

**General review of business environment**

“A state has limited capacities to assist economy, and limitless capacities to hamper economic development”.

J.M. Keynes

Tax evasion vicious practice is more or less characteristic for the considerable part of taxpayers in many countries, in spite of their historical, social-economic or ethnic-psychological peculiarities.

At present tax evasion and illegal activities phenomenon cannot be regarded as the problem of local importance, typical for only particular governments and economic environments. Financial resources of such painful problems of modern world as terrorism and political separatism are mostly gained from illegal activities. Consequently the necessity of permanent development of tax payment system is very actual.

Above-mentioned problem is the most acute one for our country as Georgian reality has been created and influenced by so called socialist entrepreneurial relationships; existing social environment and stereotype mentality, therefore absolute majority of entrepreneurs are involved in tax evasion mechanisms creation-realization processes.

In spite of lack of official and authentic information on the scale of shadow economy, in accordance with the methodology elaborated by the Georgian State Department of Statistic, rates of shadow economy are catastrophic. (Table #1)

Shares of shadow economy

Table 1<sup>1</sup>

	1996	1997	1998	1999	2000	2001	2002 1 <sup>st</sup> quarter
Total amount in million GEL	2 250	7 311	7 833	8 912	9 566	10778	2 603
Unregistered part in million GEL	1 678	2 006	2 214	2 606	2 135	3 525	848
Total unregistered amount in %	26,9	27.4	28.3	29.2	32.8	32.7	32.6
Entrepreneurial sector in million GEL	2 956	3 671	4 080	4 806	5 638	6 184	1 492
Unregistered entrepreneurial sector in %	56.8	54.7	54.3	54.2	55.6	57.0	56.8

<sup>1</sup> The table is based on the data provided by Ministry of Economics, Trade and Industry.

### Shadow economy share in %

	1996	1997	1998	1999	2000	2001	2002
Industry	43	43	40	39	41	41	41
Construction	18	35	38	38	60	58	55
Transport	38	35	36	37	35	39	38
Communications	23	23	19	24	22	25	27
Trade	66	60	57	56	56	57	54
Hotels and restaurants	62	61	60	64	67	71	71
Others	24	27	31	33	40	36	38

Existing situation is a subject of debate for executive and legislative authorities of the country. It is worth mentioning that for the majority of government officials to participate in debates on the reduction of tax rates is actually impossible. As this approach do not meet the requirements of the International Monetary Fund and obligations on the improvement of budgetary funds mobilization. Consequently the government officials, who are dependent on the support provided by the international financial institutions, have to avoid further discussions of these issues.

According to the conclusions made on the existing situation, which are widely acknowledged, there are some cardinal reasons for the alarming scales of shadow economy, namely low level of tax payment culture and corrupt practices of fiscal agents. Therefore while discussing the measures that are to be undertaken the above trends are considered as priority ones.

To our viewpoint one of the most important preconditions of existing situation is deficiency of economic legislation, which do not reflect objective economic realities. Accordingly alarming rate of shadow economy should be regarded as not only as a problem of an economy in transition but as a result of incorrect economic policy.

In favor of our viewpoint we can provide a number of normative acts and regulations, which have been elaborated and adopted by “joint efforts” of executive and legislative powers and which are actually transformed into factors for tax evasion. Since the adoption of Tax Code of Georgia in 13 June 1997, 58 amendments to the law were made, which should be referred as objectives for the absence of stability in business environment.

For the complete analysis of the shadow economy objectives, it is essential that appropriateness of tax payment liabilities have also been assessed.

From this viewpoint it is important to emphasize that nominal tax rate indices not only do not exceed but also are considerably lower than tax rate indices of many other countries. Due to this fact certain part of public servants, economists and foreign

experts do not agree with the standpoint that tax burden is one of the main objectives of alarming rates of shadow economy.

For the realistic assessment of payment liabilities it is not sufficient that only comparative analysis of various countries data on number and amount of tax rates has been made. It is absolutely essential that deep analysis of the country's entrepreneurial potential, raw material and consumer market situation, average norms of profits and losses have been made in particular fields of economy.

The format of present study does not allow us to discuss in detail wide range of specific aspects. We will highlight only those specific business conditions, which in addition to tax burden significantly complicate general conditions of business activities for the majority of entrepreneurs.

Most part of basic production assets of Georgian entrepreneurs is depreciated both, morally and physically. Low productive capacity parameters drastically increase production expenditures, which nearly approach market price of products.

