

**STABILITY, SECURITY, AND SOVEREIGNTY
IN THE
REPUBLIC OF GEORGIA**

RAPID RESPONSE CONFLICT PREVENTION ASSESSMENT
SPONSORED BY THE COUNCIL ON FOREIGN RELATIONS
CENTER FOR PREVENTIVE ACTION

David L. Phillips

Senior Fellow and Deputy Director of the Center for Preventive Action

January 15, 2004

Founded in 1921, the Council on Foreign on Foreign Relations is an independent, national membership organization and a nonpartisan center for scholars dedicated to producing and disseminating ideas so that individual and corporate members, as well as policymakers, journalists, students, and interested citizens in the United States and other countries, can better understand the world and the foreign policy choices facing the United States and other governments. The Council does this by convening meetings; conducting a wide-ranging Studies program; publishing *Foreign Affairs*, the preeminent journal covering international affairs and U.S. foreign policy; maintaining a diverse membership; sponsoring Independent Task Forces; and providing up-to-date information about the world and U.S. foreign policy on the Council's website, www.cfr.org.

THE COUNCIL TAKES NO INSTITUTIONAL POSITION ON POLICY ISSUES AND HAS NO AFFILIATION WITH THE U.S. GOVERNMENT. ALL STATEMENTS OF FACT AND EXPRESSIONS OF OPINION CONTAINED IN ALL ITS PUBLICATIONS ARE THE SOLE RESPONSIBILITY OF THE AUTHOR OR AUTHORS.

For further information about the Council or this report, please write the Council on Foreign Relations, 58 East 68th Street, New York, NY 10021, or call the Director of Communications at 212-434-9400. Visit our website at www.cfr.org.

Copyright © 2004 by the Council on Foreign Relations®, Inc.

All rights reserved.

Printed in the United States of America.

This report may not be reproduced in whole or in part, in any form (beyond the reproduction permitted by Sections 107 and 108 of the U.S. Copyright Law Act (17 U.S.C. Sections 107 and 108) and excerpts by reviewers for the public press), without the express written permission from the Council on Foreign Relations. For information, write the Publications Office, Council on Foreign Relations, 58 East 68th Street, New York, NY 10021.

CONTENTS

INTRODUCTION	1
INTERSECTION OF INTERESTS	3
THE FIRST 100 DAYS	5
FINDINGS AND RECOMMENDATIONS	6
Corruption	6
Governance	8
Economy	10
Energy	14
Sovereignty	17
Security	20
THE INTERNATIONAL COMMUNITY	22
Emergency Assistance	22
Year One Priorities	22
Performance Rewards	24
ACKNOWLEDGMENTS	26
APPENDIX A: ACRONYMS	27
APPENDIX B: MISSION STATEMENT OF THE COUNCIL ON FOREIGN RELATIONS AND BACKGROUND ON THE CENTER FOR PREVENTIVE ACTION.....	28

REPUBLIC OF GEORGIA



INTRODUCTION

The Republic of Georgia suffers from pervasive problems. Popular frustrations boiled over after the November 2, 2003, parliamentary elections, which international observers determined were fraudulent. Facing mass protests and civil disobedience, President Eduard Shevardnadze resigned. The so-called revolution of roses culminated in a peaceful transfer of power when Mikhail Saakashvili assumed the presidency after receiving 96 percent of the vote in a special ballot on January 4, 2004.

The change of power alone will not resolve Georgia's systemic problems. The country is riddled with corruption. Its economy is stagnant, unemployment is widespread, and there are acute energy shortages, especially during the cold winter months. The central government does not control its borders and has relinquished significant territory to separatist movements in Abkhazia and South Ossetia, which are supported by Russia. Georgia is entering an unstable period, as Mr. Saakashvili and other new leaders take steps to dismantle the corrupt power structure and try to promote national coherence among the country's ethnic and regional groups.

Sponsored by the Center for Preventive Action (CPA) of the Council on Foreign Relations (CFR), this *Rapid Response Conflict Prevention Assessment* provides practical, tangible recommendations for Georgia's new government and the international community. It suggests steps during the first 100 days of President Saakashvili's administration to mitigate crisis and build momentum for reform. Georgia will not, of course, be able to tackle all of its problems at once. Progress will occur slowly and unevenly. The international community, led by the United States (U.S.), must do its part to support Georgia's transition. Despite its valuable location as a link between Europe and Asia, Georgia is far from fulfilling its potential as a prosperous, stable, and democratic country.

Georgians are quick to blame Russia for their ills. Although Russia's meddling has worsened an already unstable situation, Georgia's new government should stop the finger-pointing and acknowledge Georgia's legacy of ineffective and corrupt governance. Russia has legitimate interests, which would be served by ensuring stability in Georgia and preventing insecurity in the South Caucasus from destabilizing Chechnya and other

regions in the North Caucasus. However, Russia must desist from trying to weaken Georgia in the false hope that manipulating events will serve its interests.

The international community should rally behind Georgia by providing emergency assistance in the near term. Thereafter, it should offer support only after Georgia's new leaders demonstrate they are serious about cracking down on corruption. President Saakashvili is in a position to use his popular mandate to effect reform. Georgia's future will be determined by the new government's willingness and ability to improve governance.

INTERSECTION OF INTERESTS

Russia is a critical player in the South Caucasus, with deep historical and cultural ties to Georgia, which it formally absorbed into the Russian Empire in 1801. Moscow still believes that control of the Caucasus is essential to projecting Russia's influence in the Caspian region and Central Asia. It is especially concerned that Chechen rebels and al-Qaeda members fleeing the conflict in Chechnya have found refuge in Georgia's Pankisi Valley. Russia insists on maintaining its military bases in Batumi (in Ajaria) and Akhalkalaki (in Samtskhe-Javakheti) for at least eleven more years. Russia has extensive economic ties to Georgia. It provides Georgia with its electricity and natural gas supplies. Russia is also the primary export market for Georgian agricultural products.

