

**MAIN FINDINGS AND RECOMMENDATIONS OF  
THE PROJECT:**

**“MACROECONOMIC AND STRUCTURAL  
ADVISE TO GEORGIA”**

**IMPLEMENTED BY CASE SINCE  
SEPTEMBER 2000 TILL FEBRUARY 2003.**

<b>1. INTRODUCTION.....</b>	<b>3</b>
<b>2. ISSUES COVERED DURING THE FIRST PART OF THE PROJECT ONLY – IN THE PERIOD SEPTEMBER 2000 – DECEMBER 2001.....</b>	<b>5</b>
<b>2.1. Strategic plan of economic development – PREGP .....</b>	<b>5</b>
<b>2.2. Structural reforms.....</b>	<b>8</b>
<b>2.2.1. Privatization and restructuring of the state sector .....</b>	<b>8</b>
<b>2.2.2. Agriculture .....</b>	<b>10</b>
<b>2.2.3. Small business development and support .....</b>	<b>12</b>
<b>2.2.4. Reform of the pension system .....</b>	<b>13</b>
<b>3. ANTI-SMUGGLING POLICY - ISSUE COVERED IN THE SECOND PART OF THE PROJECT ONLY – JANUARY 2002 – FEBRUARY 2003. ....</b>	<b>14</b>
<b>3.1. Introductory findings and recommendations and co-operation with the Ministry of Tax Revenues of Georgia. ....</b>	<b>14</b>
<b>3.2. Findings and recommendations resulting from co-operation with the Ministry of Finance after the ministries merger. ....</b>	<b>16</b>
<b>3.2.1. Legal changes .....</b>	<b>16</b>
<b>3.2.2. Co-operation among institutions responsible for anti-smuggling operations .....</b>	<b>17</b>
<b>3.2.3. Declarations of wealth of state officials.....</b>	<b>18</b>
<b>3.2.4. The work and reform of the Special Legion (and its successor). ....</b>	<b>18</b>
<b>3.2.5. Customs Department .....</b>	<b>19</b>
<b>3.2.6. Customs Department – internal control structure. ....</b>	<b>20</b>
<b>3.2.7. Border Guards .....</b>	<b>21</b>
<b>4. BUDGETARY POLICY AND TAX SYSTEM - ISSUES COVERED IN BOTH PARTS OF THE PROJECT – SEPTEMBER 2000 – FEBRUARY 2003.</b>	<b>21</b>
<b>4.1. Tax system reform.....</b>	<b>21</b>
<b>4.1.1. VAT .....</b>	<b>22</b>
<b>4.1.2. Excise.....</b>	<b>23</b>
<b>4.1.3. Personal Income Tax (PIT) and Profit Tax. ....</b>	<b>24</b>
<b>4.1.4. Introduction of fixed and turnover taxes.....</b>	<b>26</b>
<b>4.1.5. Social Taxes.....</b>	<b>27</b>
<b>4.1.6. Other Taxes.....</b>	<b>28</b>
<b>4.2. Budgetary analyses and planning .....</b>	<b>28</b>
<b>4.3. Law on the budget system.....</b>	<b>29</b>
<b>4.4. Deficit financing .....</b>	<b>30</b>
<b>5. CLOSING REMARKS .....</b>	<b>31</b>

## **1. Introduction**

This report presents the main findings and recommendations of the project “Macroeconomic and Structural Advise to Georgia” implemented by a team of CASE experts led by Leszek Balcerowicz. The aim of the project was the strategic advise to the President of Georgia Eduard Shevardnadze on the macroeconomic and structural reforms, which according to the introductory analysis of the Georgian situation in the half of 2000, requests from the Georgian side and CASE experience were indispensable for Georgia in the short or long run. These were:

- formulation of a long run strategic and comprehensive program for economic development;
- fiscal reform with the special attention given to the introduction of the new law on the budget system and improvement of the budget spendings' control, tax system reform, tax and customs administration reform leading to tax collection increase and improvement of budget planning;
- structural reforms with a special attention to privatization and public enterprises' management, reform of agriculture and small and medium enterprises' development and pension reform.

The project has been originally planned to last for one year between September 2000 and September 2001. However resulting from the numerous requests from the Georgian side the project has been initially non-costly extended till February 2002 and then fully extended for the next year, i.e. till February 2003.

During the first phase of the project realized within the period September 2000 - January 2002 the CASE team analyzed the wide range of issues the list of which resulted from the initial project proposal the main elements of which have been mentioned above.

CASE experts were working on fiscal policy problems, including the tax code reform and tax administrating, structural policy issues with a special attention given to the pension reform, privatization, agriculture, small business development and regulatory framework. We were also actively assisting the

government officials working on the Poverty Reduction and Economic Growth Program (PREGP).

Eventually, it became clear that there were two main and interrelated problems that must have been solved in Georgia to make any economic policy really effective. These two were smuggling and bad quality of fiscal policy and they became the only priorities in the next project's phase planned for the period since February 2002 to February 2003.

Struggle against smuggling was the top priority from the point of view of budget revenues. According to CASE estimations, the annual budget loss only due to illegal import of two main excise goods, i.e. fuel and cigarettes, was not less than 100 mln lari. The second result of the large smuggling was its devastating impact on the competitiveness of the locally produced goods on the domestic market. This factor could be even more harmful from the point of view of economic development. It destroyed all the legal manufacturing business. Local manufacturers were not able to win the competition with smuggled goods being "subsidized" by *de facto* exempting them of 20 percent VAT and 12 percent customs duties.

In January 2002 the Georgian side prepared a program of anti-smuggling activities and the President signed it. This program envisaged that due to the critical fiscal situation in the country struggle against contraband of main excise goods such as fuels and cigarettes should be the first priority.

Fiscal policy issues were perceived by the CASE team as the second strategic priority in the country experiencing budget sequester in several consecutive years. Practically all the elements of the fiscal policy have been included in the scope of the project. General regulations were to be improved in a new law on the budget system. The revenue side suffered because of ineffectiveness of tax and customs administrations. It was negatively influenced by excessively sophisticated tax system not matching the level of economic education of the society. Spending side was to be rationalized and spending units more disciplined. The budget deficit was to be more extensively financed by market sources such as treasury bills and bonds. The harmful practice of direct loans from the central bank and accruing of budgetary arrears was to be stopped.

