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## **PROBLEMS OF DISTRIBUTION OF TAX REVENUES BETWEEN BUDGETS OF DIFFERENT LEVELS IN GEORGIA**

**Abstract:** *The main source of mobilization of budgetary funds is tax revenues. One of the important levers of the state in ensuring the socio-economic development of the country is the fair distribution of tax revenues between budgets of different levels, since fiscal independence is an essential factor in coping with the challenges facing autonomous republics and municipalities. The correct selection of the mechanism for distributing tax revenues between budgets of different levels is crucial in this process.*

*In Georgia, as in other developing countries, a large share of tax revenues comes from indirect taxes. According to the Budget Code of Georgia, excise and import taxes are fully transferred to the state budget, while 19% of the funds mobilized in the form of VAT go to the budgets of municipalities, and the remaining 81% to the state budget. According to the Tax Code of Georgia, only one local (property) tax is imposed in the country. The source of tax revenues of the autonomous republic is only the income tax paid by taxable entities registered in the territory of the autonomous republics. Despite certain legislative changes, under the existing model of tax revenue distribution, the degree of dependence of local budgets on transfers from the state budget is high.*

*In addition to the above, the types of taxes established by tax legislation (only general-state and local) are compatible with unitary states and include only a two-level budget, while the state structure envisaged by the Constitution of Georgia corresponds to a three-level government.*

*Thus, in order to effectively fulfill the tasks facing municipalities, it is crucial to increase their fiscal independence, which is possible by strengthening the tax regulatory function and developing a proper mechanism for distributing tax revenues.*

**Keywords:** *Tax revenues, fiscal independence, tax revenue redistribution.*

**JEL classification:** *H2, H61, K34, E62*

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## საგადასახადო შემოსავლების სხვადასხვა დონის ბიუჯეტებს შორის გადანაწილების პრობლემები საქართველოში

**აბსტრაქტი:** საბიუჯეტო სახსრების მობილიზების უმთავრესი წყარო საგადასახადო შემოსავლებია. ქვეყნის სოციალურ-ეკონომიკური განვითარების უზრუნველყოფაში სახელმწიფოს ერთ-ერთი მნიშვნელოვანი ბერკეტი სხვადასხვა დონის ბიუჯეტებს შორის საგადასახადო შემოსავლების სამართლიანი გადანაწილებაა, რამდენადაც ავტონომიური რესპუბლიკებისა და მუნიციპალიტეტების წინაშე არსებულ გამოწვევებთან გასამკლავებლად არსებითი ფაქტორი ფისკალური დამოუკიდებლობაა. აღნიშნულ პროცესში გადაწყვეტია სხვადასხვა დონის ბიუჯეტებს შორის საგადასახადო შემოსავლების გადანაწილების მექანიზმის სწორად შერჩევა.

საქართველოში, როგორც სხვა განვითარებად ქვეყნებში, საგადასახადო შემოსავლების დიდი წილი მოდის არაპირდაპირ გადასახადებზე. საქართველოს საბიუჯეტო კოდექსის თანახმად, აქციზისა და იმპორტის გადასახადები სრულად ჩაირიცხება სახელმწიფო ბიუჯეტში, ხოლო დღგ-ს სახით მობილიზებული სახსრების 19% მიემართება მუნიციპალიტეტების ბიუჯეტებში, დანარჩენი 81% კი - სახელმწიფო ბიუჯეტში. საქართველოს საგადასახადო კოდექსის თანახმად, ქვეყანაში დაწესებულია მხოლოდ ერთი ადგილობრივი (ქონების) გადასახადი. ავტონომიური რესპუბლიკის საგადასახადო შემოსავლების წყაროს კი მხოლოდ ავტონომიური რესპუბლიკების ტერიტორიაზე რეგისტრირებული დასაბეგრი ობიექტების მიერ გადახდილი საშემოსავლო გადასახადი წარმოადგენს. მიუხედავად გარკვეული ხასიათის საკანონმდებლო ცვლილებებისა, საგადასახადო შემოსავლების გადანაწილების არსებული მოდელის პირობებში, მაღალია ადგილობრივი ბიუჯეტების სახელმწიფო ბიუჯეტის ტრანსფერებზე დამოკიდებულების ხარისხი.

გარდა აღნიშნულისა, საგადასახადო კანონმდებლობით დაწესებული გადასახადების სახეები (მხოლოდ საერთო-სახელმწიფოებრივი და ადგილობრივი) თავსებადია უნიტარული მოწყობის სახელმწიფოებისათვის და მოიცავს მხოლოდ ორი დონის ბიუჯეტს, მაშინ როცა საქართველოს კონსტიტუციით გათვალისწინებული

სახელმწიფოებრივ მოწყობას სამი დონის მმართველობა შეესაბამება.

