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### **Will an Asymmetrical System of Fiscal De- centralisation Resolve the Conflicts in the Republic of Georgia?**

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# Will an Asymmetrical System of Fiscal Decentralisation Resolve the Conflicts in the Republic of Georgia?

## **Abstract:**

This paper discusses the problems regarding the decentralisation of a formerly communist country. In Georgia, the first steps towards decentralisation failed, since the transition process led to a power vacuum that escalated in bloody conflicts and secessionist movements. The status of Abkhazia and South Ossetia is still unclear and the intra-state tensions remain unsolved. This may be one of the reasons why the most recent attempts of decentralisation are rather hesitant. It is far from clear whether decentralisation in response to regional tensions would increase instability or political stability. We identify the limited autonomy at the local and regional levels as a major obstacle and challenge for the further reform process.

## **Key words:**

Decentralisation, institutional reform, fiscal equalization, regional autonomy

## **JEL codes:**

H11, H21, H41, H50, H71, H72, H77

## **Inhaltsverzeichnis**

I. Introduction	1
II. Fiscal Decentralisation in Formerly Socialist Countries	2
III. First Steps Towards Decentralisation in Georgia	4
IV. A Second Attempt on Decentralisation	6
IV.1. An Asymmetric Approach to Decentralisation	6
IV.2. The Assignment of Expenditure Responsibilities	8
IV.2.1 Expenditure Assignment Across the Regions	9
IV.2.2 Expenditure Assignments to Different Levels	9
IV.2.3 Delegated Functions	11
IV.3. The Revenue Assignment	13
IV.3.1 Assignment of Tax Revenues	13
IV.3.2 Assignment of Transfers	14
V. Might an Asymmetric System Resolve the Conflict?	17
References	18

## **Abbildungs- und Tabellenverzeichnis**

Graph 1: Share of local expenditures in transition economies	3
Graph 2: Ethno-linguistic groups in the Caucasus Region	5
Graph 3: Public Expenditures Per Capita (2004, 2007)	9
Graph 4: Tax and Non-Tax Revenues Per Capita (2004)	15
Table 1: Central, Extrabudgetary and Local Budgets (2000-2004)	10
Table 2: Regional and Local Expenditures in Adjara	11
Table 3: Share of Exclusive and Delegated Functions in Adjara (2006)	12
Table 4: Tax Revenues by Source (2000-2005)	14
Table 5: Categories of Transfers Per Region (2007)	16

# Will an Asymmetrical System of Fiscal Decentralisation Resolve the Conflicts in the Republic of Georgia?

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## I. Introduction

Over the past decades, a global trend towards fiscal decentralisation has emerged. A number of countries have undertaken comprehensive reforms of their intergovernmental fiscal systems. This trend is evident in developed, transition and developing countries. This is apparent in the recent discussions in the European Union, in the transition process in post-communist Central and Eastern Europe and in the new trends in Latin America, Asia and Africa. The global trend is based on the wide acceptance of the principle of subsidiarity and on the view that it results in improved efficiency and delivery of public services and, hence, a more efficient allocation of resources in the economy. Besides being “economically efficient”, fiscal federalism could promote democratic and participatory forms of government, improving the accountability and responsiveness of politicians and bureaucrats.

Fiscal decentralisation is a broad topic that includes aspects of the institutional framework, the assignment of expenditure responsibilities and revenue sources to subnational governments. Therefore, fiscal decentralisation is not only an issue of fiscal relationships between different levels of administration; aspects of the institutional framework have to be taken into consideration as well. Due to the complex administrative and fiscal interactions the process of fiscal decentralisation becomes a complicated matter. This is particularly true in former socialist countries. Most of the transition countries have inherited centralized structures and intra-state tensions occurred after the collapse of the Soviet Union. Tax bases have eroded with the economic decline related to the transformation process while corruption and the shadow economy have spread.

After more than 15 years of transition process, some countries, among them most of the new EU member states, have made substantial progress towards fiscal decentralisation, while the majority of the countries in the Western Balkans and the Caucasus are still lagging behind. The leading reform countries have been more active in many of the key aspects of intergovernmental fiscal relations compared to the Western Balkans and the Caucasus. Comparatively high-income levels and relatively well-developed governance structures have backed the transformation process, while the Western Balkans and Caucasian countries have struggled with generating revenue in combination with an excessively centralized structure.

We will focus on the reform challenge of the Republic of Georgia. After the “Rose Revolution” an ambitious reform agenda was launched to improve the fiscal system and to ensure Georgia’s territorial integrity. It is far from clear whether decentralisation in response to regional tensions would increase instability or political stability. We will outline the process of fiscal decentralisation and try to identify obstacles and challenges for the future reform process.

## II. Fiscal Decentralisation in Formerly Socialist Countries

Most of the Central European and Baltic (CEB) countries and the states of the Commonwealth of Independent States (CIS) entered the transformation process with a monetary overhang and the need for price liberalisation. Macroeconomic stabilisation programmes and structural reform policies were launched to support the transition process.<sup>1</sup> The transition from a centrally planned to a market economy triggered a massive decline in production output. The tax base declined and a loss of tax revenues was inevitable. For many CIS countries, the independence from the Soviet Union also meant the loss of large fiscal transfers, which further aggravated the financial problems. A drastic fiscal adjustment in the transition countries was inevitable, whereby fiscal stabilisation was primarily accomplished through expenditure cuts. Tax collection deteriorated throughout the transition process due to shrinking and porous tax bases and a dysfunctional collection enforcement. The CIS countries started into the consolidation process with much larger fiscal deficits and had to cope with higher revenue reductions compared to the CEB countries. In comparison to the CIS states, the expenditures of the CEB countries remained relatively high. The erosion of the public provision of social services and social transfers in the CIS countries had severe effects on the population and strengthened the opposition to the reform process.

A decentralisation process accompanied the consolidation of the fiscal budget. Fiscal decentralisation was motivated by economic goals like efficiency and responsiveness, macroeconomic considerations as well as the rising political demands for more local autonomy. The autonomy at the local level was limited during the Soviet era because of the vertical power structure. Based on this bequeathed structure, most of the transition countries have adopted a decentralized unitary model. Only the Russian Federation, the Ukraine, the Federation of Bosnia and Herzegovina, the Republica Srbska, as well as Serbia and Montenegro opted for federal systems (Dunn/Wetzel 2001; Bird/Smart 2001).<sup>\*</sup> The Republic of Georgia can be characterized as a partly decentralized unitary state. Within the unitary state the Autonomous Republic of Adjara has different political and fiscal institutions.