## **2. Issues covered during the first part of the project only – in the period September 2000 – December 2001.**

### ***2.1. Strategic plan of economic development – PREGP***

Already before the project was started the Government of Georgia with the assistance of foreign institutions had been preparing the document that had been supposed to become the strategic plan of economic development of Georgia for the next several years. The first version of the PREGP was presented to CASE experts in October 2000.

It was not a good document. At first the program did not have a clearly defined objective. Fighting poverty was its main objective according to declarations. But afterward the “definition” of poverty was so broad that the reader was not able to guess which of the poverty characteristics was the most important one and hence, the first one to be addressed by the policies described further in the strategy. All, or almost all, other drawbacks of the strategy were the straight consequence of that.

The next issue was also strictly related to the lack of prioritization. The long term strategy like that should assume different scenarios of economic development. The prioritization of objectives to be achieved is essential to be able to prepare different realization schedules for different scenarios, i.e. different financial capabilities of the budget.

The strategy paid too much attention to specific sector-specific policies instead of planning actions that would facilitate the growth of legal entrepreneurship across the entire economy. Therefore some of actions proposed by the strategy were not only mismatched but also sometimes even opposite to each other.

The strategy lacked also the clear division between the analytical part and plan of actions. The result was that different parts of the strategy did not have the same logical structure.

Last but not least the document was simply too long, therefore it was not sufficiently clear. Some parts of the Strategy could be deleted without the loss of general idea.

Building on the above critique, the CASE experts started to cooperate closely with the government officials in the State Chancellery responsible for

preparing the PREGP in order to reconstruct it in the real, comprehensive strategy of economic development. The last version of the program we had our influence on was prepared in July 2001. This document was already much better than its initial version. It has been clearly structured, with the analytical part clearly divided from the program part. The additional chapter has been added presenting the main objectives of the program. The analysis of conditions for the program implementation depending on various scenarios of economic development and the chapter analyzing the external factors such as economic and political situation in neighboring countries have also been added.

The document has no longer been divided according to economic sectors, although there are still sector-specific analyses and programs present in the last version and the cost evaluation has also been prepared according to strictly sector oriented scheme. It is important, however, that macroeconomic, structural and social reforms have been clearly divided one from another in the document's structure. The special sub-chapter has been devoted to privatization as the problem of the special importance for the economy.

Unfortunately, the document even in its latest version<sup>1</sup> (November 2002) is still not free from serious shortcomings what can decrease its operational properties. Is still too long. Priorities are blurred and the entire document still lacks clarity. The same issues are being often analyzed in numerous places leading to intellectual disorder. As Georgia suffers from the recourses constrain priorities must be precisely identified and also available resources should be pointed out.

There are still a lot of very general statements (slogans) in the document and concrete and practical policies and reforms do not accompany them. Some of these slogans may endanger the main objective of the strategy, which is fast and sustainable economic development. These are for example: relating the minimum wage to social minimum or idea of job protection in declining enterprises of heavy industry. There are still numerous superfluous elements in the strategy, especially these related to social and environment issues. These programs are often costly. Actually they constitute the largest share of the strategy's cost evaluation and Georgia will not be able to implement them in nearest future. Unfortunately the

1

---

<sup>1</sup> It has to mentioned here that our project has finished to co-operate with the PREGP Secretariat in the State Chancellery in winter 2001. Preparing of PREGP has not been in the scope of this concrete project activities throughout the year 2002.

sources of financing of these programs are not clearly specified and the costs of programs as such are not calculated in the convincing way either. The existing cost and resources evaluation has been based on very optimistic scenarios and it is not clearly specified, which projects are to be implemented and which may be suspended in case of very probable lack of financial resources. The document has not been anchored in the legislative system and proposed its changes.

It has to be stressed, however, once again that in spite of these deficiencies the last version of the document is much better than the original one and it may be treated as a sufficiently comprehensive list of issues to be addressed and it might constitute the basis for the really operational program for the government activities.

Such a program, however, is still to be prepared and it should have the clearly defined main objective of fast and sustainable economic growth being the precondition for building the wealth of the society. This objective can be achieved only in case of increase of local and especially foreign investments in the country.

Therefore, sustaining macroeconomic stability should be the first priority of the program. In order to achieve it the independence of National Bank of Georgia has to be maintained and prudent fiscal policy aimed at limiting of budget deficit has to be implemented.

Reform of the state administration including the power structures is the next necessary step. Number of institutions and civil servants has to be limited and responsibilities have to be clearly assigned to individuals. Work of the officials has to be clearly monitored and any misconduct has to be punished, accordingly to precise rules. Legal acts regulating the economic activity and relationship between state institutions and entrepreneurs such as tax code, tax procedures, licensing laws, etc., have to be reviewed and changed with the aim to simplify them as much as possible. The possibility of multiple interpretation of rules has to be eliminated wherever it is possible. All of the above should be aimed limit corruption, tax crimes and smuggling.

The strategy should also envisage the reform of education system, realistic (i.e. based on current and forecasted budget possibilities) set of social reforms, program of structural reforms and effective system of monitoring.

## **2.2. Structural reforms**

### **2.2.1. Privatization and restructuring of the state sector**

Privatization and restructuring of the state sector was one of the main issues our experts dealt with throughout the entire year 2001. Ministry of State Property Management being at that time responsible for both privatization processes and restructuring of still state-owned enterprises (or with majority shares held by the state) was the main Georgian partner. Besides, our experts co-operated also with the Ministry of Economy and Commission for Telecommunications Regulation. They have also paid visits to several Georgian biggest enterprises still waiting to be privatized. These were: “Rustavi” metallurgical plant, Aviation Plant in Tbilisi, and Chemical Plant “Azoty” in Rustavi.

The analysis of the ministerial documents on Georgia’s privatization process and also talks with the representatives of the Ministry of Privatization have led to very important doubts: had there been any privatization procedures prepared at the Ministry and had the Ministry adopted any privatization strategy for the following years. Clearly, there was not any analyses of the quality of privatization performed so far, i.e. its impact on financial condition of the enterprises.

