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On the Role of the International Monetary Fund in the Post-Communist Transformation of Georgia

Abstract: *The paper analyzes the role of the International Monetary Fund (IMF) in the process of economic development of independent Georgia. Remarkable achievements have been accomplished in cooperation between post-Communist Georgia and the IMF. There were some errors too. Most of the latter should be attributed to the Georgian Government. The main achievements are creation of the legal framework of the country's financial system regulating market-based budgetary and monetary processes, successful implementation of the currency reform, liberalization of prices, and external trade. The main errors are political, methodical and methodological, resulting from confusion and a stereotyped approach, and tactical, resulting from the abuse of powers. At the same time, without financial and political assistance of the West, it will be practically impossible for Georgia to preserve its national independence. As a result, the IMF is a strategic partner of Georgia's, and it has to stay to remain so even after Georgia has overcome its current position of recipient country.*

Key words: *Georgia, International Monetary Fund, post-Communist transformation.*

After the regaining of independence by Georgia (see Gachechiladze 1995), perhaps of greatest importance was whether or not the coming to power of healthy and truly professional people who would be able to push economic reforms in the right direction was possible. To be victorious, any good idea needs serious political and financial support. For a country like Georgia though, which was so weakened by exhausting military actions, the mobilization of domestic financial resources turned out to be a very hard—if not practically unsolvable—problem. A great role in addressing this issue has been played by international financial and other insti-

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tutions such as the International Monetary Fund (IMF), the World Bank, the European Union, and others. Obviously, of these institutions, particular stress should be placed on the IMF, owing to coordinating functions, which the international financial system has conferred on it.

Naturally, it is economic science that has to answer the question of what changes should be made in the economic basis of society in the course of post-Communist transformation and especially how these changes should be made. Unluckily, it turned out that economists had not been prepared to ensure scientific "support" of the process of transformation: there was no universal economic theory, on the basis of which an essentially right economic policy for all post-Communist states could have been developed (Stiglitz 1996, p. 3). Under such circumstances, in view of, at best, sound professional intuition of an economist giving advice, any economist who makes his judgments on the basis of general principles of economic theory and the experience of market-oriented reforms implemented in other countries in transition can be regarded as optimally close to what is desired.

In the early phases of transition to a market economy, the government of Georgia was tempted to solve the hardest problems of transition on its own. In a number of instances members of the government would seek "free" advice of either their compatriots who had temporarily returned to their homelands, or foreign charlatans "transiting" through the country. Very often, these latter, ostensibly with the purpose of pushing economic reforms and improving hard social conditions of the people, would attempt to import into the country billions of dollars earned by drug trafficking, illegal manufacturing of or trade in weapons, and so on—in other words "dirty" money. In that case, the mechanism of laundering such money is to compel the government to issue financial guarantees for borrowing huge credit resources (tens and hundreds of millions, even billions of dollars). As a rule, such transactions are implemented through obviously suspicious mediators.

Given the ways by which "dirty" money is generally made and, more importantly, the sort of people who are usually involved in making such money, a natural question arises: if "dirty" money can only be made by cheating and robbing people, how can it be expected that in the course of "laundering" such "dirty" money the magnates who make that money will become honest overnight? Undoubtedly, a crook is not likely to ever give up wrongdoing, whatever the circumstances may be.

It must be noted that in the early 1990s, Georgia did have some attempts to use financial guarantees in order to attract some "dirty" money. The National Bank of Georgia (NBG) and the Ministry of Finance (MoF) issued many of letters of guarantee for many billions of dollars. Further developments showed that this was a wrong way to get credits; furthermore, the "guarantees" themselves became the subject of international speculation. If the IMF had not interfered, Georgia's financial situation could have been even more difficult.

At the time when Georgia joined the IMF and the World Bank, the number of their members equaled 170. A quota (or vote) of Georgia in these institutions amounts to 0.08 percent.

As was noted above, at the time of Georgia's joining the IMF and the World Bank, the world nations had already maintained financial order, which actually was the only lawful way to receive monetary support in the shape of "clean" money. Maintenance of such an order is the only choice for any country, including Georgia, which has opted for civilized forms of economic development.

The first IMF mission arrived in Georgia in November 1991. The objective of this first visit was to get familiar with local circumstances. After that, during each successive visit, the IMF mission would leave the Georgian government with their recommendations on how to accomplish macroeconomic stability in the country. Unfortunately, governmental officials in charge at the time (with rare exceptions) paid little attention both to those recommendations and their authors (Gotsiridze and Kandelaki 2001; Papava 1995). As a result, the country's financial system came to the state of complete disorder: in 1993 and 1994 Georgia did not have any parliament-adopted national budget; constitutional and legislative process was practically nonexistent; poor quality of adopted laws and, what really matters, extensive tax privileges to a wide range of organizations (such as churches, theaters, etc.) made it impossible to raise fiscal revenues even at a minimum level; government officials' attitude toward a temporary national currency—coupon—was that of sustainable nihilism; the NBG's self-indulgent monetary policy and repeated issue of huge amounts of Georgian currency (aimed, for example, at covering agricultural production costs) caused hyperinflation; in consequence, in 1993 and 1994 the rate of inflation reached 50–70 percent a month (Gurgenidze et al. 1994).

Achievements of the IMF in Georgia

In 1994, President Eduard Shevardnadze initiated an "anti-crisis program," one of the key premises of which was to advance relationships with the IMF to an essentially new level; specifically, the status of IMF recommendations was upgraded from "desirable" up to "mandatory." This fact was to bear very positive economic consequences.

Given this, for the facilitation of analysis, the IMF activities in Georgia can be split into two phases: during *phase one,* that is, in 1991–94, the IMF would provide the Georgian government with important recommendations, although this "naughty child" would take no notice of those; during *phase two,* that is, since 1994 to the present time, the IMF recommendations have been considered mandatory, although very often it has been hard to implement those recommendations and, above all, they have not always been commensurate with the true aspirations of some governmental officials.

