Strategic Management of Economic Development: How Developed Countries Became Developed and Why Georgia Remains a Backward Economy

The dissertation contributes to management theory by bridging the gap in management research in terms of strategic management of economic development on a country level. 'One size fits all' approach has been a norm of policy prescription for backward economies during the last decades. Georgia implemented internationally promoted economic policies and was recognized for its economic reforms. However, about 17.5% of its population still lives below subsistence minimum.

The dissertation carried out comparative historical analysis of successful economic transformations and developed the policy matrix of development strategy, which is the main theoretical contribution of the dissertation. The policy matrix defines specific development strategy domains, recommended economic policies and demonstrates how to coordinate economic policies within each development strategy domain during low-income and middle-income economy to support transformation into high-income economy. The dissertation also analyzes dominant growth models and identifies the poverty trap for backward economies. Finally, the dissertation analyzes economic transformation of Georgia in the light of the policy matrix explaining why Georgia stays backward economy as well as identifies what keeps Georgia away from implementing development strategy aligned with successful historical experience.
STRATEGIC MANAGEMENT OF ECONOMIC DEVELOPMENT: HOW DEVELOPED COUNTRIES BECAME DEVELOPED AND WHY GEORGIA REMAINS A BACKWARD ECONOMY

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DEDICATION

To my lifetime heroes – to my parents Natalia and George!
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I would like to express my deepest gratitude towards each and every person who has contributed one way or another to me successfully finishing one of the most significant marathons of life one could ever run and earning the prestigious lifetime title of a PhD.

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<tbody>
<tr>
<td>GDP</td>
<td>Gross Domestic Product</td>
</tr>
<tr>
<td>GeoStat</td>
<td>National Statistics Office of Georgia</td>
</tr>
<tr>
<td>GHSE</td>
<td>German Historical School of Economics</td>
</tr>
<tr>
<td>GNI</td>
<td>Gross National Income</td>
</tr>
<tr>
<td>IMF</td>
<td>International Monetary Fund</td>
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<tr>
<td>KfW</td>
<td>German Development Bank</td>
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<td>NBG</td>
<td>National Bank of Georgia</td>
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<tr>
<td>USAID</td>
<td>United States Agency for International Development</td>
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<td>WTO</td>
<td>World Trade Organization</td>
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ABSTRACT

The world has experienced significant progress in reducing poverty over the past decades. Despite the declining global poverty rate, many countries are still struggling with poverty. Reforms designed to achieve successful economic transformations yielded some progress, but it has been far from what was expected. During the last decades, Georgia has been praised internationally for its economic reforms. However, about 17.5% of population of Georgia lived below the subsistence minimum in 2017. It is puzzling to see a country being praised for its successful reforms and still being faced with economic backwardness.

The dissertation was inspired by the desire to gain an understanding of how today’s developed countries became developed and how Georgia can achieve a successful transformation from a middle income to a high-income economy. Therefore, strategic management of economic development on the country level was selected as the research object of the dissertation. While strategic management on an organizational level is a well-researched area, strategic management of economic development on a country level lacked an overarching framework and represented a gap in management research, which is filled by this dissertation. The research problem is formulated as a root research question: why does Georgia remain a backward economy after regaining independence from the Soviet Union? The research problem is decomposed into four research questions (RQs). RQ1 aims to understand: which development strategy domains are key determinants of successful economic transformation? RQ2 seeks to understand: how should economic policies under different development strategy domains be coordinated during different stages of economic development? RQ3 aims to understand: how can the persistent underdevelopment of backward economies be explained? RQ4 seeks to understand: why does Georgia remain a backward economy?

To answer the research questions, the dissertation relies on the research methodology of the German Historical School of Economics (GHSE) and the research method of comparative historical analysis. The GHSE emphasizes the importance of context and inductive reasoning, and comparative historical analysis allows for an in-depth understanding of relevant aspects about the phenomenon of interest.

To describe the strategic management of economic development on a country level, the dynamic model of economic development is proposed, which is based on the assumption that the economic development of a country is a function of its agricultural strategy, industrial strategy, international trade strategy and monetary strategy, conditioned by the stage of economic development. The agricultural, industrial, international trade and monetary strategies are the domains that describe the development strategy and provide the framework for analysing economic policies. The stages of economic development are defined as low-income economy, middle-income economy and high-income economy.
Differentiating economic activities in terms of increasing and decreasing returns to scale are understood as indicators in a key instrument to mark a watershed between good and bad development strategy. Diminishing returns to scale means that as production expands there is always a point after which the benefit from producing additional unit of output is less than the benefit from the previous unit of the same output. Increasing returns to scale means that as production expands benefit from producing additional unit of output is more than the benefit from the previous unit of the same output. To answer the RQ1 and the RQ2, the dynamic model of economic development is operationalised in the form of the policy matrix of development strategy. The policy matrix is developed based on the extensive historical analysis of successful economic transformations in selected countries. The country selection is guided by four strategy domains of the dynamic model of economic development. The rows of the policy matrix represent three stages of economic development, while the columns of the policy matrix represent four strategy domains. The entries of the policy matrix suggest that economic policies contribute to successful economic transformations within four development strategy domains on the respective stage of economic development.

The key function of agricultural strategy in a low-income economy is to provide sustenance and employment opportunities on a massive scale. The economic policies that support the realisation of this function are household farming and state-led agricultural infrastructure, product and market development. The key function of agricultural strategy in a middle-income economy is to support manufacturing development. The economic policies that enabling the realisation of this function are the promotion of agricultural cooperatives and state supported agricultural infrastructure, product and market development.

The key function of industrial strategy in low- and middle-income economies is to create opportunities for the rural population to move from household farming into better paid manufacturing jobs. The economic policies that support the realisation of this function in a low-income economy are export discipline and state-led search and financing of feasible economic activities under increasing returns. The economic policies that enable the realisation of the key function of industrial strategy in a middle-income economy are export discipline and state supported search and financing of feasible economic activities under increasing returns.

The key function of international trade strategy in low- and middle-income economies is to support manufacturing development. The economic policies that support the realisation of this function in a low-income economy are low-tariff and non-tariff barriers and state-led import of raw materials and export of goods under increasing returns. The economic policies that enable the realisation of the main function of international trade strategy in a middle-income economy are moderate or high-tariff and non-tariff barriers in targeted industries and state supported import of raw materials and export of goods under increasing returns.
The key function of monetary strategy in low- and middle-income economies is to support manufacturing development. The economic policies that support the realisation of this function in low- and middle-income economies are ensuring below market borrowing rates in targeted industries and channelling bank loans towards export-oriented agriculture and manufacturing.

To address RQ3, dominant growth models are analysed. Dominant growth models are defined as macroeconomic production functions with prevailing presence in economics textbooks and public discourse. Analysis of dominant growth models yielded a model of persistent underdevelopment, which explains the poverty trap in backward economies. Relying on dominant growth models based on the constant returns to scale assumption is a poverty trap. Dominant growth models explicitly or implicitly ignore the taxonomy of economic activities in terms of increasing and decreasing returns to scale. Ignoring the varying impact of different economic activities on long-term economic development leads backward economies toward specialisation in non-productive economic activities. When a country specialises in non-productive economic activities, it struggles to achieve successful economic transformation and reduces its chances to break out of the poverty trap.

RQ4 was answered by analysing the economic development of Georgia during 1991-2017 in light of the policy matrix of development strategy. The analysis of three periods: 1991-2003 during Eduard Shevardnadze’s leadership, 2003-2012 during Mikheil Saakashvili’s leadership, and 2012-2017 during the Georgian Dream leadership, allowed to understand which economic policies implemented in Georgia were not aligned with successful historical lessons. Georgia remains a backward economy mainly because its economic policies deviated and keep deviating from suggestions provided by the policy matrix. In a low-income economy, the primary function of agriculture – providing employment and sustenance on a massive scale – was realised in Georgia. However, further agricultural development was constrained by the inability of the government to govern agricultural infrastructure, product and market development. In a middle-income economy, the main function of agriculture – supporting manufacturing development – was also not realised in Georgia.

In low- and middle-income economies, the main function of the manufacturing strategy – helping people to move from household farming to better paid manufacturing jobs– was not realised in Georgia. Manufacturing strategy fully failed during 1990-2012 because neither Shevardnadze’s nor Saakashvili’s government pursued industrialisation one way or another, and they deviated from economic policies suggested by the policy matrix by not having state-led or state supported search and financing for feasible economic activities under increasing returns and export discipline. State-led search for feasible economic activities under increasing returns was realised during 2012-2017, but the manufacturing strategy is still failing because of the ignorance of the other economic policies suggested by the policy matrix.
In low- and middle-income economies, the key function of international trade strategy – supporting manufacturing development – was not realised in Georgia. During Eduard Shevardnadze’s presidency, international trade strategy deviated from economic policies suggested by the policy matrix by introducing substantial tariff and non-tariff barriers and by not having state-led import of raw materials and export of goods under increasing returns. During Mikheil Saakashvili’s presidency and the Georgian Dream Government – when Georgia moved from a low-income economy to a middle-income economy – international trade strategy deviated from economic policies given by the policy matrix by having minimal tariff and non-tariff barriers and not introducing state supported import of raw materials and export of goods under increasing returns.

In low- and middle-income economies, the key function of the monetary strategy – supporting manufacturing development – was not realised in Georgia. Monetary strategy deviated from economic policies given by the policy matrix by not channelling bank loans towards export-oriented agriculture and manufacturing and by not ensuring below market borrowing rates in targeted industries.

The dissertation also demonstrates what keeps Georgia from implementing economic policies suggested by the policy matrix by uncovering the root cause of poverty persistence. Particularly, Georgia is primarily focused on the dominant growth models, which leads to focusing on the amount and not on the quality of investments. The current development strategy of Georgia is a poverty trap because it neglects the taxonomy of economic activities in terms of increasing and decreasing returns.

The main theoretical contribution of the dissertation is the policy matrix of development strategy. The policy matrix shows how to coordinate economic policies within each development strategy domain in low-income and middle-income economies in order to support successful economic transformation into a high-income economy. The policy matrix is an evidence-based solution that takes into account the complex nature of economic development. It explains why a good economic policy of yesterday can be a bad economic policy of today. The policy matrix is a useful tool to understand how economic policies in different strategy domains affect each other. Finally, it is a useful tool to understand that without taking a systemic approach to economic development strategy it will be hard if not impossible for any low- or middle-income economy to achieve successful economic transformation.

The dissertation demonstrates that when backward economies place too much confidence in the dominant growth models while crafting a development strategy, they risk sustained underdevelopment by specialising in non-productive and vulnerable economic activities. The bottom line is that the chances of transforming Georgia into a high-income economy will be improved only as far and as deeply as the country implements economic policies prescribed by the policy matrix.
The limitations of the dissertation mainly stem from the way the countries were selected for the comparative historical analysis. One can argue that if the proposed dynamic model would contain strategy domains other than agriculture, industrial, international trade and monetary strategies, then other countries could have been relevant candidates for case studies and, therefore, the policy matrix could have different recommendations than the ones it has today.

The policy matrix confidently explains the economic backwardness of Georgia. Further research would be helpful to test wider applicability of the policy matrix. It would be interesting to see how well the policy matrix can explain the economic backwardness of other low- and middle-income economies. Application of the policy matrix to explain a number of different cases of economic backwardness will create a better understanding of how well it performs and, if needed, in which direction it can be further refined.

Keywords: Georgia, development strategy, policy matrix, growth models, poverty trap, increasing returns, decreasing returns
INTRODUCTION

I was born in Georgia, a country that experienced several wars and extreme poverty during my childhood. I vividly remember standing in long queues during the cold winters in hopes of receiving the scarcely available bread, while there was no electricity or gas at home. In this, I am not an exception, as the majority of Georgians in their late 20s and early 30s can easily recall unimaginable difficulties experienced during their early childhood. This fact made me naturally curious about gaining a deeper understanding of why Georgia remains a backward economy in spite of its international praise for economic and institutional reforms, and how today's developed countries became developed and how Georgia can achieve successful transformation from a middle-income to a high-income economy. When I started my PhD studies at Estonian Business School, I formalised my intellectual curiosity into research questions for the dissertation.

Over recent decades, policy prescription for backward economies was a one-size-fits-all policy of getting prices and institutions right. A good example of such a one-size-fits-all policy is the Washington Consensus, which is a set of 10 economic policy prescriptions considered as the “standard” reform package promoted for backward economies by Washington, D.C., based on institutions such as the IMF and the World Bank. The term was first used by John Williamson in 1989 to describe 10 economic policy instruments which were deemed as important by “Washington”. Evidence suggests that while improvements have been made, a majority of poor countries are still struggling with economic backwardness after implementation of market oriented reforms and good governance best practices.

The first systematic intellectual attack against economic backwardness started in the 1940s and culminated in the late 1950s. The work of the economists behind the intellectual attack became a foundation for what is known today as development economics, and the authors were heralded as pioneers of development. The pioneers of development shaped the field by introducing new concepts and a modelling development process (Meier & Seers (Eds.), 1984, p. i).

The neoclassical growth theory was developed in parallel to development economics. The neoclassical growth theory emphasises the role of capital, technology and labour for achieving high economic growth rate and formalises its approach in the form of production functions (e.g. Solow 1956; 1957, Cobb and Douglas 1928).

Since the late 1980s, free market policies and inclusive economic and political institutions with emphasis on the rule of law and private property proved victorious

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in the economic development discourse (e.g. Williamson 1990, Moises 2000, Rodrik 2002).

To paraphrase Nobel Memorial Prize winner economist Robert Lucas, the consequences of questions of economic development for human welfare are astounding because when one starts to think about them, it is hard to think about anything else. (Lucas, 1988, p. 5)

**The research object of this dissertation is the strategic management of economic development on a country level.** Strategic management on an organisational level is a well-studied topic in management research. (e.g. Coase 1937, Ansoff 1965, Locke 1968, Porter 1979; 1980, Williamson 1981, Pettigrew, Thomas & Wittington (Eds.) 2002, Pfeffer and Sutton 2006, Latham 2009, O’Reilly and Tushman 2016) However, the **strategic management of economic development on a country level** (e.g. List 1841, Hirschman 1958, Porter1990, Reinert 2008, Acemoglu and Robinson 2013) lacks an overarching framework and represents an existing gap in management research, which is filled by this dissertation.

Although the world is more developed than ever before, dozens of countries are still struggling with economic backwardness. **The research problem** formulated as the root research question is: **why does Georgia remain a backward economy after regaining independence from the Soviet Union?** To address the research problem of this dissertation, the root question is decomposed into four research questions (RQs).

**Economic development strategy shouldn’t be abstract; therefore, RQ1 seeks to understand which development strategy domains are key determinants of successful economic transformations.**

Prominent economic historian Paul Bairoch wrote that the main contribution of economic history to economic science is that there exist no “laws” or rules in economics which are valid for all periods of history (Bairoch, 1993). Therefore, **RQ2 seeks to understand how economic policies under each development strategy domain should be coordinated during different stages of economic development.**

Backward economies are doing, or at least are supposed to be doing, their best to overcome poverty. For example, the World Bank Doing Business report, which compared 175 economies, wrote that “Georgia is the top reformer” (Doing Business 2007, p. 1).² Ten years after the World Bank report, Georgia is still struggling with economic backwardness. Therefore, **RQ3 seeks to understand how can the persistent underdevelopment of backward economies be explained** and **RQ4 seeks to understand why Georgia remains a backward economy.**

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Research methodology

Research methodology refers to the philosophy and underlying principles of the research. Research method is informed by the research methodology and refers to techniques and procedures applied to conduct the research (McGregor and Murnane, 2010, pp. 419-420).

The research methodology of this dissertation is based on the research philosophy of the German Historical School of Economics (GHSE). The philosophy of the GHSE focuses on context and inductive reasoning as important pillars to gain a deep understanding about the phenomenon of interest. The GHSE rejects abstract economic laws based on oversimplified assumptions and accepts knowledge inferred from analysis of historical evidence (Michaelides and Milios, 2005, p. 6).

The research method of the dissertation was comparative historical analysis. Detailed historical examination allows for an in-depth understanding of relevant aspects about the phenomenon of interest. Structured comparison helps to establish or reject causal claims about the phenomenon one is trying to explain. The importance of comparative research was popularised by the prominent 19th-century economist John Stuart Mill, who developed the concepts of “Method of Agreement” and “Method of Difference”. Joseph Schumpeter, one of the greatest economists of the 20th century, wrote that since what we are trying to understand is economic change in historic time, it is a bit of an exaggeration to say that the ultimate goal is simply a reasoned history. It was obvious for Schumpeter that only detailed historical knowledge can definitely answer most of the questions of individual causation (Schumpeter, 1939, p. 213).

On the one hand, this dissertation uses the comparative historical research approach of history mediated by theory to guide the selection of cases to be examined. The history mediated by theory approach proposes “empty theoretical boxes”, which are filled based on thorough comparative historical analysis (Bonnell, 1980, p. 162). On the other hand, the dissertation uses both analytical and illustrative comparisons.

Steps Taken for Writing the Dissertation

The first and foundational step towards writing the dissertation was formulating and refining the research questions (see Figure 1). Participation in doctoral seminars and consultation meetings with Prof. Olav Aarna played an important role in the development of the research questions.
The second step was selecting the research method. PhD courses about research methods helped me to find a relevant research method for the dissertation; I selected comparative historical analysis as the main research method.

The third step was getting acquainted with the core literature about the research object. One case of searching for literature stands out in my memory. I found out that the book *Economics and World History* (Bairoch, 1993) was available only at the University of Tartu Library. I asked a friend of mine working at the University of Tartu to borrow Bairoch’s book from the library. I spent the last weekend of October 2015 in Tartu reading the book and taking notes while the city was celebrating Halloween.

The fourth step was proposing the dynamic model of economic development. Active engagement in working on the core literature helped me to formulate the dynamic model, which became the backbone of the dissertation.

The fifth step was constructing the policy matrix of development strategy. A comprehensive historical examination of selected countries helped me to uncover economic policies that contribute to successful economic transformations across time and understand how they were coordinated during different stages of economic development.
The sixth step was discovering or rediscovering the root cause of poverty persistence in today’s backward economies. Examining common assumptions of the dominant growth models in light of the taxonomy of economic activities helped me to develop the model of persistent underdevelopment.

The seventh and culminating step of writing the dissertation was conducting an in-depth analysis of the economic transformation of Georgia after regaining independence from the Soviet Union. The economic transformation of Georgia was examined in light of the policy matrix of the development strategy, which helped to explain its economic backwardness.

**Dynamic Model of Economic Development**

The dissertation focuses on the role of economic policy in economic development. The author proposes a dynamic model of economic development as a starting point for describing the strategic management of economic development on a country level. The dynamic model of economic development is based on the assumption that the economic development of a country is a function of its agricultural, industrial, international trade and monetary strategies, conditioned to the given stage of economic development. Agricultural, industrial, international trade and monetary strategies define the domains of the development strategy to describe and analyse economic policies. Stages of economic development are defined as low-income economy, middle-income economy and high-income economy. Based on an extensive literature review, it was assumed that along with a relevant coordination mechanism, the proposed four development strategy domains contain necessary and sufficient economic policies for successful economic transformations, given the existence of inclusive economic and political institutions.

The economic development of a country can be expressed by the functional relationship:

\[
D = f(A, I, T, M \mid I_{L,M,H})
\]  

where \(D\) stands for the speed of economic development, \(A, I, T\) and \(M\) stand for agricultural, industrial, international trade and monetary strategies adopted; conditioned by the current stage of economic development, where \(I_L, I_M\) and \(I_H\) refer to low-income, middle-income and high-income economies.

For the purposes of this dissertation, the dynamic model of economic development is operationalized in the form of the policy matrix of development strategy. The policy matrix of development strategy is “filled theoretical boxes” of the proposed dynamic model.

The policy matrix of development strategy is created using the analytical comparison approach. In the analytical comparison, the economic success of
Italian city-states, the Hanseatic League, England, the Netherlands, USA, Japan, South Korea, Taiwan and China were examined. Analytical comparison was used as the method of agreement for revealing time-contingent economic policies contributing to successful economic transformations across different countries and periods of history. Illustrative comparison is used as the method of difference to examine the economic development of Georgia against the policy matrix of development strategy and to explain its economic backwardness. The selection of cases (countries) for comparative historical analysis was guided by four strategy domains of the dynamic model of economic development (see Figure 2).

Figure 2: Timeline of examination period for selected countries. Source: Composed by the author based on the country cases analysed in the dissertation.

Historical analysis started with the examination of 12th century Italian city-states, since it provides one of the earliest cases where economic development can be analysed in the context of the proposed dynamic model. Then follows the analysis of remarkable economic transformations observed during the economic history of the world from medieval times to until very recently, where economic policies within proposed development strategy domains are identifiable for different stages of economic development. The reason why the comparative historical analysis starts from the pre-industrial revolution period is that it helps to identify economic policies within industrial strategy and international trade strategy, which are emulated by all examined countries. Therefore, cases were selected to build the policy matrix of development strategy and to prove its validity over space and time from the earliest possible economic success cases with available relevant historical data (e.g. Italian city-states) to the most recent economic success cases (e.g. China).
Assumptions and Limitations

It is important to emphasise once more that the context specificity in the dissertation is understood not in terms of culture, geography or natural resources but instead as four development strategy domains and three stages of economic development – low-income, middle-income and high-income economies. This is because the author examined economic policies carried out within agricultural, industrial, international trade and monetary strategy domains during different stages of economic development to build an overarching framework for development strategy and not because culture, geography or natural resources are not important aspects to consider. Another reason for not putting emphasis on culture, geography or natural resources is that their role in economic development is well understood (e.g. Chang, 2008, pp. 194-202 and Acemoglu and Robinson, 2013, pp. 48-63).

The dissertation does not focus on institutions, assuming the presence of inclusive economic and political institutions as imperative for sustainable economic development, and seeks to reveal economic policies that contribute to successful economic transformations.

The main limitation of the dissertation is reflected in the generalisation level of its findings. As far as the main findings of the dissertation are based on the selected class of cases, generalisation can be confidently applied only to the discussed cases; thus, the policy matrix of development strategy, so far, can be qualified as a middle-range theory (Bonnell, 1980, p. 159). To claim wider applicability of the dissertation findings, more cases need to be examined in light of the policy matrix. However, not claiming wider applicability of the dissertation findings does in no way decrease their importance or validity; instead, it emphasises the awareness of the limitations of the dissertation findings.

Another point to be emphasised in terms of limitations is that explaining the economic backwardness of Georgia mainly relied on secondary data – books, research papers, public interviews with policymakers and macroeconomic data from International Financial Institutions, the National Bank of Georgia and the National Statistics Office of Georgia. Relying on the secondary data raised the issue of data reliability. The challenge was mainly solved by obtaining information from various independent sources. For example, when obtaining data about annual real GDP growth of Georgia, the data were gathered from databases of the World Bank and National Statistics Office of Georgia for cross-checking.

