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Georgia Agriculture and Food Sector Review

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CURRENCY EQUIVALENTS

Currency unit - Coupon (C)

US\$ 1 = C 5 million (Sept. 1994)

US\$ 1 = C 1.5 (March 1995)

Currency unit - Lari (L)

US \$1 = L 1.2 (November 1995)

WEIGHTS AND MEASURES

Metric System

ABBREVIATIONS

CGIAR	Consultative Group on International Agricultural Research
CIS	Commonwealth of Independent States
CJSC	Closed Joint Stock Company
CSQC	State Commission for Seed Quality Control
CU	Credit Union
CVT	State Commission for Variety Testing
DOF	Department of Forestry
EU	European Union
FAO	Food and Agriculture Organization
FMD	Foot and Mouth Disease
FSU	Former Soviet Union
GAAS	Georgian Academy of Agricultural Sciences
GAVS	General Administration of Veterinary Services
GSPL	Parastatal responsible for supply of agrochemicals
IMF	International Monetary Fund
IPM	Integrated Pest Management
ISTA	International Seed Testing Association
MAFI	Ministry of Agriculture and Food Industry
MTS	Machine and Tractor Stations
NBG	National Bank of Georgia
NIIZ	Agricultural Research Institute of Crop Production
NPO	Scientific Production Associations
NWPMO	National Water Planning and Management Organization
OJSC	Open Joint Stock Company
OME	Operation and Management Enterprise
SAMTREST	State Industrial Corporation of Viticulture and Wine Making
WUA	Water Users Association
UNDP	United Nations Development Programme
UPOV	International Association for Protection of New Plant Varieties

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PREFACE

The Georgia Agriculture and Food Sector Review is based on the findings of a World Bank Mission that visited Georgia in September 1994 and reflects developments in Georgian agriculture since then. The 1994 mission which was headed by Mr. Csaba Csaki, included seven agriculture and food industry experts (E. Brook, land reform and agrofinancing; A. Valdes, incentives framework; O. Honisch, crop production, input supply and mechanization; J. Beeny, horticulture and irrigation; E. Pitt, livestock, research, and extension; G. Rasko, agroprocessing and privatization; and D. Onoprishvili, environment and statistical database). Mr. Geoffrey Fox, Chief of the Natural Resources Management Division in the Bank joined the mission during the last few days of its stay. An FAO/CP project identification mission, which visited Georgia in February-March 1995, provided additional valuable information. The "Programme of Agrarian Reform in the Republic of Georgia 1994-1995," prepared by the Georgian Academy of Agricultural Sciences was much valued as an important background study.

The Green Cover report was prepared in May-July 1995 by the principal author, C. Csaki, with the contributions of Z. Lerman, A. Valdes, E. Brook, D. Onoprishvili, and A. Zuschlag. M. Selowsky, L. Tuck, J. O'Connor, P. Siegelbaum, C. Hall, R. Burcroff, and M. Debatisse provided valuable comments. The Green Cover report was discussed with the Georgian government and representatives of academic and business institutions in October 1995. Comments from these discussions have been taken into account in the finalization of this study. The agriculture and food sector review has been organized as a joint effort of the World Bank and the Government of Georgia, during, and in the aftermath of, the September 1994 mission. On-going policy dialogues and communications with Georgian authorities since the original mission have contributed substantially to the Government's development of a comprehensive reform program for food and agriculture and the completion of this report. All the assistance received from the Ministry of Agriculture and Food Industry and other Georgian institutions is highly appreciated. Paul Strong, the British Know How Fund advisor to the Ministry of Agriculture and Food Industry, and Tim Attridge of EU-TACIS significantly supported the preparation of this study.

EXECUTIVE SUMMARY

I. This study presents a status report on the reform of the food and agriculture sector in the Republic of Georgia. In addition to giving an account of the current situation in primary agriculture and agroprocessing, this study will also recommend a set of actions to facilitate recovery in the sector and provide guidelines for replacing the present spontaneous and unstructured sectoral reform with a consistent program for transition to a market based agriculture. The main report (**Volume I**), emphasizes the necessary actions for continuing sectoral reforms and the critical first steps in their implementation, while **Volume II** provides subsectoral analyses and recommendations for improving production efficiency and investment.

Background and Constraints

II. Today Georgia is largely an agriculture-based economy. The contribution of agriculture to the net material product, according to IMF estimates, was about 68% in 1993 (in constant 1987 prices) and up to 87% (in current prices) by the end of 1994. *Traditionally Georgia was a net exporter of food products* and one of the major suppliers of vegetables, fruits, tea, wine, and brandy to the rest of the former Soviet Union (FSU). In the late 1980's the country contributed more than 10% of all inter-republic trade in food and agricultural products, and the value of Georgian food exports to the rest of the FSU exceeded by a factor of 1.7 the value of food imports from other Soviet republics. Recently, the amount of agricultural goods supplied by Georgia to other FSU countries and international markets has declined significantly, and the country has lost most of its position in export markets. As a result, Georgia is now a net importer of food products.

III. The agricultural and food production system has experienced a sharp decline in output from the peak levels of 1987. *In 1993 and 1994, agricultural output was only about one third of the 1987 level. Output of food processing in 1994 was less than 10% of the late 1980's level.* Despite this domestic contraction, primary agriculture remains the only viable and functioning production sector in the Georgian economy at the moment. Production efficiency and yields have always been below those of developed countries with similar agro-ecological conditions. Production efficiency further declined in recent years, due to the lack of inputs and overall economic difficulties.

IV. The ongoing reforms in food and agriculture in Georgia suggest that the Government is committed to continuing reforms in the economy of the country, and more specifically in food and agriculture, to complete the transition to a market system based on private ownership. Reforms in agriculture have been more spontaneous in Georgia than elsewhere in the FSU. *The lack of macro-economic stability was a very serious impediment to overall reform in agriculture.* In the absence of a functioning domestic currency in the sector, relationships between producers and processors were difficult to re-establish, and further growth in private agriculture remained constrained. Rampant inflation, a very weak fiscal position, corruption, and limited availability of credit, all combined to create an economic environment in which a legal agricultural economy could not fully function. In addition to overall macroeconomic stabilization, a recovery of an export-oriented agriculture requires a reliable supply of energy (electricity, gas, etc) and an efficient transportation system.

V. Government policies toward agriculture and its sub-sectors are also slowing down the recovery of the sector. In general, the Government has preserved some of the remaining elements of the central planning system, in the form of Soviet-style institutions and some price controls. The Government's inability to finalize land legislation and to implement a clear and effective privatization strategy in

processing and marketing also have adverse consequences. The agricultural administration is still focused on the traditional state and collective farming organizations, while the private sector, which provides the bulk of production, does not receive enough attention and support.

Overall Strategy for Continuing Reforms

VI. At present, economic and trade difficulties have led the country to turn towards supplying the domestic market rather than towards export potentials. It is fully understandable that this objective dominates the thinking of policy makers at the moment. Concerns regarding a secure domestic food supply should not, however, result in a long-term self-sufficiency program. Food self-sufficiency may be an appropriate strategy while production is recovering and output marketing systems are being improved. The negative impacts of short-term emergency adjustments upon the potential to create an open, internationally competitive, food and agricultural system need to be minimized. The ultimate objective should be the *integration of Georgian agricultural production and processing into international food and beverage markets*. This requires the creation of an open agricultural economy by fully utilizing the potential comparative advantage of Georgian agriculture. The recovery of food and agriculture should be driven by market forces and market opportunities and not by illusions of returning to production levels and structures of the Soviet period.

VII. In the long-term, Georgia definitely *can again be a significant agricultural exporting country*, although grain and a portion of the livestock products consumed will continue to be imported. Potential exists for efficiency and production increases under private ownership as the overall economic environment becomes more supportive. The privatization and rehabilitation of agro-processing is a very important precondition for any sizable food and agricultural exports to developed markets. The traditional products of the country, such as wine, canned vegetables, and fruits provide a good starting point. Improvement in production efficiency and a *more active participation in international trade, should be guided and managed by the private sector*, and supported by appropriate government policies and infrastructure. In the emerging market system *the Government cannot, and should not, directly engineer the recovery and growth needed in Georgian agriculture*, even if it were to have at its disposal greater resources than are currently available. *The Government needs only to provide an enabling environment* and to permit enterprises/farms to be the decision makers to create growth themselves in the agriculture and food economy.

VIII. Among these conditions, the most immediate priority is to develop, and to agree within the Government on, a comprehensive set of policy actions to continue and complete reforms in agriculture. This program, whatever its elements, must be consistent, and coordinated with the overall program of stabilization and privatization. In the absence of a credible program of macro-economic stabilization however, it is hard to envisage any sizeable recovery in the sector. We recommend that *the Government focus its actions in the near future on the following five major areas*:

- *Creating a supportive macroeconomic framework for food and agriculture*: (a) an open foreign exchange regime and stable currency; (b) reduced inflation; (c) a more balanced budget; and (d) an open trading regime which supports competitiveness and which is not constrained by high tariffs or by quantitative trade barriers.
- *Completing land reform and farm restructuring*: (a) finish the initial distribution of land for private use; (b) clarify the legal status of land provided under the 1992 land reform program; (c) transfer

of remaining state land and non-land productive assets to private users and operators; and (d) create conditions for a functioning land market.

- *Developing a working competitive domestic market* for agriculture products and agriculture sector services requires the acceleration of the: (a) privatization of farming and the agro-industrial complex; (b) demonopolization of distribution, input supply, and product markets; and (c) entry of foreign capital and firms into domestic agroprocessing, input distribution, and support services.
- *Creating a working financial intermediary system* providing competitive financial services for primary agriculture and agro-processing.
- *Developing an institutional framework* which is consistent with the needs of a market-based agriculture. Specifically: (a) change the role of government in agriculture from one which has traditionally administered and managed the command system, to a more passive role supporting the private sector through regulation, research and analysis, and the provision of public goods and services; (b) create a new institutional framework for a working agricultural market, including commodity exchanges, market information systems, etc; and (c) develop an extension service, research, and education focused on the needs of privatized agriculture.

IX. Agriculture alone cannot resolve the difficult problems of rural development. Growth of non-farm rural employment opportunities is an essential component of a rural development strategy which includes the promotion of sector linkages between the farm and the rural village community service sector. Rural development, especially improvements in roads, communications, and decentralized services, are needed to reduce the transaction costs of doing business in rural areas. It is important also to stress that agriculture price policy should be developed with productivity/efficiency considerations and not be used as a vehicle for social protection and support.

Supportive Policy Environment for Agriculture

X. For a small economy such as Georgia, an important element in a strategy to achieve faster growth is an open trade and investment regime, not merely within Georgia or with neighboring FSU republics, but with the rest of the world as well. This demands an explicit commitment to let price signals (domestic versus border prices, at the appropriate exchange rate) become the vital link with external markets. Significant steps have already been taken towards the liberalization and integration of the Georgian price system with international markets and of the development of an open and competitive policy environment for foreign investment. However, there are still important issues to be addressed.

XI. Major recommendations are summarized as follows:

- **Trade Policies:** (a) refrain from intervening in agricultural import and export markets with the exception of interventions acceptable under the WTO (to which Georgia is expected to apply for membership); (b) develop a legal and institutional framework to use safeguards and countervailing duties; (c) ensure that all state agricultural procurements are executed on a competitive basis; (d) eliminate formal and informal barriers in domestic trade, such as prohibition of exports, licensing, and other pervasive bureaucratic procedures and illegal rent-seeking; and (e) revise foreign exchange surrender and other requirements to eliminate remaining implicit taxation of exports;

- Price and Subsidies: (a) abstain from price interventions; (b) fully liberalize bread and milk prices; and (c) phase out remaining producer subsidies (water);
- Taxation: (a) simplify the rather complicated taxation of agroprocessing and services; and (b) guarantee the consistency of land tax with the rest of taxation; and
- Encouragement of Foreign Investments: provide a supportive framework for foreign investment in the aftermath of the foreign investment law and by passing other needed commercial codes.

XII. For agriculture outside the export subsector, a very important positive element of the present situation is that there are now virtually no direct price interventions in agricultural markets. The absence of direct interventions in agricultural markets for the non-export products have facilitated the resurgence of a dynamic private market for domestically-traded agricultural products. This is the case for meat, vegetables, some grains, wine outside the export orders systems, and some other items. Any effort by the Government to try to interfere directly in these essentially private informal markets would be counterproductive for their future growth.

XIII. We strongly recommend that the Government of Georgia abstain from becoming involved in sector-specific price interventions, both because the Government is not powerful enough to counteract the influence of price and foreign exchange policies, except at a very high fiscal cost, and because price policies are not an efficient instrument in dealing with social objectives, such as income transfers to particular segments of the population. The social safety net to protect the most vulnerable segment of both the urban or rural population -- unquestionably a most legitimate goal for the government -- should not be a burden on agriculture. It should be covered by the overall economy through direct payments from the State budget. The key to dealing with prices of tradable inputs and final products should be determined by the trade and foreign exchange regime, and not by sector-specific price policies.

Completing Land Reform and Farm Restructuring

XIV. Georgia is unique among the former Soviet republics in having allowed total paralysis of the collective and state sector both in primary agriculture and in agro-industries. According to the Government, nearly 80% of output in 1994 was produced by the private sector. Therefore, unlike most other countries in the former Soviet Union, *Georgia is probably beyond the stage when it can usefully hope to restructure the traditional large-scale farms and adapt them to efficient operation in a market environment.* Rejuvenation of agriculture should focus on: (a) rapid privatization of remaining state-owned land and assets by very simple and uncomplicated mechanisms; (b) voluntary regrouping of the new private owners into farming structures of their choice; and (c) creation of adequate farm support services for the needs of privatized agriculture.

XV. Due to civil unrest, the implementation of the 1992 land reform resolution has not been fully completed. The very much needed first step in continuing land reform is the completion of this process. In December 1994 the Head of State issued a decree *to complete the initial land distribution process* in those areas (border areas inhabited by ethnic minorities and areas around large cities) where land distribution was not implemented. By implementing this decree, the land in private use will increase by about 40,000 to 50,000 ha for a total of roughly 680,000 to 690,000 ha. Only Abkhazia will remain out of the initial land reform process. The distribution will be carried out on the same principles as the original process.

XVI. The initial distribution of land has taken place without settling the legal framework of land ownership. Legally all land is still owned by the state. Private farmers have no clearly defined owner's rights. *The legal settlement of agriculture land ownership* is therefore one of the most pressing needs to facilitate further development of the agriculture sector. A draft land law is under consideration by Parliament, however, the time and the final outcome of the parliamentary decision is not clear. A land law should be legislated with the following provisions: (a) creating full unrestricted private ownership of agricultural land with the right to sell, lease, and inherit; (b) providing land already in private use to farmers as their own property; and (c) creating a legal framework for a functioning land market.

XVII. The Government of Georgia has submitted a draft Law of Agricultural Land to Parliament. The draft settles the legal ownership status of land received under the 1992 land privatization program. The recipients will have full-fledged private ownership of their land under the terms of the law, while the undistributed land is not covered by this legislation. The present draft creates an opportunity for the development of land markets by allowing leasing and selling of privately owned land. However, the framework set by the law does not satisfy all the conditions necessary for smoothly functioning land and lease markets. The law contains a fairly complicated system of preemptive purchase rights and special inheritance provisions intended to prevent fragmentation of holdings and irrational use of agricultural land. The sale and leasing of land is still subject to administrative permissions. Though the grounds for refusing permission to sell are limited, the procedure itself may constrain the smooth functioning of land markets.

XVIII. Regarding the remaining state-owned arable and perennial land (about 320,000 ha), there is an option to extend the land distribution program so that the state land is given free to the same beneficiaries as before. However, since the 1992 land privatization program provided everybody with a basic entitlement, our recommendation is to use the remaining land to facilitate the emergence of private farms of more efficient size, providing the most efficient farmers with an opportunity to obtain land. In the latter case, the *transfer of remaining state-owned land to private producers requires two major decisions*:

- Transfer method: will the land be sold or only leased out by the state?
- Eligibility: will the entire population be eligible to obtain land, or only the current farming population, or perhaps only the current farm workers?

The ideal transfer method is to sell the land to private owners. Failing that, land should be given on long-term leases of not less than 50 years, with freely transferrable lease rights and preferably an option to buy. Market methods based on competitive bidding, are recommended for this procedure. Although there are many arguments in favor of restricting the eligibility to obtain land to the current farming population, it is not desirable to impose any restrictions in this matter. The farming population has already been given a privileged right to obtain land from the state, and now everybody must have an equal opportunity to acquire land for farming.