The most important consequences of IMF activities in Georgia are that the country has succeeded in building up its own financial system and achieving macroeconomic stability.

More specifically, one has to place stress on the following achievements (Papava 1995; 1996a; 1999; Wang 1998; Wellisz 1996):

1. The legal framework of the country's financial system regulating market-based budgetary and monetary processes has been developed and adopted.
2. As a result of "hard" monetary policy, the NBG's hyperinflation was curbed; this made possible the successful implementation of the currency reform (the Russian ruble was removed from circulation and a newly introduced stable national currency, lari, was granted the status of legal tender).
3. The process of liberalization of prices has practically been completed (the hardest part of which was a release of bread prices).
4. As of 1995, Parliament would adopt national budgets practically in the beginning of each successive year.
5. A two-tier banking system was formed by which functions of the NBG and commercial banks have been delineated; in addition, the NBG has adopted a regulatory framework for commercial banks on the basis of which the government controls the banking system.
6. The process of privatization of all former government-owned banks has been completed.
7. Full liberalization of external trade has been achieved (inclusive of the encouraging of exports via lifting value-added tax [VAT] and customs duties, as well as releasing external trade from all nontariff regulating mechanisms).
8. Foreign debts have been restructured, and conditions for the servicing of those debts have been established; Georgia has acquired an image of a country that is able to pay back its debts.

It must also be noted that the IMF took an active position with respect to the support from the World Bank, one of the key requirements of which was to give priority to the budgetary spending for education and health care. It is also noteworthy that the IMF has provided sustainable support of the World Bank programs in Georgia, the primary objective of which was to implement structural reforms of the Georgian economy.

In 1996 and 1997, as a result of the IMF operations in Georgia, a high rate of economic growth and a very moderate rate of inflation were observed. Macroeconomic stability, in the meantime, is the most important condition without which it is impossible to implement any more-or-less significant investment project in a country. Aggressive measures recommended by the IMF for forming a favorable environment for investments, under other equal conditions, are of great importance for the realization of the Silk Road reinstating plan as well (Shevardnadze 1999).

Of course, this list could be extended, but perhaps the most important outcome of cooperation between Georgia and the IMF is the fact that, at least, there has been a reduction of "popular amateurishness," a phenomenon that unluckily could repeatedly be observed in the government's actions (e.g., "swelling" foreign debts by using artificially increased clearing prices; imposing special taxes on local producers and importers of grains and flour and official attempts to get the IMF's authorization for that; announcing that the government is going to tax amnesty to tax evaders and presenting a relevant program of actions to the IMF; "distorting" the country's financial system by establishing a Ministry of Tax Revenues and weakening the MoF "for the benefit" of certain governmental officials; utilizing commercial bank loans with the purpose of implementing the national budgetary plans and thereby interfering with the process of forming a stock market; direct distribution of different food products or rendering certain services instead of paying unpaid pensions, etc.). Without insistent pressure on the part of the IMF, for example, distribution of flour in place of paying pensions (and other similar actions) in some parts of Georgia would have become a general rule rather than a single fact, which sooner or later would have brought down the national economy and finance.

The key "achievement" of such "popular amateurishness" consisted in the gradual worsening of relationships between Georgia and the IMF.

Errors of the IMF in Georgia

One of the leading economists of our time, former vice president and former senior economist of the World Bank, Joseph Stiglitz, wrote that during the sessions devoted to the fiftieth anniversary of the Bretton Woods institutions (the World Bank and the IMF), one could repeatedly hear remarks such as: "Fifty years is enough" (Stiglitz 1999, p. F577).

Naturally, everyone makes mistakes, and the IMF is not an exception—it makes mistakes too, both in general (see De Gregorio et al. 1999) and with respect to particular countries (see Gomulka 1995, pp. 14–19). Unfortunately, Georgia could not escape the IMF's mistakes as well.

Errors made by the IMF in Georgia vary both by their nature and implication. One has to note, however, that some of those errors have a very general character; in other words, they have been made by the Fund not only while working in Georgia, but also in a broader context, in other countries as well.

One has to also note that the Georgian governmental team, which had to negotiate with the IMF in the earliest phase of relationships, practically had neither any experience with conducting such talks nor a good understanding of IMF procedures, a situation the members of the IMF missions would take advantage of either consciously (perhaps to simplify a task) or unintentionally (which is more probable), but in all cases, quite skillfully (at any rate, as it seems from the present angle). In each particular case, in order to get each successive tranche, the Georgian party had to assume such commitments, the implementation of which in given time limits (actually, as a rule, in a very short period of time) would be very difficult; at the moments of accepting such commitments, the government was not always confident about how difficult the task of implementing those commitments could have been. Reformers, repeatedly resorting to unpopular measures while dealing with certain problems, as a rule, would point at the recommendations of the

IMF and other financial institutions, for which reason, the public in general, and businesspeople in particular, started strongly disapproving of those institutions.

At the same time, it must be noted that all requirements of the IMF have officially been fixed as statements of the government (rather than the IMF requirements). As a result, in each disputable situation, the IMF experts, as a rule, would remind the government that these have been the commitments taken by the government; that is, it has been the government's position, rather than that of the IMF. Also, one has to take into account the fact that in all cases, in order to carry out agreements reached between the Georgian government and the IMF, it was the governmental team conducting the negotiations that would assume a full and exclusive responsibility for the measures to be carried out. Furthermore, not all members of such teams (first of all, those responsible for fiscal and budgetary issues) would agree to assume such a responsibility; some members of the government (and Parliament too) at best never understood (and perhaps even never wanted to understand) what it meant to carry out commitments to the IMF.

