ECONOMIC FREEDOM, REFORMS AND ENTREPRENEURSHIP IN GEORGIA

PAVOL MINÁRIK, MAREK VOKOUN, ALENA ZEMPLINEROVÁ[1]

ABSTRACT

The role of entrepreneurship is recognized in economic theory as well as in economic policies, particularly in post-communist countries. This paper examines environment for small and medium enterprises in Georgia, a country that is highly ranked for its institutional environment. In a survey of local stakeholders we have confirmed that institutions are not the major obstacle for Georgian entrepreneurs. However, we have discovered additional obstacles responsible for the hindrance of entrepreneurship in Georgia, particularly difficult access to finance and adequate human capital.

KEYWORDS

Economic freedom, transition, entrepreneurship, Georgia

1 All authors are from the Department of Economics and Management, Cevro Institute College, Prague, Czech Republic. Correspondence shall be directed to Pavol Minárik, email: pavol.minarik@vsci.cz.
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1. INTRODUCTION

Entrepreneurship is the cornerstone of economic development. Austrian economists have recognized this fact for a long time and it is also accepted among other mainstream economists. Reforms in many post-communist countries have aimed at restoration of institutional conditions in which entrepreneurship can flourish. Of all the post-Soviet transition economies Georgia is often cited among the most successful. Although this assertion holds some credibility, caution should be advised as to not overestimate Georgian advances.

Georgia's economy still faces many problems. Even with the successful reforms of past decades, a considerable portion of the population faces economic hardship. There are aspects of the institutional environment that have made significant improvements, but various problems remain. In this paper, we explore the benefits of the Georgian reforms in contrast to their shortcomings.

This paper combines the knowledge from publicly available sources with our own data from local stakeholders. Among these we have not only included entrepreneurs who are the usual target of surveys but other representatives of Georgian society as well. This diverse dataset highlights a unique contrast between the typically bright picture portrayed by various indices and reports, and the reality experienced by local actors.

The paper is organized in the following manner: Part 2 summarizes theoretical concepts regarding entrepreneurship and institutional environment; Part 3 briefly outlines economic development in Georgia over past decades; Part 4 outlines improvements to Georgia's institutional environment as measured by different indices reflecting the quality of institutions; Part 5 presents our findings from local stakeholders; Part 6 concludes our findings.

2. ENTREPRENEURSHIP, INSTITUTIONS AND ECONOMIC GROWTH

Since the famous contributions to the understanding of market economies by Israel Kirzner's 1997 "How Markets Work: Disequilibrium, Entrepreneurship and Discovery," the role of entrepreneurship in market economies is hard to overlook. For these purposes, however, merely acknowledging the importance of entrepreneurship will not suffice; more is needed to gain a better understanding of the current entrepreneurial situation in Georgia. Persistent research has successfully identified influential factors key to the decision making of individuals in regards to the engagement of entrepreneurial activities. An overview of these factors is discussed in the following paragraphs succeeded by a breakdown of the institutional environment.

It is important to understand that several methods can be utilized to better understand the determinants of entrepreneurship. The first of which used in our analysis was one developed by Audretsch, Grilo and Thurik in 2007, which distinguishes the *demand for entrepreneurship* as well as the *supply side of entrepreneurship*. In regards to the demand for entrepreneurship, factors such as technology developments, demand shifts and resource availability help create business opportunities. Typically, incumbent businesses or potential new firms (latent entrepreneurs) are the first to capitalize on such determinants. Alternatively, the supply curve of entrepreneurship is subject to the abilities, resources, preferences and attitudes of a given population; factors that heavily depend on *demographics* and *culture*. Thus, in this instance the intersection of supply and demand reflects the decisions of individuals to either pursue entrepreneurial opportunities or the available alternatives, such as outside employment or unemployment.

A decomposition into individual factors, like the ones mentioned above, allows us to determine which types of interventions have effects on which types of determinants of entrepreneurship. The framework provided by Audretsch, Grilo and Thurik (2007) also explores potential consequences of public intervention. For example, public interventions can potentially influence the demand, the type, the quantity and even accessibility for entrepreneurial opportunities. There are a plethora of examples where public outcry has ceased important research and development, which otherwise likely would have yielded important technological advancements. In addition to the effects of public intervention on the determinants of demand, determinants of supply are also subject to public interference. For example, population policies (particularly policies related to migration) can greatly affect the preferences and/or attitudes of a population.

