

Statement of Work
CLARITY – Business Environment Improvement Components

1.0 Introduction

USAID/Caucasus/Georgia is soliciting proposals in direct support of the Government of Georgia (GoG) for a business environment project. The activity, Consolidation in Laws, Administration, Revenue, Institutions and Titling to Yield results (CLARITY), is designed as a four-year effort. The following sections provide the background, problem statement, planned activities, and expected results for the project. Prospective contractors may propose alternative mixes of technical assistance, a different technical approach, and should comment on proposed indicators of success, as long as proposals clearly demonstrate how the desired results will be achieved.

The base funding level is \$15.0 million for the components designed to improve the operating environment for business, including small- and medium-sized enterprises (SME). Project-funded technical advisors will assist the Government of Georgia (GoG) in the reform of the business environment by supporting the introduction of: (1) an improved legislative, policy, and regulatory framework for businesses; (2) streamlined registration systems and procedures for companies, immovable and moveable properties and collateral; (3) reduced, rationalized and simplified regulations and procedures for licensing, permits, standards, and inspections; and (4) rationalized, orderly, even-handed, and user-friendly tax and customs procedures. To facilitate the creation of new businesses, as well as the expansion of existing ones, the project will strive to reduce barriers and administrative burdens by promoting unified and streamlined government services at central locations, likely culminating in the establishment of one or more relevant “one-stop shop”(s).

The lead counterpart for CLARITY is expected to be the Prime Minister’s Office. The Investors’ Forum, currently being established under the Prime Minister, Zurab Noghaideli, is expected to become a coordinating center for all initiatives to be undertaken under the CLARITY project. Additionally, State Minister for Economic Reform Kakha Bendukidze appears currently to be leading the effort across ministries to reform regulation, licensing, and administration. Under the leadership of the Prime Minister’s Office, CLARITY will support initiatives already underway under the Ministry of Justice, Ministry of Economic Development, Ministry of Finance, and certain non-ministerial agencies. The activity may need to be flexible and responsive to political changes (conceivably even including, upon USAID approval, changes as to who are the GoG counterparts). (Note: The contractor will be required to coordinate closely with a separate USAID effort involving components on land privatization and the immovable property registry, procured via a separated mechanism and not part of this solicitation.)

2.0 Background and Problem Statement

2.1 Economic Context

Georgia’s recent macroeconomic performance has shown positive trends, especially compared to the stagnation experienced through most of the 1990s. GDP was \$4.9 billion in 2004, and per capita income was approximately \$1,000. Real GDP growth has averaged 7.5 percent since 2001. Nonetheless, a sizeable portion of the population resides below the poverty line (50-55 percent), with about a quarter of the population living in extreme poverty. Unemployment estimates are in the range of 25-35 percent, but the actual figure is probably much higher. Underemployment is rife. The informal sector constitutes a substantial part of the economy, and many people survive on subsistence agriculture. Prohibitively unpredictable tax and customs procedures lead to a vicious cycle in which business hides economic activity, the GoG can’t secure revenue thereon, and under stress the GoG resorts to unsustainable pressure tactics to generate revenue, further discouraging business from transparency.

Such an economic environment translates into a very low level of penetration of formal sector institutions throughout the economy and society. Past corruption and ineffectiveness have reduced confidence in the ability of government to provide meaningful services and tax payments are generally low. Administrative complexity further reduces incentives to comply with existing laws and regulations, and makes it impossible to plan as to tax obligations or Customs clearance.

2.2 Constraints and Challenges to Improving the Business Environment

Georgia faces a number of policy and legal hurdles to strengthening the business environment. These challenges are being addressed with numerous legal reform efforts, including new legislation on agricultural land privatization, moveable and immovable properties (separate pieces of legislation), secured transactions, credit information, alternative dispute resolution, bankruptcy, and leasing.

While legislation is sometimes problematic, an additional challenge is the development of policies, regulations, and procedures that will facilitate business operations and the growth of the private sector. The capacity of policy-setting and regulatory agencies must be enhanced, and procedures need to be streamlined and made more transparent. Where possible, regulation should shift away from the state to appropriate self-regulatory organizations that are sufficiently mature to self-certify. Key problems in Georgia's legal framework relate to the functioning of the judiciary and other support institutions, such as registries, rather than the legislation itself.

Tax administration and customs administration remain the leading complaints of business, and greater dissatisfaction exists in these areas than is observed in other countries. Businesses do not know how to comply with undeveloped, non-sustainable tax and customs procedures, and cannot plan their activities in an environment that promotes excessive interpersonal contact -- leading to corruption.

Major problems inhibiting the creation, operations, and growth of businesses thus include:

- *Lack of adequate framework legislation and implementing measures in such commercial law areas as company law, securities, secured transactions, pledge, mortgage;*
- *Underdeveloped property rights, and non-centralized, non-automated property registration systems;*
- *Confusing, burdensome, antiquated, and economically irrelevant regulation;*
- *Disorderly procedures that still promote high levels of administrative corruption;*
- *Insufficiently trained and over-staffed administrative bodies that manage the government's regulation of business;*
- *Poorly trained and inexperienced judicial staff (particularly judges) in commercial matters;*
- *Underdeveloped "out-of-court" dispute resolution mechanisms;*
- *Informal, non-transparent, non-sustainable, non-automated tax administration procedures; and*
- *Ill-developed customs procedures that do not allow for bonding or post-entry verification.*

Georgia has numerous regulatory bodies with overlapping mandates, creating confusion, adding to costs, and causing operating difficulties for businesses (there are at least 44 bodies responsible for various inspections and supervision functions). Together, these pose serious constraints (and provide myriad opportunities for illicitly seeking rents), as businesses find it difficult to plan or operate under a yoke of red tape. The business community complains that laws and regulations are unclear or inconsistently enforced, with both the judiciary and government bodies setting standards and carrying out inspections. Inspectors are often either unqualified to carry out their jobs or corrupted, and complaints persist as to lack of due process/appeals. In many cases, larger enterprises or those with contacts are able to make illicit payments for favors, resulting in unfair competition and trading practices, collusion, price fixing,

and other abuses – further discouraging businesses from operating in the formal market. Inspections and the issuance of required permits are also a problem. Companies complain of too many and too frequent inspections, with standards overlooked in favor of illicit payments. Standards are unclear and/or irrelevant, monitoring and supervision of licensors and inspectors is inadequate.

Administrative and tax-compliance burdens (for those businesses that do comply) are a top source of complaint. Transit procedures and corruption by Georgian Customs also impose great costs and uncertainties on exports of (often perishable) products from Azerbaijan and Armenia to, and imports from, Russia. The GoG made significant progress in 2004 to raise public revenue from the dismal levels achieved under the previous government. However, reliance on one-time events instead of sustainable means, and effects of the new Tax Code may lead to some erosion of tax receipts in 2005, whereas priorities such as poverty-alleviation programs suggest higher taxes in the future if administration is not improved.

