

Tax Policy Formation and the Transnationalization of the Public Policy Arena

A Case Study of Georgia

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PhD Dissertation

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ezRvneba xatuna Cankselians

Chapter 1

Introduction

Taxes not only helped to create the state. They helped to form it. The tax system was the organ the development of which entailed the other organs. Tax bill in hand, the state penetrated the private economies and won increasing dominion over them. The tax brings money and calculating spirit into corners in which they do not dwell as yet, and thus becomes a formative factor in the very organism which has developed it (Joseph A. Schumpeter 1918/1954:17).

Taxes made states in Western Europe. States emerged as a result of bargaining among rulers and the ruled. Costly wars urged the rulers to raise revenues and the ruled agreed to pay taxes to contribute to the accumulation of state finances. In return they received protection from the state (Levi 1988; Tilly 1990:96-126). Over the centuries the institutions of imposing and regulating taxes have evolved (Bräutigam 2002). States penetrated private economies, developed their capacity to tax, and the tax state emerged (Schumpeter 1918/1954). Tax structures and tax administration capacity of modern tax states changed continuously and moved from trade tax reliance to direct tax intake (Peters 1991; Bird and Zolt 2005). Income taxes, which before World War II were considered a class tax, became a mass tax following the devastating war. Nowadays, modern tax states in the West rely predominantly on tax revenues collected from individuals and the business sector, while in return they provide public goods to the taxpayers. Tax systems are built on the notion of equality and fairness, whereas the ability to pay taxes is determined by the state. Moreover, tax compliance costs are kept low due to consensus among taxpayers and decision makers on tax types and rates (Peters 1991). All in all, state building through taxation took centuries across the Western countries which are currently trying to tackle policy issues of *tax competition* and *tax policy* convergence (Ganghof 2006; Steinmo and Swank 2002; Swank 2004, 2006, 2008).

In contrast, post-Soviet countries have not had centuries to contemplate, form and re-form their tax systems. In less than two decades they had to build their states from the ruins of the post-Soviet tax regimes. They had to learn how to tax and how to administer revenues relevant to capitalist market economies (Easter 2002, 2008; Fritz 2007; Gehlbach 2008). It is therefore a challenge to get our heads around the scope and scale of the accelerated processes of modern tax system formation in post-Soviet countries. The politics of taxation in the post-Soviet realm were born in 1991 on the ruins of the Soviet regime. All

15 post-Soviet republics inherited tax policies and tax administration modeled on a planned economy. The latter had no direct taxation whatsoever, but relied on narrow tax base extracted mainly¹ from large state-owned enterprises administered through state bank transfers that never allowed a capable tax administrative institutions to emerge (Martinez-Vazquez and McNab 2000:3-4; Easter 2002:604; Gehlbach 2008:21).

The starting point of forming a market economy and building up a tax system was similar across post-Soviet states (Frye 2002). Market making and state making became parallel processes in the post-Soviet region, just as in Eastern Europe (Bruszt 2002). What actually happened was that countries formed various types of capitalist economies (Bruszt and McDermott 1998), although not all republics made similar choices. Their tax policy, state extractive capacity and reliance on various types of revenues varied and consequently, so did the outcome of those processes.² While tax levels among post-Soviet states were generally lower compared to OECD countries and the intake from indirect taxes on consumption and services was higher, which is typical for developing countries, post-Soviet states varied in their tax policy choices (tax rates and tax structures) as well as in their capacity to extract taxes in general, and in particular direct taxes (Fritz 2007; Gehlbach 2008; Easter 2002, 2008; Loung and Weinthal 2004). Accounting for these differences is therefore an interesting research task.

The dissertation focuses on a particular case of the Georgian tax policy making and reform during the period from 1991-2005. Georgia had virtually

¹ At the dusk of the Soviet regime, the Soviet tax system was slightly reformed to include a value-added tax (VAT) (Ebril and Havrylyshyn 1999).

² Reforms on taxation policies started with the reform of the enterprise profit tax, introducing personal income tax and excise tax, and replacing turnover taxes with VAT (Stepanyan 2003:13). The central European states along with all three Baltic countries were among the first to imitate a western tax system through successful tax reforms. After the Baltic States, Kazakhstan was the first to introduce a modern and comprehensive tax code in 1990. Georgia, Tajikistan and Uzbekistan followed. However, in countries such as Belarus and Turkmenistan the tax policy reform was defective. Soon after the tax reforms, Georgia and Ukraine experienced a backslide due to amendments for exemptions and tax holidays to the tax code (Martinez-Vazquez and McNab 2000:9). The western tax systems imitated by the countries in transition consisted of similar tax structures: indirect (VAT, excise, customs tariffs) and direct (personal income tax, corporate income tax or enterprise profit tax, social security or payroll) (p. 10). However, some legacies of the planned economy tax systems remained in the newly independent states: customized taxes, an interventionist tradition, lack of a tradition of voluntary compliance, absence of conventional excess burdens, taxes and income redistribution, undeveloped tax administration and public distrust of government institutions (pp. 4-6).

no state budget at early independence (1992-1993), and it was the worst tax collector in the region with tax exemptions and tax write-offs granted to business sectors favored by politicians. In 2004, it turned into a liberal tax state with surplus in the state budget, dramatically increased tax collection, and almost abolished tax exemptions in its new tax policy. At the point of departure, Georgia's tax system resembled a Swiss cheese with so many holes that the tax nest could only catch a very narrow tax base. However, the Rose Revolution in 2004 changed the political scene. The tax system was streamlined, tax rates reduced and the number of taxes shrunk from 22 before the Rose Revolution to 7 in 2004 (TI 2010). The emerging Georgian tax state not only taxed its citizens on a flat rate, it also abolished a minimum non-taxable amount in their income – and there was no equivalent in other tax policies with a flat tax on personal income in the region. Planned changes in the tax policy demonstrated the new government's determination to simplify the tax system, make it easy to administer and to comply with. Focus was on improving the tax system to make Georgia even more attractive for investments. Planned policy reforms aimed to reduce interest and dividend on income taxes to 0% before 2012 (TI 2010).

These efforts did not go unnoticed. In 2006 the economic reforms – among which tax policy and administration were a great part of – placed the country among the top ten reformers in the Commonwealth of Independent States in the World Bank's annual report on the ease of doing business in countries.³ The reformed tax administration and hard-handed tactics on tax collection that allowed the Georgian tax state to emerge from its 'failed' and 'captured' state predecessors sent a clear signal that tax rates would be reduced, but tax payments were expected from all, including the business sector. The Georgian case of tax system formation and its subsequent changes bring up the question of how to account for these changes. Why did such radical changes occur? How did they come along and why after almost 14 years of independence? The dissertation will investigate these questions boiled down to one:

Why and how did Georgia establish and reform its tax policy 1991-2005?

This research question narrows the focus of the dissertation to tax policy and its subsequent reformation, which is a vital part of building up a tax system. Rules established by tax policies affect tax collection and the state's extractive capacity. On the other hand, the result of tax policy in terms of taxes extracted

³ <http://web.worldbank.org/WBSITE/EXTERNAL/COUNTRIES/ECAEXT/BELARUSEXTN/0contentMDK:21042454~menuPK:328437~pagePK:2865066~piPK:2865079~theSitePK:328431,00.html>

feed back on policy makers' choices. Ideally, tax policies should reduce tax administration costs and help increase tax collection overall. In reality, problems related to effective administration and implementation affect policy making and constrain political choices. Both issues are thus interconnected and relevant to address even though the present investigation focuses on only one of them – the politics of Georgian tax policy rather than tax administration. Nonetheless, the theoretical as well as the empirical chapters will discuss the issue of tax collection and tax state formation as a possible explanation of tax policy. With this focus, the dissertation makes a humble contribution to the literature on former Soviet state building processes, where tax policy choices will be added up to the possible factors that may influence a state formation process in newly independent states and their state capacity formation (Fritz 2007; Easter 2002, 2008).

Tax policy is a political document that involves various policy actors throughout its making and its adoption. With its focus on direct taxes, e.g. personal and corporate income taxes, in Georgia the dissertation studies the process of tax policy adoption and its subsequent reforms over 14 years from Georgia's independence in 1991 up to 2005 when the liberal second tax code was adopted and enacted. The questions are interlinked with the literature on state building processes in the former Soviet republics and politics of tax policy formation in transition countries on one hand (among others Campbell 1996, 2001; Easter 2002, 2008; Loung and Weinthal 2004), and on the other hand, on the 'sweeping reforms in tax policies' across countries under the banner of 'tax competition' dominantly investigated in the OECD countries with focus on tax rate reduction on income tax (Steinmo and Swank 2002; Swank 2006, 2008).

Taxation is under-investigated in the transition literature, and with a few exceptions so from the state building perspective (Campbell 1996; Campbell 2001; Easter 2002, 2008; Loung and Weinthal 2004; Fritz 2007; Evans and Aligica 2008; Aligica and Evans 2009). Yet, those who study the politics of state formation across post-Communist countries find that poor extractive capacities were correlated with the lack of political regime consolidation (Fritz 2007). Moreover, state building processes were seen as a parallel process of market making (Bruszt 2002; Gehlbach 2008), where elite bargaining was the dominant model of institution formation involving powerful economic elites and state actors as the dominant group of 'state makers' (Easter 2002, 2008; Loung and Weinthal 2004; Fritz 2007). Sometimes powerful actors who were the initial winners after the market reforms were argued to have captured post-Soviet states, further hampering a completion of free-market reforms (Hellmann 1998). The claim that the governments of the newly independent post-Communist countries have lost the battle of state capture to particularistic in-

terests has been emphasized by Laszlo Bruszt, who studies the challenges of state formation through market making in post-Communist realm:

After nearly a decade of the struggle to liberate economic activity from the state, many of these countries now face the question of how to liberate the state captured by economic groups. If they want to create a functioning market order, they will need a state that is capable of regulating the highly uneven distribution of economic power in a balanced way. But, in the first place, in order to rebalance their economies, they need states liberated from the hold of powerful economic groups. The (re)making of states with the capacity to constitute and preserve market order is still on the road ahead in many of the countries of the region (Bruszt 2002:69).

However, it seems that the challenges glaring at the post-Communist states were not unique and unfamiliar to the West. Bruszt has argued that challenges of market making and state formation faced by policy makers in the transition countries have been tackled by their Western counterparts in the 18th and 19th centuries. This fact provided a rich source of information for the new states to learn the principles for making decisions in market-formation and state building in the United States (Bruszt 2002).

Hence, the process of state building and tax system formation in the post-Communist realm, as in other regions, became less a matter of domestic politics. Rather, it was a consequence of the ever-growing interconnected global markets and the need for transition countries to form modern tax systems under the auspice of the international financial institutions that made tax systems globally or within the region open to international influence. As early as two decades ago, Joel Slemrod (1990) observed that tax policies were no longer an entirely domestic matter but were affected by international trade and investment. He noted: '[Tax policy] has traditionally been thought of as an entirely domestic matter. [But] in an increasingly global world economy, nations can no longer afford to design their tax systems without accounting for the effects on international trade and investment' (quoted in Steinmo 1993:156). That said, however, national politics retain power to translate abstract policy ideas into legal norms suitable for the domestic environment (Steinmo 1993). Both developing and developed states are challenged by international taxation, and tax competition affects the way governments choose to design their tax policies; however, the degree of the challenge differs in developing and developed countries (Fjeldstad and Moore 2008). In states which are being shaped and where the tax extraction capacity is still weak, tax system reforms must be viewed through the prisms of pro-business policy norm adoption as well as state formation. This challenge is taken up in this dissertation.

Furthermore, the dissertation challenges the schools of thought mentioned above, which are clustered under the banner 'the conventional theoretical approaches'. The empirical analysis develops and tests an alternative explanation of post-Soviet tax policy formation called *transnationalization of a public policy arena*. The dissertation argues that the empirical puzzle of the Georgian case sheds light on the weaknesses of the existing theories and the fact that they overlook the power of ideas in tax policy making and reform processes, and predominantly rely on interest-driven explanations, or factors such as external pressure or domestic structures. In contrast, this dissertation aims to bring the ideas back in to explain tax system establishment and subsequent reforms across post-Soviet countries via an in-depth case study of Georgia. However, before I further discuss the theoretical argument that this dissertation builds on, I will explain how the notion of a tax policy is understood here.

1.1. Tax Policy Defined

1.1.1. A Broader Definition

Modern states stand on two feet: their public expenditure system and their tax system, which constitute the fiscal system. States have to collect revenues to have income to spend. A state purse – a state budget – thus depends on taxes as much as on expenditure (Peters 1991).⁴ But before policy makers decide where to redistribute common wealth, they have to identify, collect and administer taxes as their source of revenues, and this is done within the scope of a country's tax system. Tax systems contain legal norms on who pays and how much, it provides regulations on how to collect and administer taxes, and includes institutions which are responsible for defining tax norms and their implementation. In a nutshell a tax system is an institutional structure combining tax policy and its administration (Liebermann 2003). Tax systems combine mainly three types of actors: policy makers defining tax policy norms, taxpayers and those who have to ensure tax policy compliance and administration, i.e. civil servants. A country's tax system says a lot about the nature of the state, its strengths and weaknesses. A tax system defines state-society relationship, democratic representation of its taxpayers and is mostly focused on taxes. This point is particularly important to emphasize, since in developing countries state

⁴ Steinmo (1993:3) views taxation as the core of the redistributive policy of a modern welfare state and a part of the state's economic policy in general. Moreover, he stated that taxations are a 'complex mix of both payments and benefits' and that they are 'one of the most important policy concerns in the modern industrial state' (ibid).

revenues are not always taxes, but can be windfalls of income from natural resource exports or external funding in terms of foreign grants and aid (Moore 2004). Non-tax income of a state is less relevant in terms of tax state emergence and the state's capacity to tax, as those issues are related with direct taxation. That said, the tax system itself is a result of various policy ideas, decisions, and choices made by politicians, experts, business and societal groups. As Steinmo (1993:3-4) puts it:

[A]ny taxation system embraces a complex mix of competing goals, ambitions, and considerations. Raising revenue, redistributing income, encouraging savings, stimulating growth, penalizing consumption, directing investment, and rewarding certain values while penalizing others are just some of the hundreds of goals that any modern government tries to promote with its tax system. Indeed, taxation is a major instrument, if not *the* major instrument, through which governments try to affect the private sector. Particular outcomes, like the distribution of effective tax burdens or the reliance on one type of tax versus another, are never the result of a single choice abstracted from the maze of decisions and goals that affect any modern tax system. We must first understand that tax policies are multifaceted instruments that are at the vortex of political and economic relations.

Comparative studies have investigated tax systems from various perspectives. Some focus its component of decision making and policy elaboration (Steinmo 1993; Peters 1991; Swank 2002, 2004, 2006, 2008), others on its role in state capacity formation, and tax policy implementation (Cheibub 1998; Fauvelle-Aymar 1999; Soest 2006; Levi 1988). Few study both aspects of the tax system, referring to it as a tax state (Liebermann 2003). Tax policy implementation reflects a state's extractive capacity (i.e. tax state perspective) and is relevant to the present analysis because it emphasizes how the need to extract taxes and the existing administrative institutions may serve as a constraint on or a drive for decision making on tax legislation. Tax implementation and its implications can give policy makers incentives to initiate tax reforms to make tax administration less costly and aid overall tax collection in the country. After all tax policies as any other type of public policies are valued in terms of their implementation.

1.1.2. Narrow Definition

For the purposes of this dissertation it is necessary to adopt a more narrow definition of tax policy. However, before defining the term 'tax policy', let's clarify

the term 'tax'. A tax⁵ is a cornerstone of a tax system and therefore of a tax policy. According to OECD's definition (similar to the World Bank)⁶ taxes are compulsory unrequited payments to the government. Taxes are unrequited payments because individual taxpayers do not receive government services as benefits proportional to their taxes (Messere et al. 2003:7). Taxes bear particular characteristics that make them unique. At the same time, those characteristics are translated into policies as well. Mainly taxes are clustered into two aggregate types, such as direct and indirect. *Direct taxes* such as *income*, profit, and capital gain, and property tax are extracted from the object (tax payer) directly. Moreover, they are visible and expose who in the economic systems bears the greatest tax burden (Lieberman 2004:105). *Indirect taxes* are extracted in a hidden manner, for example VAT on goods. All indirect taxes are regressive, whereas direct tax such as income tax can be either progressive (i.e. various tax rate brackets) or regressive (i.e. a single tax rate, such as a flat tax).

Direct taxes are associated with the extractive capacity of a state, which needs to exercise its power to make entities or individuals do what they otherwise would not want to do – i.e. pay taxes (Shah and Whalley 1991; Peters 1991; Lieberman 2004). Imposing and collecting direct taxes require governments to be (or be perceived as) legitimate, as subjects of taxation (i.e. individuals or entities) have to acknowledge and obey their authority. At the same time, tax payers have to be willing to comply and act collectively for the general goal – to provide funding for the state and its activities that might not be equivalent to the individual contribution. Due to the weak state capacity of developing countries, direct taxes are often seen as less relevant in analyses of their tax policies (Bird and Zolt 2005).⁷ Nonetheless, this dissertation focuses on direct tax policy, i.e. personal income and corporate income taxes. I argue that direct taxes are an indication of a state's capacity to overcome a collective action problem and to ensure compliance from its tax objects. Direct taxes are an integral part of a modern tax system established in the Western world and

⁵ It is important to know that taxes differ from fees paid for government services or income that the state receives through other forms of financing, firstly because fees are paid for a benefit that is concrete and is proportional to the paid amount as set by the government. Tax revenues are the source of state financing and differ from borrowing, inflation, money printing (i.e., seigniorage) (Lieberman 2003:44; Easter 2002). Detailed lists of tax types and their particular features are provided in Appendix 1.

⁶ According to the World Bank quoted in Lieberman (2003:43) taxes are 'unrequited compulsory payments collected primarily by the central government.'