In parallel of above mentioned process low payment capacity of consumers market and relevantly low selling prices do not allow to compensate for production expenditures.

Consequently even nominal tax rates become a heavy burden and relevantly decrease profit level. Presence of substitutes in the form of imported cheap goods on the consumer market almost excludes competitiveness of locally produced goods and destroy capabilities of legal entrepreneurial activities in various fields of economy, in spite of tax rates.

Taking into consideration all the above, the viewpoint shared by some economists and entrepreneurs that existing tax treatment do not reflect current realities of the country and in some cases is one of the main factors of tax evasion, from our viewpoint, is a convincing argument.

As a result of existing situation, mainly taxpayers are blamed in the amount and scales of shadow economy and sometimes objective and justified arguments of taxpayers are being ignored. Consequently great majority of taxation legislative acts have been transformed into factors that only worsen and complicate business environment and encourage growth of shadow economy.

We can bring an example of the amendment made to the Georgian Tax Code, article 188, paragraph "a", dated by 13 June 2000, according to which all categories of social taxpayers (regardless of salary fund amount) were to pay not less than 16 GEL into the unified social insurance fund and this tax was an obligatory one.

This amendment which had been executed in classical style of authoritarian administration, caused considerable decrease of employment in non-budgetary sector. As for the budgetary sector, it produced "curious" situation, for example, assistant professor of higher education system working as a permanent staff member but on part time terms (half a day) and having a salary of 19 GEL had also to pay the above social tax. For that purpose the administration of a higher education state institution

received 16 GEL from state budget and than it was reimbursed to social insurance unified fund, which is also part of the state budget.

Above-mentioned legislative initiative, which was intended to increase mobilization of budgetary incomes, resulted in contrary effect, as the budget had to increase its assignments. And majority of entrepreneurs was encouraged to decrease the number of employees and pay salaries in cash – without proper registering-accounting processing.

As a result of this situation another amendment was adopted in October 2000 in the form of amendment to article 273 of the Tax Code, which terminated above discussed amendment.

It is evident that orientation on western legislation and standards is a progressive fact. Hence in practice if we do not consider absence of relevant environment for the adoption of western legislation it may cause stimulation of tax evasion practices and nihilistic attitude.

The norms listed below could be included in the above-mentioned category:

1. Article 20 of the Tax Code on property tax. In accordance with the first paragraph of article 137, real estate on urban territory is an object of this tax (buildings, constructions) excluding land.

Presently we will not discuss a problem of tax equity, when an owner of a rented apartment in a prestigious part of a city with high income and a family with many children and low income (who live in non-prestigious district with no renting value) are imposed by the same tax treatment. This is a subject of another dispute. The main problem of this legislative norm is its ad valorem character and in accordance with articles 138 and 139 of the Tax Code, the tax rate should be calculated as 1 % from inventory price (value) of buildings and constructions.

For the simple justification that inventorying has not been carried out for the last 15 years and there is no more or less complete methodology for the identification of the market price of a tax property, actually no one pays this tax and tax services do not undertake any enforcement measures.

In spite of all above said the government has not issued any order even on temporary termination of this law, though the practice of continuous amendments to legislation acts is widely exercised by Georgian Government, not to mention the necessity of taxation objects identification and further development of payment mechanisms.

2. Article 38, paragraph “c”, states that 0,05% of the value of a motorcar, which is given to an employee for personal use, is to be regarded as an income related to wages. There is a big question mark whether in a country where customs service had to address and invite non-resident private structure for the identification of imported goods value, an organization accountant can carry out price determination of a foreign production motor car. And if we take into consideration some ethnic-psychological peculiarities and a number of other factors of Georgian reality, it is absolutely impossible that number of days when motorcar was used for personal requirements

was calculated. If this number is calculated then it should be multiplied by 0,05% of a motorcar value and the figure received should be taxed in conformity with the income tax treatment. Introduction of this type of tax load, from our viewpoint is one more factor of law violation and formal approach to tax payment issues.

It is quite understandable that creation of law superiority and law-abiding atmosphere is followed by some objective complications. Though it is absolutely incomprehensible how the government, which is ambitious enough to state that they are building legitimate commonwealth, can completely ignore legitimate rights of entrepreneurs and consequently majority of entrepreneurs have to violate the law. Otherwise they will not be able to continue their business activities.

