



## THE GEORGIAN TAXATION SYSTEM – AN OVERVIEW

Tbilisi, May 2010

### Executive Summary

Taxation – fundamental to state formation and the provision of state services – has long been an issue that has plagued Georgia. Before the Rose Revolution, there was widespread tax avoidance and evasion, reflecting state weakness and corruption, and impacting severely on service delivery.

With political will, and specifically with the introduction of a new tax code in 2005, there has, however, been a major change in the Georgian fiscal landscape. Taxes have been slashed, procedures streamlined, corruption eliminated and compliance greatly improved. Reflecting this has been a massive increase in the government’s tax-take.

There are, however, some major caveats. The tax administration, while improved, is still less than efficient, and crucially has failed to apply risk analysis or other auditing mechanisms in selecting businesses for tax audits. As well as a waste of administrative resources, this fundamental omission has also allowed for the re-emergence of some disturbing practices. The excesses of the Financial Police, all too evident in the first few years of the Saakashvili administration, are again a fact of life for many businesses in Georgia. Budgetary shortfalls are a major motivating factor, but so too are political considerations, with tax audits, as one commentator noted, being used as a political club.

While the authorities have recognised that low taxes contribute to economic growth, they have failed to apply fiscal instruments to various policy areas. Reflecting an extreme liberal economic outlook, taxation has not been used as a lever to promote job creation in specific sectors or regions. Neither has it, like it is in other countries, been used to advance a whole array of public issues, such as poverty alleviation, urban renewal or decentralisation.

Ultimately, taxation is a mirror of any given country, and as such, the major advances and continued weaknesses in the Georgian tax system reflect both the concrete progress the country has made over the past six years, and the continued need for more reform.

### Introduction

We present this report on the Georgian taxation system for a number of reasons. Given its embryonic state and its many successes and controversies, the tax system is in great need for an appraisal – a snapshot of its development, a look at the gains made and its weaknesses, and an examination of both the many criticisms leveled at it and the laurels heaped upon it.

Taxation is also, for all its dryness and inane technicalities, critical. “No public policy issue,” one report noted, “is of more importance than the structure and level of taxes.”<sup>1</sup> They determine

<sup>1</sup> Initiative for Policy Dialogue, <http://www0.gsb.columbia.edu/ipd/programs/program.cfm?ptid=2&prid=89>



public spending options and their extent, and they impact on growth and development, poverty, consumption and a whole range of economic and social decisions.

On a much broader level – taking Joseph Schumpeter’s observation that “the budget is the skeleton of the state stripped of all misleading ideologies”<sup>2</sup> as a given – taxation provides a fascinating insight into the dynamics that shape a state – and are shaping the Georgian state now: policy ideas such as equity and fairness, growth and development, and efficiency, and economic and social interests such as capital and labour. As well as shedding light on power relations, taxation also tells us much about state capacity and state formation.

This report inevitably cannot delve into such issues in great detail, but it will nonetheless provide an overview of the Georgian taxation system with them as a framework.

## Background

The 2005 tax code transformed the Georgian fiscal landscape. Only six taxes emerged from the legislative deluge (down from 21 in 2004)<sup>3</sup>, with rates so low that Georgia is now ranked 4<sup>th</sup> in the world in terms of how much it taxes its citizens.<sup>4</sup> Following some amendments, the tax code now sets the following taxes and rates:

- Income tax – 20% (flat rate)
- Corporate tax – 15%
- VAT – 18%
- Excise tax – Varies
- Customs tax – 0%, 5% or 12%
- Property tax – 1% on the self-assessed value of property<sup>5</sup>

Reducing tax rates in such dramatic fashion is but one component of a three pronged approach both recommended by the IMF<sup>6</sup> and adopted by the government. The other two are broadening the tax base and improving the tax administration. Restructuring, retraining and innovations such as e-filing have meant a more streamlined and effective Tax Administration. Corruption has also

---

<sup>2</sup> Schumpeter, Joseph A. 1954. “The Economic Crisis of the Tax State.” International Economic Papers, 4; reprinted in Schumpeter, Joseph A. 1991. The Economics and Sociology of Capitalism, ed. Richard Swedberg (Princeton: Princeton University Press): pp. 99-140.

<sup>3</sup> Georgia’s Search for Economic Liberty: A Blueprint for Reform in Developing Economies, Lado Gurgendize, June 2009, American Enterprise Institute for Public Policy Research, [www.aei.org/docLib/02%20DPO%20June%202009%20newg.pdf](http://www.aei.org/docLib/02%20DPO%20June%202009%20newg.pdf)

<sup>4</sup> 2009 Tax Misery & Reform Index, Forbes Magazine, [www.forbes.com/global/2009/0413/034-tax-misery-reform-index.html](http://www.forbes.com/global/2009/0413/034-tax-misery-reform-index.html)

<sup>5</sup> Ministry of Economic Development of Georgia, Meeting with the representatives of the American Chamber of Commerce in Georgia, 25 March, 2009, [http://74.125.77.132/search?q=cache:uy0NusEC4OUJ:www.amcham.ge/photos/luncheon\\_2009-03-25/Ministry%2520of%2520Economic%2520Development.pps+tax+propert+georgia+tbilisi&cd=8&hl=ka&ct=clnk&gl=ge](http://74.125.77.132/search?q=cache:uy0NusEC4OUJ:www.amcham.ge/photos/luncheon_2009-03-25/Ministry%2520of%2520Economic%2520Development.pps+tax+propert+georgia+tbilisi&cd=8&hl=ka&ct=clnk&gl=ge)

<sup>6</sup> See, for instance, Tax Challenges Facing Developing Countries, Richard M. Bird, March 2008, [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1114084](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1114084)



been eliminated. According to one foreign businessman operating in Georgia, “there is never even the tiniest hint of corruption.”<sup>7</sup>

That in turn has made life considerably easier for taxpayers. An IFC survey of business people in Georgia, for instance, found that “[t]he number of visits or required meetings with tax officials fell significantly for firms interviewed in both years from 8.0 in 2005 to only 0.5 in 2008”<sup>8</sup> The overall ease of paying taxes – Georgia is 64<sup>th</sup> in the world on this measure<sup>9</sup> – combined with attractive lower rates – has served to facilitate the third facet of the IFC’s policy triumvirate – broadening the base. Figures are unavailable<sup>10</sup> but anecdotal evidence would suggest that the number of taxpayers has drastically increased since reforms were introduced.

