Memo: State-Owned Enterprises & Economic Concentration in Georgia

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Overview

As in the other Soviet countries, Georgia's communist-era economy was dominated by large, politically connected state-owned enterprises (SOEs). After the dissolution of the USSR, during the transition to a market economy, these enterprises were (in many cases) split up and sold to investors both foreign and domestic. The mistakes made in this process are, at this point, well-studied—in many countries (e.g. Russia, Ukraine, and Kazakhstan), firms were sold at well below cost to politically connected individuals, and these oligarchs now serve as key supporters of their countries' nondemocratic governments. Georgia, in line with its record as one of the least corrupt ex-Soviet states, mostly avoided this situation and its SOEs were sold on an open market, at market prices, following well-defined law [11]. Corporate concentration is likely higher than in the counterfactual case but not exceptionally so, and there is little reason to believe former SOEs are given special treatment in procurement processes above and beyond normal petty corruption.

There are about 160 remaining SOEs, with the largest being firms like Georgian Railways, Georgian Oil and Gas, and Georgian State Electrosystem. Firms with a majority state ownership are required to follow standard public procurement procedures, and such contracts are represented in our data as type "Enterprise with more than 50% state share participation". The government has recently announced an anticorruption and transparency push to improve performance of these firms, and is aiming to partially privatize or split the SOEs in preparation for a 2024 accession to the EU[1].

Quantitative Measures of Concentration

The standard measure of economic concentration within an industry or country is the Herfindahl–Hirschman Index (HHI), calculated by summing the shared market square of all relevant firms[2]. Unfortunately this data is not readily available across countries and so a comparative study is not feasible. A 2018 OECD hearing on the topic [18] used corporate data in commercial datasets like ORBIS and extensive statistical analysis, which would be a substantial amount of work when comparing across a large set of countries. However, Georgia

[1] The desire to join the EU was reiterated recently (Jan. 17, 2021), so I believe it is credible even with COVID and recent EU crises

[2] In practice, typically only the top 100 or so. Because of the functional form of the HHI, this has a negligible effect on the result.

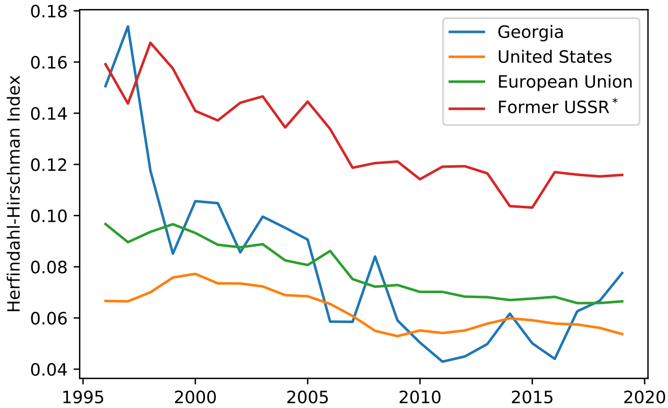

Figure 1: The evolution of the trade diversity HHI between 1996 (the first year it is available for Georgia) and 2019.
*"Former USSR" refers to the successor states of the Soviet Union and its Eastern Bloc allies. Soviet-aligned communist countries in SE Asia, Africa, and Cuba are not considered.

has been successful at privatizing its state-owned enterprises and avoiding the emergence of oligarchs when compared to other post-Soviet states; it is therefore likely that levels of economic concentration are lower as a result.

As a (very imperfect) proxy, I looked at concentration in the export sector—the rationale being that sectors captured by corrupt interests and unable to compete on the global market would demand (and have the political power to implement) a protectionist response, while competitive sectors would welcome the opportunity to compete on global and regional markets. This is *also* measured by the Herfindahl–Hirschman Index, where a high score (close to 1) indicates a single sector dominates trade, while a score of zero corresponds to a perfectly diversified trade portfolio. Figure 1 shows the evolution of trade diversity, with former Soviet states showing much higher levels of concentration than the US or EU. Georgia, in 1996, starts out at a high level similar to other post-Soviet states, but converges to about the same level as the US and EU.

Theoretical Effects of Concentration

Increased market concentration is detrimental to consumer welfare, and is associated with increased poverty and lower economic growth [17]. Oligopolistic firms earn higher-than-market returns by raising prices higher than their competitive level, and exercise their political and market power to exclude new entrants and decrease wages [9][10]. In practice, the impact to welfare is even larger than would be predicted by a simple Cournot or Bertrand model of limited competition, as firms form cartels to limit production or maintain elevated prices [19]. Bliss and di Tella [3] suggest that low state capacity and oligopoly are mutually reinforcing, since corrupt state agents will (in exchange for bribes) raise barriers to entry, and oligarchs will happily engage in corrupt behavior to avoid oversight or antitrust action.

