AN APPRAISAL OF THE EU'S TRADE POLICY TOWARDS ITS EASTERN NEIGHBOURS:

THE CASE OF GEORGIA

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EXECUTIVE SUMMARY

1. This study assesses the present state of the EU-Georgia discussions on a free trade agreement—to say 'negotiations' would be premature since the European Commission has insisted on a hugely demanding set of preconditions before agreeing to open negotiations.
2. The case of Georgia is unique in two respects. On the one hand, Georgia's own trade policy is more open towards the EU than vice versa, and Georgia has achieved governance reforms on a par with some of the old and new EU member states. On the other hand, the Commission is insisting on a complex set of preconditions being met before the opening of negotiations, which it has not done in the case of other neighbouring countries (Eastern or Southern). Taking both factors into account, the Commission's approach is strikingly anomalous.
3. This study argues that the Commission's approach is bad from three perspectives. It is bad *development* policy for Georgia. It requires Georgia to adopt and implement an enormous amount of imprecisely identified EU internal market regulations that go way beyond strictly trade-related matters, with no attempt to identify those that make sound economic sense for Georgia (and indeed for the Eastern neighbours in general). The burdensome regulatory changes imposed on Georgia are equivalent to taxing Georgian production—endangering its growth and the sustainability of its reforms and successful fight against corruption, which is so crucial for its long-term development.
4. For instance, the preconditions on *industrial technical norms* amount to a tax on Georgian industrial production, which would inevitably slow down and distort Georgia's process of industrialization. The preconditions in *sanitary and phytosanitary (SPS) measures* would trigger an average price increase of 90% for the key food products purchased by the one-third of Georgian population who live in poverty. Finally,

some requirements simply lack any rationale, such as the obligation to implement EU norms on cable cars and lifts when Georgia does not produce these products.

5. The Commission's approach is also bad *commercial* policy for the EU since it would lead to an expansion of the trade between Georgia and non-EU countries, rather than between Georgia and the EU. Georgian consumers would be induced to import what Georgian producers could no longer sell because of EU norms; and their low incomes will induce them to turn to imports from non-EU sources that are less expensive than those from the EU. Meanwhile, in order to survive, the vast majority of Georgian producers who would not be able to sell their products anymore on Georgian markets under EU norms would try to sell them to foreign markets not observing EU norms, thereby artificially boosting Georgia's exports to non-EU countries.

6. Finally, the Commission's approach is bad *foreign* policy for the EU. All these preconditions portray the EU as being hegemonic towards its very much smaller neighbour and not an enlightened and trustable anchor. They are being imposed on a country that is granted no EU membership perspective (even the accession candidates did not have to comply with such norms before the opening of their negotiations). They would make EU DCFTA (deep and comprehensive free trade agreement) partners appear like EU member state clones, but i) without full access to the EU markets in agriculture and services, ii) without EU aid and iii) without a voice in future EU decisions—clearly an unacceptable proposition.

7. There is thus an urgent need to reshape the Commission's approach. The evaluations of the current preconditions made in this study suggest a set of four concrete proposals:

    i. The EU should open negotiations with Georgia without further delay since Georgia has more than satisfied the relevant subset of preconditions.

    ii. The EU should make use of recent developments in the body of EU law and practices, which are ignored by the Commission's current approach. This body is rich enough to cope with many of the current difficulties, as shown by the nine detailed proposals suggested by this study.

iii. More broadly, the EU should design a pro-growth DCFTA process based on an integrated sequence of successive sets of commitments. Georgia would be asked to take on board these successive sets of commitments as and when its GDP per capita will reach agreed thresholds (as the *acquis* consists of fixed costs, it is easier to absorb when the income level is higher).

iv. The EU should encourage—not restrain—Georgia to pursue and develop its successful ongoing unilateral reforms.

8. The proposals focus on Georgia's side because this study relies on the proposition that a DCFTA should first and foremost boost the EU partner's growth and development. However, this study also points to the need for serious reforms on the EU side:

   i. The DCFTA doctrine should be made clearer and adapted to the circumstances of the EU partner, rather push a 'one-size-fits-all' dogma for all of Eastern Europe (in contrast to the approach taken towards the partners in the South Mediterranean neighbourhood, all of which have quite different trade agreements with the EU).

   ii. The Commission should improve its coordination among its services if the EU wants ambitious DCFTAs covering topics far removed from pure trade issues.

9. These steps should be set in motion well before the Eastern Partnership Summit in the autumn of 2011.

INTRODUCTION

This study appraises the EU's policy towards its Eastern neighbours. As these neighbours have very different political and economic structures and features, the study focuses on Georgia, which is a particularly interesting case for two reasons. As a small, lower-middle income country located in a tormented region, it faces challenges. At the same time, Georgia is the EU neighbour that has undertaken unilaterally the most dramatic reforms—with great success. In short, Georgia is the archetype of a neighbour that would immensely benefit from strong EU support, and which—in return—would establish the reputation of the EU as strong economic and political anchor.

Georgia's track record for economic reform since the mid-2000s is outstanding by any standards. Since 2006, it implemented basic free trade unilaterally for its imports from the whole of the world, such that its average industrial tariff is now 0.3%, compared with 4.6% for the EU. But its reforms have gone far deeper still, unilaterally opening all its markets to foreign direct investment and recognizing the technical standards for imports from all OECD countries, including the EU. Its governance reforms were such that its ranking under international surveys of 'ease of doing business' and 'de-corruption' have improved to the point of being now superior to various EU member states (hereafter MS).

The EU's slow and reluctant response to Georgia's reforms

While Georgia has been acting fast and decisively, the EU for its part has responded only very slowly and reluctantly. In November 2006, the EU and Georgia signed a European Neighbourhood Action Plan (ENP) which included the "possible establishment of a free trade agreement" between the EU and Georgia. This provision was introduced on Georgia's request while facing strong objections from the European Commission. It took

more than a year to agree on an innocuous wording specifying that such a free trade agreement (FTA) would be subject to a study in order to find out whether it would be feasible. The so-called 'feasibility study' was finalized in March 2008, and advocated a 'deep and comprehensive free trade agreement' (DCFTA).

In October 2008, soon after the war with Russia, the Commission sent a fact-finding mission to Georgia. In March 2009, it sent to the Government of Georgia a 'matrix' (hereafter, the 2009 Matrix) of preconditions in 11 areas (see Chapter 3). These preconditions were divided into two sets: those to be fulfilled *before* the start of DCFTA negotiations and those to be met *after* the formal launch of negotiations to facilitate a smooth implementation of the—yet undefined—DCFTA, also chosen unilaterally by the Commission. Out of these 11 preconditions, four were chosen unilaterally by the Commission as key: technical barriers to trade, sanitary and phytosanitary (SPS) measures, competition policy and intellectual property rights (IPRs). There is a last precondition on the origin of the products; however, as this precondition raises the political question of Abkhazia and South Ossetia, it is not examined in this economic study.

For all the preconditions, the Commission's language is very fuzzy, full of expressions such as "sufficient progress", "adequate system", "effective and proper implementation", etc. without defining what sufficient, adequate, effective or proper exactly means. In short, the preconditions are written in an open-ended language that gives the Commission absolute power to decide whether the preconditions are met or not.

In December 2010, the Commission sent to Georgia a document (hereafter the 2010 Document) which amplifies the asymmetrical nature of the 2009 Matrix by shifting some preconditions to be met after the launch of the negotiations according to the 2009 Matrix into the list of the preconditions to be met before. The 2010 Document also amplifies the absolute power of the Commission by adding more open-ended language.

The fundamental choice to be made by the EU

For Georgia, a DCFTA or a FTA (free trade agreement) is a logical follow-up to the unilateral dramatic reforms it has undertaken since 2004: almost no tariffs in industry, very moderate tariffs in agriculture, no barriers to foreign direct investment in the whole Georgian economy and unconditional mutual recognition of the technical norms of all OECD countries—all reforms that the EU has not yet achieved, including among

the EU member states themselves in the case of the technical norms. A DCFTA with a much larger and richer economy has two key potential benefits for the smaller partner, as illustrated by the North American Free Trade Agreement for (NAFTA) with Mexico. It is a way to consolidate the unilateral reforms done by the smaller partner by locking them into an international agreement. Looking ahead, it is a way to open a huge—in relative terms—market to the potential exporters of the smaller partner which are spurred by the reforms already undertaken, hence to boost its growth and development.

However, it takes two to tango. The role that a DCFTA could play depends largely on the approach taken by the larger trading partner—the EU in this case. The EU has a choice between two very different approaches.

A global vision

The first alternative is to develop the DCFTA within a global vision. In such a perspective, the EU realizes that the DCFTA should deliver to the small partner the expected economic benefits in terms of growth and development as quickly as possible. It also realizes that the economic benefits it will draw from a DCFTA will be small for a very simple reason—the relative size of the two partners. This is easy to illustrate in the case of Georgia: Georgia's current GDP is roughly 0.10% of the EU GDP and, even when the Georgians will be as rich as the Europeans, its GDP will be 1% of the EU GDP (this reflects the scale of the Georgian population compared to the EU population).

In such a vision, the EU realizes that the benefits it will reap from a DCFTA with a smaller partner are essentially political. If such a DCFTA is well designed and succeeds, it will show the EU's capacity to act as an anchor for growth and prosperity, attracting other neighbours. In this perspective, it is essential to realize that the political benefits for the EU of a DCFTA with a small country go far beyond the economic size of the partner. The EU will emerge as an attractive anchor for a whole region, at a time when there are plenty of emerging challengers to the EU leadership from all over the world. In short, a DCFTA is an integral and key part of EU foreign policy.

A narrow-minded approach

Alternatively, the EU can view the small economic interests it has at stake in the very small Georgian market as a reason not to be much concerned, and, to the extent that it has to get involved for reasons of neighbourhood

policy doctrine, to use its overwhelming relative size and strength to simply dictate its conditions. This is what the implicit current DCFTA doctrine seems to amount to. Some Commission officials seem to regard such small neighbours as just too much trouble for a tailor-made policy. Therefore they demand that the partner swallows loads of the EU *acquis communautaire*[1] wholesale, and simply assert that this is automatically good for the partner.

Such an approach is a route full of hazards in the 21st century of 'multipolarity'. This word is much nicer than the reality, in particular for the EU. It means that potential competing anchors are emerging fast. This is a lesson to be drawn from the increasingly tormented relations between the EU and many African countries, with the growing influence of China and India in Africa. Tbilisi is as close to Mumbai as it is to Antwerp—and, in such matters, geographical distances count even less than economic dynamism.

There is no reason to limit the list of the EU challengers to the largest potential candidates. Smaller regional anchors such as Turkey or the Gulf states may also be competitive, offering Georgia alternatives. The relative size of Georgia compared to Turkey is the same as the relative size of Bulgaria plus Romania compared to the whole EU. For the EU to represent an attractive role model in these conditions, it has to prove as agile as other foreign policy actors and tailor its offers of cooperation to the needs and demands of the partner, rather than simply throw the Brussels rule book at the partner without an intelligent selection and adaptation of its instruments. There are lessons to be drawn from the current evolution of Turkey.

The current situation: Very unsatisfactory

The highest EU authorities—Council and Parliament—have not yet clearly decided which of these two options they want to adopt. Failing to clarify this point by the time of the EU's Eastern Partnership Summit in Autumn 2011 would cost the EU influence on its borders. Pending this choice, the current situation is based on a choice left *de facto* to the Commission which is very unsatisfactory for the following reasons.

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[1] The *acquis* refers to the body of EU Directives, Regulations and all the other legal texts to be enforced by all the EU MS.

First, strangely enough, the Commission does not define clearly what a DCFTA is supposed to achieve (see Chapter 1). Worse, the preconditions imposed unilaterally by the Commission on Georgia are similar to the conditions that a fully-fledged EU MS should adopt when acceding. This leads to an awkward situation where a DCFTA signatory could be best described as an EU MS, but one:

- without full access to the EU markets (very limited access to EU agricultural markets),
- without full access to EU aid and
- without voting rights in the EU decision-making.

This is clearly not a sustainable approach.

Second, the Commission's preconditions, which focus on regulatory matters, fail to recognize the new world as it is (see Chapter 2). Georgia scores better than quite a number of old and new EU MS in terms of effective regulatory quality and the EU MS exhibit surprisingly different levels of regulatory quality. These two facts are crucial for designing an economically sound DCFTA. Georgia's good regulatory performance means that the Commission should appreciate the EU neighbours for what they have done, not for what they were. The wide range of regulatory quality among the EU MS, which have shared the same formal *acquis communautaire* for several decades in some cases, raises serious questions about how much importance is actually attached to this formal (legal) convergence of regulations [Messerlin, 2008].

Third, the preconditions imposed by the Commission on Georgia before opening DCFTA negotiations are based on a 'one size fits all' approach. As shown in Chapters 3 to 6, they constitute:

- Bad *development* policy for Georgia. The burdensome reforms imposed on Georgia are equivalent to a tax on Georgian production sold in Georgian markets. In the industrial sector, they would inevitably slow down and distort the industrialization process of Georgia, and hence endanger her growth. In the agricultural sector, they are expected to increase by 90% on average the prices of the food products consumed by the poorest Georgians—one third of the Georgian population lives in poverty. Such price hikes would greatly endanger the country's political stability and fuel an anti-European sentiment.
- Bad *commercial* policy for the EU. By imposing a tax on Georgian products sold on Georgian markets, the preconditions will induce

Georgian consumers to look for imports they can afford to buy, that is, goods that are unlikely to come from the EU and likely to come from non-EU countries. In short, they will divert Georgia's trade flows to non-EU countries, and will be mostly beneficial to Georgia's neighbours that do not have a DCFTA with the EU and to the emerging economies challenging the EU leadership.

- Bad *foreign* policy for the EU. They show the EU as an aggressive and careless neighbour, not as a trustworthy anchor. In particular, the Commission's preconditions will again fuel corruption, which has been successfully cut at great pain during the last decade—the last thing that one would like to inflict on a country having so clearly turned its back on 70 years of Soviet rule.

For all these reasons, the future of the current discussions is quite uncertain. Will the EU's highest authorities confirm the approach taken so far by the Commission, or will they instruct the Commission to defend the broad EU interests in a more enlightened manner? Will Georgia continue on a pro-European path with an EU that appears not to value its successful reforms, or will it consider that the burdens demanded by the EU are not worth the pain and expense, and instead turn to an alternative policy *à la Chile* consisting of making FTAs with every willing partner—including the US and China?

Proposals: An overview

The EU should use the unique opportunity of Georgia's demonstrated capacity to reform of the last seven years—and of the emerging benefits of its policies—to launch an innovative '*pro-growth* DCFTA' which could be used as a blueprint for other EU neighbours.

A pro-growth DCFTA should be a process allowing Georgia to absorb progressively the EU *acquis* through an integrated sequence of successive sets of commitments, starting with those considered as the most helpful from a growth perspective. Georgia would then be asked to take on board the other sets of commitments as and when its GDP per capita reaches agreed thresholds. As the *acquis* consists mostly of fixed costs, the costs of implementation, which would amount today to 5% of Georgia's GDP, would cost only 2% in 10 to 20 years from now, depending on Georgia's growth rate. Such an approach has the important advantage of making both parties interested in Georgia's high growth rates.

The study makes precise proposals related to the current discussions between the Commission and Georgia. First and foremost, the DCFTA negotiations between the EU and Georgia should start without further delay since Georgia fulfils the relevant subset of the 2009 Matrix preconditions. We consider the 2009 Matrix as the only text to take into account, whereas we see the 2010 Document as a document of lower legal status breaching the initial conditions set up by the Commission's 2009 Matrix.

Second, the study tables nine detailed proposals focusing on the four key preconditions imposed by the Commission. These proposals are summarized in Box 1. The broad aim of the proposals is to make the preconditions affordable by the Georgian economy and contributing to her growth. For this purpose, they draw on some existing elements of the rich body of EU law and practices that could both help the Government of Georgia and firms to reduce implementation costs, and the most dynamic Georgian firms to start deriving positive benefits from the EU *acquis,* while allowing the others some breathing space to adapt. They also use a better scheduling based on the objective criterion of Georgia's GDP per capita for achieving the same results.

These proposals should also be taken into account in the general review of the European neighbourhood policy currently underway in the EU institutions, which should therefore include a review of DCFTA policy. This could have implications for the cases also of Ukraine and Moldova, which are currently the subject of negotiations or pre-negotiations. However it would be beyond the scope of this study to make precise recommendations for these other cases.

Conclusion: The Autumn Summit on the Eastern Partnership

Georgia is one of the steadiest reformers among the EU's Eastern and Southern neighbours and its reforms are yielding impressive performances. That makes Georgia the best imaginable trading partner with whom the EU could build a 'DCFTA model', bringing long-term growth to its Eastern (or Southern) partners, and building the EUs reputation as an attractive economic and political anchor.

Europe should not miss this unique opportunity at the Autumn Summit on Eastern Partnership. If it does, its neighbours will quickly find alternatives among the many dynamic and tough emerging challengers to the EU as a global or even regional leader.

Box 1. Nine detailed proposals on the four key preconditions

First and foremost, the DCFTA negotiations between the EU and Georgia should start without further delay since Georgia fulfils the relevant subset of the 2009 Matrix preconditions (Chapter 3 of the study argues that the 2010 Document is an unjustifiable breach of the 2009 Matrix).

I. Proposals specific to Technical Barriers to Trade (TBTs) (Chapter 4)

The EU-Georgia DCFTA should include:

1. A provision facilitating the implementation of EU norms by Georgian exporters by allowing Georgia to have recourse to the national accreditation and certification bodies of an EU member state.
2. A provision exempting Georgian firms from EU norms when selling in the Georgian national market; the timing of the transposition of the first six New Approach Directives should be revised.
3. A provision releasing Georgia from any obligation to transpose the other New Approach Directives, except if Georgia decides otherwise.
4. Possibly a provision defining transition periods on the basis of an objective measure of the improvement of the Georgian economy, such as its GDP per capita.

Georgia should keep its own policy of unconditional mutual recognition which is more fully in line with the spirit of EU case law (*Cassis de Dijon* case) than the EU's current *acquis*.

II. Proposals specific to Sanitary and Phytosanitary (SPS) Measures (Chapter 5)

The EU-Georgia DCFTA should include:

5. A provision excluding the small-farm sector from the EU SPS *acquis* for what would be a long transition period; fixing this transition period on indicators such as the GDP per capita is not a solution because the small-farm sector is so large and disconnected from the rest of the economy; the transition period should rely on a review of the situation on a regular basis.
6. A provision allowing a very progressive introduction of the general food safety laws in the interest of Georgian consumers; the progressivity dimension is crucial in order to minimize the risks of destabilizing food price surges.
7. A provision defining a mechanism ensuring Georgian compliance with the SPS *acquis* for Georgian major agricultural exports to the EU; this mechanism should be implemented in a progressive way, that is, as and when Georgian exports become notable (in quantities) and regular (in time).

III. Proposals specific to Competition Policy (Chapter 6)

The EU-Georgia DCFTA should include:

8. A provision imposing EU-type state aid disciplines on Georgia in exchange of the renunciation of the use of anti-dumping, anti-subsidy and safeguard measures by the EU.
9. Possibly a provision supporting—not forcing—Georgia's cooperation with EU MS competition authorities on the competition issues strictly speaking (excluding state aid).

Georgia should be supported to make a more productive use of its Competition Authority by granting it (or a sister institution) the role of evaluating the impact of regulations similar to the one played by the Australian Productivity Commission.

IV. Proposals specific to intellectual property rights (IPRs) (Chapter 6)

The EU-Georgia DCFTA should recognize the fact that Georgia is a lower-middle income country and that most of the counterfeited goods in Georgia are imported from much larger economies. As a result, it should be pragmatic and focus on supporting Georgia's policy of adherence to international IPR treaties, and Georgia's fight against piracy and counterfeiting at a pace compatible with its economic growth and political stability.

PART I. 'NEW WORLD'

Part I sets the background of the choices to be made by the EU with respect to negotiating a DCFTA with Georgia.

Chapter 1 shows that the EU has no operational definition of what a 'deep and comprehensive free trade agreement' should be about. This vacuum triggers decisions that are felt as arbitrary and unfair by the EU partners. It also raises a fundamental issue—the regulator (the EU in this context) does not take the responsibilities flowing from the imposition of its regulations. The study suggests a definition: a pro-growth DCFTA is about boosting growth of the EU partners and establishing the EU's reputation as an attractive anchor. It suggests several proposals on how to make such an approach operational.

Chapter 2 shows that the EU often fails to realize how much the world has changed since the 1990s—and hence fails to value its neighbours. Many countries have made unilateral reforms. A close look at the hard facts available shows that Georgia fares better than many EU member states, an outstanding result of its reforms. It also shows that the EU MS fare very differently despite their common exposure to the *acquis communautaire*—an observation that should trigger serious thinking in the EU.

1. THE FORGOTTEN QUESTION: WHAT IS A DCFTA ALL ABOUT?

Summary

1. The Commission's insistence to use the concept of a deep and comprehensive free trade agreement as the only model for the EU Eastern neighbours is at odds with the golden rule of the EU neighbourhood policy—not to favour the Eastern or Southern region at the expense of the other.

2. The desirable goals of a DCFTA are two-fold:

- an economic one for the EU partner: to boost its economic growth and development and
- a political one for the EU itself: to build its reputation as a trustworthy anchor, a role that is increasingly challenged by the new emerging global or regional powers.

3. The current Commission's approach to DCFTA provides no clarity about the content of a DCFTA, generating great frustration among EU negotiating partners.

4. This chapter provides the basic elements of what a DCFTA should be:

- The DCFTA should be conceived as a process in which the EU *acquis* is absorbed through an integrated sequence of sets of commitments selected for being in line with the economic interests of the EU partner.
- Only the few EU regulations to be considered with high confidence as critical for boosting the growth of the EU partner should be part of the first set of commitments.
- The remaining EU regulations should be introduced progressively in the subsequent stages.
- The link integrating the various stages should be clear and economically meaningful indicators of the convergence of the EU partner on the EU's economic development, such as the GDP per capita of the EU partner.

- The regulations to be included in each set of commitments should be jointly defined by the EU and its negotiating partner—not unilaterally by the Commission—because each partner is different, particularly in its capacity to implement its commitments.
- The Commission should produce a DCFTA Handbook, assessing the costs and benefits for its partner states of implementing all parts of the EU *acquis* that it considers relevant.

This chapter sets the background of the current discussions between the Commission and Georgia. It is organized as follows. Section 1 puts the EU notion of a 'deep and comprehensive free trade agreement' (DCFTA) in the wider context of the EU's neighbourhood policy. It underscores the contradiction between the primary political rule of the neighbourhood policy—not to favour the Eastern or Southern region at the expense of the other—and the Commission's insistence on the DCFTA concept as the only model it is willing to contemplate for the Eastern neighbours. It argues that any reference to the EU enlargement to Central Europe in the 1990s for justifying this insistence is a serious anachronism—there are crucial differences between the Central European countries in the 1990s, now EU member states, and the Eastern neighbours today.

Section 2 defines the desirable goals of a DCFTA for the EU's partners as well as for the EU itself. A DCFTA should deliver mostly economic gains to the EU partners—faster growth and development—and mostly political gains to the EU—the reputation to be an economic and political anchor that can be trusted. These gains are essential for both sides in the long term. More growth is crucial for the EU's neighbours located in tormented regions. Being a trustable anchor is crucial for the EU if it aims to be a significant world power, a role that is increasingly challenged by the new emerging global or regional powers.

Finally, sections 3 and 4 tackle the more precise question of how to define a DCFTA. Section 3 shows that, today, this question has no clear answer. This situation is a source of deep frustration among the EU's neighbours, which observe that they are treated very differently without justification. Paradoxically, this situation is also a source of economic costs for the EU, as shown below. As a result, section 4 provides basic proposals that would allow a consistent approach to a DCFTA, generating a robust, fair and predictable process capable of delivering a beneficial outcome to the EU's partners as well as to the EU itself. The need for a Handbook to guide

selective adoption of the EU *acquis* by non-member partner states is stressed.

1.1 DCFTAs and the EU's neighbourhood policy

The EU has established a single European neighbourhood policy, with two branches: the South Mediterranean and Eastern Europe. This golden rule—having a single neighbourhood policy—was driven as a matter of political principle, which made also sense from a trade and economic perspective: to avoid favouring one sub-region (Southern or Eastern) at the expense of the other.

However a second principle is that there has to be differentiation in the speed and level of ambition in negotiating agreements and action plans made with individual partner states, depending on the political will, economic structures and administrative capacities of the partner states. The principle of differentiation is seen in the current processes of negotiating association agreements, including free trade agreements. Some countries, notably Ukraine and Morocco, have been singled out as candidates for the new-style association agreements. Morocco has concluded such an agreement, whereas in the case of Ukraine the negotiations remain ongoing, with the free trade element of the agreement proving still elusive, whereas other elements are understood to be agreed.

When one focuses on the free trade component of the neighbourhood policy, there is a major difference in the EU's policy with its neighbours. With its Southern Mediterranean neighbours, the EU was willing under the Barcelona process, initiated in 1995, to make 'basic' free trade agreements, with asymmetrical transition periods for the phasing in of free trade conditions—many years for the South, short periods for the EU. This first generation of agreements was basic in that it did not go far into the liberalization of service sectors or in seeking to extend much of the EU's internal market *acquis* into these countries. In recent years, the action plans of the neighbourhood policy for the Southern partner states have sought to add these features to the basic free trade agreements. But, preconditions were not set for the opening of these free trade negotiations (now strikingly illustrated by the case of Libya, a country very far away from any intention to converge on European political or economic norms). On the contrary the EU sought to open these negotiations with all South Mediterranean states in parallel.

