

## Security of the economic area from non-controlled zones of Georgia – Summary

Zurab Garakanidze, Ph.D (Economics)

A main factor in Georgia's economic development is security. The Georgian Government must protect the legal economy from contraband trafficking across borders with the country's breakaway regions. Such criminal activity carries three threats to economic growth:

- First, it undermines legal business by allowing competitors who use illegal methods to under price legal goods, forcing licit businesses to hide income (i.e., avoid taxation) and move into the “shadow”;
- Second, there is a slippery slope effect, whereby lobbying of illegal interests (a “roof”) becomes more and more accepted, that eventually payment of taxes required by law becomes the exception rather than the rule
- Third, according to the new Tax Code of Georgia, increase in excise duties, which include the significant share in importing goods from non-controlled zones (tobacco, oil products), shall enhance smuggling and shall contribute to “shadow economy” instead of the economic growth within Georgia

We show that import taxes should actually be decreased and the tax burden be placed proportionally on the retailers of such products as oil products, tobacco, excised (meaning that due to the lack of ability to control several – Thousands kilometers of break-away region Administrative borders with Georgian controlled territory, the burden of customs duty collection shall be moved from the border line to the territory of Georgia, i.e. the customs duty that had to be paid at the border shall be added to the value of the retail goods when selling them inside Georgia), as is the tax on hazardous materials (which is not in new tax code) and what control possibility the tax authority has within the economic area. This will affect, on one hand, a better administration of excise taxes, and on the other hand, contrabandists and their separatist protectors will lose significant illegal revenues. This will also impede terrorist and separatist financing. In short, administrative methods currently used (e.g., law enforcement and criminal prosecutions, especially when one considers that Tbilisi refuses to close the border with the breakaway regimes, as this would become *de facto* separation) cannot alone achieve economic security. Our economic research proves this through an examination of several goods subject to excise taxes.

Before giving details on recommendations to protect Georgia's economic development, there are two important points to make. First, any economic laws aimed at protecting Georgia must first be vetted with the Bretton Woods institutions and the WTO, as each have their own view on taxation. Second, these recommendations follow TraCCC CO's stance that under a partially guarded border it is important to use economic methods for preventing contraband. Specifically TraCCC argues that taxes should be lower than expected bribe payments to law enforcement, customs, and other groups, as this would make legal operations cheaper. Moreover, it is easier to undermine smuggling through taxation than administrative measures because smuggling operations involve hundreds of people, and hundreds of criminal cases would certainly cause great social unrest.

Broadly, the Government should carry out two overarching reforms. First, the role of National Security Council should be increased. With the Defense and Security Ministries, the NSC must actively coordinate the economic security bodies and the entire security related political, judicial and social-economic systems. Second, we suggest that crimes covered under Article 214 of the Criminal Code (violation of customs rules) fall within the competencies of the investigative bodies of the Ministry of Internal Affairs and of the Financial Police. In addition, apart from

those governmental bodies, the Georgian State Department for the Protection of Borders is also authorized to investigate these types of crimes.

Under existing legislation, investigation of tax evasion falls within the jurisdiction of the Financial Police, while the Ministry of Internal Affairs investigates corruption and economic crime. The Department for the Protection of Borders is also authorized to deal with such crimes. It is clear that these functions are not allocated by any specific unifying norm, and that the current legislation gives room for parallelism and duplication. Looking at the statistics for recent years, there is little room for optimism. The multi-pronged attack did not reduce the scale of smuggling, but rather complicated the fight against it. While there is much oversight (with corresponding duplication), because corruption has not been rooted out of the responsible government agencies smuggling within the country nearly always take place with the cooperation of government officials. Inappropriate distribution of the responsibilities (i.e., large amounts of discretion given to individuals) is the main reason for this.

Because of duplication, collusion, and discretion, several concrete steps must be taken. First, the function of fighting industrial smuggling (i.e. smuggling of Consumer Goods), should be withdrawn from the Ministry of Internal Affairs so that the Ministry gets rid of the function of controlling economic security. The latter (**Ministry of Internal Affairs**) should retain the function of investigation the smuggling of drugs, arms and radioactive substances and this should become its main task.

With regard to the analysis of economic security and forecasting possible threats, this is to be assigned to the National Security Council. Investigating tax evasion and the relevant departments of the Main Board for Fighting Corruption and Economic Crime are to be dissolved. The major function of the Main Board should be to uncover and investigate crimes against property, crime in the monetary system, bribery, etc. In other words, the Ministry of Internal Affairs has to be totally discharged from investigating economic crimes.

