



CHARTING GEORGIA'S FUTURE

Competitive, Connected, Capable

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Abbreviations and acronyms

AA	Association Agreement	MoESCS	Ministry of Education, Science, Culture and Sports
AEO	Authorized Economic Operator	MoLHSA	Ministry of Labor, Health and Social Affairs
ALMP	Active labor Market Policies	MRO	Maintenance, Repair and Overhaul
ARDA	Agriculture and Rural Development Agency	NBG	National Bank of Georgia
CAC	Central Asia and Caucasus	NDC	Nationally Determined Contributions
CAGR	Compound Annual Growth Rate	NEET	Not in Education, Employment, Or Training
CAP	Common Agriculture Policy	NJC	Net job creation
CBAM	Carbon Border Adjustment Mechanism	NTFC	National Trade Facilitation Committee
CEM	Country Economic Memorandum	NTL	Night-Time Lights
CIS	Commonwealth of Independent States	NTM	Non-Tariff Measures
CRS	Credit Reporting System	OECD	Organization for Economic Cooperation and Development
CSA	Climate Smart Agriculture	PEFA	Public Expenditure and Financial Accountability
CTC	Caucasus Transport Corridor	PISA	Programme for International Student Assessment
DCFTA	Deep and Comprehensive Free Trade Area	RCA	Revealed Comparative Advantage
EaEU	Eurasian Economic Union	RDI	Research and Development Institution
ECA	Europe and Central Asia	RIA	Regulatory Impact Assessment
EMDE	Emerging Market and Developing Economy	RS	Revenue Services
EU	European Union	RTA	Regional Trade Agreement
EV	Electric Vehicle	R&D	Research and development
EXPY	Income Content Of Exports	SARAS	Service for Accounting, Reporting and Auditing Supervision
HHI	Herfindahl-Hirschman Index	SESA	State Employment Support Agency
FDI	Foreign Direct Investment	SME	Small and Medium-Size Enterprises
FTA	Free Trade Agreement	SOE	State-Owned Enterprise
GDP	Gross Domestic Product	SPS	Sanitary and Phyto-Sanitary
GITA	Georgia Innovation and Technology Agency	STR	Student Teach Ratio
GNCA	Georgian National Competition Agency	STRI	Services Trade Restrictiveness Index
GVC	Global Value Chain	TBT	Technical Barriers to Trade
HCI	Human Capital Index	TEAW	Tertiary Educated Agriculture Worker
ICT	Information and Communication Technologies	TFP	Total Factor Productivity
IEMP	Index of Export Market Penetration	TIMSS	Trends in International Mathematics and Science Study
IMF	International Monetary Fund	TSA	Targeted Social Assistance
ISP	Internet Service Provider	UMIC	Upper Middle-Income Country
JCR	Job Creation Rate	UN	United Nations
JDR	Job Destruction Rate	VAT	Value added tax
LFP	Labor Force Participation	VET	Vocational Education and Training
LFS	Labor Force Survey	WBES	World Bank Enterprise Survey
MNC	Multinational company	WDI	World Development Indicators
MoEPA	Ministry of Environment Protection and Agriculture	WGI	Worldwide Governance Indicators

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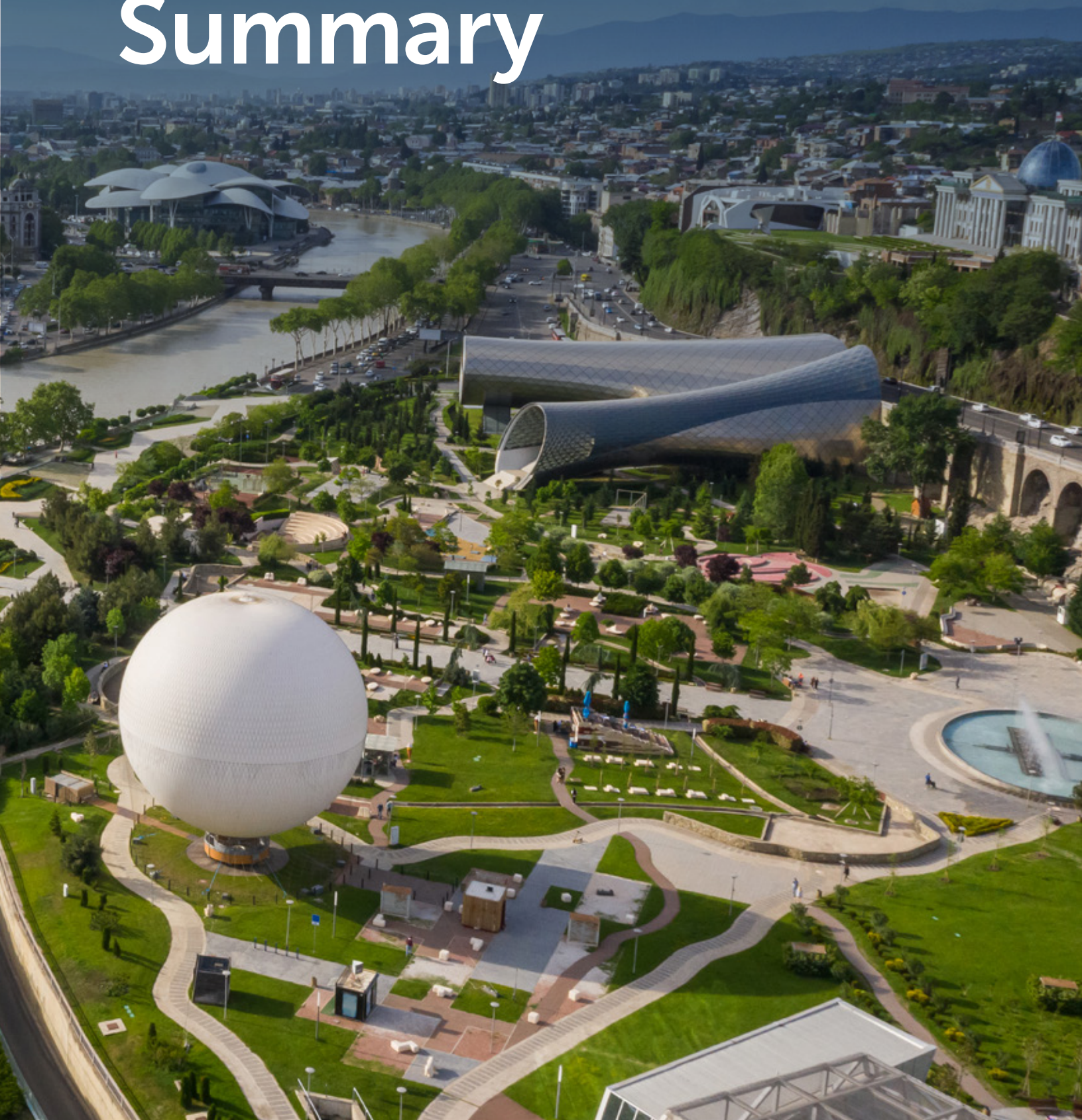
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Executive Summary



Georgia oversaw a successful economic expansion in the last decade, notwithstanding COVID. Underpinned by a sound macroeconomic framework, an attractive business environment and improving governance, real GDP per capita grew by 5.2 percent on average during 2010-2019. This made Georgia one of the fastest growing economies in the Europe and Central Asia (ECA) region. Georgia moved to upper-middle income country (UMIC) status and the poverty rate (measured at the national poverty line) declined to 19.5 percent from 37.3 percent at the start of the decade. The COVID-19 pandemic disrupted these trends, but it also demonstrated the growing maturity of Georgia's economic institutions. While GDP contracted by 6.8 percent in 2020, the government's large and timely pandemic response kept the increase in the poverty rate to only 1.8 percentage points (pp) and facilitated one of the fastest recoveries in the region in 2021, with output expanding by 10.4 percent. Still, the pandemic's impact on employment, income and human capital is likely to persist for some time.

Georgia's future aspirations are equally ambitious, anchored in the objective for closer integration with the European Union (EU). The government's 10-year economic plan envisages GDP growth rates of around 5 percent per annum until 2030 and halving of the poverty rate to below 11 percent. Georgia intends to further open markets and invest in connectivity to boost

exports. European integration is the cornerstone of this ambitious outlook. Building on the 2014 Association Agreement (AA) with the EU, Georgia has been approximating its institutions and policies with those of the EU and in March 2022 submitted a formal application for EU membership.

Despite the country's strong foundations for growth, continued success in the next decade is not guaranteed. Under a business-as-usual scenario, potential GDP per capita growth could slow from 4-5 percent currently to 3.5 percent in 2030 and to 1.9 percent by 2050. Some constraints are already binding: investments may need to moderate to stabilize debt accumulation, skills are an acute problem for firm growth and the population is aging. Other constraints will become increasingly more binding. The economy's ongoing structural transformation from agriculture to services (and to a lesser degree industry) is delivering gains, but its potency will gradually diminish. Moreover, Georgian firms have not improved their efficiency, which has meant that, despite strong GDP growth, creation of good jobs was underwhelming keeping many Georgians unemployed. Among those who are employed, many are engaged in unproductive agriculture. The Georgians that transitioned out of agriculture are doing only slightly better, as a large number are either self-employed or engaged in low-wage jobs. Finally, Georgia faces an uncertain global environment that is rapidly changing. The February 2022 invasion of Ukraine by Russia is the

third large shock to affect the Georgian economy in less than four years, following the unilateral ban on flights from Russia in 2019 and the COVID-19 pandemic during 2020 and 2021.

This Country Economic Memorandum (CEM) aims to inform the policies that could offset these headwinds. To sustain productivity growth, Georgia needs to facilitate its structural transformation and the corresponding spatial adjustment (Chapters 1 and 2). Furthermore, growth will increasingly need to come from improvements in total factor productivity (TFP) in Georgia's firms (Chapter 3) and advancement in their ability to exploit opportunities in external markets (Chapter 4). Finally, more active and better-skilled labor (Chapter 5) can help offset existing demographic trends and augment productivity. Progress in these areas, supported by higher savings, will make Georgia's economy more competitive, connected, and capable, help sustain robust GDP growth over the long-term and turn Georgia's aspirations into reality.

Navigating global trends to ensure another successful decade

From the COVID pandemic to the war in Ukraine, the world and Georgia are experiencing more uncertainty and accelerating disruption. The Russian invasion of Ukraine is taking place close to the Georgian borders and is affecting investor sentiments. This means that Georgia's policy makers face the challenge of driving a post-COVID recovery amid disruptions from the war in Ukraine, while also grappling with the global trends of falling potential growth, rising debt, strains in global value chains (GVCs), disruptive technologies, and climate change.¹ These trends had been taking shape for a while, but the combination of the pandemic and the war has caused them to accelerate, while also increasing uncertainty.

As a small open economy looking to integrate with the global economy, Georgia must carefully navigate these trends by being prepared for the risks and on the lookout for emerging opportunities. Falling population

growth and aging populations across advanced economies and China, lower global investment, and slowing TFP growth *lowered global potential growth*² to 2.2 percent by 2019, below its 3.3 percent average in the first decade of the 2000s. Under pre-pandemic trends, global potential growth was already expected to slow by 0.4 pp over the next decade (World Bank, 2021). The pandemic deepened the slowdown by an additional 0.3 pp and the war in Ukraine will exacerbate this slowdown. This will translate into lower external demand, remittances, and capital inflows for countries like Georgia. Slowing global potential growth coincided with the *largest, fastest, and most broad-based increase in global debt* in five decades. With about one-half of more than 500 episodes of rapid sovereign and/or corporate debt accumulation in emerging markets and developing economies (EMDEs) since 1970 being associated with financial crises (Kose, Nagle, Ohnsorge, & Sugawara, 2021), the recent build up in debt is a concern. At the same time, *slowing global value chain (GVCs) expansion* is limiting the integration opportunities. This is also due to *new technologies*, which, combined with changing globalization patterns, have brought the feasibility of manufacturing-led development into question for developing countries (Hallward-Driemeier & Nayyar, 2018). On the other hand, technologies also open opportunities for firms to expand their customer base and to scale up operations. The pandemic clearly demonstrated this, as technology helped many firms and households mitigate its economic disruptions. Finally, *climate change* could push between 68 and 132 million people worldwide into poverty within the decade (World Bank, 2020f). Global efforts in climate change mitigation and adaptation will reduce demand for fossil fuels and increase demand for the metals and minerals required for renewable energy generation. The war in Ukraine has also underscored the need to accelerate the energy transition and enhance energy security.

A more capable, competitive and connected Georgia will be better placed to navigate these trends. Higher savings can mitigate risks from lower global growth, but so can diversification. The CEM highlights potential for Georgia to increase exports, including in regions where growth is expected to remain robust. The expected

1 This is not an exhaustive list of all challenges, but some that have the potential to be disruptive and re-shape the next decade.

2 Potential output is the level of output an economy can sustain at full capacity utilization and full employment. It is a function of labor, the capital stock, and total factor productivity, which is itself determined by technology and factor allocation efficiency.

reshaping of GVCs, as companies attempt to increase the reliability of supply chains, is an opportunity for Georgia to better integrate in GVCs, while greater tradability of services offers opportunities for countries like Georgia to increase and diversify exports. And while Georgia's unfavorable demographic trends will drag down its own potential growth, building up skills and activating the labor force can offset some of their impact. An agenda that will target digital skills, address gaps in access and quality of internet and facilitate technology adoption can ensure that most Georgians benefit from digital transformation. Georgia's debt levels are sustainable under most plausible scenarios; still, rebuilding buffers, developing domestic capital markets and de-dollarization can lower risks from a shift in market sentiments in response to surging global debt. Making agriculture climate-smart, increasing energy efficiency, improving connectivity, and adopting a modern mining sector policy framework can help Georgia adapt to climate change, meet its Nationally Determined Contributions (NDCs) and benefit from the energy transition.

Looking back at the last decade in Georgia

When the World Bank produced the previous Georgia growth reports in 2013 and 2014, Georgia was reforming and growing rapidly, but had limited success in creating jobs and faced growing imbalances. GDP growth had averaged above 6 percent in the decade following the 2003 Rose Revolution, as the private sector responded to the far-reaching reforms. However, progress in unemployment and poverty reduction was more modest, strong domestic demand pushed down national savings, and firm-level productivity was largely stagnant.

Since 2014, and until the COVID-19 pandemic, Georgia's economy continued to perform strongly, addressing many constraints, even as some persisted and new ones emerged. GDP growth remained robust, investment moderated but remained relatively high, savings improved, and TFP, after going through

a slump in the early years, recovered as structural transformation picked up pace. Still, savings remained lower than investments, firm-level productivity did not improve, skills became an even more acute problem for businesses, and trade integration was underwhelming. Consequently, the economy continued to perform less well in the creation of well-paying jobs.

The pandemic dealt a blow to the economy, but a robust response limited the scarring and assisted the recovery. A large and timely policy response limited the pandemic's impact on living conditions and facilitated one of the strongest recoveries in ECA in 2021, with output expanding by 10.4 percent. However, the unemployment rate remains above pre-COVID levels, while a pick-up in inflation has eroded income gains.

A persistent investment - savings gap resulted in higher external debt. Investment levels, at 27 percent of GDP on average during 2015-2019, exceeded most peers (Figure 1). Investment activity took a hit during COVID and has not yet recovered, with the investment rate falling to 22 percent of GDP in 2021. And while savings increased from around 10 percent of GDP in 2010 to 20 percent of GDP just prior to COVID-19, they have plummeted since to around 12 percent of GDP (Figure 2). A relatively disciplined fiscal policy kept public sector savings positive prior to the pandemic, though adding state-owned enterprises (SOEs) will lower the savings. The household sector was the main driver of the improvement in savings (prior to the pandemic); however, Georgian households save less than households in aspirational peers.³ A corporate sector that posted relatively low profits and registered losses in five years between 2010-2020 didn't contribute much to savings. The mirror image of the investment - savings gap is a current account deficit that averaged around 10 percent of GDP over the last decade, though with a marked improvement prior to the pandemic. This, combined with a volatile exchange rate of the lari, kept the gross external debt of Georgia above 100 percent of GDP since 2015.

Debt levels are sustainable under most plausible scenarios; however, balance sheets are stretched and

³ According to Geostat, households' savings (income less consumption expenses) reached 10 percent of income only in more recent years and averaged less than 5 percent between 2010-2020. Eurostat / OECD data put these averages at 8 percent in Czech Republic and Hungary, 10 percent in Chile, and 6 percent in Russia.

Figure 1. Gross capital formation
In percent of GDP

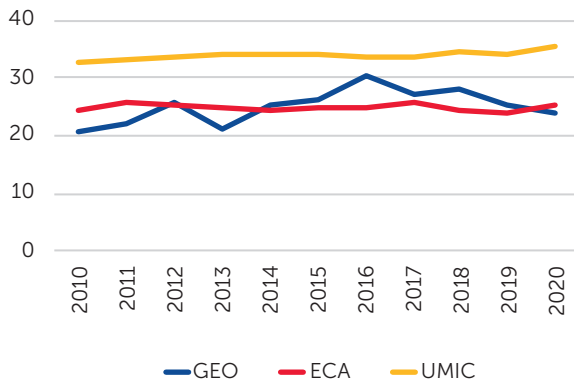
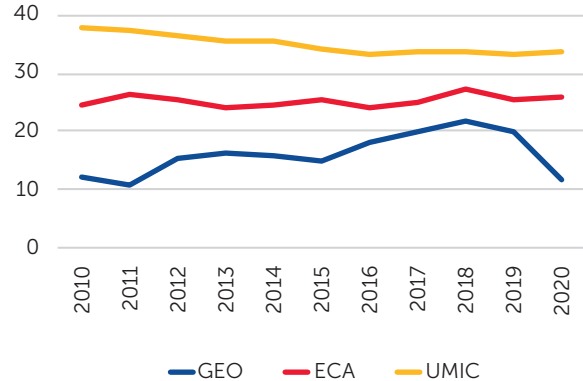


Figure 2. Gross national savings



Source: World Development Indicators.

exposed to risk due to large foreign currency exposure.

Georgia's public debt, at around 50 percent of GDP, is below the EMDE average but contingent liabilities are sizeable. The leverage ratio (liabilities / equity and reserves) of the corporate sector increased from around one in 2013 to 1.4 by 2020⁴, and corporate debt exceeded 50 percent of GDP in 2020. By the end of 2020, bank loans were 60 percent of households' disposable income, up from 31 percent in 2013.⁵ A large share of debt is denominated in foreign currency (50 percent of all loans from banks, 80 percent of government debt), increasing vulnerability to lari depreciation.

The economy is benefiting from structural transformation, but the process remains incomplete

Georgia is structurally transforming and becoming more productive, and the process is still ongoing.

The share of agriculture in GDP has declined to around 7-8 percent of GDP in recent years, similar to peers. Employment in agriculture peaked later than in peers but has been falling relatively fast recently. Still, at around 19 percent (based on the new methodology; close to 40 percent under the old⁶), it remains above peers. Services are the largest sector; compared to other UMICs, Georgia

is more reliant on services for value-added, but less for employment. Manufacturing is where the structural transformation is least visible; its contribution to GDP remains around 10 percent, and below what would be expected given the income level. While the move away from agriculture contributed almost half of the growth in GDP per capita over the last decade (Figure 3), the large share of labor still engaged in agriculture (around a fifth of employment) and the significant difference in the output per worker in agriculture and the rest of the economy (Figure 4) suggests that the potential of structural transformation is not exhausted.

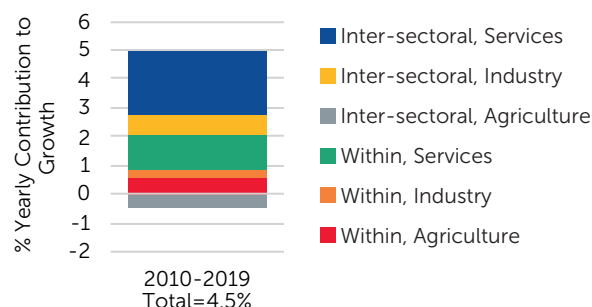
Georgia's spatial transformation is proceeding in parallel

The spatial corollary of the structural transformation has meant greater concentration in the largest cities and substantial regional disparities in output per capita. Following a period of de-urbanization in the 1990s due to civil strife and the difficult economic transition, Georgia started to re-urbanize in the 2000s and has since been one of the faster urbanizing countries in ECA during this period. Still, most secondary cities have smaller populations compared to the start of the century, and a large share of the population still

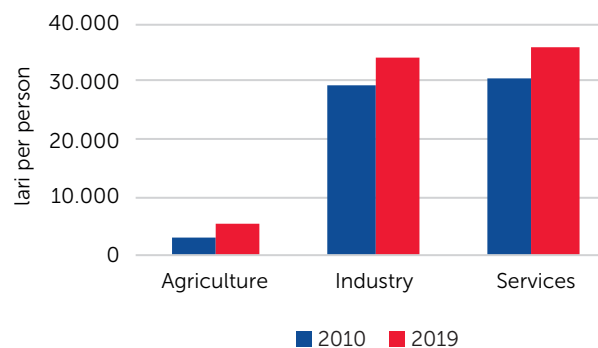
⁴ Geostat, Financial Soundness Indicators on Non-Financial Corporations.

⁵ NBG, Financial Soundness Indicators for client sectors. Still, debt service deteriorated only slightly.

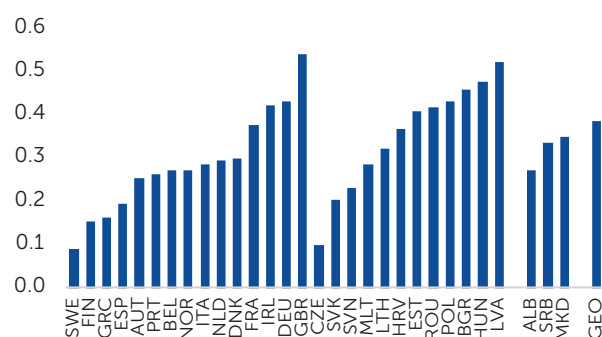
⁶ In 2020, GEOSTAT introduced changes to the labor market indicators which consider individuals working in households as employed only if more than half of their produce was sold in the market. This affects many Georgians engaged in subsistence agriculture and who were previously considered self-employed. For more details, see Box 1 in Chapter 1.

Figure 3. Labor productivity decomposition

Source: World Bank staff based on Geostat data.

Figure 4. Differences in value added per worker

Source: World Bank staff based on Geostat data.

Figure 5. Variation in regional GDP per capita 2018 or latest year

Source: Eurostat; various national statistics agencies (Western Balkans); Geostat. Note: Data presented at NUTS-3 level for EU and Western Balkans and at regional level for Georgia.

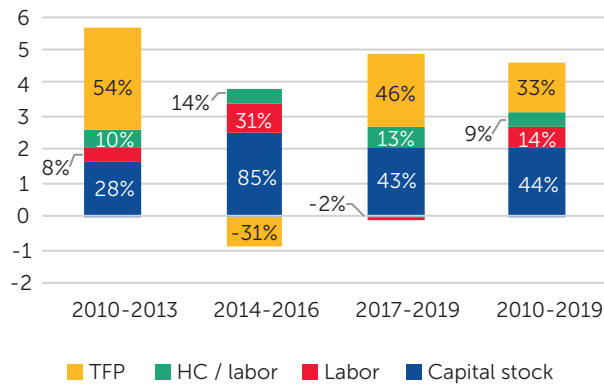
Figure 6. Nightlights intensity, by raster 2016

Source: Global Human Settlements Index; OpenStreetMaps.

lives in rural areas. Variation in regional GDP per capita in Georgia is above that of most peers in the EU and the Western Balkans, though it is not excessive (Figure 5). The pattern of leading and lagging regions is matched by patterns in investment and business demography. Outside of the more vibrant Tbilisi and Batumi, other cities have limited economic clout, and there is an absence of non-agricultural economic activity outside of cities (Figure 6). The limited pull from urban areas and constraints to labor mobility explain why a large part of the population remains in agriculture, where productivity is hampered by small plots, limited skills, weak land markets and fragmented supply chains.

Structural change delivered productivity gains, but the corporate sector is not becoming more productive

Capital accumulation and structural change drove Georgia's growth between 2010-2019; however, firm-level TFP performance has been weak. Capital accumulation explained 2 pp of the 4.6 percent GDP growth during 2010-2019 (Figure 7). Overall TFP growth accounted for one third of output growth (1.5 pp of GDP per annum) and, demonstrating Georgia's structural change, was largely driven by the movement of labor from agriculture to services and industry. However,

Figure 7. Growth accounting results

Source: World Bank staff based on Geostat data.

among a relatively large sample of non-agriculture firms, TFP in 2019 was actually 6.7 percent below its 2007 level, when estimated using firm data.⁷ Despite an improving employment rate during this period, the shrinking labor force meant that the contribution of the stock of labor was negligible (0.6 pp, or 14 percent), while small gains in the human capital per labor added around 10 percent of the observed GDP growth (0.4 pp).

Weak firm-level TFP performance is likely driven by limited upgrading of firm capabilities, as well as remaining economy-wide constraints. Among the firms in the sample, the construction sector became more productive, but TFP in manufacturing declined slightly and plummeted in services (Figure 8). Decomposing firm-level TFP trends shows that manufacturing and construction firms became more productive (i.e., reported positive “within-firm” component); but firms in services did not, indicative of limited innovation or weak management. Further, resources appear to be allocated towards more productive firms (i.e., positive “between / covariance” component) only in construction; in manufacturing and services, the correlation between market shares and TFP levels is negative. Such weak allocative efficiency

appears to be explained by the existence of larger firms that dominate employment but not productivity, and productive startups that fail to scale up after their initial growth spurt. Growth of less productive firms suggests weak competitive pressures in markets, while factors like informality and limited export orientation could be affecting the scale up of small firms.

