

## EUROPEAN ASSOCIATION AGREEMENTS AND SOME ASPECTS OF GEORGIA ECONOMICS

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### Abstract

Association agreement between the EU and Georgia, unlike the prior similar agreements, takes into account very important mechanisms of real convergence with European Union, European legislation and standards. Association Agreement with the European Union does not imply affiliation, (ex. Turkey an association agreement was signed in 1960, but the country is still not an EU member). However, an Association Agreement with the EU legislation implies such a high level of convergence that the effective implementation of the Europeanization process is irreversible. In addition, the Association Agreement with the European Union is the real mechanism of political association and gradual economic integration. However, it should be understood that the agreement is contributing to a lot of things, many of which gives rise to liability. For the proper execution of agreement relevant levers like many aspects of Georgian economy, trade policy and legislation, which we will discuss in this paper, are required.

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**Keywords:** Association Agreement, Free Trade, Civil Society, Readiness, Engagement

### Introduction

Georgia is a partner country within European Neighborhood Policy (ENP).

EU-Georgia relations date back to 1992, shortly after Georgia declared its sovereignty following the break-up of the Soviet Union. Bilateral relations have further intensified since 2003, as consecutive governments have undertaken ambitious programmes of political and economic reforms.

On the June 27, 2014, the EU and Georgia signed an unprecedented **Association Agreement** which includes a Deep and Comprehensive Free Trade Area (AA/DCFTA). The Agreement significantly deepens political and economic ties with the EU under the Eastern Partnership. It follows the Partnership and Cooperation Agreement, the previous basis for EU-Georgia bilateral relations since 1999. An EU-Georgia Association Agenda was also agreed in June to help implement the AA/DCFTA through joint priorities for 2014-2016. It replaces the EU-Georgia ENP Action Plan of 2006.

The Deep and Comprehensive Free Trade Area is expected to bring many economic benefits to **Georgia** by giving firms access to the EU's single market – the world's largest. This will create business opportunities, bring better goods and services, and boost competitiveness. The EU will work with the Georgian Government and businesses to achieve reform, and help upgrade goods and industries to the necessary standards.

Georgia's main economic activities include the cultivation of agricultural products such as grapes, citrus fruits, and hazelnuts; mining of manganese, copper, and gold; and

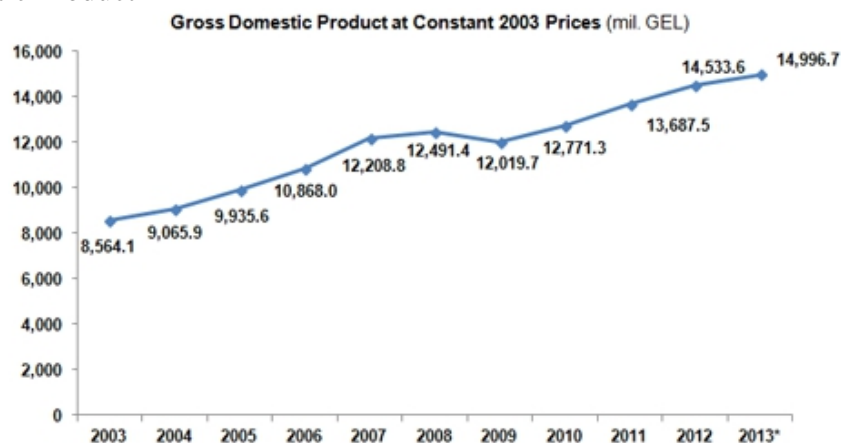
output of a small industrial sector producing alcoholic and nonalcoholic beverages, metals, machinery, and chemicals. Located on the shortest route between Europe and Asia, Georgia's transport system is a key link in the historic "Silk Road." The Government's commitment to rehabilitating main, secondary and local road networks has intensified in response to the global economic down-turn, as road rehabilitation will improve access to markets and services, and create short-term employment through civil works. Construction of the Baku-Tbilisi-Ceyhan oil pipeline, the Baku-Tbilisi-Erzurum gas pipeline, and the Kars-Akhalkalaki Railroad are part of a strategy to capitalize on Georgia's strategic location between Europe and Asia and develop its role as a transit point for gas, oil, and other goods.

