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## Caucasus and Central Asia (CCA) Review

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## Strengthening trade relations of the European Union and Georgia

Georgi Gaganidze<sup>1</sup>

*The major objective of the essay is to analyze the developments of the EU-Georgia trade relations, by finding out major trends and giving recommendations and forecasts for the future developments. The European Union as one of the major trading partners for Georgia seems to be more important nowadays due to trade conflict with Russia and other factors.*

### Basic facts and figures

Georgia has started to implement liberal measures in its economic policy, particularly in international economic relations since winning its independence in 1991. Mandatory registration of foreign contracts was cancelled, the number of products obliged to be licensed were cut; simple and relatively moderate import duties were introduced.

As a proof of efforts, Georgia became the member of the World Trade Organization (WTO). Georgia enjoys GSP++ trade regime with the EU, benefits from GSP with Switzerland, Norway, Canada, USA and Japan. Additionally, Georgia is a member of the free trade agreement of CIS (Commonwealth of Independent States).<sup>2</sup> Georgian exporters pay 0% VAT and Custom Duties on exported products and they could use duty and tax callback regime for the goods imported for re-export. As for development of foreign trade, basic statistics are presented below in the *Table 1*.

**Table 1. Georgian foreign trade in 1995-2006 (USD million)<sup>3</sup>**

Years	Turnover	Exports	Imports	Balance
1995	533.4	154.4	379.0	-224.6
1996	846.6	199.3	647.3	-448.0
1997	1108.6	250.1	858.6	-608.5
1998	1242.6	194.0	1048.6	-854.6
1999	863.3	238.2	601.9	-363.7
2000	1030.1	329.9	700.2	-370.3
2001	1004.1	320.0	684.1	-364.1
2002	1241.5	345.9	795.5	-449.6
2003	1602.6	461.4	1141.2	-679.8
2004	2492.5	646.0	1845.6	-1198.7
2005	3355.4	865.5	2490.0	-1624.5
2006	4670.3	992.5	3677.8	-2685.2
I-VI 2007	2778.0	548.6	2229.4	-1680.8

*Source: Ministry of Economic Development, State Statistics Department*

Export growth is important for the economic development in all economies, while in case of a small market like Georgia it is crucial. Export growth is not only one of the most important growth factor, but also could be a tool for poverty reduction.

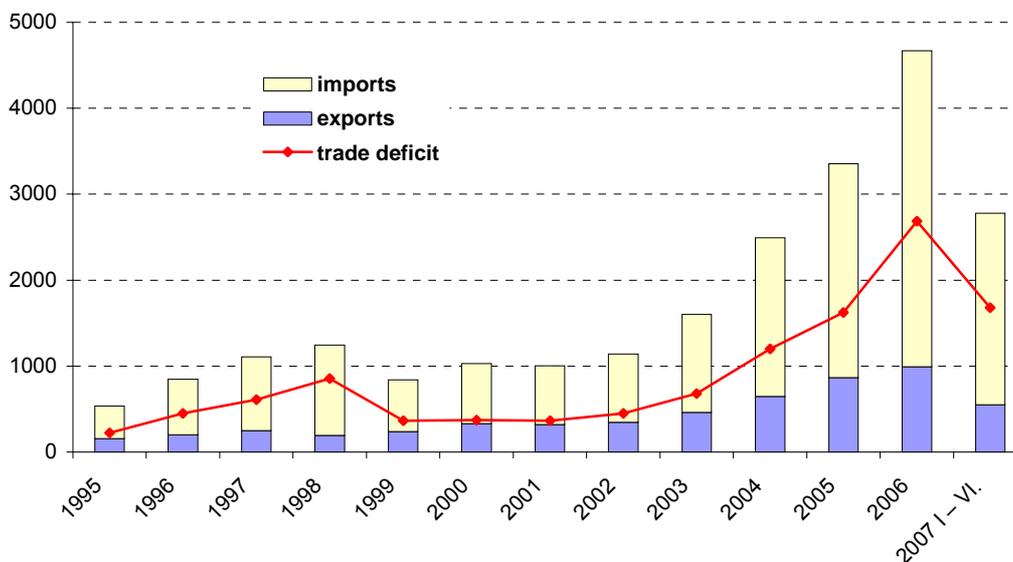
<sup>1</sup> PhD. in Economics

<sup>2</sup> GSP++ gives the opportunity to export more products under GSP as the simple GSP

<sup>3</sup> Statistical data is according to the State Statistics Department.

At the end of nineties, the government recognized the need for export driven growth and undertook several measures. Special analysis was prepared in order to clarify the problems and barriers of the exporting community. This analysis indicated among others the low competitiveness of domestic products, the lack of trading – organizationally and technically capable – companies, actively operating in exports and the scarcity of information on the products on the western markets.

**Chart 1. Main statistics of foreign trade in 1995-2006 (USD million)**



Source: Ministry of Economic Development, State Statistics Department

## EU-Georgia Trade Relations

From the very beginning export-oriented companies tried to use opportunities offered by the EU market. The EU is attractive from several aspects, such as single market with intrinsically unified regulations, high purchasing power of population, political and economical stability etc. The impact of the political and economical instability on the CIS markets was one of the strongest reasons to diversify export markets towards west. After dramatic changes in 2004, the government clearly declared the Euro-Atlantic integration as a top priority that also intensified integration efforts into European markets. Russian embargo on Georgian export products proved the necessity of such shift. As a result, the EU's share in total foreign trade of Georgia was stable.

It is interesting that the EU is officially presenting different figures on the external trade with Georgia. Below is the reference from the EU official site: "Nevertheless trade between Georgia and the EU have remained at very low levels yet - in 2002 accounting for only 0.03% of the EU's external trade (with EU imports amounting to EUR 266 million and EU exports amounting to EUR 287 million). Conversely, trade with the EU amounted to about 26% of Georgia's imports and 43% of Georgia's exports."<sup>4</sup>

<sup>4</sup> [http://ec.europa.eu/external\\_relations/georgia/intro/index.htm](http://ec.europa.eu/external_relations/georgia/intro/index.htm)

**Table 2. Data on the EU-Georgia trade (USD million and % of total)**

Years	Turnover	Exports	Imports
2002	<b>295.5</b>	<b>63.2</b>	<b>232.3</b>
	23.8%	18.2%	29.2%
2003	<b>491.0</b>	<b>81.6</b>	<b>409.4</b>
	30.6%	17.6%	35.8%
2004	<b>715.8</b>	<b>111.4</b>	<b>604.4</b>
	28.7%	17.2%	32.7%
2005	<b>792.6</b>	<b>165.2</b>	<b>627.4</b>
	23.6%	19.0%	25.2%
2006	<b>1136.4</b>	<b>188.5</b>	<b>947.9</b>
	24.3%	18.9%	25.8%
2007 I-VI.	<b>797.6</b>	<b>121.6</b>	<b>676.0</b>
	28.7%	22.2%	30.3%

Source: Ministry of Economic Development, State Statistics Department

Major exports from the EU to Georgia are machinery and transport materials. On the contrary, exports from Georgia are mainly unprocessed products. Differences in the figures could be explained by the low level of administration on the Georgian Customs (not all cargos with the exact prices are accounted on the Customs).