Multiple tiers of government exist in each country, most common are three-tier structures. Despite their similar structure, the role of the regional or middle tier varies. In Russia, Bosnia and Herzegovina the regional level plays a significant role in managing subnational public finances, while in Romania, Poland and Hungary the middle tiers act more as a coordinating agent between the central and local governments with little autonomy of their own (Dunn/Wetzel 1998). Graph 1 shows the share of local expenditures in transition economies, which is a rough measurement of the degree of decentralisation. Compared to other transition economies is the ratio of subnational expenditures to national expenditures in Georgia relatively high.

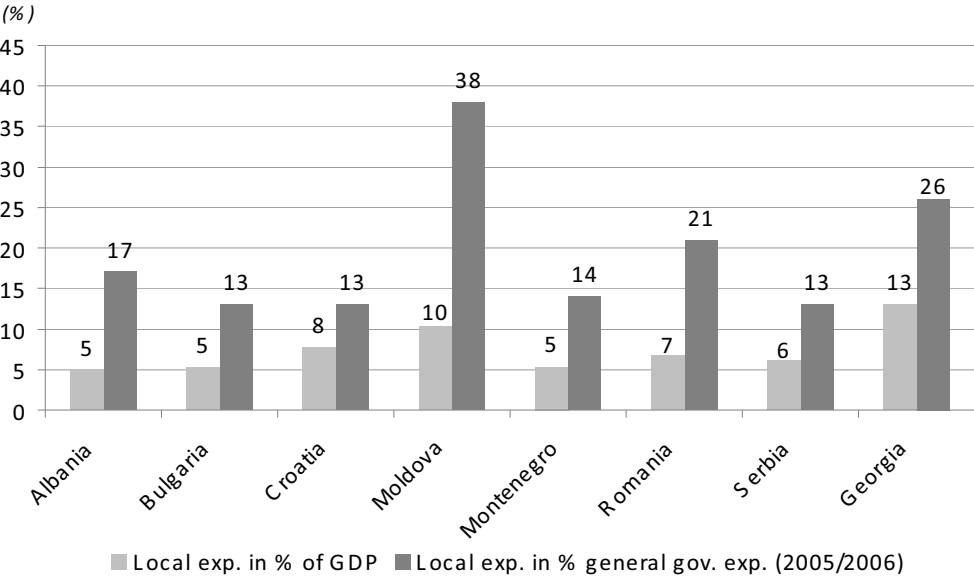
In most of the countries, the evolution of the legal and institutional framework has been subject to a historic process rather than to consistently applied rules and principles. Due to the gradual process the respective constitutions are supplemented by a myriad of laws and decrees that lead to inconsistent and conflicting provisions. The distribution of functions to local jurisdictions remains ambiguous and gaps within the legislation arise from the lack of a well defined assignment of functions and powers across different levels of government. Efficient governance requires clarity, transparency and stability, thus, achieving accountability at the

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<sup>1</sup> The macroeconomic stabilization focussed on the implementation of flexible exchange rate systems, currency reforms and the reform of the banking systems; the central elements of the structural reform policies were privatisation, price liberalization, establishment of property rights and deregulation.

administrative and the political levels. Therefore, a concrete assignment of functional responsibilities among different levels of government should be the first step in designing an inter-governmental fiscal system. Martinez-Vazquez (1998) called this “the primacy of expenditure assignment in intergovernmental fiscal relations design”.

**Graph 1: Share of local expenditures in transition economies**



Source: UNDP (2005); MoF, Republic of Georgia.

In the early years of transition spending responsibilities, particularly in education, health and social welfare assistance, were delegated to subnational governments in order to relieve the federal level from expenditure burdens. The shift of expenditure responsibilities was possible due to the absence of a formal assignment of expenditure responsibilities or ad hoc changes implemented through annual budget laws. This caused an imbalance between expenditures and revenues at the subnational level, compromising public service delivery and efficiency.

Besides the need for clarity of roles, the assignment of revenues to different levels is another key element of the decentralisation process. Subnational governments should have the autonomy to set tax rates on significant tax sources that are assigned to the subnational level to ensure accountability. Whereas the exclusive assignment of taxes plays a minor role in transition countries, revenue sharing is the dominant structure of subnational finance schemes. Thereby, two modes of revenue sharing are exercised. The traditional or “regulating” method, which uses different sharing rates according to taxes and to subnational governments and might change in every annual budget. This method is still used in many CIS countries. It provides fiscal flexibility at the central level to equalize or “regulate” revenues, but causes budget unpredictability at the subnational level and creates perverse incentives towards revenue mobilization. Most of the CEB countries and also Russia, Kazakhstan and Kyrgyzstan have adopted stable and uniform (across subnational governments) sharing rates (Martinez-Vasquez/McNab 2000). Revenue autonomy at the subnational level has been slowly introduced but remains relatively low. A number of taxes have been assigned to the local level, but the local autonomy remains limited since the tax rates are defined by the central state level, or the tax revenues are very low (e.g. land rental taxes, gambling taxes). Several CEB countries have assigned real estate property taxes to the subnational level, Croatia has introduced a surtax on



the personal income tax at the subnational level, Russia and the Ukraine have implemented a surtax on the corporate income tax (Martinez-Vasquez/McNab 2000).

Another prerequisite for a successful decentralisation is that local governments possess the administrative capacity required to effectively carry out the responsibilities assigned to them. Some progress has been made in the modernisation of the tax administration in the transition countries (Ebrill/Havrylyshyn 1999). However, significant tax administration problems remain in many transition countries, encompassing the inability to handle large numbers of new taxpayers, the lack of specialised personnel to detect tax evasion techniques and insufficient resources to build adequate information and monitoring systems. These deficiencies have caused considerable tax evasion and a growth in tax arrears (Martinez-Vasquez/McNab 2000). Besides the administrative competence, democratic representation plays an important role in a sound budget process. Equal partners in the sense of competence and legitimacy should bear the coordination and cooperation between different levels of government.

The economic decline produced a number of unintended outcomes, including the strengthening of regional players and the weakening of central control. The first decade of independence was, thus, a period of weakening state capacity and saw the empowerment of parallel political and economic power structures. The imbalance of power structures gave rise to regional tensions; some central governments reduced the pace of the decentralisation process or leaned again towards restoration of power and recentralization. The main challenge in the decentralisation process seems finding the right balance to assert political control, but meeting the aspirations of local self-government at the local level at the same time.

### **III. First Steps Towards Decentralisation in Georgia**

The Republic of Georgia is located in the heart of the Caucasus. The roots of statehood reach back to the 4<sup>th</sup> century B.C. when a Unified Kingdom of Georgia was established. After a changeful history, affected by subjugations by the Mongols as well as the Persian and Ottoman Empires, the Georgian Kingdom was incorporated within the Russian Empire in 1801. After a brief independence period (1918-1921), Georgia became a republic of the Soviet Union.<sup>2</sup>

The modern Republic of Georgia, as well as the ancient Kingdom of Georgia and the historically independent state of Georgia, encompass different ethnic groups. The major ethno-linguistic groups within Georgia are Georgians, Abkhazians and Ossetians (graph 2). Ethnic tensions always existed in Georgia but were suppressed by imperial rule. During the Soviet era the regions of Abkhazia, Adjara, and South Ossetia had the status of an “Autonomous Soviet Socialist Republic” within the Georgian SSR. The delineation of the autonomous republics corresponded to the settlements of ethno-linguistic groups in Abkhazia and South Ossetia. Despite the autonomous status, the ethnical tensions were not resolved. The autonomy of the autonomous republics was limited due to the centralized power structure. The splitting of ethnic groups over several territories, forcible settlements and the artificial merging of different people into single republics has enforced ethnic conflicts.