Georgia's economy sustained GDP growth of more than 10% in 2006-07, based on strong inflows of foreign investment and robust government spending. However, GDP growth slowed following the August 2008 conflict with Russia, and sunk to negative 4 percent in 2009 as foreign direct investment and workers' remittances declined in the wake of the global financial crisis.

Macroeconomic and financial developments of Georgia's economy demonstrated a remarkable recovery after the 2008-09 dual shock, recording a 6.5% annual average growth in 2010-12. As a result, GDP growth slowed down to 6.1% in 2012 from 7.2% a year earlier.

The main growth driver in 2012 remained buoyant investment activity driven by large-scale infrastructure projects financed by the state and through borrowings from IFIs.

Gross Domestic Product



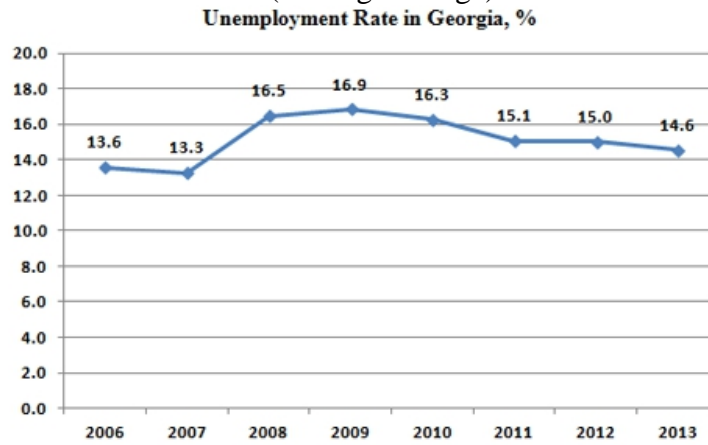
\* Adjusted data will be published on November 17, 2014.

Source: [www.geostat.ge](http://www.geostat.ge)

The World Bank expects Georgia to have 6.3 percent economic growth in 2014. The estimate was published in the Bank's Global Economic Prospects 2014, which reads that the prognosis for economic growth in Georgia in 2014 is 6.3 percent. The expectation for 2015 is also 6.3 percent and 6.5 percent for 2016. Georgia achieved robust economic growth between 2003-2012, averaging 6.1 percent annually following structural reforms that stimulated capital inflows and investment. The reforms helped improve the business environment, strengthened public finances, upgraded infrastructure facilities and liberalized trade. Growth was also supported by increased foreign direct investments (FDI) and was driven by capital accumulation and sound use of excess capacity rather than by net job creation, with productivity gains concentrated mainly in the non-tradable sectors.

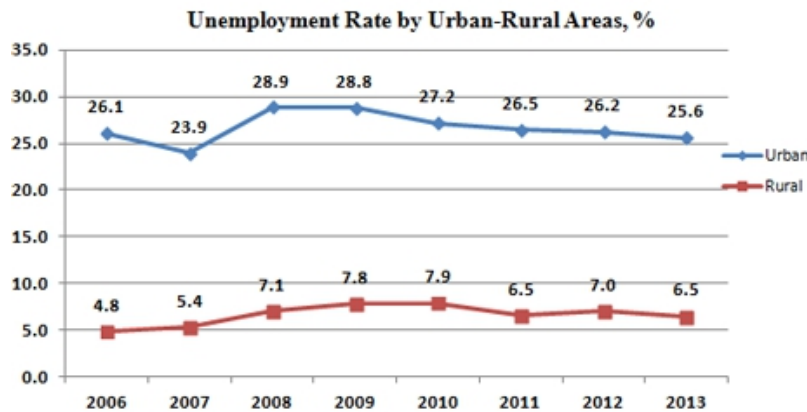
Unemployment remains the most significant public policy challenge in Georgia. The capital-intensive nature of Georgia's robust growth performance was reflected in relatively high unemployment, which remained in the 12-13 percent range even during the pre-crisis boom. Although economic situation in Georgia is undergoing a certain revival, the labour market situation still remains largely unfavorable and unstable. Unemployment peaked

