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Smuggling – Plague of the Georgian Economy

Among the many difficulties facing Georgia, the problem of smuggling is one of the most menacing for the country's economy. Smuggling has been flourishing along the borders of Georgia's two secessionist republics, South Ossetia and Abkhazia. The level of smuggling has grown for the past five years to the extent that it poses a threat to Georgia's national security.

To explore the causes and effects of smuggling on Georgia's economy and society in general, the TraCCC Georgia Office conducted extensive research on the matter. This research was

carried out by Alexandre Kukhianidze, Senior Researcher at TraCCC, Alexandre Kupatadze, Junior Researcher at TraCCC, and the Chair of the Parliamentary Budget Office of Georgia, Roman Gotsiridze. The team conducted comprehensive research on the problem of smuggling through the secessionist Georgian territories of South Ossetia and Abkhazia, zones of armed conflicts in 1990-1993 that are currently outside the jurisdiction of the Government of Georgia.

Starting in 1998 smuggling became so pervasive that it led to the involve-

ment of the poorest part of the Georgian population in this form of criminal activity. According to Dr. Kukhianidze, "the problem of contraband trade through Abkhazia and South Ossetia is especially important because it is closely related to the problem of separatism, unresolved armed conflicts, violence in these regions, and transparency of borders." Smuggling has given rise to corruption, the creation of powerful criminal clans, and has become a cause of confrontation among criminal and political groups, representatives of central, regional and local authorities, and

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"Main Challenge for New Government - Reviving the Economy"

Anti-Corruption Digest spoke with Roman Gotsiridze, Chair of the Parliamentary Budget Office of Georgia, regarding the economic situation in Georgia and the challenges that lie ahead for the new government. Dr. Gotsiridze is the recipient of a TraCCC Georgia research grant and works closely with TraCCC's Georgia Office.

AD: Dr. Gotsiridze, what do you believe is the main cause of the current economic decline in Georgia?

RG: Current economic hardship and the deterioration of living conditions

of the majority of the Georgian population is largely due to ethnic conflicts and economic collapse during the years immediately after Georgia regained its independence from Russia. Despite some economic growth for the past two years, relatively low inflation rates and a stable currency, the well-being of the general population hasn't improved significantly. Even though compared to the former Soviet republics, the poverty level in Georgia is relatively low (23% of the population as of 2000), 60% of the population faces the threat of poverty and the rapidly deteriorating quality

of (often inaccessible for the poor) healthcare and education. Moreover, over 50% of the Georgian economy is represented by shadow economy.

AD: What is the major challenge that the new government faces?

RG: I believe the main challenge for the new Georgian government is reviving the economy. The government must ensure the sustainable economic development of Georgia and significantly



Roman Gotsiridze

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law enforcement entities.

TraCCC's analysis of the legislation and situation in Georgia concerning the fight against smuggling through Abkhazia and South Ossetia led to the conclusion that the main reasons for its growth are the absence of initiative among members of the supreme leadership of the country and the high level of corruption among governmental and law enforcement bodies. Dr. Kukhianidze noted that "for the past several years, the main reasons for the flourishing of smuggling have been corrupted law enforcement agencies, loopholes in legislation, and ill-designed tax and customs policies."

Much of the research was devoted to an analysis of ongoing smuggling activities through Abkhazia and South Ossetia, looking at general tendencies, smuggling methods, the major Georgia, Abkhaz and South Ossetian groups involved in smuggling, the consequences of using sanctions imposed by the Commonwealth of Independent States (CIS) against the Abkhaz separatist government, and prospects for economic cooperation between Tbilisi and the two self-proclaimed republics.

The research also included analysis of anti-smuggling normative acts and entities whose functions include the fight against smuggling, such as the Ministry of Finance, Ministry of State Security, Ministry of Internal Affairs, General Prosecutor's Office, the Georgian courts. The activities of Abkhaz and South Ossetian separatist organizations were studied as well.

Gathering such a vast volume of data on smuggling often proved rather difficult for the researchers. Several heads of Georgian law enforcement agencies either refused to provide requested information or agreed to cooperate only verbally, while in reality working to hinder cooperation. Other obstacles were more of a technical

character: there is no reliable statistical information available on illegal trade through Abkhazia and South Ossetia. Nor are publications on smuggling in the Georgian mass media abundant or analytically sound. Furthermore, research was conducted when former President Shevardnadze and his allies were in power. The former government not only paid little attention to the problem of smuggling but often was a direct participant in this criminal activity.