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<sup>2</sup> After the Russian Revolution of 1917, the National Council of Georgia declared Georgia's independence (May, 1918). The Soviet government in Moscow recognized the independence (May, 1920), but in 1921 the Red Army invaded Georgia, and in Feb. 1921, it was proclaimed a Soviet republic.

**Graph 2: Ethno-linguistic groups in the Caucasus Region**



Source: <http://lib.utexas.edu/maps/commonwealth/ethnocaucasus.jpg>

Shortly before the collapse of the USSR, the Republic of Georgia declared its independence on April, 9<sup>th</sup> 1991. Elections were held on May, 26<sup>th</sup> and Gamsakhurdia was elected President of independent Georgia. First steps towards decentralisation were taken through the introduction of a four-tiered government hierarchy (Bolashvili, 2002). The four levels consisted of:

- *State level*: Central Government
- *Regional level*: Nine regions and two autonomous Regions (Adzharia and Abkhazia)
- *District level* (Rayons) and special status cities: 60 rayons and seven cities (incl. the capital)
- *Communal level*: Villages, towns and cities; 996 settlements with local government status.

Although the Soviet institutional structure largely remained, the independence led to a rapid destruction of political structures. Tblisi failed to assert its central power at the regional and local level, which caused a power vacuum. Basic municipal services were no longer provided in a sufficient manner and the socio-economic decline worsened the situation (Jackson, 2004). Within this vacuum of power a bloody conflict escalated in Abkhazia, when a secessionist movement of the Abkhaz ethnic minority unilaterally declared the independence of the region. During the clashes between Abkhaz forces and Georgian National Troops, which lasted for more than a year (1992-1993), more than 8,000 people lost their lives. The conflict led to ethnic cleansing and the displacement of 300,000 people (most of them belonged to the Georgian population), a significant part of the pre-war population of 525,000. In 1994, the Abkhaz and the Georgian sides agreed to a cease-fire and the establishment of the Commonwealth of Independent States Peace Keeping Force (CIS PKF) monitored by the UN. In 1996 and 1997 the number of returnees increased, until new clashes broke out in 1998 driving out 30,000 to 40,000 people once again. The implementation of recovery programmes is limited by security

concerns, the lack of both a peace agreement and an agreement on the status of the returnees (UNDP, 2005).

The conflict about the status of South Ossetia escalated in 1991, when President Gamsakhurdia unilaterally abolished the autonomous status of the region. After a bloody conflict between Georgian troops and Ossetian militia in December 1991 South Ossetia declared its independence in June 1992, which is not internationally recognized. Until today, the status of South Ossetia is still unclear (Reisner/Kvatchadze 2005).

In the Autonomous Republic of Adjara the political situation remained stable during these years of conflict due to the authoritarian rule by Abashidze. During the presidency of Shevardnadze the central government in Tbilisi ignored the situation in Adjara, even though Abashidze was involved in organized crime and human rights violations. This changed in course of the “Rose Revolution” (January 2004), when Saakashvili came to power and claimed to reunite the country. The eruption of an armed conflict was prevented by Saakashvilis ultimatums and mass protests against the autocratic rule; Abashidze resigned and went into exile in Russia. After the elections of the Supreme Council, a constitutional law on the Status of the Autonomous Republic was enacted (ICG, 2004).

Adjara is the only autonomous region in Georgia that succeeded in establishing a power sharing arrangement with Tbilisi. Unlike the regions of South Ossetia and Abkhazia, Adjara did not claim full independence and did not argue for its status on the principle of national self-determination since the people of Adjara consider themselves ethnically as Georgians. The ethnical tensions described above erupted with the independence of Georgia. Because of these unresolved conflicts the main challenge is finding a balance between the ethnic diversity of the country, the different interpretations of local self-government and the need for the assertion of central power to fill the power vacuum between the central and the local level (Jackson, 2004).

## **IV. A Second Attempt on Decentralisation**

When Saakashvili came to power in January 2004, he launched an ambitious reform agenda to improve governance and to ensure Georgia’s territorial integrity. The political will of territorial integrity is manifested in the Constitution of Georgia, which was adopted in 1995<sup>3</sup>. It points out; that the issue of territorial arrangements in Georgia will only be settled when the jurisdiction of Georgia will have been restored in Abkhazia and South Ossetia. In 1997 the Organic Law on Local Self-Government and Government (LGSG) was enacted, which is the basic legal framework for local self government. Although it is still an incomplete framework of local self government, it provides a certain limited leeway for local autonomy.<sup>4</sup>

### **IV.1. An Asymmetric Approach to Decentralisation**

The institutional framework of Georgia consists of three levels. The first level is formed of 66 Local Government Units (LGUs); the second level consists of nine regions and the Autonomous Republics of Adjara and Abkhazia and the third level is the central state level.

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<sup>3</sup> After the bloody coup of 1991 was the Constitution of 1921 reinstated.

<sup>4</sup> It was modified first in 02.08.2001 and second after the rose revolution in 2006.

The borders of the nine regions are based on historical jurisdictions. Governors who are appointed by the President of Georgia govern these regions. The governor has a twofold function: he represents the central government at the regional level and vice versa. Due to the dependency of the governor on presidential approval and appointment, the political scope might be limited and therefore the political autonomy of the regions could be restricted. At the LGU level, the respective residents elect the so-called „sakrebulo“, which in turn appoints the mayors of the villages. Every resident can apply for the mandate of the mayor, as the sakrebulo appoints the mayors from the circle of the applicants. If the mayors were to be elected directly (by the residents of the municipality) or indirectly (by a municipal council), this would strengthen the relationship between the local government and its respective constituency.

Within the State of Georgia the Autonomous Republic of Adjara maintains a special status, while the status of the Autonomous Republic of Abkhazia and South-Ossetia<sup>5</sup> is still undefined. Due to the autonomous status of Adjara, the institutions differ within that region to some extent. The head of the Adjara government is appointed by the President of Georgia, but with regard to other regions, his competences are guaranteed by law (backed by Law of the Status of the Autonomous Republic of Adjara). The power of the Government of Adjara is greater compared to those of the regional governors, but still limited. For example, the Parliament of Adjara could be suspended by the President of Georgia and acts of the Adzharian Parliament could be set off. The decentralisation might improve if the Head of Government were elected either directly by the residents of Adjara or indirectly via the Parliament of Adjara.<sup>6</sup> Besides the limitation of the local legislature the executive authority of Adjara is also limited. For instance, the local tax administration is subordinated to the Ministry of Finance of Georgia, which aggravates the level of dependency of the Ministry of Finance of Adjara on the central level government. Petersen (2008) and Ehrke (2008 – see both contributions in this volume) give a more detailed overview of the current political discussion and an analysis of the political system of Georgia.