Here should be mentioned that in the latest period Turkey has become the major trading partner of Georgia, taking into consideration the EU-Turkey relations (the EU and Turkey are linked by a Customs Union Agreement), trading with Turkey could be somehow considered as the trading with the EU.

We shortly described the major factors influencing the EU-Georgia trade relations, but the huge difference in export-import figures needs further clarification. It is clear that imports from the EU are increasing more drastically than exports; what are the major reasons for these?

Answering this question, first we should analyze the major exporting products. In 2006 top ten exporting products were nuts, wine of fresh grape, ferro-alloys, ferrous waste and scrap, copper ores and concentrates, gold unwrought, copper waste and scrap, motor cars (re-export), aircrafts, mineral and chemical fertilizers. Huge portion of unprocessed or semi-processed products are the major obstacle to increase exports to EU markets, as many other developing countries are exporting the same products in huge quantities and thus having competitive advantages over Georgian products. Wine is an important export product, but until wine production control system is not completely recognized by EU exporters could export not more than one million bottles. Wine export potential is much higher and better utilization of wine export potential could significantly improve exporting figures.

The competitiveness of export products in the EU is a major issue. European consumers do not have enough information on Georgian products and thus companies have to start from the low end of prices. This tactic brings result only in the case when companies export huge amounts and they can survive even on small margins. Georgian exporting community is not able to use this way as they are not producing products in large amounts. Additionally, exporting companies are using huge amounts of imported products, which limits the room for improving cost competitiveness.

Increasing export production is important for sustainable economic growth. Detailed analysis of export expansion<sup>5</sup> indicates the EU market as the most promising one. Thus, the government undertakes further steps to liberalize the trade and abolish import duties. Liberalization of trade could increase imports, but at

<sup>5</sup> Analysis of Georgian exports geography are clearly indicating two major destinations CIS and EU

the same time could create basis for the trading companies to start exporting operations. Lack of trading companies actively exporting Georgian products is the important obstacle to better utilization of export potential.

The analysis of export structure by country clearly indicates two major destinations: the CIS and the EU (including Turkey). CIS markets are not stable in political and economical terms and accordingly, further expansion to the EU seems the only logical solution. The recent EU enlargements created better conditions for the Georgian exporting community. Poland, Hungary, the Czech Republic, Slovakia, Bulgaria and Romania were traditional markets for the Georgian products, mainly for mineral water and wine. In these new EU members it seems easier to find market niches. The initiative of the government to achieve free trade agreement (FTA) with the EU looks logical and could be the base of further integration. FTA with the EU automatically would create FTA with Turkey, the major trading partner for Georgia.

Scarcity in modern technologies has limited Georgian exports to the EU markets yet. Transfer of modern technologies through imports and foreign direct investments has been increasing from the EU. Creation of new production facilities based on modern technologies may increase the Georgian exports to the EU. At the same time already imported technologies need modernization and imports from the EU would be further expanded. In other words, by importing technologies from the EU Georgia will strengthen the economic ties with the EU. Thus based on the existing trend, EU would become the major trading partner for Georgia steadily increasing the share in Georgia's total trade. It should be mentioned that importance of the EU to Georgia is much higher than Georgia to the EU. So increasing trading ties with the EU should be the top priority for Georgia.

Based on this analysis it is expected that the EU-Georgia trade ties will expand, Georgian government will try to achieve FTA with the EU and create preferential regimes for the EU investors. This may lead to better utilization of export potential.

## Main factors of economic growth in Armenia

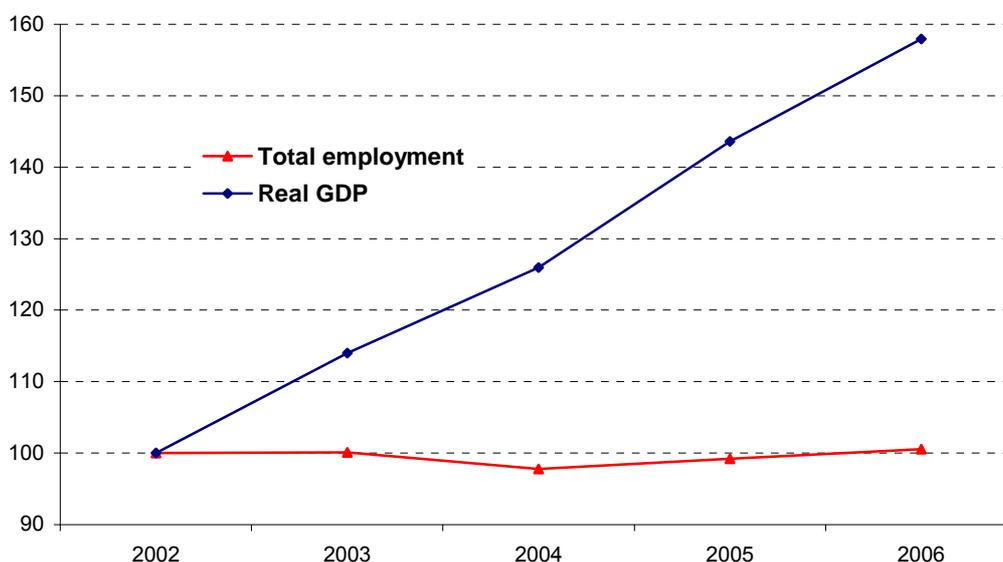
*Aghassi Mkrtychyan*

*Armenia's average annual GDP growth during 2001-2006 was around 12% which is attributed to rapid total factor productivity growth by official statistics. This article argues that the importance of total factor productivity may be overstated due to the failure of statistics to capture recent expansion in hidden employment.*

Armenia's economic growth has further accelerated since 2001, averaging 12% annually during the last five years. The most remarkable feature of Armenia's growth performance is the unusually large increase in total factor productivity (TFP) which, according to estimates based on official statistics, account for approximately three-fourths of GDP-growth. Average annual increases in TFP over the last five years were around 8% (IMF, 2004).<sup>6</sup> Thus in terms of fast and sustained TFP growth, Armenia is well ahead of the more successful transition economies of Central and Eastern Europe.

This spectacular productivity performance raises questions about the quality of the statistics underlying Armenia's growth accounting. Well-known difficulties in employment statistics could indeed be responsible for these 'inflated' productivity indicators. In other words, Armenia may be experiencing a hidden employment expansion that is not properly reflected in the traditional growth accounting methods.

