



The Fiscal Decentralization Initiative
for Central and Eastern Europe

Fiscal Equalization in Georgia

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A. Short Executive Summary

The territorial division of Georgia started early in 1921 while the creation of local government institutions and decentralization process in independent Georgia only started in 1991. It was only an attempt at decentralization, producing no serious breakthroughs in terms of reforms. Reforms in Georgia still continue and the most recent is the law on “Budget Authorities of Local Self-Government Entities” adopted on May 24, 2006 which established formulas for fiscal equalization. Despite several streams of reforms implemented from 1991, which enabled the strengthening of the fiscal capacities of local self-government units, some issues remain unregulated. The transfer distribution mechanism and other institutional issues require urgent settlement to allow for an effective system of self-governance.

B. Introduction: General Background

B.1 Brief Overview

Division of the territory began in Georgia in 1921 pursuant to the Soviet principle, “Democratic Centralism.” Accordingly, the country divided into two autonomous republics, one autonomous region (oblast), 65 regions, 10 cities subordinate to the republic and 942 village councils. After regaining independence, there were some efforts to change the existing division. In particular, on the 11th of December 1990, the Supreme Board of Georgia abolished the autonomous region (oblast) of South Ossetia. These modifications were caused not as the result of administrative and territorial reforms but mostly due to political motives and the conflict situation existing in Tskhinvali Region. Since 1993, a special community institute has been established according to an Order of the Chief of the State of Georgia focused on settlement of this problem. Special communities were established on the former territory of Tskhinvali region, Eredvi and Kurta, and on the former territory of Kornisi region, Tigvi. These special communities

integrated the villages and communities existing under the jurisdiction of the central government of Georgia on the territory of Tskhinvali region and equalized them to regions according to their status. In the aftermath of the Abkhazian conflict, a community with a similar status was established in Kodori Ravine, the territory controlled by the top authorities of Georgia.

No other fundamental changes were made to the territorial system of Georgia during the ensuing years thanks to the vision of the country’s government of that period. Pursuant to this vision, the only way to save the country and the state system was a centralized system of government, and the said division absolutely complied with the principles of the centralized state. At the same time, since the end of 1993, the centralized government has become vitally important for Georgia and the fundamental task of retaining the state system meant shaping a regional policy. The distinctiveness of the natural political and territorial system in Georgia was revealed at a crucial moment. It showed that protection of the national interests of the centralized system was absolutely impossible without considering the country’s regional problems. Moreover, the task of effectively implementing centralized management highlighted the importance of creating a regional (territory) level of government. Problems of national importance concerning various regions had not been settled at the regional level. At the same time, the territory showed the most optimal level for identifying the right balance between local and national interests.

Since October 1993, the introduction of territorial administration institutions and commissioners of the Chief of the State has begun in the country. In 1993-95, the country was actually divided into nine regions, apart from the autonomous republics. State commissioners were appointed in each region, under the authority of the statutes of each territory approved by the President of Georgia. A commissioner was a representative of the President, who had to monitor the subordinated territory and supervise protection of national state interests.

Supervision over economic reforms, legitimacy and protection of human rights, law and order and security was within their competence. A collective body existed under the commissioner – Administration of State Commissioner, which was authorized to make decisions on the aforementioned issues on a regular basis. Regional services (which are the territorial bodies of ministries) were being established simultaneous to the creation of Commissioner’s institutes.

The Constitution of Georgia was adopted in 1995 and the issue of forming the state territorial system remained open. According to Item 3 of Article 2 of the Constitution, the internal territorial state arrangement of Georgia is determined by constitutional law, on the basis of the authority demarcation principle effective over the whole territory of Georgia at such a time when there is full restoration of Georgian jurisdiction. Consequently, the territorial arrangement was not actually legally effected. Even more, the Constitution revoked the previously existing main Law on Government, which served as the most principal legal basis for the Institute of the State Commissioner, leaving it practically outside the law. In February 1997, the Parliament passed the Law on the Fund of the State Commissioner, which paved the way for creation of a special financial base to implement social and economic development programs of the territory (region). In April 1997 the Law on the Structure and Activities of Executive Power was passed. According to Article 32 of the law, the State Commissioner is a representative of the President of Georgia within the territorial units specified by the laws of Georgia, or for performance of individual assignments. Unfortunately, the law did not provide for territorial administration as a collective body and equipped the State Commissioner only with the right to perform individual assignments related to the issue of legislative enactments.

B.2 Latest Achievements in Local Government Reforms

The first elections held in 1991 served as a basis for introducing local government institutions and the decentralization process in independent Georgia, although it was only an attempt at decentralization, producing no serious breakthroughs in terms of reforms. The difficult political and socio-economic situation in Georgia at that time served as a key basis for this. Moreover, the policy of the government was inconsistent and often untimely, therefore the reforms were only symbolic and no actual results were achieved during the years.

After adoption of the Constitution on August 24, 1995, many issues stayed within the framework of the law, although the issue of administrative and territorial integrity of the country remained open in the Constitution until the settlement of territorial integrity of the country, but the Constitution did declare the introduction of self-government at the local level. In particular, the territorial and state formation of the country would be determined by constitutional law based on a delineation of functions, after full restoration of jurisdiction of Georgia over the whole country; citizen matters of Georgian national importance would be settled by self-government without violation of state sovereignty. The offices of local self-government representatives and heads of executive authorities were determined selectively, and the procedure for establishing these bodies, their rights and obligations and relation to state authorities were to be provided under organic law.

Based on the said constitutional records, in 1997 the Georgian Parliament adopted an organic law of Georgia on Local Self-Government and Government according to which, elections of local self-government bodies were held in Georgia in 1998. Following these elections, local self-government bodies were established in villages, communities, towns and cities and government representative bodies were established in regions. Thus, following the elections, three types of local units were established in Georgia:

- Local self-government bodies in villages, communities, towns and cities within the region;
- Local government bodies in regions;
- Local self-government and administrative bodies in cities not within the region.

Many problems which required immediate settlement were sorted out within these units, in particular:

- The competence of local self-government and administrative bodies was not clearly delineated, especially with regards to cities not within the region;
- Local government bodies of the region were not decentralized units;
- Decentralized local self-government bodies had no own property and other necessary tools for their activities because according to the law, they had no right to dispose or use the properties;

- Transfers from the state budget to the local budgets (consolidated in the region and in the cities outside this region) were neither special purpose nor on a pro rata basis. This served only as a possible way to balance the difference between income and expenses;
- The main fiscal, political and other tools were at the disposal of heads of executive authorities appointed by the President of Georgia in the region and the cities not within the region, hence the independence of local self-government bodies was low.

Violations of territorial integrity and the unsettled issue of administrative and territorial integrity hindered settlement of the above mentioned problems. Finally, note that actually no local self-government institute had been established and no tangible process in terms of decentralization had been implemented.

Therefore, settlement of these issues was included in the agenda; consequently the Law on Amendments and Supplements to the Law of Georgia on Local Self-Government and Government was prepared and adopted by the Georgian Parliament in August 2001. Concepts of local self-government and administration were defined and delineated under these modifications. Only local self-government bodies were decentralized and local government of the regions was the continuation of central government. The cities not within the region are governed by local self-government. This law stipulates that both representative and executive local self-government bodies are elective, except Tbilisi and Poti, where mayors were, until the current reform of 2006 under implementation, still appointed by the President of Georgia. The President of Georgia appoints the management of regional governments as well.

The law mentioned, determined the exclusive authorities for local self-government. At the same time, regional government bodies do not have such authorities, they enjoy only delegated rights. Local self-government bodies exercise exclusive rights independently according to the procedure established by the law and no other level of government could meddle in their activity, except in instances of a violation of the law.

As mentioned above, Georgia continued its stream of reforms and on April 24, 2006 adopted a new Law on Local Self-Government and Government and on May 24, 2006 a new Law on Budget Authorities of Local Self-Government. This paper concerns the period before these reforms. Thus I will refer to the mentioned laws by providing the amendments ensured in the aftermath period.

B.3 Main Concepts of Local Government, Own and Delegated Functions

The Law on Amendments and Supplements to the Law of Georgia on Local Self-Government and Government of 2001, as mentioned, determined the exclusive authorities for local self-government. At the same time, regional government bodies do not have such authorities, they enjoy only delegated rights. Local self-government bodies exercise exclusive rights according to the procedure established by the law, independently and no other level of government may meddle in their activity, except in the case of a violation of the law.