In sharp contrast, the EU has been following a very different general approach for the Eastern neighbours, insisting on the concept of a DCFTA as the only model it is willing to contemplate.

There is no official explanation for why this different approach was adopted. One explanation (others will be examined in the following chapters) is the EU's experience with its enlargement to the Central European countries, which required indeed a deep and comprehensive adoption of all EU *acquis* as absolute condition for accession.[2] This has been recognized as a real transformative process in which the EU's economic and political order was introduced wholesale to replace the collapsed communist regimes. Economists have researched the mechanisms through which this process achieved dramatic and largely positive results. Broadly speaking the economists' analysis extended beyond the traditional trade aspects (tariffs and non-tariff barriers to trade) into the much deeper matters of improved internal economic governance in the economy as a whole. Many studies, for example undertaken by the World Bank, have tended to show that the benefits from improved economic governance (regulatory reforms leading to the reduction of corruption) can be large multiples of the gains from moves in a narrowly conceived trade policy.

However, relying on the parallel with the EU's Central European enlargement for designing the current EU neighbourhood policy misses a crucial point: the EU enlargement to Central Europe occurred almost simultaneously with the reforms that the Central European countries (now EU MS) were undertaking unilaterally in their transition from communist to market economies. The case of Georgia is quite different since it has already introduced the major reforms needed for building an open and market-based economy. In this context, it should be recalled that, in the early 1990s, the Central European countries that dared to made deeper reforms than those required by the EU enlargement were forced by the EU to withdraw these reforms—such as Czechoslovakia, Estonia and Poland in trade liberalization, or Estonia in agricultural policy, to mention the most significant cases.[3]

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[2] In this study, Central Europe refers to the 12 most recent EU MS. Eastern Europe refers to the European countries outside the EU, except Russia and the Balkan countries not yet members of the EU.

[3] History tends to repeat itself. In the early 1990s, Central European countries turned to EU membership as a last-resort solution, having realized that NATO

The situation is quite different for the EU's current Eastern neighbours. As shown below, there is no simultaneity between their unilateral reforms—already enforced for a notable number of years—and possible agreements with the EU—which are still in the making, if indeed they happen. This is best illustrated by Georgia which, as shown in Chapter 2, has undertaken a series of reforms on its own that no Central European country made in the 1990s outside the enlargement process. Some Eastern neighbours may still now be hesitating on the path of reform, but this option was simply unconceivable in the 1990s when the Central European embarked upon the sweeping accession process. In other words, the EU's decision to go ahead with a DCFTA negotiation with Ukraine was quite a different bet than those taken 15 years before with the Central European countries—indeed, such a bet probably cannot be explained without the initially euphoric atmosphere prompted by Ukraine's Orange Revolution.

1.2 What should a DCFTA be about? Delivering growth and reputation

For both the EU and its neighbours, the stakes are of great importance. The EU's neighbours see a DCFTA (or a FTA) as a source of additional growth and development. The EU markets give the benefits of scale economies and the possibilities offered by the endless range of varieties of products that characterize modern economies. A DCFTA that will not deliver these benefits will not survive: sooner or later, the EU's neighbours will learn the lesson, and will look for more attractive economic anchors and will leave the EU's sphere of influence.

A DCFTA is intended to establish the EU's reputation as a crucial and trustable anchor. But the belief that there is no alternative to the EU as an anchor is an illusion - in a world where geographical distance counts much less than economic dynamism and political vision.

In order to get a sense of the main economic aspects of a DCFTA for the Eastern neighbours, Table 1.1 provides basic macroeconomic indicators. It splits the EU into seven 'cohorts' defined by the date of accession of their respective EU MS. For more precision, the 10 Central European countries

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membership was impossible for some time. Their desire to adopt market-oriented reforms and deep trade liberalization faced strong opposition from Commission officials who initially wanted to renew the existing trade agreements in force (with Hungary) and later pushed them to keep high GATT-WTO tariffs (Romania) or to re-introduce them (Poland) [Messerlin, 1992].

having joined the EU in 2004 have been divided into two different groups: the three Baltic EU MS (EU-2004b) and the seven other Central and European EU MS (EU-2004a). For simplicity sake, the three comments suggested by Table 1.1 focus on the case of Georgia.

First, as Georgia is a relatively small country in terms of population, it will always be a relatively small economy. Even when Georgians might be as rich as the Europeans, Georgia's GDP would represent only 1% of the EU's GDP. As a result, the DCFTA between the EU and Georgia is unlikely to have any significant impact on the EU economy. This makes the EU-Georgia DCFTA totally different from both the EU-Korea FTA (Korea is one-tenth of the EU economy) and from the EU-Turkey customs union in the long term (Turkey's population is 15% of the EU's population, hence Turkey would represent 15% of the EU's GDP when Turks would be as rich as the Europeans).

Table 1.1. Macroeconomic indicators setting the perspective for a DCFTA

	Population	GDP ($ billions)		GDP per capita ($)		Trade/GDP	Avg growth
	(millions)	Cer [a]	PPP [b]	cer [a]	PPP [b]	[c] %	rate [d]
EU cohorts							
EU-1958	232.5	9422.0	8181.9	40519	35186	78	1.5
EU-1973	71.8	2711.3	2643.8	37753	36813	67	2.1
EU-1980s	67.9	2017.9	2085.8	29730	30731	58	2.3
EU-1995	23.0	1028.5	861.7	44709	37457	73	1.9
EU-2004a	67.0	910.3	1390.1	13588	20750	114	3.5
EU-2004b	6.9	82.5	115.7	11894	16691	120	4.8
EU-2007	29.1	208.2	402.8	7163	13856	88	4.6
Countries under accession negotiations							
Croatia	4.4	63.0	87.8	14222	19803	87	3.1
Macedonia	2.0	9.2	22.1	4516	10824	118	2.6
Turkey	74.8	617.1	1040.3	8248	13904	50	3.7
Countries under DCFTA negotiations							
Ukraine	46.0	113.5	291.1	2468	6327	98	4.6
Countries willing to open DCFTA negotiations							
Armenia	3.1	8.7	16.3	2826	5286	56	8.8
Georgia	4.3	10.7	21.0	2520	4920	84	5.8
Moldova	3.6	5.4	1.5	1500	2824	145	4.8

[a] cer: current exchange rates.

[b] PPP: exchange rates at the PPP.

[c] For the EU cohorts, this is the GDP-weighted national trade/GDP ratios.

[d] Annual average growth rates (unweighted by country size) from 2000 to 2010.

Sources: WTO Trade profiles (website) except for growth rates [EBRD, Economic indicators (website)].

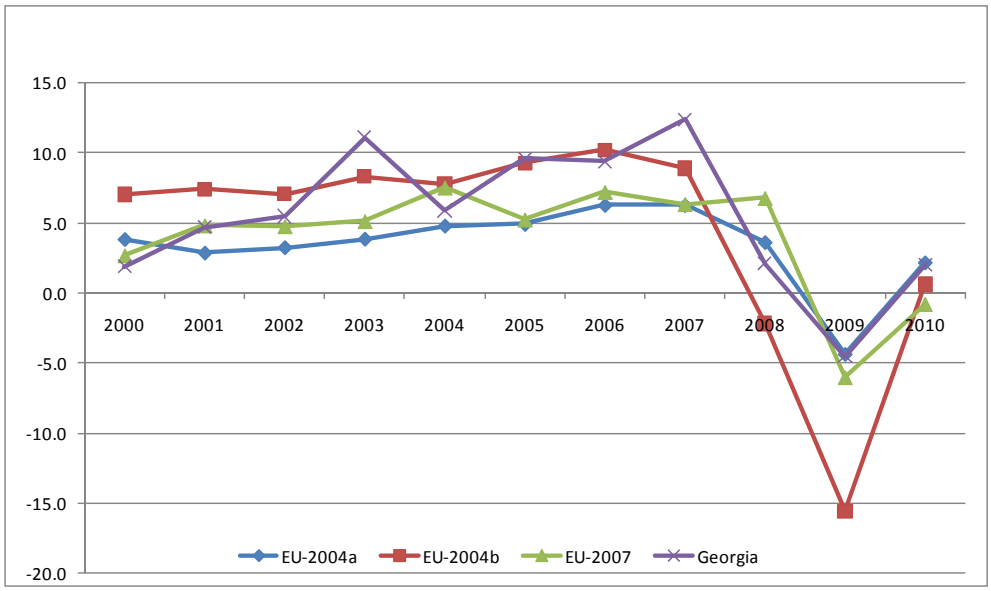
The small size of Georgia implies that the EU's benefits from a DCFTA with Georgia will have to be political, not commercial or economic. If the DCFTA between the EU and Georgia does not work, the EU should abandon any hope to conclude a truly successful DCFTA with any of its Eastern (or Southern) neighbours. Large and powerful challengers of the EU as a world power will quickly understand that they may have a fantastic opportunity to offer better alternatives than the EU to countries close to the EU borders. No need to go as far as China or India: Table 1.1 shows that the ratio between the Georgian and Turkish populations (and economies) is the same than the ratio between the EU-2007 (Bulgaria and Romania) and the whole EU.

Second, Georgia is classified as a lower-middle income country by the World Bank. Its among the poorest countries selected in Table 1.1, with a GDP per capita that is one-fourth that of Bulgaria, the current poorest EU MS. This makes it hard to understand the Commission's motive behind imposing on Georgia as preconditions for negotiating a DCFTA the most costly elements of the EU *acquis* (such as the EU technical regulations in the industrial sector or of the EU sanitary and phytosanitary measures in the farm and food sectors). It is useful to mention here the huge difficulties the Central European EU MS have had to implement these parts of the *acquis*, despite the huge amount of aid they received from the EU when acceding to the EU. In other words, the Commission is taking serious risks to impose an excessively heavy burden on the vibrant but still fragile Georgian economy, and to be a severe drag on its growth rather than a boost, as documented in chapters 4 and 5.

Third, countries that are ambitious in terms of regulatory reforms exhibit better growth rates in the long run, even if they may have experienced more accentuated ups and downs. (In short, regulatory shyness does not pay once one takes a long-term perspective: it gives the impression to be the right approach only in the short run.) This is illustrated by a comparison between the EU-2004b (the Baltics) and the EU-2004a (the other Central European EU MS) cohorts. On the one hand, Table 1.1 shows that, over the same period, the Baltics have an annual growth rate that is one percentage point higher than the EU-2004a cohort, despite the huge negative shock of the Great Crisis on their economies. On the other hand, Chapter 2 shows that, over the decade 2000-10, the Baltics exhibit systematically better performances in regulatory quality than the other Central European EU MS, despite the fact that they were an integral part of the Soviet Union and started their reforms later.

In this respect, Figure 1.1 suggests two additional useful observations. First, Georgia is more similar to the Baltic EU MS than to the other Central European EU MS in terms of growth pattern, a result not surprising when one takes into account the similarities in the rapidity and intensity of her regulatory reforms. This is despite the fact that the year 2008 was particularly difficult for Georgia which has had to absorb two—not one—severe shocks: not only the Great Crisis with its impact on the FDI inflows and on the remittances from the Georgian diasporas (a non-negligible portion of foreign inflows) but also the war with Russia a couple of months before, with its severe impact on the foreign investment climate, remittances and infrastructure (not to mention the cuts in the Russian supply of natural gas).

Figure 1.1. Growth rates, Central European EU MS and Georgia, 2000-2010



Source: EBRD, Economic indicators (website).

Second, in the aftermath of the financial crisis, Georgia needs a serious boost to its current growth. Its growth rate for 2010 is again positive: it was initially estimated at 2% for the whole year 2010 (as indicated in Figure 1.1) and it has been recently revised to 6.5%. This last result is very good in current circumstances. But, higher growth is needed. Of course, this is for

the usual economic reasons: i) the urgent need to improve a very insufficient infrastructure and ii) the longer-term objective to catch up globally and to fight poverty and inequality problems made more blatant by the success of only a portion of the economy. But, this is also for political reasons quite specific to Georgia. One of the peaceful ways for Georgia to recover the control of her whole territory is to be a vibrant economy, as West Germany or South Korea has been or is with respect to East Germany or North Korea.

1.3 Defining a DCFTA: In desperate need for clarity

The DCFTA negotiations lack elementary fairness and transparency because the Commission has never clearly defined what a DCFTA is to be. As a result, DCFTA negotiations consist of an unpredictable, open-ended journey during which the Commission shows little sign of valuing efforts made by the EU negotiating partners. During this journey, the attraction initially exerted by the EU on its neighbours is rapidly vanishing. Ultimately, the staunchest supporters of a DCFTA in the EU negotiating partners are shrinking to those who believe that their country cannot move without a strong external force, an unattractive prospect since the EU's regulatory performance is not always that good, as documented in Chapter 2.

In order to overcome the uncertainties over what the DCFTA should cover, it has been suggested to the Commission on a number of occasions that all the relevant Commission's Directorates General should undertake a combined project to prepare a "Handbook on the Costs and Benefits of EU *Acquis* Compliance by European Neighbourhood Policy Partner States". This has never been attempted by the Commission, doubtless because it would be a very challenging task both of analyzing the costs and benefits of a huge number of regulations, and of coordinating such a project across the many Commission services involved (Trade, Enterprise, Market, Competition, Agriculture, Food Safety, Transport, Energy, Environment, etc.). When the EU decided to complete its internal market by 1992, the Commission undertook a vast set of studies on precisely this question, publishing a synthesis book [Emerson et al., 1988], supported by 24 volumes of sector-specific studies. The President of the Commission at that time, Jacques Delors, judged that it would be impossible politically to secure the backing of the EU MS for this extremely ambitious legislative programme without ample justification.

Something on this scale would not be necessary for the DCFTA, yet a slimmed down version of it is desperately needed. In reply to such proposals, the Commission has indicated that it is for the individual partner states to work out themselves what they want to do. This attitude is both indefensible and contradicted by the current Commission's policy. Indefensible, because only the Commission's services have easy access to the basic technical information on which to base such evaluations. If such a task is difficult for the Commission to undertake, how much more so would it be for the administrations of the Eastern neighbour states to do this? And it is contradicted by the Commission's current policy of imposing large-scale preconditions for *acquis* compliance by Georgia. The Commission should already have prepared a "DCFTA Handbook", and should not be dictating indiscriminate and/or erratic waves of *acquis* compliance in its absence.

1.3.1 The current approach to DCFTAs: Both vague and brutal

As of today, DCFTAs are not defined, but only described in very vague terms. For instance, the Commission's Communication on Eastern Partnership [2008, p. 5] describes the DCFTAs as follows:

> They [DCFTAs] will cover substantially all trade, including energy, and aim at the highest possible degree of liberalisation (with the *asymmetry* in the pace of liberalisation appropriate to the partners' economies)… They will create real perspective for enhanced movement of goods (this *could* include Agreements on Conformity of Assessment and Acceptance of Industrial Products and the recognition of equivalence achieved by partners related to sanitary and phytosanitary standards for agricultural and food products), capital and the supply of services… to be achieved in the *long run* (authors' emphasis).

The most recent description (dated February 2010) is provided by the Commission website on the ongoing negotiations with Ukraine, and reads as follows:

> The Association Agreement will include a free trade area between the two parties. In order to mark its exceptional and far-reaching ambitions, this free trade area has been called 'deep and comprehensive'. Traditionally, standard free trade agreements foresee mutual opening of markets for goods and services. The free trade area between the European Union and Ukraine goes much further. Ukrainian laws and standards *will*

> *be* made compatible with those of the European Union in trade and trade-related areas (authors' emphasis).

The only certain conclusion to be drawn from all these vague descriptions is that the DCFTA does not open the perspective of EU membership even in the long-term. This is not very helpful since it leaves open many other questions. For instance, since membership is not a perspective, should the DCFTA partners be expected to adopt the whole *acquis*? The most reasonable answer is that they should not—all the more so because the accession process has always been accompanied by huge financial incentives during the decade needed to implement various EU regulatory standards. The experience of the Central European EU MS is however clear. Their negotiators all say that there is much in the *acquis* that would not have been justified without it having been being part of the accession package. It is frequently mentioned that various elements in the sanitary / phytosanitary and food safety *acquis* are extremely onerous when the whole of the agro-food sector has to become EU-compliant. Croatia and Turkey are currently repeating this experience.

There are a host of additional questions. What is the difference between a 'simple' FTA and a DCFTA, since both should cover "substantially all trade"? Does this condition simply repeat mechanically a condition that any FTA should fill under WTO rules, and hence echo the only clear condition on DCFTAs mentioned in the Commission's texts, namely that the EU's partner shall be a WTO member? Or does it mean more, for instance the elimination of all trade barriers in agriculture—a condition that Georgia is ready (and already close) to fulfil, but which the EU is unlikely to do? At the other end of the spectrum of concessions, to which extent does a DCFTA differ from an Accession agreement? How many "laws and standards" will be needed for a candidate's laws to "be made compatible" and to satisfy the condition of "[going] much further"? What is the meaning of the term "compatible"? In short, the DCFTA notion floats in limbo somewhere between an FTA and an Accession agreement. Not a paragon of precision.

Last but not least, the approach effectively taken by the Commission with some partners is in total contradiction with the above descriptions of DCFTAs. For instance, the second sentence of the Commission's Communication on Eastern Partnership mentions topics (agreements on conformity of assessment and acceptance of industrial products and recognition of equivalence achieved by partners related to sanitary and phytosanitary standards for agricultural and food products) that <u>*could*</u> be

included in a *long-term* perspective (authors' emphasis). Such a statement is clearly inconsistent with making these topics as preconditions for opening negotiations on DCFTA—as it is the case for Georgia.

Beyond all these general questions, there are more many more questions specific to the partner to be resolved. For instance, the above quote from the Communication on Eastern Partnership mentions the asymmetry between the EU and the negotiating partner with an implicit assumption that the EU is more open than its negotiating Eastern partners. This assumption would have made some sense in the early 1990s when the EU was more open than most of the Central European countries (except for Czechoslovakia and Estonia). But this view is far from reflecting today's reality. As shown by Table 1.2 based on the information provided by the World Trade Organization (WTO), Georgia is already much more liberal and open than the EU on five key indicators related to protection at the borders.

Table 1.2 Border protection in the EU and selected partners in 2009: Which is the most open?

	Applied tariffs (%)			WTO notifications			Services
	All goods	Agriculture	Industry	Anti-dumping	Anti-subsidy	Safeguard	under GATS
European Union	5.9 [a]	13.5 [a]	4.6	144	10	0	115
Countries under accession negotiations							
Croatia	4.9	10.7	4.0	--	--	0	126
Turkey	9.7	42.9	4.8	110	1	9	77
Macedonia	7.3	13.4	6.4	--	--	0	115
Countries with signed or ongoing DCFTA negotiations							
Korea	12.1	48.6	6.6	43	--	0	98
Ukraine	4.6	9.7	3.8	19	0	1	137
Countries willing to open DCFTA negotiations							
Armenia	2.8	6.8	2.2	--	--	0	106
Georgia	1.3	7.7	0.3	--	--	0	125
Moldova	4.6	10.7	3.7	--	--	1	147

[a] The first figure does not include the tariff equivalents of the many specific tariffs imposed by the EU on its agricultural imports.
Source: WTO Trade Profiles (website).

Table 1.2 deserves a couple of more precise points. First, Georgia does not even have anti-dumping and anti-subsidy regulations at all, while the EU is very active in these matters. Second, Georgia has no seasonal or specific tariff in the agricultural sector (since the recent elimination of those on the alcoholic beverages). In sharp contrast, the EU has many seasonal tariffs (particularly on fruits and vegetables which are products of great export

interest for Georgia) and a third of the EU tariff lines in agriculture have specific (lump-sum) tariffs. Calculating the *ad valorem* equivalents of the EU specific tariffs multiply by two the EU average tariff in agriculture, which jumps to 20-25%. This figure is only a rough estimate since as soon as the world prices in agriculture decline, the *ad valorem* equivalents of the EU specific tariffs increase mechanically.

Table 1.2 illustrates how much the Commission's language and thinking on asymmetry has not yet realized the magnitude of the recent unilateral liberalizations among some of its neighbours, and most notably Georgia, and how it has an inaccurate perception of the EU's level of openness. One could argue that Table 1.2 does not do justice to EU trade policy because it does not take into account the fact that the EU grants the Generalized System of Preferences (GSP) to most of the countries listed in Table 1.2. But, the true question here is: What is the EU's GSP worth? The answer depends on the trading partner—the EU GSP (as all GSP) is full of provisions that are sensitive to the economic conditions of the 'beneficiary'. In the case of Georgia, Chapter 3 shows that the EU GSP provides very few, if any, benefits to Georgian exporters.

1.3.2 A DCFTA partner: Is it like being an EU MS with no full market access to the EU markets, no EU aid and no say in the future EU acquis*?*

By not defining DCFTA in a precise way, the Commission makes DCFTA negotiations an open-ended process, not result-oriented. This approach generates a cascade of costly consequences for the negotiating partners *and* for the EU.

First, the current DCFTA negotiations provide no sense of fairness, transparency or predictability. To illustrate this point, Table 1.3 lists the topics ('chapters') under negotiation for accession to the EU and on DCFTA, and their timing (it would be interesting to have this information for Ukraine, but it is not publicly available). It shows no regular pattern in the timing of negotiations by partner—already a puzzling fact since the negotiating partners of the EU are not that different. Even more importantly, it shows an abyssal difference between the accession and DCFTA negotiations. In the case of the accession negotiations, the topics technical barriers to trade (TBT), sanitary and phytosanitary (SPS) measures and competition policy are scheduled at the end of the negotiations (Turkey and Croatia) or are categorized as the most difficult ones (Macedonia). And these are the topics that are those chosen as the key preconditions for opening negotiations on DCFTA with Georgia. Such

different schedules can only fuel a sense erratic behaviour from the EU negotiators and generate a sense of unfairness.

Second, the loose description of what is supposed to be a DCFTA leads to a serious problem if it happens that the DCFTA is very demanding on regulatory convergence—as is the case for Georgia (see Chapters 4 to 6).

To sum up, the key problem is as follows. A partner of the EU negotiating a DCFTA faces a balance of costs and benefits which is radically different from the balance faced by the Central European countries during the late 1990s and early 2000s. These countries were guaranteed to become EU MS. As a result, they could agree on bearing the high costs associated with the full adoption of the *acquis* for three reasons:

- they would get full access to all the EU markets,
- they would receive substantial aid from the EU for implementing the regulatory reforms, and
- once EU MS, they were guaranteed full participation in future EU decision-making.

Countries currently negotiating a DCFTA will get none of these benefits. A DCFTA partner is highly unlikely to get free access to all the EU agricultural markets—which is a serious source of bitterness for Turkey and the main reason of the current impasse with Ukraine. It will not receive the same amount of aid. Last but not least, being barred from becoming an EU MS, DCFTA 'beneficiaries' will never get type (iii) benefits, which may be the most important ones because they shape the EU *acquis* in the long run.

In short, DCFTA signatories could be described as if they were an EU MS, but one

- without full market access,
- without full EU aid and
- without voting rights in the EU decision-making.

This is clearly an unacceptable situation at a time when there is an increasing number of alternatives to an EU anchor. This is best illustrated by Turkey—with the shift from its enthusiasm for EU accession in the late-1990s to her current disillusionment, a profound deterioration of the EU image in Turkey and finally Turkey's search for a 'third way' outside a shrinking EU sphere of influence.

Table 1.3 Schedules of negotiations: Inconsistent among EU negotiating partners

	Chapters	Negotiations on accession [a]			Georgia
		Croatia	Turkey	Macedonia	
1	Free Movement of Goods	2008/07	–	4	1
2	Freedom of Movement For Workers	2008/06	–	2	
3	Right of Establishment & Freedom To Provide Services	2007/07	–	2	
4	Free Movement of Capital	2009/10	2008/12	2	
5	Public Procurement	2008/12	–	3	
6	Company Law	2007/06	2008/6	3	
7	Intellectual Property Law	2007/03	2008/6	4	1
8	Competition Policy	2010/06	–	4	1
9	Financial Services	2007/06	–	2	
10	Information Society & Media	2007/07	2008/12	3	
11	Agriculture & Rural Development	2009/10	–	3	
12	Food Safety, Veterinary & Phytosanitary Policy	2009/10	2010/06	3	1
13	Fisheries	2010/02	–	1	
14	Transport Policy	2008/04	–	3	
15	Energy	2008/04	–	3	
16	Taxation	2009/10	2009/06	3	
17	Economic & Monetary Policy	2006/12	–	1	
18	Statistics	2007/06	2007/06	1	
19	Social Policy & Employment	2008/06	–	3	
20	Enterprise & Industrial Policy	2006/12	2007/03	1	
21	Trans-European Networks	2007/12	2007/21	1	
22	Regional Policy & Coordination of Structural Instruments	2009/10	–	3	
23	Judiciary & Fundamental Rights	2010/06	–	3	
24	Justice, Freedom & Security	2009/10	–	3	
25	Science & Research	2006/06	2006/06	1	
26	Education & Culture	2006/12	–	1	
27	Environment	2010/02	2009/12	5	
28	Consumer & Health Protection	2007/10	2007/12	2	1
29	Customs Union	2006/12	–	3	
30	External Relations	2007/10	–	1	
31	Foreign, Security & Defence Policy	2010/06	–	1	
32	Financial Control	2007/06	2007/07	4	
33	Financial & Budgetary Provisions	2007/12	–	1	
34	Institutions	not relevant			
35	Other Issues	not relevant			

[a] The level of difficulty is as follows: 1. No major difficulties expected; 2. Further efforts needed; 3. Considerable efforts needed; 4. Very hard to adopt and 5. Totally incompatible with the *acquis*.