Since the Autonomous Republic of Adjara enjoys a distinct form of autonomy, the State of Georgia can be characterized as a partly decentralized unitary state. In standard text books, this case is labelled as asymmetrical federalism. In the twentieth century, several cases of asymmetrical federalism are known. The issue of asymmetrical federalism arose in nationally diverse states where national minority communities seek self-determination (Hannum, 1996, Laipoth 1997, Watts 1999). Asymmetrical federalism might resolve conflicts within a state, but state nationalists or integrationists fear that it facilitates secession and that it could promote irredentism, when minority regions unite with their ‘kin-state’ across national borders. In addition, asymmetrical federalism persists because of the ‘domino’ effect, i.e. other regions demand the same degree of autonomy. Lessons from the states with asymmetrical federalism do not support the hypothesis that asymmetrical federalism promotes instability. The outcome depends rather on the details of the autonomy arrangements and the motivations of the parties involved. Voluntary agreements are likely to be more stable than those that are the result of dictates. Where autonomy gives rise to serious instability it might require changes in the autonomy agreement rather than its destruction. In order to prevent some sort of polarisation making autonomy insufficient for a minority, it is better to offer autonomy earlier than later

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<sup>5</sup> Negotiations between the Government of Georgia and local representatives are still ongoing (see Petersen, 2007).

<sup>6</sup> The Venice Commission concluded that "this role of the President of Georgia seems democratically questionable and scarcely compatible with a status of autonomy". See Council of Europe, Venice Commission, "Draft Opinion on the Draft Constitutional Law of Georgia on the Status of the Autonomous Republic of Ajara", Opinion No. 291/2004, Strasbourg, 8 June 2004, p. 5.

and to be generous from the very beginning (McGarry, 2005). Therefore, the degree of local autonomy could serve as an indicator for the outcome of the decentralisation strategy.

## **IV.2. The Assignment of Expenditure Responsibilities**

According to the "Decentralisation Theorem" the provision of public goods should be performed at the lowest governmental level because this allows an approximate correspondence between those who benefit from their provision, those who have to pay, and those who decide on the amount provided. This model is useful, but has some limitations as a practical guideline. It is often difficult to define the scope of benefits of a specific service and to determine which specific jurisdiction will reap the benefits. Since public services are subject to economies of scale, it could be cost-effective if local governments contracted higher-level authorities to provide such a service. On the other hand it could be preferable for the central government to cooperate with local governments to provide public services on its behalf. A successful division of functions is therefore complicated to define. Often, functions are linked with different governmental and administrative levels. Education, for example, can be considered to have local benefits, but it has also national ones. National governments often provide financial support to ensure a certain level of education, while the day-to-day management responsibilities are assigned to the local government level. Within these settings different principal-agent relationships take place, in which subnational governments and central governments act both as agents and principals from different points of view. Intergovernmental fiscal relations are multi-dimensional and complex, which could lead to higher coordination costs, on the other hand they facilitate the coordination of governmental activities at both levels.

Within a field of joint responsibilities, a concrete assignment of functional responsibilities among different levels of government should therefore be the first step in designing an intergovernmental fiscal system. Martinez-Vazquez (1998) called this "the primacy of expenditure assignment in intergovernmental fiscal relations design". Since the revenue assignments and transfers should correspond to assignment of functions, they might be considered in a second step. The degree of decentralisation of government activity can be roughly expressed by the ratio of subnational expenditures to national expenditures. The assignment of the revenue expenditures to the institutional levels reflects the relative importance of subnational governments. Nevertheless, it has to be taken into account that the assigned expenditures can be delegated functions (contract management) or exclusive local functions. In the case of delegated functions the decision about the provision of the public good is made at the central level. The local government and, therefore, the local constituency do not have the competence to decide on the provision of the delegated functions. In the case of exclusive local functions the principle of fiscal equivalence would be achieved if the beneficiaries of public goods and the taxpayers were identical. To meet the objective of fiscal equivalence the local government should have the competence to decide on the provision of local public goods and the tax base should be sufficient to cover the respective expenditure needs. Since there are often disparities in the balance between resources and responsibilities at the local level, fiscal transfers have to correct vertical fiscal imbalance by filling the gap between revenue-raising capacity and expenditure needs.

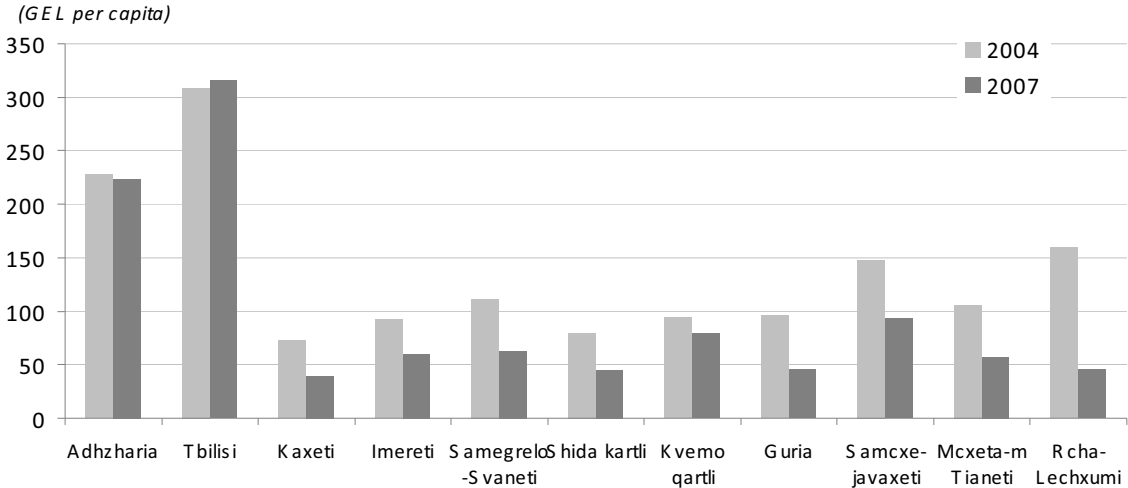
To analyse the revenue assignment it is, therefore, necessary to distinguish between delegated functions and exclusive functions. In a first step, we will rely on the conventional expenditure assignment to analyse the relative importance of the jurisdictions. Secondly, we focus on delegated functions and exclusive functions in order to quantify the "true" degree of expenditure decentralisation.

