

GEORGIAN ECONOMIC TRENDS

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About Tacis and GEPLAC

Georgian Economic Trends is a publication which is now funded by the Tacis Programme through the Georgian-European Policy and Legal Advice Centre.

The Tacis Programme is a European Union Initiative for the New Independent States and Mongolia which fosters the development of harmonious and prosperous economic and political links between the European Union and these partner countries.

Tacis does this by providing grant finance for know-how to support the process of transformation to market economies and democratic societies. It is the largest programme of its kind operating in the region, and has launched more than 3,000 projects worth over ECU 4,220 million since its inception in 1991 and through 1999.

Tacis works closely with its partner countries and provides know-how from a wide range of public and private organisations including advice and training, developing and reforming legal and regulatory frameworks, institutions and organisations, and setting up partnerships, networks, twinings and pilot projects.

Tacis also cultivates links and lasting relationships between organisations in the partner countries and the European Union to promote understanding of democracy and a market-oriented social and economic system.

The Georgian-European Policy and Legal Advice Centre (GEPLAC) was established in 1998 by Tacis in order to support economic and legal reform in Georgia. Activities under GEPLAC's programme include the production of Georgian Economic Trends and of the Georgian Legal Review, and the provision of economic policy and legal advice to the Georgian Government.



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APPENDIX I: ECONOMIC APPROACH TO THE RESTRICTION OF CORRUPTION IN GEORGIA

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Corruption is one of the most pressing problems of modern society. It has become a priority for consideration by International organizations and more generally among politicians and scientists. It should be mentioned that the scientific analysis of this problem is often of secondary importance and gives way to political approaches to ways of suppressing of corruption, not to mention proposals intended for populist effect.

It should be made clear from the very beginning what kind of event is the corruption from the economic point of view in Post Communist countries in general and particularly in Georgia. This will help in creation of an effective mechanism for its restriction.

The main question, which should be answered in the first place, is a very simple one: *Does corruption exist in Georgia*, as in one of the Post Communist countries? The answer to this, so to say, rhetorical question is simple as well: *of course, it does*. Although there should not be any doubt about the trustworthiness of such an answer, it is still necessary to underline the fact that *nothing much is said by this assertion*, because there is no place in the world where there is no corruption.

It should be mentioned that *corruption*, as such, is a *secondary phenomenon* and it will be practically impossible to elaborate an effective mechanism for its restriction without revealing the economic reasons causing it.

One terminological aspect should also be discussed. Namely, as a general rule, in respect to corruption the word combination - *"to combat corruption"* - is used, what, in our opinion *is unacceptable in principle*, because there are economic preconditions causing corruption, the fight against which, *or against economy is just nonsense*. It is true that the various manifestations of corruption could be combated, which in a short period of time will have camouflage-type pseudo-effect, but actually nothing will be changed: the "main actors" of corruption will change, but the economic reasons causing corruption will remain untouched. At the same time, if we consider, that the full disappearance of corruption is impossible in principle, then, by taking into account the above, the right approach to the problem from a terminological point of view, will be the word combination *"the restriction of corruption"*.

The nature of corruption in countries in the process of Post Communist transformation differs from that of developed countries. This process itself is unique, as the corresponding economy is no longer a command one, but is not yet fully a market one either; and it is this that is directly reflected in the causes of corruption and its various manifestations.

In order to study the nature of corruption in a period of *Post Communist transformation of the economy*, it will be appropriate to remember that this process consists of two mutually complementary sub-processes. The first is *the achievement of macroeconomic stability* and the second - *the formation of the institutions appropriate to a market economy*. Unless these sub-processes reach their logical ending, both of them may (and it is generally the case) *become the cause of corruption in the Post Communist transformation of the economy*.

If the macroeconomic stability of the country has not been achieved, which can be revealed in high rate of inflation and devaluation of the national currency and /or in considerable failure to collect the tax revenues, then this first of all, creates a possibility of "rapid" earning of dirty money.