Alternatively, the supply of entrepreneurship may actually benefit from interventions. Primarily, public interventions can improve the abilities and resources available to potential entrepreneurs. These improvements are reflected both in material resources [typically understood as access to finance or financial capital], and the knowledge and skills of people (human capital). Further interventions may be directed towards changing the attitudes regarding entrepreneurship as an alternative to employment. Although these attitudes and risk preferences are embedded in culture and difficult to change as a result, they may respond positively to increased education and media coverage on the topic of entrepreneurship.

Another set of public interventions affects the choice between entrepreneurship and (un)employment. Different policies regarding taxation, the regulation of businesses and labor markets, unemployment benefits, bankruptcy laws, etc., can have crucial impacts on the choices of individuals. On the demand side, public policy also determines whether or not new entrepreneurs, rather than incumbents, would use new market opportunities. Competition policy plays an important role in this respect, as well as the protection of intellectual property and the regulation of the business establishment.

We may produce yet another classification of problems and obstacles to SMEs development based on the problems' source. The two principal sources are inadequate environment for entrepreneurs and inadequate resources, both material and immaterial. The environment is composed of many different aspects. It comprises political stability, legal framework for entrepreneurship (particularly property rights and contract law), taxation, regulation and law enforcement (including impartial judiciary and corruption).

Availability of resources may limit entrepreneurship even when the environment is perfect. Regarding material resources, the chief limitation is typically access to finance and the cost of credit, if accessible. Additional limitations stem from the availability of required skills, both of the aspiring entrepreneur and the necessary workforce. Finally, inadequate information might restrict entrepreneurship: information about the market opportunities (domestic and foreign), financing options, regulatory environment, etc. Ignorance of market opportunities or insufficient skills to expand into new markets decreases the de facto size of the market.

The different shortcomings of each environment and each market call for different interventions. The general policy regarding the environment shall provide a "level playing field" for entrepreneurship; that is, equal conditions for all entrepreneurs. Further measures shall address particular market failures. In line with the "level playing field" idea, competition policy attempts to prevent excessive market power. Asymmetry of information is another source of market failure; it is particularly pronounced in the credit market. Finally, various positive externalities are connected to entrepreneurship, especially their contributions to innovation, productivity growth, product diversity and job creation. Without public intervention the production connected with such externalities may be suboptimal.

This paper focuses on the institutions as the key determinant of entrepreneurial activity. The impact of the institutional environment on other economic variables is now widely recognized among economists. Limitations of choice faced by individuals include those that are not only physical in nature, but also man-made intangible constraints. Thus, the framework for economic activity is formed by a combination of scarce productive resources and institutions that limit their use in different ways.

Following Aoki (2001), we may distinguish three views of institutions based on game-theoretic perspective. First, institutions may be viewed as they are in daily conversation, as prominent organizations (i.e. as players of the game). Second, following North (1990), institutions are viewed as the rules of the game, distinct from the players. As put by North: "Institutions are the rules of the game in a society or, more formally, are the humanly devised constraints that shape human interaction."(North, 1990, p. 3)

There are two types of rules in the game: formal ones (constitutional, property rights, contract law) and informal ones (norms and customs). The key issue with establishing the institutions as the rules of the game is their enforceability. While the formal rules may be transferable from country to country, the informal rules are more resilient. Thus, borrowed institutions may be neither enforceable nor functional. Including the issue of enforcement and the enforcer's motivation into the analysis leads to the third view of institutions. As put by Aoki (2001, p. 2), "[t]he most reasonable way of approaching institutions from this perspective is then to conceptualize an institution as an equilibrium outcome of the game." In the end, however, "[a] proper formulation of a concept, such as that of institutions, may depend on the purpose of the analysis." (ibid.)

