

# Small Entrepreneurship Supporting Economic Policy in Georgia

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**Abstract**—This paper discusses small entrepreneurship development strategy in Georgia and the tools and regulations that will encourage development of small entrepreneurship. The current situation in the small entrepreneurship sector, as well as factors affecting growth and decline in the sector and the priorities of state support, are studied and analyzed. The objective of this research is to assess the current situation of the sector to highlight opportunities and reveal the gaps. State support of small entrepreneurship should become a key priority in the country's economic policy, as development of the sector will ensure social, economic and political stability. Based on the research, a small entrepreneurship development strategy is presented; corresponding conclusions are made and recommendations are developed.

**Keywords**—Economic policy for small entrepreneurship development, small entrepreneurship, regulations, small entrepreneurship development strategy.

## I. INTRODUCTION

ONE of the key goals of the economic policy of Georgia is the development of small entrepreneurship, which serves as a basis for the stable development of the economy. It ensures the creation of jobs in the country, employment of people capable of working and creation of a 'middle class' – a guarantee for stable development. Currently, unemployment and poverty still remain the toughest problems for the country.

In 2014, the output of the business sector increased by 5.5 times and turnover by 6.4 times compared to 2004. Large enterprises accounted for 81.3% of production, average enterprises for 9.6% and small enterprises for 9.1%. As the figures show, small and medium business account for less than 20% of GDP, which is lower compared to other countries. For instance, the corresponding figure in Europe and Central Asia is 60%, and in neighboring Armenia it amounts to 42%. The number of people employed in the business sector increased by 1.7 times compared to 2004 (322,800 in 2004; 534,900 in 2014). With 62.9% employed in large, 16.7% in medium and 20.4% of people employed in small enterprises. In 2014 (20.4%), the number of people employed in small enterprises increased by only 6% compared to 2010 (13.8%) [1].

Some 20% of micro and small enterprises consider that the state does not care much for creating fair and just competition, they think that large business is a priority for the state [2]. The scale of most of enterprises in the agribusiness sector of Georgia is small. Stimulation of these enterprises is in fact impossible unless the state takes additional measures. It should

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be noted that micro and small entrepreneurs are self-confident and over half of them believe they have enough knowledge and skills to do their job well. However, most of them do not have bank accounts and apply to private lenders [3].

Based on the analysis, appropriate conclusions and recommendations are presented.

## II. METHODOLOGY

Both general and specific research methods are used in the paper. In order to identify the patterns between the analytical and statistical estimates, the publications of the National Agency for Statistics of Georgia, theoretical and applied researches of international organizations and research economists are applied.

## III. DISCUSSION

The creation of a business environment and the appropriate conditions and the protection of interests of small entrepreneurs should be encouraged by state economic policy, which includes taking measures for adopting proper entrepreneurship policy and increasing the competitiveness of national production, along with organizational and financial support. The following measures are considered to be the priorities of state support to the development of small entrepreneurship: tax preferences, allowances, preferential bank loans, small enterprise development programs, adoption and protection of appropriate legislation. Financial support is mainly the responsibility of financial institutions, which have significantly improved borrowing conditions in recent years. However, there is still a lot to be done in this direction.

The period of transition to a market economy is a long process. Its functioning as an economic system depends on business development in the country.

For Georgia, entrepreneurship formation features can be listed as:

- In the early 90s of the 20<sup>th</sup> century, the private sector was formed as a state property adjunct. Many people wanted to begin their 'own business'. However, we must underline, that the majority of cooperatives during those times (75-80%) were formed based on state enterprises [4];
- As well during that time, former Soviet Union countries began active trade with foreign countries with the easing of procedures and restrictions on international trade and travel. And at the time, involvement in simple trade operations resulted in substantial profits;
- During the same period, rentals (especially with the rental redemption right) were actively entering the market,

which led to a practically uncontrolled transition of state property to the private sector;

- Wealth accumulation in Georgia first began in 1993 after the collapse of the Soviet Union. The savings of much of the population were lost during the same period. Inflation transformed into hyperinflation and only a handful of individuals accumulated wealth;
- As the result of erroneous privatization, a small number of individuals were able to purchase state property for virtually nothing;
- Several entrepreneurs started businesses with foreign credit;
- Businessmen, who accumulated wealth during this period, started to enter politics, while those who made money as a member of parliament or the government began to start their own businesses at end of their tenure;
- Individuals from different socioeconomic backgrounds, professional experience and academic qualifications are representative of Georgian entrepreneurs. More than a half have completed degrees in higher education, mainly in the fields of engineering and economics;
- Before 1999, Georgia witnessed a sharp increase in entrepreneurial activity. While today, the situation remains stable.

According to 2000 to 2003 data, factors impeding the development and widening of business activities, are grouped as follows:

- I type factors:
  - Lack of government protection for businesses;
  - High levels of taxation;
  - Corruption within government structures.
- II type factors:
  - Inefficient taxation system
- III type factors:
  - Domestic market exposure to black market and smuggling activities;
  - Lack of access to credit and financing;
  - Energy crisis;
  - Excessive interference by managing and monitoring bodies in business activities.
- IV type factors:
  - Lack of protection from counterfeit and inferior quality production;
  - Under-developed financial market, which means industrial assets are less liquid.