XIX. Distribution of land without a simultaneous decision on the use of productive assets will not achieve the goal of recovery in agricultural production. Two basic approaches to the *distribution of non-land assets* held by agrofirms and state farms (including livestock) are possible:

- Sell the assets one by one through a competitive-bidding process.
- Group the assets into functionally independent entities and auction these entities as whole units.

The second approach may be preferable in the present environment, as it will immediately create operational production units (e.g., a dairy operation) and a nucleus of ready-to-function service facilities for agricultural producers. However, the adoption of the second approach should not exclude separate sale of some assets to the highest bidder.

XX. *A market for land* should be established after the land law is effective, together with creating necessary regulations. Market agriculture cannot function without a land market, but overall environmental and social objectives require land market regulation as well. Land registration offices and cadastral surveys are required immediately to facilitate the establishment of the market where buyers and sellers could meet and trade title for land. Development of a land market will permit commercial banks to accept land as collateral for investment and working capital loans and, hence, provide an essential element in the development of market based agriculture.

Creating Competitive Markets for Agricultural Products, Inputs, and Services for Agriculture

XXI. Privatization and Demonopolization of Agroprocessing. The privatization of agro-industries should be completed expeditiously in line with the general privatization program of Georgian Government. So far, the privatization program has had mixed success in agro-processing, and many newly privatized enterprises have been unable to resume production for lack of capital and other resources. The sector is badly in need of capital inflow in order to resume production and improve quality. Appropriate legislation is needed to attract foreign investors. The privatization of the former State Corporation of Bread and Poultry Industry is in progress. The Corporation was first divided into independent units, many of which have now been sold. The privatization of grain elevators and mills is scheduled for completion in 1996, albeit with the state retaining 51% of ownership.

XXII. Privatization of Input Supply and Services. A private-based commercial system is the most suitable way for supplying inputs and machinery services and for marketing agricultural products. A network of farm supply shops should be created soon by privatizing the existing network and by promoting establishment of new firms. Development of private retail, wholesale, and input supply trading systems for agricultural products requires:

- privatizing existing state and municipality owned food shops by lease or sale to the present managers and workers, without restriction on the resale of facilities and equipment;
- promoting and encouraging private sector entry at the wholesale level;
- designing programs and timetables to privatize or restructure and divest larger enterprises operating at the wholesale and product assembly levels;
- establishing a legal and regulatory framework to encompass: (a) anti-monopoly regulations; (b) competition policies; (c) corporate law, property law, and contract enforcement; and (d) legislation (and its enforcement) related to quality standards;
- facilitating investments in a new market structure including: (a) improved physical facilities such as auction halls, city markets, regional cooperative packing and grading facilities, and transportation equipment; (b) increased market information services; (c) an enlarged commodity exchange; and

(e) commercially based export marketing organizations.

XXIII. One of the major possibilities for the development of a functioning farm support sector is through the establishment of service cooperatives. These cooperatives, organized on a voluntary basis by the producers on the basis of their specific needs, may be responsible for agricultural machinery, purchase and delivery of agricultural inputs, and shipping out and marketing of agricultural products. New private service cooperatives can be based on the core of the existing collective and state farms, but farmers should be free to choose the forms of cooperation they prefer, and the new cooperation must be based on private ownership and competition. The establishment of service cooperatives should not rule out the creation of private firms in the same lines of business.

Agricultural Finance

XXIV. Agriculture, like any other productive sector, needs credit for both short-term working capital and long-term investments. The optimal strategy of credit provision is through a market-oriented commercial banking system. However, the existing banking system, including the Agrobank, is not able to satisfy the credit needs of agriculture and agro-industry in the new economic environment, and probably will not be for many years to come. Interim, admittedly suboptimal, strategies must be developed to fill to vacuum and to enable the sector to experiment with unconventional solutions in the absence of a functioning banking system.

XXV. Possible interim strategies include the adaptation of the practice used in many developing countries, which relies on linkage mechanisms between credit and product. This assumes that input suppliers and food processors provide credit for farmers to finance agricultural production, and are often repaid in kind. An additional mechanism for increasing the availability of credit to small farmers may include the creation of local credit unions or credit cooperatives in the villages. The establishment of rural credit unions began on a pilot basis in 1995. As an interim measure, an agricultural enterprise development corporation may be established to assist enterprises to develop business plans and feasibility studies, and provide investment loans.

XXVI. During the transition period, before the economy stabilizes and the agricultural markets are fully liberalized, political and social considerations might force the Government to continue providing some directed credit for agriculture at concessional terms. However, as long as subsidies are maintained, they should be preferably transaction-based, and not take the form of interest rate subsidies. Financial subsidies and supports should therefore be gradually phased out as the economy progresses toward market conditions. The ultimate objective is to have the interest rates eventually determined by market forces and to have agriculture rely on commercially supplied credit.

New Institutional Framework

XXVII. Georgia needs to make a high level commitment to changing the structure and scope of government organizations for management of agriculture. In a market driven economic system *the Government should play three sorts of roles*: regulation, provision of supporting services, and analysis. Regulation should include such things as food inspection, seed inspection, establishment and enforcement of grades and standards, establishment and control of phytosanitary standards, epidemiology and livestock

disease control. Essential services of a public nature should also be provided. This might include agricultural statistics, domestic and foreign market information, transport and shipping infrastructure, agricultural research, and farm advisory services. Finally, the Government should monitor, review, and diagnose the implication of changing circumstances and develop options for public policy.

XXVIII. *Overall institutional and policy reforms are also necessary to modernize the educational research system.* This would require a comprehensive study of alternative models for modernizing higher education, research, and extension. Given the importance of harnessing the inherent synergy between research and higher education, a strategic issue that should be confronted is how the institutes of agricultural higher education and research can be integrated. Associated with this issue is the need to rationalize the allocation and utilization of resources available for research and in the agricultural university system. The respective roles of public and private research should be defined to encourage the most cost effective use of limited resources. Ultimately this process has to lead to some hard decisions with respect to the reallocation of research resources, including large scale downsizing (some institutes were developed to service the needs of the whole FSU), privatization and the allocation of time by faculty to research, teaching and/or extension.

XXIX. The details of the recommended strategy for implementing reforms reflected in the priorities outlined above are discussed in the main body of this report. Core recommendations however, are summarized in the following **policy matrix** which provides an overview of the proposed reform agenda and ultimate policy objectives.

POLICY MATRIX

Issues	Recommendations	Ultimate Objectives	Implementing Agency
1. Supportive Policy Environment for Agriculture (a) Trade and Price Policies	<ul style="list-style-type: none"> • Remove existing restrictions on exports • Refrain from intervening in agricultural import and export markets with the exception of interventions acceptable under the WTO • Develop legal and institutional capacity to use safeguards and countervailing duties • Ensure that all state agricultural procurement is executed on a competitive basis • Eliminate formal and informal barriers in domestic trade • Eliminate remaining implicit taxation of exports • Abstain from direct price interventions • Fully liberalize bread and milk prices • Phase out remaining producer subsidies (water) 	<ul style="list-style-type: none"> • Minimal Government intervention in agricultural markets • Competitive and functioning agricultural markets • Low and uniform tariffs and no quantitative restrictions on exports • Foreign trade conducted by private agents • Promotion of Georgian competitive advantage in agriculture • Distortion free markets for products and inputs 	<ul style="list-style-type: none"> • Ministry of Economy • Ministry of Finance, National Bank • Ministry of Economy • Ministry of Economy • Ministry of Agriculture and Food Industry
(b) Taxation	<ul style="list-style-type: none"> • Simplify taxation of agroprocessing and services • Guarantee the consistency of land tax with the rest of taxation 	<ul style="list-style-type: none"> • Fair and non-discriminatory system of taxation 	<ul style="list-style-type: none"> • Parliament • Ministry of Finance
(c) Foreign Investment Incentives	<ul style="list-style-type: none"> • Facilitate foreign investment by adopting Western-style commercial codes 	<ul style="list-style-type: none"> • Supportive framework for foreign investors 	<ul style="list-style-type: none"> • Parliament

2. Land Reform and Farm Restructuring	<ul style="list-style-type: none"> • Complete the initial privatization of land as envisaged by the Presidential decree of December 1994 • Provide private ownership for beneficiaries of initial land distribution by adopting a draft land law • Transfer remaining cultivated state lands to private producers • Transfer non-land productive assets from state/collective users to private operators • Create the conditions for a functioning land market 	<ul style="list-style-type: none"> • Individual private farming as the major component of the farming system • Competitive markets for land and other agricultural assets • Secure transferable land use rights 	<ul style="list-style-type: none"> • Ministry of Agriculture and Food Industry • Parliament • Ministry of Agriculture and Food Industry • Ministry of Agriculture and Food Industry • Parliament
3. Privatization and Demonopolization of Agro-processing and Input Supply	<ul style="list-style-type: none"> • Implement the overall program of privatization without delay in agro-processing and input supply • Demonopolize state corporations (associations) and privatize them individually by plant or unit • Implement a timetable for demonopolization and privatization of the State Corporation of Bread and Poultry Industry • Adopt anti-monopoly legislation 	<ul style="list-style-type: none"> • Improved product quality and penetration of domestic and foreign markets • Facilitation of the emergence of new and restructured private firms in processing, input supply, and services 	<ul style="list-style-type: none"> • Ministry of State Property Management • Parliament Council of Ministers • Ministry of State Property Management • Council of Ministers • Parliament
4. Agricultural Finance	<ul style="list-style-type: none"> • Prepare an action plan to revitalize financial services • Implement pilot projects to establish credit unions in the villages 	<ul style="list-style-type: none"> • Viable financial institutions efficiently serving the agricultural sector • Efficient allocation of credit to profitable activities in the whole sector 	<ul style="list-style-type: none"> • Ministry of Agriculture and Food Industry • Ministry of Agriculture and Food Industry
5. Institutional Framework	<ul style="list-style-type: none"> • Prepare and implement a program of re-organization of public administration in agriculture • Review the agricultural education and research system • Support the emergence of private farm advisory services 	<ul style="list-style-type: none"> • Efficient and effective public sector administration and support services • Re-orient Government attention toward private agriculture 	<ul style="list-style-type: none"> • Council of Ministers • Ministry of Agriculture and Food Industry • Ministry of Agriculture and Food Industry

CHAPTER 1

BACKGROUND

1.1 Georgia is a small country, with a population of 5.4 million and an area of about 70,000 km². Agriculture traditionally has been one of Georgia's most important sectors, as the country's diverse climates and relatively good soils have permitted the cultivation of a wide variety of crops. Official data suggests that nearly one third of the labor force was employed in agriculture in 1993 and the contribution of agriculture to the net material product (NMP) was about 30% in 1992, the latter increasing, according to the IMF estimates, to about 68% in 1993 (in constant 1987 prices) and up to 87% by the end of 1994 (in current prices).

A. THE RESOURCE BASE

1.2 Agricultural lands total 3 million ha, which in turn, make up about 43% of the total area of the country. There are nearly 800,000 ha of arable land, and 322,000 ha of perennial crops, which together comprise only 16% of land area, the rest of agricultural land is devoted to pasture and grazing (Table 1.1). The country has substantial forest reserves. Roughly 43% of the country's territory, 2.75 million ha, is under forest cover.

1.3 Soils are generally moderately fertile and easily workable. Soil profiles on sloping land tend to be shallow, often stony, and are generally low in humus (2-2.5%) content. Soil pH ranges between an acidic 4.5 on the podsoles of Western Georgia to 8.5 on the calcareous earths of the drier Eastern Georgia.

1.4 Georgia experiences a milder climate than most parts of the former Soviet Union (FSU). The bulk of the central cultivated area enjoys average monthly temperatures ranging from 1°C in January to +22°C in July, with some 230 growing days per year. Clearly in such undulating terrain, many micro-climates are found. Rainfall varies greatly, from west to east, being 2,000-4,000 mm in Western mountainous zones, 1,600 mm on the coastal plain, to less than 400 mm on the border to Azerbaijan in the south-east. Supplemental irrigation is considered generally beneficial in Eastern Georgia, especially in mid to late summer on lands receiving less than 800 mm of rainfall annually, but only drainage is needed in the west. Agroclimatic zones vary from hot and humid in Summer, to mild in Winter on the Black Sea coast, through semi-humid conditions in the center and east, up to cool mountainous humid conditions on the northern border (see attached maps).

1.5 The main environmental concerns in Georgian agriculture include: (a) protection of topsoil from erosion, overgrazing, and other poor farming habits; (b) prevention of ecosystem contamination; and (c) rational design of support systems and development plans. The most serious environmental problems

Table 1.1: Land Use in Georgia (1994)

	ha	%
Total Area	6,949,400	100
Ag. Land	3,010,900	43
Arable	799,500	11
Perennial	322,200	5
Pasture/Hay	1,881,800	27
Other Land	3,938,500	57
Forests	2,750,000	40
Urban, Mountain.	1,188,500	17

Source: Ministry of Agriculture and Food Industry

associated with agricultural activities and forestry are degradation of cultivated land (including overgrazing), soil erosion, and deforestation.

B. AGRICULTURAL PERFORMANCE AND STRUCTURE

1.6 Georgian agricultural output grew steadily during the Soviet period (on average 3.7% per year between 1960 and 1985). The agriculture and food production system has, however, experienced a sharp decline in output since 1987. Following a more than 40% decline in 1992, agricultural production further declined by about 20% in 1993. In 1993, agricultural output was only about one third of the level reached in 1987 (Table 1.2).¹ The sharpest declines were recorded in horticulture and grain based livestock production. Notwithstanding a substantial early contraction in production, primary agriculture remains the only currently viable functioning production sub-sector in the Georgian economy. Figures for 1994 (provided by the Ministry of Agriculture and Food Industry) indicate the beginnings of recovery in outputs in both the crop and livestock sectors. Information provided by the Committee for Socio-Economic Information reports, however, a further 11% decline in overall agricultural output in 1994. The review of the physical outputs of major products indicates an overall output level in 1994 at or above 1993 levels. The FAO and CIS Committee for Statistics Information reports the continuation of a recovery in 1995 in most crops and around 5% growth in overall agricultural output.

Table 1.2: Agricultural Output (Constant 1987 Rubles %)

	Crop Output	Livestock Output	Total Output	% of Livestock in Total Output	Agricultural Output as % of Total NMP
1987	100	100	100	33	30
1990	82	98	87	37	37
1992	39	49	47	45	60
1993	33	47	38	42	68
1994	35	57	42	44	n.a.

Source: Ministry of Agriculture and Food Industry, and World Bank

1.7 The crop and horticulture sector dominates primary agriculture in Georgia. Traditionally this subsector provided about two thirds of agricultural output (Table 1.2). The contribution of livestock to the sector production total increased recently to 40-45%. These shares have not changed significantly in last three years.

1.8 Annual Crop Production. The average area under cereals, grain legumes, oilseeds, potatoes and industrial crops in the three year period 1990-92 was 333,000 ha. In 1994 it dropped to 305,000 ha. After 1990, the cropping pattern shifted in favor of cereals and oilseeds, at the expense of mainly grain legumes, and industrial crops (Table 1.3). Whereas in 1988 cereals represented 75% of the area of annual field crops (annual forage crops and vegetables are not included), and in 1990 their share was 77%, in 1994

¹ The statistical information presented in this report is mainly based on data provided by the Government of Georgia. Due to civil unrest and the inability of the Georgian information system to monitor agriculture sector developments, especially in the private and informal sectors, most of the information provided for 1992-1994 is based on estimates and must be treated accordingly. Rural household surveys indicate that the performance of the private sector has been continuously underestimated, therefore the actual outputs in 1992 and 1993 as well as 1994 have been somewhat higher than indicated in Table 1.2 and in other tables in this chapter.

the share increased to 80%. This clearly shows that in times of hardship, farmers put emphasis mainly on production of grain cereals and oilseeds, which are used to a great degree for their own consumption. In 1995 cropping area further increased to 350-370 thousand ha. There was a sharp increase in corn, sunflower, and potato areas.

1.9 Overall crop production has been rather variable. The production of most major crops declined in recent years. The results of 1994 (**Table 1.4**) show the first signs of recovery. The grain harvest of almost 500,000 tons reached the level of the late 1980's. FAO estimates indicate further increases for 1995, with harvests reaching 560,000 tons. A review of yields that are being actually achieved shows that the production potential of annual crops is seriously underutilized. Under more normal input supply, which presently is grossly deficient, and with better farm management, most crops could produce substantially more than their present yields.

1.10 **Horticulture.** In the Soviet era, Georgia was (correctly) identified as one of the primary sources of fruits, nuts, citrus and wine, and the sole source of tea for the Soviet Union. Consequently, the now independent nation finds itself overly endowed (at 10.8% of all agricultural land) with orchards and plantations. **Table 1.5** indicates that the horticulture industry suffered a major collapse in recent years. Overall output of all major products declined, plantations have been neglected and harvests in 1993 and 1994 were only 50-60% of outputs achieved in the late 1980's.

