



# **THEORETICAL FRAMEWORK OF PUBLIC INTEGRITY AND INSTITUTIONAL CHANGES OF GEORGIA'S TAX ADMINISTRATION**

**Rusudan Kemularia**

## Table of Contents

Executive Summary .....	3
1. Introduction .....	5
2. Purpose of the Revenue Service .....	6
2.1 Collection of Revenue .....	7
3. Legitimate Purpose of the Revenue Service .....	8
3.1 Constitutional Regulation of Tax Structure .....	8
4. The Pursuit of Purpose of the Revenue Service .....	8
4.1 Human Capital of the Revenue Service .....	9
5. Legitimate Pursuit of Legitimate Purpose .....	9
5.1 Procedural Fairness .....	9
5.2. Simplification of Tax Legislation .....	10
5.3 Mediation Mechanism .....	13
5.4. The Dispute Settlement Mechanism .....	14
6. Commitment of the Tax Authority .....	15
6.1 Advance Ruling .....	15
7. Robustness of Tax System .....	18
7.1. IT - Based Risk Assessment/e-filing .....	18
8. Policy Recommendations .....	19
Recommendation 1. Simplification of Tax Legislation .....	19
Recommendation 2. Consultation Process .....	20
Recommendation 3. Mediation Mechanism .....	20
Recommendation 4. Advance Ruling .....	20
Recommendation 5. IT- Based Risk Assessment / E-filing .....	20
9. Conclusion .....	21
References .....	22

## Executive Summary

Public institutional integrity is an important policy issue for developed and developing countries. Moreover, as Nikolas Kirby articulates, there has been increasing interest of academic and practitioners in the study and cultivation of public integrity as a distinct goal from anti-corruption: ‘there is a need for a more praiseworthy, and robust governance goal: a goal that not only implies addressing corruption but as it was going beyond to establish institutions truly worthy of trust. With this aim in mind, there has been a surge of interest in defining a concept of ‘public integrity’ to play this role.’<sup>1</sup>

With regards to taxation, less developed countries face greater challenges regarding tax collection. Since 2003, Georgia's tax administration transformed dramatically. In this policy report, I apply Kirby's institution-first conception of public integrity to the Georgian Revenue Service. I begin by laying out the theoretical framework of public integrity developed by Kirby. I then discuss the elements of the ‘institution-first’ concept, such as legitimate purpose, legitimate pursuit, commitment and robustness in relation with institutional changes of tax administration of Georgia (hereafter, the Revenue Service). Next, I analyze the main changes of the Revenue Service since 2003 – 2012, and identify a range of plausible policy options and stakeholders concerns. Finally, I provide evidence-based policy recommendations for building public integrity and trust toward tax administration.

---

<sup>1</sup> Working paper for discussion at the Building Integrity Workshop. An “Institution –first” conception of public integrity. By Nikolas Kirby. 3rd May 2018.

Table 1. The Roadmap of Theoretical Framework of Integrity

Elements of “Institution-First” Concept of Integrity	Integrity of the Revenue Service
<p><b>Purpose</b> – “an institution needs a clearly defined purpose in order to have integrity.”</p>	<p><b>Purpose of the Revenue Service</b> – the collection of revenue.</p>
<p><b>Legitimacy of Purpose</b> – “citizens might not agree that it is the best purpose for the institution to have, or the most just or equitable, but they should agree that, given who and/or how that purpose was set (eg. by a democratically elected government in accordance with the constitution) the institution currently can have such a purpose.”</p>	<p><b>Legitimacy of the Purpose of the Revenue Service</b> - the purpose of the Revenue Service was established by the democratically elected government of Georgia, consistent with its constitutional powers and responsibilities.</p>
<p><b>Pursuit</b> – “a public institution of integrity must pursue its legitimate purpose to the best of its abilities, given the resources that it has.”</p>	<p><b>Revenue Service Pursuit</b> – any tax administration has limited human and financial resources. Thus, it must pursue its legitimate purpose to the best of its ability to achieve the main objective effectively.</p>
<p><b>Legitimacy of Pursuit</b> – “Citizens might not agree that it has pursued its purpose in the best way, or the most just or equitable manner, but they should agree that, given who and/or how the scope of the domain and possibilities of power were set, the institution currently has a right to so act.</p>	<p><b>Legitimacy of Pursuit of the Revenue Service</b> – there are several mechanisms to legitimately pursue the purpose of tax administration, including simplification of tax legislation and mediation.</p>
<p><b>Commitment</b> – “public institutions do not merely have ex ante public duties; they also make commitments ex-post. They make commitments to the public. They also make commitments to individual members.”</p>	<p><b>Commitment of the Tax Administration</b> – the tax administration must stick to its commitment. An advance ruling helps to bind authority ex-post.</p>
<p><b>Robustness</b> – “disposition must also be robust across time and circumstance. It needs to reflect sufficient strength and resolve such that the institution can be relied upon come what may”.</p>	<p><b>Robustness of the Revenue Service</b> – there are several mechanisms to ensure robustness of tax administration, including IT - based risk assessment and e-filing.</p>

## 1. Introduction

One of the most important policy questions for any government is how to build institutional integrity. How can a government eliminate corruption and make public institutions more trustworthy? There are different concepts in theory and practice to address this question. However, I will examine the following definition of integrity in relation to Georgia's Revenue Service. Two types of public integrity can be identified: 'institution-first' approach, and 'public-officer' integrity. The first is defined as 'the robust disposition of a public institution to legitimately pursue its legitimate purpose, to the best of its abilities, consistent with its commitment.'<sup>2</sup> The second dimension is public officer integrity, which is 'the robust disposition of public officer in the course of her public duties to peruse the integrity of her institution to the best of her abilities.'<sup>3</sup> For the purposes of this paper I will explore only the 'institution-first' conception of integrity. Using the above definition of institution-first public integrity, I will discuss the changes of the Revenue Service to prove the elements of this conception of integrity.

