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GEORGIA'S ROSE REVOLUTION

How One Country Beat the Odds, Transformed Its Economy, and Provided a Model for Reformers Everywhere

THE ANTIGUA FORUM
A Place of Learning for Reformers

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About the Antigua Forum

This case study is part of the Antigua Forum, a project of Universidad Francisco Marroquín (UFM). The Antigua Forum seeks to promote market-liberal reform in order to improve human well-being through liberty. It does this by serving as a "place of learning" for those who are committed to advancing such reform and are in a position to do so.

The project has two core components. The first is an annual gathering of a small group of experienced and current political reformers, disruptors whose projects replace inefficient institutions, entrepreneurs who invest in reform efforts, and experts on political communications and strategy. Here, critical questions are discussed and lessons drawn from past successes and failures, which can raise the probability of success for future reforms.

The second component is a set of complementary resources designed to aid reformers as they study particular experiences, communicate with fellow reformers, and help others in their reform efforts. The case study is one of these resources. It is structured to dig deep into the reform of a specific country at a specific moment and to outline the process followed, obstacles overcome, key decisions made, and ultimately, lessons learned.

This study is about Georgia. After seventy years of Soviet rule, this small South Caucasian nation began its march to markets in 1992, but the economic and political transition was initially chaotic and at times violent. The move away from Soviet central planning to a market economy was clear even during the chaotic 1990s and early 2000s. However, the most important market-liberal reforms began after the Rose Revolution in 2003. Today, Georgia stands as a leading example of how a country can transform itself and obtain a market economy. We tell the story of the market-liberal reforms that followed the Rose Revolution, and we draw lessons for like-minded reformers around the world.

Prologue: Cincinnatus

Lucius Quinctius Cincinnatus (520–430 BC) was a Roman aristocrat and political figure. In many ways, Cincinnatus was like most Roman aristocrats of his time. A landowner and senator, he served for a year in 460 BC as one of the two consuls—the highest position in the Roman Republic.

Cincinnatus became famous in his own lifetime because of his willingness to relinquish power after the job was done. On two separate occasions, Cincinnatus was called upon to assume leadership roles that granted dictatorial powers. First, in 458 BC he was made dictator by the Romans to fight the Aequi, who had trapped the main Roman army. Legend has it that he was plowing his fields when informed that the senate had named him dictator for a term of six months. After leading a Roman army and defeating the Aequi, Cincinnatus resigned and returned to his farm, having held dictatorial powers for just sixteen days. Later in 439 BC, at age eighty, another crisis brought him the dictatorship, but again he quickly handled the situation and then resigned power to return home.

To this day, Cincinnatus is held up as an example of civic virtue—a man willing to give up his home life to serve his country in time of need. But more importantly, Cincinnatus was wise and humble enough not to abuse the powers that were bestowed upon him. He remains a great historical counterexample to Lord Acton's warning that "power tends to corrupt, and absolute power corrupts absolutely."

More than two thousand years later, Americans would compare George Washington to Cincinnatus. Another legend has it that Washington had to be lured from his farm in Virginia to lead the Continental army in 1775. After the American victory, Washington retired again to Mount Vernon in 1784. But again after just a few years, he was asked to preside over the Constitutional Convention of 1787. With the young nation's future still in the balance, he agreed to run for and was easily elected to two terms as president of the United States. There is little doubt that Washington could have remained president for another term or two had he run again. But, like Cincinnatus before him, Washington gave up power to return to his farm. Washington's actions are remembered to this day by his soldiers' descendants in the Society of the Cincinnati.

The willingness of individuals to sacrifice their personal comfort for their fellow countrymen in times of crisis is certainly something to be lauded. Even more laudable is having the humility to exercise power judiciously—making the tough decisions—and holding that power for no longer than necessary. The story told here involves individuals who, like Cincinnatus and Washington, answered their country's call to service in a time of great need, made the tough decisions, and then retired from public service soon thereafter.

Georgia: A Brief History

With a population of 4.5 million and GDP (in purchasing power parity terms) of US$25 billion, Georgia has a per capita income of about $5,600. Export products include fruits and nuts, wine, mined ores, and refurbished used cars that are shipped abroad. For energy, Georgia primarily relies on hydroelectric power and imports oil and gas, mostly from neighboring Azerbaijan.[1]

The history of Georgia stretches back many centuries. This fertile region on the far eastern side of the Black Sea found itself at the crossroads of early civilizations, such as Greece to the west and Persia to the east. Archaeological evidence of Georgian civilizations dates back to the seventh century BC. Major Georgian kingdoms were formed by the fourth century AD in eastern and western Georgia. In the eleventh century, the two major kingdoms unified to cover much of modern-day Georgian territory. Throughout the Middle Ages, these kingdoms faced attacks from Moguls, Ottoman Turks, Persians, and other groups.

Most Georgians today are members of the Georgian Orthodox Church, which traces its origins to Christianity from the eastern Georgian kingdom of Kartli in AD 337. Originally subordinate to the Apostolic See in Antioch (established by Saint Peter) in present-day southern Turkey, the Georgian Orthodox Church slowly established its autonomy. This was fully achieved by the eleventh century, and since that time the catholicos-patriarch of all Georgia has led the Church.

1. *CIA World Factbook*, "Georgia," last modified November 4, 2013, https://www.cia.gov/library/publications/the-world-factbook/geos/gg.html.

Over several decades during the late eighteenth and early nineteenth centuries, the Russian Empire annexed much of the region south of the Caucasus Mountains (see map, figure 1). Thus began nearly two centuries of Russian occupation and rule in the region. After a brief period of independence during the Russian Revolution, Georgia fell back into Russian hands in 1921 and eventually became the Georgian Soviet Socialist Republic, part of the Soviet Union. Then after seven decades of Soviet rule, Georgia declared independence on April 9, 1991, just before the collapse of the Soviet Union itself.[2]

Figure 1. Map of Georgia

Wikimedia Commons

The immediate aftermath of independence was chaotic, including a bloody coup d'état and ethnic conflicts in the Georgian regions of Abkhazia, South Ossetia, and Adjara. Economically, things were little better. The breakup of the Soviet Union disrupted the long-established, if economically irrational, Soviet economic plan. Countries like Georgia, which had aligned their economies to support the Soviet plan, found themselves in limbo. The basic questions of economic life—What to produce? How to produce? Who to sell to?—had not been asked by

2. The information in this section was drawn from *Wikipedia's* Georgia entry and augmented with personal knowledge acquired from conversations during many visits to the country. "Georgia (country)," *Wikipedia*, last modified November 18, 2013, http://en.wikipedia.org/wiki/Georgia_(country).

Georgians for seventy years. Many state-owned enterprises now owned by the Georgian government floundered as the patterns of specialization and trade within the old Soviet Union collapsed. Without stable tax revenue, the government resorted to printing money, which resulted in brief periods of hyperinflation. Basic items such as food and fuel became scarce thanks to price controls and supply disruptions.

In 2003 after some twelve years of civil war, political uncertainty, and economic collapse, the Rose Revolution peacefully deposed Eduard Shevardnadze, a former Soviet official who had ruled autocratically for the previous decade. Mikheil Saakashvili was elected to lead the new government, and it is at this point that our story begins. Although the issues related to the separatist regions and hostile relations with Russia remained, the Rose Revolution ultimately ushered in a period of rapid economic liberalization. The purpose of this study is to examine this reform experience.

The Georgian Reform Miracle: The Big Picture

The market-liberal reforms unleashed in Georgia have earned the country a reputation as one of the fastest-reforming nations in the former Soviet sphere, if not the entire world. International media like the *Economist* as well as numerous international agencies took notice of these reforms from the very beginning.[3] Simeon Djankov, creator of the World Bank Doing Business project and former minister of finance of Bulgaria, argues that no other country in the last fifty years has been able to conduct such deep reforms in so many areas so quickly.[4] According to the United States Agency for International Development (USAID), the closest analogues are Singapore in the 1960s, South Korea in the 1970s, Ireland in the 1980s, Estonia in the 1990s, and Slovakia between 1998 and 2002.[5] Even among this group of countries that achieved significant reforms, Georgia stands out. USAID says Georgia has made "the broadest, deepest, fastest business climate reforms of any country in the last fifty years."[6]

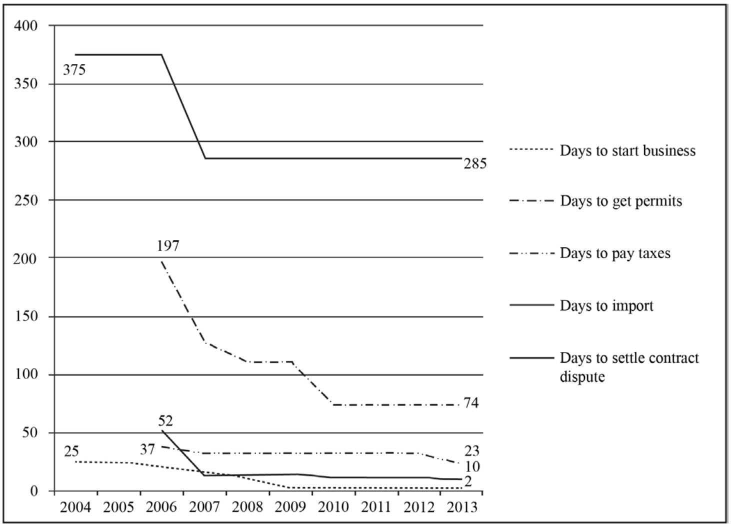
3. *The Economist*, Face Value, "A Different Sort of Oligarch," July 29, 2004, http://www.economist.com/node/2963216.
4. See *Georgia: Opened for Business Georgia Business Climate Reform Final Report* (Washington, DC: USAID, September 2009), http://pdf.usaid.gov/pdf_docs/PDACN591.pdf; "The World's Leading Reformer," Georgian National Investment Agency website, accessed November 20, 2013, http://investingeorgia.org/index.php?m=230.
5. USAID, *Key Results Achieved by the USAID-Government of Georgia Business Climate Reform Partnership* (Tbilisi, 2009), p. 4.
6. *Georgia: Opened for Business Georgia Business Climate Reform Final Report* (Washington, DC: USAID, September 2009), p. 3, http://pdf.usaid.gov/pdf_docs/PDACN591.pdf.