According to Article 7 of the organic Law on Local Self-Government and Government of 2001, the exclusive authorities of local self-government bodies are:

- a) passing the statutes of local self-government bodies, making amendments to them and controlling their implementation;
- b) possession, use and disposal of local self-government property according to the procedure established by the law of Georgia;
- c) formation, approval, execution and control of the local budget; imposition and removal of local taxes and fees in accordance with the law of Georgia;
- d) elaboration, approval and implementation of complex programs of social and economic development of the subordinate territories;
- e) establishment and liquidation of local services and relevant enterprises;
- f) creation and disposal of housing and construction funds of the local self-government under the law of Georgia and the municipal economy;
- g) creation and maintenance of local archives;
- h) promotion of transport services for the population;
- i) arrangement and maintenance of local information services, and promotion of them;
- j) equipping the subordinate territories with services and utilities and planting of greenery, including a local forest fund;
- k) arrangements for approval of general design of settlements in the subordinate territories with the consent of local bodies with state executive power and control over the construction process;
- l) promotion of the construction of social and cultural institutions;

- m) supply of energy, gas and water, maintenance and development of local melioration networks;
- n) repair, reconstruction and construction of local roads;
- o) maintenance of cemeteries, arrangements of ritual services;
- p) development, approval and implementation of the municipal programs for public health care, social protection and employment;
- q) other matters provided by the legislation of Georgia.

Local self-government bodies exercise exclusive rights according to the procedure established by the law independently and under its own responsibility. The control of state bodies over the execution of the exclusive authority by local self-government bodies is allowed only judicially, to establish compliance with relevant legislative acts and applicable laws under the procedure established by the law of Georgia.

In other words, the law provides for the exclusive authority of the local self-governments and provides a legal safeguard that they will independently fulfill these authorities. In order to fulfill these authorities, the local self-government bodies enjoy full administrative, service, investment and regulatory powers (items 5, 8, 9, 10, 11, of Article 1 of the organic Law on Local Self-Government and Government). Fulfillment of exclusive powers is the most important function of the local self-government and, accordingly, the core part of its activities must provide for the fulfillment of this authority. The European Charter of Local Self-Government covers the same principles.

Own incomes are required for implementation of the said exclusive powers. The matter concerns not incomes in general, but own finances as provided under Clauses 3 and 4 of Article 34 of the organic Law on Local Self-Government and Government, i.e. income that may include local taxes, and revenues received from federal taxes, including compensatory transfers. The local self-government bodies must freely command finances. According to Clauses 1 and 2 of Article 35 of the said organic law, local authorities' financial resources shall be commensurate with the responsibilities provided for by the law of Georgia. In our practice, we faced a situation when these incomes were not provided for by the law for the self-government units within the region, but as for the cities not within the region (including Kutaisi),

the law provided for financial resources.

Most of the incomes to the cities not within the region are from outside, such type of finances which they cannot dispose of freely and independently; accordingly, they are unable to use such resources for the fulfillment of exclusive powers.

Delegated powers to local self-government bodies are defined under Clause 2 of Article 7 of the organic law on Local Self-Government and Government:

- implementation of environmental, sanitary and veterinary activities;
- assistance to local administrative bodies in the matters of call-up;
- exercise of other powers provided by the Law of Georgia.

And, pursuant to Article 8:

- a) ***in the education sphere*** – care and maintenance of educational institutions (kindergartens and nurseries, primary and secondary schools, boarding houses, secondary vocational schools), funding operating costs and capital disbursements;
- b) ***in the cultural sphere*** – establishment and maintenance of museums and exhibitions, music schools, libraries, cinemas, cultural and recreation institutions, funding operating costs and capital disbursements; implementation of protection and promotional activities in connection with the monuments of culture located on their territories;
- c) ***in the health and social affairs sphere*** – maintenance of hospitals and outpatient clinics, old people and children's homes; orphanages and homes for disabled children, funding operating costs and capital disbursements, aid to vulnerable people, arrangement of programs for social protection and employment of population;
- d) ***in the financial-economic, agricultural and natural resources sphere*** – control over approval and implementation of the local budget; imposition and revocation of local charges and fees in accordance with Georgian law; elaboration, approval and implementation of complex socioeconomic development programs on the subordinate territory; solutions to land use matters on the subordinate territory; oversight and arrangement of environmental, ecological, sanitary, epidemiological and veterinary activities; disposal, use and management of the subordinate

state-owned property in accordance with Georgian law; establishment and liquidation of local agencies and enterprises of appropriate organizational and legal status; decision making over use of natural resources under Georgian statutory and case law; participation in the creation of state programs, establishing their funding shares and ensuring their implementation in accordance with procedures established by Georgian legislation;

e) in the sphere of conscription, public order and security – obligatory prescription; assistance to the Ministry of Defense of Georgia for organizing military training and the supply of agricultural products to military units; handling citizen military registration; protection of public order; civil defense; fire protection activities; civil acts registration; liquidation in the case of disasters, natural calamities and epidemics; promotion of civil defense activities; mobilization of residents and transport facilities in instances provided in Georgian legislation;

f) solution of other matters. As mentioned above, I also refer to current reforms now being implemented although this paper mostly describes the situation prior to these reforms. According to the organic Law of Georgia on Local Self-Government and Government of April 24, 2006, exclusive and mandatory competencies exist. Exclusive competencies can be financed only by the local self-government. These kinds of competencies are financed without any agreement with the central government. They are:

- Possession, use and disposal of local self-government property;
- Possession, use and disposal of local self-government land resources according to procedures established by Georgian law;
- Discussion and approval of the local budget, making changes and additions to it, execution and control of the local budget;
- Imposition of local taxes, fees and setting rates according to Georgian law;
- Requisitioning of local fees;
- Land use planning, division of the territory of self-governing entities into zones (green areas, relaxation, enterprise, trading and other special zones), imposing and changing its borders;
- Administration of the local forest fund and water resources;
- Review of construction works under Georgian law and supervising the local ongoing works;
- Regulation of transport services;
- Regulation of external trade;
- Regulation of external advertisements;
- Municipal maintenance including housing duties and services, defining parking places; cleaning and lighting streets in the settlements, supplying water, maintaining cemeteries, arranging ritual services, developing local melioration networks; alternatively, organizing municipal procurement for these activities;
- Repair, reconstruction and construction of roads of local use;
- Organizing social and cultural activities and supporting relevant local units (archive, library, museum, education institutions and etc.) projects;
- Creating kindergartens and nurseries, approval of their statements, appointing a person responsible person for representing and controlling their activities;
- Territorial arrangements of self-governing entities under Georgian law;
- Approval of the socio-economic development priorities, municipal programs and plans of the self-governing entity;
- Mobilization of resources in the health and social defense sphere; development, approval and implementation of relevant activities (building a safe living environment, supporting a healthy lifestyle, identifying health risks) under Georgian law and informing the population of these issues;
- Regulation over the conduct of meetings and demonstrations according to Georgian law;
- Define and organize traffic regulations on the territory of the self-governing entity;
- Executing local procurements;
- Naming and numbering the streets and squares.

Mandatory competencies are financed by the local self-government entity in the social, cultural and educational spheres. Expenses for the implementation of delegated powers defined by the organic law of Georgia on Local-Self Government and Government are delineated according to Georgian law or on the basis of a delegation agreement. The exercise of exclusive and mandatory powers that may conflict with Georgian legislation, cause a decrease in free trade or otherwise cause problems to the citizens of Georgia; in realization, these constitutional rights are prevented according to the organic law of Georgia on Local-Self Government and Government.

B.4 Number and Size of Local Authorities

Following the elections of local self-governments held in 1998, which laid the foundation of self-government and decentralized management in Georgia, the ongoing reforms of administrative and territorial division became vitally important. Elections of local authorities were held in 1031 administrative units [971 self-government (village, community, town, city) and 60 local government (cities not within the region, and regions) units].

Note that the organic law of Georgia on Local Self-Government and Administration passed in 1997 made certain modifications to the administrative and territorial division. The so called city zones (Gagra, Tkibuli, Tskaltubo and Chiatura) became regions. There was a division of cities under subordination of the republic, an autonomous republic and a region was revoked. The organic law provided for three categories of cities: 1) capital of Georgia; 2) cities, not within the region (Batumi, Rustavi, Sokhumi, Poti, Kutaisi and Tskhinvali) having exclusive status; and 3) cities within the region. Based on the said law, the Statute on Procedures of Settlement of Issues on Administrative Arrangement of Georgia was approved by Decree N321 of the President of Georgia dated May 14, 1999. This Statute provides for the procedure for creating or cancelling cities, regions, city districts, communities, towns and villages of Georgia, delineation and changes to frontiers, and accounting for naming and renaming and registration thereof. In compliance with the said Statute, administrative and territorial changes were made in 1999–2002. Mainly, villages were disaffiliated with communities. In particular, according to Orders of the President of Georgia No. 83 of March 7, 2000, No. 389 of September 27, 2001 and No. 207 of May 2, 2002, villages left different village communities and 27 new administrative units were established. Correspondingly,

on the 2nd of June, 2002 elections were held in 998 self-government units.