### IV.2.1 Expenditure Assignment Across the Regions

The Parliament of Georgia approves the state budget. According to the Organic Law (LGSG) the local budget shall be independent from the state budget. In fact, the independence is rather limited, since the completion of most local budgets depends on the approval of transfers from the central government. The transfers from the central level to the regional level are negotiated; the formulation of budgets in Georgia still follows a top-down fiscal policy approach.

Graph 3 shows total expenditures per capita.<sup>7</sup> The per-capita spending varies greatly across the regions with a coefficient of variation ranging from 0.51 in 2004 to 1.32 in 2007. Since the expenditures are highly volatile the informative content of the variation coefficient is limited. Nevertheless, the uneven distribution of the per-capita expenditure level reveals a strong concentration of public expenditures in the Autonomous Republic of Adjara and the city of Tbilisi.

**Graph 3: Public Expenditures Per Capita (2004, 2007)**



Source: MoF, Republic of Georgia.

Due to the negotiation based on the assignment of functions there is a lack of a basic and encoded criteria for the allocation of responsibilities and revenue sources between the regions, their respective LGUs, and the central state. This might lead to an insufficient provision of public goods at the local level and undermine the autonomy of the subordinated jurisdictions.

### IV.2.2 Expenditure Assignments to Different Levels

There is no first-best solution to the question of which level of government should be responsible for particular public services. The guiding principle should be the principle of subsidiarity, which leads to an efficient provision of public goods. The responsibility for the provision of services should be allocated to the lowest level of government corresponding to the “benefit area” of the public goods and services. The functional expenditure assignment in Georgia is largely in line with these principles. The central government pursues objectives of security and stability; local governments provide basic infrastructure services, primary education, and expenditures in the cultural sphere. Somewhat deviant is the assignment of redistributive functions, for instance the payment of pensions, health, and social welfare assistance. Like in

<sup>7</sup> Abkhazia is missing.

other transition countries these spending responsibilities were delegated to subnational governments in order to reduce expenditure burdens at the federal level. Musgrave (1983) argues that redistribution should remain among the competences of the central government, while Oates (1977) argues that redistribution should be assigned to subnational governments. McLure (1995) states that redistribution should be assigned to the central level, if the social standards are nationwide defined. If equality is understood in a local context, redistribution should be assigned to the local level. In Georgia, the redistributive functions should be assigned to the central government, since the social standards are uniform across the country.

The shares of subnational governments in the consolidated budget have remained relatively constant during the last years. The volume of extra budgetary funds has been increased after the Rose Revolution in order to finance the deferred payment of pensions. Extra budgetary funds were mainly used to finance pensions, healthcare and regional development programs. The funds were financed from the social tax, which was levied on wages and salaries.<sup>8</sup> The social tax stands to be abolished in course of the tax reform in 2007 and shall be counter-financed by an increase in the personal income tax.

The revenues from the personal income tax are directed towards the LGUs to finance - as a delegated function – social spending at the local level. This led to a de facto two-tier government structure, according to the expenditure assignment. The regional level, which was previously involved in the planning and the implementation of regional development programmes, has no expenditure functions. The power of the regional level is limited to a representative and control function, like in Romania, Poland and Hungary. Table 1 shows the budgets of the different jurisdictional levels. In comparison to other CIS countries the share of the local government expenditures is relatively high (table 1; see also graph 1).

**Table 1: Central, Extrabudgetary and Local Budgets (2000-2004)**

(at current prices; mln. GEL)	2000	2001	2002	2003	2004	2005**
central budget	681.4	756.1	852.6	972.7	1,513.2	2,600.0
extrabudgetary funds	179.9	206.8	238.1	234.5	452.3	428.8
local budgets	324.7	397.5	446.3	496.5	682.7	839.0
share of local budget (in %)*	27.4	29.2	29.0	29.1	25.8	21.7
*local government expenditures / total government expenditures						
** extrabudgetary funds excluding infrastructure funds						

Source: MoF, Republic of Georgia.

The expenditure assignment is different in the Autonomous Republic of Adjara.<sup>9</sup> The government of Adjara has competencies in the fields of higher education, the cultural sphere and regional development. About one-third of the public expenditures in Adjara were assigned to the regional government level (table 2). According to the share of the local budgets the degree of decentralisation is slightly higher in the Autonomous Republic of Adjara compared to the other regions in Georgia. The regional level has an explicit expenditure responsibility and the share of the local budget is higher than the average share of local budgets across the nation.

<sup>8</sup> Until January 2005, was the social tax paid by the employer (31%) and the employees (2%) (see Tax Code of Georgia, 1997). After the tax reform in 2005, the social tax rate was reduced to 20% and paid by the employer.

<sup>9</sup> According to the Law of the Status of the Autonomous Republic of Adjara (adopted in 2004).

**Table 2: Regional and Local Expenditures in Adjara**

(thsd. GEL)	2001	2002	2003	2004	2005	2006
regional budet	55,738.09	74,551.66	77,256.68	47,621.80	50,518.79	80,398.10
local budget	19,182.98	27,867.17	30,024.32	36,335.06	52,119.12	47,918.64
share of local budget (in %)*	25.6	27.2	28.0	43.3	50.8	37.3
*local government expenditures / total government expenditures						

Source: MoF, Autonomous Republic of Adjara.

The assignment of expenditure responsibility is codified in the Organic Law on Local Self-Government and Government<sup>10</sup>. This law was revised in 2006, and new responsibilities were assigned to the communal level in the field of primary education, culture, and health. Therefore, the political autonomy at the communal level increased within the reform process. The LGUs have now exclusive functions in the education sphere with the provision of pre-primary and primary schools, as well as expenditures in the cultural sphere assigned to the lower level government. The communal infrastructure, as a core competence of local governments, is exclusive assigned to the LGUs. The provided (goods and) services include waste disposal, road infrastructure, water supply, and other communal services (Art. 7 of Organic Law on Local Self-Government and Government).

The recent reforms follow the assumptions of the efficiency criterion. Communal infrastructure, expenditures in the cultural sphere and primary education with benefit areas at the local level are assigned to the local administration. Efficiency in the provision of these public goods is enhanced if consumption benefits are linked to costs of provision via local taxes, fees or service charges. Ideally, the services for water and sewerage should be provided by corporate entities operating with full-cost-recovery pricing.

### IV.2.3 Delegated Functions

Expenditure competencies can be assigned to a lower level of government as delegated functions (contract management) or exclusive local functions. Bird (2000) distinguishes three forms of decentralisation: deconcentration, delegation and devolution. Full sub-national autonomy is achieved in the case of complete devolution. Through the delegation of functions the sub-national government retains little autonomy in policymaking and service delivery. In the case of decentralisation the local government acts as an agent of the centre; both the local government and, therefore, the local constituency do not have the competence to decide on the provision of the delegated functions. The principle of fiscal equivalence is not met. Furthermore, the local autonomy is limited due to the minimal local control over delegated functions. Many expenditure responsibilities assigned to the local level are not supported by local policy; public goods are provided according to higher-level policy.