**Chart 2. Employment and real GDP (2002=100)**



Source: State Statistics Committee of the Republic of Armenia, own calculations

### How do stylized facts about TFP growth in transition economies fit with Armenian reality?

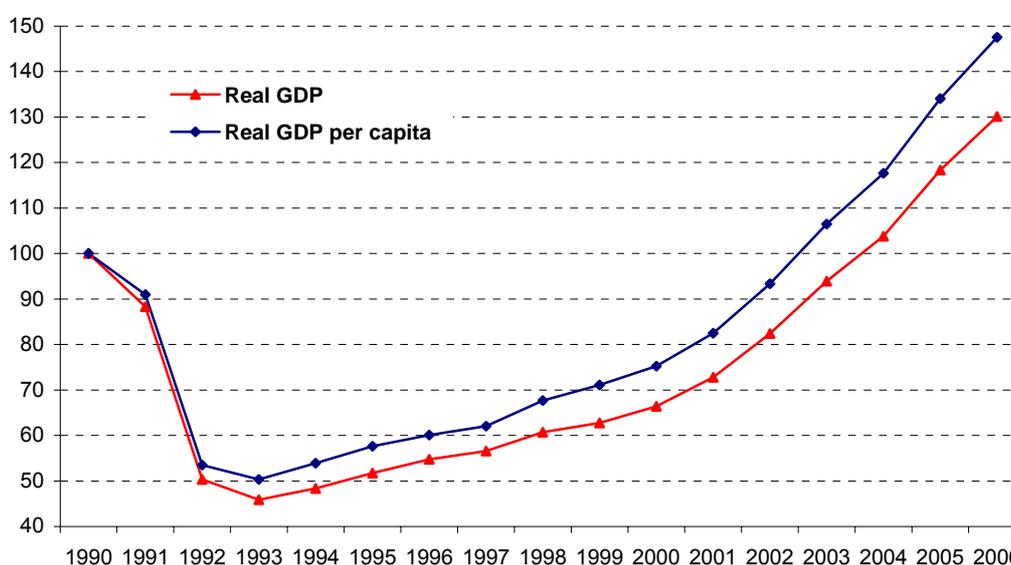
The literature on growth in transition countries emphasizes resource reallocation as a crucial determinant of efficiency gains. In the case of Armenia, it is widely recognized that massive reallocation of labor to agriculture during the early phase of transition is now being reversed, and this reversal is not adequately

<sup>6</sup> IMF (2004), "Growth and Poverty Reduction in Armenia" International Monetary Fund, Washington D.C.

captured by the official statistics. Does this shift result in productivity growth due to resource reallocation from less to more productive sectors? Probably, but it also constitutes an increase in hours worked, since there is substantial underemployment in agriculture. A similar argument is applicable to the privatization-driven reallocation of labor from less efficient sectors characterized by underemployment to the more efficient private sector.

The “catching up” process is another factor discussed in the literature which is linked to efficiency gains in transition economies. Changes in TFP are viewed as a crucial factor explaining the transitional decline and recovery. This would imply acceleration in TFP, leading towards “catch-up” first and gradual moderation afterwards. Yet, in the Armenian case, TFP growth continues to accelerate even as the economy closes the income gap associated with the transitional decline. While annual TFP growth averaged some 5% in the late 1990s, it accelerated to 8% after 2001 — when the importance of the catching-up effect is supposed to be diminishing.

**Chart 3. Recovering from transitional decline (1990=100)**



Source: State Statistics Committee of the Republic of Armenia, own calculations

TFP is also affected by capital accumulation, since more capital per worker raises productivity in a typical transition economy characterized by low initial capital stock. However, since the resumption of economic growth, Armenia’s average annual net capital accumulation rate is estimated to be only 3%, which is substantially lower than in other economies of the region that have experienced similar GDP- and TFP-growth. While most rapidly growing CIS countries enjoy massive foreign investments in their oil and gas sectors, this is not the case in Armenia which, possessing no major natural resources, has not experienced a surge in FDI. Lower rates of capital accumulation further weaken the credibility of estimates of robust TFP-growth.

With respect to the development of market institutions, a factor widely discussed in the growth literature, Armenia’s performance has been mixed. The country’s record is impressive if judged by the EBRD’s Transition Index<sup>7</sup> and the Economic Freedom indicator of the Heritage foundation<sup>8</sup> (EBRD, 2005; Freedom House, 2005). However, more specific indicators assessing the quality of market institutions suggest less

<sup>7</sup> EBRD Transition Report, 2005

<sup>8</sup> Freedom House reports are available at [www.heritage.org](http://www.heritage.org)

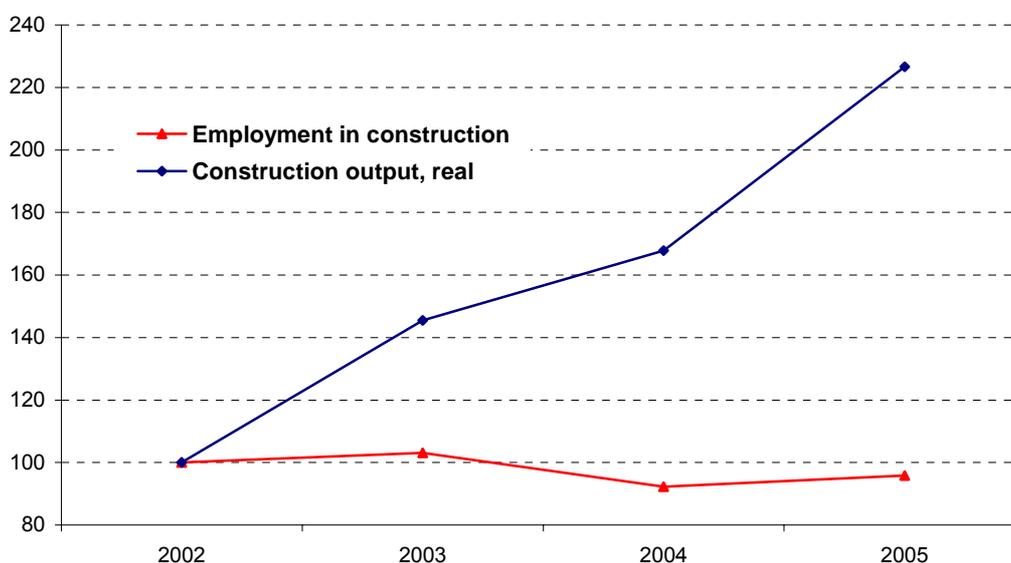
progress. While Armenia may have the highest ranking for “rule of law”, “control of corruption” and “regulatory quality” among CIS countries (according to Worldwide Governance Research Indicators Dataset of World Bank Institute<sup>9</sup>), recent trends in these indicators are not encouraging. Moreover, Armenia is falling further behind the most successful transition economies of Central and Eastern Europe in terms of these indicators. This also suggests that official reports of high TFP in Armenia are exaggerated.

