



Monitoring of Administrative Burden to Small and Medium Enterprises in Georgia

Round 2

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Background

Economic Policy Research Center (EPRC), with the support of USAID/GEGI – Georgian Enterprise Growth Initiative is conducting monitoring of business regulation in order to assess the success of government deregulation efforts. The monitoring is implemented in several rounds, where benchmark levels, as well as progress of administrative deregulation and business and investment environment is assessed.

Monitoring is based on surveys of small and medium companies in the three Georgian cities: Tbilisi, Kutaisi and Rustavi. The size of the sample was set at 500 enterprises and diverse industrial sector representation was included.

Two rounds of monitoring will be implemented within this GEGI project.

Here we give the results of second monitoring related to the first half of 2005.

Barriers to Business Development

From the results of the first monitoring round it was inferred that immediately after the change of political establishment in Georgia administrative interference and business regulation started to adjust to a new equilibrium. In most of the cases, burden associated with administrative regulation and corruption was reduced as well as enterprises in the three Georgian cities reported that real costs which they incurred as a result of government regulation and enforcement did not impede business development and operations.

It is important that administrative authorities manage to sustain this trend and therefore it is interesting to check what direction the developments in general business climate took. It is generally accepted that government actions to support improvement of environment for business functioning is one of keys to economic growth and development. In addition to regulatory mechanisms, i.e. registration, licensing, certification and inspections taxation, factors of general business climate include issues related to corruption, infrastructure development, macroeconomic health and market strength, political stability, pressure from criminal world, judicial system and enforcement of property rights among the others.

As shown on a table below, levels of difficulty associated with main types of administrative regulation of small and medium size businesses remain at the same mark. Firms report that registration, certification, licensing and inspection procedures are simple and not troublesome. Not surprisingly, we see significant decrease in the level of difficulty of taxation regime, however, the issue still remains as most problematic and procedure holds at a “relatively difficult” spot.

Table V.3: Assessing Business Regulation

	Scale: 1 - Very Easy; 3- Relatively Easy; 4- Relatively Difficult; 6- Very Difficult	Round 1 (I/2004)	Round 2 (II/2004)
Registration of Enterprises		2.58 (2.41 - 2.76)	2.81 (2.66 - 2.96)
Obtaining Permits		3.05 (2.84 - 3.25)	3.23 (3.04 - 3.43)
Licensing		3.21 (2.98 - 3.44)	3.25 (3.04 - 3.46)
Certification		3.05 (2.84 - 3.26)	3.14 (2.93 - 3.36)
Inspections		3.39 (3.22 - 3.55)	3.41 (3.27 - 3.55)
Taxation		4.42 (4.24 - 4.59)	3.98 (3.85 - 4.12) ↓***

Note: Mean values and 99% CI given, arrows indicate significant changes from previous monitoring

Real costs which Georgian companies incur as a result of administrative corruption and bureaucracy are estimated on a basis of what the management time, which firms spend on regulation, is and what the unofficial monetary payments, as well as the frequency with which these payments occur, are to regulatory agencies.

Table V.3: Bureaucracy and Corruption

		Round 1	Round 2
Fraction of company management time spent with various agencies on solving regulatory issues	SCALE: 1) 0%; 2) 1% to 5%; 3) 6% to 10%; ... 6) More than 50%	2.31 (2.19 - 2.43)	2.40 (2.30 - 2.49)
Fraction of revenues companies pay to regulatory agencies as unofficial payments	SCALE: 1) 0%; 2) up to 1%; 3) 1% to 2%; 4) 2% to 10% ... 6) More than 25%	3.19 (2.95 - 3.43)	3.22 (3.01 - 3.43)
How often companies pay bureaucrats	SCALE: 1) Always; 2) As a rule 3) Often; 4) Sometimes; 5) Seldom; 6) Never	4.47 (4.34 - 4.61)	4.64 (4.52 - 4.75)

Notes: Averages and 95% Confidence Intervals given

We observe no significant changes from the situation which prevailed in the previous half year period. It can be concluded that paying bribes to bureaucrats becomes less a practice. However, companies still report that up to 2 percent of their revenues goes to regulators. In our opinion, time costs of regulations hold at somewhat moderately problematic level too.

Alternative costs which firms are ready to pay for the improvement of business regulation and provision of public goods are reduced from the previous half year period (see the chart on the right) confirming our preceding argument that administrative burden to enterprises and its evaluation by businessmen has improved as well as situation with general infrastructure for operating the businesses has started recovering.