The result of these reforms can be measured in the actual amount of taxes collected. Two thousand and three saw a tax-take of GEL 1.19 billion, accounting for 13.9% of GDP. The equivalent figures for 2008 – GEL 4.75 billion and 24.9%, respectively<sup>11</sup> – are a result largely of the tax reforms. As one former prime minister noted, “the country rode the Laffer Curve.”<sup>12</sup>

### **The Devil in the Details<sup>13</sup>**

Despite this, the IFC survey of business people<sup>14</sup> – and confirmed by TI Georgia’s own investigations – has found numerous problems with both the Tax Administration and indeed the Tax Code itself.

Severe budgetary constraints following the Russian invasion and the international financial crisis seem to have hit a re-wind switch in the official mind. The excesses and intimidation of the Financial Police – “the boggie man... a phantom of fear”<sup>15</sup> – had been a fact of life for businesses in Georgia in the first few years following the Rose Revolution.<sup>16</sup> Its record has had, as the British ambassador to Georgia deftly put it, “an important impact on perceptions.”<sup>17</sup> In 2007

<sup>7</sup> Anonymous source 2

<sup>8</sup> Running a Business in Georgia, International Finance Corporation, [www.georgia.gov.ge/pdf/2009\\_12\\_04\\_15\\_24\\_50\\_1.pdf](http://www.georgia.gov.ge/pdf/2009_12_04_15_24_50_1.pdf)

<sup>9</sup> Paying Taxes 2010 - The global picture, World Bank, [www.doingbusiness.org/documents/FullReport/2010/Paying-Taxes-2010.pdf](http://www.doingbusiness.org/documents/FullReport/2010/Paying-Taxes-2010.pdf)

<sup>10</sup> TI Georgia requested this information from government officials – at a meeting and in written form – but no answer was forthcoming.

<sup>11</sup> Georgian Economic Review, Q1 2009, Georgian-European Policy and Legal Advice Centre (GEPLAC), [http://www.geplac.org/newfiles/GeorgianEconomicTrends/2006/GER%20I%202009\(eng\).pdf](http://www.geplac.org/newfiles/GeorgianEconomicTrends/2006/GER%20I%202009(eng).pdf)

<sup>12</sup> Georgia’s Search for Economic Liberty: A Blueprint for Reform in Developing Economies, Lado Gurgendize, June 2009, American Enterprise Institute for Public Policy Research, [www.aei.org/docLib/02%20DPO%20June%202009%20newg.pdf](http://www.aei.org/docLib/02%20DPO%20June%202009%20newg.pdf)

<sup>13</sup> Ketevan Sutiashvili, Credit Access Manager, IESC SME Support Project, in interview with author, Oct 7, 2009, in reference to the inherent problems with the tax code and its administration

<sup>14</sup> Tax Appeals System in Georgia, International Finance Corporation, [http://www.ifc.org/ifcext/georgiasme.nsf/AttachmentsByTitle/TaxAppealsSystemPolicyPaper1Eng/\\$FILE/TaxAppealsSystemPolicyPaperPartONE.pdf](http://www.ifc.org/ifcext/georgiasme.nsf/AttachmentsByTitle/TaxAppealsSystemPolicyPaper1Eng/$FILE/TaxAppealsSystemPolicyPaperPartONE.pdf)

<sup>15</sup> The Future of the Financial Police - A discussion with Finance Minister Kakha Baindurashvili, Investor.Ge, Molly Corso, Dec 2009, [http://www.investor.ge/issues/2009\\_6/04.htm](http://www.investor.ge/issues/2009_6/04.htm)

<sup>16</sup> Ombudsman Accuses Financial Police of Wrongdoings, Civil Georgia, March 2, 2006, [www.civil.ge/eng/article.php?id=11974&search=financial police](http://www.civil.ge/eng/article.php?id=11974&search=financial%20police)

<sup>17</sup> H.E. Denis Keefe at EU Eastern Neighbourhood Conference, Nov 27, 2009, at Marriot Hotel, Tbilisi



there was, however, at least a recognition of a need for a measure of restraint. President Saakashvili, conscious of the need to “decriminalize financial relations,”<sup>18</sup> merged the Financial Police with the Tax and Customs Department. Now, however, “it sounds like they are letting the dogs loose again.”<sup>19</sup>

The recent high profile case of Elit Electronics and its on-going travails with the Revenue Service<sup>20</sup> best illustrates this. The company was given a GEL 14 million tax bill, and after contesting it, it was arbitrarily halved. When the company still insisted it only owed GEL 120,000, things got nasty. Coincidentally or not, legislation was pushed through Parliament allowing the Revenue Service – before an appeals process was finalized – to freeze a business’ bank accounts, seize its cash flow, and hence close it down. The amendment to the law was applied to Elit Electronics, forcing 34 of its shops to close. The ensuing publicity, however, saw the authorities scrambling for cover, and so in May 2009 TBC Bank inexplicitly got entangled in the dispute. The company did indeed have loans, but had never missed a repayment, according to then General Director Anzor Kokoladze. The bank’s involvement did however serve to deflect attention from the real issue, with Tbilisi Mayor Gigi Ugulava claiming that the closure of the company was purely a private customer – bank matter. “It is easy to put the blame on the state,” he said, “when this or that company manager or owner spoils something.”<sup>21</sup>

Elit Electronics has since re-opened following a settlement, largely because “they [the authorities] understood they needed us.”<sup>22</sup> Killing the goose that lays the golden egg is obviously not an appropriate response to budgetary shortfalls.