In sum, underdeveloped laws, policies, and regulations; weak institutions; unclear property and company registration regimes; confusion and corruption in standards, licensing, inspections; and non-transparent and unevenly applied tax and customs procedures -- together impose serious burdens on the business community and undermine the development of orderly market and financial systems while depriving the GoG of revenue. The problems are especially important for development of SMEs who lack large the large staffing needed to deal with them in the absence of clear authorities, procedures, and centralized facilities.

3.0 Project Activities and Tasks of the Contractor

The contractor will be responsible for accomplishing the following end-of-project results through the provision of long- and short-term technical assistance and training (short-term, in-country):

- *Increased capacity and professionalism of administrative bodies connected with the government's management of business regulation;*
- *Streamlined business and property registration procedures, and collateral systems developed;*
- *Improvement in key "framework" commercial laws;*
- *Simplified, sensible, and transparent regulations and standards, as well as procedures for licenses, permits, and inspections;*
- *As a longer-term goal within the activity, one-stop shop(s) functioning for registrations, licensing, permits, etc.; and*
- *Rationalized, orderly, even-handed, and user-friendly tax and customs procedures.*

Illustrative indicators of results achievement, as well as annual targets to measure progress, should be included in proposals. The results framework, with specific outcomes, indicators, and targets will be finalized, and agreed to by USAID, part of the initial work plan.

The following project interventions will be undertaken by the contractor. Specific tasks and outputs are highlighted.

3.1 Framework Laws/Policies and Regulations/Capacity Building

Several important business-related laws such as a law on the Immoveable Property Registration, law on the Moveable Property Registration, law on Alternative Dispute Resolution, legislative package on Secured Transactions, and law on Bankruptcy are currently being drafted under the leadership of the Ministry of Justice, and are expected to be introduced in the Georgia Parliament with the next few months. Other laws related to company law, mortgage, pledge, and securities, may need to be developed.

In almost every case, these laws will require new policy and regulatory frameworks to be successful in promoting economic growth through the private sector, and in some cases, new laws will be required or existing ones will need to be modified. The passage of critical statutes and amendments (and in some cases adoption of regulations) will be essential for the improvement of the business environment. In the area of securities regulation, it seems that too many companies (even “closed” and small ones) are required to provide detailed filings, while the Securities Commission lacks the capacity to meaningfully analyze such data – it is this type of distortion which should be rationalized. The project will provide long- and short-term technical assistance to help GoG Ministries to assess existing or planned legislation to ensure that laws are conducive to business development and growth and to develop policies and regulations that are clear, transparent and that facilitate, not hamper, business operations. Such policies and regulations will support the “appropriate” role of government (hopefully delineated in the legislation) in a market economy and increase trust and compliance on the part of the business community. Where legislation is needed but not yet contemplated or drafted, the CLARITY project will offer assistance (upon USAID approval), if requested by the GoG.

The legacy of Soviet-style regulations will need to be addressed in some form. As an illustrative example, supporting a GoG initiative under the leadership of the State Minister for Economic Reform, technical advisors under the project may assess the value of a wide range of existing regulations and recommend those that need to be eliminated, modified or streamlined. A natural adjunct to such would be recommendations on the reduction in the number of regulatory and oversight bodies, where appropriate. Other illustrative efforts could include supporting rationalizing the operations of the Georgian Agency for Standards.

Government needs to reduce tax evasion and to reduce administrative burdens on tax-compliant businesses – while also collecting sufficient revenue to meet necessary costs of public services and of support for pensioners. The components to solve this problem are described in section 3.4, below.

To accomplish the above tasks, and ensure the sustainability of reforms, the project will help strengthen the capacity of those ministries, agencies, and other institutions involved in setting policies, regulating business activities, and administering revenue collection. As the technical advisors develop new policies and regulations, on-the-job training may be provided to key GoG staff. Focused study tours may also be conducted to expose Georgian decision makers and private businesses to best practices in other countries. Additionally, CLARITY will assist the government develop a concept that articulates its visions for comprehensive reform of business regulation.

3.2 Streamlined Registration and Clarification of Property Rights

The project will assist the GoG to establish streamlined, transparent and centralized registries for movable and immovable property, collateral, and companies. Simplified and transparent property registration, combined with reform of the secured transactions regime will give businesses increased opportunities to access finance. An important feature of a properly functioning property registry will be the installation of centralized, nationally-accessible data bases.

Currently, companies are registered in courts around the country, limiting the usefulness of this information for contract enforcement, purchase and sale, and investment in companies. Project advisors will assist an appropriate GoG entity to establish a transparent, centralized registry. Tax registration might also be combined with company registration.

In order to streamline company and property registration, the GoG needs support under this CLARITY procurement in order to: (a) strengthen the capacity of the National Agency for the State Registry to implement immovable and moveable property registration, and (b) train judges and arbitrators on

resolution of property and contract disputes. (The contractor will also be expected to cooperate closely with a separate, land-related project.) While much of the relevant legislation is drafted and expected to be adopted by 2005 or 2006, there are numerous tasks required for effective implementation, including drafting regulations, defining functions and responsibilities, determining information systems requirements, training personnel, and conducting public information campaigns. The project anticipates providing technical assistance and in-country training (such as workshops) in the above areas.

3.3 Reduced and Simplified Regulations and Procedures Related to Licenses/Permits, Standards, and Inspections

Under the leadership of the State Minister for Economic Reform, the GoG is currently leading an effort to review all licensing procedures. This activity will provide support as this process goes forward. Regulations and standards affecting the number and frequency of company inspections will be reviewed and recommendations made for streamlining entire inspection process. Relevant institutions must be strengthened if they are to maintain a legitimate role. As part of this, efforts will be made to remove the GoG from areas where it is neither most knowledgeable nor most capable as to regulation, and shift these responsibilities to appropriate self-regulating organizations. The legal, regulatory and state institution strengthening in this activity is expected to be complemented by a separate USAID activity that will support non-governmental self-regulatory institutions.

A medium-term objective is to establish a centralized unit for company and property registration, licensing, permits, and other appropriate functions. A “one-stop shop” facility would reduce the time spent on the above actions; provide clear, transparent and simplified procedures; and give companies adequate information on a full-range of business matters. Under the project, technical advisors will help the appropriate GoG entities establish such a unit. This will be important in simplifying and fulfilling governing regulations and other requirements, but cannot be effective until all relevant regulations, etc. are properly developed and “filtered” through the one-stop concept. Thus, a review and implementation of needed changes in laws, policies and regulations will be an important first step toward “one-stop shop”. While centralization of the various filing and registration procedures will be achieved to the maximum extent practicable, there may be more than one facility (e.g., tax matters apart from initial tax registrations might be handled at another location). One stop shops must never be allowed to operate as “one-more-stop-shops”, i.e., needless points of registration that add to administrative burdens rather than reducing such.