⁷ Indirect taxes are seen as important taxes in developing countries, which often rely on those types of taxes as they lack capacity to raise revenues from direct taxation (Soest 2002; Fauvelle-Aymar 1999).

simply because developing countries have been lagging behind to increase capacity to extract direct taxes with the same frequency as their western counterparts, this does not make direct taxes less relevant for scholarly scrutiny in the realm of developing countries. In contrast, in a study of the establishment and subsequent change of the Georgian tax system, direct taxes are relevant in terms of how and why the Georgian tax state was established through extracting directly from individuals and companies.

As said, a tax is a core of a tax policy, while the latter is a type of public policy containing norms on who pays and how much (Steinmo 1993:1). However, tax policy is distinct from other types of public policies, because 'tax policies ... provoke stronger reactions from citizens than do many other policies, and may have to be adjusted frequently to meet changing political and economic circumstances' (Peters 1991:4).⁸ A tax policy is a political document. It creates winners and losers within a certain legislative system (ibid.). Therefore, decision makers sometimes adopt tax policy norms which escape any economic calculation or rationale. A similar stance is shared by Steinmo (1993), who states that policy is the instrument in the hands of a government which can affect private interests, while striving to promote its own interests (Steinmo 1993:3). Moreover, tax policy is a 'multifaceted instrument' that combines political and economic interests, means and goals. Therefore, it is mistaken to assume that tax policies only aim to equalize wealth and income, or that they are the outcome of a 'single choice abstracted from the maze of decisions and goals that affect any modern tax system' (pp. 3-4).

At the same time, tax policy unlike any other public policy has been at the center of ideological conflicts over modern states' size, scope, and function (Steinmo 1993:1). The distinctive nature of tax policy is seen in four main features associated with policy and the policy making process: (1) its *complexity*, which makes it hard for average citizens to comprehend why they pay what they pay, while they comply with the policy and pay taxes; (2) tax policy making often involves *experts and specialists* more than just average citizens; (3) it is hard for *politicians* to use tax policy for their own benefit in political campaigns; (4) tax policy making is often a *long process* that goes on out while part of the policy is being implemented (Peters 1991:3-5). Nonetheless, Peters (1991) has argued that due to its similarities with other types of public policies, models and concepts used to explain other public policies are also applicable to tax policy.

⁸ Fauvelle-Aymar (1999:397) supports this argument of tax policy to be different type of policy distinct from other public policies due to its implosion of taxes on citizens who pay them but non-voluntarily. And plus, tax policy deals with obligations that citizens are inclined to avoid.

Thus, this dissertation follows the conceptualization of tax policy similar to Steinmo (1993) and Peters (1991) and defines a tax policy as: ‘a compilation of tax norms in a form of a legal document that determine rules on taxes, on who pays and how much.’ This investigation will cover the establishment and subsequent reforms in Georgian tax policy. Considering the goal of this dissertation, Georgian tax policy will be measured along both dimensions of a tax policy, i.e. tax structure and tax rates. I particularly focus on the legal norms referring to the income tax – here understood as personal and corporate income (profit tax). The tax policy in the Georgian case study is conceptualized as a tax code, related amendments adopted by the national parliament, and tax policy initiatives that refer to tax code project(s) to have them discussed and eventually adopted. Reforms in the tax system refer to changes (such as increase or decrease in tax rates or introduction of tax exemptions on particular income) in tax legislation that affects either a direct statutory tax rate or tax base.

1.2. Conventional Approaches to Tax Policy Formation and Reforms

There are three theoretical explanations of the processes of the politics of tax policy formation and changes towards a ‘low tax rates, broad tax base’ principle across countries. They argue either for the political and economic forces that stem from the globalization processes (Hallerberg and Basinger 1998; Basinger and Hallerberg 2004), are aid/membership conditionality related (Ramcharan 2002; Stones 2002), or see tax policy change as a result of domestic factors (Steinmo 1993). In short, these theoretical stances can be divided on two dimensions (*external* and *domestic*) and in this dissertation they are pinned as *conventional* theoretical explanations. I will discuss them in turn in relation to their power in explaining policy choices made over time in the case of Georgia, and I will argue why it is necessary to bring *external* and *domestic* factors and actors into the policy change in developing countries.

External factor proponents of a tax policy change identify market integration and the consequent tax competition as the factors forcing domestic policy makers to opt for pro-market. In the case of tax policies, it is argued that an interconnectedness of states leads to lowering of statutory tax rates (Steinmo and Swank 2002; Swank 2006, 2008). Needless to say, it is important to remain competitive in the global market in order to retain the market and to compete with other countries. Data across OECD countries, as well as in post-Soviet states suggests that there have been obvious cuts in statutory tax rates on cor-

porate taxes which are crucial for mobile capital (Ganghof 2006; Fritz 2007). However, there are two points to be made here. First, if tax competition is the only factor of policy change in post-Soviet countries, then one would expect all post-Soviet countries to have shifted to low statutory tax rates and have gotten rid of extensive use of tax exemptions, which reduce the tax base (Martinez-Vazquez and McNab 2000). Second, tax competition is a vital factor in shaping tax policies, true, but to what extent can this theoretical argument hold water in the case of post-Soviet states, particularly in Georgia, which have had low levels of FID flows and larger portions of import and export activities in the regions beyond CIS (see Tables 5.5, 6.4, 6.5, 6.6, 7.5, 7.6). Thus, I contend that the market integration argument cannot fully explain the complex process of post-Soviet – and Georgian – tax policy change. Since Georgia is not well integrated into the global market, it has less pressure to race to the bottom in the tax rate reduction race.

Aid-related conditionality is often referred to as one of the strong explanatory factors in public policy reforms across developing countries. The role of international financial institutions (IFIs) in structural reforms and in the formation of political and market economy institutions in post-Soviet countries has been pointed out (Stones 2002). Conditionality carries the connotation of coercion in itself and is imposed on financial sources that transition countries have been short on. Thus, the more a country is in need of external funding to carry out its reforms, the higher the possibility that they reform policies towards new tax policy principles. However, as the Georgian case demonstrates, conditionality obedience has been inconsistent. While being highly indebted and dependent on external funding for financing its budget deficit, Georgia opted to reform its tax policy when its macro-economic indicators were improving. How can this be explained by the conditionality approach? It is difficult not to admit the importance and the power of an aid-related conditionality to drive a reform. However, it has its shortcomings and cannot always account for a policy change, as was the case in Georgia after the Rose Revolution.

Finally, tax policy making and choices of policy actors as domestic-factor proponents argue are conditioned by structural factors or driven by policy actors or powerful policy groups with influence on the policy arena (Gehlbach 2008; Easter 2002; Loung and Weinthal 2004). Number of veto players and party politics are said to matter as well in the process of a tax policy change (Hallerberg and Basinger 1998). The main argument of this theoretical approach is that sweeping changes may not occur in a country with a large number of veto players. Studies on post-Communist tax systems add that tax systems are the result of elite and state bargaining as was the case in Russia, unlike in Poland where trade unions dominated the policy bargaining (Camp-

bell 2001). Opposing the aid conditionality argument, Loung and Weinthal (2004) conclude that Russia's tax code in 2000 was a result not of IMF conditionality but of a pact made between oil companies and the state. Political and economic institutions, a legacy from the Soviet regime, are argued to influence tax systems and tax policy choices in this region (Campbell 1996). Obviously structures matter in providing 'raw material' on which to build new institutions, which can either cause or constrain tax policy reforms. Some scholars argue that industrial structure inherited from the communist regime, economic development, and distance from the West were the structural factors that shaped actors' policy choices on whom to tax across post-Communist countries (Gehlbach 2007). However, others contended that tax policy reforms can be domestic factor driven. For instance, structural factors, such as budget deficit and/or the hunger for revenues, create challenges to the national governments. The latter are forced to address their need to raise revenues and to find resources for public finances. These types of governments suffer not only from lack of revenues, but also from dysfunctional tax systems at large. Therefore, it is expected that states with low tax collection and large budget deficits would initiate tax reforms hoping to remedy those problems (Peters 1991). In the case of Georgia, structural factors can explain just part of a story where one sees the government's efforts to raise revenues. However, it fails to explain the timing and the concrete policy choices made in Georgia's tax reform, particularly those changes that were adopted some 13 years after independence and seven years after the creations of the first tax code, which did little to improve state budget through tax collection. Furthermore, if one dwells on the interest-centered approach, there are shortcomings as well which hinder that approach in capturing the complex processes of new tax policy idea diffusion and infiltration of domestic legislation (Appel 2002). Countries where party politics are well institutionalized and the number of veto players can influence policy adoption or its making, are those with well-established democratic regimes (Ganghof 2006). Having said that, I argue that investigating the factors and the process of tax policy making and reforms across post-Soviet states, particularly in the case of Georgia, will be better off if we bridge the external and domestic factor-centered approaches, if we bring ideas back into to the policy change process, and observe the inter-linkages and interrelations of multiple actors in the process of policy making and change. I call this theoretical argument the transnationalization of the public policy arena. I will elaborate on this below.

1.3. Transnationalization of the Policy Arena: Do Ideas Matter in Tax Policy Formation?

Just to be fair, I must say that ideas were not neglected by all scholars who investigated political processes in post-Soviet states (Apple 2000; Campbell 2001; Evans and Aligica 2008). I am inspired by their theoretical arguments and I incorporate some of the elements in the model below. The studies are discussed in detail in Chapter 3.

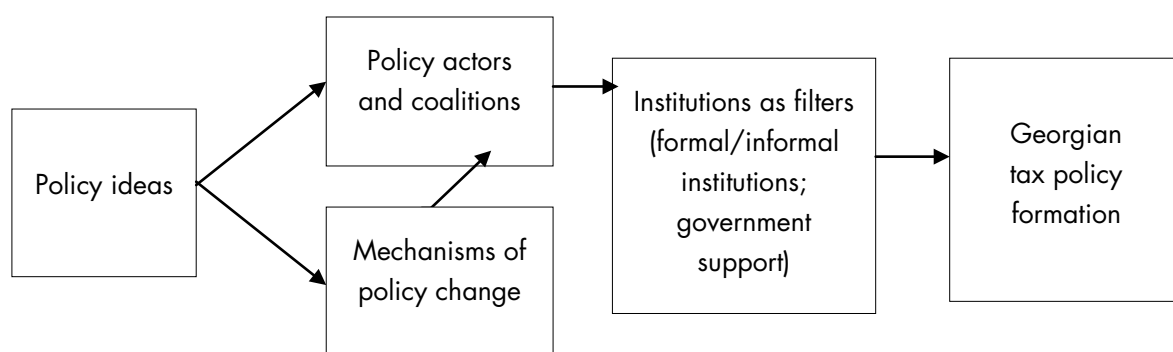
The transnationalization argument contests the conventional theoretical arguments on the following grounds: First, it argues for the vital importance of the ideas, the factor which the previously discussed theoretical approaches overlook or merely render less important. Second, it sees the mix of domestic and external factors as fundamentally important for policy making and policy change, instead of arguing for a prevalent importance of financial institutions, elites or business groups. It argues that when the focus is on ideas which diffuse and are cultivated in a certain context, it is worth observing the role of various actors in different phases of policy changes. This will allow us to see whether ideas in fact mattered and whether external pressure and narrow, particularistic interests had as much of a role in a policy change as argued by conventional theoretical proponents.

The argument of transnationalization builds on four main pillars: ideas, actors, the institutional filter, and the mechanisms of policy learning. The main argument of this dissertation builds on the proposition that, in tax policy change, ideas matter. It is believed that ideas can influence actors' mindsets and their policy preferences. Moreover, ideas that are internalized by domestic policy makers can lead to policy change and can offset the external pressure. Ideas introduced by international actors become internalized by learning and interaction between domestic and international policy actors. In this process the mechanism of policy learning is accountable for ideas to be finally internalized. In addition, both external and domestic actors form policy coalitions where they unite around a common policy idea or policy issue. The linkages that various types of actors build and retain among each other within the national borders and beyond make the policy arena complex and multi-level where external merges with domestic and only slowly and at certain points in time does the border between external and domestic policy ideas become blurred. This is what I here call transnationalization of the policy arena. Thus, ideas that enter a transnationalized policy arena can lead to the making and adoption of a tax policy if and when the internalized ideas pass through the institutional filter in the form of a project or a legal initiative. While I do not ar-

que that my explanation – transnationalization of the policy arena – of the tax policy variance and the mechanisms of idea diffusion across post-Soviet countries and in Georgia is the only possible explanation, I do insist that the role of ideas and non-coercive policy mechanisms provides a powerful lens through which to view tax policy developments in the transition countries.

The causal model built in Chapter 3 is empirically analyzed in Chapters 5, 6, and 7. The adoption of a Georgian tax policy is conceptualized as a process where policy ideas are an independent variable and tax policy the dependent variable (establishment and/or reform of a tax policy is seen in terms of its adoption by the legislative body of the country in question, as stated above). The model aims to capture factors that influence the adoption of post-Soviet Georgia's tax policy. As mentioned, the focus here is on the mechanisms that lead to policy change connecting latent ideas to adoption of legal norms. However, since ideas do not walk on their own, policy actors and institutions, through which ideas are filtered, are incorporated in the causal model alongside policy diffusion mechanisms as well.

Figure 1.1: Framework for the causal pathway of Georgian tax policy formation



The investigation of the empirical support for the theorized causality in this model is made possible by an in-depth case study of Georgia in this dissertation.

1.4. Roadmap of the Dissertation

The dissertation is structured in the following way: The theoretical frame is discussed in Chapters 2 and 3. Chapter 2 provides a critical analysis of the state-of-the-art theory in policy diffusion, globalization, aid and membership conditionality, and transition literature. Chapter 3 outlines the theoretical basis for the transnationalization argument and draws speculations which will be further tested in the empirical part of this dissertation. Chapter 4 discusses the methodological considerations, data sources, and the methods of data collection

and analysis. Chapter 5 analyzes the tax policy change processes over a ten-year period in Georgia. These analyses are contained in Chapters 6, and 7. Chapter 8 concludes based on the theoretical and empirical findings and reflects on their generalizability and prospects for future studies.

Chapter 2

Ordering From the Menu of Conventional Explanations: Pros and Cons

This chapter summarizes the main theoretical approaches to the politics of tax policy making and change. While doing so, it critically evaluates the core arguments of each school of thought and indicates their shortcomings in the light of the main goal of this dissertation, which is to explain the cause and the path of tax policy change in Georgia. The following chapter presents the theoretical backbone of the dissertation, which incorporates a theoretical frame called transnationalization of public policy arena.⁹ However, in the empirical analysis I test competing theoretical arguments side by side. At the end of each section in this chapter I will operationalize each conventional theoretical expectation.

There are only few studies on tax systems in post-communist countries (Easter 2002, 2008; Fritz 2007; Gehlbach 2008; Loung and Weinthal 2004), and there are even fewer such discussions in the literature on policy diffusion (Campbell 2001; Evans and Aligica 2008; Alegica and Evans 2009). Therefore the theoretical net is cast somewhat broader. On the one hand, I discuss a broad range of the literature with particular focus on taxation and tax policies that theorize external factors as the cause of policy making and policy change. This leaves us with theories on market integration/globalization and Europeanization. On the other hand, I review theories that focus on domestic factors, such as state building and taxation, policy diffusion and new institutionalism. Moreover, considering the regional focus of this dissertation among conventional theoretical approaches I tackle some of the transition literature as well.

The discussion of conventional theories is organized according to whether external or internal factors are seen as the main explanation of tax policy. The literature on 'top-down' diffusion mechanisms such as coercion and competition theorizes that external pressure is the driving force in policy change. These two types of mechanisms are often discussed in globalization and Europeanization literature. In contrast, the horizontal mode of diffusion examines the roles played by domestic actors who are learning and/or emulating mechanisms found in the literature on ideas and voluntary policy change. Similarly, the bot-

⁹ Transnationalization of the public policy arena is also referred to as a transnationalization argument in this dissertation.

tom-up mode of policy change relies on the domestic actors' role in policy change and views external pressure as less relevant.

Discussions in this chapter are structured as follows: Section 2.1 discusses external factors presenting the globalization literature focusing on the competition argument, Europeanization and conditionality literature. Domestic factors are discussed in Section 2.2, which discusses state building through taxation, policy diffusion, new institutionalism, and transition literature. Section 2.3 concludes with a summary of the main points.

2.1. The Impact of External Forces on Domestic Policy Change

The literature on globalization and Europeanization identifies external factors as drivers of domestic public policy change across countries (Campbell 2001). These two schools of thought overlap in their emphasis on external forces, for instance market integration related competition and aid- or membership-related conditionality (i.e. coercion), as drivers of policy change. At the same time, they disagree on the degree and scope of external influence (Graziano 2003; Hennis 2001; Vachudova 2002, 2006; Kelley 2004). While some hold that competition and conditionality lead to policy convergence, others argue the exact opposite – that non-convergence persists due to domestic institutions, interest groups and political parties (Campbell 2001, 2004; Garrett and Mitchell 2001; Drezner 2001; Steinmo and Swank 2002; Swank 2004). These theories use political and economic variables as the causal mechanism of policy change across countries, but their explanatory power has been tested mostly on developed states (EU or OECD member countries), leaving a large number of middle-income and poor countries out of the sample. Moreover, they emphasize the external supply side of the policy change equilibrium in which domestic change is predetermined due to the inevitable forces of globalization, accession, and innovation diffusion. Their mechanisms are also somewhat deterministic, as if change is inevitable and will most likely occur in a similar manner across countries (Steinmo and Swank 2002, Swank 2004; Genschel 2005). I discuss these two strands of literature in relation to the dependent variable of this dissertation.

