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Profit Tax Reform Results in Georgia

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Abstract. The main purpose of the tax system is to provide the state with financial resources. Both in previous years and in 2021, most of Georgia's planned budget revenues (approximately 62%) came from tax revenues. Therefore, proper determining tax policy and good tax administration is important for the budgetary process and the development of the country.

In general, the most reliable and popular indicator of the economic progress in the country is the Gross Domestic Product growth rate. In recent years, a number of tax reforms have been implemented in Georgia to accelerate it.

Such changes are always accompanied by several important issues, including whether they have an adequate impact on the growth of the country's macroeconomic performance and what challenges the country may face as a result of these reforms.

Keywords: distributed profit; profit tax; taxation; tax revenues of the budget.

Introduction

Estonian Model of Profit Tax

Today Estonian Model of profit tax operates in three countries: Estonia, Latvia and Georgia. First it was introduced in Estonia in 2000 and is known in academia as the *Cash Flow Taxation Model.* In Estonia, according to the tax regulations, the profit distributed in 2000-2004 was taxed at 26%, then until 2018 – at a rate of 20%, and from January 1, 2018 – at a rate of 14%. At the same time, the dividend tax rate is 7%. It should be called *Regularly Distributed Profit.* Regularly distributed profit means the arithmetic average of the profits distributed by the enterprise during the last (previous) three years. If the profit tax base for the current year exceeds the above arithmetic mean, then the distributed profit will be taxed not at 14% but at 20%.

The Estonian model of profit tax has been introduced by Latvia on January 1, 2018. The tax rate is 20%, while the tax base is divided by 0.8 and multiplied by 20%. 25% interest rate is actually accepted. (For comparison: in Georgia there is a 15% interest rate, while the tax base is divided by 0.85 and multiplied by 15%. In fact, a 17.65% interest rate is accepted).

It should be noted that the term *profit* itself is considered in many academic and practical terms. We are interested in the profit of the enterprise in terms of taxation. Thus, the mechanisms of profit distribution and redistribution are interesting.

When an enterprise sells goods and/or services, it first distributes the received revenue. In particular, it pays salaries to employees, dividends to founders, interest to creditors, and so on. This results in the initial distribution of revenue and profit, accordingly, the payment of salaries, the payment of dividends, etc. This is followed by (sometimes preceded by) further distribution or redistribution of the enterprise income in the form of income and profit taxes. For example, if an enterprise operating under the Estonian model distributes the profit to the founders of the individual (primary distribution), it is obliged to pay the profit tax and the income tax of these persons at the same time. In this way, the enterprise distributes the already distributed profit to the budget. An enterprise that operates on a non-Estonian model and makes a profit distributes and redistributes it to the founding individuals in two possible ways:

a) At the end of the year receives the net profit and distributes it in the form of dividends. In this case, the enterprise first pays the profit tax and withholds the income tax at the time of issuing the dividend;

b) The enterprise does not expect to receive a net profit at the end of the year and regularly issues dividends (so-called interim dividends) during this reporting year. In this case, when paying the dividend, it withholds only the income tax, and at the end of the year pays the profit tax in the prescribed manner. In both cases, there is a distribution of profits.

The peculiarity of the Estonian model is that it does not tax ‘income’ but ‘expenses’. These terms are emphasized because ‘revenue refers to profit and expenditure refers not to all costs associated with economic activity but to non-deductions in ordinary taxation and some other costs.’ (Uridia, 2018).

Profit taxable under normal income tax terms may not coincide with financial income (accounting profit). It is known that this is caused by the difference between the principles of accounting and tax accounting. It should be noted that costs that are not deductible under normal taxation are usually taxed under the Estonian model. However, it is interesting that in the case of ordinary taxation the non-deductible amount is taxed at 15 percent, and in the case of the Estonian model – the ‘grossed’ amount of the non-deductible amount. For example, an expense that is not documented is not normally deductible under the terms and conditions and therefore does not reduce the gross income, which means it is included in taxable profit. In the Estonian model, undocumented expenses must be ‘grossed’ (divided by 0.85) and taxed, which results in different tax burdens. (Uridia, 2018).