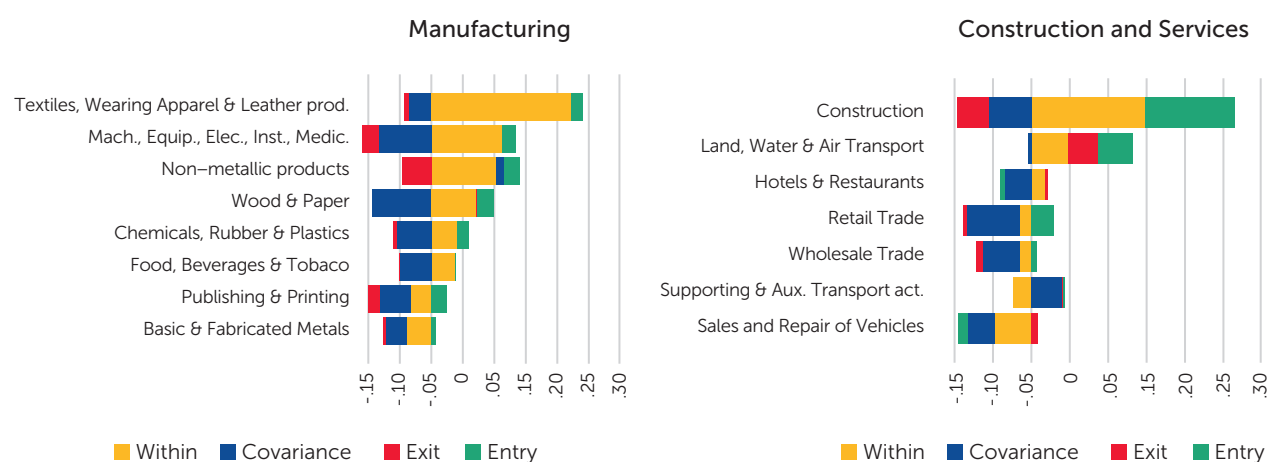
Only a few Georgian firms innovate, due to limited investments and a nascent innovation ecosystem. Irrespective of the unit of measure, the gap in R&D investment between Georgia and aspirational peers is large. Firms’ investments in ICT are limited to basic digital services, and in the absence of complementary labor skills, even these investments do not always translate into higher productivity. In addition, the innovation ecosystem is nascent, with limited incentives for research and development institutions (RDIs) to orient research towards commercialization and a relatively low stock of engineers and scientists. As a result, only 7 percent of firms introduced new or significantly improved goods or services.⁸

Management practices in Georgian firms lag peers. Better management is positively associated with performance. However, the average Georgian firm is family-managed and performs poorly on key management aspects, such as performance monitoring and dealing with production disruptions (Table 1). In addition, many entrepreneurs appear to be “pushed” into economic activity due to lack of other opportunities, rather than being “pulled” by profits, independence, or autonomy (Kuriakose, 2013), and they may also lack the needed entrepreneurial skills. Together, these factors result in one of the lowest rates of firm survival in Europe.

A sizeable, though declining, informal economy may be limiting growth of businesses. Various measures provide different results for the size of Georgia’s informal sector (Figure 9), though they all point to its decline in line with improvements in governance and the regulatory framework. Still, where informality is more present, it also presents a bigger obstacle for

7 Caution is advised in interpreting the firm-level data to be representative of the entire economy. The initial sample of firms was from Geostat’s Business Statistics survey, which covers most larger companies and a sample of smaller companies in manufacturing, construction, and some services sectors. Further entries were lost due to insufficient data to compute TFP. Most of the lost entries were for smaller and newer companies, which could be more productive. See Chapter 3 for details.

8 Geostat, Innovation activities of enterprises (2016-2020).

Figure 8. Productivity growth decomposition, by sectors (2010-2019 average, 3-year differencing)

Source: World Bank staff calculations based on GeoStat.

Note: Average TFP annual growth calculated at the two-digit level of NACE Rev. 3. Annual averages are arithmetic averages. Aggregate employment is the average 2007-2019.

Table 1. Management score in Georgian and comparator countries firms

On a scale from 0 to 1 (higher scores are better), for firms with 50-5,000 employees

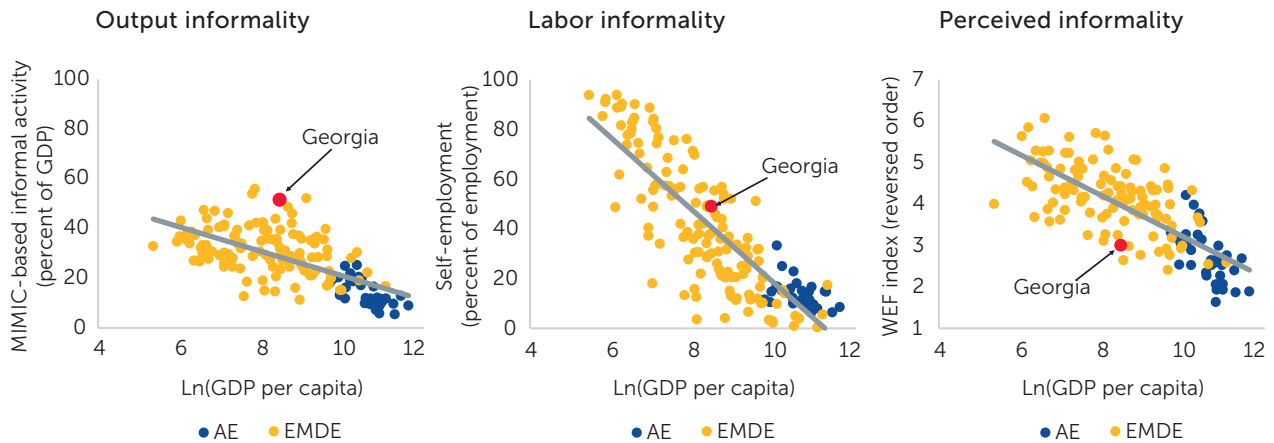
Questions	Georgia	Bulgaria	Poland	Romania	Serbia
What happens when a problem arises?	0.663	0.879	0.904	0.873	0.894
# of key performance indicators (KPI)	0.293	0.556	0.590	0.523	0.572
Time frame of operational targets	0.617	0.592	0.677	0.607	0.607
Criteria for non-managers' promotion	0.821	0.820	0.829	0.840	0.915

Source: World Bank staff calculations based on Enterprise Survey (2019).

firms. In 2019, 13 percent of firms identified competition from the informal sector as a major concern.⁹ A particular feature of informality in Georgia is that while most businesses are formal, their operations may be underreported. Around a fifth of medium-size firms in Georgia are not fully compliant with their VAT liabilities, while bunching of firms just below the VAT registration threshold may suggest that firms aim to appear small by underreporting their income (World Bank, 2021) and not growing to their full potential. Related to this, unreliable financial information is a key reason for loan rejections, contributing to access to finance being one of the biggest obstacles reported by businesses.

Weak competitive pressures could explain growth of less productive firms. More firms operate in markets with fewer competitors in Georgia compared to peers, confirming business perceptions that markets are concentrated. Still, firm-level data points to increased competitive pressures in product markets in recent years – average markups have declined, with evidence that this has been driven by TFP rather than market share. However, competition may continue to be weaker in some sectors. For example, a few sectors are characterized by higher dispersion in markups, while also having higher levels of markups. Further, in services, a small number of firms appear to be driving markups.

9 World Bank Georgia Enterprise Survey 2019.

Figure 9. Informality and development: Is Georgia an outlier?

Source: (Yu, 2020).

Note: AE: Advanced Economies; EMDE: Emerging markets and developing economies.

Georgia's labor force made a very modest contribution to growth

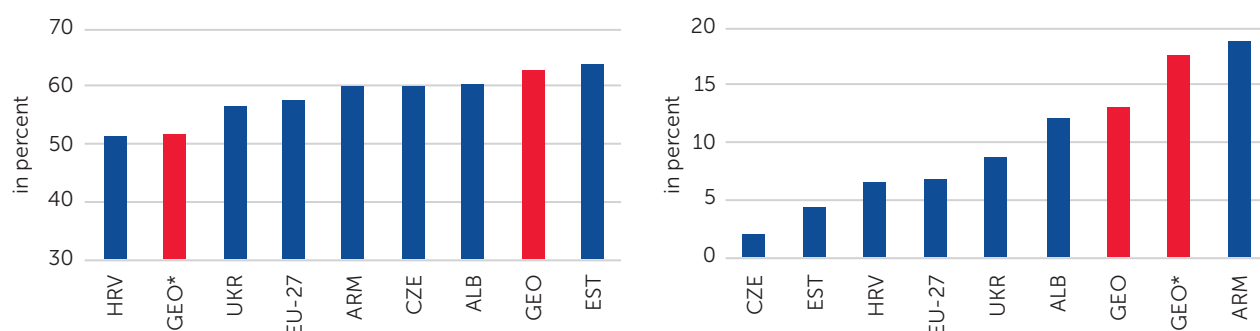
The relatively high unemployment and low participation rates mean that around 30 percent of the labor force is not actively contributing to the economy. Economic reforms delivered growth and poverty reduction; however, net job creation has not kept pace with economic growth (Posadas, Makovec, Jaef, Gruen, & Ajwad, 2018), as robust job creation in manufacturing and industry was offset by shrinking agriculture employment. Consequently, Georgia's unemployment rate at around 19 percent, while declining, is high (Figure 10). The quality of jobs is an equally big problem, with most job creation taking place in traditional and low-productivity sectors, thus keeping wages low. Participation in the labor market, at around 50 percent is low and declining, reflecting social norms and limited support services.

Skills gaps and mismatches limit the potential of the labor force. On the one hand, most jobs require basic skills, while most workers have secondary education and above. This pushes out those with lower education (for example, 16 percent of workers with upper secondary education work in elementary occupations) and keeps returns to education low for workers. On the other hand, the few high-skilled jobs that are created frequently remain unfilled because a higher education level doesn't always equate to skills. The skills gap

reflects challenges throughout the education system. Too few kids attend early childhood education and, as a result, enter the general education system unprepared to learn. The general education system fails to instill good foundational skills, which is further compounded by the weak quality and relevance of VET and tertiary education. Finally, an underdeveloped labor market information and employment services keep information asymmetries high and labor mobility low.

Georgia is integrating, but only in a few, low value-added sectors, and connectivity remains a challenge

Integration has underpinned Georgia's growth story, but in a narrow way. Trade expanded briskly in the decade prior to COVID-19, and in 2019, Georgia's trade in goods and services exceeded the expected level for its income. The country has also increasingly been able to position itself as a hub for the region, with re-exports gaining a greater share of trade. However, while Georgia now exports more products to more markets, its export basket remains relatively unsophisticated and with limited value-added. The opportunities provided by the opening of markets have not fully materialized, with Georgia exploiting only 4.2 percent of the market potential of its exports structure. Large and integrated companies benefited from the free trade arrangements, but there are only few such firms in Georgia. In fact, very few firms export, and export relationships don't survive long.

Figure 10. Labor market indicators: Georgia vs comparators (2019, in percent)

Source: ILO and Geostat for Georgia according to new methodology.

Note: * refers to Georgia using new methodology. In the EU-27, the new standards would not substantially affect labor indicators as own-account workers only represent 9.9 percent of total workers.

Georgia's GVC participation has been low and declining, due in part to its inability to attract the multinationals that typically form the backbone of GVCs. Services generate 70 percent of the exports value-added, exceeding most peers. However, apart from tourism and transport, there have been relatively few services on Georgia's export list, and most exported services are low-skilled and do not add value to other sectors.

Georgia occupies a strategic location, serving as a logistics gateway for the Caucasus region and potentially Central Asia, yet its connectivity is lower compared to peers. The country's attractiveness is restrained by higher transport and logistics costs and unpredictable delays, as simplified regulations and a modern customs administration have been outweighed by perceptions of low quality of transport infrastructure (especially in multimodal transport), high costs of infrastructure use and an underdeveloped logistics industry. Limited cooperation among stakeholders and with neighbors adds to the delays and unpredictability. The logistics disruptions during the COVID-19 recovery and the impact of the Russian invasion of Ukraine are putting existing transport arrangements to the test. Importantly, the November 2020 tripartite Peace Statement by Armenia, Azerbaijan and the Russian Federation could lead to eventual opening of corridors that are now closed, which may mean growing competition for Georgia's transit role.

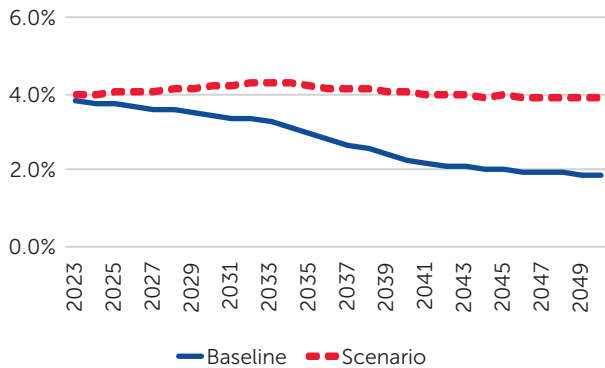
An agenda for a competitive, connected, and capable Georgia

In a more uncertain and challenging world, the key objective for Georgia is to sustain pre-COVID growth rates and to improve the quality of growth to allow people to access better-paying jobs. Under a business-as-usual scenario, potential growth will slow to below two percent by 2050 as gains from structural transformation are exhausted and push TFP growth down to global averages¹⁰, macroeconomic constraints and increased uncertainty limit investment and demographics takes a toll. But these headwinds can be offset. Restoring investment and higher savings, facilitating the ongoing structural transformation, promoting a more active and better-skilled labor force and unlocking firm productivity growth can still deliver growth rates of around 4-4.5 percent over the long-term. To achieve this, Georgia should, in many ways, do what it was doing before: continue prudent economic management, improve governance, and invest in infrastructure. However, the remaining agenda is considerable: to make businesses more competitive so that they can create more and better jobs; foster a more capable and mobile workforce; and promote the country's connectivity. The EU accession process, after it is approved and formally launched, has the potential to serve as an anchor for some of the more

¹⁰ The average TFP growth rate during 2000-2019 for a sample of 118 countries for which information is available in the Penn World Table (version 10.0) was 0.6 percent. For UMICs it was 0.7 percent.

demanding institutional reforms that are needed, while also providing Georgia with an opportunity to more closely integrate and converge in income levels with aspirational peers.

Figure 11. Long-term growth
In percent



Source: WB.

Note: In the baseline TFP declines to 0.5 percent by 2040, human capital declines by 0.01 percent annual, labor market participation stays constant; under Scenario, TFP declines to 1.5 percent by 2040, labor force participation and human capital increase to high-income levels.

Restoring investment and increasing savings

Savings should increase to maintain strong investment rates. Georgia's development needs are substantial, which elevates the importance of reversing the recent decline in investment levels. To avoid debt levels increasing further, investments will need to be matched by higher savings by the government and by households and a more profitable corporate sector. Georgia's aging demographics further strengthens the case for higher savings, with evidence that higher old age dependency negatively impacts the private saving rate (Loayza, Schmidt-Hebbel, & Servén, 2000).

In the public sector, buffers need to be restored while management of fiscal risks should be improved. Georgia's fiscal rule is robust and will see a gradual restoration of fiscal buffers, though, given the strong recovery from the pandemic, a faster adjustment could be considered. Unwinding of COVID-19 mitigation measures can provide some savings. Improved prioritization of

well-appraised public investment projects, better linking spending to outcomes, adopting cost-recovery tariffs in regulated sectors and reforming management of SOEs (i.e., implementing the new corporate governance code for SOEs, improved performance monitoring, etc.) can produce considerable savings, while improving service delivery. In addition, as off-budget activities are likely to become more important as Georgia starts to rely more on complex private-public engagements in service delivery, so will the need to monitor fiscal risks of these activities.

Household savings need to increase. Growth and job creation will increase savings; however, saving rates need to considerably exceed pre-pandemic levels. The pension reform is helping to drive savings accumulation, and additional savings could be mobilized through instruments such as unemployment and disability insurance or life insurance products. Improving the public's financial literacy, especially regarding decisions with longer-term implications (i.e., education and health), can also help. Finally, maintaining financial sector stability and supplementary tax policy measures (such as taxation of second homes or unused land) may help channel investment in jewelry and real estate into financial sector savings.

Facilitating the structural and spatial transformation

Large differences in output per worker and persistence of a high share of the labor force in agriculture suggest that the potential for structural transformation is not fully exploited. Labor in manufacturing and services produces around seven times more output compared to agriculture. Given the large share of the labor force¹¹ still engaged in agriculture, further shifting of labor from agriculture will be productivity-enhancing. Importantly, agriculture needs to become more productive, so that the remaining farmers can have better livelihoods. In addition, to incentivize the move from agriculture, the rest of the economy will also need to increase productivity to sustain the wage differential.

To create the most opportunities, growth should be efficient, and its spatial consequences adequately

11 Slightly below 40 percent of total employment based on the old methodology, which is comparable to more countries. The new methodology puts employment in agriculture at 19 percent of total employment.

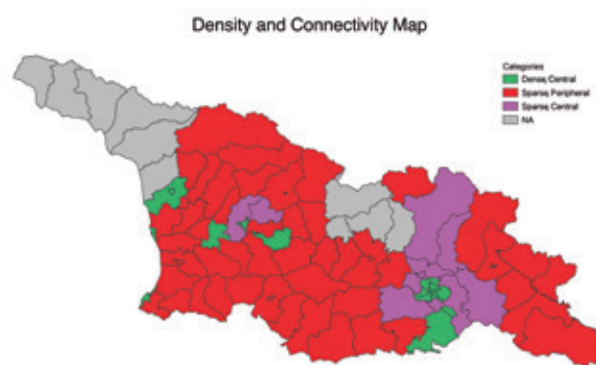
managed. This requires a framework that allows markets to identify growth opportunities and people and capital to move to be able to capture those opportunities. This starts with building up endowments across the board, such as human capital and institutions, as well as policies that target market, government and coordination failures that limit opportunities or hinder mobility. Place-based investments can be transformational for some areas; however, these are unlikely to work if distortions are not removed, the opportunities are not there and interventions are not properly appraised and coordinated. Such a growth strategy will have important spatial consequences: less, but more productive jobs in the rural economy, more jobs in the urban economy (mostly in Tbilisi, but also in some of Georgia's secondary cities), but also some areas with limited potential to support sustainable economic activities. Though these regions may continue to lag in terms of per capita output, redistributive fiscal policies, equal access to opportunities and migration can help equalize per capita consumption. Notably, urbanization will deliver the productivity dividends only if it is adequately managed to ensure that cities are better connected, planned and livable.

Regional development policy should build on these principles complemented with a clear understanding of the regional context. Labor and capital mobility are critical for effective regional development policies (McCulloch & Yellen, 1977). However, locations also differ in their starting points and structural conditions, which determine their viability. While a variety of factors impact sub-national productivity, urbanization and economic density, as well as market access and local transport connectivity, stand out as robust variables across methodologies. Bringing together density and market connectivity can help differentiate policy priorities for various regions of Georgia. For example, about 53 percent of Georgia's population (but only eight municipalities) resides in *densely populated, centrally located* (well-connected) regions which are not lagging (Figure 12) and which could benefit from properly appraised, place-based interventions directed towards improving connectivity, urban planning and providing affordable and safe housing. By contrast, another 27 percent of the population (and 60 out of 76 municipalities) *reside in sparsely populated and peripherally located* regions. These areas face substantial

structural constraints that limit their development potential. Effective policies for these areas are likely to be those that enhance equality of opportunity, with a focus on human capital. Agricultural transformation, along with niche sectoral development based on territorial endowments (natural resources, tourism) can also offer opportunities.

While density and market access may define a region's potential, to grow regions need sufficient endowments, including human capital and local institutions. A nation-wide effort to increase skills (Chapter 5) will facilitate labor mobility and benefit lagging regions. Spatially targeted efforts can help in areas with potential (i.e., training on tourism-relevant skills or climate smart agriculture). And while it is recognized that quality of local administration is associated with regional economic outcomes (Rodriguez-Pose and Ketterer, 2016), local governments in Georgia, despite some progress, remain weak. Building capacity, coupled with more autonomy and capacity to raise revenues can ensure local governments can better support local development.

Figure 12. Mapping Georgian municipalities by density and connectivity 2019



Source: Authors.

Facilitating Georgia's structural and spatial transformation will require addressing the structural factors that limit opportunities and cause frictions in factor markets, as well as building up of endowments. Lack of density and connectivity, disconnected and stagnant rural areas, inefficient land markets and lack

of affordable housing, weak human capital, as well as limited capacity of local institutions are slowing the pace of Georgia's adjustment. Accelerating the transformation will require investments in building up endowments (human capital, basic services and institutions), complemented with a focus on three broad priorities:

- **Realize the potential of rural areas through agricultural transformation, niche sectoral opportunities, and connecting to markets.** Advancing land reform (management of state land, taxation, consolidation, etc.), strengthening value chains by promoting linkages between sector participants and reorienting public support programs towards public goods and more beneficiaries are priorities for the agriculture sector. Further gains may be available for some regions from niche opportunities in sustainable tourism and forest management. Better connectivity with large agglomerations can open opportunities for product and labor market integration and attract investment, with interventions focused on areas with potential to take advantage of density.
- **Strengthen dynamism and reinforce density in secondary cities.** Effective use of public assets, improved quality of public services and performance-based firms' support could help build competitive industries in some secondary cities and support efforts to attract FDI in secondary cities. Universities have attracted and retained knowledge workers and revitalized secondary cities in parts of the EU, and a few Georgian cities have regional education institutions that could support the local economy. Admittedly, many secondary cities will continue to shrink and will need to adjust plans to manage this process; this may be an opportunity to re-invent some cities.
- **Prepare Tbilisi for sustainable and inclusive growth.** Strengthening and effectively integrating urban planning programs (with significant opportunities available for infill densification), improving public transport, and ensuring sufficient social (housing quality and affordability, schools, health facilities) and environmental (green areas, parks) infrastructure can further propel the capital

city to excel in its role as the main hub for Georgia's people and markets.

Making the most of the available human capital

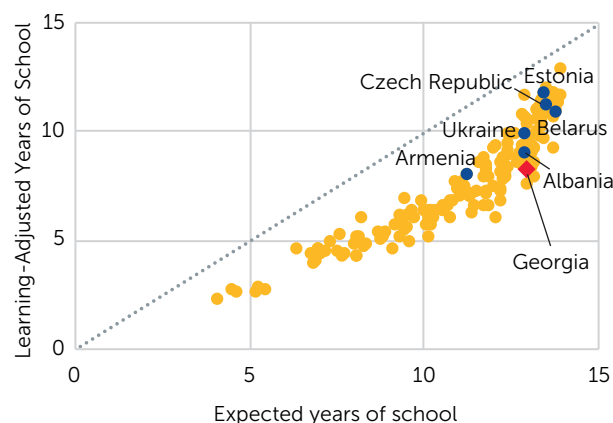
A more active and skilled labor force can support growth. More and better jobs are needed to reduce unemployment and ensure the investment in human capital is better utilized. However, jobs alone are insufficient. Workers should be better equipped for emerging opportunities, labor supply and demand mismatches need to be addressed, and the labor market should be more inclusive. Increasing participation and better skills can add around 0.4 pp to long-run GDP per capita growth. This is likely to be an underestimate as skills are also embedded in the TFP contribution. A range of policies can support a nationwide effort to improve skills, link them to the demand of the markets and match workers with jobs:

- **Improve access to pre-school education and improve learning outcomes.** With Georgia's education sector performing poorly in building foundational skills (Figure 13), focus should be placed on general education. Greater pre-school education enrollment can better prepare children to enter school. This will require more and better-financed kindergartens that provide educational (rather than caretaking) services. Growing pre-school enrollment will also make the labor market more inclusive by facilitating greater female participation. In general education, better-qualified, paid and motivated (though not more) teachers can improve students' learning outcomes. Gains can be achieved by optimizing the school network (larger schools attract qualified teachers more easily and provide education services more efficiently) and increasing instruction hours. With digital skills increasingly demanded by employers even for elementary occupations, these skills should be mainstreamed in the education system. Finally, introducing and enforcing quality standards will be important.
- **Enhance the responsiveness of the vocational education system to the changing demand for skills.** A stronger Skills Agency can help define

vocational education standards in collaboration with the public and private sectors and foster the provision of job-relevant skills. Building on this, VET programs can be expanded and tailored to the needs of the workers.

- **Strengthen labor market institutions to facilitate school-to-job transition and better match workers to jobs.** The general secondary education system can be complemented with systemic options to acquire occupational or technical, job-specific skills. The dual VET model, combining school and firm-based learning, can strengthen engagement between vocational colleges and employers. In addition, strengthening Active labor market policies (evidence-based wage subsidies, internships, work-based experience arrangements etc.) can help tap underutilized sources of labor supply and facilitate the school-to-work transition.

Figure 13. Learning gap
In years



Source: World Bank.

Sustaining productivity gains

Sustaining productivity growth will be critical.

While the move away from agriculture can keep on delivering for Georgia, over time, its potency in driving productivity gains will decline as the number of workers in agriculture falls and the remaining ones may not have the skills required in the non-farm economy. For TFP growth to be sustained, efficiency should increase

across the board. This means higher yields per hectare in agriculture and more output per labor and capital in the firms in the rest of the economy, i.e., reversing the relatively weak performance of Georgian firms so far. In addition, the more productive firms should grow and gain market share. Several factors have been associated with increased productivity, including supportive institutions, firm-level capabilities and deepened cross-border integration.