1.11 According to the assessment of the EU-TACIS team, the structure of Georgia's crop/horticulture sectors strongly reflects the impact of the Soviet economy. Georgia, being one of the southernmost republics was forced to expand tea and other plantation areas beyond its agro-ecological capacities. Only about 3% of total area (currently 5%) is suited for intensive plantation type agriculture.

Table 1.3: Recent Changes in Cropping Pattern

	1990		1993		1994	
	'000 ha	%	'000 ha	%	'000 ha	%
Cereals	256	78	245	84	243	80
Legumes	14	4	10	3	14	4
Oilseeds	21	6	14	5	19	6
Potatoes	28	8	21	7	24	8
Industrial Crops*	11	3	4	1	5	2
Total	330	100	294	100	305	100

* Tobacco, sugarbeets, etc.

Table 1.4: Development of Crop Production ('000t)

Item Description	Year			
	1989	1991	1993	1994
Grains	484.2	574.3	409.3	481.0
winter wheat	106.0	210.3	105.0	95.4
Maize	286.1	242.5	242.6	342.8
Legumes	7.1	6.2	6.7	10.6
Sunflower	7.8	6.9	3.2	7.7
Soybeans	5.5	2.2	0.1	0.1
Potatoes	332.4	254.3	248.6	276.0
Sugarbeet	39.3	19.7	12.5	8.2
Tobacco	10.1	7.2	2.2	1.6

Source: Committee for Socio-Economic Information

The comparative advantage of citrus, tea, and wine was obscured by central planning. As the EU analysis indicates, the citrus plantations in western Georgia enjoy a strong comparative advantage. Georgian wines have also been highly regarded and do possess a distinctive flavor. However only approximately 10% of the wines are produced at quality levels to satisfy Western markets. Many vineyards are sited in eastern and central Georgia in areas with flat, arable, and fertile soils best suited for field crop production. Many tea plantations are located clearly beyond the ecological limits of quality tea production.

Table 1.5: Horticulture Production ('000t)

	1989	1991	1992	1993	1994
Tea	497	437	212	129	61
Citrus	154	202	138	41	98
Other fruits	605	400	337	269	373
Grapes	514	518	328	352	284
Vegetables	515	356	308	386	442

Source: Committee for Socio-Economic Information

1.12 There are fertile soils in eastern and central Georgia where the rainfall is not a major constraint, where the application of Western crop management technology - fertilizers, plant protection, growth regulators, and proper cultivation and harvesting technologies, could, in the short-term, produce dramatic increases in cereal, oil-seed, and potato yields. Planted wheat areas for 1995 are estimated at 100,000 ha. These areas are capable of yields of five tons per ha, producing 500,000 tons of wheat rather than the 1.6 tons per ha which was actually produced for the year. With increased yields and a 50-60% increase in planted area, Georgia could become nearly self-sufficient in bread. While flat land should be turned over to wheat and other field crops in eastern and central Georgia, the vineyards on south facing slopes of hillier areas should be replanted and even extended.

1.13 Livestock. Since 1989 the production of all major livestock products, as well as the livestock population, has declined (**Table 1.6**). Grain based livestock, poultry, and pig production has contracted the most. Poultry meat production in 1994 was only about one third the level achieved in 1989. In 1985, 40 - 50% of Georgia's livestock were owned by the state and 50 - 60% were owned and raised by private households. By 1994 more than 90% of Georgia's

Table 1.6 Production of Major Livestock Products

	1989	1994	1994/ 1989 (%)
Meat '000 tons liveweight	279	171	61
Milk 1,000 liters	711	429	60
Poultry '000 tons liveweight	49	12	25
Eggs 1,000 pieces	861	251	29
Wool tons	6,403	3,375	53

Source: Committee for Socio-Economic Information

livestock were owned by private farmers. Local feed resources for livestock production were underutilized during the Soviet period. Intensive grassland management is still totally lacking. Central planners focussed on corn production for grain, while corn-silage production was neglected.

1.14 In the short-term, production increases in grains, cattle, and milk are essential for improving the domestic food supply. Increases in prices at the farm level are already providing incentives, and producers are responding by increasing production. Current conditions will continue to turn farmers away from the traditional horticultural products of Georgia and limit the number of products available for export.

The livestock sector should continue to be a supplier mainly for domestic markets. Local feed availability provides a basis for recovery in cattle, sheep, and goat husbandry. There is little scope for grain-based pig and poultry production growth. Production in these sub-sectors might later recover as private sector activity improves and the domestic economy and personal incomes begin to grow.

1.15 **Private Sector Becoming Dominant.** The distribution of additional land to the private sector as part of the process of land reform has led to a significant increase in its output. The share of the private sector in total agricultural production has increased dramatically since 1990. In 1994, the private sector accounted for practically the entire output of livestock products, potatoes and vegetables, and probably also fruits, citrus, and grapes, and for more than half the grain production in Georgia (Table 1.7). Even tea, traditionally a product of large plantations, is now produced in the private sector. Yet the increased output of the private sector was insufficient to compensate for the disintegration of the large-scale socialized farms, which practically ceased production, causing a steep overall decline in Georgian agricultural product in recent years.

Table 1.7: Share of Private Sector in Agricultural Production

	1990	1992	1994
<i>Livestock:</i>			
Meat	48	77	94
Milk	61	81	94
Eggs	34	62	96
Wool	62	70	86
<i>Crops:</i>			
Potatoes	49	69	95
Vegetables	59	81	88
Grain	26	39	74
Sunflower	1.5	1.4	21

Source: Data for 1980-1985 from Georgian Statistical Abstract, 1985; data for 1990-1994 from Georgian Statistics Committee.

C. AGROPROCESSING

1.16 Agroprocessing is a major industry in the economy of Georgia, which traditionally provided about 10% of the FSU inter-republican trade in processed food products. Wine, tea, fruit and vegetable canning, citrus processing, and mineral water bottling represent the major products. The industry operates about 500 plants including 300 large or medium size units and employs about 35,000 persons.

1.17 Output of food processing (Table 1.8) has declined dramatically since the late 1980's. According to World Bank estimates, the output of the subsector in 1994 was less than 10% of that in the late 1980's. Some parts of the food

Table 1.8: Output of Agroprocessing Industry ('000t)

	1989	1994	1994/1989 (%)
Canned Products	727	11.5	1.6
Wine (mill. decaliters)	17.4	3.5	20.0
Brandy (mill decaliters)	2.3	0.2	8.7
Tea	122	6.3	4.5
Dairy Products	257	17.3	6.7
Meat (beef, pork)	98.2	0.3	0.3
Poultry Meat	33.2	4.0	12.0
Margarine	38.9	0.1	0.2
Sugar	32.0	0.7	2.2

Source: Committee for Socio-Economic Information

processing industry, such as the meat, vegetable oil, sugar and confectionery industries have stopped operating almost completely. Exporting industries, such as wine, citrus and tea, are operating at no more than 15% of capacity.

D. SELF-SUFFICIENCY AND CONSUMPTION OF AGRICULTURAL AND FOOD PRODUCTS

1.18 In recent years Georgia has been far from self-sufficient in the production of some of the basic food products. In 1993 it produced only 18% of the bread flour, 60% of eggs, 54% of major milk and milk products, and only 24% of sugar consumed in the country. About half of the food output consists of fruits, vegetables and tea. In these products Georgia is self-sufficient and is able to export fresh and processed products. Per capita consumption of all major products (**Table 1.9**), with the exception of potatoes and fruits, fell between 1990 and 1993. Bread was the cheapest food for the population up to mid September 1994, when the prices were partially liberalized and increased 500 times in real terms. The decline in the per capita meat and meat products consumption was 55% from 1990 to 1993, while egg consumption dropped 67%, and milk and sugar dropped by more than 70%.

Table 1.9: Self Sufficiency and Per Capita Food Consumption

	Self Sufficiency (%)		Consumption per capita (kg per capita)			% Change
	1990	1993	1990	1992	1993	
Bread	67	35	184	175	114	-38
Potatoes	146	117	41	50	48	17
Sugar	29	24	39	9	10	-74
Vegetable Oil	57	104	6.0	1.3	1.2	-83
Meat & Meat Products	114	147	42	21	19	-55
Milk & Milk Products	39	54	289	87	80	-72
Eggs (pieces)	101	60	140	55	46	-67
Fruits (excluding grapes)	227	102	49	51	54	10

Sources: Committee for Socio-Economic Information and World Bank estimates.

1.19 A large share of current cereal consumption is provided by food aid. Estimates for 1994 show that 61.6% of the total available bread for 1994 distributed by the network of the Grain Corporation came from food aid, an additional 38.2% was purchased on the basis of preferential credits from the EU and Turkey, and only about 0.2% came from domestic production. The low contribution of domestic sources is a reflection, in part, of increased use of privately grown grain for livestock feeding and the result of Government efforts to maintain domestic grain prices below border prices.

CHAPTER 2

AGENDA FOR AGRICULTURAL SECTOR REFORMS

2.1 The conditions most critical to achieving recovery and completing the transition to a market-based agricultural system are: (a) an enabling policy environment; (b) fully privatized primary agriculture; (c) competitive markets for inputs and outputs; (d) an efficient financial system; and (e) an appropriate institutional environment for private agriculture and agroprocessing. The recommended actions necessary to create these conditions are discussed in the following chapter.

SECTION 1: CREATING A SUPPORTIVE POLICY ENVIRONMENT FOR AGRICULTURE

2.2 For a small economy such as Georgia, an important element in a strategy to achieve faster growth is an open trade and investment regime, not merely within Georgia or with neighboring FSU republics, but with the rest of the world as well. This demands an explicit commitment to let price signals (domestic versus border prices, at the appropriate exchange rate) become the vital link with external markets. In the long run, there is great potential for Georgia's agriculture to become a competitive exporter of a variety of high value products, if the right policies and necessary institutional changes are successfully implemented. Significant steps have been taken towards the liberalization and integration of the Georgian price system with international markets and of the development of an open and competitive policy environment for foreign investment. However, there are still important issues to be addressed. In this section, we summarize recent developments in trade patterns, review the nature of trade, price, and tax policies and analyze further steps that need to be taken, or mistakes that need to be avoided, in moving towards an open and competitive economy.

A. FOREIGN TRADE AND TRADE POLICIES

2.3 The collapse of the FSU has placed the Georgian food industry in a difficult situation. On the one hand it has lost a sizable segment of the secure and stable markets that used to guarantee regular absorption of Georgian food products and, on the other hand, disruption of the well-established trade relationships resulted in serious difficulties in the system of procurement (agricultural raw materials, energy, packaging materials, parts & components, etc.). As a result, Georgia's share of the inter-republic food trade among FSU's member states has shrunk considerably in the past three years (**Table 2.1**).

Table 2.1: Georgia's Share Of Inter-republic Trade

	1987 ^a (as percent of the FSU)	1990 ^a (as percent of the FSU)	1993 ^b (as percent of CIS) ^c
Total Exports	2.97	3.04	---
Agriculture	3.89	2.7 ^d	0.4
Food Industry	10.15	4.09	1.0
Total Imports	2.65	2.17	---
Agriculture	3.60	2.39	0.6
Food Industry	2.68	3.80	0.4

^a Georgia, A Blueprint for Reforms, The World Bank, Washington DC, 1993

^b Estimation of the Ministry of Agriculture and Food Industry

^c CIS includes all FSU republics except the three Baltic States.

2.4 Prior to independence, Georgia was a major exporter of high value agricultural commodities, such as wine, tea, citrus, tobacco, and fresh and processed fruit and vegetables. The main agricultural imports were wheat, sugar, milk, and meat. Trade was primarily with other FSU republics. It is difficult to obtain estimates of imports and exports of key agricultural commodities at present given the significant degree of informal trade across borders, as well as difficulties with data collection. On the whole, there has been a substantial decline in exports and imports of all the traditional commodities. According to official statistics, food and agriculture products contributed 30% of all exports and 16.1% of all imports in 1994. The import figures however do not include humanitarian food aid (grain) deliveries. Tea, citrus fruits, and wine were the major export items. On the import side, grain has remained at pre-independence levels, while the import of non-essential products, including sugar, has contracted significantly.

Policies on Imports

2.5 Georgia has maintained a relatively open import regime (uniform tariff and no import quotas) and firms are free to import if they find the means of payment, in rubles, dollars, or goods. Recently though, import tariff rates were increased from 2% to a uniform 12% rate. All trade with CIS countries is duty-free. Georgia should remain committed to an open and transparent import policy, based on relatively low and fairly uniform tariffs, with no quantitative restrictions. Once the Lari - dollar exchange rate adjusts to a 'cheaper' dollar, political pressures are likely to emerge for selective promotion of grains and livestock production, through higher tariffs on imports. However, the Government should not yield to such pressures.

2.6 Under an import regime based on *ad valorem* tariffs, the stabilization of domestic prices is an issue which is likely to emerge in the future. Contingency protection measures, safeguards, countervailing duties, and anti-dumping measures are WTO-legal options to consider in dealing with sensitive import competing products (e.g., milk, grains). For agriculture, safeguards could be an appropriate approach to dealing with a temporary and sharp decline in border prices. Institutional development in the form of an effective customs administration and the capacity to apply contingency measures on imports are important in protecting trade reform from the inevitable pressures for protection which are likely to emerge.

Policies on Exports, the State Order System

2.7 Georgia has moved to a more liberal export regime. Taxes on exports were eliminated in late 1994. Unfortunately, a broad list of agricultural products such as meat and meat products, dairy products, grain and grain products, sugar and mixed feed remain under export prohibition. The export of alcoholic beverages and wood and wood products among other non-agricultural goods still require licensing. The licensing system for alcoholic beverages is not being applied in such a way as to intentionally restrict exports of these products; rather the intention is to ensure that the export prices do not run afoul of EU anti-dumping regulations, and that the exporters report an accurate price when calculating their profit taxes and repatriating their foreign exchange. The licensing requirements for wood and leather, on the other hand, are explicitly restrictive, and are intended to ensure a source of low-price supply for domestic industrial processors of these products, as well as for forest conservation in the case of the former.

2.8 The Government recognizes that full development of Georgia's export potential would require removing barriers to exports of all of these products except wood. The requirements will be removed for lumber, and licenses for export of logs and timber will be given upon demonstration that the trees were

cut in accordance with conservation regulations. After licensing requirements are removed, there should be no other requirements imposed, such as for ex-ante registration requirements of any kind. Enforcement of tax laws for exporters will be carried out by the Tax Inspectorate and Customs Service in accordance with their normal procedures based on ex-post monitoring and investigations when there is cause for suspicion of non-compliance. As exceptional measures during a transition process, exporters of a few goods may be required to register export contracts *ex-ante* with the Government. The mechanisms for this need to be transparent and used only for tax enforcement and capital control purposes.

2.9 The Government also has to put in place several schemes to ensure that exporters can import their required inputs tax free. First, the current legal framework for bonded warehouses will be improved. Also, either as part of this scheme, or as a separate legal scheme, producers who export virtually all of their production need to be exempted up-front from payment of duties, VAT, and excise on their imported inputs. The Government needs to establish a legal framework for free trade and export processing zones and ensure that exporters as well as other producers will be able to get a timely refund on any VAT taxes paid on their inputs, rather than just a credit, as is now the case.

2.10 Consideration is also being given by some regional leaders to developing free trade zones that would allow firms to operate with less restrictive regulation and taxation, but to trade with the rest of the economy with payment of trade duties. Free trade zones have also been discussed as a mechanism for developing transit trade. In a small economy such as Georgia, it would be much better to try and transform the entire economy into a free trade zone, thus reaping the benefits of higher rates of growth, while at the same time focusing resources on assuring the efficient collection of VAT revenues.

2.11 The *state order system* that formally existed until June 1995 was used to set quotas for state delivery of commodities being bartered internationally or distributed domestically through state channels. Enterprises were legally obligated to sell the goods produced directly to the state — with quotas for sales to the state set at 75% of output in 1993 and 65% of output in 1994. These goods were supposed to be exchanged at negotiated prices that were intended to cover the costs of production plus a fixed margin. However, the state was unable to meet its payment obligations and the system collapsed, leading to the eventual curtailment in the supply of many goods. As a result, numerous enterprises engaged in the state order system either went out of business because of inability to obtain raw materials and energy, or simply refused to fulfill their obligations under the system. In addition, restrictions imposed on some types of exports and on internal trade, for the purpose of controlling the markets for commodities traded under the state order system, also unintentionally undermined the development of private sector exports.

