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Tax Simplification
Lessons from Georgia

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Executive Summary:

Following the Rose Revolution, which provided the framework to implement political changes not previously possible, the new Georgian government implemented much needed reforms to the tax regime. Briefly, the new Tax Code reduced the number of taxes, simplified the tax procedures, and decreased bureaucratic barriers. Since the reform, the number of businesses registered has increased as has overall tax revenue.

Introduction

Since the Rose Revolution, one of the most important initiatives of the Georgian Ministry of Finance has been the development of the new Tax Code, which became effective in 2005. Briefly, the new Tax Code reduced the number of taxes, simplified the tax procedures, and decreased bureaucratic barriers, making the Georgian business environment, according to the Ministry of Finance, the "most liberal in the region." After the changes were implemented, the number of registered businesses in Georgia increased threefold.

Context

At the end of 2003, Georgia was facing fiscal catastrophe. Corruption was widespread, taxes went unpaid, and considerable economic arrears were accumulated. The whole fiscal system was dysfunctional. According to the current Minister of Finance, Aleksi Aleksishvili, at the end of 2003 "not even one procedure in the tax or customs sphere was implemented without bribery." The November 2003 Rose Revolution in Georgia peacefully removed the former government and installed current President, Mikhail Saakashvili, who took office with a serious intent to produce reforms in the country.

Demand for Reform

In the fiscal sphere, mobilization of tax revenues was the first priority of the new government. It was immediately apparent that the existing tax legislation (the 1998 Tax Code) was unable to meet the needs of the increased political ambitions for transparency and private sector growth.

The tax regime created under the 1998 Tax Code included a large number of taxes, duplicate taxes and fees, and a large number of exemptions that were perceived as being preferential to certain individuals. Further, there was inconsistency between tax legislation and administration practice, low tax-official capacity, low taxpayer awareness, and a poor culture of tax payment. Taxpayers were clearly avoiding paying taxes, and there was no system in place to identify or pursue those who were noncompliant. As Kakha Baindurashvili, head of the Tax Department of the Ministry of Finance, noted, problems in the fiscal system in Georgia from 1998 to 2004 resulted in a high level of dissatisfaction in both the state and the business sectors.

Approach

Planning

Two to three months after the revolution, Minister of Finance Zurab Noghaideli defined the main principles, structure, and mechanisms for liberalization of taxes, as

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well as strict administration of the proposed Tax Code. At the time, both the Georgian government and the international community agreed on the general principles of the new Tax Code.

Legislation

Mr. Noghaideli's team drafted the current Tax Code with insight from the lessons learned by several countries, including Japan, the United Kingdom, Turkey, Azerbaijan, and Armenia. In addition, model tax codes prepared by the International Monetary Fund (IMF) were reviewed by the reform leaders. A number of consultations with independent experts, NGOs, Parliament, and business representatives were held during the drafting process.

The December 2004 Tax Code (effective 2005) has significantly simplified the tax system by reducing the number of taxes from 21 to 7 (income tax, profit tax, social tax, value-added tax (VAT), excise tax, property tax, and gambling tax). The income tax rate went down from 20 percent to 12 percent, the social tax from 33 percent to 20 percent, and the VAT from 20 percent to 18 percent; the profit tax rate remained the same—20 percent. In order to make tax mobilization stable for strong future budgets, a wide range of exemptions/benefits were abolished, and more strict tax administrative procedures were put into place to enforce compliance. As part of the overall effort to mobilize tax revenues in the reformed fiscal system, the Georgian government created the Financial Police under the Ministry of Finance to facilitate improved tax collection.

Additionally, filing to the Tax Department was simplified by unifying filing dates for all monthly declarations to the 15th of each month. The new code also abolished the requirement of having an independent audit report to perform annual filings. The new code further abolished the rule of declaring and paying current payables without having profit in the previous year. It also combined the forms for filing income and social taxes. Property tax was also to be paid according to the accepted current payables rule and the previous 2 percent tax on property transfer, which was owed by the buyer, is no longer in force. Furthermore, there are now several initiatives under way (with assistance from USAID and other donor organizations) to develop an online "e-filing" system in the near future.