(Gill, Izvorski, van Eeghen, & De Rosa, 2014) define “institutions” as the mechanisms to ensure stability, deliver quality public services and regulate business activity. Against this metric, Georgia has a lot to build on but also a remaining agenda in few places.

- **Georgia’s institutions are more and more capable of delivering stability, but dollarization is a vulnerability,** especially given high exchange rate volatility. Georgia’s de-dollarization agenda is in line with good practice and will bring results over time. In the interim, more active communication of information on factors affecting the exchange rate can help delink exchange rate expectations from non-economic trends.
- **While Georgian institutions’ provision of basic services (e.g., primary and secondary education, basic utilities) is closer to EU-11 levels than structural and income peers, the quality of services needs to improve.** Many Georgians fail to learn much in the present education system, firms report more electricity outages compared to peers, and twice as much water is lost compared to what is supplied to customers. The source behind these issues is often due to underfunding, but inattention towards results and lack of accountability in decision-making also play a role. Reforming SOEs is also part of this agenda, including through introducing key performance indicators and incentives for SOE management linked to productivity.
- **In terms of regulating economic activity, Georgian institutions have made significant strides, with some room for improvement.** Bribery incidence and depth are lower compared to ECA, regulations take less time to complete, and government effectiveness is on par with the ECA average.

However, informality and a still nascent ability to ensure competitive markets may be making the playing field uneven. Tax policy and administration reforms, together with digitization and financial inclusion, can remove distortions that incentivize firms to stay small. Effective enforcement of the upgraded regulatory framework for competition (merger control, market monitoring) and the introduction of a state aid framework in alignment with EU requirements can also promote more competitive markets.

Firm capabilities can be boosted through performance-linked support programs focusing on managerial practices and on innovation. In Georgia, like in other countries, better managed and organized firms and firms that invest in innovation and in ICT do better. Training or consulting services programs could improve managerial capacities, with Enterprise Georgia already exploring some promising initiatives. Existing business support programs could be reviewed to incorporate productivity and competitiveness requirements. Supporting firm growth, whether through export promotion or lower informality, can also increase innovation, given that larger firms and exporters are more likely to innovate. Still, innovation also requires complementarities, such as human capital and a supportive innovation eco-system. Policies that improve coordination between RDIs and the private sector and that ensure a sufficient supply of engineers and scientists can support firms to innovate.

Improved access to financing can support firm growth. While banks have done a reasonably good job in providing credit, firms still see access to finance as a major obstacle. This reflects the very basic services offered by banks, as well as the relative absence of alternative sources of finance. An improved credit reporting infrastructure, a private sector with greater digital footprint, a strengthened secured transactions framework and an enabling legal framework for non-bank financial activities can help broaden access to finance.

With the anticipated EU accession, Georgia has the potential to significantly improve its trade performance and solidify its logistics and transport hub position for the region. It can achieve these goals by enhancing

the capabilities of its firms and increasing their export orientation, improving the competitiveness of its transport infrastructure, and facilitating the growth of a vibrant logistics industry. From a policy and institutional standpoint, progress on these goals would require:

- **Supporting increased export orientation of firms.** A consensus on the importance of export orientation can be facilitated by an effective National Trade Facilitation Committee (NTFC). Furthermore, firms can become export-oriented through programs supporting them to adopt international certification and through stronger export promotion to overcome the information asymmetry and discovery costs associated with seeking access to external markets (especially non-traditional markets). Effective implementation of an FDI strategy that targets efficiency-seeking FDI can facilitate GVCs integration. And while the non-tariff barriers on trade between Georgia and the EU are expected to be eliminated, in practice, that means that a wide range of regulations need to be implemented in Georgia as EU norms are transposed. The transition costs associated with this will need to be managed.
- **Promoting the growth of services as an export engine.** The relatively large share of jobs in “global innovator services” and in “social services”, which are increasingly more tradeable, compared to the relatively low export of these services suggests opportunities to scale up services exports. Developing a Services Trade Restrictiveness Index (STRI) and understanding how to make services in high-potential sectors more tradeable (digital content, accreditation, visa policy) could help.
- **Addressing the remaining infrastructure bottlenecks, revamping logistics and sustaining trade facilitation gains.** Investment is needed to close infrastructure gaps (ports, rail, dry ports), but so is better regulation (rail, ports). Connectivity is increasingly multi-modal, requiring integrated logistics clusters with rail and road access and warehousing and logistics services. Georgia should also upgrade the Caucasus Transport Corridor (CTC), managing it in real-time (increasingly in partnership with neighbors). Dialogue with the

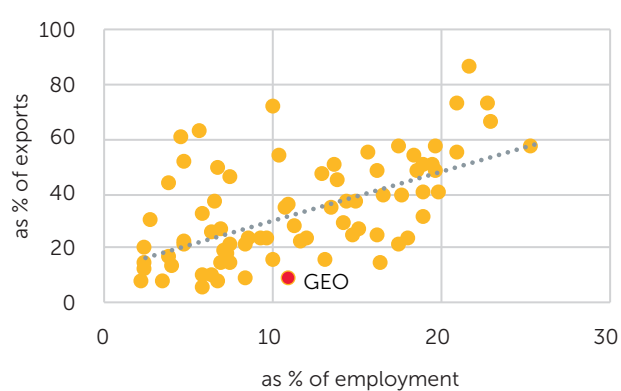
private sector can help drive investment in strategic specialized logistics facilities, such as Tbilisi as a logistics hub. Regular reviews of processes and fees in trade facilitation, (which could also involve the Competition Agency) can ensure that gains are sustained. Greater use of joint border control facilities with neighbors and functioning data

sharing mechanisms can speed up the processing of trade flow. Faster approximation of procedures and standards with the EU, including mutual recognition of Authorized Economic Operators (AEO), can also help. Similar arrangements can be explored with trade partners that run programs equivalent to the AEO.

Figure 14. Low-skilled tradeable services
Exports and employment



Figure 15. Global innovator services
Exports and employment



Source: Staff calculations based on data from (Nayyar, Hallward-Driemeier, & Davies, 2021).

Priorities for a Competitive, Connected and Capable Georgia

Sustaining long-term growth through

1. Higher savings

- Improve SOE corporate governance and introduce cost-recovery pricing in regulated sectors
- Improve financial literacy of households, especially regarding long-term decisions in education and health

2. Facilitating the structural and spatial transformation, through ...

... realizing the potential of rural areas ...

Complete land registration, promote land consolidation and adopt a policy on strategic management of state land

Promote cooperation among farmers (producer associations, cooperatives) and value chain integration (contracting, out-growing)

Increase public expenditures on research and extension services and rural infrastructure and adjust design of programs to ensure more farmers benefit from programs

... strengthening the dynamism of secondary cities ...

Attract investment through efficient use of public land and facilities, better infrastructure services and support to local businesses to upgrade quality and reach new markets

... and preparing Tbilisi for sustainable and inclusive growth.

Improve access to affordable and safe housing by strengthening land market monitoring systems, improving construction standards, supporting the retrofit of existing buildings and implementing a social housing program.

Improve public transport, by further optimizing the bus network, considering environmentally friendly alternatives (light rail, commuter rail) and increasing cost of private vehicle use

3. Making the most of the human capital, through

Reform the teaching profession by upgrading entry standards and requiring regular certification.

Focus curricula on skills demanded by the market, especially digital skills, and establish partnerships with private sector to provide options for work-based learning

4. Sustaining productivity gains, through

... stronger institutions that deliver quality public services and a level playing field ...

Improve quality of public services by linking spending to performance and accountability and reviewing functional assignments and sources of revenues for municipalities

- Lower incentives for informality by reviewing thresholds and eligibility for simplified regime taxation, and better understand bunching of firms just below VAT threshold
- Ensure markets are competitive by introducing a state aid framework in-line with EU rules and enforcing the improved competition framework (merger controls, increased fines)

... improved access to finance ...

- Digitize transactions through reviewing fees, providing basic accounts, expanding payment options and ensuring interoperability and non-discriminative access
- Improve credit information through collection of alternative data, reviewing pricing and non-discriminatory access to databases

-
- Promote asset-based financing, by adopting the legal framework and establishing a platform for factoring and reverse factoring

... as well as building managerial capacities and promoting firm-level innovation ...

- Reform business support programs (design, criteria, implementation) to promote synergies, ensure alignment with priorities (productivity, innovation, jobs, digital, energy efficiency, regional development, managerial skills) and monitoring of results

... increasing export-orientation of firms ...

- Facilitate GVC integration through assisting firm to acquire international certification (matching grants, advisory support, stronger National Quality Infrastructure) and a more efficient export promotion function.
- Develop an STRI to understand constraints to services exports, especially in priority sectors

... and better connectivity.

- Review regularly processes and charges related to trade (including steps prior and post clearance), potentially involving Competition Agency
 - Upgrade the management of the Caucasus Transport Corridor, by better linking the various transport assets (ports, rail, logistics)
 - Support investment in an Integrated Logistics Center in Tbilisi and in multi-modal facilities
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Overview



Key messages

Notwithstanding COVID-19, the last decade was a very successful one for Georgia.

The country established a strong and widely acknowledged record of economic success. In fact, with a growth rate of 5.2 percent on average in per capita terms during 2010-2019, Georgia was the second fastest growing economy in the Europe and Central Asia (ECA) region and the 14th fastest globally. As a result, GDP per capita (at constant 2010 US\$) increased from 23 percent of the EU-11¹² average at the start of the decade to 27 percent by 2019. By contrast, the convergence in GDP per capita levels in Western Balkans¹³ and Central Asia¹⁴ stagnated and actually reversed in some Commonwealth of Independent States (CIS) countries.¹⁵ In 2019, Georgia moved to upper-middle income status, and the poverty rate (measured using the national poverty line) declined to 19.5 percent from 37.3 percent at the start of the decade.

This success was underpinned by prudent economic management and implementation of a sound growth strategy. The country's policy mix included a sound

macroeconomic framework, with a robust fiscal rule, inflation-targeting monetary policy and improving financial sector regulation; an attractive business environment, with strong performance on almost all international measures of investment climate; and improving governance, with one of the lowest perceived corruption levels in ECA. These achievements emerged from the difficult first years of transition, including civil unrest, armed conflicts, high crime rates, and the loss of traditional markets and suppliers. The government was left with little choice but to carry out swift and radical economic reforms, which earned the country the brand of "star reformer".

The COVID-19 pandemic disrupted these trends, but also demonstrated the growing maturity and resilience of Georgia's economic institutions, with economic activity rebounding strongly in 2021. Georgia's strong reliance on services, especially tourism, made its economy vulnerable to the pandemic. While Georgia's 6.8 percent contraction in GDP was among the largest in ECA, the impact on living conditions was less severe, reflecting also a large and timely government response made possible by a track record of disciplined policy. As a result, despite the large economic blow, poverty increased by only 1.8 percentage points (pp) to 21.3

12 EU-11 includes Bulgaria, Croatia, Czechia, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovak Republic, and Slovenia.

13 Western Balkans includes Albania, Bosnia and Herzegovina, Kosovo, N. Macedonia, Montenegro, and Serbia.

14 Central Asia includes Kazakhstan, Kyrgyz Republic, Tajikistan, and Uzbekistan.

15 CIS includes Armenia, Azerbaijan, Belarus, Moldova, Ukraine, and the Russian Federation.

percent, and the recovery in 2021 was one of the fastest in ECA, with output expanding by 10.4 percent. Still, as economic activity continues to recover, the pandemic's impact on employment, incomes and human capital is likely to persist.

Georgia has made European integration the cornerstone of its development agenda. Following the 2014 signing of the Association Agreement (AA) with the European Union (EU), the country is making progress on approximating its institutions and policies with those of the EU, and this is reinforcing key economic, political, and social reforms. In March 2022, Georgia formally submitted its application for EU membership. Integration with the EU will open up opportunities for faster convergence in income levels with aspirational peers, but it will also place much greater demands on the Georgian government and economy (Box 1).

The past successes are commendable, and its future aspirations are equally ambitious. The government's 10-year economic plan envisages growth rates around 5 percent per annum until 2030, and further halving of the poverty rate to below 11 percent. It intends to open markets with 5.6 billion consumers by 2030 (up from 2.3 billion consumers today) and invest strongly in connectivity (both physical and digital) to underpin a robust response from exports of goods and services.

Georgia is well-placed to make the next decade as successful as the previous one, although limitations loom on the horizon. A large part of Georgia's success model will continue to deliver: sound macroeconomic policies, a business environment that imposes a light burden on business and good governance. But there are a few areas where Georgia can do better. Our analysis shows that under a business-as-usual scenario, the potential GDP per capita growth rate will slow from around 4-5 percent per annum currently to 3 percent in 2030 and further to 1.9 percent by 2050.

The country will need to address several constraints if it is to live up to its reputation as a "star reformer". Some constraints are already binding: investments may need to moderate to stabilize and eventually lower external debt; an aging population is taking its toll; and the skills deficit and mismatch are an acute problem for doing business and firm growth. Other constraints

will become increasingly more binding. The gains from structural transformation are delivering strong productivity gains but will gradually be exhausted, also because the age and skills profile of workers engaged in agriculture may limit their ability to move to other sectors. This means that productivity growth will need to rely increasingly on the ability of Georgian farms and businesses to improve their efficiency. However, the track record so far is not very encouraging. Yields in agriculture have been stagnant, while the total factor productivity (TFP) in a relatively large sample of firms has been weak. Low productivity across sectors had another important consequence: while Georgia's GDP growth was commendable, the creation of good jobs was unspectacular. Consequently, many Georgians are unemployed, and among those that are employed, a large part continue to be engaged in low-productivity agriculture. Georgians that have transitioned to other sectors are doing better, but not by much, as they are either self-employed or working in traditional low-paying jobs that are in stark contrast to their relatively high education levels. Finally, these existing and emerging constraints will need to be managed in a much more uncertain global environment. For example, the Russian war in Ukraine is the third major shock to affect Georgia's economy in a span of less than four years, after the unilateral ban on flights from Russia introduced in 2019 and the COVID-19 pandemic during 2020 and 2021.

These findings informed the choice of the topics covered in this report: i) facilitating the structural and spatial transformation; ii) increasing firm-level productivity; iii) leveraging external opportunities, and iv) improving and better utilizing human resources. The key to sustaining growth in Georgia will be to preserve robust productivity growth. Significant gains remain possible by moving more workers from agriculture to more productive sectors of the economy and addressing the corresponding spatial adjustment (chapters 1 and 2). But increasingly, growth will need to depend on improving TFP in Georgia's firms (chapter 3), an agenda that will only be fully successful if businesses are better able to exploit opportunities in external markets (chapter 4). Finally, a more active and better-skilled labor force (chapter 5) can help offset demographic trends and augment productivity. These reforms, supported by efforts to restore and beef up

savings, can make Georgia's economy more capable, more competitive, and better connected — and help sustain GDP growth rates at around 4-4.5 percent over the long-term. Progress in these areas will also bring Georgia's economy closer to the European norms (i.e., more integrated, more productive, more accountable, and more skilled) and facilitate Georgia's aspirations for closer EU integration and eventual membership. Having submitted a formal application in March 2022 for membership, Georgia will need to perform better than prospective candidates and demonstrate dedication for reform and ability to match the EU average (Sabanadze, 2021).

Undertaking transformational reforms will require a shared view among Georgians, something that has proven difficult in recent years. The share of Georgians thinking that the country is not going in the right direction has grown in recent years, while political instability was the biggest constraint identified by businesses in the 2019 Enterprise Survey — hardly the environment for tackling the far-reaching reforms needed to sustain growth. Still, Georgians showed some twenty years ago that they can manage to turn the tide despite significant challenges and save their state (Kakachia & Lebanidze, 2021). With concerted efforts and mobilizing all potential, Georgians can do that again and ensure another decade of success.

The remainder of this Overview outlines key global trends that will influence Georgia's trajectory, followed by brief summaries of the chapters of the CEM. Chapter 1, "Understanding Georgia's growth", aims to understand the drivers of growth in Georgia, as well as risks and opportunities, while also looking in greater detail into the implications of two of the identified global trends: i) the opportunities and challenges of digitization (Thematic Spotlight 1) and ii) energy use trends and the energy footprint in Georgia's enterprise sector (Thematic Spotlight 2). Next, Chapter 2 provides a deep dive on "Spatial transformation", the corollary of structural transformation, and provides a framework to design regional development policies that will facilitate the structural and spatial adjustments and ensure that most Georgians are able to benefit from the available growth opportunities. Chapter 3 on "Firm performance" looks at productivity trends in Georgia's non-agriculture firms and zooms in on a few economy-wide (access to finance, informality, and competition) and firm-specific (firm capabilities and innovation) factors that appear to be hampering it. With economies of scale being key for growth of firms, Chapter 4, "Connecting Georgia", looks at the extent of trade integration, as well as the challenges to connectivity. Finally, Chapter 5 on "Labor market and skills" unpacks the skills shortage and mismatch, one of the major constraints to firm operations reported by businesses.

Box 1. Going beyond association – the implications of the EU membership application

Georgians and their policy makers have had no doubts about where they see the future of the country. In a turbulent geopolitical region, EU membership is synonymous for many Georgians with peace and stability and an anchor for economic and political reforms. As a result, integration with the European Union has been firmly on the agenda of all governments in the last two decades. An Association Agreement (AA), combined with a Deep and Comprehensive Free Trade Area (DCFTA), was signed in 2014 and has been in force since 2016. In March 2022, the government submitted an official application for EU membership. This formally put into motion a complex and thorough process of self-assessment, screening and negotiations and regular evaluations during which the candidate country needs to reform and adapt the institutional and administrative infrastructure and align the national legislation with the 35 chapters of the EU law (*acquis communautaire*). A unanimous position of all EU member states is required at all stages of the accession process, and while some temporary adjustment periods are given to acceding countries, a key principle in the negotiations is that there will be no permanent derogation from EU rules for new EU members.

Looking at the experience of countries that have joined the EU previously, it is not surprising that Georgia wants to join the EU. The accession of each of the less developed countries that joined the EU (Greece in 1981, Spain and Portugal in 1986, Czech Republic, Estonia, Cyprus, Latvia, Lithuania, Hungary, Malta, Poland, the Slovak Republic, and Slovenia in 2004; Romania and Bulgaria in 2007, and Croatia in 2013) saw their incomes grow closer to those in more advanced EU members. This earned the EU the name of a “convergence machine”, taking in poor countries and helping them become high-income economies (Gill & Raiser, 2012). And while each EU country has its own rules and institutions in many sectors, the EU has put in place an “economic and social model” that has produced this unprecedented success, which consists of policies and institutions that foster trade and finance integration, accountable and innovative enterprises, skilled and protected labor and representative governments. Many of Georgia’s institutions provide a robust base to build on (low corruption, good investment climate, responsible economic management), and there is already reasonable integration in some respects. Yet the country still has a way to go. Trade integration is limited, firms’ capabilities are rather low, and labor is unproductive and, to a significant degree, informal.

The essential conditions that are required from all acceding countries have been laid down by the Copenhagen European Council in June 1993. These include: a) political criteria (stability of institutions guaranteeing democracy, the rule of law, human rights and respect for, and protection of, minorities); b) economic criteria (a functioning market economy, as well as the capacity to cope with competitive pressure and market forces within the EU); and c) administrative and institutional capacity to effectively implement the *acquis* and the ability to take on the obligations of membership (including adherence to the aims of political, economic and monetary union).

However, no two accession processes have been the same. The first wave of transition economies that acceded the EU in 2004 spent on average four years between the submission of their applications for membership (around 1995) and the start of negotiations (1998) and additional five years until membership. These are countries that also scored relatively high on various measures of reform efforts (e.g., the Worldwide Governance Indicators (WGI)¹ or the EBRD Transition indicators) even at the application stage. The countries that acceded in 2007 (Bulgaria and Romania) had weaker starting positions and spent five years between their membership application and the start of negotiations and further seven years until membership. Despite significant reforms, even at the time of their accession in 2007, the performance of these two countries continued to lag the earlier set of acceding countries.

1 While the WGI criteria are not the official EU membership criteria, they can be relatively easily mapped to the political, economic, and administrative criteria for EU membership.

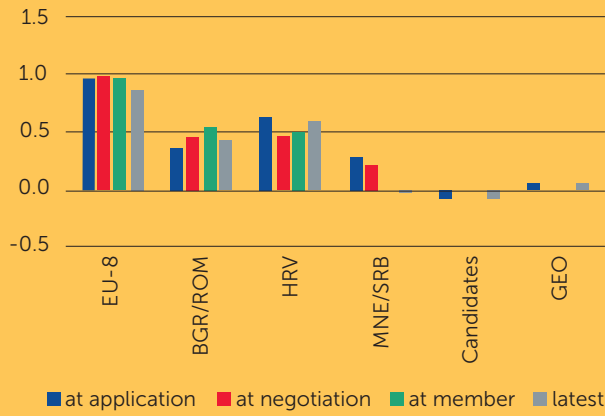
Croatia had a shorter time between application and start of negotiations (probably also reflecting its relatively better starting position) but took another eight years to join (also due to a bilateral issue with an EU member). The process has been much longer for the current wave of applicants. Montenegro has been negotiating for 10 years already and Serbia for 8 years, and neither is likely to join before 2025. Albania and North Macedonia are yet to start negotiations, more than a full decade after submitting their applications.

The difference reflects both the different challenges faced by the prospective members, as well as the changing views of EU member states towards the enlargement agenda. On the one hand, perceptions that new members have not made sufficient progress and even backtracked on some of the criteria gave rise to an “enlargement fatigue” and raised the bar for future candidates. For example, following Romania and Bulgaria’s accession, the EU introduced benchmarks for both opening, as well as for closing, negotiations for each chapter of the acquis. The methodology for later applicants was amended to ensure a stronger focus on the rule of law, fundamental rights, the functioning of democratic institutions and public administration reform. On the other hand, later stage applicants typically had weaker starting positions (proxied by lower WGI scores) and have been reforming more slowly, reflecting both the limited capacity of institutions and less than adequate commitment to the reforms, especially on political criteria. Partly because of this, convergence in GDP per capita in the candidate countries from the Western Balkans with the EU may have plateaued (Besimi & Monastriotis, 2019).

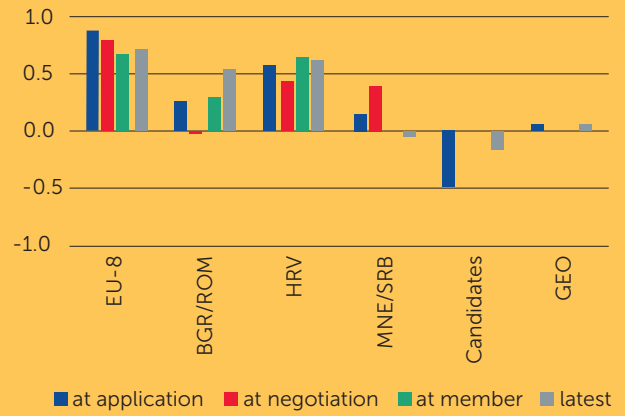
The process of formal EU accession and membership perspective itself has been a powerful tool for reform and growth. For example, Serbia and North Macedonia became attractive for multinational businesses that were trying to diversify their networks that serve the EU markets. This, as well as increased access to academic programs and exchanges, facilitated transfer of technology and know-how. It also resulted in increased inflows of assistance and improved transport connectivity along the EU corridors. Accession has also produced a push effect for tough reforms to be implemented. For example, Croatia’s repeated attempts to reform companies receiving public subsidies was only resolved once it became part of the EU accession agenda. Subsidies to these companies (shipyards, an aluminum company and several agro-combinats) were a significant drag on the budget and were not in compliance with the EU rules. Similarly, crucial reforms in anti-corruption and judiciary were pushed through in Bulgaria as part of its EU accession (Mihailov, 2006).

Georgia enters the accession process with many strengths, particularly in terms of its legislative framework. The AA was already ambitious, putting in place the framework for aligning Georgia’s institutions to those of the EU in several areas covering around 70 percent of the EU acquis (European Parliamentary Research Service, 2022). Five years into the implementation of the AA, around 50-60 percent of its requirements have been met. The country is doing relatively well in meeting the obligations for the banking sector, customs, public financial management, and the institutional infrastructure for agriculture and rural development. On paper, 98 percent of standards in Georgia are European or international; reforms in the digital area have gone beyond the requirements of the AA; the legal framework for important sectors are well on the way towards compliance with AA requirements (e.g., in energy, banking, insurance, food safety) or are being adjusted as planned (e.g., food safety, environment-related). However, there are areas where reforms have been slower. This includes judiciary reform, parts of the human rights agenda and aspects of the public administration reform. In addition, the official accession process is likely to put further focus on the implementation of the approximated legal framework, while also extending the approximation and alignment agenda to the additional areas covered by the acquis, including state aid, regulation of network infrastructure, etc.