As an example of superficial approach to law-creation process we can discuss a case when:

- According to the law on the “Levy of registration” which was imposed on 10 April 2002, for the registration of an individual enterprise, registration tax was determined as 20 GEL (Article 7, paragraph “a”), whereas a year before (30 March, 2001), in accordance with the principles of entrepreneurship supportive state policy, an amendment to the law on “Entrepreneurship” was made, dated by 28 October, 1994. Article 5, paragraph 15 of that law states that no taxes can be levied on an individual enterprise.

The amendment to the law on the “Levy of registration”, remained in force for three months and afterwards the “error” was admitted and another amendment to the law dated by 7 June 2002 was issued to improve the situation. Though entrepreneurs had enough time to experience contradictory and inconsistent character of the legislation.

Under the circumstances when entrepreneurial relationships are in the process of formation, the fact that entrepreneurs bear the liabilities of governmental institutions could be explained by not properly understood economic management principles of market economy. It is also unacceptable for the simple logic as entrepreneurs have no tangible capacities to take these liabilities and it results in necessity to find mechanisms of tax evasion.

We should also admit existence of complete neglect of division of liabilities between a state and an entrepreneur, which is very important factor of legal liabilities. For example:

1. The amendment made to Article 114, sub-clause “d” of the Tax Code of Georgia, dated by 13 June, 2000, which states that for individuals who submit VAT invoices where sellers' names cannot be identified, all previous value-added tax payments will be considered as invalid.

It is absolutely certain that fighting against tax evasion mechanisms is a right approach but to punish entrepreneurs for the violations that should be dealt by tax law enforcement institutions is totally unjustified approach. Especially as fighting against the practice of fraudulent use of VAT invoices, which are considered as documents of strict registration, is not the competency of entrepreneurs.

2. Transitional regulation of the Georgian law on “State Budget of Georgia”, dated by 13 December 2001, states that an employer has the liability to pay first 30 days of sick leave of an employee. Actually by this “legal norm”, the state refused to undertake elementary social protection liabilities and created one more predictable violation of legally justified relationships between an entrepreneur and a state.

Though the facts of violation of legitimate norms that hamper entrepreneurial activities are numerous, one circumstance, from our consideration, is extremely important.

It is well known that, only a small number of owners in Georgia receive their income in the form of percent from dividends or rents. Consequently majority of lawful part of population leave on incomes received in the forms of salaries as it is defined by the Article 38 of the Georgian Tax Code.

Accordingly, we should regard salary scales taxation regime as main criteria of entrepreneurial environment evaluation. For the determination of appropriateness of acting salary taxation mechanisms, let us consider a simple example.

Let us assume that in conformity with the employment contract an entrepreneur (employer) undertakes an obligation to pay to an employee 300 GEL monthly. As this sum in accordance with the definition formulated in Article 38 of the Tax Code is an income received in the form of a salary, in accordance with articles 185 and 188 of the same Code an entrepreneur (employer) should pay following taxes:

- To Unified Social Insurance Fund, 27% of a fixed salary;
- To Unified State Employment Fund 1 % of a fixed salary;
- And in accordance with the Georgian law on “Obligatory Insurance Payments”, article 4, sub-clause “a”, dated by 21 March 1995, 3 % of the sum received as a salary.

Hence in conformity with the existing law an entrepreneur (employer) has an obligation to pay to central budget and to special state funds 31% of salary sum. In our case it amounts to 93 GEL.

In accordance with the existing legislation an employee also has an obligation to pay income tax (article 42 of the Tax Code), and social tax (Article 188, sub-clause “c”). In accordance with the Georgian law on “Obligatory Insurance Payments”, article 4, sub-clause “c”, the amount of obligatory medical insurance tax is determined which in case if salary is 300 GEL amounts to 43.65 GEL.

Considered example clarifies that existing tax treatment is a real pressure for the taxpayers.

In addition to the above-mentioned circumstances we should take into consideration that in accordance with the article 42 of the Tax code, starting from 1997, untaxed minimal salary is defined as 9 GEL. Average annual amount of monthly subsistence

minimum from 1997 (average annual amount in 1997 was 104.7 GEL) <sup>2</sup> till present is increased by 11,9 GEL or by 11.2% (average annual amount in 2001 was 116.6 GEL).

In addition we would like to mention that absolute majority of the population (except former servants of military services and other small social groups) in spite of working years and amounts of taxes paid in the form of tax on profits or social tax, receives a pension of 14 GEL. It is easy to imagine how stimulating above-mentioned circumstances are for the entrepreneur (employer) and an employee to pay taxes.

