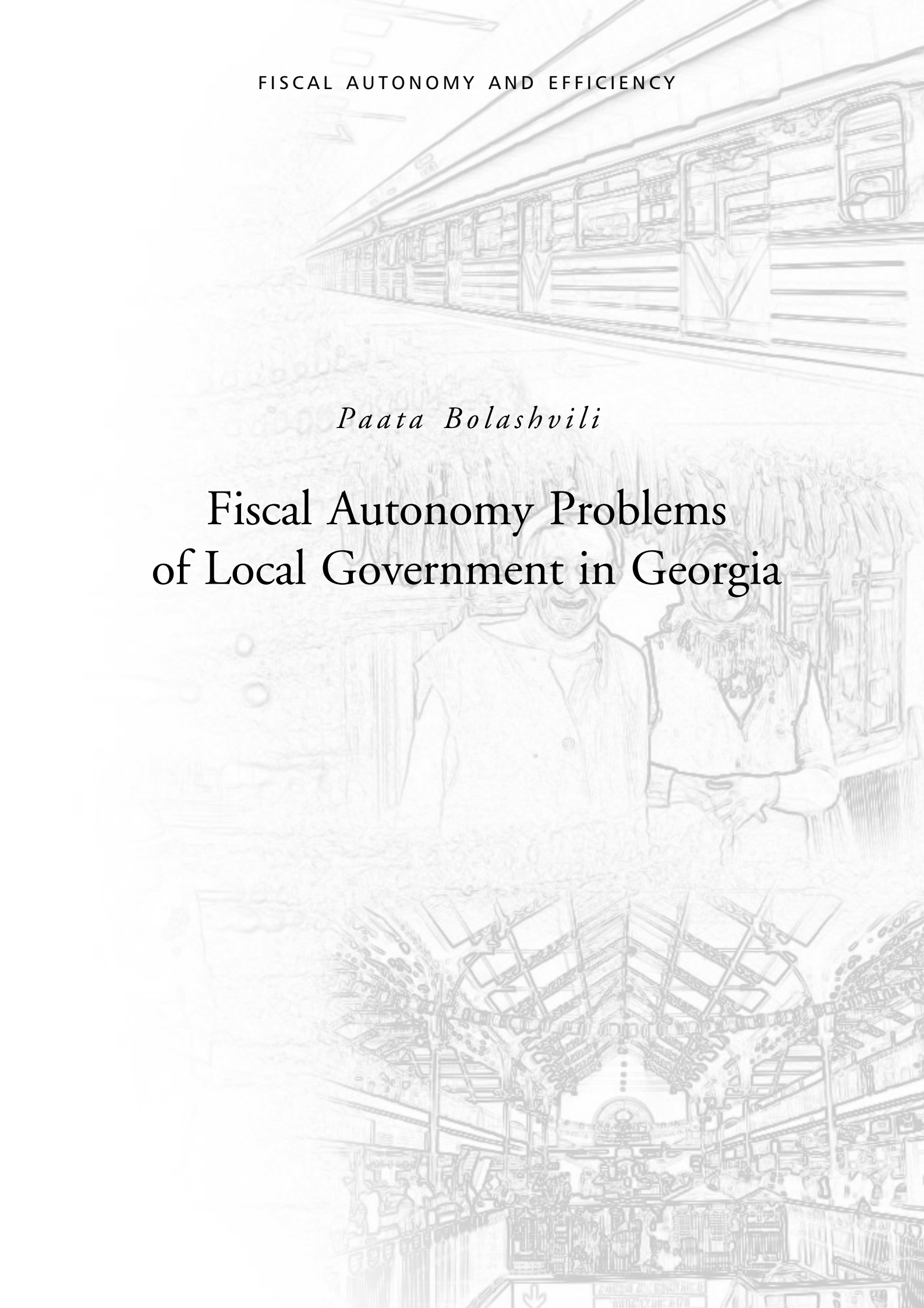


FISCAL AUTONOMY AND EFFICIENCY

Paata Bolashvili

Fiscal Autonomy Problems of Local Government in Georgia



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1. INTRODUCTION

1.1 Post-Soviet Era Georgia

1.1.1 General

Georgia, located in the center of the Caucasus, is a post-socialist country with a 3,000 year history of statehood. Through the centuries, the development of unique rules affecting living, working and general traditions have played an important role in coping with numerous national problems.

On April 9, 1991, Georgia was one of the first republics among the former socialist countries to declare its independence. This was the starting point for the formation of new public-economic relations in the country.

The initial stage of the transition period was quite hard. Due to political and economic reasons, as well as a civil war, Georgia suffered more during the transition period than any of the other countries during this period. In comparison to 1989, the level of Georgia's real Gross Domestic Product (GDP) in 1996 was the lowest among other transition countries and it comprised only 20% of GDP in 1989. Such a rapid downturn in the national economy was mainly due to the total shock in the industry fields. The 1996 volume of production in industry was not even a fifth of the volume of production in 1990. Such a rapid erosion of GDP, especially witnessed in the volume of production, which, in turn, caused sharp decreases in salaries and a catastrophic increase in unemployment, has put the population in a very difficult situation. This situation is even bleaker when taking into consideration the already existing relatively low adjustable prices compared to world prices.

In the subsequent period, the pace of economic development increased. This increase was especially high (11%) in 1996-1997, but experienced a decrease soon after. As the result of cooperation with international financial-economic organizations, a certain level of economic and financial stabilization was achieved and a vital hindrance to a functioning

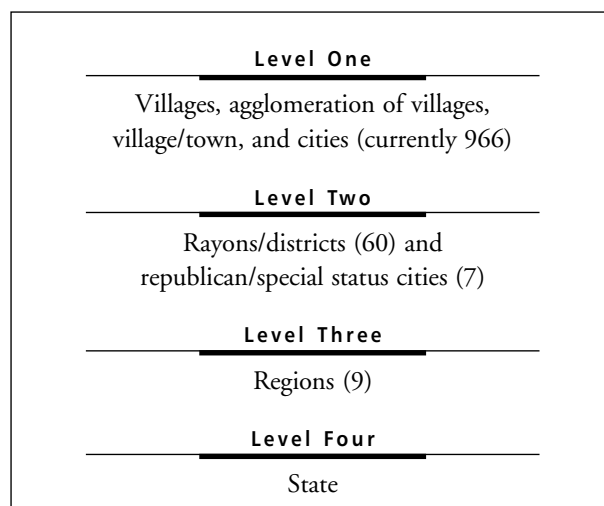
economy was resolved. Fundamental reforms were implemented in important fields: fiscal-credit relations, liberalization of prices, land reform, trade, service, etc.

Nevertheless, there are many social-economic problems that have led the transition of economic reforms to a new stage. Objectives of economic reforms at the current stage are economic development, greater employment, solutions to social problems, and an increase in the population's revenues and living standards. New activities planned for these purposes should: stimulate economic and capital investment growth in budgets at all levels, increase the regulating role of state investments, support privatized enterprises, establish an organized bond and securities market, restructure monopolistic fields (transport, communication, communal economy) and large state enterprises (energy, metallurgy), form a specific environment that becomes a precondition for fast development of production sphere and improve the investment climate.

1.1.2 Urban Demographics

Figure 4.1

Four Levels of Government



There are currently 3,736 settlements in Georgia, 60 rayons or districts, seven republican/special status cities (including the capital), nine administrative regions and two autonomous republics—Abkhazeti and Ajara. The first region—Samegrelo—was established during the civil war in western Georgia in 1993. This administrative unit was created by the decree of the Head of State in order to strengthen his power and control in the area. The region was to be governed by his plenipotentiary called the “president’s representative” or governor. From 1993 to 2000 other large regions emerged one by one, in historical provinces; there are now nine such regions.

Figure 4.2

Administrative Units of Local Governments

<p>Village</p> <p>is a registered settlement (in accordance with set rules, without considering the size of population), embracing agricultural land and natural resources.</p> <p>A union of two or more registered villages, having a united local self-governing body and administrative center is considered an agglomeration of villages.</p>
<p>Village/town</p> <p>is a registered settlement (consistent with set rules), inhabited by not less than 3,000 settlers; A settlement, inhabited by less than 3,000 settlers, may be attributed to the village/town category, if it is an administrative center of the rayon or has some prospects for economic development and population growth.</p>
<p>City</p> <p>is a large settlement registered according to set rules, inhabited by not less than 5,000 persons. Rayon/district is an administrative unit registered in accordance with set rules, unifying various kinds of settlements and agglomerations of villages and having an administrative center.</p>

1.1.3 Management System Reform

Reform of the local self-government and government systems in Georgia went through several stages and the acquired experience enables us to properly analyze the process of democratization in this field. We would like to place our attention on several principle issues.

Erosion of the Soviet political system in Georgia was followed by the destruction of local governments, which were

organic parts of the system. Unfortunately, destruction (not elimination) of the political system was followed by the deterioration of the social-economic situation. This worsened condition made it impossible for the local government to function; municipal services were paralyzed, the communal economy was severely damaged, and local resources were wasted.

