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Statement by the Hon. **ZURAB NOGAIDELI**
Governor of the Bank for **GEORGIA**
at the Joint Annual Discussion

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The new Georgian authorities embarked on a very ambitious reform program in December of 2003. The main elements of the government reform agenda in the short-term were to fix the decrepit fiscal sector, to strengthen the governance, to combat corruption and smuggling, to foster economic growth and reduce poverty, and restore the general public confidence. In February 2004 the government negotiated a new IMF program which again envisaged very bold targets for the coming years. For instance, according to the program scenario the tax revenue to GDP ratio was planned to increase by 2 percentage points to reach 16.3 percent by the end of 2004. Such a dramatic increase was unprecedented in Georgia since its independence. However, the government not only delivered on its results but in many areas and aspects even substantially outperformed the program targets. In fact, the tax revenues almost doubled relative to the last year and for the first time since its independence the budget expenditure allocations were revised upward. According to the established tendency in revenue collections, the tax revenue to GDP ratio may reach 18 percent that would be almost 4 percentage point increase compared to the previous year.

Enhanced revenue mobilization allowed the government to timely meet its spending obligations and especially in the social area. Moreover, the government started to clear the domestic expenditure arrears accumulated in the previous years. Again, the government outperformed the program indicators in this respect and by the end of 2004 arrears in the amount 2.4 percent of GDP will be cleared instead of initially programmed 1 percent of GDP.

All of the achievements above have been possible owing to the political will and intensified efforts of the new administration. Structural reforms implemented in the fiscal sector have been particularly effective in delivering on the results. Specifically, the reforms were implemented at multiple fronts simultaneously and targeted the anti-corruption, anti-smuggling and governance enhancing objectives. Within the context of these reforms the tax and customs departments have been significantly downsized and their functions have been consolidated. Furthermore, a new excise tax inspectorate was established to enable the tax administration to concentrate its efforts primarily on the excisable goods. The last but not least the Adjara tax administration was effectively integrated into the national tax authority and the Adjara customs was abolished and its functions taken over by the regional customs.

Financial police was set up shortly after abolishing the parallel structures within ministry of interior, ministry of state security, ministry of finance, customs and tax departments. The financial police today is the sole investigatory state agency responsible for the economic crimes, including tax evasion and smuggling. Rather than having these functions scattered along different state bodies today they are concentrated into one single state agency with its staffing being at only 20 percent of what it has been previously.

Significant reforms have been implemented in the treasury department of the Ministry of Finance in the current year. Three major developments are worth mentioning in particular: (1) Full commitments control system was introduced to ensure that the spending units did not incur expenditures in excess of their respective appropriations and to prevent accumulation of arrears; (2) Single revenue account was introduced that enabled to close down about10 thousand transit accounts and substantially simplify the revenue reporting and accountability; (3) Effective tax refund mechanism was introduced.

Along with the major structural changes the government developed new fiscal policy agenda. The proposed tax reform has been developed to create investor- and business-friendly environment, reduce underground activity and tax evasion and promote voluntary compliance with the ultimate goals of fostering economic growth and development. The new draft tax code of Georgia envisages the elimination of 13 out of 21 different taxes, simplification of administrative procedures and the rate reduction on some of the major taxes. Specifically, the VAT will be reduced from 20% to 18%, the personal income tax will be lowered from 20% to a flat 12% and the social tax will be down from 33% to 20%. However, in order to make the tax reform revenue-neutral the counter revenue-losing measures have been proposed, like broadening the tax base by eliminating many existing tax exemptions and increasing excise tax rates and strengthening tax administration efforts.

These positive developments in the country have substantially boosted the confidence in the government from the international community. On June 4, 2004 the IMF board approved a new PRGF program for Georgia and shortly afterwards the World Bank board approved credits for three new operations including the budgetary support reform support credit. On June 15, 2004 at the donor conference in Brussels the government received substantial pledges of donor assistance over the next coming years in the amount of over US$ 1 billion. Finally, on July 21st 2004 the Paris Club creditors agreed to restructure the bilateral debts of Georgia on the so called Houston terms that helped to relieve the debt burden of Georgia in the medium-term.

Despite the fact that substantial progress was recorded in all reform components of the government major challenges are still ahead. The intention of the government is to intensify the reforms even further and concentrate on the key priority areas. In the fiscal sector the main challenges will be to effectively implement the proposed tax reform and make the transition from existing system to the new one as smooth as possible. Moreover, the government plans to introduce the multi-year budgeting and link more closely the policies and the national priorities with the annual budgetary allocations. The government also plans in the medium-term to target the socially most vulnerable and eliminate extreme poverty in the country in the medium-term.