2.12 The full implications of abolishing the state order system in late 1995 are not yet fully known. The official intention however is to assure that any state procurement of commodities occurs at market determined prices in voluntary transactions. In the medium term, the state barter system for energy should be phased out in favor of more efficient payments mechanisms. Even in the interim period, care needs to be taken not to slip back into a system where "export" or "marketing" restrictions are used to reduce procurement costs for the state. Greater priority may also have to be given to establishing an energy supply system based on metered supplies with an ability to pay. Yet the current plan appears to be to channel energy supplies to firms according to Government established "priorities", which results, *inter alia*, in firms remaining highly dependent on government decision making.

2.13 Unfortunately, there is some evidence that some in Government may have incorrectly interpreted the collapse of state barter arrangements as a consequence of *too little* control over production

activities in the sector, rather than the inability of the state to recover its costs of supplying energy and meeting its commitments to producers. Such an interpretation could be used to support an alternative strategy based on re-establishing control of production and marketing, which would have significant adverse impacts on the development of the private sector and the prospects for re-establishment of economic growth.

2.14 Improved physical and commercial infrastructure for export trade (including improved administration of customs and port authorities, and a better communication system) should be given priority over the introduction of special incentive programs.

Restrictions on Internal Trade

2.15 Together with price liberalization, efforts have been made to privatize small scale assets in the internal trade and distribution system. As a result, there has been a rapid development of informal trading activities within the economy as the state structures have contracted severely or been privatized. Much of this trade involves individuals operating in cars or buses to move small amounts of commodities to markets. This is a positive sign, but such small scale trading activities do not capture the significant economies of scale that can be achieved through wholesale trade by even small and medium sized firms. The development of more efficient trade services has lagged, in part due to the lack of financing for investment in such activities, but perhaps more importantly, due to the hostile environment for larger scale activities. This hostile environment arises from a number of factors, such as, the threat of gangs; the extensive "official" harassment of commercial activity through the need to pay bribes to operate at a commercial level; the legal constraints on the use of the ruble or the dollar - a constraint easily evaded by small traders but exposing larger firms open to possible harassment.

2.16 The development of private sector activity has also lagged because of slow progress in privatizing transportation services. A prime example of constraints is provided by fees levied by the Ministry of Transportation for the right to operate transport vehicles outside of metropolitan areas. For instance as of March 1995 individuals wishing to provide trucking services face the following official and semi-official barriers:

- the need to join an association — required fee of \$10;
- to obtain a license to operate a private business — required fee of \$25 every three months;
- yet another license from the Ministry of Transport to operate throughout the country — required fee of \$142 every three months.

Operation without these licenses leaves truckers subject to harassment and fines. In order to increased private sector participation in these areas, a consistent policy of maintaining low licensing fees should be followed. Furthermore, in areas where the public and private sectors compete directly, equal access and treatment should be explicitly assured.

B. THE FOREIGN EXCHANGE MARKET

2.17 The lack of a credible domestic currency, and legal constraints against use of other currencies, were important factors in the slow pace of private sector development in Georgia before the introduction of the new national currency, the Lari. Excessive monetary expansion in the aftermath of the civil war in Abkhazia led to hyperinflation and the collapse of the currency. There was substantial currency substitution in which the Russian ruble and the US dollar were used as units of accounts and payments for transactions. The requirement that exporters surrender 32% of their earnings and the restrictions on the use of cash dollars put export activities at a considerable disadvantage. The planned removal of the foreign exchange surrender requirement will eliminate the implicit export tax that results from its practical application. However, during the transition period, exporters should be allowed to retain full control over their earnings until the Laris are actually reimbursed to them.

2.18 The exchange rate is perhaps the most important factor in the healthy expansion of commercial and private sector trading institutions and to encourage the integration of domestic and external markets. It is this price that determines the relationship between domestic and border prices (and in real terms between tradable and non-tradable goods) and this will determine the opportunities presented to Georgia's agricultural economy in external trade. The future evolution of the exchange rate will be critical to a successful recovery of the tradeable sector of Georgian agriculture.

C. DOMESTIC PRICE INTERVENTIONS FOR AGRICULTURAL PRODUCTS

2.19 Until the beginning of 1992, all prices were regulated. Most retail and wholesale prices were liberalized in February 1992 or during a second round of liberalization implemented in July 1992. Prices that remain under Government control are those of bread, milk, energy products, and some Government-provided services (communications and urban transportation).

2.20 Among food products, only bread and raw milk were sold at fixed prices in early 1995, but so-called "recommended" prices still applied to a number of other food products in state shops (e.g. bottled wine, beer, mineral water, various sorts of sausages, tea, a variety of dairy products, cigarettes, and canned fruits and vegetables). These "recommended" prices were, in general, lower by 30% to 80% of prices charged by private producers and importers. Recommended producer prices are calculated by adding a 10% to 20% margin to the average cost of production reported by each industry (only variable costs are taken into account). Since subsidization of bread and milk is a major item in the state budget, termination of these subsidies became an inevitable necessity, and a decision was made September 1994 to phase out the subsidization of the consumer price of bread. This decision however, was not fully implemented until the end of 1995. The rationed subsidized bread prices are about 50% lower than free market prices (0.25 to 0.35 Lari compared with open market prices of 0.45 to 0.55 Lari for an 800 gram loaf) and profit margins of bread produced by state-owned companies are still controlled.

2.21 **Table 2.2** shows the evolution of prices of selected food commodities in the Tbilisi Central Market between 1992 and 1995, calculated in US dollars. Price observations on various local markets suggest that, although the Tbilisi Central Market prices are somewhat higher than in the rest of the country, there is no significant segmentation of free markets in different locations in Georgia. The table shows that the prices on the private market are indeed moving toward border prices. These market prices are definitely beyond the reach of a large portion of the population in Georgia, whose income has not caught up with these

price increases. On the other hand, this also indicates that the private farming sector, which mainly sells through the private markets, has been able to increase its earnings substantially.

Table 2.2: Tbilisi Market Prices of Selected Goods (US \$)

	Unit	Mar 92	Mar 93	Mar 94	Mar 95	Oct 95
Beef	1 kg	1.11	1.47	1.93	1.88	2.36
Mutton	1 kg	0.61	1.45	1.33	1.46	2.36
Milk	1 kg	0.06	0.09	0.53	0.52	0.79
Cheese	1 kg	1.33	1.62	2.06	2.5	3.54
Sugar	1 kg	0.2	0.37	0.62	0.63	0.79
Bread	1 kg	0.04	0.06	0	0.31	0.40
Potato	1 kg	0.07	0.15	0.29	0.25	0.39

Source: Ministry of Agriculture and Food Industry

2.22 **Table 2.3** indicates the changes in food and vegetable prices on the Tbilisi market during the period immediately before and after the introduction of the Lari (October 1995). On September 26, 1995, all the products were sold for Rubles, while on October 2, 1995 products were being sold for the newly introduced local currency. In the second half of September, consumers purchased significant amounts of goods. The approximately 15% price increase in early October is mainly a reflection of limited supply, otherwise the conversion from Ruble to Lari took place smoothly on food markets.

2.23 Abstaining from Price Interventions. In the long-run, the main force influencing the structure of incentives for agriculture in any country in the world is the external trade and foreign exchange regime of a country. This is because agriculture is a highly tradeable sector, particularly in relatively small economies such as Georgia. Here the "structure of incentives for agriculture" refers to the domestic relative price structure for agriculture *vis-a-vis* the rest of the economy and *vis-a-vis* foreign competition. It is crucial to recognize this simple fact, and to avoid falling into the trap that by manipulating direct, agriculture specific price interventions, the government will be able to have a sustainable influence on relative prices (e.g. incentives) for agriculture. It could do this only at an enormous fiscal cost to the State budget, which is not in the realm of the possibility for the Government of Georgia in the foreseeable future.

2.24 For agriculture outside the export subsector, a very important positive element of the present situation is that there are now virtually no direct price interventions in agricultural markets. The absence of direct interventions in agricultural markets for the non-export products have facilitated the resurgence of a dynamic private market for domestically-traded agricultural products. This is the case for meat, vegetables, some grains, wine outside the export orders systems, and some other items. Any effort by the Government to try to interfere directly in these essentially private informal markets would be counterproductive for their future growth.

2.25 We strongly recommend that the Government of Georgia abstain from becoming involved in sector-specific price interventions, both because the Government is not powerful enough to counteract the influence of price and foreign exchange policies, except at a very high fiscal cost, and because price policies

are not an efficient instrument in dealing with social objectives, such as income transfers to particular segments of the population. The social safety net to protect the most vulnerable segment of both the urban or rural population -- unquestionably a most legitimate goal for the government -- should not be a burden on agriculture. It should be covered by the overall economy through direct payments from the State budget. The key to dealing with prices of tradable inputs and final products should be determined by the trade and foreign exchange regime, and not by sector-specific price policies.

Table 2.3: Change in Prices for Selected Food Products in Sept.-Oct. 1995

Food Item	Average Price on Sept. 26		Ave. Price on Oct. 2	%
	Rubles	Lari	Lari	Change
Butter - 1 kg	1400	3.5	4	12.5
Sugar - 1kg	3750	0.94	1.5	38
Oil - 1lt.	7000	1.75	2	12.5
Margarine - 25 gr	2000	0.5	0.7	29
Milk Powder - 1 kg	15000	3.75	4	6
Macaroni - 1 kg	4500	1.13	1.3	13
Egg - 1	600	0.15	0.15	0
Salt - 1 kg	1000	0.25	0.3	17
Rice - 1 kg	3500	0.88	0.8	1.1
Tomatoes - 1kg	200	0.5	0.5	0
Potatoes - 1 kg	1900	0.48	0.5	4
Carrots - 1 kg	1500	0.38	0.4	5
Grapes - 1 kg	1400	0.35	0.5	30
Eggplant - 1kg	1300	0.33	.05	-93
Apples - 1 kg	1200	0.3	0.4	25
Beans - 1kg	2000	0.5	0.5	0

Source: *The Georgian Times*, Oct. 7, 1995

2.26 **Removal of Remaining Subsidies.** A market-oriented farmer should no longer expect subsidization of inputs, not even irrigated water, which in the past had been supplied free at a considerable cost to taxpayers. The present reality is that the state-owned water enterprises operating reservoirs, pump stations, diversion structures, and main supply canals are virtually bankrupt, and are no longer maintaining their infrastructure. Many pump houses are out of action and many components in non-functional irrigation networks have been damaged. A charge for water, payable by all users according to volume supplied, would fund the water enterprises and at least allow them to undertake basic maintenance. It is strongly suggested that a law or decree be proclaimed, making payment of water charges obligatory, not only by irrigators, but also by household and industrial users. Irrigators should group into small water users associations (WUAs),

and accept ownership and full responsibility for the operation and maintenance of the part of the irrigation network falling within their farms, and collect and remit water fees.

D. AGRICULTURAL TAXATION

2.27 The Government recognizes that the sustainability of the stabilization program and the ability to perform a set of critical public functions depends crucially on the mobilization of resources for the budget. The Government intends to increase tax revenues from 3.7% of GDP in 1995 to 6.7% in 1996 and to rely mostly on domestic resources to finance current government expenditures. To reach that objective, major efforts are needed to improve revenue performance. By March 1996, the Government will expand the tax base by removing most tax exemptions (VAT, customs, excises, and profit taxes). Over the first half of 1996, tax administration will be strengthened by reorganizing the tax inspectorates; completing a comprehensive taxpayer survey; simplifying procedures and tax regulations for tax assessment; reviewing the incentive system for tax collection agencies and inspectors; and imposing higher penalties for non-compliance. The Government also intends to develop and implement, in cooperation with the IMF, World Bank, and UNCTAD, a comprehensive customs administration reform program, including development of effective procedures for control over and clearance of imports and exports, duty assessment and collection.

2.28 In view of the many changes introduced in the tax system in recent years, the Government plans to review all tax laws and draft a new VAT tax law and a new tax code for submission to Parliament by July 1996 and January 1997, respectively. In the context of the VAT, another major change is that the Government intends to carry out (but which must be done in consultation with its partners in the CIS) is to change the basis of taxing trade with these countries from the "origin principle" (whereby VAT is not imposed on imports, but is on exports) to the "destination principle" (whereby imports are VAT-taxed, but exports are not), which currently governs its trade with non-CIS countries.

2.29 The neglect of credits for VAT payments on capital goods has been common in most of the FSU countries that adopted a VAT law similar to that enacted in Russia in December 1991. Many of these countries, including Russia, have subsequently modified the VAT system to allow for tax payments on capital assets to be taken as credits on VAT obligations. In Georgia, credits for VAT payments on capital goods also exist and as of June 1995, capital imports are no longer subject to VAT. The draft foreign investment law, passed in June 1995, allows the cost of capital to be expensed against income subject to the income tax, with excess expenses carried over to future years.

2.30 Agroprocessing enterprises and agricultural services are subject to a rather complex and in many respects, pervasive taxation. Contributions to social security are equivalent to 42% of wages. The state owned firms pay 10% profit tax, while the income of the private sector is taxed at 30%. State owned firms pay an additional 1% tax on the book value of fixed assets. A road tax equivalent to 1% of the value of production is paid by all enterprises. Private farmers, if not registered as business operations and do not use hired labor, pay only land tax. Farmers are also free from personal income tax which is automatically deducted from the salaries of wage earners.

2.31 A land tax system is a reasonable option to the administratively difficult uniform VAT and profits tax, and the assessed tax rate on land should try to approximate what would be the sum of the value-

added tax and the profit tax rate for small firms in the non-farm sector.¹ The Government has introduced a land tax of \$20/hectare on average, which will be collected starting in the last quarter of 1995. The tax varies according to the potential of the land and ranges from around \$15/ha to \$30/ha. The tax is applied to all agricultural land, including household plots. The justification of the proposed tax rate requires a detailed analysis of production costs and farm revenues, which is beyond the scope of the present report.

E. ENCOURAGEMENT OF FOREIGN INVESTMENT

2.32 The foreign investment law, passed in June 1995, provides a supportive framework for foreign investments.² The experience of other countries in attracting foreign investment in an increasingly competitive international environment can usefully illustrate the key conditions necessary for attracting and maximizing the benefits from such investment. These can be summarized as follows:

- equal treatment of foreign and domestic investors;
- guarantees against expropriation or nationalization or arbitrary changes in the operating environment for the foreign investor;
- access to reliable legal channels, including international tribunals for settling investment disputes;
- clear procedures for registering investment projects outside of clearly defined areas of exclusion (for national security reasons, for instance);
- freedom from foreign exchange controls and the right to freely repatriate profits and capital at a non-discriminatory exchange rate; and
- relatively low and straight forward tax systems in which tax obligations are clearly defined and arbitrated;

2.33 The new law appears to establish the first three elements. It is not clear, however, that the open registration procedures will be put in place. The new law stipulates an approval process managed by a foreign investment board with discretionary powers. There is also a potential concern about foreign investors and restrictions of managing foreign exchange risks in what is likely to continue to be a multi-currency economy. There are also extensive exceptions to various taxes, a situation likely to lead to distortions to investment and a waste of resources in foregone revenues that is likely to be high relative to any benefits provided to the foreign investors.

¹ Article 5 of The Law on Value Added Tax exempts "raw agricultural materials and products" from the value added tax. And, The Law on Profits (Income) Tax of Enterprises exempts profits received from agricultural production produced by enterprises of any organizational/legal form, except for industrial agricultural enterprises (with a list of the enterprises subject to profits taxation being fixed by the Parliament).

² While a similar mirror law may be in preparation for domestic investment, a draft of this law was not available in early March 1995.

2.34 The Government intends to amend this law to resolve these problems. It will enact a code governing foreign investment, which will be based on a system of automatic approval of investments, with certain clearly delineated exceptions based on environmental or security concerns. In recognition that temporary concessions and holidays are not generally effective in attracting efficient investment, the code will not contain such fiscal incentives, though it may provide tax exemptions on inputs used in production for exports.

SECTION 2: PRIVATIZING PRIMARY AGRICULTURE

A. THE PROCESS OF LAND REFORM

2.35 Before independence, Georgian agriculture followed the standard Soviet template with a distinct dual organization. Commercial farming was represented primarily by the centrally controlled large-scale socialized farms, the collective *kolkhoz* and the state-owned *sovkhos*, and these coexisted with a quasi-private sector of subsidiary household plots cultivated by *kolkhoz/sovkhos* employees and producing mainly, but not only, for subsistence. At the end of 1986, the large-scale farms managed 87% of all farm land in Georgia, while the subsidiary household plots accounted for 6% of all farm land (slightly less than 200,000 ha in plots averaging 0.25 ha each).

