

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

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

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

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1. Introduction

This is the summary of the report presenting 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.

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.

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.

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

The document even in its latest version¹ (November 2002) was still not free from serious shortcomings that could decide that it would not be able to become an operational program for Georgian authorities in forthcoming years.

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¹ It has to mentioned here that CASE 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 CASE experts’ activities throughout the year 2002.

Such a program is still to be prepared and it should have the clearly defined objective of fast and sustainable economic growth.

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 a.s.o. 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 to 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. The analysis of the ministerial documents on Georgia's privatization process and also talks with the representatives of the Ministry of Privatization have lead to very important doubts concerning the quality of privatization process in Georgia. The assessment of management and restructuring of still state owned enterprises, which the ministry should have also dealt with was very similar. There was not any strategy for further privatization and management of state-owned enterprises, which was taken over by branch ministries.

CASE 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.

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. 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.

The development of the agricultural market organizers and food processing entities should be the main priority. In the present economic situation however Georgia requires capital support that could be used for financial resources for the purchase of agricultural raw materials by industrial plants and getting resources for investments to modernize processing and packaging production lines and for investments in the cooperating farms. Coordination of foreign aid programs in the area of agriculture should be the next priority.

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. 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.

Our experts suggested that it was necessary to establish a new effective micro-financial institution that would enable financing of small businesses establishing and developing. The development of such a program would require a series of actions such as: recruitment of candidates to work within the program and training them, analysis of development possibilities of small businesses in towns, development of a project to find the financing institutions and finally organizing an information campaign for entrepreneurs.

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. CASE recommended performing 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. 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 first list of preliminary recommendations in the area of interest was delivered to Georgian authorities in January 2002. The CASE experts have recommended among others:

- 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: 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. Resulting from this mission the CASE experts created the new recommendations' 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,
- 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,
- creation of the special analytical department in the Ministry of Tax Revenues.

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

3.2.1. Co-operation among institutions responsible for anti-smuggling operations

The effective fight against large-scale smuggling of excise goods is not possible without co-operation between the main institutions involved in anti-smuggling activities. This co-operation should be regulated by special act of law that should divide very precisely the competencies of various institutions. It should also regulate the obligations and procedures of information exchange.

3.2.2. Declarations of wealth of state officials

The constant monitoring of the declarations of wealth of state officials can be an effective anti-corruption measure. Declarations of wealth of state officials 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 the verification of declarations can be most effectively carried out in this ministry.

3.2.3. The work and reform plans of a Special Legion (and its successor).

The special legion should be placed in the structure of the Ministry of Finance. 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 structure. The staff of the Special Legion 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.

3.2.4. Customs Department

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 the management of 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. 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.

3.2.5. Customs Department – internal control structure.

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. It should also be seriously strengthened by the new competent functionaries, should have right for operational activities and should be 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.

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

4.1. Tax system reform

4.1.1. VAT

Increase of the VAT threshold should be one of the main points of planned tax reform. All sector-oriented allowances should be abolished. These 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.

4.1.2. Excise

The list of excise good should be limited to the first four products only: oil products, tobacco products, strong alcohol and vehicles. It may be also very hard to keep the difference between the excise rates in Georgia and in neighbor countries in the longer run. The discriminatory policy of different excise rates for locally produced and for imported tobacco products should be abolished.

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

CASE experts have proposed three main directions of reforms of income/profit taxes: introduction of the proportional (single-rate) Personal Income Tax, cancellation of all tax allowances in case PIT and serious limitation of number of tax allowances in case of Profit Tax. 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.

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 strictly defined group of micro-enterprises and the

second one is a turnover (sales) tax. These taxes should replace VAT, Profit Tax and Income Tax for respective businesses.

Introduction of simplified tax regime for small enterprises should be of temporary character. The detailed schedule of serial decreases of VAT threshold and increases of fixed tax payments should be the part of the legal act introducing the simplified regime.

4.2. Budgetary analyses and planning

Throughout the entire project CASE experts have been preparing the monthly analyses of the tax incomes. Results of these analyses have been constantly discussed with related officials from Ministry of Tax Revenues and then Ministry of Finance. Both income instability and lack of clear relationship between certain tax incomes indicated that tax administration was still working on the basis of direct monthly negotiations with taxpayers. Therefore tax incomes were more the result of the current pressure of tax inspectors on businessmen than the result of real economic developments in the economy.

In the course of the project the CASE team has only touched the problem of the budget spending planning and monitoring. 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

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 the long-term economic program for the country. It should include the rule of the medium term balancing of the public finance. 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 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 of 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. The current rules regulating the auctions, government problems with liquidity and underdevelopment of the banking system are the main reason for the extraordinary high and unstable yields paid by the MoF for the issued T-bills. 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.

- Domestic public debt department, which would be responsible for domestic market should be reactivated and 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 TBs should be extended.

5. Closing remarks

We do realize that not all of the above recommendations 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. We do, however, 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.