Order management leads to a provision of public goods at the lowest governmental level, but it does not cause an approximate correspondence between those who benefit from their provision, those who have to pay, and those who have to decide on the provided amount. The budget decision is made at the level of the Autonomous Republic, most of the tax revenues

<sup>10</sup> The Organic Law on Local Self-Government and Government also applies in the Autonomous Republic of Adjara. Additional competencies may be assigned to the local level in accordance with the Law of the Autonomous Republic of Adjara.



are assigned to the republican level but the provision is made at the local level and the beneficiaries are among the local constituency. The "Decentralisation Theorem" (Oates, 1972) is not fulfilled; the levels of public outputs might not correspond to the demands of their residents. According to the principle of fiscal equivalence, the "mapping" of taxpayers, voters, and beneficiaries may lead to an optimal provision of local goods and generated welfare gains.

The revision of the Organic Law on Local Self-Government and Government in 2006 led to a stronger decentralisation. The LGUs now have exclusive functions in the education and cultural sphere. Delegated functions at the local level comprise health and social affairs at a minimum service level, as well as the maintenance of hospitals and outpatient clinics, nursery and children homes, orphanages, homes for children with disabilities and aid to needy people. Additionally, functions in the sphere of conscription, public order and security are delegated to the LGUs (Article 8 of Organic Law on Local Self-Government and Government). Special investment projects, such as regional infrastructure programmes, which are part of a central government framework program, are also delegated to the local government. A detailed overview of the delegated functions gives Narmania (2008).

Public services with wide-spread benefit areas like the maintenance of hospitals are delegated functions. The crucial question of the delegated functions is their sufficient financing. It is wrong that the responsibility for funding is assigned to local governments to be paid out of their overall budgets. It is a better if social protection services are provided by the local government and funded by the central government. Local governments have an advantage for the efficient service delivery due to their proximity to local residents. Nevertheless, the regional funding of these services could be difficult, since the need for social welfare is much higher in poor jurisdictions which are the least able to financially provide them.

Table 3 shows the share of exclusive and delegated functions as a percentage of the total expenditures at the LGU-level. Considering the share of order management, which amounts to 35% of the local budget, the "true" degree of expenditure decentralisation, measured as the share of exclusive functions at the local level, is approximately 24% per cent (65% of 37,3%). The rough measurement expressed by the share of local level expenditures to national expenditures yields 37%, which is a fairly higher degree of expenditure decentralisation (see. table 2). The share of exclusive and delegated functions varies significantly within the considered period. This illustrates the unsteady assignment of expenditure responsibilities.

**Table 3: Share of Exclusive and Delegated Functions in Adjara (2006)**

(thsd. GEL)	Total	delegated functions	share of delegated functions (in %)
total budget	128,316.74	43,685.50	34.0
regional budget	80,398.10	27,000.00	33.6
local budgets	47,918.64	16,685.50	34.8

Source: Ministry of Finance in Adjara.

The reform of the Organic Law on Local Self-Government and Government led to a more decentralized provision of public goods and services. Nevertheless, the effective expenditure autonomy at the subnational level is limited. The regional level has no explicit competencies and the burden of delegated functions restraints the autonomy at the local level. The principle of expenditure assignment in the Autonomous Republic of Adjara might serve as a model for other regions. Besides the assignment of expenditures the ministries and central agencies have to be clearly outlined to assure a transparent role for decentralized government officials. Mini-

mum norms and standards for the provision of local services are required to assure a sufficient provision of local public goods (Boex, Martinez-Vasquez, Schaeffer, 2005). The definition of a minimum service level might also serve as a guide line for revenue assignments.

A concrete and stable expenditure assignment is the basis for the decentralisation strategy. It should be supplemented by an adequate tax revenue assignment and fiscal equalization mechanism to guarantee the continuous provision of services. This protects local government from ad hoc transfers of responsibilities and increases the reliability of budget planning at all levels of government.

### **IV.3. The Revenue Assignment**

According to the principle of fiscal equivalence each function of government should be financed at the level at which it is consumed. The main underlying theoretical argument of the principle of fiscal equivalence is the avoidance of free-riding. If fiscal equivalence is not present, the elected representatives have spending powers but no corresponding responsibilities to raise the necessary taxes (Olson 1969). Therefore, the government revenues from own taxes at the sub-national level should correspond to the sub-national government expenditures. The optimal allocation of different taxes to different levels of government is determined by tax externalities. Vertical tax externalities between central and local governments arise from concurrent tax powers. A concurrent tax power appears if a tax is co-occupied by central and local governments, and both levels of government have the capacity to change the tax rate of the same base. When the tax base is responsive to tax rate changes, a tax rate change by one level of government affects the tax revenue of the other level (Dahlby, 1996).

#### **IV.3.1 Assignment of Tax Revenues**

In Georgia the tax bases and tax rates are defined by the central state government, concurrent tax powers do not exist. The revenues of the state budget consist of the tax revenues from VAT, excise, customs duty, and profit tax. The revenues arising from income tax are transferred to the LGUs, property taxes and taxes on gambling business are assigned to the local level. The assignment of revenues from income tax is regulated by the Budget Law of the State of Georgia, which is valid for only one household period and can be easily changed by the Parliament of Georgia.

Unlike other regions, the Autonomous Republic of Adjara receives revenues from profit taxes collected in its jurisdiction. According to the principle of fiscal equivalence the profit tax is generally considered one of the best taxes to be shared with or assigned to the local government. In case of the Georgian tax system the principle of fiscal equivalence is fully assured, since most of the larger taxpayers are registered in Tbilisi and therefore the tax collection takes place in the capital. The Autonomous Republic receives not an equivalent share of the tax revenues corresponding to the economic activities in its jurisdiction. This could be eliminated, if the tax revenues would be shared according to the economic activities across the different jurisdictions.

The state taxes (VAT, excise, customs duty, and profit tax.) are the most important sources of tax revenues (about two thirds of total tax collection), whereas the local taxes generate fairly low income for the majority of the LGUs. Revenues from income tax barely reach 8% of total tax revenues. More than 90% of LGUs do not have revenues from the property tax on natural

persons and, with a few exemptions; no LGU receives revenues from taxes on gambling business (table 4). The contribution of the property tax is low due to a variety of tax exemptions. In 2005 the average household income from property was 525 GEL (Jastrzembski, 2008), a family, whose annual income does not exceed GEL 40,000, is exempt from the property tax of a natural person. A farmland plot (up to five hectares) is exempt from a farmland tax. LGUs with many land plots of more than five hectares are rare, they probably account for less than 20% of all self-government units.