3.4 Rationalized, Orderly, Even-handed, and User-friendly Tax and Customs Procedures

To promote internal transparency within the Ministry of Finance, by way of illustrative activities, TA, training, and IT assistance will be needed for a case monitoring systems for the Tax Department’s collections and audit functions (with a secure IT system for tracking implementation, evaluating employee performance, and improving revenue yield). In order to make tax auditing rational, improvement of risk-assessment capabilities will be needed so as to allow compliant businesses to rely on rational government behavior (thus permitting them to engage in tax planning), and reduce the frequency and burden of inspections, while protecting against erosion of tax revenue. In order to build predictability for business, there will be needed, as an illustrative activity, redesign of customs procedures to simplify steps, reduce face-to-face contact, and reduce use of cash payments at borders. Design and implementation work will be needed as to customs bonding/guarantee program and licensed customs brokers. An IT module for exports will be needed in order to verify VAT refund eligibility. Finally, preliminary work allowing a few taxpayers to file electronically will be expanded by increasing use of web portals for on-line interaction.

3.5 Public-Private Partnerships

Stakeholders confirm that no effort at improving the business environment is likely to succeed if the business community, being the most closely affected, is not engaged in the planning and development of the reforms. Legal changes, for example, will have the most hope of gaining needed support in Parliament if they have the backing of business constituents. Accordingly, *significant outreach efforts will be made to involve the business community in dialogue with government. This will entail support to the Investors' Forum currently being created under the leadership of the Prime Minister, and may involve collaboration with business associations on individual projects as to legal and regulatory reform.*

The Investors' Forum will directly link business community to government counterparts and relevant NGOs. The EBRD has indicated its willingness to support such an initiative. Related to this, the World Bank (i.e., its Poverty Reduction Support Credit), has discussed with the GoG the ways to engage business community in public-private dialogue. It will be important for CLARITY to engage constructively with such actors as the EBRD and World Bank, while also seeking ways to broaden the initiative as the situation unfolds. A separate USAID activity is also being considered to strengthen private sector advocacy, which may be complementary.

3.6 Consultation

Discussions have been undertaken with the Prime Minister's Office, State Ministry for Economic Reform, Ministry of Justice, Ministry of Economic Development and the Ministry of Finance on issues and approaches. The Minister of Finance wrote a letter to the USAID Mission Director requesting assistance. It is expected that Working Groups involving such organs will be established to develop implementation plans and timetables, with performance targets set and reviewed on a regular basis. Consultations have also been held with the American Chamber of Commerce, Federation of Georgian Businessmen, Georgian Chamber of Commerce and other private sector entities.

In addition to GoG and private sector support, many other donors are also committed to sustaining work in the areas described, with whom the activity design team has had consultation. In legal reform, the World Bank and the Millennium Challenge Corporation are designing conditionality/benchmarks to emphasize progress in commercial law, and the World Bank and EBRD have contributed to legal drafting in selected spheres. KfW, the World Bank and UNDP have contributed to property registration, and the World Bank and IFAD are planning further such assistance. The G-8 is interested in providing up to \$500,000 in supporting the moveable property registry. An EU project has supported improvements in licensing and standards, as have selected bilateral European donors such as the German and French governments. In tax administration and Customs, the design team has coordinated with the EU, DFID, U.S. Customs and a U.S. Treasury advisor. The World Bank/Foreign Investment Advisory Service (FIAS) has been promoting public-private dialogue on investment issues, and the EBRD is reportedly prepared to fund a secretariat inside the Ministry of Economic Development in support thereof.

There has also been consultation with other related USAID activities. An activity implemented by IRIS has tackled some administrative reform issues, including some efforts on licensing undertaken by the Association of Young Economists of Georgia. ABA/CEELI is working on judicial training. In addition, USAID is supporting a local government activity implemented by Urban Institute, with which some synergies are anticipated.

3.7 Performance Monitoring Plan (PMP)

A milestone chart to capture progress in laws, policies, and regulations will be developed with the contractor as part of the initial work plan. Quantitative indicators and targets, such as the establishment

of a one-stop shop(s), and the resulting time saved by businesses for registration and licensing might also be used to measure the success of the project. Other possibilities include measures such as reduction in the number of regulatory and licensing bodies, reduced number of inspections, and number of unnecessary regulations eliminated. Capacity building indicators for ministries, courts, etc., will also be developed.

4.0 Work Plans and Reports

The contractor will submit annual work plans detailing planned activities and projected achievements for each upcoming fiscal year. The first work plan will also include the PMP for the entire four-year effort. The PMP will include all major results (outcomes), indicators of success, and specific targets for each indicator. In addition to end-of-project results and indicators, the initial work plan should include progress indicators and targets by which to monitor progress each year of the project. The PMP will be reviewed and approved by USAID.

Data in the PMP should be kept current in order to support USAID's Annual Report. USAID/Georgia will provide additional guidance for work plans and the PMP during project start. (Note: Proposals should include illustrative PMPs with final results as provided in this SOW above, along with indicators and targets proposed by prospective contractors for CLARITY.)

Contractors will be required to submit quarterly implementation and financial reports, per specific guidance provided by USAID at project start-up. As appropriate, data should be disaggregated (e.g., by GoG ministries).

5.0 Key Personnel

The contractor will provide three long-term advisors (in appropriate disciplines) for four years each. One of the long-term advisors will serve as chief-of-party. A pool of short-term advisors will be available from the contractor, to accomplish the results and perform tasks described above. Prospective contractors should include details on the long-term advisors in their proposals, and an illustrative listing of short-termers who will be used during the course of the project. Key personnel included in proposals should have demonstrated experience, preferably in a developing country context, in legislative, policy, regulatory, and other fields related to the interventions described in Section 3.0, above. Although academic credentials are important, actual experience in the implementation of policy and regulatory activities is the most important criterion.

6.0 Period of Performance

USAID expects the contract to begin o/a September 1, 2005 and end o/a August 31, 2009.

7.0 Duty Post

The three long-term advisors will be stationed in Tbilisi, Republic of Georgia. Most of the work of the long- and short-term advisors will be in Tbilisi, but some travel within Georgia will be required, as directed by USAID.

8.0 Access to Classified Information

The contractor WILL NOT have access to classified information.

9.0 Workweek

Contract personnel will be authorized a five-day work week. A six-day work week may be authorized by the USAID CTO, as needed.

10.0 Administration and Logistics

The contractor will budget for and provide ALL logistical and administrative support to effectively carry out the terms, conditions and requirements of the contract. This includes housing and furnishings; offices and furnishings; office equipment and supplies; administrative support; supplies and other expendables; communications; and domestic and international travel expenses.

11.0 USAID Cognizant Technical Officer (CTO)

The USAID CTO will be appointed by USAID prior to implementation of the contract.