2.1.1. Globalization and Tax Competition

Globalization and market integration have influenced domestic political institutions and triggered pro-market policy changes across countries (Steinmo 1993; Ganghof 2006). Globalization can mean many things, but in this disser-

tation it follows by Campbell's definition (2004:125). Globalization refers '... to sharp increases since the mid-1970s in trade, production, and capital flows across national borders.' The effects of globalization have been studied in different policy areas across countries, ranging from welfare (Swank 2002), to regulatory systems (Levi-Faur and Jordana 2005) and tax policy (Steinmo 1993; Steinmo and Swank 2002; Ganghof 2006). The way globalization impacts national states and impels them to react by changing institutions and policies is due to the competition it creates over footloose capital moving freely across national borders. National states compete to attract and keep investments within the confines of their legislatures. This phenomenon in tax policy debates was pinned as a *tax competition*. It was argued to lead to a race to the bottom among states which competed over a mobile capital and reacted to external pressure by shifting a tax burden on labor. The race to the bottom hypothesis was developed in policy convergence studies, which contended that market integration and globalization invoked '... the tendency of policies to grow more alike, in the form of increasing similarity in structures, processes, and performances' (Drezner 2001:53). The race to the bottom approach combines the strong normative disapproval of a predicted outcome with regulation theory, where the force of the market seems to override the state's power to resist and leads to a policy change towards similar principles across countries (p. 57). The race to the bottom hypothesis predicts that the more countries are open to market integration, the more likely they are to reduce barriers to trade, capital control and regulatory policies. Moreover, once countries have taken these steps, capital mobility has to be negatively correlated with the country's regulatory standards. Furthermore, in the race to the bottom not all regulations converge, just those that have been negotiated. However, regardless of how convergent a country's policies are, all countries strive to change policies towards free market principles (p. 59).

Till now, the globalization thesis of the tax competition pressure and its policy implications has produced a handful of empirical analyses predominantly focusing on OECD countries when analyzing reductions on statutory¹⁰ or effective¹¹ tax rates on capital. The studies arrived at competing conclusions on the

¹⁰ Statutory tax rates are the percentage of a tax imposed by the legislation. The effect of market integration (tax competition) across countries is conventionally measured by comparing statutory tax rate cuts over time (Campbell 2004:138; Devereux et al. 2002). Statutory tax rates are the percentage of a tax imposed by legislation.

¹¹ The effective tax rate is the amount of tax an individual or company pays when all other government tax offsets or payments are applied and divided by the tax base (such as total income or spending). Some argue that a comparison of statutory tax rates does not reveal the impact of globalization on the tax burden. Investigation of

tax burden shift from capital to labor, for instance, Steinmo's globalization thesis (1993). He reported that industrialized countries have reduced statutory tax rates since the mid-1970s on both corporate and personal income (Steinmo 1993:30). Similarly, proving a globalization effect on tax policy by examining cuts in statutory tax rates, Steinmo and Swank (2002) conclude that corporate tax rates have been reduced from 45% to 35% in the period 1981-1995 in 13 OECD member states. Capital mobility proved to have a negative impact on corporate taxes, whereas labor taxes and social expenditures increased in 14 OECD countries in the period 1967-1996 (Bretschger and Hettich 2002). Similarly, Ganghof (2006) found that in the area of corporate tax rate reduction, tax competition overrides domestic differences in party ideologies and the importance of veto players. In his analysis, he claimed that tax competition accounted for corporate tax rate cuts across countries. Party ideologies became less relevant because policy preferences converged and supported corporate tax cuts. 'Party ideology and veto institutions were rather unimportant in the setting of corporate tax rates because tight international economic constraints led to a convergence of parties' policy preferences' (Ganghof 2006:146). Due to similar findings, some scholars stated that there '... is clear evidence that tax competition is a main drive of a tax rate choice' (Ganghof and Genschel 2005:108).

Interestingly, Steinmo and Swank (2002) did not find this overriding impact of tax competition in their own analysis when looking at the effective instead of the statutory tax rate of capital. They explain this outcome as a strategy by national governments to restructure their tax systems so that tax cuts and the related loss of revenues are compensated by reducing tax expenditures and tax holidays. In total, effective tax rates do not result in a drastic drop across countries. Those findings were in line with the conclusions made by Campbell (2004), Genschel (2002), Wibbels and Arce (2003),¹² and Garrett and Mitchell (2001). Scholars found no correlation between increased integration of countries into global markets and reduction in effective tax rates on capital or shifts in the tax burden between capital and labor. They further conclude that countries with high foreign direct inflows tend to tax capital heavily.

effective tax rates is emphasized to see who in fact pays, i.e. bears the tax burden, and whose tax burdens were eased by reduced tax rates (Campbell and Allen 2001; Campbell 2004).

¹² Although not explicitly addressing the issue of tax burden shift in their analysis, Wibbels and Arce (2003) concluded that in developing countries a burden shift could be affected by multilateral lending pressure, which in most cases undercuts left wing politics in a country. Thus, by weakening labor in favor of business, the tax burden on labor cannot be eased as easily as in the OECD countries.

The inconclusive empirical data has shown that the globalization thesis in terms of tax competition and its deterministic character is a coin with two sides. Depending on the country's characteristics and the policy area under investigation the empirical findings differ. Some scholars argue that the globalization impact on tax policies in developing countries goes beyond tax rates and included tax holidays in order to attract investment from multinational corporations. However, empirical analyses have not found support for the argument that investment and tax holidays correlate (Avi-Yonah 2001),¹³ while poor countries' tax structures seem to predominantly rely on regressive, indirect taxes (Bird and Zolt 2005). The size factor (measured in terms of population) is argued to matter because in a globalized world smaller countries cannot resist outside pressure and are more likely to lose to larger countries with larger markets (Slemrod 2004; Ganghof 2006). Ganghof (2006) and Genschel (2005) investigated this hypothesis based on data from 15 EU states from 1984 to 2004 and concluded that the correlation between country size and company tax rate is positive in EU states (even after EU enlargement). Furthermore, capital mobility (measured as rates of return on capital) and trade dependence (measured as share of GDP) was identified to be important factors through which the internationalization process and market integration pressure exert influence on tax policy changes across countries (Hallerberg and Basinger 1998). Studies investigating the globalization thesis confirm that non-convergence persists due to domestic institutions such as political parties, domestic institutions and interest organizations, which influence fiscal policy, causing variation in policy types (Garret 1998; Campbell 2004). As Lenschow et al. (2005) say in an allegoric and yet cynical way, the persistence of non-convergence seems to have been a common thing for decades:

Birds sometimes sing and sometimes they don't. In a similar vein, national policies sometimes converge and sometimes they don't. Speaking very generally and somewhat cynically, this is the key insight to be derived from

¹³ It is argued that while portfolio investments might be affected by tax holidays and tax rate reduction, foreign direct investments are not affected for two reasons. One, if the foreign tax credit is granted in the home country of an investor, then a tax holiday in the hosting country is less relevant (Avi-Yonah 2001:63). Second, granting a tax holiday to a multinational is advised, assuming that the hosting country is small. However, extensive literatures on multinationals suggest that typically they exist in order to earn economic rents. In that case, the host country is no longer 'small' in the economic sense. That is, there is a reason for the investor to be there and not elsewhere. Therefore, any tax imposed on such rents (as long as it is below 100%) will not necessarily drive the investor to leave even if it is unable to shift the burden of the tax to labour or landowners' (Avi-Yonah 2001:63).

several decades of studies on the convergence of national policies (Lenschow et al. 2005:797)

Globalization and market integration processes were hailed to have an impact on organized labor, corporatist institutions and national economic structure (Campbell 2004). This is because multinational corporations emerge as a new type of capitalist class and change national economic structures by making them vulnerable, whereas in trade unions have lost capacity to influence or hinder outsourcing (Campbell 2004:127). Moreover, globalization and market integration were argued to engender 'a potential democratic deficit' deregulation of state regulatory systems, and the curtailment of state intervention into the economy constrains state sovereignty (Drezner 2001:54). This does not imply that national states are no longer vital players in the global market but they, no doubt, face a challenge, insisted Genschel (2005:67), who ridiculed exaggerated predictions among academics about either an extreme effect of globalization on the nation state or about the lack of effect and insisted that the truth lies somewhere between those two extreme predictions.

The globalization model of policy change has provided solid evidence that national policies are indeed influenced by exogenous factors beyond the control of legitimate governments. Moreover, the globalization thesis is supported by the dynamics of statutory tax rate reductions across countries, poor and rich alike. The main strength of the globalization literature lies in its ability to temper the warnings against the withering importance of states. It has demonstrated that wherever policy coordination takes place, it is due to the ability of national states to cooperate and agree on norms on how to govern or regulate particular policy aspects (Drezner 2001:78). However, most studies on market integration and the competition argument use data from OECD countries where statistical data on collected revenues and capital flows is accurate and easier to obtain than from developing countries. In addition, the structural perspective of the globalization literature that explains the convergence of public policies under similar pressure from market integration ignores the potential importance of economic and ideational forces in the policy change process, while reducing globalization to a 'deterministic force' (p. 55). The problem of the structural approach to policy change is that it is somewhat deterministic and perhaps too parsimonious because the way the key variables are hypothesized means that they prevail over all other explanatory factors.

That said, recall that the aim of this dissertation is to explain why and how Georgian tax policy was created and reformed, and this requires closer scrutiny of the process that goes beyond structures and incorporates ideas and ac-

tors.¹⁴ With this in mind, we cannot deny the vast contribution of the globalization theory in the discussions of the tax competition. However, for the very aim of this dissertation it has little to offer on the following grounds: The main shortcoming of the competition and market integration argument is that it posits 'external influence' and the 'race to the bottom' process as fatal phenomena wherein autonomous national governments hardly have a say. It is rather deterministic and holds that the process is either/or and does not allow for other options in the policy change process. Globalization theory stresses that private economic forces such as capital and trade drive the process. Also, once countries enter this race to reduce barriers and tax rates, they cannot reverse that process (Drezner 2001:75). This perspective is inadequate because although somewhat limited, national governments still have a choice to either reform or not, even as they are held accountable for the consequences of non-adoption (Ganghof 2006; Wibbels and Arce 2003:131). Finally, theoretical debates over tax competition lack empirical studies tracing the causal mechanism of external influence on domestic fiscal policy making in developing as well as developed countries (Wibbels and Arce 2003:112). Without such empirical studies, the scholarly debate over the degree of influence can go on forever, while we still know very little about just how this influence materializes in policy reform processes.

That said, as promised in the introduction of this chapter I will empirically investigate the possible impact of tax competition in the process of Georgian tax policy making and reform. Here the general expectation is:

Expectation A1: Market integration creates a competitive environment and drives policy convergence across countries.

If tax competition was a factor in tax policy changes adopted by the Georgian government, it had to be stated in the process of policy preparation and adoption by the state officials, referring to the tax competition as an important factor to consider in tax policy change. Also, if tax competition was a factor of policy change, the government should have referred to other small¹⁵ countries within the former Soviet space as a reference of change against which the country

¹⁴ Little attention to actors was hailed by scholars to be one of the shortcomings of the globalization literature. It was argued that an actor-centered approach brings the role of international organizations (IOs) into the policy change process. It also allows for variance in IO preferences that may lead to variance in outcome. This approach is more realistic and also more difficult to falsify (Drezner 2001:65).

¹⁵ For the data on the population size in Georgia and other CIS countries see Appendix 2. Country size measured in terms of population is done following the example of Slemrod (2004) and Ganghof (2006).

was to compete in terms of being attractive to investment by moving towards a broad tax base and low tax rate policy.

2.1.2. Conditionality: Aid Related

Conditionality is a side payment to the veto players who would otherwise prefer the status quo (Jacoby 2008:62).

This section presents a theoretical discussion of conditionality, a top-down mechanism of policy change uniting two strands of literature, namely aid conditionality and Europeanization. The literature on the role of aid-related conditionality argues that it drives policy change across countries. Unlike globalization studies, conditionality scholarship predominantly focuses on developing countries. Conditionality is mainly exercised on two issues: on membership of a particular *club* such as the European Union (EU) and on access to financial resources from international financial institutions such as the International Monetary Fund (IMF) and the World Bank (WB). Global and European forces – regardless of the different end-goals – call for integration into regional clubs or getting access to financial resources by promoting global markets and economic reforms within their realm of influence (Campbell 2001:105). Often those goals are achieved by imposing conditionalities on accession and/or aid recipient countries. In this section I focus on aid-related conditionality and in the next section I turn to membership-related conditionality.

Foreign aid can either respond to a humanitarian or an economic crisis or be provided to benefit nations with more market oriented policies (Heckelman and Knack 2008: 524). Aid conditionality is attached to foreign aid, such as structural adjustment loans, provided by donors striving to improve the policy environment for private sector development and pro-market reforms in recipient countries (ibid.). Aid conditionality analysis, similar to tax competition scholarship, has often come up with competing conclusions. Some argue that aid conditionality is ineffective and even has a negative impact on economic growth (Heckelman and Knack 2008), on adopting and sustaining good policies and on achieving a balance of payment adjustment (Easterly 2005; Kapur and Webb 2000). Other scholars more moderately state that if national governments are willing to implement reforms and conditionalities are wholeheartedly exercised then poor governments may well increase their country's welfare. However, if conditionalities are not exercised all the way to the end of a reform but only in the initial reform state, it may leave room for reform opponents to challenge the reform and thus harm welfare at large (Ramcharam 2002:4-5). In a similar vein, Stones (2002) found evidence that aid conditionality

ties have produced positive changes in post-Communist Poland and Bulgaria. The IMF, which provided funding to those countries, also acted as a credibility lender and helped unite fragmented and weak governments. In addition to aid, the IMF provided ideas on policy change and bolstered reformers, who would otherwise have been marginalized but managed to stay in the policy making course in the face of fierce domestic opposition because of the IMF. The aid-related conditionality model posits that the political and economic variables of an aid recipient country matter for its degree of vulnerability to external pressure through conditionality (ibid.).

Regardless of some differences in the aid conditionality influence, scholars agree that the most important actors in aid conditionality studies are international organizations, such as IFIs, where the IMF and World Bank (often referred to as the Bretton Woods Institutions) are often singled out (Stewart 2002; Kogut and Spicer 2004). Debates over the role of IFIs often emphasize the mechanisms of their influence on loan recipient countries, consistency of their use of sanctions and conditionality, their independence from powerful states, and their coordination in terms of providing lending. Loans from one international organization often send a positive signal to other external lenders. Moreover, they can act as a prerequisite for certain type of credits: An IMF loan is often a prerequisite for World Bank adjustment loans (Easterly 2005:3). IFIs can engage in various mechanisms of influence on domestic policy adjustment and change (Lombardi and Woods 2008). But when they use the conditionality tool the mechanism is mainly coercive and contingent upon the success or failure of the sanctions they impose or threaten to impose (Chwioroth 2005; Hovi et al. 2005). Furthermore, some scholars take the position that developing countries are 'captive' of rich and hegemonic countries and hence view the role played by IFIs negatively (Stiglitz 2002; Chwioroth 2005). Policy choices on capital liberalization among 34 countries were examined to establish correlation between US Government and IMF aid provision. The evidence suggests that US policy makers were able to influence trade and security relation asymmetries with less powerful states, and that they have also brought their influence to bear on the IMF to promote capital liberalization across countries (Chwioroth 2005:18).¹⁶ These conclusions run counter to studies that consider international organizations immune to the influence of powerful states (Barnett and Finnemore 1999).

¹⁶ Chwioroth's (2005) findings are in line with the argument that Stone (2002) developed in her book on IMF lending, stating that sometimes IFIs are neutral and may be subject to intervention by powerful governments. The Clinton administration granted preferential treatment to post-Soviet countries such as Ukraine and Russia, but not to Poland and Bulgaria.

The various mechanisms that IFIs use in relation to the aid recipient countries were investigated by Lombardi and Woods (2008). Social learning through peer review, provision of information, and leveraging power relations are the three different mechanisms through which the IMF uses its bilateral and/or multilateral surveillance capability and is expected to exert influence. The detailed accounts of each mechanism revealed that manipulation of power relations within the aid dependent countries is the IMF mechanism of choice. There was less evidence to back up the peer review argument and learning as means to influence governments. It is argued that learning among IMF members is structured along a one-way channel of information and does not generate extensive engagement in peer review or learning processes among governments. Finally, rationalists argue that provision of information aimed at updating the preferences of the governments is a competition among peers. However, the evidence showed that the role of the IMF in competition is less viable than that of an information provider, but more vital in terms of sending signals to the markets about governments' positions in relation to the IMF (Lombardi and Woods 2008:732-33).

Finally, the power of the conditionality imposed by IFIs is not always clear but its influence on policy reform is negative because it disrupts the policy diffusion process (Hovi et al. 2005). Conditionality efficiency is connected with sanctions being used systematically and consistently. But sanctions for not complying with conditionality requirements are not always consistently implemented by international financial institutions. Some scholars argue that international financial institutions often use sanctions in a selective manner, considering the geopolitical interests of powerful nations whose ideology is promoted through those organizations (Chwieroth 2005). Hovi et al. (2005) examined the effectiveness of (imposed) economic sanctions and contrasted their results to the aid-related conditionality theory, arguing for the effectiveness of threatening rather than actually imposing a sanction in situations where the target does not possess complete information on the credibility, contingency and/or potency of a sanction. 'With complete information, imposed sanctions simply cannot work. Conversely, imposed sanctions can work only if at least one of these factors is initially not known with certainty' (Hovi et al. 2005:486). They found that there are two conditions under which imposed sanctions are successful, namely when they either engender political concessions or render noncompliance impossible. First, the target has to miscalculate that the threat of imposing a sanction is empty, that it will be imposed whether the target yields to the threat or not, or that the cost of a threat is lower than the cost of compliance. Secondly, these miscalculations must be corrected after the sanction is imposed (pp. 486-90). However, two conditions have been

identified that successfully affect aid conditionality in economic policy reforms in recipient countries: commitment by the domestic governments and the importance of domestic political economy factors for the direction and pace of reforms (Heckelman and Knack 2008:541).

Besides inconsistency on sanction imposition from donor countries, aid-related conditionality does not always lead to the desired policy change in aid recipient countries due to one more reason: International financial institutions are not always the only source of financial aid available to reforming states, which may be compelled to either freeze reform or to pervert it to appease powerful interest groups. Empirical evidence suggested that countries can resist change if there is an alternative way of 'funding the state'. Levitsky and Way (2007:51, 58) call this alternative a 'black knight', which can be a state hindering a particular type of a change while providing an alternative source of financial income. For instance, non-democratic change in some post-Soviet countries, they argue, was sustained by preferential treatment by the Russian Federation. This fact increased the resistance of sanctioned states to external coercion. The argument that when powerful business interests seeking to block pro-market changes are entrenched in a government, IFIs and their conditionality-related influence does not result in desired change follows the same logic.