Last, in order to liberalize the tax administration, the penalties for nonpayment in the new Tax Code have been reduced. In addition, taxpayers will have the ability to correct a declaration without a fine if done prior to receiving a notification from the tax department about carrying out the tax inspection.

Challenges to Reform

There is some opposition to the reform, mainly in terms of the content. Lasha Gotsiridze defined this opposition in two parts: "competitive opposition," from those who raise real concerns on the substance of the reforms; and "uncompetitive opposition," primarily from the opposition political parties, who are largely making populist allegations.

In response to these "competitive" criticisms, Gotsiridze mentioned that there is a strong team within the Ministry of Finance that has daily discussions with internal departments, Parliament, other ministers, and experts, allowing everyone to participate in discussions and justify their opinions. Once a decision is made, discussions continue with the Cabinet of Ministers, at the levels of State Minister, Minister of Economic Development, and Prime Minister. After the approval of the Cabinet of Ministers, the Budget-Financial Committee of the Parliament reviews the draft. During the entire period, the government ensures continuous consultations with the private sector.

Regarding the so-called uncompetitive criticism from opposition leaders, there does appear to be discontent with the tax reform; however, members of the opposition were reluctant to answer specific questions related to the results of the new Tax Code. Their primary concern is that uncertain property rights discredit all reforms and threaten foreign investment in Georgia.

Donor Involvement

Various donor organizations supported the tax reform in Georgia, but the development of the new Tax Code is viewed as a product of the Georgian government. The Ministry of Finance reforms are being supported by the United Nations Development Program (UNDP), which initiated a two-phase joint program with the Georgian government. Additional support for the Ministry of Finance and the Tax Department has come from the European Union TACIS programme; the USAID Georgian Business Climate Reform project; and the U.S. Treasury.

The EU project is for two years, and is supporting the Tax Department in three areas – structural reform, capacity building, and public awareness. The USAID project has been advising on the production of departmental strategies and plans and, more recently, on the documentation of processes, in particular with the development of the new integrated registration process. The U.S. Treasury has a team of advisors who have been visiting the Tax Department for short periods over a number of years, advising on audit, collection, and enforcement processes. UNDP have also been giving long-term assistance to the Tax Department with a focus on training.

Results

Increase in Business Start-ups

The reduction of taxes and tax rates as well as the decrease of the minimal amount needed for business start-up (from GEL 2,000 to GEL 200) helped motivate the creation of new businesses. For example, in 2006 there were 448,141 active registered businesses compared with 204,600 in 2003, which represents a 119 percent increase.

Increased Tax Revenue

There is a significant increase in tax revenue: a 190 percent increase in the revenue from the VAT from 2003 to 2006 (while the tax rate was reduced from 20 percent to 18 percent). Cutting down payroll taxes from 51 percent to 32 percent also motivated more businesses to legalize paid salaries. Income tax was decreased from a high of 20 percent to 12 percent, and social tax from 31 percent to 20 percent. As a consequence, in 2006 the amount of social tax that was paid increased by 126 percent and the amount of income tax that was paid increased by 152 percent since 2003.

Economic Growth

Economic growth continues to be stable. In the period 2003–2006, the average annual growth of real GDP was 8.83 percent and average annual inflation was 6.85 percent. From 2005 to 2006, real GDP increased 9 percent. Nominal GDP amounted to 13.8 (forecasted) billion GEL. Tax reform and the stable economic situation in Georgia also motivated an increase in foreign direct investments from US $340 million in 2003 to US $711 million in the first three quarters of 2006.

In 2003 Georgia's Corruption Perception Index Score (prepared by Transparency International) was at an all-time low (meaning that the level of perceived corruption was high). After the Rose Revolution and all fiscal reforms, the CPI Score has been steadily increasing, thus the perception of corruption has decreased dramatically.