As far as privatization processes carried out in the year 2001 were concerned, although it seemed that the preparations were really advanced, there were no basic documents that should have been prepared. There was no “Terms of Reference” for foreign advisers or samples of the privatization agreement prepared by the Ministry. Talks with officers responsible for the accomplishment of the processes have shown a lot of trust towards the hired foreign advisory firms. Popular was the view that a foreign firm would adequately carry out the whole process of privatization and the role of the Ministry was to be limited to a passive receipt of the services. The unsuccessful privatization of the telecommunication company being the main privatization priority of the Georgian government at that time may prove that assessment given by our experts was correct.

Despite the fact that the Ministry (according to its name) should have also dealt with the management and restructuring of enterprises (there are even

respective departments at the Ministry), this process has been carried out by the branch ministries. It resulted in lack of coordination between the restructuring and privatization processes and in the conflict of interests that could cause delays in the process of privatization – branch ministries did not want to privatize enterprises in order not to lose a part of their power.

The financial situation of enterprises that were still state-owned was very bad. Many of them could not continue their activities due to the lack of working capital, many were indebted at the amounts that exceeded their asset value. The management did not have restructuring ideas and proposed solutions were aimed at “survival” in a short run.

Our experts prepared two types of recommendations: a list of necessary analyses that should be performed to set in order the knowledge about privatization and to prepare a further strategy and a list of necessary efforts that should be made immediately in order to enable an effective restructuring of the enterprises that were still state-owned.

According to our experts, in order to improve the process of privatization the following analyses were to be performed:

- A detailed analysis of the Georgian capital market, both public and non-public, and possibilities of its development considering the activities of institutional investors. Especially the development potential of the Stock Exchange and the market of funds such as venture capital should be subject to the analysis.
- Checking the possibility of the Georgian enterprises access to external sources of financing, including external capital markets
- Assessing of a local market of advisory and audit firms and checking the possibility of their cooperation with external advisers.
- Defining targeted groups and the scope of material for courses, training and internships that could be organized within the framework of international external assistance (administration employees, consultants, auditors, employees of capital market institutions, personnel of state-owned enterprises).
- Assessing the effectiveness of information channels on offers concerning the enterprises on sale (especially information on small and medium-size enterprises that is directed to external investors).

- Assessing the privatization impact (considering its particular methods) on the financial and market condition of privatized enterprises.
- Measuring the impact of ownership transformations on Georgia's economy – on jobs, impact on export and import (value, volume and structure), inflow of modern technologies, processes of ownership concentration, impact on the development of market competition.
- A detailed analysis of selected privatization projects in terms of their quality and effectiveness (carryout of procedures, legal and economic and financial services' documentation).

In order to improve the management of enterprises subject to state control and to enable to begin an effective process of their restructuring and privatization, the following actions were to be taken:

- The whole process of management of state-owned enterprises should be taken by the Ministry of State Property Management.
- Establishing the Development Agency that should professionally carry out the restructuring transformations at enterprises before their privatization. It is very important, however, that the agency is a commercial not bureaucratic institution so as it is really able to perform its tasks according to the market logic and its decisions are the managerial not the clerical ones.
- Preparing the law on financial restructuring of enterprises where the majority stake is held by the State Treasury, which would enable the enterprises to get rid of the burden of their indebtedness on condition they adopt an appropriate restructuring program.

### **2.2.2. Agriculture**

The issues related to Georgian agriculture were also in the scope of interest of the CASE experts in the year 2001. The officers of the Ministry of Agriculture and the foreign advisers who work at the ministry were our main partners in this activities.

A typical feature of the Georgian agriculture is a big share of small farms that produce only to satisfy their own needs. The agricultural and foodstuff industry inherited from the former system the “production capacity” that is not used due to the lack of agricultural raw materials. At the same time, the existing

domestic market demand for the processed foodstuffs is satisfied with legal, and even more frequently illegal, imports.

Development of economic entities that would create the demand for unprocessed agricultural products is necessary in order to encourage farmers to produce more than it is necessary for own family needs and possibilities to sell only on a local market. Such entities can be as follows:

- enterprises purchasing fresh seasonal products (vegetables and fruit) that are intended to be put on the domestic market and for export, and also mass products (cereals);
- wholesale markets – places where products prepared according to defined standards, quality, packaging, etc. are traded.

The development of the agricultural market and food processing entities in the present economic situation in Georgia requires capital support that could be used for:

- financial resources for the purchase of agricultural raw materials by industrial plants,
- getting resources for investments to modernize processing and packaging production lines and for investments in the cooperating farms.

In order to restore production in agricultural and foodstuff plants in a short time, it is necessary to change the rates of customs duties for the unprocessed agricultural raw materials. Relatively lower as compared to the processed foodstuffs customs and border duties for agricultural raw materials that are not produced in Georgia or their amount produced there is insufficient (e.g. cereals) should encourage their processing domestically instead of importing ready-to-serve foodstuffs (e.g. poultry, margarine, sugar).

Due to a big number of foreign aid programs in the area of agriculture, it seems necessary to establish a unit that under the auspices of the Georgian Ministry of Agriculture would coordinate all the programs in order to:

- direct the programs to different areas in such way as to get the multiplier effect (e.g. development of seed production on the areas where the irrigation is performed and the development of the agricultural advisory center is supported).

- Perform the analysis of efficiency of the existing programs, especially in the context of further aid proposals and the planned loan that the Government of Georgia intends to take to satisfy agriculture needs.

### **2.2.3. Small business development and support**

Small and medium business support was the next issues our experts worked on in the year 2001. The representatives of the Ministry of Economy, Center for Small Enterprise Development and Assistance, Ministry of Agriculture, banks that deal with micro-lending and also existing institutions that specialize in this area in Georgia were the main partners for our experts in this respect.

It has been concluded that apart from problems related to over-regulation of the Georgian economy manifesting itself in numerous licenses, permits and state and municipal controls visiting the entrepreneur, lack of the start-up capital is one of the main factors limiting the development of the small enterprises in Georgia.