The dissertation extensively references books, research papers and public interviews of recent and previous policymakers of Georgia with a high impact on economic development. For example, books about the history of economic policy in Georgia after regaining independence from the Soviet Union written by David Iakobidze (Minister of Finance of Georgia from 1993 to 1997), Vladimer Papava (Minister of Economy of Georgia from 1994 to 2000) and Nika Gilauri (Prime Minister
of Georgia from 2009 to 2012) are useful references for the modern economic history of Georgia; thus, the absence of interviews with Georgian policymakers is explained by the accessibility of their opinions and reflections in the written form either via books, research papers or public interviews.

**Structure of the Dissertation**

The structure of the dissertation follows the sequence of the research questions. Chapter 1 starts with an in-depth overview of the main paradigms of economic development, followed by definitions of key constructs and an explanation of the taxonomy of economic activities. After setting the stage for analysis, Chapter 1 examines successful cases of economic transformations and develops the policy matrix of development strategy to identify what should be done by backward economies in terms of strategic management of economic development on the country level.

Chapter 2 discusses dominant growth models, identifies their fallacy, which contributes to the poverty trap, and develops the model of persistent underdevelopment to show what should not be done by backward economies, who are striving for successful economic transformations.

Chapter 3 is dedicated to the analysis of development strategies in Georgia after its independence from the Soviet Union. A framework of the policy matrix of development strategy is used to analyse where the economic policies of Georgia deviate from historical lessons in order to explain its economic backwardness. On the other hand, the model of persistent underdevelopment helps to explain why the economic policies in Georgia deviated and keep deviating from successful historical lessons.

Chapter 4 provides conclusions about answers to the research questions, articulates the contribution of the dissertation to management theory and its implications for policymakers. At the end, Chapter 4 discusses the limitations of the dissertation and proposes directions for future research.
1. **DYNAMIC MODEL OF ECONOMIC DEVELOPMENT**

Chapter 1 reviews the key ideas that shaped the strategy and policy of economic development since World War II, discusses the importance of taking a strategic approach to overcoming economic backwardness, defines important constructs of the dissertation and carries out an in-depth historical analysis of successful economic transformations to discover forgotten lessons of strategic management of economic development on a country level. As a result, Chapter 1 introduces the policy matrix of development strategy, which operationalises the dynamic model of economic development. The policy matrix shows which economic policies should be implemented within agricultural, industrial, international trade and monetary strategy domains by backward economies and how economic policies should be coordinated during different stages of economic development to achieve successful economic transformation.

1.1. **Main Paradigms of Economic Development**

To set the stage for a deep examination of evidence-based lessons learned from the successful economic transformations of developed countries, it is important to first examine what contributions some of the most prominent researchers of economic development have made in terms of strategy and economic policies to overcome economic backwardness. One of the first authors among the researchers of economic development was Paul N. Rosenstein-Rodan. Rosenstein-Rodan’s thinking about economic development in underdeveloped areas of the world during 1940s and 1950s led to a theory of the *big push* (Rosenstein-Rodan, 1957). The *big push* emphasised the importance of planned industrialisation to employ an excessive rural population by simultaneously mobilising sufficiently large investments in complementary industries.

There is a minimum level of resources that must be devoted to … a development program if it is to have any chance for success. Launching a country into self-sustaining growth is a little like getting an airplane off the ground. There is a critical ground speed which must be passed before the craft can become airborne. Proceeding bit by bit will not add up in its effects to the sum total of the single bits. A minimum quantum of investment is a necessary – though not sufficient condition of success. … Underlying need for a big push is the pervasiveness of rural underdevelopment – excess agrarian population. Given that mass migration and resettlement are not feasible … the movement of machinery and capital towards labour, instead of moving labour towards capital, is the process of industrialization, which together with agrarian improvement, is the most important aspect of the economic development of the depressed areas (Meier and Seers (Eds.), 1984, pp. 210-211).
The idea of the *big push* was further developed by Ragnar Nurkse – a prominent pioneer of development economics – by the *balanced growth theory* (Nurkse, 1961). Nurkse supported a role of the state in industrialisation to coordinate balanced investments in complementary industries.

Economic progress is not spontaneous or automatic affair. … a balanced pattern of investment in number of different industries *is required*, so that people working more productively, with more capital and improved techniques, become each other’s customers. (Bass, 2009, pp. 5-6)

Albert O. Hirschman summarised his contribution to development economics in the book *The Strategy of Economic Development* (Hirschman, 1958). Unlike Rosenstein-Rodan and Nurkse, Hirschman supported the *theory of unbalanced growth*. Hirschman’s key argument was that backward economies can rarely afford to undertake large-scale simultaneous investments. Therefore, investments should be realised in targeted industries with the investment criteria of having large backward and forward linkages. Backward linkage means the impact of secondary production on primary production. The idea of the backward and forward linkages became a prominent contribution to development economics and helped Hirschman claim superiority of the *unbalanced growth strategy* over the *balanced growth strategy*.

If a popularity contest were held for the various propositions I advanced in *Strategy*, the idea of favouring industries with strong backward and forward linkages would surely receive first prize. The linkage concept has achieved the ultimate success: it is by now much part of the language of development economics that its procreator is most commonly no longer mentioned when it is being invoked.

A major battle I fought in *Strategy* was against the then widely alleged need for a ‘balanced’ or ‘big push’ industrialization effort; that is, against the idea that industrialization could be successful only if it were undertaken as a large scale-effort, carefully planned on many fronts simultaneously. (Meier & Seers (Eds.), 1984, pp. 96)

The Prebisch-Singer thesis (Prebich 1950, Singer 1950) was another important contribution to development economics. The Prebisch-Singer thesis is named after pioneers of development Raúl Prebisch and Hans Wolfgang Singer. The Prebisch-Singer thesis states that the terms of trade for primary product producer countries deteriorate against manufactured goods producer countries because in the long run prices of the primary commodities decline relative to the prices of manufactured goods. Prebisch developed a theoretical foundation and advocated industrialisation by protectionism to counteract a deterioration of the terms of trade in backward economies.

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1 Italicized text belongs to the author.
Import substitution by protection counteracts the tendency toward the deterioration of the terms of trade, by avoiding the allocation of additional productive resources to primary export activities and diverting them to industrial production. … Therefore, industrialization and increased productivity in primary production are complementary. (Meier & Seers (Eds.), 1984, pp. 179)

The pioneers of research in economic development stressed the importance of international trade, targeted industrialisation and its financing by states for the successful economic transformations of backward economies.

Michael Spence (2008), a Nobel Memorial Prize laureate economist and member of the commission on growth and development, also shared the view that a government can and should have an active role in specific circumstances to support successful economic transformation.

A flourishing export sector is a critical ingredient of high growth, especially in the early stages. If an economy is failing to diversify its exports and failing to generate productive jobs in new industries, governments do look for ways to try to jump-start the process, and they should. (The World Bank, The Growth Report, 2008, p. 49)

Today’s dominant paradigm in economic development (Chang 2011, Rodrik 2006; 2008) directs attention from production towards inclusive and effective economic and political institutions.

Inclusive economic institutions, such as those in South Korea or in the United States, are those that allow and encourage participation by the great mass of people in economic activities that make the best use of their talents and skills and that enable individuals to make the choices they wish. To be inclusive, economic institutions must feature secure private property, an unbiased system of law, and a provision of public services that provides a level playing field in which people can exchange and contract; it also must permit the entry of new business and allow people to choose their careers.

Political institutions\(^4\) are the rules that govern incentives in politics. They determine how the government is chosen and which part of the government has the right to do what. Political institutions determine who has power in society and to what ends that power can be used. If the distribution of power is narrow and unconstrained, then the political institutions are absolutist. … Under absolutist political institutions such as those in North Korea and colonial Latin Amer-

\(^4\) Italicized text belongs to the author.
ca, those who can wield this power will be able to set up economic institutions to enrich themselves and augment their power at the expense of society. In contrast, political institutions that distribute power broadly in society and subject it to constraints are pluralistic. Instead of being vested in a single individual or a narrow group, political power rests with a broad coalition or a plurality of groups. (Acemoglu & Robinson, 2013, pp. 74-75 & 79-80)

Effective economic institutions are present when a government implements economic policies prescribed by the Washington Consensus and guarantees macroeconomic stability – the absence of a wild fluctuation of inflation, interest rate, exchange rate or tax burden, which hinders private investments (The World Bank, The Growth Report, 2008, p. 53).

1.2. The Need for Economic Development Strategy

Efforts to make a poor country rich became the ‘elephant in the room’. Starting from the 1980s, the Washington Consensus placed free market ideology at the heart of economic transformation. The recent reform agenda focuses on institutions and argues that inclusive economic and political institutions are decisive for economic development (Acemoglu and Robinson, 2013). ‘Market fundamentalism’ of 1980s has been followed by ‘institutions fundamentalism’ (Rodrik, 2006). Historical lessons learned from the miraculous economic transformations of Japan, South Korea, Taiwan, China and many others are forgotten. Persistent poverty is continuously explained by deviations from free market policies and good governance best practices at an institutional level (Besley, 1995, Hall and Jones 1999, Acemoglu, Johnson, and Robinson 2001). Relevant experiences of economic policy are overlooked or ignored altogether.

Historical evidence supports the claim that economic development needs the right strategy and its proper execution. Robert Walpole, the first British Prime Minister during the reign of King George I, said in his speech at the opening of the Parliament in 1721, “it is evident that nothing so much contributes to promote the public well-being as the exportation of manufactured goods and the importation of foreign raw material” (Chang, 2003, p. 4). Walpole’s message uncovers a fundamental principle of strategically managed international trade. How countries with a strong manufacturing industry used to keep their economic supremacy has been uncovered at least 175 years ago.

It is a very common clever device that when anyone has attained the summit of greatness, he kicks away the ladder by which he has climbed up, in order to deprive others of the means of climbing up after him. … Any nation which by means of protective duties and restrictions on navigation has raised her manufacturing power and
her navigation to such a degree of development that no other nation can sustain free competition with her, can do nothing wiser than to throw away these ladders of her greatness, to preach to other nations the benefits of free trade, and to declare in penitent tones that she has hitherto wandered in the paths of error, and has now for the first time succeeded in discovering the truth. (List, 1841, p.252)

Americans had no illusions about ‘ladder-kicking’, which can be observed in the quote of Ulysses S. Grant, president of the USA during 1869-1877:

For centuries England has relied on protection, has carried it to the extremes and has obtained satisfactory results from it. There is no doubt that it is to this system that it owes its present strength. After two centuries, England has found it convenient to adopt free trade because it thinks that protection can no longer offer it anything. Very well, then gentlemen, my knowledge of our country leads me to believe that within 200 years, when America has gotten out of protection all that it can offer, it too will adopt free trade. (Chang, 2003, p.6)

The only mistake made by Ulysses S. Grant was timing, as the USA adopted a free trade policy at least a century earlier than he predicted. The history of the economic transformations of today’s developed countries entails various strategies of economic development.

1.3. Foundations of Economic Development Strategy

The dynamic model of economic development, which was proposed in the introduction of the dissertation, specified that the economic development of a country is a function of its agricultural, industrial, international trade and monetary strategies, conditioned according to the given stage of economic development.

Economic development as a term can stimulate different associations, so in order to proceed without any confusion, it is useful to specify its meaning for the dissertation. Economic development, in its broad sense, is mainly concerned about production structure and capacity, the income level of an economy, the rate of consumption and savings, technological progress, etc. In the dissertation, economic development (or just development) will be understood as a level of per capita Gross National Income (GNI), which qualifies any particular country as a high-income economy (or approaching a high-income economy) by the World Bank criteria and/or sustainable high Gross Domestic Product (GDP).

5 According to the World Bank, for 2018 fiscal year, low income economies are defined as those with GNI per capita, calculated using the World Bank Atlas method, of $1,005 or less in 2016; lower middle income economies are those with a GNI per capita between $1,006 and $3,955; upper middle income economies are those with a GNI per capita between $3,956 and $12,235; high income economies are those with a GNI per capita of $12,236 or more.
**growth rates.** For example, the average GDP growth rate of China during the 28 years from 1980 to 2016 was 9.7 per cent.⁶

Defining industry and manufacturing will be also useful for avoiding any possible semantic misunderstandings. The definitions of industry and manufacturing for the dissertation coincide with the definitions used in the *lexicon of financial times.* **Manufacturing (manufacturing industry or just manufacturing)** will be understood as **the production of goods in large quantities by using machinery.**⁷ Manufacturing is understood as transforming raw materials into finished goods on a large scale. Finished goods can be used further for manufacturing complex products like automobiles, ships, aircrafts, etc. **Industry** will be understood as **the production of raw materials (basic sources of production in manufacturing), goods (incl. primary agricultural goods and processed foods) and services.**⁸ Manufacturing is a sub-set of industry.

One more definition which needs to be specified is the concept of **development strategy** (economic development strategy or just strategy). In the dissertation, **development strategy** is understood as **a coordinated set of agricultural, industrial, monetary and international trade strategies that supports the transformation of low and middle-income economies into high-income economies.**

It seems that the causes underlying the wealth and poverty of nations have been better understood many centuries ago than they are today. Specialising in economic activities subject to **diminishing** (decreasing) **returns to scale** was historically considered a bad development strategy (List 1841, Chang 2008, Reinert 2009). Diminishing returns to scale means that as production expands there is always a point after which the benefit from producing an additional unit of output is less than the benefit from the previous unit of the same output. On the other hand, specialising in economic activities under **increasing returns to scale** was historically considered a good development strategy. Increasing returns to scale means that as production expands, benefit from producing an additional unit of output is more than the benefit from the previous unit of the same output. One of the first authors who wrote about the importance of increasing returns for wealth accumulation was the Italian economist Antonio Serra. In his 1613 treatise, Serra explained that specialisation in increasing returns was decisive for the wealth of Venice (Reinert, 2009, p. 15). Diminishing returns to scale happen in production that is based on natural resources. John Stuart Mill explains the importance of understanding diminishing returns so clearly that it is worth quoting him at some length.

> Land differs from the other elements of production, labour and capital, in not being susceptible of indefinite increase. Its extent is limited, and the extent of the more productive kinds of it more limited still. It is also evident that the quantity of produce capable of being raised

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on any given piece of land is not indefinite. This limited quantity of land, and limited productiveness of it are the real limits to the increase of production. … After a certain, and not very advanced, stage in the progress of agriculture – as soon, in fact, as mankind have applied themselves to cultivation with any energy, and have brought to it any tolerable tools – from that time it is the law of production from the land, that in any given state of agricultural skill and knowledge, by increasing the labour, the produce is not increased in an equal degree; doubling the labour does not double the produce; or, to express the same thing in other words, every increase of produce is obtained by a more than proportional increase in the application of labour to the land. This general law of agricultural industry is the most important proposition in political economy (Mill, 1848, Project Gutenberg, 2009, pp. 151-152).

Increasing returns to scale usually happen in the manufacturing and service industry. Erik Reinert gives a good description of increasing returns.

When production is expanded in manufacturing industry, cost developments go … down rather than up. Once mechanized production has been set up, the larger the volume of output, lower the cost per unit produced. The first copy of a software product costs a lot to produce, but subsequent copies have a very low cost. Manufacturing and service industries have no immediate inputs provided by nature, no fields, mines or fishing grounds that are limited in quantity or quality. They experience falling costs – or increasing returns to scale – as volumes of production increase. (Reinert, 2008, p. 5)

Figure 3: Taxonomy of economic activities. Source: Composed by the author based on the taxonomy of economic activities.
Figure 3 helps to understand the difference between increasing returns and decreasing returns to scale. The taxonomy of economic activities as increasing and decreasing returns to scale lays a solid foundation for differentiating between good and bad development strategies. History shows that specialisation in the production of manufactured goods was considered (List, 1841, Chang, 2008, Reinert 2008) a good development strategy and was executed by economically and politically strong nations. Specialisation in resource-based economic activities was considered (List, 1841, Chang, 2008, Reinert 2008) a bad development strategy and was pursued by economically and politically weak nations. The taxonomy of economic activities is an evidence-based feature of production, which regrettably disappeared from the modern discourse of economic development.

1.4. Historical Lessons

Economic policies of Italian city-states, the Hanseatic League, England, the Netherlands, the USA, Japan, South Korea, Taiwan and China are examined to understand the historical lessons of successful development strategies. The selection of cases was guided by the comparative historical research approach of **history mediated by theory**. The dynamic model of economic development proposes “empty theoretical boxes”, which are filled based on the in-depth comparative historical analysis of selected countries. The analysis of selected cases helps to operationalise the dynamic model because they contain identifiable economic policies in agricultural, industrial, international trade and monetary strategy domains for different stages of economic development. On the other hand, the selected cases cover the earliest possible economic success cases (e.g. Italian city-states) as well as the most recent economic success cases (e.g. China).

1.4.1. The Italians

One of the earliest insights into development strategy comes from Italian city-states. Florence and Venice developed wool and silk manufacturing already in the twelfth and thirteenth centuries. Wool manufacturing alone involved 200 factories in Florence, which produced 80,000 pieces of fabric annually. Raw material was imported from Spain. Florence also imported raw fabric from Spain, France, Belgium and Germany and exported finished fabric to Levant. Florence attracted the most skilful silk manufacturers and inscribed their names in the Golden Book as a reward for distinguished achievements in industry and commerce.

Venice was possibly the richest place in the world during the Middle Ages. Venice had a population of 70,000 people by 1200 (Acemoglu & Robinson, 2013, p. 152). Venice used a dynamic trade policy to achieve economic progress and dominance in international trade:
Unrestricted freedom of trade was beneficial to the Republic of Venice\(^9\) in the first years of her existence; for how otherwise could she have raised herself from a mere fishing village to a commercial power? But a protective policy was also beneficial to her when she had arrived at a certain stage of power and wealth, for by means of it she attained to manufacturing and commercial supremacy (List, 1841, p. 31).

Venice used every opportunity to attract foreign manufacturers. Many silk manufacturers migrated to Venice from Lucca as a consequence of the oppression of Castruccio Castracani in Lucca.

The development strategy of Italian city-states involved specialising in economic activities under increasing returns, importing raw materials and exporting manufactured goods, dynamic trade policy and attracting industrious people from abroad.

### 1.4.2. The Hanseatic League

Germany emulated the spirit of industry, commerce and liberty of Italy. Attacks of robbers by land and sea nudged maritime towns of northern Germany to establish a union for protection. Hamburg and Lübeck formed the league in 1241, and soon it embraced all the cities of any importance along the coasts of the Baltic and North Seas. The league adopted the title of ‘Hansa’, which in Low German dialect signifies ‘league’ (List, 1841, p. 33).

The Hanseatic League developed a trade policy which resulted in unprecedented commercial success. To achieve dominance in sea trade, the Hanseatic League introduced a law that prohibited carrying their goods on non-Hanseatic vessels. When the Hansa towns took a lead in sea trade and manufacturing, it was regarded as a wise policy by economically backward countries to invite the Hanseatic League to establish factories. The Hanseatic League established a factory in London in 1250, which became celebrated under the name of ‘Steelyard’. The Hanseatic League imported wool, tin, hides, butter and other agricultural products from England to supply them with manufactured goods in exchange. In 1252, the Hanseatic League established factory in Bruges, where they exchanged the raw products taken from England and the northern states for Belgian fabrics and other manufactured goods. Later, they transported all the manufactured articles that they obtained in Belgium back to the northern states. In 1272 The Hanseatic League established factories in Novgorod, Russia, and in Bergen, Norway. From the Novgorod factory, they were supplied with furs, flax, hemp and other raw products in exchange for manufactured goods, while in Bergen they were basically occupied with fishery and trade in whale oil (List, 1841, pp.31 & 35). The Hanseatic League established factories on foreign soil in exchange for a monopoly right. The Hanseatic factory formed a state within a state in London, Novgorod and Bergen (Zimmern, 1889, p. 140).

\(^9\) Italicized text belongs to the author.
Historical accounts show that the Hanseatic League understood the importance of value added production activities and practiced a maxim of strategic international trade – exporting manufactured articles and importing raw material, using dynamic trade policy for obtaining and maintaining manufacturing and commercial supremacy.

1.4.3. The Netherlands

On July 26, 1581, some provinces of the Netherlands declared independence from the Spanish king by the Act of Abjuration to form the United Provinces also known as the Dutch Republic. The new country achieved full international recognition in 1648 (Jong, 2011, p. 46).

The Dutch laid the foundation for their power at sea. They fulfilled their needs for grain, timber, fuel and clothing materials with their sea trade, fishery and export of dairy products. The Netherlanders used a great advantage in fishery that was provided for them by the invention of Peter Böckel, who derived the best method for salting herring. The best technique of ‘Böckeling’ herring was a secret for a long period of time and was only known to the Dutch, which enabled them to obtain a dominant position in the market of sea fish (List, 1841, p. 44). Ha-Joon Chang describes the superior position of the Netherlanders at the sea:

> The Netherlands was, as it is well known, the world's dominant naval and commercial powers during the seventeenth century, its so-called ‘Golden Century’, thanks to its aggressive ‘mercantilist’ regulations on navigation, fishing and international trade since sixteenth century (Chang, 2010, p. 10).

The Dutch used all possible means to gain the dominance in sea trade including illegal means.

When the Hanseatic League was supreme at sea, the pirate was considered as the enemy of the civilized world, and extirpated whenever that was possible. The Dutch, on the contrary, regarded the corsairs of Barbary [pirates operated from North Africa]\(^\text{10}\) as useful partisans, by whose means the marine commerce of other nations could be destroyed in times of peace, to the advantage of the Dutch (List, 1841, p. 38).

The Netherlands used a dynamic trade policy to advance its economic interests:

Dutch political elites were geared to trade, not necessarily or principally to “free trade” as defined by Adam Smith. Every town or province tried to protect its own interests by regulating and often

\(^{10}\) Italicized text belongs to the author.
restricting trade. Free (international) trade was favoured by the Dutch if and when it best served the interests of the majority of their towns and provinces (Jong, 2011, p. 50). The Netherlands abolished patent law in 1869, which had been adopted in 1817. The abolition of the patent law contributed to Netherland’s economic progress. In spite of high international pressure, the Netherlands refused to re-introduce the patent law until 1912 (Chang, 2003, p. 10). The stance that the Dutch took regarding the patent law allowed them to stay flexible in adopting frontier technology in a cost effective way into the local industry.

A dynamic trade policy was at the heart of the Netherland’s development strategy. The Netherlands did their best to develop industries under increasing returns by abolishing the patent law, which allowed them to adopt foreign technology faster than it would have been possible under the patent law.