The Estonian model is a model of *costs*. Excluding dividends, such expenses are generally

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classified into three groups:

1. Non-economic costs;
2. Gratuitous expenses;
3. Representative expenses.

According to the Estonian model, the following are subject to profit tax: resident enterprise; permanent establishment of a non-resident enterprise; organization that carries out economic activities (from January 1, 2019); Commercial Bank, Credit Union, Insurance Organization, Microfinance Organization and Pawnshop (from January 1, 2023).

The object of taxation of profit tax for a resident enterprise is: distributed profit; non-economic costs; gratuitous expenses; representative expenses.

Profit distributed under the Tax Code of Georgia is a profit that is distributed by the enterprise to its partner in the form of dividends, in cash or in kind. According to this norm, the distributed profit can only be a dividend. This does not mean that profit can be distributed in a way other than dividends, although the term *distributed profit* as the object of income taxation means only dividends. However, the TCG allows cases where any other event that is not a direct distribution of profits is still considered a distribution of profits. In this case, such a distribution of profits does not constitute a dividend (for example, prices different from the market price established between interdependent persons, controlled transaction prices, etc.).

Main Part

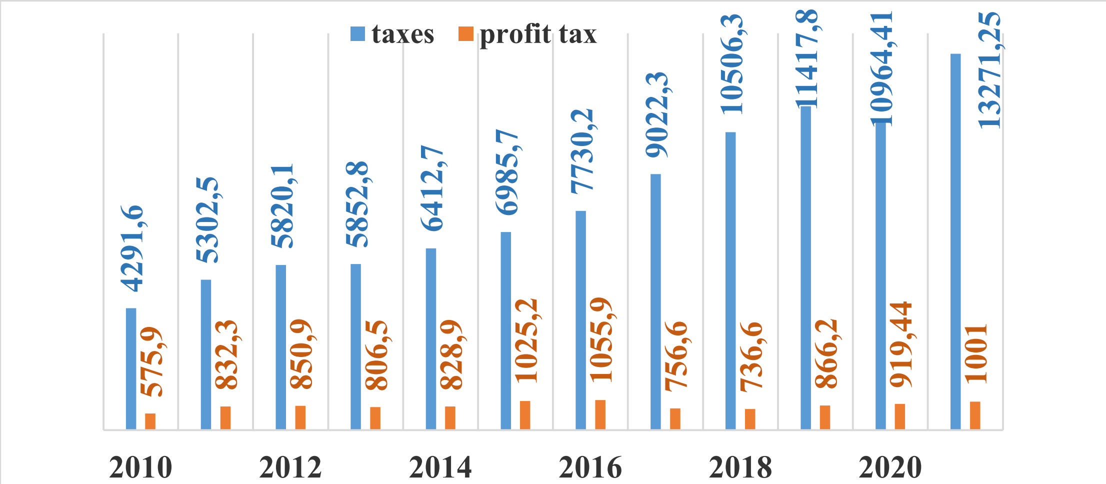
The Effect of the Estonian Model

The Estonian economy itself can be considered uniquely positive, as it became a rapidly developing country very soon after the declaration of independence. Estonia is today rated by the World Bank as one of the highest-income countries in terms of GDP (Gross Domestic Product) per capital.