during the crisis to 16,3 percent in 2010 and then fell to 14,6 percent in 2013. According to the research methodology of the National Statistics of Georgia, this 16.3% represents: “persons at the age of 15 or above, who were not employed (even for one hour) 7 days prior to the interview process, were looking for a job for the last 4 weeks time and were ready to start working within the next 2 weeks time” (www.geostat.ge).



Source: www.geostat.ge

Furthermore, according to the survey conducted by National Democratic Institute (NDI), out of 16,161 questioned, 67% of the respondents consider themselves unemployed (www.ndi.org). Of course, this number includes non-active labor force and persons not looking for a job. This issue is discussed later in the paper.

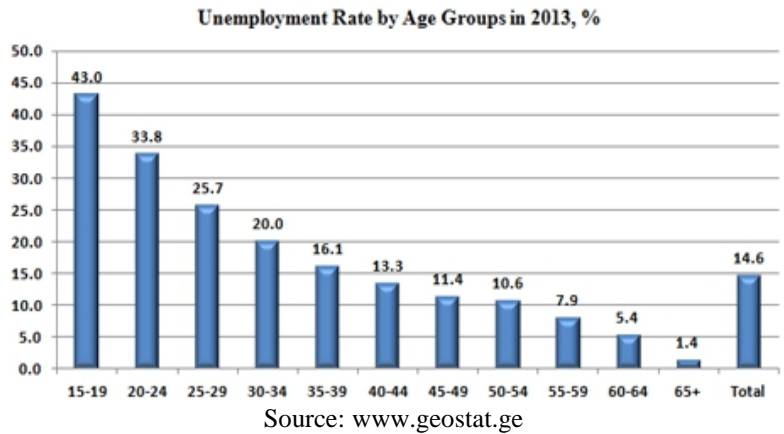


Source: www.geostat.ge

With economic transformation in Georgia, some of the older sectors and industries died, shedding their labor force. New industries grew during the same period but have not been able to absorb the workforce as effectively and overall labor demand remains weak while skills mismatches persist. The majority of the work force – more than 55 percent – is employed in agriculture (mostly self-employed), which contributes to only 8.2 percent of GDP and is characterized by family-based subsistence farming.

When talking about unemployment, another point that economists find worthy of attention is the education level of the unemployed workers. According to the Human Development Report (2010), Georgia is among the leaders with the unemployed workforce who have secondary or higher education levels. 81% of unemployed have secondary or higher education. This means that the educated workforce is idle and cannot contribute to the country’s economy. At the same time, according to the World Competitiveness Report (2011-2012), it is inadequately educated workforce that represents a major constraint to doing business in the country (www.weforum.org).