In this case, the management of the State banking system and persons close to them, having access to the State credits, are given "legally unlimited" opportunity to become rich through rapid currency or commodity transactions, with the help and by means of devaluation of national currency and increases in prices. Unfortunately, Georgia has a bitter experience in this respect, when in 1992-1994 the main form of corruption was "rapid" earning of dirty money.

Failure to collect revenues to finance the State budget is nothing else than directing them to the pockets of the tax collectors and their protectors and on the other hand incomplete budget creates the productive grounds for the authorities of the State Treasury, to give priority to those persons, who give a larger bribe, while financing the budgetary expenses, approved by the Law and in settlement with the budget. Low tax revenues are not able to ensure the relevant level of payment of the employees of the budgetary sector, and this is an objective reason for initiating corruption in respect of high officials.

Therefore, *Post Communist macroeconomic instability is quite a strong nourishing source for the corruption.*

As far as control of inflation, the achievement and maintenance of exchange rate stability is possible within a quite short period of time, this makes it possible not only to restrict, but also to practically eradicate corruption in this field. The International Monetary Fund (IMF) has a great experience of this and all those Post Communist countries, which have intensively cooperated with it, achieved the positive results in a short period of time.

Georgia is one of the best examples of this. In 1994 co-operation with IMF within the scope of the anti-crisis programme, drafted and carried out under the leadership of the Head of State Mr. Eduard Shevardnadze, resulted in the successfully implemented monetary reform of 1995.

It is far more difficult to establish perfect order in fiscal system. As proved by the international experience, there is practically no country in the world, *where concealment of revenues does not take place with the aim of evading the payment of taxes.* Such a phenomenon is known as "shadow economy". Tax evasion is the main element of illegal activities in any country with a developed market economy. In order to restrict corruption in this field it is necessary to aim at: *continuous improvement to the administration of taxation and customs systems; the development of taxation and customs legislation relevant to this process; and practically continuous education of the public in taxation and customs matters.*

Georgia had the most serious problem in this field, because *the reform aiming at the improvement of the administration of the taxation and customs systems had started very late.* The Georgian government was partly responsible for this, but the IMF and the World Bank, despite the greatest international experience failed to outline this task as priority of the reform of fiscal system at a sufficiently early stage. As a result of their recommendations, a specialized foreign company was invited to carry out *pre-shipment inspection* with the view of improving customs administration, on the grounds of the international tender, which was organized with the help and under the supervision of the World Bank. Unfortunately this did not have the expected positive outcome, because there was no timely and corresponding reform in the Customs Department. The Customs Department was made to play an obviously passive part in this reform, and *instead of reducing, the smuggling and corruption have increased for certain commodity flows.*

Even more important is the *role of the IMF in respect to the Tax Code*, which in itself is not a bad one, *but it did not reflect and consequently was not appropriate for the existing level of administration in taxation and customs systems at the start of the reform*. The most evident example of such assessment is the strictest regime recommended to Georgia by the IMF for the taxation of cigarettes and tobacco products, which transferred a great part of the corresponding business to the "shadow economy" and increased the scale of corruption in this field. Another impressive example is the taxation of those agricultural products, with value added tax, the annual circulation of which is more than USD 15,000, which was also introduced under the IMF requirements and which impedes the establishment of large scale enterprises in rural areas. These kinds of mistakes made by the Fund became even graver through continuous, irregular amendment of the Tax Code by the Georgian Government, which finally made the taxation legislation of the country non-effective. Taking into consideration all of the above there should be no wonder why it has proved so difficult to overcome the *budgetary crisis* in Georgia for the last 3 years. Hence, there should not be any doubt about the *need for a new, regulated Tax Code*. Without this the restriction of the corruption in the field of taxation will be practically impossible.