Preliminary results of the Estonian model profit tax regime in Georgia were predicted within the framework of the USAID-funded Governance for Development (G4G) project. With this, the possible macroeconomic consequences of the Estonian model tax regime were assessed. The neo-classical general equilibrium growth model was developed by economists. According to the study, the reform will have an investment incentive effect: “The steady state of capital stock according to the model would increase by 3.23%. The output will increase in the steady state by 1.44%. This growth effect took place at the cost of allocating resources from consumption to investment. The share of the consumption in the economy would decrease approximately by 0.37 percent, while the investment share to output will increase by the same percent in a closed economy case. In the open economy case, the share of consumption in the economy decreases by 0.36 percent, and the share of investment to output will increase by 0.37 percent. The extra increase in investment share comes from the decrease in current account deficit. The favoring effect of retained earnings taxation would decrease the current account deficit, but the change will not be pivotal as the share of firms owned by foreigners is small in the Georgian economy. Even though the share of consumption to total output decreases, the amount of household consumption increases by 0.83% in the closed economy scenario and by 0.84% in the open economy scenario after the tax reform. (USAID Governing for Growth (G4g) in Georgia, 2016, pp. 22-23)

Whether this reform has had an expected positive impact on the growth of economic indicators, we can assess on the basis of statistical data analysis.

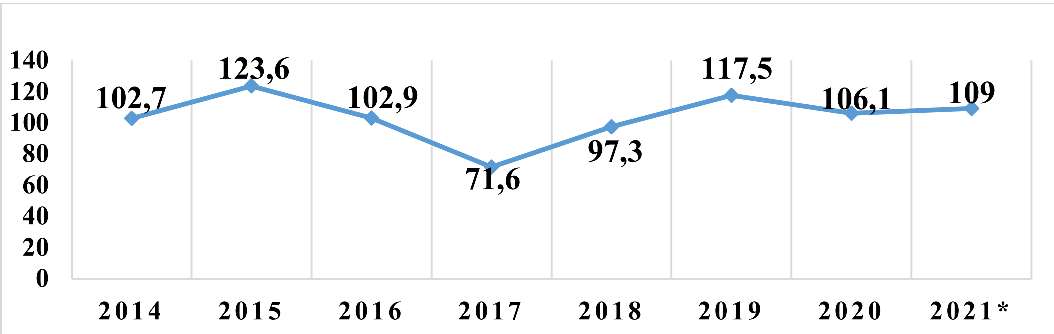
First of all, let's consider the dynamics of profit tax and budget taxes in 2010-2020:



(Ministry of Finance of Georgia, 2022)

Figure 1. Tax dynamics 2010-2020 (million GEL)[1]

As can be seen from the figure, the highest rate of profit tax was recorded in 2016, 1055.9 million GEL. As for the taxes included in the budget as a whole, there has been a trend of continuous growth since 2013, and the highest actual rate was recorded in 2019, 11417.8 million GEL. If we do not take into account the 2010 figure, the lowest rate of profit tax in the budget in 2018 was recorded at 736.6 million GEL.



(Ministry of Finance of Georgia, 2022) [4]
(Ministry of Finance of Georgia, 2021) [5]

Figure 2. Profit Tax Trend Analysis (%) (Chain)

To analyze how the share of profit tax in budgeted taxes has changed as a result of the reform, we took the data for 2016 and 2018, when the highest and lowest profit tax rates were recorded:

[1] The data marked out by * are Preliminary

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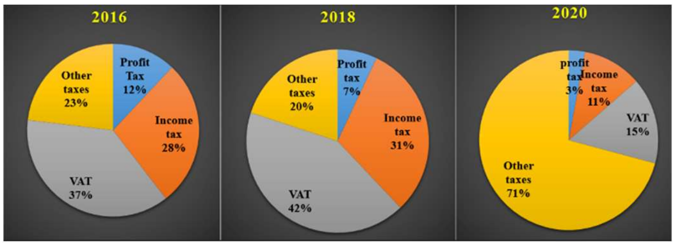

Ministry of Finance of Georgia [4]

Figure 3. Structure of tax revenues in the budget

As can be seen from the diagrams, the share of profit tax in total taxes has been significantly reduced, although total taxes increased by almost 65% in 2018 compared to 2016. But In 2020 the share of profit tax in total taxes was reduced to 3%.