Despite these difficulties, research was successfully completed, and the following recommendations have been developed by TraCCC's researchers to more effectively combat smuggling:

- 1) **Prosecution** of Georgian wholesale smugglers, corrupt law enforcement officers, and government officials.
- 2) **Provision of economic incentives:** coordination of excise and other tax policies with neighboring countries; salary increases for law enforcement; and improvement of the current legislation, particularly Georgia's Tax Code.
- 3) **Reform of the Border Guard from a Military Unit into a Border Police Organization.** A Mobile Border Patrol in the regions would represent a significant step forward towards more effective control of smuggling through transparent borders in Abkhazia and South Ossetia, even given unresolved conflicts.
- 4) **Infrastructural Reform of the Customs Department:** modernization of customs infrastructure and operations, including computerization of customs offices, training, and a new management system.
- 5) **Lift Sanctions** against secessionist Abkhazia to create an incentive for similar compromises from the Abkhaz side.

As Dr. Kukhianidze concluded, despite the unresolved conflicts with South Ossetia and Abkhazia, most

steps aimed at curbing smuggling must involve legalization of contraband markets and contraband trade. Dr. Kukhianidze warned that attempts to "forcefully destroy contraband markets may cause the renewal of armed conflicts or social disorder in Georgia."

Since smuggling represents illicit economic and business activity, development and employment of economic leverage to combat smuggling by the new government is of crucial importance. Accordingly, sufficient funds for implementing an anti-smuggling program should be made available in the Georgian state budget.

Dr. Kukhianidze described how the entire government is in need of drastic reform; government structures must be reorganized, technical capabilities must be modernized, and new human resources policies must be developed. This requires the development of a comprehensive government program of national security and the development of refined functions for each government agency, as well as the fostering of cooperation among these agencies.

The steps aimed at curbing smuggling undertaken by the previous government, including numerous presidential decrees, were never implemented due to corruption. The activities of the entity responsible for fighting smuggling, the Special Legion, were largely ineffective.

It is too early to speculate about the new government's effectiveness regarding the fight against corruption, noted Dr. Kukhianidze. However, steps undertaken by one of the recently appointed governors demonstrate that the new government is committed to eradicating smuggling.

"The fight against smuggling is a difficult and multifaceted problem, requiring the implementation of complex, multi-year programs," emphasized Dr. Kukhianidze.

A Call for Administrative Reform in Georgia

Rampant corruption in Georgia has had a profoundly negative effect on the economic, political, and social development of the country. The public sector is no exception—in Georgia it is large and highly ineffective. What has led to the ineffectiveness of the public sector? What factors have been detrimental to its development? What can be done, considering the new leadership in the country?

In a research project sponsored by TraCCC's Georgian Money Laundering and Economic Crime Project, Shalva Machavariani, Project Director and Associate Dean of the Caucasus School of Business (CSB) examined the existing situation in the public sector, looking at underlying problems and providing recommendations to address these problems.

Among the most pressing problems in the public sector, noted Dr. Machavariani, are a poor system of governance, lack of social control, a poor management style, an inadequate legal framework, poor human resources management, and the lack of modern organizational culture in public agencies.

Often there is an overlapping of functions among different ministries and subdivisions of public agencies, as well as between state agencies and legal entities. Despite some modest organizational development, many public agencies have retained certain "Soviet" features, including an autocratic style of governance. With regard to legal deficiencies, major problems are associated with regulations and standards, particularly their inconsistency with each other.

"Without a coherent legal framework, an appropriate organizational structure and modern organizational culture, proper functioning of public agents and public servants is impossible," emphasized Dr. Machavariani.

Clearly, the existing situation in the public sector calls for extensive ad-

ministrative reform, argued Dr. Machavariani, the ultimate goal of which is improvement in the functioning of the executive branch. Based upon his painstaking research, he has

"The major task ... will be development of an adequate governance system and competitive selection of honest and professional public servants."

developed a framework for reform. The first phase of the reform should encompass reorganization of the structure of the executive branch and reduction of the number of public agencies.

The second phase should aim at internal reorganization of the structure of the executive branch. The reform would be implemented by ministers, their deputies, and heads of state entities in their respective agencies. Even though the reform process should be decentralized, it would be implemented according to the principles and methodology of the State Chancellery, and under Chancellery's systematic monitoring. To ensure effective coordination and monitoring of the reform, a Special Commission would be created. The Commission would be comprised of high ranking officials, the State Minister, Finance Minister, Justice Minister and other relevant entities responsible for implementation of the reform.

