax Increase Planned,” *Civil Georgia*, November 25, 2015, <http://www.civil.ge/eng/article.php?id=28802> (accessed September 10, 2016).

¹⁶ “Georgia,” *World Health Organization*, <http://www.who.int/tobacco/media/en/Georgia.pdf> (accessed September 10, 2016).

¹⁷ “Interior Ministry Proposes Car Excise Tax Overhaul,” *Civil Georgia*, December 16, 2015, <http://civil.ge/eng/article.php?id=28857> (accessed September 10, 2016).

lari for cars that are two years old and 0.5 lari per ccm for 3- to 6-year-old cars; the tax increased for cars older than six years (up to 2.5 lari per ccm for cars that are 14 or more years old).

In 2013, the government introduced a tax-free threshold for personal income tax at the level of 500 lari per month, raising the level from the initial 300 lari per month.¹⁸ In 2015, the government decided to abolish the tax refund for minimum wage earners altogether.¹⁹

Foreign land ownership

Land ownership by foreigners remains inefficiently protected. Following public outcry resulting from massive agricultural land purchases by foreigners, in June 2013 the government introduced a temporary ban on land purchase by foreigners until December 2014, ostensibly motivated by concerns about economic security and environmental protection.²⁰ According to the opposition and some foreigners, the limitation could make the country less attractive to foreign direct investment (FDI). However, this temporary suspension was removed in June 2014 by the Constitutional Court of Georgia, which stated that such a ban was in violation of the country's constitutional right to property and inheritance.²¹

In December 2014, the government again restricted the foreign purchase of land; however, this time the restriction was more detailed in nature and better reflected the aim to fight speculative foreign investment in land, as opposed to land purchases by foreigners actually planning to use the acquired lands. In particular, the government restricted the foreign purchase of land to areas at least 5 km from the state border, to persons with experience in the agriculture sector or with a residence permit or investment license, and to sizes up to 100 hectares.

Foreign direct investment

The uncertainty around the foreign ownership of agricultural land seems not to have impacted the level of FDI in the country. According to official statistics, the amount of FDI reached \$1,758.4 million (or 10.7 percent of the GDP) in 2014 and \$1,246 million in 2015, compared to \$941.9 million (or 5.8 percent of the GDP) in 2013, thereby returning to 2006–2008 level of \$1–2 billion per year.²² This rate is equivalent to around \$339 per Georgian citizen in 2015, which is more than 10 times more than in Russia (around \$34 per person) and Armenia (around \$60 per

¹⁸ “Georgia Public Expenditure Review,” *The World Bank*, June 11, 2014, <http://documents.worldbank.org/curated/en/779561468275119198/text/781430GE0v10RE0Box0385291B00PUBLIC0.txt> (accessed September 10, 2016).

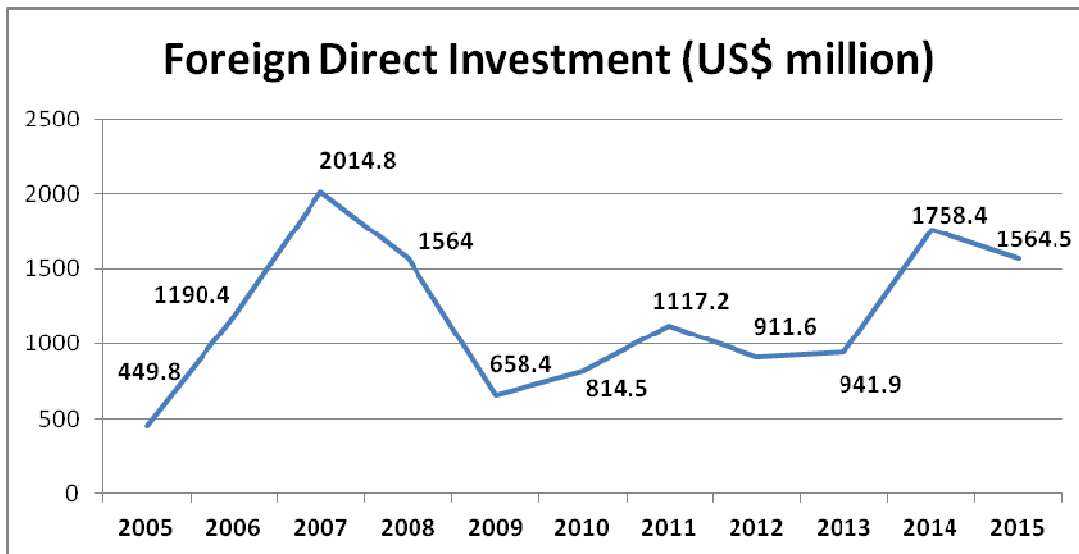
¹⁹ “Georgia: First Review under the Stand-By Arrangement and Request for Modification of a Performance Criterion,” *The International Monetary Fund*, January 2015, <https://www.imf.org/external/pubs/ft/scr/2015/cr1517.pdf>, p. 8 (accessed September 10, 2016).

²⁰ “Gov’t sets new land registration rules for foreigners,” *Agenda.Ge*, September 19, 2014, <http://agenda.ge/news/21344/eng> (accessed September 10, 2016).

²¹ “Court cancels ban on selling agriculture land to foreigners,” *Agenda.Ge*, June 24, 2014, <http://agenda.ge/news/16598/eng> (accessed September 10, 2016).

²² “Foreign Direct Investments,” *National Statistics Office of Georgia*, http://geostat.ge/index.php?action=page&p_id=2231&lang=eng (accessed September 10, 2016).

person).²³ Thus, combined with its abundance of available labor, Georgia is an attractive place to invest, and the government maintains a positive investment climate.



Source: National Statistics Office of Georgia (GeoStat)

In order to maintain its attractiveness and continue along the successful path of structural reforms, Georgia should focus on further improving the opportunities for foreign companies to do business in the country. Although intensive foreign activity in Georgia may trigger some popular discontent, as it did in the case of large land purchases by foreigners, Georgia—crippled by the long-lasting effects of the Soviet economic policies—simply has no viable alternative to attracting foreign investment in the real sector. Domestic public and private capital are scarce.

The government has been doing a good job of keeping the budget deficits relatively low (at around 3 percent of the GDP), at levels comparable to the annual economic growth, thereby maintaining the overall public debt under control. On the other hand, the country continues to be in dire need of investment, particularly in infrastructure and education.

Georgia should seek trade liberalization with the U.S. in order to conclude a free trade agreement, which would open up further opportunities for American companies to invest in construction projects that mostly non-U.S., especially Chinese, companies have been obtaining thus far. These projects would greatly benefit American businesses due to greater potential returns on investment in Georgia than currently earned and possibly in the future in the West.

The Chinese vector of Georgia's economic policy should not be overlooked either. China, with the vast surplus of cash that it is trying to invest in the West, is a great potential partner for investing in Georgia, especially in Georgia's transport infrastructure, because shortening the time required to transit goods from China to Europe is one of Beijing's priorities, as clearly

²³ Foreign direct investment, net inflows (BoP, current US\$), The World Bank, <http://api.worldbank.org/v2/en/indicator/BX.KLT.DINV.CD.WD?downloadformat=excel> (accessed September 10, 2016, authors' calculations).

demonstrated by the One Belt One Road (OBOR) initiative.²⁴ Engaging powerful external stakeholders in transit projects that would make Georgia a transit hub would balance out Russia's influence and make it more difficult for Moscow to continue its expansionist activities in the South Caucasus, thereby improving security for Georgia—and, indirectly—the U.S. and EU. Other Asian economic and investment opportunities for Georgia, including deeper cooperation with Japan, South Korea, and India, are also worth exploring.

In turn, both the U.S. Government and government of Georgia could streamline and improve information dissemination by focusing on Georgia's attractiveness as an investment destination and more actively promoting and informing the American business community about their opportunities to invest in Georgia, including its agriculture, tourism, hydroelectric power, and transportation sectors.

Building new infrastructure

The construction of the main international road and railway corridors are Georgia's ticket to ride into the 21st century. Although many projects have been delayed due to ongoing political instability after the 2008 war and the lack of financing, the work is continuing. Georgia has thus far co-financed much of its main infrastructure projects with the help of substantial loans from the World Bank, the European Investment Bank, Asian Development Bank and oil-rich Azerbaijan.

