

Georgia-EU Integration – Progress Made so far and Steps to Move Forward

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Introduction

2020 will mark the 6th anniversary after signing the Association Agreement (AA) and Deep and Comprehensive Free Trade Area (DCFTA) agreement between Georgia and the EU. It is an appropriate time to talk about preliminary results achieved so far and present recommendations for moving forward in this process of integration. Being a frontrunner in the DCFTA implementation process that now is the cornerstone for economic reform process in Georgia, the position paper will have a look at the integration process from the economic perspective.

The economic crisis brought by the Covid-19 has proved the importance to build a strong and resilient economy through establishing strategic alliances; integration with the EU is meant to bring this resilience through consistent economic reforms and increasing social welfare by private sector development. Current crisis has vividly shown the vulnerabilities of the Georgian economy and the directions that need further focus.

Namely: 1) Georgia has a relatively low level of technological development, which limits the mitigation affect that has been achieved by a temporary shift to a new mode of work (low levels of digitalization in both public and private sectors), low levels of digitalization hamper proper provision of both public and private services distantly; 2) the economy is dominated by small enterprises and informal employment (half of the population is self-employed) without a formal stable source of income therefore in the times of crisis, social welfare worsens rapidly creating humanitarian crisis; SMEs lack access to technology, finance and skilled labor which will most probably make their economic revival harder; 3) 25 percent of the country's Gross Domestic Product (GDP) is made up of receipts from tourism and remittances, both of these sources of income will see a drastic decrease this year, making the economic recovery quite problematic; 4) economy is dominated by trade and services sectors, which will suffer by both domestic and external shocks and will find it hard to overcome the crisis; 5) agriculture is expected to rejuvenate due to increased interest and efforts from the side of the population to harvest the land at their disposal; since manufacturing in Georgia is dominated by food products, beverages and metals, it is expected that this sector will also quickly overcome the crisis.

In the subsections below, an overview of various aspects of Georgia-EU trade and economic ties over the course of the past 5-6 years is presented. Analyzed tendencies will help us better understand current stance of the economic conjuncture in Georgia, its strong and weak links and the role of the EU in building and reforming the country's economy.

Economic and Trade Ties with the EU

Export with the EU

Over the course of past 5 years, economic growth of Georgia has been slightly volatile barely reaching 5 percent in 2017-2018, after two consecutive years of below 3 percent growth rate. Economic activity is led by trade, construction and transport sectors. Export base has been improving, currently standing at over 3,761 million USD.

Compared to 2014, Georgian exports to the EU countries increased by more than 30 percent, as of 2019, 22 percent of all Georgian exports go to the EU countries (products worth above 800 million USD). 89 percent of all exports are net exports. Top three export destinations, that have seen a stable increase over these years are Bulgaria, Romania and Germany (in the past three years, exports to Germany have been going down). Apart from the top three destinations, the rest of the countries have been characterized by volatilities (in some cases sharp ups and downs). Given the fact that prior to DCFTA, Georgia was already benefiting from the GSP+ that allowed it to use preferential trade regimes with the EU countries, even though DCFTA has opened up the EU market on all goods and services, the immediate impact was not as high and was neutralized due to the preferential trade regimes that were already in place.

Main export products to the EU markets are agricultural (wine, fresh and dried fruits and vegetables, plants for medical and other purposes) and industrial (copper ores and concentrates, manganese oxides, textile, wooden pet houses). Export products saw a slight diversification, namely, wider variety of fresh and dried fruits were added in agricultural category, while in the industrial category plastic dishware, animal houses and isotopes. At the same time, the number of companies exporting to the EU from Georgia has increased by 46 percent¹.

The AA and DCFTA go beyond the integration through trade and envisage an overarching economic integration of Georgia with the EU through the rigorous reforms and legislative approximation. Therefore, the impact of the agreements should not be downgraded by merely looking at the export tendencies.

