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The significance of borders in Georgia–UE trade relations

Znaczenie granic w stosunkach handlowych między Gruzją a UE

Abstract: Based on the analysis of trade and policy reforms undertaken towards greater facilitation of trade and harmonization of rules, the paper evaluates the “thickness” of borders at the current stage of Georgia–EU cooperation. The study is focused on the trade component of the formal cooperation agreements between Georgia and EU. Trade flows as well as policy reforms are analyzed in order to evaluate how the significance of borders has changed. It reviews the steps taken by both parties to overcome national borders and create larger economic space for trade.

Keywords: Georgia–EU trade, borders, barriers to trade

Streszczenie: Artykuł przedstawia ocenę szczelności granic na aktualnym etapie współpracy między Gruzją a WE przygotowaną w oparciu o analizę handlu i reform polityki handlowej. Przedstawione rozważania skupiają się na strumieniach handlu i polityce handlowej.

Słowa kluczowe: handel między Gruzją a WE, granice, bariery handlowe

Introduction

Research into the question of borders has been especially topical since the late 1990s and early 2000s in the context of intensified globalization and regionalization processes. In this context many authors¹ evaluated national borders as increasingly open and transparent and even of diminishing economic importance. There are studies, which show, that borders sharply reduce trade volumes between countries². Border effects on trade are presented by Obstfeld & Rogoff as one of the puzzles of international macroeconomics³. Anderson

¹ K. Ohmae, *The Borderless World*, Harper Business, New York 1990.

J. Sholte, *Global Capitalism and the State*, “International Affairs”, vol. 73, no. 3 July 1997, pp. 427-452.

² J. McCallum, *National Borders Matter: Canada-U.S. Regional Trade Patterns*, “American Economic Review”, No 85, 1995, pp. 615-623.

³ M. Obstfeld, K. Rogoff, *The Six Major Puzzles in International Macroeconomics: Is There a Common Cause?*, NBER Macroeconomics Annual 2000, Volume 15, edited by Ben S. Bernanke and Kenneth Rogoff, MIT Press, 2000, p. 339-412.

&Wincoop⁴. argue that border associated policies are very costly, even when formal barriers are low. Therefore despite globalization and regionalization processes, trade costs still remain substantial⁵. Political borders translate into thick bands of trading costs and represent a critical exogenous force in the integration process⁶. Therefore integration even at the highest stage of its development is incomplete.

Considering the above, from the economic standpoint borders have geographical dimension (boundaries within which states can perform their economic functions) and institutional dimension (policies, rules and mechanisms used to regulate cross-border flows of goods and services, capital and labour in their best national interests). National borders are changing under the pressure of regional and international trade agreements⁷. With this regard changes in borders are associated with changes in institutional arrangements towards other countries. At the multilateral level international economic integration is the manifestation of such changes through which countries seek to strengthen their economic linkages with partner countries. In economics literature, integration traditionally has been associated with explicit government actions to lower tariffs and other artificial barriers to the international movement of goods, services, and input⁸ and it can be discussed as a complex of policy measures that reduce the thickness of borders⁹.

The study relies on the official European and Georgian documents and policy statements as well as statistical data analysis. The article is organized as follows: first we discuss the interrelations of borders and EU–Georgia trade relations against the background of trade policy reforms undertaken. Then we evaluate trade-related institutional approximation and make a conclusion about the future steps that should be taken in order to increase permeability of borders and reach greater integration.

Borders and Georgia–EU Bilateral Trade

Borders are not merely lines separating states from each other. They reflect differences in institutions, policies and regulations which affect economic relations among countries. From the international economics and economic integration standpoint borders are viewed as obstacles to the smooth functioning of economic transactions. National borders can influence economic activity in a number of ways. They have economic, political and legal significance and provide tools for governments to regulate international flows of goods, services, and

⁴ J.E. Anderson, E. van Wincoop, *Borders, Trade and Welfare*. Prepared for the Brookings Trade Forum 2001 on Globalization: Issues and Implications, May 10-11, 2001.