ამდენად, მუნიციპალიტეტების წინაშე არსებული ამოცანების ეფექტიანად შესასრულებლად უმნიშვნელოვანესია გაიზარდოს მათი ფისკალური დამოუკიდებლობა, რაც გადასახადების მარეგულირებელი ფუნქციის გაძლიერებითა და საგადასახადო შემოსავლების გადანაწილების სწორი მექანიზმის შემუშავებით არის შესაძლებელი.

**საკვანძო სიტყვები:** საგადასახადო შემოსავლები, ფისკალური დამოუკიდებლობა, საგადასახადო შემოსავლების გადანაწილება.

**JEL კლასიფიკაცია:** H2, H61, K34, E62

## INTRODUCTION AND LITERATURE REVIEW

The economic development of the country significantly depends on the correct determination of the main directions of the budgetary and tax policy. When using this lever, it is necessary to consider the selection of a fair mechanism for distributing the main source of budget revenues, tax revenues between budgets of different levels, which will ensure the fiscal independence of the relevant level of government and effective coping with existing challenges.

Inefficient distribution of tax revenues can lead to:

- a) strengthening of regional development inequalities;
- b) slowing down of economic growth;
- c) increasing bureaucratic costs;
- d) reducing the quality of state services.

Financial independence of regions and local governments is necessary in order to:

- promote the economic development and innovative activities of local governments and regions;

- reduce dependence on central government transfers;

- make it possible to ensure financial stability.

The effective distribution of tax revenues in regions with different fiscal capacities maximizes the use of resources and promotes economic development, which is reflected in the proper provision of services, while the lack of definition of fiscal decentralization priorities hinders the economic development of the region.

In some countries, a formula has been developed for the distribution of tax revenues, which takes into account a number of factors, including population size, poverty level, economic development indicators, etc. However, after a certain period of time, it is adjusted.

In less developed regions, a different approach is necessary and the use of horizontal equalization (between regions) along with vertical (between levels of government) is necessary. The selected proportion of tax revenue distribution should be able to provide each level of the budget with adequate financial resources to perform their functions.

Germany's budget system not only applies vertical, but also horizontal equalization of income. The highest taxes in Germany are credited to budgets of all levels of the budget system in accordance with regulated standards, this provides the nation with necessary finance resources to fulfill the obligations of all levels of government.

Tax income via federal budget is re-distributed from more developed to less developed territories. This way, in Germany a vertical and horizontal equalization is performed, with the

most important aspect – the tax potential equalization of territories via system of horizontal transfers. The main instrument of the vertical equalization is the re-distribution of income from VAT between federal and total budget of federation entities (IIIAPOHOBA, 2022).

For the past two decades, international donors have praised efforts towards fiscal decentralization as one of the key policy prescriptions to address issues related to poor public service provision and poverty in Africa.

However, most LGAs are still financially weak and rely excessively on support from the central government to finance their budgets (Masaki, 2018).

The majority of Eastern European countries use mixed methods of financial equalization, which are based on both fiscal potential and budgetary needs of the territory, usually based on population (Ivanenko et al., 2021).

The policy implication is that tax and transfer reforms should be designed within an array of complementary policy instruments to address equity and efficiency objectives, taking into account country-specific context, constraints and social preferences (Causa, O., & Hermansen, M. (2017).

Transfers are of particular importance in the process of regional equalization, since they contribute to the development of infrastructure, reduce migration flows from poor to rich regions, and compensate for financial inequality between regions, which cannot be achieved only through the effective distribution of tax revenues.

The existence of transfers is especially important for regions with an underdeveloped economy and a weak tax base, which cannot provide adequate revenues even in the case of tax redistribution. Transfers can provide targeted support for a specific direction, ultimately compensating for the shortcomings of the equalization achieved through the distribution of tax revenues.

In European countries, the local revenue ratio is approximately 50-70%, which is important for their financial independence.

### **Methodology**

The research process used methods of analyzing and evaluating normative documents, reports published by various agencies, and statistical information. Statistical information reflected in budget execution reports was analyzed and relevant conclusions were drawn.

### **Research Results**

In Georgia, there are three levels of government: central, regional and local, and accordingly, three levels of budgets are presented, the revenue part of which includes both tax and non-tax revenues and transfers. Tax revenues include only two levels of taxes - general state and local.

A large share of tax revenues comes from indirect taxes. According to the Budget Code of Georgia, excise and import taxes are fully transferred to the state budget, while 19% of the funds mobilized in the form of VAT go to the budgets of municipalities, and the remaining 81% - to the state budget. According to the Tax Code of Georgia, only one local (property) tax is imposed in the country. The source of tax revenues of the autonomous republic is only the income tax paid by taxable entities registered in the territory of the autonomous republics (table 1).