Here we review four different measures to help us gauge Georgia's economic transformation over the past decade. The first three indicators—the Doing Business (DB) ratings from the World Bank, the Economic Freedom of the World (EFW) index, and the Index of Economic Freedom (IEF)—are all *direct* measures of economic reform (or lack thereof) across a large set of countries, including Georgia. The final indicator is a measure of corruption from Transparency International. Reducing corruption was a primary goal of Georgia's reforms.

The Doing Business ratings from the World Bank attempt to measure the "ease" of doing business in a given country over the life cycle of a business. The DB project provides detailed estimates of everything from how many days it takes to start a business, import a product, or settle a contract dispute in court, to how hard it is to hire a worker or pay business-related taxes. Figure 2 shows Georgia's score in several components of the overall DB ratings.[7] These indicators show the amount of time (measured in days) needed to start a business, obtain construction permits, pay taxes, import goods, and settle a contract dispute. In each case, the impressive gains in reducing obstacles to doing business in Georgia are clear. Doing Business named Georgia its top reformer in 2006.[8] The 2013 report ranks Georgia an astounding ninth in the overall ease of doing business score.[9]

7. *Doing Business: Measuring Business Regulations* (The World Bank, 2013), http://www.doingbusiness.org/Custom-Query/georgia.
8. *Investment Climate and Opportunities in Georgia* (Tbilisi: Georgian National Investment Agency, 2011), http://www.guam-organization.org/attach/geoinv6.pdf.
9. *Doing Business: Measuring Business Regulations* (The World Bank, 2013), http://www.doingbusiness.org/Custom-Query/georgia.

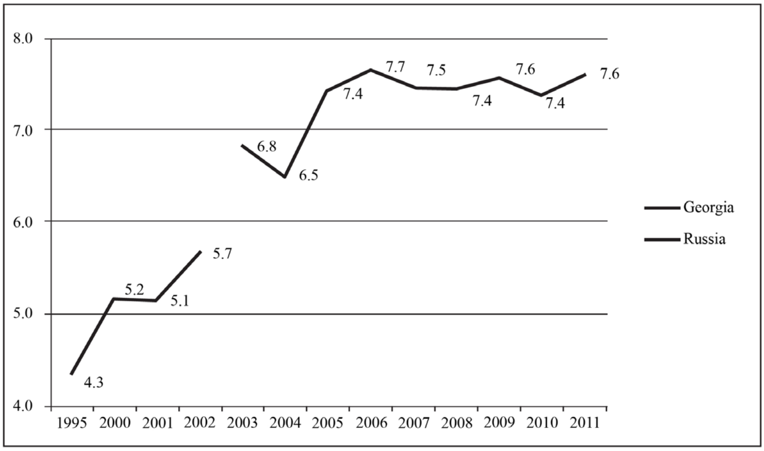
Figure 2. World Bank *Doing Business* Report: Key Measures for Georgia



Next, consider the Economic Freedom of the World (EFW) index published by the Fraser Institute. The EFW index attempts to measure the consistency or inconsistency of a nation's policies and institutions with economic freedom, and is broader in scope than the DB ratings. The EFW index has been published since 1996 and includes data for many countries back to 1970, though it was not until 2003 (the year of the Rose Revolution) that data became available for Georgia. Certainly in 1995 and arguably even into the early 2000s, it is fair to assume that Georgia was not much better in terms of economic policy than Russia, which was rated 4.3 (out of 10) in 1995 and 5.2 in 2000. Georgia's first economic freedom rating was 6.83 in 2003. By 2010 the rating had improved to 7.40. (See figure 3.) Georgia's ranking has been as high as twenty-third in the world (in the 2013 report, it ranked twenty-fifth).[10]

10. Free the World.com, website of the Economic Freedom Network, http://www.freetheworld.com. Comparing the EFW index ratings over time is a challenge because new variables have been added and old variables deleted to the index. The decline in the rating from 2009 to 2010 was largely a result of changes to the index structure. The "chain-linked" version of the EFW index adjusts for this phenomenon, but it is not available for countries like Georgia that were not rated in 2000.

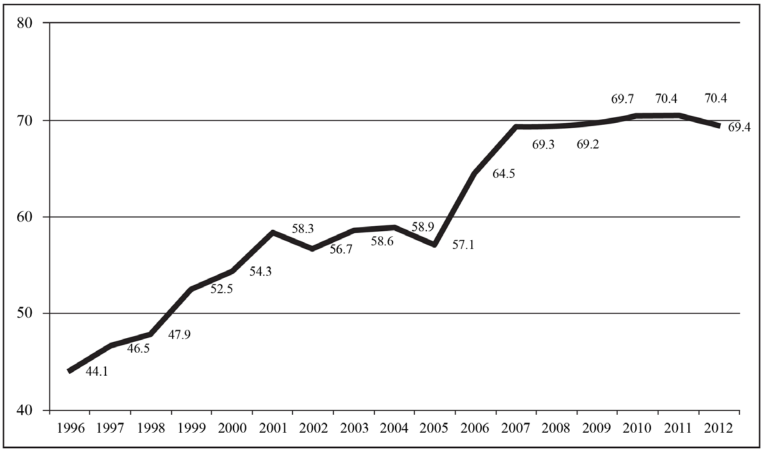
Figure 3. Economic Freedom of the World Index (Fraser Institute): Russia and Georgia's Ratings



The Index of Economic Freedom (IEF) published by the Heritage Foundation is another economic freedom rating with a very different methodology from the EFW index. The IEF rates Georgia back to 1996. Figure 4 shows these ratings (out of 100). Like the EFW index, the IEF shows the rapid economic reforms taking place in Georgia particularly during 2003 to 2007.[11] The IEF score increased from a very low 44.1 (out of 100) in 1996 to 57.1 by 2005, reflecting a slow but steady trend toward a market economy. Between 2005 and 2007, during the height of the liberalization process, the rating spiked to 69.3 in just two years. In terms of rankings, Georgia reached twenty-first in the 2013 IEF report.

11. *2013 Index of Economic Freedom* (The Heritage Foundation, 2013), http://www.heritage.org/index/. The IEF is more subjective and less purely data driven than the EFW index. As a result, the IEF is able to rate more countries (though only back to 1995 at the earliest) than the EFW index. Even more so than the EFW index however, changes to the IEF methodology in various editions jeopardize the ability to make clean comparisons over time. The IEF also labels its data by the year of publication. In contrast, the EFW index labels its data by the actual data year. Because there is about a two-year lag in getting the data together, the 2012 IEF data roughly correspond to the 2010 EFW data, with both reports published in 2012.

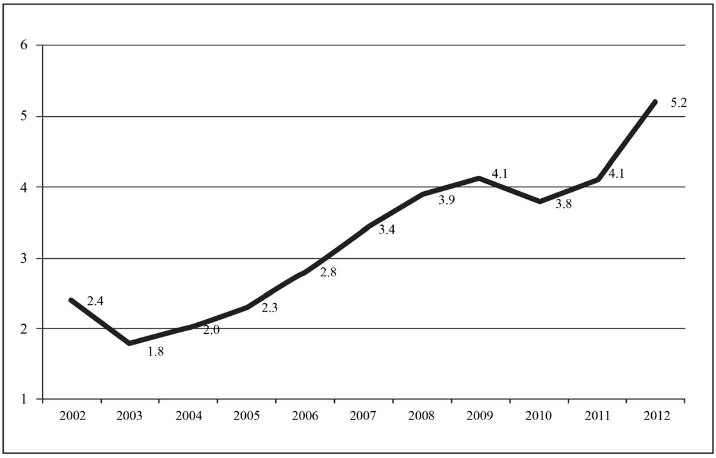
Figure 4. Index of Economic Freedom (Heritage Foundation): Georgia's Ratings



Dramatic improvements can also be seen in the area of corruption over the past decade. The Transparency International Corruption Perceptions Index (CPI) data shown in figure 5 illustrate the gains. While the ratings remain relatively low, the improvement is dramatic. The rating (on a 10-point scale) increased from as low as 1.8 in 2003 to 5.2 in 2012. The ranking has improved correspondingly from eighty-fifth to fifty-first (in 2012). While the culture of corruption in Georgia runs deep and much work remains to be done, low-level corruption among policy and government officials has largely been eradicated.[12]

12. Transparency International Corruption Perception Index 2013, *http://archive.transparency.org/policy_research/surveys_indices/cpi/2003*.

Figure 5. Corruption Perceptions Index (Transparency International): Georgia's Ratings



The reforms enacted in Georgia have been a success by most any measure. What is remarkable is how significant and far-reaching these reforms were, and how rare it is for any country to undertake such changes. Reform is hard work. It is also greatly needed.

Why Politics Often Gives Us Bad Policy

Regardless of ideological persuasion, economists and development experts generally agree on the conditions needed to promote economic growth and prosperity: protect private property, stabilize the currency, open trade and investment, maintain fiscal discipline, apply sensible regulations.

Yet in practice, governments throughout the world impose policies that are widely viewed to be counterproductive to economic growth and prosperity. Economists have many explanations for why such policies exist and why they persist. The founders of public choice economics, James Buchanan and Gordon Tullock, published a seminal book on this subject, *The Calculus of Consent*.[13] They argue that how people behave within the political process—as elected representatives, government officials, members of interest groups, and voters—is no different from how these same individuals behave in all other human affairs. Most notably, they respond to incentives.