The Baku–Tbilisi–Kars railway should become operational in 2017. The original plan was to launch it in 2010, but construction was delayed first due to the 2008 Russia–Georgia war and later due to a lack of available financing. The Georgian section of the railway was finished in June 2016.²⁵

In addition to the Baku–Tbilisi–Kars railway, the government's priority is the East–West Highway (in total, 410 km long), which should also become fully operational by 2020.²⁶ The highway also received financing from the World Bank and the European Investment Bank. Overall, the state of Georgian roads is not satisfactory, and their suboptimal condition continues to be a bottleneck for further development of the economy, especially the agriculture and industry sectors. As of early 2015, 76 percent of international roads were in a good or fair condition, while 45 percent of the secondary and 85 percent of local roads were in a deteriorated state and lacking maintenance funding.

²⁴ Gal Luft, "China's Infrastructure Play," *Foreign Affairs*, September 2016, <https://www.foreignaffairs.com/articles/asia/china-s-infrastructure-play> (accessed September 20, 2016).

²⁵ Baku-Tbilisi-Kars railway construction in Georgia completed, *Trend*, June 13, 2016, <http://en.trend.az/business/economy/2545137.html> (accessed September 10, 2016).

²⁶ "International Bank for Reconstruction and Development Project Appraisal Document on a Proposed Loan in the Amount of US\$140 Million to Georgia for a East-West Highway Corridor Improvement Project," *The World Bank*, October 19, 2015, <http://documents.worldbank.org/curated/en/927431467990989181/pdf/PAD1221-PAD-P149952-R2015-0210-1-Box393245B-OUO-9.pdf>, p. 6 (accessed September 10, 2016).

In 2014, the government adopted an action plan allocating 875 million lari for infrastructure development, including 500 million lari for road improvements. One of the priorities of the action plan is the continuation of funding for the East–West Highway corridor.

The East–West Highway, together with the Georgian section of the Baku–Tbilisi–Kars railway, has great potential for Georgia’s further development. Georgia aspires to become a regional transport–transit hub, and these two corridors (one highway, the other railway) will open up new opportunities for Georgia to fully use its potential in connecting Europe and Asia as part of the OBOR initiative for transporting industrial goods and commodities, including oil and gas. Therefore, it is in the interest of the West to continue supporting this corridor, as it contributes to the EU’s energy security.

Agriculture reforms

Similar to other Central and Eastern European countries at the beginning of the 1990s, the Georgian agriculture sector is the least efficient part of the country’s economy. Approximately half of the agricultural population owns some land, but agriculture produces only 10 percent of Georgia’s GDP. Especially in rural and mountainous areas, people tend to work on their own subsistence plots, and the memory of forced collectivization and expropriation is still strong, preventing people from organizing into shared agricultural communes and cooperatives.

Most farms (66.85 percent in 2004) are less than one hectare in land holding; around a quarter of them are 1 to 5 hectares.²⁷ This pervasive land fragmentation prevents intensive exploitation of the land resources and contributes to limiting agricultural productivity. Other obstacles to improving agricultural efficiency are the lack of modern technology, damaged soil fertility, poor land title registration preventing the development of a commercial agriculture market (only 20–30 percent of land has a title), and a lack of access to agricultural finance that would help farmers mitigate the high risks typical for the sector.

The government is aware of these problems and is committed to solving them. In 2015, it adopted the Strategy of Agricultural Development in Georgia 2015–2020.²⁸ The strategy aims to improve agricultural education, create incentives for land consolidation, improve farmers’ access to credit and insurance, enhance public management of agriculture, improve irrigation, facilitate access to modern machinery, and improve the food safety system.

Agriculture is one of the government’s priorities. It increased budget allocations to agriculture from 57.8 million lari in 2011 (0.8 percent of the budget) to 263.5 million in 2014 (2.9 percent of the budget).²⁹ The new state-funded programs have increased the total sown area. In 2014, the government launched the implementation of a cadastre program (land registry) for vineyards and established a new agricultural research center aimed at preserving Georgia’s agricultural biodiversity, supporting animal husbandry activities, developing local standards, introducing new technologies, conducting risk assessments, and providing other services. The government also

²⁷ “Strategy of Agricultural Development in Georgia 2015-2020,” *Official Website of the Ministry of Agriculture*, 2015, <http://www.moa.gov.ge/Download/Files/92>, p. 15 (accessed September 10, 2016).

²⁸ *Ibid.*

²⁹ *Ibid.*, p. 18.

adopted a new law on agricultural cooperatives aimed at better assisting these institutions and set up a special project management agency, thanks to which the banking sector has increased the financing of agricultural projects.

Dollarization and lack of trust in the lari

The persistent lack of confidence in the Georgian lari as a store of value has led to the creation of a problematic loop, as the high dollarization weakens the transmission channels of monetary policy of the National Bank of Georgia and makes it more difficult for the bank to control inflation. Approximately 60 percent of all deposits in Georgian banks are made in foreign currency.³⁰ As a result, Georgian commercial banks hesitate to issue long-term loans in lari at acceptable terms, which in turn pushes households and businesses to seek long-term financing in foreign currencies. At the same time, around 90 percent of Georgian foreign currency borrowers rely on their income in lari to pay those loans back.³¹ The resulting exchange rate risk materialized when the exchange rate of the lari against the U.S. dollar fell from 1.75 on November 1, 2014, to 2.15 on March 1, 2015. On September 30, 2016, the exchange rate was 2.43 lari per 1 USD. This resulted in an increased number of non-performing loans and lowered the predictability of foreign currency loan repayment.

The problem with the lack of trust in the lari is compounded by unpredictable inflation, although its levels for the past five years have not exceeded 10 percent per year. In addition, the somewhat volatile exchange rate of the lari and the relatively high refinancing rate of the Georgian central bank exacerbate national finances. The National Bank of Georgia's (NBG) inflation target is 5 percent for 2016 and 4 percent for 2017.³² As of September 2016, its main policy rate (the rate for auctioned one-week refinancing loans) stood at 6.75 percent per annum.³³ However, the commercial lending rate in lari amounted to as much as 20.4 percent per annum in 2015 and 10.4 in foreign currencies, which is prohibitively high for the healthy development of Georgian small and medium enterprises (SMEs).³⁴ In order to de-dollarize the economy, the NBG needs to work on lowering and better forecasting the inflation rate while making it less volatile in the long run. That, however, seems to be a rather long process due to the high dependence of the Georgian economy on external factors, exacerbated by persistent annual current account deficits of around 10 percent of the GDP, which contribute to Georgia's large net external debt.

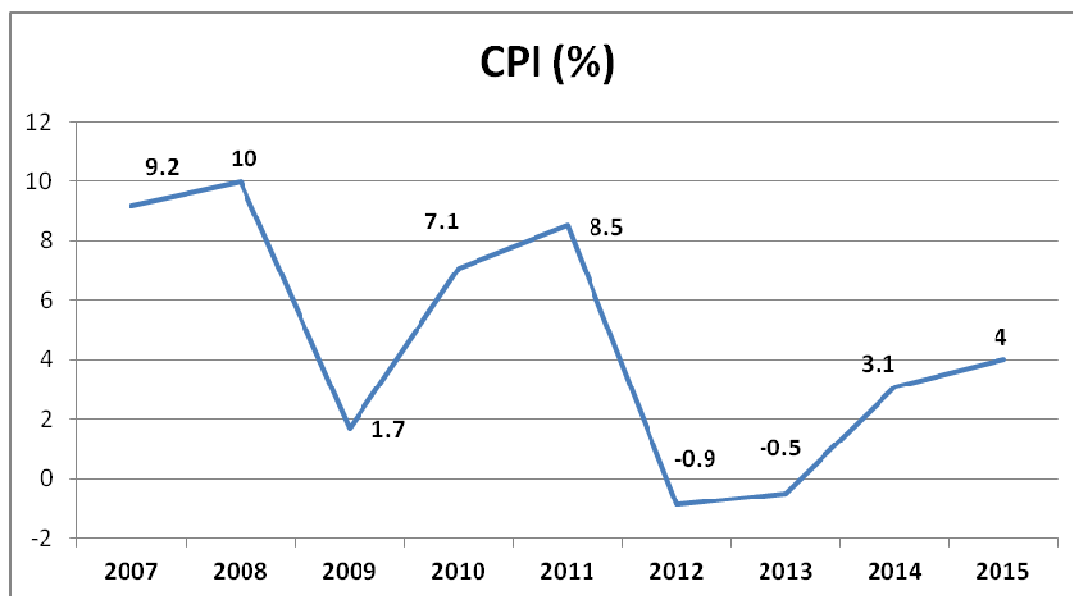
³⁰ "Georgia Financial System Stability Assessment," *The International Monetary Fund*, December 2014, <https://www.imf.org/external/pubs/ft/scr/2014/cr14355.pdf>, p. 11 (accessed September 10, 2016).