Legislative acts passed on Local Councils and Prefectures in 1991-1992 were not able to ensure improvement of critical problems in these fields; they even fastened the process of erosion. Local councils could not implement their primary representative functions intended to establish popular approval of decisions made by local governments. All this was reasoned by the institutional weakness and lack of democratic traditions.

These processes promoted the worsening of the social-economic crisis. State and municipal property was still unlimited. The sole proprietor in the municipal field was the state, lacking the ability to manage this property; also, the state voluntarily rejected to implement traditional functions and gave its role (and functions) to non-state structures. This logically caused the formation of and provided the basis for the factual liquidation of local government.

As anticipated, the unmanageable situation in nearly every field turned into a deep state crisis, which along with the erosion of central government, led to the destruction of the local government system (which was based on the executive vertical).

Beginning in 1992, a total institutional vacuum was created in the system of local governments. Directives of the Military Council, State Council and temporary government of the Republic of Georgia at the local level were performed by central entities, persons trusted by these entities, and often different formal and informal armed groups. Arduous situations emerged in Samachablo against the background of already commenced military actions. The situation became especially severe after an armed Georgian-Abkhazian conflict began.

In these conditions, there was no alternative to the establishment of a centralized government system in order to save Georgia.

By decree of the Head of the State, dated August 2, 1992, a new temporary Charter on the Establishment of Local Entities of State Governance was approved; at the same time, a charter of cities at the national level was approved. All this helped the process of forming the *foundation for municipal policy*.

Also during this period of crisis in the country, the need to implement centralized governance required defining the objective for the *formation of state regional policy*. Specifics of Georgia’s natural conditions, territorial aspects of political and economic development were identified. It was clear that it would be impossible to protect overall state interests through centralized governance without the consideration

of the country's regional characteristics. The objective of effective implementation of centralized governance necessitated the establishment of regional levels of government.

So, the preparation of conditions for regional policy was directly related to the formation of municipal policy foundation. An institution was established in Georgia's districts, composed of representatives from the Head of the State and district administrations. This institution, formed to promote a centralized system of state governance, was adequate for the political and social-economic development of the country. All this created the conditions for stage-by-stage deconcentration of centralized government, and the establishment of not only political but also social-economic preconditions for the transition to self-government.

In the process of perfecting the local (regional) government system, great importance was attached to the approval of the Regulation on Local Entities of State Governance by the decree dated September 16, 1995. This decree helped in the deconcentration of management—functions between rayons' and government bodies of rayon were delimited, relations between local (regional, city) and district government bodies were settled, competencies of different levels of government were outlined, and *implementation of municipal policy was legally grounded.*

The fundamental problem of government system reform, as well as of countries' municipal development, is the institutional establishment of self-government. This is a hard and time-consuming process. In addition, considering the requirements of a constitution, objectives of establishing of democratic society, reformation of the state government system and institutional provisions of municipal development, it was necessary to substitute local government with self-government.

Adopting an institution of local self-government to avoid ideological-political tension resulting from military, ethnic and district conflicts is complicated by the following factors: the violation of territorial unity as a result of Soviet influence and state entities lacking the ability to implement constitutional authority in several parts of the country.

Civil society has not yet been established in Georgia and it is not possible to have objective guarantees for the total implementation of self-government—i.e., required level of local staff's professionalism, experience in functioning independently from state structures, proper "self-government" mentality, etc. Formation of an appropriate system of local self-government corresponding to the international standards is an objective of the next stage of local government reformation.

It should also be considered that before the total restoration of jurisdiction throughout the country, a definition of state-territorial arrangements and principal changes of administrative-territorial division on the initial stage of adop-

tion of self-government is required. It is very important for the municipal development of the country to establish decentralized administrative arrangements and local social-economic infrastructure, respectively..

Currently, Georgia has adopted the following model for local self-government and government implementation:

At the base level—village, town, settlement, city incorporated into the rayon—is total self-government. The population elects representative bodies of self-government through direct, public, equal and secret voting. The head of the representative and executive body is the same person.

Representative and state executive bodies implement local governance in rayons and cities, which are not incorporated into the rayon. In this structure, an important role is attached to the representative body, known as the Local Council. During the implementation of local governance, this entity becomes a democratic instrument for balancing interests between local and state government. This role represents broad authority, especially in light of its control over the activities of Gamgeobas (mayor's offices). The Local Council's responsibilities include very important issues, for instance approval of the local budget, control over its implementation and defining local social-economic development programs. This allows for the interests of the respective society to be protected during the management of rayon infrastructure.

At the current stage, Georgia has established a four-level government model including a three-level regional (territorial) government model:

1. Local self-government level: comprised of village, settlement, town and city incorporated into the rayon;
2. Local government representative level: comprised of rayons. It unites state government, as well as self-government elements; there are six "separate" cities, which are not incorporated into the rayon (Tbilisi, Batumi, Poti, Sokhumi, Kutaisi and Rustavi). Self-government executive bodies of these cities also have state government functions. Among these cities is the capital of Georgia, on the special status of which the separate law was adopted according to the constitution;
3. Autonomous republics' and regions' level: comprised of autonomous republics and regions of the country. Status of political autonomies is defined by the constitutional law on state-territorial arrangement;
4. Central level.

It should be noted that the mentioned model is transitional, due to two very important factors:

- before the restoration of jurisdiction over the entire territory of the country, and the principles and structure of state territorial arrangement, the place of the coun-

try's regions and the different levels has been settled in the overall state system, their authorities in local governance field cannot be finalized;

- practically, only the establishment of self-governments has been initiated—the process of delimitation of property, budgets and authorities, transition from one system of government to a principally new system still have been determined.

From the factors mentioned above, it is clear that *the municipal reform in Georgia assumed a determined and consequent nature only from 1997, when the Presidential Decree "The State Program for Municipal Development" was approved.* But it should be noted that even after the passage of four years, after scientific researches in the regional economic, social and management fields, can only small amounts of work and information be found about municipal economy and government development or on its diversified nature.

Recent research reveals that municipal government in Georgia has an important function of regulating political and social-economic development in the country's specific territory, because it plays an important role in solving social and economic problems faced by regions and the country in a transition period. This fact makes it necessary to properly define organizational-legal basis of municipal development and its major directions on the initial stage of the transitional period.

The new role of the municipality requires a new realization in the building of social, legal, and civil society institutions as well as the establishment and functioning of a new social-economic system. In a modern context, special attention should be attached to the definition of the country's social-economic development strategy and the definition of regional and local government roles, functions and objectives. Its rationality is proven by Georgia's natural-production conditions, geo-political location of the country, different levels of social and economic development among regions, diversity of national culture, traditions, ecological and demographic specifics, etc.

2. THE STATE OF GEORGIA'S FISCAL DECENTRALIZATION

2.1 Legislative Base. Financial-budgetary Authority and Responsibility of Government Levels

An important direction of the municipal sector reformation is the proper implementation of general decentralization, including fiscal decentralization. It should be noted that no systematic research was conducted in this respect in Georgia

—including evaluation of the current level of decentralizations, definition of problems and mechanisms for their solution.

Before performing the tasks mentioned above, it is reasonable to pay greater attention to the following important issues.

2.1.1 Legislative Reform

Georgia's active legislation on local government and self-government can be divided into six major categories: General Administrative Laws; Laws Related to Local Government Finance; Laws Relating to Property and Concessions; Environmental Legislation; Banking-Audit Laws; and other types of legislation related to local Government. Among them, the most important are the following legislative acts:

2.1.2 Constitution

The Constitution of Georgia was adopted on August 24, 1995. It reflects the major issues of division of power, human rights and freedom as untouchable phenomenon.

According to the constitution, representatives of executive government are subject to parliamentary control in regard to issues like limitation of the president's power; parliament's ability to reject the president's veto; the right of parliament to impeach the president. At the same time, the president has the right to veto the draft law presented by the parliament for approval, but the majority of the parliament can reject it.

According to the constitution, citizens of Georgia may manage local relations through local self-government in a way that does not violate national sovereignty. And this should be based on allocation of power. Based on the constitution, the parliament has the right to define organic law on local self-government, which should decide the authority of local self-government representatives and their relations with state government bodies. The mentioned Law on Local Self-government and Government was adopted on October 16, 1997 (discussed below).

The constitution points out that the issue of territorial arrangement of Georgia will be settled only after the jurisdiction of Georgia will be restored in Abkhazeti and Samachablo. This explains why the constitution only offers the right for administrative arrangement. During the last three years, the local government administrative system was mainly developed on rayon and village levels, but nothing important happened at the regional level in this respect. In Georgia's regions, representatives of the president are not responsible for expenditures and do not participate in the defini-

tion of the budget. They only implement targeted programs, which are financed from the special funds, or other sources, which are not prohibited by the law.

2.1.3 *Organic Law of Georgia on Local Government and Self-government*

Adopted on October 16, 1997, the Organic Law prepared a foundation for the transformation from post-Soviet, centralized government bodies to local government and self-government bodies. The first chapter of the law grants local government the right to make decisions freely. Decisions should be related to several issues defined by the constitution and should have a local importance. The fourth chapter points out that in villages, settlements, towns and cities incorporated into rayons, executive bodies are *elected* while in rayons and special status cities the executive bodies are *appointed*.