The U.S. also has significant interests in Georgia, and should play a leading role in supporting its development. Since Georgia's independence, the U.S. has provided \$1.3 billion in foreign aid through the Freedom Support Act (FSA); Georgia is the second-largest per capita recipient of U.S. development assistance. Beginning in 2005, Caspian Sea oil will be transported from Azerbaijan to the eastern Mediterranean port of Ceyhan, in Turkey, via Georgia. By 2007, a new pipeline costing \$3.2 billion, will deliver one million barrels of crude oil per day to Western markets. A similar natural gas pipeline is also planned. The Bush administration places great emphasis on diversifying energy supplies to include sources outside the Middle East. American companies have a major stake in the development of energy fields in both Azerbaijan and Kazakhstan. Additionally, Georgia is a valued ally in the fight against terrorism. The U.S. is spending \$64 million to train and equip 2,000 Georgian border guards and to establish an antiterrorism force in Georgia. About 70 Georgian doctors and land-mine specialists are presently under U.S. command in Iraq, with another 500 due to arrive. Military equipment bound for Afghanistan is occasionally transported via Georgia's Poti Port, on the Black Sea.

There is more than a little overlap between U.S. and Russian interests in Georgia. Neither wants Georgia to become a haven for terrorists or for the country to descend into

chaos, transforming it into a failed state with adverse implications for regional economic prosperity and security.

The U.S. should collaborate with Russia to support Georgia whenever possible, especially given the considerable intersection of U.S. and Russian interests worldwide and Russia's pivotal role as Georgia's most influential neighbor. To encourage a positive approach from Russia, the U.S. should adopt policies that account for Russia's legitimate interests. For example, the U.S. should intensify its cooperation with Russia on counterterrorism in the North Caucasus and urge Russia and Georgia to collaborate more effectively on efforts to rid the Pankisi Valley of Chechen fighters. Washington's offer to pay Russia's costs in closing Russian bases in Georgia should be renewed if Russia agrees to a verifiable timetable. In addition, Georgia's new government should be encouraged to develop regional integration in the areas of trade, transportation, and economics.

While cooperating with Russia and recognizing its legitimate stake in Georgia, the U.S. must be realistic about the potentially destabilizing effect of Russia's designs. Georgia's problems have been aggravated by Moscow's policies, which have helped weaken and fragment the country. Washington cannot ignore the negative impact of Russia's policies, such as maintaining its bases in Batumi and Akhalkalaki, failing to internationalize peacekeeping forces in Abkhazia, and supporting separatism in Abkhazia, South Ossetia, and Ajaria.

If Russia continues to pursue activities that are detrimental to Georgia's interests, Washington should raise its concerns through diplomatic channels. The Bush administration should also be prepared to speak out publicly and, if necessary, work to bring about a more constructive approach on the part of Russia. That said, the key to Georgia's future lies less in either Moscow or Washington than in Tbilisi and in what Georgia's new leaders are prepared to do to improve the country's deeply flawed governance.

THE FIRST 100 DAYS

The new government of President Saakashvili is under tremendous pressure to show results. During the first 100 days, the new government should take the following steps to assert its authority and stabilize the country:

1. *Secure donor support to address the country's fiscal crisis.* Funds are needed immediately to maintain government operations and to pay the salaries of the police and the military. The new government must also take steps to bolster its treasury by improving tax-collection rates and enforcing customs.
2. *Show that it is serious about fighting corruption* by arresting criminals linked to bureaucratic networks. President Saakashvili must also have a long-term strategy for fighting corruption; he needs to strengthen institutions of accountability, engage local governments, and involve civil society and the media in this fight.
3. *Prevent a deterioration of humanitarian conditions* by increasing emergency rations and subsidized energy supplies to vulnerable groups. Assistance for internally displaced persons (IDPs) from Abkhazia, such as allowances, winterized communal centers, and grants to host families, should be expanded and implemented more effectively.
4. *Carefully manage relations with Ajaria*, a secessionist-minded region located on the Black Sea and bordering Turkey, so as not to tip it toward secession. The new government should reassure Ajaria's president, Aslan Abashidze, that it will not use military force to impose its control. Although the new government should not act unilaterally or precipitously in trying to reassert authority in Abkhazia or South Ossetia, it should initiate a discussion with regional leaders on maximizing autonomy through extensive federal power-sharing arrangements.
5. *Get its own house in order* to demonstrate an alternative to separatism. At its core, the "revolution of roses" was about fulfilling the promise of bringing democracy to all Georgians. The next step in Georgia's democratic development must be free and fair parliamentary elections, currently scheduled for March 28, 2004.

FINDINGS AND RECOMMENDATIONS

CORRUPTION

Corruption undermines economic growth, jeopardizes financial stability, and weakens the ability of the state to deliver basic services. Georgia's illicit economy includes smuggling and trafficking in drugs, guns, fuel, prostitutes, and children. In addition to bribery and kickbacks, corrupt politicians use their influence to help businesses avoid taxation, to skew market competition, and to affect regulations that favor firms with whom they have special ties. Georgia ranks 5 places from the bottom out of 133 countries surveyed for corruption by the anticorruption nongovernmental organization (NGO) Transparency International.¹

Recommendations

1. Target Violators. President Saakashvili must make the fight against corruption the centerpiece of his administration. The best way for the new government to send a message that it is serious is to throw high-profile violators in jail and seek access to their overseas accounts. To demonstrate its authority and signal its resolve, the new government should begin its Anti-Corruption Campaign with the arrest and prosecution of targeted bureaucratic criminal networks. A transparent process is essential to avoid accusations of political motivation or personal bias. The new administration should also pursue a two-track approach, strengthening the capacity of the central government while supporting reform at the local level.

¹ Transparency International, "The 2002 Corruption Perceptions Index," Berlin, Transparency International, August 28, 2002, available online at www.transparency.org.