³¹ *Ibid.*, p. 11.

³² "Inflation target," *National Bank of Georgia*, <https://www.nbg.gov.ge/index.php?m=550&lng=eng> (accessed September 10, 2016).

³³ "Committee decisions," *National Bank of Georgia*, <https://www.nbg.gov.ge/index.php?m=554&lng=eng> (accessed September 10, 2016).

³⁴ "Key Macroeconomic Indicators and International Ratings," *National Bank of Georgia*, <https://www.nbg.gov.ge/index.php?m=494&lng=eng> (accessed September 10, 2016).



Source: National Statistics Office of Georgia (GeoStat)

SMEs' difficult access to credit

SMEs in Georgia produce approximately 20 percent of the country's GDP, as opposed to around 40–50 percent in developed Western economies.³⁵ Therefore, SME development may significantly contribute to Georgia's further growth. Despite Georgia's high rating in access to finance (ranking 7th in Getting Credit in Doing Business 2016), Georgian SMEs—particularly start-ups with little or no tangible collateral—face hardships accessing loans. Due to a poor record with movable collateral, banks require immovable property as acceptable collateral, which these enterprises often do not have.

Further obstacles to SMEs growth in Georgia exist, relative political and geopolitical instability, monopolistic markets, low purchasing power of the population, and the lack of accumulated foreign investment.³⁶ More than a half of Georgian SMEs use internal finances as their main source of financing. For start-ups, the sources of financing are mainly personal and friends' savings. Private equity financing is practically non-existent due to the poorly developed financial markets.

External issues: Russia, Abkhazia, and South Ossetia

Russia's aggressive foreign policy in the Caucasus is a major obstacle for Georgia's economic growth for both objective and subjective reasons. First, nuclear-armed Russia is Georgia's most powerful, largest, and richest neighbor. Russia inevitably is and will be an important export

³⁵ "World Bank: Georgian Economy Continues to be Impacted by the External Shock," *Observer*, April 5, 2016, <http://www.observer.com.ge/en/2016/04/05/%E1%83%9B%E1%83%A1%E1%83%9D%E1%83%A4%E1%83%9A%E1%83%98%E1%83%9D-%E1%83%91%E1%83%90%E1%83%9C%E1%83%99%E1%83%98-%E1%83%A1%E1%83%90%E1%83%A5%E1%83%90%E1%83%A0%E1%83%97%E1%83%95%E1%83%94%E1%83%9A/> (accessed September 10, 2016).

³⁶ "SMEs and Country Growth Strategy: Evidence from Georgia," *Journal of Business*; ISSN 2233-369X; Volume 4, Issue 1, 2015, <https://journal.ibsu.edu.ge/index.php/jbm/article/download/704/591> (accessed September 10, 2016).

market for Georgia, which gives Moscow strong political leverage that it has not hesitated to use. Second, approximately 200,000 Georgians live in Russia, and their remittances constitute around 30 percent of all remittances from Georgians living abroad.

The worsening economic situation in Russia in the past several years has also affected the conditions of Georgians working there, contributing to the overall drop in remittances from 12 percent of the GDP in 2014 to 10.6 percent in 2015.³⁷ Nevertheless, in March 2013, Georgia managed to at least partly break the Russian economic blockade and open the Russian market for its wine, mineral water, and cognac. The Georgian government does recognize the great importance of Russia for its economic well-being and continues to seek better relations with its northern neighbor, despite the unresolved status of its two separatist regions.

The problematic status of Abkhazia and South Ossetia, created by the Russian-supported separatism in 1992–1993, prevents Georgia from joining the EU and NATO as a full-fledged member. As a result, Georgia has not yet received the NATO Membership Action Plan, which is a step toward a country's membership in the organization. The last NATO summit in Warsaw was yet another disappointment in this regard, further postponing Georgia's aspirations for Western integration.³⁸

Socioeconomic development: Mixed results and perceptions

Election reforms

In January 2014, the Georgian Parliament passed a new local government election law aimed at providing for a more balanced reflection of the voters' interests in city hall and regional representation.³⁹ The law introduced for the first time the direct election of mayors of self-governing cities and heads of the country's municipalities. The number of self-governing cities was increased from 5 to 12, as every city with a population above 15,000 became one.⁴⁰ The number of municipalities was set to 60. The only exception before that had been Tbilisi, whose mayor was directly elected even before the reform.

The new law also lowered the threshold for a party list in the local legislative councils from 5 to 4 percent and introduced thresholds of 50 percent of the popular vote in the elections of mayors and municipality heads⁴¹ (*gamgebelis*),⁴² in order to avoid a run-off. In addition, the law

³⁷ "Personal remittances, received (% of GDP)," *The World Bank*, <http://data.worldbank.org/indicator/BX.TRF.PWKR.DT.GD.ZS?locations=GE> (accessed September 10, 2016).

³⁸ Luke Coffey, "NATO Summit 2016: Keeping Georgia on the Membership Track," *The Heritage Foundation*, June 14, 2016, <http://www.heritage.org/research/reports/2016/06/nato-summit-2016-keeping-georgia-on-the-membership-track> (accessed September 10, 2016).

³⁹ "Parliament adopts local Self-Government Bill," *Agenda.Ge*, February 6, 2014, <http://agenda.ge/news/8079/eng> (accessed September 10, 2016).

⁴⁰ "Local Self-Governance Reform Bill," *Civil Georgia*, November 23, 2013, <http://www.civil.ge/eng/article.php?id=26720> (accessed September 10, 2016).

⁴¹ "Georgia," *Council of European Municipalities and Regions (CEMR)*, 2016, <http://www.ccre.org/en/pays/view/18> (accessed October 3, 2016).

introduced mandatory visual checks of voters by comparing their ID picture with the picture in the electoral list, thereby lowering the risk of election fraud.

The municipal councils now have a right to oust their respective head or mayor in case two-thirds of its members vote for such a proposal. On the other hand, the mayor or municipality head has a right to veto legislation passed by the council, with the exception of the municipality budget.

The municipal elections conducted on June 15, 2014, were considered to be generally well organized and were successful for the Georgian Dream Coalition (GDC).⁴³ The GDC won four self-governing cities and 60 municipalities in the first round, gaining 67 percent of seats in the municipality councils while the opposition got 33 percent.

The government of Georgia is also planning to change the current election system at the country level. Currently, of the 150 members of the Georgian parliament, 73 are elected in single-mandate districts and 77 are elected through proportional representation based on party lists. However, the single-mandate districts are set up in a highly uneven manner: Some have as many as 150,000 voters while others have as few as 6,000.⁴⁴ On May 28, 2015, the Georgian Constitutional Court ruled that these significant discrepancies in the size of the districts violate the rights of the voters to be represented evenly.⁴⁵

Although it is not possible to ensure absolute equality of votes in a single-mandate system, the system should, according to the court, minimize the inequality. According to the Council of Europe, these differences should not normally be more than 10 to 15 percent. Thus, abolishing or modifying the single-mandate system would automatically scrap the inequality. The Georgian Dream has resisted the single-mandate component since even before the 2012 elections, when it proposed the introduction of a fully proportional system. At that time, it was not in the interest of the UNM, which won a high number of seats in the single-mandate district.

Due to the lack of political will, the reform was not conducted in the current election cycle, yet the Georgian Dream aims to implement it after the 2016 parliamentary elections. The proposed change would require changing the country's constitution, and thus a constitutional majority (113) among the 150 members of the parliament, which may be difficult to obtain. In the meantime, the government has made some smaller changes to the current mixed election system: It introduced a 50-percent threshold for electing representatives in the single-mandate districts, which means that there may be multiple run-offs in the upcoming election.

⁴² "Elections in Georgia 2014: Local Self-Government Elections – Frequently Asked Questions," *International Foundation for Electoral Systems*, June 9, 2014, http://www.ifes.org/sites/default/files/2014_ifes_local_elections_georgia_faqs.pdf, p. 1 (accessed October 3, 2016).