Sources: EU Commission website (Turkey and Croatia), Wikipedia (Macedonia), Government of Georgia.

Last but not least, not defining DCFTA in a precise way is clear evidence of double standards, compared to the approach that the EU MS imposed on themselves in the early years of the European integration process. A provision (Art. 8 of the Treaty of Rome) set up specific deadlines to most meet of the Treaty goals—from the strict annual tariff cuts in the 1960s to the more flexible timing for the more difficult issues (dismantling non-tariff barriers, introducing progressively new regulations in the 1970s, etc.). Since then, Arts 7c and 15 in the successive TEC versions and Art. 27 in the Treaty on the Functioning of the European Union fulfils the same role and read as follows:

> When drawing up its proposals with a view to achieving the objectives set out in Article 26, the Commission shall take into account the extent of the effort that certain economies showing differences in development will have to sustain for the establishment of the internal market and it may propose appropriate provisions.
>
> If these provisions take the form of derogations, they must be of a temporary nature and must cause the least possible disturbance to the functioning of the internal market.

It is surprising, to say the least, that the Commission chooses not to apply the benefit of such a basic and sensible provision to countries eager to be closer to the EU.

The same type of argument could be made by referring to the key EU legal principle of proportionality. There is no proportionality in the current DCFTA negotiations if *de facto* the EU partners are required to adopt large blocks of the *acquis* if not all of it in internal as well as external market areas.

1.4 A 'positive' approach to the DCFTAs: Robust, fair, predictable and beneficial

DCFTA should be defined in a positive way—by what the EU and its partner are trying to achieve in common. Neighbour countries are turning to the EU to get an additional boost to their growth and to lock in the unilateral reforms that will contribute to this. They are not primarily interested in the whole *acquis*—they are not supposed to become EU MS—but they are interested in the *acquis* that will boost their growth.

1.4.1 The pro-growth DCFTA: An integrated sequence of successive sets of commitments boosting the EU partner's growth

In such a context, a positive approach to the DCFTA would conceive of the DCFTA as a process of absorbing the EU *acquis* into an integrated sequence of successive sets of commitments, based on a breakdown of the EU *acquis* into sets of regulations (in what follows, the term 'regulations' with a small 'r' is used as a synonym for the *acquis*).

- Only the few EU regulations considered with high confidence as critical for boosting the growth of the EU partner should be part of the first set of commitments in the DCFTA process.
- The remaining EU regulations should be introduced progressively in subsequent stages as and when the economy of the EU partner is converging to the level of EU economic development.

Both sets of rules should be jointly defined by the EU and its partners—not unilaterally by the Commission. This is because each partner is different—particularly in its capacity to implement the commitments it agreed on—and because there is substantial room of manoeuvre—even for the EU regulations pertaining to the first set, such as dismantling all the key trade barriers in goods (tariffs, quotas, etc.). The need to have a negotiated list of regulations to be transposed by the EU partner flows from the fact that it is impossible for the Commission alone to identify which elements in the *acquis* would offer net benefits for the partner versus those that would involve excessive costs. Such a work requires the cooperation of the two negotiating sides since it should rely on the principle of 'mutual evaluation' that the EU is routinely implementing internally under the Services Directive—a part of the EU *acquis* that the Commission seems to have chosen to ignore.

1.4.2 The link between the successive sets of commitments: An economic definition of the transition periods

In order to integrate the successive sets of commitments, the transition periods between two sets need to be agreed. Clearly, the first set of EU unequivocally pro-growth regulations is the most urgent to negotiate and implement. The logic of the above-quoted TFEU Art. 27 would suggest a minimal amount of derogations and minimal derogatory schedules.

Transition periods are generally fixed in terms of number of years (five to seven years often being the longest derogatory periods). Such a definition does not make economic sense if only because countries like Georgia or Ukraine will still have a very low GDP per capita compared to the EU MS' GDP per capita within such a short period of time, as shown by Table 1.4.

A much better indicator for defining transition periods is the GDP per capita of the negotiating partner. Georgia would be asked to take on board the successive sets of commitments as and when its GDP per capita will reach agreed thresholds. The transposition of the *acquis* imposes mostly fixed costs. As a result, if the EU *acquis* would amount to 5% of Georgia's GDP in 2010, it will cost less than 2% in 2030 (at a 5% annual growth rate) or in 2020 (at a 10% annual growth rate) as shown by Table 1.4.

Table 1.4 Growth rates and GDP per capita in Euros

Years	EU [a]	Georgia's growth rate			
		2%	5%	7%	10%
2010	32878	2520	2520	2520	2520
2020	40078	3072	4105	4957	6536
2025	44249	3392	5239	6953	10527
2030	48855	3745	6686	9752	16953
2035	53940	4134	8534	13677	27303
2040	59554	4565	10891	19183	43972

[a] The EU is supposed to grow at an annual average growth rate of 2%.

Such an approach ensures that both DCFTA signatories have an interest in high growth rates. It ensures that the transposition of the EU *acquis* is always pro-growth—a crucial benefit for the EU partner. The EU has also a strong interest in such an approach. Rushing in transposing the EU *acquis* into the laws of unprepared partners has often been a source of deep disillusions in the past. In sharp contrast, the GDP per capita criterion is:

- *Robust in fixing commitments* in the future: no EU partner would be willing to slow down its growth just to not fulfil agreed commitments—all the more so if these commitments are supportive of sustainable reforms and of growth.
- *Predictable*: everybody will know in advance when the EU partner's GDP per capita will be close to reach the targeted level, hence they could start to prepare the transposition of the coming set of commitments; and
- *Fair*: all the DCFTA candidates will be subject to similar thresholds.

In passing, it is useful to note that this approach echoes the two first successful decades of the implementation of the Treaty of Rome.

2. THE FORGOTTEN PRECONDITION: VALUING EU NEIGHBOURS

Summary

1. In its current discussions with Georgia, the Commission is focusing heavily on regulatory matters. It is thus important to have a fresh look at the effective regulatory quality of Georgia compared to the EU member states and the other EU Eastern neighbours. This fresh look is provided by four sets of measures of regulatory quality:

- Ease of doing business (from the International Finance Corporation),
- Transition path (from the European Bank for Reconstruction and Development),
- Foreign direct investment performances (from the World Bank) and
- Corruption index (from Transparency International).

2. All these measures converge to show that Georgia fares well compared to other EU countries, including to the seven 'cohorts' of EU member states (member states aggregated by their time of accession). This result reflects the depth of Georgia's unilateral reforms, which rely on three pillars:

- Almost no tariffs in manufacturing and very moderate tariffs in agriculture,
- No barriers to foreign direct investment into the whole Georgian economy and
- A full recognition of the technical norms used by OECD (and NIS) countries, a feature that makes Georgia a much stronger enforcer of the EU 'mutual recognition' principle than the EU itself.

3. All these features make Georgia the best candidate for a DCFTA model—an opportunity that the Commission is wasting with its preconditions, as shown in the following chapters.

Since the current discussions between Georgia and the Commission deal entirely with regulatory issues, this chapter compares, on the basis of the latest available information, the regulatory quality of the EU MS, Georgia and a few other selected neighbours. It shows that the current situation is very different from the situation two decades ago. The Financial Crisis has revealed serious flaws in the EU's regulatory framework, notably for financial markets. Public opinion in the EU is increasingly questioning the European integration process in its present form, and the EU's neighbours are not buying the 'EU model' as easily as they once did. Moreover, some EU neighbours have considerably improved their own governance to the point of showing better regulatory performances than some EU MS (and not necessarily the smallest or the most recent ones)—a point that the Commission completely ignores in its approach to discussions with Georgia.

The current Commission's approach on the transposition of the EU *acquis* into the partner's legal regime relies on two basic (and false) assumptions:

- that regulatory quality, which is the targeted objective, depends exclusively on adopting EU regulations (but these are only one factor for achieving regulatory quality); and
- that 'one size fits all' in regulatory matters (and denies the possibility that the targeted objective could be achieved by different regulations in different countries).

This chapter provides evidence that these two propositions are not supported by the available measures of regulatory quality presented in Tables 2.1 to 2.4, reinforcing results already available elsewhere [Messerlin, 2008]. Of course, all these measures presented below have limits—it is very hard to measure regulatory quality. Nevertheless, they are based on indicators that capture monetary, time or workload costs in a very precise way and which often converge and are supported by anecdotal evidence. Rejecting such a body of evidence without providing better alternative measures of regulatory quality is simply not an acceptable argument.

2.1 Focusing on the 'ease of doing business'

Growth requires that doing business is made easy, and a DCFTA should be very careful to avoid making business more difficult. Table 2.1 presents the ranking of countries in terms of regulatory quality in 2010 provided by the International Finance Corporation's "Doing Business" database [IFC, 2010].

It shows only the global indicator (G) of Ease of Doing Business and the nine sub-indicators (S1 to S9) on which the global indicator G is based (it does not show the 36 basic indicators used to calculate the nine sub-indicators).

Table 2.1 'Ease of doing business 'in selected countries, 2010

	Ease of doing Busines G	Starting a Business S1	Dealing with Cons-truction Permits S2	Registering Property S3	Getting Credit S4	Protecting Investors S5	Paying Taxes S6	Trading Across Borders S7	Enforcing Contracts S8	Closing a Business S9
EU cohorts										
EU-1958	38	59	112	65	46	72	92	83	48	105
EU-1973	6	18	54	26	28	70	44	17	27	63
EU-1980s	63	118	21	43	11	14	12	14	30	7
EU-1995	20	65	102	77	11	44	118	78	71	93
EU-2004a	50	67	87	58	49	80	99	60	69	45
EU-2004b	21	59	53	109	60	79	64	31	37	29
EU-2007	51	44	70	79	75	97	73	55	55	30
Countries under accession negotiations										
Croatia	84	56	132	110	65	132	42	98	47	89
Turkey	65	63	137	38	72	59	75	76	26	115
Macedonia	38	5	136	69	46	20	33	66	65	116
Countries under DCFTA negotiations										
Ukraine	145	118	179	164	32	109	181	139	43	150
Countries willing to open DCFTA negotiations										
Armenia	48	22	78	5	46	93	159	82	63	54
Georgia	12	8	7	2	15	20	61	35	41	105
Moldova	90	94	159	18	89	109	106	141	20	92

Source: IFC (2010). Cohorts of EU MS are defined by the year of accession. The rank for each EU cohort is the unweighted average of the EU MS pertaining to the same cohort.

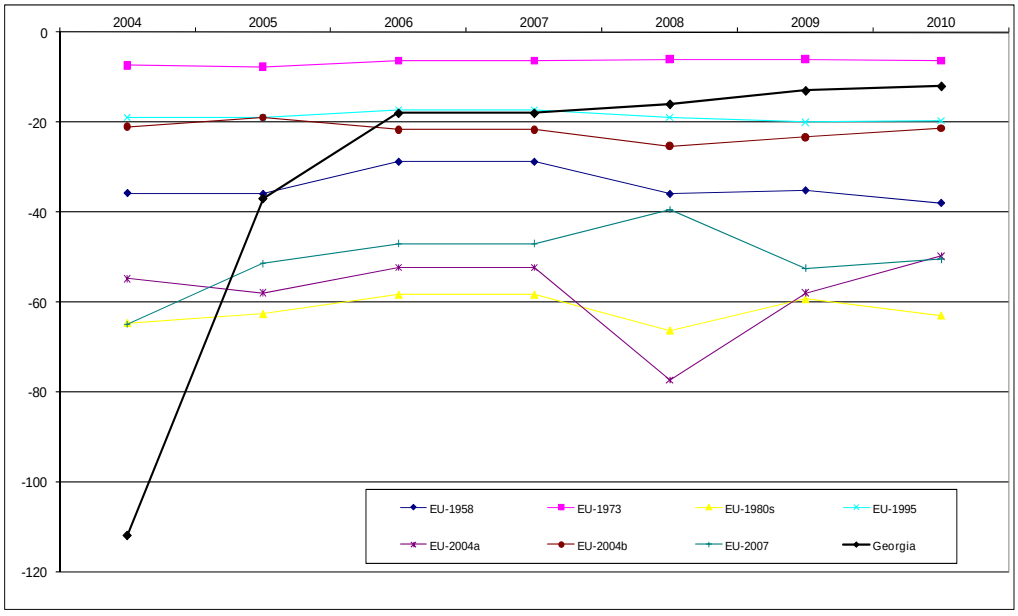
As in all the following tables, Table 2.1 splits the EU in seven 'cohorts' defined by the date of accession of their respective EU MS in order to get a sense of the regulatory quality associated with adoption of the *acquis*. More precisely, the 10 Central European countries that joined the EU in 2004 have been divided into two groups: the three Baltic EU MS (EU-2004b) and the seven other Central European EU MS (EU-2004a).

Table 2.1 provides a striking first result. Non-EU countries can have a (much) better rank than some EU cohorts. The best illustration is Georgia, which comes just behind the leading cohort EU-1973 for the global indicator (indicator G) and even ahead of this leading EU cohort for a majority of the basic sub-indicators (S1 to S5). Comparing the performances of Georgia and Ukraine underscores how much the Commission's policy is erratic: it did open DCFTA negotiations with Ukraine without

preconditions, whereas this country is the worst-performing state by almost all measures, while for Georgia it dictated a huge battery of preconditions.

It is then interesting to get a sense of the evolution of these indicators over time. For the sake of conciseness, Figure 2.1 presents only the evolution of the global indicator G over the last seven years. It reveals the rapid ascent of Georgia compared to the various EU cohorts between 2004 and 2006, with a slower but continuous improvement since 2007 until today.

Figure 2.1 The global indicator "Ease of Doing Business" in selected countries, 2004-2010



Source: IFC (2010). Cohorts of EU MS are defined by the year of accession. The rank for each EU cohort is the unweighted average of the EU MS pertaining to the cohort.

Figure 2.1 provides a crucial lesson on the regulatory quality of the EU MS themselves: the *acquis* is far from the dominant determinant of regulatory quality. This lesson relies on two observations:

- There are huge differences in terms of regulatory quality among the EU MS themselves, and these differences tend to be very stable over time (with a couple of exceptions).

- The founding EU MS which by definition have had the longest exposure to the *acquis* are not leaders in terms of regulatory quality; some recent EU MS have been able to catch up very quickly despite the fact that they have been exposed to the *acquis* a much shorter period of time, as best illustrated by the Baltics (EU 2004b).

These observations suggest that adopting the *acquis* is not a necessary nor a sufficient condition for achieving regulatory quality. They also challenge the conventional wisdom in two fundamental ways: They call into question the way in which the EU builds its *acquis*. And they undermine the assumption that a massive adoption of the *acquis* by EU neighbours delivers regulatory quality. They also suggest that two often-neglected aspects play a crucial role: the appropriate choice of the parts of the *acquis* to be transposed by the negotiating partner, and a thorough implementation of this *acquis* by the partner. In short, the quality in domestic implementation counts more than the quantity of imported regulations.

Table 2.2 Transition scores in selected countries, 2010

	Private sector share of GDP [a]	Enterprises			Markets and trade			Financial institutions		Infrastruc.
		Lg-scale privati-sation	Sm-scale privati-sation	Enterprise restruc-turing	Price libera-lisation	Trade & forex system	Competition Policy	Banking reform & interest rate liberalisat'n	Securities & non-bank financial institutions	Overall reform
EU cohorts										
EU-2004a	76	3.7	4.3	3.5	4.2	4.3	3.2	3.6	3.4	3.4
EU-2004b	75	3.9	4.3	3.2	4.3	4.3	3.4	3.8	3.3	3.1
EU-2007	73	3.8	3.8	2.7	4.3	4.3	3.0	3.5	3.0	3.2
Countries under accession negotiations										
Croatia	70	3.3	4.3	3.0	4.0	4.3	3.0	4.0	3.0	3.0
Turkey	70	3.3	4.0	2.7	4.0	4.3	2.7	3.0	2.7	2.7
Macedonia	70	3.3	4.0	2.7	4.3	4.3	2.3	3.0	2.7	2.7
Countries under DCFTA negotiations										
Ukraine	65	3.0	4.0	2.3	4.0	4.0	2.3	3.0	2.7	2.3
Countries willing to open DCFTA negotiations										
Armenia	75	3.7	4.0	2.3	4.3	4.3	2.3	2.7	2.3	2.7
Georgia	75	4.0	4.0	2.3	4.3	4.3	2.0	2.7	1.7	2.7
Moldova	65	3.0	4.0	2.0	4.0	4.3	2.3	3.0	2.0	2.3

[a] Indicators are scaled from 0 (lowest score) to 4+ (highest score).

Source: EBRD 2010.

2.2 Focusing on the transition path

A DCFTA should primarily aim at being useful for the EU neighbours. As a result, any negotiations should recognize the strengths and the weaknesses of the transition path of the EU neighbours.

Table 2.2 summarizes the information on the transition paths of the Central European EU MS and of the EU neighbours based on the EBRD transition indicators, which are divided in four main items: enterprises, markets and trade, financial institutions and infrastructure.

Table 2.2 scores should be interpreted with a sense of time. Key reforms in Georgia have been adopted in 2004-06 (see Figure 2.1 above). Hence, the scores achieved by Georgia rely on reforms put in place six to seven years ago at most, while the scores in the Central European EU MS rely on reforms initiated in the early- and mid-1990s. In order to take into account these time lags, it is useful to know when the Central European EU MS achieved a score equivalent to those recorded by Georgia. If one takes into account this time dimension, Georgia exhibits equivalent performances to the EU-2004a and EU-2004b (and 5 to 6 years faster than the EU-2007) for enterprise restructuring and competition policy—the only two scores for which Georgia has not yet reached or surpassed the EU MS scores if one leaves aside the financial sectors, which are hard to compare after the 2008 crisis.

Finally, Table 2.2 shows that the main domain where Georgia is lagging behind is overall infrastructure reform (telecommunications, railways, electric power, roads and water). If the DCFTA is conceived as a boost for growth, this is the sector that should be at the heart of the negotiations between the EU and Georgia. As underscored in Chapters 3 to 6, the preconditions imposed in the dire circumstances of Spring 2009 are very far from focusing on the infrastructure sectors that are the most critical for Georgia's future growth.

2.3 Focusing on foreign direct investment performances

A crucial factor for promoting growth is foreign direct investment (FDI)—hence the key role of the regulations allowing foreign companies to establish or acquire local firms. Table 2.3 provides indicators from the World Bank tracking restrictions on foreign equity ownership in 11 aggregated sectors (based on 33 sub-sectors). It clearly leads to the same kind of conclusions as the previous tables. In particular, it shows that EU MS—particularly the oldest ones—tend to have restrictive regulations in certain sectors (light manufacturing, electricity, transport and media). By contrast, Georgia emerges as a country with no restrictions in any sector.

Table 2.3 Restrictions on foreign direct investment in selected countries, 2010

	Mining, oil and gas	Agriculture and forestry	Light manufac-turing	Telecom	Electricity	Banking	Insurance	Transport	Media	Construction, tourism, retail	Health care, waste mana-gement
EU cohorts											
EU-1958	100	100	80	100	100	100	100	60	20	100	100
EU-1973	100	100	83	100	100	100	100	80	100	100	100
EU-1980s	100	100	100	100	50	100	100	45	50	100	100
EU-1995	100	100	100	100	71	100	100	80	75	100	100
EU-2004a	100	100	100	100	100	100	100	73	92	100	100
EU-2004b	--	--	--	--	--	--	--	--	--	--	--
EU-2007	100	100	100	100	100	100	100	80	100	100	100
Countries under accession negotiations											
Croatia	100	100	100	100	100	100	100	69	100	100	100
Turkey	100	100	100	100	79	100	100	69	63	100	100
Macedonia	100	100	100	100	100	100	100	80	100	100	100
Countries under DCFTA negotiations											
Ukraine	100	100	83	100	100	100	100	80	15	100	100
Countries willing to open DCFTA negotiations											
Armenia	75	50	100	100	100	100	100	56	100	100	100
Georgia	100	100	100	100	100	100	100	100	100	100	100
Moldova	100	100	100	100	100	100	100	100	75	100	100

Note: The figure "100" means no restrictions on foreign direct investment.
Source: World Bank, Investing across Borders, 2010 (website).

Here again, the main lesson is that the DCFTA should at any cost avoid introducing, directly or indirectly, restrictions on Georgian regulations on foreign direct investment since FDI is so crucial for Georgia's growth, in particular for improving its infrastructure. Interestingly, this point should be of utmost importance for the EU development and aid communities.

2.4 Focusing on corruption

Corruption is a sure sign of badly regulated markets combined with in effective police and judicial systems. The first element (malfunctioning of markets) can be addressed relatively quickly if there is political will for regulatory reforms. Improving police and justice is much more difficult and requires more time. With these two aspects in mind, it seems interesting to have a look at the corruption perception index developed by Transparency International. Table 2.4 and Figure 2.2 provide the annual ranks during the nine last years as well as the change over the whole period.

Table 2.4 shows that two contrasting evolutions. On the one hand, only two countries show a strong decrease in the ranking of their corruption index: Macedonia and Georgia. On the other hand, most of the selected countries—including EU MS—exhibit worrisome increases in the ranking. Some increases are continuous (for instance, the EU-1958) while others are brutal and sharp (for instance, the EU-1980s). As a result of its own improvement and of the deterioration of the situation in many EU MS, Georgia, which showed the highest level of corruption in 2004, shows now

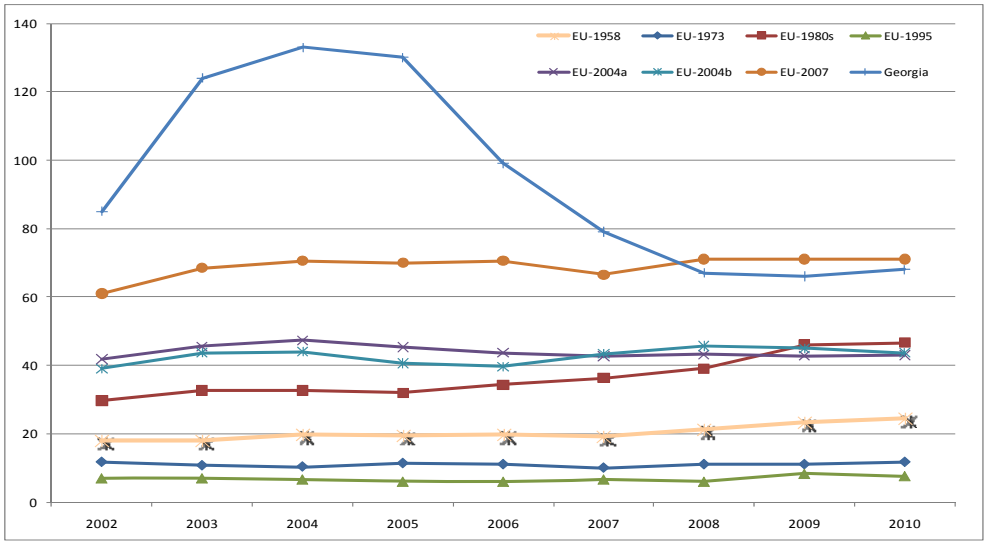
a lower ranking of perceived corruption than the EU-2007 (and than Greece and Italy, if one looks at individual EU MS). Figure 2.2 illustrates this dramatic change in Georgia's relative position.

Table 2.4 Corruption indicators, selected countries, 2010

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2010/ 2002[a]
EU cohorts										
EU-1958	18	18	20	20	20	19	21	23	25	36.1
EU-1973	12	11	10	11	11	10	11	11	12	0.0
EU-1980s	30	33	33	32	34	36	39	46	47	57.3
EU-1995	7	7	7	6	6	7	6	8	8	9.5
EU-2004a	42	46	47	45	44	43	43	43	43	2.9
EU-2004b	39	44	44	41	40	43	46	45	44	12.0
EU-2007	61	69	71	70	71	67	71	71	71	16.4
Countries under accession negotiations										
Croatia	51	59	67	70	69	64	62	66	62	21.6
Turkey	64	77	77	65	60	64	58	61	56	-12.5
Macedonia	--	106	97	103	105	84	72	71	62	-41.5
Countries under DCFTA negotiations										
Ukraine	85	106	122	107	99	118	134	146	134	57.6
Countries willing to open DCFTA negotiations										
Armenia	--	78	82	88	93	99	109	120	123	57.7
Georgia	85	124	133	130	99	79	67	66	68	-20.0
Moldova	93	100	114	88	79	111	109	89	105	12.9

[a] 2003 serves as the base year for Armenia and Macedonia.
Source: Transparency International [2010].

Figure 2.2 The evolution of the level of corruption in selected countries, 2002-10



Data source: Table 2.4.

The lesson to be drawn from these indicators on corruption is that the EU-Georgia DCFTA should avoid at any cost creating the complex web of regulations that would fuel the return of corruption. The fight against corruption is one of the most difficult fights that any government can get into, and any relapse in these matters makes things much worse—hence the extreme sensitivity of the Georgian authorities to this issue.

That said, it is hard to explain the increase in the level of corruption in the EU MS without taking into account—as one factor—the increased number and complexity in terms of content of the EU regulations. For instance, the EU's tendency to offer tariff quotas for agricultural products in FTA negotiations, as currently in the case of Ukraine, is a clear example of inciting corruption in the distribution of the quotas. This should also be a point of utmost importance for the EU development and aid communities, which have fully realized how crucial for growth and development are the best practices of good governance.