Present situation naturally results in the necessity of tax evasion practices. Situation is more tragic for those entrepreneurs (employers) who are not involved in tax evasion practices, as the increase of expenditures make them absolutely uncompetitive and either they are forced to terminate their business activities or to use tax evasion principles.

Tax treatment of the main resource of income for the majority of population or tax treatment on salaries and some other factors actually condition establishment of tax evasion practices.

We would like to review tax evasion realization schemes, mechanisms and what is the most important, deficiencies of present tax legislation in the next chapter.

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Statistical data is provided by the State Department of Statistics.

## **Tax Evasion schemes and their Analysis**

Of course one should think about “What” but mostly concentrate on “How”!

Goethe

Tax evasion “strategic” schemes and trends, which are mainly used by Georgian entrepreneurs, practically do not imply any qualitative innovations. Specialists are well informed on most of them.

Moreover, if we take into account existence of inflexible legislation, inadequate professional experience of the tax services personnel, corrupt practices of customs service servants, deals with the controlling institutions, we will see that there is no need in inventing new schemes of tax evasion.

Consequently, in the first place we would like to categorize Georgian businessmen in accordance with their capacities to use existing tax evasion schemes and mechanisms. Thus we will highlight peculiarities of Georgian tax evasion schemes and mechanisms, namely:

1. “Elite”, oligarchic part of Georgian businessmen:
  - Capacity to take decisions on governmental level favorable for their personal interests and in some cases enjoy tax privileges;
  - Capacity to use “possibilities” of enterprises registered in offshore zones on the basis of international agreements;
  - Capacity for “adjustment” tax privileges defined by the tax legislation to their own business interests;
  - Capacity of partial or full hiding of taxable objects from tax, customs and controlling institutions' representatives, through illegal deals and accounting manipulations;
2. Registered part of Georgian businessmen:
  - Capacity to “adjust” tax privileges defined by the tax legislation to their own business interests;
  - Capacity of partial or full hiding of taxable objects from tax, customs and controlling institutions' representatives, through illegal deals and accounting manipulations;
3. Illegal, unregistered part of Georgian businessmen:
  - Violations, characteristic for illegal economic activities, which in some cases imply elements of criminality.

Naturally combating against tax evasion methods, used by above described categories of Georgian businessmen requires different approaches. To fight effectively against these processes, it is absolutely necessary that the government should make emphasis on reasons and not on the results of these processes.

From this viewpoint, tax privilege is one of the most actual problems of Georgian reality. Analysis of the experiences related to tax privileges revealed that some part of Georgian businessmen transformed privileges awarded on the basis of economic, social or political considerations into effective tax evasion mechanisms.

Due to a range of objective and subjective reasons it is currently practically impossible to fully record products/services produced/ provided in Georgia, which under the tax privileges become tax-free. Despite this, the existing figures (Table 2) indicating the high specific share of tax-free consignments (due to tax privileges) in the total volume of imported goods clearly show the scales of illegal - tax-free revenues gained by the owners of the goods, as the major part of these consignments due to legal (subject to monetarism) and illegal operations are often put into circulation.

**Tax-free (due to tax privileges) imports volume, the dynamics of specific share in the total volume of the imported goods in Georgia being in free circulation.**  
(In thousand USD)

(Table 2)\*

	1999		2000		2001	
	Value	Specific value in total imports	Value	Specific value in total imports	Value	Specific value in total imports
The total volume of imports in the country put into free circulation*						
Putting the goods into free circulation	526909	100	653325.5	100	695608.8	100
Among them:						
Taxed by customs duties	325000	617	371383.9	56.8	419923.8	60.4
Tax-free due to tax privileges	201882	38.3	281941.3	43.2	230895	33.2
Including:						
Humanitarian aid	52586.1	10	61083	9.3	71250.5	10.2
Grants	7337.9	1.4	23234	3.6	20200.8	2.9
Legislation based other privileges	98130.2	18.6	126440.3	19.4	129141.4	18.6

In addition to the above, their dumping costs conditioned by tax privilege regime, jeopardizes law-abiding entrepreneurs, who produce and distribute similar products and in order to compete are urged to move into shadow economy sector. The goods imported to the country under humanitarian aid and grants represents the extremely

\* The table is based on the data published by the Ministry of Tax Revenues of Georgia.

important good will act for assisting impoverished part of the population. Nevertheless, taking into consideration the above-mentioned circumstances, it does not cast doubt that it is essential to tighten control over awarding the status of a privileged tax regime and purposeful utilization of the goods imported under this status.