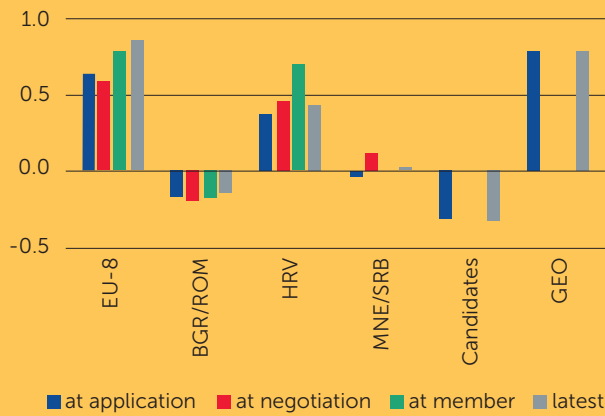
Voice and accountability



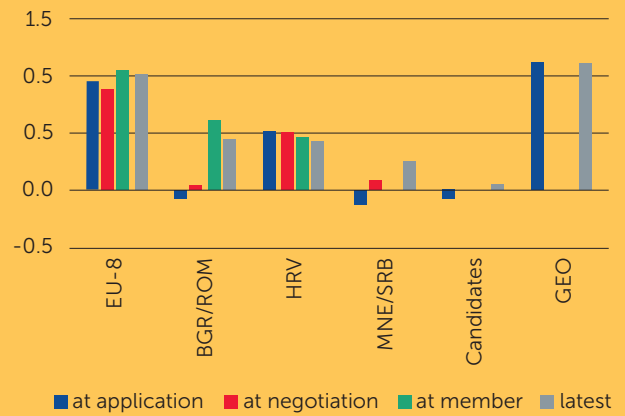
Political Stability and Absence of Violence / Terrorism



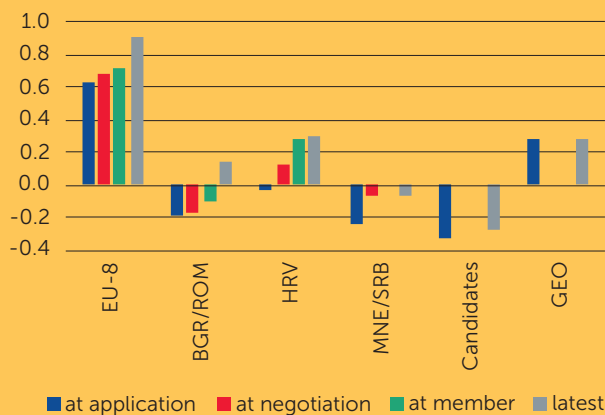
Government effectiveness



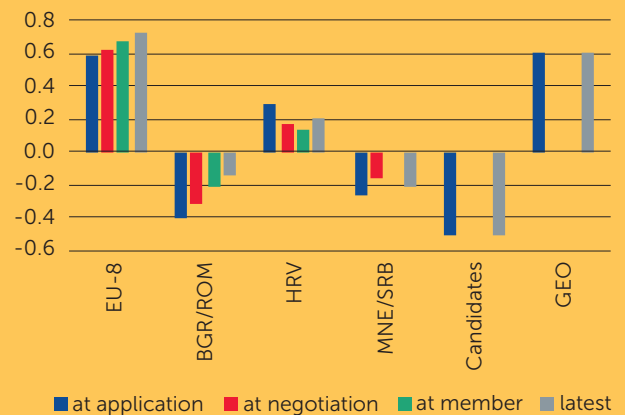
Regulatory quality



Rule of law



Control of corruption



Source: World Bank, Worldwide Governance Indicators.

Whereas Georgia is well on track in terms of legislative processes, it still faces important challenges in actual implementation. A lot of the EU-related regulatory and institutional framework will eventually open more opportunities for Georgian businesses and provide more choice and better protection for Georgian customers. However, the transition will be difficult for many sectors. To start with, it adds additional regulatory requirements for a business sector that is wary of government involvement and for whom memories of rampant corruption are still not forgotten. New functions are being added and existing ones are being reformed. In addition, compliance with the legislation incurs additional costs. For example, the introduction of mandatory third-party liability insurance has been repeatedly delayed on the grounds of the costs that it will incur for households. Furthermore, EU standards (e.g., in food safety and energy efficiency) entail high costs for Georgian businesses and households, with relatively little clarity how will these be financed. Hence, in a few instances the Georgian authorities have prolonged the timeline for enforcing approximated legislation several times (European Parliamentary Research Service, 2022), while in other cases the regulation is not enforced or has been amended (not necessarily always in compliance with the AA).

The EU integration will also likely alter Georgia's trade policy and existing trade patterns. Certainly, trade volumes with the EU will grow. Restrictions on trade with EU members will increasingly be eliminated and trade patterns will gradually shift towards the EU, as local businesses increasingly implement the necessary standards. However, Georgia will increasingly need to trade with other countries (including some of its largest partners currently) under EU rules, which could pose a challenge for some of the existing trade flows, for example, imports and re-exports of vehicles that don't meet EU homologation.

In conclusion, Georgia's EU accession provides an excellent opportunity for Georgia to continue its convergence with high-income economies, but the process will need to be carefully managed. The experiences of other countries point to the importance of political will to adopt, financial resources to implement and institutional capacity to enforce the EU requirements. Georgia's current integration levels with the EU are limited, making the efforts and costs of approximation unpopular for many. On the other hand, closer alignment will open new opportunities. A gradual and carefully planned process will increase the chances of success. Importantly, it will be critical to ensure that the process of re-regulating economic activity doesn't add excessive burden to businesses or create avenues for corruption. Additional requirements on businesses should be matched with support mechanisms to allow them to meet these requirements and access EU markets. New legislation needs to be accompanied with "regulatory impact assessments" (RIA), as well as adequate budgetary allocations. Reforms should be phased-in in line with existing capacity, while much stronger efforts need to be made to build institutions. This may mean a slower EU approximation compared to initial plans, but also one that would ensure businesses and households have sufficient support to adapt and ultimately reap the opportunities that emerge as part of the process.

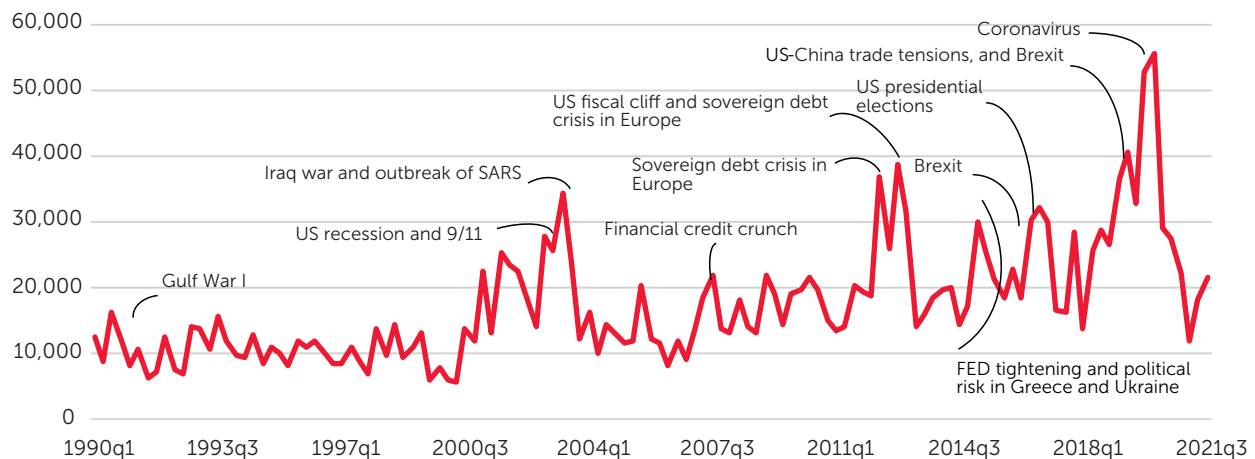
Navigating global trends to ensure another successful decade

Georgia's trajectory in the next decade will not be shaped in a vacuum: the world is more uncertain than ever and rapidly changing, with a few megatrends promising both disruption as well as opportunity. Policy makers face the significant challenge of driving a post-COVID recovery amid disruptions from the war in Ukraine, while also grappling with falling potential growth, rising debt, strains in global value chains, the changing nature of work, and climate change.¹⁶ These trends have been taking shape during most of the previous decade, but the combination of the pandemic and the war has caused a few to accelerate, while significantly increasing uncertainty (Figure 1). As a small open economy looking to increase its integration with the global economy, Georgia must carefully navigate these trends by being well prepared for the risks and on the lookout for emerging opportunities.

Global trend 1: Falling potential growth globally

Even before the pandemic, the global economy was already experiencing a decade of declining potential growth due to a combination of falling population growth and aging demographics, weak investment, and slowing TFP growth.¹⁷ By 2019, growth in global potential output had fallen to 2.2 percent, well below its annual average of 3.3 percent during the first decade of the 2000s. This decline in potential growth was broad-based, affecting three-quarters of countries, including two-thirds of emerging market and developing economies (EMDEs) (Celik, Kose, & Ohnsorge, 2020). Productivity growth fell by two-thirds in the ECA region, the sharpest fall in any EMDE region, between the early 2000s and 2019 (Dieppe, ed. 2021); in Russia, for example, it has been close to zero in recent years, whereas in Turkey, productivity growth fell by more than half following the global financial crisis. Pre-pandemic

Figure 1. World uncertainty index



Source: IMF

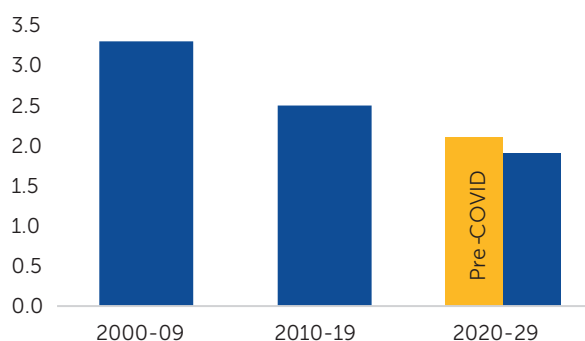
Note: Computed by counting the percent of word "uncertain" (or its variant) in the Economist Intelligence Unit country reports. A higher number means higher uncertainty and vice versa.

¹⁶ This is not an exhaustive list of all challenges, but some that have the potential to be quite disruptive and re-shape the next decade. In addition, the world economy and Georgia, are facing spiraling trade costs and inflationary pressures that have not been seen for decade. While the prevailing consensus appears to be that these are expected to subside by 2022, prolonged disturbance cannot be ruled out.

¹⁷ Potential output is the level of output an economy can sustain at full capacity utilization and full employment. It is a function of labor, the capital stock, and total factor productivity, which is itself determined by technology and factor allocation efficiency.

trends in fundamental growth drivers suggested that annual average potential output growth would slow by 0.4 pp globally over the next decade (World Bank, 2021). The pandemic may have further deepened the expected slowdown by an additional 0.3 pp per year (Figure 2), with losses concentrated among people who are already disadvantaged, making it harder for countries to return to inclusive growth after the shock recedes.

Figure 2. Estimated impact of the pandemic on global potential growth (in percent)



Note: Aggregates of production function-based potential growth estimates calculated using real U.S. dollar GDP at 2010 prices and market exchange rates. Shaded area indicates pre-COVID baseline. Sample includes 30 advanced economies and 50 EMDEs.

Periods of global economic downturns also make trade and political tensions, geopolitical risks and conflicts more likely. The war in Ukraine will exacerbate the slowdown and undo much of the region's recent progress at recovery from the pandemic. The immediate consequences of the war in Ukraine will all hurt growth and include lowered exports of goods and services, increased inflation, as well as undermined investor sentiment. But beyond this, existing global financial, trade and transport arrangements could also be disrupted, which will further fuel uncertainty and undermine the longer-term outlook. Other hotspots in the broader region could also flare up, as existing security and economic arrangements come under threat. That said, some opportunities may also open, including in making Georgia a more attractive destination for companies moving operations from affected countries and making the region a more competitive transport route for the Europe and China trade.

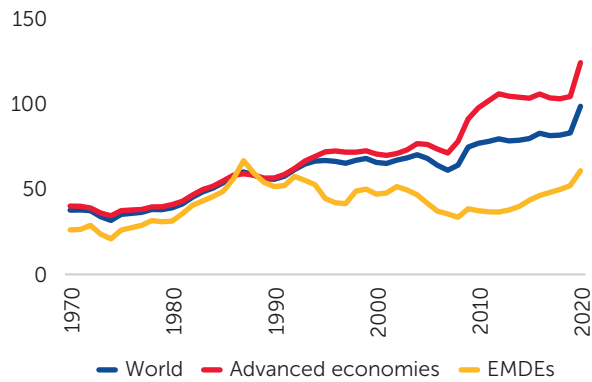
The implications for Georgia could be significant, with risks but also potential new sources of growth. Lower growth in major trading partners will reduce external demand, remittances, and capital inflows. However, downturns are not recessions. Recessions are typically synchronous and affect most economic indicators. Performance during slowdowns is more mixed (Ayhan & Ohnsorge, 2019), suggesting that opportunities for connected, capable and competitive economies will remain. Lower reliance on external savings can help reduce vulnerability, and so can greater diversification. This report finds significant potential for Georgia to increase existing exports and to expand into new products and services, as well as markets, for example, in regions where productivity growth is expected to remain robust (i.e., South and East Asia and the Pacific). Demographic trends suggest Georgia's potential growth may decline even faster than peers. To make up for this, Georgia will need to better utilize the existing labor force (including to make up for the losses from COVID-19 disruptions to the education system delivery), as well as boost productivity.

Global trend 2: Rising debt levels

The largest, fastest, and most broad-based increase in global debt in five decades started in 2010, led by EMDEs. Total debt in EMDEs reached 176 percent of GDP in 2019, driven by private debt, which rose to 123 percent of GDP. The pandemic has provided a further burst of debt accumulation atop this trend, exacerbating debt-related risks as governments and firms borrowed heavily to mitigate the impact of the pandemic. Among EMDEs, government debt is estimated to have increased by 9 percent of GDP in 2020, its largest increase since the debt crisis of the late 1980s (Figure 3). Private sector debt is also estimated to have risen sharply as firms deal with the fallout of the global recession. The rapid increase in debt is a concern, given how previous waves of debt ended – about one-half of more than 500 episodes of rapid sovereign and/or corporate debt accumulation in EMDEs since 1970 were associated with financial crises (Figure 4) (Kose, Nagle, Ohnsorge, & Sugawara, 2021).

Risks from high debt in many countries have been mitigated by low borrowing costs, but rising global interest rates may reveal vulnerabilities among EMDEs.

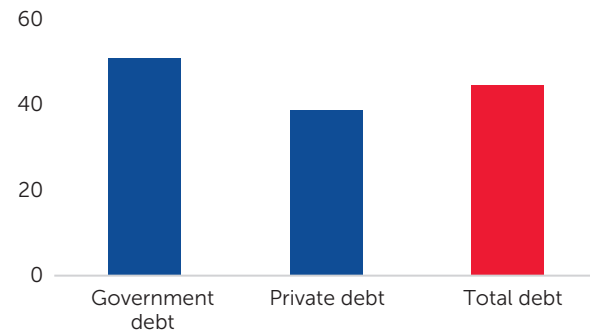
Figure 3. Government debt
In percent of GDP



EMDEs = emerging market and developing economies. Aggregates are calculated using current GDP in U.S. dollars as weights. Data for 2020 are estimates.

On a global level, borrowing costs have been trending up as inflation picks up and central banks around the world, including in Georgia's neighborhood, have tightened monetary policy. Combined with elevated geopolitical uncertainty, this has contributed to financial market volatility, with capital outflows and currency depreciation in some EMDEs. Against this background, many borrowers would struggle to finance fiscal and current account deficits if investor sentiments were to deteriorate suddenly. Underdeveloped capital markets in many EMDEs pose risks to financing in the event of tightening in global financial conditions (IOSCO, 2020), given that investor appetite for EMDE debt has proved sensitive to perceptions of risk, domestic inflation pressures, and the return on safe assets. Globally, bankruptcies are rising as credit conditions tighten, which is likely to result in substantial credit losses that will need to be absorbed (Banerjee, Cornelli, & Zakrajsek, 2020). Georgia's debt levels appear sustainable under most plausible scenarios; however, balance sheets are somewhat stretched and exposed to risk due to large foreign currency liability exposure. Rebuilding buffers will be key for preparedness, while progress on developing domestic capital markets and de-dollarization can further help.

Figure 4. Debt accumulation ending in crises
In percent



Financial crises as defined by Laeven and Valencia (2020).¹⁸ Sample includes 267 episodes of government debt and 280 episodes of private debt in 100 EMDEs over 1970-2019.

Global trend 3: Strains in Global Value Chains and growing importance of services

Greater participation in global value chains (GVCs) is associated with a host of positive economic outcomes.

Firms participating in GVCs show significant gains in productivity—a 1 percent increase in GVC participation is estimated to boost per capita income by more than 1 percent, five times the gain from standard trade (World Bank, 2020b). GVCs are also linked to employment growth and reduced poverty. However, even before the spread of the pandemic, the growth of GVCs had already slowed. GVCs' share of global trade peaked at just over 50 percent prior to the global financial crisis and slipped thereafter as trade liberalization efforts stalled (Figure 5). GVCs were further strained by international trade tensions, disruptions from the pandemic and associated lockdown measures, and most recently, the war in Ukraine and associated sanctions.

The desire of companies to increase the reliability of their supply chains can lead to a reconfiguration of the existing GVCs.

Repeated negative shocks could lead companies to consider reshoring of operations. However, previous experience suggests that GVCs are typically more reshaped, rather than reshored, with

¹⁸ An episode of rapid debt accumulation is defined as a period during which the debt-to-GDP ratio rises from trough to peak by more than one (country-specific) ten-year rolling standard deviation. The trough-peak years are identified with the algorithm in Harding and Pagan (2002).

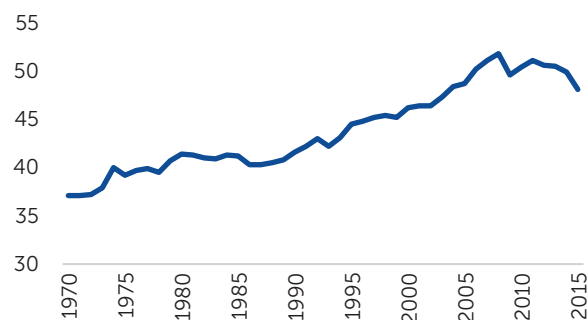
companies looking to increase the geographic diversity of inputs, and therefore the robustness of their supply network. In other words, despite the additional costs, the case for international trade, through differences in comparative advantage, specialization, and economies of scale, remains strong. Georgia has struggled to integrate in GVCs, despite its trade openness and good business environment, and the reshaping of GVCs provides an opportunity to catch up. When considering potential locations to invest, the large multinationals that form the backbone of most value chains place a high premium on a predictable and efficient legal and regulatory environment, a skilled workforce, low taxes, and a level of quality of physical infrastructure (World Bank, 2020c) that would enable a seamless integration of new locations in their supply chains. While Georgia boasts competitive business conditions, its attractiveness may be undermined by considerable informality of the labor force, shortages of skilled workers, high transport costs and limited logistics offerings. The EU accession process has the potential to make Georgia more attractive to foreign investors even during the negotiations stage, in line with the experience of current candidate countries (e.g., Serbia, North Macedonia).

Over the previous decade, global services trade grew nearly twice as rapidly as trade in goods, and now accounts for nearly one quarter of global trade (Figure 6). Importantly, services increasingly share the same attributes that made manufacturing a potent force of structural transformation in a number of developing countries, i.e., services are increasingly scalable and

tradeable, prone to innovation and with strong spillovers to other parts of the economy (Nayyar, Hallward-Driemeier, & Davies, 2021). Services also have important complementarities for the manufacturing sector, with manufacturing activities receiving additional value-added by embedding services, such as customization or servicing (Ariu, Breinlich, Corcos, & Mion, 2019). Despite continued weakness in global tourism, global services trade has surpassed its pre-pandemic level, led by strong activity in the telecommunication and financial sectors. The widespread normalization of teleworking and advances in telecommunications may make it easier for firms to outsource and coordinate complex activities at a distance, opening more sectors to international competition.

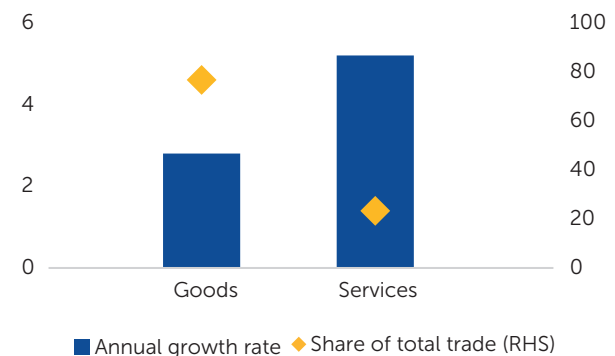
Georgia has shared in this growth in a narrow way and can capitalize on the emerging opportunities. Georgia's trade in services has grown strongly, but largely due to the growth in tourism, and mostly in the low value-added segments of the value chain. In addition, while services accounted for 70 percent of export value added in Georgia, Georgia's services are characterized by one of the shallowest linkages with other sectors (both with other services sectors and with manufacturing). At the same time, some potentially tradeable services (finance, education, digital) have a much higher share in employment compared to their share in exports, suggesting that with the right policy and institutional support, there are opportunities not only for more services to be exported, but also for services to improve the competitiveness of the rest of the economy.

Figure 5. Global value chains
As a share of global trade



Source: World Development Report 2020.

Figure 6. Exports of goods and services growth
2010-2019, in percent



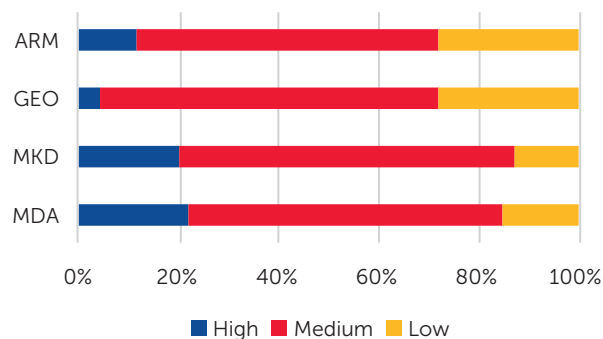
Source: World Development Report 2020.

Global trend 4: The changing nature of work

The role of digital technologies in the workplace has been steadily increasing (World Bank 2019), generating opportunities for developing countries but also carrying risks. Digital technologies allow firms to reach a wide range of people quickly and to scale up operations to a global level far more rapidly than had previously been possible. The accelerated adoption of digital services caused by the pandemic could help increase the returns to investing in human capital and bolster future productivity growth. But technologies also carry risks. Alongside shifting globalization patterns, changing technologies (i.e., advanced robotics, industrial automation, and 3-D printing) have brought the feasibility of manufacturing-led development into question (Hallward-Driemeier & Nayyar, 2018). For developing countries like Georgia, competing in the global economy now requires much more than low labor costs. In fact, automation is threatening to significantly alter jobs and make some occupations obsolete. The benefits and risks of digitization became especially visible during the pandemic, as it helped many individuals avoid some of the economic consequences of the pandemic through telework or distance education. However, those without access to the internet or the skills needed to leverage digital technologies have been less fortunate. Moreover, the longer-term impacts of disruptions to schooling are likely to particularly affect those populations with limited access to the internet or personal computers.

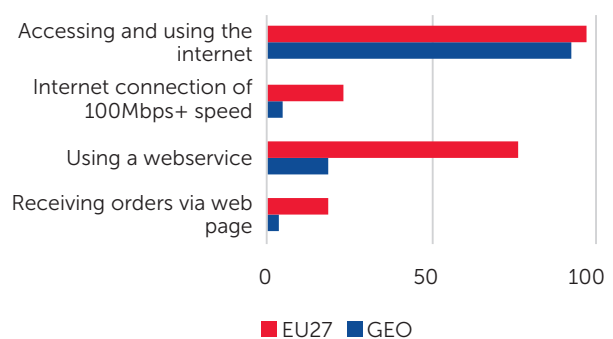
Georgia's economy is increasingly being digitized; however, businesses and households remain at risk of being excluded from new opportunities or displaced by technologies. At the macro level, ICT investments have strong spillovers into demand and jobs. One million lari of additional demand for the ICT sector was found to generate lari 1.45 million in revenues and lari 450,000 of investment in the economy, while creating 22 full-time-equivalent jobs (ISET, 2020). In addition, strong backward and forward linkages suggest a broad-based effect of digitization. However, the widespread adoption of basic ICT tools (e.g., computers and Internet) across Georgian companies has not been accompanied with the uptake of more sophisticated technologies, such as e-commerce, electronic invoicing or other software (Figure 8). Without upgrading, the Georgian economy could remain concentrated in the production of low-tech, labor-intensive, commodity-based tradeable goods, sold to small, regional markets at low margins. On the jobs side, the immediate pressures from automation are less acute, as Georgia appears to have a smaller share of its employment in professions that are more easily automated (Figure 7). Still, even basic occupations are becoming more demanding, especially in requiring digital skills, something that many Georgians are lacking. A digital agenda that will target skills development, address access and quality gaps, and facilitate digital technology adoption can ensure that most Georgians benefit from the digital transformation. The Thematic Spotlight 1 of Chapter 1 elaborates this further.

Figure 7. Risk of automation
In percent of jobs



Source: World Bank analysis based on STEP
Note: High risk of automation: probability > 70%; medium risk: 30% - 70% probability; low risk: probability < 30%.

Figure 8. ICT use by businesses
In percent of firms



Source: Geostat 2019; Eurostat 2019.
Note: Numbers are not fully comparable: for Georgia all firms with workers; for EU firms with more than 10 employees.

Global trend 5: Climate change and the energy transition.

Climate change is increasingly disrupting both ecosystems and economies. The effects of a changing climate could push between 68 and 132 million people into poverty within the decade, adding to the toll from the pandemic and slowing potential growth (World Bank, 2020f). Many categories of extreme events are becoming more frequent, with the poor suffering disproportionately from changes in agricultural and fishing yields, on which their livelihoods predominantly depend.