12.0 Technical Selection Criteria

A. Organizational and Technical Capability (45 points)

- (i) strong overall management and financial capacity – given the complexity of the activity, proposals that offer a consortium of firms with experience in specific activity components are preferred (15 points)
- (ii) demonstrated technical competence in the fields of business legal, policy, regulatory, institutional, and revenue reform -- preferably in the context of a economy in transition (15 points)
- (iii) past performance (15 points)

B. Qualifications and Experience of Proposed Personnel/Advisors (35 points)

C. Proposed Technical Approach (15 points)

13.0 Selected Reference Documents

- “Commercial Law Assessment”, Bearing Point, February 14, 2005
- “Monitoring of Administrative Burden to Small and Medium Enterprises in Georgia”, GEGI, 2004
- “SME Environment Assessment”, GEGI, 14 February 2005
- “Stimulating Economic Productivity in Georgia”, AgVantage, December 10, 2004

These documents are available for download from USAID/Georgia’s website (<http://www.usaid.gov/ge/>).

14.0 Annexes

1. USAID/Georgia SO Descriptions
2. Background
3. USAID/Georgia Economic Growth Activity Descriptions
4. Relevant Projects of Other Donors

Annex 1: USAID/Georgia SO Descriptions

USAID's EG activities have included banking development and banking supervision, rural credit, micro-finance support, credit union development, accounting reform, capital markets development, commercial law, and more recent support for leasing and development of a credit information bureau.

USAID currently has a five-year strategic plan for Georgia from 2004-08. (See table at the end of the Annex). While there are cross-cutting issues (e.g., Infrastructure and Energy deal with needed supplies and better service delivery, Democracy and Governance deal with the judiciary and local governments, Health and Social Development deal with pensions, and Anti-Corruption affects all segments of society), most of USAID's initiatives in support of SME development are under Economic Growth. A summary of SOs is highlighted below.

ECONOMIC GROWTH Strategic Objective 1.31: Accelerated Development and Growth of Private Enterprises to Create Jobs

USAID programs under this SO stimulate and strengthen the development of the overall private sector in Georgia, while emphasizing export-oriented agribusiness development and micro-finance programs as driving forces for employment generation. USAID analyses indicate that there are several aspects of private sector development where progress is critically needed to achieve this Strategic Objective. Three Intermediate Results (IRs) expected under this SO are: (i) Improved Policy and Operating Environment; (ii) Increased Access to Financial Services; and (iii) Increased Market-Driven Production and Sales.

ENERGY Strategic Objective 1.51: A Foundation for a More Sustainable Energy System

USAID technical assistance will promote commercialization of gas and electricity distribution companies through (i) improved management, (ii) increased operational efficiency and reliability, (iii) improved retail collections, and (iv) reliable payments to producers Georgia Wholesale Electricity Market (GWEM) and the dispatcher Georgia State Electric System (GSE). Expected Results and Illustrative Activities are (i) that electricity and gas sector revenues approach parity with sector costs; and (ii) the gap between electricity demand and electricity supplied narrows sufficiently to ensure basic power reliability, and renewable energy sources at the household, enterprise and community level.

DEMOCRACY AND GOVERNANCE Strategic Objective 1.1: More Effective, Responsive, and Accountable Local Governance.

This Strategic Objective addresses Georgia's democracy and governance practices and supports reforms. The Georgian Parliament has passed some of the most progressive reform legislation in the former Soviet Union. USAID's assistance in support of Democracy and Governance includes (i) local government reform; (ii) judicial strengthening; (iii) strengthening implementation of the Administrative Code; (iv) independent media; and (v) anti-corruption.

HEALTH AND SOCIAL DEVELOPMENT Strategic Objective 1.1: Catalyze Improvement of Social and Health Services in Targeted Areas.

This SO is directed at the Georgia's health and social services sector. Expected results include (i) more people above the poverty line in targeted areas as reported by Georgia Department of Statistics rises; and (ii) the number of communities improving a service with their own resources rises.

USAID Activities in Georgia

Economic Growth	<ul style="list-style-type: none"> Private Enterprise Development Agribusiness Microfinance Policy Reforms Banking Sector Support Land Privatization
Energy	<ul style="list-style-type: none"> Policy reforms Electricity Generation and Distribution Strengthening Regulatory Institutions Renewable Energy Systems
Democracy and Governance	<ul style="list-style-type: none"> Elections and Legislative Support Local Governance Media support Civil Society Development
Community Development	<ul style="list-style-type: none"> Community Mobilization Jobs/Minor Public Works Humanitarian Assistance
Health	<ul style="list-style-type: none"> Primary Health, Vaccinations Women's Health Immunization Programs Tuberculosis, HIV/AIDS Health Information and management Systems Health Professionals Training
Special Initiatives	<ul style="list-style-type: none"> Conflict Prevention Development of Youth Anti-Corruption Preventing Trafficking in Persons Training-Small Grants for Capacity Building

Annex 2: Background

I. Macroeconomic Trends and Weaknesses

Georgia's macroeconomic indicators are fairly stable, although they also point to a small economy in the aggregate. GDP was \$4.9 billion in 2004, and per capita incomes were about \$1,000. These trends have been favorable, with real GDP growth averaging 7.5 percent since 2001.

Inflation rates have been largely stabilized by prudent NBG policy focused on price stability. The medium-term outlook is that average CPI will fall below 5 percent in 2005 and then stabilize at 4 percent from 2006-08. The exchange rate has fluctuated a bit in recent years, but shown appreciation against the dollar in nominal terms and real terms since 2003. In either case, exchange rate swings have been fairly gradual since the effects of the 1998 ruble crisis settled, and monetary policy continues to operate as a managed float regime to maintain relatively stable exchange rates.

Fiscal deficits are modest and easily financed. While banks' holdings of government securities have increased, these have been modest in value relative to lending increases to the real sector. As such, fiscal deficits and government borrowings have not adversely affected SME access to credit. However, other issues related to scarce funds (notwithstanding increases in recent years from a small base) in the banking system have made loans costly for enterprises.

The balance of payments reveal relatively high current account deficits, but these are largely driven by pipeline-related imports. Deficits have been partly mitigated by rising remittance flows and other current transfers, as well as by some increases in foreign direct investment.

Georgia's debt profile remains modest in principal and interest, and thus does not impose any serious debt servicing burdens on the private sector. Combined external and domestic debt (that is publicly-guaranteed) was equivalent to 48 percent of GDP at year end 2004, with projections of decline from 2005 on. However, the quantum of exported goods and services is fairly limited, reflecting problems of export competitiveness. (For instance, Georgia's exports are lower as a share of GDP than in Armenia, Azerbaijan, the Kyrgyz Republic, Moldova, Tajikistan and Uzbekistan.¹) On the other hand, exports have increased, including in 2004, and there is cautious optimism that Georgia's agro-processing, scrap metal, transit trade and tourism sectors can sustain rising levels of foreign exchange generation.