The manner of the resolution reflects another problem. “You have to go all the way up”<sup>23</sup> when there is a contentious issue at hand, reflecting a widespread fear within the tax administration itself. There is an [ungrounded] “assumption made that the guy [at a lower or mid level position in the tax administration] is corrupt”<sup>24</sup> and so he is given little decision-making powers, or of those that he is given, he is reluctant to exercise them – “they’re scared of making a mistake.”<sup>25</sup>

It is, according to Paul Cooper of PriceWaterHouse Cooper, “an issue with empowerment.”<sup>26</sup> Added to this is what the IFC calls a “lack of legal literacy”<sup>27</sup> among tax officials. It “is one of

<sup>18</sup> President Saakashvili, quoted in Financial Police to be Re-Established, Civil Georgia, 21 Sep, 2009, <http://www.civil.ge/eng/article.php?id=21483>

<sup>19</sup> Anonymous source 1

<sup>20</sup> Resolve Your Dispute and Save Our Jobs, Employees Say, Ana Martiashvili, 09-07-2009,

<http://www.geotimes.ge/index.php?m=home&newsid=18166>

<sup>21</sup> Elit Electronics: One more ‘sad story’ on the market, Georgia Today, Nina Akhmeteli, Sept 9, 2009,

[http://www.georgiatoday.ge/article\\_details.php?id=7194](http://www.georgiatoday.ge/article_details.php?id=7194)

<sup>22</sup> Anzor Kokoladze, General Director, Elit Electronics, in interview with author, Oct 30, 2009

<sup>23</sup> Eric Livny, Director, International School of Economics at Tbilisi State University (ISET), in interview with author, Oct 8, 2009

<sup>24</sup> Anonymous source 1

<sup>25</sup> Anonymous source 3

<sup>26</sup> Investor.ge, Oct-Nov 2009, Tax Administration in Slow Game of “Catch Up,” Paul Cooper,

[http://www.investor.ge/issues/2009\\_5/06.htm](http://www.investor.ge/issues/2009_5/06.htm)

<sup>27</sup> Tax Appeals System in Georgia, International Finance Corporation,

[http://www.ifc.org/ifcext/georgiasme.nsf/AttachmentsByTitle/TaxAppealsSystemPolicyPaper1Eng/\\$FILE/TaxAppealsSystemPolicyPaperPartONE.pdf](http://www.ifc.org/ifcext/georgiasme.nsf/AttachmentsByTitle/TaxAppealsSystemPolicyPaper1Eng/$FILE/TaxAppealsSystemPolicyPaperPartONE.pdf)



the main reasons that tax officials are unable to make decisions as well as manage processes promptly and fairly.”<sup>28</sup> For businesses locked in the appeals process that has meant “[t]imelines to review the case and notify the taxpayer are often not met,”<sup>29</sup> and “the process of property arrestment is often violated.”<sup>30</sup> Basic administrative responsibilities are often discharged in a less than adequate manner:

Whenever the tax complaint is satisfied either fully or partially, the Revenue Service must send a corrected “tax notice” reflecting the decision taken. The survey results show that 65 percent of the respondents whose cases were satisfied partially or fully did receive the corrected “tax notice” (on the basis of which the full or partial amount of [the] deposit is returned back); the remainder reported that they did not<sup>31</sup>

The Revenue Service itself is well aware of its own weaknesses. In an internal Fiscal Blueprint for Taxation,<sup>32</sup> numerous areas of concern have been identified. In particular, human resources management, tax auditing, systems for taxpayer management, information technology, and structure and organization have been singled out as priority areas needing vast improvement.

The Tax Administration is of course in its infancy and so such “teething problems”<sup>33</sup> are to be expected. Indeed, the fact that it is identifying weaknesses suggests a willingness to improve and a desire to rectify problems. What is less understandable, however, is its attitude towards business, particularly given the otherwise pro-business approach the government has adopted in the last few years.

The tax authorities have, for instance, been “merciless”<sup>34</sup> in pursuing businesses, failing to understand “even the rudimentary requirements of and constraints under which they operate.”<sup>35</sup>

The problem – perhaps born of recent Georgian taxation history – lies in “an assumption that you’re a criminal.”<sup>36</sup> Taxpayers face prison for what one tax accountant in Tbilisi described as a “mistaken tax submission above GEL 25,000.”<sup>37</sup> As one business magazine wrote, “the code doesn’t rank violations in tax returns in terms of type, but rather classifies everything as fraud.”<sup>38</sup> Even where criminal intent – essentially, evasion – is not suspected, the response is still similarly draconian. If creditors fail to pay for services or goods on time – as was the case with Well 3 drilling company, which was owed GEL150,000 from its principal client – unlike in other countries where a certain amount of latitude is given in recognition of business cycles – in

---

<sup>28</sup> *Ibid*

<sup>29</sup> *Ibid*

<sup>30</sup> *Ibid*

<sup>31</sup> *ibid*

<sup>32</sup> In the author’s possession

<sup>33</sup> Anonymous source 1

<sup>34</sup> Anonymous source 2

<sup>35</sup> *Ibid*

<sup>36</sup> *Ibid*

<sup>37</sup> Anonymous source 4

<sup>38</sup> Georgia’s lighter tax burden comes with potential pitfalls for taxpayers, Giorgi Lomsadze, EurasiaNet Eurasia Insight, May 7, 2008,

[http://georgiandaily.com/index.php?option=com\\_content&task=view&id=1788&Itemid=75](http://georgiandaily.com/index.php?option=com_content&task=view&id=1788&Itemid=75)



Georgia, bank accounts are frozen and assets seized. Instead of acknowledging a business' inability to pay tax on declared, but as of yet uncollected, profit, and waiting until such time as they can, the Georgian tax authorities close the business. Well 3, for instance, was closed down five times in 2008. “with just the press of a button [to freeze the company's accounts] – usually on a Friday afternoon – without any prior warning.”<sup>39</sup> At least 21 working days' notification would be given in most countries before such a drastic action were taken, and indeed, only where evasion or some other criminal act were suspected.

Well 3 was also hit with GEL 33,000 in penalties. Its experience mirrors that of many other small and medium sized businesses.<sup>40</sup>

Often when accounts are frozen, the amount seized is in excess of the actual liability claimed by the tax authorities. One firm in Tbilisi had GEL 50,000 taken but only owed GEL 15,000. There was a three-month delay in returning the cash. Even worse, a small foreign-owned restaurant had GEL 2,000 seized, and although the Revenue Service later acknowledged a mistake had been made, the sum was not returned. Instead, the Revenue Service wrote it off against the following year's tax liability, in effect forcing the businessman to give an interest free loan to the state.