The Organic Law defines sources of taxes and responsibilities of local government and self-government entities over expenditures. It also defines those functions and responsibilities that should be implemented by the local council and Gamgeoba (mayor's office). The law envisages a general process for the formation and implementation of the local budget. The law requires the adoption of a respective normative act, which will describe a proper process for implementing the budget in detail.

In spite of the law's numerous positive elements, there are many incompatibilities with other laws as well as a lack of symmetry between articles of this law. These include the following:

- Articles 7.1 and 8.1 point out competency issues of local governments and self-government bodies. Both of them have similar responsibilities. Article 8.2 states that issues envisaged in article 8.1 "can be allocated between local government and self-government bodies through mutual agreement." Division of responsibility for expenditures between two mentioned levels may lead to a special political decision, which should by all means be based on negotiation skills of local self-government bodies.
- Articles 7.1(b) and 8.1(b) define issues of owning, using and managing local property for government and self-government bodies. Further, article 33 points out "the property of local self-government and government and the basis for its establishment," but does not define the rule for managing or using the property. Systematic and defined transfers of state property (and privatization) to local self-government have not taken place yet.
- Articles 14 and 26 define competency issues of local councils and city mayor's offices, which are not incorporated into the rayon. But the responsibility between

executive and legislative branches is not delimited and functions are often overlapping (for instance, according to the law, land arrangement, education, and cultural issues, are the responsibility of both branches).

- A major principle for members of the local council and Gamgeoba is free and independent decision-making. Article 42.3 contradicts this and says, "those state bodies, which transfer their rights to local government bodies may cancel decisions made by local self-government bodies within the responsibilities transferred by them."

2.1.4 *Law on the Elections of Local Representative Body—Local Council and Law on The Status of the Member of Local Representative Body—Local Council*

These laws were adopted on June 25, 1998 and June 26, 1998 respectively. The first law defines rights, responsibilities, activities, etc., of Local council members, and the second law defines major principles regarding the election of the Local council.

2.1.5 *Tax Code of Georgia*

The Tax Code was adopted on July 13, 1997. It defines state and local taxes, administrative provision of taxes, forced collection activities and tax flows. Rules governing the exemption from taxes and lowering the tax rate are presented in the attachments to the Code. An agreement regarding special privileges requires the addition of respective normative acts. The Code defines limits of taxes, stipulating that the local government can only impose six types of local taxes within marginal rates defined by the Code. They can also decide deadlines for paying local taxes to the respective budget of the territorial unit. These six taxes are for gambling, resort, hotel, and advertisement services, as well as for economic activity and for using the local symbol.

The tax code states that the collection of local taxes is controlled solely by state tax entities.

2.1.6 *Law on Local Fees*

This law was adopted on May 29, 1998. According to the law, the local self-government representative body (Local council) has the right to impose, cancel and grant privileges on local fees, but the fees are collected according to the instructions approved by the Ministry of Revenues of Georgia, Ministry of Finance and local self-government (government) body. Fees are entirely transferred to the local bud-

get. The law defines the assessment of local fees for the following types of activities: construction, trade, external advertising, use of public places, local passenger-good carries, changing structural-functional arrangement and façade of architectural objects, parking and tender fee.

According to this law, local government bodies have the right to administer fees (compared to local taxes). However, even in this case, only respective territorial entities of state tax inspection supervise the calculations of fees and their full and timely payment to the local budget.

2.1.7 *Law on Budget System and Budgetary Regulation*

This law was adopted on May 29, 1998. It is aimed at strengthening local financial management, principally through establishing harmonious relationships among budgetary organizations through considering budgetary classification, the main form of budget documentation, major principles of the budgetary process and general monetary system. Local government and self-government bodies have the right to independently prepare and manage budgetary process.

The law on the Budget System and Budgetary Regulation was adopted earlier than the Organic Law on Local Government and Self-government. The Organic Law makes the parliament responsible for adopting respective legal norms on the definition, discussion and implementation of local budgets within six months after the law enters into force. After that, with the numerous changes and additions to the Tax Code, it was practically impossible for the members of local government and self-government bodies to comprehend new information. Changes to the Tax Code were applied four times in 1997, four times in 1998, six times in 1999 and six times in 2000.

The twelfth article points out that all government level budgets should be balanced. In case of a budget deficit, expenditures should be sequestered through monthly proportional reduction until the end of the fiscal year. Earmarked items of budget expenditures are not subject to the sequestering. A budget deficit should be covered through public debt and credit resources.

Articles 15.4 and 16 point out that the state transfer should by all means be targeted. This type of system does not incite local government to increase taxes. If the local self-government's transfer will be reduced then it will be "penalized," because in this case local revenues should increase. Transfers are not based on a formula, but are calculated by obtaining the difference between expenses and revenues and are used for funding salaries. Nor are transfers fully allocated, because the state is suffering from tax and budget deficits.

Generally, there are four types of targeted transfers: social (including education), special, household aid, and compensation of harmed workers. Transfers are given to the rayon level, after considering the principle of subordination, and are then allocated to villages, settlements, towns and cities.

According to article 12.3, "earmarked expenditures" (at any level) should be defined by the competent representative of the state government during the approval of the budget by the local administration. These types of expenditures comprise of expenses for education, culture, sport, healthcare and social aid to the population. Neither the law nor its additions give the full list of such expenditures.

Article 19 defines issues of transferring control over budget implementation. The Organic Law of Georgia on Chamber of Control (April 15, 1997), namely article 83, points out that control over the implementation of the local budget is the responsibility of local government bodies. The Chamber of Control is required to check the tax sources of local governments and state transfers for rayons. In reality, the Chamber of Control monitors each rayon's budgets and sometimes the budgets of self-governments. The Chamber of Control, as well as the revision commission of the local government, performs this task.

2.2 **Municipal Budgetary and Financial Management**

Here we will discuss the allocation of responsibilities of local self-government for expenditures, tax sources, budget process, loans and financial management.

2.2.1 *Expenditure Responsibility*

The functions and responsibilities of local governments have not been clearly defined in either the current Organic Law or the "Law on Budget System and Budget Authority." Local government and local self-government responsibilities overlap and five types of expenditures—education, culture, sport, health care, social aid—are under sub-national responsibility. In the budget, they are referred to as "earmarked expenditures" and their sequester is impossible. Table 4.1 points out the definition of expenditures by local government and self-government bodies and responsibilities related to administrative, service, finance and regulation methods.

Representatives of local government and self-government bodies are responsible for carrying out administration and services as well as for issues related to finances. Excluded here are those functions that are the prerogative of the state. But local government cannot decrease the service level because it mainly consists of earmarked articles. It should be

Table 4.1
Allocation of Expenditure Responsibilities to Local Government Units

Function	Administrative Responsibility	Service Responsibility	Financial Responsibility	Regulatory Responsibility
Agriculture	LG	LG	LG	LG Veterinary clinics are regulated by the state government
Cemeteries	LSG/LG	LSG/LG	LSG/LG	LSG/LG
Culture	LSG/LG	LSG/LG	LSG/LG	State
Education	LSG/LG	LSG/LG The University in Tbilisi is a public legal entity and has branches in other large cities.	LSG/LG	State
Health	LSG/LG	LSG/LG	LSG/LG	state
Housing	PVT/LSG/LG	PVT/LSG/LG	PVT/LSG/LG	CIVIL CODE Construction, sale, gifting, inheritance, housing assoc., ownership.
Local Economic Development	PVT	PVT	PVT	LSG/LG/ state legislation
Local Public Administration • City hall, local admin. • Civil registry • Other	LSG/LG	LSG/LG	LSG/LG	State Government for salaries, Structure by legislation
Parks	LSG/LG	LSG/LG	LSG/LG	LSG/LG Land subject to State Laws
Public Safety • Fire • Natural disaster • Police	LSG/LG LG State	LSG/LG LG State	LSG/LG LG State	LSG/LG LG State
Public Works	LSG/LG	LSG/LG	LSG/LG	LSG/LG
Sports	LSG/LG	LSG/LG	LSG/LG	State
Social Assistance	LSG/LG	LSG/LG	LSG/LG	State
Urban Development	LSG/LG	LSG/LG	LSG/LG	State

noted that the heads of regional services of central ministries, and in the education system, appointment of directors of all schools is the responsibility of the ministry. Local self-government and governmental bodies are required to finance them.