Moreover, one has to take into account circumstances such as inclusion in the negotiating teams of certain governmental officials (at their request) who had a very poor reputation among the IMF staff. Ultimately, this would bring about a rejection of issues raised by such people, however justified from the standpoint of reforms they could be. (However, this would happen quite seldom because more often during such meetings they would raise obviously erroneous and even completely unacceptable questions, which would negatively affect the reputation of the person representing the government, as well as that of the governmental agency, which was directly represented, by such a person.) In all such instances, the negative reputation of such persons would have a negative impact on public opinion in regard to the IMF-supported programs as well. Furthermore, individual politicians, officials, and ordinary citizens would get a false impression that the members of the governmental team involved in the official negotiations with the Fund lacked competence and consistency and that they were not able to find the right arguments during their discussions with the IMF; however, if they could have taken over, the success would have been very quick and definite. Under such circumstances, without a firm reform-oriented attitude of both the president and the parliament leadership, Georgia would never achieve those results that we discussed above and that were achieved owing to the IMF's extensive support.

In the context of such an experience of cooperation with the IMF, perhaps it is easier to understand which errors could have been avoided in the very beginning and which errors were completely unavoidable.

Before starting to review those errors, it is essential to give some explanations that may facilitate our understanding of the substance of most of them. Specifically, because the majority of errors made by the IMF in Georgia are related to taxation, we must formulate those criteria, or more specifically, we must give those characteristics of the taxation system on the basis of which the nature and the meaning of each error can be evaluated.

A well-known expert on tax reform in the United Kingdom, Philip Chappell, believes (and one can hardly disagree with him) that an ideal taxation system should be built on the following key principles (Chappell 1990, pp. 41–44):

1. *Simplicity:* the primary goal of the system must be that each individual could understand independently, that is, without any assistance of tax experts, all issues related to taxes.
2. *Plainness:* taxation should be based on a single flat rate.
3. *Rate:* a tax rate should depend on a required amount of receivable incomes; at the same time, the rate should be high enough to discourage taxpayers from tax evasion.
4. *Universality:* taxes and tax rates should be universal throughout the country, and no exemptions and privileges should be allowed. At the same time, certain governmental support may be provided, for example, to the disabled. However, such support should be in the form of special social programs and grants, rather than tax exemptions.
5. *Comprehensiveness:* taxes should be imposed on both incomes and expenses.
6. *Evenhandedness:* taxes should not distort different forms of saving and ideally should not make any difference between spending and saving.

Naturally, there is no ideal taxation system in the real world, however, its significance for the estimation of strengths and weaknesses of existing taxation systems is obvious.

Political Errors

While reviewing the criticism of the IMF activities, we noted that the Fund often disregards the history, cultural traditions, and national peculiarities of the countries in which it operates. The same error could be observed from the very beginning of the IMF operations in Georgia. In particular, we are referring to the Fund's advice to the Georgian government to stay in the "ruble zone" and not to introduce a national currency. This advice was given to the Georgian government in February 1992.

It would hardly be possible to completely understand the motives that drove the Fund to give such advice. At best, we have to presume that it wanted to be cautious about irritating certain still influential and imperialistically ambitious forces in Russia. Perhaps it was for this reason that the IMF was not hurrying to make a violent intrusion into a monetary domain of the disintegrating empire. But if we remember that this advice was applicable to the rest of the former Soviet republics too, except for the Baltic states (Estonia, Latvia, and Lithuania), we may presume that the Fund would have preferred to work with one single issuer of the national currency, rather than with twelve issuers, which would enable the Fund to establish one mission instead of twelve, and thereby save some money. It is noteworthy, in this regard, that only those countries that have introduced their own currencies are eligible for the IMF credits (see, for example, Lavigne 1995, p. 207).

Anders Åslund tried to explain the IMF's desire to preserve the "ruble zone" by the fact that the IMF was skeptical about the technical abilities of the newly independent states that emerged after the disintegration of the former Soviet Union to introduce their own currencies and believed that a good currency reform should have been preceded by a country's preparation for genuine macroeconomic stabilization (which, we believe, is completely impossible if the country is out of its own monetary mechanisms of macroeconomic regulation). As a result, the IMF was afraid of being blamed for possible failures of the newly introduced national currencies (Åslund 1995, ch. 4).

Opponents who were radically critical about the IMF considered that this mistake was a result of the fact that the IMF and the governments of the donor countries—members of the IMF—had failed to understand (or even had never tried to understand) the political situation that had emerged after the disintegration of the Soviet Union; that they had failed to analyze (or even had never wanted to) the history of that imperialistic nation; that they had failed to realize national and cultural features of the countries such as Georgia, which had driven Georgia and other former Soviet republics to strive after real national independence. We believe that such a judgment is obviously exaggerated and the reason for the IMF's behaving in the above-described manner was that the IMF had been cautious about Russia.

One must presume that without stringent steps taken by Russia itself, as a result of which it ceased "providing" Georgia and other former Soviet republics with the Russian ruble bills, the IMF would never have hurried to change its attitude toward the "ruble zone." Here we must remember that the NBG raised a question of introducing a national currency at the very first meeting with the IMF mission (in November 1991), having presented all necessary calculations and samples of national currency bills and coins. The NBG requested the IMF to help Georgia prepare for currency reform. Unfortunately, this request was not taken into consideration. One has to presume that the Fund's refusal, in addition to what was stated above, was motivated by the outburst of military actions in Georgia in the winter of 1991–92.

In 1993, Georgia was practically unprepared to introduce its own currency. To a certain extent, this was prompted by the actions on the part of the IMF. However, it would be unfair to put the blame completely on the IMF, because at the time, first, the Georgian government had never paid any attention to the IMF recommendation and, second, it had been under an illusion that it would have been possible to stay within the "ruble zone" for a certain period of time. Such an attitude, under other equal conditions, was clearly reflected in the government's extremely nihilistic position on the temporary Georgian currency—coupon.

The IMF "corrected" (if we are allowed to use this word) this error in the fall of 1995, when in line with a plan coordinated with the IMF and owing to its financial support a currency reform was implemented. In other words, a new Georgian currency—lari—was introduced.

Another big error in relation to Georgia was made by the IMF while dealing with a problem of identifying the successors of foreign debts and assets of the former Soviet Union.