2.5 Concluding remarks

A better understanding of the effective performances of the EU and its Eastern neighbours in terms of regulatory quality is itself a critical precondition for defining realistic goals for the DCFTA process. Negotiating a DCFTA should be the opportunity to list and address the remaining major weaknesses of the EU's neighbours rather than to impose a straight jacket of new and pre-defined (and often artificial, as shown in the following chapters) constraints on the partners. In this way, the DCFTA would be a much better instrument of development policy for the EU neighbours—as well as a much better instrument of foreign policy for the EU.

Georgia in particular is seen under multiple indicators to be achieving results comparable to various groups of EU MS without so far applying the EU *acquis*. Yet it is still subject to pre-conditions that oblige it to implement regulations that cost-benefit analysis would not justify—as the next chapters show.

PART II. AN ANALYSIS OF THE FOUR KEY PRECONDITIONS IMPOSED BY THE COMMISSION ON GEORGIA

Part II focuses on the key points of the current discussions between the Commission and Georgia.

Chapter 3 describes the 11 preconditions of which four are considered as key by the Commission, despite the fact that they consist of imposing the most difficult and complex parts of the *acquis* on a country three times poorer than Bulgaria. It also tries to explain what could have been the motives for such a damaging choice.

The other chapters analyze the preconditions in technical barriers to trade (Chapter 4), in sanitary and phytosanitary measures (Chapter 5) and in competition policy and intellectual property rights (Chapter 6). The chapters assess the costs imposed by these pre-conditions—not only the administrative costs, but more importantly the costs on Georgian producers and consumers. They also make proposals for shaping a pro-growth DCFTA.

3. THE FOUR KEY PRECONDITIONS: WHY SUCH A DAMAGING CHOICE?

Summary

1. Out of the 11 areas on which the Commission focuses its 'recommendations' (i.e. preconditions), the most closely trade-related ones would have been the logical choice for preconditions (if any) for opening DCFTA negotiations, but these were not chosen. It is worth noting that these most clearly trade-related preconditions would have required a lot of effort from the EU a lot of effort, but none from Georgia because:

- In agriculture, Georgia has moderate, *ad valorem* and non-seasonal tariffs, whereas the EU has high tariffs, many of which are specific and / or seasonal.
- In manufacturing, Georgia has almost no tariffs, no anti-dumping and no countervailing procedures, whereas the EU grants to Georgia a largely worthless GSP+ regime and is a regular user of anti-dumping and countervailing measures.

2. Instead, the Commission decided to require a massive transposition of the EU *acquis* into Georgian law in four regulatory areas: technical barriers to trade, sanitary and phytosanitary measures, competition policy and intellectual property rights. As the EU *acquis* in these areas is well known for its complexity, its transposition will be a huge burden on Georgia's growth. This raises the question of why the Commission has made such a choice. Three reasons are examined in more depth:

- the Commission's insistence on controlling tightly the timing of the negotiations,
- the Commission's determination to impose an 'unequal treaty' and
- the Commission's insistence on following the recommendations of the feasibility study. However, a close examination of this study shows that it rests on outdated data, and that updated data would have provided the opposite recommendations—favouring a simple FTA over a DCFTA.

3. The Commission's preconditions have been presented in two texts: the 2009 Matrix and the 2010 Document. The study shows that the 2010 Document is a breach of the 2009 Matrix and is of lower legal status. As a result, the study considers that the only legitimate preconditions to be met by Georgia are those included in the 2009 Matrix. Its proposals in the following chapters are based on this conclusion.

Chapter 2 showed Georgia as one of the steadiest reformers in the EU Eastern and Southern neighbourhood, with impressive performances from the reforms undertaken—often better than those achieved today by a variety of old and new EU MS. That makes Georgia the best trading partner that the EU could dream of for building a 'DCFTA model' capable of: i) boosting growth of the EU's neighbours and ii) establishing the EU's reputation as an attractive anchor at a time where the EU is facing increasingly credible challengers for such a role.

With this background in mind, this chapter presents an overview of the preconditions imposed by the Commission on Georgia. It is organized as follows. Section 1 describes the impressive list of 11 preconditions included in the Commission's Matrix presented in March 2009 (the '2009 Matrix'). Section 2 presents briefly the four preconditions that are imposed by the Commission for launching the DCFTA negotiations. Section 3 discusses the various possible motives on the part of the Commission for imposing such a choice. Section 4 examines the feasibility study on an EU-Georgia DCFTA. It shows that that this study rests on outdated data, and that updated data would have provided opposite recommendations—favouring a simple FTA over a DCFTA.

3.1 The Commission's March 2009 Matrix of preconditions

In its 2009 Matrix, the Commission identified 11 issues as preconditions [4] to the launching of DCFTA negotiations:

1. Overall coordination negotiating mechanism
2. Tariff and non-tariff barriers (NTBs)
3. Technical barriers to trade (TBTs)

[4] The Commission's Matrix and 2010 Document use the term "recommendation", not precondition. However, the imperative tone and the detailed content leave no room for doubt that these recommendations are preconditions.

4. Sanitary and phytosanitary (SPS) measures
5. Trade facilitation and customs administration
6. Rules of origin
7. Services and investment
8. Intellectual property rights (IPRs)
9. Public procurement
10. Competition
11. Sustainable development (social and labour issues; environment).

The list is impressive. One wonders what additional concessions Georgia could conceivably grant to the EU during the DCFTA negotiations per se, having already met these preconditions with its accession to the World Trade Organization (WTO). Georgia has so few and low border barriers in trade and free foreign direct investment. Moreover, these preconditions have two features:

- They are totally asymmetrical: there is no precondition for the EU, such as eliminating EU tariffs, which are (much) higher than the Georgian tariffs.
- They are unprecedented in depth: they consist of a complete alignment of Georgian law to a large, very complex, part of the EU *acquis* (including some regulations that EU MS only started to implement in January 2010), despite the fact that Georgia never asked to join the EU.

The chapter leaves aside these important features. And, for the sake of the following discussion, it also accepts the principle—never justified by the Commission—that Georgia should meet preconditions before negotiating a DCFTA, whereas no such preconditions have been imposed on other EU neighbours.

Taking the above list of preconditions as granted, the logic would have been to choose those which are the most 'trade-related' since after all, a DCFTA is first and foremost a free trade agreement. These topics are unquestionably the points 2 (tariffs and NTBs) 5 (trade facilitation) and 6 (rules of origin). This choice would have also been consistent with the EU's own history, a key point if the EU wants to establish its reputation as a fair anchor: after the dismantlement of the intra-EEC tariffs in the 1960s, NTBs, trade facilitation and rules of origin were the bread and butter of the intra-EEC integration process during the 1970s and the 1980s.

3.2 The Commission's four preconditions for launching DCFTA negotiations

As stated above, the Commission decided unilaterally to choose a totally different set of topics. It decided to impose as key preconditions—meaning those that it intends to use to determine whether Georgia is ready for DCFTA negotiations or not—the transposition of the EU *acquis* in technical barriers to trade (TBTs, topic 3), sanitary and phytosanitary measures (SPS measures, topic 4), intellectual property rights (IPRs, topic 8), and competition policy (topic 10) into Georgian law. It is worth noting that this choice is totally at odds with the EU's own history: these four topics have been at the core of the EU Internal Market only at a late stage, roughly from the mid-1980s to today (SPS measures and TBTs are still topics raising a lot of issues within the EU).

Table 3.1 The structure of the 2009 Matrix

	Georgia's preparedness for DCFTA negotiations	Georgia's preparedness to implement and sustain the future DCFTA
	A	B
"Key priorities": "issues where Georgia to show progress to enable the Commission to conclude that it is sufficiently advanced in its preparation for the negotiating process of a DCFTA with the EU"	1	3
"Additional recommendations": "additional actions aiming at facilitating future negotiations of a DCFTA with the EU"	2	4

Source: Interviews. The Strategy Papers of the Government of Georgia.

It is important to underscore the very complicated structure and abstruse language of the 2009 Matrix illustrated in Table 3.1. Column A describes what needs to be done before the start of the DCFTA negotiations and column B what needs to be done between the beginning of the negotiations and their end. One wonders why these two columns could have not received a clearer title. One explanation could be the frequent lack of clarity

of EU official texts. An alternative explanation could be that the Commission did not want such a clarity because it would make more visible the breach of the initial 'contract' when shifting elements from Column B to Column A (as was done in the 2010 Document, see below). Whatever the reason, the distinction between key priorities and additional requirements combined with an often-repetitive language add many additional possibilities of blurring the borders among the four cells.

The Commission's choice is astonishing, to say the least, because it raises three huge problems which are examined in detail in Chapters 4 to 6.

- This choice is not development friendly. It imposes the transposition of a massive share of the most complex parts of the EU *acquis* on Georgia, that even rich EU MS (with a GDP per capita up to 15 times higher than Georgia's and with more than 20 years of experience in the EU *acquis*) have still difficulties to implement. As documented in Chapters 4 to 6, this choice inflicts unnecessary high costs on the fragile Georgian economy. But, their highest cost would be to divert Georgia's efforts away from growth and development concerns.
- This choice is an economic mistake. The Commission's choice will not bring any notable benefit to EU firms, and it may indeed favour firms from third countries, particularly from the emerging economies. This result—surprising at a first glance but explained in detail in Chapters 4 to 6—flows largely from the fact that the Commission has miscalculated the consequences of the three crucial Georgian unilateral reforms—almost no tariffs in industrial products, free foreign investment and unconditional mutual recognition of all the technical norms of the OECD countries.
- This choice is highly damaging for the EU's world reputation since it reveals an insensitivity on the part of the EU to the demands of its neighbours. This is all the more the case because the Commission imposes the transposition of the EU *acquis* in a compelling tone quite inappropriate in a negotiating context, and because it does not hesitate to impose detailed administrative structures and to insist on increasing public budgetary expenses—as if little has been learnt in the EU about the costs of excessive public expenses.

3.3 The status of the 2010 Document

The burden of this choice on Georgia has been made much heavier by a recent Commission document dated December 2010 (hereafter the 2010 Document) for the two following reasons:

- The Document shifts some of the preconditions that the 2009 Matrix presents as to be met after the opening of the negotiations into the list of preconditions to be met before the launching of these negotiations.
- It states the preconditions in a fuzzy, open-ended language, such as "a credible and adequately funded programme", "initial progress should be made", "carries out this implementation effectively and properly", etc. Such open-ended language gives no clue as to when such preconditions are satisfied, or not—and hence gives the Commission absolute power to decide whether the preconditions are met or not.

In short, the risk of 'moving targets', which was present since the beginning of the discussions between Georgia and the Commission (as shown in the previous section), has surfaced in the 2010 Document which, in many respects, is breaching the 2009 Matrix.

The following list gives the most important additional requirements included in the 2010 Document that are outside the scope of the four key 2009 Matrix preconditions (the additional requirements specific to the key preconditions are documented in the appropriate chapters):

- Requirements to impose a much tightened negotiating mechanism (institutions in charge, mechanisms of coordination, number and quality of staff available, etc.). These requirements contrast sharply with the absence of information and transparency of how the Commission's negotiating machinery works. This is all the more important in the four key preconditions because DG TRADE is not the leading Commission service in any of them: DG COMP is the leading service for competition policy, DG ENTR for TBTs and IPRs, DG AGRI and DG SANCO for SPS measures. Moreover, these four areas have a strong EU MS component in terms of both competences and implementation. Indeed, the terms that the 2009 Matrix and the 2010 Document use for stating some preconditions (for instance, on competition policy) are so open to misinterpretations that one wonders whether the competent Commission services have been sufficiently consulted.
- Requirements to increase the expenses (investments and staff) in the 2011 Georgian State budget on the ground that the current funding for the institutions imposed by the DCFTA preconditions are insufficient. These requirements are open-ended since they are not

accompanied by any justification of how insufficient the expenses scheduled for 2011 are, and by any indication on what would be the 'adequate' level of expenses. It is also hard not to make a comparison between these requirements and the endless exhortations by the Commission to trim down public expenditures in the EU.

- Requirements concerning Georgia's plan for the overall Civil Service reform on the ground that these plans are "largely divergent from the EU standards", without describing the EU standards in question (if there are any), the reasons for which they are preferable and the precise cases of divergence. Last but not least, this reform is outside the scope of a possible DCFTA, and it is not even within the scope of the *acquis*.
- Introduction of a twelfth item in the above list concerning a "dispute settlement", with no detail on its possible goal(s), scope of issues, composition, etc. Moreover, it is hard to see the logic of mentioning a dispute settlement for an agreement the negotiations of which have not even started.
- Repeated requirements to "ensure sufficient involvement of all the relevant stakeholders", an expression that suggests a wide range of organizations (businesses, NGOs, etc.). These requirements deserve three remarks. First, the fact that the Commission has never made public its 2009 Matrix or its 2010 Document suggests that it has not followed this rule on its own side. Second, as stressed above, consumers are mentioned only once. Last but not least, in the precondition on IPRs, the 2009 Matrix does not mention all stakeholders, but only "right holders"—suggesting that the concerns of the Commission are the commercial interests of EU (and non-EU) firms with IPR interests rather than the Georgian consumers.

It is not acceptable that a text with a much lower legal status (a simple letter) introduces so many changes in a text adopted unilaterally by the Commission a year before. As a result, while the rest of this study will document the many breaches introduced by the 2010 Document, it will consider the 2009 Matrix as the only legitimate text. That means that the study is assessing whether Georgia has met the preconditions on the relevant subsets of preconditions in the Matrix, and that it will make proposals with respect to the 2009 Matrix.

3.4 What are the possible motivations behind the Commission's damaging choice?

The Commission's choice raises a question that can no longer be ducked: what could be the motive(s) behind its choice—assuming that it really wants to negotiate a DCFTA with Georgia (a given assumption in this study, despite the strong evidence to the contrary). This section examines three possible general motivations.

3.4.1 Driven by vision or by routine?

The first motive to examine is whether the Commission is moved by the vision to work for the best interests of the Georgian consumers. A simple exercise on the 2009 Matrix and the 2010 Document gives an icy answer: the term "consumers" (which the literature on economic welfare considers as the critical economic operator) is mentioned only once in the two texts, whereas the terms "producers", "farmers", "right-holders" (in the IPR area) are mentioned several times in each text.

At the other end of the spectrum, a more convincing motive is the routine assumption that the EU regulations are the best of the world. Indeed, a striking feature of the 2009 Matrix and the Document is that they do not leave room for tailor-made options. Both the 2009 Matrix and the 2010 Document produce an one-size-fits-all list of measures that Georgia is asked to adopt because the EU MS have adopted them during the last 50 years. They show not even a serious effort to use the rich experience embodied in recent EU law and practices, and their capacity to provide innovative solutions that would be costless for Georgia.

3.4.2 Controlling tightly the timing of the negotiations?

Another motive could be related to negotiating concerns. The four preconditions may be a tactical manoeuvre of the Commission for tightly controlling the timing of the DCFTA negotiations. One possible reason for such a motive is Russia's accession to the World Trade Organization (WTO). The Commission may want to start the negotiations on the DCFTA only after Russia's WTO accession in order to put pressure on Georgia's position in the WTO. But this is speculation, and since it is not an argument heard publicly, we pursue it no further.

However the time control (or delay) motive is reinforced by the fact that, while Georgia has been in the course of implementing the initial list of

preconditions included in the 2009 Matrix, the 2010 Document has introduced many additional and loosely worded preconditions, making the whole process of preparing for DCFTA negotiations a 'moving target' exercise.

The 2009 Matrix and the 2010 Document deserve a final comment. They contain many references to an "EU model" or "standard" without specifying what this model or standard consists of. This claim does not fit the reality, in particular when institutional issues are at stake. The chapter on competition policy presents the wide diversity among EU MS competition authorities. The same could be done for the institutions in charge of TBTs, SPS measures or IPRs.

This permanent reference to the EU model is a very awkward and worrisome feature. It is awkward because it tends to suggest that Georgia would become a kind of 'clone Member State', while any prospect of EU accession is ruled out. And it is worrisome from the EU constitutional perspective. It shows the Commission setting abstract standards in areas where the Treaty and the practice give to the Commission a secondary role compared to the role of the EU MS.

3.4.3 Twisting arms: Unequal preconditions?

The other rationale behind the choice of the key preconditions related to negotiating tactics goes much beyond economics since it boils down to a pure *rapport de force*. The Commission uses the fact that Georgia was a *demandeur* of a FTA, and a very small one, as grounds for imposing severe constraints on Georgia, and none on the EU.

By contrast, the alternative choice of trade-focused conditions (NTBs, trade facilitation and rules of origin), which has been mentioned above as the most logical one in an FTA context, would have imposed preconditions on the EU more than on Georgia. In particular, such a choice would have required that the EU would open its markets to Georgia to the same extent that, following its WTO commitments, Georgia has already opened its markets to the EU—in other words that the EU should go much further than granting the GSP+ status (for detail, see section 4).

The current Commission's approach based on 'unequal preconditions'—no concession from the EU, deep concessions for Georgia—are not a good omen for the final treaty. They could easily drift into an unequal treaty, or a failure to agree on a DCFTA, or a failure to implement it.

Perhaps the Commission has made this choice in the belief that the potential costs for the EU of such bullying tactics are small because Georgia

is small. If this is the case, it misses the key foreign policy dimension, that is, the reputational damage of these negotiations for the EU's foreign policy.[5] The EU badly needs a success story for its Eastern Partnership, which so far has been unable to deliver any substantial outcome. In this respect, the political gains of a success are much larger than the size of the Georgian economy. They are especially important for the EU in the current multi-polar world with emerging challengers to the EU even in its neighbourhood.

3.5 The feasibility study: Based on outdated information

As stated in the introduction, the option of an FTA (not a DCFTA) was included in the 2006 European Neighbourhood Action Plan (ENP) pending the results of a feasibility study. This study [CASE, 2008] was released a few months before the Commission's fact-finding mission, and hence it may have influenced this mission and its aftermath. This explanation is all the more plausible because the feasibility study's key conclusions are as follows:

- a simple FTA would not provide notable benefits to Georgia;
- a trade agreement beneficial to Georgia should be "deep and comprehensive", a conclusion that happens to be in line with the pre-existing Commission decision to impose DCFTAs on its Eastern neighbours (see chapter 1) and
- the study interprets a DCFTA as the need for Georgia to fully adopt the EU *acquis*, in particular in TBTs, SPS measures and competition policy.

To reach these conclusions, the study relies on computable general-equilibrium (CGE) calculations, which show that the benefits from a simple FTA are significantly smaller than those from a DCFTA.

These conclusions raise a basic question, however: to what extent are they robust? What follows shows that the results of the CGE calculations rely entirely on the magnitude of two basic indicators: the level of the EU tariffs applied on imports from Georgia and the level of the Georgian border and standard costs (the feasibility study uses this expression as a generic term

[5] Unfortunately, this would not be the first time, as best illustrated by the reputation left by the yet unfinished negotiations with the African, Caribbean and Pacific countries.

for TBTs and SPS measures). The CGE results are thus robust to the extent that the values of these two indicators in the CGE calculations reflect correctly the situation of the Georgian economy.

Our analysis shows that this is not the case. The data used for these two indicators in the CGE calculations are too old to take into account the consequences of the dramatic Georgian reforms. Using up-to-date data suggests a totally opposite result to the one provided by the feasibility study: a simple FTA with the EU opening its markets would be more beneficial than a DCFTA.

3.5.1 Basic indicator 1: The level of the EU tariffs

First, the CGE calculations assume that the EU tariffs are close to zero because of the GSP+ status granted by the EU to Georgia. It is true that the EU tariffs on imports under the GSP+ regime are nil. But, it remains a problem: do Georgian exporters use the EU GSP+ regime?

The feasibility study assumes that they do, but does so on the basis of old data showing that 52% (in 2000) to 67% (in 2003) of Georgian exports to the EU markets are made under the EU GSP+ [CASE, 2008, p. 34]. The problem is that both figures date from years before the 2006 dramatic Georgian trade reform.

In sharp contrast, the most recent figure on the share of Georgian products exported to the EU under the EU GSP+ regime is roughly 25% of total Georgian exports to the EU in 2010 (down from 40% on average in 2008 and 2009). In other words, the bulk of the Georgian exports pay regular EU tariffs. These tariffs are not negligible, particularly for the farm and food products which are plagued by specific and seasonal tariffs, crucial especially in the fruit sector. The key consequence is that underestimating the EU tariffs applied on Georgian exports mechanically generates an underestimated value of a simple FTA for Georgia.

The current small and declining share of Georgian exports under the EU GSP+ needs to be explained. The reason is that the EU GSP+ has serious intrinsic limits, which are amplified by the Georgian trade reforms. The intrinsic limits are three-fold:

- First, the EU GSP+ has a concentration clause stating that, for a country to be eligible, the top five categories of its exports to the EU shall represent at least 75% of the country's total exports to the EU. Hence, as soon as a 'beneficiary' of the EU GSP+ starts to diversify, it stops to qualify for the EU GSP+.

- Second, the EU GSP+ regime is granted for only three years (until 31 December 2011). Such a time-limited market access is of little interest for exporters that produce in a largely open economy like Georgia and that need conditions that induce them to make long-term production plans.
- Lastly, the EU GSP+ regime imposes rules of origin that can be stricter than those imposed by the other large markets for Georgian exports (e.g. the CIS countries of the former Soviet Union[6]).

These features make the EU GSP+ regime unattractive for Georgian exporters in a systemic way.

But the deep trade reforms undertaken by Georgia considerably amplify this unattractiveness for the following reason. Economic analysis shows not only that import liberalization increases the exported quantities, but also that it creates very strong incentives to diversify the product and geographical pattern of the country's exports. In other words, the EU GSP+ concentration and time-limit clauses have a negative impact on Georgia's reform efforts that should lead to a diversification of its exports. And in fact they make the GSP+ regime so much less attractive that Georgian exporters prefer to pay 'regular' (most-favoured nation) applied tariffs, and hence the low share of Georgian goods exported under the EU GSP+.[7]

Updated information thus makes Georgian exporters likely to benefit more from a simple FTA since they continue to face significant tariffs when entering the EU market. The EU would not gain much simply because EU exporters already have free access to Georgian markets in accordance with Georgia's WTO commitments.

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[6] The Commonwealth of Independent States comprises Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyzstan, Moldova, Russian Federation, Tajikistan, Turkmenistan, Ukraine, and Uzbekistan.

[7] The following information gives a sense of the changes in Georgian protection and exports between 2005 and 2009. In 2005, the average tariff on industrial products was 6.2% (compared to 0.2% in 2009) and only 26.3% (compared to 85.8% in 2009) were duty-free [WTO, 2009, pp. 39-40]). In 2005, almost half (47.1%) of Georgian exports were with the CIS zone and 25% with the EC. In 2009, the figures are respectively 36.2 and 22.3%, with, the growing market for Georgian exports being the Americas (22.3% in 2009) [WTO, 2009, TPR, p. 91].

3.5.2 Basic indicator 2: The level of Georgian border and standard costs

The second basic indicator on which the CGE calculations of the feasibility study rely is the magnitude of the border and standard costs (that is, TBTs and SPS-type barriers). The study bases its calculations on estimates of the border and standard costs in Georgia compared to those in Ukraine. These estimates use the six components of the IFC *Doing Business* sub-indicator "Trading across borders" for two years (IFC, 2004 and 2006). On this basis, the feasibility study estimates that Georgian border and standard costs are 30% higher than the corresponding Ukrainian costs.

Again, this information provides an obsolete picture of the Georgian economy because it does not take into account the consequences of its reforms. Table 3.2 provides the most recent information on the six costs components (labelled A to F) of the *Doing Business* indicator that are used by the feasibility study. It shows the Georgian performances relative to (as indexes of) those of the various cohorts of EU MS and of six other selected countries in order to give a wider perspective than the feasibility study.

In 2005, the Georgian costs compared to those of Ukraine range from 105 (component F) to 188 (component D), with an unweighted average of 144. In other words, Georgian costs were 44% (144 minus 100) higher than those of Ukraine on average. In 2007, the Georgian costs relative to Ukraine's range from 36 (component E) to 133 (component A) with an unweighted average of 80, meaning that Georgia's costs were lower than Ukraine's costs by 20% (80 minus 100) on average. In 2009, the Georgian relative costs range from 32 (component B) to 85 (component C) with an unweighted average of 59, meaning that Georgia's costs were lower than Ukraine's costs by 41% (59 minus 100) on average.

As a result, the CGE calculations based on the same indicator but for the most recent years would again suggest an opposite result than the one suggested by the feasibility study, that is, no or few gains to be expected from a DCFTA, since Georgia has already cut its 'border and standards' costs for imports.