Table 4.2 shows the total consolidated share of local expenditures for education, culture, sport, healthcare and social fields. Currently, the share of local government expenditures in the education sector is the biggest (if we com-

Table 4.2
State and Local Government Expenditures by Sector, 1999 [1,000 Lari]

Sector	State	Local	Local Share [% of Consolidated Expenditures]
Education	29,563	92,605	75.8
Culture and Sport	25,582	19,392.6	43.12
Health Care	15,724	15,959.5	50.4
Social	250,203	13,900.6	5.3

Table 4.3
Sources of Taxes and Fees of Local Governments of Georgia

Taxes and Fees	Percentage Allocation		Percentage Allocation	
	State Budget	Local Budget	State Budget	Budget of Aut. Rep. of Ajara
State Taxes				
• VAT	100	0	70/60	30/40
• Excise	100	0	60	40
• Customs tax	100	0	50	50
Shared Taxes				
• Income	15	85	1	99
• Profit	15	85	1	99
Local Government Taxes				
• Land	0	100	0	100
• Natural resources	0	100	0	100
• Environment	0	100	0	100
• Property	0	100	0	100
• Transfer of property	0	100	0	100
Local Taxes				
• Economic activity	0	100	0	100
• Gambling	0	100	0	100
• Resort	0	100	0	100
• Hotel	0	100	0	100
• Advertisement	0	100	0	100
• Local symbolic usage	0	100	0	100
Fees				
• Initiation of construction	0	100	0	100
• Trade	0	100	0	100
• Advertisement	0	100	0	100
• Usage of public places	0	100	0	100
• Transport	0	100	0	100
• Change of facade	0	100	0	100
• Parking	0	100	0	100
• Tender	0	100	0	100

pare it to state government—75.8% of the consolidated budget goes toward education while the local share in the health care sector is 50%).

2.2.2 Revenue Sources

In Georgia, local governments have several sources of revenue that are granted by the law. But many of them have limitations that reduce their potential. For instance:

- The Tax Code of Georgia establishes the tax base and the ceiling on taxes that local governments can set;
- The Law on Local Fees defines the ceiling of local fees. Factually, the fee is defined and imposed by the Local Council of the respective rayon;
- All state taxes and local taxes are directly transferred by individuals and legal entities to the banking institution in their respective rayon, which later (including taxes 100% of which belong to the rayon) is transferred to the regional centers of the National Bank of Georgia. Here, they are allocated according to the normatives of central and local budgets. From the regional center, the finances of the rayon are then returned to the banking institution in the rayon which then transfers them to the local budget. Rayon tax inspection (which is subordinated to the state tax department) is responsible for checking whether taxes are paid fully and timely. In villages, for the collection of the land tax, some inspectors directly visit payers in order to collect the tax and some-

how are able to overcome very low levels of tax collection. Some local governments complain that state tax inspectors are emphasizing mainly state taxes that result in low levels of local collections. In addition, large taxpayer inspection, which is also the structural unit of the state tax department, administers taxes paid by large taxpayers (mainly large enterprises).

Table 4.3 shows state and local government taxes and major sources as well as allocation of fees. Allocation of taxes differs depending on the “type” of local government—rayon, special Status City or autonomous republic of Ajara. All shared taxes first go to the rayon and are then distributed to budgets according to the normative acts approved by the local council of the rayon. The rayon’s executive body presents a proposal (and the representative body approves it) on the allocation of shared taxes to subordinated local self-government bodies, which is the subject to the Local Council’s approval. Other revenue sources of local governments are (1) transfers, (2) revenues from the privatization of state property, (3) revenues from selling non-agricultural state land—of which 40% stays in local government, 50% goes to the state, 7% to the Land Management Ministry, and 3% to the Ministry of Urbanization and Construction, and (4) loans. Annex 2 represents a detailed list of local governments’ revenues and expenditures.

There are three additional state taxes presented in the Tax Code of Georgia: a tax for owning means of transport, a tax on bringing overloaded vehicles into the territory of Georgia (100% goes to the road fund) and a social tax (100% goes to the social provision fund).

Table 4.4

Total Revenues and Expenditures of Local Governments as the Percentage of Consolidated Budget and GDP [1,000 Lari]

Title	1996	1997	1998	1999
Gross Domestic Product (GDP)	3,898	4,586	4,796	5,700
Revenues				
• State Budget	295.0	484.6	502.8	645.2
• State as GDP %	7.6	10.6	10.6	11.3
• Local	161.5	206.2	257.2	321.8
• Local as consolidated %	23.8	9.8	29.3	33.1
• Local as GDP’s %	4.14	2 4.5	5.36	5.64
Expenditures				
• State Budget	772.4	802.9	797.3	904.8
• State as GDP%	19.8	17.5	16.6	15.9
• Local	159.4	203.4	253.3	319.8
• Local as consolidated %	17.1	20.2	24.1	26.1
• Local as GDP’s %	4.1	4.43	5.28	5.61

In 1998, the Tbilisi budget started to receive 15% of the VAT, and Poti, an important city to the state, received 5% of the customs tax. However, due to amendments to the Law on Long-term Economic Normative Acts of Receiving from State Taxes of Budgets of Autonomous Republics of Abkhazeti and Ajara and other Territorial Units, the mentioned rule was canceled beginning on January 1, 2000.

The autonomous Republic of Ajara receives 40% of its VAT and 40% of its excise tax, if the customs office collects the taxes. But if the tax department collects the taxes, Ajara is left with 30% of the taxes. Beginning on January 1, 2000 (until 2003), 50% of customs taxes collected in Ajara will be left in the budget of Ajara.

Before December 31, 2000, distribution of profit and income taxes was conducted as follows: 40% went to the state and 60% to the local government. Amendments to the Law on Long-term Economic Normatives of Receiving from State Taxes of Budgets of Autonomous Republics of Abkhazeti and Ajara and other Territorial Units changed this distribution in the following way: 15% goes to the state and 85% goes to the local government, which has been effective since January 1, 2001. Since July 1, 2000, Tbilisi receives 85% of its income and profit tax. The autonomous Republics of Abkhazeti and Ajara are exceptions; they receive 99% from these taxes and 1% goes to the state budget.

Table 4.5
Aggregated Local Government^a Revenues and Expenditures, 1999 [1,000 Lari]

Revenues/Expenditures	Plan	Actual	Percent Realized	Percent of Total (Actual)
Revenues				
State Taxes	42,930.80	47,658.70	111.01	14.80
• VAT	27,630.80	31,746.90	114.90	9.90
• Excise	9,200.00	7,826.30	85.10	2.40
• Customs	6,100.00	8,085.50	132.60	2.50
Shared Taxes	97,194.30	95,268.00	98.02	29.60
• Profit	36,018.10	35,289.00	98.00	11.00
• Withholding tax	61,176.20	59,979.00	98.00	18.60
Taxes Assigned to Local Governments	79,738.70	72,726.50	91.21	22.60
• Land	32,748.80	24,677.10	75.40	7.70
• Consumption of Natural Resources	3,836.60	5,218.20	136.00	1.60
• Environmental Pollution	19,121.60	16,530.10	86.50	5.10
• Property Tax	22,239.10	24,337.60	109.40	7.60
• Property Transfer Tax	1,792.60	1,963.50	109.50	0.60
Local Taxes	16,089.00	15,899.10	98.80	4.90
Fee and other non-tax revenue	11,903.90	9,200.40	77.30	2.90
Rev. from state owned property privatization	19,324.30	31,664.40	163.90	9.80
Special funds	6,122.20	9,037.60	147.60	2.80
Total tax and non-tax	273,303.30	281,454.60	103.00	87.50
Transfers Settlement to the central budget	43,117.00	31,760.50	73.70	9.90
Repayment of borrowings from local budget	4,869.70	3,989.70	81.90	1.20
Borrowings from central budget	82.80	82.80	100.00	0.03
Beginning of year balance to cover expenses	1,925.30	352.50	100.00	0.60
Borrowings from free bal. of budgetary funds	2,277.70	2,277.70	100.00	0.70
Total rev. including transfers + settlements	325,928.40	321,843.20	98.80	0.10

Table 4.5 (continued)
Aggregated Local Government^a Revenues and Expenditures, 1999 [1,000 Lari]

Revenues/Expenditures	Plan	Actual	Percent Realized	Percent of Total (Actual)
Expenditures				
Funding economy total ^b	90,300.40	94,470.59	104.62	29.51
Funding social cultural measures	162,954.95	141,857.76	87.05	44.32
• Education	96,334.65	92,605.05	96.13	28.93
• Culture	18,828.20	15,848.68	84.18	4.95
• Sports	3,780.90	3,543.87	93.73	1.11
• Health care	21,682.90	15,959.55	73.60	4.99
• Social welfare	22,328.30	13,900.62	62.26	4.34
Archive	232.50	288.08	123.90	0.09
Military commissioners and civil defense	875.30	723.88	82.70	0.23
Law enforcement bodies	18,003.90	24,424.76	135.66	7.63
Legislative and executive bodies	26,078.30	27,591.90	105.80	8.62
Special resources	6,122.38	8,833.72	144.29	2.76
Other expenditures	21,360.80	21,903.99	102.54	6.84
Total expenditures	325,928.53	320,094.66	98.21	100.00

NOTES: ^a – This includes two autonomous republics, Tbilisi, and 58 rayons and cities.

^b – This includes expenditures on the communal sector, provision of gas and water, veterinary services, transport and communication, road economy and agricultural activities that are not included in other categories.

SOURCE: Ministry of Finance, Georgia.

