Republic of Georgia

Assessment of USAID's Fiscal Reforms

and Options for Further Intervention

Tax Policy and Tax Administration Reforms

By Mark Rider

April 2001

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Summary of Recommendations

The purpose of this report is to evaluate the progress in implementing the comprehensive TD reform plan and, if appropriate, develop recommendations and establish priorities for follow-on activity in the tax sphere. In addition, the Assessment Team also examined linkages between fiscal reform efforts and the growth of SME, the agricultural sector and local government as well as interventions by other international donor organizations.

The following is a brief summary of the proposed recommendations for possible intervention by USAID. I submit three options involving low, moderate and high levels of engagement in TD reform for your consideration. They are presented in order of priority.

Option 1: Low level of engagement

USAID should consider continuing to support TD reform by providing technical and financial assistance in support of further computerization of the TD, particularly development of management, audit and collection modules; training at the TD; strengthening of the internal audit unit; and an extensive program of taxpayer education.

USAID should consider supporting the creation of a specialized tax court to adjudicate tax disputes. It is very important to the reforms of the TD that there be some way to check there excesses. The TD may be prone to excesses due to inexperience due to the large number of recruits; the pressure that they are under to collect additional revenue; as well as corruption and incompetence. USAID could provide technical assistance for the design and implementation of this proposal, including specialized training and study tours.

USAID should consider giving priority to strengthening the MOF. Clearly, it will be difficult to manage the re-integration of the TRMG into the MOF, while at the same time establishing an effective financial management system; implementing performance budgeting; and reforming the CS. For ways in which USAID can support this process, see the companion report on general fiscal reform. In addition, however, USAID may want to consider ways in which it could assist with the reintegration of the TRMG into the MOF, such as commissioning an implementation study on behalf of the GOG.

USAID should consider providing technical and financial support to establish a fiscal analysis unit in the MOF. The MOF should be the gatekeeper for tax policy. In order to fulfill this role, the MOF should establish a unit for tax policy analysis. USAID could support this effort by providing for an expatriate adviser to work side-by-side with such a staff for one or two years. USAID could also make a small computer and software procurement and provide financial resources to establish a reference library for this staff.

Option 2: Moderate level of engagement

In addition to the activities described above, USAID should consider the following additional activities.

USAID should provide technical assistance and training for the creation of a tax policy analysis unit in the Parliament's Budget Office. By having this capacity in the Parliament, it will give them some assurance that the analysis and recommendations proposed by the MOF are based on sound economic analysis rather than purely political expediency. USAID could support this effort by providing for an expatriate adviser to work side-by-side with such a staff for one or two years. USAID could also make a small computer and software procurement and provide financial resources to establish a reference library for this staff.

USAID should consider providing assistance to the Excise Goods Monitoring Bureau. They would like to receive computers and other tools that would assist their work as well as some technical assistance. Progress in collecting excise taxes is very important, but may require that political intervention at the highest level of government in order to overcome some of the difficult obstacles that are preventing enforcement of the excise taxes at this time.

Option 3: High level of engagement

In addition to the recommendations above, USAID should also consider sponsoring the following activities.

USAID should create a program in which individual RTIs, the LTI and Headquarters would compete with one another for targeted assistance. Interested RTI would submit development programs with specific recommendations to improve their operations, the estimated cost of implementing these reforms, proposed cost-sharing and expected benefits. In this scheme, 3 to 5 RTI would chosen on a competitive basis, according to the quality of their proposal (plan, budget and expected benefits), their revenue raising capacity and demonstrated commitment to the goals of the reforms. The goal of this intervention would be to create a few RTIs that could serve as laboratories to determine what works and provide a demonstration effect to the other RTIs.

USAID should consider providing technical assistance for the development of a blue print for tax reform. The tax code includes many low-yielding taxes that divert the attention of tax administration and taxpayers alike. The tax code also assumes a level of sophistication on the part of taxpayers and tax administration that does not appear to be realizable in the near term. Furthermore, the tax code is being used as a policy instrument to achieve a number of goals that are unrelated to the principle goal of raising revenue for the government. For example, the PIT includes a personal exemption and progressive rate structure. Since the PIT is primarily collected through withholding by the employer, these provisions complicate the task of tax administration, and only slightly reduce the degree of income inequality.

List of Abbreviations

Barents	KPMG Consulting Barents Group
CIT	Countries in Transition
CS	Customs Service
EGMB	Excise Tax Goods Monitoring Bureau
EL	Extraordinary Legion
EPT	Enterprise Profits Tax
ESS	Excise Stamp Service
GDP	Gross Domestic Product
GESP	Georgia Enterprise Support Project
GOG	Government of Georgia
IAU	Internal Audit Unit
IMF	International Monetary Fund
IRS	Internal Revenue Service
ITS	Intertek Testing Services
LTI	Large Taxpayer Inspectorate
MOF	Ministry of Finance
MOU	Memorandum of Understanding
PIT	Personal Income Tax
RTI	Regional Tax Inspectorate
SME	Small and Medium Enterprises
TD	Tax Department
TOR	Terms of Reference
TRMG	Tax Revenue Ministry of Georgia
USAID	United States Agency for International Development
USC	United States Customs Service
UST	United States Treasury
VAT	Value Added Tax

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1. Scope of Work

USAID and the TRMG entered into a MOU in March of 1999 that described a comprehensive plan to reform the TD.[1] Since this project will expire at the end of September 2001, the USAID Mission in Georgia has requested advice on how to allocate additional resources to the fiscal reform effort in Georgia beyond expiration date of the current Barents contract. The advice is to be provided in two separate reports. One report is focused on general fiscal policy and administration and the other on tax and revenue administration. This report responds to the latter. The detailed TOR for this assessment appears as Appendix 1 to this report.

The purpose of this report is to evaluate the progress in implementing the comprehensive TD reform plan and, if appropriate, develop recommendations and establish priorities for follow-on activity in the tax sphere. In addition, the Assessment Team also examined linkages between fiscal reform efforts and the growth of SME, the agricultural sector and local government as well as interventions by other international donor organizations.

The principle author of this report is independent contractor Mark Rider who worked under the guidance and supervision of Sharon Hester of USAID/Washington. This report is based on a review of background documents and selected Barents' reports. The contractor spent three weeks in March 2001 in Georgia to conduct additional documentation gathering, site visits and interviews with government officials and donor agencies and contractors. A complete list of the documents reviewed and people interviewed are provided as attachments to this document.

This report proceeds as follows. Section 2 provides a brief summary of USAID's Fiscal Reform Project, focusing on the restructuring of the TD and an evaluation of the merits and possible shortcomings of the design and implementation of this program of reforms. The linkages between fiscal reform and agriculture, SME and local government are discussed in Section 3. Section 4 concludes with suggestions for future work in fiscal reform.

2. Assessment of the Fiscal Reform Project

Experience in many transitional economies has shown that it is far easier to enact a modern tax code than it is to develop the administrative capacity to collect the taxes. In this regard, Georgia is no exception. The current tax structure in Georgia resembles the structure of tax systems in advanced industrialized countries, including many neighboring CIT, with reliance on (i) direct taxes including PIT, EPT and payroll taxes; and (ii) indirect taxes, including VAT, excises and a customs tariff. Administrative weaknesses, however, have led to high levels of tax evasion; a significant growth in tax arrears; and an overall lackluster revenue performance.

More specifically, weak administrative capacity encompasses a variety of issues:

1. Overstaffed local offices and weak central headquarters;
2. Insufficient compensation to recruit and retain qualified personnel;

[1] Barents has been under contract to implement a program of fiscal reforms since early 1998.

3. Inadequate training;
4. Inability to register and process large numbers of new taxpayers;
5. Lack of capacity to conduct full-field audits;
6. Simplistic audit plans and rare use of audit selection programs;
7. Deficient collection methods; and
8. Incipient or non-existent taxpayer services.

In an effort to alleviate these problems, USAID agreed to provide technical assistance to the TRMG to strengthen tax administration in Georgia. Accordingly, Barents, GOG, USAID and UST entered into a MOU to restructure the TD in March 1999. The plan involves a two-prong approach: a comprehensive reform program and national enforcement strategy. The national enforcement strategy is a set of measures designed to realize quick improvements in revenue collections. The comprehensive reform program is a forward-looking set of reforms to restructure the TD and lead to improvements in revenue collection over the medium haul. Section 2 proceeds with an assessment of the comprehensive reform program and then turns to a discussion of the national enforcement strategy.

2.1 Comprehensive Tax Department Reform Program

The comprehensive TD reform program focused on five interrelated interventions: (1) restructuring the TD on a functional basis; (2) human resources reform; (3) computerization; (4) establishment of an IAU; and (5) taxpayer education. Below is a brief summary of each intervention, with some comments on the effectiveness of the original plan and its execution by Barents.

2.1.1 Functional Organization

Functional organization of a tax administration authority increases efficiency through staff specialization (e.g., audit, collection, taxpayer services, etc.). It also reduces the opportunity for corruption because interactions with a given taxpayer are distributed among a variety of tax officials rather than being concentrated in the hands of a single tax official. Thus it is more difficult to pursue corrupt activities because it requires the collusion of a number of officials which is presumably more difficult to achieve. For these reasons, functional organization of tax administration authority is widely regarded to be the best practice.

The TD is now organized according to 7 functional divisions: administration, data processing, audit, collections, legal, appeals and taxpayer services. The restructuring also reduced the number of offices, from 71 to 35, and created three types of RTI, specifically type A, B and C offices. An A-type office is a fully functioning RTI, encompassing all 7 activities listed above. Type B offices are limited to operational functions: taxpayer services, data processing, audit and collections. Type C offices are limited to taxpayer services and collections. In addition to the RTI, there is a Headquarters and LTI.

At the time of this writing, it appears that this fundamental reform has not taken hold at the TD. This failure appears to be the result of several factors. First, TD employees lack experience working within this type of environment and 40 percent of the TD employees are new hires. Second, the restructuring is fairly recent and it is difficult for any organization to abandon old ideas. Third, there may be some resistance from Headquarters to restructuring the TD on a functional basis.

In short, the TD dramatically reduced the number of offices and generally followed the plan to organize offices according to the type A, B and C schema. This is a big accomplishment and overtime should increase the efficiency of the TD, assuming there is not substantial backsliding. There are concerns that the TD may backslide by increasing the number of offices and increasing the number of employees. I can not assess the validity of these concerns, but it does bear monitoring.

2.1.2 Human Resource Reforms

The human resource reforms focused on the need to reduce the number of TD employees and recruit competent staff. Compensation levels at the TD also negatively impacted on recruitment and retention of qualified staff and helped to foster a culture of corruption. Accordingly, the number of TD staff and offices were reduced to a level consistent with the budget available to pay a "living-wage" to TD employees. All existing staff and new applicants submitted to competitive examination. Those scoring above a minimum threshold were subsequently interviewed and, on the basis of the interviews, offered positions at the TD.

The human resource reforms were intended to change the culture of the TD, specifically to increase the professionalism of the staff and reduce the level of corruption. The human resource reforms seem to have met with the greatest resistance. Of course testing existing employees, eliminating offices and reducing staff were bound to generate controversy and resistance. All in all it may be one of the more successful interventions. As a result of this process, new recruits now make-up approximately 40 percent (60 percent are holdovers) of the restructured TD. TD employees are receiving substantially higher wages and are being paid more or less on time.

Barents took great care to insure that the testing was conducted in a fair and professional manner. In particular, Barents, USAID, UST and the TRMG worked together to insure the security of the exams. There is no evidence, direct or otherwise, that the security of the test was compromised. Clearly this has been a very painful process for all involved. All the parties involved should be congratulated for undertaking and completing this very ambitious intervention in the face of considerable controversy and opposition.

It is somewhat puzzling that the merits of paying a living wage to TD personnel does not seem to be fully appreciated by the MOF and TRMG. The minimum amount recommended by Barents was substantially higher than the amount finally agreed to by TRMG. This agreement was further undercut by the MOF who used part of the bonus pool that was established to pay the living wage to meet IMF budget performance conditions. In any event, the spirit of the agreement has been honored and TD employees in the restructured organization are receiving substantially higher wages. As a result, morale among rank and file employees appears to be much higher and compensation no longer appears to be an obstacle to recruiting and retaining qualified staff.

It is too early to tell whether these reforms will reduce the level of corruption at the TD. There are rumors that some people may be paying for positions at one RTI. Such rumors, if true, are worrisome because it suggests that some people may be applying for these jobs with the tacit understanding that they can supplement their income by soliciting and accepting bribes. The natural tendency of the system will be to return to the old practice of accepting bribes. Preventing this will require determined leadership and vigilance from the TD Headquarters over a number of years. Since the Headquarters is entirely staffed by holdovers who probably benefited most from the corrupt practices of the past, it is uncertain whether the Headquarters can be relied upon to realize this potential of the reforms.