The problem, as described by Buchanan, Tullock, and others within the public choice tradition,[14] is that the incentives individuals face in the political process are different from the incentives they face in the market. For example, officials in government

13. James Buchanan and Gordon Tullock, *The Calculus of Consent: Logical Foundations of Constitutional Democracy* (Ann Arbor: University of Michigan Press, 1962).
14. For a good summary of public choice economics, see William Mitchell and Randy Simmons, *Beyond Politics: Markets, Welfare, and the Failure of Bureaucracy* (Boulder, CO: Westview Press, 1994). For a more technical survey, see Dennis C. Mueller, Public Choice III (Cambridge: Cambridge University Press, 2003).

agencies by definition do not work in for-profit institutions, which means they have fewer incentives to manage their costs, and it is difficult to reward these officials for doing so. They may, on the other hand, be rewarded for increasing their budget or the number of employees in their agency, regardless of whether this is in the country's economic interest.[15] Similarly, elected officials have an incentive to support policies that create benefits for well-defined groups, in exchange for support (votes, campaign contributions, etc.) to help them win reelection, regardless of whether these policies benefit the country as a whole. Among the possible beneficiaries of the policies are voters who live in the politicians' districts and industries that operate there.

When specific groups receive special treatment from legislators or regulators, the process is known as "capture." For example, a domestic industry receives protection from foreign competitors in the form of high tariffs or restrictions on foreign ownership in the market. Or an industry is protected from domestic competitors through licensing rules, regulatory approval processes, or limitations on the number of firms in the market or how they compete.[16]

The special interests are not confined to established industries. Other groups with well-defined interests also may organize themselves and successfully lobby for government favors. Meanwhile, the average consumer has less incentive to lobby against these favors and therefore pays inflated prices or higher taxes. In many cases, the costs of these favors to special interests

15. An original analysis of the economics of bureaucracies may be found in William Niskanan Jr., *Bureaucracy and Representative Government* (Chicago: Aldine-Atherton, 1971).
16. The political economy of regulation studies how regulators may be "captured" by the industries they oversee, as well as the tradeoffs made by political decision makers regarding regulation. See George J. Stigler, "The Theory of Economic Regulation," *Bell Journal of Economics and Management Science* 2, no. 1 (Spring 1971): pp. 3–21; and Sam Peltzman, "Toward a More General Theory of Regulation," *Journal of Law and Economics* 9, no. 2 (1976): pp. 211–40.

are substantially greater than the benefits, making them harmful to the country's long-term well-being—yet many of these uneconomic policies endure.[17]

Most citizens are unaware of the harmful effects of such policies for two reasons. First, too many laws and policies are debated each day for the individual voter to be aware of the details. Second, the costs of these policies are spread across the larger population; therefore the effect of any one policy on the individual voter is too small to warrant his or her attention. These two factors provide incentives for voters to remain "rationally ignorant" of the harmful effects, while the special interests that benefit from such policies have every incentive to lobby for them.[18]

The combination of special interest lobbying (by those who want favors from their government) and rational ignorance (by those who pay the bills) can be powerful, and very harmful. One might think it would be difficult for an individual politician to get a law or policy enacted to benefit only a narrow special interest group. Won't other politicians oppose it? Don't they need to represent their constituents who have their own unique interests? Yet politicians in democratic legislatures regularly trade votes in a process known as "log-rolling." ("I support this law that benefits your constituents, and in exchange you support this other law that benefits my constituents.") The coalitions produced by log-rolling help politicians reach agreements that benefit special interests and are politically feasible. The price paid, however, can be policies that make the country poorer.

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17. For a more-detailed description of how concentrated benefits and dispersed costs can lead to inefficient results, see Mancur Olson, *The Logic of Collective Action: Public Goods and the Theory of Groups* (Cambridge, MA: Harvard University Press, 1965).
18. The term "rational ignorance" was coined by Anthony Downs, another pioneer in public choice economics. See Anthony Downs, *An Economic Theory of Democracy* (New York: Harper & Brothers, 1957).

Another problem with the political process in a democracy is that it tends to be shortsighted. Politicians have a strong incentive to create immediate, visible benefits for their constituents in order to earn votes in time for the next election, and a disincentive to impose costs on them now. This means politicians have an incentive to fund government through deficit spending, which pushes the costs (taxes) into the future and thus makes them less visible today. When taxes are raised in the future to pay for today's spending, that political cost will be borne by a future politician.[19] A prominent example all over the world is governments that promised future pension and health benefits without setting aside money at the time to pay for them. Now, as many of those obligations come due, governments are unable to pay.

The conclusion is that the politics of democracies can produce uneconomic results. They may allow bloated bureaucracies to emerge, which raises tax burdens. They may favor certain industries, which hurts competition and thus raises prices paid by consumers. They may hide the costs of deficit spending today and thus raise future taxes. These consequences flow naturally from all players as they respond rationally to the rules of the game in democratic government.

Why and How Do Reforms Happen?

Despite the limitations of democratic government, sometimes the rules are changed in ways that promote economic well-being. Sometimes reforms happen. Over the last twenty years, trade barriers have been reduced in almost every region in the world. In many countries, industries considered to be public utilities, such as telecommunications, have been privatized and their markets opened to competition. (Telecom reform in Guatemala is an excellent example, outlined in another Antigua Forum

19. A seminal work on how politics promotes deficit spending is James M. Buchanan and Richard E. Wagner, *Democracy in Deficit: The Political Legacy of Lord Keynes* (New York: Academic Press, 1977).

case study.) Other industries that were private but heavily regulated have experienced significant deregulation. (The experience with airlines and trucking in the United States in the 1970s is a well-known example.)

At the global level, between 1980 and 2000 the average EFW index rating improved dramatically, from 5.3 to 6.7.[20] In other words, consumers in countries across the world experienced significantly more economic freedom, such as more competition, fewer monopolies, and freer trade. The question is why and how do such reforms happen.

In many cases, a crisis is the common denominator in countries that reform. Milton Friedman famously argued that "only a crisis, actual or perceived, produces real change."[21] In the second half of the twentieth century, developing countries across the globe adopted import substitution, which artificially promoted domestic industries by using import tariffs, price controls, exchange rate controls, public ownership, and other market interventions. The resulting economic crises—including the 1982 debt crises in Brazil, Chile, Mexico, and beyond—pushed many countries to adopt market-oriented reforms (to greater or lesser degrees) in the 1980s and 1990s. Reforms took place in Latin America, Africa, Asia, and soon thereafter in the former Soviet economies.

Anne Krueger, former head of the International Monetary Fund and a leading expert on the political economy of reform in developing countries, published an important book in 1993 that critically reviewed these reform experiences. Echoing Friedman, she observed that many reforms only came about when economic conditions had become sufficiently desperate to force political

20. *Economic Freedom of the World: 2012 Annual Report* (Fraser Institute, 2012), p. 16, exhibit 1.4, http://www.freetheworld.com/2012/EFW2012-ch1.pdf.

21. Milton Friedman, *Capitalism and Freedom*, fortieth anniversary ed. (Chicago: University of Chicago Press, 2002), p. ix.

change.[22] As Dani Rodrik has argued: "Reform naturally becomes an issue only when current policies are perceived to be not working. A crisis is just an extreme instance of policy failure. That policy reform should follow crisis, then, is no more surprising than smoke following fire."[23]

Also in the 1990s, John Williamson gathered reform experts to share lessons from around the world. He then published a book with a list of hypotheses about how reform comes about, and when it succeeds.[24] Prominent on the list was the idea that reforms emerge in response to crisis.[25] Notably, however, Williamson found that while generalizations can provide some limited insight, no hypothesis "was either necessary or sufficient for a successful reform."[26] Examples of reform in the absence of a crisis include airline and trucking deregulation in the United States and telecommunications privatization in Guatemala.

Nevertheless, a political or economic crisis is frequently the catalyst for change. For many developing countries around the world that reformed in the 1980s and 1990s, the catalyst was unsustainable debt and the failure of import-substitution policies. In the case of Georgia, there is no lack of crises to choose from: the breakup of the Soviet Union and Georgia's subsequent independence, the civil wars in Abkhazia and South Ossetia, the Rose Revolution, and war with Russia in 2008.

Perhaps the most compelling argument linking crisis and reform is that a crisis may serve as a catalyst for change because it challenges

22. Anne Krueger, *Political Economy of Policy Reform in Developing Countries*. (Cambridge, MA: MIT Press, 1993), p. 109.
23. Dani Rodrik, "Understanding Economic Policy Reform," *Journal of Economic Literature* 34 (March 1996): p. 27.
24. John Williamson, "In Search of a Manual for Technopols," in *The Political Economy of Policy Reform*, ed. John Williamson (Washington, DC: Institute for International Economics, 1994), pp. 11–28.
25. Williamson, *Political Economy*, pp. 11–28.
26. Williamson, *Political Economy*, p. 589.

the political equilibrium. In times of crisis, coalitions of special interest groups can become unstable, which may provide an opportunity for reformers.[27] Yet even these opportunities must deal with factors that favor the status quo. For example, it may be difficult to get support for any change if people don't understand how they are going to be affected.[28] Or if they are confused as to how the costs and benefits will be distributed across groups in society.[29] Further, Daron Acemoglu and James A. Robinson have argued that established interests may actively resist reform when they benefit from the status quo, a theme of their popular book, *Why Nations Fail*.[30]

When reforms do happen, they can take many shapes. Milton Friedman followed up his comment—about real change being the result of crisis—with the remark that the shape and character of these reforms will be influenced by "the ideas that are lying about." In short, ideas matter. When opportunities arise to reform, the ideas currently in fashion tend to dominate the process.