The Center for Small Enterprises Development prepared with the active assistance of the CASE experts the market-oriented schemes for crediting small enterprises. These schemes were to be implemented with the active participation of private banks and these banks were to decide who would obtain financing. The risk of credit activity was to be shared between banks and state agency. Due to hard constraints in the Georgian budget, however, the agency has never started to operate. Probability that it would be endowed with meaningful funds in the nearest future is also very low.

Taking this into account CASE experts, drawing from the vast experience of other transition and developing economies suggested that dynamic growth of privately and internationally funded micro-crediting schemes would lead to acceleration in entrepreneurship development in Georgia.

Our experts were not convinced that the existing institutions supporting small businesses in a form of micro-loans were really focused on the assistance to these firms. Their main objective was rather to sustain their own activities. Hence, we suggested establishing a new effective micro-financial institution that would enable financing of small businesses. This would require a series of actions in the following sequence:

- Recruitment of candidates to work within the program, including candidates for the position of the program manager.
- Providing the candidates with practical possibility to learn the basic principles of micro financing through a direct and active observation of another micro-financial program performance.
- Selection of candidates.
- Analysis of development possibilities of small businesses in towns, mainly dealing with trade and services, and the analysis of financial needs of enterprises in rural areas, mainly dealing with foodstuff processing.
- Development of a program that defines a way of establishing of the micro-financial institution, methodology of enterprise financing, sources of advising and financial needs of the institution.
- Submitting the project to institutions that may be interested in its financing.

In case the project financing sources are known:

- Arranging an internship in a foreign micro-financial institution for the employees.
- Organizing an information campaign for entrepreneurs – potential recipients of the program.

#### **2.2.4. Reform of the pension system**

Throughout the entire year 2001 an intensive work on the pension system reform was performed by the Social Fund together with the World Bank experts. It has been considered to introduce a one-tier system partially based on actuarial principles and also a system similar to the one in New Zealand (with the first tier limited to the role of a social benefit and the wide development of the third, voluntary, totally capital and private tier). Our experts have cooperated in these activities both with representatives of Georgian party but also with the World Bank consultants.

CASE recommended to perform economic analyses that would compare the impact of the selected models of a pension system on the condition of Georgia's public finance and on motivation of employees and employers to disclose their real income what indirectly affects the revenues of the state budget

through the increase of income tax revenues. Therefore we have strongly suggested to both interested parties that the reform of the pension system of Georgia should be coordinated with the planned reforms of the tax system.

### **3. Anti-smuggling policy - issue covered in the second part of the project only – January 2002 – February 2003.**

#### ***3.1. Introductory findings and recommendations and co-operation with the Ministry of Tax Revenues of Georgia.***

The formal co-operation between the Georgian authorities and CASE on anti-smuggling policy started in January 2002 when the President of Georgia had issued a special Decree No.40. In this decree President ordered various structures of Georgian authorities to implement certain activities leading to more effective fight against smuggling.

The first list of preliminary recommendations in the area of interest was delivered to Georgian authorities in the same month. The CASE experts have recommended among others:

- to bind legally all authorities to cooperate with related services in anti-smuggling activities and to prepare the cooperation agreements between various state services,
- to create powerful internal control structures in all state services responsible for anti-smuggling activities, these structures should be subordinated directly to the head of service,
- to decentralize the power for investigation,
- to create a centralized bank of criminal information related to smuggling,
- to introduce a system of financial motivation for successful servicemen of related institutions,
- to create special and secret task-forces comprised of representatives of various state bodies responsible for anti-smuggling activities acting in the regions of special importance,
- to introduce certain changes in basic legal acts such as a criminal code, administrative code and criminal and administrative procedural codes.

Afterwards according to the proposed structure of the project, in February and March 2002 the group of three CASE experts were working continuously in

Georgia for the period of 5 weeks. Our experts were not only analyzing documents delivered by Georgian authorities and discussing them with the representatives of different governmental bodies. They visited various customs points located in remote regions of Georgia and private companies importing or producing excise goods. These visits enabled them to directly assess the methods of work of Georgian customs and tax authorities. Our experts were also responsible for assessment of the implementation stage of preliminary recommendations delivered to the Georgian side in January and February 2002.

Our experts have concluded that the organizational structure of Georgian institutions responsible for anti-smuggling activities was capable of effective implementation of necessary activities, although some structural changes would be desirable. It became clear, however, that some of Georgian official especially working in customs administration felt strongly discouraged and demobilized by the constant threat of never-implemented organizational reform in their respective structures. It might have had a direct influence on the quality of work and level of corruption. In addition, insufficiency of strong political determination to support the activities of related authorities was the most important factor deciding about the lack of success.

Resulting from their field mission, the CASE experts have kept in force all of the earlier recommendations often augmenting them and also created the new list including among others:

- necessity to prepare a new comprehensive law on the special legion,
- reform of the border guards reconstructing this structure into the police formation based on the professional servicemen working on contract basis,
- unconditional confiscation of all smuggled goods and confiscation of the smugglers' vehicles,
- review of the existing system of excise tax and customs duties in order to limit the economic motivation for smuggle,
- closing down of all illegal and non-standard petrol stations operating on the territory of Georgia,
- necessity to effectively close the border between Georgia and Azerbaijan for the illegal movement,

- installation of cash machines with fiscal register on all petrol stations and unconditional obligation to use them every time,
- organization of the system of multi-institutional controls on the roads from the uncontrolled zones – Abkhazia and Ossetia,
- shortening the time span allowed for movement of transit goods (especially petrol and cigarettes) through the territory of Georgia and more severe punishments for individuals responsible for breaking these regulations,
- annual changes in excise stamps patterns and introducing a ban on boxes bigger than 20 cigarettes,
- strict control of all petrol cisterns leaving the Poti port after unloading,
- creation of the special analytical department in the Ministry of Tax Revenues.

In the beginning of May 2002 the President of Georgia decided to merge the Ministry of Revenues and the Ministry of Finance. Both acting ministers were dismissed. The new Minister Mr. Mirian Gogishvili was nominated in the half of May 2002.

Below there are outlined the most important findings and recommendations worked out by our experts on the anti-smuggling issues during their co-operation with Minister of Finance Mirian Gogishvili. They are partially the results of amendments to CASE earlier recommendations resulting from changes in structure of Georgian government after the ministries' merger. Others resulted from activities performed by the new minister.