For these purposes, we understand institutions as the rules of the game. Enforcement of these rules is viewed as their characteristics (qualities).[2] Defining institutions as the

2 Following another definition by North (1988, p. 4): "Institutions are rules, enforcement characteristics of rules, and norms of behaviour that structure repeated human interaction."

rules of the game still leaves us with a great selection of different measures. There are many different rules that govern life in a society. As we mentioned above, there are formal rules, best represented by constitutions and statutory laws, but also binding court decisions (precedents) and such. Furthermore, there are different informal rules, ranging from well-known and well-described conventions to obscure customs having the nature of Hayekian tacit knowledge. As for enforcement, methods range from self-enforcement to enforcement by the power of state.[3]

In the following analysis we focus on several broad categories of institutions affecting entrepreneurship, particularly the rules related to property rights and contracts. These seem to have the most direct effect on economic activity. Property rights generally define who has the decision-making authority over use of particular assets. Limits to contractual freedom put restrictions on which property rights can be traded among individuals and under what conditions. We examine the impact of various settings on economic performance below. Finally, we explore the importance of process law. It determines the quality (especially the cost) of enforcement. As we have defined enforcement of particular rules as one of the characteristics of those rules, we will not deal with process law further, and we consider it subsumed in the quality of property-rights and contract rules.

The term "property rights" stands for a complexity of rights; each of which represents a different aspect of property ownership. Among these rights is the right to use an asset, the right to exclude others from using it, and the right to transfer the asset to others. Property rights allow the owner to determine the uses of the asset and to derive value from the asset (Anderson & Huggins, 2003). The notion of property rights allows us to better interpret property and government intervention. In fact, nominal ownership may be incomplete; i.e. the owner may not have all the property rights. For example, if there is a requirement to obtain a license for particular use of an asset, part of the property rights belongs to the government, who can decide whether the asset can be used and the manner in which it can be used.

Well-defined property rights affect economic activity in two ways. First, they are a solution for the tragedy of the commons, and second, they provide, or rather promote, incentives for savings and investments. Both of these outcomes originate from clearly defined and protected property rights that establish precisely who has the right to use an asset and derive benefits from it, or – otherwise stated – to exclude others from using it. The combination of open access and scarcity results in conflict and/or destruction of the scarce resource in the well-known "tragedy of the commons." If a society fails to develop a solution, either by establishing private property or some form of communal property governance, the effects are grave.[4]

3 For details see Voigt (2002, chapter 1).

4 More on this subject can be found in Eggertsson (2003), or the chapter 2 in Anderson and McChesney (2003).

Moreover, well-defined and enforced property rights encourage investments. In a free access setting, everyone is motivated to maximize present use of a resource. However, if the future revenue from investment is guaranteed to the owner, he has an incentive to maximize the present value of future returns. Therefore, he is willing not only to economize on scarce natural resources, but also make improvements to enhance their productivity. Overall benefit to economic welfare is thus enhanced.

After the rather lengthy discussion of property rights, let us add a short remark on contractual freedom. It is generally assumed in economic theory that voluntary exchange increases welfare of both trading parties.[5] Therefore, it is the role of institutions to facilitate exchange by decreasing transaction cost. However, some rules are specifically designed to increase transaction costs and to limit contractual freedoms. These rules may follow some social purpose other than maximization of welfare to contractual parties, e.g. the elimination of some kind of externalities or the enforcement of moral principles.[6] Generally, high transaction costs caused by government regulation or insufficient contract enforcement, discourages specialization and division of labor, and ultimately slows down economic development.

Economic growth and development is significantly dependent on the institutional environment. Generally, institutions work to reduce strategic uncertainty naturally involved in all interactions among people. In other words, institutions do reduce transaction costs. As a result, the number of transactions increases, allowing division of labor and greater specialization in society. As pointed out by Adam Smith, division of labor is the key to economic growth.

Furthermore, this analysis focuses mainly on formal institutions (i.e. institutions enforced by the state). North (1988, p. 7) points out "a critical and neglected aspect of economic history: the essential role of third party enforcement of contracts for human economic progress." As opposed to personal exchange that solves the problems of contract fulfillment by repeated dealings and a network of social interaction, modern societies must rely on different institutional settings.

Therefore, formal institutions and government performance in general are important elements of economic development. As noted further by North "while third party enforcement is far from perfect, there are vast differences in the relative certainty and effectiveness of contract enforcement, temporally over the past five centuries in the Western world, and more currently between modern Western and third world countries" (ibid.). It is precisely these differences and their impact on productivity that is the subject of present research, as Georgia's transition is characterized primarily by the adoption of Western institutions and the Western mode of enforcement.

