Local Budget Revenue Formation Reality, Obstacles and Prospects in Georgia: An Empirical Examination and Creative Approach

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Abstract. The purpose of this research is to investigate the creation of financial resources in municipal budgets and to highlight significant concerns. Local self-government is crucial for the development of a robust economy in a nation, but without a balanced budget, a municipality cannot be independent or powerful. As a result, it's crucial to identify the mechanisms for optimization and assess the difficulties associated with creating local budgets. In the study, the sources of Georgian municipal budget creation are examined and discussed. The difficulties that now exist are highlighted based on the analysis of the study findings, and modifications that should be made are suggested based on the aforesaid facts. These changes will be crucial for the efficient operation of the local budgets.

Keywords: Budget policy · Budget system · Local budget · Local taxation · subsidies and revenue

1 Introduction

In modern conditions, the experience of many countries reveals that the process of decentralization makes a great contribution to the economic development of the country. It is essential for any state to distribute power in such a way that it is not monopolized. Decentralization and financial independence in the state guarantee that the municipality will be able to exercise its powers. If the municipality does not have enough sources of its own income, then it will not be able to carry out expenses at its own discretion. Accordingly, the independence of municipalities and the effectiveness of the functioning of the program budget will be called into question.

Recently, the role of self-government in the country's financial, economic, and social development is a particularly relevant issue in Georgia. In this direction, reforms have been carried out many times for its productivity. However, today there are still gaps that need to be studied, analyzed, and the development of elimination mechanisms.

The aim of the work is to present the problems of the formation of financial resources of local self-government budgets and to determine recommendations and ways of overcoming them based on their analysis. In addition, the presentation of the main hindering factors preventing the decentralization process.

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The paper objectives are:

1. To determine the degree of dependence of the municipality's budgets on the central budget, as well as to study the relationship between the dependence of the municipality's revenues and expenses.
2. To determine the level of decentralization, study of individual components in the municipality's income.

2 Methodology for Studying Formation Local Budgets

The theoretical-methodological foundation of the research is the articles of many scientists on the research subject, where local budgeting, financial mechanisms for territorial unit growth and the peculiarities of state fiscal arrangement models are explored. Works by Melkers and Willoughby (2005), LaFrance and Balogun (2012), Mullins and Pagano (2005), Lysiak et al. (2020), Pokrovskaia and Belov (2020), Karianga (2016), Morgan et al. (2017), Seal (2003), Rossikhina et al. (2018), Patytska et al. (2021), Oprea and Bilan (2015), Glushchenko and Kozhalina (2019), Petrushenko (2014), Pelinescu et al. (2010), Ismoilova (2022), Dvoryadkina and belousova (2018), Storonyanska et al. (2021), Panday and Chowdhury (2020), Godwin (2018), Mussari et al. (2016), Sintomer et al. (2008), Abuselidze (2020, 2021), Ivanyuta et al. (2022), and others are included [1–26]. They researched and published extensively on the subjects of state governance system construction and improvement, budget regulation, financial equalization, and budget relations organization. The articles [1–3, 6–8, 15–21, 24–26] focuses particularly on budgeting for capital investments, alternative service delivery, financial management, budgeting and budget reform, and intergovernmental finance. According to Duncan and Sabirianova [27], progressivity decreases inequality in observed income but has a far lesser influence on real inequality as estimated by consumption-based Gini indices. Tax, as a key component of the system of economic interactions, is so intricate in the absence of fiscal alternatives that it always becomes an actual problem in public debates [22]. The majority of OECD nations use various sorts of progressive income tax arrangements, in which tax rates rise as income rises [28]. In the present day, the study of the optimization of taxable income taxes is not just science but also a major issue for practitioners. First and foremost, the severity of this tax is based on income tax analysis and has an influence on societal welfare. Second, it is one of the key tax collections for the budget, which is more or less predictable and is dependent on the state's functioning to cover the essential expenditures. It is well acknowledged that the tax burden impacts not only budget revenues but also investments, production factors, pricing standards, and so on. Lastly, all of the above has an impact on the country's socioeconomic standing [5, 9, 12, 22–26]. According to Denek and Dylewski [29], financial sustainability indicates not just the ability to create enough income, but also how income and spending responsibilities are satisfied. The consequences of decentralization between 2015 and 2020, according to the conducted empirical study [24–26, 30, 31], include a slowing in the pace of current rural population decline, the rate of new rural population decline, and the level of rural employment. Decentralization has increased rural development levels, which helps to ensure that there is less regional disparity in rural development. According to the findings of the paper [6], the Good Financial Governance concept has been the focus