2.1.3 Computerization

According to all reports, Headquarters and rank and file employees enthusiastically support computerization of the TD. Computerization is one of the most important elements of modern tax administration. Computerization does not simply replace manual processes, but opens up a number of new opportunities and strategies for monitoring tax compliance and productivity. It enhances the ability of management to direct resources to the highest yielding activities. It also facilitates tax enforcement activities by routinely and quickly screening a large number of tax declarations for anomalies across a variety of taxes paid by a single taxpayer.

At the end of the current project all type A and B offices should be computerized and all type A offices and the LTI should be linked by a high-speed data communication system to the Headquarters. In addition to installing computers and creating a communication link, Barents also created and installed standardized software for taxpayer registration and tax administration modules for the principle taxes (e.g., EPT, PIT, VAT and excise).

There should have been a greater emphasis on training management to use computerization as a management tool and build standardized management reports. The original implementation should also have included the development and installation of audit and collections modules as well. Having these capacities in place now would have hastened the day when the TD could begin to maintain an arms-length relationship with taxpayers and realize improvements in tax collections. These should be clear priorities for future assistance to the TD.

2.1.4 Training

Clearly such dramatic changes entailed by restructuring the TD on a functional basis, the large change over in staff and computerization had to be accompanied by significant training in order to be successful. From the outset the TD reform program recognized the key role that training would play in successfully reforming the TD. Barents found and refurbished space for the training center and recruited and trained four trainers. An active calendar of training is currently underway for audit, collections and legal-appeals.[2]

[2] Audit training consists of 8-10 weeks of classroom training on the job training over a 1-year period. Likewise, training in collections involves 1-year with 3-4 weeks in the classroom and the remainder being on the job training.

That having been said, at this time the training center does not appear to be a self-sustaining program. The costs of maintaining the training center are high by Georgia's standards ($40/day per student). Per student cost of instruction could be substantially reduced, however, it is not certain that the TD could do so without seriously compromising the quality of instruction and thereby undermining the goals of the restructuring.[3] Furthermore, it is not clear whether the TD is sufficiently committed to training. Training budgets tend to be the first thing cut. It is crucial to the future success of these reforms that the intensity and quality of training at the TD is maintained. This may require continued USAID support, for both financial and political reasons.

2.1.5 Internal Audit Unit

The U.S. Treasury provided much of the technical assistance for the development of an IAU. The purpose of an IAU is to ferret out weaknesses and potential control failures in programs and operations of the TD. In advanced industrialized countries, most ministries, and many large agencies, have such units. This is the first such unit established in any of the line-Ministries of Georgia.

The head of this unit was recruited from the Anti-Corruption Commission and appears to be committed to its goals. The head of the IAU reports to the Minister and therefore enjoys, at least in principle, the necessary independence to carry out the unit's activities. The unit also has a cadre of young professionals. They have established a website and posted their audit schedule for 2001 there. The website also allows people to report allegations of misconduct. A lot has been accomplished in a short period of time, however, the staff still requires additional training, especially in investigations and report writing, and computers.

2.1.6 Taxpayer Education

The need for an extensive program of taxpayer education is evident. Business people and government officials complain about the lack of understanding about the tax code; frequent changes in the tax code; and ambiguity in the tax code.

Currently, an extensive taxpayer education effort is under development. At the time of this writing, the "Plain Language Guide to the Georgian Tax Code" and a "Taxpayer Charter" are still works in progress. Once these documents are completed, reviewed and approved, Barents will publish and distribute them to the public. In addition, regulations for the PIT and EPT are being drafted with illustrative examples. Using illustrates was an excellent idea. Publication of these regulations should help resolve some of the ambiguity in the tax code and be very helpful to tax administration officials and taxpayers alike. As previously noted, the TD restructuring also created taxpayer service divisions at all type A and C offices.

A good foundation for effective taxpayer education services is underway. Looking forward, greater priority should be given to taxpayer education. As previously noted, one of the major

[3] Barents is covering the salaries of the 4 Georgian trainers ($500 per month each) and the cost of renting the space. Apparently, the TD plans to relocate the training center at the end of the Barents program into space owned by the TD.

obstacles facing tax administration in Georgia, and, for that matter, nearly every CIT, is the public's lack of familiarity with the means and purposes of paying taxes. This can only be overcome with time and through extensive taxpayer education.

2.1.7 Some comments on the design and implementation of the TD reforms

While there is much to praise about the Barents program, there are some shortcomings with the original design.

As previously noted, the computerization effort should have included management tools and extensive training for management as well as the development of audit and collections modules. Also, there appear to be delays in installing computers at some offices while space is being prepared for the computer centers. It is not clear whether Barents will be able to complete computerization in the time remaining under the current contract.

The comprehensive TD reform program did not address the structural issues that undermine the goal of taxpayer appeals. Taxpayer disputes are an inevitable product of ambiguities in the law, complicated business transactions and simple human misunderstandings. In order to establish a professional tax administration and the rule of law, it is necessary that taxpayers are able to settle disputes with the TD in an expeditious and even handed manner. Formally there are administrative processes in place for taxpayer appeals, however, it is widely regarded as slow, corrupt and unfair.

An effective mechanism for settling taxpayer appeals is particularly important in light of the desire to end the practice of negotiating tax payments and reduce arbitrary and strong handed actions by the TD. The legal system in Georgia, as in many CIT, does not provide for a specialized court to adjudicate taxpayer appeals. In addition, the courts are not perceived to be fair and impartial arbiters of the law. Therefore, taxpayers have little recourse but to pay tax assessments resulting from an audit, whether they regard the assessment to be consistent with the law or not. Meanwhile, tax inspectors are under tremendous pressure to meet revenue targets and therefore may resort to arbitrary and heavy-handed methods to reach their quota.

The lack of a fair and expeditious means to resolve tax disputes undermines the fundamental goals of reform: to reduce the arbitrariness of the TD and establish the rule of law. The TD reform program did not address this important issue. Perhaps there was a belief at the time that the judicial reforms, then underway, would adequately address this issue. At the time of this writing, however, the judicial reforms do not appear to have been successful at least in this instance. Looking forward, developing a fair and efficient process for settling taxpayer disputes should be a priority.

The TD reform program did not provide for the establishment of a unit to produce detailed information on tax collections by district and type of tax on a periodic basis. This would have been a natural complement to the computerization activity. Such information is valuable for transparency and also may help reduce corruption in the TD. For example, there is a rumor that one RTI reported only 4 laris in VAT collections during a particular month. Making tax collection information publically available on a routine basis could shame low performing RTI and the Headquarters into improving operations and make taxpayers more resistant to paying bribes.

While recognizing these shortcomings, the TD reform program was well designed and well executed. In particular, the expatriate staff of the Barents project is uniformly excellent. They are very experienced and talented professionals who worked very hard to implement the program under very difficult circumstances. They deserve recognition for a job well done.

2.2 National Enforcement Strategy

In light of persistent financial difficulties facing the government, Phase II of the Fiscal Reform Program also included a national enforcement strategy. This intervention was intended to realize short-term benefits by improving TD revenue collections.[4] As part of this effort, Barents developed and helped the TD carry out a number of enforcement initiatives that were focused on improving compliance with the excise tax regime, social fund taxes and presumptive tax. These initiatives were not successful. It appears that a number of factors conspired against the success of these initiatives. These factors can best be explained with some illustrative examples of unsuccessful excise tax enforcement initiatives.

2.2.1 A brief description of some unsuccessful excise tax enforcement initiatives

Since there was tremendous potential to raise additional revenue by improved enforcement of excise taxes, Barents gave priority to these taxes. One promising initiative, for example, involved sealing storage tanks to prevent unmetered removals of diesel fuel and taking meter readings on a regular basis in order to identify the under reporting of excise tax liabilities on fuels. The data were collected, but the TD did not undertake the necessary follow-on investigations. Therefore, this initiative was unsuccessful.

Barents also recommended that the TD seize and destroy bulk shipments of smuggled cigarettes in order to increase the cost of supplying smuggled cigarettes and, thereby, making them uncompetitive relative to cigarettes with tax paid. Although a few large containers of smuggled cigarettes were seized and destroyed, the TD did not maintain this effort with the necessary intensity, over a sufficiently long period of time to realize the goal of the program.

In order to reduce the demand for smuggled cigarettes by retailers, Barents also recommended that the TD seize and destroy smuggled cigarettes marketed through retail outlets, kiosks, etc. Tax officials followed up on this suggestion by going to local markets and seizing small quantities of smuggled cigarettes from little old ladies peddling them there. In other words, the TD did not make a serious effort to carry out this initiative. In fact, it was implemented in a manner best designed to discredit it.

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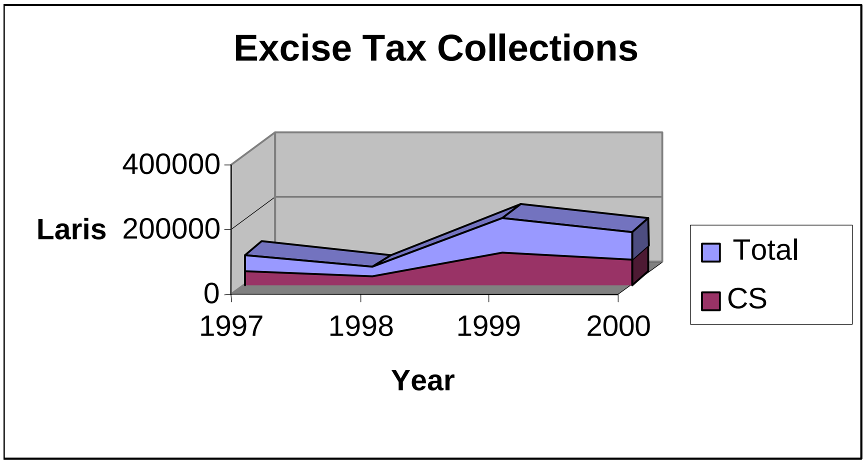
[4] Specifically, general government tax revenues as a percent of GDP are among the lowest in the region (15.4 percent of revised-GDP at the end of 1998); tax arrears approximately equal to 40 percent of tax collections (6 percent of revised-GDP); and, as a result of weak revenue performance and expenditure management, growing expenditure arrears (2.9 percent of GDP by the end of 1998).

2.2.2 Some comments on the national enforcement strategy

As the figure below shows, CY 2000 excise tax collections are less than they were in CY 1999. Furthermore, the share of excise taxes collected by the TD - the difference between total and CS collections - is declining as well. In short, the enforcement initiatives recommended by Barents were not successful because the TD was unable or unwilling to implement them.[5]



The reluctance or inability of the GOG to collect excise taxes is due to a political constraint. In short, influential people are using political connections to block tax enforcement to their commercial advantage. Until this political constraint is removed, no amount of technical or financial assistance from donor organizations will improve excise tax collections.

The inability to collect excise taxes is due to problems with the CS. The TD, and the recently established EGMB, can and should take remedial steps, like interdicting smuggled goods that arrive in the country. Though helpful, these actions can not fully substitute for effective tax enforcement by the CS at the borders. While recognizing that there are special circumstances in Georgia that make collecting taxes at the border challenging, the inability or reluctance of the CS to collect duty, excises and VAT on imported goods fundamentally reflects a lack of political will rather than administrative weakness or the need for technical assistance. The staffs of the CS, TD and EGMB are sufficiently resourceful to develop methods that, if fully implemented, would significantly increase revenues from excisable goods. It should also be pointed out that using the TD to collect excise taxes diverts attention and limited enforcement resources away from the collection of the taxes that only the TD can collect (e.g., EPT, PIT, domestic VAT, etc.).

[5] Some of this decline is attributed to the increase in excise rates, which made importers more resistant to paying tax. Also, it should be noted that these initiatives may have been hampered to some small degree because the consultant designated to assist with this effort had to leave the country for a period of time due to health reasons.

2.3 Summary

As previously noted, the Barents program was well designed and well executed. The Barents program has led to substantial improvements in the operations of the TD. But, the ultimate measure of progress should be a reduction in the bad practices of the past; a reduction in the gap between potential and actual revenues; and a sustained increase in tax collections.[6] At the time of this writing there is little evidence of progress by this standard. In fairness to everyone involved, it is premature to expect significant improvements in revenue collections from the comprehensive TD reform program. This program of reforms is not scheduled for completion until later this year. The nature of these reforms also suggests that improvements in revenue collection may not be realized for some time after that.

The same can not be said for the lack of progress in collecting excise taxes. Granted there are some difficult obstacles hindering the collection of excises on petroleum products and cigarettes. But, the inability or unwillingness to collect excise taxes undermines the TRMG credibility with taxpayers and the public and jeopardizes the reform process.

3 Interactions of Fiscal Reforms with Agriculture, SME and Local Government

The problems facing SME and agriculture in Georgia can be illustrated with an anecdote. An American veterinarian visited a dairy farm in the Kaheti Region to help improve their operations. On this dairy farm the cows must be milked by hand because they lack the necessary equipment and do not have a steady supply of electricity. If a cow contracts an udder infection - a serious malady for a dairy cow - they do not have ready access to proper medications to treat it. To compound these problems, hoof and mouth disease is endemic to Georgia. As we have all learned from the tragedy in Great Britain, although hoof and mouth disease is rarely fatal, it interferes with the ability of livestock to gain weight and produce milk, thereby reducing their commercial value. Also, the irrigation equipment (e.g., pumps) used on this dairy farm were stolen during the unrest in the early half of the 90's and they do not have the money to replace this equipment. And, they can not use the farmland as collateral to secure a loan because they do not hold individual title to the land. In short, the average yield per cow is 8 liters of milk per day, while the U.S. average is approximately 15-18 liters.