To sum up, aid-related conditionality is a coercive mechanism of influence mediated through international financial institutions on aid recipients who are financially vulnerable. Policy change is expected by default, and so is convergence of aid recipient country policies with the dominant policy paradigm. Based on this literature the expectation is therefore:

Expectation A2: Conditionality imposed on countries receiving aid changes policies to adjust to common policy principles promoted by IFIs.

In the case of tax policy, countries are expected to broaden their tax base and reduce tax rates. Thus, if I am to find the IMF conditionality¹⁷ to have mattered

¹⁷ Aid conditionality related external pressure to reform from powerful financial institutions is operationalized in two ways in political science literature on transition countries. Frye and Mansfield's (2003) article uses the amount of money received by a country through the IMF structural adjustment loans as a proxy of the vulnerability. Evans and Aligica (2008) take the level of a country's indebtedness as the measure of its vulnerability. Both are quantitative measures of external pressure and the power of IMF conditionality on post-Soviet countries, particularly on Georgia. I will provide data on both indicators (see Appendix 7 on IMF adjustment loans and Appendix 6 on indebtedness of CIS countries as % to DNP) while at the same time I will investigate in the qualitative data whether IMF has been referred to by Georgian decision makers as the 'dictator' of the particular policy changes.

in Georgian tax policy making and reform, either in the period of high indebtedness or generally in the process of a tax policy change at any stage, the government's decision to adopt a particular policy should have been stated to be due to the IMF requirement. The decision to change had to be projected as mandatory in order to obtain funding from IMF.

2.1.3. Membership Conditionality

Membership conditionality is part of the field of Europeanization research which studies the impact of European integration into national states and EU influence on policy, institutions and political processes, which are part of European integration theory at large. The role of membership conditionality has been investigated in various policy types of new EU member states while they were in the process of EU accession. The drive and the desire to enter the union were argued to be strong enough to keep accession countries compliant to *acquis communautaire* volumes of policy documents that had to be harmonized in national legislations. However, Europeanization studies often take up conditionality mechanisms along with non-coercive, voluntary forms of compliance, such as socialization (Kelly 2004; Vachudova 2002, 2006; Schimmelfennig 2007).

While theorizing Europeanization as a process resting on three pillars, which are regulatory frameworks for liberal economies, regionalization and constitutional values (i.e. human rights, the rule of law and democracy), Schimmelfennig (2007:7) attempted to map the influence mechanism of conditionality ('logic of consequences') and social learning ('logic of appropriateness') on domestic politics in accession countries. He attempted to stretch these mechanisms beyond member states, arguing for their validity in exerting EU influence even on states without membership potential (*ibid.*). However, he warned scholars not to claim a causal relationship between domestic political changes in third world countries and non-European influence and influence stemming from Europeanization beyond member states (Schimmelfennig 2007:10). Sanctions and membership as two types of conditionality appeared to work on non-member states in the Europeanization process. Conditionality is important for achieving socialization in accordance with EU norms and values – democracy, human rights and the rule of law are emphasized in accession countries (Vachudova 2002; Schimmelfennig and Sedelmeier 2005; Schimmelfennig 2007).

Vachudova (2002) and Kelley (2004) point to the importance of conditionality over social learning in domestic policy change through Europeanization. Conditionality is a stick and prospective EU membership a carrot – benefits that

adoption of recommended policy reforms can bring. Non-adoption is rarely even a choice and may lead to loss of the carrot. Kelley (2004) investigated minority policies in the Baltic and Eastern European States. The EC, OSCE and EU are brought in as key international organizations that pursue political pressure as well as socialization-based methods of persuasion and influence to make states adopt and change minority policies. She concluded that (only) socialization methods failed to yield the desired outcome and that membership conditionality played a major role. She stipulates that both external and internal cooperation are required if policy change is to be achieved and that membership conditionality met less opposition and garnered more support among domestic policy makers (Kelley 2004:453) than socialization-based methods did. Therefore, the former, unlike the latter, yielded successful policy change.

Kelley's (2004) argument on the general power of membership conditionality in steering the policy choices of domestic actors and encouraging compliance with the policies promoted by the EU overlaps Vachudova's (2002) conclusions. Vachudova emphasized the importance of membership conditionality in the Europeanization process in accession countries. She differentiated between active and passive leverage as mechanisms of influence on nation states used by the EU. EU membership is seen as a passive type of leverage that even has the power to break the path dependency of transitions in accession countries whereas active leverage involves the deliberate conditionalities formulated in the pre-accession period (Vachudova 2002:4). Failure to meet the conditionalities is punished with exclusion from the community (ibid:8). According to Vachudova (2002), active leverage is the most fruitful way to influence the political elite to translate EU policies and values into domestic policies.

In all fairness, the Europeanization literature comprises far more than just the conditionality hypothesis. It includes studies on the diffusion of particular types of institutions or policies as well as non-conditionality and non-coercive mechanisms of EU influence on members states. Non-coercive mechanisms are argued to lead to diffusion of regulatory agencies in Western Europe (Giraldi 2005) and are also familiar to IFIs. Some authors investigate their role in advisory efforts and norm diffusion along with the coercive mechanisms conventionally ascribed to IFIs. I will elaborate on non-coercive mechanisms in Chapter 3, which theorizes a transnationalization of the policy arena and reviews the horizontal modes of policy diffusion.

However, coercion mechanism through membership conditionality is missing in non-EU member states. EU is said to have been inconsistent in using this mechanism of Europeanization in countries with cooperation agreements,

such as Euro-Mediterranean Partnership or European Neighbourhood Policy (Bicchi 2006; Crawford 2005). The foreign policy agenda of stability and the security agenda are less promising as positive EU effects in non-member states (Schimmelfennig 2007:17). While there are obvious differences between policies inherent in globalization processes and policies pursued by Europeanization,¹⁸ both globalization and Europeanization theories try to capture the supranational integration mechanisms for the sake of market integration or EU membership. The conditionality hypotheses used by both strands of literature are similar on two counts: conditionality as a coercive mechanism is opposed to a voluntary mechanism, a non-coercive mode of compliance; and the effect of conditionality is not similar in all cases across countries as their level of financial dependence (in case of aid conditionality) or the presence of the strong incentive to become an EU member (i.e. a membership-related conditionality) vary.

Hence, the aid- and membership conditionality literature is in line with the globalization argument with its exaggerated confidence in the possibility of policy convergence across low- and middle-income countries, which cannot always be shown empirically. Conditionality most likely does matter and coercive mechanisms can compel impoverished governments to change their policies. The conditionality mechanism explains how donors exert influence on governments to get them to change their policies in order to make them open and competitive. If no conditionality is attached to aid, policy changes may be ignored or forgotten by domestic actors. However, in countries where EU membership has yet to be put on the policy agenda conditionality may not engender policy change. At the same time, conditionality falls short when it comes to explaining why policy changes do not occur in countries that are vulnerable to external pressure and urgently require financial resources. Nor does it explain why countries adopt new policy measures when they are not susceptible to coercion and do not have a carrot of EU accession before them. Conditionality is a powerful factor in policy change studies, but in view of the focus of this dissertation it fails to explain the outcome.

I do not dismiss the membership conditionality argument from my analysis, but to make it relevant for this dissertation, I investigate whether EU's and the Georgian government's cooperation schemes contributed to tax policy making or reform. The aim is to see whether EU, as a value-driven actor, through its co-

¹⁸ Globalization strives to build a global market, promoting deregulation and reduction of taxes on labor without proposing supplementary policies to support the 'losers' of negative integration such as that pioneered by the IMF and the World Bank, followed by the WTO. Europeanization is argued to emphasize distributive policies, including the social dimension in its policies (Hennis 2001).

operation schemes (such as Partnership and Cooperation Agreements (PCA)¹⁹ and EU Neighborhood Policy (ENP)²⁰ did exert influence on the Georgian tax policy even though it was deprived of a membership conditionality (i.e. stick), but still had a possibility to provide policy recommendations and *infect* Georgian decision makers with new ideas. That said, EU's cooperation schemes with the Georgian government are expected to act as a type of passive leverage (Vachudova 2002), carrots that may project benefits of policy reform in return for funding, free trade agreements, help to further reform and stabilize the political regime and economy, as well as to ensure stability in the country. While the process of accession to the EU has the characteristics of external pressure, the ENP cooperation framework excludes the possibility of membership conditionality to be imposed on the countries within this framework. However, it can on the other hand facilitate policy idea diffusion from EU by opening a large pool of ideas available to ENP countries. The general expectation from this perspective can be phrased as follows:

Expectation A3: EU cooperation is a carrot leading to the adoption of recommended policy reforms under the auspices of the EU.

Thus, if EU cooperation with the national government had an influence on the tax policy making or a reform in the Georgian case, I shall find proof in the empirical analysis that EU as a policy actor has been involved in the processes. Or, I shall find that decision makers or mere policy actors have referred to EU tax policy norms when drafting or adopting a Georgian tax policy.

2.2. Domestic Factors

The importance of domestic factors as mediators between external pressure for change and actual policy change was discussed above under globalization and Europeanization literature. If the previous section discussed scholarship that views tax policy choices as the result of coercion and competition on domestic actors due to external factors, this section turns the table and discusses literature that insists on the importance of domestic actors and institutions in tax policy making. This literature studies structures and their constraining power over the choices that the political and economic elites make in the

¹⁹ More information about PCA can be found at: http://europa.eu/legislation_summaries/external_relations/relations_with_third_countries/eastern_europe_and_central_asia/r17002_en.htm (July 2010).

²⁰ ENP countries by 2006 were Moldova, Armenia, Azerbaijan, Georgia, Belarus, and Ukraine. For more see http://ec.europa.eu/world/enp/documents_en.htm (last visited on July 2010).

tax state formation processes across countries. At the same time, it points out the role of domestic elites in the tax system formation as a possible explanation of the tax policy types. While pinning this scholarship as a domestic factor-centered approach and limiting the reviewed literature to tax policy, I come to tackle studies within the realm of *policy change*, *new institutionalism*, *state building through taxation and transition* literature with a focus on tax system formation here presented under the headings *domestic actors* (2.2.1) and *domestic institutions* (2.2.2). Those volumes of literature overlap in their emphasis on domestic actors or institutions in their attempt to theorize a policy change in particular countries or across regions.

First, however, it is relevant to consider the state building perspective on taxation. As mentioned above, the point of departure of the analysis of Georgian tax policy formation and change process is much earlier than the tax codes were adopted. Georgian tax policy and tax state formation started with no tax policy and almost no tax collection. Keeping in mind the ‘non-existence’ of a Georgian tax state and obviously the absence of tax policy as we know it now, I will discuss possible explanatory models which could shed light on the processes in Georgia. I will discuss tax state formation through elite bargaining and domestic structural constraints of low tax collection and budget deficit as possible factors influencing policy choices over time. This perspective will be incorporated in the sections focusing on structures and national elites. First, section 2.2.1 discusses state building through taxation literature.

2.2.1. State Building Perspective on Taxation

Exploring state-society relationships in the taxation domain perhaps helps provide us with an agenda for the study of (effective) state formation in the South that is more relevant and productive than the agenda derived from ideas that are globally dominant both in the academy and outside (Moore 2004:313).

There is a considerable amount of studies investigating state building processes²¹ through the lens of taxation, be it in the Western world (Tilly 1985, 1990; Levi 1988; Schumpeter 1918/1954) or in developing countries (Thies 2004; Lieberman 2003; Bräutigam et al. 2008). State building through taxation studies focus predominantly on two interconnected issues in the realm of politics of taxation: the processes of states’ administrative institution formation through policy bargaining between government and taxpayers; and the state’s extractive capacity which either through cooperation or coercion ensures tax

²¹ For an excellent overview of the literature on modern state building, see Ertman (1997:1-34).

compliance from taxpayers (Bräutigam et al. 2008). In other words, state building theory primarily focuses on an act of tax extraction on one side, and on tax bargaining among elites on who is going to pay or how much, on the other side. While the former is relevant for studying tax policy implementation, the latter is more related with the actual tax policy creation process. One could argue that the elite bargaining component of state building theory is relevant in the investigation of Georgian tax policy making and reform processes. It is absolutely worth considering and I will discuss this below in the domestic actor-centered approach.

At the same time, the Georgian state's extractive capacity and tax state making in a country with virtually no tax system would be another issue to incorporate in an empirical analysis of Georgian tax policy making. The rationale is that each country's tax policy influences its implementation and vice versa. So reforms in Georgia may consider the effect of tax policy on the country's weak extractive capacity. At the same time, policy reforms at one point in time and the outcome in terms of tax collection level may influence further policy reforms in the future. As we go along, I will unfold the empirical analysis of Georgia's extractive capacity and the way it was addressed in policy making in the sections that deal with domestic structures and financial constraints imposed on decision makers. But first I review the main body of state building through taxation literature.

Fiscal sociologists as well as state theorists have considered taxation the core of state formation (Schumpeter 1918/1954; Tilly 1985, 1990). Note that fiscal sociologists investigating the historical path of modern public financing in the West long before political scientists insisted on the interconnectedness of a state's taxation (tax extraction) capacity and the formation of a modern state, referred to as a tax state, due to the limited focus of a state's fiscal system (Schumpeter 1918/1954).

A tax state is a type of modern state that besides extracting taxes has an ability to draft and adopt a tax policy. The very author of the term 'tax state'²² insisted on the interconnectedness of a state and taxes, and nonetheless remained confident that modern states are much more than just tax systems (Schumpeter 1918/1954:19). Scholars saw taxes as creators of a modern state.

²² Though modern states are more than just an '... organization with a comparative advantage in violence, extending over a geographic area whose boundaries are determined by its power to tax constituents' (North 1981:21). Schumpeter acknowledges that understanding a state should not only be limited to its fiscal system; he still insists that fiscal demand formed the bases of a modern state. And the core of a tax state is the tax revenue that it collects from indirect or direct taxes (Schumpeter 1918/1954:21).

Taxes not only helped to create the state. They helped to form it. The tax system was the organ the development of which entailed the other organs. Tax bill in hand, the state penetrated the private economies and won increasing dominion over them. The tax brings money and calculating spirit into corners in which they do not dwell as yet, and thus becomes a formative factor in the very organism which has developed it (Schumpeter 1918/1954:17).

Yet, modern states are much more than just their fiscal demands and tax systems. Even when the focus of state emergence is economic policy and market making, modern states are seen to have a broader function in and capacity to uphold constitutional rights, monitor, regulate and balance relations among economic actors (Bruszt 2002:64).

Tilly's seminal work (1985, 1990) has developed a theory of war making state making where he argued that wars were costly endeavours for rulers who needed to finance their military activities. Therefore, they needed to raise taxes and extract from their subjects in return offering protection. Even though states in those cases acted as racketeers, there was consensus among the rulers and the ruled that protection cost money and that taxes had to be paid. Those sequences of activities of war making, extraction and capital accumulation were argued to have lead to nation state formation in the West:

War making, extraction, and capital accumulation interacted to shape European state making. Power holders did not ... ordinarily foresee that national states would emerge from war making, extraction, and capital accumulation (Tilly 1985:172).

In other words, nation states were by-products of war making in the West. They emerged because tax collection needed the administrative institutions in place to organize collection and further administration of those taxes. Thus, state building theory through taxation often refers to Tilly (1985), whose work has investigated a historical path of Western national state formation in the Medieval Centuries, where taxation was seen as an important factor. However, Tilly (1985) has later been criticized by authors who studied state building processes in war-hit regions where wars no longer led to state building but had a destructive effect (Schwarz 2005). Nonetheless, the basic argument of Tilly's (1985) theory on taxation leading to establishment of tax bureaucracy and therefore of a state is shared by Bräutigam (2002), who studied the process of 'building leviathan' in Spain and England. She concluded that revenue raising demand stimulated private property protection and revenue bureaucracy creation in England, whereas Spain, which had access to gold and silver from its conquest of the New World, had little incentive to develop tax bureaucracy,

domestic efficient production or protecting of property rights (Bräutigam 2002:11).

State building through taxation literature on developing countries predominantly emphasises the state's capacity to collect taxes and to ensure compliance from the taxpayers. Those studies seek to explain what enhances or hinders tax collection. Some argue that a mode of taxation that creates a state-society relationship determines the willingness of tax payers to comply and ensure quasi-voluntary compliance (Moore 2008; Levi 1988). If governments use coercive power instead of consensus among tax payers, transaction costs of the tax policy implementation and tax administration will affect the overall tax collection level negatively (Moore 2008). In this very discussion of modes of tax extraction and compliance, types of revenue sources emerge as important aspects of tax system and state building in developing countries. Modern tax states were built on direct taxes and developed their administrative capacity over decades by extracting directly from their tax payers. For instance, petro-states have been dependent on revenues from natural resources be it in Latin America or in the post-Soviet region, contributing to a weak state structure development and formation of non-democratic governments (Sabonis-Hef 2004). Thus, if a state-society relationship is built on quasi-compliance (i.e. non-coercive tax collection mode) when direct tax types are extracted, the chances are greater that modern state building occurs in a country. However, this mode of state-society relationship is often absent in developing countries that structure their tax systems around revenues obtained from natural resource exports or loans and international aid flowing from abroad (Moore 2004, 2008). Some scholars even argue that direct taxes were irrelevant for developing countries as their proportion in the overall tax collection remains small across countries (Bird and Zolt 2005). However, this statement has been challenged in recent studies on developing countries' efforts in state building.

The issues of state building through taxation by direct tax extraction in developing countries are well documented and analyzed in a recent book by Lieberman (2003). He investigates how structural factors such as race and regionalism could account in several tax policy choices and administrative capacity formation in Brazil and South Africa over several decades. He argues that the variance of tax systems across countries could be explained by their way of conceptualizing racial and spatial differences in constitutions at the end of the 19th century in Brazil and in the early 20th century in South Africa. It seems that the very conceptualization of us and them in the state building process led the upper-income class to accept the state's demand on tax payments. Lieberman's book on taxation is a great contribution to the state building theories from the taxation perspective in the developing world. In addition

to the theoretical frame of a National Political Community, the author attempts to combine both sides the taxation system, tax policy and tax administration, and investigates how both were being developed and influenced the development of a tax state in Brazil and South Africa.