The role of ideas can work for or against market-liberal reform. For example, when India became independent from the United Kingdom in 1947, the new government adopted the ideas of central planning, which were all the rage in intellectual circles at the time. In contrast, when Georgia became independent, the ideas of central planning were discredited among almost all of the former Soviet states.

27. Mancur Olson, *The Rise and Decline of Nations: Economic Growth, Stagflation, and Social Rigidities* (New Haen and London: Yale University Press, 1982).
28. Raquel Fernandez and Dani Rodrik, "Resistance to Reform: Status Quo Bias in the Presence of Individual-Specific Uncertainty," *American Economic Review* 81, no. 5 (December 1991): pp. 1146–55.
29. Alberto Alesina and Allan Drazen, "Why Are Stabilizations Delayed," *American Economic Review* 81, no. 5 (December 1991): pp. 1170–88.
30. Daron Acemoglu and James A. Robinson, *Why Nations Fail: The Origins of Power, Prosperity and Poverty* (New York: Crown, 2012). See also, Daron Acemoglu and James A. Robinson, "Economic Backwardness in Political Perspective," *American Political Science Review* 100, no. 1 (February 2006): pp. 115–31.

Whether a reform produces economic growth depends on the quality of the ideas that shaped it. Which ideas get included (and whether they endure) depends on how well they coincide with the realities of the country.

Peter Boettke, Chris Coyne, and Peter Leeson argue that the further away a reform falls from the knowledge that a society has acquired through practical experience, the less likely it will endure. The authors distinguish between institutions that emerge spontaneously within the society, those that are created within the society, and those that are "imported" from outside the society. These three examples lie upon a continuum from most to least consistent with a society's practical experiences. Institutional reforms that are imported from outside the society are less likely to endure than those that come from within.[31]

Echoing Boettke, Coyne, and Leeson, Dani Rodrik argues that successful reforms reflect political realities. In the same way that innovation in the use of technology can promote economic growth, so can innovation and discovery in the process of reform promote better institutions.[32]

Similarly, Wayne Leighton and Edward López show that ideas matter because they ultimately determine how a society's institutions emerge and evolve (whether through reforms or other means). These institutions in turn create incentives or disincentives for peaceful cooperation and economic prosperity.[33]

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31. Peter J. Boettke, Christopher J. Coyne, and Peter T. Leeson, "Institutional Stickiness and the New Development Economics," *American Journal of Economics and Sociology* 67, no. 2 (April 2008): pp. 331–58.
32. Dani Rodrik, "When Ideas Trump Interests: Preferences, World Views, and Policy Innovations," *Journal of Economic Perspectives* (forthcoming).
33. Wayne A. Leighton and Edward J. López, *Madmen, Intellectuals and Academic Scribblers: The Economic Engine of Political Change* (Stanford, CA: Stanford University Press, 2013), chapter 5.

As Leighton and López demonstrate, ideas have no effect if reformers don't pick them up. The successful market-liberal reformer recognizes the limitations of current institutions and looks for opportunities to push against these limitations to create value in society. By looking for these opportunities, the successful reformer acts like an entrepreneur in the market. This political entrepreneur may be a creator of ideas, a trader in ideas, or an implementer of a set of ideas. All play a role in the process of reform.[34]

In the Georgian reforms discussed in this case study, we see political entrepreneurship at all levels, most notably by Kakha Bendukidze and a few key allies, who had the authority and strength of will to take a bold set of ideas and turn them into reforms that transformed the Georgian economy.

34. Leighton and López, *Madmen*, chapter 5.

Georgian Economic Reforms: The Rest of the Story

Who are the political entrepreneurs in the Georgian reform story?

The Georgian reforms were inspired by idea creators such as Adam Smith, Ludwig von Mises, Friedrich Hayek, and Milton Friedman. Their ideas were picked up and popularized by intellectuals (traders in ideas), including journalists and policy analysts (such as those at Cato Institute, Mises Institute, Institute for Economic Affairs).

Within Georgia during the reform period, Gia Jandieri and Paata Sheshelidze were two of the most important contributors to an intellectual climate that favored economic freedom. As cofounders of the New Economic School–Georgia (NESG), these firebrands have been teaching the ideas of economic freedom to Georgian students, policy makers, and intellectuals since 2001. Both spent time studying at the Mises Institute in the early 2000s and have close ties to free-market think tanks around the world.

But ideas, though absolutely necessary, will not spontaneously create reforms. It takes real men and women of action to implement the idea of economic freedom.

Into this role stepped Mikheil Saakashvili, a Columbia University-educated, smooth-talking politician, who emerged as the nation's leader after the Rose Revolution in 2003. Saakashvili appointed key players, including Vano Merabishvili in the Ministry of Internal Affairs and Zurab Adeishvili in the Ministry of

Justice, to whom he gave power in the form of the opportunity and the freedom to implement their ideas.

While the role of Saakashvili is critical to the story, the central hero of Georgia's economic reforms is another man of action: Kakha Bendukidze. A Georgian native and businessman, Bendukidze made a fortune in post-Soviet Russia. In early 2004 Bendukidze left his position as chairman and CEO of OMZ, a large concern in Russia focused on heavy industry. He was about to sell his share of the company when he was invited to participate in the first Russian-Georgian economic forum. The aim of the forum was to present the Georgian government's new agenda to create more opportunities for business.

During his visit to Georgia, Bendukidze was invited to meet President Saakashvili and share his views on economic reform. The president asked him what skills were needed for a minister of economy. Bendukidze simply answered, "The main thing you need is someone who understands the meaning of freedom." By the end of the meeting he had been offered the job of Georgia's minister of economy.

As Saakashvili later confessed, no one at that time knew that this would turn out to be the crucial appointment. Bendukidze was offered the position in large part because of his reputation as a successful businessman. This did not necessarily mean that he would be a successful statesman, but bringing a businessman's perspective into government was exactly what the country needed at the time.

Together Saakashvili and Bendukidze would become a powerful force for economic freedom in the coming years. In accounts of the Georgian economic reforms, no name appears as frequently or as prominently as Bendukidze's. With the mindset of an entrepreneur, he saw an opportunity to move rapidly toward economic reform, due to a crack in the status quo created by the

Rose Revolution and the election of the popular Saakashvili. With the skill and charisma of a leader, he built a team, defined its principles, and kept everyone motivated. His team's push for economic liberalization would change this tiny country in dramatic ways over the next four years.

Most of Georgia's economic reforms can be classified into three broad categories: de-bureaucratization, privatization, and liberalization. (For a description of twenty-seven specific reforms that fall within these categories, see appendix.)

- De-bureaucratization refers to reforms that improve efficiency—often by removing excess layers of employees or redundant processes—in activities that are not privatized and continue to be performed by the government, such as public safety.
- Privatization represents the transfer of previously state-owned assets to private hands.
- Liberalization refers to the elimination of rules and regulations and other impediments facing individuals and businesses as they go about their economic pursuits.

Next, we examine important reforms from each category in greater detail.[35]

De-bureaucratization

Bendukidze and his team believed their government was bloated with too many employees doing too little work. They responded with a systematic review of executive branch jobs in early 2004, which resulted in huge personnel cuts.

For instance, Georgia's antimonopoly policies were enforced within a huge administrative structure, with numerous agencies

35. Most of the information provided in this section is from Larisa Burakova, *Why Georgia Has Succeeded* [in Russian] (Moscow: United Press, 2011).

and departments. Bendukidze started to investigate each entity individually. Despite the fact that price controls were lifted in the early 1990s, the Department of Pricing was still intact. Bendukidze invited the deputy head of this department to his office and asked what exactly they were doing. This is how Bendukidze remembers the encounter: "He explained vaguely. Then I asked how many people were working there. 'Twenty-five,' he said. I asked him to bring them all here. 'It's Thursday, no one is here. Everyone left for their weekend homes.'"

The fact that only the deputy and bookkeeper were present at the Price Inspection Office, and of sixty Antimonopoly Service employees no more than fifteen were around, served as eloquent proof that the entities were superfluous. In August 2004 the Price Inspection and Antimonopoly Service were eliminated. In their place, about one year later, the Agency for Free Trade and Competition was created, with a staff of six.

These reductions in personnel helped establish the idea of small government. They also made it possible to pay higher salaries to the remaining employees, which had a powerful effect on tackling corruption. By increasing the salaries of the government workers who remained, the bureaucrats had less need to take bribes to feed their families. Furthermore, getting caught with your hand in the cookie jar meant losing a higher paying job. The incentives for corruption were dramatically reduced.

The personnel cuts were huge. In the Ministry of Agriculture, the number of employees went from 4,374 to 600; in Tbilisi City Hall, from 2,500 to 800; in the Ministry of Environment Protection, from more than 5,000 to just 1,700. Similarly, the number of government ministries fell from eighteen to thirteen.

The most significant de-bureaucratization of the new regime was in public safety. This reform overhauled what previously seemed unchangeable in Georgia: the Ministry of Internal Affairs and the Ministry of State Security.

Prior to this reform, the Ministries of Internal Affairs and State Security employed seventy-five thousand people. In December 2004, the two ministries were merged into a new Ministry of Internal Affairs (MIA). Each department and service was reviewed to exclude duplicate functions. The new MIA had twenty-seven thousand employees, a nearly two-thirds reduction in total staff.

From the very beginning, the reformers in Georgia realized that reforms in *any* sphere would be impossible without eliminating the organized crime that was terrorizing the country (and whose higher ups were known as "thieves in law"). In the old Soviet Union, around a third of organized crime members in that vast country were originally from Georgia (while the population of Georgia was not even 2 percent of the USSR!). In the 1990s it was the thieves in law who became the real authority in Georgia. They were not only roving bandits but also racketeers controlling enterprises that generated income on a regular basis.