This anecdote illustrates the challenges facing business in Georgia: obsolete plant and equipment, inability to make needed investments due to the lack of access to capital, poor infrastructure, bad management practices and the resulting low productivity of labor. Under such circumstances, tax policy and administration are second-order problems. After all, small business, and most agricultural activity, is either exempt from taxation due to the minimum taxable thresholds or simply evade taxation.

Nevertheless, tax and fiscal policy do have a role to play in creating a favorable climate for business in Georgia. Government should play a supporting role by making infrastructure

[6] Some of these bad practices include collecting taxes based on quotas, negotiating tax liabilities, heavy handed and predatory practices.

improvements, securing property rights and providing targeted business support services, such as agricultural extension services. In order to perform this role, however, the government needs revenue. The primary source of the government's revenue should be taxes. Now, there is a large discrepancy between potential tax revenue and actual tax collected, which argues for improved tax administration. Meanwhile the government is accumulating expenditure arrears.

On the other hand, many business people and government officials argue that the level of taxation in Georgia is stifling business. For example, there is a perception that the total tax burden on labor income may be too high due, in part, to the social fund tax. The following taxes are levied on the income from labor: 28 percent tax on payroll for the social fund;[7] 3 percent tax on payroll for health insurance; 1 percent tax on payroll for the Unemployment Fund; and 12 percent (lowest bracket) PIT. Assuming the burden of these taxes is borne entirely by labor, the marginal tax rate on labor income is approximately 40 percent [(0.27+0.03+0.01)(1-0.12)+0.12+0.1].[8] In contrast, the marginal tax rate on labor income in Turkey, potentially an important market for Georgia, is approximately 25.5 percent or 37 percent lower than in Georgia.[9]

It is true that many advanced industrialized nations, particularly in Western Europe, impose similar tax burdens on labor income and successfully collect them.[10] But, Western Europe and the U.S. enjoy several advantages relative to many transitional economies attempting to levy marginal tax rates that are 40 percent, and higher, on labor income. The citizens of West European countries have a long history of paying tax and appreciate the role of taxation in a market economy. These countries also have a highly developed administrative capacity that has been refined over many years to collect such taxes. The tax burdens and public expenditures that taxation supports in these countries enjoy broad public support. These conditions simply do not exist in Georgia and many other CIT.

In the final analysis, the ability to collect tax assumes that the factors of production (e.g., land, labor and physical capital), particularly labor, produce sufficient surplus relative to subsistence to support the level of proposed taxation. There is some evidence that labor in Georgia may not be productive enough to support the levels of taxation common in advanced industrialized countries. According to the World Bank, the cost of a survival basket (or extreme poverty line) in Georgia is laris 40 per month per equivalent adult, which represents approximately 40 percent of median consumption.

If, as these data suggest, the productivity of labor is so low that it just covers subsistence, then there is little or no surplus to tax. In such circumstances labor has but three options: (1) pay the

[7] The employer pays 27 percent and 1 percent paid by employees.
[8] These calculations assume that the employee contribution to the Social Fund is in the tax base for purposes of the PIT, and the employer contributions are not. But, the tax doe is not explicit on these points, perhaps an example of ambiguity in the code. See the Tax Code of Georgia, Adopted on June 12, 1997 with Amendments and Addenda through March 24, 2000.
[9] "The Tax and Benefit Position of Employees, 1995-1996," an annual OECD publication.
[10] In the U.S., for example, the top federal tax on labor income, not including state and local taxes, is 39.6 percent, but only on incomes over approximately $280,000. Indeed, Russia and other CIT levy similar taxes as well, though it is not clear that they are any more successful than Georgia at collecting them.

tax and go hungry, (2) continue to work and avoid some or all of the tax or (3) engage in activities, such as subsistence agriculture, that is not subject to tax. Based on "conservative" estimates by the IMF, the tax compliance rate in Georgia is 53 percent. Thus it appears that many Georgians are selecting options 2 and 3.[11] Now whether they make this choice out of choice or necessity is still not clear, but there is at least some evidence that it may be out of necessity.

What is the appropriate tax policy for Georgia, given the level of economic activity, administrative capacity and expenditure needs of the country? Policy-makers in Georgia need to resolve this fundamental question. In order to arrive at sensible answers, the GOG needs to develop the capacity to conduct tax policy analysis. The IMF, World Bank and other international donor organizations are prepared to consider well thought out changes to the tax code, but such proposals need to be supported by persuasive analysis. Some of the issues that good tax policy analysis should address are as follows:

- What is the anticipated revenue effect of the proposed tax policy?
- Does Georgia have the administrative capacity to enforce the proposed tax?
- What is the anticipated effect of the proposed tax on the distribution of income?
- What is the effect of the proposed tax on business (sectors)?
- What is the effect of the proposed tax on local self-governments?

The necessary data to do such analysis is very demanding, but computerization of the TD will quickly make such data available. The MOF should give priority to establishing a staff of tax policy experts to undertake such analyses. As will be discussed in some detail below, there is a clear need and role for USAID to support such institutional capacity building.

Policy, including tax policy, should also address how to finance local government. Work is being done on writing enabling legislation for local self-government, but this effort appears to be focused primarily on the proper expenditure responsibilities of local governments. This effort can not be successful without also ensuring that local governments have sufficient revenue to undertake these responsibilities. In order to strengthen local government, the following issues need to be addressed:

- Assigning responsibilities to regional and local governments;
- Revenue assignment and sub-national tax policy;
- Intergovernmental fiscal transfers;
- Sub-national borrowing;
- Regional economic development; and
- Implementation concerns.

Currently, the central government is solely responsible for collecting all taxes, and, in most cases, reserves the authority to define tax rates and tax bases. As a result, local governments

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[11] The IMF made a number of assumptions that would overstate the level of compliance in order to obtain conservative estimates of the rate of compliance.

have very little revenue autonomy. The PIT and EPT are shared according to a formula, while property taxes and some turnover taxes are 100 percent dedicated to local governments. Local officials point-out that tax enforcement is driven by the need to meet central government revenue targets. Therefore, the TD focuses on taxes, such as the VAT and payroll taxes, which are not shared. Furthermore, the TD has very little incentive to collect property taxes or turnover taxes, which are important sources of revenue for local governments.

Clearly, tax policy needs to address the financing of local self-governments. In fact, the essence of local self-government is the ability to tax. There may be some reluctance to enable yet another agency of government, in this case local governments, to interact with business, given the proliferation of agencies that have the authority to fine business and use this authority to command bribes. Nevertheless, these issues need to be addressed. Again, this is another case in which access to a well-trained staff of tax policy professionals would be useful in helping the GOG to sort out these difficult, but important and increasingly pressing issues.

These are very general conclusions about the linkage between agriculture, SME and local self-government. In order to make more specific recommendations, it would be necessary to conduct an in-depth study of these issues.

4 Recommendations for Future Work in Fiscal Reform

Given the many important and worthy demands for financial assistance in Georgia, one may reasonably ask whether USAID should remain engaged in continuing efforts to reform the TD, particularly given the lackluster revenue performance to date. For example, revised IMF estimates suggest that actual tax revenue is approximately 15 percent of GDP, while potential collections are approximately 26 percent. In addition, there are allegations that the TD Headquarters has not been supportive of reform efforts to date. Based on such evidence, it seems that some are ready to conclude that, yet again, efforts to reform the TD have failed to work.

4.1 The case for USAID to remain engaged in fiscal reform

In my opinion, this assessment is too pessimistic and unsupported by careful analysis. First, the comprehensive TD reform program is not complete and it is too early to expect to realize improved revenue performance from these reforms. If, anything, performance may initially suffer as the TD absorbs these changes. Second, this is not a propitious time for the economy of Georgia, given the slow down in the international economy; the crisis with the Turkish lira; and the increase in energy prices. The evidence may show that the economy of Georgia did not grow in CY 2000.

IMF Estimates of Tax Compliance Rates in Georgia (by tax)	(in percent)
Total tax revenue	53.0
PIT	94.9
EPT	33.1
VAT	43.2
Customs duties	30.3
Excises	55.4
Extrabudgetary revenue	63.5

Source: IMF Staff Country Report No. 00/68

It is also instructive to compare tax compliance rates in Georgia with those in other countries. The Table above reports IMF estimates of compliance rates in Georgia by tax. This is not the place to describe the methodology that they used to arrive at these figures. Suffice it to say that the IMF tried to be, in their words, conservative by making assumptions that would tend to overstate compliance. In short, the answer is that the current tax system in Georgia should be yielding tax revenue of around 26 percent of GDP, suggesting that current tax collections are around 53 percent of potential.

How does this compare with the rate of compliance in other countries? While reliable estimates are hard to come by, the IRS has conducted extensive studies on compliance with the U.S. federal personal income tax. The IRS estimates that the rate of compliance with the federal personal income tax is 92 percent. The IRS achieves this high rate of compliance with audit rates of less than 2 percent of returns filed. This would seem to suggest that Georgia has substantial room for improvement, however, this figure is extremely misleading.

The IRS achieves such high rates of compliance with extensive third-party reporting of income. For example, wages in the U.S. are subject to third-party reporting. It is an easy matter for the IRS to conduct computer matches of these third-party reports of wages (IRS Form W-2) and individual income declarations (IRS Form 1040); identify anomalies; and issue computer generated assessment notices in those cases where income under reporting is suspected. Since wages are deductible for purposes of the tax on business income and individuals must pay the individual income tax, there is no incentive for the business to collude with employees to under report wage income. And, not surprisingly, the IRS estimates the rates of compliance on wages, interest and dividends, which are subject to third-party reporting, are 99.0 percent, 92.9 and 90.8, respectively.

If we examine the compliance rates with sources of income that are not subject to third-party reporting, we find a dramatically different story. In most cases income from farming and sole proprietorship activities are not subject to third-party reporting. The IRS estimates that the rate of compliance for these sources of income are 52.1 and 53.3 percent, respectively. The IRS relies heavily upon field audits to enforce taxes on these incomes. Georgia also relies heavily on field audits and they appear to achieve very similar results to the IRS in those cases where they rely on field audits.

In Georgia, and many other CIT, the decision was taken to make the PIT a withholding tax and to have a very low sharing rate for the payroll taxes. In such cases, business does not have an incentive to make truthful reports of payroll because the avoided taxes on payroll are greater than the value of the deduction (40 percent versus 20 percent). Indeed, truthful reports of payroll provide indirect evidence about the gross receipts of a business. So, there is a double reason for business to conceal payroll. This policy choice complicates tax administration while at the same time reducing compliance costs by reducing the number of taxpayers that must file returns. This trade-off in terms of increased administrative costs and reduced compliance costs was considered appropriate in the context of CIT because of the widespread ignorance about taxes. Perhaps, it is time to revisit this decision. Georgia is a highly literate country and document matching is one of the most cost-effective ways to enforce taxes.

Now the VAT, on the other hand, is regarded as a self-enforcing tax that creates a useful paper trail for tax enforcement, when the credit-invoice method is used. This paper trail is similar to the third-party reports in the U.S. context, described above. The Table above shows that the rate of compliance with the VAT in Georgia is 43.0 percent. This figure is undoubtedly low by international standards and significant improvements in the enforcement of this tax should be achievable.

It should be noted, however, that enforcement of the VAT is not exclusively a TD responsibility. The CS plays an important role here as well. According to some estimates the CS should collect approximately 40 percent of revenues. Inadequate tax enforcement by the CS results in significant revenue leakage. Weak enforcement by the CS also diminishes the effectiveness of the TD's enforcement activities. Since imported goods compete with domestically produced goods, domestic producers suffer a price disadvantage if VAT is not collected on imported goods while it is being collected on domestically produced ones. This commercial disadvantage erodes the ability of domestic firms to pay VAT and makes them more resistant to paying tax. While CS reforms appear to be in the works, significant change is still in the planning stages at best and the problems there are widely perceived to be much more difficult than those encountered at the TD.[12]

One also reads that many CIT have greater success at enforcing tax systems similar to Georgia's. As the Table below shows, Georgia collects a smaller proportion of GDP than many neighboring countries. Since the tax structures in these countries are very similar, Georgia's relatively poor performance is attributed to inferior tax administration. Two of the problems with such comparisons is twofold. First, the shadow economy, which is a substantial share of GDP in these countries, has to be imputed. If we computed 95 percent confidence intervals for these estimates, I suspect that we would find that there is no statistical difference between

[12] The power ministries are also reportedly interfering with the tax enforcement efforts of the CS and the EGMB. It should also be noted that there are a number of border disputes that make it more difficult for the CS to collect tax at the borders and present a serious challenge to successful Customs reform.

revenue collections as a share of GDP in any of these countries due to uncertainties about the size of the shadow economy.