Given the current credit crunch faced by businesses, this is no small matter. “We are trying to operate as much as possible on a cash basis,”<sup>41</sup> the restaurateur told TI Georgia, in an attempt to forestall the same thing re-occurring. As well as hitting the already hard-pressed banking sector, hiding cash under the proverbial mattress means a business fails to establish a credit history, without which, future credit lines are impossible. Expansion and further job creation are consequently hampered, affecting not only the given entrepreneur but the economy as a whole.

Other practices have had similar repercussions, impacting on both individual businesses and the wider economy. Well 3 – on the basis of a GEL 400,000 turnover in 2008 – was presented a first quarter tax liability in March 2009 of GEL 30,000. It had, however, no turnover for Q1 2009, but the Revenue Service, assuming similar turnover levels to the previous year, imposed a bill the company could not pay. It was only when the company had proven that volume was significantly down that the company's bank account was unfrozen. On this one occasion alone, the company was unable to operate for an entire week.

In another case known to TI Georgia, a restaurant on the east-west highway was given a GEL 400,000 fine. It was imposed following a week-long investigation in which tax officials sat in the restaurant monitoring trade and cash-flow, and on that basis, extrapolated what the restaurant's annual turnover was. Doing so in August 2009 – the busiest time of the year for a restaurant on the main road leading to the coast – of course meant an over-inflated annual turnover estimate. Nevertheless, the Revenue Service, estimate in hand, then accused the restaurant of failing to pay its proper share of taxes over the two previous years, and hence imposed a hefty fine. The fact that the restaurant had been all but closed during the summer of 2008 – because of the war – apparently went unnoticed by the Revenue Service.

<sup>39</sup> Anonymous source 2

<sup>40</sup> Reflecting the general sense of fear felt by most business people – “businesses are very apprehensive about publicity,” according to journalist Molly Corso, in interview with author – very few people have been willing to go on the record for this report.

<sup>41</sup> Anonymous source 4



Both cases – highlighting how taxes are sometimes assessed on perceived ability to pay rather than actual tax returns – are in marked contrast to practice in other countries. As one British businessman dryly told TI Georgia, “in England, we have this curious practice of paying taxes on what you actually earn.”<sup>42</sup>

As well as impacting the directly affected businesses, ironically, such behaviour discourages businesses from entering the tax net and the formal economy. “The average guy [business person] doesn’t want to register”<sup>43</sup> when he sees what happens to those already in the net. “The bad karma”<sup>44</sup> it creates has also served – one can at least surmise – to deter investors from investing in Georgia. A recent article in BusinessWeekEurope pointed out that the Elit Electronics affair was “sending signals that doing business in the country might not be as simple as recent government road shows would have potential investors believe.”<sup>45</sup> At a time when FDI is considerably down, and when foreign money represents the lifeblood of Georgian industry – this is no unimportant thing. The US Department of Commerce, in this respect, had some sobering words of warning for US companies thinking of operating in Georgia:

Laws and regulations, especially in the areas of tax and customs, are subject to uneven and arbitrary interpretation and enforcement by bureaucrats and courts. A good local attorney is indispensable for other than simple transactions.<sup>46</sup>

## Progress

The 2005 tax code is undoubtedly better than what went before it. It is, according to one expert, “pretty good”<sup>47</sup> Its administration is also incomparable to the old one, (relatively) stream-lined, computerised, well-staffed and corruption-free. PriceWaterHouseCoopers’ global tax ranking<sup>48</sup> – placing Georgia 64<sup>th</sup> out of 183 countries in terms of ease of paying taxes – is indicative of this change. Electronic tax filing is but one of the many innovations introduced that have made life easier for businesses.

It must also be acknowledged that the tax authorities are dealing with a population that has traditionally shied away from paying taxes, Tax culture in Georgia – because of colonialism and state failure, and often because people fail to see a clear link between taxes and benefits – is less developed than in other countries, and so voluntary compliance is often no more than a foreign consultant’s pipe-dream. Even today – after five years of concerted efforts to reign in the black economy – some estimates put its size at 65%.<sup>49</sup> Even the normally sober Economist Intelligence

<sup>42</sup> Thomas Blake, Director, Thames Steel UK Ltd. in interview with author, Dec 12, 2009

<sup>43</sup> Anonymous source 5

<sup>44</sup> Anonymous source 5

<sup>45</sup> Taxing issues for business in Georgia, Samantha Shields, BusinessWeekEurope, April 1, 2010, [http://businessweekeuropa.eu/story2034/Taxing\\_issues\\_for\\_business\\_in\\_Georgia](http://businessweekeuropa.eu/story2034/Taxing_issues_for_business_in_Georgia)

<sup>46</sup> Export.Gov, [www.export.gov/articles/marketofmonth/eg\\_main\\_017096.asp](http://www.export.gov/articles/marketofmonth/eg_main_017096.asp)

<sup>47</sup> Anonymous source 1

<sup>48</sup> <http://www.pwc.com/gx/en/paying-taxes/data-tables.jhtml>

<sup>49</sup> The Size of the Shadow Economy for 25 Transition Countries over 1999/00 to 2006/07: What do we know?, [www.econ.jku.at/members/.../files/.../ShadEcon\\_25Transitioncountries.pdf](http://www.econ.jku.at/members/.../files/.../ShadEcon_25Transitioncountries.pdf)



Unit says it may be as high as 50% of total GDP.<sup>50</sup> Some amount of heavy-handedness in these circumstances is to be expected. One fights fire with fire.

## A Matter of Law

However, having interviewed over twenty business people – most of whom wish to remain anonymous – and considering the results of the IFC survey, TI Georgia believes the problems are more fundamental.

Underlying many of the “mistakes”, inconsistencies – “in Georgia each key article has two or three interpretations”<sup>51</sup> – legal short-cuts and downright abuse of the tax code, we believe, is a fundamental disregard for the law. A whatever-it-takes attitude prevails – “whatever is expedient”<sup>52</sup> – too often leaving processes and laws in abeyance.<sup>53</sup>

This approach has yielded results in many cases, particularly where immediate action has been required. The construction of houses in the aftermath of the August 2008 war is a case in point. While donors have applied process – involving consultations, tenders and bureaucracy, and have taken sometimes four times as long to build fewer houses – the Georgian government has by-passed normal channels, and in doing so, has met the housing needs of thousands of homeless and dispossessed people.<sup>54</sup> While GTZ and others, according to President Saakashvili,<sup>55</sup> were still doing the paperwork, the government had already built almost 4,000 cottages.