First, however, it will be necessary to provide a brief overview of the political economy of Georgia. Georgia's transition from Soviet to modern democracy was unlike other countries. The economic collapse at the beginning of the 1990s was compounded by the conflicts in Georgia's regions of Abkhazia and South Ossetia. Furthermore, national social norms and political culture were unprepared for the new challenges. In November 2003, after the Rose Revolution started the country's economic development. The ambitious agenda of the new government included combating corruption, building public institutions, and implementing of structural reforms within the short period of time. The reforms brought in by the Saakashvili government were substantial; according to Gilauri, 'What happened in Georgia between 2004 and 2012 is one of only a handful of examples of true transformation on a national scale in the twenty-first century, and perhaps the most comprehensive case.'<sup>4</sup> Indeed, in 2006 - 2011 Georgia successfully completed 35 reforms qualifying under the World Bank's "Doing Business" criteria. According to the World Bank's 'Ease of

---

<sup>2</sup> Nikolas Kirby. "An 'Institution-First' conception of public integrity", working paper for discussion at the building integrity workshop. 3rd May 2018.

<sup>3</sup> Ibid.

<sup>4</sup> Nika Gilauri. "Practical Economics". Palgrave Macmillan, 2017. P

Doing Business' report, 'the global average for such reforms was 1.7 per year at the time.'<sup>5</sup>

In 2003, Georgia's tax base counted 80,000 taxpayers, and tax revenue was 12 percent of GDP. In 2010, the income tax base increased to 252,000 taxpayers, and collections measured 23.4 percent of GDP. These results were achieved not because of the population growth, rather through institutional changes of the Revenue Service. The corrupt civil servants were dismissed in a very short period of time, and major tax reforms were implemented. Key tax reforms included the reduction of tax rates and the number of taxes from 22 to 6 taxes, the simplification of the tax legislation and procedures, and the rapid growth of e-filing of tax liabilities.

*Table 2. Outcome of the Institutional Change of the Revenue Service*

<b>Before 2003</b>		<b>After 2003 to 2012</b>
Number of taxes	22	6
Potential tax revenue as percentage of GDP	40-45%	28-30%
Actual tax revenue <sup>1</sup> as a percent of GDP	5.6%	23.4%
Compliance rate	35%	78-85%

*Source: Data produced by the Ministry of Finance of Georgia, IMF presentation April 2011.*

## **2. Purpose of the Revenue Service**

### General Principle

According to the theoretical framework of public institutional integrity, 'an institution needs a clearly defined purpose in order to have integrity.'<sup>6</sup>

<sup>5</sup> World Bank Group, *Doing Business in a More Transparent World*, (2012), World Bank Group, access at: <http://www.doingbusiness.org/content/dam/doingBusiness/media/Annual-Reports/English/DB12-FullReport.pdf>

<sup>6</sup> Working paper for discussion at the Building Integrity Workshop. An "Institution –first" conception of public integrity. By Nikolas Kirby. 3rd May 2018.

Furthermore, the purpose is legitimate, 'when it is set by the appropriate higher authorities, is legal, and in practice would be publicly defensible as something the institution has a right to pursue.'<sup>7</sup>

## 2.1 Collection of Revenue

Edmund Burke, emphasized that 'revenue is the chief preoccupation of the state. Nay more it is the state.'<sup>8</sup> Furthermore, 'a tax institution achieves its main purpose when it raises revenues effectively and equitably for the state's necessary or legitimate activities and functions. Tax institutions have one "obligatory purpose" and that is to raise revenue effectively and equitably.'<sup>9</sup> To these ends, the Revenue Service is constituted under the ministry of finance of Georgia. According to the charter number 303, article 2, (b), one of the key objectives of the Revenue Service is the collection of revenue.

Moreover, the ratio of tax collection to GDP in developed countries usually outstrips that of developing countries. Nicholas Kaldor has suggested that 'developing countries raise about 8 to 15 percent of their Gross Domestic Product (GDP) as tax revenue, while the ratio for advanced countries is 25 to 30 percent. More than sixty years after this issue came to the fore, and after more than thirty years of tax administration reforms in developing countries, it remains largely unresolved.'<sup>10</sup>

In Georgia, before tax reforms, the Revenue Service had an objective to collect taxes. However, the revenue was not collected effectively because of corruption and the fragile tax administration. Therefore, through the 2003-12 reforms (and although the main purpose was to increase the tax revenue to GDP ratio), the Revenue Service gained subsidiary purposes: to eliminate endemic corruption, build the trust in Georgia's tax administration, while decreasing the size of the shadow economy and increasing tax compliance.

---

<sup>7</sup> Ibid.

<sup>8</sup> Frederick C. Dietz. *English Government Finance 1485-1558* (Frank Cass, 1964), 213.