Table 3.2 Georgia's border and standard costs compared to selected countries,[a] 2005-10

	2005	2006	2007	2008	2009	2010	2005	2006	2007	2008	2009	2010
	A. Documents to export (number)						**D. Documents to import (number)**					
EU-1958	206	193	193	227	113	113	278	152	152	187	107	107
EU-1973	210	200	200	200	100	100	417	194	194	194	111	111
EU-1980s	185	164	164	164	82	82	246	115	115	115	66	68
EU-1995	250	222	222	222	111	111	367	171	171	171	98	98
EU-2004a	177	157	157	158	79	79	221	103	103	105	60	60
EU-2004b	210	187	187	187	93	93	308	144	136	136	78	78
EU-2007	129	137	160	160	80	80	125	93	108	108	62	62
Croatia	129	114	114	114	57	57	188	88	88	88	50	50
Macedonia	129	114	114	133	67	67	214	100	100	117	67	67
Turkey	113	100	114	114	57	57	115	54	88	88	50	50
Ukraine	150	133	133	133	67	67	188	88	88	88	50	50
Armenia	150	133	133	133	80	133	250	117	88	88	57	67
Moldova	150	133	133	133	67	67	214	100	100	100	57	57
	B. Time to export (days)						**E. Time to import (days)**					
EU-1958	572	148	148	152	127	127	540	169	169	171	159	159
EU-1973	767	182	182	182	151	162	649	191	191	191	177	195
EU-1980s	390	89	89	89	75	75	339	95	95	95	90	90
EU-1995	675	150	150	157	131	131	698	188	194	194	181	181
EU-2004a	294	65	65	82	69	71	252	68	68	102	95	100
EU-2004b	704	156	151	151	126	133	649	175	175	175	162	169
EU-2007	204	73	76	76	63	63	197	82	87	87	81	81
Croatia	208	46	55	60	50	50	289	78	88	88	81	81
Macedonia	318	71	71	80	83	83	347	93	93	108	118	118
Turkey	270	60	86	86	71	71	208	56	93	93	87	87
Ukraine	174	39	39	39	32	32	133	36	36	39	36	36
Armenia	159	35	40	40	59	77	141	38	58	58	65	72
Moldova	169	38	38	38	31	31	149	40	40	40	37	37
	C. Cost to exports (US$ per container)						**F. Cost to imports (US$ per container)**					
EU-1958	159	124	124	124	113	118	153	118	118	113	106	111
EU-1973	212	158	158	148	136	146	202	145	145	133	129	140
EU-1980s	210	162	162	148	133	139	147	122	122	120	109	115
EU-1995	279	232	230	198	175	183	266	221	221	176	159	167
EU-2004a	174	144	144	132	121	137	167	139	139	120	112	126
EU-2004b	220	183	204	193	177	186	188	156	167	162	151	160
EU-2007	124	114	110	97	91	95	131	115	108	95	91	95
Croatia	131	109	109	108	99	104	131	109	109	117	110	115
Macedonia	139	115	115	105	88	97	139	115	115	101	88	95
Turkey	306	254	151	147	128	134	214	178	129	126	118	124
Ukraine	114	95	95	88	81	85	105	87	87	80	74	83
Armenia	98	82	112	79	73	80	84	69	89	63	60	64
Moldova	111	92	92	78	72	75	98	81	81	68	64	67

[a] The figures are the ratios of the Georgian performances over the performances of the selected trading partners for the operations A to F.

Source: Authors' computations based on data from IFC, *Doing Business* (website)

This new result is all the more plausible because Table 3.2 shows that Georgia's performance in terms of border and standard costs is also faring increasingly better than the performance of many EU MS cohorts. In other words, even if one leaves aside Ukraine, these performances raise doubts on the benefits that Georgia could derive from transposing the EU *acquis*, as captured by this indicator. An analysis of the data in absolute terms (not in relative terms as shown in Table 3.2) shows that the improvement of the relative performance of Georgia is due to both an absolute improvement of Georgia's performance and a deterioration of the absolute performance of various EU MS, most notably in terms of the number of necessary documents and the time required to export and import—precisely the two indicators that are most directly impacted by the EU's complex procedures.

4. PRECONDITIONS IMPOSED BY THE COMMISSION ON TBTS

Summary

1. If applied as currently formulated, the full set of the 2009 Matrix preconditions would have three negative impacts:

- They would distort Georgian industry: they would induce Georgian producers to canton themselves in the two-thirds of the universe of products that is not covered by the EU *acquis* on technical barriers to trade (TBTs) in order to avoid the tax on production imposed by the transposition.
- They would slow down the pace of Georgia's industrialization in the products under the EU TBT *acquis* by making their sale more expensive in the Georgian markets.
- They would favour trade flows between Georgia and non-EU countries to the detriment of those between Georgia and the EU.

2. DCFTA negotiations should start without further delay since Georgia fulfils the relevant subset of preconditions. They should address the above problems by including:

1. Provisions that would: Facilitate the implementation of EU norms by export-oriented Georgian firms; such a provision would allow Georgia to have recourse, as far as possible, to the national accreditation and certification bodies of an EU Member State if Georgia considers that it is not economically meaningful to have a national accreditation and certification bodies or to provide certain accreditation and certification services.
2. Exempt Georgian firms from the obligation to use EU norms when selling in Georgian markets; such a provision would also reschedule the timing of the transposition of the six New Approach Directives that Georgia has agreed to introduce into its legislation.

3. Release Georgia from any obligation to transpose the other New Approach Directives in this first set of commitments, except if Georgia decides otherwise.
4. Possibly define transition periods to be based on an objective measure of the catching up of the Georgian economy, such as its GDP per capita.

3. In accordance with its unilateral path of reforms, Georgia should keep its own policy of unconditional mutual recognition, which is more in line with the spirit of the EU case law (*Cassis de Dijon* case) than the EU current *acquis*.

There is a large consensus—including among Commission officials—that the EU *acquis* in TBTs is the most complex element of the *acquis*, if one leaves aside the even more complex *acquis* in SPS measures. In a nutshell, the EU *acquis* in TBT consists of four main elements:

- The Old Approach Directives aim at harmonizing the technical norms in a few sectors (agro-food, cars, chemicals, pharmaceuticals).
- The New Approach Directives aim at harmonizing only the "essential requirements" in other sectors; the producers are free to choose the technical norms as long as they meet these essential requirements.
- The New Legislative Framework regulates the wide set of activities ranging from certification to market surveillance.
- The General Product Safety (hereafter GPS) Directive focuses on consumers' rights while the Old and New Approach focus on producers' obligations.

4.1 Georgia: Ahead of the EU MS in enforcing the EU's mutual recognition principle

At the outset, it is important to underscore that the current discussions between the Commission and Georgia focuses on the producers' side (except the GPS Directive, which does not raise similar substantive issues). This is because the consumers' side is dominated by a key unilateral reform of Georgia: in 2006, Georgia recognized unilaterally all the technical norms in use in the OECD countries (as well as in the EU MS not members of the OECD) provided that there is the appropriate marking on the goods (for instance, the CE marking in the case of goods produced under EU norms).[8]

[8] This legislation applies also to the producers: a Georgian producer can produce in accordance with US, EU, Canadian, etc. norms (and CIS norms).

Ironically, this decision has made Georgia the best pupil in the world for the European Court of Justice, since it is implementing the mutual recognition principle in the fullest and most unconditional form. Established in 1979 by the famous Cassis de Dijon ruling of the Court, this principle states that goods lawfully produced in one country cannot be banned from sale on the territory of another country, even if they are produced with different technical or quality specifications. This principle is the basis of the EU New Approach and New Legislative Framework. But, it is crucial to realize that the EU New Approach and New Legislative Framework exist in their current very complicated forms only because EU MS were (still are) reluctant to mutually recognize 'unconditionally' the technical norms of the other EU MS [Messerlin, 2011]—that is, to do among themselves what Georgia has done with all the OECD countries.

The unconditional mutual recognition of OECD norms enables Georgian consumers to have the largest possible range of products to choose from, since no product could be banned from entering Georgian markets (or to be produced in Georgia) for reasons due to the 'nationality' of the technical norms of any OECD country used. It has another essential consequence: it protects the Georgian consumers (but not the producers) against any direct negative impact from the transposition of the EU TBT *acquis* into Georgian law.

4.2 The Commission's preconditions on TBTs: An overview

Table 4.1 summarizes the Commission's requirements (cells 1 and 2 of column A in Table 3.1) as they are listed in the 2009 Matrix and in the 2010 Document. It also lists the actions taken by Georgia (middle column).

Table 4.1 allows us to appreciate the hazards created by the 2010 Document. These hazards flow from three main sources:

- Point 1 of the 2010 Document requires the adoption and implementation of technical regulations for two specific products (lifts and cable cars) as a precondition that the 2009 Matrix lists in the preconditions to be fulfilled after the start of the DCFTA negotiations (column B in the Table 3.1). This shift imposes administrative costs on Georgia much faster than expected. It should be added that the Commission has chosen two products (lifts and cable cars) that are not produced at all in Georgia. Interpreting such a surprising choice is difficult.

- The rest of the 2010 Document insists on requirements on standardization, accreditation, metrology, market surveillance and conformity assessment. All these requirements are drawn from the EU New Legislative Framework that has taken eight years to be designed and adopted. The Framework is enforced by the EU MS only since 2010. It is particularly constraining because it is a reaction to the fear that some EU MS were loose enforcers of the EU TBT *acquis* in these areas [Commission SEC(2007) 173].[9] In short, Georgia is required to do in a couple of years what some EU MS have not been able to do in more than 20 years.
- The language is not only compelling. More worrying still, it is totally open-ended. What is the meaning of a "solid" institutional reform, "sufficient" legal metrology resources, "tangible" progress towards an identified market surveillance mechanism, etc.? When is solid solid, sufficient sufficient and tangible tangible?
- All these requirements are quite unprecedented. The most recent FTA often qualified as 'deep and comprehensive' by the Commission's officials—the EU-Korea FTA—does not include such an agenda. It would be interesting to hear why such a harmonization is not required in a trade agreement with a large, fully industrialized and very competitive economy such as Korea, whereas it should be a precondition for negotiating a similar agreement with a small, lower-middle income country having a very limited industrial sector, such as Georgia.

[9] The document Commission SEC(2007) 173 is the Commission's impact assessment of how the EU accreditation and market surveillance worked in the 2000s. This assessment deserves two remarks. First, it argues that some EU MS are guilty of 'regulatory dumping' (weak enforcement of the EU TBT *acquis*). Second, it provides no convincing proof of this [Messerlin, 2011]. Indeed, the latest document on the state of the implementation of the New Legislative Framework shows that implementing the EU TBT *acquis* is still far from completion [Commission, 2010].

Table 4.1. Summary of the preconditions in the TBT area

Commission's March 2009 Matrix	Actions taken by Georgia	Commission's December 2010 Document
Key priority 1		
Adopt and start implementing a governmental programme of adoption of technical regulations in line with the EU acquis in the priority industrial sectors.	1. Georgia agreed on a Programme with the Commission, adopted it, and has already started its implementation. 2. Georgia agreed a Strategy with the Commission, adopted it, and has already started its implementation.[a] 3. In accordance to the Programme, a first draft of the Code on Safety and Free Movement of Products is prepared.	1. Georgia should draft and adopt vertical / sectoral technical regulations for two sectors: cableways and lifts. 2. Georgia should draft and adopt the legislation transposing fully the General Product Safety Directive. 3. The new Code on Safety and Free Movement of Products should be drafted, adopted and enter into force.
Key priority 2		
Achieve progress in the establishment of a domestic institutional system in the area of TBT, standardization, accreditation, metrology, conformity assessment and market surveillance. Create if needed and strengthen the institutions in charge of these respective issues.	1. Georgia has adopted a Strategy in the area of TBT, standardization, accreditation, conformity assessment and metrology envisages with the strengthening of the relevant domestic institutions. 2. The Technical and Construction Inspection Agency for market surveillance has been established. **3.** Seminars and trainings are carried out on TBT issues for the relevant institutions in coordination with donors on a regular basis. Comprehensive institutions building was requested with this purpose.	1. The ongoing gap assessment in the areas of standardization, accreditation and metrology should be accomplished and initial progress in its follow-up achieved. 2. A market surveillance authority should be designed for each specific product and preparation and first steps in the implementation of a credible and adequately funded programme to establish an effective market surveillance mechanism. **3.** Georgia should specify in more detail its plans for the establishment of an adequate domestic system of certification bodies able to issue internationally recognized certificates and start to implement these plans.

[a] The preparation of a Strategy was not a precondition of starting DCFTA negotiations and was requested by the Commission only for the implementation stage of DCFTA. However, Georgia decided that this issue is very important and addressed it as a matter of urgency.

Sources: Interviews and the Strategy Papers of the Government of Georgia.

4.3 A sense of the huge regulatory burden imposed by the transposition

It is crucial to realize the tasks and burden entailed in transposing the New Approach Directives into Georgian law. In the context of the 2009 Matrix, it was agreed by Georgia and the Commission that Georgia would transpose into Georgian laws 6 out of the 21 New Approach Directives within the next 36 months (2010-2012). This first wave of transposition will be followed by four other waves according to a schedule not yet defined. As already mentioned, these initial preconditions have been unilaterally modified by the 2010 Document which made the implementation of the EU TBT *acquis* in two products that Georgia does not produce (cable cars and lifts) a precondition for launching the DCFTA negotiations.

Table 4.2 provides a sense of the regulatory burden imposed on Georgia by the first wave of the six directives to be transposed within the next 36 months.

Table 4.2 deserves four remarks:

- The New Approach Directives are not limited to their texts. They also often refer to other directives and to application texts. Table 4.1 does not take into account such connections, and hence presents a minimal account of the burden imposed on Georgian firms.
- Table 4.1 shows that when directives are updated texts (such as 88/404 and 2009/105 for the Simple Pressure Vessels), the new version is much longer than the initial one. For instance, the 2009 version of the Simple Pressure Vessels Directive has roughly 25% more words than its 1988 version. In other words, the burden imposed on Georgian firms is likely to increase over time when the existing directives will be updated—a mechanism in which Georgia will have no say since it will not be an EU MS.
- These directives refer to a large number of precise norms. The total number of norms of these six directives alone is almost 500. This is a huge number for a small country which, by its sheer size, has a relatively limited number of engineers.
- Last but not least, a crucial feature of these directives is to impose norms that are specific to the EU ('EN' norms). This is best illustrated by the Directive on Pressure Equipment which is also the directive with the largest number of norms. The only exception is the Directive on Recreational Crafts which has a majority of international (ISO) norms.

Table 4.2. Transposing the New Approach Directives into Georgian law: The first wave

	Group 1			Group 2		Group 3
	Cableway installations designed to carry persons	Lifts	New hot-water boilers fired with liquid or gaseous fluids	Pressure equipment	Simple pressure vessels	Recreational craft
New Approach Directive involved	2000/9	95/16	92/42	97/23	87/404	94/25
Number of pages	28	35	15	57	18	14
Total number of norms	25	22	--	256	7	34
Number of ISO norms	0	0	--	32	0	34
Other Directive involved			93/68		93/68	2003/44
Number of pages			23		23	18
Total number of norms			7		7	41
Number of ISO norms			3		3	33
Other Directive involved			2004/8		90/488	
Number of pages			11		1	
Total number of norms			--		8	
Number of ISO norms			--		0	
Other Directive involved					2009/105	
Number of pages					18	
Total number of norms					23	
Number of ISO norms					--	
Responsible institutions						
Min. Economic Development	x	x	x	x	x	x
Min.Regional Dev & Infrastructure	x					x
Governmental Bodies Involved						
Min. Energy			x			
Min. Environment	x					x
Dep. Tourism	x					
Technical Const. Insp. Agency	x	x	x	x	x	x
NCA	x	x	x	x	x	
NASTRM	x	x	x	x	x	
United Transport Administration						x
Tbilissi Municipality		x				
Batumi Municipality		x				
Kutaisi Municipality		x				
Non-Governmental Bodies Involved						
GTU	x	x	x	x	x	x
Importers	x	x	x	x	x	x
Users	x	x	x	x	x	x
Bagirgza	x					
Resources						
Budget Min. ED	x	x	x	x	x	x
Budget Min. RDI						x
Technical Assistance	x	x	x	x	x	x

Source: Government of Georgia, Strategy on TBT [2010].

As a result, the administrative costs of implementing these new norms are likely to be huge, as best illustrated by the many governmental and non-governmental bodies to be involved. Years will be needed for a full and smooth implementation, as has been shown by many Central European EU MS—all the more because technical assistance promised by the EU to

Georgia is minimal: it is limited to capacity-building and training of Georgian institutions, with the usual severe constraints imposed by the very bureaucratic EU funding procedures.

Finally, Table 4.2 gives a sense of the additional costs imposed by the 2010 Document requiring implementation of the EU *acquis* in TBT for cable cars and lifts by 2011. These two products may be those with only one directive (each) and a limited number of norms. But they are also those with no ISO norms: this means that Georgian producers may have to use at least two sets of norms—one for the Georgian and EU markets, and one for the other markets. Last but not least, there is no Georgian producer for these two products—once again raising the fundamental question of why should Georgia transpose rules that are not needed.

4.4 Georgia is not a Central European country

It would be wrong to believe that the transposition of New Approach Directives simply creates administrative costs for the public authorities, which are estimated in Box 4.1. It also imposes fixed costs on Georgian producers which would have to hire additional workers' time and skills in order to define the technical norms that will meet the essential requirements imposed by the Directives.

Box 4.1. Estimated administrative costs of the transposition of the EU acquis *in the TBT area*

Since Georgian consumers are 'shielded' by the Georgian unconditional mutual recognition of the OECD norms, implementing the EU TBT *acquis* should not impose too heavy costs on Georgian consumers who could always turn to goods produced under non-EU norms (for instance, US norms).

Calculating the administrative costs relies on a rough estimate of the staff to be hired. The Czech TBT institutions employ roughly 1,000 staff members for the certification aspects and 50 internal and 500 external staff members for the accreditation aspects. The Czech population is more than twice the Georgian population, whereas its value added in manufacturing is 30 times larger. That suggests that the staff required for implementing the EU TBT *acquis* in Georgia would range from 50 to 500. The exact figure will depend on how much the Commission insists on covering all the goods (in addition to cable cars and lifts) and to which extent the tasks to be done are down-sizable (that is, impose fixed vs. variable costs). Of course, there are also costs in terms of buildings and equipment.

Such costs are notable but they do not seem huge at a first glance. However, they have to be assessed in terms of opportunity costs—that is, what Georgia loses when it is forced to spend public money on TBTs rather than on more pressing investments for boosting growth (such as infrastructure). It would be certainly a better—more pro-growth—use of Georgian public money to hire 50 to 500 nurses, doctors, agricultural instructors, infrastructure-related staff, etc.

Data source: Jandieri (2011).

The supporters of the transposition of the EU TBT *acquis* into Georgian law argue that these initial fixed costs imposed on Georgian producers adopting the EU norms will be more than counterbalanced by the benefits of better access to the large EU markets.

Such an argument made sense in the case of the Central European EU MS, which are close to the huge mass of the Western EU MS' economies. Table 1.1 (chapter 1) shows that the 15 initial EU MS represent 92% of the EU 27 GDP, with 20% for the largest EU MS (Germany) alone. The well documented 'tyranny of geography'—the distance between two countries is a major determinant of their intensity to trade—suggests then that the 'natural' choice for the Central European EU MS was to send a large share of their exports to the Western EU MS, in particular to Germany which happens to be, in addition, the EU MS closest to them. Transposing the EU technical norms into their own legislation seemed thus the right thing to do for the Central European EU MS.

This argument is far from applying to Georgia which faces a very different 'tyranny of geography' as illustrated by the following data. In 1995 (at the beginning of their accession process), exports of the Central European EU MS to the EU (then limited to 15 EU MS) amounted to roughly 58% of their total exports. In sharp contrast, the share of Georgian exports to the EU (with 27 EU MS) in its total exports to the world has continuously declined from a peak of 25-26% in 2005-2006, to less than 19% for the first nine months of 2010 (back to the 2002 level).

In such a context, the benefits of the transposition should be expected to be much more limited for Georgia than for the Central European EU MS. Georgian exporters are induced to keep strong trade flows with their close CIS and Asian markets because the attraction of these markets can only grow for the following reasons:

- Even if the CIS and Asian markets are still smaller in absolute size than the EU markets, they are huge enough to absorb the limited Georgian export capacities.
- The CIS and Asian markets exhibit a much higher growth rate than the EU markets, and they have much higher potential in the very long run than the EU markets (India's population is three times the EU population).
- Georgian consumers are likely to be more similar in their demands to those in the CIS and Asian markets than in Europe because their levels of income per capita are closer.

In short, these markets have an almost infinite capacity to absorb Georgian exports and to boost Georgian growth—now and for a very long time. Arguing that the EU is the largest and most prosperous market for Georgian producers misses a crucial point: most Georgian producers do not need such a large market simply because they are so much constrained by the size of the Georgian economy.

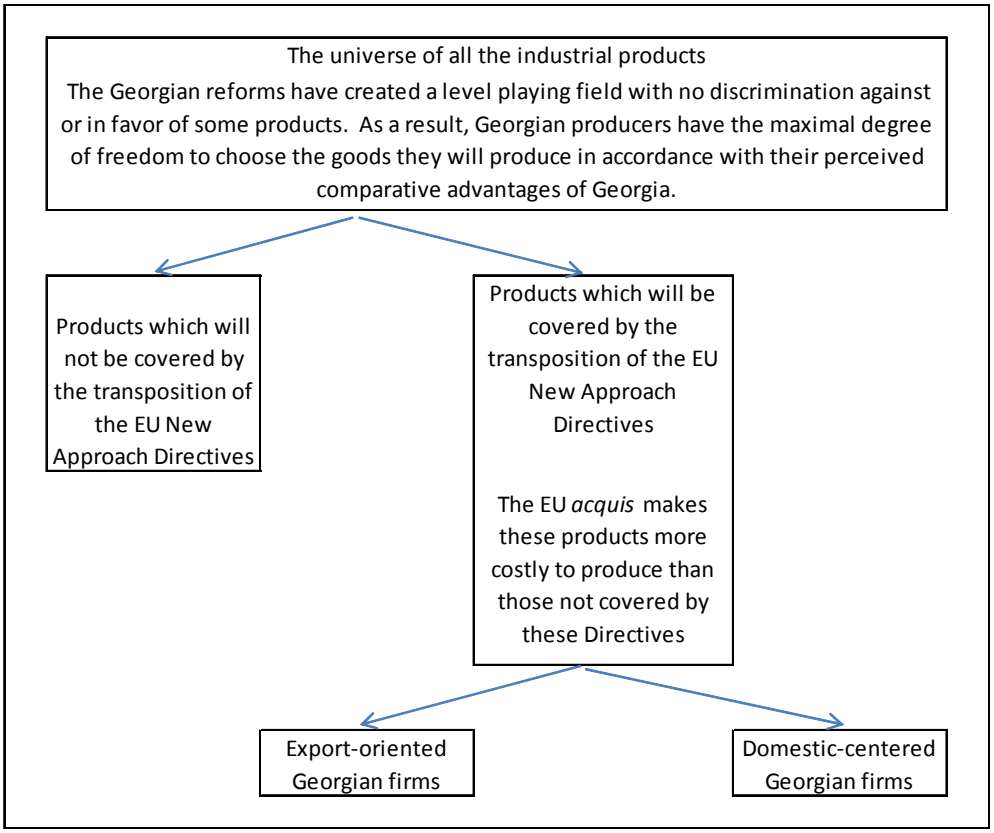
Meanwhile, the costs of the transposition should be expected to be much higher for Georgia than for the Central European EU MS. This is because the CIS and Asian markets require generally the use of non-EU technical norms. As a result, Georgian exporters will be torn between different sets of technical norms, the EU ones needed for the Georgian and EU markets and the non-EU ones needed for all the other markets—except when products are under ISO (international) norms. Producing goods with different norms (EU, CIS, etc.) is unlikely to be affordable for many Georgian producers, often too small to run different lines of production of the same product but with different norms. This dilemma would require a dramatic decision from the Georgian exporters on which markets to send their exports—the EU markets or the CIS and Asian markets, and whether to remain present in the Georgian markets, or not.

4.5 The preconditions would hinder Georgia's industrialization and trade flows with the EU

The fixed costs imposed by the transposition of the EU *acquis* in TBTs are equivalent to a tax on Georgian production of exports and domestic production. This tax is legitimate when it is imposed on Georgian exports to the EU: there is no reason to exclude Georgian exporters to the EU markets from the conformity to the EU TBT *acquis* which is imposed on all the EU firms and exporters to the EU.

What is questionable is that the 2009 Matrix imposes the EU TBT *acquis* on Georgian producers selling on Georgian markets. This represents a considerable extension of the 'tax base' that would hinder the industrialization process that Georgia needs so desperately for boosting her growth.

Figure 4.1. The economy-wide impact of the transposition of the EU TBT acquis



In order to fully understand the many negative consequences of this extension of the tax base, Figure 4.1 sketches the alternatives faced by a Georgian entrepreneur eager to start or develop a business. The main feature of the Georgian reforms—very similar tariffs and regulations for all goods—is to have created a level-playing field among products. As a result, when choosing the goods to be produced, Georgian entrepreneurs need only to assess whether they have some comparative advantage in producing the goods in question. They are not induced to choose products

because of some fiscal or regulatory reasons. Such a freedom of choice is critical when an economy is starting to industrialize almost from scratch, as is the case in Georgia, because it enlarges as much as possible the range of possibilities and opportunities.

The 2009 Matrix substantially constrains this freedom of choice because it splits the whole universe of products that a Georgian firm could produce into two very different groups as illustrated in Figure 4.1: those subjected to the New Approach Directives and those not subjected to them. The fact that the EU TBT *acquis* is equivalent to a tax will induce Georgian producers to be predisposed towards products *not* under EU norms. It is estimated that the New Approach Directives cover 30 to 42% of the EU imports and exports, respectively [Messerlin, 2011]. In other word, the transposition of the EU *acquis* acts as a disincentive for Georgian firms to produce one-third of the possible goods in a modern economy.

Let us now focus on the Georgian producers who will still consider producing goods under the EU TBT *acquis*—let us call them 'widgets'. Under the 2009 Matrix preconditions, these firms will have to produce under the CE marking not only when selling widgets in the EU markets (once again, a perfectly legitimate constraint) but also when selling widgets in the Georgian market.