### Employment statistics as a possible factor affecting growth accounting

The explanation for the steady and unusually high TFP growth rates in Armenia may lie in the poor quality of employment statistics. According to administrative registry data, employment continues to stagnate in Armenia, so that despite the doubling of GDP since 1997, the economy is still in the bottom of the transitional U-shaped employment curve.

Employment data in transition economies are often biased by the existence of large shadow economies, and also by inadequate adjustment for hours actually worked. According to Armenia’s administrative registry data, the unemployment rate is less than 10%. However, recent labor force and household survey data indicate that around 30% of working age respondents regards themselves as unemployed or underemployed. This discrepancy partly originates from data for rural areas, where the labor force is severely underemployed due to land fragmentation (with only 1.5 ha of agricultural land per household) and the absence of non-agricultural employment opportunities. At the same time there is evidence of labor migration from rural areas to the capital area, which is driven by new employment opportunities in construction, services and industry. The official statistics, however, does not capture this. Quite peculiarly, according to the official employment data there is no growth in employment in construction sector, whereas the construction sector was expanding at annual rate of above 30% in the recent few years.

**Chart 4. Employment and output in construction sector (2000=100)**



Source: State Statistics Committee of the Republic of Armenia, own calculations

<sup>9</sup> World Bank Institute (2004), Worldwide Governance Research Indicators Dataset, available at <http://www.worldbank.org/wbi/governance>

According to household surveys, a three-fold increase in household labor incomes was the main source of poverty reduction in Armenia between 1999 and 2003. This increase is significantly higher than the 80% nominal wage growth that is estimated for the same period. This discrepancy suggests that employment should have expanded as well. On the other hand, the magnitude of wage growth might also be overestimated due to better payroll tax administration. Such recent changes as minimum wage increases and the introduction of minimum payroll taxes may have weakened incentives for wage underreporting for already registered employees, while not necessarily strengthening incentives for proper employment registration.

## **Conclusions**

The reallocation of resources and major structural reforms should have indeed led to high TFP-growth in Armenia. However, the growth accounting, underlying the measurement of these trends may be contaminated by weak employment statistics. The contribution of TFP to economic growth may therefore be less significant than it looks at the first sight, while the contribution of labor to growth may be higher than official statistics would suggest. Armenia's strong economic growth therefore is probably driven by both employment expansion and productivity growth. This observation might be also valid for other rapidly growing transition economies that are experiencing high growth rates while reporting little if any employment growth.

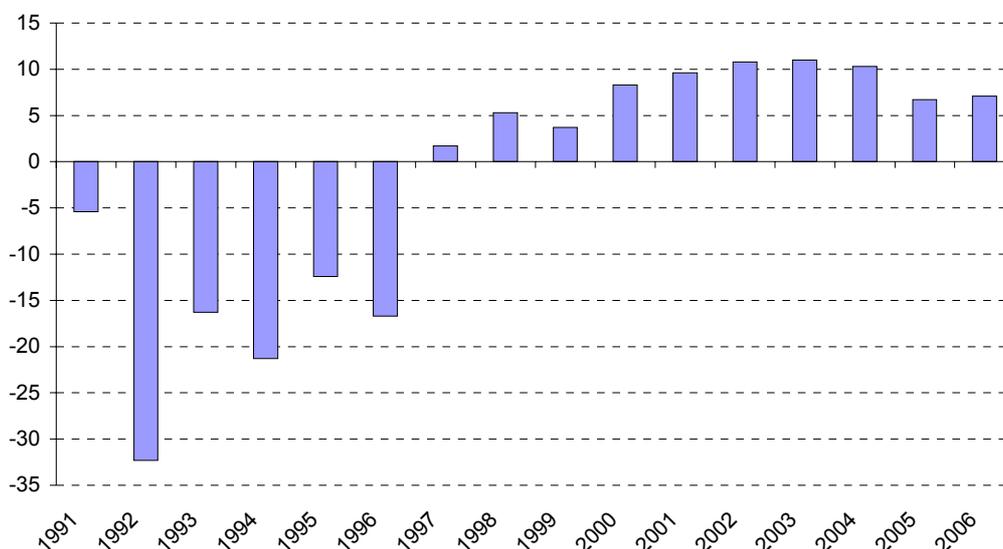
## Problems of economic growth in Tajikistan

*Khojamakhmad Umarov*

*During the last five years problems related to the rates and the character of economic growth in Tajikistan were in the top columns of scientific literature and live discussions. This is partly because of the fact that Tajikistan suffered one of the deepest economic crises caused not only by the Civil War, but as a result of unskillfully implemented economic reform in course of transition of planned economy into market economy.*

In other words, economic recession caused by the Civil War became dangerous by transformational slump, which was stimulated by economic reforms. The situation has changed for the better only after 1997, when a Peace Agreement was concluded between the joint opposition and the government. The paces of economic growth are given in the following *Chart 5*.

**Chart 5. Real GDP growth, 1991-2006 (%)**



Source: *Tajikistan: 15<sup>th</sup> Anniversary of State Independence. Statistical Collection, Dushanbe, 2006, Page 207.*