According to the results of a 2002 poll conducted among school children in the city of Kutaisi (a bastion of crime at the time), 25 percent of boys wanted to be thieves in law and 35 percent of girls wanted to be the wives of thieves in law. Only two weeks after Saakashvili's election, the reformers waged war on two fronts—one against corrupt government officials and another against the thieves in law, who at the time were actually running the country.

The first step needed to win the war was meaningful legislation. On June 24, 2004, at the initiative of President Saakashvili, parliament passed the Organized Crime and Racketeering Act, which included terms such as "racket," "racketeer," and "racket group." On December 20, 2005, a tougher version of the law was passed in which terms such as "thieves settlement," "thief in law," and "thief world" were added to expand the scope of the law by using terms that defined what it meant to be part of this mafia and criminalizing participation in it.[36]

Initially even members of parliament were concerned that the legislation might backfire and elevate the status of the criminals. Their worries were baseless. The act not only made the terminology official, it also provided real tools in the struggle against these criminals. According to the new law, a member of the thief world may be detained and sentenced from three to eight years in prison, for simply being a member of a criminal organization. Someone convicted of being a thief in law may be sentenced from five to ten years in prison. Furthermore, his property and that of his family and their associates may also be confiscated unless they can prove it was acquired legally. The law is bolstered by the mafia rule that if a thief in law denies his status, his "colleagues" will punish him with death.

The new law led to the arrest of more than two hundred members of thief groups. Those who avoided prison sentences fled, mostly to Russia. According to Georgian law enforcement authorities, in September 2006 a crime lord made a call to the head of the MIA's organized crime unit and threatened him. Unless the police ceased their attack on the thieves in law, he said, the thief world of Georgia would unite and "start a hunt" for MIA employees and their families. In response, authorities confiscated his luxurious villa in Kutaisi and converted it into a police station!

Georgian authorities chose a radical method of reforming the police structures which were not working. The first clear demonstration of this approach was with the traffic police. The State Traffic Inspection was one of the most corrupt units in the Georgian government. It was almost totally self-financed, fleecing both local and foreign

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36. http://www.parliament.ge/index.php?lang_id=GEO&sec_id=69&kan_det=det&kan_id=1680 (in Gevorgian).

drivers as they traveled Georgian roadways. According to estimates, 80 percent of the money extorted from drivers was distributed along the chain of command all the way up to the minister.[37]

The reform was headed by Vano Merabishvili, the minister of internal affairs and an ally of Bendukidze. In early summer of 2004, Merabishvili eliminated the State Traffic Inspection, firing all fifteen thousand employees in a single day! Two months later, in August 2004, the force was replaced by competitive hiring of employees for the newly formed US-style highway patrol. During the two-month transition period there was no policing of the roads, and yet the number of car accidents did not increase. There were no riots and no attempts to preserve the status quo by former employees.

The lesson is clear: abolishing a nonfunctioning institution that lived off extortion had no negative consequences; instead it cleared the way for a better institution to emerge. According to Merabishvili, "We did not follow the advice of the well-meaning Europeans who suggested that we carry out reforms slowly and gradually. We acted very harshly and fired fifteen thousand employees of the ministry."[38]

Not only was the substance of the reform—shrinking these government agencies by two-thirds—huge, the reformers also intentionally used symbolic gestures that reflected the significance of what they were doing. For example, Georgian patrol cars now operate with their emergency lights on at all times to alert drivers to their presence. Previously, patrol officers tried to remain undetected in order to ambush unsuspecting drivers and extract

37. Larisa Burakova interview with Deputy Minister of Justice Girogi Vashadze, June 2012.

38. Лица новой Грузии: интервью с министром внутренних дел страны Вано Мерабишвили. Радио Свобода. 2008. 16 октября [Faces of New Georgia: Interview with Minister of Internal Affairs Vano Merabishvili], October 16, 2008, http://www.svoboda.org/content/transcript/469290.html.

bribes. Even more symbolically, newly built Georgian police stations are typically constructed with lots of glass, a symbol of the new regime's transparency (see figure 6).

One of the new Georgian police stations.
Photo courtesy of Georgian Ministry of Internal Affairs

The reformers were also careful to communicate what they were doing through the media. Both the press and the public were sympathetic to efforts to eradicate corruption, and they were enlisted to lend their support. During the first months that the new patrol force was in place, leading television stations helped identify whatever corruption remained. News reports on television showed images of people paying bribes to new inspectors, who were filmed on hidden camera. Officers convicted of requesting fifty-dollar bribes were sent to prison for ten years. It was not long before their colleagues got the message that taking bribes was actually illegal.[39]

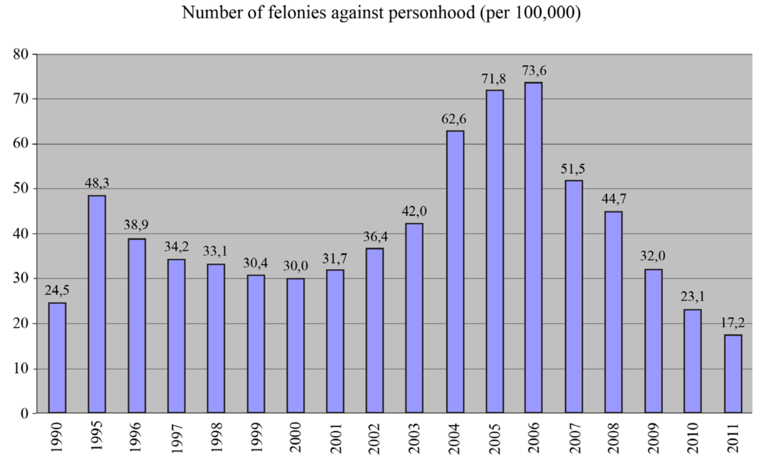
The resounding success of the police reform was so obvious that it was difficult for the opposition to criticize the authorities' actions. Desperate to attract supporters, the critics among politicians even

39. Georgy Zedgenidze, Саакашвили исполнил мечту майора Дымовского [Saakashvili Granted Major Dymovsky's Wish], *Slon.ru*, November 11, 2009, slon.ru/articles/180158.

claimed that the corruption within the MIA was a lesser evil compared to the current extremely high fines for traffic violations. But the press and, most importantly, the public didn't buy it.

In 2012 the police enjoyed the trust of 90 percent of Georgian citizens, up from just 5 percent in 2003. By 2012, Georgia had emerged as one of the safest places in Europe, according to European assessments. While previously fifty cars were stolen every day (car theft is one of the main specialties of organized crime), in 2011 not a single car was stolen in the capital city of Tbilisi. After years of steadily increasing crime rates leading up to and during the reform process, the number of violent crimes (murder, assault, rape, and robbery) has fallen to the lowest levels in a generation (see figure 7).[40]

Figure 7. Crimes (Felonies) Against Persons in Georgia (per 100,000)



40. Sources: Burakova, *Why Georgia Has Succeeded; Georgia's Democratic Transformation: An Update Since the Rose Revolution* (Government of Georgia, 2007), p. 8; Burakova interviews with Minister of Internal Affairs Vano Merabishvili, January 2012, and MIA staff. At the beginning of the reform process in 2005, there was a sharp increase in the number of reported crimes, compared to the preceding year, and a simultaneous decline in the percentage of solved cases. This was because the criminal proceedings code was amended so that any information about a crime could be grounds for opening a criminal investigation.

The new police force quickly became a symbol of reform for the new administration. The police reform was important not only because it established an effective law enforcement system but also because it actually opened the path to other economic reforms.

Privatization

Privatization began immediately after independence in 1992, although a comprehensive privatization process did not begin fully until 2004 under Bendukidze. Today most large-scale state properties have been privatized, and privatization of small- and medium-sized properties and enterprises is ongoing. Bendukidze himself coined the catchphrase for the Georgian privatization program: "Everything is for sale, except honor."[41]

Initially the idea to privatize so-called "strategic assets" was not widely accepted among government officials or the general public. With Bendukidze's leadership, that attitude quickly changed. At a cabinet meeting (late 2004 or early 2005), he asked all the ministers to share their boldest ideas about what in theory could be sold and at what price. He wrote down the ideas and calculated the potential revenue. It turned out that the amount was equal to the Georgian GDP at that time. Government officials who were against radical privatization came to the realization that for a poor country like Georgia privatization was a priority to fund budget shortfalls and new projects.

Under Bendukidze's leadership, Georgia's privatization programs were among the most extensive and least corrupt in the former Soviet Union. The strategy was simple: auction off state assets to the highest bidder, frequently without any conditions, with the funds going to the state. By all accounts the auctions

41. http://en.wikipedia.org/wiki/Kakha_Bendukidze. Note: The English translation is not as precise as it could be.

were open to everyone, with no preference given to Georgians over foreigners. Even Russians could participate, despite worries about threats to territorial integrity or the possible danger caused by selling strategic assets to other countries. Some of these fears may have been put to rest during the August 2008 war with Russia when Tbilisi did not suffer power outages despite the fact that Telasi, the electric power company, had been sold to Russian investors.

The Georgian approach of transparent auctions of state-owned assets stands in contrast to the privatizations in other post-Soviet countries. In the latter, many times assets were simply sold at very low prices to political cronies or to the political leaders themselves. In other cases, citizens were given vouchers with which they could buy stock in newly privatized companies. The reality, however, was that many people did not recognize the value of the vouchers and were eager to sell them cheaply, even bartering them for food or liquor. Many people felt that unscrupulous brokers had cheated them out of their vouchers. The unfortunate side effect was that privatization specifically, and capitalism more generally, became linked in people's minds with corruption and fraud.