According to 2004 to 2007 data, business development is impeded by the following factors: Lack of government protection for businesses (28%); Excessive interference by managing and monitoring bodies in business activities (23%); High levels of taxation (18%); Lack of protection from counterfeit and inferior quality production (17%); Corruption in state structures (7%); Lack of access to credit and financing (7%).

It is interesting to note that corruption in state structures (7%), and lack of access to credit recourses (7%) are no longer factors impeding business development [4].

From January 1, 2005 a new tax code went into force, with significant changes compared to the previous one. In particular:

- The 21 taxes of the former tax code have been revised to six. Taxation rates and the number of taxable items decreased, as well as the inter-budget sum allocation mechanisms and volume;
- The registration process was significantly simplified.

The government of Georgia has so far failed to create a favorable social, political, legal and market environment for small entrepreneurs. However, it's worth mentioning that at different stages of the development of the segment that a certain legal framework was introduced to regulate relations in the field of small business. In particular, on 23 July 1999, the Law on the Support of Small Enterprises was adopted.

In October 2000, the Ministry of Economy, Industry and Trade of Georgia initiated the "Concept of Providing State Support to SMEs" and proposed it to the Economic Council of the Ministry for approval. The concept highlighted the need for creating a favorable environment for small enterprises.

In 2002 the Law on the Promotion of Small Business was adopted. However, this law also failed to play a significant role in small business development. In 2006 the Law on National Investment Agency was amended and the definition of a small enterprise was adopted. In particular, according to the Law of Georgia on Entrepreneurs, a small enterprise is the operation or activity of any organizational and legal form, which employs less than 20 people and has an annual turnover not in excess of 50,000 Georgian lari. However, adoption of the definition was not followed by any deliberate state policy to support small enterprises [5].

In 2004, reforms aimed at liberalizing the economy were launched in Georgia which resulted in the removal of bureaucratic barriers and reductions to the overall tax burden. According to the World Bank's Doing Business Report 2014, Georgia has been one of the world's leading reformers for the past several years; the country currently holds the 8th place out of 185 in the 'Doing Business' rating [6].

In 2012, 'Caucasus', a Small Enterprise Assistance Fund was established in Georgia by international institutions, such as the European Bank for Reconstruction and Development, International Finance Corporation, Netherlands Development Bank, the Black Sea Trade and Development Bank. This is the first investment funds in the Caucasus to issue loans only to SMEs. The fund will invest in different sectors, namely, in agribusiness, distribution network, energy and retail sectors. The Fund's activities differ to the activities of banks, where there are 232 banks issuing only loans, the Fund is oriented to increasing investment. Lack of capital is the toughest problem facing SMEs. The Fund aims to help SMEs overcome this barrier, as capital is a key factor for the diversification of economic activities of enterprises and for creating new jobs. Diversification of farms will significantly increase the export of agricultural products. In order to encourage these processes, it is essential to develop a program oriented on the export rather than import of agricultural products and to reflect this program in the priorities of economic policy [7].

In our opinion, the Fund will not be able to make fundamental changes in the SME sector, but the initiative itself should be undoubtedly welcomed. The Fund will not be investing in enterprises with an annual turnover of less than 15 million GEL or less than 250 employees. If the Fund has low-risk criteria, then it will be able to finance the enterprises that banks refuse to finance. The economic policy for the development of entrepreneurship should be directed to stimulate entrepreneurial thinking, attitude and the generation of ideas in this direction. This includes the growth of entrepreneurial thinking in the economy and an increase in the number of people ready to take risks in the future. Developed countries managed to increase joint entrepreneurial activities through the growth of entrepreneurial thinking. Hence, this direction of policy is very important for economic growth [8].

The reforms launched in recent years were directed to ensuring liberalization and private sector based economic growth. Most small and medium entrepreneurs in Georgia are interested in improving knowledge and best practices, in particular, in learning the skills of strategic planning, conducting negotiations, drafting and signing the contracts, evaluation the effectiveness of enterprises, and so on. Appropriate higher education institutions should take this fact into consideration and establish training centers for entrepreneurs.

State support to small entrepreneurship is mainly determined by the accuracy of the tax system. Georgia has taken significant steps in this direction. In particular, due to the reforms in the tax system, tax legislation in Georgia is one of the most liberal in Europe. The number of taxes has been reduced from 21 to six in 2004 to 2010, with some 60% to 80%, and in some cases even more of budget revenues are tax revenues. Consequently, determination of appropriate tax policy and good administration of taxes are of greatest importance in budgetary processes and the policy of the country. It should be noted that since 2012 the status of a fixed tax payer was added to the status of small and medium business. This might include a person, who carries out one or more business activities, which are subject to fixed taxes. However, the government determines the types of these activities. Fixed tax rates on a taxable object might range from one to 2,000 GEL or 3% of the income from taxable activities. This rate is also determined by the government of Georgia according to the type of an activity [9]. A person has the right to shift to the fixed tax regime in any month of the year. The Government believes that by implementing tax and other preferences, it is possible to achieve an economic growth rate of 5%. In addition to these changes, a number of other changes have been made to the "Revolutionary Code", which means that relationship between the entrepreneur and the government is highly inter-changeable; the economy has become politicized. The general consensus among entrepreneurs is that the reformed tax system has not substantially changed the situation. From their point of view, hindering factors include lack of protection of business interests by government, instability in the country, over-interference in business by managing and controlling bodies, high taxes, etc.