⁴³ "Georgia Local Elections: June 15 and July 12, 2014," *The International Republican Institute*, 2014, http://www.iri.org/sites/default/files/fields/field_files_attached/resource/georgias_2014_local_elections.pdf (accessed September 10, 2016).

⁴⁴ Liz Fuller, "Georgian Opposition Launches New Push For Election Law Reform," *Radio Free Europe*, June 24, 2015, <http://www.rferl.org/content/georgia-opposition--election-law-reform-/27090980.html> (accessed September 10, 2016).

⁴⁵ "Constitutional Court Orders Overhaul of Majoritarian Part of Electoral System," *Civil Georgia*, May 28, 2015, <http://www.civil.ge/eng/article.php?id=28304> (accessed September 10, 2016).

Judicial and prison reforms

The Georgian government has introduced a series of reforms of the judiciary to ensure greater compliance of the country's judicial standards with Western norms. In May 2013, the government stripped the politically appointed Minister of Justice of his prosecutorial powers, ensuring greater independence of the Office of the Chief Prosecutor from political interference. The Chief Prosecutor is now elected for a single six-year term by the Prosecutorial Council, which may also initiate proceedings against him in the case of misconduct. The Prosecutorial Council is chaired by the Minister of Justice and consists of prosecutors, MPs, and judges.⁴⁶

In 2013, the government also overhauled the plea bargaining process, making it more voluntary, fair, and transparent. The government introduced new safeguards in criminal proceedings, according to which witnesses are no longer obliged to give testimony, but may now do so voluntarily.

The government has also reformed the prison system, eradicated the widespread torture of inmates and lowering the overall number of inmates from around 24,000 in 2012 to fewer than 10,000 in 2016 (without negatively affecting the crime rate). It made the system free from systemic violence and torture, doubled the minimum space requirement for inmates, and doubled the penitentiary healthcare budget, while lowering TB and hepatitis rates among inmates.

Healthcare reforms

In March 2013, the government of Georgia introduced the Universal Healthcare System (UHC). The system currently covers more than 90 percent of Georgia's citizens and is based on the government directly reimbursing healthcare providers for their services for patients from the taxes it collects in the general state budget, as opposed to dedicated healthcare contributions.⁴⁷ In comparison, only 40 percent of citizens were covered in 2012, and as few as 25 percent had medical coverage back in 2010.

Before the reform, Georgia's public healthcare spending constituted only approximately 25 percent of Georgia's total healthcare spending (the rest being private and out-of-pocket spending), compared to around 75 percent in the EU-15. Georgia's average overall spending on healthcare (both public and private) has also been very low.

Healthcare spending has increased substantially in the past couple of years. In 2013, the government spent only around 2 percent of its GDP of public money on healthcare; by 2015, this number had increased to 2.7 percent. Similarly, general government spending on healthcare rose from 4.22 percent of the total national budget in 2013⁴⁸ to 9.3 percent in 2015.⁴⁹

⁴⁶ "Law on the Prosecutor's Office of Georgia, European Commission for Democracy Through Law" (Venice Commission), Strasbourg, 19 October 2015, Opinion No. 811/2015 CDL-REF(2015)041, [http://www.venice.coe.int/webforms/documents/default.aspx?pdffile=CDL-REF\(2015\)041-e](http://www.venice.coe.int/webforms/documents/default.aspx?pdffile=CDL-REF(2015)041-e) (Accessed September 23, 2016).

⁴⁷ "WHO: Georgia's health reforms show "tangible benefits"," *Agenda.Ge*, July 17, 2015, <http://agenda.ge/news/39272/eng> (accessed September 10, 2016).

⁴⁸ "Health expenditure ratios, by country, 1995-2014: Georgia," *The World Health Organization*, <http://apps.who.int/gho/data/view.main.HEALTHEXPRATIOGEO?lang=en> (accessed September 10, 2016).

Implementing UHC, the government consolidated state-funded healthcare programs under one umbrella and extended the right of coverage to all citizens.⁵⁰ The government repurchased the publicly financed healthcare services from private insurance companies and has initiated the construction of new modern clinics.

In December 2014, the government adopted the 2014–2020 State Concept of Healthcare System of Georgia, focusing on conducting further reforms to achieve a better healthcare system and management, improve the system of financing, develop quality healthcare services and human resources in the sector, develop information systems for healthcare management, improve maternal and child health, prevent and manage priority communicable diseases, and better prevent and monitor priority non-communicable diseases.⁵¹

Nevertheless, problems remain. Out-of-pocket expenses are still relatively high. A large number of doctors still require retraining, and there is a critical shortage of doctors, nurses, and equipment outside Tbilisi.⁵² In addition, the healthcare system is predominantly privately and foreign owned, with no government regulation of how much these private facilities can charge the public healthcare funds for services rendered.⁵³ The UHC also has several restrictions—most notably a 15,000 lari annual limit on planned care, with planned procedures having to be approved by the Social Service Agency, and a 15,000 lari limit per incident on emergency care. These limitations restrict the services that a patient can access free of charge and often result in high out-of-pocket expenses. Healthcare will remain a challenging field for reforms in Georgia in the foreseeable future. The state budget can afford to fund this system going forward only if it gradually becomes more efficient.

Labor reforms

In 2013, the government of Georgia adopted a new labor code, amending and modernizing its *laissez-faire* 2006 version that contradicted ILO and EU standards. It introduced improvements in workers' rights and created a more balanced regulatory framework. The main features of the new labor code include the limitation of contractual freedom when it comes to employment contracts, better regulation of working hours and overtime, improved regulation of dismissals, and the prohibition of discrimination, including discrimination based on membership in trade unions. In line with the new legislation, only those types of employment contracts that do not contradict the cogent provisions of the labor code are valid, as opposed to the previous legal norm, which allowed provisions of the employment contract to override the labor code provisions. The

⁴⁹ “A long-term, high-growth investment story: Annual Report 2015,” *Official Website of Georgia Healthcare Group PLC*, 2016, <http://ghg.com.ge/uploads/pages/annual-report-2015-59.pdf> (accessed September 10, 2016).

⁵⁰ David Ninikelashvili, “Georgia’s Healthcare Reform,” *Georgia Today*, March 28, 2016, <http://georgiatoday.ge/news/3402/Georgia%E2%80%99s-Healthcare-Reform> (accessed September 10, 2016).

⁵¹ “On Approval of the 2014-2020 State Concept of Healthcare System of Georgia for 'Universal Health Care and Quality Control for the Protection of Patients' Rights,” *Official Website of the Legislative Herald of Georgia*, December 29, 2014, <https://matsne.gov.ge/en/document/view/2657250> (accessed September 10, 2016).

⁵² Kathleen Weinberger, “Georgia’s healthcare privatisation stands as a warning to Ukrainian reformers,” *Open Democracy*, August 6, 2015, <https://www.opendemocracy.net/od-russia/kathleen-weinberger/georgia%E2%80%99s-healthcare-privatisation-stands-as-warning-to-ukrainian-refo> (accessed September 10, 2016).

⁵³ “A long-term, high-growth investment story: Annual Report 2015,” *Official Website of Georgia Healthcare Group PLC*, 2016, <http://ghg.com.ge/uploads/pages/annual-report-2015-59.pdf>, p. 17 (accessed September 10, 2016).

amended law further obliged employers to remunerate overtime at a rate higher than the standard hourly wage, as opposed to no remuneration for overtime pursuant to the previous version.

Employers can now dismiss workers based on an exhaustive list of reasons and must notify the employee in advance, as opposed to the previous version, according to which the employer could dismiss an employee without specifying the reason and without prior notice. The law also introduced a new collective labor conflict resolution mechanism.

However, some observers have voiced concerns about the actual implementation of the new labor code, which may be well written in theory, but its practical implementation is evolving.⁵⁴ For instance, until 2015, when the Labor Conditions Inspection Department was established within the Ministry of Labor, Health and Social Affairs to implement labor law, Georgia did not have a labor inspection office. There are still reports of employers not following the labor code with impunity.