Reducing carbon emissions will require the world to shift from a reliance on fossil fuels toward greater use of renewable energy. Global efforts at both climate change mitigation and adaptation are critical and will remain so for a long period to come. Many countries and companies have announced commitments to achieve zero-carbon by 2050. This transition now extends beyond the energy sector to other sectors, including agriculture, industry, and transportation, which will also need to reduce emissions. The energy transition will have significant implications for the demand for different commodities, including reduced demand for fossil fuels, particularly coal, and increased demand for the metals and minerals required for renewable energy generation. Low-carbon technology is typically significantly more metals-intensive than fossil fuel energy. Solar-generated electricity, for example, requires twice as much copper as natural gas, and wind requires three times as much (World Bank, 2017). The same is true for electric vehicles (EVs). A traditional internal combustion engine car uses around 20kg of copper, while EVs require more than four times as much. The requirement is even larger when factoring in charging infrastructure, which also requires significant amounts of copper for wiring. The transition will also significantly alter the trade environment, as countries increasingly tax emissions at the border.

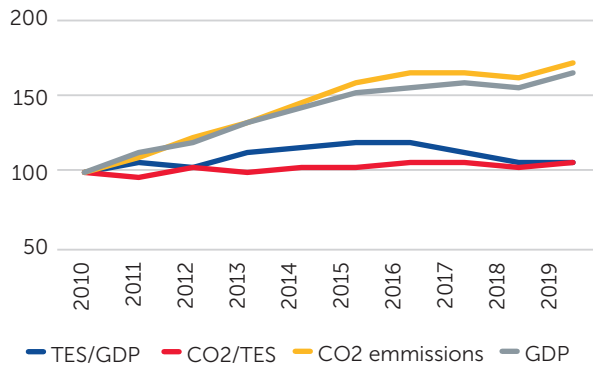
Georgia should prepare better for the climate change while exploring opportunities that the energy transition may offer. Carbon use is low in absolute terms (per capita) in Georgia, though less so when adjusted for productivity. Still, the country has made significant

commitments under the Nationally Determined Contributions (NDCs). Meeting the baseline NDC target (35 percent reduction from 1990 level by 2030) will require that the recent improvements in decoupling of economic activity from emissions are sustained (Figure 9); the more ambitious scenario would, however, require a considerable adjustment. Presently, Georgia is exposed to the impacts of climate change, especially its agriculture sector.¹⁹ Given the large share of agriculture in the economy, it will be key to make the sector climate-smart. Climate resilience in other sectors should also be supported. Investing in green infrastructure projects, offering incentives for environmentally sustainable technologies and tightening energy efficiency standards can buttress long-term growth and help adapt the economy to the effects of climate change. As a metal exporter and energy importer, Georgia could benefit from the ongoing energy transition and should explore the potential for environmentally friendly mining or producing metals and other goods with low-carbon intensity via the use of renewable energy, such as hydroelectricity. A low-emission model would allow the country to take advantage of the growing market for emissions-free or low-carbon products.

There are significant opportunities to make Georgia's enterprise sector "greener." Energy efficient companies are more productive, and the potential gains from improving efficiency are substantial (Figure 10). However, the awareness of companies about the need to increase energy efficiency is very low. Energy efficiency can be improved by: i) strengthening the reliability of the electricity network; ii) providing the right incentives (e.g., energy prices that are fully reflective of costs, as well as programs to support businesses make the required investments); iii) implementing the energy efficiency package adopted in 2020 (standards, labeling, etc.); and iv) encouraging investments in renewable energy self-generation. Building green objectives into the various business support packages will increase firms' resilience to future shocks. The EU's proposed carbon border adjustment mechanism (CBAM), which would levy a charge at the border proportionate to the carbon emitted in the production of imported goods, raises the importance of these interventions. Chapter 1's Thematic Spotlight 2 discusses these issues in more detail.

¹⁹ Notre-Dame Global Adaptation Initiative. Rank close to 1 is better (less vulnerable). Georgia's eco-systems are especially vulnerable (rank 112), followed by infrastructure (114) and human habitats (101). On the other hand, the vulnerability on food, water and health is relatively low.

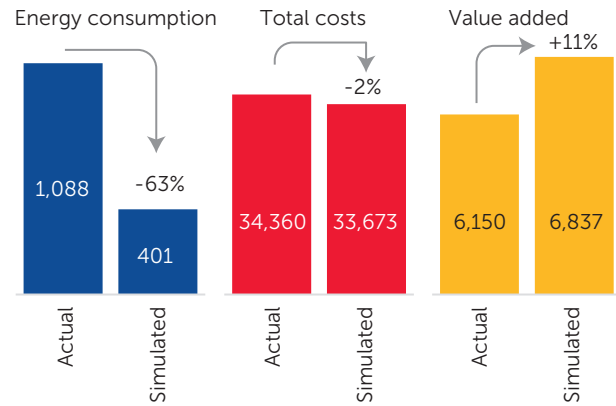
Figure 9. Energy and emission intensity 2010=100



Source: Staff calculations based on IEA data.

Note: TES is total energy supply in TJ.

Figure 10. Simulating improved energy efficiency (in lari)



Source: World Bank's calculations based on GeoStat.

Note: simulation involves increasing energy efficiency of firms below median to the median of the sector.

Synopsis

In a more uncertain and changing world, Georgia's authorities need to steer the economy towards sustaining pre-COVID growth rates, while also improving the quality of growth and allowing people to access better-paying jobs. The challenges to this are centered around the need to facilitate the structural transformation and the accompanying spatial adjustment; improve firm-level productivity, especially in sectors that have historically underperformed; strengthen connectivity (within Georgia and beyond national borders); and improve labor market outcomes.

Encouragingly, in many ways, Georgia, will have to do what it was doing before (i.e., continue to strengthen economic management, improve governance, and invest in infrastructure) as noted in the Georgia Systematic Country Diagnostic (World Bank Group, 2018). However, the agenda to make businesses more competitive so that they can create more and better paid jobs; workers capable and more mobile; and the country better connected internally and externally is significant. The remainder of this Overview presents summaries of the chapters, including the analytical findings and policy recommendations.

CHAPTER

1



Understanding Georgia's growth

Georgia has set itself an objective to become a European state, with an economy that resembles those of EU members.²⁰ Assessed against the metrics that underpinned Europe's economic successes (integration; innovation; responsible governments; productive workers; etc. (Gill & Raiser, 2012)), Georgia has plenty to build upon, but also opportunities to improve. On one hand, many of Georgia's institutions do provide a robust starting point, with low corruption, an investment climate that puts a light burden on businesses, responsible economic management, and reasonable integration in some respects. However, trade integration is limited, firms' capabilities are low, and labor is unproductive and, to a significant degree, informal. In fact, if it were to join the EU today, Georgia would be the poorest economy in the bloc, with income levels half of that of the poorest EU-member and less than 15 percent of the EU average.

When the previous growth reports for Georgia were produced in 2013 and 2014, Georgia was reforming and growing rapidly, but had limited success in creating jobs and growing macroeconomic imbalances. GDP growth averaged 6 percent per annum since the 2003 Rose Revolution, as the private sector responded to the rapid and far-reaching reforms that kept TFP (at the macro level) and gross capital formation strong. However,

progress in unemployment and poverty reduction was more modest, strong domestic demand pushed down national savings, and firm-level productivity was largely stagnant. The reports recommended more savings, reforms to boost productivity and improve export performance, as well as sector-specific reforms (apparel, wine production) to unlock the potential of the economy.

Since then, and until the COVID-19 pandemic, Georgia's economy continued to perform remarkably and addressed many constraints, even as some persisted and new ones emerged. GDP growth rates remained robust, investment had moderated but remained relatively high, savings improved, and economy wide TFP, after going through a slump during 2014-15 due to external shocks, had recovered, as structural transformation picked up pace. On the other hand, savings still fell short of investments, external debt increased, firm productivity did not improve, skills became an even more acute problem for businesses, and the integration of the country in regional and global value chains remained underwhelming. Consequently, while the Georgian economy generated strong growth, it continued to perform less well in the net creation of well-paying jobs. More polarized domestic politics and geo-politics also affected Georgia's economy, while a few potentially disruptive global trends (climate change,

20 Government of Georgia: Program for 2021 – 2024; "Towards Building a European State", February 2021.

digitization, etc.) became increasingly visible. An increasing old-age dependency ratio will progressively be a constraint – among 51 UMICs, Georgia had the fifteenth highest dependence ratio in 2018 and is projected to have the tenth highest by 2050.

The pandemic dealt a strong blow to the economy, but also demonstrated the maturity of its economic institutions. Output contracted by 6.8 percent, one of the largest contractions in ECA, also due to a relatively large share of services in output, including tourism. Still, a large (around 6-7 percent of GDP) and timely policy response limited the impact on living conditions and facilitated a robust rebound in 2021, with output expanding by 10.4 percent. However, labor market and human capital losses will probably take a bit more time to recover, with the unemployment rate still above pre-COVID levels. In addition, investment levels remain below pre-pandemic levels.

The rest of this section reviews Georgia's growth performance through a few lenses to identify drivers of growth, opportunities to build on Georgia's many accomplishments, as well as emerging challenges to growth. The investment – savings analysis aims to identify macroeconomic concerns; the structural transformation deep-dive examines to what degree growth has transformed the economy; and finally, the growth accounting framework is applied to ascertain the contribution of the various factor inputs and productivity to growth. In doing so, the analyses set the stage for the discussions in the following chapters.

An investment - savings gap has resulted in higher external debt

While Georgia doesn't necessarily have a low investment problem, it saved relatively less, translating into higher external debt levels. Investment levels, at around 27 percent of GDP on average between 2015 - 2019, exceeded most aspirational and structural peers, reflecting strong public sector investment activity and also a robust response from the private sector (both

domestic and foreign). Investment activity took a hit during COVID and has not recovered so far, with the investment rate falling to 22 percent of GDP in 2021. Gross national savings increased from 9 percent of GDP in 2010 to around 20 percent of GDP prior to COVID-19, before plummeting during the pandemic and significantly widening the investment - savings imbalance. While the public sector savings were positive during 2010-2019 (though adding SOEs will lower public savings), the improvement in gross national savings prior to the pandemic appears to have been driven by the household sector. Even so, household savings were below levels seen in aspirational peers.²¹ A corporate sector that posted relatively low profits and actually registered losses in five years between 2010-2020 didn't contribute to savings. The mirror image of a sizeable investment - savings gap is a relatively high current account deficit, which averaged around 10 percent of GDP over the last decade (though with a marked improvement in the few years just prior to the pandemic). A large current account deficit and a volatile exchange rate of the lari has kept the gross external debt of Georgia above 100 percent of GDP since 2015; this despite significant inflows of foreign direct investment (FDI).

Georgia's debt levels appear sustainable under most plausible scenarios, but balance sheets are stretched and exposed to risk due to large foreign currency liability exposure. Georgia's public debt, at around 50 percent of GDP at end-2021, is below the EMDE average but has risen around 10 pp of GDP compared to pre-COVID levels. Similarly, households and corporate debt have increased. On the corporate side, the leverage ratio (liabilities / equity and reserves) for the non-financial corporate sector increased from around one in 2013 to 1.4 by 2020²² and corporate debt exceeded 50 percent of GDP in 2020. On the household side, by end-2020, loans to households from the banking sector were 60 percent of their disposable income, compared to 31 percent in 2013.²³ A key vulnerability stems from the fact that debt (both private and public) is largely denominated in foreign currencies. In 2019,

21 A fully comparable dataset is not available, but based on data from Geostat, savings of Georgian households (income minus consumption expenses) reached around 10 percent of disposable income only in the last few years and averaged less than five percent between 2010-2020. Eurostat and OECD data put these averages around 8 percent for Czech Republic and Hungary, 14 percent for Mexico, 10 percent for Chile, 6 percent in Russia.

22 GEOSTAT, Financial Soundness Indicators on Non-Financial Corporations. However, there is a lot of volatility in the indicator.

23 NBG, Financial Soundness Indicators for client sectors. Still, as incomes increased also, debt service deteriorated only slightly.

Figure 11. Gross capital formation
In percent of GDP

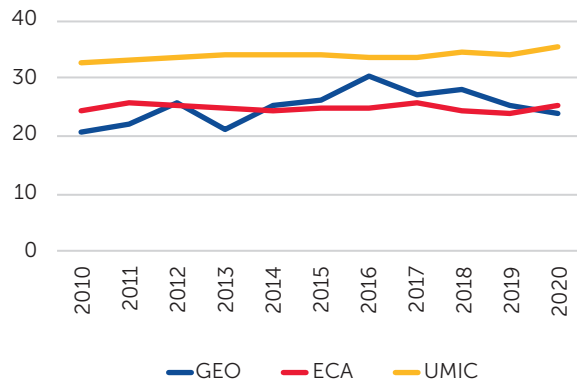
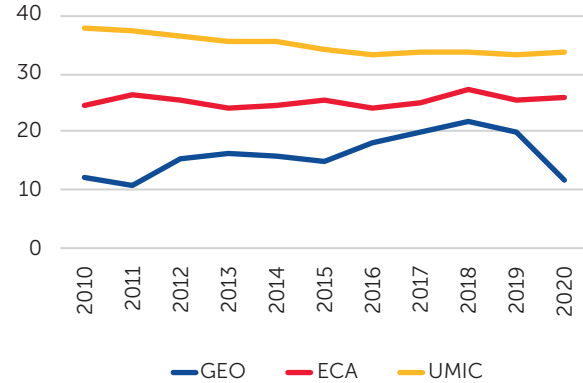


Figure 12. Gross national savings



Source: World Development Indicators.

three-quarters of Georgia's government debt and 95 percent of the country's external private sector debt was denominated in foreign currency, which increases vulnerability to currency depreciation. On one hand, this risk is mitigated partially by the fact that the country's refinancing needs over the next few years are expected to be limited; on the other, the Georgian lari has been one of the more volatile currencies in the region.

Structural transformation is making the economy more productive, but remains incomplete

Georgia's economy is undergoing a structural transformation. The share of agriculture in GDP has been on a gradual but persistent decline, with the sector contributing around 7-8 percent of GDP in recent years, similar to peers in the region. Employment in agriculture peaked much later compared to peers and, despite declining relatively fast in recent years, remains large at 19 percent of total employment.²⁴ Services are the largest sector of the economy, though their expansion appears to have plateaued over the last decade. Compared to other UMICs, Georgia's economy is more reliant on services for value-added, but less for employment.

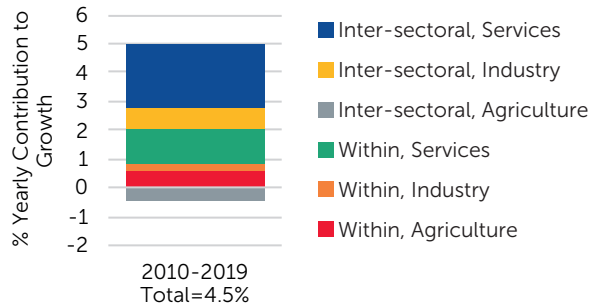
Manufacturing is probably where Georgia's structural transformation is least visible; despite strong growth, its contribution to GDP remains under 10 percent, below what would be expected given income level.

In this process, Georgia's economy is becoming more productive. Structural change, that is, the reallocation of labor from less productive to more productive sectors, contributed, on average, 2.4 pp to GDP growth during the past decade (Figure 13). In other words, almost half of the total growth in GDP per capita came from workers moving from agriculture towards services, and to some extent into manufacturing. Within-sector growth in output per worker contributed, on average, 2 pp to GDP per capita growth over the last decade, mostly from growth in labor productivity of the services sectors, followed by agriculture, then manufacturing. While within-sector growth in value added per worker has been robust, it falls short of the contribution of within-sector productivity in ECA over the last two and a half decades. In addition, based on firm-level data, analysis done as part of this report shows that growth in output per worker in a relatively large sample of non-agriculture firms²⁵ was driven largely by capital deepening, rather than more efficient use of inputs, keeping firm-level

24 The 19 percent of total employment is calculated based on new methodology, but is close to 40 percent according to the old methodology, which is more comparable to peers.

25 There should be some caution in interpreting the firm-level data to be representative of the entire economy. The initial sample of firms was from Geostat's Business Statistics survey which covers most larger companies and a sample of smaller companies in manufacturing, construction, and some services sectors. Further entries were lost due to insufficient data to compute TFP. See Chapter 3 for details.

Figure 13. Labor productivity decomposition



Source: World Bank staff based on Geostat data.

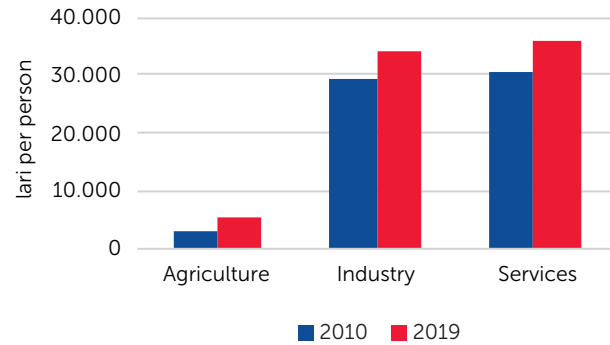
TFP performance weak (Chapter 3 on firm productivity). Similarly, agriculture yields have not improved markedly over the last decade (see Box 2 of Chapter 1).

While advancing, Georgia’s structural—and associated spatial—transformation remains incomplete. This means that many Georgians remain in rural areas and engaged in low productivity agriculture.²⁶ Many of these workers have to rely on transfers and irregular off-farm jobs or migration to make a living. This is also because urban areas have not provided the necessary dynamism to absorb more of the agriculture labor – in fact, most secondary cities have shrunk over time, while the economic pull of Tbilisi and Batumi is somewhat smaller compared to major urban areas in other countries (see Chapter 2 on spatial transformation).

Capital accumulation drove growth, with TFP gains coming largely from structural transformation

Capital accumulation and TFP drove Georgia’s growth between 2010-2019. Capital accumulation explained 44 percent of total growth. In other words, 2 pp of the 4.6 percent GDP growth during 2010-2019 was generated by investment (Figure 15). TFP accounted for one third of output growth (equivalent to 1.5 pp of GDP growth per annum). This strong TFP growth appears to have been

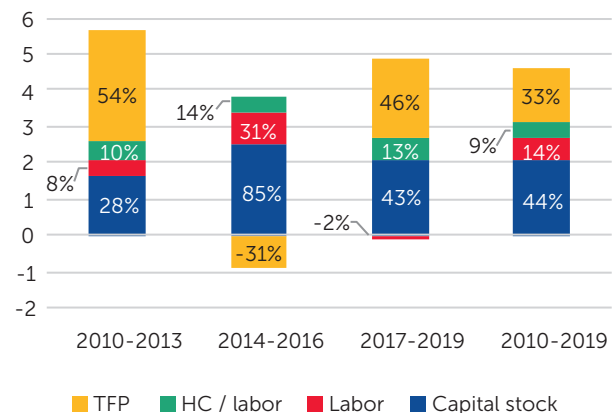
Figure 14. Differences in value added per worker



Source: World Bank staff based on Geostat data.

driven by the ongoing structural transformation away from agriculture, as among non-agriculture firms, based on firm-level data, TFP in 2019 was 6.7 percent below its 2007 level (see Chapter 3 on firm performance). Despite an improving employment rate during this period, the shrinking labor force meant that the contribution of the stock of labor to growth was negligible (0.6 pp, or 14 percent), while the small gains in the human capital per labor added around 9 percent of the observed GDP growth (0.4 pp).

Figure 15. Growth accounting results



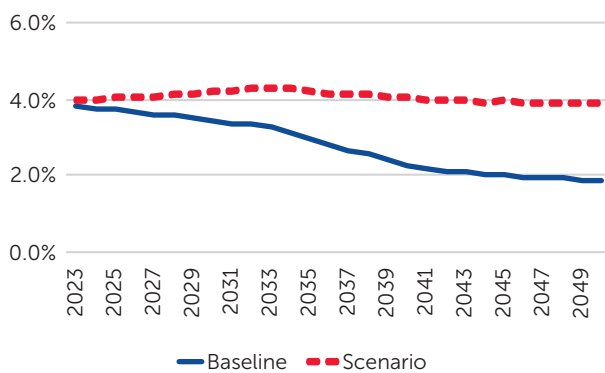
Source: World Bank staff based on Geostat data.

²⁶ Defined here as low overall value added per worker and not considering actual time worked (Fuglie et al, 2020) – indeed, the issue for agricultural work in Georgia may be more about underemployment than low productivity per se.

An agenda for strong and sustained growth would require ...

Under a business-as-usual scenario, potential growth is likely to slow, as gains from structural transformation are exhausted, macroeconomic constraints limit investment and demographics takes a toll, but these headwinds can be offset. In this scenario, investment, a key driver of past growth, will need to moderate to reduce the reliance on external savings and reduce the current account deficit. Alternatively, savings would need to be increased and maintained at levels that Georgia has achieved only for a few years before the pandemic. At the same time, TFP, another important source of growth, will slow, as the gains from structural transformation gradually fade and as an aging population further depresses potential growth. On the other hand, higher savings, more active and better educated labor and unlocking the productivity potential of Georgian firms can still deliver sustainable and strong growth (Figure 16).

Figure 16. Long-term growth
In percent



Source: WB.

Note: In the baseline TFP declines to 0.5 percent by 2040, human capital declines by 0.01 percent annual, labor market participation stays constant; under Scenario, TFP declines to 1.5 percent by 2040, labor force participation and human capital increase to high-income levels.

... restoring investment and increasing savings ...

Going forward, Georgia will need to reverse the recent decline in investment rates, and will also need

higher savings to be able to finance the investments without raising debt sustainability issues. Georgia's development needs are substantial: households need to invest in improving their living conditions and to build up their assets; firms need to invest to improve productivity; and the public sector needs to invest to close gaps in access to quality public services. These investments will need to be matched by higher savings by the government and households and a more profitable corporate sector. Global evidence that higher old age dependency negatively impacts the private saving rate (Loayza, Schmidt-Hebbel, & Serven, 2000) together with Georgia's demographics further strengthens the case for policies to promote savings.

In the public sector, buffers need to be restored, while monitoring and managing of fiscal risks should improve. Georgia's fiscal rule is robust and will see a gradual restoration of fiscal buffers. Still, with a strong recovery from the pandemic underway, it may be prudent to consider a faster fiscal adjustment. Some ease in spending pressures may arise with the unwinding of COVID-19 mitigation measures, but further opportunities to reevaluate fiscal policies are available. For example, government revenues can benefit from the review of select tax policy and administration issues, such as the threshold for simplified regime, vehicle taxation and energy pricing. In addition, with spending pressures on the rise, spending should be carefully reviewed for opportunities to improve efficiency and better target to priorities. Improved prioritization of properly-appraised public investment projects, better targeted support programs for businesses, and making better use of big-data (for example, in public procurement), can produce considerable gains. In addition, the ability to monitor fiscal risks from off-budget activities is likely to become increasingly important as Georgia starts to rely more on complex private-public engagements in service delivery. Georgia has made good progress in this area in recent years, but further efforts are needed to manage contingent liabilities, including by reforming SOEs, scrutinizing various public-private arrangements, as well as understanding climate and disaster risks.

Household savings need to increase. Too few Georgian households save, due in part to the paucity of good jobs in the economy, but also the lack of diversity of

savings options. Economic growth and job creation will help private savings – that is what happened prior to the pandemic; however, saving rates need to exceed pre-pandemic averages. Pension reform is helping to increase savings, and additional savings could be mobilized through instruments like unemployment and disability insurance or life insurance products. Improving financial literacy, especially regarding the importance of decisions with longer-term implications (education, health) can also help. In addition, anecdotal evidence suggests that people save by purchasing real estate or jewelry. Maintaining financial sector stability and reforming tax policies (increased taxation of second home, unused land, and luxury goods) may help channel these alternative savings into the financial sector. Finally, the National Bank of Georgia's (NBG) prudential measures, while avoiding buildup of risks in households that are unable to service debt, can also help savings. Already over-indebted households could benefit from the introduction of a personal insolvency framework that would allow for speedy resolution and provisions that adequately balance the availability of second chances for individuals on one hand, with creditor rights on the other.

... facilitating the structural and spatial transformation ...

Large sector differences in output per worker and persistence of a high share of the labor force in agriculture suggest that the potential for structural transformation is not fully exploited. Labor in manufacturing and services produces around seven times more output compared to agriculture (Figure 14). This means that further shifting of labor resources from agriculture will be productivity enhancing, given that around 19 percent of the labor force are still engaged in agriculture, generating only around 7-8 percent of value added. On one hand, agriculture needs to become more productive, so that the remaining farmers can have better livelihoods. On the other hand, the rest of the economy will also need to increase productivity to generate the wage differential needed to attract workers away from the agriculture sector. Addressing the structural bottlenecks to productivity growth in agriculture and the rest of the economy, as well as constraints to labor and capital mobility and connectivity, will facilitate the transformation.

Georgia's spatial economy will also need to adjust. That would mean less, but more productive jobs in the rural economy, more jobs in the urban economy (mostly in Tbilisi, but also in a few of Georgia's secondary cities), and certain other areas that would not be economically viable. While growth will be unbalanced by nature, it can still be inclusive (World Bank, 2009). This will require policies that facilitate orderly concentration (agglomeration, urbanization, migration) and equalize opportunities for everyone through economic integration (providing basic services, connective infrastructure).