Similar to Liebermann (2003), state building through taxation in developing countries has investigated causal effects of various political factors on states' tax collection level, tax compliance and states' extractive capacity (Cheibub 1998; Fauvelle-Aymar 1999; Soest 2006).²³ The core arguments of those studies is that in the developing world where states are weak and tax systems are in the making, tax collection capacity is influenced by such factors as political regime (Cheibub 1998), its legitimacy, efficiency and credibility (Fauvelle-Aymar 1999), or external pressure of donors who demand that countries ensure tax compliance from its citizens (Soest 2006; Fjeldstad and Moore 2008).²⁴

²³ Note that the administrative capacity of a state to collect taxes is measured in terms of tax collection as a percentage of GDP in most of those studies (Cheibub 1998; Fauvelle-Aymar 1999; Soest 2007; Lieberman 2003).

²⁴ The argument on the effect of political regime on tax level has been tested on 108 countries over 20 years (1970-1990). The aim was to settle a theoretical speculation on whether dictatorships or democracies are more capable of extracting more taxes. In non-democratic states governments are expected to use coercion and unlimited power to extract, while in democracies the system of checks and balances along with high tax rates might lead to lower tax levels. The conclusion is that democracies are often better at tax collection. Cheibub (1998:59) concludes that 'although there are factors that influence differently the level of taxes collected by the government in each regime, regime type does not affect the overall level of taxation. Democracies are not any less capable than dictatorships of extracting taxes from society'. The author argues that factors such as a foreign debt are less important in democracies while it can affect the tax level in dictatorships (*ibid.*). A similar argument is developed by Soest (2007), who investigates the role of external pressure by donors on neopatrimonial regimes. Countries such as Zambia where state authority is centralized and personal favors are handed out to state officials, revenue collected is expected to be low. Yet the author insists that even though the elite in multi-party Zambia has resorted to neopatrimonial practices, a strong semi-autonomous Zambia Revenue Authority was still set up and tax collection increased as a result. Donor pressure in this study was seen as an intervening variable that led to strong tax collection capacity of the state tax authority (Soest 2007). Tax compliance and tax level among other factors discussed above are argued to be influenced by three main political variables (Fauvelle-Aymar 1999): a state's legitimacy to collect taxes and demand that its population comply; efficiency when governments are capable of providing citizens with public goods in return for taxes; and finally, the state's credibility when changes or initiatives in terms of policies are predictable and create a feeling of durability of government decisions. Especially this factor is important in adoption of changes in tax policies by governments (Fauvelle-Aymar 1999:398-400). The author's main argument was that all three factors are positively correlated with high level of tax collection. Moreover, it is argued that the state's capacity to extract is in-

The role of international financial institutions has been found to be crucial in developing countries' efforts to reform tax policies and administration under the auspice of donors like World Bank and IMF (Fjeldstad and Moore 2008). The role of IFIs in transition countries and their policy reforms has been discussed by scholars of various types of policies (Orenstein et al. 2008), including tax policy (Campbell 2001).

In conclusion, it is worth noting that the literature on state building through taxation predominantly focuses on tax policy implementation, i.e. tax collection, and less on the politics of tax policy elaboration and adoption, which is the focus of this dissertation (of course, there are exceptions, such as Lieberman 2003). However, as mentioned, the tax state perspective is relevant to my investigation because it emphasizes how the need to extract taxes and the existing administrative institutions may serve as constraints on decision making. These issues are further discussed in the section on domestic structures below. Thus, I acknowledge that taxation is an interesting to political scientists; however, the focus of this dissertation limits us to zoom in on studies related to tax policy and policy change.

2.2.2. Domestic Structures

Tax system formation by decision makers is not all that free of domestic structural constraints and considerations among various choices as one might think. Tax policies are not only designed or reformed considering the tax competition exerted by external pressure or IFIs' aid conditionalities. National governments sometimes face large budget deficits due to a lack of domestic financial resources. Those challenges may drive policy reforms that would help governments raise more revenues, increase overall tax collection, and address the glaring budget deficit needs (Peters 1991). Thus, domestic structural factor driven explanations would argue that the interest of policy makers is to design a tax policy that will ensure revenue inflow to the state (Peters 1991:5).

In her predatory theory Margaret Levi (1988) brought up the importance that decision makers reduce the transaction costs of tax policy implementation. She argued that the lower the implementation cost, the higher tax compliance by taxpayers and the total level of tax collection. While she argued that elite bargaining was the actual mode of tax policy creation in historical Europe, she also stated that structural factors such as government organization, international context and the structure of society mattered in tax policy bar-

separable from tax compliance: it is high when the government and its actions are perceived as legitimate, efficient and credible by its taxpayers in developing countries.

gaining. Bargaining over policy between elites and rulers was also affected by the transaction costs of the bargaining and the implementation of the policy, besides the bargaining power of the rulers vis-à-vis the ruled, and the discount rates of rulers – meaning the way they value the present compared to the future (Levi 1988). Levi argued that tax collection is a costly endeavour and the ruler seeks to reduce those costs. In those cases emergence of representative institutions, such as parliaments, come in handy and give rulers more effective tax power to reduce costs of compliance through cooperation among tax payers (1988:179-80).

Gehlbach (2008) investigates the importance of structural factors in tax system formation in post-Communist realm. Apparently, countries that inherited less heavy industry were better off in terms of economic development at the beginning of the post-communist transition. Countries that were closer to the West tended to develop direct taxation, were better at tax extraction and extracted from small enterprises as well. More importantly, Gehlbach argued that in post-Communist countries the hunger for financial resources was decisive in tax system formation by governments that starved for revenues (2008: 14).

Following the arguments of Levi (1988) and Peters (1991), Gehlbach (1998) argues that structural factors such as budget deficits and the need to raise revenues can influence or even cause the initiation of tax policy changes. Those structural constraints take on particular importance in policy making when countries' tax policy implementation causes high transaction costs. This is when policy makers are expected to reform tax systems so that they reduce tax collection costs but increase the overall tax level. Policy makers, for instance in the case of Georgia, would try to change the tax policy so that it would be less costly to implement, eliminate loopholes that complicate tax systems and make administration costly, it would introduce a broader tax base and lower tax rates to collect more and ensure compliance due to lower tax rates.

Those theoretical arguments are worth examining, particularly in the investigation of the Georgian tax system formation. It is known that the country was the worst tax collector among post-Soviet states and it had had a chronic budget deficit for many years. However, this dissertation investigates not only the establishment of the Georgian tax system but also its subsequent change towards a broader tax base, lower tax rates and simplified legislation in general that reduced the implementation costs. The hunger for financial resources in Georgia was present over the years, but the policy changes rarely aimed at tax base broadening or compliance enhancement. Thus, some aspects of the policy change cannot be fully unpacked by structural explanations. Nevertheless a general expectation can be put forward:

Expectation A4: Domestic structures constrain policy choices of decision makers, they mediate external pressure and account for non-convergence across countries.

If the domestic-structural factor argument can be sustained in the empirical analysis, I would expect that the higher the budget deficit (as a percentage of GDP) and/or the lower tax collection is in Georgia (as percentage of GDP) 1991-2005, the higher the possibility that policy makers initiate changes in tax legislation to broaden the tax base, reduce tax rates, and simplify the tax code to make it easy to implement.

2.2.3. Domestic Institutions

Having discussed structural factors in tax system formation, I now turn to the institutions. Studies in the policy change literature claim that domestic institutions matter because they mediate external pressure and account for policy non-convergence across countries (Basinger and Hallerberg 2004:262). With this statement as a leitmotif in their analyses of tax policy change, conclusions on the importance of domestic institutions make Steinmo (1993) and Campbell (1996, 2004) overlap. Campbell (2004:129-30) argues that political institutions, such as formal regulatory and constitutional rules, organized labor, business, and electoral politics; cognitive frames for a scheme on how the world should function; and normative frames of proper behavior, mediate the influence of globalization pressure on tax policy change. He also pointed out that demographic factors and social movements can contribute to the increase of national demand for more social security reforms than the globalization thesis predicts. Having examined the globalization thesis on tax policy reform Campbell (2004:129) concludes that '... globalization is not leading to the homogenization of national-states ... divergence remains the rule rather than the exception because national institutions, which vary across countries, mediate the degree to which global pressures affect decision making by states and private actors in ways that militate against convergence ... that do not always lead inexorably toward wholesale neoliberal reform'.

Thus the political institutions listed above matter in the policy making process. They constrain the interests, capacities and strategies of social and political actors in the process of policy reform. However, the causal mechanism of how they are being constrained is argued to depend on how politics are organized in a country. A mainly regulatory system, i.e. a system based on laws that specify how those organizations can be organized and whether they will have access to decision making processes along with other actors, explains the mechanism of influence (Campbell 2004:146). Labor and business organi-

zations are politically powerful when centralized but not when decentralized. Moreover, if they have access to decision making processes then their capacity to influence the policy process is high. Labor if centralized and with access to corporatist institutions backs a high tax regime that is needed to provide high wages and social security nets to workers. Similarly, business and investors in corporatist countries seem to agree to bear high social expenditures as they benefit from the results. In countries with large social benefit systems social peace, a stable business environment, and reduced uncertainty for businesses are the incentives for the business groups to support a high tax regime. Finally, if the coalition governments are dominated by a single party, they tend to strike a compromise with their long-term partners and support high taxes. To keep their coalition intact, governments have an incentive to make sure their political partners are happy. And this on its own creates a need for high expenditures and, consequently, higher taxes. Once coalition governments change and no single party is dominating, incentives for a long-term compromise vanish as do their support for high taxes (Campbell 2004:147-48).

Steinmo (1993) also points to the importance of domestic institutions in his seminal work on taxation and democracy in three industrialized countries. Applying a historical institutionalism approach, Steinmo takes a journey over several decades aiming to explain the three different stages that modern tax systems have gone through in United States, Great Britain and Sweden. The domestic institutions which accounted for the tax system variance among those countries were political parties, constitutional rules on the separation of power of the legislative and executive bodies, and rules on decision making. Steinmo (1993:21) identifies three stages of tax system formation and insists on the need to consider the political and economic contexts that varied across space and time among the three industrialized states. As a result of a thorough empirical analysis of long and complex tax system formation processes in the United States, Great Britain and Sweden, Steinmo (1993) concludes that domestic institutions caused the variation in outcome. These conclusions are rigorous in arguing for the importance of institutions in the political processes. While I agree with the importance of domestic institutions in Georgian tax policy making, I argue that they do not cause a change or unpack the causality of the process. Domestic institutions are but one thread in the complex texture of a political process, and this fact is acknowledged and further taken into account in the causal model of this dissertation (see Figure 1.1).

2.2.3. Transition Literature

The literature dealing with the political and economic transition of post-Communist countries often takes a domestic factor-centered stance and views the outcomes of a transition based on the domestic factors. One of the early political science studies of fiscal policy in post-communist countries was done by Campbell (1996), who compared Eastern European countries (Poland, Hungary, the Czech Republic, Slovakia, Romania and Bulgaria) from the perspective of institutionalism. He criticizes the orthodox economic approach to the fiscal system development in post-communist countries on a number of counts. He points out that the complex process of fiscal system formation constrains the political elite in terms of the institutional legacy of a rigid labor market and a lack of technology and expertise as well as great pressure on newly elected governments to spend on social programs, while reforming the system and reducing tax rates. Weak administration and nihilism in tax payment obligations in states with large populations have been a source of budget deficits and a cause of low tax collection that was one of the constraints on policy makers also. Moreover, orthodox theorists assumed the existence of institutions for pro-market operations (Campbell 1996:74). However, in post-communist countries there was still a mix of socialist norms and new, pro-market norms were emerging and still weak. Interestingly, Campbell (1996:74) points out that political elites in post-communist countries were constrained by their aim to join an international organization, such as EU, IMF, WB and GATT and that the process of fiscal reform was not insulated from the international environment, as orthodox economists assumed, but just opposite. 'National economies are assumed to be relatively insulated from their international environments, but international factors heavily constrain the fiscal policies available to postcommunist governments' (ibid.). Constraints of the post-communist fiscal reforms were also accounted for based on the cross-country variance in terms of interest groups, policy legacies, political institutions and electoral considerations of the political elite (ibid.).

Campbell (1996:46) applies three theories on rational choice, organizational theory and historical institutionalism in his search to demonstrate that there is more to the post-communist fiscal reforms than just macroeconomic stabilization and governments' concerns over large budget deficits. Factors such as policy legacy, domestic pressure caused by demands from interest groups, the need to please external actors, and the facilitation of the development of the market economy were stipulated as domestic constraints to the fiscal reform in Central European post-communist countries. What makes his study particularly interesting from the perspective of policy change towards

business-friendlyism is that Campbell implicitly points out the role of external actors imposing pressure on domestic policy change processes through material and technical resources. Moreover, he points out that the networks through which domestic and external actors interact allow economic ideas to influence fiscal reforms and the ideology of domestic actors (interest groups) can also play a role in reforms: '... the ideologies and economic ideas of political elites, which are not always reducible to their self-interests, affect policy outcome' (Campbell 1996:49). These influences, though, are mediated by political institutions built in the country. Campbell views the process of a fiscal policy change as rooted in a complex environment, where marketization, democratization and international market integration are taking place simultaneously (p. 51). In line with the arguments on the institutional constraints on decision makers in post-Communist tax system formation, I too will address Georgia's weak administrative capacity to extract taxes and its need to raise revenues in the empirical analysis of Georgia's tax policy making and reforms in Chapters 5-7. Moreover, I will investigate the limitations that are placed on the decision makers by international organizations and various schemes of cooperation among the government and IOs.

Thus, based on the literature review in this subsection we can conclude that domestic institutions do matter and that they can account for the policy variance across countries, post-Communist or Western. I argue that the institutionalist approach and particularly that of historical institutionalism falls short in its capacity to unpack a causal mechanism of policy changes where transnationally diffused ideas play a vital role. The reason is that historical institutionalism is characterized by stability and continuity. It can explain how and why institutions stick rather than why they change. Once policies are institutionalized they create their own constituency which hinders change. Having said that, I share the theoretical standpoint of Hall (2005), who, in his criticism of the institutionalist approach, states that

although institutions are permitted to change within this conception of institutionalism, there are several problems with the conceptualization of change within the historical institutionalist model. One problem is that there appears to be little or no capacity to predict change ... That punctuation can be a sufficiently clear explanation after the fact, but it also comes very close to being tautological ... The change did occur, did it not, so there must have been sufficient pressure to generate the observed shift. There appear to be no a priori criteria for determining when there is sufficient political or environmental 'pressure' to generate a change (Hall 2005:78)

At the same time, when ideas are the focus of an investigation, as the case in this dissertation which explores the diffusion of new tax policy ideas, historical institutionalism brings the seeds of tautology if applied. Because as Hall (2005:74) stated:

to some extent the emphasis on embodying ideas in the structures that support institutions may be taken as a definition of the formation of institutions. It can be argued that when an idea becomes accepted and is embodied into a structural form then the institutions has been created. As with the case of normative institutionalism, however, this may be almost a tautology; the institution exists when an idea is accepted, but that acceptance is indicated by the presence of a structured institutions'.

Finally, institutions can facilitate, hinder, or retract policy change, but they can never be the only *cause* of the change (Steinmo and Thelen 1992).

I must make it clear, however, that I do not reject the importance of domestic institutions. I argue that institutions need to be considered as one of the possible factors influencing a policy change process once the focus is on multiple actors and on new policy ideas. This is because institutions often can and do act as filters to ideas in a policy making process across countries (Campbell 2004:78). I return to this discussion in Chapter 3, where I incorporate domestic institutions (formal and informal rules of decision making and support of the government on the reforms) into the competing theoretical framework that aims to fill up the gaps in conventional theoretical frameworks. Institutions along with ideas and interests have been included in the theoretical models by a number of scholars exploring the privatization policy adoption or social insurance policy change processes in developing and transition countries (Appel 2000). In a similar manner, I will take up the discussion on domestic institutions in Chapter 3, as I strive to incorporate institutions as an intermediate variable in the theoretical frame which is seen not as a cause of the policy change, but as a link in a causal chain which is key in the process of policy adoption. Below I discuss the domestic actor-centered approach of tax policy making processes.

2.2.4. Domestic Actors in Tax Policy Bargaining

Policy change literature on taxation takes up actors as one of the explanatory factors in the process of policy change. Domestic actor-centered and interest-driven approaches appear in one of the seminal works on taxation in political science written by Levi (1988). In her study, she explored the tax farming of ancient Rome and the emergence of the national tax systems in France and Eng-

land. Her model of predatory rule is based on a rational choice theory where interests of rulers, their bargaining power, and the choices they make in collecting taxes are of primary importance (pp. 10-40). Predatory rulers are defined as '... actors within a domestic and an international context' who negotiate with their constituents or agents and try to reach their ends by coercion or bargaining and so take the leading role in the predatory model (p. 11). While taxation systems are agreed through bargaining between the rulers and the ruled, their ability to extract is still limited by structural factors as well as by the need to reach agreement among the taxpayers to comply with their tax liabilities. In the modern world, rulers and ruled are projected in terms of veto players where bargaining is present, but the policy making system is more complex.

Hallerberg and Basinger (1998) applied a model of veto players in their study of a policy convergence claims within the globalization theory. They investigated the effect of internationalization on the tax systems (changes in corporate and personal income tax rates) in 15 OECD countries for 1986-1990. They found that the policy preferences of a governing party affect the cost to their constituency of a policy change. Any shift in tax policy has to be adequately accommodated, either by reducing expenditures, by shifting the tax burden or by repaying debt (ibid.). Therefore, their ideological stance on tax policy shifts matters. In the large-N test of a race to the bottom model, the authors claimed that the number of veto players and the ideological inclination of governing parties mattered in policy change. Moreover, they find that even though countries are responsive to policy changes in countries with which they compete, their decision to make a change is conditioned by the ideological distances among domestic veto players (Hallerberg and Basinger 1998). They concluded that there was no direct correlation between tax rate changes and liberalization. Countries with few veto players seemed to implement sweeping reforms, unlike those with a large number of veto players whose consent was required in order to change tax policy. Moreover, countries experiencing slow economic growth were more likely to make changes. The authors concluded that regardless of international or domestic factors, predictions on tax policy changes towards a common set of principles will not be as dramatic and as sweeping as predicted by competition theories in countries in which several institutions and/or parties have to agree.