2.2.3 Summary Analysis of Revenues and Expenditures

Revenues and expenditures of local government, its percent of Gross Domestic Product (GDP), as well as revenues and expenditures of the total consolidated budget, increased over the timeframe presented in Table 4.4. The state budget's revenue, and its percent of GDP, has significantly changed over the four years from 1996 to 1999. However, the state budget's expenditures and its percent of GDP decreased from 19.8% in 1996 to 15.7% in 1999.

In the analysis of local government finances, revenues should be grouped into two major categories: shared (i.e., regulating taxes); local (i.e., own revenues and transfers). As demonstrated in Table 4.5, Georgia's local budget revenues comprise the following: taxes and fees (which are imposed on local level by local governments within the framework set by the state) and national taxes (which are completely attached to the local governments).

The former is referred to as the local governments' "own sources of revenue" and is the smallest part of total revenues; in 1999 it represented 7.8%, consisting of local taxes, fees and other non-tax revenue. But when we add the second category of "national taxes," this number increases to 30.4% of total revenue. In 1999, shared taxes, local revenue and transfers amounted to 69.87% of total local government revenue. If we link aggregate revenue of local governments, excluding Tbilisi (line 7, Table 4.6), it amounts to 65.77% of total revenue. But if we look at local governments' aggregate revenue in only 58 rayons and cities, this number will be 83.22% of total revenue (line 8, Table 4.6).

Because Tbilisi and autonomous republics are special status regions, with different sources of revenues in comparison to other regions of the country, it is better to look at the revenues of 58 cities and rayons. In this case, in comparison to other cities, Table 4.6 shows that the sum of shared taxes, local revenues and transfers of local governments amounting to 84.22% of total revenues is not low if we look at the

Table 4.6
Revenue of Georgian Local Government, International Comparisons [%]

No.	Country	Shared Tax (1)	Local Revenue ^a (2)	Total Shared + Local (1+2)	Transfers (3)	Total (1+2+3)
1.	Hungary (1998, estimated)	14.7	29.8	44.5	52.9	97.4
2.	Poland (1997)	24.3	35.3	59.6	14.1 ^b	73.7
3.	Czech Republic (1998)	52.3	10 (approx.)	62.3	21.4 ^c	83.7
4.	Bulgaria (1999, budgeted)	49.01	12.06	61.07	23.45	84.52
5.	Armenia (1999)	—	55.36	55.36	41.96	97.32
6.	Georgia (1999, all rayons, Tbilisi, AR's)	29.6	30.4	60.0	9.87	69.87
7.	Georgia (1999, excluding Tbilisi)	23.67	26.31	49.98	15.79	65.77
8.	Georgia (1999, excluding Tbilisi, & AR's)	19.59	40.10	59.69	23.53	83.22

NOTES: ^a – This refers to all national taxes fully assigned to local governments, local own-source taxes, and fees.

^b – This comprises delegated, commissioned and own grants.

^c – These are categorical subsidies.

SOURCE: Various Urban Institute (USA) reports, data from the Georgian MOF.

Table 4.7
Aggregated Revenues and Expenditures of Local Governments, 1999 [%]: Different Grouping

Revenues and Expenditures	All Local Governments ^a	Excluding Tbilisi	Excluding Tbilisi and Aut. Reps
Revenues			
State Taxes	14.81	16.64	0.30
Shared Taxes	29.60	23.67	19.59
Local taxes	22.60	20.97	33.19
Local taxes imposed at the local level	4.94	3.12	3.69
Non-tax revenues	15.51	16.29	13.42
Transfers	9.87	15.79	23.53
Other revenues	2.68	3.53	6.29
Expenditures			
Funding of entire economy	29.51	16.33	12.94
Funding of social-cultural field	44.32	48.30	63.03
Education	28.93	33.92	47.28
Other expenditures	26.17	35.37	24.03

NOTE: ^a – comprises all cities and rayons (58), Tbilisi and autonomous republics (2).

SOURCE: Ministry of Finance of Georgia.

respective data in the Czech Republic (83.7%) and Bulgaria (84.52%). If we only consider the column for local revenues, Georgia's indicators are quite impressive.

According to the expenditure section in Table 4.7, a large portion of local government expenditures is composed of earmarked articles, where education is 28.9%. If we only study the total expenditures of rayons (excluding Tbilisi and autonomous republics), earmarked expenditures increase to 47.28%. In reality, a large part of targeted transfers allocated for local governments is used in the educational sector. According to Table 4.8, 83.44% of the transfers received by rayons belong to education.

A major part of local government expenditures, especially of the autonomous republic of Ajara, Tbilisi and Poti, is the provision of services in the communal sector, gas and water, veterinary services, transport and communication, road economy and agricultural activities. All of these mentioned services are not included in other categories ("Funding of Entire Economy"). Aggregated expenditures of local governments in this category were 28.5% of total expenditures in 1999. The second largest expenditure item of 8.6% was assigned to "expenditures for maintenance of legislative and executive bodies."

2.2.4 Transfers

As it was mentioned above, there is no effective transfer policy in Georgia, failing to stimulate interest of local governments to increase local revenues.

It may sound strange that despite this there is still an increase in the number of government bodies at the rayon level which do not receive transfers from the central level. The reason is that the central budget has problems in the financing of all planned transfers (Table 4.8). Therefore, those local bodies that have a base to increase local revenue try to increase it, with the intention of becoming independent from the central budget. Thus, they manage to cover local expenditures with their own revenues and are able to strengthen trust in the local population. The number of governments that were independent of the central transfer at the rayon level was seven in 1997, thirteen in 1998, twelve in 1999 and twelve in 2000. In 2001, it is envisaged that this number will increase to fourteen.

At the same time it should be mentioned that in comparison to 1998, 1999 state transfers to local governments increased and the same is envisaged in 2001 (Table 4.8). Also, while comparing expenditures and revenues, there is a

Table 4.8
Transfers Allocated for Rayon Government Levels [1,000 Lari]

Year	Planned Transfers	Actual Transfers	[%]
1997	46,602	44,389.8	95.3
1998	37,258	29,720.4	79.8
1999	43,117	31,760.5	73.7
2000	35,040	27,780.6	79.3
2001	42,005		

Table 4.9
Planned Targeted Transfers of Local Governments, 1999 [1,000 Lari]

Local Government	Total Transfer (2=3+4)	Social Service Transfers (3)	Social Transfers Used in Education (3a)	Education Transfers as % of Total (3b)	Special Transfers (4)
Rayons+Tbilisi+ Aut. Reps	43,117	30,508	24,488	56.23	1,769
Rayons+Aut. Reps	42,617	30,508	24,488	59.23	1,269
Rayons	33,911	22,779	20,786	83.44	1,077

SOURCE: Ministry of Finance of Georgia.

major difference between rayon level governments (Table 4.11). Poti does not receive transfers at all, but transfers to Ozurgeti amount to 38% of total revenues. Local tax revenues in Zestaponi are 60% of total revenues, but in Ozurgeti, this figure is 35%. The expenditure sections reveals that Zestaponi spends a very small portion of its total expenditures on communal services, only 4.96%; but there are significant costs for education, amounting to 54% of total expenses. In Poti, expenditures are more balanced with 32% of expenditures allocated for communal services, 26% for education and 20% for earmarked articles.

2.3 Process of Municipal Budgeting

According to the law, all levels of government should balance their budgets. In spite of the mentioned budgetary law, according to which a budget deficit should be financed by a public loan, a budget deficit at the local government and self-government level is financed by transfers allocated by the central government. Afterwards, it is the rayon's responsibility to allocate transfers among subordinated local self-governments.

According to article 8 of the Law on Budget System and Budget Authority, territorial unit budgets are independent from Georgia's state budget, as well as the budgets of the autonomous republics of Ajara and Abkhazeti and the budgets of other levels. A territorial unit budget (i.e., the local budget) is the financial plan, which mobilizes and uses funds of the local government unit. According to the law, local governments have their own revenues and authority to de-

fine the purpose of the fund's usage. The only exceptions are special transfers and loans, which are given to local governments from upper level budgets (mainly the state budget). According to article 29.2 of the mentioned Law on Local and Government Bodies of Autonomous Republics of Ajara and Abkhazeti, other territorial bodies of Georgia independently define, approve and implement their respective budgets.

However, independence assigned by the law is significantly reduced by the instability of legislation in Georgia, which is often changed. The mentioned law, since its approval on May 29, 1996, has been changed 21 times. In spite of the fact that the law defines "long-term" normatives, changes are applied every year and sometimes more than twice per year.

Finally, according to the Law on Budget System and Budgetary Regulation, definition and implementation of local budgets is the responsibility of local executive bodies. Representative bodies have authority to supervise the implementation of set parameters and apply changes, if necessary, without increasing the deficit in budget revenues and expenditures. If revenues exceed expenditures during the budget implementation process, then the excess amount remains in the respective executive and government bodies and may be used according to the views of government bodies.