2.36 The process of land reform in Georgia began with Government Resolution 48 of January 1992. This resolution is generally known as "the land privatization decree," although more properly its objective was land distribution. The notion of land privatization probably reflects the intention to transfer the distributed land eventually to private ownership. Following this landmark resolution, a "privatization reserve" of 850,000 ha was established. The reserve included the 200,000 ha actually used by household plots at that time and provided an additional 650,000 ha for augmentation of existing household plots and creation of new ones. The privatization reserve comprised predominantly arable land and perennials (the only kind of land used by subsidiary household plots) and represented about 70% of these land resources. However, as a percentage of all agricultural land in Georgia, the privatization reserve encompassed less than 30% of total agricultural area.

2.37 Under the 1992 land privatization program, land from the privatization reserve was given away free to the eligible beneficiaries. The working population of the large-scale farms received land up to a maximum holding of 1.25 ha (up from the former average household plot of 0.25 ha). Others living in villages associated with agriculture were given 0.75 ha, while people living in cities were given (and are being given) 0.25 ha if they had formerly farmed in the given village, and if not, 0.15 ha. Up to 5 ha of grazing land in mountainous areas was given to livestock farmers. There was apparently little regard for different qualities of land in the process of distribution. The distribution of land was managed by local village committees, but those on collective farms actually decided how the land was to be distributed.

2.38 Even the partial land distribution program begun in 1992 remains largely uncompleted in the first half of 1995. Although the area in private use almost trebled between 1990 and 1995, increasing from 211,000 ha to 621,000 ha, this is still far short of the target figure envisaged. The land distributed for private use up to July 1995 represents only 20.7% of all agricultural land and 42.6% of arable land and 59.5% of land under perennials (Table 2.4). Thus, close to 60% of cultivated land remains in collective and state farms, although most of them effectively ceased production. One of the major blocks that has

prevented complete distribution of the entire "privatization reserve" is clearly the political and civil unrest in Georgia. As a result, the percentage of agricultural land distributed in different districts is highly irregular (Table 2.5).

Table 2.4: Overview of Land Privatization Status (July 1995)

Land	Total Area		Privatized as of July 1995		Current state owned land		Proposed to be privatized in the near future		Remaining state owned land	
	1000 ha		1000 ha	%	1000 ha	%	1000 ha	%	1000 ha	%
Arable	797.1		339.8	42.6	456.3	57.4	325.3	40.8	132.0	16.6
Perennial	320.5		190.7	59.5	129.8	40.5	51.4	16.0	78.4	24.5
Pastures/Meadows and others	1893.3		91.5	4.8	1801.8	95.2	-	-	1801.8	95.2
Total Agriculture	3010.9		621.9	20.7	2388.9	79.3	376.7	12.5	2012.2	66.8

Source: Ministry of Food and Agriculture Industry.

2.39 The agricultural land reform process has involved agencies at the national and local government levels. At the national level a special Land Reform Committee was established to deal with all the aspects of land reform issues and to manage, through local government implementation, the land reform in the collective and state farms. This committee was later incorporated into the Ministry of Agriculture and Food Industry (MAFI), and was vested with the responsibility of planning and implementing land reform, and proposing land legislation to be ratified by the Parliament.

2.40 The land privatization decree was followed in September 1992 by a Government resolution on the reorganization of collective and state farms. This resolution provided very little guidance as to the actual process of reorganization. As a result

Table 2.5: Privatization of Land by Region in Georgia as of January 1995 (%)

Region	Total Agricultural Area	of which	
		Arable Land	Perennial Land
Abkhazia	8.6	19.4	22.2
Ajara	12.9	38.0	25.8
Svaneti	20.5	83.9	79.3
Samegrelo	25.2	50.6	21.2
Guria	42.9	58.6	66.0
Imereti	44.7	77.0	75.2
Racha	35.4	82.7	73.9
West Georgia	26.1	55.8	41.5
Javakheti	24.3	52.9	81.1
Kvemo Kartli	11.4	25.3	42.0
Shida Kartli	17.9	36.6	70.2
Kakheti	16.6	25.6	63.2
East Georgia	16.1	31.2	66.3
Georgia	19.7	40.0	53.9

Source: Ministry of Agriculture and Food Industry

of the land privatization program and the relatively spontaneous process of restructuring, the inherited large-scale farms have largely disintegrated, although they still notionally represent a wide range of specialized activities (Table 2.6) and control 55% of cultivated land (57% of the arable land and close to 40% of the perennial areas). Land cadastre records show around 2000 farming enterprises in Georgia as of February 1995, while the Ministry of Agriculture and Food Industry reports only about 1500 enterprises engaged in agricultural production (Table 2.7). These numbers do not include the individual private farms, although the small agricultural enterprises are in part based on already privatized land which has been pooled by several households.

Table 2.6: Number of State and Collective Farms in Georgia

	Collective Farms	State Farms
1989	780	653
1990	763	638
1991	629	609
1992	600	601
1993	600	550
1994	107	242

Source: Ministry of Agriculture and Food Industry

B. RECOMMENDED MEASURES TO COMPLETE LAND PRIVATIZATION

2.41 Georgia is virtually unique among the former Soviet republics in having allowed total paralysis of the collective and state sector both in primary agriculture and in agro-industries. Only the private sector continues to produce. Therefore, unlike other countries in the former Soviet Union, Georgia is probably beyond the stage when it can hope to restructure the traditional farms and adapt them to efficient operation in a market environment. Rejuvenation of agriculture should focus on: (a) rapid privatization of land and assets by very simple and uncomplicated mechanisms; (b) voluntary regrouping of the new private owners into farming structures of their choice; and (c) creation of adequate farm support services for the needs of privatized agriculture.

2.42 A necessary condition for achieving these goals is immediate continuation and completion of agricultural reforms, which primarily involve transfer of land and other productive assets to individuals. Urgent priority should be given to the following directions:

- Completion of land distribution as envisaged by the decree of 1992 for all beneficiaries in all parts of Georgia.
- Legal settlement of land provided under the 1992 land reform program.

Table 2.7: Traditional and New Farming Structures: Number of Farms as of February 1995

	Land Cadastre	MAFI
Collective farms	488	--
State farms	697	348
Agrofirms	116	184
Ag Cooperatives	307	444
Small ag enterprises	--	592
Research farms	195	--
MinDef farms	41	--
Other farms	196	--
Interfarm enterprises	50	--
Total number of farms	2090	1568

Source: Ministry of Agriculture and Food Industry

- Transfer of remaining cultivated state lands to private producers.
- Transfer of non-land productive assets from the state to private users and operators.
- Creation of conditions for a functioning land market for private use.

2.43 Completion of the First Phase of Land Distribution. Due to the civil unrest, the implementation of the 1992 land reform resolution has not been fully completed. The very much needed first step in continuing land reform is the completion of this process. In December 1994, the Head of the State issued a decree to complete the initial land distribution process in those areas (border areas inhabited by ethnic minorities and areas around large cities) where land distribution was not implemented. By implementing this decree, the land in private use will increase by about an additional 40,000 to 50,000 ha for a total of roughly 670,000 to 680,000 ha. Only Abkhazia will remain out of the initial land reform process. The distribution will be carried out on the same principles as the original process.

2.44 Legal Settlement of Land Ownership. The initial distribution of land has taken place without settling the legal framework of land ownership. Legally all land is still owned by the state. Private farmers have no clearly defined owner rights. The legal settlement of agriculture land ownership is therefore one of the most pressing needs to facilitate further development of the agriculture sector. A land law should be legislated with the following provisions to: (a) create full unrestricted ownership of agricultural land with the right to sell and inherit; (b) provide land already in private use to farmers as their own property; and (c) create a legal framework for a functioning land market.

2.45 To give adequate impetus to the restructuring of farm ownership and production arrangements, a market for land sale and transfer of use rights must be established. The following measures are necessary to form the legal and economic foundation for a land market:

- a) no moratorium on land transactions;
- b) removal of any preferential rights to land purchase by the Government, the members of the large farms to which the land parcel originally belonged, neighboring landowners, or any other buyers;
- c) no restrictions imposed on the size of an individual's land ownership, or farm sizes (including leased lands);
- d) no restrictions or controls on prices of land transactions;
- e) no restrictions on the form of land use rights (e.g., share-cropping, leasing, etc.);
- f) no land-use restrictions (e.g., designated crops) other than those associated with environmental considerations (including soil and water conservation);
- g) simple, fast, and low cost ownership transfer process for land transactions;
- h) low fees (capable of eventually covering the costs of the land registration system) should be charged only for the registration of the land transaction itself;

- I) no significant taxation on the sale of land;
- j) land title, land leases, immovable land improvements and other assets should be mortgageable;
- k) ease of public access to land information (parcel descriptions, ownership, liens, etc.); and
- l) inseparability, for sales purposes, of land from the immovable assets situated on the land.

2.46 **Draft Land Law.** The Government of Georgia has submitted to Parliament a draft Law on the Ownership of Agriculturally Designated Land. This draft should be examined in the light of the principles outlined above. The draft settles the ownership status of land received under the 1992 land privatization program, and the recipients will have full-fledged private ownership of their land under the terms of the law. The undistributed land, however, is not covered by this legislation: it remains state property and an additional law is required to settle its future disposition and ownership status. The legal settlement of land ownership relations can be regarded as fully completed only when adequate legislation is also enacted in regard to the remaining undistributed land.

2.47 The Government's proposed implementation resolution attached to the draft Land Law provides that land in legal possession prior to the publication of the law, and also land distributed to citizens according to government resolutions of 1992-1994 within legal norms (including household plots, gardens, vegetable patches, and second-home plots), will become private property and will be registered as such in the land registry. All other land will remain state property. This includes all land not distributed to the population, which at this stage is held in permanent use rights by collective and state farms and their legal descendants (apparently even if it is part of the as yet undistributed "privatization reserve").

2.48 The law applies only to agricultural land and pursues two declared objectives:

- to provide legal security for farming based on rational use of land;
- to prevent fragmentation of holdings and irrational use of land.

Farming land can be owned and used by both individuals and legal bodies. There are no apparent restrictions on leasing land, other than the obligation to use agricultural land for farming.

2.49 In drafting the proposed land law, the Government was guided by principles that are usually thought to apply to countries with high density rural populations and scarcity of good land for farming. These principles, used in most West European countries, typically stipulate that agricultural land must be preserved for family farming and that fragmentation of small farms beyond some minimum size must be avoided. The resulting approach does not consider the needs of large-scale corporate farms, which are not a dominant feature in the countries where these principles have crystallized.

2.50 The Georgian draft law of agricultural land ownership closely follows the German land law and focuses on the concept of an "agrarian farm", which is implicitly viewed as a small family farm that must be preserved by legal means as a producing entity. Although formally the law defines an agrarian farm as a "household (peasant) farm or a juridical person," i.e., a corporate farm, the spirit of the law and its provisions are obviously aimed at family farms. For instance, the law stipulates, in line with common legal practice in the world, that a share in a jointly owned family farm can be sold or leased out only with the agreement of all co-owners. Yet the law is completely silent on mechanisms for selling or leasing land by

legal persons. The draft law thus practically ignores a specific feature of Georgian agriculture, which until recently has been based on large-scale farms and where a large proportion of land is still held by large-scale farms.

2.51 The main accomplishment of the draft land law is that it recognizes private ownership of agricultural land, both by individuals and by legal persons. Moreover, the draft law does not impose any direct restrictions on leasing of privately owned land (subject of course to the proviso that the leased land continues to be used for farming). The passage of the law will thus be conducive to the development of a relatively unrestricted market for lease rights, especially among smallholders, facilitating regrouping of holdings and creation of farm sizes consistent with the different preferences of different operators.

2.52 Yet buying and selling of land is seriously constrained by the proposed law. Alienation of land by the owner (this excludes leasing) requires official permission by the Ministry of Agriculture and Food Industry. Even in cases when no permission is required (i.e., when alienation serves to improve plot boundaries; when alienation is for the purpose of more efficient and rational use of plots; when the buyer needs the land for subsistence or for efficient supervision of an existing farm, etc.), the owner must apply to the Ministry to obtain a certificate confirming that no permission is required. The permission must be granted within two months, which in itself is a serious impediment to smooth completion of land transactions, and if refused, the applicant may turn to the courts. Similar permission requirements are standard practice in land laws of Germany and other Western European countries. But the bureaucratic and legal traditions and procedures in Western Europe are entirely different from what they are in Georgia and throughout the FSU. In practice, the administrative permission-granting mechanism and the legal-appeal outlet may cause very serious difficulties to land owners in conducting buy, sell, and lease transactions, and thus potentially block the development of land markets. Without functioning land markets, Georgia will be unable to reap the benefits of its agricultural reform program.

2.53 Another characteristic borrowed from the German land law is the granting of fairly broad preemptive rights in land to various groups of beneficiaries, which is intended to prevent fragmentation of holdings and irrational use of agricultural land. The nature of these preemptive rights is not explained and not specified in the draft law. Representatives of the Georgian Ministry of Justice have assured the World Bank mission that the preemptive rights are always used in the sense of their definition in the Civil Code, where they are introduced as a right of first refusal with a strictly limited duration of validity. If practiced in this manner, the preemptive rights, however cumbersome and inconvenient, are not likely to be a major impediment to land transactions.

2.54 In a further attempt to prevent fragmentation of farm land, article 20 of the draft law bluntly and sweepingly states that "it is forbidden to separate any portion of an agrarian farm into separate plots." Although understandable for smallholder farms of a minimum size, such as most household plots in Georgia, such provision should not apply to large farms, which often must be split and restructured to improve efficiency.

2.55 The present draft creates an opportunity for the development of land markets by allowing leasing and selling of privately owned land. Because of restrictions on buy and sell transactions, there is a possibility that the development of full-fledged land markets will be severely constricted by the proposed restrictions. The Georgian Government should give serious consideration to the system of land property rights and the land ownership legislation as practiced in the U.S.A. and the U.K. Contrary to the Western European system of administrative permissions, the Anglo-Saxon system is largely free, with land owners

possessing virtually unrestricted rights to dispose of their land (with the exception of environmental and zoning regulations). The Western European (and in particular, German) system, although originating in countries that, similarly to Georgia, have a scarcity of agricultural land, assumes a totally different bureaucratic and legal mentality in the civil service and among the judiciary. It can hardly be recommended as an ideal model for a country with strong former Soviet traditions.

2.56 Unfortunately the status of the draft land law providing private ownership for those who received land in the framework of the 1992 privatization decree has not changed. The draft discussed with the Bank was submitted to the Parliament in early 1995, however it has not been discussed and approved there. A counter proposal has also been submitted by the conservative members of Parliament. It is expected that the new Parliament will discuss and resolved the differences. According to a recent survey, 68% of the population supports the proposal to provide full-fledged private ownership to the beneficiaries of the 1992 land reform. Accordingly, it is most probable that the Government's proposal which was coordinated with the World Bank will pass in 1996.

2.57 Privatization of Remaining State Land. Table 2.4 provides an overview of the current status of land privatization. As of July 1995, 20.7% of agricultural area was under private use with unsettled ownership status. The state still owns 79.3% of land, representing 2,388.9 thousand ha used by large-scale farms, or communally. Out of this, 1801.8 thousand ha are pastures and meadows, mainly in the hilly areas that the Government intends to keep in permanent state ownership. An additional 210.4 thousand ha is located in Abkhazia/Ossetia, and the border areas are used by research and extension farms as well. This area also cannot be privatized in the foreseeable future. The Government right now needs to make decisions on the use of the remaining 12.5% (or 376,700 ha) of arable and perennial land. The ongoing completion of the pledges made to the rural population in 1992 reform will require another 40,000 to 50,000 ha, the rest, about 320,000 ha, is left for transfer to private use .

2.58 In principle, there is an option to extend the land distribution program so that the remaining state land is given free to the same beneficiaries as before. However, since the 1992 land privatization program provided everybody with a basic entitlement, our recommendation is to use to remaining land to facilitate the emergence of private farms of more efficient size, providing the most efficient farmers with an opportunity to obtain land. In the latter case, the transfer of remaining state-owned land to private producers requires two major decisions:

- Transfer method: will the land be sold or only leased out by the state?
- Eligibility: will the entire population be eligible to obtain land, or only the current farming population, or perhaps only the current farm workers?

The ideal transfer method is to sell the land to private owners. Failing that, land should be given on long-term leases of not less than 50 years, with freely transferrable lease rights and preferably an option to buy. Market methods based on competitive bidding, are recommended for this procedure. Although there are many arguments in favor of restricting the eligibility of obtaining land to the current farming population, it is not desirable to impose any restrictions in this matter. The farming population has already been given a privileged right to obtain land from the state, and now everybody must have an equal opportunity to acquire land for farming.