Investments from the EU

From the investment point of view, almost half of investment inflows in Georgia in 2019, came from the EU countries (almost 600 million USD); over the past 7 years, the share of European investments in Georgia has been slightly fluctuating, keeping on average around 40 percent of total investment inflows. Since 2014, total FDI inflows from the EU countries to Georgia amounted to 4 058 mln USD. If we compare the trends of FDI inflows from other countries vs. the EU countries, we can see that both sources of investment have been following a similar increasing or decreasing tendencies. Namely, since a peak in 2017, investment inflows have been on the downside from both EU and non-EU countries. 95 percent of all EU investments in 2019 came from 9 EU countries. If we look over the past 4 years, Georgia has been an attractive destination for investors from Great Britain, the Netherlands and Luxembourg. In 2019,

¹ https://eeas.europa.eu/sites/eeas/files/1_en_act_part1_v6.pdf?fbclid=IwAR0baN7C82Alzh-BMpw1pLEBpTr22ZNDICb_u9nSVE8BiHaYSDfgzfQi07o

investments from Ireland were the second largest from the EU. Major sectors for EU investments are real estate, financial sector, hotels and restaurants, mining, energy and transport.

EU has brought substantial amount of 'green' investments for energy efficiency and municipal infrastructure, thereby decreasing energy consumption, pollution and greenhouse gas emissions, and strengthening environmental and climate resilience across the region².

In the conditions when ongoing trade war with China will be re-mapping and re-shuffling the global supply chain, this represents an opportunity for countries like Georgia that can offer competitive, young and educated workforce along with favorable business and investment climate. However, in order for this opportunity to materialize, the Government of Georgia needs to strengthen and speed up the reform processes in the direction of building a predictable and stable political climate governed by independent judiciary and the rule of law. Specific investment offers and packages should be presented to potential investors. On the EU level, increasing awareness and information about investment opportunities in the Associated countries among the EU investors will be an important step.

Strong reforms in the direction of rule of law and good governance, create political and economic stability which is key in attracting investments especially from the EU countries. Therefore, stronger reforms should be fostered in this direction.

Transport Connectivity

DCFTA seeks to strengthen and expand cooperation in the direction of transport. This in fact is the cornerstone in ensuring integration of Georgia's industries into EU supply chains for further promoting economic integration through increased investment and export opportunities. Georgia has the ambition to become the connecting and logistics hub between Asia and Europe. DCFTA sets out and gradually implements and opens up regimes for transportation by sea, road, rail, air (Common Aviation Agreement).

Private Sector Dynamics

Private sector composition is rather peculiar in Georgia. There are more than 686 thousand registered business entities in the country, out of which a mere 23 percent are active (Geostat, 2018)³. Apart from business statistics, there are above 800 thousand individuals who are self-employed, most of whom run *de facto* micro enterprises and could be regarded as potential entrepreneurs. Sectoral breakdown shows that more than one third of all enterprises are engaged in trade and reparatory works, while activity of the other 28 percent is not known. Business sector in Georgia employees roughly 700 thousand people (40 percent of total employment and 80 percent of formal employment). 99.7 percent of all business enterprises in Georgia are SMEs⁴, 98.62 percent being small and only 1.12 of medium size (the problem

² https://eeas.europa.eu/sites/eeas/files/1_en_act_part1_v6.pdf?fbclid=IwAR0baN7C82Alzh-BMpw1pLEBpTr22ZNDICb_u9nSVE8BiHaYSDfgzfQi07o

³ National Statistics Office of Georgia. Business Register
<https://www.geostat.ge/en/modules/categories/64/business-register>

⁴ According to the new definition Large size enterprise is an enterprise, where average annual number of employed exceeds 249 persons and/or volume of average annual turnover - 60 million GEL.

of the so-called “missing middle”). However, when it comes to value added by enterprise size, 40 percent of the value-added is generated by the large enterprises and 30 percent by small, while the rest by medium sized enterprises.

EU and IFIs have brought about substantial support for small and medium sized enterprises (SMEs) directed towards facilitating access to finance, knowledge and skills. In order to support Georgian enterprises to develop and internationalize their activities, it is important to foster sectoral support and strengthen links with EU innovation ecosystems, foster knowledge and technology transfer initiatives, having a stronger focus on knowledge and education provision together with the access to finance programs.

Legal approximation

DCFTA implementation has unveiled all the difficulties faced by Georgia to ensure rapid use of the opportunities provided by the agreement through placement of Georgian products and services on the EU market. Bringing Georgian products and services into compliance with the EU standards is not an easy task. It was made clear that achieving the compliance with the EU standards was quite difficult for Georgian entrepreneurs. This difficulty is especially obvious in respect of small and medium-sized enterprises, which unfortunately do not have enough resources and capacities to re-equip their respective enterprises, to hire highly skilled personnel and to cope with new regulations.