Taxation in Georgia
International Comparisons
(percent of GDP)

	1998
Armenia	19.5
Turkmenistan	17.2
Azerbaijan	16.0
Georgia	**15.4**
Kazakhstan	13.9

Second, many features of a given economy influence the cost of tax administration. For example, the size distribution of business influences the cost of tax administration. So, in an agriculture economy, like Georgia, the cost of collecting tax may be more difficult than in an economy in which oil extraction is the primary business activity, as in Turkmenistan and Kazakhstan. The cost of collecting revenue is lower in a country with a few large firms, than one with many small firms. Also, the resistance to paying tax may vary from country to country, which also influences the cost of tax administration. Again, Georgians have a long history of defying authority and engaging in black market activities suggesting that they may be rather resistant to paying tax, whereas Azeria are reputed to have a greater respect for authority. In any event, I do not believe relative rankings like the ones below are very revealing about the relative performance of tax administration in these countries. Is tax administration weak in Georgia? Yes, it is. But, it is weak throughout the CIT. Is it weaker than in many other countries? Perhaps, but I do not think we have adequate data upon which to base firm conclusions.

In short, USAID should remain engaged with reform of the TD for the following reasons. First, improving tax collections is clearly a priority area if Georgia is to remain an independent country. Second, the comprehensive TD reform program is not complete and it will only show results over time. It is simply not realistic to expect to see significant improvements in revenue collections from reforms, such as computerization, human resource reforms and restructuring the TD on a functional basis in such a short period of time. These reforms were not intended to lead to an immediate improvement in revenue performance. Third, USAID has accumulated tremendous experience and credibility with the GOG through the TD restructuring over the past two years. This experience and credibility may not carry over, if USAID suddenly shifts focus to another activity without completing the job of restructuring the TD.

4.2 Options for future work in fiscal reform

In my opinion, USAID should remain engaged in the reform of the TD. Progress in increasing the professionalism of the TD; reducing corruption; and increasing tax revenues will require sustained commitment over several more years.

Although general fiscal reform is the subject of the companion report, it is important to note that a lot of tax money is wasted. This, in turn, negatively impacts on tax administration. The public is naturally resistant to paying taxes if they do not believe that they are being put to good use. With that caveat in mind, I submit three options involving low, moderate and high levels of engagement in TD reform for your consideration. Before describing these 3 options, however, let me discuss two suggestions that I considered, but did not recommend.

Some have suggested that USAID should play a coordinating role in the CS reform effort. ITS is currently performing this role, but their contract expires at the end of this year and will not be renewed. Given the many international donor organizations committed to providing assistance to the CS reform effort, there is clearly the need for some institution to play a coordinating role. I asked a USC officer working in Georgia, if they would welcome USAID's assistance in that capacity. He felt that USC should play this role since they are making the largest financial commitment to reform of the CS in Georgia. USC may not be the best outfit to reform the CS in Georgia. For example, Georgia's CS is primarily a revenue collection agency, USC is not. USC also does not have experience collecting a VAT. I do not mean to suggest by anything that I have written that the USC officers working in Georgia are anything other than highly dedicated professionals. In fact, I think that they are highly dedicated professionals. Nevertheless, I do not believe USAID should try to facilitate coordination of CS reform, without the unqualified support of the USC. It is not prudent to have U.S. agencies competing with one another.

It was also suggested that TD reform should proceed by placing expatriate advisers in the TD Headquarters to work side-by-side with the various deputies there. This suggestion is driven by concerns that the Headquarters does not support reform and, consequently, reform can not succeed without energetic support from the top. This proposal has merit and appears to have been used in other countries, particularly by the British. I suspect that this is a colonial model, or a modern version of it, designed for countries without the human capital to sponsor reform. This model provides on the job training for those already committed to reform, but lack some of the skills to sponsor it. I am not sure whether such a model has been successfully employed in a country in which there may be resistance to reform. In any event, Georgia is an independent country with ample human capital to manage these reforms. Success or failure ultimately depends on them and the U.S. should not step into the breach to rescue them from corruption and incompetence. Much as we may like to, we should not protect them from the risk of failure; some lessons are best learned the hard way.

<u>Option 1: Low Level of Engagement</u>
USAID's first priority for enhancing fiscal reform in Georgia should be to continue to assist reform of the TD. USAID should consider providing assistance for further computerization of the TD, particularly the development of the audit and collections modules. For example, in many cases there should be a correspondence between the declaration of sales for VAT purposes and gross receipts for the purpose of the EPT. Likewise, there should also be a correspondence between an enterprise's payroll deduction for purposes of the EPT and social fund tax. It is simply not possible to make such comparisons on a large number of tax declarations by hand. Computerization allows the TD to make such comparisons and identify

anomalies quickly and at very little cost. The ability to make such comparisons also makes it much more difficult for tax officials to continue to engage in the practice of negotiating tax liabilities. Finally, the program maintains a history of changes that should also help to curtail corrupt activities at the TD. In short, the ability to process large volumes of data is the essence of modern tax administration.

USAID should also provide software support to produce an array of standardized management reports and extensive training for management in the use of a computer system as a management tool. USAID should provide technical assistance and hardware to the VAT-invoice processing unit, as needed. Barents has recruited and trained specialized Oracle programmers. USAID should work with Barents to insure that these personnel can be retained between the shutdown of Phase II and the start-up, should there be one, of Phase III.

The Training Center is a critical element in developing a cadre of professional tax inspectors. The TRMG may not have sufficient resources to support high quality and extensive training. USAID should consider providing financial assistance to the established Training Center. Training should be expanded to include management training, risk assessment and new entry training. In light of the fact that nearly 40 percent of the TD consists of new recruits substantial training will be required to bring them up to speed. USAID may want to consider committing the necessary resources to create a public sector Training Center, or at least expand the scope of training provided to provide training for the range of responsibilities of a reunited MOF and TRMG.

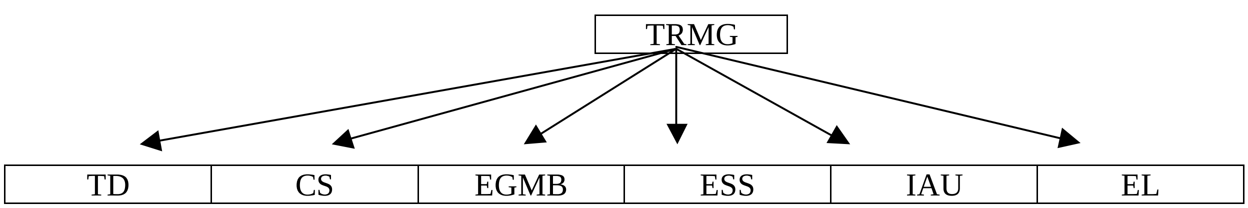
USAID should consider supporting taxpayer education by providing financial support for the publication and distribution of the "Plain Language Guide to the Tax Code" and the "Taxpayer Charter." In addition, USAID could provide financial support to insure that all tax offices have an ample stock of the necessary tax forms and accompanying instructions. USAID could also support taxpayer education by integrating this activity into some of their other activities including GESP, micro-finance projects and agricultural support activities. USAID should also provide financial support for the production, publication and distribution of the "Plain Language Guide," "Taxpayer Charter," and all tax forms in Armenian, Azeri and Russian.

USAID should consider providing support to strengthen the IAU. This unit has committed leadership and is staffed with young recruits. It also serves as an example to other line-Ministries that may wish to establish similar units in the future. The IAU will serve to prevent a return to the excesses of the past and help uncover administrative weaknesses. The UST adviser to the IAU should be asked to stay for at least an additional year. He has established a very good working relationship with the IAU and is doing very valuable work there. USAID should perform an assessment in cooperation with the Head of the IAU and the U.S. Treasury advisor to determine their exact needs. For example, they expressed a desire to acquire additional personal computers; training in forensic audit techniques; and report writing. USAID support for this unit may also help shield them from political interference with their investigations.

Finally, USAID should consider providing technical assistance to the TD to create a unit to produce regular reports on tax collections by type of tax and by district for pubic distribution. These reports should provide detail on tax arrears, amount of tax arrears settled, current payments, interest, penalty, number of audits, yield per audit, number of registered taxpayers, the number of active taxpayers and the number of new registrations. The IRS periodically releases this type of information. The IRS Annual Report and reports by the Statistics of Income could serve as models. If necessary, USAID should provide assistance to publish and distribute this information and make it available through the internet.

USAID should consider providing support for the creation of a specialized tax court to adjudicate tax disputes. If this is not feasible, then USAID should recommend and support the creation of a body to arbitrate tax disputes on a voluntary basis. For example, the Association of Young Professional Lawyers and Association of Chartered Accountants could be recruited to provide expert opinion on such matters. If this is not feasible, then USAID should consider providing resources to GEST to support business engaged in tax disputes. It is very important to the reforms of the TD that there be some way to check there excesses. The TD may be prone to excesses due to inexperience due to the large number of recruits; the pressure that they are under to collect additional revenue; as well as corruption and incompetence.

The second priority for enhancing fiscal reform in Georgia is to strengthen the MOF. The MOF should regain control of all activities currently under control of the TRMG. As the figure below illustrates the TRMG currently consists of 6 parallel organizations: Tax Department (TD), Customs Service (CS), Excise Goods Monitoring Bureau (ECMB), Excise Stamp Bureau (ESS), Internal Audit Unit (IAU) and Extraordinary Legion (EL).



All six organizations cannot report directly to the Head of the MOF; some streamlining of the organizational chart is therefore required before the MOF can re-absorb these functions. For example, perhaps the CS should take control of the EL and EGMB. Currently, the CS does not have an intelligence unit or ability to seize contraband goods. These functions are part of the EL. The CS is merely a tax collection agency and it cannot effectively collect tax without an intelligence capacity and the ability to seize contraband goods. The MOF may want to elevate the IAU, so that it performs this function for the entire MOF. In any event, there are a number of important issues that need to be thought about, if the MOF is going successfully to re-absorb the functions of the TRMG. It should also be noted that MOF will need to manage a lot of change over the next few years, including continuing reform of the TD, CS reform and reform of the financial management system. The MOF also needs to think about how best to manage these changes.[13] USAID may want to consider ways in which it could assist the reintegration of the TRMG into the MOF, such as commissioning an implementation study on behalf of the GOG.

In addition, the MOF should serve as the gatekeeper for ALL proposed tax legislation. Legislative proposals should be subject to a routine system of vetting, including estimates of the potential revenue effects as well as analysis of the economic and distributional impacts of proposed tax policy. There are several benefits to having such a unit, particularly in the MOF. It strengthens the role of the MOF in the formulation of tax policy. It provides valuable support to the MOF in formulating credible policies. Finally, the staff can provide independent analysis and help identify weaknesses in enforcement and opportunities for enforcement initiatives.

The MOF is in the process of establishing a Fiscal Statistics Department, perhaps this would be an appropriate home for such a unit. The unit should consistent of tax policy experts. Typically, such a unit would be staffed with several economists to perform the analysis and tax attorneys to draft the legislation, perhaps one of each per tax. MOF would also need to ensure that the TD will provide this unit with any and all tax data. Protocols should be developed for the routine exchange of such data, including the type of data, format, etc.

USAID should consider providing assistance to train such a staff. USAID could provide a resident technical expert (tax economist) for one or two-years to work side by side with the proposed staff. USAID could also provide for in-country and out-of-country training. For example, USAID could conduct a study tour of similar staffs in the U.S., specifically the U.S. Treasury's Office of Tax Policy, Joint Tax Committee, Congressional Budget Office and the IRS's Statistics of Income. USAID could also provide financial resources to purchase the necessary computers and software for this unit, establish a communication link to the TD databases, provide for internet access, and establish a research library.

<u>Option 2: Moderate Level of Engagement</u>
In addition to the initiatives described above, USAID could supplement the activities described in Option 1 above with the following activities.

USAID should consider providing technical assistance and training for the creation of a tax policy analysis unit in the Parliament's Budget Office in addition to the one proposed above for the MOF. By having this capacity in the Parliament, it will give them some assurance that the analysis and recommendations proposed by the MOF are based on sound economic analysis rather than purely political expediency. Such a staff would also help vet proposals that originate in the Parliament and help shoot down "bad" proposals before they get to far. Granted it does involve some duplication of effort, but this can also be useful by contributing to the

[13] Please see the accompanying report written on general fiscal policy and administration for more on detail on the importance of MOF re-absorbing the functions of the TRMG and reform of the financial management system.

development of the necessary consensus to pass proposed tax legislation into law. USAID could support this effort by providing for an expatriate adviser to work side-by-side with such a staff for one or two years. USAID could also make a small computer and software procurement and provide financial resources to establish a reference library for this staff. USAID should consider providing assistance to the EGMB. They would like to receive computers and other tools that would assist their work as well as technical assistance. Progress in collecting excise taxes is very important, but may require that political intervention at the highest level of government in order to overcome some of the difficult obstacles that are preventing enforcement of the excise taxes at this time. The Embassy will have to assess whether the benefits of such an intervention are worth the price of pursuing. Without an explicit agreement to increase excise tax collections by a given amount over a given period, I would recommend against providing support to the EGMB. Clearly, assistance should be conditioned on certain well-defined goals being achieved on a date certain and sustained. The MOU should explicitly rule achieving goals by requiring advance payments and some of the other games that can be used to demonstrate progress on a temporary basis.