1.4.4. The English

The English economy laid a foundation for its economic progress through wool manufacturing. Before the first appearance of the Hanseatic League on British soils, sheep farming was not highly developed. The King of England provided many benefits to the Hanseatic League for establishing the Steelyard in London. One of them was to export raw wool from England to the Hansa towns, for which sheep farming was decisive, and to import manufactured fabrics into England. Almost a century after the establishment of the Steelyard, Edward III (1312-1377) got the idea that his nation might do something more useful than just exporting the raw wool and importing woollen manufactured clothes. He established an attractive environment in England for Flemish weavers by granting them privileges, and as soon as a considerable number of them migrated to England, he introduced prohibition against wearing any articles made from foreign fabric. England achieved important progress in wool manufacture during James I (1566 – 1625):

As far back as the days of James I, the export of woollen manufactures represented nine-tenths of all the English exports put together. This branch of manufacture enabled England to drive the Hanseatic League out of the markets of Russia, Sweden, Norway and Denmark. …It was around the woollen industry of England that all other branches of manufacture grew up as around a common parent stem; and it thus constitutes the foundation of England’s greatness in industry, commerce and naval power (List, 1841, p. 48).

England warmly welcomed the emigration of foreign artisans. The immigration of protestant artificers into England, especially those who had been driven out from France by Louis XIV (1638 – 1715), supported the accumulation of industrial skill and manufacturing capital. With the skills of these artisans, England mastered its
manufacture of fine woollen cloth, the art of making glass, paper, clocks, watches, hats, linen, silk and metal manufacture.

England fought for manufacturing and commercial supremacy because between two countries who are in free trade with one another, the one who sells manufactured goods will be superior and the one who can only sell agricultural products will be subservient. For example, England didn’t allow the production of any manufactured articles in her North American colonies, even the production of a single horseshoe nail.

To achieve manufacturing and commercial supremacy, England used a dynamic trade policy. Table 1 provides data about weighted average tariff rates on manufactured products in percentages in the United Kingdom.

Table 1: Weighted average tariff rates on manufactured products in percentages in the UK. Source: Composed by the author based on Chang, Ha-Joon, 2003, p. 2 which he cites from Bairoch, 1993, p. 40, table 3.3.

<table>
<thead>
<tr>
<th>Year</th>
<th>1820</th>
<th>1875</th>
<th>1913</th>
<th>1925</th>
</tr>
</thead>
<tbody>
<tr>
<td>United Kingdom</td>
<td>45-55</td>
<td>0</td>
<td>0</td>
<td>5</td>
</tr>
</tbody>
</table>

The table 1 data show that England used high protective tariffs to protect domestic manufacturing, while developing its manufacturing and commercial powers, and they introduced a free trade policy only after achieving manufacturing and commercial supremacy. England placed a dynamic trade policy at the heart of its development strategy, consciously promoting the development of economic activities under increasing returns, and attracted foreign manufacturing skills.

1.4.5. The Americans

One of the main drivers of the American Revolution was their willingness to create a strong national economy based on the manufacturing industry, which was opposed by the British. Historical evidence shows that the Americans have fought hard to defend the infant industry argument to develop manufacturing (Hamilton, 1791). During the tariff battle, the following was said in the Congress:

We did buy, according to the advice of modern theorists, where we could buy cheapest, and our markets were flooded with foreign goods; English goods were sold cheaper in our seaport towns than in Liverpool or London. Our manufacturers were being ruined; our merchants, even those who thought to enrich themselves by importation, became bankrupt. (List, 1841, pp. 83-84)
Manufacturing development had strong support among high-profile American politicians; George Washington wore a suit of domestically manufactured cloth on the day of his inauguration ‘in the simple and impressive manner so peculiar to this great man, to give to all his successors in office and to all future legislators a memorable lesson upon the way in which the welfare of this country is to be promoted’ was written in one of the New York journals (List, 1841, pp. 77-78, 86). Table 2 provides data about the dynamic trade strategy used by the Americans.

Table 2: Weighted average tariff rates on manufactured products in percentages in the USA.

<table>
<thead>
<tr>
<th>Year</th>
<th>1820</th>
<th>1875</th>
<th>1913</th>
<th>1925</th>
<th>1931</th>
<th>1950</th>
</tr>
</thead>
<tbody>
<tr>
<td>United States</td>
<td>35-45</td>
<td>40-50</td>
<td>44</td>
<td>37</td>
<td>48</td>
<td>14</td>
</tr>
</tbody>
</table>

Table 2 shows that the United States used a protective tariff system while developing the manufacturing industry and significantly lowered the level of protection after achieving world dominance both in manufacturing and in trade. The success of the American economy came about thanks to state supported specialisation in economic activities, increasing returns and a dynamic trade strategy.

Recent developments in US politics offer the latest example about the importance of the dynamic trade strategy. For example, Donald Trump, president of the USA, blames NAFTA (North Atlantic Free Trade Agreement) for weakening the international competitiveness of the American economy.

1.4.6. The East Asians

East Asian countries11– Japan, South Korea, Taiwan and China are examples of successful economic transformations based on innovative approaches that have fascinated the world over the last decades. The East Asians implemented good agricultural strategies. The main feature of the East Asian agricultural strategy was a land reform, which restructured agriculture as labour intensive household farming. Farmers were offered intensive support in infrastructure, product and market development. The success of the East Asian manufacturing strategy was based on an import substitution policy and export-led growth, conditioned on an innovative ‘reciprocity principle’ (Amsden, 2004) or ‘export discipline’ (Studwell, 2014). Under the export discipline, subsidising manufacturing industry was conditioned on export performance. The East Asian development strategy also contained another vital element – a monetary strategy. The goal of the monetary strategy was to serve the development purposes of agriculture and manufacturing mainly via controlling credits.

11 In the dissertation “East Asians” means Japan, South Korea, Taiwan and China if otherwise is not specified.
1.4.6.1. Agricultural Strategy

There are some strong arguments for why land reform and agriculture should be the primary focus of a development strategy for an economically backward country. First of all, during early economic development the majority of the population is employed in agriculture. Agriculture offers poor countries the immediate opportunity for employment and increasing economic output. Second, increased agricultural productivity enables a poor country to not spend all foreign exchange capacity on imported agricultural goods and to direct it towards importing manufacturing technology.

The East Asians made a good start in economic development by focusing on agriculture. National governments created an almost textbook case of competition on the agricultural market via equally redistributing farming lands among rural families. The competition was characterised by a large number of market participants, so that no single player was able to influence price formation, there were no barriers to entry to the market, and information was freely available. Suddenly, it turned out that every family had its capital – land – along with the opportunity to access technical support, credit, the market and to compete with their neighbours on equal basis (Studwell, 2013, p. 6).

The successful East Asian land reform originates from Meiji Japan. A process was started by overthrowing the Togukawa Shogunate\(^{12}\), which ended with the restoration of the Japanese empire in 1868 under Emperor Meiji. 109 million certificates of land ownership were issued in three years under the Meiji land reform, which for the first time enabled farmers to mortgage and sell their farms. These changes produced growth in agricultural yields, which ran from Meiji restoration until the First World War. Agriculture supplied the Japanese economy with silk – a leading export article and source of foreign exchange. In just three decades after the Meiji restoration, Japanese progress was such that the country could defeat China (1895) and Russia (1905) in wars. Meiji’s Japan discovered the development strategy encapsulated in development economist Michael Lipton’s dictum, ‘if you wish for industrialization, prepare to develop agriculture’ (Studwell, 2013, pp. 6-8).

Between the two world wars, no further improvements happened in Japan’s land reform and agricultural development. At end of the Second World War, there was more appetite for bold policy than ever before and land reform won a crucial victory in the winter of 1945-1946. General Douglas MacArthur, Supreme Commander of the Allied Powers that were occupying Japan, was persuaded to make ‘land to the tiller’ an official policy. Wolf Ladejinsky was the most important adviser of the US government on agricultural issues in Asia. He was a naturalised American born in Ukraine, who had fled the Russian revolution. He has said, ‘I came to this advising job\(^{13}\) chiefly as a result of a lesson I learned from my experience

\(^{12}\) The Togukawa Shogunate was last feudal-military government in Japan, which existed between 1603 and 1868.

\(^{13}\) Italicized text belongs to the author.
before I left Russia in early 1921, namely that the communists would never have attained political power if they had not dealt with land question resolutely, by turning the land over to the peasants.’ Based on Ladejinsky’s advice, MacArthur sent following instructions to the Japanese government:

In order that the Imperial Japanese Government shall remove economic obstacles to the revival and strengthening of democratic tendencies, establish respect for the dignity of man, and destroy the economic bondage which has enslaved the Japanese farmer to centuries of feudal oppression, the Japanese Imperial Government is directed to take measures to ensure that those who till the soil of Japan shall have more equal opportunity to enjoy the fruits of their labour… The Japanese Imperial Government is therefore ordered to submit to this Headquarters on or before 15 March 1946 a program of rural land reform (Studwell, 2013, pp. 18-19).

As a result, the new land reform bill was passed in the Japanese parliament in October of 1946. The reform involved a limit to retain a maximum of 3 hectares of land per household.

Land ownership in South Korea prior to land reform was the most unequal among the East Asian states. At the end of the colonial era in 1945, Japanese interests owned about one-fifth of all Korean land and the majority of farmers were tenants. In September of 1945, the American Military Government took power in South Korea and initiated rent control. Governor General Archer L. Lerch did not support large-scale land reform and regarded it as a socialist policy. Developments in North Korea forced the American Military Government to start the land reform. North Korea introduced its land reform in March 1946, with a limit to retain a maximum of 5 hectares of land per household. The US State Department decided to implement the land reform in South Korea in fear of a peasant riot. In late 1947, after the death of General Archer, the American Military Government organised a small-scale redistribution of land previously held in Japanese interests. In 1948, South Korea became a sovereign state and its new parliament passed a substantive land reform law. The South Korean land reform was not completed until the end of 1952, as its implementation was disturbed by the Korean War, which started in June 1950. According to the land reform, a 3-hectare land retention limit was introduced, as it was done in Japan. The agricultural strategy played an important role in the economic development of South Korea. Agriculture employed vast numbers of people until the manufacturing industry was ready to absorb them, it provided cheap food for urban workers through government subsidy and generated considerable local consumption for the early output of South Korean manufacturers (Studwell, 2013, pp. 20-22).

At the end of the Chinese civil war in 1949, the defeated Nationalist government under Chiang Kai-shek retreated to Taiwan. Taiwan experienced massive
investments in irrigation and land reclamation during the Japanese colonial occupation (which ended in 1945). Taiwan supplied rice and sugar cane to Japan. In 1951, Chiang’s government started selling the rural population land, which was confiscated from former Japanese owners, and by the end of the decade 140,000 families had bought an average of half a hectare of land. The US government pushed Taiwan to implement a more radical land policy, and a land reform bill was passed in 1953. The terms of the land reform were quite similar to those in Japan and South Korea. The maximum land retention limit was 3 hectares. Land reform was coupled with state investments in rural infrastructure, agricultural extension service and marketing support. Agricultural production grew and dominated Taiwanese exports at the beginning of its economic development. The Taiwanese experience was the most vivid demonstration of how powerful labour-intensive private household farming can be during early economic development. Taiwanese farmers helped to fund early manufacturing development.

The victory of communists in 1949 provided China with a government that was not able to speed up agricultural development from the beginning, like it was done in Japan, South Korea and Taiwan. The Communist Party of China (CPC) believed that at the early stage large-scale agriculture is suitable for economic development. The CPC collectivised farming in the mid-1950s. Chinese agriculture was struggling until the era of Deng Xiaoping started in China. Since 1978, China showed an impressive economic progress record and became the second East Asian state after Japan to fascinate the world. China has delivered a 9.9 per cent average GDP growth rate for twenty-eight years, from 1980 to 2008. From the late 1970s, China escaped collective agriculture and allowed household farming. In the early 1980s, China managed to increase its agricultural output by more than one-third by letting poor people garden. For example, grain production under collective farming in 1978 was 305 million tonnes and it was 407 million in 1984, by which time almost all land had been converted to household agriculture with average plot size of just over one-third hectare. The restoration of household farming in China was not planned by the CPC when Deng Xiaoping rose to power in 1978. It was the farmers themselves who declared that their families should be collective units and made household farming afait accompli, as Deng Xiaoping later admittedly said in his autobiography, ‘it was the peasants who invented the household contract responsibility system.’ Agriculture has been supported by Japanese, Korean and Taiwanese-style agronomic advice, training programmes in villages, and by state-provided storage and marketing services. In 2005, President of China Hu Jintao said in his keynote policy speech that China moved from its first stage of economic development, when ‘agriculture supports industry,’ to a new stage in which ‘industry gives nourishment back to agriculture and cities support villages.’ A critical aspect, which separates a Chinese farmer from her/his counterpart in Japan, Korea and Taiwan is that the Chinese household doesn’t own its land. In 1984, government granted farmers 15-year ‘use’ rights for their plots, and in 1998 issued a Land Management Law, which formalised longer, 30-year use rights. Household farming has served its developmental function in China in terms of
incentivising economic take-off as it has done in Japan, South Korea and Taiwan (Studwell, 2013, pp.183-190).

Historical evidence shows that the initial development challenge in agriculture is to maximise its output by employing the whole labour force of the rural population. Household farming achieves this goal. Afterwards, as industrial development evolves and the rural population begins to move towards better-paid manufacturing and service jobs, farming needs to orient its focus on productivity and profit, e.g. the development of agricultural cooperatives.

1.4.6.2. Industrial Strategy

At the heart of industrial strategy is the manufacturing strategy. Meiji development theorist SugiKōji wrote about the need for Japanese business to be ‘protected until they are mature, just as children are by their parents and students by their teachers’ (Studwell, 2013, p. 65).

Meiji’s Japan began to implement the manufacturing strategy in the 1870s by establishing a series of state pilot factories in basic industries. At the same time, Japan started re-engineering imported manufacturing machinery and created incentives to attract foreigners with essential technical knowledge. In the 1880s, the Japanese government sold most of its pilot firms in mining, cotton spinning, wool thread production, silk reeling, shipbuilding and cement. In 1889, the Japanese government put much of the businesses in the hands of professional bureaucracy. The bureaucrats nurtured an early generation of entrepreneurs with various protective mechanisms and subsidies. For example, Mitsubishi, founded by Iwasaki Yataro in 1870, was given government vessels and a huge subsidy until the firm was able to compete in global shipping. Japan was not ready to build a large-scale factory until the 1880s, after relying on raw silk as main foreign exchange earner for two decades. Japan began with textiles – a business with limited capital requirement and large markets. The well-known Meiji entrepreneur Shibusawa Eiichi designated a technician to study cotton spinning and opened a steam-powered factory with 10,500 spindles. The government actively raised tariffs and protected the local raw silk market, and by 1914 various textiles accounted for 60 per cent of all Japanese exports. Exports, which was at the beginning mainly raw silk and simple manufacturing by small-scale firms, began to take off from a low base and grow by a factor of 8 between 1880 and 1913 (Studwell, 2013, pp. 70-71).

With the start of domestic recession in Japan in 1920, thousands of manufacturers began to close businesses. In response to the recession, Japan discovered the final essential part of a successful manufacturing strategy: a subsidy system that forced big business to export. The new mechanism created unique incentives for big business to focus on export as a subsidy and access to credit was conditioned on export performance. The export discipline, in essence, is similar in principle to what Michael Porter considers as one of the main prerequisites for a long-lasting
competitive advantage: “… for sustaining competitive advantage … company must adopt a global approach to strategy. It must sell its products worldwide.” (Porter, 1990, p. 8) Export discipline helped Japan to pick the winners and, most importantly, to weed out the losers. In 1949, the Ministry of International Trade and Industry (MITI) was founded in Japan. MITI initiated, supported and coordinated large-scale manufacturing projects with various means of subsidy and protection.

Japanese government’s commitment to exporting became more serious after World War II. Import substitution and exporting were deliberately connected in ways that were highly visible to the naked eye of Japan’s students: the idea was that MITI should promote both exports and domestic sales. To do this, it formed a Supreme Export Council composed of the prime minister; minister of MITI, finance, and agriculture; the governor of the Bank of Japan; the president of the Export-Import Bank; and several top business leaders (Amsden, 2004, pp.175-176).

From 1952 – the Japan’s independence was restored – Japanese manufacturing and mining output increased more than tenfold in two decades (Studwell, 2013, p. 74).

The man who defined South Korea’s industrial development and modernisation era was General Park Chung Hee. Park came to power through a coup on 16 May, 1961. Park had served as a lieutenant in the Japanese colonial military and knew how to run the country based on the Japanese way of development. General Park had understood the importance of private incentives well and declared that in Korea the state would do the planning and the private sector would lead the investments, “The economic planning or long-range development program must not be allowed to stifle creativity or spontaneity of private enterprise. We should utilize to the maximum extent the merits usually introduced by the price machinery of free competition, thus avoiding the possible damages accompanying monopoly system. There can be and will be no economic planning for the sake of planning itself.” South Korea’s government allowed the entrance of different firms in the same area of production to encourage competition in the process of manufacturing development. Michael Porter highlights the decisive importance of competition among local firms for achieving international competitiveness:

Presence of strong local rivals is … powerful stimulus to the creation and persistence of competitive advantage. This is true of small countries, like Switzerland, and it is true in the United States … Domestic rivalry, like any other rivalry, create pressure on companies to innovate and improve … But unlike rivalries with foreign competitors, which tend to be analytical and distant, local rivalries often go beyond pure economic or business competition and become intensely personal … One domestic rival’s success proves to others that advancement is possible … Companies often attribute the success
of foreign rivals to ‘unfair’ advantages. With domestic rivals, there are no excuses (Porter, 1990, p. 85).

The government nurtured and coordinated the development of internationally competitive automobile manufacturing. Alice Amsden cites the explanation given by the first president of Korea’s prestigious economic think-tank – the Korea Development Institute to account for the success of South Korea’s automobile industry:

It is true that the success of the Korean automobile industry was achieved by private initiatives. But it is also true that the success could hardly be attributed to market competition per se. Korean automobiles faced severe competition in the export frontiers. However, it was not market competition that stimulated the industry to grow strong enough to venture into the world market. I am not arguing that market competition was useless. Rather, I would like to point out that the environment was provided in which the private sectors’ creativity and responsibility could be maximized (Amsden, 2004, p. 141).

Alice Amsden elaborated further on the issue and argued that the environment referred by the first president of the Korea Development Institute was a reciprocal control mechanism with its conditionality and performance standards.

In 1962, Korea’s merchandise exports were USD 56 million and three years later the figure had grown to over USD 170 million. Starting from 1964, Park established every 30 November as the Korea National Export Day. During the 1960s, Korea established an organisation that was fairly identical to Japan’s Supreme Export Council with same urgent commitment to expand export (Amsden, 2004, p. 176). Alice Amsden noted that Park’s regime made export a compulsion rather than a choice. The interest rate paid by exporters ranged between a quarter and a half of the rate paid by everyone else engaged in non-export activity.

Park was assisted in his manufacturing development efforts by other Koreans, and among them was a group in the Economic Planning Board (EPB), headed by Chang Ki-Yong. Park gave the EPB the same power for manufacturing and trade development as it was given to the MITI in Japan. In the 1970s, the EPB set out a massive heavy and chemical industries (HCI) investment program. The World Bank 1974 report expressed ‘grave reservations about practicability of many of the export goals set for individual heavy industries’ and recommended to stay with textiles. For 1984, three-fifths of Korean exports came from heavy and chemical industries instead of planned one-quarter at the start of the HCI drive in 1973. By the 1987, the World Bank was writing that an integrated Korean Steel Plant, Pohang Iron and Steel (known as POSCO), was ‘arguably the world’s most efficient producer’ (Studwell, 2013, pp. 75-77).
In POSCO, two years before construction began (1971), the first trainees, armed with a list of guidelines for the most beneficial utilization of their sojourn, were sent to gain experience in the Japanese steel industry.

… POSCO got better finance through political channels than it could have gotten on the open market (or through the World Bank which refused to finance under U.S. pressure on the grounds that the world steel market already suffered from excess capacity). The Korean government extracted war reparations from the Japanese government to finance a larger steel mill than private financial markets would consider (Amsden, 2004, pp. 217 & 219).

Between the beginning and the end of the 1970s, iron and steel production increased by a factor of 17.1 in South Korea.

In Taiwan, the government set out import substitution and export-oriented manufacturing promotion as a cornerstone of its manufacturing development.

Rapid post-war progress was due partly government policy. When Taiwan could no longer import textiles from communist China and imports from Japan began to eat up foreign exchange, the Taiwan government heavily promoted the import substitution of textiles by offering various types of assistance to encourage investment by local entrepreneurs; investors practically enjoyed guaranteed profits (Amsden, 2004, p. 106).

The Taiwanese government offered direct cash subsidy to exporters, organised cartels in order to ‘manage’ competition and introduced a limited amount of concessionary export credit, which from 1957 to the 1970s provided short-term loans at a rate that was around 50 per cent cheaper than non-exporters paid. In 1970s, Taiwan pushed further into heavy industry, synthetic textile and electronics, for which it is best known today. The Taiwanese government set up the Industrial Technology Research Institute (TRI) in 1973 and the Electronic Research and Service Organization (ERSO) in 1974. The purposes of the TRI and ERSO were to license foreign technology, to undertake publicly funded R&D and to select public and private firms for the utilisation of the research to make new products. Taiwan linked subsidy to export performance. Cotton textile, steel products, paper, rubber products, cement and wool textile industries all formed industry associations and agreements to subsidise exports (Amsden, 2004, p. 151). Export discipline helped Taiwan to expand its export from 9 per cent of the GDP in 1952, to 50 per cent of the GDP in 1979.

In 1982, Taiwan started to promote strategic industries (machinery, automobile parts and information technology) based on six criteria: large linkage effects;
high market potential; high technology intensity; high value added; low energy intensity; and low pollution (Amsden, 2004, pp. 136-137).

Since 1978, China’s path of manufacturing promotion was somewhat different in its tactics compared to other East Asian countries, but the Chinese manufacturing development strategy was mainly in line with the strategies of Japan, South Korea and Taiwan. The tactical difference was that China retained state ownership of big manufacturing firms, while other East Asian countries privatised them and used intensive subsidies conditioned on export performance. Strategic similarities in manufacturing development were that China kicked out loss-making big state firms and encouraged competition among firms in the same sector by not allowing only one big firm for one sector, which lead them to succeed in export discipline. For example, starting from 1993 under Zhu Rongji, in oil and gas, petrochemicals, electricity generation and distribution, coal, telephone services, insurance and banking, state sector competition among a small number of big companies was increased dramatically, leading to a higher level of efficiency. Textiles and clothing became China’s leading sectors, accounting for almost a third of its total exports in 1990 (Amsden, 2004, p. 178). In 2003, the last year of Zhu’s premiership, 196 biggest businesses or groups of businesses were placed under the control of a new agency, the State Asset Supervision and Administration Commission. Chinese firms are acquiring international competitiveness mainly in mining and construction machinery, aerospace, machine tools, shipbuilding, thermal, hydro and wind power and telecommunications infrastructure. The biggest enforcer of export discipline on manufacturers is the China Development Bank (CDB). During 2006-2013, it financed over USD 100 billion deals mainly in South East Asia, Africa, Latin America and Russia. Some of the biggest loans were for straightforward raw material investments, but many were infrastructure projects in developing countries, where the CDB provides finances to Chinese state construction firms to do the building work, and Chinese manufacturers supply and install the hardware. Concessionary financing from the CDB encouraged power equipment makers that aimed international markets such as India, Pakistan, Vietnam and Indonesia. Chinese manufacturers gained around one third of the growing Indian market in the early 2000s. In 2010, the biggest firm Shanghai Electric signed a 5-year deal to supply India’s Reliance Power with equipment for thirty-six power stations in a contract amounting to USD 10 billion (Studwell, 2013).