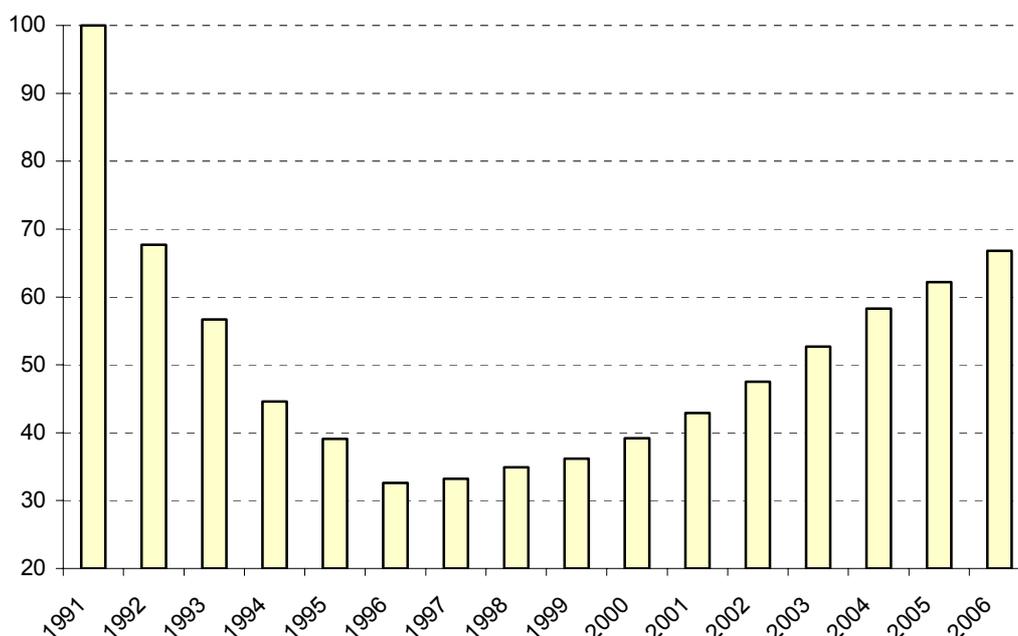
The above mentioned data is the evidence of the fact that at the beginning of 1997, volumes of GDP in Tajikistan decreased by 2/3. (*Chart 6*) Such a sudden slump in volumes of GDP was observed only in Caucasian economies. The majority of countries in the post soviet area have succeeded in recovering and exceeding those volumes of GDP that they had in 1990, with exception of Georgia, Kyrgyzstan and Tajikistan. These countries still cannot succeed in achieving the level of economy of 1990. In this regard, the biggest gap in economy is observed in Tajikistan. For January 1, 2007, according to official statistics data, volumes of annual GDP made up 65.3% compared with the level in 1991.

### Impact of factors

In the last three years the real GDP growth has slowed down. Rates of growth in 2000-2004 made up from 8.3% to 11.0%, while during 2005-2007 they made up 6.4-7.1%. Such changes in the rates were unavoidable. This is explained by the fact that over the period 2000-2004, the rates of economic growth had non-investment nature. The flow of direct foreign investments and its volumes were marginal. Positive rates, including higher ones, were achieved owing to the use of those resources, which were available at separate

enterprises and households. The matter concerns those enterprises and households, which had circulating assets, functioning equipment and qualified manpower. After normalization of political situation, the unequipped, but available means of production and manpower have been involved in an economic turnover and provided the rapid growth of output. However, by 2005, such resources have been exhausted.

**Chart 6. The development of real GDP, 1991-2006 (1991=100)**



Source: *Tajikistan: 15<sup>th</sup> Anniversary of State Independence. Statistical Collection, Dushanbe, 2006, Page 207.*

Decrease in the rates of growth in Tajikistan, where almost 80% of population live in poverty, has become the reason for a new wave of political and professional discussions. Scientists of the Institute for Economic Researches formulated the opinion that for a quick leading out from a crisis and solving very serious social problems, including poverty reduction, it is necessary to hold the stable and high rates of economic growth, i.e. 11-13%. Such rates would make realistic to achieve the 1990 level of GDP production per capita by 2015. The government determined such goal as an important priority. The officials of the Ministry of Finance of Tajikistan and representatives of IMF in Tajikistan do not agree with this point of view. They hold the opinion that the high rates of economic growth may cause “overheating” of economy. The last, in particular, may lead to super normative accumulation of a finished commodity in the storehouses, i.e. rise of complications in sales of products.

It is impossible to deny that such risk in conditions of Tajikistan exists. This is explained by the still-functioning and incompletely transformed administrative-command system in management activities of a number of ministries and their subdivisions. In other words, the existing problem of “overheating” is concerned with the incomplete formation of market economy. If there would be free competition in full capacity in the country, laws and sub legislative acts would be implemented completely, and then there would be no traces of command methods of state management.

The economic development factors in their current form can be used only on the basis of requirements of insufficiently developed segments of domestic market. Production and services produced with their help (with the exception of some) are far from being the objects of export. Raising the volumes of production and services on the basis of using available factors of production development is possible only by means of the

command methods that are fraught with “overheating”, which is forecasted by the country office of IMF and Ministry of Finance.

Fixed capital in overwhelming majority of enterprises has become antiquated. Level of depreciation makes up from 70 to 90%. The exception is telecommunication, as well light and food industry enterprises that develop on the basis of joint business. An active part of a fixed capital consists of machinery and equipment, produced, mainly by the enterprises of the Soviet Union in 60-80's of the last century. It is impossible to produce a competitive production both for external and domestic markets. Renewal and replacement of a fixed capital is possible only by means of attracting direct foreign investments, since the predominant part of enterprises, redemption funds do not have enough resources.<sup>10</sup>

The other factor of economic growth that is of crucial importance is the labor force, which is also in unsatisfactory condition. The low level of wages cannot be the basis of stability of unit stuffs, since it leads to the mass labor migration and strong shortage of manpower. Therefore many enterprises are closed or cut down the production volume. The average wage on a national scale makes up USD 45. Therefore, Tajikistan differs from all other Post Soviet countries by its highest level of external labor migration. According to calculations of economists, currently 0.9 up to 1.4 million of people work in other countries, in order to feed their families<sup>11</sup>. Approximately 65-70% of the aggregate labor force of the most active age working out of the country as labor migrants<sup>12</sup>. Thus, remittances play important role in the country. At present, there is a lack of qualified labor force in all industrial branches of Tajikistan. This problem is a serious obstacle for gradual rising of production of high-quality, competitive goods.

Regarding the agriculture, the specialists have valued its condition as the worst one. Soil erosion makes up 90% of the arable lands and 97% of the whole grazing acreage (author's estimation). Out of 757 thousand hectares of the arable lands, 70 thousands are nearly waterlogged and 30 thousand hectares are in condition of strong salinity, and therefore these lands have got out of use. Because of this, the crop capacity of cotton, other agricultural crops as compared with 80s of the last century has severely decreased. It is impossible to grow production of a high-quality which would stand the competition in the world markets. Agriculture being the leading branch of Tajikistan's economy loses its ability to influence positively on the rates of economic growth. In conditions of Tajikistan, the high rates of agricultural development are very important, since this branch of industry stands as a source of raw materials for development of light and food industries, which hold dominating position in the structure of national industry.

As regards entrepreneurship which is also one of the important factors, at present it is in unfavorable condition. There is far from free competition in the country. One may do a successful business in Tajikistan only if he is under patronage of governmental officials of a senior rank, representatives of tax and custom bodies, as well as senior employees of the power structures. If the real competitive relations were fixed in the country, then the overwhelming majority of entrepreneurs would suffer bankruptcy. As for those groups of entrepreneurs that are really able to ensure and provide a rapid economical development, and can successfully perform at both domestic and foreign markets, a lot of formal and informal obstacles put in their way that prejudices their achievements.