In 1993, Russia and Georgia signed an agreement (known as a "Zero Scenario") according to which Russia would become a successor of all foreign debts and assets of the former Soviet Union. For some reason, the text of the signed agreement did not contain (more precisely, were "dropped" from it) provisions about the fate of both the Diamond Stocks of the former Soviet Union and the deposits of the Georgian individuals and entities in the Vnesheconombank of the Soviet Union, which had been included in the original, initialed version of the agreement.

Unfortunately, during the subsequent seven years, the IMF constantly refrained from intervening in this disputable question, although because of the above-described difference between the signed and the initialed versions, Georgia would refuse to ratify the agreement; meanwhile, according to the IMF procedures, this might have become a serious impediment to the IMF's extending credits to Russia because of the failure of Russia to settle its foreign debts.

After the end of this seven-year period, however, when the question of restructuring Georgia's debts to Russia (accumulated after the disintegration of the Soviet Union) was put on the agenda, under the pressure of the Russian government and with the silent consent of the IMF, Georgia had to ratify the said agreement, thereby putting a question mark over the possibility of serving justice and reinstating in the agreement the above-mentioned provisions that had been "dropped" from the initialed text of the agreement.

Methodic Errors

Immediately after gaining independence, Georgia faced the problem of establishing numerous governmental institutions. A taxation system was one of those institutions: there was a need to adopt a new tax law, establish tax and customs offices, and ensure the staffing of these latter in spite of the scarcity of qualified human resources. One has to remember that by then, the people of Georgia and particularly its developing businesses had no experience and tradition of paying taxes under the conditions of market economy, and a sense of responsibility in this regard had been practically nonexistent. In other words, neither taxpayers accurately knew what and how they should pay, nor the government knew what and how it should collect. Naturally, under such circumstances, the taxation system could not avoid certain shortcomings and errors and, as an immediate effect of it, corruption as well (it is noteworthy that at the time corruption was based on the traditions and experience accumulated during the Soviet period).

Elementary logic requires that at the initial stage of transition to a market economy, the taxation system should be as simple as possible. On the whole, the IMF shares such a belief too. Specifically, one of the leading IMF experts, Leif Mutén, notes that in the course of transition to a market economy the taxation system must be simple enough (Tanzi 1993, ch. 8).

The improvement of the taxation system must be carried out gradually, in line with the improvement of tax education and the development of taxpayer habits.

In view of this logic, it was a complete mistake to replace the turnover tax with the VAT from the very beginning, when the financial system of independent Georgia was still in its embryonic state. The point is that in Communist-type economies, the turnover tax by its nature is not a tax at all; instead, it is a government-established difference between a unit cost and a producer's price (or wholesale price) (see, for example, Tanzi 1993, ch. 7; 1994, ch. 6). As to the VAT, its economic contents, calculating methodologies, and mechanisms of collection are too complicated for mass application. By far more justified would be to impose any other indirect tax, the administration of which would be much simpler. The sales tax (or the turnover tax based on a value-added rate) is a good example, because it has to be paid at the final stage of procurement; for this reason, the mechanism of imposing this tax is quite transparent to a taxpayer and, at the same time, it is quite easy for a tax collector to administrate it. This practice was applied, for example, in Romania (Tanzi 1994, ch. 6).

One has to admit though that, owing to its economic nature, the VAT is more acceptable than the sales tax because, in the case of the former, subject to taxation are all phases of business and, therefore, a burden of taxation lies on all such phases. Despite this, in the United States, a country with long and rich tax traditions, the sales tax is still in effect and discussions on the topic of whether or not the VAT should be introduced seem practically endless (see, for example, Slemrod and Bakija 1996, pp. 209–215).

In the countries of West Europe, the VAT was introduced after quite a long period when market traditions had finally been established. For example, in the United Kingdom and other European countries the VAT was introduced as late as 1973, although by then the country had had a centuries-old (!) tradition of market relationships. Besides, a long period had elapsed from the time when this tax was developed to the moment when it was finally recognized and established. Specifically, EU member countries introduced the VAT after about twenty years had passed since 1954 when it was invented in France.

Today, the VAT is one of the key conditions precedent to a country's joining the European Union (for example, in order to become an EU member state, Finland introduced the VAT as late as July 1994). Desire to become members of the European Union is exactly the key motive for which the post-Communist countries have adopted the VAT (Tanzi 1993, ch. 9).

It must be noted that the IMF has developed an eighteen-month schedule for the adoption of the VAT (Tanzi 1993, ch. 9). For the benefit of some countries, this schedule can even be extended; for example, in Romania, two and a half years passed in order for the VAT to be established (Tanzi 1994, ch. 6). According to the leading specialist of the IMF in fiscal issues, Vito Tanzi, if there is no uniform sales tax in a country, a two-year period is required for the introduction of the VAT; this period can be reduced to a year though, if transition to the VAT is to take place from the existing sales tax (Tanzi 1992, p. 49). If you add to this a period of five to ten years, which, according to the IMF experts, is necessary for ensuring computer and telecommunications support of the VAT administration (IMF 1991, ch. V.4), there will be no doubt how long and difficult the process of introducing and establishing the VAT can be.

To this extent, one has to admit that it was a big mistake on the part of the Georgian government to make an overnight shift from a Communist-style turnover tax to the VAT. By doing this, it disregarded the first principle of the above-described ideal taxation system—*simplicity.* As a result, Georgia lost huge tax revenues, the public got a very negative attitude toward the VAT, and favorable conditions for the booming of corruption were created.

The IMF's error was that unlike the Georgian government it knew what negative consequences could come up after instituting the VAT. Therefore, the right action from its part would be if it recommended the Georgian government to adopt the sales tax on a temporary basis and in parallel to take preparatory steps to ensure a smooth transition to the VAT. The IMF never did that. Whether or not our remark is correct can be verified by the Tax Policy Guidelines developed by the IMF experts primarily for the benefit of economists working with the IMF missions, in which it is clearly and directly stated that the introduction of the VAT should be preceded by broad taxpayer education and tax officer training campaigns. It is for this reason that in some cases the Fund recommends that before the VAT is introduced certain steps should be taken for the improvement of the sales tax collection practices (Shome 1995, p. 280). Unfortunately, the IMF gave no such recommendation to the Georgian government.