Similar conclusions were reached by Ganghof (2006) in his comparative study of the following seven countries: Finland, Norway, Sweden, Denmark, Australia, New Zealand and Germany. He claimed that political electoral institutions and the number of veto players mediated the race to the bottom claim on tax policy reforms across OECD countries. Yet, in his conclusions, Ganghof did not discount the tax competition claim totally and stated that it accounted

for the capital tax rate reductions across countries, whereas domestic institutions (veto players and political party ideologies) mattered in the income tax policy changes made across countries.²⁵ Note that while putting actors in the spotlight of analysis, none of the scholars discussed above disregarded the importance of institutions. In her seminal work Levi (1988:7) argued that institutions and actors are equal. She stated: 'I want to emphasize the importance of structures and institutions while bringing people back into the state.' This quote makes it clear that a domestic actor-centered approach has to be investigated vis-à-vis domestic institutional and structural factors. Needless to say, the ruler who bargained over tax policy in Ancient Rome, for instance, was largely constrained by the need to raise revenues (i.e. the lack of financial resources). Tax policy making is not free from the policy makers' tax implementation considerations. At the same time, policy choices made by policy makers lead to institution formation, which can act as constraints on the actors in doing politics. Thus investigating causality among actors and institutions sometimes becomes tautological, but I have already discussed this under the heading of institutions.

2.2.5. Elite Bargaining in Transition Literature

Transition literature studying taxation and tax policy formation among post-communist countries has also dwelled on the interest-driven actor-centered bargaining model.²⁶ For instance, Loung and Weinthal (2004) investigated the interest of oil companies and the government in bargaining and compromising on the final version of the tax code in Russia. The tax policy creation during 1998-2002 is argued to contain less coercion from the state authorities as well as from powerful external international actors (i.e. IFIs) in Loung and Weinthal's Russian case study (2004). The authors view the new Russian tax code adopted in 2001 as a phenomenon that challenges both the coercive mode of institution formation and the process of the authoritarian rulers' imposition of new legislation. They also see policy creation as the path of negotiation where both oil companies and the (central) government were aware that negotiations were the way to reach consensus on the optimal tax code. They take up the rational choice approach where actors' interests in the policy outcome

²⁵ In a similar vein, Campbell (2001:129) in a cross-country analysis of Poland, Hungary and Czechoslovakia finds empirical support for the argument that the more fragmented the electoral system of a country is, the more difficult it is to initiate and implement new tax reforms.

²⁶ In a different policy type, a similar argument building on the financial interests of the reform-minded governmental faction is argued to have been an important impetus for the trade liberalization across some of the post-communist states (Frye and Mansfield 2003).

drive the process of negotiation. The external shock that Russia's economic crisis of 1998 was the exogenous factor that produced a shared state of vulnerability and interdependence of oil companies as well as of the government which had to secure collection of revenue and recovery of the shattered economy. Those two factors led to creation of common knowledge, i.e. information on payoffs and parameters of the game, where both powerful actors were involved. Finally, Loung and Weinthal conclude that tax policy creation in Russia is the result of a contractual mode of institution formation where actors pursue their own goals based on coordination and negotiation and reach consensus on the final legislation.

Similarly, Gerald Easter (2002) takes up the process of revenue extraction system formation in post-communist states as the state vs. elite bargaining process. He seeks to explore the way configuration of power resources (collective action through representation or informal bargaining) formed constraints on the state leaders' choices on revenue extraction strategies (p. 606). He assigns importance to the structural legacy inherited from previous regimes (left-overs of command economy such as weak tax administration capacity and a narrow revenue base) as constraints on the strategies and decisions that actors make (pp. 604-6). At the same time, he brings in power resource redistribution as an important factor in revenue extraction strategies used by leaders (p. 603). While concentrating on two different cases (Poland and Russia), he tries to explore why in Poland state leaders opted for a social contract by choosing income tax over household tax, whereas in Russia corporate profit taxes were given a priority in tax policy over labor income resulting in an elite-dominated bargaining process (pp. 606-17).

A closer look at Easter's model reveals that he incorporates elements of the bargaining model and the institutional model of tax system formation. His model which tries to unpack the state vs. non-state actors' bargaining process over taxation concentrates on an important factor of transition politics: 'structural and political conditions', i.e. configuration of power resources as he calls them (p. 621). These very resources, he argues, accounted for two different revenue extraction system formations in the two post-communist countries Russia and Poland. The taxation system was seen to be implemented through 'quasi-voluntary' compliance in Poland where economic structure was deeply dependent on agriculture and semi-privatized small businesses. The Russian state applied to the 'coercive-administrative' compliance and depended mainly on valuable commodity exports and natural resources (pp. 604-5). After reviewing both cases separately and comparing the two, Easter concludes that the Polish state negotiated with trade unions through 'concession and compromise' and achieved a social pact on keeping household revenues,

which first met social resistance (p. 621). However, the Russian state yielded to the elite which disputed the state's claim over the 'rich commodity exports' by taking advantage of the fragmented institutions and by acting as intermediaries between state and society in extracting revenues. The elite '... found ways to withhold revenue from the state center. The state resolved this conflict by sharing its claim on revenue with a select group of elite intermediaries. The result was a revenue extraction strategy based on elite bargaining' (p. 622).

To sum up, the studies discussed in this subsection explain tax policy change or tax system formation from an actor-centered perspective very elegantly. Their arguments are convincing and their conclusions illuminating. However, keeping in mind the main focus and the goal of this dissertation the domestic actor-centered approach falls short of capturing all the twists and turns that a multi-level, multi-actor process of tax policy idea diffusion incorporates (for more see Chapter 3). I argue that a veto player model, where the number of veto points and the political party ideologies are scrutinized as factors influencing the policy change outcome, is less relevant in the present case study of Georgia. One has to be cautious in using a model based on democratic states in the analysis of countries that do not have well-developed political institutions (Tsebelis 1995, 1999, 2000, 2002). Political parties across post-Soviet space emerged in the early 1990s and have suffered from weak organizational development and lack of a clear ideological stance. Furthermore, the level of democracy in post-Soviet countries, such as Georgia, has been low over the years which meant that politics were centralized and the actual number of veto players could do little in the legislative body under strong presidentialism. However, this does not mean that once the level of democracy has changed among post-Soviet states over the years and their political parties have evolved and strengthened their organizational capacity or ideological stance, it would not be worthwhile to test whether the number of political parties could play a significant role in a policy change. Therefore the following expectation will be incorporated in the study:

Expectation A5: The number of veto players influences the policy making and reform process. Sweeping reforms are often hindered by high numbers of veto players.

Elite bargaining perspectives on policy change in post-communist states discussed above overlap in emphasizing the policy preferences and interests of states and strong business actors. In studies of the tax code creation in Russia (Loung and Weinthal 2004) or the tax compliance and taxation in Poland and Russia (Easter 2002) actors' political power resources and interdependence

under the uncertainty that the crisis brought to Russia are explored in the process of policy making. Certainly, those studies provide an in-depth understanding of how politics were twisted and ran in the local policy arena of post-communist states. However, they overlook that domestic actors in the globalized world are no longer immune to external influence, and that a domestic tax policy is no longer only a 'domestic' matter in the growing interdependence among states (Shields 2004: 133-34). In a post-communist world the influence of powerful international actors must not be forgotten (Stones 2002; Orenstein et al. 2008), neither must the power of ideas that may inspire domestic policy makers and lead to a policy change through policy learning (Apple 2000; Evans and Alegica 2008; Alegica and Evans 2009).

Finally, policy bargaining and the interests of actors are no doubt relevant for such a particular type of policy as taxation. The latter creates losers and winners and, of course, is the terrain where actors with different interests clash (Peters 1991:4). However, those theoretical frames building on rational choice principles fall short in explaining processes where ideas may as well account for a policy change. Overlooking ideas and their importance in tax system formation in particular is a shortcoming for any theory when one aims to investigate tax policy idea diffusion across countries, and particularly in Georgia. Moreover, when countries are undergoing structural changes, as post-Soviet states have been ever since the Soviet regime collapsed, where increased uncertainty prevails, the interest-centered approach gives little help in explaining the policy making processes. Predetermined policy preferences of actors require rather stable environments where information is available at a low cost. However, in post-Soviet states (and in Georgia particularly) there were periods of information scarcity and a light level of uncertainty as to where actors' interests could be best accommodated (Apple 2000:522-25). Having said that, I join the scholars who aim to bring ideas into post-Soviet transition studies rather than take up policy bargaining and the interest-driven approach. The reason is the very focus of this dissertation and its aim to explain policy change through ideas. I promised in the beginning that I would test conventional theoretical speculations in the empirical analysis. The number of veto players is expected to have a negative effect on all tax policy adoption (see Table 3.2.). Thus, if the actor-centered approach was to explain the politics of Georgian tax policy making and its subsequent changes, I would find that the smaller the number of political parties in the Georgian parliament, the higher the chances that a tax policy change would be hindered. I shall investigate whether parliamentary elections lead to multiparty parliament formation in the country and whether it had an influence on tax policy reforms. Thus, in the years when the country had a higher number of representations in the parlia-

ment less tax policy changes are expected to have occurred. I will now summarize the main points of the theoretical discussions of this chapter.

2.3. Summary

The conventional explanations provide an enormous amount of information on what drives political change and the mechanisms that do so. However, they all try to claim primary importance for either external pressure or for the ability of domestic institutional capacity to resist change. The aim of the former is to explain policy convergence and the latter aims to refute the convergence theory. However, current trends in tax policy changes across various regions, including post-Soviet countries, show a process in which four important factors need to be incorporated and investigated thoroughly to ascertain exactly what leads to policy change (Djelic and Sahlin-Andersson 2006; Orenstein et al. 2008; Shields 2004). The claim that different schools of thought benefit by *borrowing* elements from each other instead of trying to set themselves apart, thus limiting the power of their explanatory models, is at the heart of the emerging literature on transnationalization.

I join the scholars in this school of thought. My aim is to provide an alternative explanation for the tax policy change pattern in Georgia (and across the post-Soviet countries) using the theoretical model embedded in the transnationalization literature. The transnationalization literature emerged along with the Europeanization and globalization literatures and relies heavily on the diffusion literature for mapping causal mechanisms (Bruszt and Holzacker 2009: 4). Therefore, the literature discussed above is used selectively in the transnationalization discussion so that political change is viewed in a broader perspective rather than merely as discussions of external vs. domestic (international relations vs. comparative politics) or ideas vs. resources (constructivists vs. rationalists). Besides incorporating insights from the discussed perspectives in the transnationalization framework, a number of expectations will be pursued in the case study. These are summarized in Table 2.1 along with more specific expectations for the case study.

Table 2.1: Summary of theoretical expectations for Georgian tax policy formation analysis

Theoretical perspective	Expectation	General expectation	Specification for case study
Competition	A1	Market integration creates a competitive environment and drives policy convergence across countries.	Were references to tax competition and/or the situation of other small countries within the former Soviet space made in the process of policy preparation and adoption?
IMF Conditionality	A2	Conditionality imposed on countries receiving aid changes policies to adjust to common policy principles promoted by IFIs.	Were references to mandatory IMF requirements made in the process of policy preparation and/or adoption?
EU Cooperation	A3	EU cooperation is a carrot leading to the adoption of recommended policy reforms under the auspices of the EU.	Was the EU involved in tax policy making and/or were references to EU standards made in the process of policy preparation and adoption?
Domestic Structures	A4	Domestic structures constrain policy choices of the decision makers, they mediate external pressure, and account for policy non-convergence across countries.	Did the level of the budget deficit and/or the level of tax extraction affect policy preparation and adoption?
Domestic Actors	A5	The number of veto players influences the policy making and reform process. Sweeping reforms are often hindered by a high number of veto players.	Did the number of parties in the Georgian parliament affect policy preparation and adoption?

Chapter 3

Transnationalization of the Public Policy Arena: Why and How Do Ideas Matter in Policy Change?

The transnationalization of our world has multiple dimensions. Transnationalization has arguably quite an impact on many aspects of our everyday life. Many of the goods we consume have been produced through a transnational chain – think of a bag made up of high-quality Italian leather, designed in France and stitched and produced in China ... Transnationalization, in other words, is a powerful contemporary trend reflecting upon most dimensions of our lives (Djelic 2009:285).

The purpose of this chapter is to construct a theoretical framework to address the following questions:

Why and how did Georgia establish and reform its tax policy 1991-2005?

What theoretical explanations can shed light on those processes?

How does transnationalization explain the process involved in policy change?

The ambition of this dissertation is to unpack the process of Georgian tax policy formation and its subsequent reforms and to trace a mechanism of policy change beyond conditionality and market incentive. Specifically, it sets out to explain why Georgia chose to adopt direct tax policy where personal income tax was first progressive and later shifted to a flat tax rate, becoming regressive, while corporate income tax was set on a low statutory tax rate. Finally, why and how did Georgian tax policy tackle the issue of tax exemptions and holidays on income taxes?

An alternative theoretical explanation of policy change is based on the argument that the transnationalization of the public policy arena, that is when new ideas are introduced and internalized by domestic actors and promoted domestically, does influence policy making and change, as an outcome. In short, I theorize how, when and under what conditions ideas matter in the transnationalized policy arena. The question of how exactly transnationalization explains policy change is addressed in this section. Subsection 2.1 presents the theoretical argument; subsection 2.2 discusses policy phases; subsection 2.3 discusses the transnationalization literature in general; subsection 2.4 discusses ideas; subsection 2.5 discusses the policy change mechanism as learn-

ing; subsection 2.6 maps important factors involved in the policy making process at various times and conceptualizes coalitions among various actors. Finally, subsection 2.7 summarizes the main points of this chapter.

3.1. An Alternative Explanation: Transnationalization of a Public Policy Arena

The explanatory power of the conventional theories is limited in terms of unpacking a causal model and explaining policy making and change beyond conditionality, market integration forces and/or domestic structures and interest-based factors discussed in Chapter 2. In particular, this limitation surfaces once policy making and change are seen in terms of idea diffusion with the active involvement of multiple actors that are non-state, state, external and domestic that form ties with one another and interact through various mechanisms throughout the policy elaboration and adoption processes. I do not reject the capacity of the theories on conditionality, competition or domestic actors and structures to explain some of the aspects of public policy making and change across countries. However, I argue that they are limited in their explanatory capacity to provide the full story of the factors and processes through which ideas diffuse transnationally and to answer why some ideas are adopted in national legislation while others are rejected.

The lack of a comprehensive theoretical framework to capture all nuts and bolts of this process, I argue, can be solved by applying an alternative explanation to the tax policy establishment in the post-Soviet realm and particularly in Georgia, which I will call transnationalization of the public policy arena. However, before I list all the building blocks of the alternative theoretical frame, I will define the term 'transnationalization of public policy arena'. The way it is understood in this dissertation is very close to the definitions provided by Djelic and Sahlin-Andersson (2006) on 'transnational governance' and Bruszt and McDermott (2009) on 'transnationalization of economies, states, and civil societies'. Thus, transnationalization of public policy arena refers to the increased importance of ties and cooperation among multiple types of actors in the process of a policy making and a policy change. A public policy arena is transnational when the boundaries between domestic and non-domestic actors progressively disappear in the explanation of a domestic policy change, and while diverse non-state actors appear as new players (Dadalaouri 2009: 190).

My theoretical claim is that new ideas, diffused externally and learned (i.e. internalized external policy norms and preferences) by domestic policy actors

which consequently become carriers of those ideas and push for new policies through domestic institutions, can lead to a policy change. The alternative explanation of the tax policy elaboration and change in post-Soviet countries is embedded in the transnationalization framework. However, at the same time, it heavily draws upon the literature on ideational policy change, domestic institutions in the policy change, and the studies on the policy diffusion mechanisms. All four components, i.e. ideas, policy change mechanisms, policy coalitions and institutional filters that build the theoretical frame of the transnationalization of public policy arena are borrowed from the theories mentioned above and are addressed in detail below.

In contrast to the conventional explanations, transnationalization of a public policy framework advances the role of ideas. Ideas are the cornerstone of the policy making and subsequent change in this dissertation. Actors' interests are also considered but they are assumed to be influenced by ideas that can affect actors' beliefs and, consequently, their policy choice.²⁷ Ideas are carried, learned, turned into domestically proposed policy initiatives. This process entails a mix of domestic and external, state and non-state actors who interact, form ties and links and are involved on the various levels of a policy change process. Yet, for the transnationalization argument to explain the policy making and a subsequent change, non-state actors' role is seen as important in knowledge dissemination among domestic actors.²⁸ The alternative theoretical argument does not downplay the role of institutions. However, in contrast to conventional institutional explanations, here institutions are not the cause of change or non-change but a link in a causal chain. Institutions in this dissertation are seen as filters through which ideas have to pass to be finally adopted, i.e. for a policy change to take place. Lastly, the alternative theoretical frame uses the mechanism of non-coercive policy change to account for incorporating tax policy principles in the national legislation. This mode of policy idea dissemination and adoption is an alternative to conventional theories where ideas are overlooked and coercive mechanisms are considered to lead to tax system making and change.

²⁷ This line of reasoning is shared by scholars within the ideational policy change theory, e.g. Blyth (2001, 2002), Apple (2000), Campbell (2002, 2004).

²⁸ This stance (i.e. emphasized importance of non-state actors in the policy change process) is shared by scholars within the transnationalization framework (Stark et al. 2006).