As of 2019, 112 out of 270 acts were approximated in sanitary and phytosanitary (SPS), 11 out of 21 directives were approximated and 2 are in progress. New legislation governing public procurement sector was submitted to the Parliament in 2019, the new legislation shall ensure better participation of SMEs and fostering innovative procurement practices. In the trade in services direction, 8 directives are in process of approximation, which will ensure increased export potential for Georgian intellectual service providers.

Recognized Economic Operator or Authorized Economic Operator (AEO) system was introduced by the Revenue Services of Georgia in order to simplify customs procedures for companies with good record of transparent and law-abiding operation. The system is a part of European concept of trade facilitation and the Georgian companies enrolled in the program will additionally benefit from simplified export and customs procedures while exporting to the EU market as well. Moreover, the program does not differentiate companies by size and turnover, any company despite its size can be enlisted as long as they have positive record of operations.

Some of the challenges related to the legal approximation process relate to the following: 1) lack of administrative resource to ensure full implementation and enforcement of approximated relations in real sectors; 2) lack of qualified human resource especially in the SME sector to understand and comply with

Medium size enterprises are all enterprises of organizational-legal form, where average annual number of employed ranges from 50 to 250 persons and average annual turnover – from 12 million to 60 million GEL. Small size enterprises are all enterprises of organizational-legal form, where average annual number of employed does not exceed 50 persons and average annual turnover - 12 million GEL. These changes resulted in statistical increase in the number of SMEs.

the new regulations; 3) low understanding of DCFTA benefits among entrepreneurs to ensure better compliance and favorable reception (acceptation) of new regulations; 4) lack of laboratory infrastructure for conformity assessments.

EU assistance to Georgia in the framework of AA

EU support to Georgia aims at improving the quality of life of ordinary Georgians in a tangible and visible manner and provides over EUR 120 million to Georgia annually in grant assistance. In this context, EU assistance to Georgia supports country's reform efforts in line with the Association Agreement/DCFTA.⁵ EU announced 183 million euro support to Georgian on Covid-19⁶.

In accordance to Association Agreement and Government of Georgia priorities, the 2017–2020 single support framework of the EU to Georgia focuses on four main areas: economic development and market opportunities; strengthening institutions and good governance; connectivity, energy, environment and climate change, mobility and 'people to people' contacts.

In 2018, EU allocated EUR 134 million mostly focusing on the implementation of the AA, including Georgia's increased participation in Erasmus+ and action on strategic communication. A new economic governance and fiscal accountability programme was targeted to bring Georgian system closer to the EU model of economic governance, while a holistic programme on security, accountability and the fight against crime aimed to strengthen good governance, the rule of law and the security of Georgian citizens.

Along with the above stated sectors, EU actively supports Georgia's agriculture sector. As of 2019, the EU provided assistance for the implementation of food safety regulations (partly to facilitate an increase in exports to the EU) and further promote rural development.

EU provides assistance for economic development of Georgia through various programs, including EU4Business initiative, which aims to provide financial aid and trainings in order to strengthen SME sector and increase Georgia's export on EU market. In the frames of EU4Business initiative 23 project have been implemented, EU allocated EUR 69 million and 10 300 additional new jobs were created.⁷

Since 2009, in order to strengthen institutional cooperation between EU and Georgia, numerous Twinning and TAIEX projects have been successfully implemented. Twinning projects bring together public sector expertise from EU Member States to Georgia, with the aim of achieving concrete mandatory operational results through peer to peer activities. While, TAIEX (Technical Assistance and Information Exchange instrument of the European Commission) supports public administrations with regard to the approximation, application and enforcement of EU legislation as well as facilitating the sharing of EU best practices. Twinning and TAIEX programs have been implemented in agriculture, civil aviation, transport, accreditation, education, energy, urban and regional development and other sectors.

⁵ https://ec.europa.eu/neighbourhood-enlargement/neighbourhood/countries/georgia_en

⁶ https://eeas.europa.eu/delegations/georgia/77393/eu-announces-%E2%82%AC183-million-support-georgia-covid-19_en

⁷ https://ec.europa.eu/neighbourhood-enlargement/sites/near/files/eu4business_georgia.pdf

Conclusions and Recommendations

We can conclude that notwithstanding a visible progress in Georgia-EU integration, there is room for improvement and for better utilization of the benefits that the AA offers. The need of building a strong economy and creating strategic alliances becomes even more acute in the time of economic backsliding and crisis. The reason behind the fact that Georgia currently only moderately utilizes EU Association Agreement primarily lies in the following: 1) low competitiveness of Georgian private sector; 2) low diversification of export base; 3) lack of branding and marketing on the EU market of Georgia and Georgian products at large; 4) low access to knowledge, finance, technology and digitalization of Georgian private sector which also makes it extremely vulnerable in the times of crisis and economic backsliding.

