ANALYSIS AND RECOMMENDATIONS FOR EFFECTIVE FISCAL DECENTRALIZATION

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EXECUTIVE SUMMARY

Five main laws regulating economic and financial fundamentals of self-government units are the Local Self-Government Code of Georgia, the Budget Code of Georgia, the Tax Code of Georgia, the Law of Georgia on Grants, and the Law of Georgia on Local Fees.

Fiscal relationships are mainly regulated by the following organic laws: the Local Self-Government Code of Georgia, the Tax Code of Georgia and the Budget Code of Georgia.

The aspiration of Georgia to integrate into the European space sets the aim to implement the subnational fiscal reform in the country, which will ensure the fiscal autonomy of self-government units. One of main goals of the reform is to bring the system in line with the European principles of the regional development in order to facilitate the use of development potential in the regions to its maximum extent.

Components of fiscal decentralization. One of main problems of decentralization is the optimal distribution of revenues and expenditures. The components of subnational fiscal distribution include the grants (that is transfers and shared taxes), local taxes, and local fees. The systems differ by countries. In general, the systems are differentiated by:

- Dominating property tax with the property tax being the main source of local revenues;
- Dominating income tax with residents' income defined as the taxable base;
- Mixed use of property and income taxes;
- Enhanced tax discretion of the self-government with a local government having the power to impose both direct and indirect taxes;
- Absence of local taxes with centralized establishment and collection of taxes.

When decided on a direction of the reform, the main debate concerns the choice of taxes and transfers.

RECOMMENDATIONS

- The Ministry of Finance will have to make an important choice between leaving the income tax to local government by the place of taxation source or by the place of registration of physical person. Proceeding from the principle of local tax, it is better to choose the place of taxpayer's registration because physical persons receive services at their places of residence and consequently, should contribute to their self-governments (however, since the registration is not compulsory in Georgia, many employees are registered at one place whereas receive services somewhere else). If the income tax is left according to the place of registration, the employers will have to pay the deducted tax according to the places of registration of each employee. For example, the income tax deducted from the salary of a Tbilisi-based private company's employee (who is registered in any other municipality) shall be transferred in accordance with the place of registration of that employee, onto a different treasury codes, thereby making the employer's financial management complicated and administering the tax rather difficult. Moreover, this will make the preliminary estimation difficult because it will require a detailed analysis of the entire base of income tax payers. As regards the availability of statistics, the data on public sector employees by municipalities is relatively accurate, but it would be difficult to calculate the amount of potential income tax paid by them because the information about salaries in the regions is not available. The number of employees outside the public sector by municipalities is estimated. It will be difficult to determine the number of employees in branches because no official statistics is available on that (there is a problem of branches in the employment statistics). This will require to apply for the information from companies, which is a quite difficult if not impossible task. There are large employers which have huge networks and many branches and consequently, employ local population. For example, the Georgian Railways, Energo-Pro, commercial banks, companies owning gas-filling stations, drugstores, et cetera. The end result will be the taxes paid by employees registered in various municipalities coming to Tbilisi;

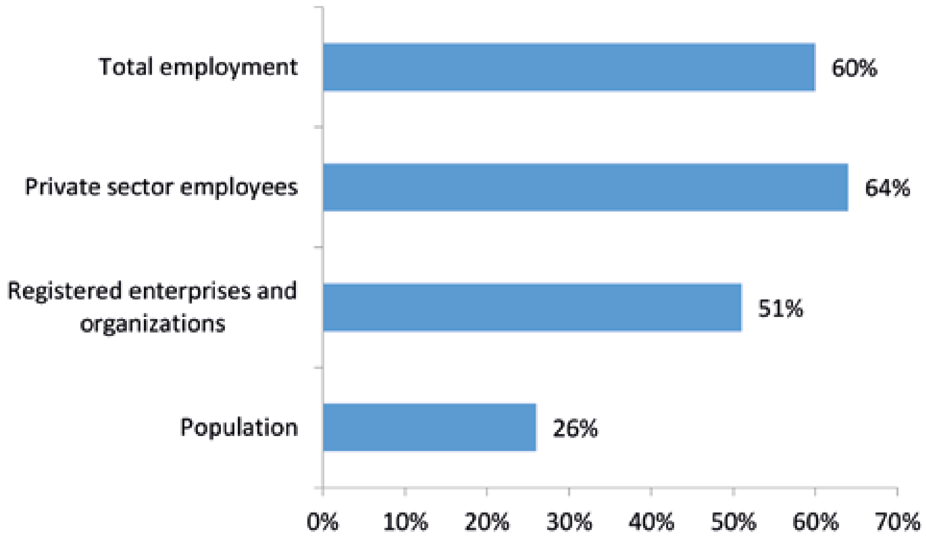
- The decision to leave income tax to a local government will lead to significant changes in the allocation of resources. On the one hand, it will decrease/eliminate vertical inequality for several self-governments (for example, Tbilisi, Batumi) but will leave the situation unchanged in the majority of self-governments. When income tax was taken away from local budgets to the central budget in 2008, the average inequality coefficient of the country increased from 25 percent to 80 percent which decreased in the following years and was maintained at 72 percent in 2013. The change in the tax distribution system will decrease the coefficient countrywide but very insignificantly for a whole number of municipalities;