Consistency, rules and equity are, however, basic requirements of a taxation system. Ignoring them, while sometimes yielding short-term gains, ultimately serves to undermine the system itself. If arbitrariness takes the place of rules, then confidence – a basic requirement of a taxation system – is undermined.

## Risk Assessment

Rectifying this is a challenge, but not an insurmountable one, either.

“It all comes back to risk analysis,”<sup>56</sup> according to one insider. Risk analysis, which has been instrumental in the success of the reform of the Customs Service, is effectively not used by the Revenue Service. “They claim it is being used”<sup>57</sup> and indeed the head of the Revenue Service

<sup>50</sup> Economist Intelligence Unit – Georgia Country Profile 2008

<sup>51</sup> Anonymous source 4

<sup>52</sup> Anonymous source 7

<sup>53</sup> See Decision-Making and Georgia’s Perpetual Revolution: The Case of IDP Housing,” Till Bruckner, *Caucasus Review of International Affairs*, Vol 3(2), Spring 2009, [http://cria-online.org/7\\_5.html#\\_ftn13](http://cria-online.org/7_5.html#_ftn13)

<sup>54</sup> See Cottage Settlements for Georgia’s New IDPs: Accountability in Aid and Construction, April 2010, Transparency International Georgia, <http://www.transparency.ge/en/post/report/cottage-settlements-georgias-new-idps-accountability-aid-and-construction>

<sup>55</sup> Saakashvili Delivers State of Nation Address, Civil Georgia, February 12, 2009, [www.civil.ge/eng/article.php?id=20421](http://www.civil.ge/eng/article.php?id=20421) (accessed March 20, 2009).

<sup>56</sup> Anonymous source 1

<sup>57</sup> *Ibid*



told TI Georgia that it was, “in at least 70% of cases,”<sup>58</sup> and that it would be applied to all tax audits by the end of the year. The reality, however, based on what we have been told and having seen the situation on the ground, is that the Revenue Service may indeed have “a top 50 hit list ... [but] they go behind closed doors and select twelve”<sup>59</sup> for audit. Risk analysis – an essential tool for a scientific, nonpartisan targeting of high risk and potentially non-compliant businesses – is essentially nullified. As well as a scattergun, ineffective and wasteful use of auditing resources at the Revenue Service, impartiality and fairness are severely compromised as a result.

## Tax Terrorism

There is of course one obvious question that needs answering: why is there no risk analysis, or for that matter, other mechanisms<sup>60</sup> to ensure procedures are followed?

For international donors, the answer is inevitably framed in terms of capacity, and the solution is hence one of consultants, roundtables and capacity-building training seminars in Gudauri and exchange visits to Atlanta or Barcelona. While foreign expertise has indeed proven useful – and indeed has sometimes been instrumental – there is an alternative explanation for why there is “capriciousness in how it [the tax code] is applied.”<sup>61</sup> “It suits them.”<sup>62</sup>

It suits them in a few different ways. As one prominent businessman noted, “they use the financial police as an instrument of law and order and political control.”<sup>63</sup> Given the poor tax culture and the reality of operating a business in Georgia – where financial literacy is in short supply – “a pretext can always be found”<sup>64</sup> to send in the auditors. As one business consultant in Tbilisi noted, “Every business in Georgia has flaws but only the select few are put under the tax microscope.”<sup>65</sup> The select few have included ARTI Group, which immediately following sensational allegations made by former Defence Minister Irakli Okruashvili against the Saakashvili government – was closed, ostensibly because of financial irregularities.<sup>66</sup> Similarly, Channel 25 in Batumi – a regional TV station known for its anti-government stance – was threatened with closure because of unpaid tax liabilities dating back to the time when it was under the control of local strongman Aslan Abashidze. The case was eventually resolved, but only after a lot of media and political attention – sometimes, international<sup>67</sup> – and the subsequent

---

<sup>58</sup> Giorgi Tskhakaia, Head, Revenue Service, Ministry of Finance, in interview with author, Feb 19, 2010

<sup>59</sup> Anonymous source 1

<sup>60</sup> For instance, “they haven’t got an external audit management system”, according to Anonymous source 1, in interview with author, Oct 27, 2009. As well as this [t]here is currently no recognised performance management regime to support the introduction of performance indicators and systemic improvements in the effectiveness and efficiency of the administration.” [Tax Administration Fiscal Blueprints Final Report, in author’s possession]

<sup>61</sup> Anonymous source 8

<sup>62</sup> *Ibid*

<sup>63</sup> Anonymous source 5

<sup>64</sup> Anonymous source 8

<sup>65</sup> *Ibid*

<sup>66</sup> Okruashvili to Speak Out, as Tax Inspectors Launch Probes, Civil Georgia,  
<http://www.civil.ge/eng/article.php?id=15860--->

<sup>67</sup> See, for instance, the US State Department Human Rights Report 2009,  
<http://www.state.gov/g/drl/rls/hrrpt/2009/eur/136032.htm>



intervention of both the ombudsman and the minister for finance.<sup>68</sup> The outcome, although welcome, highlights once again the need for the intervention of high-ranking officials, rather than allowing due process to prevail.

Tax Terrorism plays itself out in Georgia in a number of other ways, too. TI Georgia has come across cases where commercial rivalries have been fought out with one side bringing in the Financial Police to undermine the other. We have also heard of incidents where personal animosities have been settled by tax audits rather than fisticuffs or shouting matches. In one case known to us, the manager of a hotel who refused to allow a high-ranking government official to stay in his hotel for free was subsequently arrested on charges of tax evasion. It was only for the fact that the manager had connections at an even higher level, that the charges were eventually dropped.

We have also come across some disturbing cases where businesses have been forced to buy grapes from farmers. One Tbilisi-based restaurateur – accompanied by an official from the Revenue Service – had to buy five tonnes, costing GEL 2,000. It is “an artificial system to keep Kakheti quiet but it’s destroying the market,” he pointed out.