Along with profit tax reforms, the COVID 19 pandemic is noteworthy. With COVID-19 emergencies affecting the lives of many people, governments around the world are taking many-sided actions to provide services to their citizens, businesses and vital public services. In particular, to alleviate the tax burden on taxpayers, to support businesses that have cash flow problems or difficulties in their tax obligations. The Government of Georgia has taken a number of measures like other countries, to impose point restrictions, which have led to the deferral of property and income taxes, in particular, the introduction of income and property deferrals to alleviate taxpayers' tax burden. In 2020, income and property taxes were deferred to a total of 6,545 taxpayers, for a total of GEL 219,810,061. (Ministry of Finance, 2020, p. 9).

According to our G4G survey above, it was expected that the reform would result in a reduction in profit tax on total revenues and an increase in income and VAT taxes. The authors of the study suggested that in order to achieve the new budget balance, the government should maintain a sfigure rate of spending. Our analysis of the actual figures for budget expenditures shows that the government has failed to increase this figure compared to previous years. The figures for 2021 in the figures brought by Chen are forecast. This year's actual figures are only available for 9 months. In the first 9 months of 2021, the forecasted revenue from consolidated budget taxes was set at GEL 9,406 million, with GEL 9,504.7 million mobilized during the reporting period, representing 101 percent of the forecast.

GEL 2,717.4 million was mobilized as income tax, which is 102 percent of the forecast (GEL 2,664.8 million). 90 790.9 million GEL was mobilized as profit tax, which is 103.4 percent of the forecast (764.7 million GEL). 4 GEL 4,337.9 million was mobilized as value added tax, which is 102.4 percent of the forecast (GEL 4,236.4 million). 1,277.6 million GEL is mobilized as excise, which is 103.4 percent of the forecast (1,235.3 million GEL). 60 60.8 million GEL was mobilized in the form of import tax, which is 102.8 percent of the forecast (59.2 million GEL). 39 394.5 million GEL is mobilized in the form of property tax, which is 101.9 percent of the forecast (387 million GEL).

In the third quarter of 2021, compared to the same period of the previous year, consolidated budget revenues increased by 33.9 percent, while expenditures increased by 6.9 percent. At the same time, the consolidated operating budget, which represents government savings, amounted to GEL 152.9 million, while the total balance was set at GEL -745.6 million. A significant share of budget revenues is accounted for by tax revenues, accounting for 90.4 percent in the third quarter of

2021. The consolidated budget received GEL 3,496.2 million from taxes, which is 32.4 percent more than the previous year. Revenue from income tax increased by 64.2 percent year on year and amounted to GEL 1,039.5 million. High growth is observed in the form of value added tax revenue, which increased by 22.7 percent year on year compared to the previous year and amounted to GEL 1,651.5 million, accounting for 47.2 percent of tax revenues. At the same time, there is a significant increase in tax revenue from profit and import taxes. In particular, revenue from profit tax increased by 30.3 percent, while revenue from import tax increased by 18 percent. Revenue from excise tax increased relatively slightly, accounting for 15 percent, while the growth rate was 5 percent. Expenditures in the third quarter of 2021 increased by 6.9 percent year-on-year to GEL 3,713.5 million. The largest share of budget expenditures is in social security expenditures, which account for 41.8 percent of total expenditures, while the annual growth rate is equal to 0.6 percent. Expenditures in the form of subsidies also increased significantly, with an annual growth rate of 39.7 percent, amounting to GEL 443.8 million, accounting for 12 percent of total expenditures. As for other items of expenditure, wages (12.9 percent of total costs), goods and services (15 percent of total costs), interest (4.9 percent of total costs) and other costs (13.3 percent of total costs), respectively, compared to the corresponding period of 2020, respectively. 4.4 per cent, 13.7 per cent, -6.3 per cent and 8.7 per cent more were targeted at them. Ministry of Finance of Georgia, 2021, pp. 18,19).