With inspiration from Soule and King (2006)²⁹ and Orenstein (2008),³⁰ the process of Georgian tax policy making is conceptualized in three consequential phases: are policy learning, policy development and policy adoption. Each phase incorporates four factors (ideas, mechanisms, actors and institutions) presented in the causal model (see Table 3.1). To prove establishment of a tax policy empirically within the transnationalization framework, all three phases must be detected as a sequence over the period under investigation. Yet, while the theoretical argument builds on policy studies within the transnationalization frame, I argue that bringing public policy diffusion and ideation change of a policy theory into the analytical frame will make it possible to conceptualize a causal model of an ideational policy change. The elements selected from these theories and why they were selected are described below.

The combination of theories of policy diffusion and policy change has been done previously to map the causal model of ideational policy change, but I want to combine the theories within the transnationalization policy frame. Note, however, that while I do not argue that my explanation – transnationalization of a policy arena – of tax policy variance across post-Soviet countries is the only possible explanation, I do insist that the role of ideas and non-coercive policy mechanisms is a powerful approach to post-Soviet developments. To test my theoretical argument and trace the causal mechanism of ideational policy change I develop as specific theoretical propositions as possible to make the theory empirically testable and falsifiable. But first, I describe all three phases of policy change with their main components that will make tracing tax policy ideas and their influence on policy change in post-Soviet states feasible, particularly in Georgia.

3.2. Phases of the Tax System Formation

Recall that in this dissertation tax policy formation is not concerned with the implementation of a tax policy. The theoretical frame developed here aims to unpack the process of tax policy creation and its adoption by the national legislative body in the country in question.

I conceptualize tax policy making and change as a process containing three sequential phases. Each phase contains actors, ideas, mechanisms and institutions that build the pathway of a tax policy formation and reform. Due to my emphasis on the process and the mechanism leading to the output – a tax

²⁹ Soule and King (2006) have investigated the process of policy development in the state ratification of the Equal Rights Amendments 1972-1982.

³⁰ Orenstein (2008) conceptualized social policy shift on a Chilean model in three phases.

policy – I name each phase after its main mechanisms. Phase one is the policy learning phase, when new ideas are diffused and introduced to domestic actors. Those open to new ideas start to learn from external actors and thus become part of a horizontal policy idea diffusion. In phase one, ideas are general and actors are a mix of domestic and external, state and non-state organizations. Yet, the existence and active participation of non-state domestic actors in this learning process is crucial for further policy change to follow where a coercive mechanism is not applied.

Phase two is the policy development phase where actors are grouped as policy coalitions under a common policy idea and policy issue and coordinate among themselves to have their policy proposals adopted. This phase demonstrates the result of learning from external actors by domestic actors. The policy ideas in this phase are concrete and directed at solving a particular policy problem. Here too the non-state actors' role is crucial because they are the empowered group with substantial information and knowledge of particular policy issues. When a policy proposal is elaborated and ready to be pushed for adoption through the legislative body, the second phase reaches its end.

Phase three is the policy adoption phase when the domestically elaborated policy proposal that incorporated new ideas diffused transnationally and was internalized by domestic policy actors is pushed through institutional filters to be adopted. Institutions and government support are crucial for new ideas to get through the legislative body and to become encoded in national legislation. Ideas need to be consensual among state, non-state and external actors. Policy coalitions form linkages with decision makers in order to influence their policy preferences and try to win the government's support. Government support is one of the most crucial factors that will either block or support policy adoption. Post-Soviet countries have strong presidential systems where decision making is centralized and often influenced by the political stance of the ruling party and the President to whom those ruling parties are mere political platforms. Therefore, the ideational stance of the political establishment often matters in policy adoption which introduces significant changes to the domestic economic policy. The three phases of tax policy formation along with their components are illustrated in Table 3.1.

Identifying each phase in the policy making and change processes that are modeled on the transnationalization of a public policy framework presented in Table 3.1 is crucial, because the core of the transnationalization claim to be proved, i.e. existence of ideas that were learned and internalized, can be detected through the learning and development phase. I argue that if the policy development process was not preceded by policy learning then the transnationalization model is irrelevant. Policy development and adoption can

easily be part of policy competition or conditionality-based policy change in post-Soviet countries and particularly in Georgia. Therefore, policy learning is the first building block of the process that is expected to lead to policy change via horizontal idea diffusion. Thus, having described the tax policy change phases I will now discuss the transnationalization literature from which the theoretical argument developed here originated.

Table 3.1: Phases of tax policy formation and reform

Main components	Phase I	Phase II	Phase III
Mechanisms of policy change	Policy learning	Policy development	Policy adoption
Ideas	General	Specific	Consensual
Actors	Triad of actors (external, domestic state, and non-state) forms policy coalitions and facilitate learning within and across the coalition	Policy coalitions among actors united under policy issues	Policy coalitions advancing the policy proposal
Institutions	Of little relevance	Formal and informal institutions matter	Government support, informal institutions and formal institutions matter in filtering ideas before adoption takes place

3.3. Transnationalization Literature

Studies within the transnationalization framework have recently emerged in the intersection of two types of scholarship in political science: international relations and comparative politics. It has combined the methods of both schools of thought and has argued that the domestic and international dichotomy in political science is fading away and that theoretical models must overcome the shortcoming of concentrating either on domestic factors and actors or on external factors and actors solely as the cause of outcome (Orenstein et al. 2008; Djelic and Sahlin-Andersson 2006; Bruszt and Holzhacker 2009).

The transnationalization framework is based on five main theoretical claims. First and foremost, it argues that other factors besides globalization and market integration frames of development across countries lead to different outcomes in different contexts. Secondly, it emphasizes the importance of non-state actors in the trends of transforming politics globally. Third, it argues that state agencies have links beyond the diplomatic type or those based on hierarchy

with international regimes. State agencies can be included in various policy networks. Fourth, ideas and interests are both taken seriously in studies of political developments across countries. Finally, the claim that non-state actors matter is backed by the way transnationalization studies view processes that lead to change (Djelic and Sahlin-Andersson 2006; Bruszt and Holzhacker 2009; Orenstein et al. 2008).

The theoretical discussions on the transnationalization framework and its conceptualization are still in their infancy. Transnationalization is related to the proliferation of regulatory activities (Levi-Faur and Jordana 2005) and emergence of transnational governance (Djelic and Sahlin-Andersson 2006), and its emergence is also seen through transnational investment in nation states (Shields 2004), social networks forming links and diffusing ideas and values (Keck and Sikkink 1998), financial markets contributing to the non-national state controlled processes (Wiess 1999:179) or through transnational actors in world politics and their influence on nation-states (Risse 2002). Transnationalization has emerged in parallel with scholarship of Europeanization (Schimmelfennig 2007; Graziano 2003; Schimmelfennig and Sedelmeier 2004) and evolution of liberalized markets and making and enforcement of regulations (Levi-Faur and Jordana 2005; Drezner 2001; Ganghof 2006). Even though these studies have contributed greatly to our understanding of how international actors and factors influence domestic policy making (i.e. in Europeanization studies), how regulatory activities have infiltrated states and become a mode of governance (Levi-Faur and Jordana 2005) or how market liberalization and externally imposed competition have influenced domestic policy making (Drezner 2001; Ganghof 2006), transnationalization studies instead concentrate on explaining domestic policy making or policy change by focusing on transnational ties, multiple actors and their modes of interaction (Bruszt and Stark 2003; Stark et al. 2006; Stark and Verdes 2006; Orenstein 2008; Orenstein et al. 2008; Bruszt and Holzhacker 2009).

The concept of transnationalization is an authentic notion that differs from globalization as well as from Europeanization. It is more accurate and capable of capturing the complex process of economic and political forces influencing policies across and within nation states (Djelic and Sahlin-Andersson 2006:4). Unlike processes of Europeanization or globalization, a state's transnationalization goes beyond the drive towards membership and is not driven by powerful external actors. Policy change processes in transition countries that are not competitive on global markets and are not considered EU membership candidates, would be difficult to investigate via the models of Europeanization or globalization, leaving out the transnational forces which emerge as powerful in reforms in post-Soviet state.

Transnationalization studies have developed models of public policy change (Orenstein 2008) as well as the theoretical frame explaining the emergence of economic institutions in Eastern European countries (Bruszt and McDermott 2009), East and Central European transition through transnational actor involvement (Orenstein et al. 2008), transnationalization of a state (Shields 2004) and social policy (Orenstein 2008). The limited approach to the post-communist transition was defended by scholars who urged due attention to the important influence that transnational actors (such as EU, IFIs, aid agencies and international organizations, or foreign state agencies) have exerted on the politics and development of emerging democracies (Orenstein et al. 2008). Orenstein et al.'s (2008) book on transnational actors and their effect on various policy areas in post-communist states acknowledged the need to look at external actors' influence not only on domestic state actors but on civil societies. The primary focus of the volume, however, was to empirically test the understudied aspect of quadrad transition, i.e. the mechanisms through which transnational actors influence domestic actors and the extent to which transnational actors can influence domestic politics.

Similarly, the need to open the theoretical frames of post-communist development to incorporate transnational forces as important factors shaping such domestic matters as state building was advanced by Shields (2004) in his investigation of the Polish state. While the roles of transnational actors are also pointed out here, the focus is not only on investigating the influence of transnational actors but rather on unpacking the process, which is a complex interplay of domestic and transnational forces that shape domestic politics. Those studies take a slightly different approach to the transnationalization of a policy arena, i.e. they focus on identifying the extent of transnational influence on domestic politics or on the role a domestic-external mix can play. Yet the arguments that non-state actors matter in domestic politics and that transnational linkages have influence beyond domestic state actors are the common themes in Orenstein et al. (2008) and Shields' (2004) investigation of the Polish state formation.

More studies have emerged in the realm of transnationalization framework where post-communist states were also included in the analysis. Those studies also emphasize the need to look at transnational mechanisms, actors and linkages, which shape policy change and institution formation processes across countries (Orenstein 2008) and even regions (Bruszt and McDermott 2009). Bruszt and McDermott (2009) have developed a framework called Transnational Integration Regimes (TIRs) explaining the variance in the path of creating economic institutions in emerging democracies. TIRs find their place at the intersection of international and comparative political economic studies and

are argued to be an alternative theoretical frame to market integration and development studies (Bruszt and McDermott 2009:23). Scholars argue that market liberalization and domestic institution formation in those two theories are explained within hierarchical power relations or with emphasis on the economic incentives as the stimulus for state or non-state actors to keep on forming domestic institutions. In contrast, the authors suggest that Transnational Integration Regimes (TIRs) go beyond conditionality and economic incentives in market integration and offer normative models, resources and integration mechanisms to developing countries. The core reason why TIRs work in economic institution formation in developing countries, Bruszt and McDermott (2009:35-36) argue, is that they empower various stakeholders among domestic actors and this alters or reinforces their role and power balance among domestic stakeholders.

The other study in transnationalization literature that tackles transnational actors' influence on policy change was conducted by Orenstein (2008). His book is a comparative study on the transnationalization of social policy and explains policy change across post-communist countries which moved towards the Chilean private pension model developed in the 1970s. He views the process of the privatization of pension schemes as the effect of the transnational actors' influence that was vital in the diffusion of private social security reforms across countries with different domestic structures. The model of transnational actors' influence that Orenstein (2008:60) develops builds on a model of veto players (Tsebelis 2002) coupled with the bureaucratic approach towards the study of international organizations developed by Barnett and Finnemore (1999). Also combining rational choice and a constructivist approach to institution formation, he takes interests and ideas as equally important factors in explaining the extent of transnational actors' influence on domestic politics. Orenstein (2008:42, 55) defined transnational actors as organizations acting individually or in coalitions transnationally affecting policy preferences of domestic veto players. Unlike the TIRs framework (Bruszt and McDermott 2009), Orenstein tries to incorporate various transnational actors and does not emphasize only one external actor (or single out an external force leading towards integration such as EU and NAFTA). Another set of actors in his model are proposal actors which, unlike veto players, do not have a veto point but can make very clear policy proposals and influence their transfer and implementation by using various mechanisms of influence such as cajoling, persuasion, recruitment of veto players for their own cause, co-optation or inspiration (Orenstein 2008:37).

Despite the differences in the theorizing of transnationalization by Bruszt and McDermott (2009) and Orenstein (2008) they share similarities in three

domains: both attempt to capture the external influence of transnational integration regimes (Bruszt and McDermott 2009) or transnational actors beyond the EU frame (Orenstein 2008). While doing so, they acknowledge that transnationalization contains multiple actors and various resources (intellectual or material). Yet, in this realm, empowering non-state actors plays an important role either for policy norm transfer (Orenstein 2008) or for domestic institution formation (Bruszt and McDermott 2009). Thirdly, they argue that mechanisms of influencing domestic policies are combined by transnational actors and vary from idea diffusion to persuasion or assistance provision.

3.3.1. What Does the Alternative Theoretical Frame Borrow and From Whom?

While my aim is to form a model that will allow me to test my theoretical argument on whether transnationally diffused ideas matter in domestic public policy change once they are learned and internalized, I build a causal model which greatly benefited from the theoretical models discussed before. For instance, similar to the TIRs frame, I point to the role of learning as an important mechanism through which domestic policy change can be triggered and will empower the domestic state as well as non-state actors. Learning empowers before marginalized actors which if institutionally facilitated can emerge as important policy actors and influence the national policy arena. However, unlike the TIRs framework, I view the sources of learning to be multiple. The process of policy change in post-Soviet countries is conceptualized in three subsequent phases as in Orenstein's (2008) illuminating study of social policy reform. Unlike him, I do not conceptualize policy change as a cause of crisis; nor do I focus on a combination of veto players and transnational actors. Instead I focus on how ideas introduced by transnational actors turned domestic and empowered not only state actors but also non-state actors.

Moreover, I investigate how the latter could influence the policy arena not necessarily by only cooperating with state actors, but by searching for government support and/or by taking up posts in the state institutions that would allow them to influence a decision making process. The latter, I argue, is crucial particularly in countries with strongly centralized decision making, such as Georgia. While emphasis is on collaboration among state and transnational actors to influence policy adoption and implementation in Orenstein's model (2008), I only view cooperation among multiple actors all the way through the idea diffusion to policy adoption. Moreover, in the transnationalization of public policy framework, non-state actors are the crucial leaders in idea diffusion and learning. Thus, when investigating the path through which ideas turn into poli-

cy norms, I view the role of non-state actors as an important factor in policy change.

Finally, what distinguishes my model from those discussed above is that my aim is not to theorize and empirically test the influence of transnational actors on domestic policy or the effect that large clubs and integration programs might have on public policies. I compare the influence of various actors on policy phases in order to see when they matter, why and how. Nor do I view external factors as the only sources of financial or other material resources that can facilitate and enhance policy change processes. Once ideas have become internalized and the initiators propose their policy project, they can search for the resources they need domestically, provided they find ideational allies. Hence, as my theoretical argument is embedded in the transnationalization literature, it builds on several theoretical assumptions that are an indispensable part of this field. The process of tax policy change in post-Soviet countries is non-monolithic and consists of at least three phases (see Table 3.1.). Different types of actors matter more in some situations than others, but their influence on the process varies across time and space. Therefore, I assume that external and domestic, as well as state and non-state actors matter in this process. Second, the transnationalization model builds on the assumption that public policy arenas are no longer insulated from non-state actors, be they non-governmental organizations, interest groups or epistemic communities. Policy making is open to influence from non-state actors, and it is important to incorporate their role in the model to avoid underestimating the role of non-veto actors in policy change processes. Policy making is a multi-level exercise (process) in the transnationalized policy arena, and it involves multiple types of actors in different stages of the policy change process. Third, the framework of a transnationalization of the public policy arena challenges the argument on policy diffusion through a coercion mechanism. The hegemony of knowledge and the possession of new policy ideas are no longer geographically limited because ideas are diffused and become locally embedded and reconstructed. Ideas evolve over time and across countries and are changed by domestic actors trying to convey them to local decision makers as their own. Therefore, learning as the mechanism of policy change is vital to incorporate ideas.

Having discussed the transnationalization scholarship and stipulated what distinguishes my theoretical model from already existing frameworks, I will explain in detail the model of transnationalization of public policy and I discuss theoretical expectations from further empirical tests in a case study in the coming chapters. The following sections identify actors and policy coalitions drawing from transnationalization and policy shift literature. I will discuss the me-

chanism of policy learning, which is theorized in the policy diffusion studies, as well as the influence ideas have on policy change, drawing heavily on the ideational policy change literature. The model is complete once the theoretical expectations are derived from the institutionalist theory where formal and informal institutions are expected to influence policy change.

3.4. Ideas as Weapons for Change

There is a growing interest in focusing on the role of ideas in economic policy studies across countries (Blyth 2001; Apple 2000; Hall 1993; Campbell 2004). Those studies place ideas between structural factors (such as crises) and the institutional change or the policy shift as the outcome. Ideas become crucial tools for solving the policy problems decision makers face under conditions of great uncertainties (Blyth 2001).

In the study of ideas as a cause of policy change defining what ideas mean is important for theoretical as well as for empirical reasons. The typology of ideas and their influence on policy making was mapped by Campbell (2004), who identified four types of ideas: (1) programs and paradigms, which were cognitive, (2) outcome, (3) frames, and (4) public sentiments, which are normative and non-outcome oriented (Campbell 2004:94). Not being outcome-oriented, normative ideas serve as frames and mainly contain symbols that legitimize decisions and assumptions that constrain the normative range of legitimate programs. Cognitive ideas are outcome-oriented and comprise programs and paradigms. While paradigms are wider concepts referring to a particular theoretical model, programs are rather narrow, problem-oriented concepts that provide clear-cut solutions to problems (Campbell 2004:94). Policy programs are '... cognitive concepts and theories that enable or facilitate decision making and institutional change by specifying for decision makers how to solve specific problems' (Campbell 2004:98). There is a difference between a paradigm and a policy program – the former is a larger frame 'providing an overarching understanding of how the world works' and addresses 'broad policy goals', whereas '... programmatic ideas are more precise guidelines about how already-existing institutions and instruments should be used in specific situations according to the principles of well-established paradigms' (Campbell 2002:28).