In Georgia, by contrast, the new transparent privatization process was seen as a good thing, even though the revenue from the funds would go to the state's coffers instead of being distributed directly to citizens. Opponents of privatization frequently accused authorities of sleazy backroom deals to enrich themselves or their cronies. But the transparent nature of the auctions defused these accusations.

An excellent example of how well the process worked is the privatization of the Intourist Hotel, the first property to be sold under Bendukidze's new plan. This highly desirable hotel was located in the Black Sea resort town of Batumi.

The challenges began with the first potential buyer, who appeared almost immediately. He was a local crony who offered 150,000 lari (about $80,000). Bendukidze's project manager replied, "No. We are going to sell the hotel at auction and we expect it to be sold for at least three million US dollars." The buyer increased his offer to 500,000 lari, but the decision had been made to carry out an open auction, with bids starting at three million dollars.

A presentation was prepared for international financial companies and commercial banks. The hotel building was decorated with a large red ribbon with a bow on top, and photographs were displayed of other properties that were up for sale. When the prime minister asked Bendukidze to join him for a cup of coffee with the crony and several local officials, Bendukidze reiterated his position. The crony labelled it a catastrophe: "You want to take money from businessmen. Instead of enabling new construction and development, you want to kill business." Bendukidze's position remained unchanged: "If you want to do something without me, go ahead, do as you wish. We are going to sell it at auction."

The crony did everything he could to disrupt the auction and scare away potential bidders, including spreading rumors that the bidding was already rigged in his favor. In the end, a Siberian businessman with Georgian roots and fond memories of the location from his youth was identified by Bendukidze's agent and encouraged to participate in the auction. He won the bidding with a final price of $3.02 million.

Instantly, everyone paying attention to the privatization process knew that a new era had dawned. First, the deal didn't go to a local crony as usual; instead it went to a foreigner. This first sale was crucial to proving that privatization could be done differently. It was widely reported in the media. The president invited the Siberian businessman who had won the auction to a meeting, in order to demonstrate that the government welcomed this type of businessman. Random people on the street shook hands with the new owner to show their respect and approval. Second, the price the government got was better than anyone previously thought possible. Instead of seeing the privatizations as a looting of the state's wealth, the opposition had to admit that privatization could provide much-needed revenue for the government.

Another key principle of Bendukidze's privatization plan was that there would be no conditions on the sale of assets. The properties were to be sold as is, and the new owners would be free to do with them as they pleased. This principle was frequently tested, however, when it came to so-called "strategic" assets. The political reality was that many large privatizations required conditions. The challenge was to adopt conditions that satisfied these political realities but did not interfere substantially with market realities so that the assets ended up in the hands of those who valued them most highly.

For example, hydroelectric power plants were often sold to the highest bidder, but with conditions related to the performance of the plant. The winner of the auction would be required to price electricity at rates established in the privatization agreement, which included the rules for increasing rates and their relation to inflation. Some distribution companies made agreements with the government not to raise rates until a certain date.

This mechanism was not fully acceptable to free-market supporters, foremost Bendukidze himself. However, in order to make the reform happen, they accepted the conditions. Bendukidze provided insight into his negotiating strategy during a discussion on the privatization of the largest hydroelectric power station in Georgia, the Inguri Hydro Power Plant (HPP), located on the border of the conflict zone.

> I think that all facilities could be privately owned, including the Inguri HPP, the lines, the load scheduling, everything. Because I don't really understand what government ownership means. Only a big royal stamp may be government property! But if I began to propose complete liquidation of government ownership without any regulation, and the sale of Inguri HPP, no one would listen to me.
>
> You always need to find a compromise between what you think is correct and what will just be heard as a radical point of view. The second task is to always propose a more radical option, because if you want to break a stick in half, then take it by the ends. If you grab it where you want it to break, then it will break in another place. I sometimes did that when I sent a draft law to Parliament that contained obviously unacceptable, though not key, clauses. That concentrated the argument on those points to then make a compromise. The argument started on those points, so I compromised, compromised, compromised and as a result was able to preserve the main point. So, *initially you propose compromise, but radical compromise, and after this, genuine compromise is born* [emphasis added].[42]

The privatizations went well beyond the largest state-held assets such as hotels and power plants. On a smaller scale, but no less politically sensitive, was the issue of state-held farmland. Here, privatization would present both an opportunity and a challenge.

In Georgia, a significant portion of the farmland belonged to the government and was leased to farmers living in local villages. The reformers set about getting this land into private hands. As is the case in many countries where land has both economic and symbolic value, people were concerned that privatization would put this valuable resource in the hands of

42. Burakova, *Why Georgia Has Succeeded*.

a few privileged and well-connected individuals. Residents of small villages were especially concerned that people from Tbilisi would buy up everything.

A key compromise was adopted to assuage fears and make privatization work politically, while retaining the key principle of selling off state assets as efficiently as possible. During the early stages of the draft law, it was decided that certain farmland auctions would be open only to residents of neighboring villages. These were for parcels that had been rented from the government, about 35 percent of the farmland. In addition, the local residents themselves could decide on the size of each lot (but these could be no less than three hectares, if there was no natural border such as a forest or river). Opening bids were set at twice the annual land tax, and residents could bid this up in competition to acquire land. While this more restrictive approach likely reduced revenue from land auctions, it also reduced political tension and allowed the process to work.

Another challenge came up regarding lands located along the border. In the 1990s a five-kilometer strip along the entire border had been excluded from privatization "on security grounds." Nevertheless, the reformers intended to privatize all lands, including those in border regions. The head of the border service along with his wife, who was the parliamentary chair, managed to drum up a serious wave of resistance, arguing that privatization represented a threat to national security.

At the request of Bendukidze, the Association for Protection of Landowners' Rights took aerial photos of the entire border. From the photos it was clear that the arable land along the border had already been broken up into small, cultivated plots. It turns out that border service officials had already taken the land for themselves! When news surfaced of the de facto privatization of the borderlands, the opposition melted away.

Bendukidze next addressed security concerns with the Ministries of Defense and Internal Affairs. He showed them a report that indicated modern weaponry could provide sufficient security with a boundary zone that was only fifty meters wide. Parliament would not approve such a narrow buffer, so a compromise was reached establishing a border zone of five hundred meters (where no activity was permitted), and a five-kilometer proximity zone (usable with government permission).

In a few special cases, state assets were privatized with different conditions. Hospitals in particular required special treatment. The reformers wanted to get inefficient state-run hospitals out of the hands of the government. At the same time, whatever rules they established would need to guarantee a certain standard of service. Compromises would have to be made to privatize hospital properties. For example, if an investor was interested in a state hospital building in a commercially attractive location, such as the capital's downtown, he could acquire the property without buying it directly. Instead, the investor would assume the responsibility of building new hospitals in specific areas stipulated in the contract, and guarantee the availability of a minimum number of beds. This allowed the property to be privatized and put to its most valued use while assuring the public that hospitals would still be available. Even though the government's first priority was to generate revenue, it was understood that not all assets could be sold immediately and without conditions.

Liberalization

Private property is the bedrock of a market system. When the freedom to produce, hire and fire, buy and sell, and consume freely is severely restricted, private property is per se not that valuable. True economic freedom requires eliminating the impediments facing people in their business lives. The Georgian economy left over from its days under the Soviet Union was in desperate need of economic liberalization in virtually every sphere of economic life. From paying taxes to hiring workers to opening businesses, red tape and complexity needed to be reduced.

Immediately following the disintegration of the Soviet Union, the income and payroll tax systems were modeled after high-income nations and designed with the help of the International Monetary Fund. The tax system was highly complicated and progressive, and even more ill-suited to a poor, mostly agricultural economy attempting to attract foreign investors. The system was so complex, and so corrupt, that it raised little revenue. Something needed to be done to simplify the tax code, weed out corruption, and get people paying some taxes.

Bendukidze and his reformers set out to radically reshape the tax system. Both the number of taxes and the tax rates were dramatically lowered. The number of distinct taxes was reduced from twenty-two to seven, and later to six. Tax rates were lowered just as notably. Georgia first instituted a 12 percent flat income tax and other reforms such as a relatively simple 18 percent value-added tax (VAT). Three years later, the wage tax used to fund social pensions was eliminated entirely and folded into the flat income tax. This brought the total tax on wages down from 33 percent to 20 percent. Significantly, and in contrast to many wealthier countries, pensions are now funded out of the general budget just like any other expenditure program.

Budget-minded bureaucrats were concerned that revenue would fall as a result of these tax rate reductions and were the main opponents. Yet one need not be a proponent of the Laffer curve (which posits higher tax revenue from lower taxes under certain conditions) to see how both taxpayers and the treasury could benefit from this reform. Going from a complicated and frequently corrupt tax code to a simple one with low rates that are relatively easy to enforce can bring in more revenue. And indeed tax revenue has increased steadily since the tax reforms were put in place.

Oddly enough one of the reforms the administration couldn't get passed was a *new* tax. The government wanted to institute a simple property tax, but opposition to this was simply too strong. The notion that the elderly and low-paid civil servants would have to pay taxes on their expensive flats inherited from the Soviet era was too much to take.

Tax reform was accompanied by amnesty for most taxpayers who owed back taxes under the previously high rates. This measure helped to drum up support for the new system among taxpayers themselves.

Another lesson can be drawn from the selection of the initial 12 percent rate for the flat tax. Why 12 percent? Certainly, there were discussions about whether this rate or some higher or lower figure would be sufficient in terms of revenue generation. But part of the reason for establishing this rate is that Russia had chosen a flat tax of 13 percent. The idea of outdoing your rival and former oppressor was particularly attractive. The reformers wisely played upon this rivalry to encourage a policy in which Georgia would adopt a lower tax than its neighbor.