⁵ World Bank, *Doing Business 2005*, Retrieved from: <http://www.doingbusiness.org/~media/GIAWB/Doing%20Business/Documents/Annual-Reports/English/DB15-Full-Report.pdf>

⁶ M. Fratianni, *Borders and the Constraints on Globalization*, 2004, Retrieved from: <http://kelley.iu.edu/riharbau/RePEc/iuk/wpaper/bepp2004-05-fratianni.pdf>

⁷ Ibidem.

⁸ J. Ceglowski, *Has Globalization Created a Borderless World? Business Review*, March April 1998, retrieved from file:///C:/Documents%20and%20Settings/user/My%20Documents/Downloads/brma98ce.pdf

⁹ OECD, *Reducing The Thickness Of Borders To Promote Trade And Participation In Global Value Chains*, An Issues Paper, 2012, Retrieved from: www.oecd.org/dac/af/ReducingtheThicknessofBorders.pdf

factors of production. These tools take a variety of forms. According to Evans (2003), there are three groups of factors that can create restrictive border effects. Each of them has varying economic consequences. The first is a high elasticity of substitution between domestic and imported products. Second, transaction costs of doing business abroad and domestically differ from each other. Third, bilateral trade barriers between two countries tend to create obstacles to trade.

In the first case, the degree of the border effect is related to a high degree of similarity between imports and domestic goods. In the second case, the price differential reflects transaction costs related to varying business procedures and regulations on export and imports, customs, transportation as well by the cost of doing business in a cultural environment where border effects arise. In the third case, border effects are frequently driven by tariff and non-tariff measures Evans (2003). Tariffs create a wedge between internal and external prices, frequently with the protectionist intentions. Non-tariff barriers often have the same or worse effect. The latter is a broad category of barriers and comprises technical standards, SPS, licensing and certification requirements, health and safety regulations, border formalities, government procurement practices, etc.

According to Anderson & Wincoop (2001) tariffs and non-tariff barriers can be referred to as rent-bearing barriers as they create rents from private beneficiaries. There are also non-rent bearing border barriers such as language, cultural and institutional barriers that also affect trade and economic activities.

In addition to direct trade policy measures such as tariffs and non-tariff measures, there are other factors which determine the effectiveness of countries involvement in trade. They are classified by Wilson et al. (2004) into two broad categories: “border” barriers such as port efficiency and customs administration as well as “behind-the-border” barriers such as the quality of infrastructure and a regulatory environment. The latter may not be directly related to national borders and act inside a country.

Borders create two types of costs: transaction costs and costs related to tariffs and non-tariff barriers. Anderson & Wincoop (2001) found out that the smaller the country the larger is the fraction of its output exposed to trading costs. Protection thickens borders more for the small than the large country. From this point of view the significance of borders can vary for Georgia and the EU as for trade partners of non-proportional sizes. The analysis of trade flows shows that the European Union is Georgia’s largest trade partner and the second largest export partner taking a 30% share in Georgia’s total exports. The first place as an export partner is occupied by the CIS region with 36%¹⁰. Obviously the geographical proximity with this region as well as historically established trade and economic ties play an important role. At the same time the EU enlargement series brought its border closer to Georgia. Despite this territorial proximity the volume and composition of trade flows show that Georgia is still a less important trade partner for the EU, compared with other EU neighbouring countries.

¹⁰ www.geostat.ge

Table 1. Georgia–EU Trade Dynamics

	2010	2011	2012	2013	2014
Trade turnover (million US dollars)	1.736	2.477	2.780	2.879	2.990
Exports	297	424	353	608	621
Imports	1.439	2.053	2.427	2.271	2.369
Annual percentage change	13%	41%	12%	3%	4%
Exports	25%	46%	-17%	72%	2%
Imports	10%	40 %	18%	-7%	4%
Share in Georgia's total trade turnover	26%	27%	27%	27%	26%
Share of Exports in total	19%	19 %	15%	21%	22%
Share of imports in total	28%	29%	31%	29%	28%

Source: Ministry of Economy and Sustainable Development of Georgia.