## Policy Options

Ironically – given the obviously unofficial support given to the hard-pressed farmers of Kakheti – there has been little other use of tax as a policy instrument. The reason is partly ideological. As ex-Prime Minister Lado Gurggenidze explained, “in general, we’re libertarians.”<sup>69</sup> “We’re not trying to do anything: we do not have any industrial policy of any kind for any sector,” the former prime minister explained. “Government should not do this; it doesn’t matter where the growth comes from.”<sup>70</sup>

The government’s approach is instead based on having a low tax regime that will, they hope, ultimately act a driver of economic development. Academic literature seems to concur with this position:

An empirical study conducted by Marsden (1990), based on a cross-sectional analysis of 20 countries, compared the selected countries on the basis of lower and higher levels of taxation and their influence on growth rates over a ten year period. In all cases, the countries that imposed a lower effective average tax burden on their populations achieved substantially higher rates of GDP growth than did their more highly taxed counterparts.<sup>71</sup>

<sup>68</sup> Ombudsman Meets Finance Minister over Batumi-Based TV’s Tax Dispute, Civil Georgia, Oct 30 2009, [www.civil.ge/eng/article.php?id=21624](http://www.civil.ge/eng/article.php?id=21624)

<sup>69</sup> Lado Gurggenidze at the Milken Institute Global Conference 2009, Los Angeles, 28-04-09, <http://www.milkeninstitute.org/events/gcprogram.taf?function=detail&EvID=1923&eventid=GC09>

<sup>70</sup> *Ibid*

<sup>71</sup> The Influence of Tax Mix and Tax Policy on Savings and Capital Formation in Developing Economies: a Survey, Vasanthi Monsingh Peter and Ian A. Kerr, Asia-Pacific Development Journal Vol. 8, No. 1, June 2001, [www.unescap.org/dpad/publication/journal\\_8\\_1/PETER.PDF](http://www.unescap.org/dpad/publication/journal_8_1/PETER.PDF)



Georgia certainly fits into this low-tax approach, collecting a mere 26% of GDP in taxes. “To out libertarian instincts,” Gurgenzidze has said, “that was too much.”<sup>72</sup> “The state is getting too big,”<sup>73</sup> he added.

As well as this, tax breaks and tax incentives – common in many other countries – are largely non-existent in Georgia. Corruption fears – the old Georgian bogeyman that has played a part in other decisions to deregulate the wider economy<sup>74</sup> – seem to be a major rationale behind this decision, too. By doing so, “you remove one major driver of corruption.”<sup>75</sup>

There is again academic support got this position. “Conventional wisdom also seems right about what should be done with virtually all tax incentives: eliminate them,” one report found. “Even to the limited extent that some incentives are effective in inducing investors to behave differently that they would have done in response to market signals the result is often inefficient, diverting scarce resources into less than optimal uses (MsLure 1999).”<sup>76</sup>

While all of this is true – that the market generally allocates resources more efficiently than governments; that corruption breeds where there are regulations and bureaucracy; and lower taxes are an incentive for people to work harder and invest in the economy – other countries have, however, seen fit to take a different approach, seeing that the potential gains outweigh the risks.

Recognising that tax has distortionary effects, most developed countries see a need for a tax intervention. The Irish government’s Commission on Taxation, for instance, could hardly be accused of orthodox fiscal interventionism as it worked on the premise that “the level and pattern of economic activity is affected much more by the general economic policy of the government than by any set of specific measures labeled incentives.”<sup>77</sup> It still, however, saw the need to intervene for the purposes of “correcting market failure, attracting mobile investment, or offsetting shortcomings in other areas of public policy.”<sup>78</sup>

Whilst Ireland – and indeed other low-tax economies often cited by the Georgia government as examples to emulate – is indeed conscious of the dangers of overburdening its citizens with

<sup>72</sup> Lado Gurgenzidze at the Milken Institute Global Conference 2009, Los Angeles, 28-04-09, <http://www.milkeninstitute.org/events/gcprogram.taf?function=detail&EvID=1923&eventid=GC09>

<sup>73</sup> *Ibid*

<sup>74</sup> Competition law and food safety regulations, for instance, have largely been gutted and made ineffective, with corruption in the application of the law cited as the main reason. See: Food Safety in Georgia, Transparency International Georgia, <http://www.transparency.ge/en/content/food-safety-georgia>, and Competition Law in Georgia, Transparency International Georgia, <http://www.transparency.ge/en/content/competition-georgia>.

<sup>75</sup> Lado Gurgenzidze at the Milken Institute Global Conference 2009, Los Angeles, 28-04-09, <http://www.milkeninstitute.org/events/gcprogram.taf?function=detail&EvID=1923&eventid=GC09>

<sup>76</sup> Tax Challenges Facing Developing Countries, Inaugural Lecture of the Annual Public Lecture Series of the National Institute of Public Finance and Policy, New Delhi, India, March 12, 2008, Richard M. Bird, [http://www.nipfp.org.in/working\\_paper/wp\\_2008\\_Richard.pdf](http://www.nipfp.org.in/working_paper/wp_2008_Richard.pdf)

<sup>77</sup> Report of the Commission on Taxation, Part 7: Supporting economic activity, [www.commissionontaxation.ie/Report.asp](http://www.commissionontaxation.ie/Report.asp)

<sup>78</sup> *Ibid*



prohibitively high taxes, it is not dogmatic, accepting that there is a place for tax instruments in securing wider policy objectives.

Job creation is the main focus in this regard, with a whole raft of incentives consequently put in a place to attract FDI, of the sort that actually creates jobs rather than takes advantage of a sell-off of state assets.

Tax credits for the construction of factories, tax holidays,<sup>79</sup> and tax credits for R&D expenditure,<sup>80</sup> are but some of the measures favoured to off-set market failures.