### ***3.2. Findings and recommendations resulting from co-operation with the Ministry of Finance after the ministries merger.***

#### **3.2.1. Legal changes**

The effective smuggling prevention is not possible without the suitable legal solutions. In Georgia there were planned several reforms in the law and the structure of the law enforcing agencies. The most important of them were:

- decentralization of investigation competencies,
- restructuring of the Special Legion into the Fiscal Police under the Minister of Finance,
- changes in the Criminal Procedural Code,

In the current legal system the investigation procedure is divided in two stages. The first stage is carried out by various state law enforcement bodies such as a police, border-guard or Special Fiscal Legion. Then the case is forwarded to the prosecutors office and similar investigation procedures are to be repeated there before the case can be judged by the court. According to the proposed changes the investigation procedure is to be unified and will be carried out “till the court” by various bodies under the supervision of the prosecutors office. This direction of the reform is strongly supported by the CASE experts.

In the longer time span there are planned broader changes in the Criminal Procedural Code. Serious simplification of procedures is the main objective of the reform being prepared with a strong support of German experts.

The legal status of the Special Fiscal Legion is not well defined in the legal system of Georgia. Both its responsibilities and competencies are blurred. It seriously complicates the operations of this very important structure. This status has to be clearly defined by a special legal act.

Confiscation of smuggled goods and also of vehicles used by smugglers is one of the most productive tools of anti-smuggling operations. Unfortunately, according to the verdict of the Constitutional Court of Georgia this method may not be used as unconstitutional. This problem has to be solved appropriately and confiscation of a crime tool and a crime object has to be legally allowed.

Georgian authorities plan also to reform the Customs Code. Currently the work on the new code is entirely concentrated only in the Customs Department. According to our experts, such a serious and sophisticated legal act should not be prepared by one institution only. Already from the very beginning all the works should be performed by a multi-ministerial committee that should be headed by at least the Deputy Minister of Finance. Only such a work pattern would guarantee the successful implementation of well designed project.

### **3.2.2. Co-operation among institutions responsible for anti-smuggling operations**

Opposite to numerous verbal declaration of Georgian officials, there has not been any clear evidence for co-operation between various state bodies involved in the anti-smuggling activities such as: the Special Fiscal Legion, Police, Border-Guard Department, Customs Department, Prosecutor office and

Ministry of State Security. The effective fight against a large-scale smuggling of excise goods is not possible without such a co-operation. According to CASE experts the frames of this co-operation should be regulated by special act of law. This legal act should define very precisely prerogatives of various institutions. It should also regulate the obligations and procedures of information exchange.

### **3.2.3. Declarations of wealth of state officials**

The constant monitoring of the declarations of wealth of state officials can be an effective anti-corruption measure. Since large-scale smuggling is strictly related to corruption such declarations can also be an important obstacle for smugglers. Currently in Georgia there exists a special structure - The Office of Declarations of Wealth of State Officials, the role of which is to collect the wealth's declarations of state officials. The only obligation of an official is to submit his/her declaration on time. Political responsibility is the only consequence of presenting a false declaration. Unfortunately, there is not any formal system of declarations' monitoring. On the other hand, declarations are open for public, i.e. they can be reviewed, copied and controlled by anyone.

According to our experts, declarations of wealth have to be checked in a systematic manner with a legal responsibility for submitting a false information. The existing office should be included into the Ministry of Finance since verification of the declarations can be most effectively carried out in this ministry.

### **3.2.4. The work and reform of the Special Legion (and its successor).**

Our experts have deeply analyzed the proposed new Law on the Fiscal Police (as in February 2003). The new law increases the responsibilities of the new structure that will be created on the basis of the current Special Tax Legion. Among others it will be fully responsible for fight against smuggling. It will also have the power for investigation. It is very important to locate the new structure in the Ministry of Finance as it is already planned. Only this ministry has a constant access to all information about taxpayers being necessary for this body to work effectively.

According to estimations of the head of the legion at least half of the staff of future Fiscal Police should be able to carry out the investigation procedures. Unfortunately, currently only 20-30 percent of the legion's staff is prepared to cope with this task. Therefore, according to CASE experts, it is absolutely

necessary to start the intensive training of the legion's staff. It is also necessary to recruit young persons with legal education. These new persons should be adequately trained, including the special courses abroad and should constitute a core of the new structure. The management of the legion should prepare the precise schedule of activities that should be undertaken if the legion is to effectively start the work related to new responsibilities and competencies as soon as the law on the Fiscal Police is in force.

The staff of the Special Legion (in future Fiscal Police) should be constantly verified and not only during the recruitment process. All the Fiscal Police staff members should submit the declarations of wealth every half a year, these declarations should be verified by the special structure in the Ministry of Finance. It is strongly advised to use the lie detector during the staff verification process.

It is very important from the point of view of effectiveness of the future activities but also from the point of view of safety of functionaries to give them the right for the use of firearm. However, the law should more precisely regulate the rules of use of this weapon by the legion's agents.

Last but not least, the Ministry of Finance should provide the adequate funds for the process of reorganization of the Legion.

### **3.2.5. Customs Department**

The new organizational structure of the Customs Department of Georgia was introduced on September 10, 2002. In the new regional structure there are 4 regional divisions and 2 special ones: energy customs and railway customs. This reorganization results in the simplification of the structure of the Customs Department, reduces the number of managing staff by 40 percent and gives a chance to put a special control over the strategic fields such as railway transport and energy resources' import.

The process of verification of the staff has still not been started in the Customs Department, although according to the plans of the Ministry of Finance it should have been completed by the end of the year 2002. Till the completion of the verification procedures, according to which all the persons working in the customs department should pass the specially prepared test of professional knowledge, the management of the new regional and special divisions should not

be nominated. CASE experts support the idea of the open contests for the managing functions in the Customs Department, however, the contest procedure has to be regulated by the legal act issued by the Minister of Finance and should be based on the world standards in order to secure the maximum objectivity. We do also strongly support the idea to involve the representatives of foreign institutions such as US Customs into verification process .

The successful verification of the staff and the attestation of the places of duty will determine the efficiency of the work of the restructured Customs Department.