2. *Support the Guardians of Accountability.* The Anti-Corruption Campaign should be integrated into the World Bank's overall country assistance strategy, with the goal of strengthening the Anti-Corruption Commission and its Coordinating Council. Adequate resources should be provided to the Ministry of Internal Affairs, and to ensure transparency, funding should be appropriated directly by the parliament and not the Finance Ministry. The national parliament has been particularly effective in exposing corruption and raising public awareness through public hearings. The parliament should continue its efforts, placing emphasis on strengthening state auditing procedures and harmonizing key legislation and regulations. Other institutions, such as the Chamber of Commerce, also have a role to play in investigating and publicizing allegations of corruption.

People with the highest ability should be appointed to head institutions in the accountability framework. Selected independently of political considerations, enforcers must be paragons of clean government. Both their integrity and autonomy are essential to tackling deeply entrenched patronage networks. In addition, to take on the task, they need a clear job description and adequate resources. No one should be exempt from scrutiny. Efforts should target the power ministries (i.e., the military, the police, prosecutors, and tax and customs authorities). Civil-service violators must also be punished, using administrative sanctions and criminal prosecution.

3. *Involve Civil Society.* One of Georgia's greatest assets is its large and dynamic civil society. To advance its Anti-Corruption Campaign, the central government should emphasize effective community participation of local government and NGOs. Transparency must extend to public review of policymaking, including review of the budget. Donors should support the efforts of NGOs to evaluate the performance of local government officials, monitor the expenditures of local government, and publish bulletins uncovering irregularities. Government audits should be publicized using information technologies and the media. As demonstrated by the independent television transmitter Rustavi-2, an independent media is essential to transparency.

GOVERNANCE

Corruption erodes public confidence in governance. Politicization of the civil service, abuse of the meritocracy principle, and inadequate professional capacity have further undermined Georgians' trust in state institutions. The erratic supply of essential services, such as electricity and water, has also affected confidence. A 1999 UN survey found that only 20 percent of funds budgeted by the government actually reached their intended destination.²

Georgia's overall fiscal deficit of up to \$100 million is compounded by difficulties in collecting taxes and customs duties, especially in Ajaria, the nation's most significant customs clearance center. At 14 percent of gross domestic product (GDP), Georgia's tax-collection rate is the lowest of the Commonwealth of Independent States (CIS) countries.³ Government coffers could be increased by 50 percent, some \$300 million, if customs agents were able to crack down on smuggling and enforce levies on items such as fuel and cigarettes.⁴ Customs corruption and administrative inefficiency are the biggest barriers to investment.⁵

Although President Saakashvili introduced reforms during his term as justice minister, courts are still subject to political manipulation. The police, public prosecutors, and the judiciary are deeply flawed in their own accountability, let alone in their ability to enforce the accountability of others. Interior Ministry special units, such as the SGB, a spin-off from the Soviet KGB, are reportedly involved in extortion and have a reputation for brutality. Human rights violations include disappearances and torture. Kidnappings for ransom also occur.

The 1995 constitution includes a bill of rights but lacks special provisions for group rights, including property rights for religious ministries. To strengthen local governance, a law on local government and self-governance was passed in October of 1997. The bill provides expanded powers for the decentralized administration of Georgia's twelve

² United Nations UN Office for the Coordination of Humanitarian Affairs, "Early Warning Assessment," November 2003.

³ USAID Congressional Budget Justification for 2004.

⁴ Economic Intelligence Unit, *Eurasianet*, December 12, 2003.

⁵ Embassy of the United States in Tbilisi, "Georgia: Investment Climate Statement 2002," September 30, 2002.

entities (*Mkhare*) and eighty-four districts, or microentities (*Raion*). However, decentralization has had the unintended effect of diffusing corruption and reducing effective central government oversight.

Recommendations

1. Collect Taxes and Customs. Simplifying tax structures and reducing tax rates, coupled with increasing tax collection, is the formula for success. Steps are needed to modernize the State Tax Department, overhaul the Administrative Code, and clarify tax rates by sector. A flat tax combined with lower rates should be considered. In addition to administrative reforms, a new approach is needed to foster partnership between government and business. As stipulated in the 2000 Tax Code amendment, the Tax Department should eliminate arduous conditions that invite corporate malfeasance. Tax officials can stimulate business by suspending arbitrary actions, including unofficial inspections and unfair penalties.

The Customs Code also requires an overhaul. Procedures at the border gate should be expedited and a system established to accurately value goods. To improve professionalism, border guards should be paid adequately and steps should be taken to reduce turnover of customs personnel. The public can be engaged through the use of guidebooks on customs procedures and the establishment of a more efficient legal complaint system.

2. Downsize Government. To downsize the bloated bureaucracy, the government should cut its payroll by about 30 percent over two years. This can be accomplished through a hiring freeze and accelerated retirement procedures. Limiting the responsibilities of the executive branch would also enable staff reductions at ministries and other departments. To this end, civil-service legislation should be adopted aimed at clearly defining government functions, eliminating duplication, and improving personnel performance via training and capacity building.

3. *Strengthen Local Government.* Fiscal decentralization would diffuse resources and expand the provision of services at the local level. To this end, the national parliament should adopt legislation transferring property from the central government to local governments that meet anticorruption criteria. The new government should seek donors to assist with community priorities, such as the rehabilitation of infrastructure, irrigation systems, and schools. By supporting community mobilization activities, donors can promote effective partnerships among local government, civil society, and businesses. The Georgia Councils Association, an association of local government officials, should expand training programs in finance and infrastructure management.

4. *Reform the Constitution.* Once Georgia gets through the turbulent transition phase, it should consider constitutional reforms that would reduce the powers of the presidency and strengthen those of the prime minister, the cabinet, and a bicameral parliament. Constitutional reform should also emphasize a system that decentralizes power and harmonizes competing claims. However, the move toward federalism should proceed gradually, with regional leaders involved in discussions about how power sharing can best be suited to Georgia's specific political, regional, and demographic conditions. Rather than a constitutional shake-up, the new government's first priority should be building confidence with the regions and encouraging discourse on a new *modus vivendi*.