of extensive research in its understanding as a new paradigm for local financial management. Yet, in practice, it has certain flaws, notably with regard to the accountability and legitimacy of its foundation. That is, financial sustainability indicates the budget's balance and the probability of its breach. These researchers have highlighted issues in this subject, but the fiscal arrangement and fiscal system require ongoing development and investigation. The Local Self-Government Code of Georgia, the Budget Code of Georgia, the Tax Code of Georgia, the Law of Georgia on Grants, and the Law of Georgia on Local Fees control the economic and financial foundations of self-governing entities. Moreover, Georgia has accepted the European Charter of Self-Government, on which self-government law is founded. Organic laws primarily govern fiscal relations: the Local Self-Government Law, the Tax Code of Georgia, and the Budget Code. Local self-government is Georgian people' right and chance to control and manage matters of local relevance in line with the population's interests through local self-government authorities. The Code of Self-Government outlines self-government powers, which are classified as delegated, self-governing, and voluntary (Local Self-Government Code). To reduce socioeconomic disparity across various territorial entities, it is required to examine regional welfare circumstances and implement legislative rules.

3 Results and Discussion

When discussing the independence of municipalities and the decentralization process, we mean first of all the existence of financial resources necessary for independence. Based on the fact that in the process of formation of the budget revenues of the municipalities of Georgia, certain peculiarities were revealed, in the paper, A systematic, empirical research has been used, which distinguishes the peculiarities of the revenues of 69 municipalities of Georgia.

To assess how important tax revenues are in total revenues at the municipal level, we have identified several indicators:

- Indicator 1: ratio of municipal tax revenues to total revenues;
- Indicator 2: ratio of tax revenues of the municipality to expenses;
- Indicator 3: Ratio of municipal grants to total revenues.

The mentioned indicators best reflect how financially independent the municipality is because only its sources of income ensure the determination of expenses at the discretion of the municipality.

As a result of the study of 69 municipalities according to indicator 1, it was revealed that the situation is quite complicated in this regard, as several municipalities were identified, whose tax revenues are meager and in fact they depend on other types of revenues. As a result of empirical research, the table presents the 5 municipalities whose ratio of tax revenues to total revenues was the least among 69 municipalities:

According to data, in 2016–2018 there were municipalities whose own incomes in the form of taxes were only up to 10%. This point to the fact that the municipalities were actually managed by the central government and decentralization is not possible for municipalities with such a budget.

As a result of the 2019 change in the mechanism of distribution of tax revenues to municipalities, the situation of the mentioned municipalities' changes:

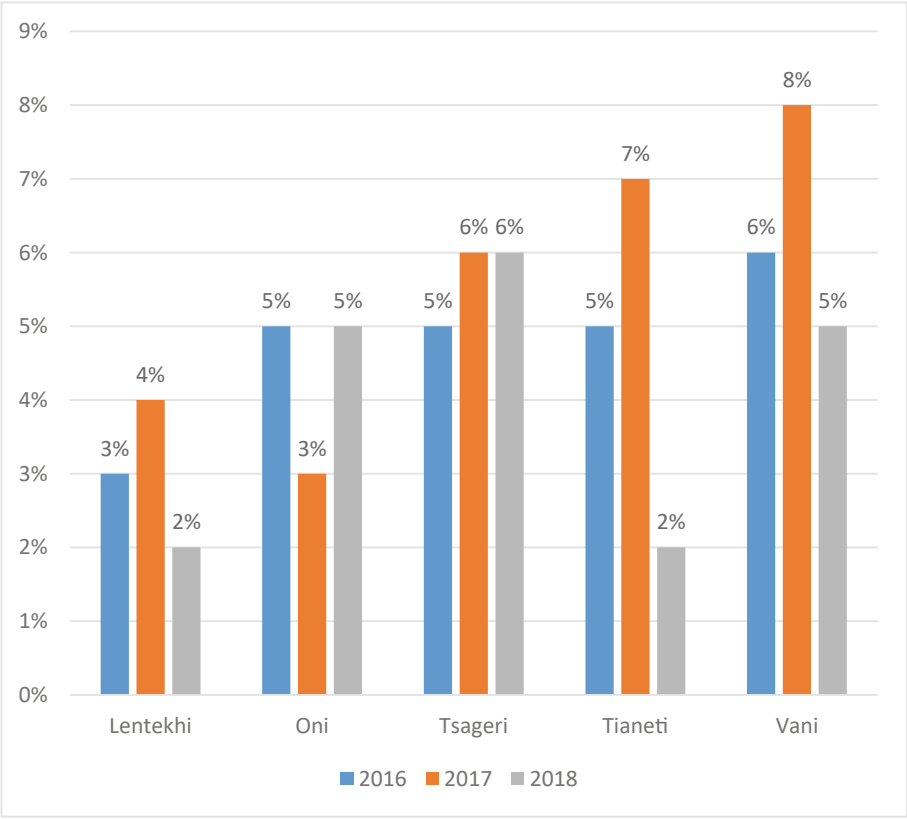

Fig. 1. Ratio of tax revenues to total revenues (%). Source: compiled by the author based on the data of the Ministry of Finance of Georgia [32–34]

As we can see, the situation changes after 2019, when the reform was carried out and 19% of VAT was assigned to local governments. However, it is interesting how the value- added tax (VAT) was distributed among the municipalities shown in the Fig. 4:

The difference in the increase of the tax revenues of the municipalities in the mentioned years is quite noticeable. From a financial point of view, of course, the distribution of 19% of VAT is beneficial for municipalities, but how fairly the said financial funds are distributed and how it affects the development of municipalities in the long term is already a controversial issue.

Since 2019 the least tax revenues have been received by the municipalities in Fig. 2 and Fig. 3. Until 2018, completely different municipalities received the lowest tax revenues. Until 2018, they received income from both property tax and certain categories of income tax. Therefore, the municipalities shown in Fig. 1 are the least economically active.

As we can see, 4 municipalities have received the smallest amount of VAT: Bolnisi, Borjomi, Kazbegi, and Shuakhevi. As a result, they are at the top of the list with the least amount of tax revenue in total revenue. While the municipalities in Fig. 2 had the least

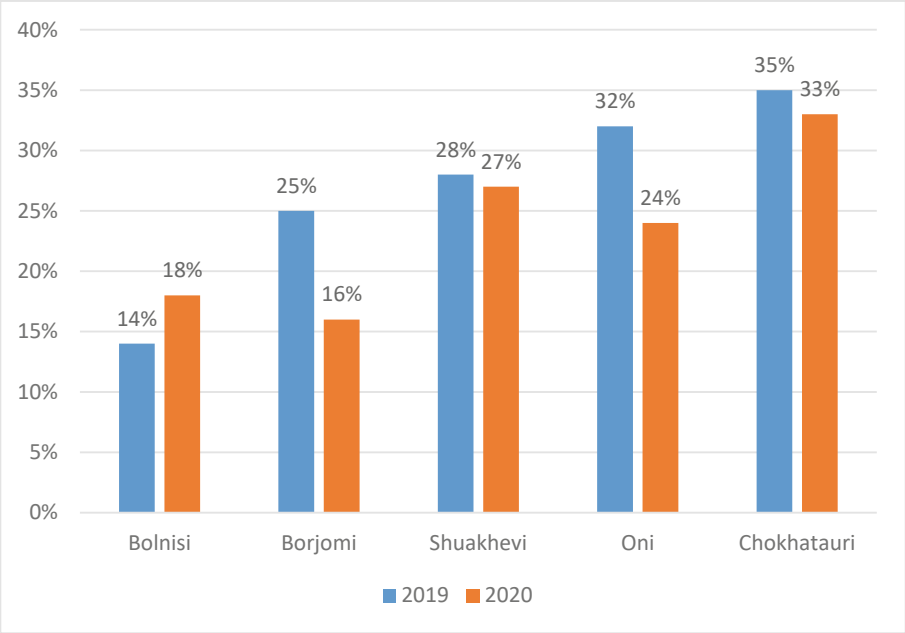

Fig. 2. Ratio of taxes to total revenues in 2019–2020 (%). Source: compiled by the author based on the data of the Ministry of Finance of Georgia [32–34]