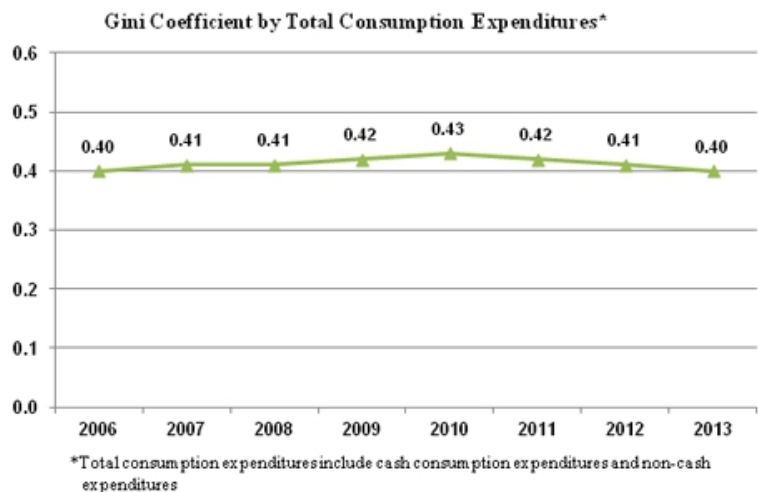
This particularly concerns the former Soviet Republics where the values have been revised and the Soviet-educated workforce ended up with the “wrong” kind of skills. Inadequately, educated workforce does not only concern older generations; even though educational reforms are under way, the system is still inefficient in preparing future leaders with the skills that meet current market needs. On the graph that depicts the age groups of the unemployed, we see that the latter statement holds true, since the largest share of unemployed are representatives of the younger generation - aged 20-35.



After the collapse of the Soviet Union, as well as under the forces of globalization we are faced with the lack of skills or language barriers among the workers. This brings us to the problem of age discrimination on the Georgian Labor market, since Soviet-educated work force lacks the skills or language requirements demanded by the companies. Quite often we are faced with the job advertisements that convey a discriminatory message asking for a specific gender or age for an eligible applicant. In western countries this type of discrimination is regulated by strict laws that are not in place in Georgia.

Another unemployment type that we believe is of interest in Georgian reality is cyclical unemployment. This type of unemployment is a short term one and occurs during economic recessions, when economic output falls and when business cycles are affected by low demand on the market.

Gini Coefficient is the most popular indices of living conditions which measures the extent to which the distribution of income or consumption expenditure among individuals or households within an economy deviates from a perfectly equal distribution.



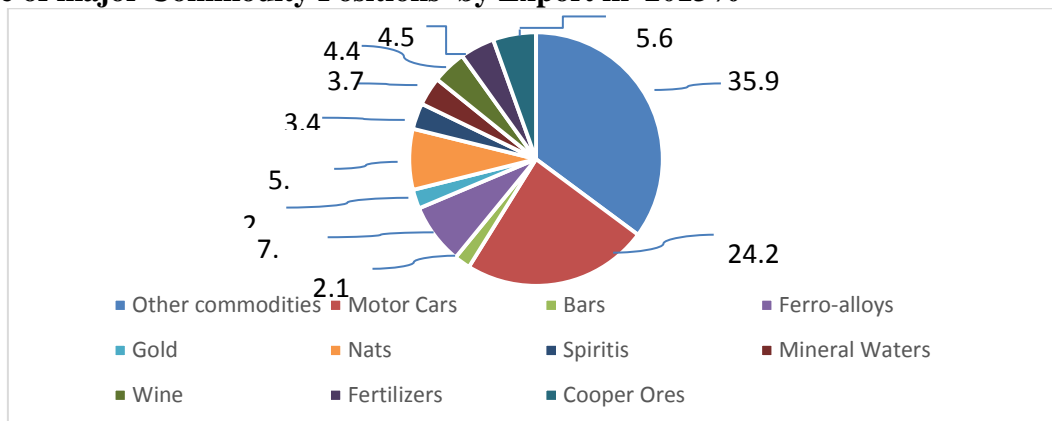
These indices and Coefficients of EU member countries are essentially different. For example, Gini Coefficient for Belgium is 33.0% (0, 33), 26 0% (0, 26) for Czech Republic and 28, 3 (0, 28) for Germany.

ON the way of its independence, the most important moment for Georgia economy was its enrolment in the World Trade organization. These processes took place so rapidly that the government has not even made a deep, thorough analysis of the existing opportunities and consequences of the step. However in 1998-2001 the multilateral meetings, negotiations and extensive discussions were held on joining of the WTO. Among the many problematic issues, there were also issues like Georgian status, tariff rates, intellectual property rights, the role of subsidies and foreign aid.