Georgia – as one would expect given Gurgenidze’s attitude – by contrast, has no coordinated approach. Even though there has been an obvious market failure to deliver jobs, with some estimates putting unemployment at over 29 percent,<sup>81</sup> generally the market is left to dictate. There are admittedly some minor incentives,<sup>82</sup> but very little in the way of actually facilitating and attracting industry in the same way as has been done elsewhere. There has been only one instance where tax has been successfully used to attract job-creating, green-field investment – the Fresh factory in Kutaisi. This, however, is truly the exception that proves the rule, a point Economic Development Minister Pololikashvili perhaps inadvertently demonstrated when he said that “no such large-scale employment has been created in recent years in this region.”<sup>83</sup>

Tax instruments are not just confined to employment generation. Other objectives can also be met. In Dublin, for instance, “areas of long-standing blight gained new life from the mid-eighties on as a result of strongly tax-driven urban renewal schemes.”<sup>84</sup> Urban renewal is objectively a policy focus for the Georgian government, too – evidenced by major reconstruction projects in the Old Town and on Agmashenebeli St. in Tbilisi – but tax incentives have not been used to

<sup>79</sup> Start-up companies in Ireland, for example, get a tax exemption if their annual tax liability is less than EUR 40,000. Ireland foreign Investments Incentives, [www.worldwide-tax.com/ireland/ire\\_invest.asp](http://www.worldwide-tax.com/ireland/ire_invest.asp)

<sup>80</sup> “A 25% tax credit can be claimed against qualifying R&D expenditure by Irish tax-resident companies within the European Economic Area (EEA),” Industrial Development Authority Ireland, <http://www.idaireland.com/home/index.aspx?id=659>

<sup>81</sup> Officially, unemployment stands at 16.3 percent, but this figure is highly suspect, as National Democratic Institute self-assessment surveys have demonstrated. See: 2 + 2 = 5: Georgia's Official Statistics and an Unfolding Greek Tragedy, Mar 24, 2009, Transparency International Georgia, <http://www.transparency.ge/en/blog/p2-2-5-georgias-official-statistics-and-unfolding-greek-tragedy>. The official statistics are also called into question in other reports: Environmental Overview for Care Long-Range Strategic Planning Mid-Term Review. Care, George Welton, [http://www.geowel.org/files/country\\_overview\\_for\\_care\\_strategic\\_planning\\_2008.pdf](http://www.geowel.org/files/country_overview_for_care_strategic_planning_2008.pdf), and Georgia Poverty Assessment, World Bank, 2009, [http://www-wds.worldbank.org/external/default/WDSContentServer/WDSContentServer/WDSP/IB/2009/04/29/000350881\\_20090429111740/Rend ered/PDF/444000ESW0P1071C0Disclosed041281091.pdf](http://www-wds.worldbank.org/external/default/WDSContentServer/WDSContentServer/WDSP/IB/2009/04/29/000350881_20090429111740/Rend ered/PDF/444000ESW0P1071C0Disclosed041281091.pdf)

<sup>82</sup> Georgian-produced cigarettes have a lower excise rate than imported ones; domestic airlines pay no excise on fuel; wine no longer is subject to excise duties, etc. See: Georgian Pocket Tax Book, <http://v1.georgia.gov.ge/?lang=2&event=pdf&topid=2&botid=28&page=1>

<sup>83</sup> Last year tough but fruitful, Nino Edilashvili, Georgia Today, Jan 1, 2010, [http://www.georgiatoday.ge/article\\_details.php?id=7602](http://www.georgiatoday.ge/article_details.php?id=7602)

<sup>84</sup> Geographical regions in Ireland – Reflections at the Millennium, Arnold Horner, Department of Geography, National University of Ireland, Dublin (UCD), [www.ucd.ie/gsi/pdf/33-2/regions.pdf](http://www.ucd.ie/gsi/pdf/33-2/regions.pdf)



attract private capital. Relying on public money is not just a waste of taxpayers' lari, but also a failure to imaginatively utilize tax instruments and levers for public good.

Perhaps the biggest failure, though, has been in terms of regional development. With the World Bank's Georgia Poverty Assessment report finding massive regional imbalances in poverty levels – with Shida Kartli having 59% poverty level, while Samegrelo's is just 14%<sup>85</sup> - this omission is even more glaring.

Meanwhile, other countries such as Norway have taken fiscal steps to deal with such regional variations in economic and social development.

An important regional policy element of the tax system is the differentiated Payroll tax paid by employers. This tax differentiated by zone, ranging from 14.1% of wage costs in central areas to 0% in the weakest zone (North-Troms and Finnmark).<sup>86</sup>

Another area where tax instruments have largely gone unused is in local self-governance.

While “central governments [everywhere] have been reluctant to release taxing powers to sub-national governments”<sup>87</sup> – with developing countries ceding only 10% of total tax power to non-central agents and developed countries slightly better at 20%<sup>88</sup> - in Georgia, the situation is particularly dire. Despite lip-service to local self-governance, Georgia has no real decentralization strategy.

Local municipal governments do not yet have any meaningful revenue autonomy. Local own source and local municipal revenues remain unpredictable due to the resulting vertical fiscal imbalance, local municipal governments have to continually Negotiate with higher levels of government authorities for stopgap fiscal transfers.<sup>89</sup>

For Georgia, this is particularly grave as “decentralization reforms, properly developed, can help resolve Georgia's regional conflicts by assuring systemic buy-in by minority groups.”<sup>90</sup>

Like local self-governance and conflict resolution, tourism has also been an important – albeit obviously less so – area of focus for the government. It too, however, has remained off the radar for tax officials or others setting fiscal policy. While Tbilisi does indeed boast some five star hotels, it has little in the way of affordable mid-range accommodation favoured by tourists. With the market failing to respond, fiscal incentives are required to encourage the development of

<sup>85</sup> GeoWel Research, [www.geowel.org/index.php?article\\_id=30](http://www.geowel.org/index.php?article_id=30)

<sup>86</sup> Regional policies for remote areas in Norway, Jan Mønnesland, [www.iiasa.ac.at/Research/ERD/net/pdf/monesland\\_1.pdf](http://www.iiasa.ac.at/Research/ERD/net/pdf/monesland_1.pdf)

<sup>87</sup> Tax Policy in Developing Countries: Looking Back and Forward, Roy W. Bahl, May 2008, Institute for International Business, [www.rotman.utoronto.ca/userfiles/iib/File/IIB13\(1\).pdf](http://www.rotman.utoronto.ca/userfiles/iib/File/IIB13(1).pdf)

<sup>88</sup> *ibid*

<sup>89</sup> An Assessment of Fiscal Decentralization in Georgia, Jameson Boex, Jorge Martinez-Vazquez, Michael Schaeffer, Problems of Economic Transition, vol. 49, no. 1, May 2006, pp. 51–94, <http://ideas.repec.org/a/mes/prectr/v49y2006i1p51-94.html>

<sup>90</sup> *ibid*



such infrastructure. This was the approach taken in Ireland, where over a ten year period, there was a 150 percent increase in hotel room numbers.<sup>91</sup>

Obviously, not all – or perhaps not even any – of the various fiscal instruments alluded to here are necessarily applicable to Georgia. Copy-pasting from others will never work as a fine-tuned application of specific instruments for targeted purposes is required. The purpose of their inclusion in this report is instead to demonstrate the potential tax has, and to show how there has been a complete failure to realize this potential in Georgia.