Currently, Georgia's trade turnover with the EU-member states amounts to 27% of the country's total trade turnover. As shown by the table 1 data Georgia is mainly an importer from the EU. Trade structure shows an unbalanced picture. To compare with 1995 data, the share of the EU in Georgia's trade has increased from 8.7% in exports in 1995 to 15% in 2012. The share in imports is stable around 31% in both periods. The sectoral composition of Georgia's export has not changed much over time. Mineral and agricultural products take the largest share in it. In 2010 the two largest exported commodity categories _ nuts and mineral fertilizers took almost 70% of all exports within the GSP+ scheme. The indicator was about 84% in 2011 and 73% in 2012. The majority of exported products was classified as sensitive by the GSP+ framework and was not subject to significant tariff reductions.

Georgia in the framework of WTO accession significantly dismantled trade barriers and lowered tariffs to reasonably low levels. By the WTO 2012 data MNF trade weighted average tariff rate is 1.9% with a bound rate of 7.4%¹¹; 96.4% of manufacturing tariff lines and 41.8% of agricultural tariff lines are free of duty (at the 6 digit level of the Harmonized System). In terms of these criteria, Georgian foreign trade regime remains one of the most liberal in the region. Export policies in Georgia are also highly liberalized. There are no export taxes. The number of export documents, time to export (9 days) and nature of export procedures are close to average OECD indicators. However, costs to export 1,355 US dollars per container are higher than the OECD average (1,080.3 dollars per container), but much lower than in Europe and Central Asia (2,154.5 dollars)¹². Analysis of recent practitioners and expert evaluations shows that the main challenge Georgian exporters are facing in the EU market is high formal trade barriers, especially non-

¹¹ https://www.wto.org/english/res_e/statis_e/statis_maps_e.htm

¹² Doing Business 2015, World Bank.

tariff ones, including technical standards and regulations which are a major impediment for Georgian export industries.

To examine Georgia's relative performance in its major export markets, including the EU, Athukrala & Wagle analyzed trade data using the gravity modelling¹³. They revealed that Georgia under-exports to the major European economies like France, Germany Italy and the United Kingdom notwithstanding the GSP+ trade preferences offered by the EU. In 2010 the number of exported product categories was 35, while in 2011 – 39. Considering that the GSP+ scheme covers 7200 products, Georgia evidently underemployed its opportunities.

Apparently, there are two reasons for that. First, Georgia has not been successful in implementing an effective export diversification strategy and therefore is weak to establish itself in the EU market. The second reason is related to the reluctance of the EU to further liberalize its border and behind-the-border barriers. EU countries according to customs union rules have common tariffs and for the two last decades have been very active in promoting trade liberalization towards other trade partners. Therefore the EU represents the best example of pursuing 'deep' integration through liberalization of trade and investment and harmonization of economic policy. However recent studies show that its protectionist efforts intensified after the 2008-09 global crisis. The number of restrictive trade measures significantly exceeded the number of trade liberal or neutral actions made by the EU¹⁴. The same study showed that the total number of behind-the-border measures amounted to 237 for the EU countries, this exceeded non-tariff border measures which amounted to 63¹⁵. Evidently before signing the Association Agreement Georgia had more liberal trade with the EU, than the EU with Georgia.

The DCFTA as a step taken towards further opening EU markets for Georgia can be an important impulse for enhanced economic cooperation. Since the implementation of the DCFTA on 1 September 2014, Georgia's exports to the EU have increased by 7% for September-December 2014, compared to the same period in 2013 (European Commission, 2015). As a result of full implementation of DCFTA Georgia and the EU will eliminate duties on 100% and 99.9% (in trade value), respectively, of their imports from the other party. For industrial goods, the DCFTA involves the immediate removal of import duties on both sides. Trade in agricultural products will be also fully and immediately liberalized with minor exceptions¹⁶.