As a result, the 2009 Matrix splits Georgian firms into two subsets: those that feel capable of adopting an export-oriented strategy and those—likely to be much more numerous if one takes into account the tyranny of geography, the differences in size, income and technological level—that target the Georgian market as their main target (and possibly non-EU markets). Let us called such firms 'domestic-centred' firms.

Focusing first on the domestic-centred Georgian firms, the implicit tax imposed by the Matrix would force them to charge higher prices in order to pay the fixed costs imposed by the 2009 Matrix. This price increase would result in less demand for their output, and the smaller Georgian production would force Georgian consumers to turn to other sources of supply. There are then three major possible scenarios.

- *Scenario 1. The domestic-centred Georgian producer cuts its activity* (and possibly disappears). The Georgian consumers would then need to satisfy their demand with imported products. As they are relatively poor, they are unlikely to choose products imported from the EU, which tend to be too expensive. In sum, Georgian production is reduced, imports from non-EU countries grow (much) more than imports from the EU (and possibly Georgian exports to non-EU

countries grow if the Georgian producers divert their domestic sales to non-EU markets).

- *Scenario 2. The domestic-centred Georgian firm wants to keep domestic sales.* The main option is to shift its plant to a neighbouring country that has not signed a DCFTA with the EU and to export to Georgia products under non-EU (less expensive) norms. In short, Georgian production disappears while Georgian imports from non-EU countries grow, with the main beneficiaries of the DCFTA being countries having no DCFTA with the EU.
- *Scenario 3. The Georgian producer tries to attract a foreign investor (owner)* in order to survive in Georgia. Paradoxically, this decision may well be more beneficial to non-EU firms than to EU firms. This is due to the quasi-absence of Georgian industrial tariffs on imports from the rest of the world and to Georgia's mutual recognition of all the OECD norms. In such a context, efficient Japanese, Korean or Chinese firms producing widgets that they already export to the EU or that they produce in the EU—in short, widgets produced in accordance with EU norms—will be able to produce these widgets n Georgia at no additional costs once Georgia implements the EU *acquis* in TBTs. A key point in this scenario is that firms from emerging countries are more attuned to the Georgian economic environment than their EU competitors: they work with skills and labour costs on the production side, and incomes and tastes on the consumption side that are more similar to those in Georgia than typically are EU firms. Hence, they may well be induced to invest in Georgia (much) faster than are the EU firms. In short, the haste to impose the full EU *acquis* to Georgia may well advantage non-EU firms compared to EU firms.

To sum up, as currently formulated, the 2009 Matrix has three very negative impacts: it distorts the Georgian industrial sector by greatly reducing the benefits of the Georgian reforms because it induces Georgian producers to canton themselves into the two-thirds of the universe of products not covered by the EU TBT *acquis*; it hinders the pace of Georgia's industrialization by making more expensive the products to be sold in the Georgian markets; and it favours trade flows between Georgia and non-EU countries to the detriment of those between Georgia and the EU.

4.6 Proposals

First and foremost, it should be underscored that, since Georgia has met the relevant subset of preconditions of the March 2009 Matrix (see Figure 4.1), the DCFTA negotiations should be launched without further delay. That said, the above section shows an urgent need to reshape the other preconditions when negotiating the context of the DCFTA content.

4.6.1 Export-oriented Georgian firms: Make Georgia a model enforcer of the New Legislative Framework

As is the case with any exporter to the EU, the export-oriented Georgian firms have to comply with EU norms for their export operations. In other words, the 2009 Matrix represents only a marginal challenge to them. That said, it is possible to greatly improve the 'one size fits all' of the 2009 Matrix by using the rich body of EU law.

Indeed, a key provision of the recent EU TBT *acquis* has so far been ignored by the Commission. The New Legislative Framework, which rules functions such as the certification, accreditation, etc., allows any EU MS to have recourse to the institutions of another EU MS, as stated by Article 4, paragraph 2, of the EU Regulation 765/2008:

> Where a Member State considers that it is not economically meaningful to have a national accreditation body or to provide certain accreditation services, it shall, as far as possible, have recourse to the national accreditation body of another Member State.

Included in the DCFTA, this provision would allow Georgia to request the accreditation body of a given EU MS to cooperate in handling the needs of export-oriented Georgian firms. This option deserves three remarks:

- As the accreditation bodies are the core institution in the whole EU TBT institutional machinery, it seems logical to extend the benefit of Article 4.2 to Georgia for the other bodies required by the EU TBT *acquis* (conformity assessment bodies, laboratories, etc.).
- The only institution that escapes Article 4, paragraph 2 is the market surveillance authority. But this is not a problem since Georgia has already established such an institution.
- Finally, this option does not prevent Georgia from creating all these institutions in due course. But, it would be a domestic decision taken after a comparison of competing regulations on technical norms from

other countries and at a speed that will be supportive of Georgia's growth, rather than harmful to it.

The benefits of this proposal for Georgia are obvious and large. A legislative and bureaucratic nightmare is set aside, with all its costs. The focus is shifted from a bureaucratic and nation-wide approach to an approach that focuses on firms, and hence fits much better Georgia's need to boost its growth and development.

But there are also two main large benefits for the EU. First, relying on EU MS institutions would eliminate all the suspicions and accusations on the quality of implementation of the EU TBT *acquis* by Georgia that a hasty implementation of the EU *acquis* in Georgia would almost certainly create.

Second, the use of Article 4.2 would become an attractive option for other EU neighbours—the foreign policy dimension of a DCFTA model. This use would allow the rapid creation of a larger geographical coverage of EU norms without forcing trading partners to renounce their current policies in the TBT area. If the EU decides to limit the offer of using Article 4.2 to those neighbours that have made serious reforms, benefiting from this provision may become an incentive for faster and/or deeper autonomous reforms in the neighbours that are slow to reform before entering into negotiations with the EU. In all these cases, the political benefits for the EU are huge.

4.6.2 Georgian firms selling on domestic markets: Reschedule the timing of the transposition

The 2009 Matrix is particularly detrimental to the Georgian firms selling in the domestic markets—weakening and/or delaying the creation of a lively pool of nascent firms in Georgia. In this respect, substantial changes in the 2009 Matrix are needed. They consist of a rescheduling of the transposition of the New Approach Directives necessary all the more because the current schedule generates serious risks of introducing distortions into the Georgian economy.

The risks of distortions come from two factors, which are shown in Table 4.3. First, trade distortions are more likely if tariffs are relatively high. For instance, a high protection of EU firms favours the existence of inefficient EU firms which could then use a preferential access to the Georgian markets to sell their products there—keeping at bay more efficient non-EU firms and grabbing unjustified rents from Georgian consumers. The average EU tariffs imposed on the products under the directives to be transposed are often not too different from the average tariff for all the

industrial products (5.6%). But, the maximum tariffs (that protect segments of the products in question) are very high for Waves 2, 4 and 5, with a noticeable share of tariffs higher than 15% (peak tariffs) for the group 1 of Wave 2. These observations suggest substantial potential risks of inefficient EU firms trying to grab rents in Georgian markets although Georgia's low tariffs on industrial products are a powerful 'shield' protecting Georgian consumers since they allow these consumers to turn easily to non-EU products if necessary.

Table 4.3. Waves of transposition of the New Approach Directives into Georgia's legal regime (%)

	Wave 1			Wave 2		Wave	Wave	Wave
	Group 1	Group 2	Group 3	Group 1	Group 2	3	4	5
EU average and maximum tariffs of the products covered by the Directives (%)								
maximum tariff	8.1	11.0	9.0	17.6	19.8	7.8	18.7	24.4
average tariff	6.5	5.4	6.6	5.9	5.2	4.6	5.4	5.6
share of tariffs >15%	0.0	0.0	0.0	3.7	1.6	0.0	1.3	0.6
Share of the products covered by the Directives in total manufacturing exports (%)								
EU to the World	0.3	7.1	0.8	8.4	22.4	8.5	24.2	17.1
Georgia to the EU	0.0	1.7	0.0	1.1	4.5	0.9	3.3	19.8
Georgia to Rest of World	0.0	4.2	0.3	1.6	3.4	0.4	10.0	20.3
Share of the products covered by the Directives in total manufacturing imports (%)								
EU to the World	0.2	8.4	1.4	4.6	28.8	5.7	15.3	17.9
Georgia to the EU	0.1	5.5	0.0	6.9	32.1	7.5	21.2	12.3
Georgia from Rest of World	0.3	7.2	0.1	5.3	26.5	4.9	18.2	17.1

Sources: WTO-IDB and COMTRADE databases. Authors' calculations. As one tariff line can be covered by two or more Directives, the figures in the table cannot be cumulated. The 2009 Matrix defines 'waves' of transposition, that is, sets of Directives to be transposed at roughly the same time (see above section 3).

A second source of costs from trade distortions is the importance of trade flows (the larger they are, the higher the related costs can be). From the EU side, there are notable trade flows for all the products in question, except for Groups 1 and 3 of the Wave 1 Directives. That said, Georgia imports mostly from non-EU sources, and its unconditional mutual recognition of the norms of all OECD countries is a powerful 'shield' protecting her consumers by allowing them to get easy access to the widest range of varieties of such products available in the OECD (and CIS) zone. On the export side, Georgian exporters tend to export to non-EU markets, mirroring the fact that Georgia is very different from the Central European EU MS before their accession.

All these factors suggest the following changes in the schedule of transposition. First, there should be a rescheduling of the six Directives that Georgia has agreed to transpose:

- No change needs to be made for the Group 1 of Wave 1 since these Directives cover limited (even nil) trade flows for both partners, and no production in Georgia, hence limit the costs of the transposition to the administrative ones in the short term. However, if there are no immediate consequences for Georgia's industrial structure, there may be consequences for its future industrial structure since the transposition acts as a de-industrialisation and anti-diversification policy.
- Group 3 of Wave 1 should be transposed before Group 2 of Wave 1 because it shows two features minimising the risks of large costs: a lower trade coverage and norms mostly expressed in ISO terms. The costs of transposing the EU *acquis* will thus not be associated with dramatic decisions to be made by Georgian exporters between the EU, Georgian and non-EU markets.
- Group 2 of Wave 1 should be transposed over a much longer period of time because, in sharp contrast with the Group 3 of Wave 1 directives, the Group 2 of Wave 1 Directives cover a notable share of industrial trade for both partners, are protected by high peak tariffs in the EU, and are expressed largely in EN norms.

Second, there should be a provision leaving to Georgia's discretion whether, and if so, when, it will transpose the rest of the New Approach Directives (Waves 2 to 5 and also possibly Group 2 of Wave 1). This approach reflects the trust that Georgia's credentials in reform deserves.

As argued in chapter 1, Georgia and the EU could agree on periods of transition in order not to leave completely open-ended these flexibilities. As argued in chapter 1, transition periods should not be expressed in a number of years fixed arbitrarily, but in terms that are economically meaningful such as the GDP per capita. For instance, the transposition of the six first directives could be triggered when Georgia will have a GDP per capita equivalent to the GDP per capita of Bulgaria when it acceded to the EU. Once again, such a transition criterion ensures that Georgia will abide by its commitments and that the EU *acquis* is supportive of Georgia's growth.

4.6.3 Proposal on Georgia's policies accompanying the DCFTA implementation

In accordance with its unilateral path of reforms, Georgia should keep its own policy of unconditional mutual recognition. Not only it is more in line with the spirit of the EU case law (*Cassis de Dijon*) than the current EU *acquis*, but it also enables Georgian consumers to have the largest possible range of products to choose among, since no product could be banned from entering Georgian markets (or to be produced in Georgia) for reasons due to the 'nationality' of the technical norms used.

The EU should thus refrain from making any attempt to curb this Georgian provision.

5. PRECONDITIONS IMPOSED BY THE COMMISSION ON SPS MEASURES

Summary

1. If applied as currently formulated, the full set of the 2009 Matrix preconditions on sanitary and phytosanitary (SPS) measures would have two negative impacts:

- They would create a huge surge in food prices, which can be estimated at 90% of the current cost of the food products bought by the one-third of the Georgian population living in poverty.
- They would require an inspection mechanism covering hundreds of thousands of very small farmers (less than 1.5 hectares) which would be unmanageable and / or would fuel corruption.

2. DCFTA negotiations should start without further delay since Georgia fulfils the relevant subset of preconditions. They should thus address the above problems by including:

1. a provision excluding the small-farms sector from the EU SPS *acquis* for what would be a long period of transition. Fixing this transition period on indicators such as the GDP per capita would not be proper because the small-farms sector is so large and disconnected from the rest of the economy. The transition period should thus rely on a review of the situation to be undertaken on a regular basis.
2. a provision allowing a progressive introduction of the general food safety laws in Georgia. The progressivity dimension is crucial in order to minimize the risks of destabilizing food price surges.
3. a provision defining a mechanism ensuring Georgian compliance with the SPS *acquis* for major Georgian agricultural exports to the EU. This mechanism should be implemented in a progressive way, that is, as and when Georgian exports become notable (in quantities) and regular (in time).

3. With respect to Georgia's policies accompanying the DCFTA implementation, the country should continue to strengthen its own emerging SPS policy in pursuit of its own unilateral path of reforms.

The problems raised by the transposition of the EU *acquis* in SPS measures into Georgian law are of similar nature than those raised in the TBT area. But, they are much more intractable for two reasons: i) the sheer complexity of the SPS regulations; and ii) the huge gap between the Georgian and EU agricultural sectors.

5.1 The Georgian agricultural sector

To appreciate how completely unrealistic are the Commission's preconditions in the SPS area, one must realise that Georgian agriculture is very similar today to the prevailing conditions found in the farming sector in the early 1950s in the poorest regions of some of the founding EU member states. [10]

- The farm labour force (self-employed people included) represents 55% of the total labour force—more than ten times the EU average.
- This farm labour force is relatively unskilled, often stays in the farm sector as a 'last resort' option and has very limited entrepreneurship capacities – all features inherited from the large collective farms in place until the early 1990s.
- The early 1990s privatisation policy excessively fragmented the large collective farms (the average size of the farms was 1.1 hectare in 2009). This feature makes it socially very difficult to establish the core of large estates required by a 'modern' farm sector. However, the fact that 60% of the farmers are older than 55 years will slowly facilitate the much-needed consolidation of the Georgian farm estates.
- These features explain the very low level of labour productivity: 55% of the Georgian labour force employed in agriculture produces 10% of the Georgian GDP (the GDP share of the value added in agriculture) while the 5.5% share of EU labour working in agriculture produces 3% of the EU GDP. The growth rate in the Georgian farm

[10] In this section, agriculture is divided into two sectors for the sake of clarity (the problems are not at all similar): the farm sector (farmers) and the food sector (the industrial agribusiness sector).

sector is low on average, with huge ups and (negative) downs over time.

- A modern farm sector based on large farms with new technologies is only emerging, because the fragmentation of the farm land and the lack of available entrepreneurs inhibits domestic and foreign investment in agriculture.
- Georgia has comparative advantages in some traditional farm products which are already successfully exported: fruits, nuts, waters and wine. However, agricultural exports are expected to increase by a modest 3 to 5% (as in the past) in the absence of the deep changes in the farm structure that would allow production of new agricultural goods.
- The processed food sector is only nascent. Most farm production is consumed by the farmers or their close neighbours, while the demand for food in the urban areas is satisfied to a large extent by imports.
- The urban and rural Georgian incomes, which were not so different a few years ago, exhibit a serious gap in 2009, with rural incomes being 25% lower than urban incomes—in sharp contrast with what prevails in the Western EU MS.

All these factors reveal the huge gap between the EU and the Georgian farm and food sectors—and make the farm and food sectors an extremely difficult issue in Georgia in the DCFTA context.

In such a context, imposing the transposition of a vast chunk of the EU *acquis* in SPS—by far the most complex part of the EU *acquis*—is puzzling, to say the least. It is all the more so because any parallel between Georgia and Central European EU MS is even less valid in the SPS case than for the other preconditions for a powerful additional reason: Georgian farmers will never benefit from the billions of euro of subsidies of the Common Agricultural Policy (roughly 40% of the EU budget during the last five years) which cushion EU farmers from the high costs of the EU SPS *acquis*.

5.2 The Commission's preconditions on SPS: An overview

Figure 5.1 summarises the Commission's requirements (cells 1 and 2 of column A in Chart 3.1) as they are listed in the 2009 Matrix and in the 2010 Document. It also lists the actions taken by Georgia (middle column).

Table 5.1. A summary of the preconditions in the SPS area

Commission's March 2009 Matrix	**Actions taken by Georgia**	**Commission's December 2010 Document**
Key Priority 1		
Start implementing the suspended food safety legislation, including through creation if needed and strengthening of the institutional capacities of all the bodies in charge.	1. Implementation of all suspended articles of the Law on Food Safety and Quality started as of July 2010. Inspection and traceability articles were enforced as of July 2010 and applied to export-oriented companies at the first stage. 2. Implementation of: • registration requirement for food business operators started from February 2010. • food safety control for all food business operators started from January 2011. 3. The 2010 Annual State Control Programme of Food Business Operators has been elaborated by the National Service. In accordance with the Programme, inspections were carried out in 51 food business operators exporting to the EU. 4. In accordance with the Food Safety Strategy, drafting of new Law on Food Safety and Veterinary is underway. 5. For strengthening of the institutional capacities, comprehensive institutions – building was requested for the National Service for Food Safety, Veterinary and Plant Protection. 6. Seminars and trainings are carried out on SPS issues for the relevant governmental institutions in coordination with donors on a regular basis.	1. Georgia should start implementing the articles of the Food Safety Law on compulsory inspections and traceability requirements for the originally foreseen group of establishments, i.e. all food producers, and demonstrate that it carries out this implementation effectively and properly.

Key Priority 2		
Prepare a comprehensive strategy, possibly with accompanying operational programme, of establishment of a solid food safety system.	1. Comprehensive Strategy and Legislative Approximation Programme were agreed with the Commission and adopted by the Government of Georgia. The Government has already started implementation of the Strategy and Programme. 2. In accordance with the Strategy, the following Implementing Legislation has already been approved by the Government of Georgia: • General Hygiene Rules for Food/Feed Business Operators • Official Control Rules for implementation of inspection and traceability – related provisions of the food safety law • The Rule on How to Destroy Food and Feed • Relaxed Hygiene Rules for Small Food/Feed Business Operators. • The Government Decree on General Crisis Management Plan in Food and Feed Safety Area was adopted in 2010 Q4, which is in compliance with Commission Decision 2004/478/EC of 29 April 2004 concerning the adoption of a general plan for food/feed crisis management.	
Additional Recommendation		
Continue preparations for achieving the inter-connection with the EU Rapid Alert System for Food and Feed (RASFF).	Georgia is a member of the EU RASFF system.	

Sources: Interviews and the Strategic Papers of the Government of Georgia.

In order to appreciate the extremely high costs that such preconditions would impose on the Georgian farm and food sectors, Table 5.2 presents the structure of the *acquis* in SPS as defined by the Screening exercises with Croatia and Turkey (hereafter the Screening). Table 5.2 deserves three major preliminary remarks.

First, it presents only a portion of the total EU SPS *acquis*. Second, there is no standard contour of the EU SPS *acquis*. For instance, comparing the SPS *acquis* in Food Law listed in the Screening and the SPS *acquis* listed in the Commission's website shows many discrepancies. Some EU texts considered as key in one document are not mentioned in the other one, and vice-versa. This phenomenon is not limited to the SPS domain (for instance, the *acquis* in air transport varies from 32 to 49 directives and regulations depending the sources quoted, despite the fact that all these sources were from the Commission or were closely working with it [Bertho & Messerlin, 2009]).

Last but not least, the Commission did not give to Georgia a list of the texts of the SPS *acquis* to be transposed—an awkward point after what has just been said on the fuzzy contour of the EU *acquis*. Rather, the Commission told the Georgian authorities to work out what to do with the help of consultants—Table 5.2 gives the outcome of this process which is hardly a good example of what could be a well functioning "*overall coordination negotiating mechanism*" (a condition that the Commission imposes on Georgia).

That said, Table 5.2 shows clearly two key features of the preconditions imposed by the Commission. First, the regulations to be transposed are spread over the whole spectrum of the EU *acquis*. The only chapters or sections with no regulation to be transposed are irrelevant (such as those focusing on intra-EU trade or on the EU's international agreements).

Second, although Georgia exports mostly plants (fruits, wine, waters) the Commission has adamantly insisted on the fact that the transposition into Georgian law should cover all the aspects of farm and food sectors—in particular animals, a sector well known for its extremely stringent constraints in the EU SPS *acquis*. This insistence means that the precondition imposed by the Commission not only inflict heavy costs on Georgia's existing production but also—even more crucially—raises huge entry barriers to the development of new farm activities, condemning to attrition its present and future farm and food sectors.

Table 5.2 The transposition of the EU SPS acquis *into the Georgian legal regime*

			Lists of EC texts planned for transposition into Georgian law					
TITLE 1 GENERAL								
	Chapter 1 Food Law		178 / 2002	2004 / 478				
	Chapter 2 Committees		(irrelevant)					
	Chapter 3 Acts of Accession		(irrelevant)					
TITLE 2 VETERINARY								
	Chapter 1 Control system in the internal market		2009 / 158					
		I. Live animals, semen, ova and embryos						
		II. Animal Products	882 / 2004					
		III. Certification	96 / 93	2002 / 99				
		IV. Mutual Assistance						
		V. Computer Systems TRACES: new ANIMO						
		VI. Funding of checks						
		VII. Safeguard measures						
	Chapter 2 Control system for imports							
		I. Live animals						
		II. Animal products	882 / 2004	2002 / 99				
		III. Border Inspection Posts	882 / 2004	2002 / 99				
		IV. Computer Systems TRACES: new SHIFT						
		V. Safeguard measures						
		VI. Funding of checks	2002 / 99					
	Chapter 3 Identification and registration of animals and registration of their movements							
		I. Bovine animals						
		II. Porcine animals						
		III. Ovine and caprine animals						
		IV. Equidae						

	Chapter 4 Control measures for animal diseases						
	Chapter 5 Intra-community trade in live animals semen, ova, embryos	(irrelevant)					
	Chapter 6 Non commercial movements of pet animals						
	Chapter 7 Prohibition of substances and control of residues						
	I. Prohibition of substances						
	II. Residues controls						
	Chapter 8 Import requirements for live animals and animal products						
	A. Live animals Semen Ova and Embryos	2000 / 13	1924 / 2006				
	B. Animal Products	852 / 2004	853 / 2004	854 / 2004	2002 / 99	1924 / 2006	2009 / 158
	C. Lists of establishments	854 / 2004					
	Chapter 9 Community International Agreements	(irrelevant)					
	Chapter 10 Animal welfare						
	I. Farm animals						
	II. Animals during transport						
	III. Animals at the time of slaughter or killing						
	Chapter 11 Zootechnics						
	Chapter 12 Veterinary expenditures						
TITLE 3 PLACING ON THE MARKET OF FOOD AND FEED							
	Chapter 1 Hygiene rules.	178 / 2002					
	Chapter 2 Specific rules for animal products	2002 / 99	854 / 2004	882 / 2004			
	Chapter 3 Control rules	854 / 2004	882 / 2004				
	Chapter 4 Specific control rules for animal products	854 / 2004	882 / 2004				

	Chapter 5 Rules for animal by-products						
	Chapter 6 Funding of checks	882 / 2004					
TITLE 4 FOOD SAFETY RULES							
	Chapter 1 Labelling presentation and advertising	1924 / 2006					
	Chapter 2 Additives authorised and purity criteria						
	Chapter 3 Extraction solvents						
	Chapter 4 Flavourings						
	Chapter 5 Food contact materials	1935 / 2004					
	Chapter 6 Food supplements						
	Chapter 7 Food for particular uses Food supplements	1333 / 2008					
	Chapter 8 Quick frozen foodstuffs						
	Chapter 9 Contaminants	315 / 93					
	Chapter 10 Novel foods and GMOs						
	Chapter 11 Ionising radiation						
	Chapter 12 Mineral waters						
TITLE 5 – SPECIFIC RULES FOR FEED							
	Chapter 1 Feed Additives						
	Chapter 2 Compound Feeding stuffs	183 / 2005					
	Chapter 3 Feed Materials						
	Chapter 4 Undesirable Substances						
	Chapter 5 Feeding stuffs intended for particular nutritional purposes						
	Chapter 6 Certain Products used in Animal Nutrition (Bioproteins)	183 / 2005					
	Chapter 7 Medicated Feed						

TITLE 6 – PHYTOSANITARY							
	Chapter 1 Plant Health – Harmful Organisms						
		I. General control measures						
		II. Specific control measures						
		III. Protected zones						
		IV. Registration of operators - Plant passports	92 / 90					
		V. Import from third countries	2000 / 29					
		VI. Inspections and notification of interception						
		VII. Derogations						
		VIII. Solidarity and liability						
		IX. Infrastructures						
	Chapter 2 Plant Health – Plant Protection Products						
		I. Placing on the market	396 / 2005	183 / 2005	1107 / 2006	2009 / 128		
		II. Pesticide residues						
	Chapter 3 Quality of Seeds and Propagating Material						
	Chapter 4 Plant Variety Rights						
	Chapter 5 Community International Agreements		(irrelevant)					

Sources: Interviews, the Strategic Papers of the Government of Georgia, Commission website and Turkish Government's website.