No matter how paradoxical it may seem, in 200 Georgia joined the WTO as a developed country only due to agricultural production. Otherwise, he would have had the status of the transition period, which would only be a factor of obstacle to the integration process. This is the first mistake that was made by the authority. He does not even take into account that the developed countries are significantly different from the requirements of developing and low developed countries. They should be more open space partners. Discriminatory factors, in goods and service trade in this case enjoy a higher level. Wouldn't this step follow economic dependence instead of independence? These issues were left open at this time. But if we look into the issue, liberal trade policy, in accordance with the national supporting regime, implies horizontal, vertical and specific commitments. The latter is connected to the national supporting regime, as well as market access. According to B. Hoekman's methodology, the absolute level of Georgian specific obligations is 315, which is quite high not only in low and middle-income countries, but also compared to developed countries such as Bulgaria-308, Slovakia-306, the Czech Republic-304; that means that commitments connected to Georgia service are quite liberal.

Despite the huge army of supporters to join the WTO, in the first few years of WTO accession it was clear that positive changes have not taken place in the trade of Georgia. According to the statistics if in 2000, the trade balance was 359 thousand USD, in 2002 it was 384,4 thousand USD and in 2003-it reached 613.7 thousand USD.<sup>26</sup> Export import coverage ratio in this period of time was 42%. Nowadays, real picture is not of a reliable value. The balance is still negative and equals 4065 thousand dollars. It is not good that in 2013 Georgian export structure cars held the largest export commodity positions- 24%. (Figure 1.)

**Share of major commodity Positions by Export <sup>27</sup>**  
**Share of major Commodity Positions by Export in 2013%**



<sup>26</sup> Georgian Economic Trends 2000. #1; p.105.

<sup>27</sup> Geostat.ge; 2013; External Trade Of Georgia; p.16.

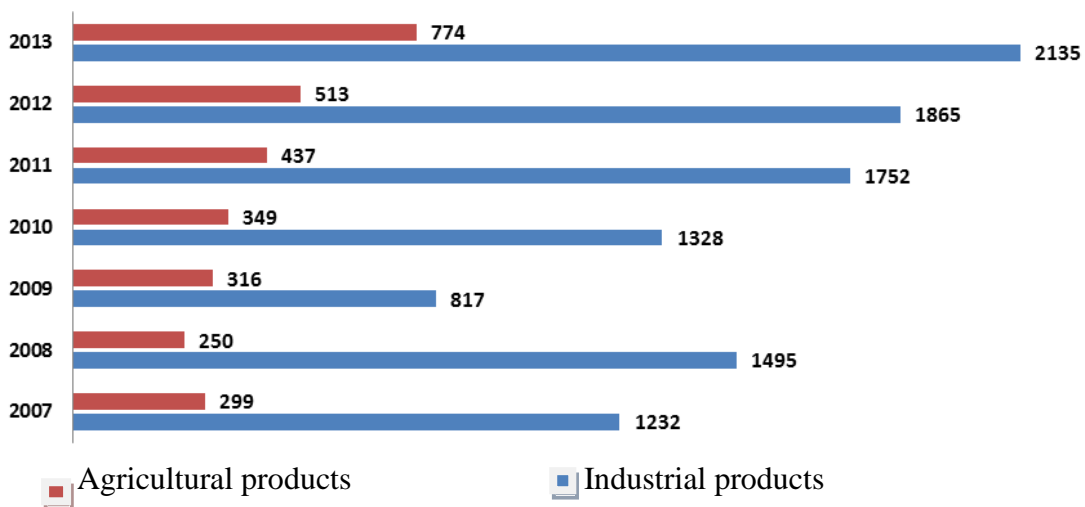
The picture does not really reflect the growth of the real sector of Georgian economy. Damping prices have a significant impact on the results of this study which were regulated improperly from the very beginning. By 2001, the government of Georgia announced that antidumping, countervailing duty and security measures would be used prior to full compliance with the WTO provisions. More general security measures were regarded as the main tools against “unfair competition”. They do not need more sophisticated legislative base and were easy to use. In this connection, many developing countries used only security measures to protect local manufacturers. This is a kind of mistake that is very hard for the fledgling.