2.3.1 Budgetary Process

The budgetary year coincides with the calendar year (January 1-December 31). According to the law, if the budget is not approved at the beginning of the fiscal year, then all levels of

Table 4.10
Transfers of Local Governments, 1997-2001 [1,000 Lari]

Total Transfers	1997	1998	1999	2000 ^a	2001 ^b
Transfers					
Planned	46,602	37,258	43,117	35,040	42,005
Actual	44,389.8	29,720.4	31,760.5	27,780.6	
Revenues					
Planned				327,500	382,000
Actual	206,199.7	257,195.3	321,843.2		
Transfers as % of total revenue	21.53	11.55	9.87	10.70	11.00

Notes: ^a – approved volume;

^b – protected volume;

Data was obtained from the Ministry of Finance of Georgia

SOURCE: Parliamentary Budget Office of Georgia.

Table 4.11
Allocation of Revenues and Expenditures for Selected Cities, 1999 [%]

City (Population)	Revenues				Expenditures			
	Shared Taxes	Local Tax Revenues	Transf.	Non-tax Revenues	Funding of Economy	Education	Other Ear- marked Items	Other Expenses
Telavi rayon (78,200)	12.08	55.84	21.3	10.78	2.61	47.01	22.21	28.17
Kutaisi (240,000)	20.31	47.76	15.74	16.19	15.48	35.84	20.71	27.97
Zestaponi rayon (77,400)	27.80	60.42	1.79	9.99	4.96	54.23	16.58	24.22
Poti (50,000)	29.66	58.98	0.00	11.36	31.52	25.66	20.15	22.68
Zugdidi rayon ^a (192,000)	19.83	42.09	26.93	11.15	3.51	54.88	20	21.61
Ozurgeti rayon (91,800)	14.96	34.95	38.81	11.28	4.35	44.59	21.34	29.73

NOTE: ^a – comprises every refugee in city.

SOURCE: Ministry of Finance of Georgia.

government are entitled to have monthly expenditures within one-twelfth of the factual expenditures of the previous year. For instance, the state budget for 2000 was adopted in March 2000. Because local government and self-government depend on the transfers from the state budget, adoption of their budgets was also delayed; budgets of local governments were adopted in July/August 2000 and budgets of local self-governments in July/September 2000. The state and local government budget calendar is presented in Table 4.12.

Local self-governments' draft budgets are dictated by the financial services of the self-governments as well as the rayons' draft budgets—which in turn are dictated by the rayons' financial officers and by the order of the rayons' executive bodies. So, rayons prepare their own independent budgets and prepare consolidated draft-budgets for the rayon; these are composed of the rayon budget and draft budgets of subordinated territorial units. The objective of the latter is to define the transfer for the rayon.

Draft budgets should be based on budget revenues and expenditures forecasts. Forecasts of expenditures and revenues should be presented to the local government (executive) body by the financial entity of the territorial unit before the new budgetary year. After the executive body approves it, the draft

is submitted to the local council for approval. The budget should plan for excess reserves, which will cover contingencies during the year. At the same time, after the reserves expire (the balance is transferred to the next year), official procedures require the replenishment of the reserves as soon as possible.

2.3.2 Budget Structure

According to article 10 of the Law on Budget System and Budgetary Regulation, expenditures at every level of government are divided into capital and current expenditures. Capital expenditures are aimed at placing investments and increasing capital, while the remaining expenditures are deemed current.

Point 4 of Article 35 of the mentioned law specifies articles presented under the approved budget. Namely, the approved budget should reflect the following:

- total amount of revenues and expenditures according to its main source and direction;
- increase of expenditures relative to revenues (and the respective transfer from the central budget to cover the deficit);

Table 4.12
The Budget Calendar

Month	Preparation Year	Execution Year	Post-Execution Year
January February			
March	Local governments and self-governments start to work on the draft-budget		President submits to parliament the report on implementation of state budget
April		Parliamentary committees discuss implementation of state budget	
May	MoF, Ministry of Economy and Department of Statistics project social and economic development indicators and major directions of state government budget and tax policy		Parliament discusses report on implementation of state budget and either approves it or not
June	Major data and directions of the state draft-budget are submitted to the parliament		
July	<ul style="list-style-type: none"> • Every rayon city not incorporated into rayon and aut. reps submit budgets to the MoF for review and definition of annual transfers; • parliamentary committees submit conclusions on draft state budget to the president 	MoF presents analysis of budget implementation for the first six months, which is discussed by the parliamentary committees	
August			
September	MoF prepares state budget and submits to the president	Parliamentary committees discuss implementation of state budget	
October	President submits the state budget to the parliament		
November	Local governments and self-governments submit draft-budgets to local councils for approval no later than 45 days prior to the new budget year		
December	Parliament reviews the state budget and approves it		

- amount of reserves, revenues and expenditures of targeted and other funds as well as the amount of transitional turnover funds;
- standards for the allocation of state taxes among budgets of other government levels.

Local budgets are three to five pages long and are accompanied by tables of revenues and expenditures. For instance, the Rustavi budget for 2000 contained three pages along with tables explaining expenditures and revenues. It had seven attachments that contained a detailed list of expenditures and revenues. The Kutaisi budget for 2000 was even longer, containing five pages with nine attachments and a detailed list of earmarked and general items.

The consolidated budget of Georgia consists of more than 1,000 territorial unit budgets, which are consolidated into 61 regional budgets and the state budget. The rayon budget consists of the rayon budget and the budgets of its subordinated local self-government bodies. The rayon's consolidated budget is not subject to the approval of any locally elected body.

The rayon budget finances expenditures that exceed the capacity of its subordinated small territorial units (i.e., education, healthcare expenses, municipal police and veterinary services). Most local self-government budgets finance educational and cultural (i.e., libraries) expenditures.

2.3.3 Budget Control

According to the Law on Budget System and Budget Regulation, expenditures are monitored by the local council's financial-audit commission. According to the Organic Law on the Chamber of Control of Georgia, the chamber can only monitor the state budget (including local government transfers); but in reality, they are also controlling local budgets.

2.3.4 Municipal Loans

There are three types of loans available to local self-governments: from a commercial bank, from the state or rayon budget, or from the municipal development fund.

Loans from the commercial bank. Access to this loan is only possible with the President of Georgia's approval. The Department of Territorial Budgets of the MoF reviews the loan's justification and the rayon's debt capacity. This system was adopted in order to avoid the lari's devaluation. The term of the loan from the commercial bank is three to six months (for the management of cash flow) and is implemented only at the rayon level.

There are additional limitations based on the Presidential Decree dated January 28, 1997. Article 8 of this decree

states that "considering the interests of implementing financial-budgetary and fiscal policy in the territory of Georgia, government bodies at every level of the executive government are prohibited from taking any bank credit and should provide respective guarantees of budget liability for local as well as for foreign credit resources without the approval of the President of Georgia." It should be mentioned that this decree was issued under the Activities to be implemented by the Urgent Financial Program of the President of Georgia for 1997, and is still active.

2.3.5 Budget Loans

These loans are also short-term loans and require a special agreement between the Ministry of Finance and the *gamgebeli* (mayor). In the case of delinquency, there is a penalty charge in the amount of 0.1 percent of the total value of the loan, assessed for each delayed day (i.e., 36.5% on an annualized basis).

The majority of these loans are used to cover the salaries of personnel in earmarked sectors.

2.3.6 Loans from the Municipal Development Fund

The Municipal Development Fund was established in 1997 with funding from the Municipal Development and Decentralization Project of the World Bank. Initially, the right to use the Fund's money belonged to a limited number of municipalities at the rayon level—a total of twelve municipalities including one municipality from each region, Batumi from Ajara as well as Poti-City. At the same time, for the implementation of a specific investment project, each municipality is required to allocate a 20% counterpart-financing share. Half of the loan allocated by the Fund is a grant and half is a credit with 15% annual interest.

In the future, it is envisaged that the Fund will provide access to funds for all government bodies at the rayon level with four conditions: (1) The municipality, which has an operating deficit due to last year's implemented activities, will not be given a loan; (2) Payment for the loan service, including a proposed loan and another loan, should not exceed 25% of revenues gained through activities implemented last year; (3) The expected revenue from the proposed investment can be used during the calculation of the loan service payment; (4) The total amount of the loan, including the proposed loan and liabilities (including salaries and other loans), should not exceed 40% of revenues gained through current activities (excluding transfers).

2.3.7 *Municipal Financial Management*

Currently, there seems to be little or no use of financial management techniques (such as forecasting of revenues and expenditures, development of fiscal indicators, capital vs. operating budgets, etc.) by local governments. Some cities adjust the current year's budget for the expected inflation and arrive at the budget for the next fiscal year. Other cities state that they evaluate and project revenues for the next fiscal year based on actual collections of the current year. Practically no city prepares separate operating and capital budgets, or prepares multi-year budgets. Due to the lack of revenue at both the local and state government level, capital and infrastructure investments have not been made for the last four to five years. The few cities that have undertaken capital investments have done so only via specific donor funds—primarily the World Bank's Municipal Development Fund.

In March 2000, Georgia's Ministry of Finance and State Department for Statistics issued a decree that approves different yearly, quarterly and monthly standard accounting forms to be used by the territorial units for defining state consolidated budgets. Consultants through the Decentralization and Municipal Management Grant provided by the IDF prepared these forms; the forms are based on existing tax, financial and budget legislation and normative acts, existing budgetary structures and processes. These activities should provide for the computerization of financial reports presented by the local government bodies to the central financial entities and for modern correspondence.