<sup>9</sup> Edmond J. Safra. Research Lab Working Papers No. 25. October 3, 2013. [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2335619](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2335619).

<sup>10</sup> Mohammed Abdullahi U. Nyende Festo T. *Challenges of Tax Administration in Developing Countries: Insights from the 5<sup>th</sup> Annual Tax Administration Research Center Workshop*.2017.

### 3. Legitimacy of Purpose

#### General Principle

According to the theoretical framework of public institutional integrity 'citizens might not agree that it is the best purpose for the institution to have, or the most just or equitable, but they should agree that, given who and/or how that purpose was set the institution currently can have such a purpose.'<sup>11</sup>

#### 3.1 Constitutional Regulation of Tax Structure

The taxpayer does not like to pay taxes but as Benjamin Franklin once observed, 'in this world nothing can be said to be certain, except death and taxes.'<sup>12</sup> Democratically elected government and its tax administration can have a purpose of tax collection in order to provide public goods. Before changes to Georgia's constitution in 2010, the government had the flexibility to raise the taxes and modify the tax structure without a referendum. Currently, however, Georgia's constitution requires this. Furthermore, article 94 of the constitution stipulates that 'taxes and fees shall be paid in the amount and under the procedure determined by law. Only law shall determine the structure of taxes and fees and the procedure for introduction thereof. Exemption from taxes shall be permitted only by law.'<sup>13</sup> In general, such strict regulation and minimized discretion of government could increase the public trust toward tax administration. However, it could be problematic for the government to address economic shocks, and balance high budget deficit in a timely and effective manner.

### 4. The Pursuit of Purpose of the Revenue Service

#### General Principle

According to the theoretical framework of public institutional integrity 'a public institution of integrity must pursue its legitimate purpose to the best of its abilities, given the resources that it has.'<sup>14</sup>

---

<sup>11</sup> Kirby, 'An Institution-First Conception of Public Integrity.'

<sup>12</sup> Franklin, Benjamin, and Albert H. Smyth. *The Writings of Benjamin Franklin*. New York : London: Macmillan Company, 1905.

<sup>13</sup> Art. 94, Constitution of Georgia, Parliament of the Republic of Georgia, access at: <https://matsne.gov.ge/en/document/view/30346?publication=35>, last accessed: 23/10/2018

<sup>14</sup> Kirby, 'An Institution-First Conception of Public Integrity.'

#### 4.1 Human Capital of the Revenue Service

Any tax administration has limited human and financial resources, which are critical for the effective collection of revenue. There are only so many well-trained civil servants and tax inspectors, especially in developing countries.

Since 2009, the government of Georgia established the finance academy of the ministry of finance to train civil servants on the job, as the tax legislation is complex and requires special knowledge. The Netherlands, Austria, and Singapore have similar training centers. While these initiatives have been important, tax administrations still face the problem of highly qualified civil servants moving to the private sector rather than staying in the public service. This 'leakage' of highly trained tax specialists to the private sector diminishes the resources at the disposal of tax administrations.

However, alongside these training schemes, the Revenue Service has implemented other mechanisms in order to achieve its institutional objectives to the best of its ability, such as IT-based risk assessment and e-filing, which will be discussed in section 7.

## 5. Legitimacy of Pursuit

### General Principle

According to the public institutional integrity 'the institution's actions are *intra vires*. Citizens might not agree that it has pursued its purpose in the best way, or the most just or equitable manner, but they should agree that, given who and/or how the scope of the domain and possibilities of power were set, the institution currently has a right to so act.'<sup>15</sup>

### 5.1 Procedural Fairness

It is important for the taxpayer to be treated in a respectful and procedurally fair manner as they pay their share of taxes. Picking up on this, Hartner et al. suggest a responsive regulatory approach encapsulates this relationship between citizens' expectations of public institutions in relation to procedural fairness, and their own obligations as taxpayers: 'The responsive regulation approach proposes that governments adjust regulatory efforts to the behavior of taxpayers. People highly identified with the nation and committed to pay

---

<sup>15</sup> Kirby, 'An Institution-First Conception of Public Integrity.'

their fair share of taxes want to be treated in a respectful and fair manner in order to honestly declare taxes.<sup>16</sup>

Well-defined organizational structure helps to facilitate this procedural fairness. After 2003, the charter of the Ministry of Finance of Georgia went through drastic changes to clearly define functions of departments and units. The main challenge has been crosscutting functions, where it is difficult to draw a line between the responsibilities of departments. Unfortunately much of this is the nature of the bureaucracy of the ministry and cannot be fully addressed.

## 5.2. Simplification of Tax Legislation

Simplification of tax legislation is important to legitimate pursuit of purpose. Before 2003 taxes were collected through illegitimate means. The main tool for tax collection was bargaining the taxable amount with taxpayer. The complex tax system and vague tax provisions created the preferable regime for fraudulent and corrupt transactions. Thus, a simplification of the tax code of Georgia and the elimination of ambiguous norms surrounding tax rules enabled the Revenue Service to achieve its core objectives in legitimate ways.