- Generalization of indicators of income tax paid to local budgets in 2007 (Appendix 2) show that in 2013, significant income tax revenues would have been accumulated only in large urban centers. Moreover, the horizontal inequality would have increased among self-government units. Tbilisi budget would have received 870 million GEL in excess of planned revenues. The transfers would have been totally replaced only in 19 municipalities, with the sum of their surplus reaching 153,9 million. The total of 171 million worth transfer would have been needed to cover the deficit of 42 municipal units. As the simulation showed, the amount of transfers to be allocated would have decreased by 794 million (excluding autonomous republics and Adjara's municipalities); however, a) the state budget would not have received around 1,96 billion GEL in the form of income tax and additional transfers to be allocated to local governments and b) the horizontal inequality gap would have further widen among self-governments the eradication of which would have required additional resources from the state budget. Consequently, the net loss of the state budget (the spending made on the subnational level) would have been above 1 billion GEL with the bulk of it (870 million) accounting for Tbilisi.

- The calculations made by actual data of the income tax paid in 2013 did not provide the ground for optimism either. For example, a potential income tax per capable employee for Kutaisi, Gurjaani and Ozrugeti municipalities, stood at 278 GEL, 76.1 GEL and 97.9 GEL, respectively. The simulation showed a significant decrease in vertical inequality coefficient for Kutaisi alone, thus proving that in case of leaving the tax to local governments, resources will accumulate only in large cities;

- One should also take into account that 51 percent of operational enterprises and organizations are registered in Tbilisi; according to the data of the first quarter of 2014, of all private sector employees countrywide 64 percent account for Tbilisi; 60 percent of total employees of the private and public sectors in the country are employed in Tbilisi (Appendix 1) when the population of Tbilisi comprises 26 percent of the country's population. As said above, if income tax is left to local government, the potential revenues of Tbilisi will be quite large compared to other municipalities;

Chart 29. Population, enterprises and organizations, business sector employees and total employees in Tbilisi; % of total country indicator*



Source: National Statistics Office of Georgia

* Official statistics provides indicators of employment in public sector and private sector alone. The number of employees in the civil sector cannot be obtained even on the regional level and therefore, the indicators of public and private sector employees are used for the analysis and estimation.

- In case of deducting the income tax by the place of registration of employer, several main scenarios of leaving tax to local governments may be considered:

1. The income tax deducted from the income of physical persons by all locally registered employers and paid by physical persons from their income received from local organizations or private companies; including the public sector (which also include schoolteachers), private sector (including the income tax paid by physical persons of private law), civil sector and the tax deducted from the income of employees of branches of Tbilisi-based organizations;

2. The income tax deducted from the income of physical persons by all locally registered employers and paid by physical persons from their income received from local organizations or private companies excluding public sector; that is it does not include public sector employees;

3. The income tax deducted from only locally registered public sector employees;

4. A share of the total income tax paid to a local government to be left step by step according to a schedule draw up by years. For example, an initial 20 percent with the prospect to be increased in the following years. Some 20 % in the first year, an additional 20 percent in the following years and so on and so forth.

Scenario 1	Scenario 2	Scenario 3	Scenario 4
Employees of local public sector Private and civil sectors	Private and civil sectors	Public sector	Step by step leaving of a share or/and mixed scenario – leaving only part of income tax in large cities

- In case of the first scenario, no income tax will go to the state budget and the state budget will not receive around 2 billion GEL. At the same time, the majority of municipalities will still be in need of transfers (according to the simulation provided in the Appendix 2, the estimated number of such municipalities comprises 42) and the polarization of large cities will occur. This is shown by generalization made on the basis of 2007 actual data and calculations made on the basis of 2013 actual revenues (Ozurgeti, Gurjaani and Kutaisi examples). As a result of changes to the system, the total amount of transfers to be allocated from the state budget in the following years will decrease roughly by 800 million GEL, but it will not receive the budgetary resources of more than 1 billion GEL of which 900 million GEL will go to the Tbilisi budget.

- In the event of the second scenario, the state budget will see lesser decrease in revenues than in the first scenario. However, given that in the majority of municipalities the number of public sector employees is higher than that of private sector employees (see Appendix 1), leaving income tax by private companies to those municipalities will not improve the financial state of these municipalities. In this case, the problem of branches will arise and the polarization of Tbilisi revenues will occur. According to our estimates based on 2013 actual revenues, the private sector alone (including sole traders) paid the income tax exceeding 1.2 billion GEL which the state budget will not receive if it is left to local municipalities. In this case, the decrease in transfers will be less than in the previous scenario;