Table 1. Distribution of taxes between the republican budget of the state of Georgia, the budgets of autonomous republics of Abkhazia and Adjara and municipal budgets, according to percentages

	Type of tax	State Budget of Georgia	Republican budgets of the Autonomous Republics of Abkhazia and Adjara	Municipal Budgets
1	Income tax:			
1.1	Income tax, except for income tax paid by taxable entities registered in the territory of autonomous republics	100%		
1.2	Income tax paid by taxable entities registered in the territory of autonomous republics		100%	
2	Profit tax	100%		
3	Property tax			100%
4	Value Added Tax	81%		19%
5	Excise	100%		
6	Import tax	100%		

Source: Budget Code of Georgia

It is noteworthy that until 2018, the Budget Code of Georgia provided for the issuance of equalization transfers to the budgets of municipalities. However, with the amendment N4017 of December 14, 2018 to the Budget Code of Georgia, the equalization transfer mechanism was abolished and it was actually replaced by the introduction of VAT distribution. The goal of this amendment was fiscal decentralization and ensuring greater independence of municipalities.

To assess the quality of fiscal decentralization, we studied and analyzed the budget execution reports of the state budget, the republican budget of the Autonomous Republic of Adjara, and the Batumi Municipality for 2018-2023.

When studying the state budget reports, we focused on the amount and structure of financial assistance provided (table 2).

Table 2. Financial assistance transferred from the state budget to the budgets of republican and local self-governing units of autonomous republics (thousand GEL)

Years	Equalizing transfer	Targeted transfer	Special transfer	Capital transfer	Total	Total cash execution of state budget appropriations	Share of financial aid
2018	705,080.00	~	248,033.00	276,835.40	1,241,707.70	12,590,181.60	10%
2019		11,764.10	207,533.30	371,161.60	590,459.00	13,469,689.00	4%
2020		12,000.00	214,818.60	439,974.80	666,793.40	16,174,636.10	4%
2021		12,000.00	231,031.40	439,171.00	682,202.40	19,807,502.50	3%
2022		13,415.00	385,515.20	537,907.30	936,837.50	20,163,012.50	5%
2023		20,485.40	643,846.80	445,308.10	1,109,640.30	22,350,179.40	5%

Source: Compiled by the authors based on the annual reports on the implementation of the state budget for 2018-2023

As can be seen from the table, after the reform, the share of financial assistance in state budget payments decreased from 10% to an average of 4%, however, this is due only to the replacement of equalization transfers with VAT distribution, since the volume of targeted, special and capital transfers is increasing every year.

When analyzing the budget execution reports of Batumi Municipality for 2018-2023, we focused on the structure of its revenue part (table 3).

Table 3. Actual figures of the Batumi Municipality budget (thousand GEL)

Years	Tax revenues		Grants and financial assistance		Other revenues		Decrease in non-financial and financial assets		Total income	Total payables
	Amount	Share (%)	Amount	Share (%)	Amount	Share (%)	Amount	Share (%)	Amount	Amount
2018	32,055.00	19.19%	81,242.10	48.64%	48,950.80	29.31%	4,779.70	2.86%	167,027.60	164,527.10
2019	80,404.60	45.36%	38,463.20	21.70%	49,551.20	27.96%	8,824.40	4.98%	177,243.40	172,591.50
2020	62,478.60	43.95%	60,777.60	42.75%	17,500.90	12.31%	1,410.40	0.99%	142,167.50	140,992.80
2021	77,736.00	39.41%	59,638.50	30.24%	43,077.00	21.84%	16,774.90	8.51%	197,226.40	178,358.60
2022	98,039.50	36.84%	87,327.80	32.1%	69,208.60	26.01%	11,558.30	4.34%	266,134.20	246,557.30
2023	102,991.50	29.99%	134,000.40	39.02%	96,372.80	28.06%	10,092.10	2.94%	343,456.80	337,641.20

Source: Compiled by the authors based on the annual reports on the implementation of the Batumi Municipality budget for 2018-2023



The presented information shows that after the introduction of VAT distribution, the tax revenues of the Batumi municipality budget doubled (from 19% to an average of 40%), however, a significant share (35-40%) of the budget revenues is occupied by financial assistance. It is noteworthy that in the example of this municipality, its own tax revenues provide only 40% of budget payments.

We also studied the structure of financial assistance of the mentioned municipality (table 4).