On the contrary, firms face problems with courts when trying to solve corporate disputes and defend their business, property and contract rights. Companies report that often judges are corrupt and judicial system as a whole is not just. Further evidence is that the only area where situation has improved and stands at a relatively not problematic spot is amount of payments to lawyers and notaries for their services, i.e. related to operational, not to systematic factors. From this evidence we conclude that Georgian judicial system needs more systematic reforms to take.

Other aspects of assessment business environment are related to how well firms are aware of legal framework for the operations of their businesses. To our opinion, this can be important factor noting that legislative environment is dynamic and rapidly changing in Georgia. 72 % of all companies say that Georgian firms know normative regulation well and only 4% of companies respond that SME executives and managers are very badly informed and not aware of Georgian legislation.

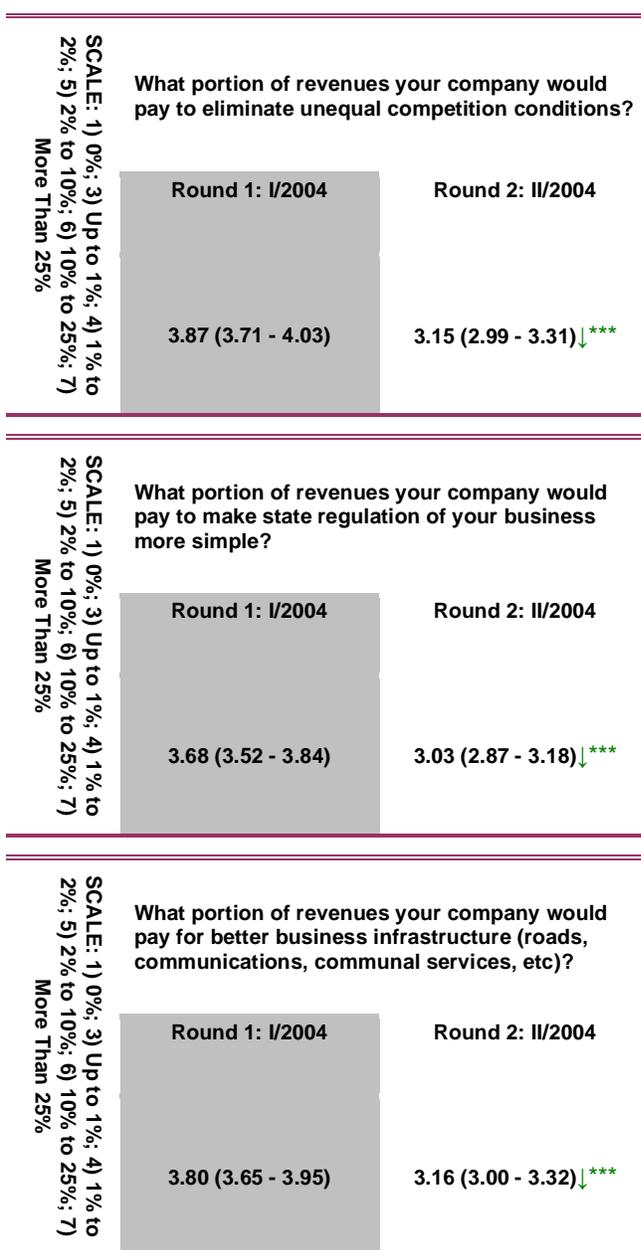


Table V.4: Corporate Disputes and Judicial System

Evaluate how often Georgian judicial system is:	Round 1	Round 2
Just	4.18 (4.02 - 4.35)	3.92 (3.74 - 4.10)
Fair and not corrupt	4.23 (4.06 - 4.4)	4.21(4.05 - 4.38)
Adequate to react	4.28 (4.09 - 4.48)	4.10 (3.92 - 4.28)
Costs of judicial services (lawyers, notaries) are acceptable for companies	3.87 (3.66 - 4.09)	3.39 (3.21 - 3.59) ↓***

Table gives averages and 99% CI-s

It follows from the analysis of general business environment factors that, similar to the situation during the preceding monitoring round, firms are most of all hurt by high costs of energy resources and other factors which affect direct costs of their business operations. In fact, increased oil and gas prices are the only factors which remain a “serious impediment” to business activities of small and

medium enterprises (table below).

Overall political situation has been settling down in Georgia during the second half of 2004 and not surprisingly, we see the significant improvement in the level of difficulty which businessmen associate with political uncertainty. Another factor, where we track changes from the previous monitoring period is tax regime. If it was the case that heavy tax burden was included in a group of factors with serious threat to SME development and activities in the first half of 2004, later in this monitoring round firms report significant improvements and rate this factor among the ones of moderate complexity.