It should be noted that at present there is no appropriate legislative base regulating the issues of awarding grant or humanitarian aid status to the imported goods and their further utilization. Despite the fact that starting from 28<sup>th</sup> July 1996 the Georgian law "About Grants" is being in force the problem still remains unresolved, as extremely general character of the law does not allow placing the major part of problems, which arose from the process of awarding imported goods the status of humanitarian aid and grant, within the legal framework and their resolution, as well as active, efficient governmental control over the further utilization of these goods.

The problems related to the control over the utilization of imported goods referred as humanitarian aid and grants unfortunately cannot be completely regulated even by the main provisions of the Decree No. 326 of the President of Georgia dated by August 13, 2001 – "About awarding the status of grant and humanitarian aid, records and utilization of the imported goods (funds) into Georgia."

In the joint reports of the former Ministry of Tax and Revenues, the department of monitoring tax privileges and the department of control methodology, the agreement between the Georgian Republic and the US government "about the facilitation of cooperation in humanitarian and technical and economic assistance" ratified by the resolution of the Georgian Parliament No. 525 dated December 11 1996 is named as the main hindering factor in the control over the organizations importing goods under humanitarian aid and grants. Namely, according to the provisions of the Chapter 3 of the Agreement " . . . the representatives of the United States have the right to inspect utilization of any products, foodstuff and other property or services in the places of their location or utilization . . .". Some of the charitable organizations perceive the above wording as the exclusive right of the US representatives to establish control over their activities. Consequently this formulation seriously impedes the activities of Georgian controlling bodies to reveal and prevent violations existing in this sphere. In the opinion of the Ministry of Tax and Revenues the above-mentioned circumstances, require appropriate amendments in the Agreement and in the statutes of some charitable organizations registered on the basis of the above Agreement.

In our opinion, in order to avoid current violations of law, in parallel with the above-mentioned measures, it would be expedient to abolish tax privileges for the goods imported as humanitarian aid, and especially purposeful utilization of the goods subject to monetization. In addition the necessity of creation of centralized clearing-realization mechanisms of the above goods should be considered. Full application of current taxes on the goods imported under humanitarian aid and grants would practically rule out their dumping prices. Consequently, fraudulent entrepreneurs would not be able to get untaxed incomes.

Execution of customs clearance and other tax liabilities of the goods required by the society under the humanitarian aid and grants, in our opinion, should be provided by a structure established for this purpose by the state budget and other organizations.

If we take into consideration the events concurrent with the customs clearance of goods enjoying tax privileges, imported as humanitarian aid and grants, existing problems in the sphere of product realization at the consumer market, and also the costs related to warehousing and realization of the goods imported as humanitarian aid and subject to monetization, which often create additional problems for the aid recipient organizations, then establishment of such a structure which would free them from these responsibilities would be fully acceptable.

In order to realize this idea, it is necessary to maximally avoid these faulty tendencies and create the above structure. It should be based on shared participation of all resident and non-resident, governmental and non-governmental, business, humanitarian or other profile organizations interested in this issue and will distribute votes on parity principles in the management process.

Establishment of legal and transparent realization and auction practices of the imported goods subjected to monetization and relating to humanitarian aid, performed by this new structure and most importantly adoption of a special law "about grants and humanitarian aid" would in our opinion give a significant impulse to combating illegal incomes.

In parallel with the problems of tax-free illegal incomes due to tax privileges it is essential to pay attention to the general formulation given in the I paragraph of the Article 101 of Tax Code -"according to the licenses given for the delivery of goods (works, services) for the implementation of fuel and gas operations to the investors and operating companies" are exempt from VAT.

Under the current corrupt practices among public servants, exemption from VAT of vague nomenclature products according to the above phrase, entails the danger to become one of the means to "legally" evade payment of taxes. However, if we take into consideration the regulation of the paragraph "a" in the fifth part of Article 13 of the law "About Fuel and Gas" dated by April 16, 1999 – "remuneration principles, rules and procedures for the expenses and costs incurred by an investor for the provision of fuel and gas operations according to work program and budget. i.e. determination of those expenses and costs, which can be compensated from the fuel and gas production in the form of fuel and gas" should be regulated by an agreement (not a law) on the production sharing. It is evident that existence of very logical, at a single glance, tax privileges can be used as a tax-free, illegal income mechanism of the Tax Code.