The East Asian experience suggests that the government plays a decisive role in manufacturing strategy during early economic development by initiating and coordinating import substitution and export promotion policies. An effective control mechanism for import substitution and export promotion is the export discipline or reciprocity principle. The reciprocity principle means that subsidies are allocated to make manufacturing profitable, while not becoming giveaways. Recipients of subsidies are subjected to monitorable performance standards, for example, a pre-agreed percentage of the total production should be exported (Amsden, 2004, p. 8).
1.4.6.3. Monetary Strategy

The Japanese state exercised control over the banking system via a mechanism called ‘rediscounting’. The central bank provided loans to commercial banks against loans they had already extended. Rediscounts increased the commercial banks’ loan portfolio and profit potential but also allowed the central bank to set the borrowing criteria that must be met. Qualification for the rediscounts depended on export performance and the sector focus of the firms that commercial banks ultimately lent to. In the 1960s and 1970s, Japanese corporations were dependent on the banking system for 40-50 per cent of their total funding needs. Banks played a decisive role in the success of the Japanese manufacturing policy.

Park Chung Hee designed South Korea’s monetary strategy after the 1961 military coup by renationalising commercial banks.

According to the 1969 Annual Report of the Korea Development Bank (KDB), top priority in lending was given to export industries and industries designated in a Bank Act that improved industrial structure and balance of payments. These included import substitute industries. Import substitution and export promotion were not seen as antagonistic; both involved large, long-term capital investments. (Amsden, 2004, pp. 137-138)

In 1969, the KDB accounted for 53 per cent of the total long-term capital fund loans. During the 1970s, the National Investment Fund supported the development of heavy and chemical industry (Amsden, 2004, p. 128). From 1974 to 1980, at the height of Korea’s heavy and chemical industry development, the average real borrowing rate in the banking system was 6.7 per cent. Loans were channelled through the banking system towards exporters and big firms that were on the frontiers of technological learning (Studwell, 2013, pp. 146, 148-149). Ha-Joon Chang reflects on monetary policy of South Korea, “The country’s obsession with economic development was fully reflected in our education. We learned that it was our patriotic duty to report anyone seen smoking foreign cigarettes. The country needed to use every bit of the foreign exchange earned from its exports in order to import machines and other inputs to develop better industries.” (Chang, 2008, p. 7)

The Government of South Korea channelled and coordinated private business initiatives towards the development of high value-added industry through development banking.

Development banks influenced the efficiency of their clients by subjecting them to performance standards related to firm-level management practices (techno-standards) and national policy goals (policy standards). Among other goals, policy standards included (1) exporting; (2) localizing the production of parts and components
(typically in the automobile and electronics industries); (3) pricing; (4) building (not building) “national leaders” by concentrating (diffusing) resources in a few (many) firms; and (5) strengthening technological capabilities. (Amsden, 2004, p. 140)

Taiwan inherited a well-functioning banking system from Japan. Taiwan did well in agriculture, with rural lending institutions providing effective support to household farming. In manufacturing, compared to Japan and South Korea, Taiwan failed at some degree either to discipline large firms to manufacture for export or to support smaller manufacturers to become large ones. The principle of monetary strategy in Taiwan was similar to the monetary strategies of Japan and South Korea.

According to the 1973 Annual Report of the Bank of Communications (a quasi-development bank), the government has directed the different banking institutions to provide special credit facilities for different industries. As late as 1978 as much as 63.4 per cent of domestic bank loans in Taiwan went to public enterprises. (Amsden, 2004, p. 129)

Taiwan kept its banking system on a short leash until the late 1980s. Taiwan allowed very little freedom to the banking sector in their lending policy. (Studwell, 2013, pp. 153-155)

Before 1978, the Chinese banking system was a Soviet style mono-banking system. At the beginning of 1985, already four state-owned banks had been established:

- The Agricultural Bank of China (ABC) was created to finance agriculture.
- The Bank of China (BOC) was created to finance foreign trade and investment.
- The People’s Construction Bank of China (PCBC) was renamed the China Construction Bank (CCB), and in March 1996 it was created to finance construction and fixed-asset investment.
- The Industrial and Commercial Bank of China (ICBC) was created to finance business activity.

The establishment of specialised banks created a competitive situation, which was described as “the BOC is landing, the ABC is entering into cities, the ICBC is going to villages, and the PCBC coming into enterprises” (Okazaki, 2007, p. 8). In 1994, the government of China established three policy banks—the China Development Bank, the Export and Import Bank of China, and the Agricultural Development Bank of China to separate policy lending from commercial lending, and the four existing specialised banks became known as “state-owned commercial banks” (SOCBs).

The monetary strategy of China shared the same underlying monetary strategy principle as those of Japan, South Korea and Taiwan. The government controlled the banking industry to support agricultural and manufacturing development.
Targeted export industries were given cheap credit for technical upgrading and priority access to raw materials (Amsden, 2004, p. 178). China controlled the direction of national investments and channelled them into the domestic market to support development of high value-added industries (Studwell, 2013, p. 211).

The historical examination of the monetary strategies of developed countries allows deducing that the goal of the monetary strategy for a low- or middle-income county is to coordinate and support the development of agriculture and the manufacturing industry through development banks and investment funds.

1.4.7. Summary of Historical Lessons

Evidence suggests that there is no single strategy in agriculture, manufacturing, monetary policy or international trade, which can be equally suitable for all levels of economic development. Michael Porter supports the idea that a development strategy should be dynamic and conditioned on the level of economic progress:

In the continuing debate over the competitiveness of nations, no topic engenders more argument or creates less understanding than the role of the government. Many see government as an essential helper or supporter of industry … Others accept the ‘free market’ view that the operation of the economy should be left to the workings of the invisible hand. Both views are incorrect. … Government’s proper role is as catalyst and challenger. It is to encourage – or even push – companies to raise their aspirations and move to higher levels of competitive performance, even though this process may be inherently unpleasant and difficult … Government policies that succeeded are those that create an environment in which companies can gain competitive advantage rather than those that involve government directly in the process, except in nations early in the development process … Japan’s government, at its best, understand this role better than anyone – including the point that nations pass through stages of competitive development and that government’s appropriate role shifts as the economy progresses. (Porter, 1990, p. 87)

The historical lessons of these selected cases show that a successful development strategy is dynamic and shifts with the level of economic development. In-depth comparative historical analysis uncovered that economic policies as well as the role of the government change, as a country moves from one stage of economic development into another. Therefore, static “one-size-fits-all” economic policies are not based on the lessons obtained from successful economic transformations.
1.5. Policy Matrix of Development Strategy

To answer RQ 1 and RQ 2, the author proposed the dynamic model of economic development on a country level, which suggests that the agricultural, industrial, international trade and monetary strategies are the key development strategy domains, and successful economic transformation requires the coordination of economic policies within each strategy domain, based on a given stage of economic development. Comparative historical analysis of different cases (see p.1.4) allows to build the policy matrix of development strategy (see Table 3), operationalising the dynamic model of economic development. The rows of the policy matrix represent three stages of economic development: low-, middle- and high-income economies. The columns of the policy matrix represent four strategy areas. The entries of the policy matrix sketch the economic policies contributing to successful economic transformations within four development strategy domains based on the stages of economic development.

Entries of the policy matrix were found by identifying economic policies consistently applied in the selected cases within agricultural, industrial, international trade and monetary strategy domains during the given stages of economic development.

Table 3: Policy matrix of development strategy. Source: Composed by the author based on the Chapter 1.

<table>
<thead>
<tr>
<th>Low-income economy</th>
<th>Agricultural Strategy</th>
<th>Industrial Strategy</th>
<th>International Trade Strategy</th>
<th>Monetary Strategy</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>• Household farming.</td>
<td>• Extensive state-led search of feasible projects under increasing returns.</td>
<td>• Low tariff barriers.</td>
<td>• Channelling bank loans towards export oriented agriculture.</td>
</tr>
<tr>
<td></td>
<td>• State-led agricultural infrastructure, product and market development.</td>
<td>• Extensive state-led financing of feasible projects under increasing returns.</td>
<td>• Low non-tariff barriers.</td>
<td>• Channelling bank loans towards export oriented manufacturing.</td>
</tr>
<tr>
<td></td>
<td>• Key function: providing employment and sustenance.</td>
<td>• Export discipline.</td>
<td>• State-led import of raw materials and export of goods under increasing returns.</td>
<td>• Ensuring below market borrowing rates in targeted industries.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Key function: helping people to move from household farming to better paid manufacturing jobs.</td>
<td>• Key function: supporting manufacturing development.</td>
<td>• Key function: supporting manufacturing development.</td>
</tr>
</tbody>
</table>
| Middle-income economy | • Promotion of agricultural cooperatives.  
• State supported agricultural infrastructure, product and market development.  
• Key function: supporting manufacturing development. | • State supported search of feasible projects under increasing returns.  
• State supported financing of feasible projects under increasing returns.  
• Export discipline.  
• Key function: helping people to move from household farming to better paid manufacturing jobs. | • Moderate or high tariff barriers in targeted industries.  
• Moderate or high non-tariff barriers in targeted industries.  
• State supported import of raw materials and export of goods under increasing returns.  
• Key function: supporting manufacturing development. | • Channelling bank loans towards export oriented agriculture.  
• Channelling bank loans towards export oriented manufacturing.  
• Ensuring below market borrowing rates in targeted industries.  
• Key function: supporting manufacturing development. |
|----------------------|-------------------------------------------------|-------------------------------------------------|-------------------------------------------------|-------------------------------------------------|
| High-income economy  | • Providing agricultural extension.  
• Providing moderate or low subsidy. | • Extensive search for feasible projects under increasing returns. | • Low tariff and moderate or high non-tariff barriers. | • Price stability. |

The policy matrix presented in Table 3 is a robust practical guide to economic policies, which captures the key aspects of development strategies. The policy matrix can be readily used for analysing the deficiencies of existing development strategy and designing economic policies, whose implementation could bring long-awaited successful transformation to a backward economy. The policy matrix specifies which economic policies need to be implemented in agricultural, industrial, international trade and monetary strategy domains based on the context in which a backward economy could find itself. The policy matrix is used as the main framework to explain the economic backwardness of Georgia in Chapter 3, when analysing the development strategy of Georgia.
Dominant growth models are defined as macroeconomic production functions with prevailing presence in economics textbooks and public discourse. Growth models can be theoretical as well as empirical. Theoretical growth models emphasise key components participating in the production of economic output. On the other hand, empirical growth models not only give precise descriptions of inputs and the ways inputs and output relate with each other but can also be applied in practice. A deeper understanding of the dominant growth models and assumptions on which they are based helps to shed light on the major poverty trap of backward economies. A poverty trap is any self-reinforcing mechanism which causes poverty to persist. (Azariadis & Stachurski, 2005, p. 326) Understanding the major poverty trap of the backward economies will help to understand the root cause of poverty persistence in Georgia.

A popular way of thinking about economic development is to examine growth models on a macroeconomic level and to derive lessons for economic policy. The experience of the last few decades suggests that economic policy based on dominant growth models is largely failing to deliver expected economic development. Critically examining growth models is not a novelty. Growth models have been actively criticised in the 1950s, 1960s and 1970s. Joan Robinson has even called the production function a powerful instrument of misleading education:

The production function has been a powerful instrument of miseducation. The student of economic theory is taught to write where \( L \) is a quantity of labour, \( K \) a quantity of capital and \( Y \) a rate of output of commodities. He is instructed to assume all workers alike, and to measure \( L \) in man-hours of labour; he is told something about the index-number problem involved in choosing a unit of output; and then he is hurried on to the next question, in the hope that he will forget to ask in what units \( K \) is measured. Before ever he does ask, he has become a professor, and so sloppy habits of thought are handed on from one generation to the next. (Robinson, 1953-1954, p. 81)

Starting from the 1980s growth models regained dominance in the discourse of economic development. Gaining a better understanding of the common deficiencies of the dominant growth models is essential. Decision makers in underdeveloped countries need the correct understanding of wealth-creating mechanisms to implement the right economic policies.

The terms ‘growth model’ and ‘production function’ are used interchangeably by different authors; for convenience, the term growth model is adopted in the dissertation to refer both growth models and productions functions. Examination of the dominant growth models as they are widely encountered by students and
practitioners of economic policy – simple growth model, the Cobb-Douglas growth model, the Solow growth model and formula of Gross Domestic Product – reveals the most important poverty traps and helps to explain poverty persistence in backward economies.

2.1. Simple Growth Model

The simple growth model is a classical case for economics textbooks (i.e. Mankiw, 2012, p.243):

\[
Y = b * f(L, K, H, N)
\]  

(2)

This growth model describes a relationship between the inputs used in production process and the output of production. In formula 2, \(Y\) stands for total quantity of the output; \(b\) stands for available technology for production; \(L, K, H, N\) denote a quantity of labour, a quantity of physical capital, a quantity of human capital and a quantity of natural resources. Formula 2 does not say anything \textit{per se} about what relationship is between the inputs and the output, but in economics textbooks it is presented as a linear function. The function is linear if \(= c_1L + c_2K + c_3H + c_4N\). Formula 2 is assumed to have the constant returns to scale property, meaning that the output will be increased proportionally with respect to an increase in the inputs. Constant returns to scale property is presented in the following formula:

\[
c * Y = b * f(c * L, c * K, c * H, c * N)
\]  

(3)

Assigning the constant returns to scale property to formula 2 is an arbitrary decision and can’t be generalised over space and time. To understand what kind of a function is formula 2 means to solve a parameter identification problem, which requires a real data. Formula 3 shows constant returns to scale property of the growth model without examining any data and represents an abstract theoretical model, which has limited practical value if any at all. Another important problem with formula 3 is that additional units of input aren’t necessarily qualitatively alike to the previous unit of the same input (For example, an additional unit of agricultural land does not necessarily have same quality as its previous unit). The growth model given by formula 2, with the constant returns to scale assumption, is an oversimplification of the real production and neglects taxonomy of economic activities.

2.2. Cobb-Douglas Growth Model

Charles Cobb and Paul Douglas examined manufacturing data from 1899-1922 in the US and derived the following growth model:

\[
Y = b * L^n * K^{1-n}
\]  

(4)
where \( Y \) represents the total output; \( L \) stands for the total amount of wage earners employed in the manufacturing sector based on man-years instead of “standard” man-hours; \( K \) stands for the total value of manufacturing machinery, tools, equipment and factory buildings at their original costs; \( n \) stands for the product elasticity of Labour and \((1-n)\) denotes the product elasticity of the Capital; and \( b \) stands for total factor productivity. The Cobb-Douglas growth model has constant returns to scale property, as a sum of \( n \) and \((1-n)\) is unity. At first sight, formula 4 does not look like a linear model, but logarithmic transformation will help to prove the linearity of formula 4:

\[
\ln(Y) = \ln(b) + \ln(L^a) + \ln(K^{1-a})
\]

\[
\ln(Y) = \ln(b) + n\ln(L) + (1-n)\ln(K)
\]

\[
\ln b + n\ln(cL) + (1-n)\ln(cK) = \ln b + n\ln c + n\ln L + (1-n)\ln c + (1-n)\ln K
\]

\[
\ln b + \ln c + n\ln L + (1-n)\ln K = \ln Y + \ln c
\]

If one multiplies \( L \) and \( K \) by a factor \( c \), then the product will be increased \( c \) times.

Cobb and Douglas defined \( n \) as 0.75, based on 1899-1922 data. Cobb and Douglas believed in the generality of their growth model, “One may … be still a supporter of socialism, communism or individualism and still square his social philosophy with the theory of production which we have developed.” (Cobb & Douglas, 1928, p. 164)

The constant returns to scale property of the Cobb-Douglas growth model holds true for 1899-1922 data, and it does not provide justification to believe that the linearity of the growth model can be generalised over space and time. In a short time span, production can be characterised by constant returns to scale property. In the long run, production happens under increasing or decreasing returns.

### 2.3. Solow Growth Model

Robert Solow (1956, p. 66) proposed the following production function:

\[ Y = f(K,L) \]

(5)

where \( Y \) represents output; \( K \) and \( L \) stand for capital and labour inputs in “physical” units. After introducing the production function, Solow proceeds and says, “About production all we will say at the moment is that it shows constant return to scale. Hence the production function is homogeneous of first degree. This amounts to
assuming that there is no scarce non-augmentable recourse like land. Constant returns to scale seem the natural assumption to make in a theory of growth” (Solow, 1956, pp. 66-67). Solow developed an aggregate production function “by use of the (practically unavoidable) assumption of constant returns to scale” (Solow, 1957, p. 317) to differentiate variations in output per head due to a technical change from those due to changes in the availability of capital per head.

Solow examined 1909-1949 data from the US and concluded that “Gross output per man hour doubled over the interval, with 87.5 per cent of the increase attributable to technical change and the remaining 12.5 per cent to increased use of capital.” (Solow, 1957, p. 320) The constant returns to scale property of the Solow growth model is supported by 1909-1949 data; as in the case of the Cobb-Douglas growth model, it simply says that during some specific time span production can be characterised by constant returns to scale on an aggregate level; in the long run, production happens under increasing or decreasing returns.

The practical usefulness of the theoretical growth model (the formula 2) is limited because of its constant returns to scale assumption and lack of empirical applicability. On the other hand, empirically founded growth models (i.e. the Cobb-Douglas growth model and the Solow growth model) are admired by many academic researchers and policymakers. It is generally believed that whatever properties and implications come with empirically founded growth models, they can be trusted. However, evidence shows that growth models with constant returns in the short time span can’t be generalised as a law of production:

It has been conceded in recent literature that the theoretical basis of aggregate production functions is, at best, weak. At the same time, the empirical basis has generally been presented as being strong. In particular, striking dominance of the constant returns to scale Cobb-Douglas function … has often been taken as providing a good measure of support for production function analysis, in spite of the theory. … the empirical results do not in fact have much to do with production conditions at all. Instead, it is demonstrated that when the distribution data (wages and profits) exhibit constant shares there exist broad classes of production data (output, capital, and labour) which can always be related to each other through a functional form which is mathematically identical to a Cobb-Douglas with constant “returns to scale” … . Since the above is a mathematical consequence of constant shares, true even for very implausible production data …., it is argued that the so-called empirical strength of production function analysis is in reality nothing more than a statistical reflection of the (unexplained) constancy of income shares (Shaikh, 1974, p. 119).

Robert Solow’s growth model can’t be taken as a benchmark to design economic development policies, especially in economically backward economies, because
of its constant return to scale assumption. Solow’s purpose in developing the production function was to see where a more flexible assumption about production could result in a simple model (Solow, 1956, p. 91).

2.4. Gross Domestic Product

The formula of the Gross Domestic Product (GDP) by expenditure method is following:

\[ Y = C + I + G + (EX – IM) \]  

(6)

where \( Y \) denotes the GDP; \( C, I, G, EX \) and \( IM \) stand for Consumption, Investments, Government purchases, export and import. The GDP as a measure of economic output has been criticised on many occasions for its inability to capture all added value created in a given period of time. The GDP doesn’t count the value of non-marketed output (i.e. a household work – including cooking, cleaning, care work for children and elderly relatives. Many estimates set the value of household work as equivalent to around 30 per cent of the GDP)\(^{14}\). Another problem with the GDP is that it implicitly neglects qualitative difference between economic activities. Formula 6 suggests that, among other things, increasing \( I \) will increase \( Y \). The main goal of a backward economy is to achieve a high growth rate of \( Y \) and their economic policy is generally shaped by the motivation to stimulate the increase of \( I \). Thinking solely of how to increase \( I \) without paying enough attention to its structure, blinds policymakers to the reality that some economic activity is superior over other economic activity in terms of growth potential. The sources of the policymakers’ ignorance towards the qualitative difference of economic activities induced by the GDP formula could be demonstrated by further expanding the logic of the GDP formula. David Moss of Harvard Business School (Moss, 2007, pp.110-113) elaborates that gross product of economy equals to its gross income, which after adjustment to include transfer payments \( Tr \) necessarily equals to the sum of private consumption \( C \), private savings \( S \) and taxes \( T \), since all income must ultimately be used in one of these three ways. As a result, formula 6 can be rewritten as follows: \( Y = C + S + T – Tr \), which after simple manipulation produces the following formula regarding the sources of private investment:

\[ I = S + (T – Tr – G) + (IM – EX) \]  

(7)

where \( T – Tr – G \) (government budget surplus) reflects government savings and \( IM – EX \) (net imports) reflects foreign borrowing, since any excess of imports over exports can only be funded through borrowing from abroad. Formula 7 says that investment is funded out of three basic sources: private savings (personal savings plus retained earnings of firms), government savings and borrowing from abroad.

If a country wishes to increase its level of investment, it must either reduce its private consumption in order to increase private savings, reduce its government spending or raise taxes in order to increase government savings, increase its foreign borrowing or do a combination of the three. In an underdeveloped country, private consumption is low and its further reduction to increase private savings seems unsustainable. An increase of government savings can hardly be achievable because having a sustainable government budget surplus is at least politically unfeasible. The only feasible option to increase investments and, thus, economic growth is to increase foreign borrowing, which often takes the form of foreign investments.

National governments are advised by experts to promote a good investment climate and encourage foreign investments into the national economy. Foreign investments, on the other hand, mostly seek for short term high returns, which are often achieved by investing in unproductive industries (e.g. finance). The bottom line is that if foreign investments are not targeted and directed to promote balanced growth and the development of internationally competitive industries under increasing returns, a surge of foreign investments into the local economy will further result in the persistence of underdevelopment in the long run.

IMF is promoting the use of dominant growth models to analyse macroeconomic developments at its capacity development courses. For example, the training manual for Financial Programming and Policies (FPP) prepared by the IMF Institute for Capacity Development uses dominant growth models (formula 4 and formula 6) to estimate potential output growth. Therefore, dominant growth models are used by policy practitioners to set specific macroeconomic targets and design polices to achieve those targets (FPP, pp. 53-57).

### 2.5. Model of Persistent Underdevelopment

Examination of the dominant growth models shows explicitly (in the case of empirically founded growth models) or implicitly (in the case of theoretical growth models) that constant returns to scale can be a property of production in some specific time span. The first problem with growth models with constant returns to scale is that while aggregate industry level data shows constant returns to scale, it does not mean that individual or country-level production is also characterised by constant returns to scale, even within a specific time span; therefore, generalisation of constant returns to scale property of production can’t be justified by dominant growth models. Second, in the long run production is characterised by increasing or decreasing returns.