II. Profile of SMEs

Georgia's economy is largely private sector in orientation, although a sizeable portion of the economy operates in the informal sector,² and Georgia still has several large enterprises in the state sector accounting for a large share of GDP and employees. Most private sector companies are very small, with fewer than 10 employees and well below \$100,000-equivalent in *reported* annual revenues. (Recorded turnover approximated \$3 billion in 2003, or about \$113,000 among 26,871 SMEs and large-scale enterprises. Figures for the additional 83,525 registered firms, mostly individual enterprises with no more than five employees, would add marginally to the gross turnover figure while bringing down the average significantly.) While revenues or turnover may be under-reported for tax avoidance/evasion purposes, most of Georgia's enterprises remain exceedingly small in scale and cash flow. On the other hand, the number of reported employees may be lower than the actual use of contracted employees due to the burden to firms of hiring permanent employees under official labor contracts. Tax incentives (i.e.,

¹ See "Analysis of Recent Growth in Low-Income CIS Countries", IMF Working Paper 04/151, August 2004.

² The State Statistical Department estimates this to be 26-35 percent of economic activity. A higher estimate of 67 percent is provided by the World Bank (see *Cost of Doing Business*, 2005). Other estimates are even higher, such as from several business associations and analysts in Georgia.

exemption from personal income tax) offered to companies with five or fewer employees have been used to reduce constraints to permanent hiring, although this exemption may have been overturned with the recently adopted Tax Code, and other administrative inconveniences such as filing and accounting requirements have reduced the effectiveness of tax incentives for hiring.

Georgian firms are very basic and fundamental in terms of governance standards and management structure. In the case of governance, few firms have outside ownership, and as such are not subjected to external scrutiny. In this regard, such external scrutiny is exercised by banks when lending to enterprises, in the form of regular reporting to determine if enterprise borrowers are adhering to loan covenants. However, as most Georgian firms do not have bank loans, there is no real external scrutiny apart from that of the tax authorities (or other government “inspectors”). However, this is more related to revenue collection, and has little to do with competitiveness or productivity on the part of enterprises.

As such, due to the lack of incentives, Georgian enterprises rarely have qualified, independent boards that exercise scrutiny over management. Annual shareholder meetings, when held, are generally formalities to ratify decisions made by one or a handful of controlling interests. Modern financial management systems are uncommon. Internal audit is underdeveloped as an autonomous function within the company to report to the board on the effectiveness of internal controls and efficiency of operations. Other building blocks that would otherwise make it more feasible for enterprises to access loans and possibly go to the capital markets for additional financing (e.g., bonds, equities) do not exist.

Management tends to be concentrated, with most firms run by one person. With some of the larger and medium-sized companies, there is periodic evidence of management teams in which various specializations are present and combined to forge consensus on financial and operational decisions (e.g., wine sector). However, this is not usually the case, and one person is ordinarily responsible for most major decision-making. This is not uncommon around the globe, and many closely held, privately held, family-run, and small-scale businesses operate this way. On the other hand, it often means that such companies are less willing to cede control, and are very protective of information. As such, the behavior of most firms is often disinclined towards disclosure, resulting in insufficient information provided to financial institutions for them to decide on the credit worthiness of a firm, and tax evasion. This represents a business culture constraint in the system, and one that needs to be addressed for SMEs to increase access to bank loans and other sources of formal finance. It is also a constraint that needs to be addressed by the public sector for it to be able to expand the fiscal base and increase “legalization” of enterprises.

III. The Business Environment

There are no reliable statistical indicators by which to measure financial return, operational efficiency, managerial performance, and related reflections of firm-level competitiveness. Moreover, macroeconomic data are less than reliable as an indicator due to the high level of informality in the economy. In general, while progress has been made in many areas, such as actual legislation, registration requirements, and the recently adopted Tax Code, there are many areas in which Georgia’s economy are insufficiently developed to support and actively promote SME development. Key areas of needed improvement include legal reforms, property and collateral registration systems, credit information, trade policy, competition policy, and tax/customs administration:

- *Legal*: Significant changes are needed in legal and judicial infrastructure, as well as shortcomings in numerous laws related to property rights, contract enforcement, and secured transactions.
- *Enterprise, Property and Collateral Registration*: The business environment would benefit significantly from comprehensive, unified, automated business, property and collateral

registration systems that easily interface. This would provide needed information to creditors and investors in determining whether to commit financial resources, and how to price risk. An improved system would also introduce new financial products and broaden the fiscal base.

- *Credit Bureau*: The absence until very recently of a functioning credit information bureau also adds time and cost to the credit risk evaluation process, translating into smaller loans at higher cost to those SMEs able to obtain loans in the first place.
- *Trade*: A strengthened environment for cross-border trade based on improved customs administration and border-crossing protocols, lower tariffs for needed imports, and increased capacity for prospective exporters to meet certification standards (e.g., phyto-sanitary) in potential export markets.
- *Competition*: More balanced competition, including liberalization of “natural monopolies” which have failed to render better service at lower cost in many areas of critical importance to SMEs (e.g., power, telecommunications).
- *Tax and Customs Administration*: Major improvements are needed to modernize tax and customs administration built on a broad fiscal base, reduced corruption, simplification, greater consistency, and rising compliance based on lower average costs for households and enterprises.

Above all, enterprises face numerous problems with regard to tax administration and a broad array of inspections. Recent changes in the Tax Code may lead to reduced informality and less incidence of tax evasion. However, the biggest problems have to do with administration and enforcement, including better information and valuation systems, simplified procedures for compliance and collection, and a fair system of appeals.

While legislation is sometimes problematic, the real challenge has to do with legal enforcement and the incentive structure under which institutions operate. As such, the key problems in Georgia’s legal framework relate to the functioning of the judiciary and other support institutions (e.g., registries), rather than the actual legislation itself. This undercuts the ability to enforce contracts, provide needed protection for risk-taking, and build a framework for formal transactions and market development. Major problems include:

- Commercial training and experience of judges.
- Judicial infrastructure support, such as support staff and automation/computers for caseload management.
- Excess reliance on courts for all matters, instead of rationalization and specialization.
- Underutilized out-of-court dispute resolution mechanisms (e.g., via specialized commercial courts).
- Absence of centralized and automated systems for enterprise, property and collateral registration.
- Absence until very recently of a credit information bureau.
- Corruption.
- Procedural delays.
- Lack of judicial independence from government authorities.
- Implementation and enforcement of tax policy, namely shortcomings in tax and customs administration.
- Underdevelopment of property registration systems and market-based accounting and appraisal systems (which reduces property tax revenues).

- Transfer taxes on properties, which serve as incentive to undervalue assets, resulting in lower property tax revenues.

These and other weaknesses undermine confidence, and discourage banks and other creditors from lending. This likewise has the effect of discouraging SMEs from placing deposits with banks and seeking loans, instead bypassing the formal legal (and tax) system. This fosters a climate of illicit payments, fragmented information, and general lack of trust and transparency. All of this undermines prospects for market development, adds to uncertainty, and reduces the willingness of lenders or investors to commit resources for anything but short periods of exposure.