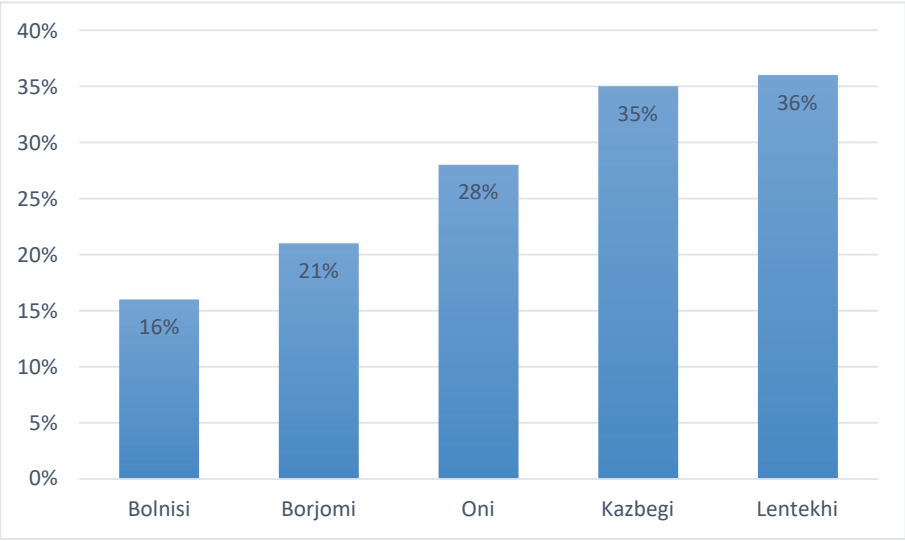

Fig. 3. Ratio of taxes to total revenues in 2021 (%). Source: compiled by the author based on the data of the Ministry of Finance of Georgia [32–34]

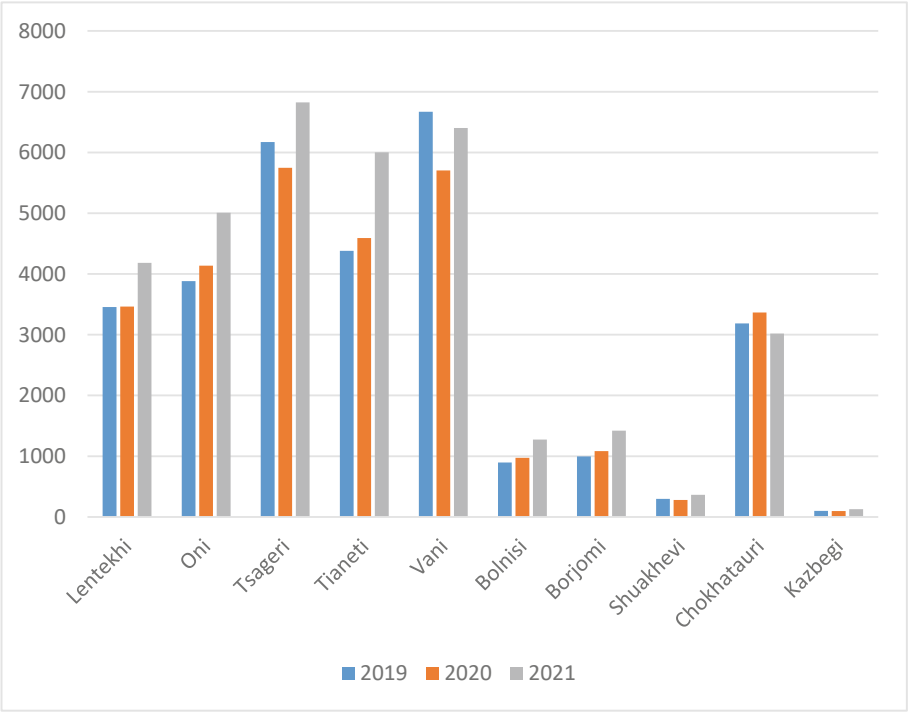

Fig. 4. Value added tax distribution by municipalities, thousand GEL. Source: compiled by the author based on the data of the Ministry of Finance of Georgia [32–34]

tax revenue, they received much more revenue from the distribution of VAT than other more developed municipalities.

To see the difference more clearly, consider the following Fig. 5:

According to the diagram, the tax revenues of the municipalities whose economic activity was the lowest in 2018, by 2019, their tax revenues are increasing several times. Moreover, their revenues exceed those of the municipality, whose tax revenues were much higher before the distribution of VAT. The amount distributed from the value-added tax is included in the tax revenues of the municipalities, therefore their distribution should be done in accordance with the added value created by the municipalities. Based on all of the above, questions arise that question the fairness and adequacy of the distribution of VAT. VAT replaces the equalization transfer, but with the difference that the distribution of financial resources in this form imposes certain frameworks on more developed municipalities.