2.59 The land bought or leased under this process will probably augment the existing private

farms and lead to larger farming endowments. The recipients of land may form family farms based on individual households or aggregate voluntarily into partnerships, small agricultural enterprises, agricultural production cooperatives, or other private farming structures based on multiple families or households and cultivating proportionately larger tracts of land. Thus, distribution of land to private producers does not necessarily imply total fragmentation and dismantling of large-scale agriculture. New medium-scale structures may emerge as a result of consolidation of individual holdings, but the decision to create such structures must be left to individuals, who should control most of the cultivated land.

2.60 The Government prefers leasing arrangements providing lease rights to local agricultural producers based on the decisions of the local authorities in the Ministry of Agriculture and Food Industry. Two pieces of legislation have been drafted in this regard. The draft Civil Code includes the general rules of land leasing, while the Ministry of Agriculture and Food Industry prepared a separate piece of legislation on leasing state owned agricultural land. Both drafts fall short of the requirements, especially because they do not establish clearly transferrable lease rights and the distribution process envisaged is not based on competition. The transfer of the remaining land from the state to private producers requires a proper legislative base. This base must be developed very quickly so as not to delay the reform process. State-owned agrofirms and state farms in different parts of the country are beginning to make *ad hoc* arrangements for distribution of land to their workers through leasing. This process may advance spontaneously to such an extent that the government will eventually find it difficult to implement its own policies in full.

2.61 Voluntary regrouping of land owners in new farming structures is an essential part of the process of reform. Instances of such regrouping are already evident in Georgia in cases where several farmers consolidate their holdings to create a farming operation with 10-20 ha. Experience in Russia shows, however, that it is the process of regrouping after distribution that involves the greatest practical difficulties. To enable this process to proceed freely and on a national scale, proper assistance is required in the form of information services in the districts. These services should be able to describe the available options to the new land owners, help them make a choice, and guide them through the necessary administrative arrangements. This information and guidance must be available at the level of the district center, so as to be freely accessible to the entire rural population.

2.62 Transfer of Non-Land Assets of Large Farms. Distribution of land without a simultaneous decision on the use of productive assets will not achieve the goal of reinvigorating agricultural production. Two basic approaches are possible to the distribution of non-land assets held by agrofirms and state farms (including livestock):

- Sell the assets one by one through a competitive-bidding process.
- Group the assets into functionally independent ("technologically closed") entities and auction these entities as whole units.

The second approach may be preferable in the present environment, as it will immediately create operational production units (e.g., a dairy operation) and a nucleus of ready-to-function farm service facilities, which may be organized as agricultural service cooperatives. However, the adoption of the second approach should not exclude the separate sale of some assets to the highest bidder.

2.63 The implementation of this process requires appropriate government resolutions. In addition, it requires information services that will assist the traditional farms in preparation of plans for

distribution of assets and guide them through the difficult process of distribution by auction. Without organized systematic guidance, the process is likely to proceed spontaneously, possibly at variance with desired policies.

2.64 Legal and Technical Foundation for Land and Lease Markets. Under the 1992 land distribution program as carried out thus far, about 250,000 "Land Owner" certificates were distributed to about 25% of all rural families. These certificates, however, include all the plots that have been distributed to one owner; thus they are owner-based rather than land parcel-based. Once land starts to change hands through sale, leasing, etc., this personal approach will cause major problems and soon become unworkable. Each land parcel (and any subdivision of it) needs to be registered separately and allocated a unique identification number. The establishment of legal frameworks for a modern land registration should begin with the adoption of a land registration law. A preliminary draft law exists, but it requires further work and the incorporation of provisions related to: (a) the recovery of the registration and titling costs, penalties for failure to pay the fees, and resolution of earlier payments for land owner certificates; (b) an agreement not to re-open decisions by land committees that gave individuals land in excess of 1.25 ha (unless fraud was involved); (c) establishment of a national Unique Parcel Referencing System; (d) declassification of survey coordinates and maps required for the registration work; and (e) where necessary, resolution of Sakrebulo boundary (rayon) disputes.

2.65 A market for land should be established after the land law is effective, together with the creation of necessary regulations. Market agriculture cannot function without a land market, but overall environmental and social objectives require land market regulation as well. Land registration offices and cadastral surveys are required immediately to facilitate the establishment of the market where buyers and sellers can meet and trade titles for land. A fee reflecting the expenses related to the administration of changes in ownership should be charged for registering land transactions. During an interim period of Government budget uncertainties, this fee might be higher than transaction related expenses, in order to generate additional revenue. The tax component however, should not hamper the emerging land market. Development of a land market will permit commercial banks to accept land as collateral for investment and working capital loans and, hence, provide an essential element in the development of market based agriculture.

2.66 Unless early steps are taken to create a modern property registration system by reorganizing, equipping, and training property registration offices in each rayon for all real property whether urban or rural, the advantages of a market oriented economy will be difficult to realize. As time passes, unclear property rights will mean that the marketability of land will decrease, mortgages will be difficult to acquire, and the likelihood of conflicts over ownership and boundaries will increase. The security of tenure required for the level of investment that the country needs will be difficult to achieve. Moreover, without a systematic and comprehensive system for incorporating changes in rights, the present extreme fragmentation of land holdings will remain a constraint on the consolidation of land ownership through the land market and thereby on the abilities of the farmers to take advantage of economies of scale.

2.67 A Land Market Action Plan should be programmed with the following objectives:

- a) to create as soon as possible a modern property registration system to record, display, and protect rights to real property;
- b) to record as soon as possible the newly created property rights as well as public rights to real

property in this system;

- c) to establish programs and institutions of a land market which will support: (i) accurate valuation of real property; (ii) improvement of information about the supply and demand for land in the market; (iii) land use zoning to guide urban and rural development; (iv) preservation of agricultural land; and (v) mortgage mechanisms facilitating access of capital poor families to the land market.

SECTION 3: CREATING A COMPETITIVE MARKET FOR AGRICULTURAL PRODUCTS AND SERVICES

A. PRIVATIZATION AND DEMONOPOLIZATION OF FOOD PROCESSING

2.68 Establishing a market economy with increased competition will lead to improvement in the agro-processing sub-sector performance and functioning of enterprises, and in the market infrastructure. Consequently, the key priority is to encourage competition and to help the market function. This will be achieved by:

- privatizing all state enterprises in the food chain (including foreign trade organization);
- promoting the establishment of new private ventures and processing cooperatives owned by the farmers;
- implementing antitrust regulations and monitoring competitive conditions;
- ensuring equal conditions for operation of foreign firms and joint ventures;
- improving general marketing services.

2.69 Process of Privatization. Privatization of agro-industry in Georgia began in 1990, when a number of agro-industrial enterprises were privatized under the Soviet law that allowed leasing with an option to buy. After independence, in August 1991, Georgia passed an enterprise privatization law, which allowed the workers or their nominees to acquire 51% of the stock in each enterprise and left 49% in the hands of the state for future disposal through a process of competitive bidding. After the passage of the 1991 Georgian privatization legislation, the use of leasing with an option to buy was discontinued.

2.70 The operative document for enterprise privatization today is Government Resolution 288 (April 14, 1993), which prescribes conversion of all large industrial enterprises with assets in excess of 30 million rubles (excluding state farms) into open joint-stock companies with tradable shares. Small enterprises with less than 30 million rubles in assets are not automatically transformed into joint-stock companies. They may be privatized as one whole, or in functionally independent subunits, through a process of auction or tender.

2.71 In the process of privatization, the workers' collective always has the right of first refusal, and the workers are moreover entitled to purchase their 51% allotment of shares at a deep discount. To facilitate the acquisition of a majority interest in the privatized enterprise by the workers' collective, two

mechanisms are recognized in addition to direct purchase by existing workers: (a) the workers may admit to the collective any outsider with funds (an individual or a legal body) in order to purchase their allotment of shares; (b) the workers may delegate the collective's right to enterprise shares to a third party. The packet retained by the state (49% of the shares), as well as the unwanted shares of the 51% allotted to workers, is mostly intended for mass privatization, and for sale to outside investors.

2.72 A voucher scheme went into effect in April 1995. The vouchers are used in two different ways: (a) enterprise employees can use the vouchers at the announced nominal value to purchase the worker's allotment of shares in their enterprises; (b) all other citizens can use the vouchers to purchase shares from the state packet in privatized enterprises at values determined through competitive bidding.

2.73 Foreign and other domestic outside investors can participate in the first phase of the privatization program, however due to the share distribution procedure, it is unlikely that they would be able to acquire a controlling interest in the first round. Foreign and other domestic investors may acquire a significant share of an enterprise offered for privatization only through the workers' collective. Foreign and domestic investors may be invited to join the workers' collective, or the workers may delegate their rights to enterprise shares to outside investors. Alternatively, an outside investor may make an offer for workers' shares after privatization, once these shares become tradeable. Another possible channel for participation of outside investors in industrial enterprises is through investment in expansion of privatized facilities or investment in new joint ventures. New investment is not subject to any preemptive rights of the workers' collective.

2.74 Out of a total of 440 state-owned agro-industrial enterprises scheduled for privatization in October 1995, 212 enterprises have been corporatized and at least begun to privatize (Box 2.1). However, only two-thirds of these enterprises had completed privatization at that time. The pace of privatization differs widely across sub-sectors of the food industry (Table 2.8). Progress has been made in privatizing state enterprises that produce canned food, wine and alcoholic beverages, soft drinks, and tobacco: over 50% of the enterprises in these sub-industries were privatized by October 1995. Privatization is much slower for meat and dairy products and tea processing, where fewer than 30% of the enterprises have been privatized.

2.75 The Government has retained 51 agro-industrial enterprises in state ownership, partly to be available for individual sale to primarily foreign investors. The

Status of Privatization in Agro-Industries
(March 1995)

There are 491 agro-industrial enterprises in Georgia. Of these:

51 state owned enterprises (SOEs) will remain under state control and do not have Government consent to form OJSCs.

The remaining 440 agro-industrial enterprises generally fall into one of five categories:

135 open joint stock companies (OJSC): Privatization under this scheme is underway. OJSC applicants are considered to be OJSC even though, in most cases, shares have not been purchased or auctioned.

31 closed joint stock companies (CJSC): Most CJSC privatized into closed joint stock companies under the lease-to-own scheme, a privatization option which is no longer available. Twenty four of these 31 companies are wholly owned by the former lessees.

32 companies leased from the State: New owners hold a majority of shares.

15 companies sold by auction and competitive bidding: before September 1994.

227 state owned enterprises (SOEs) which were instructed to submit OJSC applications but have not.

Box 2.1

process of direct sales of these enterprises should be accelerated in order to obtain the very much needed capital infusion for the rehabilitation of the agroprocessing subsector. It is recommended to reduce the number of agroprocessing enterprises remaining in state ownership to the minimum, even in the short term.

Table 2.8: Agroprocessing Enterprises under the Ministry of Agriculture and Food Industry (Oct. 1995)

Division	Number of enterprises	Number privatized	Of which joint-stock company	Of which privatized through competition or auction	Of which rented	Scheduled to be transformed to a joint-stock company
Tea	147	55	54	1		119
Wine	108	78	64	1	13	75
Canning	54	30	21	3	6	25
Meat & Milk	79	22	18	3	1	6
Tobacco	7	4	3	1		6
Mineral Water and Juice	27	11	4	2	5	11
Glass Tare	7	4	4	4		10
Other Food Industries	11	8	8			10
Total	440	212	176	11	25	281
Agricultural Services		31	24	4	3	

Source: Ministry of Agriculture and Food Industry

2.76 Privatization alone does not bring about all the needed improvements. A considerable number of enterprises that came to a standstill during the civil unrest have been unable to resume operation after being privatized. For example, the margarine factory in Tbilisi has been inoperative for eight months although 51% of the shares is already owned by private investors. All the shares of a dairy product factory and a meat processing plant in Telavi are owned by private investors, but the industrial complex has not produced a single kilogram of commercial output since privatization. Similarly, partially privatized wineries and canning factories are idle. In addition to privatization, efforts should be made to restore regular energy supplies and improve transportation and communication facilities for enterprises. The creation of a working financial system and a proper economic environment are also essential conditions for the recovery of the newly privatized agroprocessing sector.

2.77 The principal shortcoming of the existing privatization procedure is that it transfers the enterprise to private ownership without any financial consolidation and practically without capital. Unfortunately, neither the new owners nor the state as a co-owner are able to provide working capital for normal operation of the privatized enterprises or for the much needed new investment. The future success of the privatized enterprises will largely depend on their ability to find and recruit investors who are willing to inject financial capital in their operations. This will require development of share trading mechanisms and appropriate legislation to encourage new foreign and domestic investors to enter the privatized enterprises.

2.78 One of the ways to raise capital is through foreign investment. However, without a comprehensive supporting legislative framework, reliable foreign companies will never invest in the Georgian food processing industry. Although foreign investors have always been welcome and have been promised no restrictions, they have been very cautious and have not made any substantial investments so far. The few existing joint ventures primarily focus on trade activities (wine, juice, essential oil, tea). Until now only German, Dutch, and Turkish investors have established joint ventures. Total foreign investment in the food industry was estimated at US \$100,000 in late 1994. The foreign investment law passed by Parliament in June 1995 is a prerequisite for increasing the inflow of foreign capital.

2.79 A system of modern accounting and auditing, capable of clearly measuring profitability of enterprises needs to be adopted. Private enterprises should be obliged to conform to the new system because their tax liability should be determined on the basis of standard accounting governing all enterprises. A modern accounting system will also provide management with information needed to make decisions on manufacturing activities, product lines, and marketing channels. The adoption of a Western style accounting system is also essential for the needs of potential investors.

2.80 Demonopolization. As in every other ex-Soviet republic, the trade of foodstuff and the food processing industry was almost exclusively controlled by "state corporations," later by so-called associations, and market competition was unknown. These circumstances contradict the basic principles in which any efficient market economy is embedded. Therefore, in the interest of establishing a truly competitive marketing environment, it would be unwise to privatize the monopolistic food industry trusts in their present form; they should first be dismantled into small units.

2.81 Most of the Georgian food industry is still structured in the form of large state-owned enterprises which cover production and trade of tea, canned food, wine, vegetable oil, tobacco, meat, milk and dairy products, wheat mills, vermicelli and noodles, and bread and other bakery products. A government decision has already been made that all the food industry enterprises belonging to a state corporation will be sold individually. The associations will exercise their supervisory functions only until the beginning of the concerned companies' privatization process. This is an important but rather formal decision as production output has nearly hit bottom in most of sub-sectors. Since the break-up of the State Corporation for Bread and Poultry Industry in 1995, no state enterprise or corporation enjoys a monopolistic edge in the food industry of Georgia. It is hoped that, the state "trusts" and "associations" have already provided sufficient evidence of their incapability of organizing production processes and their liquidation is highly recommendable, without exception.

2.82 Privatization in the Grain Sector. The Government has paid special attention to the demonopolization and privatization of the grain sector. Until 1995, the State Corporation for Bread and Poultry Industry was the largest state monopoly in the food and agriculture sector, operating independently of the Ministry of Agriculture and Food Industry. This corporation carried all the feature of enterprise practices established under central planning and, in addition to controlling the whole grain sector (including milling and bakeries), it also incorporated state owned poultry farms and poultry processing factories. The Bread Industry is the only remaining element of the Government food planning and production entity. Facilities are operational, however their physical and technical conditions have deteriorated significantly. An action plan for reorganizing and dismantling the corporation was developed recently using resources provided by the World Bank institution building credit. This plan was discussed by the Government in 1995 and a program for privatization of the Corporation was adopted.

2.83 The implementation of the program for demonopolization and privatization of the State Corporation for Bread and Poultry Industry began in June 1995 with the separation of the poultry units and the creation of independent companies on the basis of these units. All of the corporation's 140 units have been proposed for privatization. In July 1995 a program for the privatization of the grain/bread companies was adopted. Smaller-scale holdings were sold mainly to employees. Larger bakeries will be privatized now that corporatization has taken place at the end of 1995. The overall objective is to keep grain storage facilities and mills in majority (51%) state ownership, when they are partially privatized in 1996. One of the major grain processing units - the Tbilisi Bread Combinat - has, however, already become privately owned and the sale of 51% of the Poti Bread Combinat is also in process. The regulatory functions of the Grain Corporation will be separated and moved to the Ministry of Agriculture and Food Industry by the end of 1996.