**Table 4: Tax Revenues by Source (2000-2005)**

(at current prices; mln. GEL)	2000	2001	2002	2003	2004	2005
income tax	108.9	135.8	142.9	152.9	268.7	290.7
profit tax	79.2	65.2	82.2	101.1	161.6	210.3
value added tax	279.7	347.7	404.6	406.8	628.2	987.4
excise tax	90.1	87.4	86.7	100.1	163.8	286.4
customs duty	53.1	55.0	59.0	70.3	100.1	123.4
other taxes	86.8	91.1	114.0	128.0	134.1	84.4
total	697.8	782.2	889.4	959.2	1,456.5	1,982.6

Source: MoF, Republic of Georgia.

### IV.3.2 Assignment of Transfers

The local level receives additional conditional transfers, special transfers and unconditional transfers from the central government. The composition of the local budgets varies from LGU to LGU and among the regions. In 2007<sup>11</sup>, transfers financed about 1.9% of local budgets on average. Four regions finance more than 10 percent of their budgets with revenues from transfers (table 5).

Conditional transfers are designed to finance delegated functions. The allocation of the conditional transfers is based on negotiations between the representative of the LGU (sakrebulo) and the Minister of Finance (MoF). Unlike other regions the LGUs of Adjara receive conditional transfers from the government of the Autonomous Republic of Adjara. The transfers are negotiated between the representatives of the LGU and the Adjara Minister of Finance. Due to the assignment of transfers based on negotiations the autonomy at the local level is restricted and the reliability of budget planning is limited (Narmania, 2008). This could lead to an insufficient provision of public goods at the local level and undermine the autonomy at the subordinated jurisdictions.

According to the Organic Law on Local Self-Government and Government the special transfers are designed for cases of emergency, for example, natural disasters, special infrastructure programs, and current expenditures. The purpose of the special transfers is quite vaguely defined as it comprises exceptional cases like the case of emergency as well as current expenditures. Furthermore, it makes no distinction between delegated and exclusive functions. The allocation of unconditional transfers is formula based. It is encoded in the Law on Budget Authorities of Local Self-Government Units, which was adopted in 2007. The transfer is designed as an equalization transfer that reduces differences in fiscal capacity whereby the extent of equalization depends on geographical factors.

<sup>11</sup> According to the projections of the MoF and own calculations.

The amount of equalization transfer  $T_i$  directed towards the jurisdiction  $i$  is defined by the difference of the average potential revenue per capita  $R$  (excluding Tbilisi) and the potential revenue per capita  $R_i$  of the local self-governing entity  $i$ , multiplied by the number of residents  $P_i$  and the correcting factor  $K_i$ :

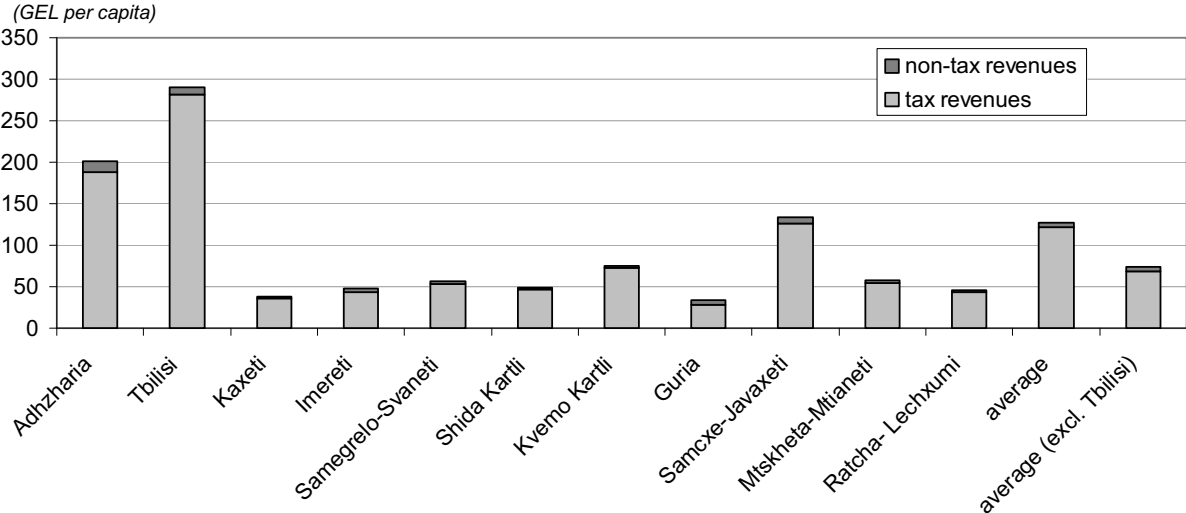
$$T_i = (R - R_i) \times P_i \times K_i \times 70\% .$$

$K_i$  is defined as

$$K_i = K1_i \times K2_i ,$$

it is in other words the product of  $K1$  - the high mountain factor - and  $K2$  - the factor for thinly populated territorial entities. The factors  $K1$  and  $K2$  are defined in the Law of Socio-economic and Cultural Development in High Mountainous Regions. Eligible for benefit are all communities with a potential revenue capacity per capita ( $R_i$ ) below the average (excluding Tbilisi) potential revenue per capita ( $R$ ). The potential revenue capacity comprises tax revenues and non-tax revenues<sup>12</sup> and is estimated by the MoF. The contribution of non-tax revenues is quite low (4.5% on average). Graph 4 shows the disparities in per-capita revenue collections across regions. While total revenues per capita (tax and non-tax) are GEL 290 in Tbilisi and GEL 201 in Adjara, the country’s average is only GEL 127 – excluding Tbilisi drops the country’s average to GEL 73.

**Graph 4: Tax and Non-Tax Revenues Per Capita (2004)**



Source: MoF, Republic of Georgia.

Due to the definition of revenue capacity and the partial coverage the equalizing effect is limited. The volume of unconditional transfers is significantly reduced by the use of the average revenue capacity excluding Tbilisi as reference measurement. This is worsened by the only partial (70%) coverage of the fiscal gap. According to our estimations, the transfer volume would increase by GEL 6.6 million, if Tbilisi were included in the potential average (table 5).

The impact of the factor  $K_i$  is limited as well. The factor  $K1$  varies between 0.1 (costal regions or lowland) and 1.8 (mountainous region), the factor  $K2$  ranges from 0.5 (high population density) to 1.5 (low population density). In the probable case of a LGU, which is located in a plain area ( $K1_i = 0.1$ ) with a relatively high population density ( $K2_i = 0.5$ ) the resulting correction factor is  $K_i = 0.05$ . The equivalent transfer reduces the fiscal gap by 3.5% (70% of 0.05). In the case of an LGU located in a mountainous region ( $K1_i = 1.8$ ) with a low population den-

<sup>12</sup> Non-tax revenues are revenues from fees and capital incomes.

sity ( $K2_i = 1.5$ ) the correction factor will be  $K_i = 2.7$ . The transfers will be nearly twice as much as the defined fiscal gap (70% of  $2.7 = 1.89$ ). Therefore only the combination of a low population density in a mountainous region leads to significant transfers.