With the view of establishing order in the fiscal system, apart from improvement of taxation and customs institutions, it is no less important to adopt a *realistic State budget, to improve the Treasury and introduce the institution of public procurement*, where despite the positive role of the IMF and the World Bank, *Georgia is, unfortunately, still not behaving itself*.

As proved by the international experience, the reformation of fiscal system requires much more than one year. A longer period is needed for the second constitutive sub-process of Post Communist transformation of the economy – the establishment of the institutions appropriate to the market economy. At the same time, *the lack or imperfection and weakness of the part of such institutions create possibilities for corruption*. It should also be stressed that *the creation of some institutions in a hasty way*, for which, as a general rule, the direct copy of Western analogues is used, does not prove right in most cases, *not to mention the obvious adverse effects revealed in some cases*. One of the relatively "harmless" examples of the above in Georgia is the *law on bankruptcy*, which is practically a copy of the German legislative model, drafted with the help of German experts and then adopted by the Georgian Government a couple of years ago. *Despite the general approval of foreign experts the law was stillborn from the very beginning, inasmuch as according to this law none of the de facto bankrupt enterprises was de jure bankrupt*. After the improvement of this Law *its possible enactment was halted for an undetermined period of time by the Law on Tax Arrears Restructuring*, the draft of which was prepared with the help of the World Bank experts and which expresses the nationally detrimental interests of the most anti-reformatory wing of the industrial lobby of Georgia. It tries to demonise bankruptcy. Yet, it should be stressed, that prolongation of the operation of a bankrupt undertaking is equivalent to maintenance of bad management without any changes (something which destroys the development prospects of an undertaking). *The Tax arrears restructuring procedure is of a corruptive nature for enterprises*, because the preparation of the draft of the approval on restructuring, consideration of deadlines and other conditions in this draft is dependent upon a public official. Furthermore, the above mentioned lobby has been trying for years to introduce a mechanism for writing off the tax arrears, what will obviously be a step "forward" towards corruption in this field. An already difficult situation is made even more complicated by *transferring the right of management of the state share in enterprises to sector ministries*. *This is not just a return to the communist system of economic management, but also intensifies the existence of corruption in this field*, under the condition of the current mechanism of national debt restructuring.

There is only one way out of this situation: *the sector ministries should be deprived of the right of management of the state share in enterprises and it should be delegated to the Ministry of State Property Management, prior to urgent privatisation. The Ministry itself should be reformed; procedures provided by the Law on Bankruptcy should be simplified and after this, the Law on Tax Arrears Restructuring should be repealed (in an exceptional case the Law could be maintained only with the purpose of attracting foreign investments during the privatisation of the relevant enterprise and long-term transfer of the right of its management).*

An evident example of obvious adverse effects of rapid copying of Western analogues for the purpose of establishing the institutions appropriate to the market economy in Georgia is the Tax Code, which was already discussed above.

In order to restrict corruption caused by the institutional vacuum, that is characteristic of the Post Communist economic transformation, *it is inevitable to choose that main institution*, without which the establishment of a market economy will be impossible: the *institution of private property*.

The difficult process of establishing the institution of private property in a Post Communist transformation is the main cause of corruption and thus differentiates itself from the reasons for corruption in Western Countries.

The creation of a liberal legal environment, necessary for the development of the entrepreneurship, is the basis for the reinforcement of the institution of private property. It is also necessary to place all of the entrepreneurs, both local and foreign ones, in equal conditions, in order for *fair competition* to be the only way of revealing the winner.

Primary accumulation of capital is taking place in the countries of the Post Communist transformation. This process took place a long time ago in well-developed Western countries; without it transition to a market economy is impossible.

History does not show any example of carrying out the process of primary accumulation of capital with *"clean hands" and only legally*; usually, this process was based on the phenomenon, which today is considered as corruption.