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5 Abstracting from various discussions on rationality, ex-ante and ex-post utility and exchange between persons with limited capacity.

6 Examples may include drug prohibition, occupational safety and health regulation, prohibition or regulation of Sunday shopping, production and sale of pornography, etc.

3. INSTITUTIONAL DEVELOPMENT IN GEORGIA

Georgia has a small open economy that transformed from a Soviet-type economy to a modern market economy. For the Georgian transition, weakened by military conflicts, the role of the International Monetary Fund (IMF) and other institutions such as the World Bank and the European Union was crucial. The IMF helped coordinate the transformation process (Papava, 2003). As a result there were important achievements in the 1990s: A new financial system with national and commercial banks was established: hyperinflation was curbed, price liberalization began, the privatization of state banks was completed, Parliament was approving the national budget, foreign trade was liberated, foreign debt was restructured, and Georgia became a country capable of paying its debts. In 1993 Georgia withdrew from the ruble zone and introduced a national currency in 1995. In the same year, prices were liberalized and privatization began. Although this was an economically efficient solution, it also led to much confusion. More than 90% of retail turnover was private by 1997, and 11.5 thousand small businesses (with less than 50 employees) had been privatized mainly by insider sales by the next year. The energy industry had unbundled and was privatized in 1998, followed by other industries including land, water supply, ports and telecommunications.

In general, economists do not possess a universal blueprint that can successfully transform a communist economy into a competitive market economy with limited government. Traditionally, the transformation process in post-communist countries includes an establishment of political and market competition; that is, it removes the previous authoritarian regime and initiates the deregulation and trade liberalization, which leads to massive structural and institutional changes and a new market orientation. These reforms require countrywide support for the new regime, which includes national elites and new regional leaders. Transparent cooperation without corruption and rent-seeking behavior is necessary. According to Gould and Sickner (2008), this was not the case in Georgia, where corruption and rent seeking was common practice among economic and political agents. The support of regional and national elites was very limited up to the Saakashvili reforms.

Nonetheless, the Georgian economy saw significant growth over the last decade. From 2003 until the financial crises the average growth rate was 9.3 percent. Georgia experienced a setback, however, due to the coinciding financial crisis and armed conflict with Russia in 2008. In 2009 the growth declined to −4.0 percent. Despite achievements in the last decade, Georgia still remains in an unstable macroeconomic environment majorly impacted by political challenges. It suffers from a high unemployment rate and low income for most of its population.

4. MEASURING INSTITUTIONAL CHANGE IN GEORGIA

The key problems of institutional analysis are measurement and quantification. In this paper we use different indices that reflect quality of institutions in Georgia and its changes in time. These indices reflect different aspects of institutional environment. Altogether they show a positive image of Georgian institutional development – a picture that Georgia proudly presents to the outsiders.

The Economic Freedom of the World project conducted by the Fraser Institute produces annual reports of economic freedom around the world. The index measures the degree to which the policies and institutions in different countries are supportive of economic freedom – defined as "personal choice, voluntary exchange, freedom to enter markets and compete, and security of the person and privately owned property" (Gwartney, Lawson, and Hall, 2014, p. v). The chief components include the size of the government (expenditures, taxes, and enterprises), the legal structure and security of property rights, access to sound money, the freedom to trade internationally, and the regulation of credit, labor, and business.

In the latest report that reflects the situation of 2012 (Gwartney, Lawson, and Hall, 2014), Georgia was ranked as the 16th economically freest country in the world. It excels mainly in the field of international trade (eighth in the world), business regulation (ninth) and credit market regulation (14th). The index does not allow tracking institutional change far back, as complete data for Georgia are only available since 2004. However, it is fair to say that Georgia was a free country in that year and its ratings have improved even further since then.