In order to further exploit new opportunities and benefits of the AA, for building a stronger economy, and in the context of building mutually beneficial strategic partnerships, recommendations could be clustered in the following statements:

- Covid-19 crisis has shown vulnerabilities and gaps in development for all three DCFTA countries; the crisis highlighted the importance of Eastern Partnership policy objectives beyond 2020, especially in such directions as the need to build resilient, sustainable and integrated economy through stronger partnerships, efforts towards digital transformation and strengthening the reform process towards accountable institutions, the rule of law and security for increasing chances to attract investments that are on a decrease globally;
- Support should be strengthened towards integrating Georgian private sector (and of other DCFTA countries) into the EU value chains and supply chains; this could be done through research and analysis, identification of competitive edge high value adding sectors and using a sectoral approach in boosting their growth and development;
- In line with the current developments, seeing the crisis as an opportunity for the associated countries and Georgia among them; namely, the post Covid-19 period might be associated with reshuffling of current supply chains and outsourcing mechanisms. A number of investment opportunities might be shifting from the Asian perspective (namely China) towards Eastern European countries, given the need of diversifying outsourced production to avoid rapid disruptions in supply. In such cases, Associated countries might be of direct interest for potential investors; Strengthening support in Georgia (and other DCFTA countries) in the direction of economic reforms, evidence based policymaking practices for ensuring favorable and foreseeable business and investment climate;
- Expanding focus for supporting digital infrastructure, such as e-services both related to further development and advancement of public services as well as in the direction of e-commerce for both local and international markets; namely, using EU funding and EU supported programs to be more focused in the directions of knowledge and technology provision, in order for the Associated countries to overcome quite acute technological setback; technological upgrading in the existing and new production, will also increase export base and ensure competitiveness of production;
- Exploitation of new sectors and uncovering new potential, especially in the direction of trade in services, through further development and investments in the direction of intellectual services (to name just a few, information and communication technologies (ICTs), consultancy for private

sector representatives in such fields as marketing, advertising, management and business processes, fashion and interior design, etc.); EU countries are already outsourcing considerable amount of services especially in the fields of ICT to DCFTA countries, this could be expanded to cover broader number of services. Trade in services are more resistant in the times of economic crisis and more sustainable rather than trade in goods;

- Support in the direction of transport and logistics. Due to the high transportation and connectivity costs, Georgian products become less competitive as opposed to the European counterparts; in order to take advantage of economies of scale, one supporting mechanism could be establishment of logistical hubs on the EU territory for storage and uninterrupted supply; lack of such storage facility hinders Georgian companies to 1) ensure uninterrupted supply; 2) take advantage of economies of scale through transporting larger amounts of products to EU at a time;
- Encouraging programs and investment in the direction of education and overcoming the skill mismatch problems for increasing employability of Georgian population, this could be done through a special focus in the investment towards primary and secondary education (as well as vocational programs, VET) with a special focus on STEM subjects; special focus should be made on improving and advancing digital skills among youth, especially in the rural areas;
- Facilitating marketing Associated countries in the EU, among consumers as well as investors, to increase informational awareness about the products, services and the potential that these countries can have for the mutual benefit of EU on the one hand and of these countries on the other hand;
- Stronger focus on SMEs through building resilience of this segment which is particularly vulnerable in the times of crisis; providing support schemes for overcoming their problems related to liquidity and technological underdevelopment;
- Fostering and exploiting the potential in the direction of joint ventures with EU and Associated countries as counterparts, through joint project, investments, etc;
- In the direction of green economy and Green Deal, fostering investments and support in implementing the requirements of AA especially in the direction of renewable energy, waste management, pollution and other issues to decrease negative environmental impact through strengthened focus in the directions of green energy and green economy;
- Strengthen coordination and institutional support on the issues of AA/DCFTA implementation among EaP+ for sharing experience and knowledge.