The study on the impact of the EU-Georgia DCFTA conducted by the Centre for Social and Economic Research (CASE) and Ecorys in 2012 focused on the costs and benefits of the DCFTA, states that after full implementation of the DCFTA, Georgia's GDP could increase by 4.3% and 6.5% over the long term. In the next five years, Georgia's export will increase by 12% and imports from the EU will increase by 7.5%¹⁷.

¹³ P. Athukorala, S. Wagle, *Export Performance in Transition: The Case of Georgia*, "Working Paper", No. 2/2013.

¹⁴ M. Wajda-Lichy M., *Traditional Protectionism versus Behind-The-Border Barriers in the Post-Crisis Era: Experience of Three Groups of Countries: the EU, NAFTA and BRICS*, "Journal of International Studie", Vol. 7, No 2, 2014, pp. 141-151.

¹⁵ Ibidem.

¹⁶ http://eeas.europa.eu/delegations/georgia/documents/eap_aa/dcfta_guide_2014_en.pdf

¹⁷ Trade Sustainability Impact Assessment in support of negotiations of a DCFTA between the EU and Georgia and the Republic of Moldova. 2012. http://trade.ec.europa.eu/doclib/docs/2012/november/tradoc_150105.pdf

Trade-related Institutional Reforms

According to Scott (2015) the 'politics of borders' is an integral part of the European Union's project of integration, enlargement and regional cooperation, this is also reflected by the formal cooperation instruments. The development of these instruments between Georgia and the EU started in 1992. In 1996 Partnership and cooperation Agreement was signed which provided wide-ranging cooperation in the areas of political dialogue, trade, investment, economic, legislative and cultural fields. In 2004 Georgia was included in the European Neighborhood Policy (ENP) and the EU – Georgia ENP Action Plan was adopted in 2006. Georgia is also a part of the EU's Eastern Partnership (EaP), launched by Poland and Sweden in 2009 to deepen bilateral and multilateral engagement with Europe's Eastern neighbourhood. The EaP played an important role in the acceleration of visa facilitation and association agreements, leading to completion of the Deep and Comprehensive Free Trade Agreement.

Although the EU has been clear that EaP does not offer membership prospects to its eastern neighbors¹⁸, overall, ENP and the Action Plan (AP) strengthened the institutional cooperation between the EU and Georgia. The EU's engagement in Georgia's institutional development has been significantly stronger under the EaP compared to the previous period of EU-Georgia cooperation in the three priority areas (TBT, SPS and competition policy) for which Georgia developed "comprehensive strategies" and started their implementation¹⁹. The DCFTA as the most important policy instrument of the EaP offered to Georgia, a new mechanism with major focus on the reforms related to trade and economic fields.

The Association Agreement, visa liberalization, and the Deep and Comprehensive Free Trade Area (DCFTA) are considered important achievements and necessary steps to full integration with the EU²⁰. Progressive liberalization of trade and further reforms in the areas of competitiveness, enforcing investors' protection, strengthening the role of small local producers, raising production standards and consumers' safety are at the agenda. The EU provided substantial assistance to Georgia which has significantly increased in the period 2014-2017, with up to €410 million available to support the political, judicial and economic reforms envisaged in the Association Agreement²¹.

The EU promotes policy convergence in its neighborhood and in Georgia by two main approaches. The first is "external governance" implying expansion of its *aquis communautaire* by the EU. The second is "Europeanization beyond the EU" through which the EU promotes legislative, regulatory and policy approximation (Sierra, 2010). Lack of harmonization of trade-related institutions, regulations and practices increase the economic significance of borders as an impediment to trade

¹⁸ C. Morari, *European Integration of Georgia And The Republic of Moldova: Evolution and Prospects*. Seventh Framework Programme Marie Curie Actions People. International Research Staff Exchange Scheme (Deliverable Draft), 2013, Retrieved From: <https://eupreacc.files.wordpress.com/2013/06/pdf11.pdf>

¹⁹ Implementation of the European Neighbourhood Policy Action Plan for 2012 in Georgia in Trade and Some Trade Related Areas Assessment of Civil Society Representatives (Report Summary) retrieved from: http://www.epfound.ge/files/report_final_eng.pdf