Implementation of subsidies in agriculture, which were distributed to farmers for tea and grape, were regarded as another mistake. These subsidies belonged to “de minimize” category. In case of developed countries, aid does not exceed the amount of 5 percent. (It is worth paying attention that as we mentioned above, Georgia joined WTO as a developed country). Under general conditions the agreement provides a broader aid. In this case it is also clear that the interest of WTO should be taken into account and its rules and regulations should be followed. Here arises the question: where are the interests of Georgia? Where is dual interest seen? “De minimize” is not enough volume to be necessary for the rehabilitation of agriculture of Georgia in that period of time.

A confirmation of the abovementioned is the structure of dynamics of exports in 2007-2013 (Figure 2) which shows that the growth of agricultural products even nowadays carries on in a low speed.

**Export dynamics in the structural context. 2007-2013 (million USD).**

**Figure 2<sup>28</sup>**



In 2013 export of agricultural products was 774.2 million USD. The figure is increased by 261.7 USD 2012 compared with 2012. It is worth noting that the decline in export is marked on such products as wheat, fruit and vegetable juices; live sheep and lamb meat; export taxes are also hindering the growth rates in agriculture.

Why were these mistakes made? What was the main reason? If these questions remain open and error cases are not addressed, the next steps will be more severe for economical life of the country.

<sup>28</sup> Ministry of Economy And Sustainably Development of Georgia; External Trade of Georgia; 2013 p.10

From our observation it is clear that the first and the main reason is the economic and legal aspects of non complexity. They are not considered as a whole and their harmonization cannot occur, which is vital for the proper management and successful outcomes.

If aspects of political, economic and legal harmonization do not occur inside the country, the convergence of European standards cannot be implemented. For economic and business development of the country just “one shop” principle is not enough. We should not deceive ourselves, and we should not forget that it is the only condition for the quick start of the business.

EU Association Agreement means in terms of the deadline, according to the concrete commitments, Georgian legislation to be in content with EU legislation, and most importantly, to implement and establish European instruments ‘standard’. The legislation takes into account to make Georgian legislation closer to 300 EU legal acts. Thus, the whole set of normative (rules, instructions etc.) and sub-normative acts gradually should be developed /or changed, which should set up the mechanism of law enforcement of European implementation, but, to what extent is the civil society ready for this change, when in fact the adoption of anti-discrimination law was followed by an anxiety of small but agitated people. Therefore, in the process of implementation of the agreement right awareness and involvement of civic society is of paramount importance. In this regard, the Association Agreement, economic corporation and taxation issues (Chapter V) are very important, where it is mentioned that “The European Union and Georgia will spur economic reform process through rising awareness about fundamental principles of their respective economies, formulation and implementation of economic policy.” Not a single verse of this record is random. In this case we can mark out the aims of raising awareness about the fundamental principles of economics, economic policy formulation implementation of economic policy. At the same time, the chapter of the Association Agreement practically emerges these obligations: “Georgia should aspire to establish gradually and converge its economic, tax and financial regulations to EU regulations and at the same time to ensure the correct tax policy.” It is no secret that more than a dozen years in the annual reports of the World Bank about Georgia the following statement is given: “in the country the level of business and tax culture still has remained low. Most part of payers is not aware of the rules and the nature of calculation”. Evaluation is real; it may have been more sever. Unfortunately, for decades the country has not been established the equal duty relationships between the taxpayer and the tax collector. In this chapter of the Association Agreement it is marked out that “the parties that collaborate in the tax are to strengthen good governance”. May be it is clear for everyone what is meant by collaboration - “In terms of good governance”. This is creation of such climate of tax policy and administration when the tax payer and the tax collector are equal, both, together with their rights, properly understand their duties. When the tax collector is not only punitive administrative body, but the supportive, serving body of a taxpayer, such standards of regulations of tax relationship is seen in Europe, a serious effort is required to achieve this level of standards.