All the mentioned traits of factors implicate uncompetitive conditions for Tajik economy. For those countries that are going over to the market relations, the last appears as synthesizing obstacle in the ways of acceleration the rates of economic growth and the going out of systemic crisis. Hence, it appears that if drastic adjustment measures parallel with economic reforms are not taken, the rates of economic growth

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10 During the Civil War means of redemption funds were either robbed or misused

11 Facts and Comments, 16 July 2007

12 Events, 9 July 2007

continue to decrease. Moreover, as it was mentioned above, fundamentals of growth without investment are exhausted. In the real conditions of Tajikistan the top-priority orientation of investments for the development of power sector, may accelerate the rapid rates of economic growth. In our opinion, in 2008 with putting Sangtuda Hydro Electric Station into operation, it has become possible to fastening economic growth, due to raising level of power supply at the industrial enterprises in a winter season, and agricultural works in the period of irrigation. Many enterprises at separate period of time stop their production activity owing to the lack of electric power. The same concerns the process of putting into operation motor-car roads, which are of national significance.

By the same period, i.e. the end of 2008 the highways Dushanbe – Chanak and Dushanbe – Jirgatal, crossing the main part of country's territory, from the south to the north and from the west to the east will put into operation. After putting into operation, the given highways will considerably reduce transport expenses within the country, and raise the accessibility of towns and large commercial and industrial centers of the country for all the regions, especially for producers of raw materials and food. However, the growth rates, related to these reasons will have temporary nature, as after the raise of economy, caused by the improvement of road infrastructure, the necessity of using new growth factors arises.

### **Worsening situation**

In the absence of state investment policy and extremely slow rates of capital re-equipment, the given reasons will rapidly exhaust themselves. The economy will be confronted with the acceleration in the rates of decreasing fixed capital, sharply differing from the rates of its renewal. We can mention confidently that in 2010-2011 due to the abovementioned disproportion, the decrease in the rates of economic growth will take place.

Further the situation with the rates of economic growth may become worse, if some measures would not be taken for inflow of large-scale foreign direct investments, with the purpose of complete renewal of key assets in a short period of time (not more than 5 years).

Domestic investments are incapable to solve this problem, because of their insignificance. Moreover, the volumes of gross accumulation of a fixed capital increasingly remain behind the volumes of its use. If in 2000 the ratio of the first to the second made up 68.9%, then in 2005 this index was reduced to 50.8%. This means that in real conditions of Tajikistan, where the means of depreciation funds of enterprises remain extremely insignificant, the volumes of decreasing fixed capital considerably exceeds the aggregate volumes of their renewal at the enterprises. In 2000, the volumes of utilized fixed capital exceeded the volumes of the gross accumulation of fixed capital to 30.7 USD million. In 2005 this difference amounted to 249.3 USD million, i.e. increased 8.1 times.<sup>13</sup>

The problem of influence of fixed capital's renewal on the rates of economic growth in Tajikistan has a specific nature. As compared with many other countries here demand in the basic repair of machinery and equipment remains insignificant, it is explained by the high specific weight of physical and functional depreciation of equipment. The main part of equipment, which needs to be changed, refers to the previous generations and in rival-countries such equipment are not used at all. This means that in Tajikistan for accelerating the rates of economic growth, it is not required to make the basic repair of fixed capital or modernization of equipment. Besides, at the overwhelming majority of enterprises there is a lack of internal funds for the thorough repair, not mentioning the renewal of fixed capital.

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<sup>13</sup> The calculations are made, according to statistical collection «The main indicators of the system of national accounts». Dushanbe, 2006, pages. 14,15.

Nevertheless, the modern social-economic actualities stand in favor of the fact that the without high rates of economic growth. Without them it is impossible to solve the problems of poverty, drastic increase of employment and reduction of unemployment to the natural level, overcoming of social and technical-economic backwardness of number of regions, rapid development of educational potential, reduction of disease incidence among population and etc.

## **Conclusion**

In this respect, it is beyond the question that acceleration of the rates of economic growth is impossible on the basis of existing industrial structure of economy. However, the changes in industrial structure of production require considering the needs of both domestic and foreign markets. In this respect the whole industries that have been functioning in conditions of socialism may become absolutely needless in a new present day conditions, if not to take measures on their transfer to foreign strategic investors. The matter concerns the mechanical engineering, electro technical, chemical and mining industries, as well the air transport. Otherwise, the mentioned branches will be exposed to the gradual destruction.

The active innovation policy is favorable to the high rates of economic growth. It proposes achievement of the high rates of fixed capital on the basis of new techniques, accelerating the training of qualified personnel, creation of equal conditions for the whole sphere of entrepreneurship, taking measures for land hygienic, sanitation and scientific running of agricultural production and thorough development of market infrastructure. Development of the last is necessary especially for avoiding “the overheating” of economy owing to the high rates of its growth.

Though, the most effective factor of accelerating the rates of economic growth may be the introduction of free competition and creation of equal conditions for running business. The Laws approved by parliament, which are called for ensuring the equal conditions for all groups of entrepreneurs, including the Law on bankruptcy, do not function in full measure. There are still no equal conditions, and it is due to the all-penetrating corruption. Equal conditions can be realized only by means of effective struggle against corruption. As is well known, Tajikistan is among the 10 most corrupt countries of the world. A large-scale corruption impedes the development of competitive among of entrepreneurs.

Hence, goes the conclusion that among the series of measurements on acceleration of economic growth, the determinant place is given to the removal of all barriers, impeding the development of competition. A full-value development of competitive relations appears as a link, which is able to call for all other factors, determining the speed of economic growth.

The external economic links are not favorable for the country's rapid economic growth. Over the period 1991-2005 the export volumes increased by 13.3 times, import volumes by 21 times. As a whole, during this period the balance of trade was negative. In the last two years the higher rates of export growth have been observed, though the import of goods and services still exceeds the volumes of their export. Materially the import volumes greatly exceed export volumes, which is explained by the large scales of smuggled goods and deliberate depreciation of import volumes by the corrupt circles. Primary aluminum and cotton fiber prevail in the export structure (65-80% of export). Consumer goods prevail in the import structure. Such structure of foreign trade ties endanger the sustainable economic growth. The export structure is of a raw nature and the prevalence of two kinds of raw materials; raise the dependence of country's economy on price change in the world markets. In spite of the negative experience of reducing export gains due to the slump in prices of aluminum and cotton fiber in recent years, the situation with export structure remained unchanged.

The present import structure creates a powerful competition for light and food industries of Tajikistan. In connection with the challenges in the real sector of economy (almost complete wear out of machinery and

equipment, lack of qualified workers and managers and etc.) even in home market the domestics do not meet the competition with imported goods. As a result the local enterprises are either closed or sharply reduce their production volume. In spite of the fact that the wear level of fixed capital makes up from 60 up to 90%, in the majority of the real sector industries in the import structure, the share of machinery and production equipment still remains low (from 9 to 12% in the last 5 years). Such import structure contradicts the concern of the rapid modernization of country's economy.