Table 4. Types of financial assistance from the Batumi Municipality budget

Years	Equalizing transfer		Special transfer		Financial assistance from the republican budget		Current grants from the budget of another self-governing entity		Grants from international organizations		Total amount
	Amount	Share	Amount	Share	Amount	Share	Amount	Share	Amount	Share	
2018	40,286.40	49.59%	3,925.30	4.83%	37,030.40	45.58%		0.00%		0.00%	81,242.10
2019		0.00%	3,931.90	10.22%	34,531.30	89.78%		0.00%		0.00%	38,463.20
2020		0.00%	34,574.00	56.89%	26,203.60	43.11%		0.00%		0.00%	60,777.60
2021		0.00%	1,548.30	2.60%	57,590.20	96.57%	500	0.84%		0.00%	59,638.50
2022		0.00%		0.00%	87,302.40	99.97%		0.00%	25.4	0.03%	87,327.80
2023		0.00%		0.00%	133,824.80	99.87%		0.00%	175.6	0.13%	134,000.40

Source: Compiled by the authors based on the annual reports on the implementation of the Batumi Municipality budget for 2018-2023

As the data show, the main source of financial support for the budget of Batumi Municipality is the budget of the Autonomous Republic of Adjara.

To present the problem of tax revenue distribution, it is important to assess the fiscal independence of the autonomous republic, which we carried out based on the data of the republican budget of the Autonomous Republic of Adjara (table 5).

The presented data demonstrate that the fiscal independence of the republican budget of the Autonomous Republic of Adjara is quite high. 87% of revenues are generated by tax revenues, the only source of which is income tax. It is noteworthy that this revenue provides 86% of payments, of which transfers to municipal budgets account for an average of 29% (which has increased to 38.81% of payments by 2023).

In accordance with Part 5 of Article 1145 of the Budget Code of Georgia, the maximum percentage increase in the forecast volume of income received by each municipality as a result of the distribution of value-added tax in 2024 compared to the previous year was determined at 25%. (Law on the State Budget of Georgia for 2024) <https://www.mof.ge/5677>).

**Table 5. Actual figures of the republican budget of the Autonomous Republic of Adjara (thousand GEL)**

Years	Tax revenues		Grants and financial assistance		Other income		Decrease in non-financial and financial assets		Increase in liabilities		Total income	Total payables	Including transfers to municipal budgets	
	Amount	Share (%)	Amount	Share (%)	Amount	Share (%)	Amount	Share (%)	Amount	Share (%)	Amount	Share (%)	Amount	Share (%)
2018	245,804	85.10		0.00	15,223	5.27	27,814	9.63		0.00	288,841	344,399	68,720	19.95
2019	274,872	89.29		0.00	19,830	6.44	13,129	4.27		0.00	307,831	325,967	71,339	21.89
2020	237,233	85.13		0.00	10,652	3.82	30,773	11.04		0.00	278,657	291,464	53,002	18.18
2021	273,404	88.95		0.00	11,699	3.81	22,258	7.24		0.00	307,362	328,308	104,773	31.91
2022	377,682	85.45	40	0.01	9,669	2.19	34,579	7.82	20,000	4.53	441,970	397,082	135,152	34.04
2023	482,890	89.00	277	0.05	22,197	4.09	37,199	6.86		0.00	542,563	532,279	206,574	38.81

*Source: Compiled by the authors based on the annual reports on the implementation of the republican budget of the Autonomous Republic of Adjara for 2018-2023*

By 2025, the maximum percentage increase in the projected revenue of each municipality as a result of the distribution of value-added tax compared to the previous year will not apply to a municipality whose projected value-added tax, in the case of distribution without restrictions, is less than 15 million GEL, in order to replenish the projected value-added tax of this municipality up to 15 million GEL.

The aforementioned legislative amendments do not explain why the goal is to replenish the revenues of different municipalities up to 15 million GEL under conditions when their needs are not the same.

Finally, it should be noted that the transition from an equalization transfer system to a value-added tax distribution system in Georgia failed to ensure the mobilization of sufficient financial resources in the budgets of local governments, which is important for their fiscal independence.

### CONCLUSIONS

- Municipalities are highly dependent on capital transfers from the state budget, therefore, the current level of fiscal independence cannot ensure infrastructural development;
- Following the example of the Autonomous Republic of Adjara, it is possible to increase the fiscal independence of municipalities by introducing a mechanism for distributing income tax;
- In the conditions of unequal tax potential of regions and local governments, it is necessary to provide different levels of government with sufficient financial resources, which will lay the foundation for their equal development opportunities. Therefore, for the purpose of optimal distribution of tax revenues, it is important to select fair mechanisms for inter-budget distribution of taxes, which, on the one hand, will increase the accountability of the government to the local population and reduce dependence on transfers.

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