After 2003, hundreds of changes were made to the tax legislation. These were necessary to mitigate the risks associated with corruption and to rebuild public trust toward the tax authority. However, frequent changes to the tax law created uncertainty and concerns: the biggest achievement was the consultation process held between tax institution and stakeholders in order to discuss the legislative changes, however this process was not always transparent and comprehensive. Furthermore, many changes were made to tax law, without taxpayer's involvement. Communication of these changes in time would be critical for some taxes, still, there may be policy reasoning for implementation of changes with minimum pre-announcement. This may be the case in order to mitigate cases of avoidance – for example, through the artificial shifting of income between tax periods to minimize income tax burdens. In general, there was a trade-off between achieving the objective of reforming the tax system in a very short period of time, or delaying the progress.

This trade-off is important, as evidence shows that even in OECD countries, the design and implementation of tax legislation poses challenges for administrations attempting to create conditions of tax certainty. For example, a report by the OECD and IMF in March 2017 suggests that 'the major source of tax uncertainty is complex and poorly drafted tax legislation and the frequency of legislative changes.'<sup>17</sup> Further, according to the same report,

---

<sup>16</sup> Procedural Fairness and Tax Compliance Martina Hartner, Silvia Rechberger, Erich Kirchler, and Alfred Schabmann\* University of Vienna; Economic analysis and policy, VOL. 38 NO. 1, March 2008. P 149

<sup>17</sup> IMF/OECD Report for the G20 Finance Ministers March 2017. p. 6

'Tax certainty is a high priority for tax administrations, with over 80% of respondents to the tax administration survey identifying it as a very high or extremely high priority of their tax administration.'<sup>18</sup>

As a result of tax reforms in 2003-2012, Georgia simplified the tax code and eliminated ambiguities within the legislation. However, the frequent changes were a problem for tax certainty in the short-term. It has been argued that frequent and unexpected changes in tax law can create tax uncertainty and mistrust toward the tax institutions.<sup>19</sup> Yet tax legislation is not static, the government is required to address its economic and social objectives, therefore changes are to be anticipated. Furthermore, if changes simplify the tax system and rationalize it, uncertainty may be reduced in the longer term, even if short-term uncertainty could temporarily affect taxpayer's decisions.

Retroactivity of legislation is another critical issue, which creates arbitrariness and mistrust toward the Revenue Service. According to the IMF/ OECD report

true "retroactivity" would mean changes to tax laws that are applied to past tax years, as opposed to changes in the law that apply to future years. Defining the concept in relation to anticipated returns to existing investment would imply that no change in tax policy, including changes in tax rates, could be applied to any existing activities.<sup>20</sup>

Georgia's tax code includes few articles, which are retrospective. However, this is not a common policy and could have a minor effect on legitimacy of pursue of the objective of the Revenue Service.

Transitional provisions are common in Georgia's tax code, which are critical for building trust between taxpayers and the tax authority, and credibility of the tax rules. The IMF/OECD report also argues that 'adopting transitional (for instance, a phase-out period) or grandfathering provisions in respect of that existing investment on certainty and transparency grounds.'<sup>21</sup>

Tax provisions implemented on a temporary basis are often used in Georgia's tax legislation, which could create mistrust toward the tax institution. Furthermore, it is argued that uncertainty is generated, when the expiry date of provision is unclear. Gulen and Ion find evidence that

---

<sup>18</sup> *ibid.*

<sup>19</sup> *ibid.*

<sup>20</sup> *ibid.*

<sup>21</sup> *ibid.*

policy uncertainty is persistently and negatively correlated with corporate investment, with an important part of the negative effect of tax-related uncertainty measured as the presence of temporary measures where the expiration date or the possibility for renewal are unclear. Such uncertainty risks creating a hold-up problem, as firms defer investment until the uncertainty is resolved—so undermining the effectiveness of such measures.<sup>22</sup>

However, temporary measures could be very effective policy tools to introduce tax incentives for investment to encourage spending during an economic downturn and achieve the legitimate purpose of the Revenue Service. The IMF/OECD find that:

such temporary incentives implemented in the US during the 2001-02 economic downturn and the latest global financial crisis were effective in stimulating investment spending. If the expiration date is clear and credible, the temporary nature of the provision should incentivize firms to spend today to capture the transient tax benefits now.<sup>23</sup>

To summarize, after 2003 the Revenue Service pursued to the best of its abilities to achieve its legitimate purpose. Simplification of tax legislation and the elimination of ambiguities was a legitimate way to pursue the objectives of the tax authority of Georgia. However, simplification of tax legislation as a mechanism for tax administrations to pursue their legitimate purposes of revenue raising can only go so far. The complexity of tax systems, and issues such as tax avoidance, continue to be problems facing many tax authorities. According to the IMF/OECD report,

even the best designed and drafted tax laws are not capable of anticipating every new product, service or business model and every taxpayer transaction and structure, particularly those of an aggressive nature or those that are otherwise undertaken for tax avoidance purposes. Therefore, various tax integrity or anti-avoidance rules may need

---

<sup>22</sup> Gulen, Huseyin and Ion, Mihai, Policy Uncertainty and Corporate Investment (June 24, 2015). *Review of Financial Studies*, Vol. 29 (3), 2016, 523-564. Available at SSRN: <https://ssrn.com/abstract=2188090> or <http://dx.doi.org/10.2139/ssrn.2188090>

<sup>23</sup> IMF/OECD Report for the G20 Finance Ministers March 2017, p. 20

to be implemented in order to effectively counter tax avoidance practices and protect the integrity of the tax system.<sup>24</sup>

Moreover, the frequent changes to the tax legislation and retroactive, transitional legal provisions within tax legislation are common not only for Georgia but for most countries. Thus, the challenge for the responsible institutions is to design the best tax legislation possible in order to pursue the legitimate purpose of raising revenue.