### **3.2.6. Customs Department – internal control structure.**

CASE experts do believe that the existence of an effective internal control structure is one of the necessary conditions for the correct functioning of a customs service in any country.

The current position and competencies of the internal control structure in the Customs Department are absolutely unacceptable. It is not able to fulfill its functions. It is located only in the headquarter, subordinated to the head of the section for special affairs and then indirectly to one of vice-chairmen of department. There are only 7 persons in the structure's staff, including the head and the vice-head. Practically it works only on issues that have been complained about earlier. It is not implementing its own activities and it is not able to obtain information in the operational manner. It means it is not an internal control structure but the bureau of complains.

According to our recommendations, which have been several times delivered to the interested Georgian parties, the internal control structure should be:

- directly subordinated only to the head of the Customs Department,
- seriously strengthened by the new competent functionaries,
- it should have right for operational activities,
- allowed to initiate operations on its own,
- it should have agents in all regional structures of the Customs Department and these should be directly subordinated only to the headquarters

The above listed recommendations are the necessary element of an effective anti-corruption system in state services and they are also in accordance with the widely accepted European standards and as such they have been accepted by the head of the Georgian Border Guard.

### **3.2.7. Border Guard**

There are plans of widespread reforms in the Georgian Border Guard Department. The department is to be transformed from the military formation to the police one. It means the change of competencies and responsibilities. It will obtain the power to carry out investigation and it will be able to operate in the extended zone – 30 km from the state border. Consequently, the internal structure of the department is to be changed as well.

The entire program of the reform is being prepared in co-operation with the German high rank experts. It is even directly supported by visits of German Minister of Internal Affairs and the head of the German Border Guard (*Bundesgrenschutz*).

The recommendations of the CASE experts are in line with those given by the German side. However the CASE experts do believe that the position of the head of the Border Guard Department should be strengthened. The head of the formation should directly supervise the entire internal control service, including its regional branches.

Since the entire reform is scheduled for the period of 2-3 years it is very important that the Minister of Finance will ensure the process with adequate funding throughout the entire period. It is highly recommended, especially taking into account the present strong involvement of German experts, to actively apply for additional funding from international partners, especially the European Union. Especially the border infrastructure could be financed with foreign assistance.

## **4. Budgetary policy and tax system - issues covered in both parts of the project – September 2000 – February 2003.**

### **4.1. Tax system reform**

More than 90 percent of all tax incomes of Georgian authorities (including territorial units) come from 8 main taxes only and these are:

- Value Added Tax (VAT)
- Excise
- Personal Income Tax (PIT)
- Profit Tax
- Customs Duties
- Social Taxes
- Road Fund Tax
- Property Tax

In this report we will analyze mainly the reforms of the four main taxes: VAT, Excise, PIT and Profit Tax. We will mention also some issues related to Social Tax and other local taxes.

#### **4.1.1. VAT**

Value added tax in Georgia has only one 20 percent rate, which is exactly the same as in neighboring countries. It seems, therefore, contrary to view of many Georgian entrepreneurs, that it may not be considered as very high.

The VAT rate has not been changed over time, but VAT threshold was altered several times. At the very beginning it was only 3000 lari, i.e., 2300 USD of the annual turnover. Then in 1998, due to observed weakness of the tax administration, it was increased to 20.000 and then to 35.000 but only in case of farmers. Then since July 2000 there is once again common threshold for all kinds of economic activity – 24.000 lari. These changes may not be considered as the effect of a coordinated policy. They were implemented rather accidentally, leading to a mess in the tax system.

The current threshold level is still very low. Annual turnover of 24.000 lari is about 70 lari per day, hence it includes even very small firms. Owners of these firms are not sufficiently economically educated be able to calculate tax liabilities on their own. As a consequence, they are not able to defend themselves against the corrupted official of tax administration. Nevertheless, even if we assume that tax officials are not corrupted they are not able to effectively control such a big number of taxpayers. According to the official data of tax administration (from the beginning of 2002) out of 193.000 of taxpayers only 15.000 are registered as VAT payers.

Very generous and complicated system of tax exemptions is the next drawback of the VAT system. Currently there are more than 30 of various exemptions, many of them having social and sector oriented character.

Increase of the VAT threshold should be one of the main points of planned tax reform. According to calculation performed in the Ministry of Finance with the assistance of our experts already in 2001 the new threshold should be set on 100.000 lari of annual turnover. Only about 25 percent of all current taxpayers would fall in this new threshold and they are currently paying about 95 percent total VAT payments. This increase should be accompanied by introduction of special tax regimes for entrepreneurs falling below the new threshold. More detailed description of these regimes is presented in part 4.1.5.

Unconditional liquidation of all VAT sector-oriented concessions (such as special allowances for companies involved in oil related investments or special exemptions for note-books and other printing materials) should be the second main step of the reform. All allowances of social character should be replaced by the system of targeted subsidies for needy people. Other tax concessions such as these for humanitarian aid or diplomatic services should be reviewed to limit the possibility of abuse.

Taking into account the weakness of tax administration and the poor economic education of the society, Georgian authorities should also introduce a special tax regime for farmers. Various solutions can be applicable. It can be the system of fixed taxes for certain group of smaller farmers and ordinary regime for others. A special system of fixed mark-ups on prices of agricultural products is an alternative solution. In that case a buyer (for example entrepreneur running a food processing company) and not a seller (farmer) would be the paying agent.

#### **4.1.2. Excise**

Apart from oil products, tobacco, strong alcohol and vehicles there are several other products, on which excise is levied on such as caviar, jewelry, bear or bottled gas. However, only the first four group of products are really meaningful from the point of view of budget revenues. For example, excise revenue from caviar are virtually zero, making this tax essentially fictional.

Taking into account the low effectiveness of the Georgian tax administration, the list of excise goods should be limited to the first four products

only. The direct fiscal cost of this operation would be negligible and tax and customs administration officers could devote more of their time to most important excise goods.

The excise tax rates are the other issue. It may be very hard to keep the difference between the excise rates in Georgia and in neighbor countries in the longer run.

The same applies to the discriminatory policy of different excise rates for locally produced and for imported tobacco products. First, such a policy may be questioned by the WTO, but the second issue is even more important. The system of production monitoring in local tobacco factories is very weak and the CASE experts in their recommendations have addressed this weakness. Hence, it is very easy for companies, which both produce at home and import tobacco products to falsely “increase” their local production at the cost of budget revenues.