2.3.8 *Non-budgetary Accounts*

Since April 1, 1998, budgetary organizations have one account for revenues and expenditures and additional account for special revenues. Special revenues are revenues from leasing, special trainings and fees for the last two years of secondary school. Special revenues should be allocated to the sources from which they are received, except for receipts from leasing which are not earmarked and can be consolidated into general budget revenues.

3. EVALUATION OF FISCAL DECENTRALIZATION STATUS IN GEORGIA

3.1 Evaluation Rules

Modern literature (Roy Bahl, *Implementation Rules for Fiscal Decentralization*, 1999) proposes several approaches (twelve

rules) that allow for analyzing and evaluating the fiscal decentralization level of a specific country, as well as defining the direction of its future development. Several criteria, that in our view are acceptable for Georgia, are discussed below.

First. An important issue is that fiscal decentralization should be viewed as a comprehensive system. Major elements of this activity can be presented in the following way (Table 4.13).

Second. It is necessary to provide the required funds for implementing assigned functions (Finance Follows Function). The assignment of revenue responsibility should follow the assignment of expenditure responsibility to local governments.

Unfortunately, this order is reversed in Georgia.

Third. The central authority must have strong and adequate capacity to monitor and evaluate decentralization.

The "controllable" and sequential process of fiscal decentralization requires involvement of the central government in terms of financial accounting, audit, rules for granting loans, and unified rules for the allocation of grants. Several local self-government bodies require technical assistance, especially in issues such as accounting, treasury, tax administration, data processing and project development. These are activities that do not frequently happen in Georgia.

Another problem is that the central government does not have the ability to perform appropriate monitoring. In addition, data, especially new information, is not accessible. Forecasting, which would give the local finances some direction, is rarely done.

Fourth. One intergovernmental system does not fit both the urban and rural sectors. Experience shows that it is better to start decentralization in larger units and give smaller ones the possibility to "grow."

Different sub-national levels have different abilities to finance and provide services, as well as varying access to loans. It is necessary to define a system, where different local governments will be equipped with different powers and responsibilities for expenditures.

Fifth. Fiscal decentralization requires significant local government taxing powers.

Voters will hold their elected officials more accountable if local public services are financed to a significant extent from locally imposed taxes, as opposed to the case where financing is primarily conducted with central government transfers. The tax must be visible to local voters, large enough to impose a noticeable burden, and the burden must not be easily exported to residents outside the jurisdiction.

What is the situation in Georgia? As the above analysis shows, local governments cannot access many important taxes. At the same time, local governments lack the ability to independently impose local taxes.

Sixth. The central government must maintain the fiscal decentralization rules that they draft.

Table 4.13
Major Elements of the Fiscal Decentralization System

Activity	Status in Georgia	Comments
Necessary Conditions		
• elected local council	yes	
• locally elected main officials	no	the head of the rayon level executive body is appointed by the central government who then appoints other officials
• provide significant freedom to local government to increase revenues	no	the Tax Code defines types and upper limits of taxes
• important responsibility of local government over expenditures	no	only targeted transfers exist
• budget autonomy	yes	budget is defined and approved by the local council
• non-existence of lack of budget funds	no	local budgets are not able to fully finance necessary investments and services
• transparency	yes	process needs further development
Desirable Conditions		
• freedom over expenditures	no	only targeted transfers exist
• not-conditioned transfers from upper levels	no	only targeted transfers exist
• loan possibilities	yes	significant limitations exist

The central government plans the fiscal decentralization and should develop this process exactly according to this plan. A negative effect of this process results when rules and laws related to the decentralization frequently change. At the same time, local government expenditures depend on central replenishments that make it impossible to discuss autonomy.

Seventh. It is better to keep everything simple. The administrative system of local government often lacks the ability to manage complex intergovernmental fiscal relations. The same could be said of the central government system, which is needed to monitor and evaluate intergovernmental fiscal relations.

But this does not mean that the simplicity should manage intergovernmental reform.

There are complications that can not, and should not, be avoided (i.e., the revealing of local governments' loan requirements, whole accounting systems that envisage adopted standards, functioning according to the audit principles, etc.). However, the main rule for securing simplicity is through reducing the number of each policy tool's objectives and aiming for administrative potential in terms of managing the established system.

Eighth. The intergovernmental transfer system design should match the objectives of the decentralization reform.

Unfortunately, this guideline is difficult to assess in Georgia, mainly because the transfer system has not yet been defined. This is very important because the transfer system is a key element of the decentralization program in every country.

Ninth. Fiscal decentralization should consider all levels of government.

Georgia is experiencing some progress in this respect, but this process is neither systematic nor targeted.

Tenth. Impose a hard budget constraint. It is necessary to establish strict budget limitation, with the goal that those local governments with autonomy be required to balance the budget at the end of the year without the help of the central government. This rule should be secured by the central government and local governments should depend on "themselves."

As mentioned above, Georgia is showing some signs of progress in this respect.

Eleventh. Recognize and plan for the fact that intergovernmental systems are always in transition.

In Georgia, this was necessary when the decentralization program was defined.

Twelfth. There must be a champion of fiscal decentralization.

It is a paradox that fiscal decentralization is very popular among developing and transition countries, but there are

very few enthusiastic champions. The same could be said about Georgia.

Considering the above, we can conclude that Georgia is at the initial stage of decentralization.

3.2 Key Problems and Recommendations

The *key problems* found in the local government bodies are the following:

1. LGUs have limited financial autonomy and are constrained in their ability to allocate and manage resources relevant to their responsibilities;
2. LGUs do not face hard budget constraints, but because budget deficits are covered by transfers from the state, have a disincentive to increase local revenues since. Conversely, local governments that succeed in increasing their revenues may be penalized by the MOF by having their transfers reduced;
3. Most LGUs generate insufficient revenue from local sources;
4. LGUs are forced to rely on land and property taxes as their primary discretionary sources of local revenue;
5. The assessment and collection of LGU taxes is problematic and controlled by state authorities;
6. LGUs are subject to mandatory expenditures on protected items (education, sports, health, culture and social aid) which account for 50-75% of their expenditures;
7. Local government budgets are not currently transparent or user-friendly. The budgets are a list of expenses with no details about service accomplishments or program results;
8. LGUs still do not own land and property in their jurisdiction. These assets are transferred in a piecemeal manner to LGUs via an ad hoc and complicated process;
9. Currently, the development of municipal credit and bond markets is neither feasible nor realistic; this will remain until the appropriate legal and fiscal framework is in place.

In order to eliminate the problems mentioned above, we recommend:

1. To find a global solution for the decentralization problems, it is essential to elaborate on the "Master Program for municipal sector in Georgia," which has not yet come into effect. The important role of fiscal decentralization, and its close links with political, administrative and economic decentralization, must be emphasized in the program;

2. Special attention must be given to elaborating the country's social-economic development strategy and to the process of defining the roles, functions and tasks of its regional and local governance. Georgia's natural setting conducive for manufacturing, geopolitical position, variety of national culture and tradition, as well as its unique ecological and demographic characteristics, justify the expediency of this effort;

3. Special arrangements for enlarging the municipalities must be realized. After the elections of local self-governance (1998), the number of these bodies now exceeds 1,000. The problem is that these bodies exist in areas with populations of only several hundred people. This circumstance impedes the process and determination to solve problems, including the problem of fiscal autonomy;

4. Special attention must be shifted to *widening the budget independence* of the local government bodies. It will be adequate if some of these changes are made in the acting legislation, which will force the municipalities to decide on their local fees and taxes. The income from the local taxes must be fully transferred into the local budget;

5. The *transfer system* must be regulated, as currently no central system for effective transfers exists in Georgia. We can even mention that the situation is the opposite: the acting system promotes the disinterested attitude of municipalities in the sphere of raising local taxes, because if the municipal income grows, the transfers from center will be reduced. Taking all this into account, we consider it desirable to do the following:

- non-targeted (equalized) transfers must be divided by the consequent formulation and must be based on the level of social-economic capacity of the municipality. The usage of these transfers must be at the prerogative of the municipality;
- targeted transfers can be used for the execution of competence delegation and/or the financing of the municipal programs. In the first case, the central power can be passed to the municipality for implementing the consequent program and provide financing. The relations between center and municipality should be seen as primarily contractual.

In the second case, when financing of the municipal program is insufficient, the local body can apply to the central level for help. Also, legislation must exist to prevent the process of making these types of transfers a limitation to municipal independence;

6. It would be advisable to carry out the following activities to improve municipal financial management:

- Develop a more transparent and user-friendly budget. Budgets serve as the basis for financial reporting to the mayor, city council, MOF, municipal departments, budgetary institutions and citizens. A budget is also a link between mobilization of funds and attainment of municipal goals and objectives. But most importantly, the major purpose of budgeting is to promote democracy. The budget should reflect the will of the citizens and should open the government to public scrutiny. This is currently not the case with Georgian local government budgets.
- Develop techniques for local budget execution and monitoring of expenditures. Improved budget execution will prevent unauthorized appropriations in the planned budget and will monitor spending. Budget execution should also be accompanied by a reporting system that compares actual expenditure and output against budgetary plans.