### 5.3 Mediation Mechanism

A mediation process was introduced to allow taxpayers to resolve the tax disputes through facilitated cooperation with the Revenue Service. This has been an effective mechanism to avoid a long and costly litigation process. Before tax sanctions and penalties are imposed, the taxpayer has a right to submit relevant documentation and clarify the taxable transaction. Namely, prior to issuing the formal audit report, the draft report is presented to the taxpayer. The taxpayer then has ten days to justify their position and request amendment to the draft audit report. If the request at the first stage is not successful, the taxpayer has another chance to submit the request to the mediation council.

The strength of this system is that it gives the chance for taxpayers to clarify taxable transactions. It is an effective way to avoid tax disputes at the initial stage before the final audit report is enacted. As Jones and Maples have articulated, out-of-court mediation processes may increase taxpayers' trust in tax dispute resolution systems, which may then have the positive flow on effect of ensuring compliance with tax rules:

a successful tax mediation regime can not only help parties to move away from adopting entrenched litigious positions and towards focusing on early resolution outside of the Courts; but it may also help to improve taxpayers' views of the tax dispute resolution system, thereby increasing voluntary compliance. If appropriately used, mediation should result in significant time and cost efficiencies for both taxpayers and the tax authority.<sup>25</sup>

Finally, mediation – done well – is a legitimate negotiation between the taxpayer and the Revenue Service. It helps to increase trust toward tax administration. According to the World Bank Group, 'as tax laws are complex, tax disputes are often fact-intensive. A combination of these factors can

---

<sup>24</sup> *ibid.*

<sup>25</sup> Jones and Maples 'Mediation as an alternative option in Australia's tax disputes resolution procedures' (2012) 27 Australian Tax Forum

contribute to uncertainty regarding the correct interpretation of the issues in the dispute, and thereby warrant mediation or negotiation that allow parties to search for creative solutions that fulfill the needs of both disputants.<sup>126</sup>

However, mediation is not without shortcomings: it imposes additional costs, even though it brings in tax revenue. Furthermore, the mediator has a direct contact with the taxpayer before the final report is issued. This could raise the risk of corruption and affect the quality of the audit report if handled improperly.

#### **5.4. The Dispute Settlement Mechanism**

Another tax instrument to legitimately pursue the legitimate purpose is the dispute settlement mechanism. The effective and fair system helps to build the trust toward the Revenue Service. In Georgia, the dispute settlement process allows two independent appeal mechanisms to review the decision taken by the tax institution. The first instance of dispute resolution is the Revenue Service. If, however, a taxpayer disagrees with the decision made by the authority, it can then be appealed at second instance – by a tax dispute resolution council under the Ministry of Finance of Georgia. Another option is to take the dispute directly to the court for resolution. However, in Georgia, courts have rarely been preferred for tax dispute resolution, because of the level of independence and the competence in taxation.

Yet there are concerns regarding the dispute settlement mechanisms within the system of the Ministry of Finance of Georgia. Most of the members could be dismissed by the head of relevant authority; there are no safeguard mechanisms in legislation. There is no differentiation in terms of the procedures for small and big claims, which makes the tax dispute settlement mechanism less effective. The same members are involved in the discussion of all types of disputes, which has an impact on the timing of dispute resolution and quality of decisions, as the number of the tax disputes are rising. In 2011, the Revenue Service received 7,900 tax appeal claims and this number doubled in subsequent years. However, the IMF technical assistance report 2016 identifies that overall in Georgia the 'dispute resolution mechanism is accessible and independent.'<sup>27</sup>

To summarize, Georgia's tax dispute settlement mechanism is an instrument for the Revenue Service to legitimately pursue its legitimate purpose. However, there are concerns regarding the procedures of the dispute settlement mechanism. In order to allow this institution to achieve its objective, it is critical

---

<sup>26</sup> 'The Role of the Lawyer in Out of Court Dispute Resolution' IM-Mediation Resolution April 2013, The World Bank

<sup>27</sup> International Monetary Fund technical assistance report 2016, p. 7.

to improve the current dispute resolution mechanism within the system of the Ministry of Finance of Georgia.

## 6. Commitment of the Tax Authority

### General Principle

According to the theoretical framework of public institutional integrity 'public institutions do not merely have *ex ante* public duties; they also make commitments *ex post*. They make commitments to the public. They also make commitments to individual members.'<sup>28</sup>

### 6.1 Advance Ruling

In 2010, the private advance ruling (hereafter advance ruling) was introduced within Georgia's tax code. The advance ruling is legally binding for the tax administration and the taxpayer. The aim of the regulation is to promote clarity and consistency regarding the application of the tax law and commit the Revenue Service to act according to the ruling. A taxpayer can submit the application to the Revenue Service asking the interpretation of particular taxable transaction.<sup>29</sup> After introducing such rulings the tax administration is obliged to follow its interpretation.

A taxpayer may also request written explanations of tax provisions from the relevant institutions. However, these explanations are not legally binding and cannot protect the taxpayer against tax assessment. The ruling must be issued within the 90 days after submission of application and it is not free of charge. If a taxpayer receives a negative ruling, it can be challenged through the appeals process.