As far as the VAT is concerned, a bigger mistake was that it was imposed on agricultural produce as well, although there had been no objective conditions for administering this tax in rural areas.

There is an assumption that has been shared by everyone in the IMF that as a general rule, agricultural sectors of the countries in post-Communist transformation are represented mainly by the big government-owned and cooperative companies, which can be made accountable for the VAT, and in relation to which appropriate VAT collecting practices could be developed. Small farmer businesses are exempted from the VAT, and they are responsible for paying it only in the case that their annual turnovers reach a certain upper limit (Tanzi 1993, ch. 9). It was due to this general assumption that the Georgian government, at the IMF's insistence, imposed the VAT on agricultural production. Originally, the upper limit of annual turnover above which all agricultural businesses should be liable for the VAT was set at $2,300; later it was raised, first to $10,000, then up to $17,500; finally, however, it was lowered to $12,000, which became applicable to all sectors of the economy.

Here we have to stress the fact that, as is stated in the above-mentioned Guidelines, the Fund usually identifies those sectors in which, because of certain difficulties connected with the VAT administration, it should not be applied; for example, it is recognized that agriculture should not be subject to the VAT. However, as a matter of fact, the IMF restrained from applying this general rule to the post-Communist countries, and the reason for doing this was that those countries had preserved big agricultural enterprises (Shome 1995, p. 280).

While applying this scheme to Georgia, the IMF failed to take into account the fact that almost immediately after the reestablishment of national independence all big agricultural enterprises (both government-owned and cooperative enterprises) had broken up and that by the time of making that recommendation the Georgian agricultural sector had been represented mainly by small farmer businesses. Naturally, under such circumstances, first, the whole sector had been left without indirect taxation, and second, a strong disincentive discouraging the enlargement of agricultural companies and, therefore, the growth of economic efficiency of agriculture had come up. From the perspective of the ideal taxation system, broken were both the first principle—*simplicity*—and the fourth one—*universality.*

The Georgian government's suggestion about a potential replacement of the VAT with an increased land tax (administration of which is obviously simpler and which is practically safe from corrupted practices) was completely rejected by the IMF experts. As they explained, the reasons for their negative attitude toward this question were twofold: first, all sectors should have been subject to the VAT, as this tax had been the most "developed" among all other indirect taxes (see IBRD 1991, p. 31); second, the IMF experts recognized that in case of raising the land tax rate by the level of the VAT rate, they would have been unable to develop a mechanism of recalculating it at the later stages of VAT having been paid by producers at preceding stages.

Another methodic error of the IMF existed in its recommendation—which later became its requirement—that the Georgian government lift the exemptions from VAT from such parts of corporate profits that should have been used for reinvestments. By doing this, the Georgian businesses, which had actually suffered from a big deficit of investments, would face a problem of losing all incentives to save some funds for the business development. To do justice, one has to note that in 1995, when the IMF demanded that the said exemption be abolished because of the significant drop of production output over the preceding period, the factual extent of its applicability was very little. However, the very fact of abolishing this exemption "washed away" from entrepreneurs' horizon even distant hopes for getting financial incentives from the government to use their own funds for reinvestments. What should also be underlined in this respect is that by exempting the reinvested sections of profits from any taxes, inclusive of the VAT, one may contribute to the smoothening of the profit accounting system too, which ultimately may result in the growth of tax revenues. Unfortunately, the abolition of the said exemption caused negative effects to the tax accounting system in general.

Also evident is the IMF's error with respect to the income tax, that is, its progressive nature. To shed light on this problem we must bear in mind that under the Communist rule all employees used to work for state-owned companies and agencies and, accordingly, only staff salaries could be subject to the income tax. Under such circumstances, instead of charging tax on each individual separately, it would suffice to withhold the income tax from a company's payroll. Under the market economy, however, where, on one hand, people are involved not only in the public sector but also (and even to a greater extent) in the private sector, and on the other hand, where, in addition to salaries, they get some other income too, such as interest, rent, dividends, and so on, the government has to deal with a problem of taxing the incomes of each individual separately.

The administering of the progressive tax requires a quite sophisticated mechanism that should be based on a taxable earnings declaration scheme. Under this scheme every individual, at the end of each calendar year, should sum up his or her earnings for the year that he or she received from all sources and, accordingly, earned a taxable income; after that, on the basis of a progressive schedule, he or she should calculate a taxable amount and pay it. To the extent that tax payment practices among the population are either completely nonexistent or, at best, very poorly developed, it is no surprise that very few follow such a procedure. In addition, even tax offices are not prepared to carry it out properly. For this reason, the progressive income tax only facilitates the growth of a tax-evader mentality in each taxpayer and prompts him or her to break the tax law. Thus, in this case, out of the above six principles of an ideal taxation system, the first two were disregarded—*simplicity* and *plainness.*

From the perspective of administering, by far simpler and, accordingly, more transparent is a proportional income tax scheme, where all individual earnings are charged a uniform tax rate and nobody has to make any additional recalculations.

Given all that was stated above, it must be clear what a big error was made by the IMF in Georgia when it demanded establishment of the progressive income tax scheme. The reason for such behavior of the IMF seems especially obscure in the context of what the IMF's leading experts say in this regard. For example, Ved P. Gandhi and Dubravko Mihaljek believe that in the initial phase, it is more reasonable to apply a proportional income tax scheme (Tanzi 1993, ch. 7). Leif Mutén, in turn, points out that the progressive income tax scheme may create disincentives to work and risk and discourage people from observing the tax law (Tanzi 1993, ch. 8).