The research has identified the factors indicating the presence of certain gaps in the existing system of financing of the municipality. Accordingly, it is necessary to consider separately the distribution of VAT and its objectivity.

The Fig. 6 shows the 5 municipalities that received the largest share of VAT according to the 2021 budget law:

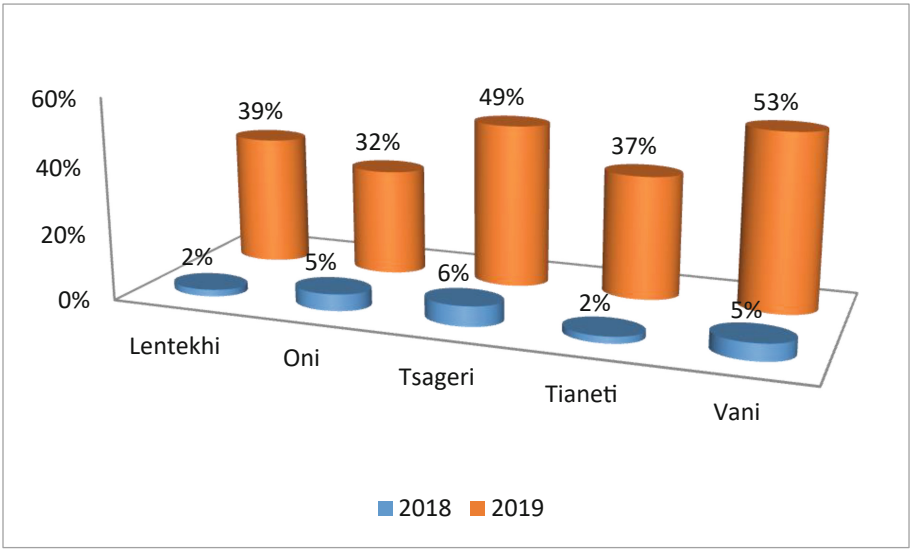

Fig. 5. Change in tax revenues in 2018–2019. Source: compiled by the author based on the data of the Ministry of Finance of Georgia [32–34]

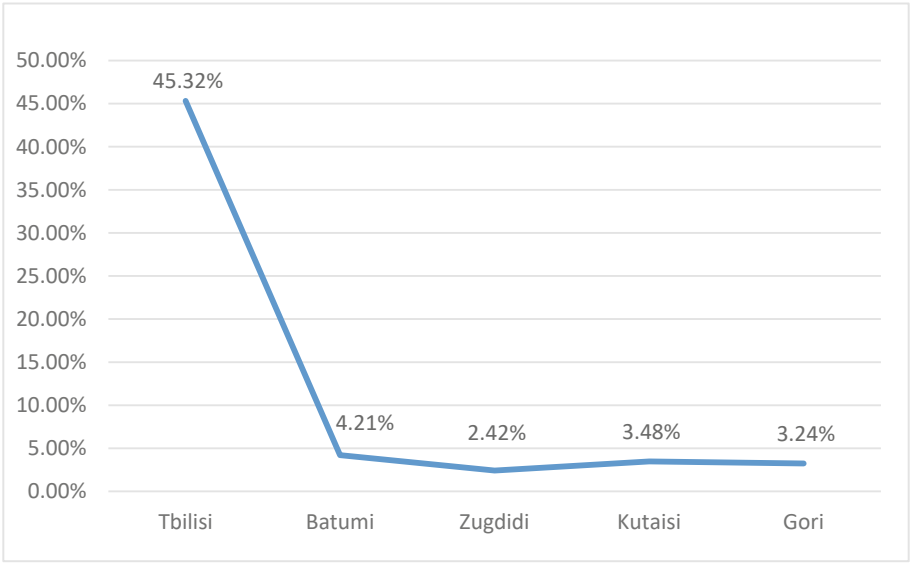

Fig. 6. Municipalities with the largest share of VAT by 2021, %. Source: compiled by the author based on the data of the Ministry of Finance of Georgia [32–34]

Municipalities that were more active compared to other municipalities receive the least revenue from value-added tax (Fig. 7). For instance, consider Kazbegi, which receives the lowest value-added tax by 2021. Until 2019, the ratio of Kazbegi tax revenues