Train local government officials in modern financial management techniques such as revenue maximization, forecasting revenues and expenditures, developing fiscal indicators, etc. This will help governments make more efficient and responsive choices in the use of limited budget resources.

3.3 Future Plans and Perspectives

The Second Stage State Program for Municipal Development, which was adopted in March 2000, defines major directions for the development of decentralization in the short-term (2000-2001) and long-term (until 2005).

The program envisages the subsequent allocation of responsibilities by local government bodies for better provision of urban services, as well as for the improvement of the legal, organizational, financial and informational foundations.

The program involves two stages:

- The first stage consists of perfecting the local government legal base and developing its institutional and social-economic foundation. This stage will be completed after the local elections in 2001.
- The second stage (2002-2005) envisages the preparation of institutional and social-economic conditions for transforming two-level local government into single-level.

Recently, the state government has been able to implement several elements of administrative decentralization. Local self-government is empowered to prepare the budget and elect government representatives. In practice, regarding transfers, the collection and allocation of taxes and the provision of some services by local self-government bodies depend on rayons. Many departments under local government units—health care, education, social provision, etc.—have double subordination. They are responsible to the mayor's office as well as to the ministry, which reduces the autonomy of local entities. The legal foundation for the functions of local government bodies is also weak, causing overlapping and unclear division of responsibilities between local government and local self-government bodies.

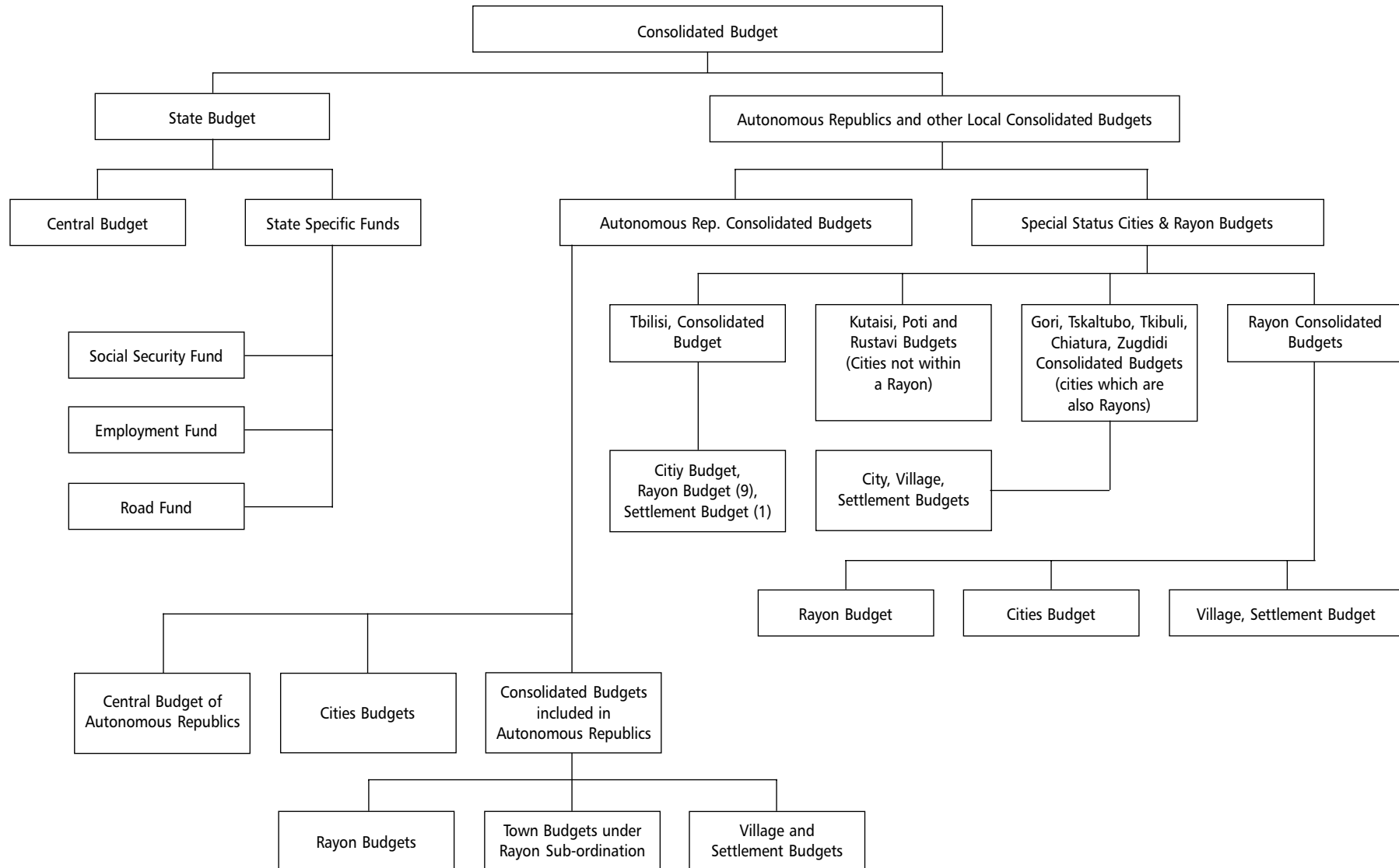
Future laws. According to the Second Stage State Program for Municipal Development, there are several future draft laws including the following:

- Law on the Local Budget (draft) describes local taxes and responsibilities for expenditures; it also dictates the formulation, discussion and approval of the budget.
- Law on the Regulation and Management of Local Property (draft) (being prepared by the State Chancellery).
- Law on the Management of Property by Local Government and Self-government Bodies (draft) (being prepared by the Ministry of Property Management).
- Law on the Allocation of Powers of Local Government Bodies over the Arrangement of Land Owned by the State (draft) (being prepared by the State Committee for Land Management).

LIST OF ABBREVIATIONS

LG:	Local government (rayons and special status cities)
LSG:	Local self-government (villages, agglomeration of villages, village/town, and cities)
LGU:	Local Government Unit (used to imply both LG and LSG)
NGO:	Non-Governmental Organization
GDP:	Gross Domestic Product
FSU:	Former Soviet Union
GEL:	Georgian Lari
AR:	Autonomous Republic
MOF:	Ministry of Finance
GOG:	Government of Georgia
PVT:	Private

Georgian Consolidated Budget Structure, 2000



ANNEX 2

List of Revenues and Expenditures

Table 4A.1

Sources of Revenues
I. Tax Revenues
• VAT
• Excise Tax
• Customs Tax
• Income Tax
• Profit Tax
• Land Tax
• Tax on Natural Resources
• Pollution Tax
• Real Estate Tax
• Real Estate Transfer Tax
• Tax on Economic Activities
• Tax on Gambling
• Resource Tax
• Hotel Tax
• Advertising Tax
• Trademark Tax
I. Total Fees
• Fee on Construction
• Fee on Trade License
• Fee on External Advertising
• Fee on Limitation of Public Places
• Fee on Local Transport
• Fee on the license needed for changing the structural-functional order of architectural objects
• Fee on parking
• Fee on tender
• State tax
• Registration fee
• Fee on copying declarations of high officials and complementary materials
• Income from other fees

Table 4A.1 (continued)

Sources of Revenues	
II.	Non-Tax Revenue
	• Income from state property sales (except land), privatization
	• Income from sales of agricultural land owned by the state
	• Income from leasing (sales) of state non-agricultural land owned by individuals or legal persons
	• Revenues from state property leased, including land
	• Revenues from dividends and shares of net profit generated by legal persons using state property
	• Revenues from royalties
	• Revenues from realization of intangible assets
	• Revenues from fines for highway code violation
	• Revenues from other administrative fines
	• Revenues from confiscated goods
	• Revenues from the realization of property transferred to the state through gift or heritage
	• Revenues from old accounts payable and accounts receivable
	• Revenues from special resources
	• Total tax and non-tax revenues
III.	Total Revenues from other Non-Tax Incomes Imposed by the Law
	• Revenues from transfers
	• Revenues from grants
	• Revenues from donations
	• Remainder of budget sources recorded at the beginning of the year aimed at covering the cost
	• Borrowing of budget sources from transitional means
	• Revenues from other non-tax incomes imposed by the legislation
Sum of Revenues	
Sources of Expenditures	
I.	Financing of Economy
	• Communal economy
	• Accomplishment
	• Provision of gas and water
	• Environmental pollution control
	• Veterinary service
	• Agricultural activities (not included elsewhere)
	• Transport and communication
	• Road economy
	• Other costs

Table 4A.1 (continued)

Sources of Revenues
II. Financing of Social-Cultural Activities
• Education
• Culture
• Sport
• Health-care
• State social aid to the population
III. Archive
IV. Expenses of Military commissariat and Civil Defense
V. Law-Enforcement Bodies' Maintenance Expenses
VI. Government and Self-Government Maintenance Expenses
VII. Expenses from Special Revenues
VIII. Reserve Fund
IX. Other Expenses