... making the most of the available human capital ...

Going forward, sustaining growth will require a larger contribution from Georgia's labor force. High inactivity and unemployment rates mean that more than 30 percent of the labor force is not actively contributing—a high price to pay for any country. It will be important to increase female labor force participation (by changing social norms, providing more child and elderly care opportunities, tackling discrimination); reintegrate more of the discouraged and long-term unemployed (around a quarter of Georgians who did not work cited “gave up looking for work” as the reason (UN Women, 2018)) and the recipients of social assistance programs and other transfers. In addition, the quality of human capital should be addressed. A child born in Georgia today will be 57 percent as productive as his/her full education and health potential. While this is in line with countries at similar levels of development, it is below the ECA average (excluding high-income countries) (63 percent), and the EU average (74 percent).

Two priority areas are likely to be relevant to improve the quality of the labor force. First, given identified shortcomings in foundational skills, Georgia is well-advised to invest more in lower education levels to close access gaps in early education and build core skills in the general education system. Second, to increase participation and facilitate the school-to-job transition, greater focus should be put on vocational education and training (VET) (OECD, 2019). Beyond skills, labor market intermediaries should be strengthened to facilitate efficient matching of workers and jobs. In our estimates, increasing labor force participation and improving skills

can add around 0.4 percentage points to GDP per capita growth over the long term. This is likely to be an underestimate, as improved skills are also embedded in a strong TFP contribution. Chapter 5 of this report looks in greater details at the agenda for addressing the skills shortage and making the labor market more efficient and inclusive.

There are additional gains to be achieved from improvements in other aspects of human capital. Improving human capital will also require improving financial access to health services (out of pocket payments are still exceptionally high despite recent declines), reducing stunting (which can still be observed in 6 percent of children) and promoting healthier lifestyles (Georgians face among the highest incidence of non-communicable diseases in ECA due to high prevalence of tobacco and alcohol consumption and unhealthy diets).

... and sustaining productivity gains

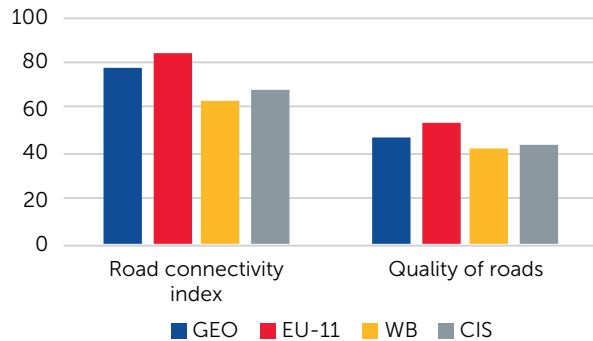
Sustaining productivity growth will be critical. While the move away from agriculture can keep on delivering for Georgia, over time, its potency in driving productivity gains will decline as the number of workers in agriculture falls and the remaining ones are unlikely to have the age profile and skill set required in the non-farm economy. Hence, it will be critical to increase efficiency across the board, meaning higher yields per hectare in agriculture and more output per labor and capital in manufacturing and services. As mentioned earlier, on this metric, the performance of Georgian firms has been more mediocre. Several stylized facts have been associated with increased productivity (see (Dieppe, ed. 2021) for an extensive discussion), including "*proximate sources*", mostly related to the quality of factors of production (capital and labor), within a "*supportive environment*" (institutions, cross-border integration, social conditions, urbanization) which nurtures "*firm-level capabilities*" (innovation, management). The rest of this section focuses on institutions, with firm capabilities, labor, urbanization and integration being discussed in subsequent section.

(Gill, Izvorski, van Eeghen, & De Rosa, 2014) define "institutions" as the mechanisms to ensure stability, deliver quality public services and regulate business

activity. Against these metrics, Georgia has already laid strong foundations upon which to build, but a significant agenda remains.

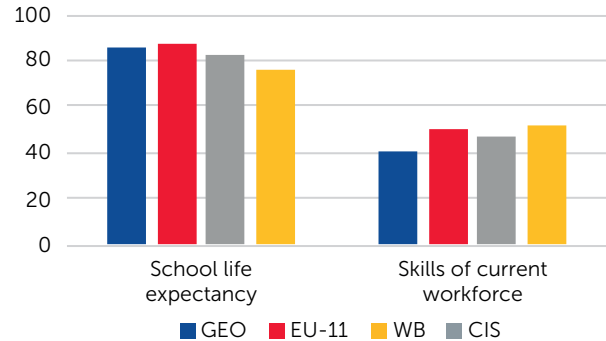
- **Georgia's institutions are increasingly capable of delivering stability, but dollarization is a vulnerability.** Georgia's macroeconomic framework – fiscal policy underpinned by a robust fiscal rule, inflation-targeting monetary policy, a flexible exchange rate and a financial sector increasingly regulated in line with good practice – has helped it to grow and to adjust to shocks. However, this was accompanied by significant exchange rate volatility, in many instances triggered by non-economic events and amplified by a shallow foreign exchange market. The volatility keeps dollarization high, contributes to price volatility and is a pressing constraint reported by businesses. There has been some progress in de-dollarizing the economy, but exposures remain large and mostly unhedged. Georgia's policies to promote de-dollarization are in line with good practice and will bring results over time. In the interim, authorities could more actively communicate information on factors affecting the exchange rate and help delink exchange rate expectations from non-economic trends.
- **While access to basic services is improving, quality of services also needs to improve.** Georgian institutions are doing a fairly good job at providing access to services. For example, years spent in school and access to some services (electricity, water) are closer to EU-11 levels rather than structural and income peers (CIS and Western Balkans). However, gaps are larger on a few services, such a road connectivity or sewage. In addition, the quality of services, which has been shown to be an enabler of productivity growth, lags. For instance, many Georgians fail to learn much in the education system, Georgian firms report more frequent electricity outages compared to peers, and twice more water is lost compared to what is supplied to customers. Some of these issues are due to underfunding, but inattention towards results and lack of accountability in spending decisions also play a role. Linking spending to performance and strengthening accountability and efficiency across the public sector will improve quality of services,

Figure 17. Access to and quality of roads
Score, on a scale from 0-100, high value is better



Source: WEF GCR 2019.

Figure 18. Access to and quality of education
Score, on a scale from 0-100, high value is better



Source: WEF GCR 2019.

supporting both productivity as well as savings. Reforming SOEs is also part of this agenda, including through introducing key performance indicators and transparent incentive systems for SOE management that are linked to SOE productivity.

- **When it comes to regulating economic activity, Georgian institutions have come a long way but can do a better job at leveling the playing field.** Supportive institutions provide a light administrative and regulatory burden while being able to control corruption. Bribery incidence and depth are

much lower in Georgia than in ECA and globally; regulations take less time to complete; goods flow faster through Georgian borders; and government effectiveness is at par with the ECA average (and above UMIC). However, Georgian institutions may be doing a relatively weaker job in ensuring a level playing field, due in part to informality and to the slow pace at which its ability to ensure competitive markets is evolving. The anchor provided by the EU DCFTA has the potential to further strengthen the ability of Georgia's institutions to level the playing field.

CHAPTER

2



**Spatial
transformation**

Georgia's spatial transformation is proceeding in parallel to its structural transformation

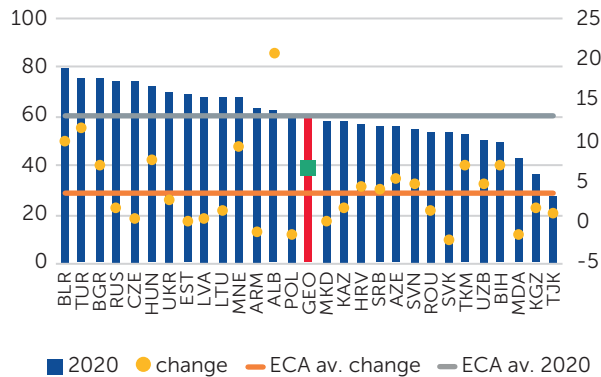
Georgia's structural transformation has also altered its spatial trends. There is now greater concentration of people in the largest cities, while the population of rural and smaller cities has declined. Following a period of de-urbanization in the 1990s, a consequence of the civil strife and the difficult economic transition, Georgia started to urbanize from the 2000s. Initially, the process was confined to just a few larger cities, but over the last decade, a few additional smaller cities have started to regain scale. In fact, since 2000, Georgia has been among the faster urbanizing countries in ECA, with the urban population reaching around 60 percent in 2020, around the average for the transition ECA countries (Figure 19). Still, most locations, including most secondary cities, remain below their scale from the start of the century (Figure 20), and a relatively large share of the population remains in rural areas with limited economic opportunities.

This economic geography has given rise to two related, but distinct, concerns among policymakers over the past decade. The first is that a significant share of Georgia's population, and most of its rural population, is engaged in low productivity agricultural activities, which

translates into continued high levels of poverty in rural areas. The second concern relates to the large disparities in economic activity and socio-economic outcomes across regions and between Tbilisi, secondary urban and rural areas. This is typically articulated by policymakers as a desire to spread out economic activity from Tbilisi to other parts of the country. It is worth noting that addressing the first concern of low productivity would not necessarily address the second concern of regional disparities. Indeed, in the short term at least, it may exacerbate it.

Looking to the future, Georgia should follow the path that most successful countries have gone through: fewer, but more productive, workers in rural areas increasingly engaged in non-farm activities and further concentration in more dense urban areas. To illustrate this, the share of agriculture employment in total employment in Georgia would need to fall by half to reach levels seen in structural and income peers in ECA; the gap with aspirational peers is even bigger. Many of these workers will need to find jobs in the urban economy, but there can also be opportunities in off-farm rural jobs. That seems to be the case in a few ECA countries that have around 40 percent of their population living in rural areas, even though agriculture accounts for a much smaller share of employment. On the urban side, Tbilisi and its agglomeration should grow to exploit the potential for agglomeration, with a few other urban areas likely to potentially have scale (Batumi, Kutaisi).

Figure 19. Urban population, by countries 2020, as % of population and change compared to 2000

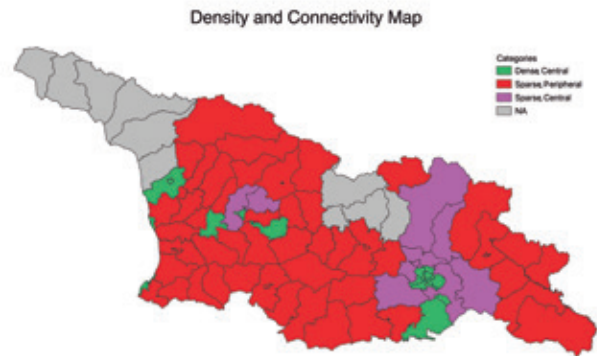


Source: WDI.

Regional disparities in GDP per capita in Georgia are high, though not extraordinary, but are likely to increase. Variation in regional GDP per capita in Georgia is above the average of newer EU member states and the countries of the Western Balkans, though a few countries do have higher differences (Figure 21). Disparities could increase further. First, as Georgia deepens its integration into regional and global markets to support faster productivity growth, spatial disparities are likely to widen, similar to the experience of the recent EU accession countries in central and eastern Europe. Second, evolving technologies and skills demands will also aggravate tendencies toward spatial divergence. Returns are likely to increase for workers with the skills to complement new technologies. This will benefit workers in leading metropolitan areas at the expense of peripheral and rural areas, as most productive firms and workers concentrate there. And while the COVID-19 pandemic and advances in digital connectivity may have lessened the appeal of urban areas, the concentration of economic activity in cities is likely to persist.

Georgia's economic geography is characterized by the poles of Tbilisi and Batumi, the small scale of other cities, and absence of non-agricultural economic activity outside of cities (Figure 22). Only Tbilisi and Adjara, home to Batumi, Georgia's second largest city and a main port, have GDP per capita above the national average. The pattern of leading and lagging regions does not necessarily show a clear link to urbanization – in fact, some of most lagging regions

Figure 20. Population change, by municipality 2010-2020

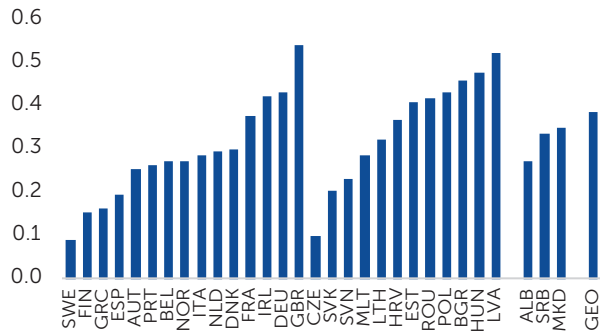


Source: Geostat.

in Georgia are home to some of its main cities (e.g., Gori in Shida-Kartli, Kutaisi in Imereti), underscoring the challenges facing secondary cities and the limited links between cities and adjacent rural areas. Spatial patterns are, however, matched by patterns in investment and business demography. Outside of the Tbilisi agglomeration (including Rustavi and parts of Mtskheta-Mtianeti) and Adjara, the firm structure is comprised mainly of SMEs and microenterprises, and FDI is almost non-existent. The limited pull from urban areas and barriers to labor mobility explains why a large part of the population remains in rural areas and engaged in agriculture.

Agriculture is a significant source of jobs, but agricultural earnings make only a limited contribution to household incomes in rural Georgia, and workers continue to gradually transition away from agriculture (Figure 23). This suggests that agriculture lacks the productivity to generate sufficient earnings for most rural households. Indeed, non-farm wages (likely from informal and possibly irregular employment) contribute a higher share of income than agriculture to most rural households. However, non-farm earnings are still a relatively small component of rural household earnings, as opportunities are limited. Small farm sizes, limited skills, weak land markets (unclear and unregistered ownership, lack of strategic management of state land) and fragmented supply chains contribute to these outcomes. Growing public support to address these key constraints has thus far had limited success.

Figure 21. Variation in regional GDP per capita 2018 or latest year



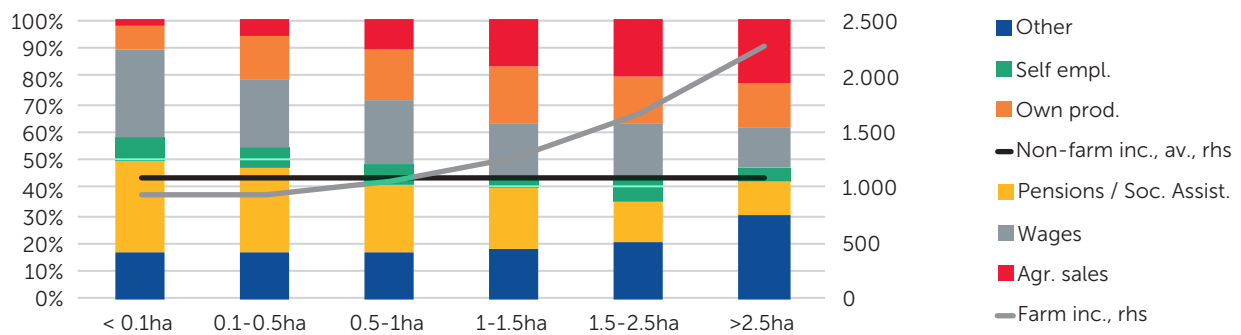
Source: Eurostat; various national statistics agencies (Western Balkans); Geostat. Note: Data presented at NUTS-3 level for EU and Western Balkans and at regional level for Georgia.

Figure 22. Nightlights intensity, by raster 2016



Source: Global Human Settlements Index; OpenStreetMaps.

Figure 23. Income of rural households (2019)



Source: World Development Indicators.

A framework for regional development seen through the lens of density and connectivity

To create the most opportunities for the Georgian labor force, growth needs to be efficient and its spatial consequences adequately managed. That means putting in place a policy framework that allows markets to identify growth opportunities and people and capital to move to be able to capture those opportunities. Such a policy framework starts with broadly universal policies to build up endowments, such as human capital (education, health, and access to basic services) and institutions, as well as policies that target market, government and coordination failures that limit growth opportunities or hinder factor mobility. Place-based investments can

be transformational for some areas; however, they are unlikely to work if distortions are not removed, the market opportunities are not there, or interventions are not properly appraised and coordinated. Growth that takes this dimension into consideration will be efficient, but it will have two important spatial consequences. First, not all areas have the potential to support sustainable economic activities. While these regions may continue to lag in terms of per capita output, redistributive fiscal policies, equal access to opportunities and migration can help equalize per capita income and consumption. This is already happening to some degree in Georgia. Second, urbanization will deliver the productivity dividends only if it is managed to ensure that cities are better connected, planned and livable. However, most

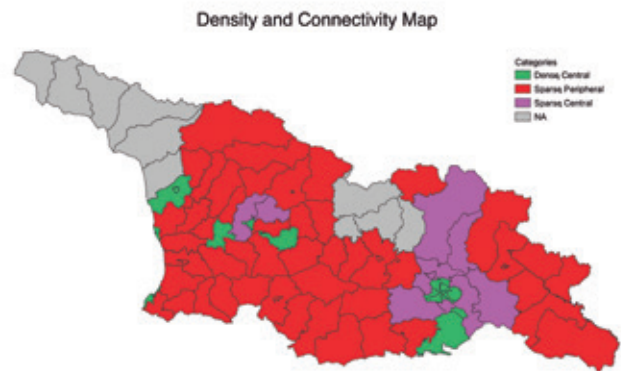
Georgian cities having a considerable unfinished agenda in this area.

Regional development policy should build on these principles, complemented with a clear understanding of the regional context and capabilities. Territorial development strategies are often set out with the objective of achieving convergence in economic outcomes across regions. And while labor and capital mobility are important for the effectiveness of regional development policies (McCulloch & Yellen, 1977), locations also differ dramatically in their starting points, in their structural conditions, and in the assets that they have available to exploit. Effective regional policy needs to begin with an understanding of the specific context, scale and nature of the potential of differential locations, as well as the forces that led to the spatial inequalities. While a variety of factors potentially impact sub-national productivity, the literature has demonstrated a few key determinants as robust across methodologies, time periods, and territories (Roberts, 2016), including urbanization and economic density, as well as market access and local transport connectivity. Density allows firms and workers to take advantage of the productivity benefits of agglomeration. Market access enables firms to lower costs of trade and inputs and take advantage of scale economies. Georgia lacks locations with significant density, and more generally, possesses some rural areas with significant structural barriers; it should accordingly take these factors into consideration when planning its regional development policy.

Bringing together density and market connectivity can help differentiate policy priorities for various regions. About 53 percent of Georgia's population, but only eight municipalities, are *densely populated, centrally located* (well-connected) regions which are not lagging (Figure 24). Properly appraised place-based interventions may make sense and would probably be best directed towards improving connectivity, urban planning and providing affordable and safe housing. For example, Tbilisi performs relatively poorly on affordability of rental prices compared to capitals in eastern and central Europe. On the other side of the spectrum, the bulk of municipalities in Georgia (60 out of 76) are *sparsely populated and peripherally located*, though

they only account for 27 percent of the population. These areas face substantial structural constraints that likely limit their potential and viability. Place-based policies should be deprioritized in favor of policies to enhance equality of opportunity, with a focus on human capital. Niche sectoral development based on territorial endowments (natural resources, tourism) may also offer opportunities, along with policies to support agricultural transformation that address fragmented supply chains and weak land markets. For example, many rural people cannot efficiently use one of the few assets they possess, as banks are reluctant to lend to the agriculture sector or consider agricultural land as collateral. Finally, a further nine municipalities across seven regions account for 20 percent of the population and are *sparsely populated, centrally located regions*.²⁷ These regions are typically located close to larger agglomerations, so the priority is generally to improve the connectivity of the region to the agglomeration.

Figure 24. Mapping Georgian municipalities by density and connectivity 2019



Source: Authors.

Quality and mobility of human capital and local institutions will play critical roles

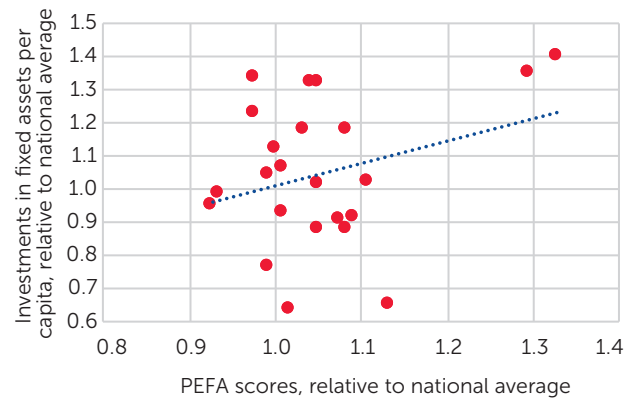
The degree to which regions take advantage of their potential depends on the quality of human capital. Availability of skills is a critical determinant of productivity nationwide, as well as at the regional level (see chapter 5 on Labor market and skills). In addition, the challenge in many parts of Georgia is as much one of quantity as

²⁷ *Densely populated, peripherally located regions* is the most common category for lagging regions in the EU, but there is no such region in Georgia.

of quality. While sharp demographic declines during the 1990s and early 2000s have abated somewhat over the past decade, low fertility and outmigration continues, with rural areas and regions outside of Tbilisi and Adjara being hit hardest. A nation-wide effort to increase the skills of the labor force and ensure universal access to quality education will improve labor mobility and benefit lagging regions, where skills are less available. Some spatially targeted efforts may also be helpful in areas with identified potential (e.g., training on tourism-relevant skills or climate-smart agriculture). Equally importantly, better functioning land markets, more efficient labor markets as well as availability of affordable and secure housing can improve labor mobility.

Local institutions also matter. Quality of local administrations has been strongly associated with regional economic outcomes in the EU (Charron, Dijkstra, and Lapuente, 2015; Rodriguez-Pose and Ketterer, 2016), due to their role in investment, service delivery, and establishing the environment for investment and enterprise operations. Despite progress, local governments in Georgia remain relatively weak, lacking capacity on the one hand and autonomy on the other. In fact, except Tbilisi and Batumi, the quality of public financial management at the local level is rather weak across the board, with poor revenue planning, weak public investment management, limited performance information on service delivery and so on (World Bank, 2018), which is likely to be impacting economic outcomes (Figure 25). Most local governments lack finances needed to support significant development efforts and have limited capacity to raise revenues, in part due to poorly developed rural land markets. And while the Local Self-Government Code defines the responsibility of municipalities to prepare spatial planning documents, most local governments neither prioritize the creation of new master plans, nor have sufficient funds and capacity to update existing plans to meet current socioeconomic realities (Asian Development Bank, 2016). More generally, the legal framework increasingly envisages a greater role for local government units (i.e., subsidiarity principle coupled with commensurate financial resources); however, lack of human, material and financial resources necessary for the exercise of power prevents local self-governments to fully and effectively execute their mandates (Government of Georgia, 2019).

Figure 25. Quality of local institutions matters 2019, cities with 10,000 population and more



Source: Staff calculations based on PEFA data from MOF and Geostat. Note: PEFA scores are average for scores on indicators that are available for all municipalities and likely to depend less on central level institutions.

An agenda for efficient spatial transformation

Completing Georgia's structural and spatial transformation will require addressing the structural factors that limit opportunities and cause frictions in the functioning of factor markets and building up of endowments. Productivity improvements and sustainable economic growth at the subnational level are impeded by: i) lack of density and connectivity (outside of a few larger cities); ii) disconnected and stagnant rural areas; iii) inefficient land markets and lack of affordable housing; iv) limited human capital; as well as v) limited capacity of local institutions. Georgia should invest to build up endowments (human capital, basic services and institutions) through broadly universal policies, and complement these by focusing on three broad priorities:

- *Realizing the potential of rural areas* by focusing on agricultural transformation, niche sectoral opportunities, and connecting to markets. Advancing land reform (registration and strategic management of state land, land taxation and efforts to promote consolidation, etc.), strengthening value chains by promoting linkages between sector participants, and reforming public support are key priorities for the agriculture sectors. Beyond agriculture, progress in sustainable forest

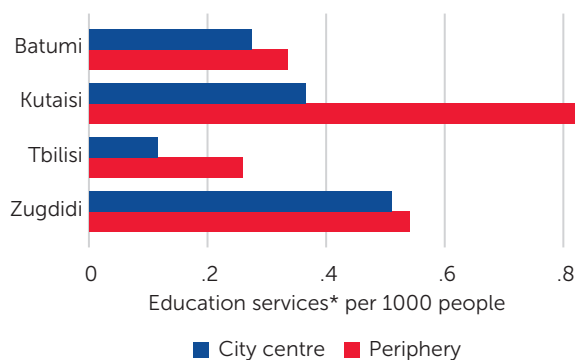
management provides additional opportunities to develop the forestry and wood-processing value chain. Tourism has delivered growth and jobs, but sustainable development in the future will require: i) strengthened land use planning; ii) managing and protecting tourism assets; iii) diversifying business opportunities around those assets (e.g., agritourism or nature-based tourism); and iv) finally, and most importantly, focus on sharing the benefits and making sure that they reach local communities. For central regions, better connectivity with large agglomerations can open opportunities for product and labor market integration and attract investment in manufacturing and services activities, though investments need to be focused on regions with clear potential to take advantage of density.

- *Strengthening dynamism and reinforcing density in secondary cities* by facilitating investment in tradeables (especially as market towns to connect rural areas to market), leveraging the potential of education institutions, ensuring basic infrastructure and services to support improved livability, and managing assets in response to structural changes. Currently, the urban system outside of Tbilisi is narrow, with most secondary cities lacking density and stagnating. Policies to attract FDI in secondary cities, effective use of public assets and performance-based support to firms in improving standards and expanding markets could help

build competitive industries in some secondary cities. Universities have been key in attracting and retaining knowledge workers; this strategy has proven critical in revitalizing some secondary cities in the European Union. Georgia has a few regional education institutions that could support the local economy through more impactful research and development (R&D) and attracting talent. Admittedly, many secondary cities will continue to shrink, and cities will need to adopt urban and economic plans to manage shrinkage; this may be an opportunity to re-invent some cities.