IDP welfare reform

Better targeting the budget contributions to Georgia's internally displaced persons (IDPs), who had to flee the conflict zones of Abkhazia and South Ossetia in the 1990s and again in 2008, was the focus on another reform. Prior to this reform, all IDPs were entitled to a monthly contribution of 30 lari—a minute sum.⁵⁵ The government limited the assistance eligibility to those whose monthly salary was 1,250 lari. As the government re-registered all IDPs to determine their number, it increased the monthly assistance to those that remain eligible to 45 lari per month. Although the amounts may seem modest, with the overall number of registered IDPs surpassing 271,500 in June 2013, the measure has had a significant impact on the state budget (around 20 million lari per year) in the years since. As a result of the reform, the official number of IDPs fell slightly to 262,704 people as of December 2014.⁵⁶

Education reforms

Education has been a major hurdle on Georgia's way to greater prosperity. Despite the fact that Georgians value education, its reform has been partly impeded due to the lack of funding and insufficient institutional capacity.⁵⁷ In today's Georgia, even finishing higher education does not necessarily guarantee better job opportunities. The 2010 statistics show that the unemployment rate among university graduates is at 22 percent, while the unemployment rate among high-school and vocational school graduates is at 17 percent, demonstrating the low added value and

⁵⁴ Sarah Delys, "Georgia's labor code still favors employers," *Democracy & Freedom Watch*, December 9, 2014, <http://dfwatch.net/georgias-labor-code-still-favors-employers-99090-32593> (accessed September 10, 2016).

⁵⁵ "Parliament Discusses New Bill on IDPs," *Civil Georgia*, November 26, 2013, <http://www.civil.ge/eng/article.php?id=26728> (accessed September 10, 2016).

⁵⁶ "Georgia IDP Figures Analysis," *Internal Displacement Monitoring Centre*, <http://www.internal-displacement.org/europe-the-caucasus-and-central-asia/georgia/figures-analysis> (accessed September 10, 2016).

⁵⁷ "From Strategy to Action: Developing Georgia's Education and Tourism Sectors," *The World Bank*, January 28, 2015, <http://www.worldbank.org/en/news/feature/2015/01/28/from-strategy-to-action-developing-georgia-education-and-tourism-sectors> (accessed September 10, 2016).

large skills mismatch generated by the system.⁵⁸ In April 2014, then-Georgian Prime Minister Irakli Garibashvili admitted that Georgia's education system was in a "fatal condition."⁵⁹

One problem is teachers' remuneration. In 2009, the average teacher earned less than a gardener, who received around 300 lari per month.⁶⁰ In 2013, Georgia spent only 1.98 percent of its GDP, compared to 4.87 percent in Europe and Central Asia and 4.95 percent in Germany.⁶¹ In recent years, however, things have been changing for the better—albeit slowly. In 2014, the average teacher's base salary rose to 350 lari, and the government increased it further to 400 lari starting in September 2015.⁶² On top of that, the monthly bonuses for qualified teachers were increased to a maximum of 200 lari, up from 75 lari in 2012.⁶³ Still, the salary of an average teacher is well below the average salary of workers in the country, reaching only 818 lari in 2014.⁶⁴

⁵⁸ "Social-economic Development Strategy of Georgia "GEORGIA 2020"," *Asian Development Bank*, 2014, <http://www.adb.org/sites/default/files/linked-documents/cps-geo-2014-2018-sd-01.pdf>, p. 41 (accessed September 10, 2016).

⁵⁹ "Georgia's education system in "fatal condition"," *Agenda.Ge*, April 21, 2014, <http://agenda.ge/news/12643/eng> (accessed September 10, 2016).

⁶⁰ Hazel Feigenblatt, "The Corruption Notebooks 2009,"

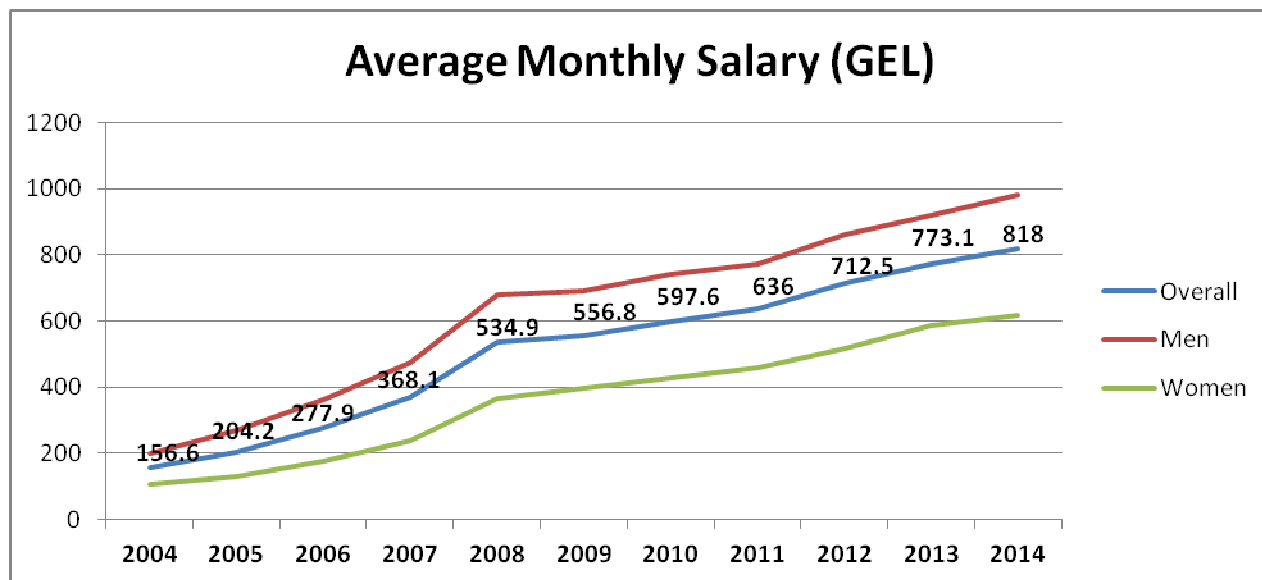
<https://books.google.sk/books?id=gnHvAgAAQBAJ&pg=PA28&lpg=PA28&dq=2009+georgia+teacher+salary+gardener+gel&source=bl&ots=u1Wa93cMvp&sig=LK3iE5hfMuAPs0iaUmF7DfgB5NY&hl=sk&sa=X&ved=0ahUKEwjS-oOi8vjOAhUEExoKHRSpAicQ6AEIGjAA#v=onepage&q=2009%20georgia%20teacher%20salary%20gardener%20gel&f=false>, p. 28 (accessed September 10, 2016).

⁶¹ "Government expenditure on education, total (% of GDP)," *The World Bank*, <http://api.worldbank.org/v2/en/indicator/SE.XPD.TOTL.GD.ZS?downloadformat=excel> (accessed September 10, 2016).

⁶² "Georgia: First Review under the Stand-By Arrangement and Request for Modification of a Performance Criterion," *The International Monetary Fund*, January 2015, <https://www.imf.org/external/pubs/ft/scr/2015/cr1517.pdf>, p. 7 (accessed September 10, 2016).

⁶³ Motoko Akiba, "Teacher Reforms Around the World: Implementations and Outcomes," https://books.google.sk/books?id=ISIMCiSWFbsC&pg=PA38&lpg=PA38&dq=georgia+teacher+salary+gel+per+month&source=bl&ots=VsMFiyU-AQ&sig=lo_c2SoRFXqkMzTLt95TetT0sVc&hl=sk&sa=X&ved=0ahUKEwiLt8yArPjOAhUC8RQKHYZgDbUO6AEIMjAD#v=onepage&q=georgia%20teacher%20salary%20gel%20per%20month&f=false, p. 38 (accessed September 10, 2016).

⁶⁴ "Wages," *National Statistics Office of Georgia*, http://geostat.ge/index.php?action=page&p_id=149&lang=eng (accessed September 10, 2016).



Source: National Statistics Office of Georgia (GeoStat)

Salary increases have not been the only changes in the education system. The government has also focused on vocational education, which—similar to other post-communist countries—suffers from a lack of social prestige. In 2013, the government adopted the Vocational Education and Training Development Strategy for 2013–2020, in which it formulated seven main priorities: higher participation of the private sector in vocational education, creation of a well-managed and inclusive network of vocational schools, tailoring of the vocational programs to the market’s needs, better preparation of vocational teachers, creation of a unified system of recognized vocational certificates, facilitation of graduates’ access to information about vocational vacancies and their characteristics, and the ensuring of higher recognition of vocational education in society.⁶⁵ These measures are aimed at maximizing the potential of the country’s human resources, ensuring further social development, and fighting poverty.