It is possible to establish a new state department modeled on the Financial Police. This new department would be subordinated to the President. It can be named as a State Department of Financial or Tax Police (similarly formed services are functioning in the Russian Federation, Ukraine, Europe and many other countries; recently the Federal Bureau of Financial Investigation, which is directly subordinated to the President, was established in Kazakhstan.). The main function of such a Department will be the fight against industrial smuggling and tax evasion. A single government agency fighting smuggling and tax evasion would reduce duplication and corruption opportunities.

In order to create a legal framework to fight industrial smuggling and tax evasion, several changes must be made.

- A body directly responsible for the actual fight against industrial smuggling and tax evasion in the country will be established in the state as an independent state department;
- Parallelism, duplication and the never-ending process of looking for the wrong and right party will finally end;
- Such measures will have positive feedback from international organizations and foreign states. At the same time it will be interpreted as the beginning of a process with implications for the police and other security bodies, which would be expected to support financially and technically the newly established services. Society will have a positive attitude towards this decision, in particular people involved in business and in the economic field in general. They will know clearly who is fighting smuggling and tax

evasion; there will be a proper legal basis for the recruitment of staff (it is difficult to find other agencies more advanced in employing relatives and friends).

Due to the strategic, Eurasian corridor function, and also to the increasing danger from international terrorism, the Tax Code should contain a separate article on "Contraband." Such a classification would differentiate so called industrial smuggling and other classical types of contraband (e.g. weapon, chemicals, radioactive materials, drugs, etc). Amending the Penal Code with Article 214 shall be changed so that assessment of the sanctions/penalties on the smuggled goods shall be not according with the amount and/or volume of the smuggled goods in concrete situations, but with the value of the whole smuggled goods.

- The Article should not refer to custom taxes avoided but rather the market value of the smuggling goods.
- Within the New Tax Code there still remain several preferences (i.e. tax holidays) which are used as "umbrellas" to evade paying taxes determined by law. Particularly, it is necessary to perfect the legality-economy of the VAT preferences (i.e. some of the goods are free of VAT, thus, it is important to re-evaluate the list of VAT free goods) in the former Article 101 and the new Article 230 of the Tax Code.

The above recommendations are backed by our theoretical research. Generally, the best method for measuring contraband is the so-called "mirror comparison". This method entails comparing reported exports against the reported imports of our trade partner country (or vice versa). If a negative balance is discovered, it is assumed that contraband goods have been imported to Georgia. Such a well-known organization as the World Health Organization (WHO), in the tobacco convention, which was approved on the 56th meeting of World Health Assembly on May 21, 2003, says that the measure of the quality of contraband is defined relatively to import and export. While the mirror-comparison method is useful, there are three difficulties in implementing it in Georgia. First, the corruption in border authorities of trade partners and unaccounted trade operations should not be excluded. Second, the data collected by another country's border authority may be different and therefore unreliable for statistical purposes. Finally, and the most important issue, is Georgia's main trade partner, Russia, which officially considers selling goods in Abkhazia and so-called "South Osetia" as an export to Georgia, wherefrom these goods are coming via smuggling routes to other parts of Georgia. Obviously, a "mirror comparison" of Georgia and Russia will be unrealistic, the difference being more than tens of millions of Lari.

A different method of assessing the unrecorded sector in Georgia may be implemented that shall be conducted and coordinated by a separate analytical department that shall be created within the National Security Council. This is because, nowadays, the very National Security Council is the one coordinating the inte-sectoral work in compliance with the Article 99 in Georgian Constitution and is capable of collecting all the information needed from all the law enforcement bodies in Georgia.

Cooperation among the Ministries in the NSC should include sharing of data, which would give an opportunity to build a database for economic, auditing and judicial bodies. Therefore, it is possible to put them in the presented formula and consider concrete areas, where the level of unaccountability is increasing. Also, such calculations exclude errors which are typical for "mirror comparisons" because they do not include foreign borders with the uncontrolled territories. The National Security Council should start work on forecasting and modeling dangers (such a case is discussed in the second chapter). In addition to providing data for the territory of Georgia under Tbilisi's control, it would also allow the National Security Council to monitor the economic consequences of separatism. In the long version of this work,

the cases of existing dangers of economic separatism in Samtskhe-Javakheti and Kvemo Karti are discussed.

One of the activities of struggling against smuggling is to systematically inform society about the criminal cases for such illegal actions and country's damages from the side of legal and physical bodies. According to the peace initiative expressed by President M. Saakashvili in Strasburg in 2004, and supported by the US President during his visit to Georgia on May 9-10, 2005, it would be possible to declare Zugdidi as the customs place for goods imported through Abkhazia and the Tskhinvali region. It is possible to involve the World Trade Organization in the process of solving the customs problem and to use, as an additional barrier of fighting against smuggling, the Russian example of applying for the membership of this significant organization. Therefore, it is possible to create strong central lobby in the separatist regions which will have economic concerns.