**Table 5: Categories of Transfers Per Region (2007)**

(mln. GEL)	conditional transfers	special transfers	unconditional transfers	Unconditional transfer (incl. Tbilisi)*	tax and non-tax revenues	total**	transfers as share of total of revenues (%)
Adjara	0.0	0.0	4,555.0	6,234.2	53,888.9	58,443.9	7.8
Tbilisi	0.0	0.0	0.0	0.0	771,000.0	771,000.0	0.0
Kaxeti	180.0	0.0	268.0	1,400.1	21,039.0	21,487.0	2.1
Imereti	1,215.0	4,263.0	1,205.0	1,817.0	38,885.2	45,568.2	14.7
Samegrelo-Svaneti	309.0	664.0	793.0	962.8	34,035.4	35,801.4	4.9
Shida-Kartli	171.0	482.0	1,208.0	2,079.5	14,541.7	16,402.7	11.3
Kvemo-Kartli	139.0	83.0	1,377.0	2,027.5	44,807.5	46,406.5	3.4
Guria	126.0	0.0	223.0	459.2	5,893.6	6,242.6	5.6
Samcxe-Javaxeti	117.0	219.0	126.0	319.6	13,707.2	14,169.2	3.3
Mcxeta-Mtianeti	291.0	416.0	757.0	1,073.4	10,168.3	11,632.3	12.6
Racha- Lechxumi	0.0	0.0	891.0	1,588.3	2,645.3	3,536.3	25.2
Total	2,548.0	6,127.0	11,403.0	17,961.6	1,010,612.1	1,030,690.1	1.9

\* Tbilisi was included when calculating the potential average revenues.  
\*\* Includes revenues from transfers, tax and non-tax revenues.

Source: Own calculations, MoF, Republic of Georgia.

The unconditional transfers have more the character of an earmarked transfer for mountainous regions, since the transfer volume is low for all other regions. The partial coverage of the fiscal gap does not accomplish the target of fiscal equalisation. To achieve fiscal capacity equalization a higher transfer volume would be required, which could be difficult to finance in the transition process. A fair allocation of revenues with a low transfer volume could be accomplished by an expenditure-based approach of fiscal decentralisation. However, an expenditure-based approach is difficult to implement, since it requires a broad knowledge of the fiscal need. Historical data for indicators are related to the supply, not the demand of public services. If past decisions do not reflect the current demand of public services, due to political influences in the past or a shift in the demand of public services, regions with excess capacities, other things equal, would continue to receive larger transfers.

The formula based approach increases the reliability of the transfer volume, but the endorsement “potential” limits the reliability. The transfer volume depends upon the estimation of the MoF about the “potential” fiscal capacity. The determination of the potential fiscal capacity is subjective. The simplest concept to determine the fiscal capacity would be to rely on past years' revenue collections. Since subordinated ministries collect the taxes the problem of taxpayer compliance does not arise. All together, the reliability of the transfers toward the LGUs is limited. Conditional and special transfers depend on negotiations with the superior government, and the assignment of unconditional transfers is still unclear and not reliable. The reli-

ability of the transfers could be increased if the allocation would rely on a clear defined and codified allocation rule.

The assignment of tax revenues is also insufficient. The local tax bases are weak; their contribution to the local budgets is small. This leads to a high dependency of local jurisdictions on transfers from the central level government. Vertical imbalance could be reduced by revenue sharing. For instance, the profit tax could be shared between the central level and local level government. Revenue sharing decreases the vertical imbalance and increases local autonomy and therefore accountability and efficiency. Due to the uneven distribution of the tax bases across the jurisdictions, the tax assignment has to be supplemented by grants.

## **V. Might an Asymmetric System Resolve the Conflict?**

The answer might be yes and no at the same time. It is difficult to draw a clear-cut recommendation in such a complex process. Unquestionably, the limited autonomy at the local and regional level in the Autonomous Republic of Adjara is unsatisfactory. Further approaches towards decentralisation are required to enhance transparency and accountability at all levels of government. An asymmetric system of decentralisation might be an appropriate framework for further progress.

In contrast to the case of Adjara the conflict over the status of Abkhazia and South Ossetia is based on ethnical tensions. The experiences with armed hostilities and displacements have aggravated the potential for conflict. To overcome the past the willingness of both conflicting parties is necessary in order to negotiate a common future. A clear commitment of the central state government towards decentralisation could pave the way for a reintegration of the renegade states. Up to now, the case of the Autonomous Republic of Adjara does not serve as an example of a successful decentralisation strategy, since the autonomy is very weak. An asymmetric system could be the first step towards the integration of the regions, but would probably not lead to a stable solution. An asymmetric system could provoke the “domino effect” where other regions demand the same degree of autonomy. This would result in a federal state rather than an asymmetric system. An asymmetric system with three strong regions and a central government could be facing a latent danger of secession, since the balance of countervailing powers fails. Therefore, an asymmetric system could serve temporarily as a role model for the decentralisation process. In a long-term view the structure of a federal state with strong regions would provide a more stable framework than a central state with regions.

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<b>Nr. 29 b</b>	04/00	s. Nr. 29 a	Titel s. Nr. 29 a <span style="float: right;">(Teil b, tabellarischer Anhang)</span>
<b>Nr. 30</b>	04/00	H.-G. Petersen B. Raffelhüschen	Die gesetzliche und freiwillige Altersvorsorge als Element eines konsumorientierten Steuer- und Sozialsystems
<b>Nr. 31</b>	07/02	S. Anton M. Brehe H.-G. Petersen	Das Konzept der Einfachsteuer im empirischen Text
<b>Nr. 32</b>	08/02	H.-G. Petersen	The Polit-economic Situation in Germany: Chances for Changes in Resource and Energy Economics
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<b>Nr. 35</b>	02/03	H.-G. Petersen	Soziale Gerechtigkeit und Leistungsfähigkeit in dynamischer Perspektive
<b>Nr. 36</b>	07/03	H.-G. Petersen	Globalisierung und soziale Gerechtigkeit
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<b>Nr. 39</b>	12/03	H.-G. Petersen A. Fischer J. Flach	Wirkungen der Einfachsteuer auf die Steuerbelastung von Haushalten und Unternehmen
<b>Nr. 40</b>	12/03	J. Flach	Die Auswirkungen der Unternehmenssteuerreform auf ausgewählte Unternehmen
<b>Nr. 41</b>	02/04	H.-G. Petersen	Capital Flight and Capital Income Taxation
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**Prof. Dr. Hans-Georg Petersen**

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