Opportunities for Further Reform

The following is a list of further reform opportunities that have been identified:

- *Arbitration mechanism.* According to Nugzar Kavtaradze (the Tax Ombudsman of Georgian Business Federation), the main deficiency in the current tax regime is the lack of an arbitration mechanism, leaving only the court system for dispute resolution. An arbitration mechanism is being considered that will consist of representatives from both the state and the business community. In addition, the Ministry of Finance plans to form a Dispute Settlement Council, which will include an equal number of Georgians and foreign experts.
- *Role definition for financial police.* Several businesses interviewed also pointed to the unclear role of the Financial Police and their use of inappropriate methods for tax collection enforcement, such as very short notice for preparing documents and inconsistent implementation of requirements. The Ministry of Finance has recently taken steps to mitigate this situation by enacting legislation that merges the Financial Police with the Revenue Office of the Ministry of Finance. The law merged three entities—the Customs Department, the Tax Department, and the Financial Police into one body to provide better services for taxpayers in order to mobilize revenues. This is part of an overall effort to shift the tax collection system from a "strong-arm" enforcement regime to a voluntary self-compliance regime.
- *Amendment frequency.* During the period from the adoption of the new Tax Code in 2004 until December 2006, 17 amendments were made to the code, 4 clauses were added, and changes were made to 95 clauses, out of which 3 were abolished and 19 were changed completely. In various clauses, 119 parts and subprovisions were changed, 11 were abolished, and 33 were added. Though "taxpayers find it difficult/inconvenient to quickly follow these frequent changes," claimed Mr. Chumburidze, "there is no mechanism to make the information on changes available for taxpayers in a timely manner." Here there may be an opportunity for a reform incorporating information technology.

- *Poor processing of tax refunds.* The inability of the fiscal system to refund the surplus paid on taxes is a big concern for businesses.
- *Tax Department personnel.* Another issue that worries the taxpayers is the low level of experience and training of most of the Tax Department staff, mainly at middle management levels. The Ministry of Finance is taking steps to improve the qualification level of tax officers and give them adequate training.
- *Public awareness.* Public awareness of the new Tax Code is mostly based on media sources. The public lacks information about their legal rights and responsibilities under the new Tax Code. Most want information related to their rights on tax issues; which categories of citizens are exempted from taxes; who is legally obliged to pay taxes; what the penalties for late payment are; how to dispute a tax decision; where one must pay their taxes; what happens to tax evaders; etc.

Conclusions

At the current stage of the reform process, public opinion about the new Tax Code remains mixed. There still are serious uncertainties about the "where money goes" issue: 43 percent of individuals surveyed in a February 2007 EU-funded survey on taxpayer awareness believed that the money collected actually went to the state budget, and 57 percent said that it is pocketed. The survey of the socioeconomic impact of new Tax Code on families implies that only 7.2 percent of respondents think that their economic situation has become much better or somewhat better while the large majority say that it has remained about the same (42 percent) or become somewhat worse (39 percent).

The approach followed by the new Georgian government has created momentum for further reform. Giorgi Isakadze noted that "it is desirable to further simplify the procedures and establish a `one-window principle' to quickly meet taxpayers' expectation. It is very important to perfect the legislation on a permanent basis in order to regularly improve the taxpayer service."

Deputy State Minister on Reforms Coordination Vakhtang Lejava mentioned that there is still room for further improvement to the fiscal system; however, future reforms will not be as radical and wide scale as was the 2004 reform effort. Lasha Gotsiridze described how ideas today are developed at the government level and then are rigorously discussed with the business community and local and international experts. According to the government officials interviewed, this collaborative process is, and will continue to be, the basis for future reforms in Georgia.

About BizCLIR:

BizCLIR, or the Business Climate Legal & Institutional Reform Project, is a multi-year initiative of the United States Agency for International Development with the goal of improving the efficiency and impact of assistance programs intended to help developing countries improve their business enabling environments. This series, Best Practices for the Business Environment, represents one of many knowledge management components of the BizCLIR project. The goal of the series is to highlight the known best practices, case studies, lessons learned, and in some cases worst practices, so that the lessons can benefit other practitioners in the field. All issues are available at www.bizclir.com.