5. *Promote Group Rights.* Reflecting international norms laid out in the 1990 Document of the Copenhagen Meeting of the Conference on the Human Dimension of the Conference on Security and Cooperation in Europe (CSCE), Georgia's parliament should adopt comprehensive legislation on the protection of minority rights. The government should also adopt a new law on religious rights, one that protects freedom of worship as well as the property rights of religious groups.

ECONOMY

Pervasive corruption and the arbitrary implementation of laws and regulations limit Georgia's economic prospects. Economic activity that is illegal or off-the-books—the so-

called gray economy—constitutes up to 80 percent of Georgia’s overall output.⁶ By 2002, the national economy had contracted to 38 percent of its adjusted GDP purchasing power in 1989. Georgia is also saddled with a huge external debt of \$1.7 billion, with payments to Paris Club creditors scheduled to start in 2004 and extend over fifteen years. Georgia’s foreign debt is equal to more than half the country’s GDP.

Presently 51.1 percent of the population lives below the poverty line, and 23.6 percent are unemployed.⁷ Widespread illicit activity undermines the competitiveness of legal imports and locally produced goods.⁸ Privatization failures, limited investment, and inadequate restructuring have also constrained manufacturing growth, resulting in urban unemployment of over 40 percent. Since 1989, the population has shrunk by 900,000, as many Georgians have left the country to seek jobs in Russia and Ukraine

Most Georgians earn their livelihood in the agricultural sector. Through land reform, 57 percent of arable land is now privately owned, and 27 percent is leased by the state to farmers.⁹ However, agricultural output is limited by inadequate access to credit, poor irrigation, and the high cost of inputs such as fuel, pesticides, and machinery. Profitability is also affected by exorbitant transportation costs. Russia has traditionally been a major export market for Georgian goods, but Russia’s 1998 economic downturn sent Georgian exports into a tailspin. Georgia’s agricultural sector was further devastated by severe drought in 2000.

As a result of investments in the Baku–Supsa “early oil” pipeline, foreign direct investment (FDI) peaked at \$288 million in 1998. It is anticipated that FDI associated with the Baku–Tbilisi–Ceyhan oil pipeline will revitalize the economy to robust growth rates, estimated at 6.5 percent in 2003 and 9 percent in 2004. The Baku–Tbilisi–Erzurum gas pipeline could lift Georgia’s economic growth rate even further, to 12 percent in 2005.¹⁰ The Georgian lari is stable and inflation is under control.

⁶ Interview with government official at the German embassy in Tbilisi on September 24, 2003.

⁷ USAID Congressional Budget Justification for 2004.

⁸ Embassy of the United States in Tbilisi, “Georgia: Investment Climate Statement 2002,” September 30, 2002.

⁹ World Bank, Report No. 26964-GE, August 20, 2003.

¹⁰ Economic Intelligence Unit, *Eurasianet*, December 12, 2003.

Recommendations

1. Improve the Regulatory Environment. An improved regulatory environment and a more favorable business climate would enhance FDI rates. The government can help create these conditions by enforcing laws governing commercial activity and adopting new pro-business legislation. As part of its fight against corruption, it should crack down on bribery by encouraging whistle-blowing and doubling the Criminal Code's maximum penalty for violations. Other aspects of the Criminal Code should be amended to protect businesses and consumers. The Georgia Business Council should expand efforts to remove administrative barriers to business operations, improve the business climate for investment, and upgrade financial and investment institutions.

2. Clarify Licensing Procedures. More transparent procedures can be achieved through new legislation that defines what activities should be subject to licensing and outlines licensing procedures by sector. The 2002 licensing law should be harmonized with provisions of the Administrative Code. Establishing a single agency to oversee licensing would result in streamlined registration, licensing, and certification procedures.

3. Target the Agricultural Sector. A national plan for revitalizing the agricultural sector should start with a microeconomic analysis, including an assessment of technologies, input and production costs, as well as taxes, tariffs, and other legal or regulatory constraints. The assessment should also address land rights, credit requirements, and farm-to-market networks. To boost production, farmers need more affordable supplies of seed and other inputs, including pesticide. Farmers also need increased access to credit from finance cooperatives organized locally. The U.S. Department of Agriculture's PL 480 program could be used to expand local grant and loan programs. Rehabilitating infrastructure is also a high priority. Irrigation and drainage systems, distribution channels, and pumping facilities all need work. Land reform is also essential. The government can stimulate development of a land market by further surveying, registering, and clarifying ownership titles of agricultural plots. Linkages among producers, processors, and markets must also be strengthened.

4. Emphasize Transportation Infrastructure. To enhance the competitiveness of the South Caucasus route, Georgia and the European Union (EU) should strengthen their partnership agreement and accelerate the Transport Corridor Europe-Caucasus-Asia (TRACECA) project. Other measures rehabilitating the Great Silk Road can be advanced through the creation of a Caucasus Stability Pact involving Turkey, Georgia, Armenia, and Azerbaijan. The Stability Pact should be keyed to opening the border gate between Turkey and Armenia as a precedent for restoring normal travel and trade throughout the region. Improving rail service and substantially reducing rail rates, including north–south links, is also a priority.

The Shah Deniz natural gas pipeline project offers opportunities for investors in the energy sector as well as related infrastructure industries. Accelerated development of the Baku–Tbilisi–Erzurum pipeline would complement the 2003 contract between Georgia and the Russian gas company Gazprom, while offering the added benefit of reducing Georgia’s reliance on natural gas exclusively from Russia. A north–south pipeline would further diversify gas supplies.

Georgia’s Poti Port, on the Black Sea, could be transformed into a model enterprise zone, maximizing links to the Black Sea Economic Cooperation Council (BSECC). Both donor and private investment funds should be used to refurbish port facilities; to upgrade transport infrastructure, including railway connections; and to commercialize Georgia’s Black Sea fleet of 140 ships. Similar arrangements could be considered for Batumi, in Ajaria.