B. RESTRUCTURING THE AGRICULTURAL SUPPLY AND DISTRIBUTION SYSTEM

2.84 The domestic market for food and agricultural products has undergone major changes. The traditional state procurement system has almost totally disintegrated. In parallel with the collapse of the state procurement system, private marketing of food and agricultural products has come to dominate. This market is based on the Ruble, without Government intervention. Prices are determined in supply/demand interactions and seem to be transparent throughout the country. Transportation difficulties, insufficient protection by law enforcement against organized crime, and underdeveloped physical structures of markets represent serious impediments to trading of private agriculture products. However, this market offers private agricultural producers the best alternative for disposing of their products.

2.85 The elimination of the central command system and the changing role of traditional large-scale farms requires radical restructuring of the farm service network. The village-level agroservice centers envisaged by existing farm-restructuring resolutions are intended to focus primarily on machinery and mechanical maintenance and repair. The input supply and product marketing organizations, formerly owned by the state, have been, or are being, transformed into joint-stock companies, and the Georgian government now views the farm support sector as "privatized". Thus, the giant service networks of Gruzagrotekhservis (machinery services), Sel'khozsnabzheniye (spare parts and new machinery), and Gruzsel'khozkhimiya (fertilizers and chemicals) have been converted into commercial structures. Thirty-one service enterprises were privatized as of October 1995, mainly through management and worker buyouts. Yet these "privatized" entities have not changed their mode of operation. They do not have a real identifiable owner who can provide the badly needed capital and motivate the management to adopt strictly profit-oriented behavior. They have not been demonopolized and no competing organizations have been created in the process of privatization.

2.86 The dramatic decline in the volume of operation of the traditional farm sector has produced a commensurate decline in the volume of activity of these farm support organizations. Household plots are now beginning to develop direct relations with some of these entities, and private entrepreneurs are emerging into the vacuum left by the former system. There are indications that the existing farm support organizations are now conducting a higher share of their business with new, non-traditional customers, and that the market share of the existing organizations is declining as new competitors emerge. Despite these encouraging signs of real change, the system on the whole does not appear to be functioning. There are no operating channels for regular flow of inputs to the farms and counterflow of products from the farms, and the entire farm support sector must be received as part of the rejuvenation of agricultural production.

2.87 The recovery of the agriculture sector, and the growth of commercial and private farming will depend upon the development of the farm support sector-- material/technical supply, agricultural services, and marketing of agricultural commodities. Without the establishment of competitive markets for inputs and outputs, farms will remain dependent on local authorities. Rapid demonopolization of input supply and product marketing systems should start immediately, beginning with privatization of small shops, and encouragement of the creation of other private marketing channels, including commodity exchanges, private transport companies, and service and marketing cooperatives.

SECTION 4: FINANCIAL SERVICES

2.88 The Status of the Banking System. The Georgian banking system is at a rudimentary stage of development. At present it comprises 130 banks, including three large former state owned banks that are now in the process of privatization. The legal, regulatory, and supervisory framework for banking activity is as yet weak. However, a major coordinated effort is underway, supported by the World Bank, IMF and bilateral donors to strengthen the banking system's infrastructure. With the aid of this assistance, several private banks are expected to qualify during 1996, for participation as lending institutions extending modest amounts of loans under the proposed IDA assisted project.

2.89 The moratorium on the licensing of banks continues, and the number of local banks is expected to shrink significantly when the minimum level of capital will again be raised, this time to US \$500,000 as of June 1, 1998. An estimated 30 banks might be able to comply with the new National Bank of Georgia (NBG) capital requirements, as well as the prudential banking standards.

2.90 The majority of the private commercial banks are solvent, albeit, inactive. About 80% of these banks have no more than 3-5 customer accounts. Overall, the banks are extremely weak in all areas of banking operations. Management and the banking staff lack the necessary banking skills in treasury and funds management, credit administration, trade finance, and risk analysis. Because of the absence of International Accounting Standards (IAS), the integrity of the banks' portfolios is highly questionable. Credit procedures are improving but still far below international standards. Loan servicing is virtually non-existent. All loans are collateralized, poorly underwritten, and lack proper documentation. All the banks engage in roll-overs, provide little or no loan loss provisions, and continue to accrue interest in delinquent and long overdue loans.

2.91 There are, however, several small banks that are fairly well capitalized and would have no difficulty meeting the soon-to-be increased US \$500,000 minimum capital requirement and IAS prudential banking standards. Their managements are fairly well-trained and believe in acquiring the necessary banking skills and operating infrastructure to operate efficiently. Preliminary discussions with these banks suggest that with technical assistance and training, they stand a good chance to qualify for external lines of credit, under tight and monitorable eligibility criteria.

2.92 The Agrobank is the main lender to agro-industries and agriculture, and its loan portfolio is 13.5% of all domestic bank loans in Georgia (excluding the Export-Import Bank, Table 2.9). The new commercial banks still have not begun lending to the agricultural sector, and at this stage commercial lending is mostly directed to other sectors and the urban areas, where risk is considered lower than in agriculture.

Table 2.9: Structure of Bank Lending in Georgia (Jan 1995)

	Loans Outstanding		
	US \$ millions	% of loans in total banking system	% of loans excluding Export-Import Bank
Total Banking system	79.7	100%	--
Former State Banks	64.7	81%	60%
Agrobank	5.1	6%	14%
Industry Bank	6.8	10%	18%
Housing Bank	6.6	8%	18%
Savings Bank	3.5	4%	10%
Export-Import	42.6	53%	--
Commercial Banks	15	19%	40%
Total loans excluding Export-Import Bank	37.1	47%	100%

Source: Ministry of Finance

2.93 The Agrobank has about 80 branches spread all over the country and employs nearly 1,700 people. In the past, the Agrobank, like all Soviet banks, functioned primarily as a sole government disbursement agency transferring public funds to collective and state enterprises in accordance with centrally prescribed budgets and clearing payments between them. As a result, the Agrobank staff is not trained for the delivery of bank services that are essential in a market-based economy and has no capacity to judge the creditworthiness of its potential borrowers. The Agrobank's legal status today is not entirely clear. According to management reports, the bank has been recently corporatized. The employees hold a 20% share in the ownership, while the rest is still owned by the state.

2.94 Although no information is available on the flow of new lending to agriculture, the data provided by the National Bank of Georgia indicate that long-term lending has disappeared, and all credit in 1994 is in the form of short-term loans. This is an undesirable but understandable development in an environment with galloping inflation where credit is not indexed and the interest rates are charged in nominal terms.

2.95 Developing a New Rural Financial System. Agriculture, like any other productive sector, needs credit for both short-term working capital and long-term investments. The optimal strategy of credit provision is through a market-oriented commercial banking system. However, the existing banking system, including the Agrobank, is not able to satisfy the credit needs of agriculture and agro-industry in the new economic environment, and probably will not be for many years to come. Interim, admittedly suboptimal, strategies must be developed to fill the vacuum and to enable the sector to experiment with unconventional solutions in the absence of a functioning banking system.

2.96 A common strategy for financing agriculture in developing countries relies on linkage mechanisms between credit and product. This assumes that input suppliers and food processors, because of their relatively large size, have easier access to credit than agricultural producers. One of the simplest

linkage mechanisms is supplier credit to farms, which in certain cases may be repaid in kind (bartering farm products for inputs). Another linkage mechanism involves the marketer or the processor, which provide credit at the beginning of the production cycle in return for the farm's promise to deliver a certain proportion of its output to the lender at a specific price, e.g., a price linked to the general level of prices at the time of payment. Processors and marketers also can support farming operations by providing farm inputs (fuel, seeds, fertilizers, etc.) as an advance against future produce deliveries. Linkage mechanisms on a higher level can be established in the form of a local or regional service cooperative created by the farmers. The cooperative uses bank loans and own capital to supply inputs and credit to its member-farmers, who discharge their obligations by delivering their produce to the cooperative for marketing or processing. In all these mechanisms, non-financial organizations effectively supply the financing needs of farmers in an environment where farmers do not have ready access to bank credit. The development of these mechanisms requires procedures for enforcement of contracts and for use of stocks and future product deliveries as collateral.

2.97 An additional mechanism for increasing the availability of credit to small farmers may be through the creation of local credit unions (CUs) in the villages. Farms that can demonstrate an ability to repay should receive credit to purchase inputs such as fertilizers, fuel, chemicals, feed, and possibly also machinery and construction materials. The CUs legal basis would be that of credit cooperatives, and at the village level they would be managed by a committee of officials elected by the participating members. Local CUs capitalize on their access to information about the borrower's character and the project quality. As a result, the CUs will be better able to determine the financing and credit needs of small farms, assess of the creditworthiness of their members, and manage the lending and collection of loans. They suffer, however, from covariance in supply and demand for funds, and from covariate yield risk. They are therefore not optimal without serious diversification. The establishment of rural credit unions started in Georgia in 1995 on a pilot basis. In 1996 a credit union development unit will be established with the support of the World Bank.

2.98 As an interim measure, an enterprise development corporation might be established as a consortium of privatized banks with two functions: (a) assist enterprises seeking investment funds to develop business plans and feasibility studies, and identify suitable foreign investors; and (b) evaluate and make loans for investments from funds provided from external and domestic sources. The subloans should be made at commercial rates, while loan collections could be used as a revolving fund for additional investment lending.

2.99 Special measures for credit should be considered in the interim until inflation is reduced and sector price policies are changed. Production loans should be made with sufficiently long maturities for the farm to complete production, market its products and receive payments (e.g., nine month to one year). The loans should be collateralized by farm production or equipment using market prices and repayment enforcement (according to the bankruptcy law). The legal framework should be such that contracts for collateral can be enforced outside the court system. Interest rates should reflect the real cost of capital, being calculated on variable-rate terms and indexed either to the exchange rate of the domestic currency or the domestic cost-of-living index. As an alternative during high inflationary periods, the principal may be indexed to the price of some key commodities that represent the main production lines in agriculture.

2.100 During the transition period, before the economy stabilizes and the agricultural markets are fully liberalized, political and social considerations might force the Government to continue providing

some directed credit for agriculture at concessional terms. However, as long as subsidies are maintained, they should preferably be transaction-based, and not take the form of interest-rate subsidies. Financial subsidies and supports therefore should be gradually phased out as the economy progresses toward market conditions. The ultimate objective is to have the interest rates eventually determined by market forces and to have agriculture rely on commercially supplied credit.

2.101 So far, neither the banks nor the Government have made any effective efforts to mobilize resources for servicing the financial needs of privatized agriculture. The Government, with the assistance of international donors, should commission a study of rural credit-related issues, focusing on modalities and collateral procedure, which will assess the various components of credit requirements, the transaction costs of various type of loans, and determine how collateral can be provided in all types of business activities.

2.102 Future relations between financial institutions and agricultural producers must be based on accepted financial and economic criteria. Banks should adopt improved methods for evaluating credit applications and managing the loan portfolio. All farm and enterprise borrowers should be required to prepare a brief business plan which informs the financial intermediary about the existing financial position of the borrower and the business plan. Initially, farmers and enterprises will require external assistance to teach them how to prepare business plans and feasibility studies to be submitted with their loan applications. A new cadre of bank officers will have to be trained for effectively serving the privatized sector.

SECTION 5: INSTITUTIONAL FRAMEWORK FOR PRIVATIZED FOOD AND AGRICULTURE

2.103 Successful transition requires not only policy actions, but also the building of institutions for market-based agriculture. Institution building requires the revamping of existing organizational structures and new legislative mandates for these institutions. This process needs to start as quickly as possible by adapting existing institutions and creating the new institutions required for market-base agriculture.

A. REDEFINING THE ROLE OF GOVERNMENT

2.104 Government management of agriculture reflects the characteristic features of the command economy. A large bureaucratic administrative structure is still functioning above the farm level to provide central control over farms and other agricultural activities. The Ministry of Agriculture and Food Industry (MAFI) is responsible for the implementation of agricultural policy and the realization of agriculture production objectives. But, as in most governments, it is not the only government institution that affects agricultural policy. Up to November 1995, the food and agriculture sector was supervised by a Vice Prime Minister and two commissions under his leadership (the Board of Food Matters and the State Food Commission). Parallel to the MAFI, the Department of Forestry, and the State Corporation for Bread and Poultry Industry operated as an independent ministerial level organization. In November 1995, as a part of an overall reorganization of the Government, the posts of all Vice Prime Ministers were eliminated and the MAFI became the major government organization dealing with food and agriculture. The State Corporation for Bread and Poultry Industry lost its ministerial standing and was reduced to its component parts for privatization in 1995. The Ministries of Finance and Economy, as well as the Ministry of Foreign

Economic Relations also have powerful roles in agriculture as well, as they are directly in charge of price and subsidy policy as well as trade and marketing regulations.

2.105 At the regional levels, the administrative structure of the socialist era has been preserved with little change. The agricultural departments at the rayon level were created to implement direct administrative controls and they continue to function. These organs are supposed to coordinate the activities of local agricultural and processing enterprises. Their main role has been to transmit targets for production and delivery and to distribute inputs and machinery to farms.

2.106 The transition to a market economy requires a fundamental change in the role of the Government in agriculture and in the economy in general. Direct government intervention in the agricultural economy, such as establishing mandatory targets for production and/or delivery of goods and central distribution of investments and inputs must be ended. The Government's role should be to establish the general rules and facilitate the conditions for smooth operation of markets and independent business organizations. This role is not less important than the previous one; however, it requires a different philosophy, as well as different means and institutions.

2.107 The Government of Georgia needs to make a high level commitment to changing the structure and scope of government organization for management of agriculture. In a market driven economic system the Government should play three sorts of roles: regulation, provision of supporting services, and analysis. Regulation should include such things as food inspection, seed inspection, establishment and enforcement of grades and standards, establishment and control of phytosanitary standards, epidemiology, and livestock disease control. Essential services of a public nature should be provided. This might include domestic and foreign market information, agricultural research, farm advisory services, and higher education in agriculture. Finally, the Government should monitor, review, and diagnose the implication of changing circumstances and develop options for public policy (Figure 2.1). Details of restructuring and staffing needs to be developed within this framework.

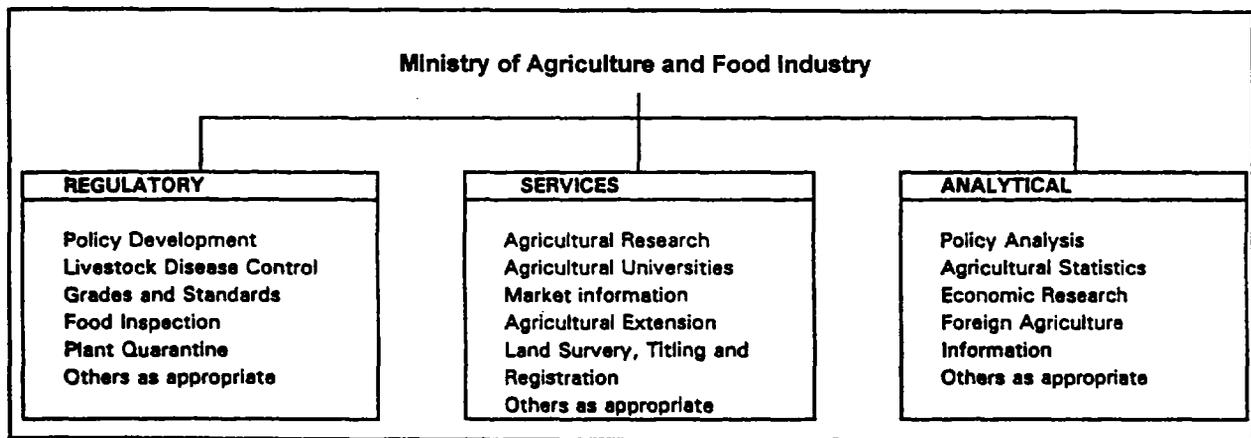


Figure 2.1

2.108 A system of statistical data collection is one of the essential public goods that the Government should provide. Reliable up-to-date statistics are needed for proper decision making and

performance evaluation at all levels, starting with government ministries and down to the farm level. Unfortunately, the Georgian agricultural statistical system is in a complete disarray, mainly because of inadequate funding, but also because of tremendous difficulties with transport and communications. The 1993 Statistical Abstract has not been published (only a German version exists), the 1994 data are estimates and there are no plans to produce definitive data for 1994. There was virtually no survey work or field data collection in 1994 and none is being conducted in 1995. Another difficulty is that the traditional system of Soviet statistics is inadequate for covering the activities of the new privatized agriculture. A new methodology must be introduced, similar to that used in market economies. The international community can play an important role in re-establishing the essential agricultural statistical services in Georgia.

