

# 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.

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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 II: TAX FEDERALISM CONCEPT: CONSENSUS VERSUS SEPARATISM**

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Today, when the country is in the severest of budgetary crises, the most important task is to do the utmost to find and use all the reserves to ensure the growth of budget revenues. In this respect, it is particularly important to choose such a pattern of regional arrangement of the fiscal system that can provide a maximum of budget receipts.

It should be noted from the very beginning that the aim of this article is not to discuss this or that type of taxes or the expediency of their amounts but to discuss a system of tax income distribution between Regions and the Centre of the country.

The tax system is an element of a financial and budgetary system and is to a large extent defining an income item of the budget. In its turn, the territorial aspect of the financial and budgetary system is predetermined by a territorial structure of the State. Economists usually use a term "financial and budgetary federalism" regardless of whether it is a federal or a unitary State (Hewitt, Michaljek, 1993, p. 392). It is necessary to underline that jurisprudence does not give a full definition of a concept of "Federal State" while some well-known legal experts even altogether reject the possibility of defining it (e.g. Gogiashvili, 2000, p. 23-28; Khubua, 2000, p.212-216).

The term "financial and budgetary federalism" covers both sides of the State's financial and budgetary system: on the one hand, it regulates tax incomes and on the other – it deals with the distribution of expenditures to be financed by the government between the central ("Centre) and territorial ("Regions) government authorities. In the case of a federal state, by "Agents of a Federation" we mean regions hereinafter provisionally referred to as "Federal Regions".

"Tax Federalism", i.e. the separation of taxation power between the Centre and the Regions in a unitary state and between the Centre, Federal Regions and Regions in a federal state is the most complicated task for economics and one can say that no common and at the same time generally acceptable and hence a faultless pattern is available (Hewitt, Michaljek, 1993, p. 395). Although modern economics does not possess any more or less cogent arguments concerning optimum ways of separating taxation powers, there is a smaller diversity of possible approaches to distribution of tax levying functions between Centre and Regions in unitary states than between the Centre, Federal Regions and Regions in the federal states of the West<sup>1</sup> (Hewitt, Michaljek, 1993, p. 392). This explains why "financial and budgetary federalism" and in particular, "tax federalism" is more interesting in the context of federal rather than unitary states.

The choice of this or that pattern of "financial and budgetary federalism" depends on what functions the Central Government intends to perform itself and what functions are to be delegated to Agents of Federation. To this end, the original problem is to define so-called "minimal functions" of the Central Government, which is a basic condition providing for the integrity of the state. These "minimal functions" include state defense, establishment of a common legal space, foreign relations, introduction of a common trade regime, emission of a common currency and control over its turnover,

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<sup>1</sup> This is proved by the analysis of the practice of some Unitary and Federal States (Русакова, Кашин (ред.), p.235-456).

achievement of macro-economic stability, application of measures ensuring equalization of the social and economic development of regions. As international practice shows, any "other functions" could be, partially or fully, performed by the Agents of Federation.

In any democratic (or claiming to be such) state, a central government, usually, declares its readiness to give as much freedom to regional authorities as possible. This means the delegation of "more functions" to them and exactly in the same way, these last very often publicly claim their loyalty to the central government and their endeavours towards strengthening the unity of the state. Despite this, the practical evidence is such that almost none of the Federal States has succeeded in a perfect realization of these publicly made declarations: there is always a number of problems discussed between the Centre and the Regions (especially between Centre and Federal Regions) with more or less ardour in the course of discussions on the separation of state functions.

In Federal States with a comparatively longer history of democratic development the frame for discussion is comparatively narrow and the discussion itself is correspondingly less arduous.

As proved by international practice, the following principal approaches are used in the above-referred confrontation between the Centre and the Regions:

The Centre as a rule, is practically never content with implementation of just "minimal functions" (though, certainly it does not declare it) and seeks to maintain some extra instruments of state management. To this end the Centre retains such mechanisms as transfers from the central budget intended for the regulation of problems both throughout the country and in separate regions. So, it is only natural that in many cases the Centre tries to extend the system of "transfers".