The real sector is burdened by a variety of regulatory bodies that add confusion, cost and difficulties for SMEs. Georgia suffers from institutional weaknesses in many supervisory bodies, often manifested in unnecessary, overly frequent, burdensome, and/or costly inspections carried out by public sector offices. There are at least 44 bodies responsible for various inspections and supervision. This adds to the complexity and confusion, reducing the incentive of SMEs to be compliant with norms. Thus, there is a need for functions that are simplified and streamlined in support of a better functioning environment for SME development.

A general criticism is that laws and regulations are unclear or inconsistently enforced, with both the judiciary and government inspectors either unqualified to carry out their jobs or corrupted. There are also complaints about the lack of due process or suitable appeals process. In many cases, larger enterprises or those with contacts are able to make illicit payments for favors, resulting in unfair competition and trading practices, collusion, price fixing, and other abuses. In the end, this serves as a disincentive to SMEs to grow and to operate more openly in the formal market.

The approach the government had traditionally taken (until recently) in the post-Soviet period is to have official inspectors check on companies for compliance with regulatory standards and requirements. However, in practice, many of these standards have been overlooked in exchange for illicit payments, resulting in inadequate regulatory enforcement and a lack of protection in critical health and safety matters for consumers. Key weaknesses in this domain include:

- There is insufficient monitoring and control of licensors and inspectors.
- The issuance of licenses and permits is subject to local discretion, resulting in corruption. This is particularly prevalent in construction and trade, and is likewise reported to be a problem with customs at border posts.
- Notwithstanding recent improvements and lower costs, inspections are viewed as disruptive, burdensome in terms of documentation, and inconsistent as inspection rules sometimes change.
- The worst offenders are tax authorities, sanitary and fire inspectors, electricity supervisors, and the Sakstandarti.
- Local testing and certification is mandatory and costly, yet ineffective and unaccepted by international trade partners, thereby undermining export competitiveness while adding cost for domestic market production.
- Local testing and certification is burdened by corruption and lack of choice in certifying institutions.

Annex 3: USAID/Georgia Activity Descriptions for Economic Growth

The Strategic Objective 1.31 of ECONOMIC GROWTH is “Accelerated Development and Growth of Private Enterprises to Create Jobs”, under which three intermediate results are expected:

- IR 1.31.1: Improved Policy and Business Operating Environment
- IR 1.31.2: Increase Access to Financial Services
- IR 1.31.3: Increase Market- Driven Production and Sales

USAID’s broad, multi-year economic growth program that began in June 2003 includes demand-driven policy and regulatory reforms in banking and fiscal policy administration; consolidation of banking sector reforms; land reforms; and building private sector capacity for policy advocacy. In supporting policy reform, USAID seeks to create a predictable and transparent environment for trade and commerce, including a fair and efficient system of tax collection and application of laws and regulations. Two follow-on programs to improve agribusiness competitiveness and access to credit also began in 2003. The first one (Agvantage) will support increased market-oriented production by removing constraints to the development of value-added market-targeted products especially in the agricultural sector. The second (Microfinance) was designed to expand access to credit; further strengthen the capacity and outreach of the financial sector, including micro-finance institutions; and promote the use of land as collateral for credit.

Expected Results and Illustrative Activities

- 60% increase in registered private enterprises from 2004 to 2008; and
- 80% increase in jobs created by USAID’s programs under this SO.

Three Intermediate Results (IRs) will contribute to the accomplishment of this SO:

IR 1.31.1: Improved Policy and Operating Environment: Priorities for a national business agenda are expected to begin emerging from private sector partners. Technical assistance will ramp up to support priority needs identified by the private sector related to policy, financial infrastructure, and competitiveness. The Georgia Enterprise Growth Initiative (GEGI) has been USAID’s principal resource for addressing these priority needs. However, this program ends in mid-2005, and the current proposed CLARITY is expected to build on this initiative. Two sub-level results are intended to guide these efforts:

► **IR 1.31.1.1: Regulatory Environment for Business Improved:** The regulatory environment will be improved through the following illustrative activities.

Illustrative Activities supporting the above results:

- Support for promotion and fair application of the tax code;
- Assist courts of arbitration to increase use of alternative dispute resolution;
- Assist Georgia to prevent adulteration and trademark violation of selected products;
- Assist Georgia in replacing mandatory standards with voluntary standards;
- Assist Georgian entities to conform to selected priority WTO standards and protocols;
- Assist the Ministry of Finance in tax and customs policy and administration;
- Develop simple, centralized systems to establish businesses and conduct inspections;
- Assist in addressing commercial law and policy reform.

Other regulatory issues will be addressed as they emerge on a demand-driven basis during the course of program implementation.

► **IR 1.31.1.2: Corruption as a Barrier to Business Growth Reduced:** Anti-corruption activities are integrated throughout the Economic Growth program. The primary approach is to utilize business associations and public-private partnerships to ensure that State policies and practices provide a level playing field for business and eliminate the burdensome extra-legal payments endemic in Georgia today. The private sector will be strengthened to serve as an independent monitor of public sector activities, as a watchdog of corrupt practices, and as forceful advocates for a crackdown on corruption. The SO seeks to reduce corruption through five activities.

- Develop public-private partnerships to eliminate corruption (e.g., effort to combat smuggling of oil products);
- Reduce corruption in the banking sector through rigorous banking supervision;
- Reduce fraud through establishment of a company registry, collateral registry, and credit information bureau;
- Publicize land registration requirements and set up transparent procedures; and
- Streamline agricultural product inspection regimes to reduce bribe-taking opportunities.

IR 1.31.2: Increased Access to Financial Services: Over the strategy period, the Mission has supported increased access to financial services by focusing on land markets, micro-finance and rural credit, and other types of financial infrastructure. Subsequent work is anticipated to refine its strategy for SME finance and development. Sub-level results to guide these efforts include:

► **IR 1.31.2.1: Land Market Developed:** Following the successful completion of the titling and registration of 2.4 million small land plots, the USAID land reform program is supporting legislative efforts to privatize larger State-owned farm lands, which make up about a third of all arable and economically viable plots in the country. Subsequent efforts are expected to include standards for titling and registration of these economically viable plots, implementation of the legislation, and development of a comprehensive property registration system. This will serve as a basis for development of a planned collateral registry system.

► **IR 1.31.2.2: Financial Institutions Developed:** USAID has supported several initiatives to strengthen financial institutions. Additional work remains to be done to refine future strategy in this area. Initiatives recently supported and coming to closure no later than mid-2005 include:

- The banking infrastructure program started under the previous Strategy to ensure that the National Bank of Georgia is capable of sustaining the implementation of improved bank supervision systems;
- The Georgia Microfinance Stabilization and Enhancement activity that has provided technical assistance and grant funding in support of micro and small enterprise finance in both urban and rural markets;
- The Georgia Enterprise Growth Initiative (GEGI) has supported financial infrastructure development and other initiatives supported by the private sector.