Other areas which representatives of small and medium enterprises predict as moderately impeding, include general macroeconomic health, unequal competition, access to financial resources and issues related to corruption. Based on the monitoring results, we can not observe any significant changes in these issues. Possible explanation is that, majority of these factors reveal long run equilibrium and perhaps they will be affected only with some lag.

Aspects which have been least problematic for enterprises during both monitorings are related to administrative regulation of businesses, racket and pressure from criminal groups and quality of services which are provided by partners and execution of contracts and other business obligations.

Table V.5: Assessing Business Climate: Do You Consider the Following Factors Impede Your Business Activities?

	Round 1 (I/2004)	Round 2 (II/2004)
Market strength	2.37 (2.25 - 2.50)	2.18 (2.07 - 2.29)
General Macroeconomic Situation	2.66 (2.55 - 2.78)	2.64 (2.53 - 2.74)
Access to Financial Resources	2.65 (2.53 - 2.78)	2.63 (2.53 - 2.72)
Tax Level and Administration of Tax Regime	3.11 (3.01 - 3.21)	2.67 (2.59 - 2.76) ↓***
Business Regulation (Registration, Licensing, etc.)	2.05 (1.93 - 2.16)	2.06 (1.97 - 2.15)
Unequal Competition Conditions	2.71 (2.6 - 2.83)	2.53 (2.42 - 2.63)
Level of Infrastructure Development (Transportation, Communal, Telecommunication etc.)	2.46 (2.34 - 2.58)	2.45 (2.35 - 2.55)
Corruption	2.76 (2.62 - 2.9)	2.58 (2.47 - 2.71)
Pressure from Criminal world	1.82 (1.68 - 1.95)	1.83 (1.70 - 1.96)
Direct Interference of Administrative Agencies into the Business Operation	2.04 (1.91 - 2.17)	2.00 (1.90 - 2.10)
Quality of Fulfillment of Contracts and Obligations by Partners	1.90 (1.78 - 2.02)	1.89 (1.79 - 1.99)
Unstable Legislation	2.84 (2.73 - 2.95)	2.61 (2.52 - 2.71) ↓***
High Cost on Energy	3.2 (3.09 - 3.30)	2.99 (2.89 - 3.08) ↓***
Political Instability	3.06 (2.94 - 3.18)	2.85 (2.74 - 2.96) ↓**

Note: Mean values and 99% CI given, arrows indicate significant changes from previous monitoring

From regional perspectives there are some differences. Situation in Tbilisi is better than in other cities. Here firms enjoy better infrastructure in terms of technological development, communications and financial intermediation services. All of these support better climate for doing business. The evidence is depicted on the third line of table V.6., where we see very large gap in respective indicator. Most of managers from enterprises located in Tbilisi agree that business environment is better in capital than in other regions. Firms in Kutaisi and Rustavi report the similar results that environment for entrepreneurial activities is discriminated in their cities and not enough government action is taken for the development of investment and business climate.

Further, regions are really disadvantaged, as entrepreneurs do not agree that there exist any grounds for successfully investing the capital, starting and developing businesses in regional cities. It is noteworthy, that these perceptions emerge despite the fact that business operation costs are higher (both in absolute terms and in subjective terms) in Tbilisi than in Kutaisi or Rustavi. Operational expenses are higher in Tbilisi not only on rent, but on labor too. Therefore, perhaps it would

be reasonable for Georgian government to better develop business infrastructure in regions and create more incentives for investments there.

Table V. 6: Business Climate Assessment by Regions

<i>Do The Enterprises Agree to the Following Statements?</i>	SCALE: 1 - Agree; 2- Partially Agree; 3- Partially Do Not Agree; 4- Do Not Agree		
	TBILISI	KUTAISI	RUSTAVI
Existing Infrastructure (Informational, Communicational, Communal etc.) Supports Business Growth and Development	2.77 (2.69 - 2.85)	2.90 (2.70 - 3.10)	2.94 (2.78 - 3.10)
Local Business Environment Attracts Investments and Supports Business Development	2.51 (2.43 - 2.58)	2.97 (2.76 - 3.19)	3.11 (2.95 - 3.26)
Business Environment is Better in my City than in Most Other Georgian Regions	1.34 (1.28 - 1.41)	3.08 (2.83 - 3.33)	3.30 (3.11 - 3.49)
Local Rent Price on Real Estate is Acceptable	2.67 (2.58 - 2.76)	2.56 (2.36 - 2.76)	2.43 (2.23 - 2.63)
Local Rent for Land is Reasonable	2.67 (2.58 - 2.77)	2.41 (2.22 - 2.60)	2.52(2.33 - 2.71)

Note: Mean values and 90% confidence intervals are given in the table

Finally, enterprises do not express particular optimism on their future growth perspectives. In fact, firms forecast nominal growth of their revenues only under 5 % in 2005. This is below what they reported during the survey as nominal expansion in 2004 (from 5 to 10 percent). If we further deflate these figures by increase in price indexes, we conclude that small and medium companies in Georgia underperform the real growth of larger firms and do not serve as an engine for the growth of Georgian economy.