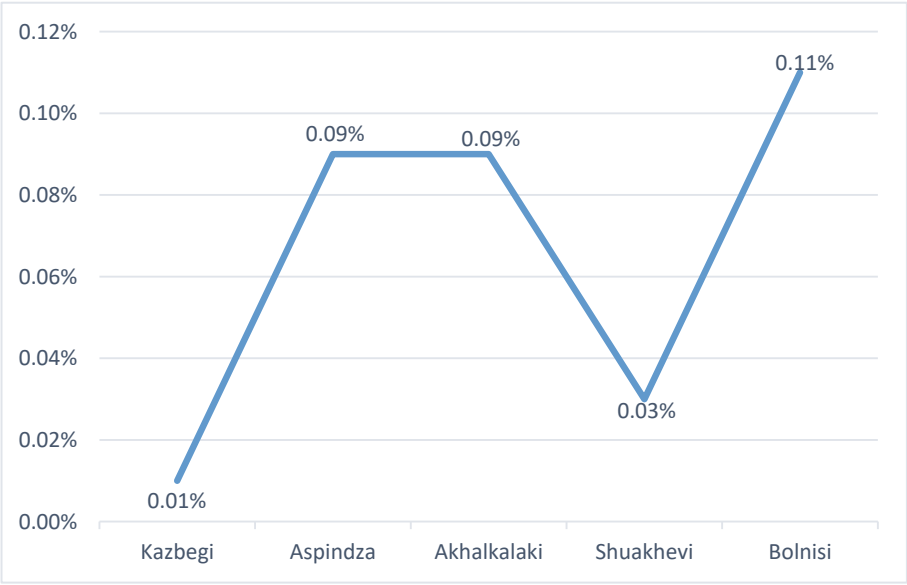

Fig. 7. Municipalities with the lowest share of VAT by 2021, %. Source: compiled by the author based on the data of the Ministry of Finance of Georgia [32–34]

to total revenues was: 50% in 2016, 45% in 2017, and 45% in 2018. Accordingly, Kazbegi is among the municipalities of Georgia that create significant added value on the territory of the country, although it receives the least revenue from the state when distributing VAT.

It is much easier for municipalities to administer other types of tax than value-added tax. As we have seen, it is common in European countries to assign a share of income tax to local governments. Georgia also has a similar experience, although the incomes received in this way were not enough for the activities of the local self-government. Hence the government can also consider assigning profit tax to municipalities.

As an indicator of the municipality's independence, we can also apply how it can manage to cover expenses with its sources of income. Therefore, we defined the next indicator as the ratio of taxes and expenses (Table 1 and Table 2).

As we can see, since the municipalities in Fig. 7 received the least tax revenues, their ability to cover the expenses is the least. Therefore, the obtained results clearly show and emphasize that the tax revenues received by the municipalities are not enough to cover their expenses. The situation is changing again in 2019 when the tax revenues increase, and the ability of the municipalities to cover the expenses they incur increases accordingly.

In addition, it should be noted that until 2018 only 6 municipalities (Akhalkalaki, Aspindza, Kazbegi, Gardabani, Shuakhevi) were allocated on average, whose tax revenues covered 100% or more of the municipality's expenses Since 2019, when local governments retain 19% of VAT, the number of such municipalities has increased to 30.

Table 1. Ratio of taxes and expenses in 2016–2018 (%)

Municipality	2016 year	2017 year	2018 year
Lentekhi	5%	7%	3%
Tianeti	7%	8%	7%
Khoni	10%	10%	10%
Tsageri	10%	11%	11%
Oni	12%	9%	11%

Source: compiled by the author based on the data of the Ministry of Finance of Georgia [32–34]

Table 2. Ratio of taxes and expenses in 2019–2021 (%)

Municipality	2019 year	2020 year	2021 year
Bolnisi	19%	29%	22%
Borjomi	45%	29%	36%
Tkibuli	53%	70%	78%
Chokhatauri	57%	63%	72%
Dedoplistskaro	65%	68%	68%

Source: compiled by the author based on the data of the Ministry of Finance of Georgia [32–34]

Accordingly, almost half of the 69 municipalities have the opportunity to cover their expenses with their tax revenues and without depending on the state budget.