5. Target Vulnerable Groups. Economic development should target IDPs and other socially vulnerable segments of the population, such as the unemployed and single-headed households. Building on the experience of the European Bank for Reconstruction and Development (EBRD) and the Eurasia Foundation, donors could provide more grants and loans to support initial investment in and operating costs of small businesses (e.g., sewing, handicraft, kitchen garden, animal husbandry, and bakery operations). Sustainable income-generating kits would include business management and training.

ENERGY

Historically, Georgia's oil sector has been self-sufficient, with adequate supplies from Ninotsminda and secondary recovery from the Gurian fields despite Georgia's abundant hydropower, both Georgia's export potential and its ability to meet domestic demand have been undermined by corruption. Georgia's position on the energy corridor, which will include natural gas from Kazakhstan, presents an opportunity to meet the country's gas shortfall inexpensively.

For the time being, Georgia depends on outside sources for energy, with energy supplies constituting the country's leading import. Georgia needs an energy security plan with the goal of energy independence. Until Georgia achieves energy independence, the import of fuel and power will continue to cause acute shortages, undermine economic activity, and create macroeconomic pressures. Energy shortfalls, especially during the cold winter months, depress the population.

The energy sector's fiscal crisis is due to poor payment-collection rates for energy use. Poor collection rates result from unmetered electricity use and the fact that most meters are more than thirty years old, one-third are defective, and one-eighth have been vandalized.¹¹ Other factors include the nonpayment of households hit by declining incomes and the subsidies that are granted to fixed-income pensioners and IDPs. State-owned enterprises also exhibit significant default rates. In addition, although the central government's power system delivers 20 to 25 percent of its capacity to Abkhazia and South Ossetia, it receives no compensation from these areas.¹² The fiscal crisis contributes to erratic energy supplies and health problems caused by the breakdown of the sewerage infrastructure. Supply disruptions in the gas sector have exacerbated electricity shortages by forcing households to use inefficient electrical devices for cooking and heating.

Although there is no substitute for marketplace discipline, Georgia has tried a quick fix by privatizing energy assets. Its experience shows that partial privatization ahead of institutional improvements and the commercialization of operations does not improve the

¹¹ World Bank Technical Paper No. 423, "Non-payment in the Electricity Sector in Eastern Europe and the Former Soviet Union," June 16, 1999.

energy sector's overall performance.¹³ The Telasi state power company was acquired by a U.S. concern, AES, in 1998. Business conditions hampered profitable operations, and AES sold its position to RAO Unified Energy Systems, led by the Russian economist and privatization reformer Anatoly Chubais, in August 2003. Gazprom recently assumed responsibility for upgrading and managing Georgia's gas distribution pipelines. Privatization does not always work; privatization of the natural gas distributor Tbilgazi was canceled due to commercial losses of 60 percent and collection rates as low as 20 percent.¹⁴

Georgia has significant hydropower potential. However, only 10 percent of Georgia's hydro potential is presently online. The most dramatic example is the 1,300-megawatt Inguri hydropower station, which is damaged and in urgent need of repair. Georgia also needs to refurbish its transmission network. The primary load centers are in the east, while most of the generating capacity is in the west. Since there is only one major transmission line, peak demand periods cause overloads and system instability.

Recommendations

1. Improve Collection Rates. All energy users must appreciate that electricity supply is a commercial service available only to those who pay their bills. The government can improve revenue collection for large state and industrial users by eliminating the exemption specific enterprises now enjoy from having their power cut off and by instead disciplining nonpayment with disconnection. To ensure transparency, collection rates should be monitored and published so that officials will not interfere in the decision to disconnect. Electricity subsidies to Ministry of Internal Affairs and state security personnel and other prominent persons should be stopped.

Measures are also needed to improve collection rates for regular households. Meters should be repaired or replaced to reduce electricity theft. Accounts should be computerized. Collection rates can also be improved by requiring consumers to pay their

¹² Georgia's National Energy Regulatory Commission, *2002 Annual Report*.

¹³ World Bank, Technical Paper No. 423, "Non-payment in the Electricity Sector in Eastern Europe and the Former Soviet Union," June 16, 1999

¹⁴ USAID Congressional Budget Justification for 2004.

dues directly to the utility or at the bank, rather than paying cash to collection agents, which invites corruption. Collection agents operating on commissions should be replaced with more accountable full-time utility company staff. A public information campaign is needed to highlight that electricity theft is a criminal offense punishable with fines and jail terms.

2. *Adopt a Safety Net.* Improving collection rates must not be done at the expense of vulnerable groups. A safety net should be established by eliminating consumer subsidies and replacing them with targeted means-tested energy grants disbursed directly to poorer families as part of their social security payment. Directly distributing electricity subsidies would enable the government to discontinue transfers from the budget to large utility companies (e.g., the energy company Sakenergo). This measure would serve as a precedent for cutting utilities off from budget support, covering their deficits, with donor assistance tied to collection rates. Innovative collection strategies, such as bartering with corporate customers, should be expanded as an alternative to nonpayment. Funds from the International Development Association (IDA) Energy Sector Adjustment Credit (ESAC) could be applied to bridge the gap between collection deficits and enhanced services and capital improvements.

3. *Privatize the Energy Sector.* Privatizing the energy sector would reduce corruption by imposing better management and financial discipline. It would also improve overall system performance, increase supply, and enhance access to capital and technology. However, privatization is not a panacea. Regulatory conditions must be right. Rushing to privatize energy assets will not succeed and may, in fact, attract corrupt operators. To prepare energy assets for eventual privatization and improve their attractiveness for acquisition, assets should be placed under a management contract, with experienced foreign utility companies working with qualified Georgian subcontractors. The government should also work with institutions such as the International Finance Corporation (IFC) and the EBRD to cushion cash-flow problems facing private investors during the immediate post-privatization period. As part of its pre-privatization strategy, the government should seek donor support to build up the capacity of oversight

mechanisms in ministries, the parliament, and Georgia's independent energy regulatory body. Foreign aid to pay off energy arrears could be considered as part of a debt-restructuring plan.