The role of state budget in country's economical development is rising. In 2000 the state budget revenues were equal to 13.9% of the GDP and budget expenditures were 14.5%. By 2005 these indicators made up accordingly 19,6 and 19,5%. The specific gravity of the expenditure for the development of social sphere is increasing (to 49% of budget expenditure). This creates a favorable social background for increasing the rates of economic growth. However the role of state budget in the development of economy is decreasing step by step, that is concerned with the privatization of state ownership and restriction of state interference in economic development. The latter considers the requirements of WTO, however is still the subject of discussions in the country, Nowadays/Currently the role of state budget includes the share holding in implementation of a large-scale infrastructure projects jointly with the foreign partners (motor roads, bridges, tunnels, Hydro Electric Stations, power lines and etc.)

## Challenges of consolidated budget in Azerbaijan

*Zaur Veliev and Orkhan Javadov*

*The current analysis gives a review of the main issues of consolidated budget in Azerbaijan, that operates under special circumstances of a particularly oil driven economy. The essay intrinsically is dedicated to matters of non-oil budget deficit.*

According to national legislation, a consolidated budget consists of state budget, off-budget funds (State Oil Fund (SOFAR) and State Social Protection Fund (SSPF)) and the budget (revenues and expenditures) of Nakhichevan Autonomous Republic.<sup>14</sup> In the case of this Caucasian economy, the off-budget funds have special role, especially concerning the one in connection with the oil sector.

Since 2003, state budget revenues started to increase significantly, particularly due to accelerated economic development mainly as a consequence of precipitously rising oil prices. For parallel increasing expenditures, beyond the social orientation of state budget's expenditures, serious steps have been taken strengthening investment orientation and promotion of entrepreneurship sector's development. The new orientations brought to the forefront the necessity to attract additional funds, like the State Oil Fund (SOFAZ) and its growing revenues. Additionally, strengthening of fiscal discipline and implementing special measures concerning oil related budgetary revenues became top priorities.

Underpinning statistically these processes, in 2003-2006, consolidated budget revenues grew in average by 27.3% (63.3% in 2006), while expenditures by 30.8% annually (77.4% in 2006). For comparison, during 2000-2002 this figure was in average 9.3% annually for revenues and 21.0% for expenditures. In the course of last four years, state budget revenues grew annually by 43.3% (88.6% in 2006), expenditures by 41.2% (76.5% in 2006). In 2006, during one budgetary year, they increased by 88.6% and 76.5%, respectively. During 2000-2002, the same indices were 17.5% for revenues and 8.4% for expenditures. Main growth was observed concerning public investments (2.7 times).

Analyzing the consolidated budget, it became clear that in case of predominantly oil based economy of Azerbaijan the non-oil budget deficit has to be investigated. This indicator is calculated as follows:

**Non-oil budget deficit = expenditures of consolidated expenses - revenues of SOFAR - oil revenues of state budget (taxes of SOCAR<sup>15</sup> and profit tax of AIOC<sup>16</sup>) - tax credits granted to energy sector**

In general, the budget diversification to oil and non-oil sectors rooted in the consolidation on one hand, in the noted revenue sources dependence of the budget on the other hand. For instance, 59% of revenues of state budget were falls on the revenues from oil.

<sup>14</sup> Nakhchivan is the enclave of the Republic of Azerbaijan that borders Armenia to the north and east, Iran to the south and west, and Turkey to the northwest

<sup>15</sup> The State Oil Company of Azerbaijan Republic that arm-in-arm with its many subsidiaries are responsible for the production of oil and natural gas, for the operation of the country's two refineries, for running the country's pipeline system, and for managing the country's oil and natural gas imports and exports. SOCAR is party to all of the international consortia developing new oil and gas projects in the country.

<sup>16</sup> Azerbaijan International Operating Company is a consortium of currently 10 petroleum companies that have signed extraction contracts with Azerbaijan. These are BP (UK), Amoco (USA), Devon Energy (USA), UNOCAL (USA), Statoil (Norway), Türkiye Petrolleri Anonim Ortaklığı (TPAO; Turkey), Amerada Hess (USA), State Oil Company of Azerbaijan (SOCAR; Azerbaijan), Exxon Mobil (USA), Inpex (Japan), Itochu (Japan).

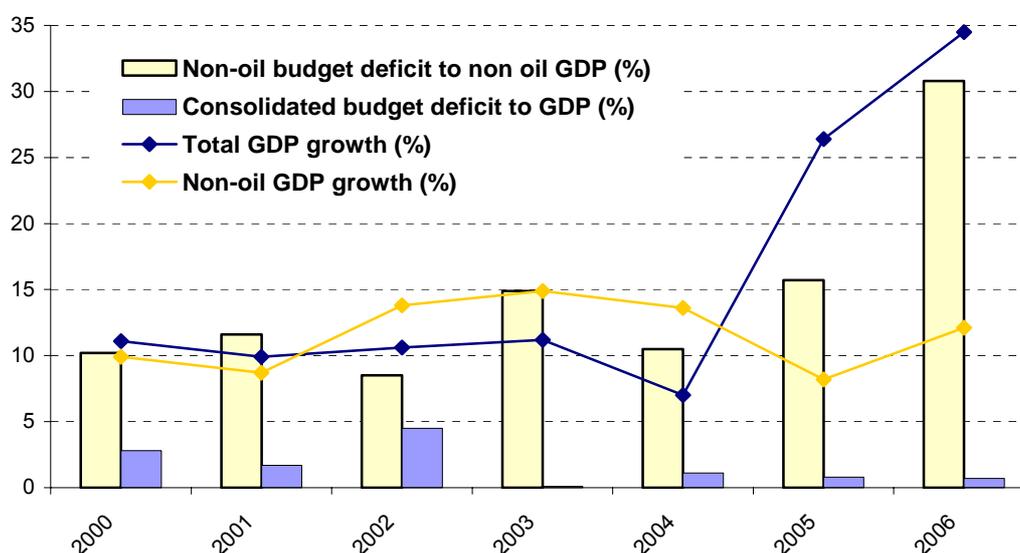
**Table 3. Non-oil budget deficit of the Republic of Azerbaijan**

	2000	2001	2002	2003	2004	2005	2006
<b>Non-oil budget deficit (AZN million)</b>	338	422	355	743	616	1098	2535
<b>Non-oil budget deficit to non-oil GDP (%)</b>	10.2	11.6	8.5	14.9	10.5	15.7	30.8
<b>Consolidated budget deficit (AZN million)</b>	131	93	272	-9	90	104	123
<b>Consolidated budget deficit to GDP (%)</b>	2.8	1.7	4.5	-0.1	1.1	0.8	0.7

Source: Ministry of Finance, State Social Protection Fund and State Oil Fund, own calculations

As it is presented in the *Table 3*, in 2006 the non-oil budget deficit reached 30.8% of GDP that is almost three times higher than the average of 2000-2004. Thus, the developments of recent period may not be assessed as favorable, fading in the necessity reducing the dependence of consolidated budget and its processes on revenues determined by fossil fuels.