In addition to tax policy, another area in need of reform was the labor market. The labor code was a residual of the Soviet-era code from 1973. As such, unionization was essentially required and labor unions enjoyed many special privileges under the law. According to Vato Lejava, a former deputy for Bendukidze in different ministries, the reform team proceeded to attack this problem with several principles in mind:

1. Equality of parties. An employee would enjoy no special legal status in labor law relative to the employer, and vice versa.
2. Freedom of contract, freedom of work, freedom of entrepreneurship.

3. Compliance with international law. In particular, compliance with the International Labor Organization (ILO) conventions ratified by Georgia.
4. Freedom of revision. Establish default regulations but provide parties with freedom to agree on a different standard.
5. De-monopolization of unions. In particular, remove the monopoly held by the Georgian Trade Union Confederation (direct heir of the Soviet-era Trade Union).

Georgia's new labor code is very similar to the English common law "at will" code and only about twenty pages long.[43] The key rule is that employees and employers must honor contractual agreements. They can be individual or collective, but there are no special privileges conferred to unions above and beyond those afforded to individuals. Some regulations exist related to termination notifications, severance pay, leaves, vacation pay, and the like. Frequently, however, the law allows the parties to explicitly contract around these regulations.

This substantial reform has been highly controversial. Within Georgia, once-prominent unions such as the Georgian Trade Union Confederation saw a significant decrease in their political leverage. Outside the country, international groups such as the ILO and western labor unions opposed a free labor market. But the reformers held fast, and over time have increased their leverage. Recently, the labor code was elevated to the status of a constitutional law, making it harder to amend or eliminate.

Bendukidze's reform team worked closely with the Liberty Institute in drafting the law. The Liberty Institute is a highly respected NGO that was instrumental during the Rose Revolution, and getting them on board was deemed important. The Liberty Institute

43. http://www.ilo.org/wcmsp5/groups/public/---ed_protect/---protrav/---ilo_aids/documents/legaldocument/wcms_127828.pdf.

was mainly interested in nondiscrimination codes, but in the end agreed to the more general idea of simple equality under the law.

Initially it was not on Bendukidze's agenda to work on the labor code; Attorney General Zurab Adeishvili began the process. But when Adeishvili saw the draft bill drawn up by the lawyers, he called for Bendukidze's help because their version was even more restrictive than the existing code. Bendukidze assembled a team consisting mainly of young professionals to attack the issue. The labor reform was one of the few reforms accompanied by tough discussions in the media and parliament. The main strategy of the reformers was to explain the expected outcome of liberalization since the majority of the opposition simply embraced Soviet-style paternalistic logic.

The **Liberty Institute** is a Georgian research and advocacy organization that advances individual, economic, and national liberty.

It aims not only to analyze and comment on public policy but to change it. The institute provides not just an academic forum for critical discussions and debates but acts as a catalyst for reform. Combining analysis, advocacy, and action, it generates path-breaking ideas on a wide range of public policy issues.

The ideas of Friedrich Hayek, James Buchanan, Alexis de Tocqueville, Bruno Leoni, Edmund Burke, Eric Voegelin, Milton Friedman, Adam Smith, Karl Popper, and Max Weber are major intellectual influences on the Liberty Institute's philosophy and shape its activities.

Liberty Institute was instrumental in drafting, advocating, and lobbing for various laws, including the following:

- Freedom of Information chapter of the General Administrative Code: provides for transparency and accessibility of public documents and meetings
- Law on Control of Entrepreneurial Activity: provides habeas corpus type rights for businesses and prohibits inspection without judicial authorization

- Law on Freedom of Speech and Expression: decriminalizes libel, protects individual journalists from lawsuits, shifts burden of proof to the plaintiff, provides whistle-blower protection
- Reintroduction of jury trial
- New Criminal Procedure Code: based on principles of an adversarial system of justice, equality of the parties before the law, expanded rights of defense, strong exclusionary rules for inadmissible evidence, etc.
- New Labor Code: chapter on strikes and lockouts
- Anticorruption and antimafia legislation: provisions for confiscation of property illegally obtained by public officials and members of organized crime groups
- Laws on General and Higher Education: provisions on educational vouchers, student's rights, academic freedom, institutional autonomy
- Law on Patients' Rights
- Law on Broadcasting

Similarly, the reformers deemed it necessary to make sure the code was at least superficially compliant with ILO standards. While the ILO surely does not approve of Georgia's labor code, the minimum standards are sufficient to allow Georgia to say it is ILO compliant, which is an important factor in many other areas, including trade agreements.

Conclusion: Lessons Learned

Georgia's economic reforms are so far-reaching and substantial that it's impossible to discuss them all in detail. This study simply shows the most important elements, with the ultimate objective of learning how these reforms might be emulated elsewhere. Here we highlight some of the lessons from the Georgian reform process.

> **Lesson #1** When trying to reform, straightforward and transparent processes can reduce opposition. It is hard for opponents to accuse you of impropriety if the entire process is open to inspection.

The transparency of the privatization auction process illustrates this point. Many people were initially suspicious, with good reason, that privatization would end up being a way for cronies to get rich quick with little gain for the public at large. The open process served to convince people that the new privatization plan was authentic.

> **Lesson #2** A high profile, successful demonstration project can help persuade skeptics that your plan will work.

The successful sale of the Intourist Hotel in Batumi showed that privatization can be accomplished efficiently and without favoritism. Similarly, the firing of the traffic police demonstrated that the government was serious about addressing corruption. In addition to quieting skeptics, these examples made clear to future participants in the process that good rules were in place, and that they would be followed.

> **Lesson #3** It is often necessary to compromise in certain nonessential areas in order to get things done. Flexibility is not a sign of weakness, and it is possible to stay true to your ideas while compromising on marginal issues.

Despite the reformers' reputations as ideological firebrands, they exhibited throughout a willingness to give in order to get. Bendukidze's remark about including things in your reforms that you are willing to give up is worth attention. If a reform program includes ten elements, but only eight are really important, then start with all ten in the plan. Then when the opposition rallies, you can easily give up the two less-important elements to signal your willingness to compromise.

This does not mean giving in, but rather engaging the opposition in a forthright and honest way. It is fine to compromise on specific details but not on core principles. The handling of strategic assets during the privatization process illustrates the importance of compromise while remaining true to the general principle. Bendukidze's mantra of "Sell everything, but honor" is sage advice.

> **Lesson #4** Avoid resentment. When trying to enact a new good policy to replace an old bad policy, your chances of success will increase if people are not harshly penalized for transgressions that took place under the old rules.

The wisdom of this is seen in the tax reforms that offered sensible amnesties to people who had failed to comply with earlier rules. Similarly, the traffic police who were fired were not prosecuted for previous transgressions (only if they continued their criminal behavior).

Lesson #5 Use competition with your rivals to your advantage. Frame the debate around the need to keep up with others.

Setting the initial flat tax rate one percentage point below Russia's allowed reformers to frame the reform as one-upping their former political masters. Georgian reformers were keen to make Georgia appear as competitive as possible to investors relative to other countries.

Lesson #6 Form alliances as needed. By working closely with other groups who don't necessarily share all your goals, you nevertheless make them co-owners of the reform.

Georgian reformers worked with both allies and potential opponents to develop the labor code. Not only did they work with the Liberty Institute, they also engaged the United Nation's ILO, despite its opposition to liberalizing rules in the labor market.

Ultimately, there is no magic formula on how to implement specific reforms. It takes committed and principled leaders to make reform a reality, along with a willingness to act. Georgia was lucky to have these in Kakha Bendukidze and his team.

This small army of committed individuals working closely with Bendukidze came to be known as "Benduki." Originally, the name was used by the opposition to disparage his young and enthusiastic disciples, but eventually the label was embraced. Years later, at a reunion of reformers who had worked closely with Bendukidze, T-shirts were passed around with "Benduki" written prominently across the front. What was once a term of derision is now a badge of honor.[44]

Like Cincinnatus, Bendukidze was drawn from private life to answer the call of his nation. Bendukidze followed Cincinnatus' example by serving briefly. He is currently focused on strengthening the Free University in Tbilisi, which he founded, and the Agricultural University of Georgia.

At the same time, Saakashvili's United National Movement party has experienced electoral setbacks. In October 2012 a coalition led by Boris Ivanishvili won a majority in parliament and began to dismantle the accomplishments of Saakashvili, Bendukidze, and their allies. We will have to wait to see if Georgia's amazing market-liberal reforms are rooted deeply enough to survive into the next generation.

At the end of the day, the country has undergone one of the most impressive pro-market economic transformations of any nation in history, and should be celebrated as such. As Vato Lejava puts it: "In the world of reforms, it is crucial that you believe in something you can't see yet. You have to believe in something first, in order to understand how to achieve it. Ironically, in the case of Georgia's reforms, you have to see the results before you can believe."[45]

44. "Benduki" or "Bendukies" was coined by a long-serving former minister of economy with mainstream views. In English it would be translated as Bedukite (like Thatcherite). Today there are Bendukites who have never worked with Kakha Bendukidze, but defend and promote his ideas. Another legacy of Bendukidze's reforms is the term "Bendunomics"—meaning libertarian economics.
45. Vato Lejava, interview by Larisa Burakova, June 2012.

Appendix
Partial List of Reforms in Georgia

Source: *Why Georgia Has Succeeded* by Larisa Burakova. The Georgian privatization website provides a list of nearly two thousand specific property sales between 2004 and 2011, http://privatization.ge (in Georgian).