As part of its vocational education reform, Georgia started introducing dual vocational education in February 2016. This form of education, which has a centuries-long tradition in Europe, is based on the schools being responsible for providing the theoretical background to their students, who acquire practical skills by working directly in firms, which may later become their employers.⁶⁶ The dual vocational education reform implemented in Georgia is based on the successful German model and is currently being introduced mainly in tourism, agriculture, construction, and manufacturing sectors.⁶⁷ A skilled workforce in industrial professions will, in turn, make the country more attractive for foreign direct investors and should be taken note of by the international business community.

⁶⁵ “Vocational Education and Training Development Strategy for 2013-2020,” *Official Website of the Ministry of Education and Science of Georgia*, http://www.mes.gov.ge/uploads/12.%20VET%20Strategy%202013-20_EN.pdf (accessed September 10, 2016).

⁶⁶ Tamta Maridashvili and Mariam Zaldastanishvili, “Obstacles for Dual Vocational Education in Georgia,” *The Financial*, June 6, 2016, <http://www.finchannel.com/index.php/opinion/143-op-ed/57803-obstacles-for-dual-vocational-education-in-georgia> (accessed September 10, 2016).

⁶⁷ <http://bpi.ge/index.php/a-successful-cooperation-with-the-successful-companies/?lang=en>

Pension and targeted social assistance reforms

The government has been gradually increasing the pension levels for Georgia's pensioners (women aged 60 and over and men aged 65 and over). In September 2015, the government increased pensions from 150 to 160 lari per month.⁶⁸ In July 2016, it increased the pension level further to 180 lari for most pensioners and to 216 lari for pensioners living in Georgia's mountainous areas, starting in September 2016. However, even after the increase, the pensions barely approach the minimum subsistence level in the country.

A systematic indexation of the pensions might be a better alternative to these ad hoc pension increases. In addition, pensions appear to have been raised indiscriminately for the entire retired population. Better targeting the vulnerable groups and the poor would make it possible to fight poverty more effectively.

Lowering the unemployment rate

The persistent skills mismatch keeps unemployment high. In recent years, the unemployment rate fell from 15 percent in 2012 to 12 percent in 2015, despite the economic downturn in Eurasia.⁶⁹ However, a statistical problem exists: The large population that is self-employed in agriculture does not participate in the unemployment statistics, as the Georgian law qualifies every person who works on at least one hectare of land and their family members as self-employed. Therefore, the highest unemployment rate among Georgia's regions is in the capital, Tbilisi (21.4 percent in 2015),⁷⁰ as the unemployed there cannot be classified as self-employed farmers due to the absence of agricultural land in the capital. This situation contrasts that of developed Western countries, where the unemployment level in the capital is traditionally among the lowest in the country. In addition, official statistics show that the unemployment rate among the rural population was only 4.8 percent in rural areas in 2015, while in urban areas the number was 21.5 percent.⁷¹ This suggests higher unemployment rates than reported and the need to improve labor statistics.

Lowering the poverty rate

Despite Georgia's stable economic growth for the past decade, the poverty rate continues to remain high, also due to a large part of the population working in the country's inefficient agricultural sector. In 2012, 14.8 percent of the population lived in poverty (91.2 lari per adult equivalent per month), and 3.7 percent lived in extreme poverty (52.9 lari per adult equivalent per

⁶⁸ "Pension increases 65% for 713,000 people in Georgia," *Agenda.Ge*, July 1, 2016, <http://agenda.ge/news/61158/eng> (accessed September 10, 2016).

⁶⁹ "Employment and Unemployment 2015 (Annual)," *National Statistics Office of Georgia*, May 27, 2016, http://www.geostat.ge/cms/site_images/files/english/labour/employment%20and%20unemployment%202015%20press%20release.pdf (accessed September 10, 2016).

⁷⁰ "Employment and Unemployment," *National Statistics Office of Georgia*, http://www.geostat.ge/index.php?action=page&p_id=146&lang=eng (accessed September 10, 2016).

⁷¹ "Employment and Unemployment 2015 (Annual)," *National Statistics Office of Georgia*, May 27, 2016, http://www.geostat.ge/cms/site_images/files/english/labour/employment%20and%20unemployment%202015%20press%20release.pdf, p. 2 (accessed September 10, 2016).

month).⁷² The territorial proximity of Russia and the large number of Georgians working there and sending remittances home continue to make the country vulnerable to Russia's economic pressure and hostile policies.

According to the World Bank, the poverty level dropped from 42.5 percent in 2012 to 32.3 percent in 2014, when poverty was defined according to the national poverty definition (i.e., \$2.50 [4.5 lari] per person per day).⁷³ The World Bank expects the poverty level to continue to decline and reach 25.5 percent in 2018. The sharp decline in poverty has been a result of the increase in pensions and the reform of the Targeted Social Assistance (TSA) program. In 2014, the government conducted yet another reform of the program, introducing a new—albeit small (10 lari per month)—contribution to children who score below a certain threshold in the TSA score.

On the other hand, the TSA also leads to disincentives. It may discourage people from looking for employment, as a World Bank paper suggests.⁷⁴ The paper found disincentives to look for work among people who may lose the assistance in case they do find work, especially young married women with children. In addition, there is anecdotal evidence that people are less willing to take seasonal jobs, which causes problems in labor-intensive occupations in rural areas.⁷⁵ The problem with the TSA is that it may be paying too much as it is poorly targeted. In 2007, when the TSA was 50 percent smaller than what it is now, no disincentives were found in a similar World Bank study.

Nevertheless, the poverty level in Georgia in 2014 was higher than in Armenia or Moldova, which have a lower GDP per capita than Georgia. The Gini index fell from 41.3 in 2012 to 40.1 in 2014, suggesting a slightly more egalitarian distribution of wealth, even though Georgia's inequalities are still high compared to Europe. The after-tax income of the highest 20 percent of the population is roughly twice as high as that of the next 20 percent, suggesting even higher inequality at the top of the income ladder. In 2010–2014, the poverty rate fell mostly thanks to labor income from an increasingly dynamic job market and from higher and more targeted social transfers. Unlike the period from 2006 to 2010, in 2011–2014, the economic growth led not only to salary increases, but also to employment growth, which allowed more Georgians to benefit from it. Those who live on less than \$2.50 per day from agriculture constituted 25.8 percent of the population, as opposed to 11.1 percent of those living on more than \$10 per day (which is considered the middle class in Georgia).

⁷² “Country Partnership Strategy for Georgia FY2014 – FY2017,” *The World Bank*, April 9, 2014, <http://documents.worldbank.org/curated/en/249271468274498717/pdf/852510CAS0P144080Box385177B00OU090.pdf>, p. 2 (accessed September 10, 2016).

⁷³ “Georgia: Recent Trends and Drivers of Poverty Reduction,” *The World Bank*, August 17, 2016, <http://pubdocs.worldbank.org/en/980951472223098077/Georgia-PPA-FY16-presentation-AUG2016-final.pdf> (accessed September 10, 2016).

⁷⁴ “The Impact of Targeted Social Assistance on Labor Market in Georgia,” *The World Bank*, May 2015, <http://documents.worldbank.org/curated/en/200181467986257291/pdf/98707-WP-P128205-Box393176B-PUBLIC.pdf> (accessed September 10, 2016).

⁷⁵ Nino Ghoghonidze and Eric Livny, “The Puzzle of Poverty and Wages in Georgia,” *Georgia Today*, September 18, 2014, http://old.georgiatoday.ge/article_details.php?id=12688 (accessed September 10, 2016).

Another factor contributing to rural poverty reduction is the diversification of the job opportunities in rural areas. In 2010–2014, the growth in non-agricultural sectors in rural areas constituted 4.8 percent in manufacturing, 6.1 percent for construction, and 4.7 in services. Employment diversification in rural areas is clearly the way to go.

In 2012–2014, the government increased its overall social spending by 60 percent in real terms. Government spending on healthcare increased by 72 percent, on kindergartens by 114 percent, on pensions by 22 percent, on TSA and non-pension assistance by 88 percent, and on general education by 14 percent.