The only tool left to achieve a high economic growth rate in a world where the Washington Consensus dominates is to promote a good investment climate. The constant returns to scale assumption of the dominant growth models
leaves policymakers blind to understanding the taxonomy of economic activity. Neglecting the taxonomy of economic activity makes it difficult to understand that all investments are not equal for promoting economic development. Solving the puzzle of why poverty persists in economies with a highly attractive investment climate is rooted in ignorance of increasing and diminishing returns to scale. When the economy is specialising in activities under diminishing returns, after a certain point additional investments can become the main reason for poverty persistence. To understand that increasing investment will cause poverty to persist is counterintuitive and can’t be understood unless the importance of the taxonomy of economic activity will be brought back into public debate. Figure 4 illustrates the model of persistent underdevelopment in backward economies.

Figure 4: Model of persistent underdevelopment. Source: Composed by the author based on the Chapter 2.

Arrows in figure 4 describe the sequence of steps that contribute to poverty persistence. If the policy matrix of development strategy, which was developed in Chapter 1, shows how to manage successful economic transformations, on the contrary, the model of persistent underdevelopment shows how economies can fall in poverty trap. The policy matrix of development strategy shows what needs to be done, while the model of persistent underdevelopment shows what should not be done by backward economies. The understanding of the strategic management of economic transformation at a country level gained in Chapter 1 and Chapter 2
is an important foundation for Chapter 3, which analyses the development strategy of Georgia. Using a framework of development strategy given in the policy matrix helps to discover what economic policies should be promoted but aren’t promoted by the development strategies of Georgia. On the other hand, the model of persistent underdevelopment helps to understand what economic policies should not be promoted but are promoted by the development strategies of Georgia.
3. ANALYSIS OF DEVELOPMENT STRATEGIES OF GEORGIA

In this chapter, the economic development of Georgia during 1990-2017 is analysed in light of the policy matrix. The economic transformation of Georgia during 1990-2017 is divided into three logical periods to examine the economic development of Georgia under different political leaderships. 1990-2003 describes the economic transformation of Georgia during early independence and under Eduard Shevardnadze’s leadership. 2003-2012 describes the economic transformation of Georgia after the Rose Revolution and under Mikheil Saakashvili’s leadership. 2012-2017 describes the economic transformation of Georgia under the leadership of the Georgian Dream.

3.1. Framework of the Development Strategy Analysis

The economic transformation of post-Soviet Georgia happened in parallel with several civil unrests and wars (i.e. the 1991-1992 war in South Ossetia, the 1992-1993 war in Abkhazia and the war with Russia in 2008). The research focus is on the development strategy implemented in post-Soviet Georgia, in isolation with the damaging effects of the wars on economic development. Georgia is ranked as a lower middle-income economy by the World Bank with a Gross National Income (GNI) per capita of $3,810, based on 2016 data. Examining the main causes of the economic backwardness of Georgia is especially challenging, considering the economic reforms implemented after the 2003 Rose Revolution. Georgia was deemed to be a highly promising economy due to the 2004-2006 reforms; the World Bank Doing Business 2007 report says: “Georgia is the top reformer, improving in 6 of the 10 areas studied by Doing Business” (Doing Business 2007, p. 1). Georgia became the internationally recognised number one reformer in 2007, but after almost 10 years of the ‘right’ economic reforms, its economic development is still very modest.

To explain the current economic backwardness of Georgia, it is important to define a framework of development strategy or policy domains under which economic reforms carried out in post-Soviet Georgia will be examined. Such a framework development strategy allows comparing the economic reforms of post-Soviet Georgia with internationally practiced economic reforms that proved successful, and the comparison has the potential to explain which economic policies have contributed to the current economic backwardness of Georgia.

The historical examination of successful development strategies shows (see p.1.4) that the decisive policy domains of economic transition from a low- and middle-income economy to a high-income economy are:

- Agricultural strategy;
- Industrial strategy;
• Monetary strategy;
• International trade strategy.

The policy matrix of development strategy presented in p.1.5 will be used as a framework for analysing the development strategy of Georgia. The periodisation of the analysis is based on the fact that Georgia experienced economic transformation under three different governments after independence from the Soviet Union: in 1991-2003 mainly under Eduard Shevardnadze’s leadership, 2003-2012 under Mikheil Saakashvili’s leadership, and 2012-2017 under the Georgian Dream leadership.

3.2. Agricultural Strategy

The historical examination of successful development strategies shows that in low- and middle-income economies, agricultural strategy has two key functions: 1) to employ people on a massive scale during the early stage of economic development in order to provide them with sustenance; and 2) to support manufacturing development as the country becomes a middle-income economy in order to allow people to move from household farming to better paid manufacturing jobs.

Successful historical experience shows that agricultural strategy, which contributed to the transformation of low- and middle-income countries into high-income countries, included the following economic policy elements: household farming and state-led agricultural infrastructure, product and market development during low-income economy; when the country becomes a middle-income economy, agricultural cooperatives are promoted to replace household farming and the state supports agricultural infrastructure, product and market development.

3.2.1. Land Reform

At the heart of the agricultural strategy is land reform. In Soviet Georgia, agricultural land was totally nationalised. The major form of farming was centrally controlled large-scale collective farming, which co-existed with limited quasi-private household plots/parcels cultivated mainly for sustenance. At the end of 1986, 87% of all farmland in Georgia belonged to the large-scale farms, while the quasi-private plots accounted for 6% of all farmland with an average plot size of 0.25 ha (the World Bank Country Study: Georgia, 1996, p. 16).

In 1991, almost all agricultural land was owned by about 1,300 collective and state farms (USAID, Land Tenure Georgia, 2010, p. 9). The land reform in Georgia began in January 1992 with government resolution № 48. The aim of the resolution was distribution of the agricultural land among households. A 850,000 ha privatisation reserve was established with the intention of free transfer of the land to the households. The privatisation reserve comprised mainly of arable land and perennial land, which accounted for approximately 70% of such land
resources. However, the whole privatisation reserve represented less than 30% of the agricultural land of Georgia.

In the framework of the 1992 land privatisation program, on average 0.25-1.25 ha farming plots were freely transferred to each household. In many cases, farming plots under the ownership of a single household were fragmented from one to four parts located in different places. The initial land distribution program, which started in 1992, was still in the process of completion in 1995 mainly due to civil unrests and wars. Table 4 provides land distribution data between the private and state sector as of January 1995.

Table 4: Land distribution between private and state sector as of January 1995 in thousands of hectares. Source: Composed by the author based on The World Bank Country Study Georgia: Reform in the Food and Agriculture Sector, the International Bank for Reconstruction and Development/the World Bank, the USA, 1996, p. 152.

<table>
<thead>
<tr>
<th>Category</th>
<th>Total</th>
<th>State Sector</th>
<th>Private Sector</th>
<th>% Private</th>
</tr>
</thead>
<tbody>
<tr>
<td>Arable Land</td>
<td>799.5</td>
<td>459.7</td>
<td>339.8</td>
<td>42.5</td>
</tr>
<tr>
<td>Perennial Land</td>
<td>322.2</td>
<td>131.5</td>
<td>190.7</td>
<td>59.2</td>
</tr>
<tr>
<td>Orchards</td>
<td>80.2</td>
<td>12.8</td>
<td>67.4</td>
<td>84.0</td>
</tr>
<tr>
<td>Vineyard</td>
<td>117.9</td>
<td>35.7</td>
<td>82.2</td>
<td>69.7</td>
</tr>
<tr>
<td>Tea Plantations</td>
<td>64.4</td>
<td>46.3</td>
<td>18.1</td>
<td>28.1</td>
</tr>
<tr>
<td>Citrus</td>
<td>24.8</td>
<td>11.3</td>
<td>13.5</td>
<td>54.4</td>
</tr>
<tr>
<td>Other</td>
<td>34.7</td>
<td>25.2</td>
<td>9.5</td>
<td>27.4</td>
</tr>
<tr>
<td>Hay Fields</td>
<td>154.4</td>
<td>116.3</td>
<td>38.1</td>
<td>24.7</td>
</tr>
<tr>
<td>Pasture</td>
<td>1,727.4</td>
<td>1668.3</td>
<td>59.1</td>
<td>3.4</td>
</tr>
<tr>
<td>Fallow</td>
<td>7.4</td>
<td>6.4</td>
<td>1.0</td>
<td>13.5</td>
</tr>
<tr>
<td>Total</td>
<td>3,010.9</td>
<td>2,382.2</td>
<td>628.7</td>
<td>20.9</td>
</tr>
</tbody>
</table>

The table 4 data show that only about 21% of the total agricultural land had been transferred to private ownership by January 1995. About 43% of arable land, 59% of perennial land, 25% of hay fields and 3% of pasture land were transferred to private ownership.

The land distribution program was continued during the following years, and 763,000 ha of agricultural land was transferred to private ownership by of April 2003. Private ownership of agricultural land was comprised by 54.6% of total arable land, 68.5% of perennial land, 29.3% of hay fields and 4.7% of pasture (EI-LAT, 2012, p.15). It must be noted that only Abkhazia and South Ossetia were left out of the land reform process.

The land reform which started in a hard political, economic and social environment (in 1992) resulted in highly fragmented household plots. Table 5 provides data about farm numbers and sizes based on the 2004 Agricultural Census.
Table 5: Number of farms with agricultural land and their size in hectares – 2004 agricultural census. Source: Composed by the author based on GeoStat, 2004 Agricultural Census.

<table>
<thead>
<tr>
<th>Farm Size</th>
<th>Number of Farms</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than 0.1</td>
<td>57,019</td>
<td>8.24</td>
</tr>
<tr>
<td>0.1 - 1</td>
<td>462,340</td>
<td>66.85</td>
</tr>
<tr>
<td>1 - 5</td>
<td>160,993</td>
<td>23.28</td>
</tr>
<tr>
<td>5 - 50</td>
<td>10,112</td>
<td>1.46</td>
</tr>
<tr>
<td>50 - 500</td>
<td>1,041</td>
<td>0.15</td>
</tr>
<tr>
<td>More than 500</td>
<td>42</td>
<td>0.01</td>
</tr>
<tr>
<td>Total</td>
<td>691,577</td>
<td>100</td>
</tr>
</tbody>
</table>

The table 5 data show that 8.24% land users owned less than 0.1 ha land, 66.85% owned 0.1-1 ha land and 23.28% owned 1-5 ha land, which proves high fragmentation of agricultural land owned by holdings.

President Mikheil Saakashvili’s government, which came to power with the 2003 Rose Revolution, didn’t exert any consecutive effort to support the transition of household farming to agricultural cooperatives. The Georgian Dream government, which came to power after the 2012 parliamentary elections under the leadership of billionaire Bidzina Ivanishvili, is continually implementing projects to promote agricultural cooperatives in Georgia. 2014 Agricultural Census data, which is presented in table 6, gives the most recent information about the number of holdings with agricultural land and their sizes.

Table 6: Number of farms with agricultural land and their size in hectares – 2014 agricultural census data. Source: Composed by the author based on GeoStat, 2014 Agricultural Census.

<table>
<thead>
<tr>
<th>Farm Size</th>
<th>Number of Farms</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than 0.1</td>
<td>86,988</td>
<td>15.15</td>
</tr>
<tr>
<td>0.1 - 1</td>
<td>355,552</td>
<td>61.93</td>
</tr>
<tr>
<td>1 - 5</td>
<td>122,960</td>
<td>21.42</td>
</tr>
<tr>
<td>5 - 50</td>
<td>7,100</td>
<td>1.24</td>
</tr>
<tr>
<td>50 - 500</td>
<td>1,353</td>
<td>0.24</td>
</tr>
<tr>
<td>More than 500</td>
<td>124</td>
<td>0.02</td>
</tr>
<tr>
<td>Total</td>
<td>574,077</td>
<td>100</td>
</tr>
</tbody>
</table>

The table 6 data show that 15.15% of holdings with agricultural land owns less than 0.1 ha land, 61.93% owns 0.1-1 ha land and 21.42% owns from 1-5 ha land. The table 6 data provide evidence that endeavours to consolidate fragmented agricultural lands and the promotion efforts of agricultural cooperatives are still struggling in Georgia.

During the initial transfer of the agricultural land to private ownership, no clearly defined legal status of the distributed land was introduced. Legally all land was
still owned by the state. Registration of the legal status of privately transferred lands started in 1998-99 with support from USAID; the handling process of the land ownership certificates was completed in 2014. Approximately 2.4 million land ownership certificates have been issued. The final process of forming a functioning agricultural land market started in 2008 with the initiating development of a united cadastral system, which was established with the support of the KfW (EPRC, 2013, pp. 6-7). According to the Ministry of Agriculture of Georgia, the national cadastral system contains geographic and legal aspects and only 20-30% of the agricultural land is officially registered in the National Agency of Public Registry (strategy for agricultural development in Georgia 2015-2020, p. 16). In August 2016, the Georgian Dream government started a project of registering agricultural lands in a united cadastral system; within the framework of the project, the government financed efforts to assess the costs of agricultural land parcels with the support of the World Bank.

3.2.2. Big Picture

To see the big picture result of the agricultural strategy in Georgia, it is important to start by tracking the rural population development. Figure 5 provides data about the rural population of Georgia in 2001-2017.

Figure 5: Rural population of Georgia as of the beginning of the year in thousands of inhabitants during 2001-2017. Source: Composed by the author based on GeoStat.

The Figure 5 data show that the rural population was experiencing minor changes in 2003-2014 years and was mainly around 2.1 million people. In 2015, compared to 2014, the rural population declined by 488 thousand people; such a drastic decline was due to the 2014 Population Census in Georgia. Indeed, it is hard to trust a figure claiming that 488 thousand people suddenly decided to leave their
villages in order to move to towns or to emigrate. A rather compelling story is that Georgian villages were emptying over the years, especially since the Rose Revolution, and the 2014 Population Census gave us data which reflected this process. The fact that the drastic population decline in Georgia is mainly due to emigration is emphasised by development economist Robert H. Wade in his reflection on visiting Georgia in April 2016:

Between the early 1990s and today, Georgia’s population fell by one third, to about 3.4 million: its diaspora is now mostly in Russia, Turkey and Europe. It is almost as though someone had said: ‘here is the deal: you get your independence and free market economics; but you lose a third of your population.’

The historical experience of successful agricultural strategies shows that after providing sustenance for the rural population during a low-income economy, the function of the agricultural strategy is to support manufacturing development when the country becomes a middle-income economy. An agricultural strategy that supports manufacturing development realises the need of transferring the labour force from household farming to better paid manufacturing jobs. In Georgia, people were leaving villages not to join a surge of manufacturing development but mainly because of emigration.

Government spending on agriculture is critical information to get an overall understanding of the state’s attitude towards agricultural development. Figure 6 provides data about state budget allocations to the Ministry of Agriculture for the years of 2008-2017.

The Figure 6 data support the understanding that was common among average Georgians– Saakashvili’s government was not a big supporter of agricultural development. In 2010, Saakashvili’s government spend about 30.6 million GEL on agricultural development, which emphasizes the fact that the agricultural strategy was mainly overlooked during 2004-2012. In 2012, compared to 2010, Saakashvili’s government allocated about 7.5 times more money to the Ministry of Agriculture. This was not the result of paradigm shift within Saakashvili’s government but rather due to the 2012 parliamentary elections, which were won by the Georgian Dream coalition led by billionaire Bidzina Ivanishvili against the National Movement, led by the President of Georgia Mikheil Saakashvili.

In the early years of the Georgian Dream government, agricultural development was declared a priority. Under the Georgian Dream government, agriculture financing exceeded 300 million GEL for the first time in the history of independent Georgia. The Georgian Dream government also created the Agricultural Development Strategy 2015-2020, which does not recognise explicitly or implicitly that

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nowadays the main function of the agricultural strategy in Georgia should be to support manufacturing development. Ignorance of supporting manufacturing development as a key function of agricultural development can be an explanation for why active government support of agricultural development is losing faith in the Georgian Dream government. In 2017, compared to 2016, the Georgian Dream government reduced the financing of the Ministry of Agriculture by about 63.4 million GEL. Such a drastic reduction of agricultural financing shows that the popularity of agricultural development is fading for the Georgian Dream government.

To have a clear understanding about critical differences between the Saakashvili and the Georgian Dream governments in terms of attitudes towards agricultural strategy, it is helpful to see in greater details the state financing of agricultural development. Table 7 provides data about the state financing of some major agricultural development activities.

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**Figure 6: State budget allocations to Ministry of Agriculture in thousands GEL in 2008-2017.**

Source: Composed by the author based on Ministry of Finance of Georgia.
Table 7: State financing of agricultural development activities in thousands GEL during 2011-2017. Source: Composed by the author based on Ministry of Finance of Georgia.

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Renewal of agricultural machinery and equipment</td>
<td>3,000</td>
<td>74,750</td>
<td>86,800</td>
<td>0</td>
<td>26,000</td>
<td>23,000</td>
<td>20,000</td>
</tr>
<tr>
<td>Sowing support</td>
<td>0</td>
<td>24,300</td>
<td>0</td>
<td>50,000</td>
<td>46,000</td>
<td>48,000</td>
<td>0</td>
</tr>
<tr>
<td>Modernization of amelioration systems</td>
<td>0</td>
<td>13,600</td>
<td>64,400</td>
<td>50,100</td>
<td>63,523.9</td>
<td>63,000</td>
<td>69,320</td>
</tr>
<tr>
<td>Popularization of agro products</td>
<td>0</td>
<td>130</td>
<td>800</td>
<td>299</td>
<td>908.1</td>
<td>1,000</td>
<td>1,000</td>
</tr>
<tr>
<td>Vintage support</td>
<td>9,000</td>
<td>41,000</td>
<td>25,000</td>
<td>18,000</td>
<td>24,567</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Agricultural research and extension</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>3,105</td>
<td>8,279.9</td>
<td>10,000</td>
<td>4,970</td>
</tr>
<tr>
<td>Supporting agricultural cooperatives</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>801.5</td>
<td>2,570.1</td>
<td>7,240.0</td>
<td>4,870.0</td>
</tr>
<tr>
<td>Subsidizing agro credits</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>42,800.0</td>
<td>34,473.5</td>
<td>41,000.0</td>
<td>47,000.0</td>
</tr>
<tr>
<td>Supporting agro insurance</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>10,000.0</td>
<td>4,796.5</td>
<td>9,000.0</td>
<td>7,000.0</td>
</tr>
</tbody>
</table>
The Table 7 data show that before the Georgian Dream government, there was no state support for agricultural research and extension, agricultural cooperatives, agro credits or agro insurance. In 2012, Saakashvili’s government allocated 24.3 million GEL for supporting sowing activities, but in 2011 there was no money allocated for the same purpose from the state budget. This information makes it safe to conclude that financing 2012 sowing activity from the state budget was a political calculation for the 2012 parliamentary election. In 2014-2016, the Georgian Dream government allocated 144 million GEL from the state budget for financing sowing activities. In 2017, the Georgian Dream government, like its predecessor, stopped financing sowing activities; to explain such a decision, it is potentially helpful to explore data about cropped land. Figure 7 provides data about cropped land in Georgia.

Figure 7: Sown areas of crops in Georgia in thousands of hectares during 2006-2016. Source: Composed by the author based on GeoStat.

The Figure 7 data show that during 2014-2016, the years when the state financing of sowing activities reached its historic maximum, cropped land was decreasing annually and in 2016 it dropped to the lowest level. Consecutive reductions of cropped lands during 2014-2016 can be an explanation of the Georgian Dream’s decision to stop financing sowing activities in 2017. On the other hand, it might seem puzzling to see the cropped lands decreasing while financing of sowing activities increased. The main explanation for this phenomenon can be the fact that farm lands in Georgia are fragmented (about 77% of holdings own agricultural land with a size of less or equal to 1 ha.), agricultural cooperatives are still in the early stage of development, and in such conditions household farming does not seem attractive for individual agricultural land owners. Therefore, when farmers were receiving vouchers for sowing purposes, they were using these vouchers for other purposes, e.g. for buying electric grass trimmers.
To gain a comprehensive understanding of the agricultural strategy performance, it is necessary to have a look at agricultural output development.

Figure 8: Total output of agricultural products in millions GEL during 2006-2016. Source: Composed by the author based on GeoStat.

The Figure 8 data show that output of agricultural products is increasing year by year with the exceptions of 2008 and 2009, which can be explained as the result of the 2008 Georgian-Russian War. During the Georgian Dream Government, in four years from 2013 to 2016, compared to 2012, output of agricultural products increased by 40.4% to 3,942.1 billion GEL. Such a result suggests that policies implemented under the agricultural development strategy of the Georgian Dream mainly coincides with historically proven successful agricultural development policies for middle-income economies; particularly, promoting commercial agriculture by supporting agricultural cooperatives, promoting agricultural infrastructure by supporting the modernisation of amelioration systems, supporting agricultural research and extension, providing subsidised agro credits, agro insurance, financing the leasing of agricultural machinery and equipment, and market development. According to successful historical experiences of agricultural strategies among middle-income economies, the most important mistake made by the Georgian Dream government was the failure to realise a key function of the agricultural strategy. Without understanding that during a middle-income economy the key function of the agricultural strategy is to support manufacturing development, even the right agricultural development policies will not help to transform a middle-income economy into high-income economy. Otherwise, the result will be as disappointing as it is in Georgia: based on 2016 data, 62.4% of the employed population is employed in rural areas (mainly in agriculture) and the share of agriculture and fishery in the GDP is 9.3%. This means that 62.4% of the employed population creates 9.3% of the total output of the economy. People need to get out of self-employing household farming jobs in order to move to more productive manufacturing jobs and not to emigrate.
3.2.3. Summary of the Agricultural Strategy

During the early years of Georgia’s regained independence, the agricultural strategy mainly met its function: to provide employment opportunities and sustenance via household farming as a result of the land reform, in accordance with successful historical experience of low-income economies that managed to become high-income economies. One of the most popular sayings about the 1990s is that “during the difficulties of the 1990s, the bean saved Georgia”. This saying is a reflection of the common knowledge among Georgians that agricultural products, particularly beans, played a significant role in saving people’s lives from famine during the 1990s. While the agricultural strategy in the early years of independence mainly met its function, the strategy was far from being perfect because it didn’t support policies such as agricultural infrastructure, product and market development.

After the 2003 Rose Revolution, until the Georgian Dream rose to power, the agricultural strategy was mainly neglected. During Saakashvili’s government, Georgia became a middle-income economy and gained authority on an international level for its effective economic and institutional reforms. Saakashvili’s government didn’t recognise and realise a key function of the agricultural strategy for middle-income economies – to support manufacturing development. Saakashvili’s government went against the successful historical experience of middle-income economies that managed to become high-income economies and followed a strategy of “no agricultural strategy”. Saakashvili’s government didn’t put much effort into supporting the transformation of household farming into agricultural cooperatives and mainly relied on the lead of international organisations in this regard. Saakashvili’s government also rejected to implement successive projects to support agricultural infrastructure, product and market development.