Whatever the case may be, there is nothing to be done with regard to the first of the above three problems, that is, the potential replacement of the VAT with the sales tax. The point is that the Georgian government has already received from the IMF quite a bit of technical assistance for improving VAT collecting practices, owing to which certain positive results have already been achieved. More importantly, for the reasons described above, it does not make sense that Georgia, a country that has already expressed its aspirations to join the European Union (in a long-term perspective), gives up the VAT at the present stage. Despite this, both the government and Parliament are determined to introduce the turnover tax on small businesses and trade agencies, even though the IMF does not seem to be satisfied with that scenario. If the decision is still made, one has to expect negative consequences not only for the reason of possible deterioration of relations with the IMF, but also because of substantial incompatibility of these two types of indirect taxes with each other. As a result, the companies, which are charged by law to pay the VAT, will tend to divert their business (at least in part) into the "shadow economy."

Also quite dubious seems the possibility that the IMF will change its mind in respect of charging agriculture by the VAT. However, some chances still exist, especially if one takes into account the fact that this position of the IMF is not shared by either private experts from Germany (Horn and Zurek 1998, p. 10) or those from the European Union (EC 1999, p. 67); both Germany and the European Union, like the Georgian government, believe that it would be more reasonable to raise the land tax rate.

As per the exempting of reinvested profits from the VAT, this issue has to be discussed with the IMF, especially as according to an expert of the IMF, Krister Andersson, one of the most important steps toward improving the efficiency of tax policy is to extend investment credits (Tanzi 1993, ch. 5).

While it is unlikely that given the deep budgetary crisis existing in Georgia, the IMF will not agree to take such a step, negotiations should be continued. If consensus is not reached, it will be hard to foster development of businesses and, in the long run, to ensure the growth of the national budget revenues.

Although the need of transition from the progressive income tax scheme to the proportional income tax scheme seems obvious (to which assumption, as was noted above, even agrees with the IMF experts), odds are that no agreement will be reached with the Fund on this issue. The point is that the transition from the "progressive" system to the "proportional" system is generally considered one of the hardest political steps. Therefore, one should not expect that the IMF, given certain "obscure" guarantees, will agree to allow a return from the already existing progressive system to the proportional income tax scheme.

Methodological Errors

Of no less importance is the fact that some well-known economists (for example, Gary S. Becker in relation to Georgia (Becker 1998) and Jeffrey Sachs in relation to Ukraine (Mankiw 1998, p. 169)) have advocated reducing the tax burden in such countries in order to encourage both economic activities and an increase in tax revenues to the state budgets.

In 1995, during the period before the presidential and parliamentary elections in Georgia, the author of this work developed a "social promotion" method of economic reforms (Papava 1996a; 1996b; 1999), one of the key elements of which was "tax therapy" (Papava 1996a, pp. 263–267; 1999, pp. 285–291). According to this approach, one of the key incentives for the development of production should have been the lessening of the tax burden through cutting tax rates.

The methodological base of "tax therapy" can be found in our theoretical arrangement titled "The Laffer-Keynesian Synthesis." More specifically, we tried to prove the probability of production development through establishing low tax rates on condition of simultaneous growth of supply and demand.

The main premise of supply-side economics is that a decrease (increase) in tax rates to a certain point encourages (discourages) production development and an increase (decrease) in tax revenues of the national budget (Canto et al. 1983; Gandhi et al. 1987).

According to the Keynesian approach, however, the decrease in tax rates results in the growth of consumption; in a short-term perspective, the increase in consumer spending results in the growth of demand for goods and services, that is, the growth of production and employment rate. At the same time, the decrease in capital accumulations (savings), caused by the growth of consumption, results in the intensification of competition between investors. This, in the long run, brings about the increase in interest rates, which, in turn, discourages local investments and promotes the inflow of foreign capital (see, for example, Mankiw 1992, ch. 16). Such an effect is regarded as negative for developed economies. As to the post-Communist countries, in this context one may observe obviously positive aspects of it: first, because of the decline of production output, significant amounts of production capacities stay idle and decreased tax rates are quite likely to trigger indirectly the increase in their operation; second, given the outdated technologies, it is completely impossible to organize the production of competitive goods without modern foreign investments (Papava 1996a, p. 264; 1999, p. 287).

Discussions on whether tax rates are high or low are senseless, if they are not compared to the level of development of tax administration. Such an attitude has completely been shared by the IMF (Shome 1995, pp. 267–272).

In 1995, the crime rate in Georgia was very high, for which reason it was completely pointless to talk in earnest about the improvement of tax administration. Incidentally, the improvement of the crime rate was one of the key elements of my "social promotion" approach. Suggestions developed within the context of "tax therapy" were in harmony with a state of tax administration at the time.

In addition to the above-mentioned positive effects, the key objective of "tax therapy" was to reduce the scale of the "shadow economy" and corruption. It must be noted that the IMF basically agrees with this assumption, as one of the leading experts of the Fund, Alan Tait believes that given the appropriate penalties it is not more tempting to evade paying a 5 percent tax than a 10 percent, a 15 percent, and certainly a 20 percent tax (Tait 1988, p. 18). The assumption that high efficiency of a taxation system in the context of relatively low tax rates still can be accomplished is shared by another expert of the IMF, Krister Andersson (Tanzi 1993, ch. 5). As far as we are concerned, we would like to stress once more that low tax rates, as was noted above, comprise the third principle of the ideal tax system. Here one has to remember that, as Philip Chappell says, high tax rates are the invention of Karl Marx whose objective was to shatter the power of the bourgeoisie (Chappell 1990, p. 43).

The "tax therapy" approach included a number of specific suggestions with regard to the liberalization of the Georgia taxation system. In 1995, all those suggestions were presented to the IMF experts who declined it for the following reason: to the extent that there is no clear evidence in the world that the decrease in tax rates will inevitably result in the growth of budgetary revenues, Georgia should not take such a step. Such an assumption rested on the experience of the Economic Recovery Tax Act proposed by President Reagan and adopted by the U.S. Congress in 1981, in consequence of which the cutting of tax rates resulted in the growth of the budget deficit instead of its reduction (see, for example, Krugman 1998, p. 48; Slemrod and Bakija 1996, p. 28; Steinmo 1993, pp. 163–164).