²⁰ T. Khidasheli, *Georgia's European Way*, 2011, Retrieved from: http://library.fes.de/pdf-files/ipg/2011-3/09_khidasheli.pdf

²¹ http://eeas.europa.eu/delegations/georgia/documents/newsletters/trade_2015/trade_insight_8_en.pdf

cooperation. From the trade viewpoint greater permeability of borders requires that reforms go beyond tariff and non-tariff liberalization and cover specific trade facilitation measures. At present experts identify two major concerns: reforms in the infrastructure and regulation related to border crossing and a need for a regional approach to trade facilitation (Baindurashvili, 2013). Effective bi-lateral cooperation is needed in the areas of technical regulations, metrology, market surveillance, accreditation, conformity assessment procedures, food safety standards, customs procedures, rules of origin, anti-circumvention mechanisms and other technical areas which are related to the movement of cross-border flows of goods and services.

Georgia's trade and economic integration with the EU appears weak by the European Integration Index, which is a helpful indicator to evaluate a country's performance progress in relationship with the EU. It evaluates linkages (including trade and economic ties), approximation between the institutions, legislation and practices as well as management of the integration process. In 2012 Georgia had the highest score among Moldova and Ukraine for trade in goods with the EU and demonstrated the best business climate. As for the linkages component, Georgia was the third best performer and the second by the approximation component. The Index also reveals that Georgia has the least numbers of mutual trade barriers with the EU. Overall in 2013 it maintained the position of the second best performer and continued to improve its position in 2014. However, it could not improve substantially its linkage position. The progress is shown in table 2.

Table 2. Georgia's EU Integration Index

	2012	2013	2014
Linkages	0.51	0.53	0.59
Approximation	0.60	0.63	0.69
Management	0.51	0.58	0.74

Source: The European Integration Index for Eastern Partnership Countries

In addition to the formal barriers there can be informal barriers related to beliefs and attitudes. The relationship between the EU and Georgia mostly evolved at the 'elite' and to some extent at the „intermediary” (civil society) levels, while these channels were poorly developed at the wider 'societal' level²² (Khuntsaria, 2014). This can partly explain the recent trend of a slight decrease in trust in the EU and an increase in distrust. In 2008 trust was 64%, while by 2013 it has dropped by 16 percentage points which is a sign of a more ambivalent attitude towards the EU appears to have emerged in 2012 and 2013²³. This ambivalence can have its reflection in trade and economic relations, therefore a more comprehensive analysis is needed of how to reduce formal institutional, and as well as informal institutional differences.

²² T. Khuntsaria, *External Democracy Promotion in Georgia: The Role of The European Union*, 2014, retrieved from http://css.ge/files/PhD%20dissertations/PhD_Thesis_Summary_-_Tamar_Khuntsaria.pdf

²³ Expectations and the EU Association Agreement <http://www.civil.ge/eng/article.php?id=27501>

Conclusion

The borders in Georgia-EU trade relations involve many restrictive measures and policies comprising both non-tariff and regulation and institutional barriers. Therefore the permeability of borders is still low. Despite a broad liberalization path, the EU maintains high non-tariff and behind the border barriers which raise the restrictive significance of borders. The restrictive role of borders is higher for Georgia than for the EU. The reason for that is Georgia's minor share in the EU's total trade (0.1%), while the EU is the first trade partner of Georgia. In addition to that Georgia liberalized its trade earlier and to a greater degree, towards the EU, than vice versa.

As a result of the enlargement processes the geographical border of the EU got closer to Georgia. That is an additional trade facilitation factor. However, the EU is primarily an institution rather than mere geographic territory. Therefore reduction of institutional differences is more important. Trade policy in Georgia should be discussed as part of broader institutional changes. Georgia should go on trade policy reforms designed to strengthen harmonization with the EU, because full realization of the profits from bilateral trade depends on the pace of convergence and the removal of institutional borders.

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