One might conditionally sort out three levels in the territorial system of Georgia:

- upper (regional) level (capital, autonomous republic of Ajara and Abkhazia);
- intermediate level (a region and six cities not subordinate to the region);
- lower level (village, community, town, city).

B.4.1 Upper (Regional) Level

In the years 1993–95 regions (except the regions within the autonomous republics) were grouped according to economic, historical and ethnic levels. Hence, the country was practically divided into nine regions and state commissioners were appointed in each region. Following the escalation of conflicts existing on the territory of South Ossetia autonomous region (oblast), and then on the territory of the autonomous republic of Abkhazia, the majority of these territories fell into the hands of separatist forces, and the question on formation of the state territorial system remained open. According to Item 3 of Article 2 of the Constitution, the internal territorial state arrangement of Georgia is determined by constitutional law on the basis of the authority demarcation principle effective over the whole territory of Georgia at such a time when there is full restoration of Georgian jurisdiction.

This provision of the Constitution postponed both the issue on termination of the status of the autonomous republics of Ajara and Abkhazia and legitimating actually existing regions.

Only the capital of the country is legally affected at this level. The status of the capital, the joint competence of the state and the capital, the authority of the representative and executive bodies of the capital and the procedure of its establishment is specified in the Law on Tbilisi – the Capital of Georgia in compliance with the Constitution and the organic law on Local Self-Government and Government. The capital is divided into 5 districts, but there will be no representative bodies in the capital. There are only executive bodies – district Boards of Administration (Gamageoba). Sakrebulo is the united representative body of the capital. The government is the united executive body of the capital, which ex officio includes administrators (gameblebi) of the districts of the capital.

B.4.2 Intermediate (Government) Level

The intermediate level encompasses regions and the so-called independent cities (cities not within the region). Georgia is divided into 67 regions and 6 “independent” cities, wherefrom 6 regions and one independent city are a part of Abkhazia, and 5 regions and one independent city belongs to the Ajara autonomous republic.

As a result of modifications to the organic law of Georgia on Local Self-Government and Administration made on August 2, 2001, the cities not within the region were granted the status of self-government units. These cities have the delegated powers relevant to the competence of local governments as provided under the organic law.

B.4.3 Lower (Self-government) Level

The lower (self-government) level encompasses villages, communities, towns and cities which are consolidated in regions.

According to the Statute on Settlement of Issues on Administrative Arrangement approved by the President of Georgia, a village is a settlement (in spite of the number of inhabitants), including a land plot and other natural resources necessary for agricultural activity; a community is a union of one or two settlements (mainly of several villages) that has a united body of local self-government and an administrative center. Only self-government bodies of a community are elected in the villages that are part of the community; a town is a settlement with at least 3,000 inhabitants, which has industrial plants, a municipal economy, a network of medical and socio-cultural institutions, through which it fulfills the functions of a local economic and cultural center; a city is a large settlement with at least 5,000 inhabitants, a municipal economy and is an economic and cultural center.

In total, there are 55 cities, subordinate to the region, 49 towns, 843 communities and 164 villages where self-government bodies were elected.

Therefore, there are a total of 1,111 self-government units including 4,597 settlements on the lower (self-government) level. In 2002, elections of representative bodies were held in 998 self-government units. The elections were not held in the autonomous republic of Abkhazia and on the territory of the former autonomous territory of South Ossetia which do not fall within the jurisdiction of Georgia.

Table 1. presents the number and size of self-government units in Georgia.

Table 1.

Inhabitants of Administrative and Territorial Units of Georgia (Quantity of Self-Government Units Relative to Quantity of Inhabitants)

Inhabitants	Self-Government Units
More than 10,000 inhabitants	49
7,000–10,000	33
5,000–7,000	57
3,000–5,000	171
2,000–3,000	199
1,000–2,000	260
500–1,000	123
Less than 500 inhabitants	80
Total	972*

Note: * No information was gained on the other 26 units.

It should also be mentioned, that according to the new law of Georgia on Local Self-Government and Government adopted on April 24, 2006, there will only be 68 self-governing entities (villages, communities, settlements and etc.) after the elections which will be held in autumn this year. Thus, the government implemented a major consolidation of the self-governing entities.

Legal Independence of Local Authorities in Relation to the Following: Budgeting, Tax Collection, Expenses, Right of Ownership, Taking of Loans, and Legal Ground for These Functions.

According to Item 4 of Article 2 of the Constitution of Georgia passed in August 24, 1995, “citizens of Georgia regulate matters of local importance through self-government as long as this does not encroach upon state sovereignty.” This paved the way for the formation and development of self-government bodies. The reform of local self-government and administration and the formation of its financial structure passed through several phases. The collapse of the Soviet political system was followed by a sharp letup of local government that complicated the social and economic situation. Thus, in practice, local government did not operate. Local economies were paralyzed. Municipal economies faced pending losses, and local funds were embezzled.

The legal enactments on sakrebulo and prefectures adopted in 1991–1992 not only failed to improve the existing crisis situation but aided the deterioration of local governing bodies. Sakrebulo failed to fulfill the

functions vested with them because of their institutional weaknesses and the lack of democratic traditions. At the same time, the scope of prefects' competence was not regulated during the national decision making process and were void of any legal and institutional frameworks.

Approval of the Statute on Procedure for Settlement of Issues of Local Governing Bodies and Administrative Arrangement by Orders (No. 362 of September 16, 1995, No. 702 and 703 of December 29, 1998, and No. 321 of May 14, 1999) of the Chief of the State of Georgia (the President of Georgia) was vitally important. Superior bodies were prohibited, to ensure no administrative interference in the competence of local bodies of the government. Prior to adoption of the constitutional law on the Territorial State Arrangement of Georgia, a procedure for the creation and cancellation of cities, regions, city districts, communities, towns and villages of Georgia, the delineation and change of frontiers, transformation, accounting of naming and renaming and registration thereof, was established. The structure of the government of local bodies was significantly adjusted, a procedure for formation and activity of the Board of Administration was defined, and competence of administrators and the Board of Administration was demarcated. Mainly, the board of administrations with enterprises, organizations and institutions in the subordinate territory were formulated.

The transition of the government's regulatory approach to market trends required carrying out fundamental reforms to the whole financial system and, especially to its main element, the budget system. The period following the regaining of Georgian independence showed that autonomous budget operations were one of the most difficult problems. The Law on Budget System and Budget Authorities (May 29, 1995) played a key role in partial settlement of this problem. This law provided for the drafting, consideration, approval and execution of budget receipts and expenditures, as well as articulation of basic principles for receipts and expenditures for the state and autonomous republics of Georgia and other territorial units of Georgia (region, city, town, community and village). This law also provided for general financial and budget authorities of superior bodies of the government of Georgia and autonomous republics and representative and executive bodies of government, and guidance on: principles of budgeting, budget classification mechanisms, procedures for sequestration and protected provisions, and the inter-dependence of budgets with other elements of the financial system.

The Georgian Budget System Law (April 24, 2003) repealed the said law. This Law determines the principle

of formation of the budget system of Georgia and regulates budget drafting, approval, fulfillment, reporting and control as well as budgetary relations and the responsibility of the central authority of Georgia, authorities of autonomous republics and local authorities.

A new law, Budget Authorities of Local Self-Government Entities was adopted on May 24, 2006. This law filled the vacuum concerning local self-government budgets. In relation to the budgetary process, competences between representative and executive bodies of local self-government are plainly divided, for instance:

- The local self-government *executive* body's competences are: forming and presenting the budget projects of local self-governing entities, preparing and presenting changes to the budget, budget execution and reporting.
- The local self-government *representative* body's competences are: hearing, discussing and adopting of the budget projects of local self-governing entities, making changes prepared and presented by the executive body in the budget, controlling the budget execution, assessing and reporting approval on its execution.

According to the Law on Property of Local Self-Governing Entities, the property of local self-government is divided into primary (non-disposal) and additional property. Primary property is used to carry out self-governance activities and can be used only for the execution of public functions and authorities. Disposal of this property is permitted only after cessation of its function which may be caused by obtaining new property. Primary property does not have to be located on its own territory. It can be located on the territory of another self-governing entity or in an area that is not a property of any self-governing entity. For instance, the initial point of a water pumping facilities can be located at a place which is not a territory of any self-governing entity, but can be a property of one or two self-governing entities.

The legal and organizational basis of economic activity of local self-government and administrative bodies in Georgia is provided under the Law on Arrangement of Economic Activity of Local Self-Government and Administration Bodies (June 11, 1999).