4. Diversify Power Production. Power production facilities, especially the Inguri hydroelectric plant, should be rehabilitated. Georgia should ask the UN to take the lead in arranging funds for capital improvements and negotiating load-sharing agreements between Georgia and Abkhazia. Other multilateral and bilateral assistance can be used to rebuild power facilities servicing regional demand and to improve the reliability of supply. In addition, Georgia has abundant mini-hydroelectric power potential. Donor-assisted programs designed to stimulate independent, small power producers should include contracts with utilities to purchase power production at standard market rates. To take advantage of these opportunities, Georgia needs to extensively refurbish, develop, and expand its electricity distribution infrastructure.

SOVEREIGNTY

Georgia's inability to exercise sovereignty has exacerbated its problems as a weak state. The provinces of South Ossetia and Abkhazia have seceded from Georgia and, drawing on their ties with Russia, function as de facto independent entities. The Autonomous Region of Ajaria is also not subject to control by the central government. According to a Georgian government official, these regions are like "black holes" that undermine governance and fuel corruption.¹⁵

South Ossetia declared independence in 1990 and sought to join North Ossetia, in Russia. More than 100,000 people were displaced prior to a 1992 cease-fire and the establishment of a Russian-led peacekeeping operation. Russian goods bound for Turkey and the Caucasus traverse South Ossetia's de facto duty-free zone. Both South Ossetia and Abkhazia use the Russian ruble as their local currency. Local officials, criminal networks, and some peacekeepers stationed in these provinces are involved in the smuggling of contraband goods.

¹⁵ Anonymous, meeting notes, December 19, 2003.

The 1993–94 conflict with Abkhazia caused the displacement of 300,000 persons before a CIS peacekeeping force was authorized and deployed along the Inguri River. The CIS mandate requires renewal by the UN Security Council every six months. All peacekeepers are Russian and are under Russian command, and one Russian battalion presently involved in peacekeeping fought side-by-side with Abkhaz separatists. Russian nationalists in the Duma have demanded the annexation of Abkhazia, heightening concern in Georgia about Russia’s role in undermining Georgia’s territorial integrity. Although a UN civilian police force was recently deployed and about 40,000 displaced persons returned to their homes in the Gali district, the United Nations Observer Mission in Georgia (UNOMIG) has made little headway in negotiating the “distribution of competencies between Tbilisi and Sokhumi.”¹⁶

The minstate of Ajaria is controlled by Aslan Abashidze. Ajaria pays no taxes or revenues to the central government. Although President Shevardnadze was able to keep Ajaria from seceding, deep antipathy exists between Abashidze and Georgia’s new leaders, who believe that Abashidze conspired with Shevardnadze to steal the November 2 parliamentary elections. As an indication of his distrust, Abashidze joined a meeting of secessionist leaders from South Ossetia and Abkhazia in Moscow on November 26, 2003.

Georgia’s ethnically diverse population also includes 356,000 Armenians, 277,000 Russians, and 250,000 Azeris.¹⁷ Intermarriage between Christian Armenians and Christian Georgians has existed historically. With close ties to both Yerevan, and Moscow, Armenians in the Samtskhe-Javakheti region are increasingly uneasy about the viability of Georgia’s central government, and desire greater power sharing. Georgia’s new leadership has acknowledged the region’s problems and indicated its willingness to address them.

Georgia’s constitution is deliberately ambiguous about territorial arrangements between entities pending “the full restoration of the jurisdiction of Georgia over the whole territory of the country.”¹⁸ A national consensus has yet to emerge on political arrangements for power sharing between the central government and the regions.

¹⁶ UN Security Council, Resolution 1393, January 31, 2002.

¹⁷ U.S. Department of State, “Background Note: Georgia,” available online at www.state.gov/r/pa/ei/bgn/5253pf.htm.

¹⁸ 1995 Georgian constitution, Article 2.3.

Preliminary ideas regarding asymmetrical federalism, which would maximize autonomy for separatist-prone regions, have been raised, however, and have been welcomed in political and civil-society circles.

Recommendations

1. Internationalize Peacekeeping in Abkhazia. Since the UN Security Council authorizes the CIS peacekeeping force, Georgia's foreign minister should press the permanent members of the Security Council to internationalize the force. He should also explore arrangements with countries potentially contributing troops, as well as with decision-making bodies of the CIS. The U.S. should work with Russia to develop a rotation system, initially expanding the participation of military observers from CIS countries, then integrating troops from CIS countries participating in the North Atlantic Treaty Organization (NATO) and its Partnership for Peace (PfP) program, and finally establishing a regional force with costs covered by the international community. The UN Secretary-General's Group of Friends on Georgia should simultaneously seek to expand the mandate of the special representative of the secretary-general (SRSG) to include oversight of the peacekeeping operation in Abkhazia.

2. Close Russian Bases. The new government should urge Russia to close its military headquarters in Tbilisi by the end of 2004. In addition, it should look to negotiate with Moscow an accelerated schedule for Russia to close its bases in Batumi and Akhalkalaki within three years. Georgia is owed money for electricity it has been providing to Abkhazia and South Ossetia over the years. If Russia refuses to close its bases, Georgia could diminish the value of its energy debt to Russia by the value of the electricity it has provided to Abkhazia and South Ossetia. To address Russia's security concerns, while the bases are being phased out, Georgia should broaden both its cooperation in the fight against terrorism and its collaborative efforts to combat crime.

The new government should petition the SRSG and the Organization for Security and Cooperation in Europe (OSCE) to pressure Russia to fulfill its obligation to withdraw its forces from its base in Gudauta, Abkhazia, and to monitor and verify the withdrawal.