B. EDUCATION AND RESEARCH

2.109 The agricultural education in Georgia is divided into three levels: (a) the Tbilisi Agrarian University as well as the Veterinary Institute (Tbilisi) and the Subtropical Institute (Sukhumi); (b) seven agricultural colleges; and (c) nine agricultural technical schools. The agricultural technical schools recently began providing training for farmers. There are many private colleges and institutes providing higher level training in which agriculture is a popular course of study. As there is no substantive accreditation system, there is a wide range in the quality of education provided by these institutions. Some private colleges are more progressive than their state counterparts in the teaching of economics and management. The organization of research is similar to other FSU republics. Research is conducted in independent institutions, while the main role of the university and colleges is teaching. The research system is organized under the Georgian Academy of Agricultural Sciences (GAAS). There are 27 major research institutions for agriculture altogether, seven of them are under joint control of the MAFI and the GAAS. The level of education and of basic agricultural research meets international standards in most areas.

2.110 Georgia's agricultural education and research system is in serious difficulty. If agriculture is going to be responsive to the country's needs it must be current with international scientific and technological developments: the system is now out of touch, indeed isolated. Scientists are also out of touch with the evolving needs of domestic farmers. They need more contact to ensure the relevance of their work, and to develop a constituency that will ensure long term financial sustainability for the system. A premium needs to be placed on the system's ability to be creative, promote excellence, encourage entrepreneurship and foster agility in the use of scientific resources.

2.111 The agricultural university, institutes, and the research institutes are undergoing an unprecedented period of budgetary stress that threatens their core. Their most important asset, the human capital embodied in scientists and faculty could be lost if the situation is not corrected soon. As a quick response, to forestall irreversible damage to the institutions, as well as initiate some of the more immediate modernizing requirements, the immediate repair and maintenance of instrumentation, and ending the professional isolation of the universities and research institutes from their international peers are needed. Resources need to be augmented to support collaborative research and attendance at international professional meetings, to provide access to and modernization of information systems, and to develop new course offerings and updated curricula.

2.112 Georgia has far more research institutes, colleges, and employees than warranted by the size and diversity of the agriculture and food industry, and far more than Georgia can support under present state budgets. Overall institutional and policy reforms are also necessary to modernize the

educational research system. This would require a comprehensive study of alternative models for modernizing higher education, research and extension. Given the importance of harnessing the inherent synergy between research and higher education, a strategic issue that should be confronted is how the institutes of agricultural higher education and research can be integrated. Associated with this issue is the need to rationalize the allocation and utilization of resources available for research and in the agricultural university system. The respective roles of public and private research should be defined to encourage the most cost effective use of limited resources. Ultimately this process has to lead to some hard decisions with respect to the reallocation of research resources, including large scale downsizing (some institutes were developed to service the needs of the whole FSU), privatization and the allocation of time by faculty to research, teaching and/or extension.

C. EXTENSION AND ADVISORY SERVICES

2.113 The breakdown of the state order and the collective and state farm system has increased the need for information services and farm management advice. New private farmers will have to learn the skills associated with organizing and running private endeavors. The basis on which to build a modern agricultural extension service exists. There are large numbers of well trained, experienced, agricultural specialists. In addition, there are the other formal and informal information communication channels such as TV and radio, farmers clubs, associations, local government institutions, and schools that provide some of the traditional functions of extension. Existing heavily-staffed government research and technical services should be rationalized, with special training provided. Agricultural, veterinary, and commercial education would be adjusted to reflect these changes. Encouragement in the establishment of specialist services for both smallholder and commercial producers would be directed to the private sector, where they would receive various financial and other incentives to alleviate the many risks involved in these early development stages.

2.114 It is essential that the Government recognize the fundamental change in the country's agriculture that has occurred with privatization of the large-scale farms. Small farmers now own most of the livestock, much of the vineyards, a significant portion of the deciduous fruit and much of the arable farm land. Each farmer is therefore manager of a small, but complex, integrated farming system, and will respond to market forces. Providing advice and extension to such farmers is very different to supplying technical information to the former sovkhos and kolkhos specialists. The "new" farm families need farm management advice based on financial criteria and maximization of benefits to individual farm families. Gone are the days of maximizing production at any cost. The skills to be developed by an appropriate extension service have change markedly.

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2.115 The successful transition to a new more productive agriculture system in Georgia requires not only changes in the policy environment and incentive framework, but also improvements in the production efficiency and investments in the physical and human capital of the country. Production technologies and the management of crop and livestock have to adjust to the new conditions of private agriculture and the market system. The physical rehabilitation of the food processing sector is an essential precondition of improved competitiveness for Georgian agricultural products on world markets. These issues are covered in Volume II of this report, which contains detailed subsectoral analyses and recommendations for improving the efficiency of farm production as well as agroprocessing.

CHAPTER 3

PROPOSED SHORT-TERM AND MEDIUM-TERM ASSISTANCE PROGRAM

3.1 Georgia has embarked on a historic and difficult transformation of its economy from a centrally planned to a market-oriented system. External assistance can ensure that this transition process is efficient and effective, and help the Government to minimize the transition problems. In the agriculture and food processing industries the assistance most needed in the short and medium-term would include:

- budgetary support for provision of critical inputs for agricultural production to avoid serious food shortages in the present critical period;
- technical assistance to help formulate and implement a consistent transition program in food and agriculture and develop the institutions and support facilities needed to implement the transition program and;
- capital investments for the development of competitive production, processing, and marketing.

3.2 Technical Assistance and Institution Building. Many difficult policy, technical, and institutional issues are emerging during the transition, and skills are generally not available in Georgia to deal with them effectively. Technical assistance and training, covering broad areas of food supply and agriculture, are needed to facilitate the transition. The topics identified below are indicative only. In many of these areas a number of multilateral institutions, governments, and private organizations are already involved. But their present support, in general, meets only a fraction of the need. The most urgent technical assistance requirements include:

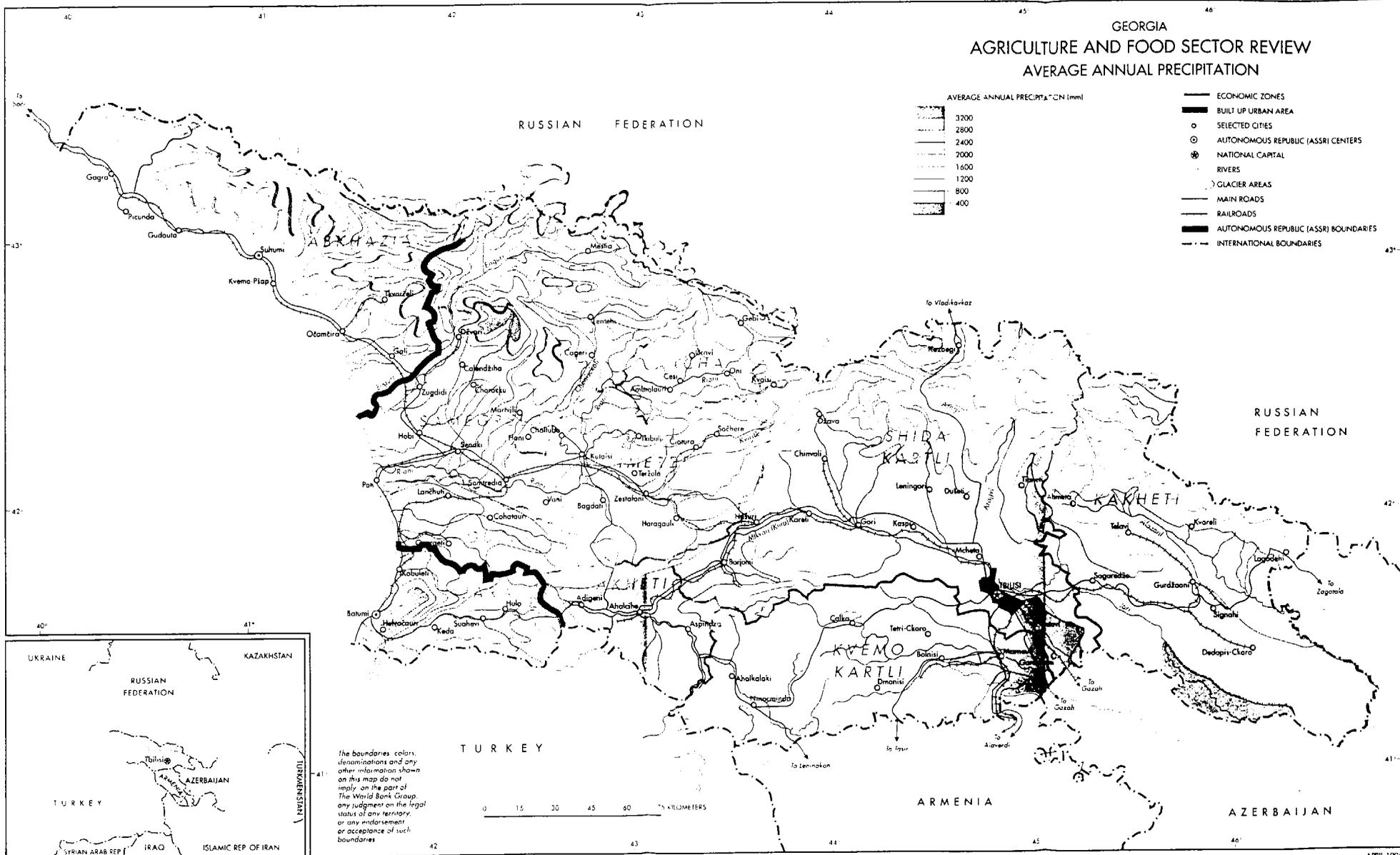
- Land reform implementation: establishment of a land administration and land registration system; modern cadastre and land reform information system; establishment of a land market and land bank; Western-type agricultural cooperatives; and farmers training and demonstration farms.
- Competitive input and output marketing systems: auction halls; commodity exchange; market regulations; food safety and quality control; and market information system.
- Enterprise privatization: privatization strategy and procedures; development of business plans for privatized agro-processing enterprises; pilot projects; modern accounting practices; and management of corporatization, demonopolization, and privatization.
- Policy analysis and policy development skills: reorganization of public administration in agriculture; and adjustment of statistical information services.
- Rural financing: design of an efficient rural credit system; modern banking practices; and training of bank employees.
- Research, education, and extension: emphasize transfer of technology and adaptive research; design an extension system; design new curriculum; retrain university personnel; and retrain large-scale farm technicians.

3.3 **Bank Assistance Program.** The World Bank short- and medium-term assistance program for Georgia food and agriculture should facilitate three objectives: *one*, sustain agricultural and food production under the present difficult economic conditions; *two*, increase exports both to Western markets and former markets in the FSU, thus increasing hard currency earnings of food and agriculture; and *three*, assist the Government in the transformation of agriculture and food processing from a centrally planned economy to a market oriented, independent one. The Bank assistance program would aim to provide support for four crucial components of the transformation process: (a) privatization restructuring of food processing; (b) support for primary agriculture and private farm development; (c) land reform implementation; and (d) institution building.

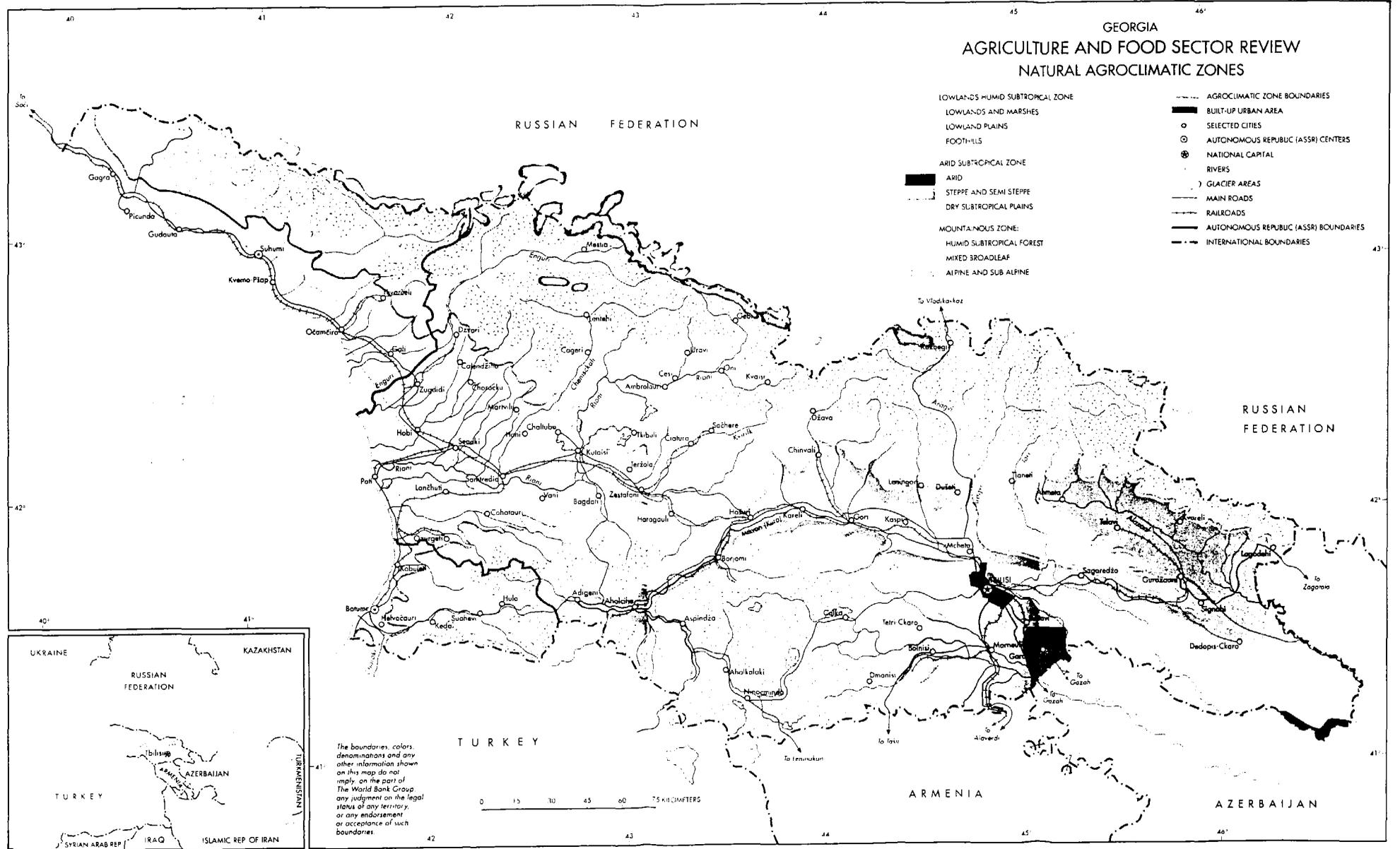
3.4 The realization of the Bank objectives in support of Georgia's food and agriculture would require a set of interlinked projects:

- Structural adjustment operation (SAL), which is based on Government agreement to a set of macroeconomic and sectoral policies required to create an enabling economic environment for the recovery of the sector, and provide assistance for the most critical needs for the country, including food and agriculture.
- An agriculture sector loan, which would provide assistance through the Government for investment in export oriented agro-processing utilizing modern technologies to improve the quality and range of products; support for the development of external and domestic marketing and rural financial intermediation services; and development of critical institutions, including land administration and land registration system.
- An agriculture infrastructure and support services rehabilitation project, which would facilitate the rehabilitation of critical productive infrastructure, such as irrigation, drainage, rural roads, veterinary services, marketing facilities, etc., and their adjustment to the needs of privatized agriculture.
- The recovery of the agriculture sector is also greatly dependent upon the improvements in transportation, port facilities, and energy supply, which are facilitated by a number of projects being prepared by the Bank.

GEORGIA AGRICULTURE AND FOOD SECTOR REVIEW AVERAGE ANNUAL PRECIPITATION



GEORGIA AGRICULTURE AND FOOD SECTOR REVIEW NATURAL AGROCLIMATIC ZONES



- LOWLANDS HUMID SUBTROPICAL ZONE
 - LOWLANDS AND MARSHES
 - LOWLAND PLAINS
 - FOOTHILLS
- ARID SUBTROPICAL ZONE
 - ARID
 - STEPPE AND SEMI STEPPE
 - DRY SUBTROPICAL PLAINS
- MOUNTAINOUS ZONE:
 - HUMID SUBTROPICAL FOREST
 - MIXED BROADLEAF
 - ALPINE AND SUB ALPINE
- AGROCLIMATIC ZONE BOUNDARIES
- BUILT-UP URBAN AREA
- SELECTED CITIES
- AUTONOMOUS REPUBLIC (ASSR) CENTERS
- NATIONAL CAPITAL
- RIVERS
- GLACIER AREAS
- MAIN ROADS
- RAILROADS
- AUTONOMOUS REPUBLIC (ASSR) BOUNDARIES
- INTERNATIONAL BOUNDARIES



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