The main objectives of Dr. Machavariani's proposed administrative reform include:

- * ***Improvement of the structure of executive branch;***
- * ***A smaller public sector;***
- * ***Decentralization and reduction of the number of subordinate agencies;***
- * ***Elimination of overlapping functions among public agencies;***
- * ***Rational spending of limited budget resources;***
- * ***Development of a coordination***

policy for government agencies, including regulatory functions;

* ***Rationalization of management and regulation systems;***

* ***Introduction and enforcement of the concept of responsibility in public administration; and***

* ***Improvement of the mechanisms of remuneration and material incentives.***

Dr. Machavariani believes the proposed reform would eliminate inertia, inflexibility and other deficiencies preventing the adequate functioning of the executive branch of government.

"Most importantly, implementation of the reform would ultimately ensure greater trust, transparency, accountability, and effectiveness in the work of the executive government structures," underlined Dr. Machavariani. He went on to say that the success of the reform would largely depend on the implementation of institutional changes and implementation

and management of recommended programs. The major challenge, believes Machavariani, would be the development of an appropriate governance system and the merit-based selection of an honest and professional cadre of public servants. If the government is represented by professionals, Dr. Machavariani anticipates no major obstacles in the process of implementation of administrative reform.

"The most crucial precondition required for successful implementation of the administrative reform is political will," underlined Dr. Machavariani.

Dr. Shalva Machavariani is an Associate Dean at the Caucasus School of Business in Tbilisi. He Directs TraCCC's Georgia Money Laundering and Economic Crime Project.



Shalva Machavariani

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decrease corruption in the country. Unless necessary changes are rapidly implemented, the future of the current political alliance will be questionable, which in turn will create a favorable environment for the defeated political forces.

The new government faces several threats: internal separatists, attempts of Russia to create controlled instability in Georgia, and certain ethnic problems, among others. The new government will certainly not be able to eradicate all the threats and challenges immediately. However, achievement of a measurable degree of economic success might help the population regain confidence in the government and lay the foundation for further success.

AD: *What economic reforms are necessary in Georgia in the immediate future?*

RG: The new government should make rapid and sustainable economic development and poverty reduction its top priorities.

A medium-term program must be developed for the following four years. The main objectives should be the creation of an adequate tax system, reduction of administrative barriers and red tape, implementation of social reforms and creation of a new pension system, improved quality and better accessibility of social protection services, and improved effectiveness of economic infrastructure.

AD: *What are the barriers and obstacles to implementation of these reforms?*

RG: Georgia's economic development in the immediate future requires improvement of living conditions and economic modernization at the same time, which should be done considering external debt servicing and mobilization of resources to ensure the country's security.

In the short-term, existing problems in the Georgian energy sector will prove a hindrance. It is impossible to achieve sustainable economic development without modernizing the energy

sector and fully utilizing its potential. Substantial investment in the energy sector should become the main precondition for the modernization of the energy sector and revival of the economy.

Georgia's economic development is further hampered by the existence of conflict regions at its borders. To date, the central government of Georgia is unable to exercise control over 16 percent of its territory.

Given the existing circumstances, implementation of a short-term development strategy requires high rates of economic development, which should reach at least an 8 percent mark in the following four years. Such high rates of development require implementation of governmental reform, decreased corruption, and fundamental social changes.

AD: *What possible outcomes do you envisage as a result of implementation of these reforms?*

RG: Implementation of a comprehensive development program will elevate Georgia to a fundamentally different level, marked by stable economic growth, effective state governance, a strong middle class, and strong social and political relations.

The role of market institutions in the regulation of economic subjects will increase, barriers for market entrance will be reduced, and fair conditions for competition will be created, thus providing a favorable environment for the growth of small enterprises. The share of shadow economy will decrease. Investment will increase, utilization of which will contribute to the technological development of the country. With an increased GDP growth rate and inflation not exceeding 4-5%, pensions and salaries will increase. And eventually the gap between the poor and the rich and other existing inequalities will be gradually decreased.

AD: *One of the most pervasive problems in Georgia is institutionalized corruption. What steps do you believe would be effective in combating and eventually eradicating corruption?*

RG: A comprehensive multi-step anti-corruption program must be developed, top government structures being the first target for anti-corruption activities.

Granting tax breaks to businesses enjoying patronage from influential economic groups is one of the most visible signs of corruption. This practice must be eliminated, especially since those benefiting from tax breaks are not the socially unprotected.

It is noteworthy that the central budget loses more funds not due to allowing tax benefits to certain segments, but due to abuse of these benefits. Often goods imported to Georgia that must be taxed are registered as transit or other benefit-eligible goods. Imported food products, petroleum products, flour, wheat and others are registered at customs as foreign investment or [tax-exempt] humanitarian aid, which represents one of the main sources of corruption in the Customs Department.