There is also a significant difference in the occupational composition of those who live on less than \$2.50 per day versus those who live on more than \$10 per day. Although 39 percent of the first group is classified as “self-employed in agriculture,” only 14 percent of the second group has the same occupational category. Only 14 percent of the first group is regularly employed, compared to 42 percent in the second group.⁷⁶ These data confirm the acuteness of unemployment in the rural sector and the need to prioritize its amelioration.

Public perceptions of Georgia’s development

According to a National Democratic Institute survey conducted in Georgia in June 2016, the population has mixed—and worsening—attitudes toward the progress and economic and political direction of their country.⁷⁷ Poor availability of jobs remains the main concern of the population, with 56 percent of the population ranking it as one of the three most pressing issues. The second and third items on the public agenda are poverty (which is related to unemployment) and territorial integrity, accounting for 29 and 28 percent, respectively.

While the number of people caring about territorial integrity has fallen from almost 50 percent in 2009, the issues of jobs and poverty have remained practically unchanged for the past seven years, suggesting little progress on the ground in these areas. On the other hand, more than 50 percent of the population acknowledges that the affordability of healthcare has changed for the better since October 2012. Not much progress has been perceived in the education sector, and the perceptions of corruption, job scarcity, and poverty have reflected a worsening trend. In addition, for most respondents (47 percent), the poor state of the roads is the most pressing infrastructure issue in their city or village, while in Tbilisi it is the pollution of the environment.

Overall, only 25 percent of the population believe that Georgia is going in the right direction, while 34 percent believe that the situation is not changing and 33 percent believe the country is going in the wrong direction. This is a major change since November 2012, when nearly 60 percent believed Georgia was going in the right direction and only 10–15 percent said it was going in the wrong direction or was not changing.

⁷⁶ “Georgia: Recent Trends and Drivers of Poverty Reduction,” *The World Bank*, August 17, 2016, <http://pubdocs.worldbank.org/en/980951472223098077/Georgia-PPA-FY16-presentation-AUG2016-final.pdf>, p. 37 (accessed September 10, 2016).

⁷⁷ “Public attitudes in Georgia: Results of a June 2016 survey carried out for NDI by CRRC Georgia,” *Civil Georgia*, 2016, <http://www.civil.ge/files/files/2016/NDI-poll-June-2016.pdf> (accessed September 10, 2016).

Similarly, the number of people saying that their household has worsened since October 2012 has risen dramatically over the past two years, and the approval rate of the government has steadily declined from late 2013 (approval rate of around 75 percent) to March 2016 (under 40 percent).

On the other hand, around two thirds of the population support Georgia's stated goals to join the EU and NATO; the support for Georgia's membership in these organizations is higher among the youth than among the elderly and higher among those with a higher education. It is clear that even individual charity of the scope provided by Mr. Ivanishvili cannot replace economic growth and working, modern public finances.

Recommendations for the U.S. Government

The U.S. has a long-term and strategic commitment to the security and prosperity of Georgia for geopolitical reasons and to assist Georgia in its civilizational choice as well as help it become a model post-communist democratic and market-based society. Specifically, the U.S. should:

- **Pursue a free trade agreement between the U.S. and Georgia:** Following the example of the EU, the U.S. should expand discussions with Georgia on a free trade agreement. Although Georgia is substantially poorer than the U.S. and, thus, a place where the U.S. businesses can potentially outsource their production, the small size of the country and its current low competitiveness in industrial production cannot harm U.S. businesses in any noticeable way.

The potential negative—and miniscule—impact from cheap Georgian production would be greatly offset by political benefits for the U.S. and Georgia arising from such a step. Establishing a free trade area with Georgia would help Georgia in several ways. First, it would send a clear signal of continued American support for the country, even after the focus of the U.S. foreign policy in the region shifted to Ukraine. Second, it would send investors a clear signal that Georgia is stable enough to do business. Third, it would make Georgia more attractive to its separatist regions than Russia, thereby facilitating their potential de facto reunification with the rest of Georgia.

- **Support more academic exchanges and legislative visits:** According to the World Bank, Georgian lawmakers often lack appropriate skills to fulfill their mandates, both as lawmakers and as supervisors of other state institutions (e.g., through parliamentary committees). Therefore, American lawmakers and Congressional staff should intensify their contacts with their Georgian counterparts in order to transfer some of the U.S. legislative know-how and culture to Tbilisi. As Georgia is aspiring to become a regional hub for foreign investment, a more effective legal framework and more smoothly functioning government are necessary.
- **Promote visa liberalization with Western countries:** Currently, Georgian citizens do not enjoy visa-free access to the EU or the U.S. When it comes to the question of visa-free access to the EU, Georgia has met the technical requirements, including having biometric passports; thus, the question of granting Georgia visa-free access to the EU is now purely

political. In June 2016, EU officials—notably those from Germany and France—did not support granting Georgia visa-free access due to risks of increased crime, as it attributed part of its organized crime to Georgian immigrants.⁷⁸ Consequently, the EU delayed its decision on the visa liberalization regime for Georgia until it receives additional guarantees from Tbilisi regarding migration issues.⁷⁹ Similarly, Georgians are not part of the U.S. Visa Waiver program. Nevertheless, benefits for the U.S. from granting Georgia a visa waiver would outweigh potential risks, mainly that of increased illegal immigration to the U.S. from Georgia. The issue is the percentage of Georgians who overstay their visas in the U.S. Therefore, as part of its political dialogue with Tbilisi, the U.S. should initiate talks on potential visa liberalization. Such a step would be a material sign of the willingness of the U.S. Government to help Georgia. It could also contribute to making Georgia a more attractive alternative to Russia for the separatist Abkhazia and South Ossetia, which would help Tbilisi more easily convince these regions to seek ways to settle their disputes with Georgia and integrate back into the country as autonomous republics.

- **Assist Georgia in reaching out to the occupied Abkhazia and South Ossetia:** Georgia should work diligently to return the occupied Abkhazia and South Ossetia back under its control. Tbilisi needs to reach out to these regions by becoming an attractive alternative to their close ties with Russia. However, while doing that, Tbilisi needs to be ready to recognize the proper level of autonomy of these regions and treat them in a consistent and predictable manner both before and after the potential reunification. In addition, by modernizing its infrastructure and governance, attracting foreign investment, and demonstrating economic growth leading to higher shared prosperity, Georgia can eventually sway the public opinion in these republics in its favor. Abkhazians and South Ossetians are neither culturally nor linguistically any closer to Russia than they are to Georgia, and any animosity of the peoples in these separatist republics toward Georgia is socially constructed (as a result of both the two wars for independence from Georgia and the Russian propaganda and subsidies) and can be overcome. The August 2016 events in Abkhazia, when the Abkhaz people voted in a marred referendum aimed at ousting President Raul Khajimba, demonstrate that—despite Moscow’s financial and political efforts to consolidate control—the loyalty of the Abkhaz people toward Russia is not based on firm ground and can be gradually changed. This loyalty is constantly undermined by internecine Abkhaz political struggles, with Abkhaz politicians using the threat of Abkhazia losing its sovereignty to Russia to promote their agendas.⁸⁰

⁷⁸ “EU puts brake on visa liberalization for now amid immigration fears,” *Reuters*, June 1, 2016, <http://www.reuters.com/article/us-europe-migrants-eu-visas-idUSKCN0YN56F> (accessed September 10, 2016).

⁷⁹ Nicholas Waller, “EU Tables Decision on Visa-Liberalization for Georgia,” *Georgia Today*, June 2, 2016, <http://georgiatoday.ge/news/3928/EU-Tables-Decision-on-Visa-Liberalization-for-Georgia> (accessed September 10, 2016).

⁸⁰ Beslan Dzhonua, “Priznannoye odinochestvo Abkhazii” (“The Recognized Solitude of Abkhazia”), *Gazeta.Ru*, August 26, 2016, https://www.gazeta.ru/politics/2016/08/26_a_10161389.shtml (accessed September 10, 2016).

The situation in South Ossetia is somewhat more complicated, as Moscow is preparing for a 2017 referendum in which the population will vote on granting the president and the parliament the authority to propose to the Russian Federation to accept South Ossetia as one of its subjects, thereby leading to it joining the Russian Federation as an autonomous republic. Such a referendum was held in the region in 1992, and the South Ossetian population overwhelmingly supported this step. However, such a move is currently not greatly in the interest of Russia, as it violates international law and could further provoke anti-Russian sentiments around the world. Instead, in 2015, Russia signed an agreement with the South Ossetian capital Tskhinvali on cooperation and integration, which provides for the creation of a common area of law enforcement and defense.⁸¹ Therefore, for Tbilisi, winning the hearts and minds of South Ossetia may be somewhat more difficult than in the Abkhaz case, but it is not hopeless, especially due to the geographic location of the region south of the Caucasus Mountains and its difficulty of access to Russia.