The Regions (especially Federal Regions) act through radically different mechanisms. They seek the growth of that part of tax revenues which is intended to remain in regions, at the expense of the coverage of the types of taxes and so through delay the process of tax incomes distribution to their benefit. This, in its turn, results in "pulling over" the functions to be performed by the government at a regional level. Apart from these legal methods Regions in some cases also use illegal mechanisms. Namely, as mentioned in one of the general surveys conducted by IMF, in some Federal States, where transfers of their shares by the Agents of Federation to the Central Budget are made in conformity with relevant laws in a full amount and a due time frequently, there is one such Agent of Federation who contrary to law retains a part of income which belongs to the Central Budget; in such cases, the Centre cuts transfers for the offending "Federal Region" by a corresponding amount but a winner in this confrontation is still the "Agent of the Region" as such action gives him a strong financial instrument empowering him to influence the policy pursued by the Centre; consequently the conclusion is that proceeding from common state interests, the Centre should be able to collect payments directly from those who participate in economic activities without consensus of the Agents of Federation (Hewitt, Michaljek, 1993, p. 392).

Conceivably, the Budgetary Office of the Georgian Parliament was guided by these concepts when it considered inadmissible to let the budget of the Autonomous Republic (AR) of Ajara retain a part of the proceeds from VAT payments, excise, and customs taxes according to the long-term budget norms (Budgetary Office of the Parliament of Georgia, 2000, p.4).

According to the above-mentioned IMF survey, at first it is difficult not to agree to the concept referred to by the Budgetary Office of the Parliament. We discuss this issue in more detail below.

Economics, as already mentioned, does not have any strict criteria, on the basis of which it would be clearly defined whether this or that kind of tax is federal or local by its nature. The only thing that could be said thereof is that a more or less precise theoretical statement as to their "hierarchical" nature could be found with regards to just two kinds of taxes: real estate tax (including land) and customs duty. The first one is considered as local for accumulation of property occurs on a certain territory and the second one is federal, for the customs belongs to the entire country and not to its separate regions. There have been frequent attempts to give a logical explanation as to why VAT and excise duty should also be regarded as federal. Theoretical grounds to this end are so artificial that they could by no means be considered satisfactory.

It should also be underlined that developed countries, where there is a federal structure, use various schemes for the division of the taxation functions and there are no criteria for choosing the best among them (in terms of effectiveness); at the same time it is also remarkable that there is no explanation for proving why "collection" of several taxes by the Centre and the Regions at one and the same time is impossible.

Let us consider the particular situation existing in Georgia on the grounds of the international practice and economic recommendations on the basis of which it will be possible to find the most appropriate decision at this stage.

As noted above, according to the position of the Budgetary Office of the Parliament of Georgia it is inadmissible that the budget of the AR of Ajara retains a part of the VAT, excise duty and customs duty under the long-term budget normatives. Presumably, the budgetary office of the Parliament of Georgia is even more against leaving a part of the VAT in Tbilisi or a part of customs duty in Poti (being quite an acute issue between them) to say nothing of other regions of Georgia (for instance, Imereti, where the analogous proposals are being actively implemented by the authorities).

It should also be noted that an approach suggesting a strict separation of taxes in accordance with the hierarchy is becoming more and more popular with the governmental structures of Georgia, when let us say, VAT shall be counted as a federal tax and recovered 100 per cent in the Central Budget while for example an income tax shall be counted as a local tax and shall also be recovered 100 per cent by the local budget, respectively. Within this context it is remarkable that as proved by the international practice, in more than one Federal or Unitary State an income tax is also federal (and not local) by a hundred percent and in some of them it is divided between the Centre and the Regions (See Table 1).

Such an approach, to our mind, is the main principle of the tax federalism pattern. At one glance it seems quite attractive, as the scheme of division of taxation powers is simplified, which to some extent gives grounds for an actual exclusion of objective possibilities to illegally retain or "hide" the tax income due to the Central Budget by an Agent of Federation. Recently, one of the main subjects for dispute between the Central Government and local authorities of the AR of Ajara was compatibility of the amounts of all kinds of taxes transferred to the Central Budget with the regulations prescribed by Legislature. Under the above-referred approach, the issue at point becomes irrelevant as the Law states that the proceeds from this or that tax revenues should be transferred to the Central Budget either a hundred percent or not transferred at all. The fact that in this case the subject for dispute disappears and the action of the federal region becomes rather transparent does not at all guarantee that, as proceeding from the above-mentioned international experience, the Agent of the Federation would not be left a chance to avoid Law in order to have a political impact on the Centre.