Accompanied by the head of the UN Observer Mission in Georgia, the SRSG would visit Gudauta to verify Russia's compliance with the Conventional Armed Forces in Europe (CFE) protocol. Once the withdrawal was complete, the SRSG would issue a statement confirming that the only Russian troops in Gudauta are ones associated with the CIS peacekeeping mission.

3. Manage Relations with Ajaria. President Saakashvili must carefully manage relations with Ajaria so as not to tip it toward secession. He should reach out to Abashidze with assurances that Georgia will not use military force to impose its control. At the same time, the new government should convey to Abashidze the importance of paying remittances and allowing a political succession process that adheres to international norms. Saakashvili should also explore Ankara's proposal for a Caucasus Stability Pact, with the purpose of developing a web of cooperative trade and transport arrangements among Turkey, Georgia, Azerbaijan, and Armenia, which would benefit Ajaria. The new government should ask Russia to suspend, until Georgia's parliamentary elections have occurred, the "temporary" procedures it now has in place whereby Ajarians are issued visas on their arrival at Moscow's airport.¹⁹

SECURITY

By 1997, about 700 Chechen refugees, infiltrated by Chechen fighters and al-Qaeda members, had crossed into Georgia's Pankisi Valley, a remote mountainous region on the Georgian-Russian border. In October 2001, Chechen fighters appeared in the Kodori gorge, a Georgian-controlled territory in Abkhazia. Fierce fighting ensued when they joined forces with displaced Georgians from Abkhazia and launched an offensive against Abkhaz and Russian forces. In August 2002, Russian Special Forces launched cross-border raids and air assaults without approval from Tbilisi. Georgia and Russia subsequently negotiated procedures for increased security cooperation, including enhanced border patrols.

¹⁹ Economic Intelligence Unit, *Eurasianet*, December 16, 2003.

In 2001–2002, Chechen fighters in Pankisi were infiltrated by about seventy al-Qaeda members. Georgia’s opaque regulations governing financial institutions have also rendered the country a haven for money laundering associated with drugs and arms sales. Reports suggest that funds have been transferred to al-Qaeda members for use in terrorist operations. In 2002, the Federal Bureau of Investigation (FBI) established an office in Tbilisi to assist the authorities in cracking down on money laundering and to provide advice on pipeline security.

Recommendations

1. Strengthen U.S.-Georgian Military Cooperation. The U.S. “equip and train” program should be continued until Georgia demonstrates it is capable of controlling its borders and rooting out Chechen fighters from the civilian refugee population. To stabilize conditions in Pankisi, the governor and municipal councils should receive assistance to strengthen the rule of law, improve the delivery of services, and establish more effective overall governance.

Abkhaz political leaders should desist from inflammatory statements about a military solution to the situation in Abkhazia and abandon far-fetched demands for an international war-crimes tribunal to prosecute Abkhaz separatist leaders.

To demonstrate the continued commitment of both countries to security cooperation, Georgia should seek to strengthen the U.S.-Georgia Bilateral Working Group on Defense and Military Cooperation and invite the renewal of fly-over rights and arrangements to refuel aircraft bound for the Middle East and Afghanistan in Georgia.

2. Collaborate on Antiterrorism Efforts. The new government should amend the anti-money laundering law to meet international standards, especially regarding property confiscation. Georgia should seek an expansion of the FBI office in Tbilisi to include other aspects of security cooperation in the fight against terrorism.

THE INTERNATIONAL COMMUNITY

Georgia's problems are so broad, deep, and encompassing that it will be hard for Georgia's new government to move forward without the energetic participation of the international community. Foreign aid, however, should only be provided based on Georgia's progress on meeting reform benchmarks, with the exception of humanitarian and democratization assistance.

EMERGENCY ASSISTANCE

Progress is being made to ratchet up emergency assistance during the first 100 days of the new government's rule. For example, the U.S. is expanding its Winter Heat Assistance Program by providing electricity subsidies to vulnerable segments of the population and to essential industries. It is also increasing its Wheat for Education Program, with the possibility of introducing an additional 50,000 tons of wheat into the pipeline. Additionally, it is providing grants to help subsidize essential government operations, including covering salaries for the military and the police. The U.S. is also augmenting assistance by the EU and the Netherlands to the OSCE for the parliamentary elections scheduled for March 28, 2004, with an emphasis on improving voter rolls and providing election observers.

YEAR ONE PRIORITIES

The United Nations should:

- Increase emergency food supplies and enhance food security through a Food for Work Program (World Food Program);
- Strengthen the role of the UN Secretary-General's Group of Friends on Georgia, which includes the U.S., Russia, Germany, France, and the United Kingdom, and expand the mandate of the SRSG;

- Increase the number of civil-society contacts between Georgians and Abkhazians, emphasizing cooperation between women's groups and activities promoting economic integration (UNOMIG); and
- Deploy additional UN civilian police to support an IDPs reintegration plan focusing on the Gali region (UNOMIG).

Russia should:

- Close its military headquarters in Tbilisi and negotiate its withdrawal from bases in Batumi and Akhalkalaki within three years;
- Internationalize the CIS peacekeeping operation in Abkhazia and thereby gradually establish a regional force;
- Suspend special visa arrangements for Ajarians; and
- Expand joint border patrols and other forms of security cooperation with Georgia on the Chechnya and Ingushetia borders.

The U.S. should:

- Continue military cooperation via the "equip and train" program;
- Expand the FBI office in Tbilisi to include anticorruption training;
- Renew its offer to cover the costs of removing Russian troops and equipment provided that Moscow agrees to a verifiable drawdown schedule;
- Increase support for political reform and privatization in conjunction with other donors and the international financial institutions (IFIs); and
- Expand support to U.S. NGOs providing democratization assistance and sponsoring programs strengthening Georgian civil society (e.g., the Eurasia Foundation, the National Endowment for Democracy, and the National Democratic Institute).