Entrepreneurs consider that the substantial weakness of the tax system is its instability and irregularity, for example, during any financial year, amendments are often made to the law. Small entrepreneurs, who cannot afford the services of qualified tax consultant, are not able to become acquainted with the benefits and observe the changes. According to one entrepreneur interviewed, "there has been an obvious trend of improvement in recent years, but they try to improve the tax system so quickly that in certain cases there are quite a lot of mistakes made and we come across serious problems." Tax changes in EU countries take place once or twice a year. Thus, there is enough time for the tax authorities to issue special instructions and for entrepreneurs to become acquainted with them. Many shops and small enterprises have closed in Georgia recently, with owners citing unbearable tax pressure, which very few can endure, as the reason.

A micro-entrepreneur, whose annual turnover is less than 30,000 GEL, is not subject to tax, but only in cases where they do not use hired labor, which is absurd; as businesses that use hired labor and create jobs are generally encouraged in countries around the world. These micro-entrepreneurs are in fact self-employed and such people are not taxed anywhere. If a person creates a job himself and can keep his family, it is a great relief for the state. A small entrepreneur, who has a turnover of 100,000 GEL, has to pay 3% to 5 % tax. No trader or entrepreneur can afford to pay so much. According to a law adopted in 1999, the annual turnover threshold for small business was 500,000 GEL; however, according to the new Code, this threshold was lowered to 100,000 GEL. According to an EU recommendation, annual turnover of the small entrepreneur should not exceed 10 million Euros; and yet the threshold was lowered to 100,000 GEL in Georgia. Entrepreneurs believe that along with fixed taxes (since 2012), it would be advisable to introduce tax licenses. This system involves the entrepreneur purchasing a tax license for one or several months, during which time they are free from all taxes. When tax becomes affordable, everybody can contribute and the state can gain huge revenues. A similar system in Ukraine has proven quite successful. It has emerged that despite a number of important changes, there are plenty of problematic issues still apparent in the current tax system, which in many cases hinders the development of entrepreneurship.

In 2014, the government of Georgia launched several initiatives to support entrepreneurship. In particular, the Entrepreneurship Development Agency was established and the program made in Georgia was initiated [10].

The objective of the Entrepreneurship Development Agency is to improve the skills of small and medium-sized entrepreneurs, improve accessibility to financial resources, assist startup businesses and strengthen the export potential of entrepreneurs. The government of Georgia will encourage development of business incubators where potential entrepreneurial skills will be developed and improved, and they will be informed about and have access to increased investment possibilities.

The state program 'Made in Georgia' aims to assist the development of entrepreneurship in Georgia, encourage the

establishment of new enterprises and increase the competitiveness of the private sector and export potential through improving accessibility to finances, real estate and modern technologies, and by providing technical assistance.

The program includes three components: financial accessibility, infrastructure accessibility (real estate) and consulting services. These components are available for the entrepreneurs both jointly and separately. The program will support the development of production-oriented industries, which are selected by the following criteria: volume of imports and local production potential. This program is a unique opportunity for all startup businesses to implement their own plans and establish new enterprises in agricultural, as well as industrial sectors.

The program Produce in Georgia was launched on June 1, 2014. As yet, these initiatives are new and therefore it is still too early to discuss and evaluate the outcomes.

#### IV. CONCLUSION AND RECOMMENDATIONS

The conducted analysis enables us to make certain conclusions: Studies have shown that the institutional reforms implemented in Georgia are not sufficient for the development of small enterprises.

The main problems are considered to be:

- Political instability and conflict zones;
- Failure of the government to protect the interests of small business;
- Instability and irregularity of the tax system;
- Difficulties in accessing credit resources;
- Inflation;
- High interest rates;
- High tax rates;
- Lack of clarity in the tax code;
- Lack of investment and export subsidies.

Based on the analysis and the conclusions, we have developed the following recommendations:

- ✓ The state should assist the development of entrepreneurship through implementing the following measures: creating attractive environment for investors, making preferential loans accessible, establishing the system of insurance, and the development of infrastructure, etc.;
- ✓ It is very important to increase the effectiveness of the tax policy (simplicity and clarity of the tax system, optimal level of tax rates);
- ✓ Encourage growth of export (develop a strategy for penetration into international markets, creation of a wide marketing network, etc.);
- ✓ Existence of a stable legal environment is necessary for investors that will guarantee due protection of their property and their business interests;
- ✓ Development and implementation of small entrepreneurship development programs.

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