### **Tax as a Mirror**

In many ways, this failure is symptomatic, a reflection of where Georgia is in developmental terms. “No matter what any country may want to do with its tax system, or what anyone might think it should do from one perspective or another (ethical, political, or developmental), what it does do is always constrained by what it can do.”<sup>92</sup> Its ability is of course defined in terms of administrative capacity, but also political power. Georgia, for instance, has no inheritance tax, no capital gains tax, and no wealth tax. Neither does have a differentiated, progressive tax structure, relying instead on a simplified flat income tax. From an administrative point of view, this makes life easier, but it also makes the tax burden of the rich considerably less than if they were being taxed according to standard European rate structures. If, as one study suggests, “taxation provides one of the principal lenses in measuring... power relations in a society,”<sup>93</sup> then the level of employment in Georgia, or indeed the extent of so-called state capture, are problematic. While other countries’ citizens dictate the developmental pace and agenda, demanding that fiscal instruments be used to provide all manner of public goods, Georgian citizens effectively remain disempowered.

The abuses we have outlined in the tax administration are also reflections of this, demonstrating how state resources are sometimes used for purposes other than advancing the instruments of the state itself or ordinary citizens.

### **Conclusion**

That said, there “are good stories and bad stories”<sup>94</sup> and Georgia “is getting there; it’s just a matter of time,”<sup>95</sup> something that is mirrored in the concrete advances the tax system as a whole has already made over the past few years. Recent months, in particular, have brought a welcome

---

<sup>91</sup> Tourism: Getting back on track, Business and Finance magazine, Eoin Hahessy, Oct 7, 2009, <http://www.businessandfinance.ie/index.jsp?p=378&n=384&a=1856>

<sup>92</sup> Tax Challenges Facing Developing Countries, Inaugural Lecture of the Annual Public Lecture Series of the National Institute of Public Finance and Policy, New Delhi, India, March 12, 2008, Richard M. Bird, [http://www.nipfp.org.in/working\\_paper/wp\\_2008\\_Richard.pdf](http://www.nipfp.org.in/working_paper/wp_2008_Richard.pdf)

<sup>93</sup> The Political Economy of Taxation and Tax Reform in Developing Countries, Jonathan Di John, July 2006, United Nations University, <http://www.wider.unu.edu/stc/repec/pdfs/rp2006/rp2006-74.pdf>

<sup>94</sup> Anonymous source 4

<sup>95</sup> Anonymous source 1



re-appraisal on the government's part, with, for instance, President Saakashvili unveiling a raft of pro-business measures. These include the immediate refund of GEL 35 million in VAT to businesses, business representation on the Tax Dispute Council and, crucially, giving the finance minister sole responsibility for freezing a company's bank accounts.<sup>96</sup> Underlying these positive indications are shifting political sands, with Nika Gilauri's appointment as Prime Minister, in particular, suggestive of a move away from the neo-liberal orthodoxy best personified by Kakha Bendukidze, who has now departed the political stage. The establishment of two new tax-free industrial zones – both still empty, however – is suggestive that a more fiscally interventionist approach may be in the air.

In any case, it must be acknowledged that fiscal interventionism has actually been used, not necessarily to create jobs *per se*, but instead to create the conditions that will allow job creation to flourish. Reflecting economic gains, but also presaging them, has been the phenomenal growth in the banking sector,<sup>97</sup> some of which can be attributed to fiscal decisions made under Gurgendze's watch.<sup>98</sup> That legacy has been recently copper-fastened with further incentives to encourage bank deposits. "Tax on income from interest and dividends will be reduced annually until 2012," according to the 2009 version of the Georgia Pocket Tax Book, "when it will go to 0%."<sup>99</sup> Furthermore, effective as of January 1, 2009, interest income received from licensed financial institutions is no longer subject to withholding tax.<sup>100</sup>

Relative to developed countries, Georgia's performance is less than optimal but relative to where its tax system was before the Rose Revolution, its success has been remarkable. Administrative capacity – in line with wider state capacity – has been strengthened, tax receipts are massively up, and increasingly – are being used to advance fledgling policy agendas.

If "the public finances are one of the best starting points for an investigation of society, especially though not exclusively of its political life,"<sup>101</sup> then what we see in the Georgia taxation system, although imperfect at times, mirrors, some of the finer aspirations of the post-2003 political elite.

This report was prepared as part of TI Georgia's International Commitments Monitoring Programme that is funded by the British Foreign & Commonwealth Office and Norwegian Government through Transparency International Secretariat. Views expressed in this report do not necessarily imply endorsement by the British Foreign & Commonwealth Office and Norwegian Government.

<sup>96</sup> Saakashvili Offers New Economic Incentives, Civil Georgia, Nov 11, 2009, [www.civil.ge/eng/article.php?id=21661&search=vVAT Saakashvili president tax](http://www.civil.ge/eng/article.php?id=21661&search=vVAT%20Saakashvili%20president%20tax)

<sup>97</sup> Georgian Banking Sector Overview, Invest in Georgia, <http://www.investingorgia.org/sectors/banking>

<sup>98</sup> Eprem Urumashvili, Deputy Chief Financial Officer, Bank of Georgia, in interview with author, Jan 24, 2009

<sup>99</sup> Georgia Pocket Tax Book, [www.georgia.gov.ge/pdf/2009\\_11\\_19\\_11\\_47\\_25\\_1.pdf](http://www.georgia.gov.ge/pdf/2009_11_19_11_47_25_1.pdf)

<sup>100</sup> *ibid*

<sup>101</sup> Schumpeter, Joseph A. [1918] 1954. "The Crisis of the Tax State." In International Economic Papers, No. 4, eds. A. Peacock *et al.* London: Macmillan and Co. Ltd.