5.3 The preconditions: An unsustainable shock for many Georgian consumers

The magnitude of the costs imposed on Georgian consumers by the EU *acquis* in SPS measures is shown by the rough estimates of Box 5.1. If the preconditions in the SPS area are enforceable (a big "if", taking into account the current situation of the Georgian farm sector), the huge food price surges that the Commission's preconditions will inevitably generate in Georgia will severely hurt a large share of the Georgian citizens—above all the poorest third who live in poverty [EBRD, 2010]—and half of the Georgian labour force employed in agriculture (not the richest part of the

Georgian labour force). The current events in the EU Southern Mediterranean neighbours should remind the Commission of the political dangers associated with food price hikes in middle-income countries.

Box 5.1. Estimated costs of transposing the EU acquis *in the SPS area*

The transposition of the EU *acquis* in the sanitary and phytosanitary (SPS) area can be expected to generate three sets of costs: those imposed on Georgian consumers, those on Georgian producers and administrative costs.

The costs for Georgian consumers will be generated by the price surges imposed by the Commission's preconditions. The table below is based on prices collected by the Georgian Statistical Office which have been split into three levels of quality (1 being the highest quality and 3 the lowest) for the 12 most important food products. What follows relies on the plausible proposition that goods of quality 3 will be eliminated by the Commission's preconditions, while the two other types of goods will still be sellable under the Commission's preconditions.

Expected price increases for 12 selected food products

	Average price (in lari) for goods of			Price
	quality	quality	quality	increases for
Product	1	2	3	the poorest [a]
Butter (1 kg)	18.0	12.0	6.5	84.6
Oil (1 l)	7.0	5.3	3.7	43.2
Bread (0.6 kg)	2.5	1.2	0.7	71.4
Milk (1 l.)+	5.0	3.0	1.8	66.7
Cheese (1 kg)	20.0	10.0	4.0	150.0
Meat (1 kg)	18.0	9.0	5.0	80.0
Coffee (1 kg)	100.0	50.0	20.0	150.0
Tea (1 kg)	84.0	52.0	32.0	62.5
Soft drinks (1 l)	1.4	1.2	0.4	200.0
Egg (a dozen)	4.0	3.6	2.4	50.0
Sugar (1 kg)	4.0	3.0	1.8	66.7
Potato (1kg)	1.5	1.0	0.6	66.7
Average price increase for the poorest Georgians				91.0

[a] *Note:* Price differences between the goods of quality 2 and 3. The highest quality is 1.

The price increases related to the disappearance of the food products of quality 3 are huge—on average 91%, with peaks up to 150-200% for cheese, coffee and soft drinks. The poorest portion of the population will have little choice: i) to pay the full price increases (the price elasticity for such products is likely to be very low) if it can afford to do so; ii) to restrict its consumption, which is already often not sufficient if it cannot afford the price increases; and iii) to turn to systematic law infringement, hence corruption.

Transfers from the public budget cannot solve this huge shock. The budget already represents almost 40% of the Georgian GDP. The total number of the families receiving social assistance today is 450,000 (40% of all families) with more than 100,000 families close to qualifying for inclusion on this list.

Turning to the Georgian farmers, there are two main possibilities. If they decide to enforce EU norms, their products will become (much) more expensive and hence will not fit domestic demand (which would then turn to imports from cheaper non-EU sources), while their chances to be successful in the EU markets are slim, to say the least. If the Georgian farmers decide not to enforce EU norms, they will keep the Georgian markets at the cost of a systematic breach of the law and of some shifts of their exports to non-EU markets. In short, there are the same de-industrialization and trade disintegration effects as in the TBT case.

The trade disintegration effect is likely to be stronger in the SPS case than in the TBT case because a vast majority of EU SPS norms are EU-specific. As said above, a critical factor determining the costs of the EU *acquis* on their activities is the relative share of EU-specific norms and ISO norms. Norms specific to the importing country (such as EU norms) have been shown to inhibit the farm and food exports of the EU partner [Chen & Mattoo, 2008; Shepherd & Wilson, 2011].

The administrative costs are far from being negligible. It is useful to note that such costs for Turkey (which has a farm sector relatively similar to the Georgian sector, including a very limited access to EU agricultural markets) are estimated to be higher than €2 billions—roughly 1.5% of the total public expenditures [Togan, 2011]. Based on the case of Lithuania (roughly the same size of population and territory as Georgia), enforcing the EU regulations in SPS in Georgia would require at least 800 persons (Lithuania's staff numbers 1,800 [State Food and Veterinary Service of Lithuania website]). It is important to underscore that two-thirds of the staff costs are related to enforcing EU regulations on animals. Again, what truly counts is the opportunity costs of all these jobs, that is, the foregone chance to hire more pro-growth jobs (nurses, doctors, agricultural instructors, infrastructure-related staff, etc.).

The SPS area illustrates a relatively ignored aspect of the preferential trade agreements, that is, their bias against small firms in favour of large firms. It is reported that the number of food companies after the EU accession has dramatically decreased: from 5,000 to 500 in Poland, from 2,000 to 400 in Hungary, and from 11,000 to 700 (with only 52 approved for trade with the EU) in Romania [Milton, 2010]. Of course, there is some merit to business consolidation, and it would be unfair to attribute these dramatic collapses exclusively to the EU SPS *acquis*. That said, the *acquis* nevertheless is certainly a strong force pushing in this direction since it imposes fixed costs.

Data source: Jandieri (2011).

To sum up, all these elements combined suggest that the main—highly undesirable—outcome of the transposition of the EU SPS *acquis* into Georgian law are as follows:

- It would undercut the assumed positive impact of the EU SPS *acquis* on Georgian food safety, including by boosting imports from non-EU countries.
- It would require an army of inspectors to enforce the EU SPS *acquis* on the numerous small Georgian farmers.
- It would not favour, and probably harm, EU food exports, including by making the whole food chain more expensive.
- It would re-install a culture of corruption in Georgia that would require decades to be eradicated all the more so because SPS regulations involve a very large number of farmers (while TBT regulations involve a limited number of producers). This last aspect should not be a surprising scenario for the Commission since it has occurred in the EU. When the first elements of the EU SPS *acquis* were introduced in the EU farm sector, it immediately triggered a massive wave of corruption in the EU (for instance, veterinary frauds in the beef sector, in particular related to hormones).

5.4 Proposals

First and foremost, it should be underscored that, as Georgia has met the relevant subset of preconditions of the 2009 Matrix (see Table 5.1), the DCFTA negotiations should be launched without further delay. That said, the above sections showed an urgent need to reshape some of the other preconditions when negotiating the context of the DCFTA content.

5.4.1 The Georgian small-farm sector: Be prepared to exclude it for a long time from the coverage of the EU SPS acquis

The problems raised by the transposition of the EU *acquis* are much more severe in the SPS area than in the TBT domain because they concern all the consumers and half of the labour force (the agricultural labour force). The proposals to revise the current precondition in SPS measures should thus be much more drastic than those in TBTs.

The most important proposal is that the small-farm sector should be excluded from the transposition of the EU SPS *acquis* for what will be a long period of transition. This makes a lot of sense from an economic,

institutional (governance) and political view. From an economic perspective, imposing the EU SPS *acquis* on the small-farm sector (assuming that it could be done) would imply the collapse of a large share of the sector which will be unable to cope with the increased costs. From an institutional (governance) point of view, it does not make any sense to try to implement an unenforceable legal regime. From a political perspective, such a collapse would raise serious tensions in Georgia and fuel anti-EU sentiments. Finally, this exclusion presents no risk for the EU consumers since, in Georgia as in all the countries, small farmers are not much involved in international trade.

How long should the transition period be? As in the TBT case, fixing an arbitrary number of years (5 or 10 years) does not make sense. An automatic indicator, such as the level of the GDP per capita, would not be capable of taking into account the full extent of current problems of the Georgian farm sector—its size, backwardness and its possibilities of rapid evolution. The only sure thing is that the transition period will necessarily be long since such a large share of the Georgian labour force is in the farm sector today.

As a result, the best solution seems to be a regular review (say every three years) of the situation in the small farm sector in order to determine when the time would be ripe for including the small-farm sector in the common Georgian law in the SPS area.

5.4.2 The Georgian exporters of food products: Establish a progressive mechanism of mutual evaluation

The most difficult pending problem is the handling of the SPS issues for Georgian food products exported to the EU. However, the fact that internationally traded goods are mostly produced by large farms (still very few in Georgia) and by food firms (multinational firms or Georgian private or cooperative firms) – as in all the countries of the world – makes things easier than it looks at a first glance. Indeed, Georgia has already established registration requirements for food business operators (from February 2010) and food safety control for all food business operators (from January 2011), among other measures (for details, see Table 5.1).

The key missing element is an appropriate treatment for Georgian exports to the EU. The Commission's preconditions make no attempt to benefit from the rich body of EU practices in this domain. In particular, there are two interesting options.

- The first option would be to introduce a mechanism similar to the EFTA Surveillance Body, which evaluates the regulations prepared by the EFTA countries and assesses their consistency with EU rules. This approach has the great virtue of being consistent with the latest model of EU regulation—namely the EU Services Directive with its 'mutual evaluation' of the partners' laws and its unconditional mutual recognition once the evaluated regulations have been found to create no problems. Unfortunately, this approach was not adopted for Turkey, a country with very similar food production to Georgia's. The reasons behind such a choice are very diverse, but the dominant reason may well be the Commission's lack of trust towards the EU's Eastern neighbours.
- The second option would be to extend to Georgia the mechanism used for Turkey's exports of fruits and vegetables to the EU [Togan, 2010]. This mechanism relies on i) Turkish EU-compatible standards [Togan, 2011] and on ii) checks of export operations and control certificates as determined by the OECD Scheme for Implementation of International Standards on Fruits and Vegetables [OECD, 2006].[11] Control certificates are granted only for the agricultural products to be exported within the scope of the standards (mandatory in exports).

Whatever option is adopted, it leaves a final problem: how to define the goods that will be eligible for the mechanism adopted. Here, progressivity should be the rule. The principle of progressivity is enshrined in the Treaty of Rome and its successors. And, since the Commission's preconditions impose obligations on Georgia that make it a quasi-EU MS, it would seem fair that Georgia does benefit from a key principle of the Treaty. As a result, the transposition of the EU SPS *acquis* would:

- be imposed on very precisely defined farm products;
- be conditional on a guaranteed minimum size of annual exports to the EU so that Georgian exporters could reach a certain scale of operation before having to pay the tax equivalent imposed by the transposition of the EU *acquis* in SPS; and also

[11] The OECD Scheme facilitates international trade in fruits and vegetables through the harmonization of implementation and interpretation of international marketing standards. All the EU MS that are also OECD members are signatories. The Scheme also has non-OECD country signatories, such as Morocco and South Africa.

- be conditional on a guaranteed minimum number of continuous years of exporting the farm product in question so that Georgian exporters could have a grace period before having to pay the tax equivalent imposed by the transposition of the EU *acquis* in SPS.

Conflicts over implementation should be sent to a specific dispute settlement system relying on a panel of independent experts from the EU MS, the Commission and the Government of Georgia. The solutions to the conflicts should be explicitly subjected to the rule of proportionality, echoing the basic principle of the EU Treaty and the case law of the Court of Justice.

5.4.3 The Georgian consumers: A progressive consolidation of Georgia's general food safety laws

Georgia should complete its ongoing introduction of the few general food safety laws for the food sector. The DCFTA should simply recognize that this should be done progressively if one wants to avoid the spill-over effects on the Georgian farm sector, in particular severe price hikes endangering the living standard (even the life) of a substantial share of the Georgian population living in poverty. Such a completion means a consolidation and more systematic application of the existing general food safety regulations. Such legislation is scheduled to be introduced in the Georgian Parliament in the first quarter of 2011.

6. THE PRECONDITIONS IMPOSED BY THE COMMISSION ON COMPETITION POLICY AND IPRS

Summary on competition

1. If applied as currently formulated, the full set of the 2009 Matrix preconditions on the competition issues, strictly speaking (excluding state aid), is unlikely to provide net benefits to the Georgian economy. The gains from a competition authority in a country such as Georgia, which has a wide open trade, investment and norms regime, are tiny, as illustrated by the experience of Estonia. By contrast, the costs of an authority that is reminiscent of the price-fixing and rent-seeking authorities of the Soviet era could rapidly become huge. The 2009 Matrix preconditions on state aid do not make sense: there is no state aid discipline at the EU MS level, and such disciplines exist only in the context of the trade agreement linking the EU MS.
2. DCFTA negotiations should start without further delay since Georgia fulfils the relevant subset of preconditions. They should address the above problems by including:
    1. a provision imposing EU-type state aid disciplines on Georgia in exchange for the renunciation of the use of antidumping, antisubsidy and safeguard measures by the EU against exports from Georgia; and
    2. possibly a provision supporting—not forcing—Georgia's cooperation with EU MS competition authorities on strictly defined competition issues (excluding state aid).
3. Following its unilateral path of reform, Georgia should be supported—not forced—in its efforts to open new horizons in good economic governance matters. In particular, Georgia should consider how to use the competition authority in a more productive way—for instance by granting it (or to a sister institution) a role of impact assessment of regulations similar to the one played by the Australian Productivity Commission.

Summary on intellectual property rights

1. DCFTA negotiations should start without further delay since Georgia fulfils the relevant subset of the 2009 Matrix preconditions. They should recognize the fact that Georgia is a lower middle-income country and that most of the counterfeited goods in Georgia are imported from much larger economies. As a result, they should focus on supporting Georgia's policy of membership to international IPR (intellectual property rights) treaties, and target the sources of the counterfeited goods outside Georgia.
2. Following its unilateral path of reforms, Georgia should continue to strengthen its fight against piracy and counterfeiting at a pace that is compatible with its economic growth and political stability.

This chapter deals with the two last key preconditions which share the same feature: they are far removed from trade policy concerns (the introduction of intellectual property rights (IPRs) in the WTO is largely the result of particular circumstances that occurred during the negotiations of the Uruguay Round). This feature is mirrored by the fuzzy—to say the least—language used by the Commission's 2009 Matrix and 2010 Document on these issues, as best illustrated by the requirement on state aid that does not make sense even in the context of the EU *acquis*. Finally, these two last preconditions raise serious basic economic problems that have to be taken into account in any economically sound DCFTA and that are briefly reviewed at the beginning of each of the two sections of the chapter.

6.1 The preconditions in competition policy

Since the mid-1990s, the Commission has systematically tried to introduce competition policy in trade fora—with no success so far. In 2003, the WTO Ministerial in Cancún rejected the Commission's attempt almost unanimously. The EU-Korea FTA has a chapter (Chapter 11) on competition policy that is a long series of good intentions with no teeth: transparency (a provision that cannot go very far because of the confidentiality clause, which is a basic constraint in all competition laws), best behaviour, consultation, cooperation, etc. The Commission's efforts to include this issue in the new Economic Partnership Agreements with the African, Caribbean and Pacific countries have not been more conclusive, to say the least.

In these circumstances, imposing the introduction of a competition policy as a precondition for negotiating a DCFTA with Georgia appears odd and raises serious basic questions.

6.1.1 Basic questions

At first glance, the EU *acquis* in competition matters looks like a good candidate to be part of the set of EU regulations that could be included in a DCFTA because competition policy is fundamentally pro-growth (see chapter 1 on how to define a DCFTA). But, as underscored in chapter 1, the transposition of any set of EU regulations into the national law of the negotiating partner should not be made mechanically, but should take into account the specificities of the negotiating partner. The following sections show that the introduction of EU regulations on competition in Georgian law is not necessary at this stage.

6.1.2 Which benefits for Georgia?

The benefits for Georgia of the transposition of the EU *acquis* in competition policy are in any case small because Georgia is such a largely open economy, in terms of trade, foreign direct investment and norms. As amply shown in chapter 2, all the available indicators confirm that foreign firms can enter Georgian markets easily, whether as exporters or as investors. A rough indication of the cases that a Georgian Competition Authority might have to handle is given by the cartel cases examined by the Estonian Competition Board at the end of the 1990s: milk processors and wholesalers, taxi services in Parnu, Association of Estonian International Road Carriers and a distributor of sport and leisure goods (Hawai Express). None of these cases is huge or has a clear international impact. Indeed, the milk case may mirror a reverse causality: it may well have been caused by the EU Common Agricultural Policy which favours anti-competitive behaviours in the agro-food industries.

Likewise, state aid disciplines are much less necessary in a very open economy than in other economies. The main reason is that subsidies rapidly become very expensive when they are not ‘protected’ by tariffs or other non-tariff barriers.

In fact, any lack of competition in the Georgian markets is likely to be due to a very specific feature that is totally out of the reach of competition policy: Georgia suffers above all from being a small economy located in a tormented region. Foreign firms are likely to plan to trade and to invest in

other regions before considering extending their activities to the South Caucasus. No competition policy can address this issue: it is not in the power of any Competition Authority to create competitors. This problem can only be handled by creating the most favourable possible environment for high growth in Georgia—a target seriously endangered by the Commission's 2009 Matrix with all its preconditions.

6.1.3 Which benefits for the EU?

What can be the benefits of the transposition of the EU *acquis* in competition into Georgian law for the EU? From an economic perspective, the benefits are close to zero for a simple reason: over the next decade, the number of expected cases is tiny (if any) and the economic interests at stake in each case are likely to be (very) small. Both features are due to the small size of the Georgian economy, the limited trade with the EU and the fact that the Georgian economy is very open—and thus sustainable anti-competitive behaviour is unlikely.

From the EU perspective of promoting competition rules in the world trade regime, the transposition of the EU *acquis* in competition into Georgian law will not create a valuable precedent: Georgia's economy is too small to be expected to initiate a domino effect among EU trading partners.

Rather, such an initiative imposes substantial political costs on the EU's image as an attractive anchor. All the EU neighbours that could be candidates for a DCFTA with the EU—and all the small economies in Asia and elsewhere that the EU is approaching for concluding preferential trade agreements—will realize that the Commission has twisted the arms of Georgia, and hence will think twice before considering a DCFTA.

Indeed, the EU competition authorities (whether the EU MS competition authorities or the Commission's DG Competition) have never shown a great enthusiasm for the introduction of competition policy under the legal authority of a trade agreement. These authorities know very well that, to be effective, competition policy needs to become part of the national economic culture, and that it is a long process. In 2005 Georgia chose the full opening of its economy over the reliance on a competition institution: it abolished the former competition authority, which was largely discredited. This choice made a lot of sense in a very small and open economy which had been a command (non-market) economy for a very long time.

The history of the EU's competition policy itself echoes all these concerns. Only two founding EU MS (France and Germany) had competition authorities when the original EEC was created, and the qualification of the

French competition law as an 'exercise in futility' by two of the best specialists in French competition law was still valid until the early 1980s [Jenny 7 Weber; 1975].[12] One of the founding EU MS (Italy) did not get a Competition Authority until 1990, with clearly no serious damage for the success of the Single Market until then.

6.1.4 The preconditions in competition matters

Table 6.1 summarizes the Commission's requirements (cells 1 and 2 of column A in Figure 3.1) as they are listed in the 2009 Matrix and in the 2010 Document. It also lists the actions taken by Georgia (middle column).

The 2009 Matrix requires a draft of a comprehensive strategy in competition policy, and it specifies the components that should be part of this strategy. Georgia has fulfilled the Commission's requirements. Before analyzing the 2009 Matrix requirements in more details, it is easy to observe that the requirements in the Commission's 2010 Document are clearly in breach of the 2009 Matrix. Moreover, they are written in an open-ended language. What does the expression "relevant powers and competences" mean? When does something become relevant? This is not a minor question because competition policy is a constantly evolving area, requiring frequent institutional and legal updates. For instance, Estonia has had three successive versions of its competition law in less than a decade (1993, 1998 and 2001) [Estonian Competition Authority, 2001]. Which of these three versions would the Commission have considered as fulfilling the fuzzy language of the 2010 Document?

The Commission's whole approach deserves two comments, one of which is related to the competition issues, strictly speaking (that is excluding the state aid issues), the other to the state aid issues.

[12] In fact, for a long time "competition policy" in France was mostly a price-monitoring policy.

Table 6.1 A summary of the preconditions in the competition policy area

Commission's March 2009 Matrix	**Actions taken by Georgia**	**Commission's December 2010 Document**
Key Priority		
Demonstrate a genuine political commitment to establishing a modern competition policy in line with EU standards by preparing a comprehensive strategy for this area, including the following components: • Undertaking the necessary reforms to ensure the independence and effective investigative powers of the Agency for Free Trade and Competition, both in the area of antitrust and state aid. Significant strengthening of the Agency's administrative capacities (notably through recruitment of additional staff and enhanced training) and improvement of its functioning in terms of transparency and efficiency. • Drafting and adopting a general competition law in the area of antitrust. • Taking steps to ensure swift implementation of the adopted law, including adequate institutional- and capacity-building.	1. Comprehensive Strategy and Operational Programme were agreed with the Commission services and adopted by the Government of Georgia. The Government of Georgia has already started the implementation of the Strategy and Programme. 2. Respective legal amendments to the Law on Free Trade and Competition were adopted and the new competition agency as an independent legal entity of public law was established. 3. The management and the stuff of the Agency have been appointed. 4. The drafting of the Competition Framework Law is underway. 5. The Agency for Free Trade and Competition has started a long-term, systemic, structured assistance project with SIDA, the Swedish Competition Agency and the Estonian Competition Authority.	1. Equip the new competition authority with relevant powers and competences.
Additional Recommendations		
Start to prepare a reform of the regulatory framework in the area of state aid in order to approximate it with the EU and international standards.	1. Preparation of a reform of the regulatory framework in the area of state aid has begun. 2. Necessary legislation drafting is underway.	

Sources: Interviews and the Strategic papers of the Government of Georgia.

6.1.5 Competition issues strictly speaking

The Commission presents all its requirements with a reference to "EU institutional standards". But there is no such a thing. For instance, the alleged standard of one "independent competition authority" does not fit the fact that the EU MS with the longest traditions in competition policy have several competition bodies (three in Germany and in the UK and two in France) and that some of these bodies have close links with the Executive. If such diverse and complex structures have emerged and survived, it is for good reasons—competition issues are much more complex than trade issues, and hence require a subtle balance of institutional checks and balances. It happens that Georgia favours one competition authority, hence its request for support by the Swedish and Estonian competition authorities. But this decision could evolve in the future, and there is no robust reason for keeping the Commission's alleged standards.

Similarly, the Commission's requirements give the impression that there is a 'general' competition law in the EU, and that a DCFTA requires the same competition provisions in Georgia as in the EU. Neither proposition, however, is not supported by evidence. EU competition law is a complex aggregate of a handful of Treaty articles and directives, and numerous (evolving) regulations which interact with EU MS laws, which are often substantial legal pieces. This highly variable legal structure is due to the fact that competition problems have multiple pros and cons, that countries have a wide range of options with which to strike the best balance they can between all these different facets, and that competition cases are dominated by the rule of reason (a case-by-case approach).

6.1.6 State aid issues

The Commission's requirement on state aid is puzzling, to say the least. The Commission's precondition on state aid would require logically that there exist rules on state aid *per se* at the EU MS level. But, there are no such rules, unless one considers that Parliaments are institutions imposing competition-driven discipline on state aid, a view that is hard to justify. The strong intra-EC discipline on state aid reflects the principle that the EU MS cannot impose countervailing or antidumping measures on the exports of other EU MS—in other words, they mirror their decision not to use the

WTO-type trade instruments, but to use the disciplines spelt out in the Treaty of Rome. It is one single package at the EU level.

The rules on state aid make sense only at the EU level for a very simple reason: these rules state that, in order to be prohibited, state aid should have a distortive impact on intra-EU trade flows. If it is not the case, the Treaty of Rome and its successors consider state aids as legitimate. In other words, disciplines on state aid cannot be defined outside the context of a trade agreement (indeed as it is the case for Georgia as a WTO Member).

In these circumstances it is hard to conceive which state aid disciplines Georgia should adopt. For instance, there are possible trade-offs between the state aid discipline that Georgia would be ready to adopt and the renunciation by the EU to use WTO countervailing and antidumping measures against Georgia's exports. Stricter state aid discipline could be a price that Georgia would be happy to pay for the renunciation of the EU to use antidumping, countervailing and safeguard measures against Georgia's exports. But so far the EU has shown no inclination to consider such a trade-off. Another question is how to deal with the fact that most of Georgia's state aid is likely to be under the threshold of the state aid in the EU (simply because of the small size of the Georgian economy).

Box 6.1 Estimated cost to transpose the EU acquis *in the competition area*

In principle, Georgian consumers are expected to gain from the enforcement of a competition policy. However, the value of this general proposition depends on the specific conditions prevailing in the EU partner. In the case of the very open Georgian economy, these gains are expected to be very small, as suggested by the few cases examined by the Estonian Competition Authority (with once again, one case probably related to the EU Common Agricultural Policy).

By contrast, there are some substantial costs. Based on the case of the Estonian Competition Authority, one can estimate that Georgia's competition-related institutions may need 75 staff members. This does not seem a high price to pay. But, the right assessment to do is to balance the tiny gains from a Competition Authority in a very open economy with the opportunity costs due to the fact that recruiting these staff members mean less staff members in more urgent pro-growth jobs (nurses, doctors, agricultural experts, infrastructure specialists, etc.).

Data source: Jandieri (2011).

6.1.7 Proposals in the competition policy

First and foremost, it should be underscored that, as Georgia has met the relevant subset of preconditions of the March 2009 Matrix (see Table 6.1),

the DCFTA negotiations should be launched without further delay. They should also bring a satisfactory solution to the two following questions. What could be the state aid disciplines useful for Georgian exports? What could be the use of a Competition Authority in a wide open economy?