The Article 280 of the Association Agreement should be taken into account: “The parties acknowledge and undertake to carry out the principles of good governance in the tax area, such as transparency, exchange of information and fair tax competition. They facilitate the development of fair tax revenue administration, and take steps to ensure the effective implementation of the above mentioned principles.”

The Article 282 also states that “the parties will also strengthen and intensify their cooperation aimed at the development of tax administration system, including strengthening of tax collection and control capabilities, ensure efficient collection of taxes and become more active in the fight against tax fraud.” In this part main accent is made on performing particular actions against the fraud and smuggling of excise goods and on retaliatory actions.

This collaboration includes gradual convergence, growth of excise tariffs on tobacco products.

In addition, according to the Article 285, unilateral commitment is imposed on Georgia, which is established as an imperative norm saying that “it could converge national legislation, EU legislation and international legal instruments due to the same Appendix of XXII contract” which is an integral part of this contract. The appendix is a common and in some cases different tax regimes and regulations, general instruments, including a list of laws that must be implemented step by step, including value added (VAT) of the total system, which should be enforced in five years time.

Georgia takes the commitment gradually, in approximate terms to converge native legislation, EU legislation and international legal instruments in the following areas:

- . Tax exemption;
- . Operations within the European Community
- . Import and Export;
- . International transport Trade;
- . Total system of value-added tax (VAT), invoice generation, declaring, accounting rules.

In addition, special liabilities and schemes related to the import and export of goods are determined, for example, special scheme for electronic commerce, etc.

There are exceptions in the above listed appendix, which are still in force in some EU member states. It is worth emphasizing that practically all countries taking into account their national interests fix some reservation in connection with some kind of taxation regime or with special mechanisms of control.

Georgia will be no exception in this regard. For example, Georgia reserves the right to exempt spirits from excise tax which are produced by individuals in small quantities and are intended for home consumption and not for the market.

Also Georgia has the right to exempt goods and service delivery from VAT tax that comes into force on the basis of the Georgian tax code. But as for the question – “the exemption of goods from value added tax and excise tax, imported by the passengers from the third countries”, it used only the part of the directive, which imposes quantitative restrictions. It is noteworthy that these provisions should be performed in a different period from the effective date of this Agreement, not in five but in three years period of time, etc.

The next step is to form a Deep and Comprehensive Free Trade Area (DCFTA) and to sign appropriate contract between Georgia and EU.

In Association Agreement, DCFTA is a real actual mechanism of economic integration with EU. DCFTA gives opportunity to Georgia to receive three of four freedoms from EU internal market: goods, services and free move of capital.

In addition, the formation of a deep and comprehensive Free Trade Area opens the way to EU internal market for Georgian goods and service and contributes to the growth of the country’s investment and attractiveness. A deep and comprehensive trade area opposed to conventional free trade agreement includes both tariff and non tariff barriers to smooth and regulate a wide range of trade-related issues. For example, food safety, product safety, competition policy, intellectual property rights, customs issues, public procurement, etc. Unlike other trade agreements, DC FTA covers trade legislation and the creation/modification of institutions. There is no doubt that the establishment of free trade area will support formation of a trading system compatible with EU market; transparent, stable business environment, the investment attractiveness and therefore, the growth of foreign investments; creation of new enterprises and export products; at the same time creation of new working places in regard with the growth of the local industry; limit export expenditure for Georgian exporters; secure and safe delivery of the product for Georgian customers; development of public administration body (including tax) in accordance with the



best European practice; in general, formation of economic growth and the country's economic development; step by step convergence with the relevant EU regulation and administrative mechanisms (according to agreed schedule).