As for the change in other economic indicators, which has been recorded in the official statistical data, we have done a correlation analysis of some of them and profit tax changes over the last five years:

Table 4.

Correlation analysis (million GEL)

	profit tax	GDP at market prices (at constant 2015 prices)	Investments in fixed assets	Final consumption
2015	1025.2	30197.1	4333.6	30795.9
2016	1055.9	31138.7	4665.4	30487.2
2017	756.6	32614.5	5586.1	34115.4
2018	736.6	34198.7	4967.8	36801.3
2019	866.2	35947.5	4877.3	41206.5
2020	919.4	33578.7	4350.1	47018.3
CORREL		**-0.469136056**	**-0.743783999**	**-0.30471367**

National Statistics Office of Georgia. [8]

As it can be seen from the table, there is a negative correlation between profit tax and all three macroeconomic indicators. In particular, there is a rather weak inverse relationship between profit tax and final consumption. As already mentioned, this refrain was aimed at increasing the share of reinvested earnings from the profits generated by companies. This in itself would lead to an increase in investment in fixed assets, which unfortunately is not confirmed by the above data. Conversely, investing in fixed assets has been on a downward trend since 2018. Are these changes caused only by the 'Estonian model of profit tax'? To answer this question a more detailed and in-depth study is required. Because their change is influenced by other environmental factors. According to experts, the economically justified 'Estonian model' in Estonia could not have achieved

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similar results without a stable macroeconomic environment. (Kharkhelauri, 2021, p. 115).

Conclusion

According to the Estonian model, the distributed profit is object of profit taxation, which is paid by the enterprise to its partner in the form of a dividend in cash or non-cash form. It is very important that reinvested earnings are not taxed in this case.

In Georgia, a reduced profit tax alone will not attract foreign investment, will not give a strong signal of reinvestment to business entities, if the representatives of the local business sector or foreign investors are warned about the instability of the national currency, *comprehensive* political fluctuations or protectionism. Therefore, let us not have the illusion that the Estonian model will be able to significantly stimulate economic growth independently. The success of this tax model depends on the creation of the environmental conditions that are, in itself, necessary for economic development.

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ანოტაცია. საგადასახადო სისტემის ძირითადი დანიშნულებაა, სახელმწიფო უზრუნველყოს ფინანსური რესურსებით. როგორც გასულ წლებში, ისე 2021 წლისათვისაც საქართველოს დაგეგმილი საბიუჯეტო შემოსავლების უმეტესი ნაწილი (დაახლოებით 62%) საგადასახადო შემოსავლებზე მოდის. ამიტომ, საგადასახადო პოლიტიკის სწორად განსაზღვრას და გადასახადების კარგ ადმინისტრირებას უდიდესი მნიშვნელობა აქვს საბიუჯეტო პროცესსა და ქვეყნის განვითარებაში.

ზოგადად, ქვეყანაში ეკონომიკური წინსვლის ყველაზე სანდო და პოპულარულ ინდიკატორად მთლიანი შიდა პროდუქტის (მშპ) ზრდის ტემპი განიხილება. ბოლო წლებში მის დასაჩქარებლად საქართველოში მთავრობის გადაწყვეტილებით, არაერთი საგადასახადო რეფორმა განხორციელდა.

მსგავს ცვლილებებს, ყოველთვის თან სდევს რამდენიმე მნიშვნელოვანი კითხვა, მათ შორის, ახდენენ თუ არა ისინი ადეკვატურ გავლენას ქვეყნის მაკროეკონომიკური მაჩვენებლების ზრდაზე და რა გამოწვევების წინაშე შეიძლება დადგეს ქვეყანა ამ რეფორმების შედეგად.

საკვანძო სიტყვები: ბიუჯეტის საგადასახადო შემოსავლები; განაწილებული მოგება; დაბეგვრა; მოგების გადასახადი.

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