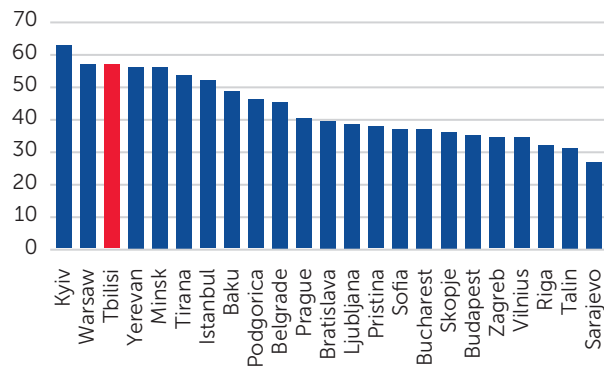
- *Preparing Tbilisi (and Batumi) for sustainable and inclusive growth* by strengthening urban planning, expanding public transport, and improving social (housing quality, schools, health facilities) and environmental (green areas, parks) infrastructure. Tbilisi's urban planning efforts needs to contain the urban expansion through sustainable infill densification. While a number of plans have been adopted to advance urban development, there is a risk that they may not be fully coordinated. Furthermore, investment in the appropriate social infrastructure, including schools, childcare facilities, healthcare, and green and public space in the center and periphery appears not to be happening in a consistent way, forcing residents to travel across districts to access services, contributing to congestion and air pollution. Like most large cities,

Figure 26. Availability of education services
Tbilisi vs major cities



Source: OpenStreetMaps.
*Colleges, kindergartens, schools, and universities.

Figure 27. Rent prices
As percent of average wage



Source: Numbeo and Livingcost.org
Note: rent price for 1 bedroom apartment outside of city center.

Tbilisi faces large and growing challenges with inclusion, especially in access to affordable housing. Finally, for a more sustainable and livable city, urban expansion should be driven more by sustainable urban planning, rather than real estate development. Recent improvements in public transport should be sustained and built upon, policies should be strengthened to deal with transport emissions to lower pollution, and green spaces should continue to increase.

CHAPTER

3



428.59

1,538.78

0.0

37,492.43

19,56.90

26,465.54

28,161.92

26,465.54

198.45



Firm Performance

Productivity has been held back by weak improvement in firm-level efficiency, and by growth of relatively less productive firms

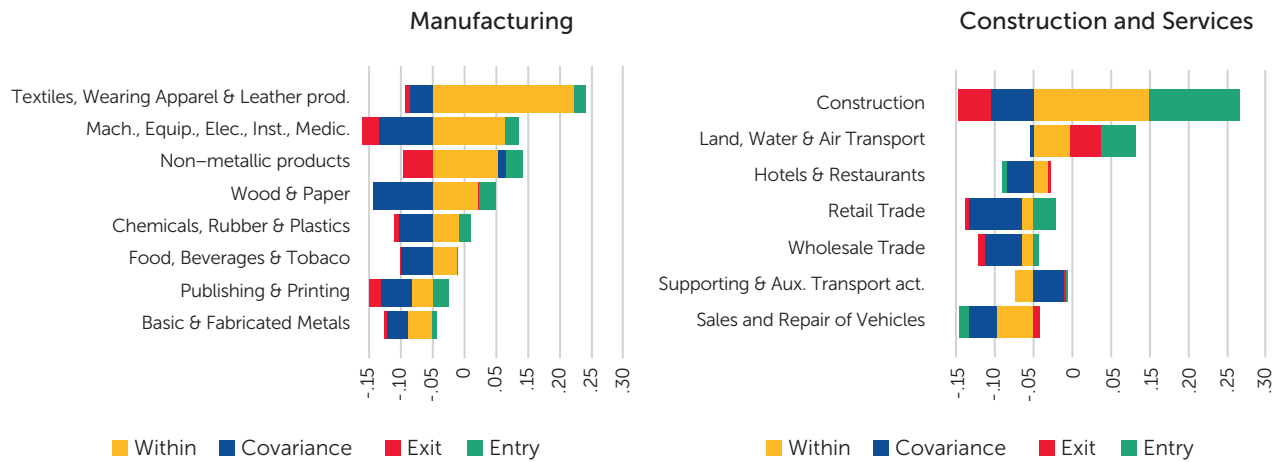
Firm-level productivity growth in Georgia in a relatively large sample of firms during the 2007-2019 period was somewhat weak, though with significant heterogeneity across sectors.²⁸ Among non-agriculture firms, based on firm-level data, TFP in 2019 was 6.7 percent below its 2007 level, with the construction sector becoming more productive, manufacturing TFP declining slightly (1.4 percent) and services TFP plummeting (Figure 28). Overall TFP performance can be driven by three channels: a “within” component measuring the gains from firms’ own productivity performance; a “covariance” (also called “between”) component measuring gains due to the change in the efficiency of allocation of resources between firms; and an “entry” and “exit” component (presented sometimes together as “selection”) measuring gains due to entering and exiting firms. Decomposing Georgia’s TFP trends along these lines shows that Georgia’s manufacturing and construction firms became more productive over

the analyzed period (i.e., reported positive within-firm productivity); but firms in services generally didn’t. In addition, except in the construction sector, it appears that resources are not being re-allocated towards more productive firms (i.e., registered negative “between” component). In both manufacturing and services sectors, the correlation between market shares and TFP levels is typically negative and detracts from overall productivity growth. The contribution of firm entry and exit has been relatively small, and not always in a productivity-enhancing manner.

Large firms dominate employment growth in Georgia, and to a lesser extent productivity growth; startups are dynamic but fail to expand after their initial growth spur. Large firms have significantly higher employment growth rates. At the same time, young firms are characterized by high growth rates, both in terms of employment and in terms of TFP; however, starting from year three this growth path quickly stabilizes, and stagnates in many cases. These findings can explain Georgia’s low contribution of allocative efficiency to TFP growth: large firms with relatively lower TFP are expanding, while small, productive firms are not growing.

²⁸ There should be some caution in interpreting the firm-level data to be representative of the entire economy. The initial sample of firms was from Geostat’s Business Statistics survey which covers most larger companies and a sample of smaller companies in manufacturing, construction, and some services sectors. Further entries were lost due to insufficient data to compute TFP. Most of the lost entries were for smaller and newer companies which could be more productive. See Chapter 3 for details.

Figure 28. Productivity growth decomposition, by sectors
2010-2019 average, 3-year differencing



Source: World Bank staff calculations based on GeoStat.

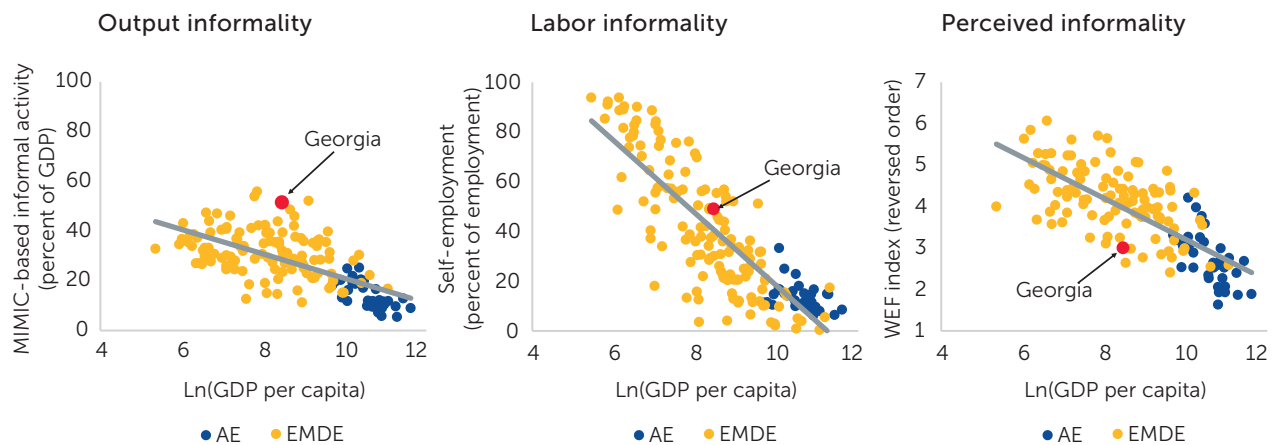
Note: Average TFP annual growth calculated at the two-digit level of NACE Rev. 3. Annual averages are arithmetic averages. Aggregate employment is the average 2007-2019.

Weak firm-level productivity and allocative efficiency suggest that, despite a good business environment, Georgian markets are not functioning very efficiently and that firm capabilities are weak. Georgia's good business environment was strongly emphasized in interviews with businesses during the preparation of the CEM. However, the limited reallocation of market shares from less productive to more productive firms, as well as the exit of relatively more productive firms, point to the importance of deepening reforms that promote better market functioning and allow more productive firms to scale up and gain a larger share of the market. A few economy-wide and firm-specific issues could be contributing to these outcomes. Challenges to firm growth may be related to access to finance, the second biggest obstacle reported by businesses. In addition, promoting formalization could help, as informality is likely to explain the fragmentation of the enterprise sector and inability to scale up (opportunities for scaling up through exporting are analyzed in Chapter 4). Competition is key, especially in small markets like Georgia and given evidence that competitive pressures, while improving, may be weaker in certain sectors. In addition, the limited contribution of "within" productivity component points to weak firm capabilities, including firm-level innovation and managerial practices.

An agenda for improved productivity, through more efficient markets and firms

Access to finance is improving, but firms still see it as a major obstacle to their operations. While banks have done a reasonably good job in providing credit to the private sector, the offering is basic while alternative sources of finance are largely absent. Better functioning land and product markets, an improved credit reporting infrastructure, greater financial inclusion (through a more formal, digital and transparent private sector and better availability of financial services), a strengthened secured transactions framework and an enabling legal framework for non-bank financial activities can help improve access to finance.

Sizeable, though declining, informality could also be hampering the opportunities to scale up Georgian companies. Various measures provide different results for the size of Georgia's informal sector (Figure 29). While output informality models put the size of the non-observed economy significantly above peers, labor informality estimates appear to be similar to peers, and in terms of perceived informality, Georgia actually outperforms most peers. Still, all measures point consistently to a decline in informality over the last two decades, coinciding with strong growth, improving

Figure 29. Informality and development: Is Georgia an outlier?

Source: (Yu, 2020).

Note: AE: Advanced Economies; EMDE: Emerging markets and developing economies.

governance and regulatory quality. As a result, less firms in Georgia appear to be competing against unregistered and informal firms. However, in the sectors where informality is more present (retail trade, non-food manufacturing), it is also a bigger obstacle for firms. Tax policy and administration reforms can help lower the incentives for informality (reviewing the threshold and eligibility for simplified regimes, understanding better the bunching of firms around the VAT threshold, etc.), while greater financial inclusion and digitizing transactions can also help.

Firm-level data point to increased competitive pressures in product markets, though competition may be weaker in some sectors. Average markups of Georgian firms show a downward trend in recent years with regression results showing that TFP, rather than market share, drives markups. However, heterogeneity in markups between firms is large, and the trend in markups in services is still driven by a small number of firms with high markups and not by the median firm. Also, sectors characterized by higher markups dispersion tend to also have higher levels of markups, indicative of imperfect market functioning. Promoting competition can improve consumers' welfare (through lower markups) and also promote employment growth. This would require better enforcement (merger control, market monitoring) of the recently improved regulatory framework, adopting a competition lens in policy-making (including in regulated sectors), stronger cooperation between regulators with competition

mandates, and adopting a state aid framework in line with EU requirements.

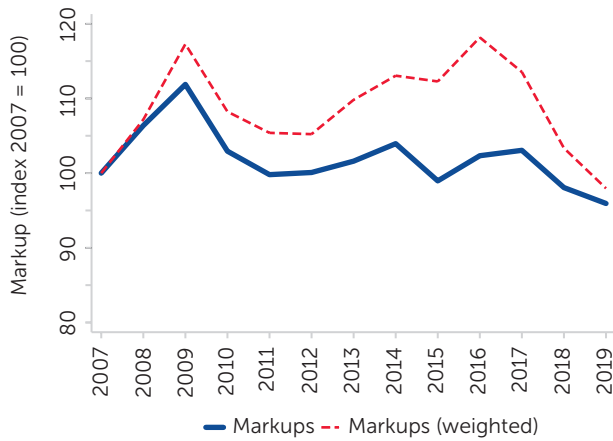
Innovation is an important driver for productivity growth; however, few firms innovate, and the innovation eco-system is nascent. To innovate, firms need to invest significant resources in machinery, equipment, and R&D, and devote time to improve the productive processes. Hence, promoting innovation also requires a diversified range of financial instruments that mirror the type of innovation and the stage of development of firms. Traditional financial institutions are often risk-averse towards early stages of innovative firms (seed, start-up, early-growth). Technical assistance/training, network support, grants and equity financing instruments are usually more suitable mechanisms to support these firms, and there is some room to reform Georgia's business support programs to focus on innovation by firms. Market size appears to be playing a significant role in promoting innovation in Georgia: evidence shows that larger firms and exporters are more likely to innovate, which suggests export promotion and lowering informality can encourage firm innovation. Innovation also requires complementarities, including human capital (Chapter 5 on Labor market and Skills), as well as a supportive innovation eco-system. Policies should be put in place to improve coordination between research and development institutions and the private sector and to ensure a sufficient supply of the human capital that is needed for innovation (engineers and scientists).

Evidence of spillover effects of innovative activities further strengthens the case for such support.

Management practices are key to improving firm performance, but many Georgian companies are poorly managed. Adopting better management practices is positively associated with employment, sales, and labor productivity (Figure 32). However, management practices in Georgian firms lag peers. In addition, the quality of management practices differs widely across companies. The low survival rates of businesses also

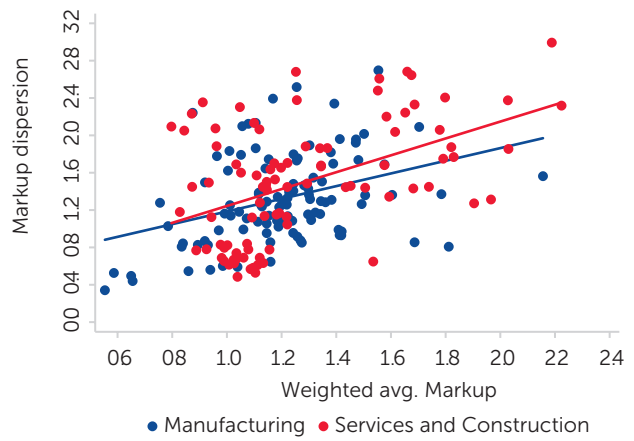
suggests that managerial skills are limited. Support programs to build managerial capabilities could have a huge impact on business performance. Enterprise Georgia, the agency implementing most of the government's business support program, is currently exploring the feasibility of managerial capabilities and digitization programs, as well as creating a local market for firm consulting services. The agency should consider combining different modalities for providing training and technical assistance to firms, in close coordination with industry participants.

Figure 30. Average markups
Manufacturing



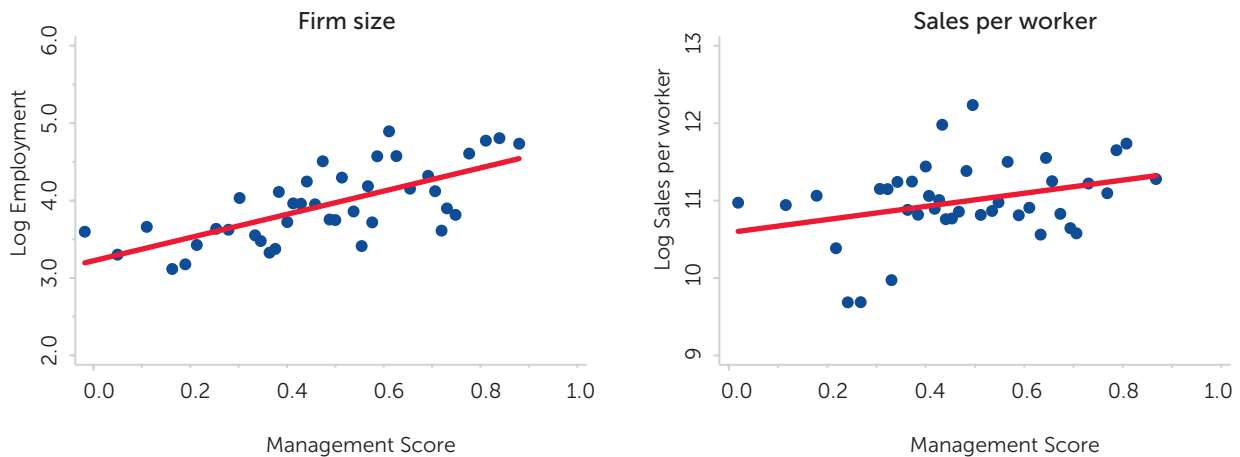
Source: World Bank's calculations based on GeoStat.

Figure 31. Average markups and dispersion
All sectors



Source: World Bank's calculations based on GeoStat.
Note: Dots represent sector at the two-digit level.

Figure 32. Firm performance and management practices



Source: World Bank's calculations based on WBES (2019).

Note: Scatter bin with 50 bins. Management score is the unweighted average of the score for each of the 8 questions in the World Bank's Enterprise Survey (WBES), where each question is normalized to a 0-1 scale, following the spirit of Bloom et al (2019). The sample contains all WBES observations in 2019 with at least 4 non-missing responses to the set of 8 questions of management practices questions and have positive employment and sales values. Sample size is 275 establishments. Dependent variable is management score (in levels).

CHAPTER

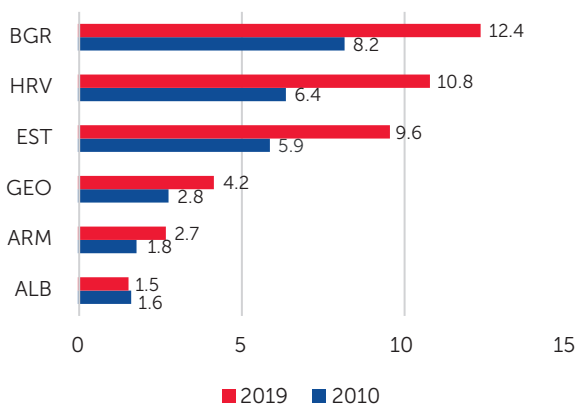
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An aerial photograph of a large stadium under construction at dusk. The stadium's seating bowl is visible, with rows of seats and structural elements. The sky is filled with a large flock of birds in flight, silhouetted against the twilight. The overall scene is bathed in the soft, blue and purple light of the evening.

Connecting
Georgia

Exploiting the opportunities from the global economy has been a common feature of all successful development episodes (Commission on Growth and Development, 2008). And it is even more important for small economies like Georgia. Openness gives exporters from small markets an opportunity to achieve economies of scale. It also makes domestic companies more efficient by facilitating access to inputs that are not available at home (or are available at higher prices or lower quality) and gives consumers more choices and lower prices. More importantly, openness allows ideas, technologies, and know-how from the rest of the world to flow freely.

Figure 33. Index of Export Market Penetration



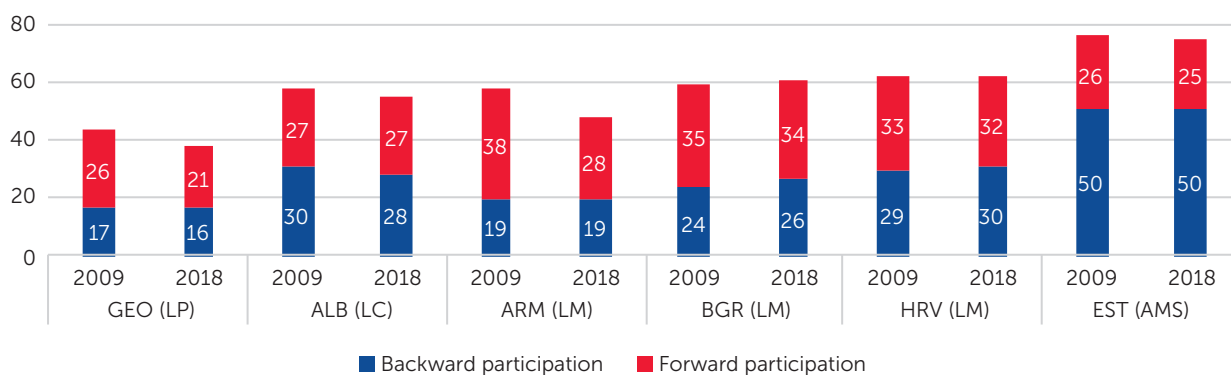
Source: Based on data from UN Comtrade / WITS.

And while recent developments in globalization and new technologies may have raised the bar for developing countries to integrate, openness will remain important for growth. Export opportunities in manufacturing will remain for competitive, connected and capable economies (Hallward-Driemeier & Nayyar, 2018), while services can provide additional opportunities for countries that can lower barriers to trade, expand use of digital technologies and build up skills (Nayyar, Hallward-Driemeier, & Davies, 2021).

Georgia is integrating, but needs a more sophisticated product offering, more open markets and more efficient export and investment promotion

Integration has been an important element of Georgia's growth story, and much potential remains to be tapped. Trade expanded briskly in the decade prior to COVID-19, and in 2019, Georgia's external trade in goods and services exceeded the expected level given its income. Georgia was also increasingly able to position itself as a supply hub for the region, with re-exports gaining a greater share of trade. Yet even though Georgia now exports more products to more markets, goods exports remain concentrated in low value-added and unsophisticated products, with concentration increasing over the last decade. The fact is, few companies export, and export relationships do not last long. Opportunities provided by deeper trade

Figure 34. GVC participation index: Georgia and comparators
2009 vs 2018, percent of gross exports



Source: Author's calculations based on UNCTAD-EORA.

Note: GVC participation categories: LP Low commodity; LC Limited commodity; LM Limited manufacturing; AMS Advanced manufacturing and services.

integration with more developed markets have not fully materialized. Indeed, Georgia exploited only 4.2 percent of the market potential of its exports structure in 2019 (Figure 33). Services generate 70 percent of the exports value-added, exceeding most peers, but most exported services are low-skilled. Also, the largest share of exported services value-added is generated within the same sector, and only 30 percent adds value to other export sectors (other services, agriculture, or industry).

To increase export sophistication, Georgian firms need to innovate, absorb technology more rapidly and oriented towards export markets. Government support programs with clear indicators to measure improvements in productivity and competitiveness can help (see Chapter 3 on Firm Productivity). This would also mean supporting firms to adopt international certification for their products and services, something that even less demanding export markets are increasingly looking for. A stronger export promotion function, including through an efficient network of foreign offices, can help potential exporters benefit from greater availability of information to overcome the information asymmetry and discovery costs associated with seeking access to external markets. Greater availability of trade financing can help more firms orient towards exports. Further gains are available through trade policy, for example, via efforts to expand markets through free trade agreements (especially with countries in the Gulf and Asia). Such efforts could be combined with more flexible rules of origin that allow more products to carry the label “made in Georgia”,

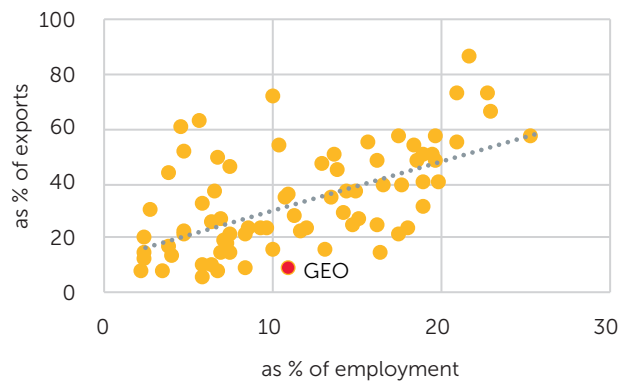
though these initiatives would need to increasingly be coordinated with the EU's foreign trade policy. And while the DCFTA envisages almost complete elimination of non-tariff barriers on bilateral trade between Georgia and the EU, in practice, a wide range of trade regulations will need to be implemented in Georgia as EU norms are transposed. The EU accession process will increase the ambition of these efforts. The associated transition costs will need to be managed.

Georgia should aim to increase participation in global value chains (GVCs), something that it has struggled to achieve (Figure 34). Implementing an FDI and export promotion strategy that focuses on efficiency-seeking FDI can help attract multinational companies (MNCs), which typically form the backbone of GVCs. These investors place a high premium on factors that will facilitate the seamless integration of new sites into their existing supply chains, as well as a predictable and efficient legal and regulatory environment, a skilled workforce, low taxes, and connectivity (World Bank 2020c). As MNCs attempt to find alternative locations for their sites in response to the sanctions over Russia due to its invasion of Ukraine, Georgia could be a strong candidate. In addition, the EU accession process can provide further assurances to investors, as it did in current candidates (e.g., Serbia, North Macedonia). Later, local supplier programs can ensure gains are more widely shared, although this would require that local firms already have capacity to absorb the more stringent requirements associated with participating in GVCs.

Figure 35. Low-skilled tradeable services
Exports and employment



Figure 36. Global innovator services
Exports and employment



Source: Staff calculations based on data from (Nayyar, Hallward-Driemeier, & Davies, 2021).