The Heritage Foundation and the Wall Street Journal publish the Index of Economic Freedom jointly. It defines economic freedom as "the fundamental right of every human to control his or her own labor and property" (Heritage Foundation 2015). The index is based on 10 quantitative and qualitative factors reflecting four broad categories of economic freedom: the rule of law (property rights, freedom from corruption), limited government (fiscal freedom, government spending), regulatory efficiency (business freedom, labor freedom, monetary freedom), and open markets (trade freedom, investment freedom, and financial freedom). Thus, the approach roughly corresponds to that of the Fraser Institute's Economic Freedom of the World project – although, it should be noted that the data sources and evaluations somewhat differ.

In the latest report (Heritage 2015), Georgia is ranked as the 22nd economically freest country in the world. It is highly rated in trade (seventh in the world) and business (16th) freedom, as well as monetary freedom (22nd), which combined mean stable currency for Georgia. The index also allows tracking institutional improvements in Georgia since 1996. The Georgian economy has improved from controlled (rating 44.1 out of 100) to one of the freest economies in the world (the latest rating is 73.0). The world average over the same period has changed from 57.1 to 60.4: Georgia has significantly outperformed the world in this respect.

The Global Competitiveness Report published by the World Economic Forum (2014) evaluates different aspects of an economy's competitiveness. Out of twelve pillars of competitiveness, as defined in this evaluation, institutions are the first and they are included among the most basic requirements of competitiveness. The Global Competitiveness Index allows for cross-country comparison over several criteria – although due to the infancy of the index it does not allow for comparison over time.

Georgia's overall performance as measured by the Global Competitiveness Index is 4.2 out of 7, which ranks Georgia 72nd in the world. The score has improved even further in recent years. Institutions are among the relatively best components of Georgia's score; the score of 4.0 out of 7 places Georgia at the 64th place in the world. According to the Global Competitiveness Report (2014) major obstacles to conducting business include access to financing, inadequately educated workforce, poor work ethic among national labor forces, and policy instability. The latter two problems are basically institutional, although they are not easily solved by economic policy.

The Doing Business survey by the World Bank (2015) presents a rather different picture of Georgia. The survey focuses on 11 areas that affect the ease of doing business: starting a business, dealing with construction permits, getting electricity, registering property, getting credit, protecting minority investors, paying taxes, trading across borders, enforcing contracts, resolving insolvency, and labor market regulation (not included in 2015 edition).

Georgia is ranked as the 15th best country in the world for doing business. In several components it has received even better rankings: starting a business (5th), dealing with construction permits (3rd), registering property (1st) and getting credit (7th). Georgia's institutional performance has continuously improved over the past decade according to the Doing Business survey and it appears to be one of the best places in the world to start and conduct a business.

5. PERSISTENT HINDRANCES TO ENTREPRENEURSHIP IN GEORGIA

Economic performance of Georgia does not conform to the bright picture portrayed by several indices presented above. There are manifold obstacles that prevent the Georgian economy from achieving higher outputs. We present findings from our survey of Georgian stakeholders that point to certain problems hindering entrepreneurship in Georgia.

Georgian small and medium enterprises have a lower share of employment and output in comparison to developed European countries. Papiashvili and Chiloglu (2012: 22) show that "there is a set of macro factors (for example, unstable legal environment, low purchasing power of the population, lack of qualified human resources, lack of market information, etc.) and micro factors (such as low coordination between organizations supporting the SME's, lack of proper marketing and managerial skills, uncompetitive products, and the like) that still brake the development of the SME sector in Georgia." It is an important task in economic policy to identify and address these problems.

5.1. FINDINGS FROM A UNIFORM QUESTIONNAIRE

In our research project a uniform questionnaire was prepared and sent out to various stakeholders and experts. To help the respondents, the questionnaire was translated and distributed both in English and Georgian. The selected group included 13 respondents. In the first part of the questionnaire template respondents were asked to evaluate to what extent the factors listed were impeding the development and activities of the SMEs in the country. On a scale from 1 to 4, 1 represented "not at all", 2 represented "somewhat", 3 represented "significantly", and 4 represented "very significantly." An NA option was provided in case the respondent did not know.

Parallel to this exercise, respondents were asked to mark "help" in case they thought that an intervention would be advised and welcomed.[7] Some respondents marked "help" parallel to giving a number from 1 to 4, thus signaling the importance of the given topic. Other respondents understood "help" as the way of expressing that the issue was of crucial importance and policy recommendations and knowledge transfer were most welcome regarding the given issue; they marked only marked "help" instead of giving a value from 1 to 4. We coded these responses as 4.