Complex provisions which formed the basis of local self-government and administrative bodies were formulated in the organic law of Georgia on Local Self-Government and Administration (October 16, 1997), especially when it was modified in August 2, 2001. Based on this law, the exclusive rights of local self-

government and the delegated powers of local government were demarcated unilaterally and unambiguously. The following terms were fully defined: “local self-government,” “self-government unit,” “local representative and executive bodies,” and “local administration.” The main economic arrangements and budgeting processes of local self-governments as well as the types of transfers were sorted out.

Laws on separate taxes were adopted at the end of 1993, which paved the way for creation of a national tax system in Georgia. It developed general principles for the formation of a tax system and established methodological principles for the formulation of taxes and fees. Adoption of the Tax Code of Georgia in 1997 was a crucial step towards formation and improvement of the tax system of Georgia. This law provided the legal procedure for the imposition, changes and cancellation of taxes, principles, forms and methods tax payment, established the types of federal and local taxes and determined the functions of local self-government in the process of fixing local taxes. In compliance with Article 208 of the Tax Code, local self-government (and not government) bodies shall, within the scope of their competence, set limited rates and establish terms for payment of these taxes in compliance with the Code. National tax authorities monitor payment of local taxes. Since January 1, 2005 a new Tax Code has come into force and effect, which preserved only two local taxes: property tax (including land) and gambling business tax.

Based on a correlation of mutual obligations between the budgets of the State of Georgia, the autonomous republics of Abkhazia and Ajara and other territorial units of Georgia, to form a stable basis for local budget revenues at all levels, the Laws of Long-term Economic Standards of Allocations from Federal Taxes to the Budget of Autonomous Republics of Abkhazia and Ajara and other Territorial Units of Georgia were issued. In particular, this kind of law was passed on February 21, 1997 (for 1997–1999) and on March 10, 2000 (for 2000–2004). Since January 1, 2005, the Law on Distribution between Tax, Non-Tax and Capital Incomes Budgets changed the mechanism of distribution of incomes between the budgets of different levels to some extent.

According to Article 35 of the Law on Local Self-Government and Administration, a local self-government body is entitled to take a loan in the amount and according to procedure established by law. According to the Law on Budget System, loans are one type of local budget receipts and therefore the loans received from

the state budget and budgets of autonomous republics and are determined by this Law.

C. Basic Structure of the Intergovernmental Financial System

C.1 Revenues

According to the Law on Budget System, local budget receipts are the following:

- Revenues:
 - current tax revenues;
 - current non-tax revenues;
 - capital revenues;
- Grants, received from internal and external sources;
- Loans, which are other loans received from the state budget, republican budgets of autonomous republics and determined by this Law.

All types of budget funds and state special funds are divided into source of revenue and deficit financing.

Revenues are divided into tax and non-tax revenues.

- **Tax revenues** are the integrity of sums accrued according to taxes specified in the law of the country (Tax Code of Georgia). Federal and local taxes may be distinguished according to the level of government.

Federal taxes: – Income Tax;
 – Profit Tax;
 – Value Added Tax (VAT);
 – Excise;
 – Social Income.

Local taxes: – Property Tax;
 – Gambling Business Tax.

- **Non-tax revenues** consist of the following:
 - Taxes and fees received from issuing permits, licenses and other state services;
 - State fee (this tax is paid in court during an appeal, issue of different documents by the state, etc);
 - Income gained from the lease of state property;

- Dividends and parts of profit received from legal entities established through state property in full or by state property participation;
- Royalty (charge for extraction and use of minerals, for use of copyrights, patent, trade mark and other rights);
- State loan, deposit, bill of credit and other interest (percentage rate);
- Income from the sale of state property;
- Income from grants.

According to the budget law, a budget of any level may be profit and deficit. The positive difference between the budget receipts and cash grants, on the one hand, and the outlays and crediting, on the other hand, represents *budget profit*. *Budget deficit* is when outlays exceed revenues. A deficit is covered by an increase of state debt and the use of credit resources, as well as income gained from privatization of state property according to the state programs.

Sources of deficit financing:

- Foreign credits and loans;
- Internal credits and loans, including sums mobilized from state treasury liabilities;
- Sums received from privatization.

In compliance with the Law on Distribution between Tax, Non-Tax and Capital Incomes Budgets, mobilized taxes are distributed between budgets of different levels. According to the law, property and gambling business taxes shall be fully paid to the budgets of local self-government. Local, income and profit taxes of cities not within the region shall be fully paid to their budget. Federal taxes are distributed in the manner described in Table 2.

According to the mentioned law, the following shall be paid to the budget of local self-government units:

Tax revenues include property taxes and the gambling business tax; non-tax revenues, which consists of license fees for street trade, outdoor advertising, use of public places, vehicle parking; tender fees established by representative bodies of local self-government; state fees established by executive bodies of local self-government; fees from the lease of property and land owned by the local self-government; fees from the sale of property owned by local self-government, and; dividends received from enterprises established by share participation of this self-government unit.

Transfers from state budgets play a key role in the formation of budget revenues. According to the organic Law on Local Self-Government and Government, the following issues are defined in relation to transfers:

There are three types of transfers: compensatory transfer, purpose-oriented transfer and special transfer.

Table 2.
Distribution of Tax Revenues Between the State Budget of Georgia, Budgets of Autonomous Republics of Abkhazia and Ajara and Other Territorial Units (2005)

Incomes	State Budget	Regional Budget	Municipal Budget not within the Region	Budget of Other Territorial Units
Income tax		100.0	100.0	
Profit tax		100.0	100.0	
Value Added Tax				
Mobilized by tax authorities of Georgia	100.0			
Mobilized by tax authorities of autonomous republics	100.0			
Imported products	100.0			
Excise				
On products sold on the territory of Georgia	100.0			
Imported products	100.0			
Customs duty	100.0			
Social tax	100.0			
Local taxes				
Property tax			100.0	100.0
Gambling business tax			100.0	100.0

According to the organic law, a special law defining the formula for distribution of *compensatory transfers* must be adopted. No such law was passed before May 26, 2006 when the formula for delivering equalization transfers was determined (see Appendix 5b). *Purpose-oriented transfers* are funds transferred to finance delegated authorities. *Special transfers* are funds allocated in case of natural disasters or other special cases.

According to Clauses 3 and 4 of Article 34 of organic law, local self-government is granted the right to its own income, i.e. income, which the local self-government acquires independently. Such income may be any kind of income (local tax, local fee, revenues received from federal tax, compensatory transfers), but this principle is not relevant to purpose-oriented transfers. According to the organic law, particular types of own revenues of local self-government must have been provided under the law and, no such changes were made to the law. The main types and amount of revenues are still determined by the region.

Powers are delegated to regional governments and local self-government bodies of the cities not within the region under the organic law. Such delegated powers are listed in Clause 1 of Article 8 of this law. Moreover, Clause 2 of Article 7 specifies the powers delegated directly to local self-government.

C.2 Expenditures

The organic law of Georgia on Local Self-Government and Administration grants authorities to the self-government units of the region, municipalities within the region and the cities not within the region. Local authorities must make budget expenditures in compliance with the granted authorities.

Local budget expenditures are divided into current and capital expenditures, crediting and depreciation of debt. Capital expenditures are all budget allocations for funding investment and innovation programs, as well as all expenses related to the increase of capital. All other expenditures, allowances, expenses borne for goods and services, current transfers, subsidies, payment of loans and other current expenses are current expenditures. Crediting means participating in the shared capital, and depreciation of debt is payment on the principal amount of the loan.

A classification system was developed to help the state estimate and analyze their expenses properly. According to this classification, each type of expenditure has its own number. The budgetary classification is

the systematic classification of the budget receipts and outlays, which includes:

- Classification of revenues according to the source of the revenue and delimiting the current and capital revenues;
- Economic classification of expenditures according to the type of expenditures and delimiting the current and capital expenses;
- Functional classification of expenses according to the similarity of the purpose of expenses;
- Organizational classification of expenses according to the spending institution.

The classification of budget revenues is designed to ensure proper and accurate accounting of state receipts. Accordingly, taxes and non-tax revenues (including other budget revenues) are divided (classified) into separate groups pursuant to certain criteria and features. Revenue is divided into six main groups, which are then classified according to different groups, functions and appropriate budgets:

- 1) Tax revenues;
- 2) Special state funds;
- 3) Non-tax revenues;
- 4) Revenues from capital operations;
- 5) Grants;
- 6) Loans.

Economic classification of budget expenditures meets two goals: 1) helps the Parliament and executive bodies assess the impact of state expenditures on the economy; 2) assists in estimating the accuracy and expediency of scheduled expenditures towards the attainment of defined goals.

Economic classification divides expenditures into three main groups: current expenditures, capital expenditures and crediting less payment.

Current operational expenses (salaries, bonuses, business trips, office expenses, expenses for public utilities, etc.) are recorded in current expenditures by government organizations of the country.