In this regard, worth noting is the work of Ukrainian economists, V. Vishnevski and D. Lipnitski, according to whom the fact that the decrease in tax rates caused the rise in the budget deficit can by no means be used as a proof of irrelevance of "supply-side economics." These authors believe that the question should be raised in the context of each individual country, taking into account a specific time period within which the reduction of tax rates will finally bring about the growth of budget revenues (Vishnevski and Lipnitski 2000, pp. 107–108). The significance of this work is that it identifies a number of conditions, the implementation of which will result in the growth of both production output and budget revenues; at the same time, the likelihood of realizing such conditions is relatively higher in the post-Communist countries (Vishnevski and Lipnitski 2000, pp. 110–111).

Unfortunately, the majority of Georgian governmental officials never agreed to the ideas of "tax therapy." Naturally, whenever issues of particular theoretical and practical importance are on the agenda, the government needs to demonstrate a sustainable unity and determination, which is an insufficient, but undoubtedly a necessary condition of success in negotiations between the government and the IMF.

Despite such an unfavorable context, in 1996 the government managed to receive from the IMF a go-ahead for cutting some taxes and charges. The implementation of steps formulated within the "tax therapy" approach shaped the following picture: in 1997, as a result of reducing the payments rate for the Social Welfare and Medical Insurance Fund (SWMIF) from 37 percent down to 27 percent, total payments made by legal entities for the benefit of the SWMIF went up to 41 percent; payments to the Employment Fund grew by 1 percent as a result of lowering the tax rate from 3 percent down to 1 percent; budgetary revenues increased by 26.4 percent and 34.6 percent, respectively, as a result of reducing the excise rate on beer from 100 percent to 15 percent and import duties on certain goods from 12 percent to 5 percent.

As we can see, even a strongly moderated version of "tax therapy" bore fruit. This enables us to suppose that if the IMF had not disagreed, we could have accomplished more impressive results in terms of improved tax collections as early as 1997. An "anti-example" of the justifiability of "tax therapy" was the government's decision—made under IMF pressure—to raise, as of January 1, 2000, the cigarette excise rates by 60 percent for filter cigarettes and by 110.5 percent for nonfilter cigarettes. As a result, tax revenues from the cigarette business dropped by 36.9 percent.

A new attempt to raise the question of implementing a large-scale "tax therapy" approach before the IMF is obviously not likely to be successful. The main reason for this is a deep budgetary crisis, which broke out in Georgia in 1998 and which, unfortunately, still continues. As is shown in the above-referenced work by Vishnevski and Lipnitski, usually, as an immediate effect of reduced tax rates, a decrease in budget revenues occurs; a rise in budget revenues is only possible after a certain period of time has passed, for which reason it is always very difficult to apply "supply-side economics" under the circumstances of deep budgetary crisis (which is characteristic in most of the post-Communist countries). At the same time, the need to control the "shadow economy" through tax rate cuts requires that this approach be applied in quite a comprehensive manner, which step initially would also significantly diminish budget revenues (Vishnevski and Lipnitski 2000, pp. 114–116).

Despite this, the renewal of discussions on cutting rates for some taxes and charges looks quite likely. In this context, more cutting of the SWMIF payments rate seems more feasible, as the present rate (32 percent in aggregate) is obviously too high. Furthermore, once, not long ago, the IMF expressed its general no-objection with regard to this issue (pending was just the question of a new rate and the date of instituting such a change). Unfortunately, later the IMF changed its mind again (for the second time) and now it insists that the social tax rate is not very high and has to be retained at the present level (IMF 2000, pp. 29–32).

The Republicans' return to the U.S. administration at the turn of the twenty-first century (especially if one takes into account the U.S. Treasury's influence on the IMF) brought about an opportunity to have the IMF review its attitude toward tax rates, "reviving" thereby, at least in part, "supply-side economics," which certainly will be reflected in the Fund's approach to its programs in different countries.

Error Resulting from Confusion

In 1995–96, the government would almost permanently raise the question of excise marks. The IMF's position would remain categorically negative, as the IMF experts believed that the government would not be able to avoid the forgery of those marks. In 1998, however, the IMF started insisting on the opposite: it demanded in a most categorical manner that the government institute excise marks on cigarettes and alcoholic beverages. In 1999, after the introduction of excise marks, average monthly revenues from imported cigarettes grew by 3.2 times and from locally produced cigarettes by 19.2 times. This enables us to conclude that over the preceding years the country's budget must have lost huge amounts of income.

Error Resulting from a Stereotyped Approach

One of the most manifest errors of the IMF resulting from its stereotyped approach is the Tax Code of Georgia, which was drafted by the Finance Ministry under pressure of the IMF experts and which was adopted by Parliament in late 1997. Of course, the very fact of adopting a new tax law can only be welcomed. However, the Code is written in such "awkward" language (perhaps because of the stereotyped translation of an English sample) that sometimes it is hardly comprehensible not only to an average taxpayer, but also to specialists. In addition, some procedures described in the Code are so sophisticated that businesspeople would rather pay bribes to avoid certain "confusions." It is worth noting that even the IMF has recognized that one of the reasons for inadequate tax collections may be procedures that are too complicated (IMF 1997).

If we approach the Georgia Tax Code from the perspective of the above-described ideal taxation system, we can easily notice that it has failed to meet all of its six principles altogether. But the most disappointing thing, in our opinion, is that the Code disregards the most important of those principles—*simplicity.*

Many government officials, researchers, businesspeople, and media people consider that one of the key reasons for the burst of fiscal and budgetary crisis in Georgia in 1998 is the new Tax Code, which contains numerous mistakes and obscurities and, therefore, is hardly understandable.

Despite repeated attempts of some Georgian governmental officials to persuade the Fund to allow the government to reconsider the existing Tax Code, the Fund's stance has been unchangeable: *institutional patriotism* prevents its experts from admitting their own errors.

Tactical Error

The adverse impact of Russia's financial crisis of August 1998 (which the IMF had failed to predict [Zevin 2001, pp. 17–18]) was first felt by Georgia as early as the beginning of September. A sensitive shortage of U.S. dollars in the Russian domestic market caused a dramatic increase in the need of U.S. dollars in the CIS (Commonwealth of Independent States) countries. Especially sensitive to such a need were those countries for which Russia has been the most important trade partner.