- The administration will be the easiest in case of the third scenario and the revenues will be distributed relatively evenly because the size of public sector (including educational institutions) is proportional to the population of a municipality. However, transfers will still be required and Tbilisi will not mobilize as much revenues as in case of previous two scenarios. Although the decrease in the revenues to the state budget will be the least compared to two previous scenarios, in nominal terms this will still be a heavy burden. By 2013, the amount of public sector employees across the country comprised 42 percent of total employment in public and private sectors (a corresponding indicator of first quarter of 2014 is 40 percent) whilst an average salary in public sector is lower than in the private sector. According to our estimates of actual revenues, in 2013, the public sector alone paid approximately 400 million GEL in income tax which the state budget will not receive if it is left to local governments while the amount of transfers will decrease insignificantly. In terms of administering, this seems most attractive option, but since the motivation of local governments should be the increase in their own tax revenues, in this case they will lack the motivation to think about and support the formation of business environment. The reliance on income tax received from the public sector alone will encourage them to increase employment and salaries in the public sector;

- According to the fourth scenario a predetermined percentage of the income tax is left step by step. For example, initially only a certain share of total collected income tax, say 10 percent, will be left to local government. Thereafter, over the years, the amount of revenues left to local government will gradually increase. For instance, on the first stage some 20 percent of income tax collected in the private sector will be left, which will be 240 million GEL based on the analysis of 2013 actual figures. In this case, though, transfers will still be required by the majority of municipalities and the total amount of transfer will not change much. To plan this process and make corresponding estimates, the following will be needed:

    - To put to right the taxpayers' database existing in the Revenue Service in order to allow accurate preliminary calculations by municipalities;

    - Availability of statistics on employment, income (including salaries) and business activities on municipal level;

- As a result of calculations made in the study and discussion of several above provided scenarios one may conclude that the reform will have a somewhat positive effect if the income tax is entirely left to local governments and even in this case, it will not tackle the problem of horizontal inequality in full. The polarization of revenues of large cities will occur and the majority of municipalities (42 municipalities) will require transfers while, at the same time, the state budget will not receive up to 1 billion GEL. In case of leaving income tax to local governments the horizontal inequality will further increase and the state budget will not receive a larger amount (above 1.2 billion GEL in case of leaving income tax paid by private companies and sole traders, and up to 400 million GEL in case of leaving income tax paid by public sector). Whereas in case of leaving a share step by step, although this will have no fiscal effect for local governments on the initial stage, the central government will be able to implement the reform gradually and in an unpainful manner;

- Based on above discussed scenarios and corresponding analysis it can be concluded that at present the most optimal option seems to be the fourth scenario – leaving a share step by step or leaving a different share, which will enable the Finance Ministry to implement the reform in an unpainful manner, on the basis of preliminary calculations and analysis.

- In case of any scenario Tbilisi will receive larger revenues as compared to other municipalities because the indicators of employment as well as of registered enterprises and organizations are quite high in Tbilisi. An average salary is also higher in Tbilisi. In fact, the situation will be similar to that which existed before 2008. In case of leaving income tax in full, three interconnected problems will emerge:

1. Tbilisi will receive large amount of income tax whereas the income tax collected by other municipalities will not be sufficient for the majority of municipalities;

2. Apart from Tbilisi, only a few municipalities will not be in need of transfers which means that the state budget will not see any significant amount of saving by decreased transfers;

3. All this will be a heavy burden for the state budget as it will be deprived of significant revenues that would have been spent on various programs.

The use of mixed scenario will allow to leave different shares of tax to local governments. For example, Tbilisi may retain only 50 percent of income tax (especially considering that Tbilisi have a potential to increase the property tax). Such an approach would remove the threat of income polarization and decrease the shortage of the central budget caused by the change to the system. At the same time, a source of unconditional revenues will increase of other municipalities, which they can spend independently.

- Income tax to local budget is nothing else but a type of unconditional transfer. Despite the change in the rule of distribution, it will be necessary to allocate transfers from the central budget to local governments, save few exceptions. Moreover, if the tax is transferred to a budget by the place of residence of employees, there is a high probability that none of municipalities will be able to meet spending needs with their own revenues. Transfers will be received by such units too for which the income tax will become a significant source of performing the budget. Consequently, before taking a decision it is necessary to evaluate 1. the burden associated with administering and 2. To determine the amount of the shortage created as a result of the changes and sources of coverage of this shortage both for local and central budgets.

One of the arguments of channeling income tax to local budgets is the encouragement of self-governments to attract investments and support the rise in employment. In general, the approach is not groundless, but it should be kept in mind that if self-governments are not vested with power to establish tax breaks or/and change tax rates, this will not bring about any result (however, self-government units in Georgia are not ready for that yet and therefore, the reform may be considered premature). At the same time, it is important that the increase in received revenues does not cause the decrease in transfers to be received from the central budget. A crucial principle which must be observed in calculating transfers is the potential of local tax base and the assessment of its use by a local self-government. When this condition is not observed, self-governments lose a motivation to support the development of economy and collect local taxes and fees. Therefore, when applying the transfer formula, potential revenues shall be calculated not by actual performance trend but by the existing tax base. Thus, it is necessary to consider the changes to the rule of income tax distribution in conjunction with the transfer formula and to devise a new mechanism of equalizing so that to ensure the economic growth that is based on local potential in municipalities.

- In terms of increase in local revenues, the property tax has a potential which must be used because in its essence the property tax is the most desirable and easily administered local tax. It is also important to improve the system of local fees and service charges as the resources mobilized from them may become a significant source of covering local expenditures.