IR 1.31.3: Increased Market-Driven Production and Sales. The Agvantage project enables the production, processing and export sale of selected Georgian agricultural products through identification

and mitigation of critical constraints.
Illustrative Activities include:

- Creation of an import/export trade brokerage service;
- Establishment of a leasing company;
- Construction of a pilot processing facility for selected products;
- Support for agricultural services;
- Improve competitiveness; and
- Support for selected pilot non-agriculture industry cluster development efforts.

Annex 4: Illustrative List of Other Donor Projects

There are several donor agencies providing various levels of economic policy reform and private sector development assistance in Georgia. The following is only a brief illustrative list of some relevant activities.

International Monetary Fund

The IMF has provided in excess of \$434 million in lending to the Government of Georgia, some of which has been tied to modernization and reform of the banking and payment system. While not directly tied to specific SME or business environment programs, the macroeconomic effect of IMF-supported policies has a major influence on SMEs, including money supply and interest rates, exchange rates, and fiscal requirements (tax rates and administration, as well as customs administration).

World Bank Group

The World Bank Group (IDA, IFC, etc.) has provided in excess of \$900 million since 1992. This has included several projects focused on enterprise and banking system reform, legal reform, the business environment, and rural development (including credit union development). FIAS issued a report on the business environment in June 2004, and the Bank conducts its regular Cost of Doing Business surveys that track progress in the business environment. Meanwhile, the IFC is specifically focused on improving the investment climate and increasing financing for SMEs by focusing on governance, leasing, and SME development.

European Bank for Reconstruction and Development

The EBRD has had more than 30 projects dating back to 1994, amounting to more than €185 million in net commitments (as of year end 2003). This was primarily in the form of loans, but also included nearly €12 million in equity. The major program focused on SMEs, the Small Enterprise Lending Program, had a loan portfolio of \$11.5 million at year end 2004. (With 6,154 loans outstanding, this is an average of about \$1,869 per loan. Loans are generally for 15 months, with interest rates ranging from 17-36 percent. Minimum loans are \$200, and maximum loans are \$50,000.)

The European Union—TACIS

The European Commission plans to provide significant assistance as to training in the areas of the tax code and taxpayer services, whereas in the customs area it plans support as to risk assessment (customs, not tax), customs code refinement and implementation, and development of significant secondary legislation. The European Commission provided €369 million in total grants from 1992-2003, and had plans to provide an additional €137 million in 2004-06. The Tacis program is the primary vehicle for institutional and legal reforms, private sector development, and development of infrastructure networks. Total Tacis grants were €84 million through 2003, and cumulatively approximated €100 million as of year end 2004. This includes participation with EBRD in the Small Enterprise Lending Program.

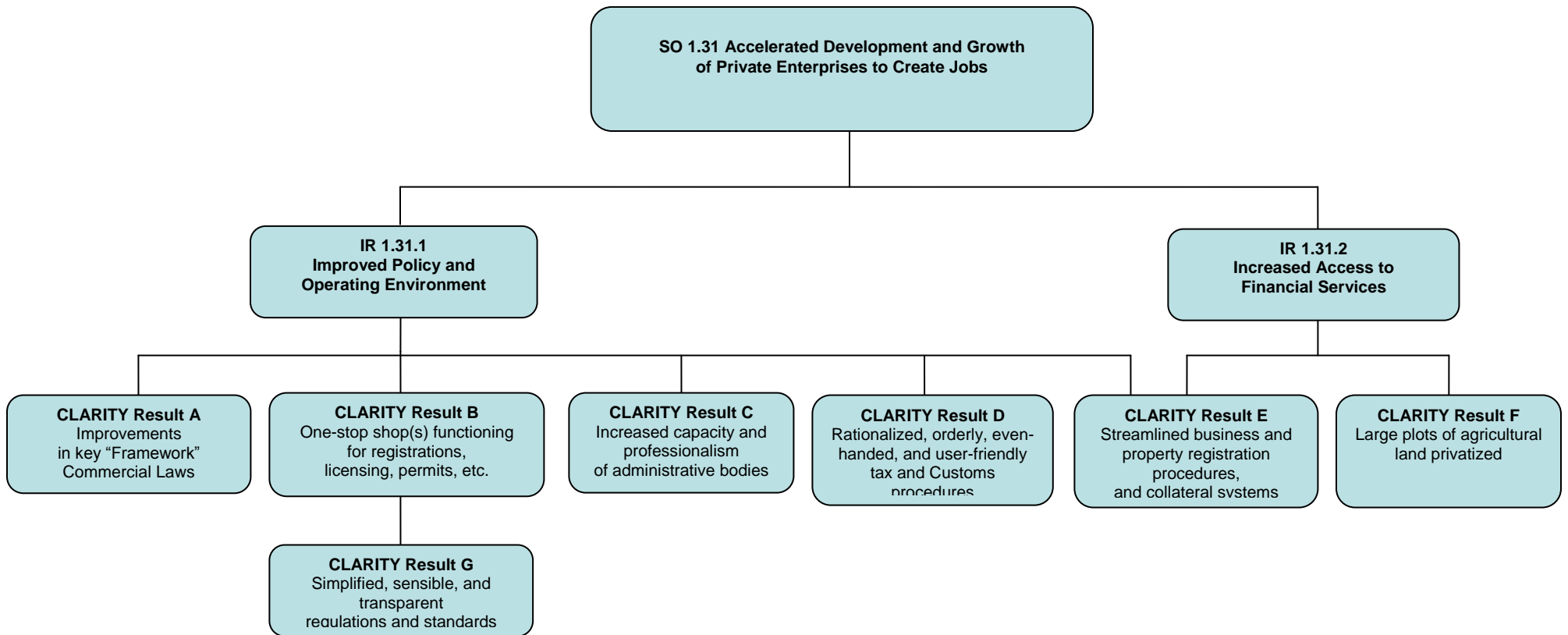
GTZ and KfW

GTZ and KfW have provided about €160 million in assistance since 1997, expected to reach a cumulative €200 million by 2005. This has included €15 million to update the land cadastre, and additional funds for equity investment and loan funds for ProCredit Bank. KfW is also taking the lead role in assisting NBG with development of a deposit guarantee scheme.