Such specific issue existing in Georgia as restructuring regime of debt payment, i.e. establishment of individual payment privileges for certain enterprises can be considered as an extension of the major problem of tax evasion due to tax privileges.

Special attention should be drawn to the following laws and regulations, namely the Decree dated September 11, 1992 adopted by the Georgian State Council "about enterprise bankruptcy", a special law dated July 25th 1996, "about handling bankruptcy cases" and to the fact that there are more than 34.5 thousand enterprises, which have "debts amounting to 1120.2 million GEL, i.e. practically equaling

country's annual budgetary revenues," according to the data published by the Ministry of Tax and Revenues.

The current situation can be regarded as a logical result of above-mentioned legislative acts. The existence of legislative basis "About Bankruptcy" and what is more important the analysis of the permanent visual "attention" of the government towards the enterprises having debts, makes the relevance of these decisions hardly understandable.

The point is that in accordance with the Georgian Law "about the basics of tax system", Article 8, the last paragraph, dated by 21 December 1993, establishment of tax privileges was forbidden. In order to illustrate execution of this law and its contradiction with the practices of elite part of businessmen, we could discuss an example of one of the football clubs. The above example could not be referred as an exceptional one due to the chaotic economic conditions of the country.

The introduction of Article 94, sections 2 and 3 of the Georgian Constitution, in August 24, 1995, significantly limited the use of mechanisms for gaining tax free, actually illegal incomes through individual tax privileges. The norms of the above Article defined that:

- " Only the law defines the structure and rule of introduction of taxes and levies";
- " Exemption from taxes, and allocation of treasury funds is defined by the law";

The amendment made to the Georgian law "About the basics of tax system", Article 8, paragraph 4, dated by February 21, 1997, could be regarded as a delayed but adequate reaction on the above issue, which reads as follows: " The President of Georgia is authorized to restructure delayed budgetary debts, imposed fines and sanctions on these debts of separate juridical entities".

We will not discuss legitimacy of this procedure, when even terms of enforcement of restructuring were not defined; this is a subject of another dispute. But it is evident that by this order a part of entrepreneurs regained the rights of enjoying tax privileges.

The " activities" related to law making practices on the delay of debts payments were continued by the adoption of Tax Code in June 13, 1997.

Namely, Article 4, paragraph 5 of this law states that: " Introduction, elimination or changes to the order of tax payment is performed through the amendments made to the Code". Article 6, paragraph 8 of this Code states that " Introduction of individual tax privileges is prohibited". Against the background that the law on bankruptcy did not work and a part of entrepreneurs enjoyed tax privileges, business environment worsened and it became even more complicated. A new amendment to the Tax Code was made in December 12, 1997, which stated, " the order of delayed debts restructuring is defined in accordance with the relevant law".

Consequently, Georgian Parliament in March 5, 1998 approved special law on " Restructuring of delayed tax debts". It is worth mentioning that the law considered requirement of the Tax Code and Article 2 of the new law determines regime of debt restructuring and some important issues of regulatory character.

The analysis of the recent experiences revealed that the law on “ Restructuring of delayed tax debts”, dated by 5 March, 1998, which was intended to improve financial-economic situation of some enterprises and to mobilize budgetary revenues, was used for the personal interests of some part of entrepreneurs. This is well justified in the report of temporary parliamentary commission. Here are some conclusions of this report:

- “The enterprises which in accordance with this law were allowed to delay debts payment, enjoyed priority conditions in comparison with the enterprises which were put in the same conditions. Actually these enterprises received very low three-year commercial credits –4 % annual interest. If we make a comparison with LIBOR tariff, it is 7 % annual interest. Consequently, adoption of this law did not improve financial conditions of the enterprises and did not increase revenues; on the contrary, it increased number of enterprises with the tax debts (as the law legalized tax debts or in other words possibilities not to pay debts). Budgetary debts of these enterprises for the last two years increased from 170 million GEL to 519 million GEL”.
- “Adoption of the law didn’t have any positive effects, on the contrary, it became stimulating for not paying budgetary debts. The enterprises do their best to use privileges and to work under debts restructuring regime, as this law does not define sanctions and fines. The enterprises prefer that their taxes were “ frozen” for an year and then use credit for two years for 4 % annual interest, which is reimbursed by the inflation processes.”
- “ Commission believes, that adoption of this law, which awarded privileges and priorities to some enterprises was conditioned by the personal commercial interests of Senior Civil Servants.”<sup>3</sup>

To our viewpoint the conclusions made by the above-mentioned parliamentary commission do not need any comments. But there is a need of comments from the Government side on not considering parliamentary recommendations, which stated that the above-mentioned law was to be immediately cancelled.