<u>Option 3: High Level of Engagement</u>
In order to make substantial progress in improving the performance of the TD in a short period of time will, in all likelihood, require two things. First, USAID may need to make a deeper commitment to reform of the TD. Second, Georgia will need to undertake tax reform to reduce administrative and compliance costs and promote economic growth. This option involves another round of assertive intervention by USAID over 2-3 year period.

As previously noted, there are concerns that the TD Headquarters is not as supportive of the efforts to reform the TD as they need to be for the reforms to be successful. In order to get around this potential obstacle, USAID should consider creating a program in which individual RTIs, the LTI and Headquarters would compete with one another for targeted assistance. Interested RTI would submit development programs with specific recommendations to improve their operations, the estimated cost of implementing these reforms, proposed cost-sharing and expected benefits. Proposals could include plans to refurbish office space, create a computer center and link type A, B and C offices in a district through the communication system. In addition, they could request technical assistance, training and, where appropriate, financial assistance to improve the activities of any or all 7 divisions of an RTI (e.g., administration, data processing, audit, collection, etc.). In this scheme, 3 to 5 RTI would chosen on a competitive basis, according to the quality of their proposal (plan, budget and expected benefits), their revenue raising capacity and demonstrated commitment to the goals of the reforms.

The goal of this intervention would be to create a few RTIs that could serve as laboratories to determine what works and provide a demonstration effect to the other RTIs. Continued participation in the program would be conditional on meeting or exceeding agree upon benchmarks in terms of new registrations, improved collections and normalizing the relationship between tax inspectors and taxpayers. These benchmarks should be established by the RTI and serve as one of the selection criteria.

Tax reform also plays an important role in reducing the administration and compliance costs of taxation in Georgia. The tax code includes many low-yielding taxes that divert the attention of tax administration and taxpayers alike. The tax code also assumes a level of sophistication on the part of taxpayers and tax administration that does not appear to be realizable in the near term. Furthermore, the tax code is being used as a policy instrument to achieve a number of goals that are unrelated to the principle goal of raising revenue for the government. For example, the PIT includes a personal exemption and progressive rate structure. Since the PIT is primarily collected through withholding by the employer, these provisions complicate the task of tax administration, and only slightly reducing the degree of income inequality.

Furthermore, the tax code is almost certainly supporting corrupt tax officials in their efforts to extort bribes from legitimate business. If tax burdens are unrealistically high and businesses simply can not meet these obligations and survive, then tax authorities have a powerful stick that they can use to extort bribes from business. In this case, the tax code compels tax authorities to negotiate tax liabilities with taxpayers, otherwise the business will simply go bankrupt. This is akin to the old Soviet practice of making everything illegal and requiring payments to officials to look the other way.

Given the administrative capacity and lack of taxpayer knowledge, Georgia needs a simple tax system. As previously noted, the PIT includes special exemptions, personal exemption and a progressive rate structure. Since the PIT is primarily a withholding tax, these provisions unnecessarily complicate tax administration. In addition, income taxes are complex taxes. It requires that unfamiliar concepts like interest, dividends, profit and capital gains be defined, all in a country without modern accounting systems and a concept of profit. Also, there are too many taxes, which scatter the attention of the TD and confuse taxpayers.

Thus, there appears to be an important role for tax reform as a way to improve tax administration:

- Reducing tax burdens would reduce resistance to paying tax;
- Simplification would reduce administrative and compliance costs; and
- Lowering marginal tax rates would stimulate economic growth.

USAID should consider providing technical assistance in support of tax reform. Ideally, MOF and Parliament would establish the fiscal analysis units described above, with USAID training support and computer procurement. USAID would provide a few long-term consultants to support the MOF staff in developing tax policy proposals and the supporting economic analysis. USAID would also provide short-term assistance to evaluate the merits of the proposals and conduct special analysis, as needed. This would give the MOF ownership over the reforms; provide intensive on-the-job training for the fiscal analysis units; and lead to well developed and supported tax reform proposals.

The GOG needs a simple tax system that supports investment and employment by business. Some suggested areas for reform include the following:

- There are a number of unproductive taxes that should be eliminated;
- Excise taxes should be applied to a smaller number of commodities with uniform rates among like commodities (e.g., filtered and unfiltered cigarettes);
- The taxes on labor income are too high;
- The PIT should be simplified, specifically it is difficult to administer a withholding tax with a progressive rate structure, personal exemptions and other exemptions;
- Local government require some revenue autonomy;
- Local governments should receive grants from the central government, rather than relying on shared taxes;
- The EPT should provide for loss carry-backs as well as loss carry-forwards;
- The treatment of depreciation should be simplified and accelerated; and
- The taxes on interest, dividends and capital gains should be eliminated.

Services that would normally be provided by local governments - education, roads, water, sanitation, police - are being neglected. It is essential that tax policy, and the MOF more generally, insure that there is an adequate correspondence between the expenditure obligations of local self-governments and their revenue capacity. This may require the develop system of grants from the central government to local governments and providing for some revenue autonomy by local government (i.e., the ability to set the tax rate and define the tax base).

List of People Interviewed

<u>Government of Georgia</u>

Abziandze Badri, Head
Office of the Inspector General, Tax Revenue Ministry

George Gachechiladze, Chairman
Customs Department, Tax Revenue Ministry

David Gamkrelidze, Member
Parliament of Georgia

Roman Gotsiridze, Head
Budget Office, Parliament

Temur Khevsuriani, Chief
Extraordinary Legion of Tax Revenue, Ministry of Tax Revenue

David Kirvalidze, Head
Budget Office, Ministry of Finance

Koteshvili, Head
Excise Goods Monitoring Bureau, Tax Revenue Ministry

Mikheil Machavariani, Minister
Tax Revenue Ministry of Georgia

Sulkhan Molashvili, Chairman
Chamber of Control of Georgia

Zurab Nogaideli, Minister
Ministry of Finance

George Sheradze, Premier
Tbilisi City Government

Georgia Shonia, Deputy Minister
Ministry of Economy, Industry and Trade of Georgia

<u>USAID Contractors</u>

USAID Fiscal Reform Project

David Crawford, Tax Advisor
KPMG Consulting Barents Group

Catherine Irvine, Senior Consultant, Senior Consultant
KPMG Consulting Barents Group

Edward Koos, Tax Attorney
KPMG Consulting Barents Group

Malcolm Laing, Indirect Tax Advisor
KPMG Consulting Barents Group

Peter Muir, Chief of Party
KPMG Consulting Barents Group

Craig R. McPhee, Senior Economic Advisor
KPMG Consulting Barents Group

Gibbie Porcari, Computerization Advisor
KPMG Consulting Barents Group

Georgia Enterprise Support Project

Sandro Amashukeli, Policy Team Deputy Manager
Sibley International

William M. Cane, Chief of Party
Sibley International

Ramaz Erikashvili, Deputy Regional Manager (Imereti Region)
Sibley International

Paul Lewis, Regional Director (Imereti Region)
Sibley International

Alex Zguladze, Deputy Legal Services Manager
Sibley International

Macroeconomic & Structural Reforms Advice to Georgia

Jerzy Miller, Deputy Project Coordinator

Center for Social and Economic Research Foundation

Mateusz Walewski, Project Resident
Center for Social and Economic Research Foundation

<u>U.S. Embassy</u>

Sandra E. Clark, First Secretary
Political and Economic Section

<u>U.S. Treasury's Office of Technical Assistance</u>

Preston Benoit, Resident Advisor
Tax Revenue Ministry of Georgia

Regis Chapman, Ph.D., Resident Budget Advisor
Ministry of Finance of Georgia

Richard Marsh, Tax Revenue Advisor
Tax Revenue Ministry of Georgia

<u>Other International Donor Organizations</u>

Laurence D. Beck, Advisor to the Chamber of Control
Criminal Law Liaison, American Bar Association

J.A.M. Brown, Customs Reform Adviser
Intertek Testing Services, Foreign Trade Services

Michael Welling, Senior Customs Advisor
International Monetary Fund

<u>Miscellaneous Interviews</u>

Fady O. Asly, President
American Chamber of Commerce in Georgia

Revaz Dzadzamia, Chairman of the Board
Georgian Federation of Professional Accountants and Auditors

Tevflik Mehmet Yaprak, Country Manager in Georgia
The World Bank

Site Visits

Computer Center, Tax Department

Red Bridge Customs Check-point

Rostavi Regional Tax Inspectorate: Type B (Bolnisi) and C (Danisi) offices

7 Georgian entrepreneurs in the Imereti Region
(Arranged by GESP)

Republic of Georgia
Assessment of Fiscal Reforms and Options for Further Intervention
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(May 2000, IMF Staff country Report No. 00/68)

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Memorandum of Economic and Financial Policies for 2001-2003

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The Guidelines for the National Anti-Corruption Program of Georgia (October 31, 2000)

Republic of Georgia
Assessment of Fiscal Reform Efforts and Options for Further Intervention
Summary of Recommendations

This paper presents a summary of recommendations found in the main body of the accompanying assessment of fiscal reform efforts in Georgia. The main focus is on the past and current reform efforts funded by USAID and other donors within the Ministry of Finance (MOF) and the chosen executing agency, the Ministry of Agriculture and Food (MAF).

With the exception of the KPMG Barents reform efforts at the Revenue Ministry, the technical assistance that has been provided to the MOF and MAF over the past five years has not had much positive effect. There have been a series of starts and stops of various types of expert advice from a variety of donors and their agents. During this period, the MOF has remained a weak institution that is not in control of fiscal policy nor fiscal implementation. Unrealistic budgets for both revenue and expenditure have been the norm. While the revenue administration has been severed from MOF, no internal capacity for medium-term forecasting or fiscal policy management remains.

Generally, there seems to be no advocacy for an integrated approach to financial management across the budget execution cycle. Budget, accounting, treasury and audit (the four pillars of financial management) are treated as independent functions. USAID, the World Bank, UNDP and the Inter-American Development Bank have cooperated on several successful integrated financial management projects in Latin America over the past fifteen years. That experience, especially the “lessons learned” aspects, should be adapted and applied to the Georgian needs.

Both in terms of budget formulation and budget execution, MOF needs to get off the “expenditure control” mentality and move towards performance standards. MAF could serve as a pilot project for introducing MOF-led reforms in Integrated Financial Management Information Systems (IFMIS) and performance evaluations. Success at MAF should be replicated throughout the public sector. All technical assistance targeted to institutional reform of line agencies that is based on performance standards should flow through the Budget Department of MOF. This may take a longer period to realize results but the positive effect would be the institutionalizing of the methodology at the proper level of decision-making.

The accounting function within MOF should be clearly defined and given separate status, either within the Treasury Department or as a separate controllership type arrangement. The MOF accounting records should interface with line agencies accounting systems on an IFMIS basis. If the IMF advisor is not prepared to take on this responsibility for directing an accounting unit development, USAID or other donors may consider the recruitment of an additional advisor for this purpose.

In line with the main thrust of the recommendations described above, the following table presents possible donor intervention by USAID and others. They are presented in order of priority.

Recommendations	Options for Donor Interventions
The first priority for enhancing fiscal reform is to strengthen the Ministry of Finance. The progressive weakening of MOF that has been occurring over the past four years should be reversed. Line agencies should have one single point, the MOF, to transact budget and performance business.	USAID should play a supporting role in this endeavor. The IMF and US Treasury both are scheduled to place senior advisors with MOF in April 2001. They should take the lead.
The fiscal managers at the center, ideally the MOF, need to get systems and training to make a fundamental switch away from "expenditure control" and cashiering to performance evaluation.	Key to revitalizing MOF is the strengthening of the Budget Department. . USAID should consider a small computerization and software procurement that could form the nucleus for the integration of the budget, accounting and treasury database within MOF.
The IMF and US Treasury technicians assigned to MOF Treasury and Budget Departments respectively should be given the KPMG Barents turnover documents that were generated in August 1999. This material is consistent with IFMIS methodology and provides good background for a way forward for institutional strengthening at MOF.	USAID should consider funding overseas site visits for relevant MOF staff from the Budget and Treasury Departments. The author of the KPMG Barents turnover documents (Peter Muir) should meet with the IMF and US Treasury consultants, who should be taking up their respective assignments within the next month, for the purpose of presenting and clarifying the technical aspects contained in the documents.
With regards the line agencies, the institutional review that is currently underway at MAF should be conducted at all Ministries and agencies. Institutional review of line agencies' operations, with a view to bring them in line with national needs, should be the sole prerogative of the Budget Department at MOF.	This will likely require expertise beyond a single US Treasury designated expert. USAID should consider adding a second consultant to the Budget Department who is an expert in performance-based budget formulation and monitoring
It is proposed to combine the training facility requirements of the Revenue Ministry, MOF, the Chamber of Control and any one else involved in fiscal management, for example line agencies accounting and budgeting staff. In addition to having a core staff, consultants working on fiscal reform projects would be encouraged to conduct workshops and training at this site.	USAID should reactivate its task order (2000) under the Georgian Enterprise Accounting Reform program. Funds should be allocated to expand the current training center at the Revenue Ministry to accommodate its expanded scope.
The Government should consider giving preferential treatment to SME's in the procurement process. The creation of a small business administration that would support the development of SME's and provide guidance on procurement opportunities could channel funds to them in a transparent way with no need for direct subsidies.	USAID should considering funding procurement specialist as part of the proposals for restructuring line agencies. In line with the variation on the "McKinsey" and "umbrella" approaches (see page 16 of the report), the agricultural private sector could be empowered to do business with the Government. Eventual creation of a SBA-type promoter of small business could be an objective.