The international financial institutions should:

- Announce a debt moratorium until 2007 (Paris Club);
- Make anticorruption a core activity of its country assistance strategy (World Bank);
- Promote energy reform by increasing tariffs and improving tariff collection (EBRD);

- Provide financing to bridge the gap between energy-revenue-collection deficits and capital improvements to the energy infrastructure (IDA); and
- Support private energy-sector investors during the immediate post-privatization period (IFC).

Donor countries should:

- Provide aid to pay off energy arrears to Armenia and Russia, with funds to Russia contingent on Moscow's fulfilling its base closure commitments under the Istanbul Agreement (EU and European bilateral donors);
- Move forward with the rehabilitation of the transport infrastructure along the Great Silk Road (EU/TRACECA);
- Support the activities of the Georgia Business Council; and
- Expand the training of border guard and pipeline security forces.

The private sector should:

- Accelerate the construction of the Baku–Tbilisi–Erzurum gas pipeline (BP);
- Invest in the Poti port as a model public-private partnership enterprise zone; and
- Establish holding companies for Georgia's utilities to prepare the assets for eventual privatization.

PERFORMANCE REWARDS

Rather than viewing performance rewards as a burden, Georgia's new government should embrace them as leverage against opponents of reform. Performance rewards can help politicians make difficult choices needed to bolster a fledgling democracy. Without benchmarks, foreign aid runs the risk of feeding corruption or having its impact nullified.

While acknowledging that everything cannot be done at once, the international community is right to expect reasonable progress. The UN should establish a Georgia Coordination Group (GCG), under the leadership of the deputy secretary-general, to bring together the UN agencies, bilateral donors, and the IFIs for monthly donor-

coordination meetings. The GCG would forge a common approach, measure progress, and issue performance reports.

Conditions placed on U.S. bilateral aid and U.S. support through the IFIs should be based on Georgia's performance in

- Conducting free and fair parliamentary elections
- Cracking down on corruption
- Cooperating in the fight against terrorism

ACKNOWLEDGMENTS

The Center for Preventive Action (CPA) is grateful to those who contributed their views and expertise. (This report does not necessarily reflect the views of these individuals or of affiliated institutions.)

NADIA DIUK, National Endowment for Democracy

FIONA HILL, Brookings Institution

JANINE W. HILL, Council on Foreign Relations

AUREN HOFFMAN, Stonebrick Group

SCOTT HORTON, Patterson, Belknap, Webb and Tyler

VAN KRIKORIAN, Global Gold Corporation

MARIA J. KRISTENSEN, Council on Foreign Relations

JONATHAN LINCOLN, Council on Foreign Relations

DAVID E. MARK, New York University

J. COBB MIXTER, Council on Foreign Relations

WILLIAM L. NASH, Council on Foreign Relations

ROBERT J. O'DONOVAN JR., Eurasia Foundation

ANTHONY RICHTER, Open Society Institute

STAN SALETT, Philanthropic Network

STEPHEN R. SESTANOVICH, Council on Foreign Relations

PETER SINNOTT, Columbia University

BETTY SITKA, American University

DAVID SMITH, National Institute for Public Policy

The CPA is also grateful to officials from the U.S. and Russia, as well as other countries, for providing their views. UN and OSCE officials were also consulted.

APPENDIX A: ACRONYMS

BSECC	Black Sea Economic Cooperation Council
CFE	Conventional Armed Forces in Europe
CIS	Commonwealth of Independent States
CPA	Center for Preventive Action
CSCE	Conference on Security and Cooperation in Europe
EBRD	European Bank for Reconstruction and Development
ESAC	Energy Sector Adjustment Credit
EU	European Union
FBI	Federal Bureau of Investigation
FDI	Foreign direct investment
FSA	Freedom Support Act
GCG	Georgia Coordination Group
GDP	Gross domestic product
IDA	International Development Association
IDP	Internally displaced person
IFC	International Finance Corporation
IFI	International financial institution
NATO	North Atlantic Treaty Organization
NGO	Nongovernmental organization
OSCE	Organization for Security and Cooperation in Europe
PfP	Partnership for Peace
SRSR	Special representative of the secretary-general
TRACECA	Transport Corridor Europe-Caucasus-Asia
UNOMIG	United Nations Observer Mission in Georgia

APPENDIX B: THE COUNCIL ON FOREIGN RELATIONS MISSION
STATEMENT AND BACKGROUND ON THE CENTER FOR
PREVENTIVE ACTION

Founded in 1921, the Council on Foreign Relations is an independent national membership organization and a nonpartisan center for scholars dedicated to producing and disseminating ideas so that individual and corporate members, as well as policymakers, journalists, students, and interested citizens in the U.S. and other countries, can better understand the world and the foreign policy choices facing the U.S. and other governments. The Council, which is headquartered in New York and maintains an office in Washington, D.C., does this by:

- Convening meetings in New York, Washington, and other select American cities where senior government officials, global leaders, and prominent thinkers come together with Council members to debate and discuss the major issues of our time;
- Conducting a wide-ranging studies program through which Council fellows produce articles and books that analyze foreign policy issues and make concrete policy recommendations;
- Publishing *Foreign Affairs*, the preeminent journal covering international affairs and U.S. foreign policy;
- Maintaining a diverse membership and organizing special programs to foster interest and expertise in the next generation of foreign policy leaders;
- Sponsoring Independent Task Forces whose reports help set the public foreign policy agenda; and
- Providing up-to-date information about the world and U.S. foreign policy on the Council's Web site, www.cfr.org.

The Center for Preventive Action seeks to help prevent deadly conflicts around the world, find ways to resolve ongoing ones, and expand the body of knowledge on conflict prevention. It does so by bringing together representatives of governments, international

organizations, NGOs, corporations, and civil society to develop and implement practical and timely strategies for promoting peace in specific conflict situations. The CPA focuses on conflicts in countries or regions that affect U.S. interests, where prevention appears possible, and for which resources of the Council on Foreign Relations can make a difference.