There is significant room to grow services as an export engine. Apart from tourism and transport, there have been few services on Georgia's export list. However, the relatively large share of employment in "global innovator services" and in increasingly more tradeable "social services" (e.g., health, education) compared to the relatively low export of these services indicates significant opportunities to scale up services exports (Figure 36). This will mean more exports of financial, education and a whole range of digitally provided services. Importantly, a more diverse and modern offering of services will also develop deeper linkages between services and other sectors (e.g., manufacturing), as well as capture a bigger share of the supply chain (e.g., in tourism). Global experience suggests that Georgia may want to focus on training and technology adoption to unlock opportunities for services exports. In addition, developing a Services Trade Restrictiveness Index (STRI) and analyzing how services in high potential sectors can be made more tradeable or embedded in other sectors (digital content, increasing quality of tertiary education and its international accreditation, visa policy) could also help support growth in services exports.

An agenda to improve logistics, close infrastructure gaps and sustain gains in trade facilitation

Georgia needs to be better connected. Georgia's connectivity is restrained by high transport and logistics costs and unpredictable delays. A simplified regulatory

regime and modern customs administration have been outweighed by perceptions of relatively low quality of transport infrastructure, high costs of infrastructure use and an underdeveloped logistics industry (Figure 37). Removing transport and logistics barriers is even more important for participation in GVCs, where predictability and reliability requirements are much more stringent.

Georgia is strategically located in a challenging and changing regional context. It has direct access to large markets (Turkey to the south, EU across the Black Sea and the Russian Federation to the north). It is also a logistics gateway for the Caucasus region, where multiple conflicts have resulted in border closures and trade blockades. In addition, it potentially serves as a port option for the countries of Central Asia, which are aiming to diversify their port access. Finally, the Caucasus Transport Corridor (CTC), which is part of the Belt and Road Initiative connecting Europe and China, traverses Georgia, though its multi-modality and multi-stakeholder nature affect its competitiveness. Still, the increasing challenges on the northern route in response to sanctions of Russia could increase the attractiveness of the CTC and redirect cargo flows through Georgia. More generally, the increased uncertainty of the trade and transport environment due to the pandemic, local but also broader regional conflicts, and geopolitics, is putting a premium on more diverse connectivity options. The November 2020 tripartite Peace Statement by Armenia, Azerbaijan and the Russian Federation could lead to the eventual opening of corridors that are

Figure 37. Georgia's trade facilitation and logistics needs and gaps

Source: World Bank.

Figure 38. LPI and other logistics indicators: Georgia and selected comparators (2018)

Country	Pop.	GDP	LPI Rank	LPI Score	OECD TFI	WEF GCI	WEF QPI	UNCTAD LSCI
Armenia	2.9	12.4	92	2.61	1.38	61.3	-	-
Azerbaijan	9.9	46.9	89	2.64	1.23	62.7	-	-
Bulgaria	7.0	65.1	52	3.03	1.62	64.9	4.3	7.25
Georgia	3.7	17.6	119	2.44	1.58	60.6	4.1	6.84
Lithuania	2.8	53.4	54	3.03	1.70	68.4	4.8	20.69
Romania	19.5	239.5	48	3.12	1.55	64.4	3.9	25.47
Turkey	82.3	771.3	47	3.15	1.55	62.1	4.7	57.45
Ukraine	44.7	130.8	66	2.83	1.04	57.0	3.9	26.88

Source: World Bank LPI, World Economic Forum.

Note: LPI Logistics Performance Index; LSCI – Liner Shipping Connectivity Index; WEF – World Economic Forum; GCI – Global Competitiveness Index; QPI – Quality of port infrastructure.

presently closed. A broader commitment to regional connectivity could also see the Armenia and Turkey border opening. Even if these opportunities eventually materialize, it will take time for the new corridors to match the quality of the existing connections going through Georgia. Still, over time, Georgia may see growing competition for its transit role. Improved connectivity can ensure Georgia remains the preferred transit corridor.

Infrastructure gaps are gradually narrowing. Businesses perceive the quality of the country's transport infrastructure to be on par with the Central Asia and Caucasus (CAC) peers, but below the average for the ECA region. Significant investments have helped narrow the infrastructure gap, but bottlenecks remain. Ports require not only new investment, but also a modern regulatory structure to lower costs and capture the potential benefits of transit opportunities. Road

connectivity is improving, and highway tolling could help ensure sustainable financing. The railway needs to be modernized through both additional investment and institutional reforms. Enhanced connectivity will require multi-modal services. Integrated logistics clusters with access to rail and road networks and with sufficient warehousing and logistics service provision have promoted multimodality in Europe and can do so in Georgia. Finally, Georgia should upgrade the CTC, manage it in real-time and connecting it to a network of transport and logistics centers. Presently, the corridor is a collection of disparate transport assets with limited logistics connections.

The logistics industry is probably Georgia's weakest link. With few exceptions, sector participants are small, fragmented and provide limited services of poor quality. The still relatively low trade volumes (Figure 39) keep costs of good quality logistics services high and demand low, thus reducing the attractiveness of investments in the sector. Promoting exports, especially of higher-value added products, as well as cargo consolidation (including from the broader region), can offset this disadvantage. Programs can help to upgrade skills of logistics professionals through the entrance of international logistics companies, and training plans can be introduced for road operators, as well as measures to develop transport cooperatives. Regular dialogue between the private sector and the government will be essential. This will help drive investment in developing a network of specialized facilities that will provide complex logistic services. The focus should be on strategic projects with potential transformational impact, such as: a) developing Tbilisi as a key logistic hub and trade platform, providing integrated logistics services to cover the industrial center and catchment area around the capital region, and attracting logistics chains from Armenia, Azerbaijan and Central Asia; and b) analyzing the potential of Tbilisi airport to increase air freight operations, particularly for perishables and e-commerce, as well as for services such as maintenance, repair, and overhaul (MRO).

Gains in trade facilitation need to be sustained. Regular time-release studies (covering also steps prior to and post border clearance), as well as periodic review of processes and fees (especially in areas identified as being expensive – ports, air), should be undertaken. Greater use of big data (artificial intelligence, machine learning)

Figure 39. Freight volumes in the broader region (Thicker lines signify larger volumes)



Source: World Bank.

can help improve efficiency of processes. Greater use of joint border control facilities with neighbors and functioning data-sharing mechanisms can speed up the processing of trade flow. Faster approximation of procedures and standards with the EU, including mutual recognition of Authorized Economic Operators (AEO), can help. Similar arrangements can be explored with other trade partners that run programs like the AEO.

Improving coordination within Georgian institutions and with neighbors is key for Georgia to be a transit and logistics hub and elevate its export orientation. Domestically, a consensus on the importance of strengthening Georgia's export performance can help sustain the momentum for reforms and the interagency cooperation needed. This would require a stronger public private dialogue process, which can be provided by effective functioning of the National Trade Facilitation Committee (NTFC). A review of the funding and administration of the NTFC should be undertaken. Bringing more of the national institutions involved in trade closer to the capacity of the Customs can ensure an effective single interface for business at all clearance points, as well as harmonized controls and permit systems with regional trade blocs including the EU. In addition, the plethora of transit systems would need to be implemented and seamlessly integrated. Developing standard operating procedures across agencies and private operators and with neighboring administrations to deal with future climate and health emergencies can help limit their impact on trade.

CHAPTER

5



Labor Market
and Skills

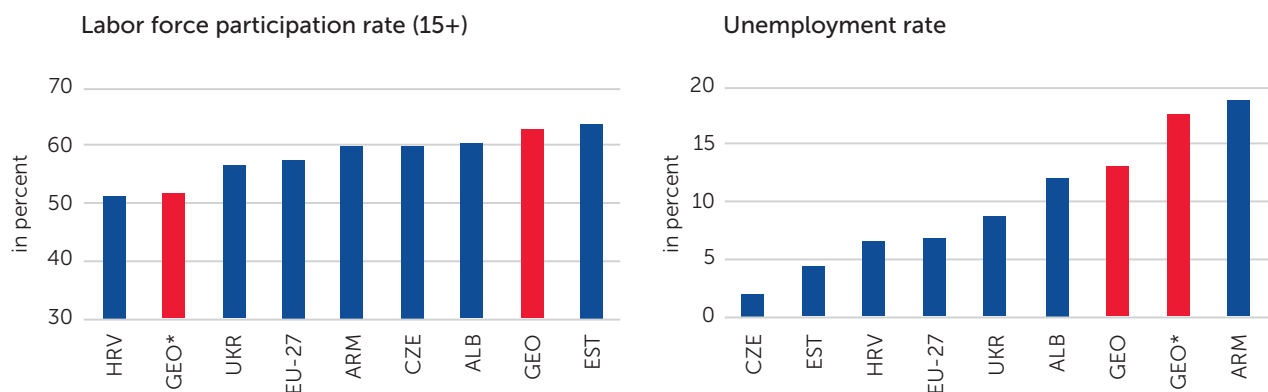
Jobs are the cornerstone of economic and social development. People work their way out of poverty through jobs. Economies grow as people get better at what they do, as they move from farms to firms, and as more productive jobs are created, and less productive ones disappear (World Bank, 2013). While a dynamic private sector is needed to create jobs, workers should have the skills, a key component of human capital, to take on these opportunities. Better human capital has been linked to growth; in fact, (Hsieh & Klenow, 2010) show that human capital accounts for around 10-30 percent of the differences in income across countries. This is probably an underestimate, as human capital also helps the operation and adoption of technologies (Acemoglu, 2005), thus supporting TFP, which itself accounts for around 50 percent of income differences. Beyond skills, an efficient labor market is needed to facilitate labor force participation and efficiently match workers with the most suitable jobs for their skillset.

Changing technologies are increasing the skills bar, even for basic occupations. In high-income countries, the reduced intensity of routine tasks is associated with the increased use of computers and other digital technologies. In developing countries, on average, two-thirds of all jobs are susceptible to automation (World Bank, 2016b). Low wages and slower technology adoption may have slowed the transition in developing countries, but still, demand for routine manual and

cognitive skills is declining (World Bank, 2019b). Instead, high-level cognitive skills (e.g., problem-solving and verbal ability) acquired through strong foundational education are seeing increasing demand, and so are technical skills. Future workers will need to more than ever rely on social and behavioral skills to work in interdisciplinary teams. The Georgian labor market is already going through this transition, and developing high-level cognitive and digital skills will be essential to help Georgians take on higher productivity jobs.

Georgia's labor market performance has been mixed

Georgia's unemployment rate, while declining, is high (Figure 40), and most jobs are in traditional, low-productivity sectors. Economic reforms have proved effective for increased growth and poverty reduction but were less successful in creation of good jobs. In fact, net job creation has struggled to keep pace with economic growth (Posadas, Makovec, Jaef, Gruen, & Ajwad, 2018), as robust job creation in manufacturing and industry was offset by shrinking agriculture employment. As a result, even though the unemployment rate had been declining since the start of the 2010's, 18 percent of the active labor force (using the new methodology) was still unemployed prior to the pandemic. The pandemic reversed some of these modest gains, with the unemployment rate edging up to 20.6 percent in 2021.

Figure 40. Labor market indicators: Georgia vs comparators (2019, in percent)

Source: ILO and Geostat for Georgia according to new methodology.

Note: * refers to Georgia using new methodology. In the EU-27, the new standards would not substantially affect labor indicators as own-account workers only represent 9.9 percent of total workers.

Many job openings remain unfilled due to skills mismatches and shortage of skills.

Most jobs that are created are basic positions that require only basic skills; however, most Georgian workers have secondary education and above. In addition to creating difficulties for employers to fill these basic positions, this also results in well-educated workers ending up in jobs requiring low skills (Figure 41), which in turn keeps returns to education low and pushes out workers with lower education. The end result is a cascading effect, with high unemployment among the workers with tertiary education, who also crowd out workers with secondary education (including in agriculture) (Rutkowski & Honorati). On the other hand, the few good jobs being created frequently remain unfilled because, in many cases, education doesn't equate to relevant skills, and occupations, even basic ones, are becoming more skills-intensive (for example, basic digital technologies and foreign languages are now required even for drivers) (Figure 42). Finally, an underdeveloped labor market information system keeps information asymmetries high and lowers mobility.

The skills shortage reflects challenges experienced up and down the education system.

Too few kids attend early childhood education; as a result, they enter the general education system unprepared to learn. Next, the general education system fails to instill good foundational skills (basic literacy and numeracy). The lack of relevance of the skills offered by VET and tertiary education, compounds the problem, leading to a shortage of technical skills, higher-order cognitive

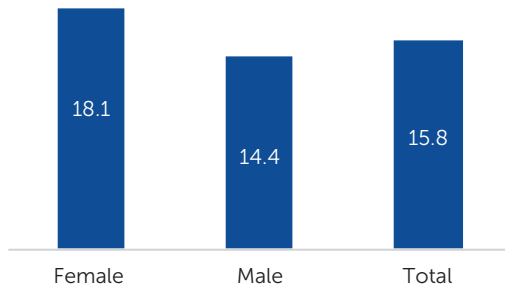
skills (such as critical thinking and problem solving), and socio-behavioral skills (such as leadership and initiative). Georgia needs better skills development mechanisms across the board to respond to the demands of the firms, but also to the emerging challenges driven by technology and globalization trends.

Unemployment and inactivity (i.e., not even looking for a job) are also due to a difficult school-to-work transition, which especially affects young women and people in rural areas.

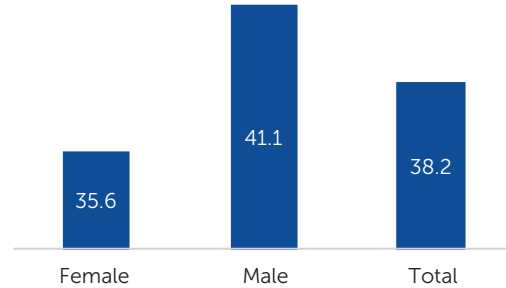
Only 40 percent of workers find jobs within six months of leaving school, leading to unemployment and inactivity. The youth (15-24 age group) unemployment rate is very high (39 percent) compared to the ECA average (16 percent), and aspirational peers (Czech Republic, 6 percent; Estonia, 11 percent). The share of young people not in education, employment, or training (NEETs) was also one of the highest among peers (Figure 43). Economic inactivity (which excludes those in education or training) is the most prevalent condition for non-employment among NEET women, whereas unemployment is the most common status among NEET men (Buitrago-Hernandez, Fuchs, & Cancho, 2019). In addition to the lack of skills which prevents graduates from being hired, the school-to-work transition is also made more complicated by job search practices that tend to rely on personal networks and may put people with better connections at a clear advantage, perpetuating the inequalities that keep certain groups out of jobs, as well as limited labor market information and employment search support.

Figure 41. Occupational mismatch (2019, in percent of total, aged 15-64)

Workers with upper secondary education working in elementary occupation



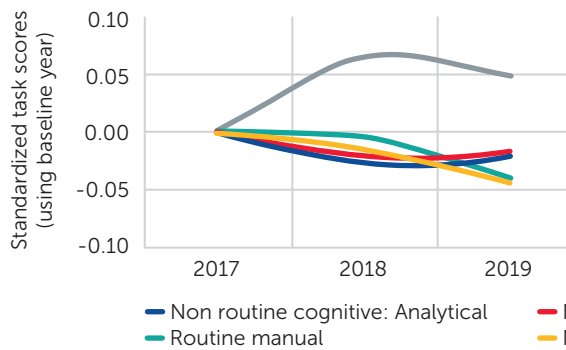
Workers with tertiary education working in semi-skilled occupation



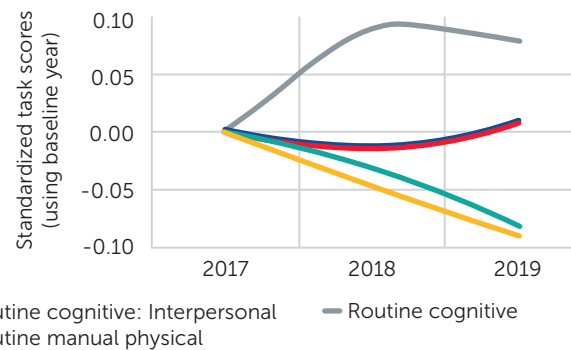
Source: World Bank Staff calculations based on LFS 2019.
Note: Excluding self-employed working in agriculture.

Figure 42. Task scores standardized against baseline year by task content measure
Change in task skill intensity indexes among workers, change in scores units standardized with base in 2017

All workers



Young workers cohorts; born 1985 and later



Source: Authors' calculations using Georgia LFS 2017, 2018 and 2019.

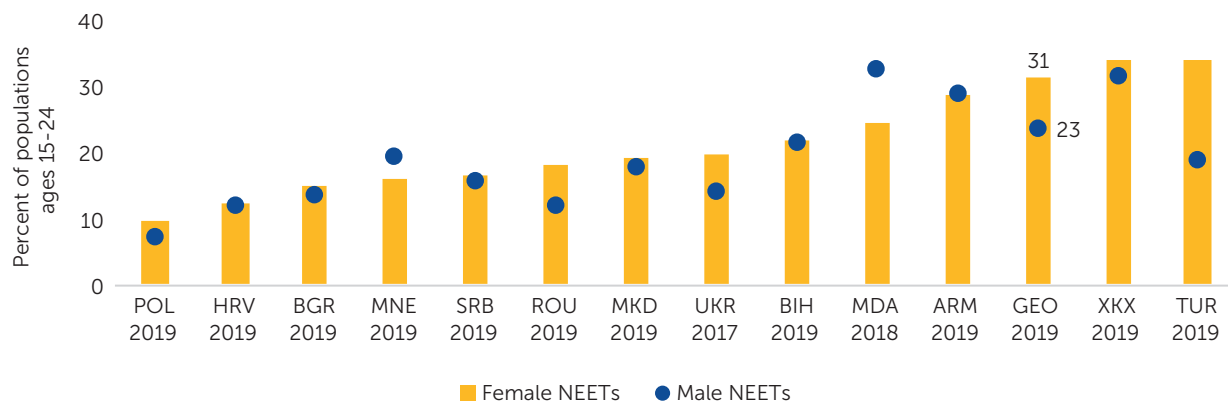
Note: Based on the approach of Acemoglu and Autor, 2011, each occupation is assigned a skill intensity value for each of the five skills (ranging from 1 to 5). Then, the weighted average across all occupations for each skill is computed based on the share in the labor force of each occupation. Results are finally standardized over time. For details on the methodology see (Aedo, Hentschel, Luque, & Moreno, 2013).

A shrinking population and large inactivity add to the challenges. High unemployment and low participation rates mean that around 30 percent of the labor force is not actively contributing to economic development. The youth, women, minorities, and vulnerable groups, such as internally displaced persons, are disproportionately affected. Many Georgians, especially women, are not actively participating in the labor market due to prevailing social norms, limited support services and an inefficient labor market. The resulting under-utilization of human capital due to low skills and inactivity is a very

high price to pay for any country, and Georgia is no exception to this.

An agenda for better skills, and a more inclusive and efficient labor market

A better functioning labor market will require more jobs, better skills, efficient matching of workers and available jobs, and greater inclusion. First, more jobs are needed to reduce unemployment and ensure that the investment in human capital is better utilized.

Figure 43. NEET rates for youth 15-24 years old

Source: Geostat LFS for Georgia, WDI for comparators.

Importantly, better jobs are needed to absorb the well-educated and would require expansion of the modern, high value-added sector of the economy. But job creation is also needed in more basic occupations outside agriculture to facilitate reallocation of labor away from subsistence farms and provide opportunities for many of the currently unemployed who are less educated and skilled. *Second*, given existing skills gaps, jobs alone will not resolve Georgia's labor market underperformance; workers need to be better prepared to take on these opportunities. *Next*, the contrast between educational attainment and employers' complaints about the level of skills points to a mismatch between labor supply and labor demand, which requires more efficient labor market institutions. *Finally*, Georgia needs to activate more of its scarce labor force.

Given the weak performance of Georgia's education sector in building foundational skills (Figure 44), an immediate area of focus should be placed on general education. With the skills frontier moving rapidly, the cost of inaction on human capital development will only go up (World Bank, 2019b). Greater enrollment in pre-school education can ensure children enter the education system better prepared – this will require more and better-financed kindergartens that provide better educational, rather than caretaking, services. While in school, having better trained teachers will be key to improving students' learning outcomes; this will require better qualified, better paid and more motivated teachers. Additional gains can be achieved

from optimizing the school network and classes and increasing instruction hours. In VET, increased investment in quality of infrastructure, equipment and instructor skills is needed. Given labor market demand and existing capacity, further increasing tertiary education enrollment may not be most efficient.

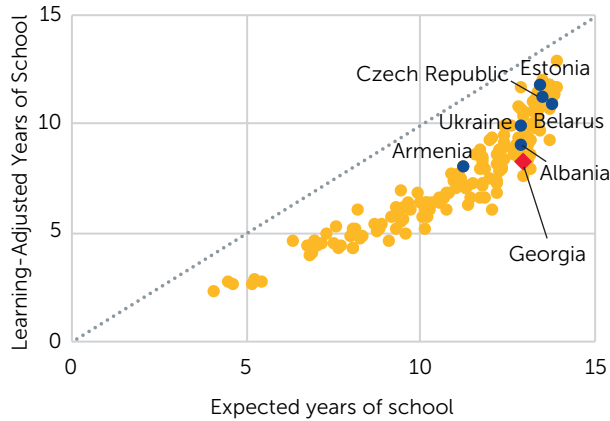
Importantly, the education systems should flexibly adjust to the changing demand for skills by employers.

Feedback from employers should be incorporated in the overall skill development cycle, from the identification of skills, to curricula design, material, delivery of training (on-the-job and classroom-based), and students' and teachers' assessments. Although the recently adopted legislative framework for VET has enabled greater collaboration between education institutions/training centers and the private sector, interaction is still limited due to low interest from the private sector and lack of funding and capacity to manage the coordination. The new Skills Agency should perform an important function in this respect, defining vocational education standards in collaboration with the public and private sectors, and fostering the provision of job-relevant skills by upscaling and diversifying vocational trainings among public providers and stimulating training by private providers.

Digital skills should be mainstreamed throughout the education system to unlock new job opportunities.

Basic digital skills are now part of the foundational skill sets of workers and are demanded by employers even for elementary occupations. Stronger digital skills are

Figure 44. Learning gap
In years



Source: World Bank.

expected to have an impact on the employability of youth, as well as productivity of small firms. In addition, more attention should be paid to transversal skills (i.e., languages, organizational skills) that are adaptable to the changing nature of jobs. The longer-term education reforms imply rethinking the role played by the general secondary education system. Given the limited demand for workers with only generic skills, secondary general education needs to be complemented by systemic options to acquire occupational or technical, job-specific skills, for example, by developing a system of post-secondary technical occupation.

Enhanced labor market information systems are needed to lower information asymmetries, inform labor market, education, and training policies, and inform budget allocations. Information on occupations and skills in demand is crucial to better align skills supply with demand. It allows educational and training institutions to better adjust program offerings and curricula to labor market needs, while helping students (prospective workers) and jobseekers to make informed career decisions and invest in skills that are in demand. To start with, more—and more frequent—statistical surveys, coupled with “real-time” labor market information from online job postings and administrative data is needed to provide up-to-date, granular data and shed light on how the demand for occupations is evolving. Next,

labor market institutions should provide stronger career advisory services, and intermediation and job matching services to reduce labor reallocation frictions for both workers and employers. To improve the quality of job intermediation services, new tools should be developed to profile and orient vulnerable jobseekers. In case of capacity constraints at the State Employment Support Agency (SESA), outsourcing can be a good option too, though SESA would need to set standards and frequently assess the providers’ performance. Analysis of big data, such as real-time vacancy data posted in private online job portals, should be part of the SESA’s methodology to identify and forecast skills in demand. Worknet’s, SESA’s e-portal for employment services, partnerships should not be limited to collaborations with public sector bodies but also should include the private sector. By establishing linkages with privately managed job portals, the government can play an important role in coordinating labor market information and ensure that all stakeholders in the labor market have accurate and timely information for decision making.

Finally, more can be done to make the labor market more inclusive. To reduce gender disparities, the Government of Georgia may consider adopting measures for pay transparency similar to those recently proposed by the European Commission.²⁹ Improvements to childcare, including early childhood education, and elderly care will be particularly crucial. In addition, tapping underutilized sources of labor supply by strengthening active labor market policies (ALMPs) (e.g., evidence-based wage subsidies, internships, work-based experience arrangements etc.) would increase economic growth and inclusion. The school-to-work transition could be facilitated by expanding work-based experience arrangements and strengthening the linkages between schools and employers (mandatory short-term internships, integration of firms’ capstone projects in curricula). The dual VET model may be an option for stronger and more systematic engagement between vocational colleges and employers.

Georgia’s pre-existing skills mismatches and high unemployment have been accentuated by the labor market disruption from the COVID-19 pandemic. While the economy is recovering, education and labor

²⁹ The proposal sets out measures, such as pay information for job seekers, a right to know the pay levels for workers doing the same work, as well as gender pay gap reporting obligations for big companies.

market losses may have long-term consequences on equality of opportunity, vulnerability, and gender gaps. Targeted policies may be needed to compensate for the learning and health losses. In addition, the pandemic may have accelerated the structural shifts imposed by technological changes (e.g., automation, digitalization). The increased use of computers and digital technologies

implies an increased demand for both basic digital skills and socio-emotional skills, which not all workers in Georgia possess. Jobs in the post-COVID phase will require investment in up-skilling workers, broad improvements to foundational human capital, as well as enhanced employment services to facilitate labor reallocation.

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