After 2013 with the Georgian Dream government in charge, policies under the agricultural strategy were implemented in accordance with the successful historical experience of middle-income economies that managed to become high-income economies. In particular, the Georgian Dream government implemented successive policies to support agricultural infrastructure, product and market development. On the other hand, the Georgian Dream government is following the path of its predecessor in failing to recognise and realise a key function of the agricultural strategy for middle-income economies – to support manufacturing development. Nowadays the agricultural strategy is failing mainly because of the failure to recognise and realise a key function of the agricultural strategy for middle-income economies – to support manufacturing development, although the agricultural policies implemented by the Georgian Dream government highly meet the successful historical experience of middle-income economies that managed to become high-income economies.

Table 8 provides a summary of the agricultural strategy performance in Georgia, where “+” means that the strategy meets successful historical experience and “-” means that the strategy doesn’t meet successful historical experience.
Table 8: Summary of agricultural strategy performance. Source: Composed by the author based on the Chapter1 and Agricultural Strategy of Georgia.

<table>
<thead>
<tr>
<th>Low-income economy</th>
<th>Agricultural Strategy</th>
<th>Successful historical experience</th>
<th>Georgia’s experience</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>During early independence and Shevardnadze’s government</strong></td>
<td>Household farming.</td>
<td>+</td>
<td></td>
</tr>
<tr>
<td></td>
<td>State-led agricultural infrastructure, product and market development.</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Key function: providing employment and sustenance.</td>
<td>+</td>
<td></td>
</tr>
<tr>
<td>Middle-income economy</td>
<td><strong>During Saakashvili’s government</strong></td>
<td>Promotion of agricultural cooperatives.</td>
<td>-</td>
</tr>
<tr>
<td></td>
<td>State supported agricultural infrastructure, product and market development.</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td><strong>During the Georgian Dream government</strong></td>
<td>Promotion of agricultural cooperatives.</td>
<td>+</td>
<td></td>
</tr>
<tr>
<td></td>
<td>State supported agricultural infrastructure, product and market development.</td>
<td>+</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Key function: supporting manufacturing development.</td>
<td>-</td>
<td></td>
</tr>
</tbody>
</table>

3.3. **Industrial Strategy**

A historical examination of successful development strategies shows that the key function of the manufacturing strategy during a low- and middle-income economy is **helping people move from household farming to better paid manufacturing jobs**.

Successful historical experience shows that industrial strategies that contributed to the transformation of low- and middle-income countries into high-income countries contained the following economic policies: extensive state-led search and financing of feasible economic activities under increasing returns during a low-income economy; keeping the state supported search and financing of feasible economic activities under increasing returns and placing export discipline at the heart of the industrial strategy when the country becomes a middle-income economy.

During the Soviet era, Georgia was developing its production capabilities in food processing, the light manufacturing industry (i.e. cotton, wool and silk fabric productions), manufacturing of chemical products (i.e. fertilizers) and the heavy manufacturing industry (i.e. steel and iron production). Table 9 provides data about the structure of Georgia’s industrial production in 1980, 1985 and 1990.

Table 9: Structure of Industrial Production. Source: Composed by the author based on Yuphunia, 2007, p. 254.

<table>
<thead>
<tr>
<th></th>
<th>1980</th>
<th>1985</th>
<th>1990</th>
<th>% change in 1990 compared to 1980</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td></td>
</tr>
<tr>
<td>Electricity</td>
<td>2.5</td>
<td>2.0</td>
<td>2.0</td>
<td>-0.5</td>
</tr>
<tr>
<td>Fuel Industry</td>
<td>3.6</td>
<td>2.0</td>
<td>1.0</td>
<td>-2.6</td>
</tr>
<tr>
<td>Ferrous Metallurgy</td>
<td>4.7</td>
<td>4.3</td>
<td>3.5</td>
<td>-0.4</td>
</tr>
<tr>
<td>Non-Ferrous Metallurgy</td>
<td>0.4</td>
<td>0.4</td>
<td>0.4</td>
<td>0</td>
</tr>
<tr>
<td>Chemical and Petrochemical Industry</td>
<td>3.2</td>
<td>3.8</td>
<td>4.5</td>
<td>+1.3</td>
</tr>
<tr>
<td>Mechanical Engineering and Metal Production</td>
<td>10.2</td>
<td>14.4</td>
<td>15.1</td>
<td>+4.9</td>
</tr>
<tr>
<td>Timer, Wood Processing and Cellulose-Paper Production</td>
<td>2.3</td>
<td>4.0</td>
<td>3.4</td>
<td>+1.1</td>
</tr>
<tr>
<td>Building Materials Production</td>
<td>5.1</td>
<td>5.6</td>
<td>5.3</td>
<td>+0.2</td>
</tr>
<tr>
<td>Light Manufacturing Industry</td>
<td>20.9</td>
<td>20.7</td>
<td>22.0</td>
<td>+1.1</td>
</tr>
<tr>
<td>Food Processing</td>
<td>38.7</td>
<td>37.6</td>
<td>36.9</td>
<td>-1.8</td>
</tr>
<tr>
<td>Other</td>
<td>8.4</td>
<td>5.2</td>
<td>5.9</td>
<td>-2.5</td>
</tr>
</tbody>
</table>

The Table 9 data show that food processing and the light manufacturing industry (together close to 60%) were the key parts of Georgian manufacturing. Also, mechanical engineering and metal production were substantially developed parts of the manufacturing industry (15.1% in 1990). Soviet Georgia’s manufacturing was far from being internationally competitive, but the presence of differentiated manufacturing production could have been used for enhancing its sophistication during early years of independence. Georgia not only missed the chance to create an internationally competitive manufacturing industry during the transition period, but it also destroyed the majority of its production capabilities inherited from the Soviet era. Georgia experienced the steepest decline of total output among Commonwealth of Independent States. According to the 2002 World Bank report Transition – the first ten years, Georgia experienced five consecutive years of output decline after independence and the real GDP in 2000 was only 29% of the 1990 level. (World Bank, Transition, 2002, p.5) This astonishing decline in output
was in large part due to the difficult political situation. The World Bank classified the political system of Georgia during 1990-1999 as a war-torn regime. War-torn political regimes used to be engaged in prolonged wars or civil conflicts, which had generally been rooted in ethnic or territorial divisions. Such conflicts have placed severe strains on the capacity of the state. (The World Bank, Transition, 2002, p. 99) Figure 9 provides data about real GDP growth in Georgia during 1990-1999.

Figure 9: Real GDP growth % in Georgia during 1990-1999. Source: Composed by the author based on Transition Report 1999 – Ten years of transition, EBRD, p. 73.

![Real GDP Growth %](image)

The Figure 9 data show that Georgia experienced a sharp decline in total output during its first years of independence. 1992 was especially dramatic in this regard, as the real GDP declined by 44.8% mainly as a result of the War in Abkhazia.

One of the major reasons behind the steep output decline, other than wars and conflicts, is the failed privatisation of state-owned enterprises. Privatisation of state owned enterprises started in 1993, and more than 1,500 enterprises were privatised before the 2003 Rose Revolution. (Aggressive Policy of State Property Privatization, Green Alternative, 2007, p.6) Hundreds of factories were demolished and sold as scrap. (Robert Wade, Neo-liberalism and Industrial Policy in Georgia, 2016) Figure 10 provides data about the share of the scrap and ferrous waste in the total export of Georgia during 1999-2003.

The Figure 10 data show that scrap metal was a leading export commodity from the late 1990s until Mikheil Saakashvili came to power with the 2003 Rose Revolution. Figure 11 data show that during Eduard Shevarndadze’s time the share of industry in the GDP was behind the Soviet era level and the share of manufacturing in the GDP stayed somewhat stably low.
During the low-income economy, Georgia did not implement the industrial strategy in accordance with historically successful industrial strategies, which helped low-income economies to become high-income economies and set a strong foundation for internationally competitive manufacturing development. Specifically, Georgia did not implement an export discipline policy and did not organise extensive state-led search and financing of feasible economic activities under increasing returns. The EBRD transition report supports this conclusion: “In countries such as … Georgia, where war has taken a severe toll on the capacity of the state to play a substantial role in the economy, the state is unable to intervene in or to subsidize firms directly.” (Transition Report 1999 – Ten years of transition, EBRD, p. 128)

As a result, the industrial strategy in Georgia did not fulfil its function – helping...
people move from household farming to better paid manufacturing jobs – during the low-income economy. According to the World Bank transition report, in 2000 Georgia was on the list of the poorest countries in the world with per capita income of 610USD. (The World Bank, Transition, 2002, p.55)

### 3.3.2. Industrial Strategy of the Rose Revolution (2003-2012)

The failure to implement the transparent and corruption free privatisation of state-owned enterprises under the leadership of Eduard Shevardnadze (Chairman of the Parliament of Georgia 1992-1995 and President of Georgia 1995-2003) partially became a driver for the 2003 Rose Revolution. The newly elected government under the leadership of President Mikheil Saakashvili made major improvements in terms of establishing democratic institutions, fighting against corruption and organised crime and promoting Georgia's international image building; however, at the same time it grossly failed in developing globally competitive manufacturing. Saakashvili’s government placed libertarian economic philosophy at the heart of economic reforms – i.e. rapid privatisation, a substantial decrease in the number of licenses and permits for business activities, adopting an employer-friendly labour code, etc. Privatisation of large-scale state-owned properties and enterprises is a major footprint of Saakashvili’s government. Late Kakha Bendukidze, minister of economy and state minister for reform coordination, will be well remembered for his statement in the context of privatization, “Everything is for sale except conscience.” The drive to privatise was not inspired by the development of an internationally competitive manufacturing industry, which is reflected in the fact that scrap metal stayed among the leading export commodities until the end of Saakashvili's government. Figure 12 provides data about the share of scrap and ferrous waste in the total export of Georgia during 2004-2012.

Figure 12: Share of the scrap and ferrous waste in total export of Georgia during 2004-2012. Source: Composed by the author based on GeoStat.
During Saakashvili’s second term as a democratically elected president, the government implemented some policies to support industrial development. The government implemented the “Cheap Credit” program in 2008-2009, with the aim of supporting the creation of new businesses and strengthening existing enterprises. In 2008, about 49.6 million GEL and in 2009 about 2.5 million GEL was allocated from the state budget for the “Cheap Credit” program. After 2009, the government stopped financing the “Cheap Credit” program. In June 2011, the government established the JSC Partnership Fund, with a 100% state ownership of its shares. The Partnership Fund incorporated 100% of the Georgian Railway shares, 100% of the Georgian Oil and Gas Corporation shares, 100% of the Georgian State Electricity System shares, 100% of the Electricity System Commercial Operator shares and 24.5% of the JSC Telasi shares. The Partnership Fund was created to strengthen private-public cooperation by directly supporting new businesses via capital funding, partial financing of credits and guarantees.\textsuperscript{16} The minor effort of Saakashvili’s government to support industrial development is understandable, as their economic policy was based on a non-interventional philosophy of free market capitalism. As a result, the economy grew, but Saakashvili’s government mainly failed to establish a firm foundation for internationally competitive manufacturing development. Figure 13 data show real GDP growth in Georgia during 2004-2012.

Figure 13: Real GDP growth in Georgia during 2004-2012. Source: Composed by the author based on GeoStat.

Figure 14 data show that during Saakashvili’s presidency the share of industry and manufacturing in the GDP declined by 1.9% and 0.6%, respectively.

\textsuperscript{16} Government decree, #230, June 2011.
During Saakahsvili’s presidency, instead of manufacturing tourism was declared a strategic sector to promote economic prosperity. The renovation of some cities (i.e. Sighnaghi and Batumi) was undertaken to support tourism development. Figure 15 provides data about state budget allocations for tourism development during 2007-2012.

The Figure 15 data show that state budget allocations for tourism development substantially increased in 2010-2012 compared to the post 2008 war level, which indicates that Saakashvli’s government was actually dedicated to making tourism a key pillar of Georgia’s economy. Figure 16 provides data about rural employment during 2004-2012.
The figure 16 data show that in 2012 about 1.1 million people were employed in the rural area, which is only 35.1 thousand persons less compared to 2004 rural employment. A high concentration of employed people in the rural area indicates that during Saakashvili’s government the industrial strategy did not fulfil its function – helping people move from household farming to better paid manufacturing jobs.

In a nutshell, neither Shevadnadze’s nor Saakashvili’s government managed to organise state-led or state supported search and financing of feasible economic activities under increasing returns and enforcing an export discipline.


The Georgian Dream government, which came to power after the 2012 parliamentary elections under the leadership of billionaire Bidzina Ivanishvili, declared the construction of 100 factories to be one of the most important election promises. Ivanishvili said in December 2012 that “the first year will be hard. The second year will be tangibly better. During the third year, the majority of the population will feel improvement for themselves and in their own pocket. The fourth year will be very good.” The Georgian Dream soon drafted the Social-Economic Development Strategy 2020, which could hardly be considered a development strategy of any particular sector. The Social-Economic Development Strategy 2020 mainly focuses on the desirable economic indicators for 2020 and says little about how it can be achieved through a systemic approach. The Georgian Dream government, unlike its predecessors, took practical steps to promote manufacturing production.
The legal entity under public law (LEPL) Entrepreneurship Development Agency (EDA) was created in the beginning of 2014 under the Ministry of Economy and Sustainable Development with the aim of promoting the competitiveness of the local private industry. The key source of EDA funding is the national budget. In June 2014, the EDA initiated the program Produce in Georgia. The following directions have been declared as priorities: production of construction materials, paper and cardboard production, wood processing, production of finished metal goods, chemical production, rubber and plastic production, pharmaceutical production, machine production, electrical devices and textile production. According to the EDA 2015 report, 75 industrial enterprises were supported under the program Produce in Georgia with a total investment of 205.1 million GEL. According to the EDA 2016 report, 150 industrial enterprises were supported under the program Produce in Georgia with a total investment of 215.5 million GEL.

Georgia’s Industrial Development Group was created within the Ministry of Economy and Sustainable Development in 2014. The aim of the group is to promote production diversification by supporting the identification of feasible projects under increasing returns. The Group’s vision states that the private sector is not able to start new large-scale economic activities due to high risks. At the same time, the government should not create new economic activities, and the public-private partnership is necessary for risk distribution among the parties. The group carried out feasibility studies for different investment projects, i.e. the production of ceramic tiles, yarn, socks, textile, clothing, essential oil, etc.

LEPL Georgia’s Innovation and Technology Agency (GITA) was created in 2014 to coordinate the development of innovations and technologies. GITA implements programs where research, engineering and start-ups & accelerators are among the top priorities. Giorgi Kvirikashvili, Prime Minister of Georgia, opened the Innovation Park on January 11, 2016. The Innovation Park was built on the initiative and under the supervision of GITA, which offers opportunities for entrepreneurial people to use its co-working space, accelerators and other start-up supporting tools to commercialise their projects.

In 2016, the Georgian Dream government presented Government program 2016-2020 – freedom, fast growth, prosperity. The key pillar of the program is a 4-point reform plan, where the main part is economic reforms. The economic reforms of the 4-point reform plan aim at supporting business development mainly by developing tourism, creating a formal mechanism for start-up financing, easing tax administration, implementation of the “Estonian corporate income tax reform”, which means that there is no profit tax for reinvested profit, and decriminalisation of economic crime. In 2016, the Georgian Dream government initiated a new program called Start-up Georgia under the supervision of the

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17 Decree of the Minister of Economy and Sustainable Development, April 2014, #1-1/90.
JSC “Partnership Fund” as part of the 4-point reform plan. The goal of Start-up Georgia is to support start-up development mainly via financial participation between 15,000 - 100,000 GEL. These activities helped the economy to achieve positive growth trends. Figure 17 data show real GDP growth in Georgia during 2013-2017.

Figure 17: Real GDP growth in Georgia during 2013-2017. Source: Composed by the author based on GeoStat.

A slow growth rate of the economy (average 3.7% growth rate in 2013-2017) puts additional constraints on a fast structural transformation of the economy. In spite of the active support for industrial development by the Georgian Dream Government, there is no major improvement in the structure of the Georgian economy in terms of industry and manufacturing development. The share of industry in the GDP in 2017 was 24.5%, only 0.5% higher compared to 2012, before the Georgian Dream came to power. In 2017, the share of manufacturing in the GDP was 15.5%, which is 2.1% higher than it was in 2012. Figure 18 provides data about the share of industry and manufacturing in the GDP in 2013-2017.
The number of people employed in the rural areas did not significantly change after the Georgian Dream government came to power. Figure 19 provides data about rural employment in 2012-2016.

Figure 19: Rural employment in thousand persons during 2012-2016. Source: Composed by the author based on GeoStat

The Figure 19 data show that in 2016 about 1.099 million people were employed in rural areas, which is only 800 persons less compared to 2012 rural employment. The existing high concentration of employed people in the rural areas indicates that during the Georgian Dream government, the industrial strategy did not fulfill its function –helping people move from household farming to better paid
manufacturing jobs. No major changes can be expected in the near future in terms of having fulfilled the key function of the manufacturing strategy, as the Georgian Dream government still lacks a systematic approach towards economic development and relies mainly on tourism and start-up development.

The Georgian Dream’s “success” to keep failing in terms of manufacturing development, despite all that it has undertaken, can partially be explained by inconsistency and a lack of coordination to develop and implement a comprehensive industrial strategy. While the Georgian Dream government initiated and implements a number of formal instruments to support manufacturing development, inconsistency in manufacturing development can be traced in the speech made by Dimitry Kumsishvili on December 28, 2015 when presenting his vision for economic development in the parliament of Georgia as a candidate minister of economy and sustainable development, “As you all know very well, the best export is tourism. This is a kind of export that comes by its own foot.” The vision of Dimitry Kumsishvili, who holds the position of First Vice Prime Minister in the Georgian Dream government, about tourism as the most important export of Georgia suggests that all programs and endeavours undertaken by the Georgian Dream government to support industrial development lack a systematic approach.

3.3.4. Summary of the Industrial Strategy

After more than 25 years of independence, Georgia still doesn’t have an internationally competitive manufacturing industry. The manufacturing strategy in Georgia deviated from successful historical experience. During Shevardnadze’s presidency when Georgia was a low-income economy, there was no extensive state-led search and financing of feasible economic activities under increasing returns, there was no export discipline policy implemented, and the industrial strategy did not meet with its function – helping people move from household farming to better paid manufacturing jobs. During Saakashvili’s presidency, there was no major improvement in manufacturing development and the industrial strategy was failing in Georgia during the middle-income economy as it did during the low-income economy. During the Georgian Dream government with the middle-income economy, Georgia has experienced some economic policies that support manufacturing development in accordance with successful international experience. In particular, the Georgian Dream government organised state supported search and financing of feasible economic activities under increasing returns. However, the Georgian Dream government did not implement an export discipline policy to support manufacturing development and industrial strategy is still not meeting its function – helping people move from household farming to better paid manufacturing jobs.

Table 10 provides a summary of the industrial strategy performance in Georgia, where “+” means that the strategy meets successful historical experience and “−” means that the strategy doesn’t meet successful historical experience.
Table 10: Summary of industrial strategy performance. Source: Composed by the author based on the Chapter 1 and Industrial Strategy of Georgia.

<table>
<thead>
<tr>
<th>Low-income economy &amp; middle-income economy</th>
<th>Industrial Strategy</th>
<th>Successful historical experience</th>
<th>Georgia’s experience</th>
</tr>
</thead>
<tbody>
<tr>
<td>During early independence and Shevardnadze’s government – low-income economy</td>
<td>Extensive state-led (or state supported) search of feasible economic activities under increasing returns.</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Extensive state-led (or state supported) financing of feasible economic activities under increasing returns.</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Export discipline.</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Key function: helping people move from household farming to better paid manufacturing jobs.</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>Middle-income economy</td>
<td>State supported search of feasible economic activities under increasing returns.</td>
<td>+</td>
<td></td>
</tr>
<tr>
<td>During the Georgian Dream government</td>
<td>State supported financing of feasible economic activities under increasing returns.</td>
<td>-,+</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Export discipline.</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Key function: helping people move from household farming to better paid manufacturing jobs.</td>
<td>-</td>
<td></td>
</tr>
</tbody>
</table>
3.4. International Trade Strategy

A historical examination of successful development strategies shows that the key function of international trade strategies during low- and middle-income economies is to support manufacturing development. A dynamic trade policy is the way towards a high-income economy: low tariffs and non-tariff barriers for international trade and state-led import of raw materials and export of manufactured goods during a low-income economy; moderate or high tariffs and non-tariff barriers in targeted industries during the development of internationally competitive manufacturing and state supported import of raw materials and export of manufactured goods.

3.4.1. International Trade Strategy since 1991

During the early 1990s, Georgia experienced harsh economic, political and social conditions. Georgia was somewhat unprepared to meet its independence: democratic institutions were absent, and civil unrest, criminal activities and wars were the prevailing events. Georgia was not able to design and implement a development strategy in the best interest of the country and an international trade strategy was not an exception.

From the beginning of independence, the development of Georgia’s customs policy and trade strategy has undergone several important changes. The first major document concerning customs policy was presented by the Government of Georgia in August of 1992, and it included temporary regulations on quotas and the licensing of export-import. Quotas were introduced for 25 items, which included food products, ferrous alloys, metal products and all kinds of natural resources. Import licensing was introduced for 6 items of goods: medical appliances, drugs, chemical means of plant protection, industrial waste, narcotics, weapons and ammunitions (Papava and Beridze, winter of 1996/97). General customs tariffs were introduced in 1992 at rates of 2% on imports, 8% on exports and 20% of contract value for barter operations (Papava, 2013). The second stage of import-export regulation was the resolution of the Cabinet of Ministers of the Republic of Georgia in March 1993, which left unchanged the number of items under quota and licensing but increased the number of prohibited items to import from 13 to 15. According to the resolution in 1994, a single uniform 12% import tax was introduced, export was exempted from taxation and 20% of contract value was left unchanged for barter operations. The next resolution “On Perfection of State Regulations on Export-Import of Goods (jobs, services)” was adopted in January of 1995, which separated goods subject to quota and licensing (decreased to 8 items) from goods subject to only licensing (another 8 items of goods) and decreased the number of prohibited items to 12 from 15. In February 1995, the resolution, which had been adopted the previous month, was amended with the following changes: tea and coal were removed from the quota list, copper production was moved from the prohibition list to the licensing list, “unwashed wool” was added to the list of licensed items and wood was moved from the licensing list to the prohibition list.
Another important step towards the liberalisation of export-import operations was the resolution of the Head of the Republic of Georgia in April 1995, which initiated a cancelation of the quota system from June 1995 and introduced new list of goods subject to licensing, which consisted of only 9 items. According to the law on the “State Budget of Georgia, 1996”, tax rates on barter operations were decreased to 12% of the contract value (Papava and Beridze, Winter of 1996/97).