As it was mentioned only “elite”, oligarchic part of the entrepreneurs has a chance to use above described tax evasion schemes. As for the registered part of the entrepreneurs, they use rather primitive tax evasion mechanisms –they simply do not register products (services) produced.

The case is that in accordance with the Georgian law on “ Consumers rights “ dated by 20 March, 1996, Article 20 states that “ The form of payment on the purchased goods is negotiated between a consumer and a seller (cash payment or without cash transfer). This is a quite democratic and civilized legislative norm but in Georgian reality it was transformed into the mechanism of realization of unregistered goods.

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<sup>3</sup> Report of temporary parliamentary commission on financial-budgetary crisis.

To improve situation and develop accounting registration mechanisms and therefore effectively fight against shadow economy, it was decided that cash payment was to be performed only through cash registers.

The President of Georgia issued a number of orders on the use of cash registers, namely presidential order # 352, dated by 12 September, 1995, presidential order # 272, issued in 1996 and presidential order 657, dated by 9 December, 1999. But these orders even did not provide installation of cash registers for all the objects working in this regime. “ The number of cash registers required amounted to 11 419 sets, in accordance with the data of 2002. Actually only 9832 ones were registered, among them 7 983 cash registers in trade sector and 1 215 ones in service sector. Registered number of apparatus was only 86.1 % of the amount required”<sup>4</sup>

It should be also admitted that struggle against untaxed-illegal incomes, namely decision on the introduction of cash registers, was also transformed into the source of corrupt practices by the representatives of controlling bodies. As the owners of the objects, where these apparatus are installed and the owners of objects where these apparatus are not installed, generally use the practice of corrupt deals with the control organ representatives to avoid any “ complications”.

Above described case is one more argument that decisions on economic management of the country should be adjusted to existing economic realities. It is absolutely evident that studies and analysis of the reasons of present situation reveal deficiencies of the legislation. One of the legislative deficiencies that should be addressed with special attention is possibility to exclude from income tax only 9 GEL. Which practically conditions the situation that there is no interest for the majority of Georgian consumers to get invoices for goods or services purchased.

If we take into consideration Article 87, paragraph “e” of the Tax Code, which reads as follows: “ resident physical persons, whose expenditures during one year period exceed 25 thousand GEL, are to fill in income declarations and submit them to taxation bodies”, actually is not enforced, it is evident, that sellers (providers) of goods and services are not interested in the registration of incomes through cash registers.

We consider that urgent measures should be elaborated for the enforcement of the Article 87 of the Tax Code.

Together with the mentioned above, with the regard to current mechanisms of salary schedule improvement, in parallel with the ideas listed below, we could consider it expedient to reduce such costs of the incomes received as salaries by the marginal amount of costs incurred by adults for the education and medical care of their teenager children. This in parallel would increase the possibility to fully tax the activities of persons who sell these goods and services and would give a positive impulse to overcome a certain psychological syndrome, which hinders the use of cash registers.

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<sup>4</sup> Magazine “ Revenues”, M. Buachidze, Cash payment through cash registers, April, 2002.

Conditioned by the above circumstances, the vividly discriminative environment created for the law-abiding entrepreneurs, especially for those who due to a range of factors, are obliged to fix (mostly by cashless settlement) the received incomes, and therefore become forced to use all mechanisms for the evasion (described in the previous paragraph) of income taxes on salaries.

Therefore, as a rule, the vast majority of entrepreneurs (employers) do not fix the full volume of remuneration for their employees. The difference between the appropriately fixed and taxed salary schedule and actually paid salaries composes quite significant amount of funds (“dirty money”) and the entrepreneurs are forced to deal with illegal financial manipulations in order to get these funds. Below are presented views of tax department experts on this issue.

The entrepreneur (employer) shows significantly lower amount of salary payment funds compared to real figures. For instance, in the example described earlier in the above chapter this was one third of the salary, i.e. 100 GEL. The total amount to be paid by the employer as taxes and insurance fees on this amount equals to 31 GEL, besides the employee himself having the salary of 100 GEL according to the existing legislation has to pay 12.92 GEL.