*Chart 7* shows that while the government managed to keep the consolidated budget closed to the balance, the non-oil budget deficit increased in line with total GDP growth, reflecting that the fiscal policy has not really been able to separate development of its non-oil expenditures from the oil and gas related revenues. It is fair to mention however that the structure of non-oil expenditure matters. For instance, it is unfavorable to finance those types of expenditures on the account of oil and gas related revenues that may prove to be problematic to reduce in case of fossil fuels' world market conditions. Thus, the long term sustainability of such position is doubtful.

**Chart 7. GDP growth and budget deficit, 2000-2006**

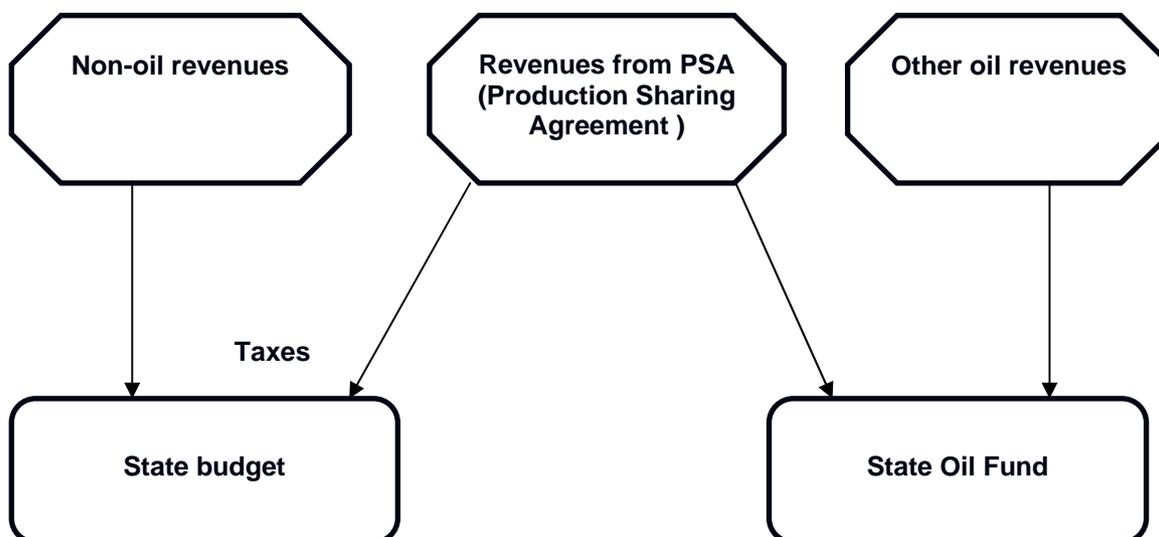
Source: Ministry of Finance, State Social Protection Fund and State Oil Fund, own calculations

It is demonstrated by *Chart 8* that oil revenues are divided into two sections: revenues from Production Sharing Agreement (PSA)<sup>17</sup> and other oil revenues. These revenues are added to the state budget and the State Oil Fund. PSA refers to the distribution of output produced by foreign oil companies. Such companies are under specific regime of taxation, coordinated according to specific protocol. In addition, noted organizations pay only corporate income tax and profit tax since 2006.

<sup>17</sup> According to PSA, the government gets a part of oil profit as a product along with tax or other payments.

Due to the fact, that noted organizations were busy with reducing of operational expenditures from early 90-s, and have fully paid noted disbursements only in previous year. With this purpose, companies paid a huge amount of profit tax, AZN 971 million.

**Chart 8. Distribution of oil-based revenues**



This way, the dependence of state budget on oil is somehow reduced. The end of implementation of major social and economic measures has to be considered in relation to state budget. Thus, if dependence of state budget on oil was relatively slight, it would more realistic to finance social-economic programs from budget after the end of the oil era. Public economy should coordinate social-economic problems by revenues from non-oil sector.

But it will be possible even due to the GDP growth of non-oil sector. The real rate of GDP growth is forecasted to be 11.7% in average during the forthcoming four years (2008-2011), while for non-oil sector 9% (Source: Ministry of Economic Development) This means for either total and for non-oil revenues to increase on a close to similar pace.

Another interesting aspect regarding consolidated budget is that there is a relation between increase of expenditures of consolidated budget and increase in GDP. Thus, as noted above, during the period of 2003-2006 expenditures of consolidated budget increased annually by 30.8%. At the same time, real average growth rate of GDP was 20.5%. Consequently, the consolidated budget somehow seems to be above its means, but it is worth to give it a glance.

It is positive, if the growth of expenditures is realized particularly in those areas that are able to facilitate the country's long run economic growth potential, like education, healthcare, especially in the light of very low level of per capita expenditures on both issues. It is also favorable if the investments in fixed capital can be kept high, especially in case of decreasing, or scarce foreign investment.

From other point of view, it is unfavorable, first of all because the sustainability of current paces of real GDP growth is unlikely, as the economic performance is biased by oil- and related sectors. Second, the realized investments possibly crowd out private investments, not mentioning the doubtful efficiency and transparency of public investments and the distortions caused by targeting of them. It is also a key problem, if the growth

of downward inflexible expenditures (wages, pensions) is in force – this is also general aspect that budgetary expenditures are less flexible than revenues.

To generalize the abovementioned factors the conclusions and the objectives might be summarized as follows. The non-oil budget deficit has to be first of all fixed and permanently reduced to achieve a more balanced level. The growth rate of consolidated budget expenditures has to be moderated and constrained minimally by real GDP growth rate.

With this purpose, enhancement of employment in non-oil sector is necessary on behalf of better utilization of oil-based revenues on the principle of constant real expenses that is originated from “Long-term Strategy for distribution oil and gas income”. Its essence lies in equal utilization of revenue from Oil Fund after its compilation from oil-based revenues. Term equal refers to as average annual level of oil-based revenue. Taking into consideration, average income level was stated at 3.34%, utilization of oil-based revenue in this framework can be considered as acceptable.

Decreasing growth rate of expenditures of consolidated budget must particularly provide decrease in growth rate of investment expenditures. Thus, according to economic classification, 50-60 % of socially directed expenditures are spent on protection. In accordance with legislation, expenditures of defense cannot be reduced.

From another point of view, the slow-down of investment spending will help to keep the macro balance and to prevent the speed-up of inflation.