While the political and economic situation started to stabilise in the middle of 1990th, the following excerpt from the paper of Vladimer Papava, who served as minister of economy during 1994-2000, and Teimuraz Beridze provides a good account about what kind of international trade policies were considered for implementation in the government of Georgia:

Two alternative approaches to reaching these most ambitious goals (to make Georgia’s industrial products competitive on European market)\(^\text{18}\) maybe proposed. The first is the protection for domestic producers by way of imposition of differential customs tariffs and excise taxes, whereby domestic production will enjoy lower levels of excises, while imported raw materials and semi-finished goods (inputs) will be tax exempt (including VAT exemption). Meanwhile, the finish goods imports will be subject to higher customs tariffs (and to higher VAT). At the same time, the domestic finish goods exports should be tax exempt, while raw materials and semi-finished goods should be taxed at a higher rate. The second approach advocates uniform excise tax levels for domestic and imported goods. Customs tariffs on all imported goods should be same - relatively low-level. In the future, all exports shall be tax exempt. Machinery and equipment may constitute the only – and temporary – exception.

The “industrial elite” supports the first scenario and lobbies it hard in the government. Unfortunately, some of our scholars also back this stance. Some government officials (mainly economists) are in favour of the second scenario. Their position is backed by the international financial institutions (the IMF and the World Bank) which draw from the wealth of international experience (Papava and Beridze, 1996/97, pp.69-70).

The excerpt shows that the Government of Georgia in the mid-1990s did not consider a third option for trade strategy, which is a dynamic trade strategy based on the historical trade policy of developed countries.

Transformation of the customs policy was continued in the law “On Customs Tariffs and Taxes”, which entered into the force on March 20, 1998, and introduced two differentiated levels of import tax rates: 5% and 12%. The next important step

\(^{18}\) Italicized text belongs to the author.
in the formulation of the international trade policy was amendments to the law “On Customs Tariffs and Taxes”, passed by the Parliament of Georgia on December 6, 2002, which introduced a new system of differentiated import tax rates from 0% to 30%, divided into 22 levels that entered into force from 2003. Another amendment was introduced in 2005, which decreased the number of differentiated import tax rates from 22 to 16 (0%, 4%, 5%, 6%, 7%, 8%, 10%, 12%, 14%, 15%, 16%, 17%, 18%, 20%, 25% and 30%).

On September 1, 2006, a new law “On Customs Tariffs” entered into force, which introduced three levels of import tax rates (0%, 5% and 12%), instead of the previous 16 levels of import tax rates. A 12% import tax rate replaced all existing import tax rates from 12% to 30%, a 5% tax rate replaced existing tax rates from 5% to 12%, and 0% import tax rate replaced existing tax rates from 0% to 5%19.

On January 1, 2011, the Customs code was united with the Tax code, but existing export-import tax rates were left unchanged, and currently Georgia has 0%, 5% and 12% import tax rates, while export is exempt from taxes. Table 11 provides data about the history of Georgia’s customs tariffs.

Table 11: Customs Tariffs in Georgia. Source: Composed by the author based on various sources.

<table>
<thead>
<tr>
<th>Year of Reform</th>
<th>Import Tax</th>
<th>Export Tax</th>
<th>Non-Tariff Trade Barriers</th>
</tr>
</thead>
<tbody>
<tr>
<td>1992</td>
<td>2%</td>
<td>8%</td>
<td>Numerous</td>
</tr>
<tr>
<td>1994</td>
<td>12%</td>
<td>0</td>
<td>Numerous</td>
</tr>
<tr>
<td>1998</td>
<td>5% and 12% (differentiated into two levels)</td>
<td>0</td>
<td>Few</td>
</tr>
<tr>
<td>2002</td>
<td>From 0% to 30% (differentiated into 22 levels)</td>
<td>0</td>
<td>Few</td>
</tr>
<tr>
<td>2005</td>
<td>0%, 4%, 5%, 6%, 7%, 8%, 10%, 12%, 14%, 15%, 16%, 17%, 18%, 20%, 25% and 30% (differentiated into sixteen levels)</td>
<td>0</td>
<td>Minimal</td>
</tr>
<tr>
<td>2006</td>
<td>0%, 5%, and 12% (differentiated into three levels)</td>
<td>0</td>
<td>Minimal</td>
</tr>
</tbody>
</table>

The table 11 data are the result of a long and effortful search for reliable sources of data about the historical development of the export-import tax rates and non-tariff trade barriers. The 2% import tax rate, 8% export tax rate and several non-tariff barriers were in force in 1992, when the GNI per capita in current USD (based on Atlas method) was 750 USD. Georgia was a low-income economy in 1992, and having a 8% export tax rate and a number of non-tariff trade barriers can be considered as deviations from historical evidence of successful international trade strategies. A 12% import tax rate, 0% export tax rate and a number of non-tariff trade restrictions in terms of quota and licensing were in force in 1994 with the GNI per capita at 510 USD. While some international trade policy was implemented in accordance with successful historical experience, namely cancelation of the export

tax, having a flat 12% import tax rate and a number of non-tariff trade restrictions can be considered as deviations from successful international trade strategy. Two levels of import tax rates (5% and 12%) were in force, export was exempted from taxes and non-tariff barriers in terms of quotas were abolished in 1998, with the GNI per capita at 820 USD. Again, some international trade policy was implemented in accordance with successful historical experience, namely, the cancelation of quota barriers, but having two import tax rates could qualify Georgia’s international trade strategy in 1998 as deviating from successful historical experience of international trade strategies for low-income economies. Georgia introduced twenty-two levels of import taxes with the minimum tax rates of 0% and maximum tax rates of 30% in 2002, with the GNI per capita at 770 USD, which can be strictly qualified as deviation from successful historical experience of international trade strategies for low-income economies. Georgia implemented a complicated import tax scheme instead of introducing low tariff barriers for import. Import tax levels were decreased from 22 to 16, the export tax rate was 0%, and no quota barriers were present in 2005 with the GNI per capita at 1,410 USD. With the GNI per capita at 1,410 USD, Georgia moved from a low-income economy to a middle-income economy, and the liberalisation of international trade can be qualified as a deviation from successful historical experiences of international trade strategies. Since 2006, Georgia has three import tax rates (0%, 5% and 12%), a 0% export tax rate and no quota barriers. The existing international trade strategy of Georgia is deviating from successful historical experience. Middle-income economies need to support manufacturing development through an international trade strategy. Based on the successful historical experiences of international trade strategies, middle-income economies need to introduce moderate or high tariff and non-tariff barriers in targeted industries to support the development of an internationally competitive manufacturing industry. Since regaining independence, the international trade strategy of Georgia mainly violates the principles of a dynamic trade strategy, which helps to explain its failure to develop an internationally competitive manufacturing industry and to create a high-income economy.

The Government of Georgia didn’t manage to lead or support the importation of raw materials and exportation of manufactured goods, neither during Sheverndadze’s nor during Saakashvili’s presidency, which explains the fact that scrap metal was one of the major export commodities during the 1990s and the first decade of the 2000s. During the Georgian Dream government, high value-added manufactured goods were still not among the major export commodities. Table 12 provides data about the share of major export commodity groups in 2013-2016.
Table 12: Percentage share of major export commodity groups during 2013-2017. Source: Composed by the author based on GeoStat

<table>
<thead>
<tr>
<th>Major Export Commodity Group</th>
<th>2013</th>
<th>Major Export Commodity Group</th>
<th>2014</th>
<th>Major Export Commodity Group</th>
<th>2015</th>
<th>Major Export Commodity Group</th>
<th>2016</th>
<th>Major Export Commodity Group</th>
<th>2017</th>
</tr>
</thead>
<tbody>
<tr>
<td>Motor cars</td>
<td>24.2</td>
<td>Motor cars</td>
<td>18.1</td>
<td>Copper ores</td>
<td>12.0</td>
<td>Copper ores</td>
<td>14.8</td>
<td>Copper ores</td>
<td>15.4</td>
</tr>
<tr>
<td>Ferro-alloys</td>
<td>7.9</td>
<td>Ferro-alloys</td>
<td>10.0</td>
<td>Ferro-alloys</td>
<td>9.0</td>
<td>Nuts</td>
<td>8.5</td>
<td>Ferro-alloys</td>
<td>11.3</td>
</tr>
<tr>
<td>Nuts</td>
<td>5.7</td>
<td>Copper ores</td>
<td>8.7</td>
<td>Motor cars</td>
<td>8.0</td>
<td>Ferro-alloys</td>
<td>8.0</td>
<td>Motor cars</td>
<td>8.6</td>
</tr>
<tr>
<td>Copper ores</td>
<td>5.6</td>
<td>Nuts</td>
<td>6.4</td>
<td>Nuts</td>
<td>8.0</td>
<td>Motor cars</td>
<td>7.9</td>
<td>Wine</td>
<td>6.3</td>
</tr>
<tr>
<td>Fertilizers</td>
<td>4.5</td>
<td>Wine</td>
<td>6.3</td>
<td>Drugs</td>
<td>6.0</td>
<td>Wine</td>
<td>5.4</td>
<td>Drugs</td>
<td>5.2</td>
</tr>
<tr>
<td>Wine</td>
<td>4.4</td>
<td>Fertilizers</td>
<td>4.8</td>
<td>Fertilizers</td>
<td>5.0</td>
<td>Drugs</td>
<td>5.1</td>
<td>Spirituous beverages</td>
<td>4.6</td>
</tr>
<tr>
<td>Mineral waters</td>
<td>3.7</td>
<td>Mineral waters</td>
<td>4.8</td>
<td>Wine</td>
<td>4.0</td>
<td>Spirituous beverages</td>
<td>4.3</td>
<td>Mineral waters</td>
<td>3.5</td>
</tr>
<tr>
<td>Spirits</td>
<td>3.4</td>
<td>Spirituous beverages</td>
<td>3.3</td>
<td>Crude petroleum</td>
<td>4.0</td>
<td>Gold</td>
<td>3.8</td>
<td>Nuts</td>
<td>3.0</td>
</tr>
<tr>
<td>Gold</td>
<td>2.5</td>
<td>Drug</td>
<td>3.2</td>
<td>Mineral waters</td>
<td>4.0</td>
<td>Mineral waters</td>
<td>3.8</td>
<td>Fertilizers</td>
<td>2.8</td>
</tr>
<tr>
<td>Bars</td>
<td>2.1</td>
<td>Bars</td>
<td>2.2</td>
<td>Spirituous beverages</td>
<td>3.0</td>
<td>Fertilizers</td>
<td>3.1</td>
<td>Gold</td>
<td>2.6</td>
</tr>
<tr>
<td>Other</td>
<td>36.0</td>
<td>Other</td>
<td>32.2</td>
<td>Other</td>
<td>37.0</td>
<td>Other</td>
<td>35.3</td>
<td>Other</td>
<td>36.7</td>
</tr>
</tbody>
</table>
The Table 12 data show that raw materials and low value added commodities are still among the leading export commodities in Georgia during 2013-217. For example, raw materials like copper ores and nuts are among the top ten export commodities; the majority of top 10 export commodities are low value-added commodities like wine, spirits and Ferro-alloys. The leading place of motor cars in the top 10 export commodities can’t be regarded as a major achievement of manufacturing development, because Georgia is engaged not in production of motor cars but in their re-export.

3.4.2. International Trade Agreements

Georgia follows a path of liberal international trade policy. The following message is posted on the webpage of the Ministry of Economy and Sustainable Development: “Liberal foreign trade policy is one of the major principles of the economic policy of Georgia. …nowadays Georgia has one of the most liberal foreign trade policies in the world, which implies … low import tariffs and minimal non-tariff regulations. … Based on the law of Georgia on Licenses and Permits, the legislation does not consider any non-tariff limitations in foreign trade (licenses, quotas, prohibitions and other) except when restrictions are necessary for healthcare, security and environment protection purposes.”

Georgia signed a number of international trade agreements and, ironically, has no freedom anymore (or at least its freedom is highly limited) to choose whether to impose higher import tariffs and non-tariff barriers or not. Georgia has the following international trade agreements:

- **Bilateral Free Trade Agreements** are in force with Azerbaijan, Armenia, the Russian Federation, Ukraine, Moldova, Kazakhstan, Uzbekistan, Turkmenistan and Turkey. Out of these free trade regimes, only agreements with Russia and Turkey contain exceptions for certain goods.
- **Multilateral Free Trade Agreements** are in force among the Commonwealth of Independent States (CIS), except the Russian Federation. A Multilateral Agreement on the Creation of Free Trade Zone among CIS countries was summarised in 1994.
- A Free Trade Agreement was signed between Georgia and the European Free Trade Association on June 27, 2016, which came into force on September 1, 2017. At this stage, the agreement covers free trade between Georgia, Norway and Iceland.
- **Membership in the World Trade Organization (WTO)** from June 14, 2000. Upon its entry into the WTO, Georgia was granted the Most Favoured Nation (MFN) treatment by all WTO members and has conferred MFN treatment in return. **MFN: treating other people equally** is a principle of the WTO agreements, which means that countries cannot discriminate between their trading partners. If granting someone a special

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favour (such as a lower customs duty for one of their products), then one has to do the same for all other WTO members.  

- **A Generalised System of Preferences (GSP)** is in force with the EU, the USA, Japan, Canada, Switzerland and Norway. The idea of a GSP is to establish low rate tariffs on goods imported from the beneficiary country, which facilitates access of goods from developing countries to the markets of developed countries.

- **A Deep and Comprehensive Free Trade Agreement (DCFTA)** is in force with the EU since September 1, 2014, which enables Georgia to export duty-free to the EU. However, certain quota barriers still remain for Georgian goods. For example, garlic can be imported to the EU market without taxes, but no more than 220 tons.


### 3.4.3. Summary of the International Trade Strategy

The international trade strategy of Georgia mainly fails to realise its function – to support manufacturing development. The Georgian international trade strategy mainly deviates from successful historical experience throughout its independence from the Soviet Union – Georgia had increasing tariff and some non-tariff trade barriers during the low-income economy, when it should have had no or minimal tariff and non-tariff trade barriers in order to have supported manufacturing development; Georgia has minimal tariff and non-tariff trade barriers during a middle-income economy, when it should have moderate or high tariff and non-tariff trade barriers for targeted industries to support manufacturing development.

Table 13 provides a summary of international trade strategy performance in Georgia, where “+” means that the strategy meets successful historical experience and “-” means that the strategy doesn’t meet successful historical experience.

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### Table 13: Summary of international trade strategy performance. Source: Composed by the author based on the Chapter 1 and International Trade Strategy of Georgia

<table>
<thead>
<tr>
<th>Low-Income Economy</th>
<th>During early independence and Shevardnadze’s government</th>
<th>International Trade Strategy</th>
<th>Successful historical experience</th>
<th>Georgia’s experience</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Low tariff barriers.</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Low non-tariff barriers.</td>
<td>- , +</td>
<td>-</td>
</tr>
<tr>
<td></td>
<td></td>
<td>State-led import of raw materials and export of goods under increasing returns.</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Key function: supporting manufacturing development.</td>
<td>-</td>
<td>-</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Middle-Income Economy</th>
<th>During Saakashvili’s government</th>
<th>During the Georgian Dream government</th>
<th>Moderate or high tariff barriers in targeted industries.</th>
<th>-</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td>Moderate or high non-tariff barriers in targeted industries.</td>
<td>-</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>State supported import of raw materials and export of goods under increasing returns.</td>
<td>-</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Key function: supporting manufacturing development.</td>
<td>-</td>
</tr>
</tbody>
</table>

#### 3.5. Monetary strategy

The historical examination of successful development strategies shows that the key function of monetary strategies during low- and middle-income economies is to support manufacturing development. Successful monetary policies over space and time that supported transition from low- and middle-income economies to high-income economies involve channelling credit towards export oriented agriculture and the manufacturing industry mainly via development banking and investment funds and ensuring below market borrowing rates for bank loans in targeted industries.
3.5.1. Introduction of National Currency

After the collapse of the Soviet Union, Georgia stayed within the “Rouble Zone” until Georgian banknotes—the Georgian Coupon, issued by the National Bank of Georgia (NBG) – became the sole legal tender of payment in August 1993. The Georgian Coupon didn’t meet a good fortune and experienced hyperinflation with a monthly inflation rate of 60-70 percent from late 1993 until autumn of 1994 (Papava, 2013, p.15). Program development for restoring trust in Georgia’s economy was started in March 1994, after president Shevardnadze’s meeting with executive directors of the World Bank and the IMF in the USA. The program was started in September 1994 and resulted in economic growth (Iakobidze, 2009, p.48). With the help of the IMF, the exchange rate of the Georgian Coupon was stabilised. At the end of 1994, 1USD was equal to 1.3 million Georgian Coupons (Papava, 2013, p.19). The IMF helped Georgia in the successful currency reform implementation in fall 1995, when Georgia introduced the new national currency – the Georgian Lari (GEL). The initial exchange rate was 1 USD = 1.3 GEL. The GEL gained trust among the Georgian public and still keeps performing its role successfully. In 1995, the Parliament of Georgia also approved the first official budget after independence. Georgia introduced full current account convertibility in June 1996 and modified the exchange rate regime from a managed float to a free float in December 199822.

3.5.2. The National Bank and the Monetary Policy

The transformation of Georgia’s financial system started from the early independence and finished with a -tiered banking system in 1995 after the privatisation of five state banks - Eximbank, Savings Bank, Agromretsymbank, Mretsvesenbank and Binsotsbank. In June 1995 and in February 1996, the Parliament of Georgia adopted the Organic Law of Georgia on the National Bank of Georgia and Law on Activities of the Commercial Banks, which equipped NBG with the authority to define and implement monetary policy independently.23The main goal of the monetary policy of NBG is price stability and it never aimed, neither formally or informally, to support export oriented agricultural and manufacturing development. The NBG used a monetary targeting regime as its core monetary policy instrument before 2009. The main idea behind the monetary targeting regime was managing inflation through directly controlling the monetary base (the money supply). Georgia switched to an inflation targeting regime in 2009, and price stability became the main objective of the NBG’s monetary strategy. The introduction of the inflation targeting regime was followed by the use of new monetary policy instruments (i.e. refinancing loans and reserve requirements) from 2010. Nowadays, the main monetary policy instrument of the NBG is the monetary policy (refinancing) rate –an interest rate applied to NBG’s one week refinancing loans to banking institutions. The monetary policy rate is considered as a reference point for

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market lending interest rates and is used to align the projected inflation with the targeted inflation rate. Georgia introduced full interest rate liberalisation already in 1990s. The premature liberal monetary policy of the NBG during the early years of independence was criticised by the NBG itself in its 2006-2009 development strategy:

By then, the NBG was implementing unjustified liberal monetary policy. Furthermore, imperfect banking legislation, weak requirements set for the licensing of the commercial banks and administering norms (e.g. the minimal statutory capital established for the banks in 1994 comprised approximately 500 USD in real terms) and liberal policy implemented by the NBG in the country encouraged rapid growth of the number of banking institutions in the country. If in 1991 only 5 commercial banks were functioning, by the end of 1993 the number increased to 179 units and in 1994, there were 226 commercial banks functioning in the country. The biggest part of the commercial banks, already in 1994, faced financial difficulties. In fact, the volume of deposits in the banking system then dropped to almost zero, basically conditioned by hyperinflation and collapse of so called pyramid banks.24

The Government of Georgia promoted the privatization of state-owned banks during the early years of independence and a short time later the consolidation of the banking sector.25 Figure 20 provides data about the asset share of state-owned banks in financial institutions in 1990-1998.

Figure 20: Asset share of state-owned banks in 1990-1998. Source: Composed by the author based on Transition report 1999 – ten years of transition – EBRD, 1999 p. 223.

![Asset Share of State-Owned Banks](image)

The Figure 20 data show that the asset share of state-owned banks was 0% already in 1996, which means that the government successfully achieved the goal of privatising state-owned banks. The number of licensed banks was 36 in January 2001 (Kakulia & Khelaia, 2003, pp. 197-200), which also shows that the government successfully achieved the goal of banking sector consolidation. 16 banks were officially licensed at the end of 2017. Figure 21 provides data about the structure of loans extended to the national economy during 2003-2017 as of December 1 of each period.

Figure 21: Structure of loans extended to the national economy in percentages during 2003-2017. Source: Composed by the author based on NBG and own recalculations.

Today Georgia is a middle-income economy and needs to support its manufacturing development with a monetary policy that promotes export oriented agricultural production and manufacturing. The figure 21 data show that in 2017 the share of agricultural loans in the total share of loans extended to the national economy is reduced by a 0.2 percentage point, compared to 2016, and stands at 1.8%. The share of loans to industry (11.3%) overtook the share of loans to trade (10.3%) not because of a substantial increase of its share, but instead the share of loans to trade is reduced by a 1.7 percentage point in 2017 compared to 2016. The Government of Georgia and the NBG are failing to channel credits towards export oriented agricultural and manufacturing development and deviating from successful international experience of monetary strategy. Figure 22 shows the development of interest rates on loans disbursed to agriculture, industry and trade in 2003-2017.
The Figure 22 data show that in 2003, when Georgia was a low-income economy, interest rates on loans disbursed to agriculture and industry were 33.0% and 22.0%. In 2017, interest rates on loans disbursed to agriculture and industry were 9.4% and 10.7%. When a country is a low- or middle- income economy with high interest rates on loans disbursed to agriculture and industry, it is highly probable that the development of internationally competitive agricultural production and manufacturing will not happen without the government ensuring below market interest rates in targeted industries. Saakashvili’s government implemented a “cheap credit” program in 2008-2009 and the Georgian Dream government implements programs with partial financing of interest rates of bank loans, but none of the programs have been designed based on a development strategy with export oriented agricultural production and manufacturing at its heart. The fact that export oriented manufacturing development is not at the heart of Georgia’s development strategy can be observed from figure 23, which provides data about the share of manufacturing in the total FDI in 2007-2017.

The Figure 23 data show that overall, the share of manufacturing in the total FDI has a decreasing trend and achieved its lowest level of 4.0% in 2017, which emphasises the failure of the Government of Georgia to place manufacturing at the heart of its development strategy.
3.5.3. Summary of the Monetary Strategy

The monetary strategy of Georgia fails to realise its function – to support manufacturing development. The monetary strategy of Georgia deviates from successful historical experience throughout its independence from the Soviet Union – the Government of Georgia and the NBG did not manage to channel bank loans towards export oriented agriculture and manufacturing industry, and did not ensure below market borrowing rates for bank loans during a low-income economy or a middle-income economy.

Figure 23: Share of manufacturing in total FDI during 2007-2017. Source: Composed by the author based on GeoStat.
Table 14: Summary of monetary strategy performance. Source: Composed by the author based on the Chapter 1 and Monetary Strategy of Georgia.