Even though MAF may be downsized and reoriented in their strategic mission in the future, the experience that they have gained in building databases and monitoring performance should be recognized and re-enforced. In the future, the accounting department should become the gatekeeper at the MAF level and have the hardware and software tools to control and manage data as it flows through IFMIS.	USAID and other donors, principally the EU, should consider funding a small computer and software procurement that could form the nucleus for the integration of the budget, accounting and treasury (payments) database within MAF. This recommendation mirrors the one above for MOF. The same consultancy could provide both.
The Revenue Ministry should be disbanded and re-incorporated with MOF. Tax and revenue collections should be transferred to the Treasury Department consistent with its role of cash custodian. Tax administration and enforcement would be assigned to an independent department within MOF, reporting directly to the Minister.	No technical assistance required.
MOF remains weak in tax and economic policy formulation. Mid-term economic forecasting and revenue projections should continue to be the focus. The Minister of Finance should be encouraged to establish a small unit (5 professionals) to take on this task.	The KPMG Barents macroeconomic advisor at MOF, whose term is scheduled to expire in September 2001 should be replaced. USAID or other donors should consider supporting this unit with a small infrastructure of computing and research capability via software modeling and Internet access to other countries' experiences.
The accounting function within MOF should be clearly defined and given separate status, either within the Treasury Department or as a separate controllership type arrangement. The MOF accounting records should interface with line agencies accounting systems on an IFMIS basis.	If the IMF advisor is not prepared to take on this responsibility for directing an accounting unit development, USAID or other donors may consider the recruitment of an additional advisor for this purpose.

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Project Authority and Scope of Work

The United States Agency for International Development (USAID) has requested advice as to whether to allocate additional resources to the Georgian fiscal reform efforts beyond the anticipated September 2001 expiration date of the KPMG Barents contract that was initiated in 1998. The advice is to be provided in two separate but coordinated reports: tax and revenue administration, and general fiscal policy and administration. This report responds to the latter. The detailed terms of reference for this assessment appears as Appendix 1 to this report.

In summary, the terms of reference call for a review of the strengths and weaknesses of fiscal reform efforts to date and the provision of recommendations for follow-on activity, if any. Special attention is to be given to the effect of the fiscal environment on the development of small and medium enterprises (SME) especially in the agriculture and agri-business sectors.

The main author of this report is independent contractor Paul Stroh who worked under the general guidance and supervision of Sharon Hester of USAID/Washington. The contractor and Ms Hester met with David Owen and his staff at the International Monetary Fund (IMF) prior to the mission to Tbilisi, Georgia. Additionally, prior to departure to the field, an extensive review of background documents and selected KPMG reports was made. Subsequently, the contractor spent three weeks in March in Georgia to conduct additional documentation gathering, fact finding and interviews with government officials and donor agencies and contractors.

Review of Fiscal Reform Activities to Date

Document Review

In order to appreciate fiscal reform efforts and results in Georgia, it is necessary to catalogue the array of donor and contractor interventions, mainly but not limited to the Ministry of Finance (MOF), over a time-line dating from the first major study conducted by the IMF in 1996 to the present. In addition to viewing reform from the MOF perspective, the experiences of the Ministry of Agriculture and Food (MAF) in dealing with fiscal reform will be introduced in this section of the report.

The principal documents or reports that is relevant in describing the fiscal reform efforts since 1996 are presented in the table below. This is a representative sample and not meant to be all inclusive. Of the seven documents listed, it is remarkable that not one makes reference to any of the others. It appears that each is a stand-alone document that, most certainly, satisfied either a contractual obligation or a Mission stated goal. Some, in fact, contradict others. For example, items No.'s 2 and 7, which propose to set up the Treasury Department of MOF as a separate autonomous entity with broad powers over budget execution, runs contrary to the main themes present in the other five documents: a strong and unified MOF based on the concept of the budget process as a continuum of events and transactions from formulation to execution.

Report/Document Title	Author and Date	Comment
1. Georgia: Building Fiscal Institutions	IMF September 1996	Major (106 page) report in standard IMF format
2. Georgia: A Revised Expenditure Control Framework	IMF February 1999	Narrow focus on measures to ration cash releases by main Treasury
3. Handover of Budget Reform Agenda	Barents August 1999	US Treasury assumption of budget and fiscal reform at MOF. Documentation of Barents work effort from March 1988 through August 1999.
4. Georgia: Restoring Fiscal Credibility and Pursuit of Fiscal Sustainability	World Bank Mission May-June, 2000	10 page document authored by former IMF employee
5. Draft Law on Budget System of Georgia	Ministry of Finance August 2000	US Treasury advisor provided main input
6. Critical Actions Needed to Improve Georgia's Financial Policies and Processes	Georgia-US Four Point Program, Budget and Expenditure Control Workgroup (15 members from donor/ GOG and contractors) Report to the State Minister and the US Ambassador October 16, 2000	Collated by US Treasury advisor. Contains 96 discreet actions within 26 categories within 9 functional fiscal areas.
7. Draft Law on the Treasury of Georgia	Parliament Committee January 2001	Informal translation provided by US Treasury advisor

Items No.'s 1, 4 and 6 in the above table read like textbooks. They describe ideal fiscal and management tools in public administration, list the inevitable lapses in the Georgian environment, and make recommendations to close the gaps. However, they lack a clear timetable and sense of priority and thus present a sense of overwhelming complexity for implementation. Nevertheless, they do include some useful discussions on certain aspects of fiscal management. For example, Chapter 3 of the 1996 IFM institutional review contains a good summary for developing macroeconomic forecasting and analysis capacity within MOF. Also, Chapter 6 of the IMF document lays out the issues related to the MOF role in intergovernmental fiscal relations. These two chapters should be reviewed and incorporated into the new work plans that should be developed by the US Treasury and IMF advisors due to arrive shortly at MOF.

The two documents that merit resuscitation are items No.'s 3 and 5. The first, which is a transmittal of work performed by KPMG Barents during 1998-99, is a very comprehensive document with sections ranging from concepts to training models to computerization needs. The work plans laid out in that document are as fresh today as at the date they were written.

Item No. 5, the draft law on the budget cycle (formulation through execution and audit), firmly places the MOF in charge as the agency for normative centralization and recognizes the line agencies as agents for operational decentralization. This proposed law draws on US Treasury's experience in other FSU nations such as the Ukraine, Serbia and Croatia. US Treasury got the details right and the Minister of MOF is ready to push for its passage in Parliament.

Item No. 7 is very recent document that has been issued from within Parliament. It proposes to establish the Treasury as an independent agency separate and apart from MOF. A candidate for Treasurer would be "approved by the Parliament upon being presented by the President." Some of the terminology and descriptions in this document, such as reference to a "single State Treasury account (fund)" would be fine in some other context. However, the main theme of this document is to minimize MOF's role in budget allocations and to empower Treasury to intervene in line agencies' operations. For example, Article 24 stipulates that 15 days after the State budget comes into force (January 15th of each year), "the approved consolidated budget distribution is passed on to the Treasury for execution…" Article 26 states "the order of priority and rules for issuing permission to realize State budget expenditure is determined by the Treasury in accordance with this law." This proposed law runs counter to many of the themes found later in this report. As currently drafted, *the Draft Law on the Treasury* should be shelved.

Donor and Contractor Personnel Review

The cast of personnel involved in fiscal reform at the MOF and line agencies is wide and varied. They include staff and contractors from the following donor agencies:

Functional Expertise	Funding Source	Personnel/Duration	Status
Budget Process	USAID	Barents Team (5) 1 year	Turnover function to US Treasury in September 1999
Budget Process	US Treasury	1 Budget Expert 18 months	Vacant as of March 15, 2001 Replacement being recruited
Treasury	IMF	1 Treasury Expert 1 year assignment, renewable	Vacant since February 2000, replacement due in April 2001
Economics/Forecasting	USAID	1 KPMG Consultant 30 months	Scheduled end of tour September 2001

Budget	British Know How Fund	Several proposed	Proposal under consideration by MOF
AG Sector Support At MOF At Ministry of Agriculture	European Union	 2 consultants 1 consultant	Indefinite tenure
Donor Coordination Capacity Building for Public Sector	UNDP		Project expired in 1999
Streamlining the Government Sector and Improving Efficiency of Public Spending	World Bank		Structural Adjustment Credit, Closed December 1997
Coordination of External Donor Technical Assistance	World Bank		Institution Building Credit, Closed June 1998

The most notable concrete outputs achieved within the MOF as a result of this technical assistance are the compilation of a draft budget law (UST), a series of budget forecasting and outturn reports produced over the last year (KPMG Barents), and a budget preparation model and tracking system for budget execution at MAF (EU). The KPMG Barents' work accomplished during the year ended August 1999, which as previously stated above is very comprehensive and relevant, has become dormant.

It is very apparent that the World Bank and UNDP attempts to build institutional capacity to coordinate donor technical assistance have not taken hold. The proposal for yet another budget reform project, recently submitted by the British Know How Fund, was a big surprise to the US Treasury advisor who has been the resident advisor on budget matters for the past 18 months. The proposed statement of work for this British team is very broad in scope and not clear as to eventual improvements to be achieved.

Over the past six months the MAF has made significant improvements in budget planning based on performance outputs and in tracking budget execution in financial and physical progress terms. This has been accomplished with hands-on assistance by the EU Food Security Program consultants. The EU funding of MAF works on a reimbursement basis after the goods and services have been delivered and paid for by the national budget. The EU has offices both in the MAF and the MOF to coordinate this process.

Although the technical advice provided to MAF and MOF by the EU seems to be technically sound, the process is not working, and in fact, may be completely irrelevant to fiscal reform needs. It's not working because the MOF has released zero funds (other than payroll) to the MAF between December 1, 2000 and March 31, 2001. The lack of operational funds during this period has forced MAF to abandon seasonal fieldwork that cannot be restarted until the next seasonal cycle. Therefore, no reimbursements can be requested to the EU and external funding has been lost and, in fact, has temporarily ceased altogether.

Secondly, it is uncertain if the programs operated by the MAF are relevant to Georgia's needs. The draft report of an USAID funded assessment of MAF's structure, staffing and functions provides strong indications that the MAF needs a general overhaul that may include a drastic reduction in its size and scope of operations. Fine-tuning the MOF/MAF/EU disbursement and reimbursement mechanisms may not be the best application of resources at this time.

In addition to the EU led funding effort in agriculture and the USAID assessment of the MAF, there is another analysis of the MAF that does not seem to contribute any additional light on fiscal and output performance in the agriculture sector. This report, issued by the KPMG Barents macroeconomic team at MOF, follows the model promulgated by the World Bank "Public Expenditure Review" Department. It is unclear the reasoning for conducting such an analysis that presents planned, actual and cash budget outturns in terms of percentage variations for the past two fiscal years. Expenditure reviews loosely document what has been purchased in the past. Current and projected performance reviews would be much more informative. The MAF senior management does not find their expenditure review useful for their internal management needs and have filed it away.

There are plans to conduct six more "Expenditure Reviews" by KPMG Barents before their departure. Also, the World Bank has plans to send in a team later this year to conduct a "Public Expenditure Review" for the entire central government. The Minister of Finance should question the utility of such an effort. Unless the MOF can integrate this type of review into the functional structure of fiscal management, and relate the expenditure experience with performance, they should not go forward.

In summary, the technical assistance that has been provided to the MOF and MAF over the past five years has not had much positive effect. There have been a series of starts and stops of various types of expert advice from a variety of donors and their agents. During this period, the MOF has remained a weak institution that is not in control of fiscal policy nor fiscal implementation. Unrealistic budgets for both revenue and expenditure have been the norm. While the revenue administration has been severed from MOF, no internal capacity for medium-term forecasting or fiscal policy management remains.