It is important that from the date entry into force of this agreement, the parties shall eliminate all customs duties on products originating in the other party, except certain cases. In this section it should be considered and well calculated what will be the amount of revenue loss for revenue part of Georgia budget and how it should be compensated. One thing is clear - the budget revenue, without customs tax got from import, will be reduced by about ¼. We think, we can fill it in the expense of gradual increase of excise on cigarettes/tobacco and spirits.

“No party is at liberty to impose or maintain prohibition customs or other tax”, except domestic fees, in accordance with agreement connected with the export of goods on the territory of the other party. However, according to the record, each party shall ensure that all types of payments and fees that are imposed on or associated with the production of export or import should not exceed the approximate costs of rendered services. The products listed in Appendix II-A of the agreement, are the subject of separate analysis.

They should be imported as duty-free within the framework of the tariff quota. Naturally, we have a question - what happens if the product exceeds the import tariff quota. The Appendix II-A of the agreement clearly explains the process and in case if the goods are delivered more than required by quota, there should be used the most favored/preferential rate of customs duty. At the same time, “neither party shall establish or maintain a prohibition or restriction on the import or export of other side, or exports for sale which is for other country.

“Contracting parties agree that their respective customs, tax and trade legislation should be stable and comprehensive. The provisions and procedures should also be proportionate, transparent, fair, predictable, non-discriminatory, equitable, efficient and uniformly enforced. Of course, it is obvious that parties lay out the obligations first of all to the Georgian side, as from the side of EU, standards of border integrity and liabilities, standardization of simplified documents, quick set-up of goods at the border, are much higher. For Georgia, due to geographical situation, transit theme is very important. In the agreement, the parties take responsibilities to facilitate the process of cooperation between the agencies and departments. As for transit, the EU countries will try to help and support Georgia to implement their progressive transit system and achieve mutual connection. It is important to agree on customs fees. In trade between the two sides, the determination of the customs value of goods will take place in accordance with the WTO agreement. Georgia takes responsibility to share the best practices related to customs operations, in particular, control system based on risk management and in the sphere of intellectual property protection, especially counterfeit goods, etc.

## **Conclusion**

As we can see, despite the integration of Georgia in the World Trade Organization, its export products are not still fully depended on donor countries' consumer market and the question of being a savior will remain a myth for good, if we do not realize policy properly and hastily make decisions. Of course, the West and the World have their reasons for fast and wide creation of economic and political blocs. This is primarily interest for the resources of the Caspian Sea and Central Asia. On the other hand, the World wants to reduce Russia's influence over the former Soviet Union. In this regard, the energy provider has a favorable geo-strategic location between energy supplier and the West. Effective realization of this goal is the implementation of trade and economic relations with the west would be acceptable to it, which of course reflects the type of agreement in a manner that does not endanger their own economic interests. But for Georgia it is important to be an equal partner of the West.

Further 3-5 years of the signing the association agreement will be important when we move to the stage of implementation. First of all, it will be important for Georgia to ensure the irreversibility of the European perspective. According to experts, by the Association Agreement /DCFTA - domestic product of the country will grow by 6.5%, while the amount of foreign direct investment of USD 2014.8 thousand (2007) will reach 11.36 billion (2020sec.). For example, in Poland after the Association Agreement, quantitative investment increased by 4.5 times. In addition, in 2012, according to the joint survey about DCFTA, results made by the company “Ecorys”- (the Netherlands) and the Case (Poland), increase of export from Georgia to EU is expected by 12% and import by 7.5%. According to an independent survey, it is expected that the long-term perspective of the gross domestic product may rise 4.2%, - 292 million Euro, etc.

But in every case, if the Association Agreement is soon followed by a deep and comprehensive Free Trade Agreement, its results will be properly implemented and preserved. Today, Georgia is in this content. The case is how properly and promptly we can use this opportunity.

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