It is important to differentiate within-market (which we are discussing here) and between-market concentration of ownership, since theoretical evidence regarding the welfare effects of the latter is far more mixed. Robust evidence suggests that within-market concentration of ownership (whether due to oligopoly or common ownership due to index funds) is associated with higher prices and a reduction in welfare [2]. These firms are also less innovative, less competent, and have worse management [1].

The emergence of an oligarchic class also has implications for democratic government and the potential for economic reforms. Perotti and von Thadden [16] show that, in the presence of corporate and wealth concentration, those interests will tend to dominate government in exchange for some degree of labor rents—with a decrease in welfare compared to the more democratic counterfactual where those groups do not hold an outsized role. Bourguignon and Verdier [4] study the stability of such an arrangement and suggest that, although there are circumstances where an educated middle class emerges endogenously and initiates a transition to democracy, concentrated wealth tends to be stable and self-reinforcing.

The Soviet Context

In retrospect, the mistakes made in transitioning the economies of the post-Soviet states are obvious. Large, technologically lagging bureaucracies and their assets were sold at below-market rates to politically connected individuals, and competition was limited post-privatization [22]. This was further complicated by the SOE's role, in the Soviet economy, as the provider of housing and social services for employees and their families, which made the transition to a western-style firm difficult [13] and politically unpopular. Increased volatility in the labor market and outdated managerial practices poorly suited to a competitive economy [5] led to political resistance and other difficulties in breaking up large enterprises [22].

Georgia's Transition to a Market Economy

After the dissolution of the USSR, Georgia underwent a very turbulent transition. The years immediately following independence were marked by intense civil conflict in the north, with separatists in South Ossetia and Abkhazia pushing for independence. After a Russian-brokered ceasefire in 1994, GDP had declined by about 70%, tax revenues were only about 3% of GDP, and the resulting economic crisis threatened the stability of the government [21].

In 1995, Eduard Shevardnadze (the former leader of the Georgian SSR and face of the *perestroika* reforms, who had fled when the Soviet Union fell) was elected president with a 75% majority on a pro-reform platform, and immediately took aggressive action to stabilize the economy and increase output. Within a few years, the government deficit was reduced from about 25% of GDP to 7%, with the bulk of the savings coming from privatizations and efficiency gains. Subsidies for staples like fuel and grain were eliminated, and controls on prices and trade were liberalized. The land controlled by Soviet agricultural co-ops was distributed to individual farmers (leading to significant increases in agricultural productivity) and remaining SOEs were subjected to a hard budget constraint [8]. However, his administration was also marked by accusations of corruption and nepotism, mirroring other Soviet states at the time—economic reforms reduced opportunities for graft and petty corruption by low-level officials, but did little to foster effective and honest government at the national level.

By 2003, spiraling levels of corruption and an economic crisis in Russia (Georgia's largest trade partner at the time) had slowed economic growth and led to widespread discontent with the Shevardnadze administration. In November of that year, after a fraudulent election, protesters forced Shevardnadze's resignation and elected Mihkeil Saakashvili as president. Parties and groups aligned with the protests' anticorruption platform dominated the subsequent parliamentary election, beginning a new round of economic reforms and strengthening the rule of law and other liberal institutions [14]. These events—the *Rose Revolution*—more closely aligned Georgia with European institutions, increased trade with the EU, and led to a new round of privatization of state-owned enterprises [7].

Since then, Georgia's progress towards a competitive economy and democratic rule has been slow but consistent. Many of the NGOs and reformers who played a critical role in the protest movement entered government (or became advisors) [12], and have pushed for liberalizations and other democratic reforms. Although the EU's power are limited (and often overestimated), the possibility of access to the single market and security assurances has encouraged reforms and a broad alignment with Europe (and against Russia) [20]. There are still sectors, especially those dominated by the remaining SOEs, that are resistant to modernization—for example, the energy sector is still dominated by informal networks and corrupt practices [6]—but corruption overall is broadly similar to that found in Central and Eastern Europe, with an optimistic trend [15].

Summary

Georgia has been one of the most economically successful post-Soviet states, and there is no reason to believe that the legacy of powerful and corrupt state-owned enterprises plays a significant role in the structure of the modern Georgian economy. Corruption and low state capacity remain a problem, but not uniquely so, and the country has been relatively competent at implementing reforms. The remaining state-owned enterprises are subject to the same transparency regulations applied to state agencies, and are well-represented in our data.

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