The recent proposal to severe Treasury from MOF would complete the dismemberment. At this rate, MOF will be left with the functions of budget formulation and management of the public debt. And if the Chancery and Parliament continue the process of negotiating the budget formulation details directly with the line agencies, and bypassing MOF, then the very existence of the Ministry is in doubt. Reasonably, public debt management could be assigned to the Central Bank and the doors of MOF could be closed. The only thing stopping this from happening is the force of personality and foresight of the current Minister of Finance.

Process Review

There is a consensus among the donor community, government officials and the public at large that the entire public sector is not managed well. At the risk of being repetitive and redundant for those readers who have lived and worked in Georgia, the following observations are presented to those who may not be so familiar with the local setting and environment:

- Georgia has not only a very high incidence of corruption, bribes are estimated to amount to 8% of GDP, but the corruptors are equated to extortionists. There is no friendly understanding as to the price of doing business (bribe requirements) as apparently is the case in a notoriously corrupt neighboring State.
- The general population resists paying fees and taxes because the State does not provide services
- The State cannot provide services because the general population does not pay fees and taxes
- There needs to be more donor coordination
- Public sector wages are low and generally in arrears by several months
- Ministries and line agencies have non-budgeted sources of revenue used to supplement wages
- Budget reductions are made arbitrarily by MOF, no consideration is given to programmatic priorities
- MOF is incapable of managing public finances
- Ministers have direct lines to the Parliament/Chancery, bypassing MOF
- The Revenue Ministry should be reunited with MOF
- More expenditure control is needed
- The arrearages problem must be solved, especially for wages and pensions
- The arrearages problem is getting worse

These observations provide the context of factors that will impact any future plans to improve fiscal management in Georgia. Until very recently, MOF has been a weak actor in the fiscal arena. As voids tend to fill, the Parliament, the Chancery, the Revenue Ministry, the Chamber of Control and the line agencies themselves have assumed some of MOF traditional functions. MOF has been reduced to a filter for distributing cash through the Treasury based on a set of artificial priorities not in any way related to productivity or relevancy in solving societal problems. Why should the payment of salaries be given the highest priority when the Government does not have a clue as to what these employees are doing or not doing?

As the responsibility for fiscal management has been disbursed to institutional actors removed from MOF, and MOF has been demoted to the rank of “Chief Cashier” in a bankrupted treasury and budget process, a substitute for fiscal management has emerged: *Expenditure Control.* This term is used in consultant’s reports. It peppers conversations with donors and government officials. It seems to be the thing to do. The only problem with the phrase, and the concept, is that it is meaningless in terms of fiscal management. The word "expenditure" is an accounting term that has meaning to bookkeepers and accountants. A bookkeeper (or accounting system) records an expenditure when there is evidence that goods or services have been delivered, a receiving report is made and the vendor has submitted an invoice. Based on this evidence, an expenditure is recorded with a corresponding credit to accounts payable. Disbursement of cash (paying the liability) may, and often is, delayed.

What needs to be controlled is the ordering of goods and services. The point of this control is within the line agencies at the level of program or project managers and ultimately with Ministers. Under the parliamentary system, a Minister automatically becomes an "Accounting Officer". This means that he or she must be accountable for insuring that goods and services are procured under government rules and regulations and are funded in the current year budget. The accountability rule extends to the point that the goods and services were actually put to good use, as planned and approved. Performance is paramount. Periodic reporting and financial and physical output or goal attainment should be made to MOF. Summary reports, usually on an annual basis should be issued to the public. This implies transparency. This means control.

The substitution of the term "performance management" for "expenditure control" might be viewed by some as purely semantics. However, it goes beyond that. Performance implies action, expenditure means bookkeeping. The fiscal managers at the center, ideally the MOF, need to get systems and training to make this fundamental switch away from cashiering to performance evaluation. Within the central government organization, this function is normally performed by the budget department or agency. In the case of the United States, there is a separate agency called the Office of Management and Budget (OMB). Please notice the use of the word "management" in their title. As any US government agency manager is aware, OMB authorizes the use of budget authority and must be informed as to their proper utilization.

In the Georgian context, the Budget Department within MOF should perform this role. The Treasury Department within MOF currently performs two functions. First and foremost, it is custodian of all centralized cash deposits. It receives funds in the form of taxes and other revenues and distributes cash to the executing line agencies to carry out their programs. Secondly, it records transactions related to the inflow and outflow of cash in accounting ledgers. Financial reports are generated annually and submitted to the Chamber of Control and to Parliament.

The accounting role of Treasury is assumed to be the logical outcome of its activities. The IMF FAD consultants invariably build this accounting role into their definition of what a Treasury should look like. This is one option. However, regardless of where you place the accounting function at a central agency such as MOF, it should be recognized that the treasury and accounting functions are two separate disciplines that require different skill mixes. And, even if they are placed organizationally within one department such as Treasury, there should be a firewall between them.

Secondly, the accounting function is required and in fact present at each and every executing agency. The level of accounting at this level should be much more detailed and tailored to meet the needs of internal management. At a summary level, the accounting records maintained at the line agency level should be a mirror image of the records kept at the center.

One rarely hears arguments or debates as to the adequacy of the public sector accounting systems in Georgia, as though they were on automatic control. This is not the case. It can be useful to view the accounting function as part of a continuum in the budget execution cycle. Government financial management systems should be designed to integrate the budget, accounting, treasury and audit processes, as follows:

1. Budgeting
2. Accounting
3. Treasury (including debt management)
4. Auditing (External to Parliament, internal to Minister)

Operating features of the first three of these components can be summarized as follows:

Budget	Accounting	Treasury
Formulate budget -Financial -Performance Issue Allotments Modify appropriations as needed Review performance	Record financial transactions Consolidate financial operations Management accounting (analysis and forecasting) Policy and standards for systems and internal control issues Maintain chart of accounts	Make payments Collect revenues Forecast cash needs and resources Manage debt Interface with Central Bank Bank account management and reconciliations

Budget

Although the separate components are interrelated in terms of transaction flow processing and information sharing, generally, in most national governments, budget planning and formulation are organizationally separate from both Accounting and Treasury. The emphasis in budget operations is to recommend resource allocations after an analytical examination of budget proposals from executing agencies that are based on outcomes and priorities, and to provide policy oversight during budget execution based on performance reviews.

Accounting

As indicated above, accounting represents the system and procedures used "to record financial transactions." Accounting occurs at different levels and places in the governmental hierarchy. Ministries, agencies and other program executing institutions will likely account for their approved budgets, internal allocations of budgets to subordinate units, projects, programs, etc. They also record commitments, expenditures and payment requests to insure that their invoices are paid and that debts are settled. They should maintain a General Ledger to record transactions flowing from the budget execution ledgers and to post and report on revenues, assets and liabilities.

Treasury
The treasury function involves the managing of cash receipts, payments, and custodial of cash and financial investments and liabilities.

With the assistance of packaged accounting software, these processes can be automatically linked into a common database that would be available to all interested (and authorized) parties at the appropriate level of aggregation. This common database is typically referred to as an Integrated Financial Management Information System (IFMIS).

The accounting ledgers within IFMIS operate at two basis levels as follows:

1. Budget execution
   Appropriations
   Allotments
   Reservations
   Commitments
   Expenditures

2. General Ledger
   Budget execution control accounts
   Accounts payable and disbursements
   Assets, liabilities and fund balance
   Subsidiary ledgers of above items

Points of Accounting Recognition During the Budget Execution Process Flow

As appropriations are recorded and executed through the various phases that lead up to disbursements being made, there are clear demarcations at which accounting transactions are recognized and recorded. These accounting entries are designed to record events that originate at three different organizational levels: the MOF Central Budget Department, the Executing Ministries and Agencies and the Treasury Department at MOF. The following matrix presents these relationships:

Appropriation Ledger	Event or Document	*Responsible Organization*
1. Appropriations	Budget Law	MOF Budget
2. Allotments	Periodic Work Plans	MOF Budget
3. Reservations	Internal Agency Plans	Executing Agency
4. Obligations	Contract/Purchase Order	Executing Agency
5. Expenditures	Receiving Report/Invoice	Executing Agency

General Ledger

6. Accounts Payable	Generated from Expenditure	Executing Agency/Treasury
7. Payments	Available Cash in Bank	Treasury

General Ledger (Revenue)

1. Record Estimates	Budget Law	Treasury
2. Collections	Cash Receipts	Tax/Customs/Funds/ Treasury

It is recognized that the above definitions might appear as Greek to the current managers of Georgian fiscal affairs. However, it is useful to present a target that should be the eventual goal of reform efforts. Over time, engaging the Georgian authorities, as well as donor agencies and prospective consultants, hopefully would get the focus off "expenditure control" and into a dialogue of financial and performance management that can be useful in gaining control over the use of public funds.

Generally, there seems to be no advocacy for an integrated approach to financial management across the budget execution cycle. Budget, accounting, treasury and audit (the four pillars of financial management) are treated as independent functions. USAID, the World Bank, UNDP and the Inter-American Development Bank have cooperated on several successful integrated financial management projects in Latin America over the past fifteen years. That experience, especially the "lessons learned" aspects, should be adapted and applied to the Georgian needs.

Recommendations to Move Forward

Institutional Capacity for Change

Central Level

The current dilution of fiscal authority away from MOF to Parliament, the Revenue Ministry and government entities that operate independently from central authority is the number one obstacle to bringing financial discipline to the public sector. The ability of Ministers to bypass MOF to propose changes in the tax code, as was done recently by Minister of Agriculture, makes MOF superfluous and weak. The willingness of the Chancery and the President to accept such proposals and to recommend them to Parliament for approval would dishearten any Minister of Finance. The fact that the Minister of Finance presented his resignation if the President did not reverse course attests to the courage and foresight of Mr. Nogaideli. While MOF is far from possessing the tools and the talent to begin moving towards the IFMIS model described in the previous section of this report, they should be edged in that direction.

With regards the line agencies, the institutional review that is currently underway at MAF should be conducted at all Ministries and agencies. However, to avoid the waste of donor funds and the time and effort of reform minded Ministers, the Budget Department at MOF should be empowered and engaged in these reviews. The purpose of these reviews is to determine what should be shed and what should be maintained or enhanced at the level where services are to be delivered by Government. The results should be translated into programmatic budgeting to be considered for funding. The Budget Department should be trained to take the lead. Donor support in the form of consultant experts or materials should be targeted to a given sector through the auspices of MOF budget formulation responsibilities. This may take a longer period to realize results but the positive effect would be the institutionalizing of the methodology at the proper level of decision-making.

As MOF is strengthened over time, the line agencies should be required to present their budgets and performance reports exclusively to MOF who should act as the Government's agent to establish and monitor fiscal management throughout central government

In Georgia, fiscal management, from economic forecasting to budget formulation and execution and audit requires a gatekeeper. This implies only one road on which to place the gate. This road should be a dedicated highway that passes through MOF, no detours allowed.

Line Agency Level

Even though MAF may be downsized and reoriented in their strategic mission in the future, the experience that they have gained in building databases and monitoring performance should be recognized and re-enforced. With the assistance of the EU consultants, they have managed to build a budget formulation model using a Microsoft Excel spreadsheet. However, this spreadsheet is stretching the data capacity limits of Excel and should be migrated to a RDBMS as soon as possible. Separate and apart, MAF has recently introduced a separate piece of software to perform the tracking function of budget execution. As mentioned above, this tracking process is used to document reimbursement request from the EU Food Security Program.

However, this EU supported development for budget preparation and tracking does not connect in any way of fashion to the Ministry's internal accounting operations. The IFMIS described in the previous section of this report is as relevant to the line agencies as it is to the central agencies. The functions of budget formulation, budget execution (performance and financial), accounting, treasury and audit can and should share a common database. The accounting department at MAF continues to use manual ledgers that are posted by hand with a staff of four. In the future, this department should become the gatekeeper at the MAF level and have the hardware and software tools to control and manage data as it flows through IFMIS.

Internal and External Audit

With the exception of the Revenue Ministry, the internal audit function does not exist. Nor is there any evidence that the concepts of establishing internal control mechanisms (by management) is appreciated. The development of internal controls and the establishment of internal audit units would not be appropriate at this time. Until the line agencies rationalize and defend their programs based on performance criteria, and modern budget, accounting and treasury operations are introduced, there is nothing to audit other than to perform “expenditure controls”. As discussed previously, this type of control mechanism is useless. The process of engaging the line agencies to review goals, objectives and performance standards would likely reveal much more potential leakage of budgeted funds and other corrupt activities than an audit could hope to accomplish given the current state of rudimentary budget, accounting and treasury systems.

The Revenue Ministry has introduced the internal audit function in the form of the Inspector General’s office. This makes sense in light of the major reforms that are underway in the tax administration area. Based on a document review and a visit to the Inspector General’s office at Revenue, it appears that they have undertaken a worthwhile initiative. For example, they have setup a website where any interested party may view their audit standards, audit plans, and audit results. This is modern thinking that promotes compliance and transparency of operations.