Taxation

Tax regime in Georgia has been by large perceived as most hampering factor to business development. Taxation legislation has often been ambiguous, tax burden high and tax administration and enforcement weak. Issues, such as administrative corruption and tax evasion have been intertwined with other drawbacks of regime. Consequently, not only high tax level and weak administration caused distortions to the economy, but also firms were forced to succumb part of their businesses to the informal sector.

Starting at the end of previous year and in the beginning of this year Georgian government took rigorous actions aimed at improving tax regime in the country. These steps coincided with the second round of our administrative monitoring, fuelling up our interest in current developments. Among other changes to the tax legislation, new tax code of Georgia reduced overall number of different tax categories, particularly local taxes, as well as drastically cut down major tax rates considerably reducing overall tax burden. Along with amending legislation, tax authorities also remarkably succeeded in administering taxes and significant rise in budget tax revenues serves as the good evidence to this. We interviewed small business representatives comprehending that these changes would have long term nature and produce real effect with some lag, but rather having in mind to assess company perceptions about regime changes.

As it was done during the previous round of monitoring, several aspects of tax system are assessed at this phase too. These factors include both issues related to tax legislation and to regulatory enforcement, as well as issues concerned with distortions that deficient system brings into the economy.

The central argument from the first monitoring round was that, most of the problems for Georgian small and medium firms related to taxation issues were legislative by their nature. Among them, the large number of tax categories and high tax rates were most troublesome. Also, company representatives regarded tax regulations as unclear and taxation legislation itself as unstable. Against this backdrop, it is important to note that government in Georgia has been adequate and successful in addressing most vital issues. Small and medium firm representatives think that new tax code is more supportive to business operations and healthier business environment.

Table V.1: Assessing Taxation Aspects

Scale: 1 - Not problem at all; 2- Relatively not problematic; 3- Relatively problematic; 4- Very problematic

Mean Values:	1st Round (I/2004)	2-nd Round (II/2004)
Unstability of Taxation Legislation	2.78 (2.65 - 2.90)	2.47 (2.37 - 2.56) ↓***
Large Number of Taxes	3.12 (3.01 - 3.23)	2.74 (2.65 - 2.83) ↓***
High Tax Rates	3.3 (3.19 - 3.41)	2.87 (2.77 - 2.96) ↓***
Clarity of Normative Regulation that Determines Tax Base	2.44 (2.31 - 2.57)	2.26 (2.16 - 2.36) ↓**
Clarity and Straightforwardness in Preparing Tax Accountability Forms	1.76 (1.66 - 1.87)	1.94 (1.85 - 2.03) ↑***
Response from Tax Authorities to Get Clarification Regarding Tax Payments	2.06 (1.93 - 2.19)	2.0 (1.89 - 2.11)
Tax Inspections	1.99 (1.87 - 2.11)	1.97 (1.87 - 2.07)
Unequal Tax Treatment of Market participants due to Inconsistent Tax Regimes	2.31 (2.18 - 2.44)	2.20 (2.10 - 2.30)
Unequal Competition from Informal (Shadow) Sector of Economy	2.52(2.37 - 2.66)	2.28(2.18 - 2.38) ↓**

Note: Arrows indicate statistical significance, whereas brackets give 99% confidence intervals

From the cross regional perspectives, there are no systematic differences in executing tax regime, administering system and tax burden on enterprises among the three cities, which were included in the survey. Perhaps, the exception to this rule is that, tax burden is slightly heavier in other two cities than in Kutaisi, whereas tax inspections remain more problem for firms in Rustavi compared to other cities. Interestingly, companies in Tbilisi more succumb their operations to formal sector of economy and shadow economy here is seen somewhat less as a problem.