Table 1: Distribution of income taxes among various levels of government<sup>2</sup>

	Countries	Upper Level Central Government	Medium Level (states, lands, etc.)	Lower Level (local authorities)
I.	Unitary States			
	Developed states			
	Belgium	90.9	—	9.1
	Great Britain	100.0	—	0.0
	Netherlands	100.0	—	0.0
	Norway	47.6	—	52.4
	France	100.0	—	0.0
	Sweden	24.7	—	75.3
	Developing and Post-communist states			
	Zimbabwe	100.0	—	0.0
	Israel	100.0	—	0.0
	Kenya	100.0	—	0.0
	Poland	75.9	—	24.1
	South Africa	100.0	—	0.0
	Thailand	100.0	—	0.0
	Hungary	71.9	—	28.1
	Chile	100.0	—	0.0
II.	Federal States			
	Developed states			
	Australia	100.0	0,0	0,0
	USA	81.1	17,2	1,7
	Germany	39.1	40,8	20.1
	Spain	92.9	1,2	5.9
	Canada	63.5	36,5	0,0
	Developing			
	Argentina	34.2	65,8	0,0
	Brazil	100.0	0,0	0,0
	India	100.0	0,0	0,0
	Mexico	98.1	1,3	0,6

At the same time the above approach, when the division of taxation power according to the types of taxes is made on the principle "all or nothing", ultimately lead us to "taxation separatism", when the interests of the Agents of Federation are totally isolated from the national taxation interests with negative consequences for the integrity of the Federal State. Proceeding from this, we call the application of the above-referred approach in separation of taxation power the " doctrine of taxation separatism".

In order to give a full description of this issue, it is also necessary to underline that apart from the above-referred defect the "doctrine of taxation separatism" owing to its nature, is also practically unrealizable. The case is that development in the regions of any state is marked by inequalities both from the social and economic viewpoint and because of this situation tax collection varies between taxes and from region to region. Consequently, this means that there is a big possibility that while ascribing a regional title to the several types of taxes, an amount collected and retained in one of the regions might appear to be so small that it would need to be supplemented through transfers from the central budget, whereas in any other region tax collection according to the same types of taxes, makes up such a large amount that it would exceed the demand of this region for current budgetary expenditures and it would be reasonable to use it together with this surplus for the above-mentioned central budget transfer. Thus, in practice, the principle "all or nothing" might also come to an obvious disagreement with the maintenance/development of the country's state integrity.

Proceeding from all the above, it becomes apparent that the "Doctrine of taxation separatism" is generally unacceptable for any Federal State and for Georgia in particular.

<sup>2</sup> The table has been completed based on Norregaard, 1995, p.250.

In Georgia, at a contemporary stage of building up its statehood, when restoration of its territorial integrity is not yet covered by the question of its administrative-territorial system, great importance is attached to economic instruments creating incentives for regions to ascribe to a so-called "regional consensus" so as, in the first place, to make them economically interested in amplification of the state integrity of Georgia.

The concurrent mobilization of taxes both in central and local budgets, could be used as such instruments.

Again it should be stressed that there is no more or less cogent argument in economics which would at the least prove why it is impossible to recover this or that type of taxes at one or another level of state hierarchy.

As mentioned above, the most "impressive" is the definition of real estate tax as local and of custom tax payment as federal. But, let us suggest that a natural or a legal entity owns real estate within (and not only within) various regions of the country, then it becomes difficult to decide unambiguously whether this payment should be paid to the local budget or to the Central Budget. According to the location of the real estate it would be logical if the taxes are paid to local budgets but insofar as the property belongs either to a natural entity which can without restriction move within the territory of his own country or to a legal entity, which might be functioning in several regions at one and the same time, the grounds for mobilizing this payment to the Central Budget should not be considered less justified. International practice proves that the real estate tax is regarded as entirely federal only in some unitary states, in other states (except Kenya, where it is regarded as entirely local) this payment is distributed between the various levels of government (see Table 2).