The Chamber of Control (COC) group that is responsible for reviewing the financial and performance conduct of the entire public sector is meeting the external audit responsibility. The COC is short on modern audit tools and audit methodology but at least understands what they are missing and are determined to make improvements. A visit to a regional COC office in Gori revealed that the auditors conduct little work due to lack of transportation (they take public buses to audit sites) and low morale due to low salaries and arrearages in salary payments.

Both internal and external auditors have adopted an aggressive posture in conducting their audits. They are requesting that a percentage of any recoveries of monies that may result from the audits be used as a salary supplement. Although there is comprehension that they are not adequately paid, this proposed salary supplement regime should not be supported. Other ways of compensating public sector staff should be found. The audit function should be seen as a management tool, not a policing action. Financial and performance audits should provide management with information to take corrective action for the purpose of improving public sector management. Only in the case of forensic audits should there be a policing attitude. Audits of individual taxpayers by the Revenue Ministry should be oriented towards compliance with the law and collecting more taxes in the normal routine, not putting people in jail. As of today in Georgia, the vast majority of audits being carried out are forensic based that lead to criminal prosecution and freezing of bank accounts. For example, the principal MAF bank account, with a considerable balance, has been frozen due to a tax dispute that may take years to untangle. These aggressive actions should be balanced with financial and performance audits that are more positive and forward looking.

Motivation and Reward

Everyone is aware that the level of salaries for public sector employees is far below what is necessary to provide a living wage. And staff of those agencies that are undergoing serious reforms are desperately looking for ways to supplement them. It is not within the scope of this current report to identify remedies to this inadequate pay structure. However, the current fad of creating bonus pools based on prosecutions or based on percentages of collections or other sources of miscellaneous receipts should be discouraged. It has been recommended by some experts in the field that there are special categories of public sector servants that receive these bonus funds in the short-term. This includes revenue collectors, auditors, lawyers and judges. However, once this path is taken, it will be very hard to reverse direction.

A different approach is suggested: if your ministry/agency undergoes reform, as in the Revenue Ministry and MAF, and efficiencies are realized either in the form of reduced costs or service improvements, salaries will be increased through the normal budget process. Those who manage reform successfully, should get rewarded.

Secondly, if a Ministry with an important business development role, such as MAF, undertakes substantial reform as a government priority, they should receive special consideration through the budget process. For example, MAF should not be expected to work with an array of outside consultants to restructure and modernize their administration unless there is a commitment from the center to support their revised programs with incremental funding.

Effect of the Fiscal Environment on the Development of SME's

The main negative effect that the current fiscal environment has on the development and sustainability of SME's lies in the revenue and tax administration areas. This is the subject and focus of the companion report to this one. With regards to the non-revenue side of fiscal management, the main negative aspect to SME's in general is the police and prosecutorial orientatation of the Revenue Ministry's Inspector General's office and the Chamber of Control. Secondly, MAF's pseudo control over its operational departments that have substantial independence to charge the general public for services rendered, opens up substantial space to extort funds from SME's and others. This ability to extract fees and other charges by these departments may or may not have a direct relationship to the value of services rendered. Either MAF needs to gain control over these departments or they should be abolished or privatized. Although other Ministries beyond MAF were not examined in detail, the existence of government-sponsored enterprises is pervasive. These also should be scrutinized, closed or privatized.

The other significant impact on SME's by the government's fiscal policies and practices is to restrict SME's in selling goods and services to the government. During the continuing government financial crisis, payment of salaries takes precedence. As payrolls are reduced, funds will be freed-up to support (goods and materials) those programs and staffs that are actually accomplishing work. As this develops over time, the Government should consider giving preferential treatment to SME's in the procurement process. The creation of a small business administration that would support the development of SME's and provide guidance on procurement opportunities could channel funds to them in a transparent way with no need for direct subsidies.

Recommendations and Options to Consider by USAID

Institutional Strengthening of MOF

The first priority for enhancing fiscal reform is to strengthen the Ministry of Finance. The progressive weakening of MOF that has been occurring over the past four years should be reversed. MOF should regain control over the budget cycle including the return of tax administration to its portfolio. Georgia is too small to have an independent OMB, Treasury and Revenue Ministry. This dispersion of responsibilities for fiscal management is proving detrimental. The Parliament and the Chamber of Control should be involved as reviewers of MOF performance, not active participants. Line agencies should have one single point, the MOF, to transact budget and performance business.

USAID should play a supporting role in this endeavor. The IMF and US Treasury both are scheduled to place senior advisors with MOF in April 2001. They should take the lead. The IMF advisor, who will provide assistance and advice to the Treasury, is an experienced consultant who will be coming off a successful assignment in Azerbaijan. The US Treasury advisor is currently being recruited to replace the recently departed budget advisor. The selected candidate should be interviewed and selected directly by the Minister of Finance. The proposed technical assistance by the British Know How Fund should be postponed until the Minister has his two new advisors on board.

The MOF Budget Department should be strengthened to become an active participant in the review of line agencies restructuring and downsizing. The Know How proposal might be tailored to fit this role. However, they should be integrated with the US Treasury scope of work. If that is not feasible, the Know How proposal should be rejected. The US Treasury person should be supported with tools, not more advice. USAID should consider a small computerization and software procurement that could form the nucleus of integration of the budget, accounting and treasury database within MOF.

These IMF and US Treasury technicians should be given the KPMG Barents turnover documents that were generated in August 1999. This material is consistent with IFMIS methodology and provides good background for a way forward for institutional strengthening at MOF. No sense in reinventing the wheel. Budget, accounting and treasury staff at MOF should become well versed in the methodology of IFMIS. This could be accomplished fairly easily and quickly by means of a workshop and perhaps an on-site visit overseas where IFMIS has been implemented. Three possible sites that would be relevant and accessible would be Bolivia, Chile and Croatia. The size of government operations in these countries is comparable to Georgia.

MOF remains weak in tax and economic policy formulation. The KPMG Barents advisor, whose term is scheduled to expire in September 2001 should be replaced. Mid-term economic forecasting and revenue projections should continue to be the focus. The Minister of Finance should be encouraged to establish a small unit (5 professionals) to take on this task. USAID or other donors should consider supporting this unit with a small infrastructure of computing and research capability via software modeling and Internet access to other countries' experiences.

The Revenue Ministry should be disbanded and re-incorporated with MOF. Tax and revenue collections should be transferred to the Treasury Department consistent with its role of cash custodian. Tax administration and enforcement would be assigned to an independent department within MOF, reporting directly to the Minister.

Treasury should be limited to collecting receipts, managing public debt, short-term borrowing and paying bills. Treasury should have control over all Government bank accounts. Consideration should be given to centralizing all payments through Treasury. Payment vehicles should be restricted to the issuance of checks or direct deposits in the banking system. The new IMF advisor should be encouraged to pursue this goal even though it may not be possible in the short run. A possible model to be reviewed is the Treasury payment system in Turkmenistan. While nothing else within the Turkmenistan financial processes seems to be worth looking at, they have accomplished a simple and effective way to pay their bills through a consolidated Treasury clearing mechanism. Receipts and payments in Turkmenistan are cleared through the Central Bank network of offices on a daily basis. Treasury maintains a zero balance via overnight transfers to the main Treasury accounts maintained in the Ashgabad Central Bank.

The accounting function within MOF should be clearly defined and given separate status, either within the Treasury Department or as a separate controllership type arrangement. The MOF accounting records should interface with line agencies accounting systems on an IFMIS basis. If the IMF advisor is not prepared to take on this responsibility for directing an accounting unit development, USAID or other donors may consider the recruitment of an additional advisor for this purpose. The Minister of Finance must concur with any such proposal.

While the establishment of an internal audit function within MOF should be a goal, tackling this challenge should be deferred for the foreseeable future. There is little benefit to be gained in auditing a system that is seriously deficient in providing ongoing and current financial and performance data. However, the advisors to MOF should immediately introduce the concepts and practices of establishing internal control mechanisms. The task of establishing internal controls falls on the management of any organization. The Minister of Finance should be assisted in this endeavor.

Institutional Review at Executing Agencies

The assessment of MAF's structure, staffing and functions should be repeated at all public sector agencies. By intuition alone, it is apparent that a country the size and complexity as Georgia does not need a public sector bureaucracy in excess of 100,000. The question is how and where to reduce it. There is no substitution for conducting a thorough review of what the Government is accomplishing with this level of effort. And once that is determined, the next question is whether this output should be the responsibility of government or be relegated to the private sector. Paying salaries and accomplishing little else surely is not sustainable.

An option floated during discussions with the donor community was to perform an intense review of all government operations simultaneously. Let's call that the "McKinsey" approach. Another was to form a permanent secretariat that would guide the effort. Let's call that the "umbrella" approach. There is some merit to both suggestions.

The first, the "McKinsey" approach has the advantage of getting the suffering over quickly. The shock treatment would put executing agencies on notice that their operations were due to be cut, reduced, expanded or whatever. Implementation of recommendations nevertheless would take some time due to the probable serious repercussions in levels of unemployment and predictable opposition. There are also a series of legislative modifications that would be required to dismantle the myriad of enabling rules and laws that allow executing agencies to collect monies and hold bank accounts outside budgetary controls. During the inevitable lapse between the McKinsey overhaul and final implementation the shock might well wear off. Georgians are fully capable of mounting rearguard attacks to defuse and dilute the best intentions of the reformers. The lack of managerial capability generally found within Government would likely lead to mediocre results of a McKinsey style intervention.

The "umbrella" approach that would support a permanent secretariat that could call on additional donor support to take advantage of reform opportunities would more clearly match the Georgians ability to assimilate change. The main challenge to this approach would be the assignment of sufficient authority to carryout an institutional reform mandate. Similar "umbrella" type operations have been funded buy the World Bank and UNDP, with little effect. These two projects came under the guise of "donor coordination. The concept was that if we could just channel all the donor assistance, in a coordinated way, then reform efforts would be more efficient and effective. This approach has not proved to be effective and should not be repeated.

A third approach, which this author supports, does not preclude either the "McKinsey" or the "umbrella" approaches. Institutional review of line agencies' operations, with a view to bring them in line with national needs, should be the sole prerogative of the Budget Department at MOF. Donors should channel resources to enhancing the capabilities for resource allocation of federal financing by means of a rigorous examination of budget decisions. Call it zero-based budgeting or program-performance budgeting if you will. By supporting the budget process, we strengthen the MOF. Most importantly, the review of government priorities and resulting organizational matrices and funding levels would become institutionalized at the only logical place in the government hierarchy that has a global view.

A variation on this theme should also be considered. Select a ministry that has the potential to impact favorably on private sector development, say MAF. Then select an area(s) of the country that has substantial agriculture and agro-business activity. Then, engage the MOF, MAF, Chamber of Control, Inspector General's Office at Revenue, tax collectors, lawyers, judges and relevant NGO's to initiate a "new approach" to managing the relationship between Government and farmers and businessmen. This slice of government funding and private sector within the State would receive preferential treatment. The first step would have the MOF and MAF agree on a realistic budget to solve actual problems faced by the targeted agricultural community. Once agreed, funding would be guaranteed for at least one fiscal year. Salaries of all the government actors listed above would be increased to a "living wage". Tax collectors, auditors, MAF technicians would be provided materials and travel funds to allow them to get out of their offices to perform work. Donor agencies would be encouraged to fund development activities in the targeted areas. These funds or personnel should be incorporated in the annual budget under the title "new approach programs".

This variation would serve as a demonstration to the rest of the Government and to the private sector that there is a way out of the current morass. And the resources involved would likely be minimal, perhaps representing between 5 and 10 percent of the budget. Similar to the McKinsey" and "umbrella" approaches, the MOF Budget Department should take the lead.

Meeting Training Needs

The USAID Mission provided a document written about one year ago in Tbilisi that described the need to organize, build and staff a training center for the Chamber of Control. The document took the form of a task order under the Georgian Enterprise Accounting Reform. As the MOF also requires such a training facility, the suggestion of teaming the Chamber of Control and MOF to establish such a facility on a joint basis was considered. The scope of work outlined in the task order is well defined and supported. It would just be a matter of expanding the scope to include topics related to fiscal management and IFMIS type training.

This idea was basically squashed with the pronouncement by the Minister of Finance that MOF intended to team with the Revenue Ministry's training facility organized and funded under the KPMG Barents contract. He saw no need to have a separate facility for MOF. He had the same idea except that he chose a different partner, one who already has a facility as opposed to a contingent plan to build one for the external audit group.

Taking the lead from the Minister, it is proposed to combine the training facility requirements of the Revenue Ministry, MOF, the Chamber of Control and any one else involved in fiscal management, for example line agencies accounting and budgeting staff. One central training institute could meet the needs of all the parties. In addition to having a core staff, consultants would be encouraged to conduct workshops and training at this site. With a little imagination and management, the training institute could serve as a vehicle to coordinate programs among the donors providing assistance to fiscal reform efforts. The French Government built and supports such a facility in Beirut Lebanon that has been very successful for both delivering training and coordinating donors. It is called the Finance Institute. This could serve as a model for Georgia (with funding from France?). The newly developed training center built for the Revenue Ministry could serve as the nucleus for the Finance Institute of Georgia.