The questions targeted six domains relevant to the development and daily activities of SMEs. The main domains were: Labor and skills, Red tape/bureaucracy, Tax burdens, Law and order, Market specificities, Finance and other issues. Statistics on survey responses are summarized in the Appendix.

Evaluations of the Georgian institutional environment in various indices presented above are generally confirmed by our survey. As we expected, red tape and bureaucracy domain was considered to be the least important problem for the Georgian small and medium enterprises (SMEs). Similarly, the taxation system did not seem to be a major source of difficulty – although, some point to frequent changes and certain ambiguities (e.g., Kuriakose 2013). Regarding the rule of law, survey respondents cited weak property rights and weak judiciary as problematic areas. Again, this confirms the existing information on the situation in Georgia.

The most impeding factors identified by our respondents were within the domains of labor and skills, and market and finance. In the first domain, respondents cited low market skills of entrepreneurs and lack of business experience. Low availability of high skilled workers was another problem in this area that hinders the development of businesses in Georgia. In the market domain, the most impeding factors were weak market position of SMEs, which could be linked with the excessive market power of some of the companies, and perhaps also linked weakly to unfair competition and weak SME organizations. Furthermore, respondents pointed to political and macroeconomic instability and barriers for exports.

To sum up, the problems for enterprises in Georgia are not dominantly institutional. However, the situation is not very favorable for Georgian entrepreneurs. Among the institutional problems political instability is perhaps the most serious. Otherwise, entrepreneurs face problems with regards to resources, both human and material. In this respect, our findings are in line with previous observations from the literature.

Political stability is an important factor in the entrepreneurship environment. This may be especially important for foreign trade partners and potential investors. In this respect, the recent history does not provide a very optimistic picture of Georgia. Political instability

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7 Our research was part of a larger project seeking to provide suggestions for interventions in SME policies in cooperation between Visegrad countries and Georgia, Moldavia and Ukraine.

is cited as the main obstacle by representatives of small, medium and large firms in Georgia (World Bank 2013). However, the political situation and international relations can hardly be seen as a possible target of entrepreneurship policies. Regardless, we shall be mindful of these limitations within the environment for the activities of the SMEs. Also, the image of a country vis-à-vis (potential) foreign business partners can be improved in a planned and coordinated manner.

Unlike the institutional environment, the availability of resources is not very favorable for entrepreneurship in Georgia. This is true both for material and immaterial resources. Existing literature as well as our survey point to problematic access to finance, inadequate skills of entrepreneurs and labor force, and insufficient information among SMEs. Our survey confirms that access to finance is an important domain to be addressed by public interventions. Respondents pointed to difficulties in accessing financial services and high cost of credit. Help in this area is needed to overcome the existing problems.

Inadequate skills are also cited as a problem both in previous studies and our survey. The World Bank report (Kuriakose 2013) lists "difficulty recruiting highly skilled employees" among the most frequently cited obstacle to SME's development and recommends reforms to education systems. The World Economic Forum's 2013 Global Competitiveness Report ranks this issue as the second most important (access to finance being the first). In our survey, respondents point to low skill or education of entrepreneurs, lack of experience as well as low availability of high skill workers. Low labor market flexibility and lack of language skills are also rated as significant.

Finally, there is a major issue concerning information of business opportunities, especially concerning foreign trade. The size of the market is assessed as one of the weakest points of Georgian economy in the World Economic Forum's 2013 Global Competitiveness Report. Expansion of exports requires specific skills and information on potential foreign partners that are obviously scarce in Georgia. In our survey, lack of experience in foreign trade, particularly with the EU, and lack of knowledge of EU regulations (coupled with institutional differences with the EU) is marked as a significant problem that requires intervention. Lack of language skills and contacts abroad is also considered as a somewhat serious problem among our respondents, as well as foreign barriers to trade (although these are not specified). Finally, our respondents point to lack of open communication channels with the EU.