Other Active Donors

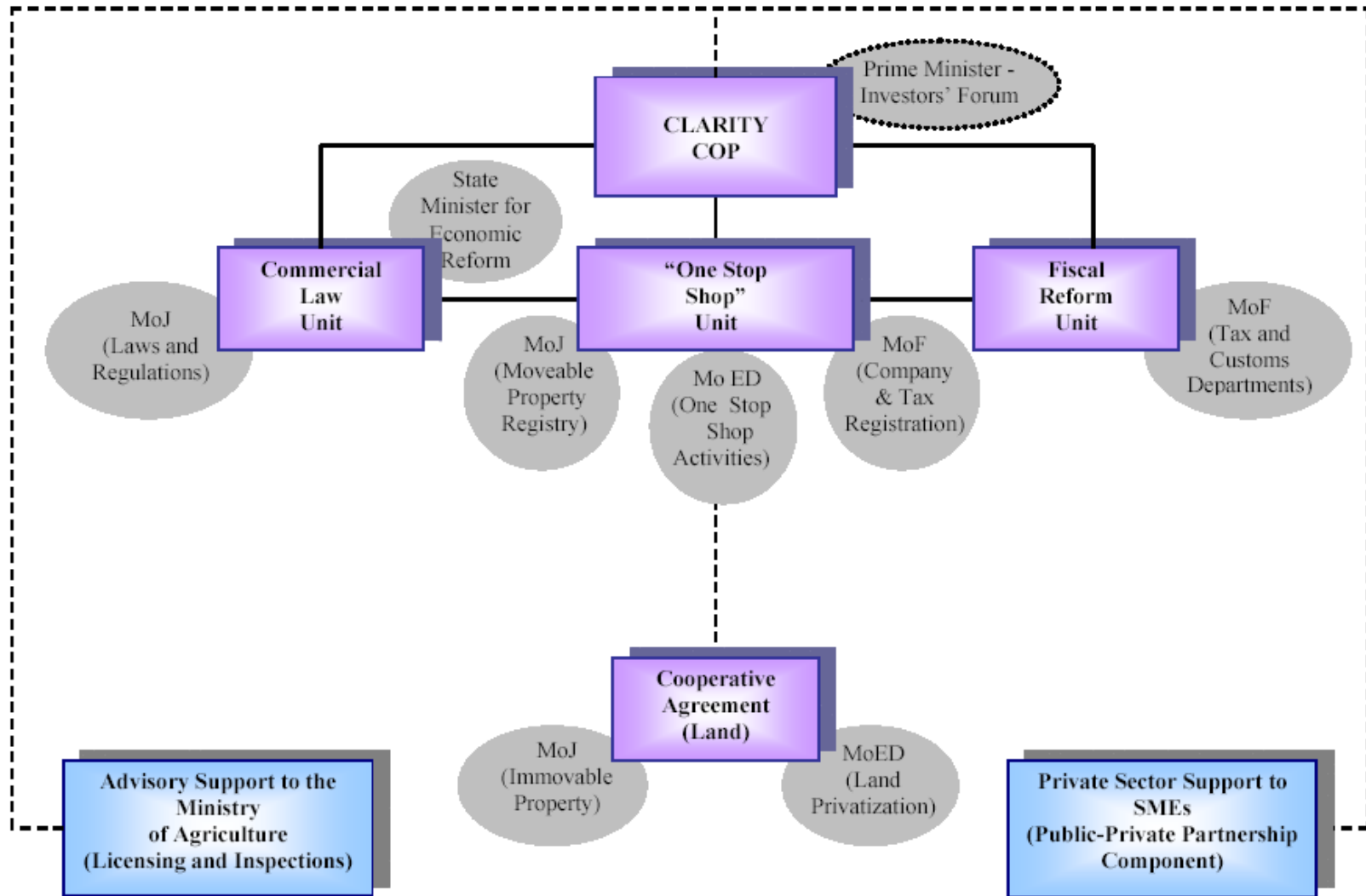
Other donors active in varied SME activities include the Canadian International Development Agency (support for the IFC's SME activities), UNDP (business advisory services and business incubators), Oxfam (regional database for trade links), and the USAID-funded Eurasia Foundation (grants for tourism and business association development).

CLARITY and SO 1.31 Results Framework



Annex 6: CLARITY Management Structure

CLARITY MANAGEMENT STRUCTURE



Annex 7: Illustrative Agenda and Timelines to Support GoG Institutions under CLARITY

ILLUSTRATIVE AGENDA AND TIMELINES TO SUPPORT GoG INSTITUTIONS UNDER CLARITY PROJECT

GOG COUNTER-PART	TASKS	Illustrative Timeline	
Prime Minister (Investors' Forum) - in close cooperation with the State Minister for Economic Reforms	1. TA to Assess the Existing "Soviet-Era" Regulations	Fall 2005 - Summer 2006	
	2. TA to Develop a Concept for Comprehensive Reform of Business Regulations	Spring 2006 - Spring 2008	
	3. TA to Develop Recommendation on Reduction in Number of Regulatory Bodies	Fall 2005 - Fall 2006	
	3. TA/Training to Investors' Forum	Spring 2006 - Fall 2009	
Ministry of Justice	1. TA in Drafting Framework Laws, Policies and Regulations: Law on the Immoveable Property Registry Law on the Moveable Property Registry Law on Alternative Dispute Resolution Law on Secured Transactions Law on Licensing Law on Credit Information Bureau Company Law Mortgage Law Pledge Law Securities Law Support Development of Implementing Regulations for the Laws Above	Fall 2005 - Spring 2007 Fall 2005 - Spring 2006 Fall 2005 - Spring 2006 Fall 2005 - Spring 2006 Fall 2006 - Fall 2006 Fall 2005 - Fall 2006 Spring 2006 - Spring 2008 Summer 2006 - Fall 2007 Summer 2006 - Fall 2007 Spring 2007 - Spring 2009 Spring 2006 - Fall 2009	
	2. IT/Systems for the Ministry & Related Training	Spring 2006 - Fall 2008	
	3. TA, Training and Commodities to the National Agency for State Registry Capacity Building Moveable and Immoveable Property Registries Electronic Collateral Registry	Fall 2005 - Spring 2007 Fall 2005 - Spring 2007 Spring 2007 - Spring 2008	
	4. Training for Judges & Arbitrators on Property/Contract Dispute Resolution	Spring 2006 - Spring 2007	
	Ministry of Finance	1. TA, Training, IT Assistance for Company/Tax Registration ("One Stop Shop") Electronic Tax Filing System Company Registry	Spring 2006 - Summer 2009
		2. TA, Training, IT Assistance for Case Monitoring Systems for Collections/Audit Risk Assessment and Inspections Secure IT System for Employee Performance and Revenue Yield;	Fall 2005 - Spring 2008
3. TA to Customs Department to Redesign/Streamline Customs Procedures		Fall 2005 - Spring 2008	
4. TA/Training for Customs Bonding/Guarantee Program and Licensed Customs Broker		Spring 2006 - Spring 2008	
5. IT Module for Exports to Verify VAT Refund Eligibility		Summer 2006 - Spring 2008	
Ministry of Economic Development	1. TA, Training, Commodities and IT Assistance to MoED	Fall 2005 - Summer 2008	
	2. Privatization of Large Tracts of Agricultural Land	Summer 2005 - Summer 2008	
	3. TA/Training for Public-Private Policy Dialogue and Public Outreach	Spring 2006 - Fall 2009	