Capital expenditures are made in pursuance of the key objectives of the country's economic development. Capital expenditures include all sorts of budget expenditures for funding investment and innovation programs,

as well as all the expenses related to the increase of capital (purchase and major overhaul of buildings and equipment, purchase of a land plot, etc.).

A credit less payment is the volume of loans recognized by the government, less their redemption (amount paid off).

Functional classification is designed to display the state expenditures in relation to a broad national goal. Functional classification systems enable the government to plan, distribute and analyze expenditures in compliance with main groups (functions), compare the expenditures to similar large categories of expenses in different countries and help make certain conclusions. The functional classification system in Georgia was accepted by Order No. 153 on Budget Classification of Georgia by the Minister of Finance of Georgia dated March 15, 2004. There are 14 functional groups in the Georgian budget:

- 1) general-purpose state services;
- 2) defense;
- 3) public order and safety;
- 4) education;
- 5) health protection;
- 6) social insurance and social welfare;
- 7) housing;
- 8) organization of recreation and cultural-religious activity;
- 9) heat and power engineering complex;
- 10) agriculture, forestry, fishery and hunting;
- 11) mining and processing of mineral resources (less fuel), construction;
- 12) transport and communication;
- 13) other services related to economic activity;
- 14) expenditures not included in the main sections.

Functional classification unifies the expenses designed for the same or similar purpose. For example, a hospital subordinate to the Ministry of Defense falls within the health protection group according to the functional classifier.

Organizational classification covers expenditures according to the spending institution, from which finances must be allocated certain levels of the budget.

D. Measures of Equalization

Transfers from central budgets are a major part of local self-government and government revenues. According to the organic Law on Local Self-Government and Government, there are three types of transfers:

- purpose-oriented transfer;
- compensatory transfer;
- special transfer

According to the organic law, a special law defining the formula for distribution of *compensatory transfers* was required to be adopted. No such law was passed before May 26, 2006, when a formula for equalization transfer was determined (see Appendix 5b). Second, *purpose-oriented transfers* are funds transferred to finance delegated authorities. Third, *special transfers* are funds allocated in cases of liquidation, natural disaster or other special circumstance.

Own incomes are required for implementation of the said exclusive powers. The matter concerns not incomes in general, but own finances as provided under Clauses 3 and 4 of Article 34 of the organic Law on Local Self-Government and Government, i.e. income that may include local tax, revenues received from federal taxes, local fees, non-tax revenues, including compensatory transfers. The local self-government bodies must freely command finances. According to Clauses 1 and 2 of Article 35 of the said organic law, local authorities' financial resources shall be commensurate with the responsibilities provided for by the law of Georgia. In our practice, we faced a situation where these incomes were not provided for the self-government units within the region by the law. The law provided for financial resources to the cities not within the region (including Kutaisi), but not for own incomes. The majority of the incomes of the city budgets not within the region were from outside, of such type that cannot be spent freely and independently. Accordingly, such resources could not be used to fulfill the exclusive powers.

According to Item 5 of Article 6 of this law: "delegation of powers to local self-government bodies by the state authorities is allowed only under the law of Georgia, along with the transfer of adequate material and financial resources." Pursuant to Item 3 of Article 34, the programs and events provided under the delegated authority shall be funded by the transfer of specially allocated funds and/or by other relevant revenues; and according to

Item 3 of Article 351, “the purposeful transfers shall be used for exercise of the powers delegated by the state bodies.” In other words, delegated authorities must be secured in full. There is only one reasonable form of securing delegated authorities – a purpose-oriented transfer, but unfortunately, as mentioned above in the organic law, “by the transfer specially allocated for such purpose and/or by other relevant revenues.”

It is interesting that the majority of budget revenues of the cities not within the region may be determined by the central authority as “any other appropriate revenue” through which delegated authorities are financed. This logic is continued in Item B of Article 14, Items 1, 3 and 17 of Article 21 of the law of Georgia on State Budget of Georgia – 2003. According to these items, the central authority assigns the local self-government to pay some expenses (e.g. public health, social security) to the budget. A number of such kinds of enactments exist and may exist. Correspondingly, the central authority is able to pass laws or by-laws, the realization charges of which the central authority assigns to the city specifying that it has provided standards from federal taxes for this purpose.

While defining transfers to each local budget, negotiations are always carried out between the central authority and the local government as it is a tool to improve the balance of the local budget. In this case, the government demonstrates skepticism regarding the volume of misbalance of the local budget; and thoroughly considers the consolidated receipts and expenditures of the budgets of regions and cities not within the region according to the types thereof. In this case, the central authority points out that the local government may increase income and decrease expenditures pursuant to the types of separate revenues so that the amount of transfer is acceptable to the central authority.

E. Wrap-up

E.1 Advantages and Disadvantages of the National Financial System

Based on the aforementioned activities and analysis, the situation of local finances and transfers is the following:

- *There are no legislative enactments on local budgets in Georgia, which would completely regulate: the*

provisions of the European Charter of Local Self-Government; the procedure for financial provision to fulfill the exclusive and delegated authorities under the organic Law on Local Self-Government and Government, and; the requirements of the law of Georgia on Budget System. The applicable law provides only for general principles of formation and implementation of local budget, and does not thoroughly delineate the budget authorities of local self-government and government. None of the existing normative acts govern the types of budget revenues of local self-government units, or the budgeting mechanisms, and they fail to ensure their financial self-sufficiency;

- *There is not a uniform operating system of long-term economic standards of allocation from taxes and non-tax revenues for formation of budget revenues of local self-government units. Budget revenues between the State of Georgia, autonomous republics and other territorial units of the country are demarcated according to the procedure of the applicable law of Georgia. Moreover, these revenues are designed for consolidated budgets of autonomous republics and other territorial units of Georgia;*
- *The state property owned by local self-governments has not yet been transferred to their possession according to the appropriate normative acts, although some months ago the Parliament adopted the Law on Property of Local Self-Government Units and it is being implemented now. The financial outlook will be somewhat increased by the transfer of the property to the local self-government units;*
- *The applicable law does not provide for a unique lawgiving approach for putting local taxes and local fees entirely into the possession of local self-governments and the introduction thereof;*
- *Despite the existence of the law, territorial units with a low number of inhabitants and poor economic potential do not integrate voluntarily;*
- *Revenues received from local taxes and fees are low (on average, not exceeding 15%) and will not contribute adequately to financial independence;*
- *Classification of budget receipts and expenditures must be improved; it must completely comply with the international classification of state finances.*

The applicable classification does not provide for the coding of local self-government units' expenditures;

- *Treasury services of the budget must be improved.* At present, this service is rendered by regional (city) financial offices on a limited basis. This process is implemented by local self-governments in a primitive manner;
- *Accounting procedures for local self-government budgets must be approved as well.* Any newly introduced uniform methods and forms of accounting must allow for the specific features of the types of receipts and expenditures of local budgets;
- *Elected local self-government bodies, except the four cities mentioned above, cannot freely forecast their own budget receipts pursuant to the types of revenues provided by the law.* As this is not governed by the law, regional government units determine the types and actual amount of revenues to self-government units within the composition of the region, absent any established procedure on an annual basis;
- *Delegated authorities are mostly encumbered with the activity of local self-governments.* The quality of their independence is evidently limited and practically becomes functionary, merely executing orders made by a higher level of government. The central authority, local government bodies of the region and the big machine of the President territorial commissioners would have performed these functions without local governments. Subject to the foregoing, the appointment by election of local governments loses significance as the elected bodies are vested solely with the function to fulfill vertical orders.
- *There are functions naturally vested with local self-government, but the taxes related to them belong to the region:* E.g. building licenses, permits to change an architectural structure, national transportation charges, as well as tender fees, which is only a regional fee, whereas the tenders themselves must be held by local self-governments.
- *The concept of a "local budget" is not clearly defined.* Correspondingly, two different types of budgets – a local self-government (village, community, town and cities within the region) budget; and a local government (regional) budget combined under one state. Normative acts provide only for the general concept of a local budget. Accordingly, there is not

an individual approach to these budgets of different types and concept.