#### **4.1.3. Personal Income Tax (PIT) and Profit Tax.**

Personal incomes in Georgia are taxed according to the progressive rates, with the highest one of 20 percent. Since thresholds are quite low, 90 percent of taxpayers finally reach the maximum rate. Despite of that, PIT in Georgia may not be considered as high. Unfortunately, there is still the widespread practice of income underreporting. Possibly it is mostly related to (also not high, comparing to other countries) Social Taxes which sum up to 33 percent. However, the role of the progressive PIT should not be underestimated either. Firms’ profits are taxed according to flat rate of 20 percent.

The system of tax allowances is very generous and sophisticated both in case of PIT and Profit Tax. There are special PIT exemptions for war veterans, single mothers, handicapped people, highlanders or women with the title of “honorable mother of Georgia”, and many others. Concessions for firms located in mountainous regions, for firms being run by handicapped people or producing special rehabilitation articles or for firms using the energy from renewable resources are listed, among others. in case of Profit Tax. Most of these allowances especially as far as PIT is concerned have definitely a social character.

A progressive system with a series of allowances directed to certain individuals or firms should be accompanied by strong tax administration being able to register and effectively monitor all taxpayers. High level of economic

education of society seems to be the next inevitable condition for such a system to work properly. Unfortunately, neither of these two is true the in Georgian case.

The system of taxpayers' registration is very poor, especially in case of PIT. Single taxpayers are not identified at all by a system. Only persons gaining their incomes from more than one source and self-employed have to submit tax declarations. The rest of citizens are completely out of control of tax administration and the information about their incomes may be found only in accounting records of their employers.

CASE experts have proposed three main directions of reforms of income/profit taxes: introduction of the proportional (single-rate) PIT, cancellation of all PIT allowances serious limitation of number of Profit Tax allowances. Introduction of special simplified tax regimes (in line with the proposed VAT reform) for small entrepreneurs, self-employed and possibly also for farmers is the last element of the proposed reform.

There are three main arguments in favor of proportional PIT. First, as a developing country Georgia needs a tax system encouraging honest citizens to work and earn more and, hence, to invest. Social solidarity issues should in this case be of secondary importance. Similar steps have already been taken in other countries of the region, with the most well known examples of Russia, Estonia, Latvia, Lithuania and Slovakia. Second, the progressive PIT creates a much stronger motivation for tax evasion than proportional one. Last but not least, the proportional tax is much simpler for taxpayer to calculate and for tax administration to monitor. The last argument, however, is true only if all tax allowances are cancelled. In that case one does not need a system of individual registration of all PIT taxpayers, that is still to be built in Georgia.

The most difficult issue is calculating the single PIT rate. First, it should be at least fiscally neutral, it means that expected budget revenues should not be changed. Second, it should result in minimum possible losses for lower income strata of population. The CASE experts together with the Ministry of Finance estimated such a rate to be 16 percent. The calculation was done in 2001 basing on 2000 data, therefore most probably it should be repeated. The last proposition (end of 2002) of the Ministry of Finance was the 20 percent rate. This, however, has been calculated taking into account the fiscal effects (that most probably would be positive), of reform only. Redistributive consequences have not been taken into

account what seems important from political point of view, it may simply lower the probability of positive voting in the parliament.

#### **4.1.4. Introduction of fixed and turnover taxes**

Introduction of the simplified tax regime for small enterprises is the last main element of the tax system reform, which has been proposed to Georgian authorities by our experts. We have been proposing to introduce two kinds of simplified regime for all entrepreneurs, falling below the VAT threshold. The first is the fixed (lump-sum) tax for micro-enterprises and the second one is a turnover (sales) tax. These taxes should replace VAT, Profit Tax and PIT for respective businesses.

Entrepreneurs running the smallest firms would pay the fixed tax. A closed list of economic activities allowed to pay this tax would have to be constructed. The size of the fixed tax should depend on two main factors: kind of economic activity and location. For example, wall-painter in Kakheti should pay much smaller tax than similar person in Tbilisi and they both should probably pay less than jewelers in respective regions. Other criteria such as size of occupied premises or number of employees can also be applied.

If the kind of economic activity of a firm does not appear on the final list of activities taxed according to lump-sum method and a firm's annual turnover (sales) falls below the reformed VAT threshold then it should pay the turnover tax. The rate of turnover tax should be calculated taking into account the average value added in respective branches. For example, it should be much lower for trade than for services.

The final amounts of fixed tax and final rates of turnover tax should be based on the existing real data on economic activity. However, since the quality of the Georgian economic data, especially on micro level, is very poor simple common sense and vast experience of tax administration officials should also be taken into account. Final results should also be consulted with business representatives.

Introduction of simplified tax regime for small enterprises should be of temporary character and this fact should be taken into account from the very beginning, similarly as in the case of VAT threshold increase. The optimal solution is to set a well-defined path (scheme) of the system's withdrawal. The

detailed schedule of serial decreases of VAT threshold and increases of fixed tax payments should be part of the legal act introducing the simplified regime.

Such a serious change in the tax system can be introduced only in the beginning of a year and should be supported by an earlier information campaign, especially among the business community. Introduction of the reform in the middle of a year without any information for entrepreneurs will lead only to additional complications and may appear counterproductive.

#### **4.1.5. Social Taxes**

Till the end of 2001, there were three contributions in the Georgian social tax system: Pension Fund, Health Fund and Employment Fund. Altogether they summed up to 33 percent mark-up over the gross wage of an employee. In the beginning of 2002, the employment fund contribution was replaced by new Social Tax, leaving the total sum of social payment unaltered. Looking at the nominal rates of social taxes in Georgia one can conclude that they are not very high even comparing to the other post-Soviet countries. Despite that the practice of tax avoidance is especially severe just in case of these taxes. It seems to be the result of a very bad quality of social services, which citizens expect to get for their contributions. Pensions are of symbolic size, so are the unemployment benefits. Medical services are free only in theory. Hence, the first step to improve the collection of social taxes is the complex reform of the welfare system of the country, including the pension reform.