As noted by IMF in 2016, the advantages of a private tax ruling are 'promotion of clarity and consistency regarding the application of the tax law for both taxpayers and the tax authority.'<sup>30</sup> Increased certainty around the tax treatment of transactions also raises taxpayer confidence in the tax system.

There are, however, arguments against a private ruling practice. The disadvantages of a private ruling practice could include: 'risk of base erosion

---

<sup>28</sup> Kirby, 'An Institution-First Conception of Public Integrity', p. 25.

<sup>29</sup> For example: is a nonresident obliged to pay income tax on a salary received in Georgia's territory? The RS can provide the following ruling: if the nonresident is a physical person and works in Georgia for more than one month she/he is obliged to pay 20% of income tax on received salary in Georgia

<sup>30</sup> IMF technical note 2016

where incorrect or inappropriate rulings are issued or published.’<sup>31</sup> If the incorrect ruling is issued, it could decrease revenue. However, the revenue risk is limited, because the tax ruling is confined to the taxpayer to whom it was issued. In addition to this, the advance ruling system may help tax authority to identify potential structural weaknesses in the tax legislation.

It is argued that advance ruling could lead to ‘privatization of the tax law.’<sup>32</sup> This may be the case, where the ruling system is used as a means of attracting tax base from other countries.

Another concern is that cost is associated with the application process, which could undermine the objective of providing equal access to the advance tax ruling system, especially for taxpayers with limited financial resources. The private rulings have no precedential value beyond the taxpayer who submits the request. However, the advance ruling system has a ‘wider precedential effect even if they are not published.’<sup>33</sup> Moreover, the European Commission has concluded that ‘certain tax rulings that were issued by various tax authorities conferred selective tax advantages on particular taxpayers.’<sup>34</sup>

---

<sup>31</sup> *ibid*; While formally private rulings do not have precedential value beyond the taxpayer and the arrangement concerned, in practice they do have a wider precedential effect even if they are not published.

<sup>32</sup> IMF technical note 2016; p. 4

<sup>33</sup> IMF technical note 2016; p. 4.

<sup>34</sup> IMF technical note 2016; p. 4

Table 3. Advance ruling by OECD countries

COUNTRY	Public rulings		Private rulings			
	Public rulings are issued	Binding/ not binding on revenue body	Private rulings are issued	Binding/ not binding on revenue body	Time limits for private rulings	Fees for private rulings
<i>1) OECD countries</i>						
Australia	✓	Binding	✓	Binding	✓ /1	×
Austria	✓	Binding	✓	Binding	✓ /1	×
Belgium	✓	Binding	✓	Binding	✓ /1	×
Canada	✓	Binding	✓	Binding	✓ /1	✓
Czech Repub.	✓	Binding	✓	Binding	×	✓
Denmark	✓	Binding	✓	Binding	✓ /1	✓
Finland	✓	Binding	✓	Binding	✓	✓
France	✓	Binding	✓	Binding	✓ /1	×
Germany	✓	Binding	✓	Binding	×	✓
Greece	✓	Binding	✓	Binding	✓ /1	×
Hungary	✓	Binding	✓	Binding	✓ /1	×
Iceland	✓	Binding	✓	Binding	✓ /1	✓
Ireland	✓	Binding	✓	Binding	✓ /1	×
Italy	✓	Binding	✓	Binding	✓ /1	×
Japan	✓	Binding	✓	Not binding	×	×
Korea	✓	Binding	✓	Binding	×	×
Luxembourg	✓	Binding	×	-	-	-
Mexico	✓	Not binding	×	Not binding	✓ /1	×
Netherlands	✓	Binding	✓	Binding	×	×
N. Zealand	✓	Binding	✓	Binding	×	✓
Norway	✓	Not binding	✓	Binding	✓ /1	✓
Poland	✓	Not binding	✓	Not binding	✓	✓
Portugal	✓	Binding	✓	Binding	×	×
Slovak Rep.	✓ /1	Binding	✓ /1	Binding	✓ /1	×
Spain	✓ /1	Binding	✓	Binding	✓	×
Sweden	✓	Binding	×/3	Binding	× /1	✓ /1
Switzerland	✓	Binding	✓	Binding	×	×
Turkey	✓	Binding	✓	Binding	×	×
UK	✓	Binding	✓	Binding	✓	×
USA	✓	Binding	✓	Binding	×	✓
<i>2) Select non-OECD countries</i>						
Argentina	✓	Binding	✓	Binding	✓	×
Bulgaria	✓	Binding	✓	Not binding	✓ /1	×
Chile	✓	Binding	✓	Binding	×	×
China	✓	Binding	✓	Binding	×	×
Cyprus	✓	Binding	✓	Binding	✓ /1	✓ /1
Estonia	✓	Binding	×	-	-	-
Latvia	✓	Not binding	✓	Binding	✓	✓
Malaysia	✓	Binding	✓	Binding	✓ /1	✓
Malta	✓ /1	Not binding	✓	Binding /1	×	×
Romania	✓	Binding	✓	Binding	✓ /1	×
Singapore	✓	Binding	✓	Binding /1	✓ /1	✓
Slovenia	✓	Binding	✓	Binding	✓ /1	×/1
South Africa	✓	Binding	✓	Binding	✓ /1	✓

Sources: IBFD and country survey responses

To summarize, the Revenue Service 'acts collectively consistent with its collective commitments' when issuing the legally binding advance ruling. This mechanism helps to avoid inconsistent treatment by the Revenue Service. Given that 'the single most important factor in determining uncertainty is unpredictable or inconsistent treatment by tax authority'<sup>35</sup> the advance ruling process plays a crucial role in limiting tax uncertainty. The advance tax ruling is an effective instrument to protect the taxpayer from dual interpretation of tax law while binding the tax authority to its commitments. However, there are risks associated with the implementation of the advance ruling system, such as corruption.