As for the remaining salary schedules to be paid to the employee, according to current practice, is writing off the funds, the established method of leaving 10-12% of funds in a fictitious business structures established for the “money revitalization” purposes. In case of our example after the payment of 20 GEL (which is the “money revitalization” cost – 10% of 200 GEL) the entrepreneur (employer), without any tax payment liabilities pays the employee 180 GEL.

The mentioned amount together with that of legally paid and fully taxed salary schedules demonstrates the fraudulent salary payment relations between the employer and the employee.

In the case described above, remuneration of labor exceeds the amount of legally recorded salary by 12.73 GEL. The expenditure of the employer decreases by 42 GEL, and the state budget and the specialized state funds lose 92.73 GEL. Therefore, it is absolutely clear why this method is so well established in business practice.

In order to overcome the existing situation, according to one part of economists, it is necessary to decrease social and income taxes.

In order to resolve the above problem, it would be more effective to speed up the process of pension provision system establishment, provision of propositions for gradually bringing to conformity minimal salary and tax-free minimum with the living wage, and what is most important, to start work on the establishment of the regressive system of existing social and income tax.

In order to discuss this issue, let us imagine a situation in which amendments to the laws on “Tax Code of Georgia” and “About obligatory insurance fees” have been made and as a result the entrepreneurs who compared to previous account period would triple the salary schedules, would have to pay half the amount of social and

obligatory medical insurance fees, in other words instead of the established 31 % the salary schedules of this entrepreneurs would be taxed by the total amount of 15.5%.

In addition to the above, in parallel with the equalization of tax-free minimum with the living wage amounting to 120 GEL, for an employee earning more than 300 GEL, 13% income tax rate should be introduced. And the total state fund payment and the obligatory state medical insurance fee should be reduced from 1% to 0.25%.

As a result of introduction of the proposed regressive tax system the entrepreneur tax liabilities, in case of employee's salary amounts to 300 GEL, would equal to 46.5 GEL. And the employee would be liable to pay income tax amounting to 23.4 GEL plus other taxes - 1.5 GEL, totally 24.9 GEL.

Elementary calculation shows that the proposed mechanism is fully acceptable considering the interests of both, the entrepreneur and the state budget.

In comparison with the present fraudulent mechanisms, in case of 300 GEL salary, entrepreneur's (employer's) expenses decrease by 4.5 GEL, the employee's already taxed salary increases by 6.02 GEL, and the revenues into the state budget and specialized state fund increases by 27.48 GEL.

Introduction of regressive tax scale does not result in the decrease of taxable base and existing budgetary revenues. Currently existing tax rates will be applicable for those entrepreneurs who do not triple the salary schedules. For those entrepreneurs who will fix the increase of salary schedule by legalizing shadow economy activities, the tax load will be considerably alleviated, and what is most important they will be enabled to avoid violation of law.

PS. The existing tax evasion situation is aggravated by the fact that the salary rates of the public servants' 19,7\* thousand army, who is authorized to somehow overcome this problem, are below the living wage. Therefore their "salary deficiency" might be compensated by private sector entrepreneurs - i.e. by bribery, which takes place in the process of various illegal deals and "law trading."

## Conclusions and Suggestions

In order to reveal and eliminate conditions fostering tax evasion and shadow economy, we consider it appropriate to:

- Start studying/inventorying guidelines and provisions operational in the field of legal normative base regulating economic sphere, in international agreements, at customs, tax and administrative body systems. Work out proposals for necessary amendments and if required even abolishment of particular articles of the provisions.

The following should be reviewed and worked out:

- Creation of mechanisms for abolishment of tax privileges for goods subject to monetisation, humanitarian aid and for centralized customs clearance and realization;
- Make amendments in the provisions of Article 101, Part 1;
- Abolishment of Georgian law “About overdue tax debts” dated March 5, 1998;
- Necessary measures for putting into effect Article 87, paragraph “e” of the Georgian Tax Code.
- The issues related to the package of measures - speeding up of the process of transition to the retirement insurance system, gradual bringing in conformity minimal salary and tax-free minimum with the living wage, and reduction of certain expenses from the earned income.
- The issues of creating a mechanism for the elaboration and putting into effect social and income tax regressive system.

*Translated from Georgian into English by Manana Porchkhidze*