6.1.8 The state aid issue

There are disciplines on state aid among the EU MS because there is a trade agreement—the 'Common Market'—linking the EU MS economies. The EU MS do accept state aid disciplines because they have renounced the use of antidumping, antisubsidy (in the sense of countervailing measures taken by the EU MS themselves) and EU MS-triggered safeguard measures.

The DCFTA is thus the place to negotiate a similar balance between the EU and Georgia. In short, it should include a provision by which Georgia would agree to implement EU state aid disciplines, and the EU would agree to renounce antidumping, antisubsidy and safeguard measures against Georgian exports.

6.1.9 What to do with the Georgian Competition Authority?

The net benefits from the implementation of competition policy in Georgia are likely to be negligible—if one assumes that it does not awake the old ghosts of price-fixing and rent-seeking institutions under the Soviet regime. In this context, the minimum that the DCFTA could do would be to support—not force—a strengthening of existing Georgian links with EU MS competition authorities.

But, the DCFTA could also include a provision allowing Georgia to make better use of its Competition Authority (or to reshape its Competition Authority along the following lines). An attractive alternative to a traditional competition authority is offered by the model of the Australian Productivity Commission (APC). The APC mandate is to be an "independent research and advisory body on a range of economic, social and environmental issues affecting the welfare of Australians" [APC website].

This mandate is attractive for two reasons. First, the APC goal is the "welfare of Australians" which includes producers, but also consumers and taxpayers, hence allowing the APC to take the widest possible economic interests into consideration when providing its advice. Second, the APC independence is ensured at the cost of no executive power (APC is an

advisory body). In other words, the APC is not absorbed by attending to the most urgent things first (behave as a government). Of course, this independence comes at a cost: the influence of an APC-type institution is not instantaneous. Rather, it flows from its capacity, year after year, to deal with thorny issues, by collecting the appropriate information, providing sound economic analysis and disseminating both via numerous hearings involving all parties—in short, from its capacity to build over the years a strong reputation to offer sound solutions. All these features make APC-type institutions quite different from competition authorities—indeed much more useful for a wide-open economy such as Georgia looking for the best possible governance in order to boost its growth as much as possible.

6.2 The preconditions in intellectual property rights

There are two very different perspectives to take into account in the IPR context. The first one is to remember the basic economic analysis of the IPR, which is essential for an enlightened enforcement of IPR policies in an international context. The second point discusses the IPR issue in the context of the current discussions between Georgia and the EU.

6.2.1 The economics of IPRs as a guide for international trade relations

IPRs are monopoly rights granted by governments for a given period of time in exchange for innovations produced by firms and beneficial to consumers. Unfortunately, if the monopoly rights are sure to generate price increases, the existing IPR regimes do not ensure *ex ante* that these rights will deliver what they are supposed to—beneficial innovations. Industrialized countries have recently witnessed hot debates revealing an increasing recognition of this fundamental problem, often on an *ex post* basis. For instance, institutions managing social security in some EU MS have begun to eliminate drugs of dubious value from the list of reimbursable drugs, and there is a very lively ongoing debate on the magnitude of the share of really useful drugs.[13] There are also sectors where a lively public debate on IPRs has been stimulated by the emergence of new technologies that *de facto* limit IPRs, as in the case of authors' rights in audiovisuals in some European countries.

[13] In the current debate in France, some doctors argue that 50% of the drugs sold in France are useless, and 25% of them are only marginally useful.

Because of this unavoidable ambiguity of IPRs, trade negotiators of the rich countries should be very careful when supporting IPRs if they do not want to be seen as having been totally captured by the vested interests of their country. In the EU-Georgia context, this risk is illustrated by the fact that, as already noted, the Commission's 2009 Matrix limits the participation in an effective dialogue in Georgia on IPRs to the rights' holders alone, in breach of its insistence to include all stakeholders, including consumers, for the other preconditions.

There are two additional reasons for such a restraint on IPRs by trade negotiators of the rich countries. First, imposing IPRs on small and relatively poor countries is particularly costly for these countries for two combined reasons. The relatively poor consumers of these countries are asked to pay high (monopolistic) prices (the unavoidable consequence of the IPR regimes) when buying goods protected under IPRs. And the producers of these countries are unlikely to produce a large flow of innovations, hence IPRs. As a result, the net international balance of IPRs for small and relatively poor countries is very negative—in short, IPRs are large transfers from poor to rich countries. Once again, this situation is justifiable, but only when the innovations are proven and beneficial, and as mentioned above, the emerging debates in drugs and audiovisuals in industrial countries cast serious doubts on how frequently this is the case.

Second, IPRs are an easier issue to deal with when consumers are rich and producers innovative, as in most EU MS. Indeed, the EU's current fondness for IPRs is likely to become cooler when the majority of patents and other IPRs will come from India or China (at some point in the course of 2011, China is expected to produce more patents than the US). This inescapable evolution explains China's current efforts at a much stronger enforcement of IPRs. In other words, the EU has strong long-term incentives to generate a more restrained approach towards IPR regimes in the international trade system before it is too late for its own interests.

To sum up, IPRs and freer trade of goods are two very different animals: IPRs increase prices and favour vastly large and industrialized countries whereas freer trade reduces prices and generates gains for all the countries, small or large, industrialized or developing.

6.2.2 The IPR issue in the DCFTA context

Table 6.2 summarizes the Commission's requirements (cells 1 and 2 of column A in Table 3.1) as they are listed in the 2009 Matrix and in the 2010 Document. It also lists the actions taken by Georgia (middle column).

Table 6.2 A summary of the preconditions in the intellectual property rights area

Commission's March 2009 Matrix	**Actions taken by Georgia**	**Commission's December 2010 Document**
Key Priority		
Achieve tangible progress in the implementation of the relevant PCA and ENP Action Plan's provisions aiming at significantly improving the implementation and enforcement of the existing IPR legislation, notably as regards the fight against piracy and counterfeiting, through in particular, launching a study on piracy and counterfeiting in Georgia and ensuring an effective dialogue with rights holders as foreseen in the ENP Action Plan.	1. Study on piracy and counterfeiting was completed. 2. In order to strengthen the institutional mechanism for copyright protection, the Government of Georgia approved the establishment of an Inter-Agency Coordinating Council on Copyright Protection. 3. Seminars and training are carried out on IPR issues for the relevant governmental institutions and other stakeholders in coordination with donors.	1. Establish *ex-officio* powers for the enforcement authorities (both police and customs). 2. Improved IPR protect-tion and enforcement should then be reflected in increased number of i) raids and seized pirated and counterfeited goods (including at the borders); ii) court cases (civil and criminal) in the IPR area; iii) registered cases found to infringe IPRs (including at the borders); iv) goods destroyed.
Additional Recommendation 1		
Accomplish drafting, adopt and start to implement the new separate design law approximated with the EU *acquis*.	1. New separate Design Law is in force. 2. In order to ensure the smooth implementation of the Design Law, respective secondary legislation was adopted, namely the Implementation Rules for Design Registration.	

Additional Recommendation 2		
Accomplish drafting, adopt and start to implement the new legislation concerning supplementary protection certificate.	Legislation on supplementary protection certificate is in force.	
Additional Recommendation 3		
Amendments to the system of fees in the areas of designs and patents will be approved together with draft legislation on industrial designs and amendments to patent law. New system of fees will not be based on the GDP level of the origin of the applicant and it will be in full accordance with TRIPS requirements (envisaged after the launching the negotiations on DCFTA)[a]	IPR registration fees are now equal for local and foreign persons. The WTO requirement of non-discrimination is thus fulfilled.[b]	

[a] The preparation of a Strategy was not a precondition of starting DCFTA negotiations and was requested by the Commission only for the implementation stage of DCFTA. However, Georgia decided that this issue is very important and addressed it as a matter of urgency.

[b] This action was requested by the EU only for the implementation stage of DCFTA, not as a precondition to start negotiations.

Sources: Interviews and the Strategic Papers of the Government of Georgia.

The 2009 Matrix focuses mostly on the fights against piracy and counterfeiting within the existing Georgian IPR law. The December 2010 Commission document changes dramatically the situation and the whole tone by introducing a long list of additional requirements. Some of those new requirements seem to restate previous requirements, raising the question of the rationale behind such repetitions.

The additional requirements raise serious concerns. First, an important case concerns the *ex-officio* powers for customs actions in the IPR area, which was listed in the 2009 Matrix as among the things to be done after the beginning of the negotiations (column B of Table 3.1). Second, as said earlier in this chapter, the language is often 'open-ended'. For instance, when would the level of 'increased' actions and outcomes be judged

sufficient for opening the DCFTA negotiations, and by whom? Last but not least, the language of the additional requirements is a mix of quantitative targets for actions and results, such as the points 2(i) to 2(iv) which were also shifted from preconditions during the DCFTA negotiations to preconditions for launching the DCFTA negotiations. Which is the critical criterion—actions or outcomes? What would happen when there will be a gap between actions and outcomes—for instance if the increased number of raids does not lead to a substantial increase in the number of seized pirated and counterfeited goods?

Box 6.2 Estimated costs to transpose the EU acquis *in the IPR area*

As in the TBT and SPS case, there are three major possible sources of costs: the costs imposed on the Georgian consumers, those imposed on the Georgian producers and exporters, and the administrative costs of implementing the EU regulations.

The costs imposed on the Georgian consumers are hard to estimate because of the lack of data. These costs are likely to hurt all layers of the population—for instance, the middle to relatively rich consumers for media or software products, the poor to the middle-class consumers for brand clothes.

The immediate costs to the Georgian producers are small because most of the counterfeited products available in Georgia are imported: media and software products from Russia, clothes from Turkey, Iran or China. If the EU wants a better IPR enforcement, the best policy would thus be to target the producers of counterfeited products. In the long run, the industrial structure and the current skills of the Georgian labour force do not give much hope for gains from IPRs for the Georgian economy since IPRs tend to favour large firms and/or large markets, and Georgia has none of these two features.

The administrative costs have been estimated on a basis of 300 staff members (200 inspectors, 40 border controllers and the rest for the legal implementation, such as supervisors, lawyers, etc.). Once again, the opportunity costs in terms of pro-growth jobs (doctors, infrastructures specialists, etc.) that could have been filled instead are the best measure of the losses due to the implementation of the IPR regime.

Data source: Jandieri (2011).

6.2.3 Proposals in the intellectual property rights area

First and foremost, it should be underscored that, since Georgia has met the relevant subset of preconditions in the March 2009 Matrix (see Table 6.2), the DCFTA negotiations should be launched without further delay.

That said, the above section underscores that IPRs are a difficult question for every country since their benefits (useful innovations) are much less certain than their costs (price increases generated by the monopoly power). On top of this common feature, IPRs are a very difficult item to sell politically in an international context. This is because they are a source of vast transfers (costs) from the small and/or poorer countries such as Georgia to the large and industrialized countries—with even less certainty that IPRs largely designed for rich consumers deliver beneficial and useful innovations for significantly poorer consumers.

Since Georgia does not seem to pose any more serious problems in pirating or counterfeiting than an average country [UNDP, 2010] – if only because it is not a notable producer of counterfeited products, it seems wise for the EU to keep to a very moderate approach in the DCFTA by supporting Georgia's efforts to fight piracy and counterfeiting.

There is no miracle in this area. The fight against piracy and counterfeiting is long and complex (because it is also economically ambiguous). It certainly requires effective police and judicial institutions. But it equally requires a (much) better design of the current IPR laws, as suggested by a new body of economic literature.

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ANNEX
GEORGIA'S TRADE PATTERNS BY PRODUCT GROUP AND COUNTRY, 2002-2008

Table A1. Merchandise exports by product group, 2002-08

	2002	2004	2005	2006	2007	2008
Total exports ($ million)	346.3	648.8	866.2	991.5	1,232.9	1,497.5
			(per cent of total)			
Total primary products	58.5	60.8	57.3	49.1	49.5	41.5
Agriculture	32.0	33.2	37.0	25.7	26.3	18.3
Food	29.7	31.0	34.9	23.5	24.0	16.5
1124 Spirits	1.6	2.9	3.4	3.0	4.7	3.9
1121 Wine of fresh grapes (including fortified wine)	9.6	7.5	9.4	4.2	2.5	2.7
1110 Non-alcoholic beverage, n.e.s.	5.8	5.1	6.1	4.7	4.4	2.6
0577 Edible nuts fresh, dried	2.0	2.7	8.1	5.7	5.3	2.1
Agricultural raw material	2.2	2.2	2.1	2.1	2.3	1.8
2484 Wood of non-coniferous, sawn to a thickness > 6 mm	1.4	1.4	1.2	1.1	1.2	1.0
Mining	26.5	27.6	20.3	23.4	23.2	23.2
Ores and other minerals	19.2	23.9	17.0	20.2	19.0	20.0
2831 Copper ores and concentrates	3.8	4.9	4.2	8.0	6.4	7.9
2823 Other ferrous waste and scrap	8.8	12.7	8.5	5.5	5.2	6.4
2882 Other non-ferrous base metal waste and scrap, n.e.s.	2.9	2.9	2.7	4.5	4.5	3.1
2822 Waste and scrap of alloy steel	1.8	2.1	1.2	1.8	2.6	2.1
Non-ferrous metals	1.9	0.2	0.1	0.3	0.5	0.2
Fuels	5.5	3.5	3.2	3.0	3.7	3.0
3330 Crude oils of petroleum and bituminous minerals	1.9	1.5	2.7	2.6	2.3	1.6
3510 Electric energy	1.9	0.0	0.4	0.2	1.4	1.1
Manufactures	33.2	36.2	38.7	46.0	44.9	51.7
Iron and steel	4.9	7.7	9.8	9.4	13.4	19.5
6715 Other ferro-alloys (excl. radio-active ferro-alloys)	3.6	5.4	7.8	8.5	12.2	15.6
6714 Ferro-manganese	0.9	1.2	1.5	0.5	0.8	2.2
Chemicals	7.0	6.8	6.7	7.9	9.6	10.5
5621 Mineral or chemical fertilizers, nitrogenous	3.5	4.4	4.1	4.7	4.6	7.0
5429 Medicaments, n.e.s.	0.8	0.4	0.4	0.8	1.2	1.3
Other semi-manufactures	0.5	1.8	2.8	4.3	7.2	6.3

6612 Portland cement and similar hydraulic cements	0.0	0.7	2.0	2.9	5.2	5.3
Machinery and transport equipment	19.2	18.7	17.0	20.8	12.4	12.9
Power generating machines	0.4	0.6	0.3	0.8	0.5	0.2
Other non-electrical machinery	1.7	2.1	3.4	5.6	2.2	1.1
Agricultural machinery and tractors	0.0	0.1	0.1	0.2	0.0	0.0
Office machines & telecommunication equipment	0.5	0.2	0.1	0.2	0.3	0.3
Other electrical machines	0.3	0.2	0.2	0.2	0.6	0.4
Automotive products	0.5	1.1	2.8	7.1	6.1	7.9
7812 Motor vehicles for the transport of persons, n.e.s.	0.2	0.6	2.1	5.1	5.7	7.6
Other transport equipment	16.0	14.5	10.3	6.9	2.7	3.0
7911 Rail locomotives, external powered	0.4	0.3	0.1	0.1	0.5	2.1
Textiles	0.1	0.1	0.0	0.0	0.0	0.1
Clothing	0.4	0.3	1.0	1.2	1.2	1.3
Other consumer goods	1.1	0.9	1.3	2.4	0.9	1.0
Other	8.3	2.9	4.0	4.9	5.6	6.9
9710 Gold, non-monetary (excl. gold ores and concentrates)	8.3	2.9	4.0	4.9	5.6	6.7

Source: UNSD Comtrade database, SITC Rev. 3, WTO, Trade Policy Review: Georgia, 2009.

Table A2. Merchandise imports by product group, 2002-08

	2002	**2004**	**2005**	**2006**	**2007**	**2008**
Total imports ($ million)	793.3	1,847.0	2,490.9	3,674.5	5,214.1	6,055.7
			(per cent of total)			
Total primary products	43.1	39.3	38.3	37.0	34.9	35.9
Agriculture	21.4	21.4	17.8	16.9	16.3	15.9
Food	20.5	20.9	17.4	16.4	15.7	15.3
0412 Other wheat (including spelt) and meslin, unmilled	1.9	2.9	1.4	2.4	2.5	1.6
0461 Flour of wheat or of meslin	1.1	2.6	1.8	0.8	0.9	1.2
1222 Cigarettes containing tobacco	2.4	1.5	0.6	0.6	0.7	1.0
4215 Sunflower seed or safflower oil, and their fractions	0.4	0.9	0.9	0.6	0.6	0.8
0123 Poultry, meat and offal	1.4	0.5	0.6	0.6	0.7	0.7
0989 Food preparations, n.e.s.	0.6	0.3	0.4	0.4	0.5	0.7
Agricultural raw material	0.9	0.5	0.4	0.5	0.6	0.5
Mining	21.7	17.9	20.5	20.1	18.7	20.0
Ores and other minerals	0.5	0.4	0.3	0.4	0.7	1.5
2877 Manganese ores and concentrates	0.0	0.1	0.0	0.0	0.4	1.2
Non-ferrous metals	0.3	0.3	0.2	0.3	0.4	0.4
Fuels	20.8	17.3	19.9	19.4	17.6	18.0
3432 Natural gas, in the gaseous state	6.1	4.0	3.5	5.6	5.5	3.3

Manufactures	56.6	58.9	60.1	60.9	59.8	63.6
Iron and steel	2.6	6.6	2.5	2.9	4.4	4.8
Chemicals	13.4	9.9	9.6	9.0	8.5	9.1
5429 Medicaments, n.e.s.	7.0	3.9	3.4	2.7	2.4	2.6
Other semi-manufactures	7.2	7.4	8.7	8.6	8.5	9.5
6612 Portland cement and similar hydraulic cements	0.1	0.3	0.5	0.5	0.6	0.9
6624 Non-refractory brick, tiles, pipes, etc.	0.4	0.5	0.5	0.6	0.5	0.7
Machinery and transport equipment	25.4	26.7	29.4	28.9	27.8	29.2
Power generating machines	0.6	2.8	3.0	0.8	0.4	0.4
Other non-electrical machinery	7.9	7.1	5.5	6.3	6.4	6.2
Agricultural machinery and tractors	0.4	0.1	0.2	0.5	0.4	0.2
Office machines & telecommunication equipment	5.7	4.0	4.5	6.3	6.2	6.8
7643 Radio or television transmission apparatus	2.1	0.8	1.0	1.5	1.9	2.3
7611 Colour television receivers	0.2	0.5	0.6	0.7	0.7	0.7
7641 Electrical apparatus for line telephony / telegraphy	0.6	0.2	0.2	0.4	0.4	0.6
Other electrical machines	2.9	3.3	3.7	3.6	4.0	4.4
7731 Insulated wire, cable etc.; optical fibre cables	0.5	0.6	0.7	0.8	0.9	0.7
Automotive products	4.3	7.9	9.9	10.6	9.3	10.2
7812 Motor vehicles for the transport of persons, n.e.s.	2.8	6.3	7.2	8.0	7.1	7.7
7821 Goods vehicles	0.7	0.7	0.9	1.1	0.9	1.0
Other transport equipment	3.9	1.6	2.8	1.3	1.4	1.1
Textiles	0.9	0.7	1.2	1.5	1.4	1.2
Clothing	0.4	1.5	1.4	2.0	1.8	2.3
8458 Other garments, not knitted or crocheted	0.0	0.1	0.1	0.1	0.1	0.7
Other consumer goods	6.7	6.0	7.4	8.0	7.4	7.3
8215 Furniture, n.e.s., of wood	0.5	0.4	0.5	0.7	0.6	0.6
Other	0.4	1.7	1.6	2.2	5.2	0.6

Source: UNSD Comtrade database, SITC Rev.3, Trade Policy Review: Georgia, 2009.

Table A3. Merchandise exports by destination, 2002-08

	2002	2004	2005	2006	2007	2008
Total exports ($ million)	346.3	648.8	866.2	991.5	1,232.9	1,497.5
			(per cent of total)			
America	4.2	3.9	8.1	12.6	20.1	19.9
United States	3.9	3.3	3.1	5.9	12.1	6.8
Other America	0.3	0.6	5.0	6.6	7.9	13.1
Canada	0.0	0.6	4.1	4.9	5.7	8.8
Mexico	0.0	0.0	0.4	0.5	1.0	3.5
Europe	42.3	41.0	39.6	39.4	36.5	40.0
EC(27)	18.4	19.8	25.0	25.8	21.8	22.3
Bulgaria	0.0	2.4	4.9	6.3	4.8	7.1
United Kingdom	9.5	4.9	3.7	2.5	1.9	2.9
France	0.9	1.5	1.3	3.1	0.9	2.7
Germany	1.6	2.5	3.3	4.6	4.6	2.2
Spain	0.2	1.5	1.6	1.7	1.2	1.3
Italy	2.2	1.8	3.9	2.4	1.4	1.1
Romania	0.0	0.2	1.0	0.6	0.6	0.9
Netherlands	1.3	1.5	1.3	0.7	1.0	0.8
EFTA	7.0	2.8	0.4	0.2	0.1	0.1
Other Europe	16.9	18.4	14.2	13.4	14.6	17.7
Turkey	15.5	18.3	14.1	12.6	13.9	17.6
Commonwealth of Independent States (CIS)	48.7	50.7	47.1	39.8	37.5	36.2
Azerbaijan	8.5	3.9	9.6	9.3	11.1	13.7
Ukraine	3.7	2.4	4.3	5.7	7.6	9.0
Armenia	5.8	8.4	4.6	7.4	9.0	8.3
Russian Federation	17.7	16.1	17.8	7.6	3.7	1.9
Kazakhstan	0.9	1.2	1.1	1.6	2.8	1.5
Belarus	0.7	0.4	0.3	0.3	0.4	0.7
Other CIS	11.6	18.4	9.4	7.8	2.8	1.1
Africa	0.8	0.4	1.6	1.4	0.4	0.1
Middle East	2.0	1.5	1.2	3.5	3.4	1.8
United Arab Emirates	0.6	0.4	0.5	2.3	1.5	0.7
Iran Islamic Republic	1.0	0.7	0.5	0.3	0.5	0.6
Asia	1.9	2.6	2.4	2.6	2.1	1.8
China	0.3	0.5	0.6	1.0	0.7	0.6
Japan	0.2	0.1	0.2	0.1	0.0	0.0
Six East Asian Traders	0.5	0.6	1.1	0.2	0.4	0.5
Other Asia	0.8	1.4	0.5	1.3	1.0	0.7
India	0.6	0.9	0.3	0.9	0.7	0.6
Other	0.0	0.0	0.0	0.0	0.0	0.2

Source: UNSD, Comtrade database, Trade Policy Review: Georgia, 2009.

Table A4. Merchandise imports by origin, 2002-2008

	2002	2004	2005	2006	2007	2008
Total imports ($ million)	793.3	1,847.0	2,490.9	3,674.5	5,214.1	6,055.7
			(per cent of total)			
America	12.2	8.2	8.0	5.6	5.9	6.3
United States	8.7	6.0	6.0	3.5	3.9	4.0
Other America	3.5	2.2	2.1	2.0	2.0	2.4
Brazil	2.3	1.3	1.3	1.4	1.6	1.7
Europe	45.7	49.0	43.9	45.8	44.9	43.8
EC(27)	31.3	36.2	31.5	30.0	29.5	27.4
Germany	7.3	8.2	8.3	9.6	7.4	7.1
Italy	5.3	3.3	2.6	2.8	2.8	3.0
Netherlands	1.9	1.9	2.1	2.0	2.0	2.1
Bulgaria	1.7	2.1	2.9	3.1	3.5	2.0
France	2.0	3.4	3.9	1.9	1.9	1.5
Romania	0.7	0.8	1.6	1.1	1.7	1.5
United Kingdom	3.4	9.3	2.8	1.7	1.4	1.4
Austria	1.4	1.2	0.8	0.9	1.0	1.1
Czech Republic	0.7	0.7	0.8	1.2	1.0	1.0
Greece	1.1	0.8	0.7	0.6	1.0	0.9
EFTA	2.5	1.6	0.8	1.0	1.3	1.2
Switzerland	2.3	1.4	0.7	0.9	1.2	1.1
Other Europe	11.9	11.2	11.6	14.8	14.1	15.3
Turkey	11.3	10.9	11.4	14.2	14.0	15.1
Commonwealth of Independent States (CIS)	36.9	35.6	40.1	38.1	35.5	33.0
Ukraine	7.4	7.7	8.8	8.7	11.0	10.8
Azerbaijan	10.1	8.5	9.4	8.7	7.3	10.0
Russian Federation	15.4	14.0	15.4	15.2	11.1	7.0
Turkmenistan	1.8	1.8	3.8	2.8	2.9	2.2
Armenia	1.2	1.4	1.6	1.1	1.1	1.2
Kazakhstan	0.7	1.2	0.5	0.7	1.2	0.9
Africa	0.2	0.5	0.2	0.3	0.6	0.7
Middle East	2.1	3.8	4.5	4.8	5.9	6.2
United Arab Emirates	0.8	2.5	2.9	3.0	4.1	4.5
Asia	2.9	2.9	3.3	5.3	7.0	9.3
China	1.1	1.6	1.9	2.8	4.0	4.9
Japan	0.5	0.3	0.3	1.1	1.1	1.6
Six East Asian Traders	0.2	0.4	0.5	0.7	1.0	1.8
Other Asia	1.0	0.6	0.6	0.7	1.0	1.0
Other	0.1	0.1	0.0	0.0	0.0	0.6

Source: UNSD, Comtrade database, Trade Policy Review: Georgia, 2009.