Approximate Date	Category	Type of Reform	Description
December 12, 2003	Liberalization	Tax reform	Taxes evaded prior to January 1, 2004 were annulled, which applied to 95% of taxpayers. The administration introduced 100% depreciation of capital expenditures for all companies. A flat income tax of 12% was adopted. And in 2008, social taxes were blended with income taxes, and the rate dropped from 33% in 2004 to 20% in 2008. Tax arbitration reform was tried but failed, as it was enacted too slowly. Property tax reform also failed, as opponents to the reformers were strongly opposed to enacting a property tax. However the new tax code significantly simplified the tax process (the number of taxes decreased from 22 to 6) and tax rates gradually declined.

January 1, 2004	Privatization	Social welfare reform	A statistical approach was developed for determining need, and a poverty line was determined. The poverty line was defined by the government's budget. The government determined how much money was available for social assistance, and that is how much was spent. Voucher systems were created to pay for healthcare, energy and gas for the poorest citizens.
January 1, 2004	Liberalization	Construction reform	Prior to reform, construction sites were built without licenses since they were so difficult to get. Initially, reform focused on a reduction in the amount of documents needed to receive construction permissions. 21 procedures were eliminated, and a simplified processes for obtaining licenses were enacted. In the World Bank Doing Business ratings for 2010 and 2011, Georgia ranked 7th among 183 countries, jumping 20 places in three years. The number of construction sites also increased dramatically.
January 1, 2004	Liberalization	Visa reform	Citizens from more than 80 countries can now enter Georgia without a visa.
February 11, 2004	De-bureaucratization	Reform of the executive branch	All of the government structures, positions and job descriptions were reviewed. Of the 1000 or so employees, only around 50 remained, the overall number of ministries was reduced from 18 to 13 and the number of agencies was reduced from 52 to 34.
April 1, 2004	De-bureaucratization	Interim budget planning	Instead of one-year budgeting, they began to use interim planning for three years in order to capture a more broad view of the reforms.

April 1, 2004	De-bureaucra-tization	Defining priorities for ministries	This reform had mixed results. Ministries wrote up five priorities for interim development. All of the data was then compiled in one document called "Key Data and Directions" which was used in budget planning. However, oftentimes these priorities were not practical and some ministries had trouble drafting this document.
July 1, 2004	De-bureaucra-tization	Reform of Ministry of Internal Affairs	One of the most successful reforms. The GIA (police) was completely eliminated and a new American-style police force was formed, whose responsibilities were law enforcement and road safety. New cars and uniforms were purchased, and salaries of police officers were raised significantly. Trust in the police increased from 3% in 2003 to 84% in 2010. Most of the mafia in Georgia left for Russia, and those that stayed were imprisoned. The Ministry of Internal Affairs became a symbol of the reform movement and the new administration.
July 1, 2004	Liberalization	Elimination of Anti-Monopoly Service	Georgia eliminated its anti-monopoly legislation that was enacted in 1992, which defined situations where the government could intervene, regulated mergers and acquisitions and had the right to regulate the activity of any business. They replaced this service with the Agency for Free Trade and Competition, which created conditions for free trade and pricing. The reformers had to compromise and mandate non-discriminatory access to infrastructure, but overall the reform was a success.

July 15, 2004	Privatization	Sale of Intourist hotel in Batumi	The Intourist Hotel was sold for US$3.02 million and was the first sale in the privatization process. An auction was held, and a Georgian-born businessman in Russia became the new owner.
September 1, 2004	Privatization	Privatization of energy sector	Companies were now allowed to combine several stages of energy production, as vertical separation was eliminated. The wholesale market of energy was liquidated. The energy producer now knows to whom they are selling. The Electricity System Commercial Operator (ESCO) was formed and bought extra energy to sell within or outside of Georgia. Tariffs were partially deregulated, meters were installed and the government invested money to restore the capacity of both hydro and thermo-electrical facilities. By 2007, Georgia was a net energy exporter.
December 1, 2004	Privatization	Sale of Krtsanisi government residence	The American Basel Group purchased the Krtsanisi government residence for US$15 million.
January 1, 2005	De-bureaucratization	Salary reform	A maximum and minimum salary was set for a minister and the ineffective unified tariff system was abolished. Because of staff cuts and increased budget revenues, salaries for government employees increased five times. This greatly helped attract qualified employees.

June 24, 2005	Liberalization	Standardization and certification reform	Under this reform, standardization and accreditation were split up into two different agencies (prior to reform they were under one agency). There is no longer a list of goods subject to obligatory certification. Processes were simplified, re-verification of imported goods was eliminated, and a new agency called The National Bureau for Food Production, Veterinarian Activity and Plant Protection Safety was built.
July 1, 2005	Liberalization	Labor code reform	The new labor code is simple and understandable: it only offers minimum social guarantees, places limits on the hiring of children and pregnant women for hard labor, guarantees two-week holidays and maternity leave, and calls for safety in the workplace. The government also no longer participates in labor relations. The biggest difference in the old code and the new code is that there are no privileges for companies or employees; before, workers' rights were the focus. The trade unions' monopoly was liquidated. Now workers can choose whether or not to join a union.
July 8, 2005	Privatization	Privatization of agricultural lands	85% of former land renters purchased their land. The remaining lease agreements are set to expire and the rest of the property is being auctioned openly by the Ministry of Economy. However, unresolved problems still remain. Low-level corruption continued, as some were forced to settle up with those who had previously acquired the land illegally.

December 23, 2005	Privatization	Pension reform	The pension system was drastically reformed. By 2003, there was virtually no money left in the pension system. The methodology for calculating pensions changed and the many categories for determining benefits were reduced. There is no separate pension fund in Georgia, either in the fully-funded pension fund sense or the "pay as you go" pension fund send, only a government budget which disperses funds.
December 24, 2005	Liberalization	Reform of license and permit system	License issuing needed to be made simple and systematic, and unnecessary permissions eliminated. To increase transparency, natural resource ownership rights were sold. Radio frequencies were offered through auctions, and auction participants were presented with specific conditions.
January 1, 2006	Privatization	Privatization of natural gas companies	The reformers set out to become attractive to foreign investors, to correct prices to compete with other energy sources and to expand the gas distribution network. They suspended wholesale tariffs and the gas distribution companies were transferred to private ownership (the government owns only the network pipelines).

January 1, 2006	Liberalization	Financial reform	Free Industrial Zones (FIZ) territories were established. They were developed to encourage foreign investment in Georgia, to stimulate exports and to develop Georgia's international trade-transit activities. The FIZs are exempted from VAT on exports, imports and economic operations inside the zones, as well as from property tax. The financial reforms also created the concept of an international financial company, which are exempted from profit tax. Private citizens are also exempted from paying tax on income earned abroad. And finally, the reform aimed to achieve overall macro-economic stability for the country. The reformers passed a law mandating a federal budget surplus and the Georgian National Bank was required to control national inflation. The financial reform also created an institutional approach for stock market development. The interests of creditors and co-founders became better protected. The law on insolvency underwent serious change. There was a fundamental expansion of creditors' claim rights.
May 1, 2006	Privatization	The sale of Amalgamated Telecommunication Company (Telekom)	The largest fixed-line operator was sold for US$90 million to an affiliate of Kazakh Bank TuranAlem.

June 1, 2006	Privatization	Reform of public property registry	Electronic document management was introduced for registration of land ownership, which significantly reduced the amount of time it took to get a registration document. Due to the increased efficiency, the Tbilisi Registry took on registration of mortgages and is working on a registry function for personal property. You can also now get a passport in just a few hours. Georgia ranks second in the world for ease of ownership registration.
July 1, 2006	Privatization	Healthcare reform	Georgia began to transfer hospitals to private owners. Grants were awarded to rural doctors willing to repair and update their facilities. The reformers set out to create “100 New Hospitals,” but opposition demonstrations and the Russian-Georgian war has impacted progress.
August 1, 2006	Privatization	Privatization of wine industry	The wine industry had blurry ownership rights and was heavily regulated, so Kakha attempted to privatize it. This reform was not successful, however, as the winemakers fought privatization.

February 1, 2007	Liberalization	Forestry reform	This reform was introduced with long-term licenses (with the prospect of privatization) and forestry administration reform. Initially, most of the forest was to be transferred to long term licenses, and about 15% was to be left as protected national park lands. The infrastructure of the forestry department was recreated. The reformers laid off thousands of workers, salaries increased, and new equipment and uniforms were purchased. The system began to work successfully. An environmental police force was formed to control the foresters and to watch for plundering and exploitation without licenses. It appears that the long term leasing aspect was not fully implemented.
October 1, 2007	Privatization	Sale of the water system, Tbiltskalkanali	The Swiss company Multiplex Solutions won the auction for the sale of Tbiltskalkanali for US$85.7 million and then invested US$350 million in the water system.
December 1, 2007	Privatization	Privatization of the Georgian railroad	The sale of the Georgian railroad still remains unresolved. Five companies from Kazakhstan, Switzerland, the United States and Russia expressed interest. The Ministry of Economic Development even put in a bid. But the Ministry executed its right to stop the sale discussions.

In 1992 after seventy years of Soviet rule, the small South Caucasus nation of Georgia began a slow and chaotic march to economic freedom. The most important market-liberal reforms began in 2003, after the Rose Revolution. Under the leadership of a committed minister of reform, Kakha Bendukidze, Georgia massively cut its bureaucracy, privatized everything from government-owned hospitals and hotels to electric power plants, lowered both the number of taxes and the tax rate, and liberalized labor laws.

The significance of these reforms was soon noticed. The World Bank's *Doing Business* report rated the country ninth in the world in ease of doing business, ahead of many far richer countries. According to the report, no country in the last fifty years had carried out such significant economic reforms so quickly and in so many areas. Echoing this view, the United States Agency for International Development remarked that Georgia had made "the broadest, deepest, fastest business climate reforms of any country" over the last half century.

Today, Georgia stands as a leading example of how a country can transform itself and obtain a market economy. This case study tells the story of how it happened, with lessons for reformers around the world.

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