<table>
<thead>
<tr>
<th>Monetary Strategy</th>
<th>Successful historical experience</th>
<th>Georgia’s experience</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Low-Income Economy</strong></td>
<td><strong>During early independence and Shevardnadze’s government</strong></td>
<td>Channelling bank loans towards export oriented agriculture.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Channelling bank loans towards export oriented manufacturing.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Ensuring below market borrowing rates in targeted industries.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Key function: supporting manufacturing development.</td>
</tr>
<tr>
<td><strong>Middle-Income Economy</strong></td>
<td><strong>During Saakashvilli’s government</strong></td>
<td>Channelling bank loans towards export oriented agriculture.</td>
</tr>
<tr>
<td></td>
<td><strong>During the Georgian Dream government</strong></td>
<td>Channelling bank loans towards export oriented manufacturing.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Ensuring below market borrowing rates in targeted industries.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Key function: supporting manufacturing development.</td>
</tr>
</tbody>
</table>

### 3.6. Summary of the Development Strategy of Georgia

This section summarises the results of a comprehensive analysis of development strategies of Georgia during the period of 1991-2017. This analysis enables a systemic understanding of why Georgia remains a backward economy. Table 15 provides the summary of Georgia’s development strategy performance against the policy matrix of development strategy (see p.1.5), where “+” means that Georgia’s strategy meets successful historical experience, “-” means that Georgia’s strategy doesn’t meet successful historical experience, and “+/-” means that Georgia’s strategy partially meets successful historical experience: some economic policies are aligned and some economic policies are not aligned with successful historical experience.
The agricultural strategy is the only exception that fulfilled its primary function – providing employment and sustenance on a massive scale – during a low-income economy. This success was mainly due to the land reform, which promoted household farming. Further development of agriculture during the low-income economy was impeded by government failure to have led agricultural infrastructure, product and market development. The agricultural strategy fails to fulfil its function – supporting manufacturing development – during the middle-income economy. However, the Georgian Dream government, in power after the 2012 parliamentary elections, implements key agricultural policies in accordance with successful historical experience. The Georgian Dream government promotes agricultural cooperatives and supports agricultural infrastructure, product and market development, while its predecessor – Saakashvili's government – has failed to implement these policies.

The manufacturing strategy has never fulfilled its function – helping people move from household farming to better paid manufacturing jobs – neither during a low-income or middle-income economy. Under president Shevardnadze's and president Saakashvili's leadership, the manufacturing strategy failed to fulfil its function mainly because Georgia went against successful historical experience and did not organise state-led or state supported search and financing of feasible economic activities under increasing returns and did not implement an export discipline. During the Georgian Dream government, the manufacturing strategy failed to fulfil its function mainly because the government did not implement an export discipline.

The international trade strategy has never fulfilled its function – supporting manufacturing development – neither during a low-income nor a middle-income economy. During early independence and Shevardnadze's presidency, Georgia went mainly against successful historical experience and introduced substantial tariff and non-tariff barriers and did not organise state-led importing of raw materials and export of goods under increasing returns. It should be mentioned that non-tariff barriers were set in accordance with successful international experience in 1998, but this was a fragmented change and did not help the overall international trade strategy to fulfil its function. Under Saakashvili's and Georgian Dream leadership, Georgia went fully against successful historical experience and introduced minimal tariff and non-tariff barriers and did not organise state supported importing of raw materials and export of goods under increasing returns.

The monetary strategy has never fulfilled its function – supporting manufacturing development – neither during a low-income nor a middle-income economy. During early independence, Shevardnadze's presidency, Saakashvili's presidency and the Georgian Dream leadership, the government and the NBG failed to implement a monetary strategy in accordance with successful historical experience, did not channel bank loans towards export oriented agricultural production and manufacturing, and did not ensure below market borrowing rates for targeted industries.
Table 15: Summary of Georgia’s development strategy performance against the policy matrix of development strategy. Source: Composed by the author based on the Chapter 1 and the Chapter 3

<table>
<thead>
<tr>
<th>Low-Income Economy</th>
<th>Agricultural Strategy</th>
<th>Industrial Strategy</th>
<th>International Trade Strategy</th>
<th>Monetary Strategy</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Historical lessons</td>
<td>Georgia’s experience</td>
<td>Historical lessons</td>
<td>Historical lessons</td>
</tr>
<tr>
<td>Low-Income Economy</td>
<td>Household Farming.</td>
<td>+</td>
<td>Export discipline.</td>
<td>Low tariff barriers</td>
</tr>
<tr>
<td>During early independence and Shevardnadze’s government (1990 - 2003)</td>
<td>State-led agricultural infrastructure, product and market development.</td>
<td>-</td>
<td>Extensive state-led search and financing of economic activities under increasing returns.</td>
<td>Low non-tariff barriers</td>
</tr>
<tr>
<td></td>
<td>Key function: providing employment and sustenance.</td>
<td>+</td>
<td>Key function: helping people to move from household farming in better paid manufacturing.</td>
<td>State-led import of raw materials and export of goods with increasing returns.</td>
</tr>
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<td></td>
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<td></td>
<td>Channeling bank loans towards export oriented agriculture and manufacturing.</td>
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<td>Ensuring below market borrowing rates in targeted industries.</td>
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<tr>
<td>Promotion of agricultural cooperatives.</td>
<td>-;+</td>
<td>Export discipline.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>State supported agricultural infrastructure, product and market development.</td>
<td>-;+</td>
<td>State supported search and financing of economic activities under increasing returns.</td>
<td></td>
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</tr>
<tr>
<td>Key function: supporting manufacturing development.</td>
<td>-</td>
<td>Key function: helping people move from household farming to better paid manufacturing.</td>
<td></td>
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<tr>
<td>-</td>
<td>Moderate or high tariff and non-tariff barriers in targeted industries.</td>
<td>-</td>
<td>Ensuring below market borrowing rates in targeted industries.</td>
<td></td>
</tr>
<tr>
<td>-</td>
<td>State supported import of raw materials and export of goods with increasing returns.</td>
<td>-</td>
<td>Channeling bank loans towards export oriented agriculture and manufacturing.</td>
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<tr>
<td>-</td>
<td>Key function: supporting manufacturing development.</td>
<td>-</td>
<td>Key function: supporting manufacturing development.</td>
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</tbody>
</table>
The bottom line is that Georgia remains a backward economy mainly because its development strategy deviates from successful historical experience, and to break the poverty trap it needs to implement economic policies in accordance with the policy matrix of development strategy. Figure 24 integrates and summarises the main findings of Chapter 1, Chapter 2 and Chapter 3 by using backward induction.

Figure 24: Backward induction of economic backwardness. Source: Composed by the author based on the dissertation.

Figure 24 shows that the economic backwardness of Georgia can be explained by its deviation from the policy matrix. On the other hand, what keeps Georgia deviating from the policy matrix is its short-sighted focus on the dominant growth models, which rely on the constant return to scale assumption and, thus, neglect the increasing and decreasing returns to scale property of production.
4. CONCLUSIONS

Answers to the research questions

To answer RQ1: which development strategy domains and economic policies are key determinants of successful economic transformations and RQ2: how should economic policies under each development strategy domain be coordinated during different stages of economic development the author proposed the dynamic model of economic development on a country level, which suggests that the agricultural, industrial, international trade and monetary strategies are the key development strategy domains, and successful economic transformation requires the coordination of economic policies within each strategy domain based on a given stage of economic development. The dynamic model of economic development was operationalised using comparative historical analysis to build the policy matrix of development strategy. The rows of the policy matrix represent three stages of economic development: low-, middle- and high-income economies. The columns of the policy matrix represent four strategy domains. The entries of the policy matrix sketch the economic policies contributing to successful economic transformations within four development strategy domains based on the stages of economic development.

The key function of the agricultural strategy during a low-income economy is to provide sustenance and employment opportunities on a massive scale. The economic policies that support the realisation of this function are household farming and state-led agricultural infrastructure, product and market development. The key function of the agricultural strategy during a middle-income economy is to support manufacturing development. The economic policies that enable the realisation of this function are the promotion of agricultural cooperatives and state supported agricultural infrastructure, product and market development. The difference between state-led and state supported economic activities is philosophical as well as practical. During a low-income economy, the state recognises that the development of an internationally competitive private sector won’t happen without its leadership. During a middle-income economy, the state also recognises that the engine of sustainable high economic growth should be the private sector and its function is to support the development of internationally competitive national leaders in a number of different industries.

The key function of the industrial strategy during a low- and middle-income economy is to create opportunities for the rural population to move from household farming into better paid manufacturing jobs. The economic policies that support the realisation of this function during a low-income economy are export discipline and state-led search and financing of feasible economic activities under increasing returns. The economic policies that enable the realisation of the key functions of the industrial strategy during a middle-income economy are export discipline
and state supported search and financing of feasible economic activities under increasing returns.

The key function of an international trade strategy during a low- and middle-income economy is to support manufacturing development. The economic policies that support the realisation of this function during a low-income economy are low tariff and non-tariff barriers and state-led import of raw materials and export of goods under increasing returns. The economic policies that enable the realisation of the main function of an international trade strategy during a middle-income economy are moderate or high tariff and non-tariff barriers in targeted industries and the state supported import of raw materials and export of goods under increasing returns.

The key function of a monetary strategy during a low- and middle-income economy is to support manufacturing development. The economic policies that supporting the realisation of this function during a low- and middle-income economy are ensuring below market borrowing rates in targeted industries and channelling bank loans towards export oriented agriculture and manufacturing.

To answer RQ3: **how can the persistent underdevelopment of backward economies be explained** the author carried out an in-depth analysis of dominant growth models and developed a model of persistent underdevelopment, which shows that relying on dominant growth models based on the constant returns to scale assumption is a poverty trap. Dominant growth models explicitly or implicitly ignore the taxonomy of economic activities in terms of increasing and decreasing returns to scale. Ignoring or at least not paying special attention to the difference between various economic activities in terms of their impact on the long-term economic development leads backward economies toward specialisation in non-productive and vulnerable economic activities. When a country specialises in non-productive and vulnerable economic activities, it deviates from the development strategy given by the policy matrix and reduces its chances to break the poverty trap.

To answer RQ4: **why does Georgia remain a backward economy**, the author analysed the economic development of Georgia in1990-2017 in light of the policy matrix. The economic transformation of Georgia in1990-2017 is divided into three logical periods to examine the economic development of Georgia under different political leadership. 1990-2003 describes the economic transformation of Georgia during early independence and under Eduard Shevardnadze’s leadership. 2003-2012 describes the economic transformation of Georgia after the Rose Revolution and under Mikheil Saakashvili’s leadership. 2012-2017 describes the economic transformation of Georgia under the leadership of the Georgian Dream.

Georgia remains a backward economy mainly because its economic policies deviated and keep deviating from suggestions provided by the policy matrix. During a low-income economy, the primary function of agriculture – providing
employment and sustenance on massive scale – was realised in Georgia. However, further agricultural development was constrained by the inability of the Government of Georgia to govern agricultural infrastructure, product and market development. During a middle-income economy, the main function of agriculture – supporting manufacturing development – was not realised in Georgia either.

During a low- and middle-income economy, the main function of the manufacturing strategy – helping people move from household farming to better paid manufacturing jobs – was not realised in Georgia. The manufacturing strategy fully failed in 1991-2012 because neither Shevardnadze’s nor Saakashvili’s government pursued industrialisation one way or another and deviated from economic policies suggested by the policy matrix by not having state-led or state supported search and financing for feasible economic activities under increasing returns and strict export discipline. State led search for feasible economic activities under increasing returns was realised in 2012-2017, but the manufacturing strategy still keeps failing because of the ignorance of the other economic policies suggested by the policy matrix.

During a low- and middle-income economy, a key function of an international trade strategy – supporting manufacturing development – was not realised in Georgia. During Eduard Shevardnadze’s presidency, the international trade strategy deviated from economic policies suggested by the policy matrix by introducing substantial tariff and non-tariff barriers and by not having state-led import of raw materials and export of goods under increasing returns. During Mikheil Saakashvili’s presidency and the Georgian Dream Government – when Georgia moved from a low-income economy to a middle-income economy – the international trade strategy deviated from economic policies given by the policy matrix by having minimal tariff and non-tariff barriers and not introducing state supported import of raw materials and export of goods under increasing returns.

During a low- and middle-income economy, a key function of the monetary strategy – supporting manufacturing development – was not realised in Georgia. The monetary strategy deviated from economic policies given by the policy matrix by not channelling bank loans towards export oriented agriculture and manufacturing, and by not ensuring below market borrowing rates in targeted industries.

The dissertation shows that the main reason why Georgia remains a backward economy is that its economic policies deviated and keep deviating from the policy matrix of development strategy recommendations. While it is true that starting from 2013 the Georgian Dream government implemented some economic policies within the agricultural and industrial strategy domains in accordance with the policy matrix (e.g. state supported agricultural infrastructure development and state supported search of economic activities under increasing returns), Georgia remains a backward economy because the majority of the economic policies suggested by the policy matrix are still missing (e.g. an export discipline and
channelling the bank loans toward export oriented agriculture and manufacturing). This dissertation not only shows why Georgia remains a backward economy but also demonstrates what keeps Georgia from implementing economic policies suggested by the policy matrix by uncovering the root cause of poverty persistence. In particular, Georgia is primarily focused on the dominant growth models, which leads towards focusing on the amount and not on the quality of investments. The current development strategy of Georgia is a poverty trap because it neglects the taxonomy of economic activities in terms of increasing and decreasing returns.

**Contributions to Theory**

The dissertation contributed to management theory by bridging the gap in management research in terms of strategic management of economic development on a country level. The main theoretical contribution of the dissertation is the policy matrix of development strategy, which operationalises the dynamic model of economic development. The policy matrix gives specific development strategy domains, economic policies and defines how to coordinate economic policies within each development strategy domain during low-income and middle-income economies in order to support successful economic transformation into a high-income economy.

This dissertation uncovered the overarching framework for a development strategy on a country level. While much is written about the importance and specifics of agricultural strategy, industrial strategy, international trade strategy and monetary strategy in isolation from each other, the dissertation showed a holistic development strategy with a coordination mechanism of economic policies under each development strategy domain, based on the given stage of economic development. The policy matrix is a tool for designing the development strategy as a coordinated combination of strategies applied in four strategy domains, conditioned by the current stage of economic development.

Instead of focusing on various development strategy domains in isolation, the dissertation offers the policy matrix as a tool for designing the development strategy on a country level. The policy matrix is an important theoretical contribution to the research in the strategic management of economic development on a country level because it is an evidence-based solution that takes into account the complex nature of economic development. The policy matrix is a useful tool to understand that a good economic policy of yesterday can be a bad economic policy of today. The policy matrix is also a useful tool to understand that achieving the goal in one development strategy domain depends on how successfully the goals of other development strategy domains will be realised. The policy matrix is a useful tool to understand how different economic policies affect each other. And finally, the policy matrix is useful tool to understand that without taking a systemic approach to the economic development strategy, it will be hard if not impossible for any low- or middle-income economy to achieve successful economic transformation.
Implications for Policymakers

The dissertation demonstrates that when backward economies place too much confidence in the dominant growth models while crafting a development strategy, what they are risking is sustained underdevelopment by specialising in non-productive and vulnerable economic activities.

The dissertation offers evidence-based lessons for policymakers in Georgia. Particularly, the promotion of agricultural cooperatives and state supported agricultural infrastructure, market and product development should be continued. Georgia should implement an export discipline policy and not only keep state supported search of economic activities under increasing returns but also start to finance the most promising economic activities identified under increasing returns. Georgia needs to target specific export industries and then find a way to introduce moderate or high tariff and non-tariff barriers in targeted industries whenever it would be feasible. Georgia also needs to have state supported import of raw materials and export of goods under increasing returns. Georgia should start finding ways to ensure below market borrowing rates for targeted industries and channelling bank loans towards export oriented agriculture and manufacturing. Georgia needs to focus not only on the amount but also on the quality of investments. The bottom line is that the chances of transforming Georgia into a high-income economy will be improved as far and as deeply as the country implements economic policies prescribed by the policy matrix.

Limitations and Directions for Future Research

The limitations of the dissertation mainly stem from the way in which the countries were selected for the comparative historical analysis. The dynamic model was proposed and a comparative historical approach called history mediated by theory was used to select the country cases. It can be argued that if the proposed dynamic model would contain other strategy domains than agriculture, industrial, international trade and monetary strategies, then other countries could have been relevant candidates for case studies and, therefore, the policy matrix could have different recommendations than it has today.

The policy matrix as a tool for designing a development strategy on a country level confidently explains the economic backwardness of Georgia. Further research would be helpful to test wider applicability of the policy matrix. It would be interesting to see how well the policy matrix can explain economic backwardness of other low- and middle-income economies. The application of the policy matrix to explain a number of different cases of economic backwardness will create a better understanding how well it performs and, if needed, in which direction it can be further refined.
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Tööstusstrateegia eesmärgiks madala sissetulekute tasemega majanduses on luua maapiirkondade elanikele võimalus suunduda paremini tasustatud tööstusliku tootmisega seotud töödele. Selle eesmärgi realiseerimist toetab madala sissetulekute tasemega puhul ekspordidistsipliini ning kasvava lisandväärtusega tegevalad riiklikult suunatud otsing ja finantseerimine. Keskmise sissetulekute tasemega puhul on eesmärgi saavutamiseks vaja ekspordidistsipliini ning riigi toetadud kasvavas lisandväärtusega tegevalad otsingut ja finantseerimist.

Rahvusvahelise kaubanduse strateegia eesmärgiks madadal ja keskmisel sissetulekute tasemel on luua maapiirkondade elanikele võimalus suunduda paremini tasustatud tööstusliku tootmisega toetamise arengu. Madalal sissetulekutese tasemel on eesmärgi saavutamist madalad tollid ja mittetariffsed tõkked koos riigi toetatud kasvava lisandväärtusega tootmisele vajaliku toorme impordi ja kaupade ekspordiga. Keskmise sissetulekute tasemega puhul on eesmärgi saavutamiseks vaja mõõdukaid või kõrgeid tolli ning mittetariffsed tõkkeid selgelt sihitatud sektorites koos riigi toetatud kasvava lisandväärtusega tootmisele vajaliku toorme impordi ja kaupade ekspordiga.

Rahandusstrateegia eesmärgiks madatal ja keskmisel sissetulekute tasemel on toetada tööstusliku tootmise arengut. Madala sissetulekute tasemel puhul toetavad selle eesmärgi saavutamist madalal tollil ja mittetariffsed tõkkeid koos riigi suunatud kasvava lisandväärtusega tootmisele vajaliku toorme impordi ja kaupade ekspordiga. Keskmise sissetulekute tasemega puhul on eesmärgi saavutamiseks vaja mõõdukaid või kõrgeid tolli ning mittetariffsed tõkkeid selgelt sihitatud sektorites koos riigi toetatud kasvava lisandväärtusega tootmisele vajaliku toorme impordi ja kaupade ekspordiga.


Gruusia ei realiseerinud ka rahvusvaheline kaubanduse strateegia põhieesmärki madala ja keskmise sissetulekute taseme juures – ei toetanud tööstusliku tootmise arengut. Eduard Ševardnadze valitsuse ajal erines rahvusvaheline kaubanduse strateegia oluliselt politiika maatriksis soovitatust, sest kehtestati kõrged tollid ja mittetariffsed tõkked, samuti ei suunanud riik kasvava lisandväärtusega toodetele vajaliku toorme importi ja selliste toodete eksporti. Mikheil Saakašvili ja Gruusia Unistuse valitsuse ajal, kui Gruusia liikus madalalt sissetulekute tasemelt keskmise sissetulekute tasemega riigiks, erines rahvusvaheline kaubanduse strateegia samuti oluliselt politiika maatriksis soovitatust, sest kehtisid ja kehtivad minimaal-sed tollid ja mittetariffsed tõkked ning riik ei toeta kasvava lisandväärtusega toode-tele vajaliku toorme importi ja selliste toodete eksporti.
Madala ja keskmise sissetulekute taseme juures ei realiseerunud Gruusia ka rahandusstrateegia põhieesmärki – toetada tööstusliku tootmise arengut. Rakendatud rahanduspoliitika erines poliitika maatriksis soovitatust, sest pangalaenusid ei kanaliseeritud ekspordile orienteeritud põllumajandus- ja tööstusettevõtetele ning selgelt sihitatud sektorites ei rakendatud ka alandatud intressimääraga laenuvõimalusi.


Dissertatsioonis näidatakse, et kui vähearenenud riikides pannakse arengustrateegia väljetöötamisel liiga suurt rõhku domineerivatele majanduskasvu mudeleitele, siis sellega kaasneb risk jätkuva alaarenguks, kus spetsialiseerutakse madala lisandväärtega ja haavatavatele tegevustele. Gruusia jaoks järel on siit, et kõrge sissetulekute tasemega riigiks saamine sõltub sellest, mil määr ala ja kui kiiresti rakendatakse poliitikamaatriksis soovitatud politikaid.

Dissertatsioonis pakutud mudelete rakendatavuse piirangud tulenevad ajaloolise võrdlusuringu riikide valikust. Võib arvata, et kui pakutud majandusarengu dünaminiline mudele sisaldaks põllumajandusstrateegia, tööstusstrateegia, rahvusvahelise kaubanduse strateegia ja rahandusstrateegia erineva strateegia valdkondade nimistu, siis võiks võrdlusesse haaratud riikide nimistu olla teistsugune ja poliitikamaatriksi soovitused erineksid samuti pakutust.

Poliitikamaatriks selgitab usaldusväärselt Gruusia majandusarengu puudusi. Edasisest uuringutes oleks soovitav testida poliitikamaatriksi rakendatavust teiste madala ja keskmise sissetulekute tasemega riikide juhtumitel. See võimaldab mõista, kui hästi mعدل töötab ja kui vaja, millises suunas seda täiendada või täpsustada.
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LANGUAGES: Eng
Strategic Management of Economic Development: How Developed Countries Became Developed and Why Georgia Remains a Backward Economy

The dissertation contributes to management theory by bridging the gap in management research in terms of strategic management of economic development on a country level. ‘One size fits all’ approach has been a norm of policy prescription for backward economies during the last decades. Georgia implemented internationally promoted economic policies and was recognized for its economic reforms. However, about 17.5% of its population still lives below subsistence minimum.

The dissertation carried out comparative historical analysis of successful economic transformations and developed the policy matrix of development strategy, which is the main theoretical contribution of the dissertation. The policy matrix defines specific development strategy domains, recommended economic policies and demonstrates how to coordinate economic policies within each development strategy domain during low-income and middle-income economy to support transformation into high-income economy. The dissertation also analyzes dominant growth models and identifies the poverty trap for backward economies. Finally, the dissertation analyzes economic transformation of Georgia in the light of the policy matrix explaining why Georgia stays backward economy as well as identifies what keeps Georgia away from implementing development strategy aligned with successful historical experience.

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