At the same time, the structure and volume of budget receipts was completely modified by the changes made to the Georgia Budget System Law at the end of December 2004, by passing a new Tax Code and the Law on Distribution between Tax, Non-Tax and Capital Incomes Budgets. The resulting tax yields decreased. In particular, there are only 7 taxes¹ instead of 21 taxes; the rates and taxation objects of some taxes, as well as the mechanism and amount of sums distributed among the budgets decreased. As the result of these changes, the local self-government units received rather low tax receipts; hence they became more dependent on the central authority for transfers. The main results of the modifications are:

The quite big tax reliefs available in the property tax left most local self-government units (especially villages, communities and towns) without incomes². In particular:

- A family, whose annual income does not exceed 40 thousand lari³, is exempted from a tax on the property of a natural person. Families with income exceeding the annual income limit, do not live in villages, communities and towns, and not even in the centers of regions, most of these families live only in Tbilisi and some other cities. This resulted in the following: ***more than 90% of local self-government units do not have income from the property tax on natural persons.***
- A farming land plot (up to five hectares), which was in the ownership of a natural person as of March 1, 2004, is free from a farm land tax. Self-government

¹ Although it should be mentioned that according to the new Tax Code a property tax includes a new property tax on enterprises and natural persons, land tax and vehicle owner's tax plus a new sub-type of taxes on owners of airplanes, helicopters and yachts (launches); income tax includes the recently existing tax for property transfer as a difference between prices of the property granted. Thus, discussion over the decrease of the amount of taxes threefold is very relative.

² Today the number of such self-government units in Georgia amounts to 920, out of 998 self-government units in Georgia, including Tbilisi.

³ GEL – Georgian national currency

units with many land plots, on average having more than five hectare-area lands for each owner is a rare event, probably, 15–20% of total self-government units. This resulted in the following: *most self-government units do not receive income from a farm land tax. The organization, maintenance and development of a melioration system falls directly within the competence of self-government unit; it turns out that even if a land tax is not paid, a self-government unit must provide this service to their population from some other source of income.*

- Non-farming land is land not used for agricultural purposes. Lands with building and construction thereon, as well as enterprises and open pits may be considered non-farming land. Most of Article 276 of the Tax Code provides for such exemptions. In such conditions, *the majority of local self-government units (villages, communities and towns) do not receive income from a non-farming land tax. Only cities have this key source of income.*
- Operable enterprises (both Georgian and foreign) and organizations, on the balance of which is registered taxable property⁴. One would rarely find such enterprises and organizations in villages, communities and towns. There are mainly trade objects, the activity of which does not require fixed assets subject to taxation. As a result, *most self-government units do not practically get income from property tax.*
- Automobile owners that own their cars for more than 6 years, despite the volume of their engines, must pay GEL 5 per car. Since the majority of cars registered in Georgia are in this category, the budgets of self-government units cannot obtain significant income from these taxes (except the budgets of Tbilisi city and some other big cities, where motorcar owners own rather new motorcars and are subject to a higher tax). *GEL 5 a year is a very scant amount which cannot even cover the administrative expenses for collecting this tax*⁵. At the same time, some cars are registered in different regions, but they are actually in Tbilisi and drive on its roads. *The impact of this tax on the budgets of the self-government unit will total a maximum of GEL 1000 per year in villages, communities and*

towns, with aggregate ownership of less than 200 cars.

- Yachts (boats), helicopters and airplanes owned by natural persons are mainly registered in the territorial units such as Tbilisi, Batumi, Poti, Kutaisi, and some others. Therefore, *more than 95% of local self-government units do not practically have any income from taxation of such property in their budgets.*

Note that revenues from taxes on gambling businesses contribute to the budgets of some local self-government units but most of the budgets of self-government units (especially, villages, communities and towns) do not have income from such businesses. In particular, proceeds received from selling lottery tickets, gambling tables and game-playing machines allocated for gambling and prize-winning games, bingo and lotto, bonus games and electronic games are taxable objects of the gambling business tax. *There is no village, community or town in Georgia, where such form of gambling business is arranged, and accordingly, the budgets of these self-government units do not receive any kind of income from them. This tax still remains as a source of income in Tbilisi and other cities.*

As to non-tax incomes, their nature and object of taxation has not changed significantly. As it was before, considering the type of such income, the budgets of self-government units still are the only source of these poor incomes. Such taxes are not applied on the territory of most self-government units, as they do not have any source of payment.

E.2 General Overview of Advantages and Disadvantages of Existing Equalization System

During the period of the previous budget system in Georgia, the central authority always transferred certain finances to local budgets, though not in any logical operational way (appropriate use, equalization, etc.). Referring to the so called transfer past of Georgia, one must note the following disadvantages:

- At present there is no mechanism or appropriate formula for defining purpose-oriented and compensatory transfers in the country. Similar to the allocation

⁴ Property (fixed assets), costing up to GEL 1000, is not registered or subject to a property tax.

⁵ When the requirement for technical examination of an automobile is restored (by January 1, 2007), this avoidance mechanism will no longer be available.

of long-term economic norms from the assignment of taxes, allocation of transfers from the central budget is undertaken for the consolidated budget of the region. Transfers to local self-government units are allocated from the consolidated regional budget by a regional representative body and approved thereafter. This procedure is not determined by the formula of compensatory transfer and, thus cannot ensure economic and budget equalization between the local self-government units;

- The share remaining from the state taxes that goes to the budgets of local self-governments is dependent on the decision of the regional Sakrebulo. Region-associated Sakrebulo consisting of administrators of self-government units within the region are officially required not to leave a tetri in the budget and distribute the incomes received from state taxes completely to the self-government units. In practice it works differently: the funds from the so called “protected provisions” (i.e. the funds required for financing salaries of the employees of the self-government units) are accumulated in the budgets of the self-government units, and exclusive competences of self-government are practically left without a source of financing;
- Local governments of the region and its budget authorities are referred to on an institutionally incorrect basis. According to the organic Law on Local Self-Government and Administration, the regional administration fulfills only the delegated authorities and is not equipped with exclusive powers. Based on this logic, it cannot define appropriate expenses and it will not have any tax or non-tax revenues in the budget, of which it can dispose of independently. Regional financing must come only from purpose-oriented transfers, with appropriate expenses defined centrally at the drafting and execution stage. Presently, the bounds of regional administrative independence are not precisely defined by the central authority. In general, there is a consolidated regional budget which is officially divided into the budgets of the self-government units and the region. Regional budgets include income from local taxes, assignments of federal taxes, non-tax revenues, transfers, which serve as a key tool for meeting a deficit. Expenditures include a mixture of authorities delegated by the central authority (and regulated by them), and local self-government own authorities (with a high level of independence at the local self-government level).

E.3 Consideration of Planned or Possible Reforms

Despite the planned reforms suggested by the Young Economist Association of Georgia in 2004–2005, the central government has changed the vector of reforms.

In 2004–2005, the Young Economists Association of Georgia in cooperation with a coalition of NGOs implemented a project called “Minting a Decentralization Strategy in Georgia” for “national democracy and self-government.” The goal of the project was to collect and analyze all views on decentralization in Georgia, share foreign experience and draw up adequate strategic documents for the development of local self-government and decentralization. After the documents were drawn up, preparation of an appropriate legislative package and lobbying for its adoption was planned; with the intent of holding national elections for conditions of a qualitatively new system of government and territorial arrangement. According to the prepared conceptions, introduction of the following transfer mechanisms is declared:

E.3.1 Compensatory (No-purpose) Transfer

The central authority should distribute compensatory (no-purpose) transfers directly to the budgets of self-government units. According to the law, at least 5% of total budget receipts are allocated for compensatory (no-purpose) transfers from the central budget.

Compensatory transfers are not purpose-oriented for self-government units. Self-government units spend incomes gained from transfers at their own discretion for fulfillment of compulsory or voluntary exclusive competences.

Self-government units define compensatory transfers according to a formula established by the law. It is annually approved together with the state budget as law.

Appendix 5a presents the formula for calculation of a compensatory transfer, which has two steps. The first is determining a compensatory ratio for the self-government units, and the second is determining the amount of compensatory transfers for each self-government unit using the compensatory ratio and special formula.

E.3.2 Purpose-oriented Transfer

Delegated authorities must be financed by a purpose-oriented transfer. Purpose-oriented transfers are moved from the state budget to the territorial budget according to the delegated competence, or from the state budget to the self-government unit or from the territorial budget to the self-government unit. A purpose-oriented transfer completely reimburses the costs required for a delegated

competence. The purpose-oriented transfer can be less than the costs necessary for the delegated competence, where there is a potential of making the difference up by charging fees, duties or tariffs on the service related to the delegated competence. There must be a formula concerning each delegated competence, pursuant to which the amount of transfers to individual self-government units is determined; provided that the service rendered under the delegated competence across the whole country is uniform and meets a national standard. The formula for purpose-oriented transfers is based on the cost required to provide the service to a beneficiary.

E.3.3 Capital Transfer

A capital transfer is provided during implementation of a certain capital project and its amount is based on the cost estimate for the project.

E.3.4 Equalization Transfer Implemented in Accordance to Current Reforms

Although the above mentioned reforms were suggested, slightly different formula for equalization were implemented according to the new Law on Budget Authorities of Local Self-government Units passed on May 24, 2006. The amount of equalization transfers to the local self-government bodies is given in Appendix 5b.