5.2. INTERVIEWS WITH SELECTED STAKEHOLDERS

Interviews with stakeholders shed some light on the actual state of the Georgian economy and revealed some serious problems. All interviews were carried out in Tbilisi in February 2014. We conducted 12 interviews, which took approximately an hour each. We interviewed major public and private institutions dealing with SMEs and SME administration. The goal of these interviews was to provide a first-hand experience and gain additional insight to the Georgian economy. In other words, we wanted to unravel issues and possibly even expose informal institutions, which are usually not visible to foreigners.

Many respondents described the problems mentioned above such as the lack of skilled personnel, high collateral for SME loans and general lack of awareness about publicly funded projects. However, we identified three additional major issues in the health sector, banking sector and the system of public procurement.

One of the respondents described issues regarding the health sector and the establishment of a non-profit, non-governmental organization (NGO). For an NGO it was problematic to become registered and established in the 1990s. Later, a tax for NGOs was introduced that destabilized this sector in Georgia. This tax led to salary cuts for the most qualified workers, coincidentally the most difficult to find. In the health sector there have been radical changes in nearly every political cycle since the 1990s. This has led to underinvestment in the sector. Investors are very cautious when it comes to long-term investment in the Georgian health-care sector because their predecessors were heavily indebted and often went bankrupt.

Another respondent described issues in regards to the banking sector. Leasing officers use the same restrictive approach to SMEs as their colleagues from the loan departments. This makes both financial and operational leasing an inaccessible alternative to the problematic loans. Moreover, we were informed that loan officers do not honor the secrecy of business projects. However, we were not able to verify this statement because all major banks in Tbilisi rejected our requests to meet and discuss the SME agenda and related issues in the banking sector.

Yet another respondent stated that there were issues in the very modern and transparent electronic system of public procurement. According to the respondent, large companies predominantly control it and there are barriers for SMEs. The procurement specifications lack more categories to ensure quality and they are tailored to the needs of large companies. Also services such as catering and cleaning are secured and provided by internal sources from the public sector. These services could be outsourced to SMEs. As we have stated above, large companies are perceived as dominant in Georgia. However, Georgian ministries and statistical office do not have the exact numbers of SMEs and large companies according the European definition of enterprise categories, so the actual ratio is difficult to verify.

6. CONCLUSION

The institutional environment is undoubtedly an important factor affecting entrepreneurship and economic progress. Post-communist countries have undergone a profound institutional change in quest for institutions better suited for a market economy. Some countries have been quite successful while others struggle. Georgia presents an interesting case in this respect – some reforms work well and put Georgia on top in country ratings, while some areas remain problematic.

Our survey aimed to achieve a perspective on Georgian economy that is different from what is presented by existing surveys of institutional or business environment. Local stakeholders point to certain hindrances to the rapid economic growth of Georgia. Predominantly, however, these are not concerned with institutions. In fact, the institutional environment – with the unfortunate exception of political stability – is quite favorable. The most important shortcomings are in the area of resources, both human and material. The experience of Georgia highlights an important fact: although institutions do matter, they are merely a part of the necessary infrastructure for economic development.

In the following years, political, economic and institutional development of Georgia will be significantly affected by its cooperation with the European Union. The relations with the EU present both opportunities and threats. The regulatory framework of the EU that will be transplanted to Georgia may reduce some of the economic freedom developed by Georgians. On the other hand, however, the cooperation with European countries presents vast opportunities for enlarged markets; that is, both an increase in the potential demand and the potential supply of resources in Georgia – including finance. Furthermore, European countries could share some of the good practices in governance with Georgia. Improvements to governance capacity combined with sound law on the books could improve the Georgian economy even further.

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APPENDIX

GEORGIAN EXPERTS' SURVEY RESULTS

LABOUR AND SKILLS DOMAIN

1	Domain/Obstacle	Mean value	SE	Obs.
A	Low market skills of entrepreneurs / Inadequate business education	**3.31**	0.21*	13
B	Lack of business experience	**3.00**	0.28	13
C	Lack of experience in foreign trade, in EU in particular	2.54	0.18*	13
D	Lack of knowledge of EU regulations	2.69	0.24*	13
E	Lack of language skills and contacts abroad	2.69	0.24*	13
F	Low availability of high skill workers	**3.00**	0.25	13
G	Low availability of low-skill workers	2.08	0.14*	13
H	Demographics / low number of young labour market entrants	2.15	0.25*	13
I	High emigration	2.54	0.24*	13