There is no (or almost no) objective economic basis for the corruption in the developed countries, because, first of all, high officials are provided with rather high wages and what is most important, they, as a general rule, already have capital accumulated by their ancestors, which other things being equal, is a guarantee for their respectable existence and secondly - practically perfect institutions are already established in these countries, which ensure the protection of ordinary citizens. Despite this, it is still "popular" to expose the governments or separate ministers of the whole EU or of any of its Member States, of USA or Japan in corruption. In these countries they usually use *administrative methods* for the restriction of the corruption, which is fully justified.

In the process of primary accumulation of capital, the use of mainly administrative methods with the purpose of restriction of the corruption will inevitably fail. The introduction of a rule that every official should prove that his property has been legally acquired (a breach of the principle of the "presumption of innocence"), and that in the absence of documentation of the origin of the property, its owner should be fined, or the property should be seized, etc. *will finally result in returning of the process of primary accumulation of capital to its point of origin*. Launching this process all over again will prolong the *"life" of corruption*. Besides, as a result of imposing the mentioned punitive measures *a renewed process of primary accumulation of capital* will be carried out in an even more disguised manner and accordingly

will develop as a more hideous event. Today the main way of transformation of newly accumulated capital into property terms in Georgia is house-building, or creating other immovable property, from which many people are employed and get remuneration for their work, construction materials are bought, and gives employment to the workers of their enterprises etc. If punitive measures are introduced, first of all *the rate of bribery will be increased* because of the increased possibility of disclosure (or risk-factor), and secondly - *illegally gained money will not be transferred into property terms in Georgia, but it will flow out abroad.* In other words corruption will not be restricted, but its "main actors" will change and the *society will be deprived of the indirect effect of primary accumulation of capital.*

In order to restrict corruption and establish the institution of private property, it is *necessary to legalize the existing results of primary accumulation of capital,* which will let it "act" in the public interest.

Such an approach does not exclude *the punishment of all the lawbreakers according to the law, provided the constitutionally recognized, very important principle of "presumption of innocence " is not violated.*

Measures for restricting corruption *should be carried out in law enforcement agencies with particular care, and to this end institutional reforms should be carried out together with the financial stimulation of the officers.* Otherwise, the agencies intended for the defence of order, may become the initiators of an extension of corruption or in a worse case even *institutions of political settlement* (the epoch of Stalin, when because of the well known events of 1937 many persons, who had different thinking, the whole army of innocent people were subjected to repression, was a bitter experience for us).

From this point of view, special care is needed in regard to the establishment of any *anti-corruptive institution, or institution having special rights* (namely the right of criminal prosecution and investigation) *for combating corruption. In conditions of weakness in the institutional arrangement of the State, such an institution will become a shelter of corruption itself.* Unfortunately there are many examples of this in the world practice. *Only the creation of an institution with coordinating functions is acceptable,* which at the same time will monitor the measures to be carried out for the purpose of the restriction of the corruption.

With a view to the restriction of corruption, it is very important to comply with the *principle of publicity,* which should ensure the provision of the society with maximum information regarding the current processes, in order to increase the efficiency of the measures to be carried out. To this end, it is *appropriate to publish information on the expenditure of budget funds by the State agencies on a monthly basis,* which will be an effective possibility of public monitoring of these funds.

Corruption is a contagious disease, the whole society is more or less sick from it– the appropriator of collected taxes, the thief of the Treasury, or the ordinary citizen who does not pay for electricity consumed. Unfortunately, even *media could not avoid this disease,* when financially powerful clans (some of them of political nature) can bribe them and dictate the kind of information to be publicly spread. This first of all is caused by existence of unorganised state institutions and by grave economic conditions in the country, when the press and the television have the difficulties to survive independently. But despite this, *only the press and the television are efficient instruments, which could be used for restricting corruption, through the State promotion of competition between them.*

And finally, as corruption is a secondary phenomenon, *the overcoming of poverty by means of economic growth should be the main objective of the country. This itself will be the precondition for the restriction of the economic basis of corruption.*