Table V. 2: Taxation - Round 2

Scale: 1 - Not problem at all; 2- Relatively not problematic; 3- Relatively problematic; 4- Very problematic

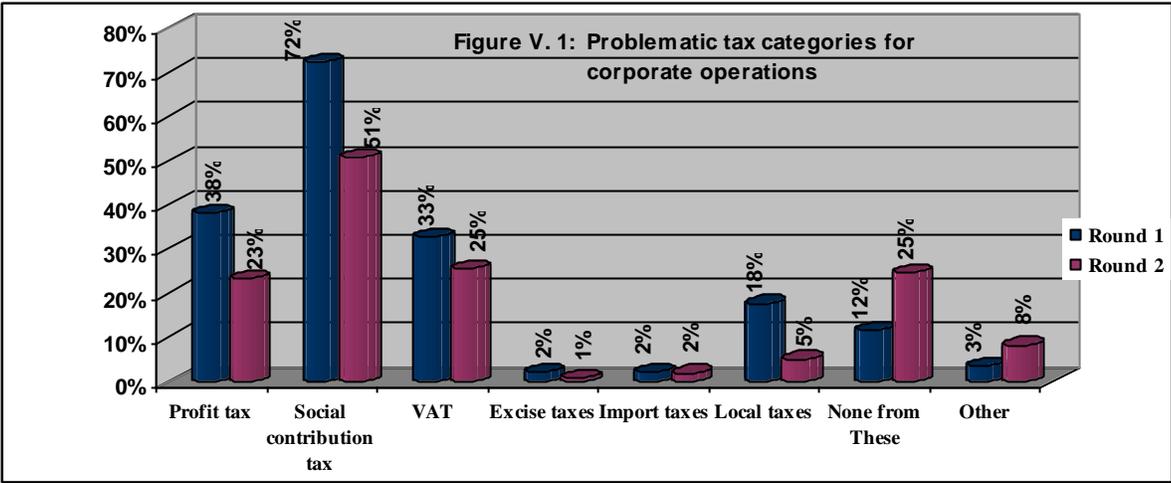
	TBILISI	KUTAISI	RUSTAVI
Unstable Tax Legislation	2.45 (2.37 - 2.53)**	2.50 (2.28 - 2.73)**	2.53 (2.33 - 2.72)**
Large Number of Taxes	2.79 (2.71 - 2.87)**	2.56 (2.37 - 2.75)**	2.79 (2.62 - 2.95)**
High Tax Rates	2.89 (2.81 - 2.97)**	2.71 (2.52 - 2.89)**	2.98 (2.81 - 3.14)**
Clear Normative Regulation to Determine Tax Base	2.20 (2.12 - 2.28)**	2.24 (2.03 - 2.44)**	2.45 (2.27 - 2.63)**
Response from Tax Authorities to get clarification on Tax Payments	1.98 (1.88 - 2.08)**	1.98 (1.79 - 2.17)**	2.08(1.86 - 2.30)**
Tax Inspections	1.97 (1.88 - 2.07)**	1.77 (1.59 - 1.94)**	2.27 (2.08 - 2.45)**
Unequal Tax Treatment of Market participants due to Inconsistent Tax Regimes	2.14 (2.05 - 2.22)**	2.21 (2.0 - 2.42)**	2.38 (2.19 - 2.56)**
Unequal Competition from Informal (Shadow) Sector of Economy	2.16 (2.08 - 2.25)**	2.41 (2.20 -2.61)**	2.53 (2.29 -2.77)**

Note: Mean values and 95% confidence intervals are given in the table

New tax code significantly reduced rates for most tax categories. As a result, tax system in Georgia less hinders business activities of enterprises and makes financial planning easier for them. If labor taxes, profit tax and VAT were named as most problematic categories during the first monitoring round with the frequency of 72, 38 and 33 percent respectively of all time

In fact, second monitoring round reveals, that areas where we see improvements are those areas, which are related to new tax legislation, i.e. most problematic categories according to the results of the first round. These areas include instability and clarity of tax regulations, as well as high tax rates and large total number of taxes in Georgia. Not only these aspects improved, but also our estimators indicate that these categories are “less than problematic” on the estimated subjective scale.

by respondents (Figure below), these tax categories became significantly painless since the adoption of the new code. Simultaneously, the fraction of respondents who experience problems with neither tax categories increased almost twofold.



Based on responses from firms, it is possible to give small & medium enterprises assessment of the volume of informal economy in Georgia. Company respondents were asked to evaluate fraction of total turnover of Georgian firms that is concealed from what is officially declared and therefore not accounted in official statistics of the country. Although certain caution should be given to this judgment, since estimates may be downward biased, it is interesting to learn that, estimated volume of shadow economy has slightly decreased from its previous mark at 26-35% to current level of 26-30% of total economy.