J	Expensive labour / Mismatch between labour cost and productivity	2.31	0.29	13
K	Employer-employee conflicts	2.00	0.25	13
L	Low labour market flexibility	2.77	0.23*	13
M	High syndicalization / Excessive power of labour unions	1.62	0.31	13
N	Low labour ethics	2.54	0.18*	13
O	Low business ethics	2.85	0.19*	13
1	Labour & Skills	2.54	0.23*	13

**) Mean value significant at 5 %*

RED TAPE AND BUREAUCRACY DOMAIN

2	Domain/Obstacle	Mean value	SE	Obs.
A	Difficulties in registering company	1.25	0.25	12
B	High cost of market entry	2.18	0.30	11
C	Difficulties to expand business activities / bureaucratic obstacles	1.75	0.25	12
D	Non-transparent / inconsistent regulations	2.00	0.16*	13
E	Poor overall regulatory framework / Excessive burden of regulations	1.92	0.19*	12
F	Foreign trade barriers	2.92	0.23*	12
G	Institutional differences with EU	2.83	0.30	12
2	Red Tape /Bureaucracy	2.12	0.24	12.00

**) Mean value significant at 5 %*

TAX BURDEN DOMAIN

3	Domain/Obstacle	Mean value	SE	Obs.
A	Unstable and non-transparent tax rules and/or their applications	2.33	0.22*	12
B	High cost of compliance	2.25	0.18*	12
C	High effective SME presumptive tax rates	2.11	0.11*	9
D	High effective personal income tax rates	2.33	0.26	12
E	High effective corporate income tax rates	1.90	0.28	10
F	High effective value added tax / trade tax rates	2.36	0.31	11
G	High custom charges	1.91	0.25	11
H	Other high taxes and fiscal fees/charges	1.89	0.35	9
3	Tax burden	2.14	0.25	10.75

**) Mean value significant at 5 %*

LAW AND ORDER DOMAIN

4	Domain/Obstacle	Mean value	SE	Obs.
A	Weak property rights / weak contract enforcement	2.69	0.26	13
B	Crime and violence (low safety)	1.58	0.23*	12
C	Corruption / Clientelism / Favouritism	1.83	0.27	12
D	Weak judiciary	2.77	0.26	13
4	Law and order	2.22	0.25	12.5

**) Mean value significant at 5 %*

MARKET DOMAIN

5	Domain/Obstacle	Mean value	SE	Obs.
A	Small market size / Weak demand	**3.23**	0.28	13
B	Barriers for exports to foreign markets	**3.15**	0.19*	13
C	Unfair competition / Uneven playing field / Informal economy	2.58	0.19*	12
D	Monopolization / Excessive market power of some participants	**3.00**	0.23*	13
E	Weak market position of SMEs	**3.38**	0.14*	13
F	Weak professional organizations of SMEs	2.92	0.18*	13
G	Weak analytical and policy advocacy of SME organizations	**3.25**	0.13*	12
H	Discriminatory practices of authorities	2.00	0.17*	12
I	Unfair privileges for foreign investors	1.75	0.18*	12
J	Macroeconomic instability (demand, inflation, exchange rate)	2.92	0.21*	13
K	Political instability	**3.00**	0.23*	13
L	Insufficient market information/governmental support for SMEs	2.92	0.23*	12
M	Weak support/lack of support by international organizations	2.42	0.19*	12
N	Low level of activities of venture capital	**3.25**	0.25	12
5	Market	3.03	0.20*	12.5

**) Mean value significant at 5 %*

FINANCE AND OTHER DOMAIN

6	Domain/Obstacle	Mean value	SE	Obs.
A	Difficulties in accessing financial services	**3.15**	0.27	13
B	High cost of credit	**3.31**	0.24*	13

C	Inappropriate infrastructure	2.45	0.25	11
D	Weak professional organizations of SMEs	2.75	0.18*	12
E	Difficult access to internet / Lack or low quality of business websites	2.50	0.23*	12
F	Lack of open communication channels with EU	**3.00**	0.19*	11
6	Finance and other	2.86	0.23*	12

**) Mean value significant at 5 %*