<sup>35</sup> Measuring corporation tax uncertainty across countries: Evidence from a cross-country survey; Michael P. Devereux. Oxford University Centre for Business Taxation European Tax Policy Forum; April 2016.

## 7. Robustness of Tax System

### General Principle

According to the theoretical framework of public institutional integrity 'disposition must also be robust across time and circumstance. It needs to reflect sufficient strength and resolve such that the institution can be relied upon come what may.'<sup>36</sup>

### 7.1. IT - Based Risk Assessment/e-filing

In 2009, IT-based risk assessment was introduced in Georgia's Revenue Service, in order to create a more robust tax system. Before introducing this mechanism the tax inspections were conducted manually. Then, the selection of companies for assessment was based on the tax inspector's preferences. The risk assessment system (software) was therefore developed based on a number of objective parameters, such as profit margin, average salaries of employees, changes in revenue and profit, etc. This system helps to increase tax certainty as there is low risk of taxpayers being selected based on individual interests. Furthermore, the system is effective in terms of tax collection. It selects companies based on risk level. At the initial stage of the system's introduction (2009-2010), 80–90 percent of all tax audits were conducted based on the IT system. Nowadays all audits are triggered electronically.

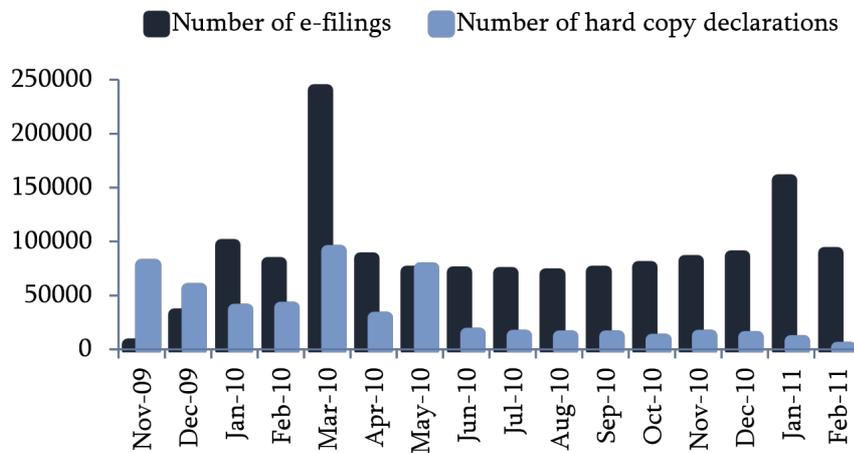
Second, e-filing was introduced for only large companies at the initial stage. This system has played a key role in decreasing Georgia's shadow economy. The objective of introducing e-filing was to minimize interactions between taxpayer and tax authority in order to eliminate corruption. Today all taxpayers use the e-filing system, and the government disallows any paper-based tax return.

Both IT-based risk assessment and e-filing are the key mechanisms for eliminating the corruption and allow the Revenue Service to pursue its legitimate purpose. The robustness of the system was achieved through the implementation of the IT mechanisms.

---

<sup>36</sup> Kirby, 'An Institution-First Conception of Public Integrity.'

Table 4. Number of e-filings and hard copy declarations 2009-2011



## 8. Policy Recommendations

There is no universal tax system, which can be adopted by countries to address fully the tax administration's and the taxpayer's concerns. In order to build the public institutional integrity at tax administration, all elements of the theoretical framework of integrity have to be implemented. Based on the findings discussed in this paper I provide recommendations regarding several tax mechanisms, which can be adopted by similar economies.

### Recommendation 1. Simplification of Tax Legislation

Simplification of tax legislation could be one of the key policy instrument, especially for developing countries. Georgia's example shows that the simplification of the tax code was instrumental in achieving the main objective of tax administration. As Umar and Tusubira found at the 5<sup>th</sup> Annual Tax Administration Research Center Workshop in 2017, 'complexity of the tax system and the knowledge/information gap were some of the challenges identified... the appropriate policy response should be a continuous simplification of the tax system.'<sup>37</sup>

The simplification of the tax legislation increases institutional integrity as it is one of the policies that allows the Revenue Service to pursue the legitimate purpose of tax administration. The challenge for relevant authority lies in how

<sup>37</sup> Challenges of tax administration in developing countries: insights from the 5<sup>th</sup> annual tax administration research center workshop, 2017. Mohammed Abdullahi Umar, Nyende Festo Tusubira. P.117.

*much* to simplify the tax system. Furthermore, each tax administration needs to assess its financial and human capital before reforming the tax legislation.

### **Recommendation 2. Consultation Process**

The consultation process between stakeholders and tax administration is instrumental, especially during the legislative changes. In Georgia's case the consultation process was not always transparent, which was a big concern for stakeholders.