The other characteristic feature of the Georgian social tax system is that farmers, constituting almost half of working population, are not paying any contributions and afterwards they are eligible for benefits. Self-employed are practically not paying the contributions either, although according to current law they are obliged to do it.

Reforming the welfare system is the long run process and may not be implemented immediately. The short run reform should be aimed to widen the tax base by including not paying groups into the system. Therefore, a defined share of the fixed tax and turnover tax payment could be automatically transferred to social funds and this rule should apply to farmers as well.

#### **4.1.6. Other Taxes**

In Georgia there exist also several other taxes financing local budgets only. Since general level of incomes generated by these taxes is rather low we have not analyzed them in details. It seems, however, that some of them could be abolished without any serious consequences even for respective local budgets, these are: tax on local symbols, resort tax and hotel tax. Some of these taxes, taking into account their small relative importance for total incomes and high level of complexity should be certainly simplified. These are especially ecological taxes.

The tax on economic activity should be definitely abolished, as it seems dangerous for the clarity of entire tax system. It is calculated as the 1 percent of the difference between the total income of an enterprise and material costs. It means that it is something in between of VAT and turnover tax. Calculation of this tax is related to special accounting procedures, requiring very precise definition of material costs. The plan to abolish this tax has appeared in all versions of the tax reform proposals prepared by the Ministry of Finance thus far.

#### **4.2. Budgetary analyses and planning**

This stream of the work was started with an auditing phase. Results were disappointing. Available data were not updated and degrees of consistency and comprehensiveness were not sufficient to run an appropriate analysis. At that time, analyses prepared by the ministry were limited to simple tables presenting the main macroeconomic parameters such as inflation, value-added growth and exchange rate and to monthly tables presenting the budget incomes. The data concerning tax revenues were not corrected for the changes in law. They were neither recalculated for real dynamics nor corrected for seasonal factors.

During the working meetings with Georgian authorities it was agreed to run analytical reports that would allow them to get precise understanding of factors influencing revenue and expenditure side of the central budget:

- Scope of the required reports has been identified, Georgian partners were obliged to update reports
- Financial impact of all legal amendments introduced in the period of 1996-2001 would be identified and monitored
- Based on the above mentioned information revenue time series would be cleaned up and standardized

- Closer cooperation with the Department of Statistics should be started.

The macro-model of Georgian economy that had been developed at the Ministry of Finance was examined. Upon CASE expert's request sensitivity analysis was prepared and results were interpreted during the common workshop.

Throughout the entire project CASE experts have been preparing the monthly analyses of the tax revenues. Each month current performance of the revenue side was compared with targeted results. It helped to monitor improvements in tax and customs administration and also to assess independently the outcomes of the anti-smuggling program. Results of these analyses have been constantly discussed with related officials from Ministry of Tax Revenues and then Ministry of Finance. Tax revenues although slightly improving even in real terms on annual basis (till the end of 2002) were clearly demonstrating weaknesses of the tax administration. Both revenue instability and lack of a clear relationship between tax revenues and tax base indicated that tax administration was still working on the basis of direct monthly negotiations with taxpayers. Therefore, tax revenues were more the result of the current pressure of tax inspectors on businessmen then the result of real economic developments.

In the course of the project the CASE team has only touched the problem of the budget spending planning and monitoring. The preliminary findings suggest that there is much to be done to rationalize it. It seems that the ministries and other spending units of the government every year prepare unrealistic figures already in the phase of preliminary planning. Then these figures are presented to the Minister of Finance with an expectation to be cut. Such a procedure may not lead to effective allocation of resources.

### **4.3. Law on the budget system**

In the course of the project the CASE experts have been working with the Ministry of Finance in preparing the new Law on the Budget System. After the series of discussions CASE experts decided to developed their own proposal. The draft of the Law on the Budget System has been submitted to the Ministry of Finance in mid 2001.

According to our experts there exists a list of key issues that should be incorporated into the new law. A transparent budget classification should be introduced. The law should give the Minister of Finance coordinating position

during the budget process. It should also increase the role of the Minister of Finance in the process of preparation of a long-term economic program for the country. It should include the rule of medium term balancing of the public finances. There should be a formal requirement to balance the budget in the short run, for example, by setting a certain limit to the annual budget deficit. A single institution should be responsible for the entire situation of the public finance - the responsibility should not be divided between the ministry and local authorities. Deficit financing by the National Bank of Georgia should be banned. Clear rules of the public funds management and disciplinary measures including the arrest of funds on the accounts should be specified. The relationship between the central and local budgets should be more precisely regulated. Finally, verification of consistency of the new law with other legal acts has to be performed.

#### ***4.4. Deficit financing***

Lack of market sources of budget deficit financing is a serious problem in Georgia. Currently the Ministry of Finance issues only the short term (maximum 182 days) T-bills practically not traded afterwards on the secondary market. The current rules regulating the auctions, government's problems with liquidity and underdevelopment of the banking system are the main reason for the extraordinary high and unstable yields paid by the MoF on their securities. The volumes traded are also very small.

Based on many interviews and own analytical work CASE experts have developed a series of recommendations in this field:

- Department on domestic public debt, which would be responsible for domestic market should be reactivated; currently the public debt department which is in charge of the public has been focusing on the foreign debt management.
- The new deputy of the Minister of Finance should be nominated who would be in charge of the both domestic and foreign public debt management.
- Cut off rule should be implemented.
- Each year, the budget bill should be accompanied by the so called “public debt management strategy”.
- Maturity of the T-bills should be extended.

## **5. Closing remarks**

During the course of the 2-years long project the CASE experts have been working on the wide range of issues. We have prepared 3 general reports for the President and a long series of detailed reports for respective ministers and other state officials. All of findings and recommendations summarized above were included in these documents, often being accompanied by more in-depth analyses and technical recommendations.

We do not claim that not all of the above analyses and recommendation are still valid. One has to remember, however, that although officially published at the end of 2003 the above analysis is the effect of the work that was suspended at the beginning of 2003 in case of fiscal part and in the beginning of 2002 for all other issues. Nevertheless, we believe that this document may be a good starting point for the new Government of Georgia when formulating the program of economic reforms to be started in 2004.