Another important indicator, by which we can judge how dependent the budget of municipalities is on the state budget, is the share of grants in total revenues. Most grants are received by those municipalities with small tax revenues. However, it is worth emphasizing the fact that there are quite a lot of municipalities whose incomes are half or more from grants.

The data obtained from the research result are presented in the Fig. 8:

As we can see, the dependence of municipalities on grants is quite high until 2020, however, after 2020, there is a tendency to decrease. At first glance, it seems that the dependence of municipalities on the state budget is decreasing, however, we must take into account the fact that the revenues of municipalities have increased significantly with the allocation of 19% of VAT, therefore the percentage share of grants in total revenues has decreased.

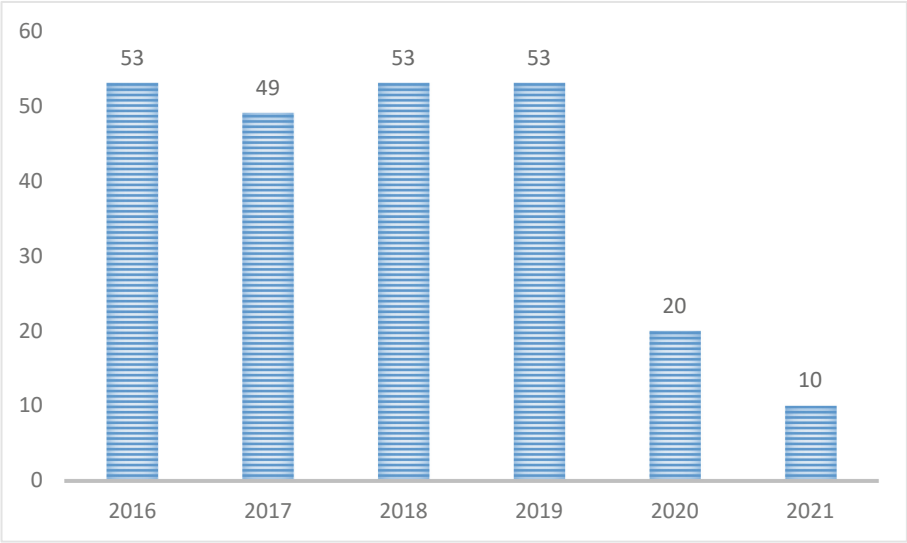

Fig. 8. Number of municipalities with 50% or more of their income from grants **Source:** compiled by the author based on the data of the Ministry of Finance of Georgia [32–34]

4 Conclusions

The financial dependence of the center and municipalities is determined via the budgets. Perfection of the formation of municipal budgets provides a guarantee of economic development of local self-government. The municipalities have been granted independence in the process of forming the program budget; however, its revenues do not allow the power to be effectively exercised. Improving revenue generation ensures that municipalities can manage their finances independently, which is a prerequisite for decentralization.

During the study of the formation of municipal budgets, certain problems were revealed. Based on the statistical analysis of the mentioned problems, we can draw the following conclusions:

- The only tax that belongs 100% to the municipalities is the property tax. It is necessary to review (evaluate) its fiscal effectiveness and by introducing progressive taxation, formulate the optimal tax burden;
- In Georgia today, economic inequality between municipalities remains an actual topic, therefore, canceling the equalization transfer contradicts the role of the state to ensure the economic equalization of the country's territorial units. It would be better to leave the equalization transfer, however, with the implementation of an effective mechanism for its redistribution;
- The 2019 change related to the distribution of 19% of VAT to municipalities increases the dependence on the central budget. The research identified the increased incomes of the municipalities, although it is confirmed that the amounts received from the mentioned distribution are not objective, it is impossible to determine which municipality belongs to the value-added tax depending on the level of its economic activity;

- To increase the municipality's income and at the same time stimulate its economic activity, it would be better to develop a legal framework that would leave the income and/or profit tax in the budget of the municipalities. This would help to encourage the municipality in terms of attracting additional jobs or investments in the territorial unit. However, leaving the income tax in an unequal position will put those municipalities where the share of employees is relatively less. Therefore, the state should implement an effective equalization policy.

Thus, the implementation of changes only in one direction will not be enough to overcome the problems of the formation of municipal budgets. A complex approach and analysis of the strengths and weaknesses of each municipality is needed. To complete the process of decentralization of Georgia, it is necessary to carry out specific reforms that ensure the raising of the financial independence of municipalities and the fair distribution of financial funds.

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