One of the steps in the fight against corruption might be simplification of business registration. The strenuous process of business registration negatively affects Georgia's economy not only because it leads to fewer jobs but because it incurs the cost of maintaining government bureaucracy. Consequently, when it is difficult to start a business, businesses are forced to “go underground” fostering the shadow economy.

The challenge is elimination of bureaucratic barriers. It is crucial to develop healthy competition in the market and reduce market barriers, allowing new firms to compete with older ones. As such, simplification of market entry mechanisms and the registration process for businesses will play a key role.

We shouldn't cherish the illusion that all these reforms will be easy to implement. However, the new government has a unique chance to implement these reforms and should use this chance effectively.

Spearheading Research on Corruption: TraCCC Georgia Office

"Transnational crime will be a defining issue of the 21st century for policymakers - as defining as the Cold War was for the 20th century and colonialism was for the 19th. Terrorists and transnational crime groups will proliferate because these crime groups are major beneficiaries of globalization..."

Louise I. Shelley

The Transnational Crime and Corruption Center (TraCCC) is the first center in the United States devoted to teaching, research, training and formulating policy advice on transnational crime, corruption and terrorism. Founded in 1995 with seed money from the MacArthur Foundation and currently funded by the US Government and private foundations, TraCCC's fundamental goal is to better understand the causes and scope of transnational crime and corruption and to propose well-grounded policy solutions to reduce and eliminate these problems.

Much of TraCCC's work to date has focused on the analysis of transnational crime and corruption in the countries which constitute the former Soviet Union and Eastern Europe. To accomplish this, TraCCC works with NGOs, the public, the media, and law enforcement, policymaking, legislative, judicial, academic and business communities. To undertake this kind of collaborative work, TraCCC has partnered with leading scholars and practitioners in Russia, Ukraine and Georgia through multidisciplinary research centers.

TraCCC began its involvement in Georgia with a grant in 2001 to conduct research on money laundering in the country. TraCCC soon formed a network of talented Georgian researchers to conduct in-depth analysis of the subject matter.

"Despite the pervasive nature of corruption in the country, there was an overwhelming interest among Georgians of all walks of life in doing something about the crime and corruption which mired the country in economic hardship and political instability," noted Dr. Louise, Shelly, founder and Director of TraCCC.

TraCCC identified several active members of Georgia's civil society who were willing to take action on this issue. In January of 2003, TraCCC opened its office in Tbilisi. The Georgia Office operates as a non-partisan think-tank for US and Georgian officials, governments, and all interested groups in both countries. The Office, sponsored by the US Department of State in coordination with the Department of Justice's Office of Overseas Prosecutorial Development Assistance and Training, serves as an objective source of information on issues of organized crime and corruption for policymakers and society in general.



TraCCC founder & director Dr. Louise Shelly

The goal of the Georgia Office is to attract and foster the research of experts in the field of organized crime and corruption who will then be able not only to contribute to policy debates and scholarship on these issues, but also to train others in this field. The Georgia Office's research is being publicized through mass media, newspapers, newsletters, and its website. In addition, the Office conducts a series of public outreach events and trainings on topics of organized crime and corruption and their relationship to Georgian social and economic development.

Areas of Research/Main Activities

The TraCCC Georgia office collects, studies and analyzes information and conducts research on the following problems:

- ***Cross-Border Issues and Smuggling***
- ***Corruption in the Transport Sector (Railways, Ports, Pipelines)***
- ***Corruption in the Energy Sector***

- ***Corruption in Georgia's Law Enforcement Agencies***
- ***Organized Crime and Corruption in Georgia and in the Former Soviet Union***
- ***Human Trafficking***
- ***Corruption in Higher Education***

The TraCCC Georgia Office can provide international organizations and private individuals with the following services: collecting legal and statistical information; preparing and reviewing information on organized crime and corruption; analyzing legal reforms in Georgia; and translation of legal codes and legal documents passed by the Parliament of Georgia and the President.

Among its other functions, the Georgia Office provides administrative and technical assistance to: support the drafting of legislation to combat organized crime and corruption in Georgia; produce research and policy papers on organized crime and corruption; conduct public outreach via public fora on topics of organized crime and corruption and their relationship to Georgian societal and economic development; organize and support exchange and training programs for Georgian policymakers, law enforcement, legislators, government officials, and students and scholars to interact with their peers in the US, Russia, Ukraine, and the EU to explore methods of increasing the effectiveness of combating organized crime and corruption; and develop training curricula for Georgian law enforcement, legislators, government officials, and students.

Research conducted to date by the TraCCC Georgia Office includes work on smuggling through Abkhazia and South Ossetia, international means of combating organized crime and corruption, and crime and corruption in the transport, energy, and higher education sectors.

The Georgia Office looks forward to publishing its reports on these subjects in the near future.