The consultation process helps to better understand the needs and concerns of stakeholders. It is a multilateral process, when the information is not flowing only from one direction from tax administration to the taxpayer, rather from stakeholders to tax administration. Furthermore, in most cases, big businesses are involved in discussions and small/micro businesses, individual taxpayers are left out from the consultation process. Thus, tax institutions have to ensure that all voices are heard equally. Such policy will help to increase tax efficiency and raise institutional integrity of tax authorities.

### **Recommendation 3. Mediation Mechanism**

In Georgia's case, the mediation mechanism has the potential to increase the legitimacy of the pursuit of purpose. However, there are corruption risks as the tax auditor (tax inspector) has direct contact with the taxpayer, before issuing the final audit report. Thus, before adopting the mediation mechanism, tax administrations have to establish the monitoring mechanism to prevent such risks. Moreover, each tax administration has to assess the risk and cost associated with establishing such a mechanism.

### **Recommendation 4. Advance Ruling**

There are different models of advance ruling. In Georgia's case, private advance ruling is legally binding and it is subject to the fee defined by the law. Overall, it is an effective mechanism and can be used by other countries. However, each tax administration has to assess its capacity before implementing the advance ruling as the implementation of this mechanism requires a large number of qualified civil servants. Moreover, there have been cases of conflict of interest and corruption in practice. Again, in order to minimize these risks the strong monitoring mechanism has to be implemented within tax administration.

### **Recommendation 5. IT- Based Risk Assessment / E-filing**

Many countries are using the electronic systems for tax administration purposes worldwide. However, it is costly and subject to budgetary constraints for most developing countries. Georgia's case shows that IT systems can be vital for effective tax collection and reducing corruption in the tax system. The adoption of IT systems for a tax auditing and E-filing is therefore recommended

in order to achieve effectively the main objective of the tax administration. Moreover, it is important to update the software frequently as the business transactions are changing rapidly. This can create additional administrative costs for relevant authorities, but in the long-term, the benefits – increases in the collection of tax revenue and reduced corruption – typically outweigh the costs.

## **9. Conclusion**

In this policy report, I have explored the theoretical framework of 'institution-first' concept of public institutional integrity in relation to changes in Georgia's Revenue Service (2003-2012). It was demonstrated that the improvement of all components of institutional integrity, such as legitimate purpose, legitimate pursuit, commitment and robustness lead to improvements in the tax system and improved public trust towards the tax administration. The institutional change that resulted created a strong platform for the implementation of further reforms, which is a topic for future research.

## References

- Brock, Gillian; Russell, Hamish, "Abusive Tax Avoidance and Institutional Corruption: The Responsibilities of Tax Professionals". Harvard University, Edmond J. Safra Center for Ethics. February 17, 2015.
- Brock, Gillian "Institutional Integrity, Corruption and Taxation". Harvard University, Edmond J. Safra Center for Ethics. March 13, 2014.
- Devereux, Michael, "Measuring Corporation Tax Uncertainty across Countries: Evidence from a Cross-Country Survey". Oxford University Center for Business Taxation, WP 16/13, April 2016.
- Dietz, Frederick C. English Government Finance 1485-1558 (Frank Cass, 1964), 213.
- Franklin, Benjamin, and Albert H. Smyth. *The Writings of Benjamin Franklin*. New York : London: Macmillan Company, 1905.
- Gilauri, Nika "Practical Economics". Palgrave Macmillan.2017.
- Constitution of Georgia, Parliament of the Republic of Georgia, access at: <https://matsne.gov.ge/en/document/view/30346?publication=35>, last accessed: 23/10/2018
- Gulen, Huseyin and Ion, Mihai, 'Policy Uncertainty and Corporate Investment' *Review of Financial Studies*, Vol. 29 (3), 2016, 523-564. Available at SSRN: <https://ssrn.com/abstract=2188090> or <http://dx.doi.org/10.2139/ssrn.2188090>
- Hartner, Martina, Rechberger, Silvia, Kirchler,, Erich and Schabmann\*, Alfred, Procedural Fairness and Tax Compliance, *University of Vienna; Economic Analysis and Policy*, VOL. 38 NO. 1, March 2008.
- IMF/OECD Report for the G20 Finance Ministers. "Tax Certainty". March 2017.
- Jones and Maples. "Mediation as an Alternative Option in Australia's Tax Disputes Resolution Procedures." Australian Tax Forum 2012.
- Kirby, Nikolas, "An 'Institution-First' conception of public integrity", Building Integrity Programme Working Paper, (available at: <https://integrity.bsg.ox.ac.uk>)
- Waerzeggers, Christophe ; Hillier, Cory, "Introducing an Advance Tax Ruling (ATR) Regime". Tax law IMF technical note 02/ 2016.
- Umar, Mohammed Abdullahi; Tusubira, Nyende Festo, Challenges of Tax Administration in Developing Countries: Insights from the 5th Annual Tax Administration Research Center Workshop, 2017.
- World Bank. "Fighting Corruption in Public Services Chronicling Georgia's Reforms." <http://documents.worldbank.org/curated/en/518301468256183463/pdf/664490PUB0EPI0065774B09780821394755.pdf>
- World Bank Group, *Doing Business in a More Transparent World*, (2012), World Bank Group, access at: <http://www.doingbusiness.org/content/dam/doingBusiness/media/Annual-Reports/English/DB12-FullReport.pdf>