- **Further support fight against corruption:** The U.S. Government should continue supporting Georgia's development of a vibrant civil society at the grassroots level, including development of the modern judiciary, prosecutor's office and prosecutorial service, competent courts and competent, corruption-free judges, free media, which will, in turn, ensure more public oversight of the government and a better control of corruption.
- **Support English language education:** The lack of financial resources prevents the hiring of qualified teachers, especially teachers of foreign languages. In Georgia, similar to other post-Soviet and post-communist countries, the persistent lack of an English-speaking or multilingual workforce denies the labor force better-paid opportunities. In that regard, the underfunded education system fails the population.

One widespread problem facing English teachers in Georgia is that they are able to read and write in English, but face issues speaking and understanding English speech properly.⁸² In turn, poor English language skills hinder international dialogue as well as educational and professional international exchanges and are a constraint on FDI to Georgia. Therefore, the U.S. Government should encourage both English-language education in Georgia and Georgian English-language teacher training in the U.S.

In 2010, Georgia introduced the Teach and Learn with Georgia program, aimed at bringing volunteers from native English-speaking countries to Georgia to assist in teaching English.⁸³ However, the volunteers receive only modest compensation by

⁸¹ "Dogovor mezhdru Rossiyskoy Federatsiey i Respublikoy Yuzhnaya Osetiya o soyuznichestve i integratsii" ("Treaty between the Russian Federation and the Republic of South Ossetia on Alliance and Integration"), *The Kremlin*, <http://kremlin.ru/supplement/4819> (accessed September 10, 2016).

⁸² "Another wave of foreign teachers in Georgia," *Georgian Journal*, April 21, 2011, <http://www.georgianjournal.ge/politics/4906-another-wave-of-foreign-teachers-in-georgia.html> (accessed September 10, 2016).

⁸³ "Background," *Official Website of Teach & Learn with Georgia*, <http://www.tlg.gov.ge/content.php?id=93&lang=eng> (accessed September 10, 2016).

Western standards (approximately 500 lari net of taxes per month),⁸⁴ which limits the number of applicants. Therefore, the Georgian authorities, the diaspora, and American charities should increase support for the education of Georgian language teachers, including the Teach and Learn program, and consider funding study visits of Georgian teachers in the U.S. in order to master the language.

- **Combat the influence of anti-Western voices and Russia’s anti-Western propaganda in Georgia:** Most Georgians get their news from television.⁸⁵ Approximately one quarter of Georgians also get their news from watching foreign channels, mostly Russian, which gives Russia an advantage in influencing the opinion of a significant fraction of Georgia’s population. In order to combat this trend, the U.S. needs to provide more support to Georgian TV channels and the production of programs refuting the Russian propaganda content. Due to the Georgian population’s limited knowledge of English and other Western languages, relying on existing Western TV channels that often provide low quality entertainment or no translation into Georgian may not be sufficient.
- **Further invest in Georgian NGOs and journalist training:** The Georgian civil society sector continues to grow, but remains concentrated in Tbilisi and other larger cities. According to USAID, the Georgian civil society continues to remain underfunded, with no clear path for further development. Therefore, in order to combat the still-prevailing tendencies to apply pressure on the civil society to stop criticizing the incumbent government, further support for Georgian NGOs is needed. The U.S. Government and international NGOs should focus on those NGOs that work with the grassroots. Another constraint to further development of the civil society and good governance is the mentality of in-group solidarity and out-group mistrust, which is also widespread in other post-Soviet countries, such as Russia, and will be difficult to overcome in the short run. However, as the changed perceptions of corruption have demonstrated, rapid change in mentality cannot be excluded in the case of a deep enough change in the living environment.
- **Increase funding for the Overseas Private Investment Corporation (OPIC) to attract more U.S. FDI to Georgia:** OPIC is the prime tool for facilitating direct U.S. investments to Georgia, providing financing where the market requires, political risk insurance and support for investment funds. OPIC is well-suited to act as a bridge between U.S. businesses and Georgia, which has a growing economy, but also has a political system that lacks stability and predictability. As of April 2016, OPIC has financed more than 50 projects in Georgia, totaling more than \$500 million, mainly in the

⁸⁴ “Benefits,” *Official Website of Teach & Learn with Georgia*, <http://www.tlg.gov.ge/content.php?id=95&lang=eng> (accessed September 10, 2016).

⁸⁵ “Public attitudes in Georgia: Results of a June 2016 survey carried out for NDI by CRRC Georgia,” *Civil Georgia*, 2016, <http://www.civil.ge/files/files/2016/NDI-poll-June-2016.pdf>, p. 70 (accessed September 10, 2016).

agriculture, tourism, and infrastructure sectors.⁸⁶ In April 2016, OPIC also teamed up with Georgia's Partnership Fund to mobilize equity financing for new projects.⁸⁷ Expanding this type of support will not only benefit Georgia, but will also help U.S. businesses to take further advantage of Georgia's high returns on investments with some of the risks borne by U.S. taxpayers.

- **Support the independent business dispute resolution system:** In order to efficiently adjudicate cases between businesses, and most importantly, between the state and businesses, Georgia's business dispute resolution system needs to be made more predictable and reliable. Improving the business arbitration and mediation system will help further reduce the litigation costs of businesses operating in Georgia, and build another key element of a stable and efficient business environment. In particular, Georgia would benefit from U.S. assistance in training its mediators and reaching out to the business community to build confidence in the effectiveness of arbitration and mediation compared to traditional litigation.

Conclusion: Georgia faces both internal and external challenges, but the outlook is positive

For the past four years, the government of Georgia has moved the country forward. The executive branch has continued the fight against corruption, ensuring that Georgia earned the best World Bank Group's WGI corruption control indicator in its history.

The government has continued to reform the tax system in order to motivate entrepreneurs, both foreign and domestic, to reinvest more of their income and raise the overall investment level in the country. The government launched a reform of the school system, raising the salaries of the underpaid teachers, while also reforming vocational education and striving to fill some of the gaps with volunteers from abroad. Georgia has entered into a free trade area with the European Union, allowing its successful businesses to penetrate the competitive European markets while making the country more attractive for foreign investors, who are much needed for the country's further growth.

Nevertheless, a high poverty rate, high unemployment, and public dissatisfaction with the government persist. Although the government increased pensions and took other measures to better target the poor, further work needs to be done in this area. Georgia's economic growth may not yet be inclusive enough to convince a majority of the society that changes are occurring for the better.

Constrained by the need to maintain a reasonably balanced budget, the government cannot afford to invest as much as would be necessary for a broader safety net, while at the same time financing

⁸⁶ "OPIC, Partnership Fund team up to finance new projects in Georgia," *Agenda.Ge*, April 26, 2016, <http://agenda.ge/news/56821/eng> (accessed October 3, 2016).

⁸⁷ Partnership Fund Signs Memorandum with OPIC, *Georgia Today*, April 26, 2016, <http://georgiatoday.ge/news/3644/Partnership-Fund-Signs-Memorandum-with-OPIC> (accessed October 3, 2016).

new infrastructure and further development of human capital. Therefore, foreign assistance and investment continue to be of essential importance.

Georgia's main competitive advantages are its cheap labor force, attractive location, and relatively stable political and economic environment. Although its political culture is still evolving and continues to suffer from typical transitional issues, such as an inefficient public sector, a high degree of personalization in politics, and weak grassroots participation in the civil society, it is far ahead of its neighbors. Moreover, the government clearly realizes that FDI is indispensable for Georgia's future development and that domestic stability is indispensable for attracting that FDI.

Help from the U.S. is, therefore, still needed and welcome. The U.S. Government should continue to support Georgia not only financially, but also politically, including establishing a free trade area with the country.

Overall, Georgia is on the right track toward greater stability and prosperity. Much has been done in the past four years. Expecting any government to solve all of Georgia's problems in one election term would be naïve. Georgia is firmly set on a Euro-Atlantic course and further economic and political integration with the EU and NATO. The Georgian elites and the government are committed to these goals and are doing what they can to ensure stability and well-being for Georgia and its people.

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