Customs payment could also be made subject to similar considerations. Namely, as customs belongs to the state as a whole and not to any separate region, the idea of mobilization of customs payment to the Central Budget solely, looks quite justified theoretically, though in practice customs-houses are located only in a few separate regions (peculiarly at the country's borderlines, seaports or airports), which creates some extra "burden" for these regions and therefore the reason for retaining at least a small portion of the revenues by a local budget of the region could be as successfully argued.

Therefore, a concurrent mobilization of all types of payments to the Central and Local budgets is a viable economic mechanism for attaining "regional consensus" in a federal state; to determine proportions for such distribution, first of all it is necessary to take in consideration the statute of the Agent of Federation and at the same time the ratio of actual tax collection with regard to any type of taxes in each region to distribution of the budgetary expenses between the Centre and the Regions.

Table 2: Distribution of real estate taxes among various levels of government<sup>3</sup>

	Countries	Upper Level (Central Government)	Medium Level (States, Lands, etc.)	Lower Level (Local Government)
I.	Unitary States			
	Developed states			
	Belgium	100.0	—	0.0
	Great Britain	99.2	—	0.8
	Netherlands	65.1	—	34.9
	Norway	37.9	—	62.1
	France	100.0	—	0.0
	Sweden	100.0	—	0.0
	Developing and Post-communist states			
	Zimbabwe	11.5	—	88.5
	Israel	12.3	—	87.7
	Kenya	0.0	—	100.0
	Poland	48.3	—	51.7
	South Africa	25.5	—	74.5
	Thailand	81.9	—	18.1
	Hungary	100.0	—	0.0
	Chile	19.7	—	80.3
II.	Federal States			
	Developed states			
	Australia	2.4	57.8	39.8
	USA	6.0	6.7	87.3
	Germany	2.0	61.2	36.8
	Spain	5.8	50.5	43.7
	Canada	0.0	16.2	83.8
	Developing			
	Argentina	49.2	50.8	0.0
	Brazil	2.2	40.5	57.3
	India	33.7	66.7	0.0
	Mexico	1.2	0.0	98.8

Proceeding from the above-mentioned approach, inasmuch as Ajara enjoys the status of an autonomous republic defined by the Constitution its claim for a comparatively large part of income from this or that type of taxes seems quite natural; in its turn, it is no wonder that Tbilisi, as proceeds from its status as the capital of Georgia, claims a part of the actually recovered VAT payment; proposals made by the other regions of Georgia, including such regions as Imereti, Kvemo Kartli and the city of Poti, concerning establishment of "Tax Federalism" in the country, is to be taken into account as well.

In order to mobilize additional reserves of tax incomes, together with the budget normatives defined by the budget of tax proceeds, it is also necessary to approve increased budget normatives in the corresponding budgets of each of the regions of the country to be used if the target of budgetary receipts is overdrawn.

Let us call the above-referred approach, where the distribution of recovered tax revenues between the Centre and the Regions is applicable to all types of taxes a "doctrine of tax consensus". It can play a significant role in the formation of federal structure in Georgia and for reinforcement of its statehood. The importance of the "tax consensus" principles in the peaceful settlement of the problems concerning Abkhazia and former South Osetia is also to be taken into account.

As noted above, none of the patterns of the "financial and budgetary federalism" exclude a breach of the Budget Law on the part of any non-payer region (first of all "federal region") when it illegally retains amounts due to the central budget, but the "doctrine of tax consensus" to a great extent serves to ease

<sup>3</sup> The table has been completed based on Norregaard, 1995, p.250.

tension between the Centre and the Regions and under other equal conditions it might even minimumise the above-mentioned cases of non-payment.

Today, Georgia as a state is not institutionally ready to implement a complete pattern of the "doctrine of tax consensus". To this end, the most important impeding factor is that the process of territorial arrangements is still underway in Georgia. It is also remarkable, that for realization of a complete pattern of the "doctrine of tax consensus" the country must have a united, strong Ministry of Finance comprising Taxation, Customs and Treasury so as to conceive the system of "financial and budgetary federalism" of Georgia (i.e. not only expenditure but also revenues) within a single context. Nevertheless, all elements of the "doctrine of tax consensus" are to be gradually realized with regard to all regions of Georgia, which in its turn shall make the prospects for territorial arrangement of Georgia more clear.

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