In the Georgian context, the situation was aggravated by the fact that the Russian military bases existing in the Georgian territory were used as a facility for uncontrolled imports into the country of devalued Russian ruble bills with the purpose of buying and carrying U.S. dollars to Russia. In the meantime, the Tskhinvali corridor, which has practically been beyond the Georgian government's control, was used for the intensification of smuggling cheap Russian goods and for carrying huge amounts of U.S. dollars out of the country to Russia. This negatively affected the exchange rate of the national currency—lari, which had been adjusted by the NBG via implementing dollar interventions in the interbank currency exchange. Under such circumstances, the NBG had no choice but to release dollar stocks it had kept so strictly by then. Obviously, this could not last for a long time, as the amount of such stocks was limited and could be exhausted shortly.

Under such circumstances, the IMF's recommendation was that the NGB stop implementing currency interventions and give up lari exchange rate adjustments, which would enable it to preserve the NBG dollar stocks. Had the government followed this recommendation, it would inevitably have done irremediable harm to the country: the released exchange rate would have dropped immediately, provoking panic at the currency market, which, in turn, would have contributed to a further decrease in the lari exchange rate. Such circumstances would have prompted people to rush to commercial banks to carry away their savings, which ultimately would have resulted in the bankruptcy of most commercial banks and, thereafter, the impoverishment of all those individuals and companies that had kept their money with such banks.

One has to admit that the reaction of both the NBG and the government to the situation was highly commendable. They never agreed to the above—obviously wrong in terms of tactics—advice of the IMF and by manipulating the lari exchange rate through a gradual devaluation alerted commercial banks and the public, in general, to the need of converting their lari stocks into dollars. Although this maneuver cost the NBG tens of millions of dollars, by the time it stopped its currency interventions into the currency market, the lari exchange rate had been as low as necessary to prevent, in commercial banks (because they had already disposed of most of their lari reserves), immediate and harmful devaluation of the Georgian currency. The immediate effect of such tactical steps was that irrespective of the destructive impact of the Russian financial crisis, no single commercial bank of Georgia went bankrupt for the reasons described above.

Unfortunately, the IMF experts disregarded such a successful—in general terms—performance of the Georgian government, having focused their attention on the fact that the NBG had spent a considerable part of its hard currency reserves.

Errors Resulting from the Abuse of Powers

Earlier in this paper, when we touched the history of the Bretton Woods institutions, we described how the functions of the IMF and the World Bank had been delineated from each other. The IMF has repeatedly confirmed that there are certain areas, such as reformation of government-owned enterprises and public service, ensuring the right to ownership, ensuring that agreements be observed and public procurements be implemented, and so forth, with respect to which the Fund must be guided by more competent institutions and, basically, by the World Bank (IMF 1997).

From this perspective, very strange seems the IMF's categorical statement made in September 1999, that in the very near future the Georgian government would have to establish a new governmental institution—an independent anticorruption service endowed with broad responsibilities.

Meanwhile, a memorandum of the IMF Executive Board dated July 25, 1997, says that all issues related to governance, inclusive of corruption, should be considered by the Fund exclusively from the economic standpoint and within the limits of the IMF's mandate (IMF 1997).

Indeed, the problem of corruption is one of the most serious of those Georgia faces today; the fact is, however, that in this particular case the IMF obviously abused its powers. Only after the World Bank had stepped in and—having been based on both international experience and institutional underdevelopment of Georgia—had expressed its disagreement to the establishment of an independent anti-corruption department, the IMF "softened" its tone and shifted its focus to a possibility of applying predominantly economic mechanisms of struggle against corrupt practices existing in the financial system.

Another error related to the IMF's abuse of powers was made in the fall of 2000, when the IMF insisted that the government, in order to address a problem of outstanding debts of the energy sector, commit itself to raising an electricity tariff by U.S.$0.15–0.35 per kW.

Meanwhile, in 1997, under the pressure of the World Bank and with the support of the IMF, Georgia established and has since operated a National Energy Regulating Committee (NERC), which was designed to be a self-governing agency, totally independent from the government. One of the key functions of the NERC was to pursue an independent tariff policy of the energy sector and to harmonize its decisions only with the principles of market economy. Accordingly, the government had no right (and, of course, the IMF was aware of this fact) to commit itself to effecting any changes to the existing electricity tariffs. Unfortunately, the independent (from the government)—by virtue of law—NERC actually became dependent on the will of the government and, ultimately, of the IMF.

The IMF—A Strategic Partner of Georgia

At present, though in a very difficult stage of development, Georgia has already made an exclusively right choice—to tie up its future with Europe, with the West (Rondeli 2001). This is both a very difficult and a long way to go, and success in it is achievable only by the gradual adoption of the European system of values. Indeed, such an approach concerns all spheres of life, inclusive of the financial and economic arrangement of the country.

Today the IMF has no alternative, and the existing global financial order requires that Georgia perform the role of recipient country defined by that order itself. Otherwise, Georgia may be deprived of the right to receive the comprehensive assistance that is so important for accomplishing a genuine national independence. Again, without the financial and political assistance of the West it will be practically impossible for Georgia to preserve its national independence, especially bearing in mind the hardships of economic transition and temporarily lost territories.

Irrespective of some errors as described above, the IMF remains a reliable financial guarantor and a real supporter of the Georgian government in its striving to establish a sound and healthy financial and economic system for Georgia. If one keeps in mind the fact that the IMF is changing its programs and tactics, the key objective of which is to alleviate poverty and ensure economic growth (in Georgia this program was initiated by the IMF in early 2001), one may see that the intensification of cooperation with the IMF is a need that is beyond all doubts.

Indeed, the IMF is a strategic partner of Georgia, and it has to remain such even after Georgia overcomes its current position of recipient country. This is true because there is no alternative for Georgia other than to become an integrated part of the civilized world.

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