E.3.5 Conclusion

Despite the implemented and current reforms for local self-governance, some issues remain unregulated. These problems concern the transfer distribution mechanisms and other institutional issues. Without resolution of these problems, an effective system of self-governance can not be achieved in Georgia.

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Appendix 1.**Revenues and Expenditures of Local Authorities as a Part of Public Incomes and Domestic Product, as well as Mean Incomes and Average consumption per Head (Over the Last Three Years)**

	2004	2005
Gross Domestic Product (thousand GEL)	9,800,033	11,400,000
Public revenues (thousand GEL)	2,576,201	3,378,127
Population (thousand)	4,315.2	4,321.5
Revenues		
Own income of local budgets (thousand GEL)	579,054	607,296
Per capita average of own income	134.2	140.5
Percentage of local budget own revenues in GDP	5.9%	6.2%
Percentage of local budget own revenues in Public revenues	22.5%	23.6%
Total income of local budgets (thousand GEL)	717,699	733,465
Per capita average of total income	166.3	169.7
Percentage of local budget total revenues in GDP	6.3%	6.4%
Percentage of local budget total revenues in Public revenues	21.2%	21.7%
Expenditure		
Expenditure of local budgets (thousand GEL)	717,699	733,465
Per capita expenditure of local budgets	166.3	169.7
Percentage of local budget expenditure in GDP	5.9%	6.2%
Percentage of local budget expenditure in public revenues	22.5%	23.6%

Appendix 2.

Revenues and Expenditures of Local Government Both in Figures and in Percents

There are 998 self-government units in Georgia, beginning from Tbilisi and ending with the smallest community. Besides, there are 65 administrative regions (except Ajara and Abkhazia). As no changes were made to the budget law resulting from modification of the organic law, the financial basis for fulfilling the exclusive functions of local self-government is very poor⁶. The budget of local self-governments and local governments (except Ajara and Abkhazia) as of 2003 totals GEL 440 million, or approximately USD 210 million. Hence, about GEL 290 million was allocated for financing delegated authorities. Not more than GEL 130 million, or approxi-

mately USD 65 million is spent by local self-governments for exclusive authorities. If you take into account that more than half of this sum is spent for the four cities – Tbilisi, Rustavi, Poti, Kutaisi, less than GEL 40 million, i.e. USD 20 million is spent for implementation of the aforementioned exclusive authorities in the remaining part of Georgia (the population of which is 2.5 million without the four cities). There is no legal guarantee at the drafting and execution stage, pursuant to which the local self-government units will have funds to fulfill their exclusive authorities. These trends are still in progress this year. Subject to the foregoing, we can conclude that the sum allocated by self-governments for their principal exclusive costs are only symbolic in Georgia.

⁶ This refers to situation including year 2005.

Appendix 3.

Revenue of Local Government per Head in Quarter (the Poorest – 25%, Next Level – 25%, Next Intermediate Level – 25%, the Wealthy – 25%) by Applying to the Equalization System and without it (Recent Data are Preferred, if No Crucial Changes Were Made Thereafter)

	2004				2005			
	Own Income (thousand GEL)	Own Income per Capita (thousand GEL)	Total Income (thousand GEL)	Total Income per Capita (thousand GEL)	Own Income (thousand GEL)	Own Income per Capita (thousand GEL)	Total Income (thousand GEL)	Total Income per Capita (thousand GEL)
Region 1	3,212	1.642	11,716	5.99	700	0.358	9,136	4.671
Region 2	82,603	0.22	90,233	0.24	46,112	0.123	92,589	0.246
Region 3	325,596	0.301	329,741	0.305	414,710	0.383	414,710	0.383
Region 4	16,032	0.039	30,959	0.076	16,874	0.041	24,906	0.061
Unit 1	888	0.021	3,032	0.073	1,471	0.035	2,814	0.068
Unit 2	2,176	0.03	4,862	0.067	2,174	0.03	4,124	0.057
Unit 3	1,912	0.062	2,712	0.088	2,039	0.066	2,475	0.08
Unit 4	4,489	0.064	5,869	0.083	4,534	0.064	4,937	0.07
Unit 5	814	0.016	3,603	0.071	755	0.015	2,322	0.045
Unit 6	3,573	0.06	3,821	0.065	3,092	0.052	3,092	0.052
Unit 7	1,143	0.026	3,816	0.088	1,242	0.028	2,740	0.063
Unit 8	1,036	0.028	3,243	0.086	1,568	0.042	2,402	0.064
Region 5	40,171	0.057	65,979	0.094	30,248	0.043	47,710	0.068
Unit 9	12,322	0.066	20,930	0.113	12,869	0.069	16,690	0.09
Unit 10	2,601	0.046	5,151	0.091	2,447	0.043	3,453	0.061
Unit 11	911	0.029	2,875	0.092	745	0.024	2,249	0.072
Unit 12	1,634	0.022	3,655	0.049	1,418	0.019	1,418	0.019
Unit 13	636	0.022	2,004	0.069	523	0.018	2,018	0.069
Unit 14	666	0.019	2,809	0.082	426	0.012	1,804	0.052
Unit 15	9,106	0.119	9,318	0.122	4,558	0.06	5,319	0.07
Unit 16	1,306	0.029	2,923	0.064	1,516	0.033	3,364	0.074
Unit 17	7,736	0.128	8,029	0.133	3,032	0.05	4,291	0.071
Unit 18	2,212	0.047	3,760	0.08	1,700	0.036	3,475	0.074
Unit 19	589	0.021	2,198	0.079	540	0.019	1,757	0.063
Unit 20	451	0.014	2,326	0.073	474	0.015	1,874	0.059
Region 6	23,185	0.05	42,804	0.092	23,567	0.051	36,209	0.078
Unit 21	14,643	0.311	14,920	0.316	15,780	0.335	15,780	0.335
Unit 22	3,011	0.018	7,351	0.044	2,407	0.014	3,660	0.022
Unit 23	378	0.013	2,191	0.076	393	0.014	3,760	0.131
Unit 24	473	0.011	3,261	0.073	440	0.01	2,158	0.048
Unit 25	513	0.036	2,946	0.207	360	0.025	1,920	0.135
Unit 26	1,495	0.029	3,193	0.061	1,234	0.024	2,218	0.043
Unit 27	356	0.012	2,287	0.076	348	0.012	1,678	0.056
Unit 28	905	0.023	3,264	0.081	845	0.021	2,525	0.063
Unit 29	1,411	0.034	3,390	0.082	1,760	0.043	2,510	0.061

	2004				2005			
	Own Income (thousand GEL)	Own Income per Capita (thousand GEL)	Total Income (thousand GEL)	Total Income per Capita (thousand GEL)	Own Income (thousand GEL)	Own Income per Capita (thousand GEL)	Total Income (thousand GEL)	Total Income per Capita (thousand GEL)
Region 7	14,403	0.046	26,116	0.083	10,206	0.032	17,797	0.057
Unit 30	4,524	0.032	9,500	0.067	4,500	0.032	7,254	0.051
Unit 31	111	0.023	952	0.201	53	0.011	593	0.125
Unit 32	83	0.028	1,083	0.365	33	0.011	240	0.081
Unit 33	1,493	0.029	3,733	0.071	1,502	0.029	2,698	0.052
Unit 34	1,237	0.025	3,422	0.07	1,280	0.026	2,310	0.047
Unit 35	34	0.021	348	0.219	30	0.019	547	0.344
Unit 36	6,922	0.11	7,079	0.113	2,808	0.045	4,155	0.066
Region 8	38,665	0.078	49,826	0.1	34,904	0.07	39,266	0.079
Unit 37	10,542	0.091	12,172	0.105	9,462	0.081	9,765	0.084
Unit 38	10,762	0.145	11,058	0.149	12,933	0.174	12,933	0.174
Unit 39	6,972	0.061	9,615	0.084	4,220	0.037	4,220	0.037
Unit 40	2,384	0.085	2,686	0.096	2,507	0.089	2,507	0.089
Unit 41	2,662	0.105	4,019	0.158	890	0.035	1,911	0.075
Unit 42	4,196	0.035	7,629	0.065	4,356	0.037	5,929	0.05
Unit 43	1,147	0.055	2,647	0.127	535	0.026	2,001	0.096
Region 9	6,590	0.046	14,514	0.101	5,167	0.036	7,893	0.055
Unit 44	1,975	0.049	3,941	0.097	1,850	0.046	1,328	0.033
Unit 45	3,512	0.045	7,632	0.097	2,521	0.032	4,835	0.061
Unit 46	1,102	0.046	2,940	0.122	797	0.033	1,729	0.072
Region 10	19,136	0.092	32,828	0.158	17,921	0.086	26,554	0.128
Unit 47	554	0.027	2,132	0.103	508	0.024	1,588	0.077
Unit 48	440	0.034	1,727	0.133	328	0.025	1,497	0.115
Unit 49	982	0.016	5,438	0.089	914	0.015	3,800	0.062
Unit 50	3,133	0.068	5,613	0.122	2,482	0.054	3,712	0.08
Unit 51	13,341	0.411	14,381	0.444	13,101	0.404	13,101	0.404
Unit 52	685	0.02	3,537	0.103	589	0.017	2,856	0.083
Region 11	7,195	0.057	14,732	0.117	6,770	0.054	10,442	0.083
Unit 53	386	0.05	1,664	0.216	617	0.08	1,455	0.189
Unit 54	1,399	0.042	3,887	0.116	1,109	0.033	2,471	0.073
Unit 55	441	0.031	2,027	0.145	351	0.025	1,407	0.1
Unit 56	4,395	0.068	4,855	0.075	4,155	0.064	4,308	0.066
Unit 57	575	0.109	2,299	0.437	538	0.102	803	0.153
Region 12	2,266	0.044	8,253	0.162	1,966	0.039	6,251	0.123
Unit 58	907	0.056	2,155	0.134	898	0.056	1,797	0.112
Unit 59	446	0.05	2,063	0.229	300	0.033	1,202	0.134
Unit 60	311	0.034	1,514	0.163	308	0.033	1,262	0.136
Unit 61	602	0.036	2,521	0.152	460	0.028	1,992	0.12
Region 13	579,054	0.132	717,699	0.164	609,146	0.139	733,465	0.168

Appendix 4.

Case Example: The Educational System and Financing in Kutaisi

As of January 1, 2004 the following public institutions of preschool and secondary education operated in Kutaisi:

- 26 general education schools (these schools provide basic education, grades 1–9);
- 6 secondary schools (these schools provide a complete course of secondary education, grades 1–11);
- 5 elementary schools (these schools provide only primary education, grades 1–6);
- 5 gymnasiums;
- 11 lyceums;
- 45 pre-school institutions.

The quota of pupils studying in secondary institutions totals 28,000 and the number of pedagogues amounts to 2,573.

The following problems exist in the educational system:

- There are significant differences in the number of pupils between the schools. In cities there are institutions of general education, where some have 250 pupils and similar institutions, where the number of pupils exceeds 1,350;
- The sums paid by the state per pupil differ sharply. In particular, in some institutions of general education GEL 140 is spent on average for the education of a child, in some institutions this sum amounts to GEL 324;
- The number of pupils per teacher completely differs between institutions. For example, in one institutions there are 5 pupils per teacher, in other ones, 15 pupils;
- There is no competition between educational institutions that fail to improve efficiency of the education process;
- Administrations of educational institutions have no motivation to improve effectiveness (relation between expenses and outcomes) and efficiency (results of educational process at each level of education) of the educational process;
- Teaching materials, technical equipment and school libraries are poor and undeveloped;
- The quality of educational institutions is low;
- There is no mechanism for evaluation of outcomes of costs spent from the budget for education.

Appendix 5a.

Formula for Determining Compensatory Transfer

The formula for calculating a compensatory transfer has two steps. The first is determining a compensatory ratio for the self-government units, and the second is determining the amount of compensatory transfers for each self-government unit using the compensatory ratio and special formula.

The *compensatory ratio* for each self-government unit is calculated in the following manner. For communities, it is:

$$K_{iv} = (1.5K_1 + K_2 + 2K_3 + K_4 + K_5 + 1.2K_6 + 1.2K_7) / 7 \quad (1.a.)$$

For cities:

$$K_{iv} = (K_1 + 1.5K_2 + K_3 + K_4 + 1.5K_5 + K_6 + K_7) / 7 \quad (1.b.)$$

where, K_1 is the compensatory ratio of a self-government unit, out of which, K_1 is inhabitants' ratio, K_2 – manpower ratio, K_3 – active land ratio, K_4 – upland ratio, K_5 – fiscal ratio, K_6 – isolation ratio, K_7 – distance ratio.

Determine each ratio separately below.

Inhabitants' ratio (K_1)

Quantity of inhabitants relative to the quantity of self-government units	K_1
Up to 1,000 heads	1.1
1,000-3,000	1.15
3,000-5,000	1.2
5,000-7,000	1.25
7,000-10,000	1.3
10,000-15,000	1.35
15,000-20,000	1.4
20,000-30,000	1.45
30,000-40,000	1.5
50,000-75,000	1.55
75,000-100,000	1.6
100,000-150,000	1.65
150,000-200,000	1.7
200,000-300,000	1.8
Over 300,000	1.9

Manpower ratio (K_2)

is the division of *total population* to *active manpower*; where *total population* is the total population of the

unit, and *active manpower* is calculated according to the formula below.

$$active\ manpower = total\ population - minors - retirees - invalids - migrated\ citizens - other\ disabled\ citizens.$$

Active land ratio (K_3)

Active land ratio per head is the difference between *total area of the land* and *land plot areas not used for agricultural activity and urban construction* divided by the *quantity of inhabitants*.

Active land ratio (K_3)

Active areas of land per head	K_3
Up to 0.5 ha	1.95
0.5-1	1.90
1-1.5	1.85
1.5-2	1.80
2-2.5	1.75
2.5-3	1.70
3-3.5	1.65
3.5-4	1.6
4-4.5	1.55
4.5-5	1.50
5-5.5	1.45
5.5-6	1.40
6-6.5	1.35
6.5-7	1.30
7-7.5	1.25
7.5-8	1.2
8-8.5	1.15
8.5-9	1.1
9-9.5	1.05
9.5-10	1.0
Over 10	0.95

Upland ratio (K_4)

	K_4
Over 2,000 m	1.0
1,800-2,000 m	0.85
1,500-1,800 m	0.75
1,200-1,500 m	0.5
1,000-1,200	0.35
800-1,000	0.2
Below 800 m	0

Fiscal ratio (K_5) is the average personal budget revenues per head during the last three years.

Fiscal ratio (K_5)

Amount of revenues	K_5
up to 5 lari	2.0
5–10	1.95
10–15	1.90
15–20	1.85
20–25	1.80
25–30	1.75
30–35	1.70
35–40	1.65
40–45	1.6
45–50	1.55
50–60	1.50
60–70	1.45
70–80	1.40
80–90	1.35
90–100	1.30
over 100 lari	1.25

Isolation ratio (K_6)

This ratio indicates isolation of self-government units from the central highway because of climatic conditions and blocking of roads.

Isolation ratio (K_6)

	K_6
Road is blocked over 6 months	2.0
Road is blocked from 3 to 6 months	1.5
Road is blocked not more than 3 months	1.0
Road is not blocked	0.0

Distance ratio (K_7)

This ratio shows the distance of settlements from the central highway and closeness to the state border.

$$K_7 = 0,015 S_1 + 0,025 S_2 + 0,035 S_3 + 0,045 S_4$$

where, S_1 is the distance from a road of international importance in km, S_2 – distance from a road of state importance in km, S_3 – distance from a road of internal regional importance in km, S_4 – distance from a road of inter-municipal importance in km.

Determination of the volume of transfers by ratio and special formula

Define T as the aggregate amount of funds designed for compensatory transfers from the central budget; T_j as the amount of transfers to each self-government unit, provided that:

$$\sum T_j = T$$

Auxiliary parameter A is calculated according to this formula:

$$\frac{1}{\sum K_j} = A$$

where, $K_1, K_2 \dots K_M$ is the equalization ratio of self-government units.

The formula defining the amount of transfers to self-government unit is the following:

$$T_j = T \times A \times K_j$$

or written another way:

$$T_j = \frac{K_j}{\sum K_j} \times T$$

where,

T is the total sum allocated for compensatory transfers from the central budget in the country, and

K_j is calculated from formula (1.a.) or (1.b.).

Appendix 5b.

Formula for Delivering Equalization Transfer

The amount of equalization transfer to the local self-government bodies is defined by the following formula, according to the Law on Budget Authorities of Local Self-Government Units.

$$T_i = (R - R_i) \times P_i \times K \times 70\%$$

where, T_i is the amount of equalization transfer allocated to the local self government budget; R – average annual potential income per head according to the budgets of all local self-government entities; R_i – average annual potential income per head of the local self-governing entity; P_i – the population of the local self-governing entity; K – correcting ratio and is given by

$$K = K_1 \times K_2$$

where, K_1 is the high mountainous ratio and K_2 is the ratio of thinly populated territorial entities.

The number of population of self-governing units and those territorial entities defined under the law of Georgia on “High mountainous regions socioeconomic and cultural development” is used to calculate the high mountainous ratio (K_1). According to these data, you can calculate the percentage of the population that is settled in high mountainous places out of the total population of the local self-governing entity. The ratio of thinly populated territorial entities (K_2) is defined according to the level of population and preference for a thinly populated territorial entity.