Interestingly, Campbell's (2004) notion of ideas and their ascribed characteristics are shared by Blyth (2001), who investigated the way ideas influenced model change in Sweden in the 1980s. For instance, Blyth distinguished

three³¹ ways in which ideas can be seen, e.g. as blueprints by defining the crises agents find themselves in and by projecting possible reforms or policy changes that can solve the problem (2001:3). Ideas can also be weapons when they are introduced by agents, i.e. they not only explain the cause of the perceived economic problem, but also offer a solution. Moreover, viewing ideas as weapons can provide a scientific as well as a normative critique of the existing economic model (p. 4). Finally, ideas can act as 'cognitive locks' when they become institutionally embedded and policy making is viewed as possible only within those ideas (p. 4). Thus, while ideas as blueprints overlap with paradigms in their way of influencing policy change, policy programs overlap with ideas as weapons. Regardless of the terminology, I argue that those concepts indicate a similar phenomenon. Ideas in the study of tax policy can be general, i.e. blueprints of paradigms, or specific as weapons or policy programs. For instance, policies favoring capital over labor in taxation are part of a new policy paradigm, but the reduction of corporate tax rates is argued to be a policy program for attracting investments. Thus, a paradigm can comprise a number of policy programs.

I now turn to the discussions on the causality of ideas and policy change.³² Ideational policy change literature views ideas as crucial tools for solving the policy problems decision makers face under conditions of great uncertainties (Blyth 2001). Ideas are like an instruction sheet to agents in times of uncertainty. When interests are unclear and institutional change is so that all is up for grabs, ideas tell agents what is happening and what can be done to tackle the policy problems they are facing. Ideas can project possible changes that might yield benefits to the agents thus indicating where their best interests may lie. Due to those characteristics of ideas, they empower policy actors in difficult situations to make decisions or to act. Thus, while ideas can lead to a policy

³¹ In his later work, Blyth (2002) stipulated five theoretical speculations on how economic ideas act in times of economic crises and influence institutional formation. Besides the three types of effects that ideas are argued to have, Blyth (2002) mentioned ideas as important in delegitimizing existing institutions and providing a blueprint for new types of institutions.

³² The ideational proponents are criticized by rational choice supporters because they fail to unpack the exact causality which leads an idea to action and makes actors choose one of a number of competing ideas (Weingast 2005). Those claims are not all groundless, and especially when referred to early attempts to advance the role of ideas in policy change processes. However, several illuminating works in ideational policy change literature have shown the causality of how ideas are accepted and how they lead to action without applying a rational choice approach (e.g. Roy and Deznau 2008; Blyth 2001, 2002; Orenstein 2008; Walsh 2000; Poteete 2003; Jacoby 2008; Apple 2000).

change they have an empowering effect on policy actors. Moreover, if interests can lead actors to pull resources together, ideas can direct actors on how to use those resources (Blyth 2001:26). It is interesting that ideational policy change does not ignore the importance of interests. But whereas rational choice supporters place policy interests of actors before ideas, ideational proponents do just the opposite. Interests are defined in terms of ideas so in a causal chain ideas would precede interests and affect actors' policy preference change. Blyth (2001) views interests in terms of ideas which reduce uncertainties and allow forming institutions: '... interests must be defined in terms of the ideas agents themselves have about the causes of the uncertainty they are facing. Ideas are important precisely because they reduce uncertainty, give content to interests, and make institutional construction possible' (2001:3). Similarly, Weingast (2005) argued that actors' preferences can be influenced by new ideas besides new evidence or changing circumstances. He stated that 'The role of ideas is critical to understanding people's preferences, and, moreover, peoples' preferences over actions changed as a result of changing ideas' (Weingast 2005:165).

In this dissertation I opt to call policy ideas weapons. However, it is not to assume that all ideas that are floating in the policy arena matter in a policy making and change process. To reiterate Goldstein and Keohane (1993:11), this type of assumption would be erroneous, because ideas are always present in policy discussions, yet what makes them affect policy choice is something to be explored rather than assumed since '... some intrinsic property of an idea explains its choice by decision-makers'. Having said that, I claim that ideas which are accepted, learned and internalized become those ideas that open the horizon of the policy actors and provide new understandings of the cause and effect of the policy problem they face or aim to tackle. While internalized ideas are the cause of the non-coercive mode of policy change in this dissertation, I take the stance of scholars who put ideas side by side with interests. Yet, unlike ideational policy change scholars I do not see policy failure as the only cause of policy change. The theoretical expectation that will be investigated in this dissertation is derived from this discussion as stated below:

Expectation B1: Ideas act as weapons of policy change. They first have to be available to policy actors and, second, have to provide a policy solution (perceived) for the policy problem actors face.

Note that to capture policy ideas in the empirical study, I choose to specify where tax policy ideas can come from that will potentially affect the tax system formation. I argue that policy ideas as weapons can come in the form of

policy advice, best practice (i.e. a reform precedent that was perceived and marketed by transnational actors as a modular phenomenon), and/or concepts from economic theories, as long as they contain policy specific information, can provide an understanding of the tax policy shortcomings to the policy agents, and can offer solutions to those shortcomings. More precisely, tax policy ideas should provide information on how capital and labor are to be taxed, what a tax base and/or rate should be and why.³³

Policy ideas overlap with policy learning mechanisms on three dimensions due to its characteristics (i.e. capacity of ideas to empower actors, influence actors' interests and to actors' understanding of the cause and effect of a policy problem). In allegoric terms, if ideas are seen as a weapons (or tools) of change, then learning is the path on which those weapons are carried and delivered, transferred to others and owned, and finally used for a change of the status quo. I will discuss the mechanism of policy learning that allows ideas to exert influence on policy change processes below.

3.5. Mechanism of Idea Change: Policy Learning

Considering the focus of policy change in this dissertation which falls on output of policy (i.e. adoption) rather than its outcome (i.e. implementation), I leave out mechanisms that affect policy implementation. Similar to ideational public policy change, policy diffusion and transnationalization literature where policy ideas are learned, I emphasize the policy learning mechanism that allows voluntary learning and horizontal diffusion of ideas (Hall 1993; Dobbins et al. 2007; Meseguer 2006; Bruszt and McDermott 2009). Learning as a mechanism of influencing institution formation in EU accession countries was incorporated in the TIR framework discussed above (Bruszt and McDermott 2009). A learning mechanism creates horizontal channels through which ideas diffuse and are being learned. Thus, similar to TIRs framework, here too the learning mechanism is multiplex in its form, as learning not only allows ideas to be channeled between two types of actors, but also allows horizontal diffusion among various public, private and international actors. Considering the theoretical claim of this dissertation that sees an alternative way of policy change through ideas which were externally introduced and internalized by domestic actors, I discuss the horizontal mechanism of policy idea diffusion here. However, in order to explain how learned ideas can appear in the policy proposal mechanism I will

³³ Campbell's (2004) notion of policy program and Blyth's (2001) description of ideas as weapons have inspired my own definition of ideas.

summarize the policy learning mechanism and its indicators, which will make empirical testing feasible.

Recent attempts to theorize policy learning increased the possibility of empirically testing the mechanism of information intake that changes actors' beliefs (Dobbins et al. 2007:460). Evidence as example of or information on a particular policy is a source that may change actors' beliefs on cause and effect (Elkins and Simmons 2005). Policy learning as a mechanism of policy change differs from mechanisms like coercion, competition, imitation (Dobbins et al. 2007). Policy diffusion literature identifies three approaches to learning. One is a social learning, which is a sum of technical and theoretical knowledge among actors that builds their consensus on how a public policy needs to be designed to achieve its social goal (Dobbins et al. 2007:460). According to Hall (1993), this type of learning leads to policy change as it encodes learned inferences into organizational routines. Social learning proponents see learning as socially channeled rather than done by policy makers in relation to particular policy making or reform (Hall 1993:280). Learning that accumulates new knowledge affects actors' interests and policy beliefs, which in ideational policy change literature allows ideas to be placed before interests in a causal chain (Hall 1993; Blyth 2001).

The second type of learning originates from the rational choice approach which is known as Bayesian learning. The logic is that governments add new information on their prior knowledge on particular issue. Learning can come from one's experience or policy experiences from elsewhere. Policy makers update their knowledge on particular policy issues based on the estimations on what will work due to the country's experience and thus, knowledge is being accumulated. The latter proves or disproves the hypothesis on what will work and the more consistent the evidence, the more likely policy makers are to agree on a narrow range of interpretations (Dobbins et al. 2007:460). This type of learning was pinned as a rational learning by Meseguer (2005) similar to Meseguer and Gilardi (2007), who argued that social learning and rational learning are often opposed in discussions, but both are compatible and can better explain how and why policy makers accumulate knowledge and how the mechanism of learning works across countries and regions.

Finally the third type of learning in political science literature is known as learning from 'others' (Dolowitz and Marsh 2000). The logic of this type of learning is that countries learn from their neighbours and is specifically used to investigate drafting and implementation of public policies in developing countries which are affected by examples from their neighbours. Dobbin et al. (2007:461) referred to it as channelled learning as the process is present across regions despite learning variance outcomes and due to the institutional envi-

ronment in these countries. Channelled learning in social learning literature is seen as a hierarchical learning when transnational actors play a crucial role in disseminating information and educating domestic policy actors and empowering them (Orenstein 2008). Thus the essential difference between the two approaches to social learning is that one views learning as a non-hierarchical and horizontal process, e.g. when examples from other countries, such as the Chilean pension fund reform, are being diffused horizontally (Wayland 2005), and the other sees social learning as hierarchical, e.g. when transnational actors are accountable for diffusing particular knowledge and information which empowers domestic policy actors (Orenstein 2008).

I argue that conceptualizing the learning process as only horizontal or hierarchical when tracing a process over a number of ideas is tricky and might not reflect the structure of the mechanism properly. In other words, if at the very beginning of the knowledge diffusion external actors brought the knowledge to the domestic actors it does not mean that horizontal diffusion of the knowledge among external and domestic actors cannot also take place afterwards or in parallel with the hierarchical knowledge diffusion process. As I see it, the problem of the hierarchical learning mechanism is that it does carry the seeds of coercion when domestic actors are state actors. Because when/if external actors are in a position to be authoritative and able to impose besides educate, then how to draw borders between ideas imposed and ideas suggested by the same actors? Even if the tone of suggestion is free of imposed conditionalities, it still makes one think that domestic actors might have felt the hidden threat or pressure from those external actors. And if external actors provide best practice and examples through their policy research to domestic actors, it falls within the category of social learning through examples (i.e. bounded learning) and is a horizontal mode of learning. When international organizations such as IFIs or EU provide policy advice to governments, one cannot expect that this is free of coercion. Thus, if IFIs and EU disseminate knowledge to third-sector representatives this can be viewed as horizontal diffusion of policy ideas. If international organizations have mandate to coerce while advising domestic actors, it is empirically difficult to detect whether policy learning was either free of coercion or merely horizontal and non-coercive. To make the distinction between coercive and non-coercive modes of information diffusion, learning in this dissertation is thus viewed as a horizontal process, whereas vertical and hierarchical are the coercive mode of policy change.

Let me make clear, however, that it is beyond the ambition of this dissertation to settle the theoretical disputes on the assumed differences in the three types of learning discussed above. The aim here is to define learning so that it can be operationalized as a process which can be empirically tested. The

overall definition of learning while stripped of adjectives such as bounded and rational is that a learner learns from relevant information (Mesequer 2006:37). In this dissertation, learning is a horizontal process of diffusion and intake of ideas that lead to change of beliefs and consequently the behavior of actors and empowers domestic actors to initiate policy change (tax policy reform). In this process, a crucial role is assigned to non-state actors to be present among learners because a hierarchical power structure is absent in their interaction with external actors, which facilitates horizontal diffusion of tax policy ideas. This definition builds on Hall (1993) and Mesequer (2006), and the characteristics ascribed to learning by the TIRs framework (Bruszt and McDermott 2006).

Since we know what learning does (i.e. empowers domestic actors) and what its components are (i.e. flow of information), I will now determine what we need to search for when investigating the learning process empirically. In ideational policy change, policy learning and policy diffusion literature three factors have to be present to detect the learning process: (1) availability of information and ideas (Mesequer 2006); (2) channels of communication, interaction and linkages among various actors who disseminate knowledge and those who learn (Orenstein 2008; Way and Levitsky 2007); and (3) ideas have to be perceived and upheld as solutions to the existing problems in the policy making process (Blyth 2001). Having summarized the theoretical background of the policy learning mechanism, I will examine the following theoretical expectations in the empirical part of this dissertation.

Expectation B2: Linkages/channels of communication among domestic and external actors facilitate policy ideas to be channeled and diffused. Yet, in order for diffusion to be horizontal non-state actors need to be part of the policy arena and the process of the policy idea diffusion.

Expectation B3: Availability of policy, in particular public policy changes, can serve as a source of learning for policy actors elsewhere.

Expectation B4: Not all diffused ideas are important, only those that are internalized, as they change the beliefs of policy actors and empower them to elaborate on policy proposals by policy coalitions.

Since learning entails actors who disseminate knowledge and those who intake the information, I will turn to the discussion of policy actors and coalitions and conceptualize their importance in policy change.

3.6. Policy Actors and Coalitions

In policy change actors are important for two reasons: They generate and/or spread new policy ideas and they adopt and implement them. In the search for the causal mechanism through which ideas are carried, conveyed and translated into policy output it is essential to identify the actors who are present and able to influence the process. Policy diffusion studies persistently emphasize the role of non-state actors along with powerful external actors, such as IFIs, and state actors in the process of policy transfer (Stone 2004). Among non-state actors we find interest groups, non-governmental organizations (NGOs), law firms, banks, consultancy firms and think tanks (*ibid.*). Non-state actors are involved in broader policy areas and the mediation of ideas through so-called 'soft transfer'. Yet, non-state actors cannot bring change in policy alone. They need to team up with other actors who can provide resources and access to the policy arena and decision making realm (Stone 2004; Orenstein 2008). 'Non-state actors cannot bring about policy transfer alone but are dependent on governments and international organizations to see policy transfer instituted. Accordingly, these organizations are often to be found in partnership or coalition on either an ad hoc or more permanent basis with government departments and agencies, international organizations, or with other NGOs' (Stone 2004:558). The need to consider multiple actors in the policy change and institution formation is one of the theoretical arguments that transnationalization studies make (Orenstein et al. 2008; Orenstein 2008; Bruszt and McDermott 2009; Bruszt and Holzhaacker 2009). International non-governmental organizations, private enterprises, foundations, state bodies, associations, intergovernmental organizations, all those that act on policy in the transnational space are viewed as important in transnationalization processes (Orenstein et al. 2008:7).

Moreover, multiple actors do not act alone, but try to team up with various actors in the process of a policy change or an institution formation to ensure that their final goal is achieved. Policy learning, policy change and transnationalization literature recognize the role of policy coalitions made in the process of policy change and idea diffusion (Sabatier and Jenkins-Smith 1993; Weible et al. 2009; Orenstein 2008; Stone 2001, 2008). Regardless of the fact that policy actors, be they non-governmental, state agencies or international organizations, all differ in terms of their mandate, resources and ideas, they still come together to form a policy coalition around a common set of ideas and policy issues among various actors (Orenstein 2008:6-7).

Policy coalitions are a network of actors known in global governance literature as, e.g., epistemic community (Haas 1992), transnational advocacy

networks (Keck and Sikkink 1998) and campaign coalitions (Tarrow 2005). Various policy coalitions have various modes of influencing the policy change process. For instance, the epistemic community is made up by experts who share consensual knowledge in particular policy areas and learning is promoted by experts and their professional knowledge (Haas 1992; Campbell 2002:30). Transnational advocacy groups appear to affect public policy and the public agenda through symbols, language and morally compelling cognitive frames (Evans and Davies 1999; Keck and Sikkink 1998). In those types of network coalitions knowledge is promoted on expert as well as on grass-root level and the learning process goes mainly through norm building (Keck and Sikkink 1998). Campaign coalitions (Tarrow 2005) are issue focused, highly flexible, less institutionalized, have long-term goals and rely on voluntary work by their members. The aim of those coalitions is to push the government to change policy.

Regardless of theoretical and empirical differences among policy coalitions and networks, they still share a number of commonalities: they are all united based on voluntary compliance and cooperation; 'are vehicles for the spread of ideas and structural location for social learning' (Ladi 2000:211), and their goal is to change a policy either based on expert knowledge or by influencing policy makers' beliefs and preferences (Stone 2001). Actors in policy networks may be independently effective in disseminating ideas, the political dynamics of networks entail that negotiation, compromise and persuasion are unavoidable and these actors are dependent upon decision makers and other power holders to see ideas selected for transfer and institutionalized in policy (Stone 2001).

Due to the dissertation's focus on the influence of ideas on policy change through actors, I choose to adopt a notion of a policy coalition similar to Orenstein (2008) that resembles its connotation with policy networks. The core of the policy coalition as understood in this dissertation is that it combines state, non-state and/or international organizations which share a common set of ideas and are working on a policy issue. Policy coalitions coordinate their work among members through voluntary compliance, their work mode is cooperation and the important feature of their work is to reach consensus on policy proposals. Policy coalitions draw 'together organizations with different capabilities and specialties and have developed mechanisms of consultation and modes of collaboration that facilitate a division of labor' (p. 49). Policy coalitions disseminate knowledge inside and outside the coalition through working groups, conferences, workshops and meetings with policy stakeholders.

I view the role of policy coalitions to be important in all stages of policy making, from idea diffusion and in the process of elaborating policy proposals

and adoption. Having discussed the role of actors as well as that of their coalitions in the course of a tax policy change, I will derive a number of theoretical expectations that will be further tested in the empirical discussions. The aim is to see how and when actors influence the policy change process. Thus, I expect to find that:

Expectation B5: Triads of actors (i.e. state, non-state, and international organizations) affect policy change in a transnationalized public policy arena.

Expectation B6: Policy coalitions are formed around sets of ideas or policy issues and facilitate learning among their members.

Expectation B7: The interest of a policy coalition is to have its policy initiatives adopted through coordination and consensus.

What makes a coalition powerful is its composition, its resources and the variety of strategies it employs in communicating its goals in a policy change. Therefore, inclusiveness in coalitions is important on two accounts: to reach a consensual policy program and for the final adoption of the policy proposals. The more inclusive the coalition is the stronger the consensus on the policy they promote and the weaker the opposition to their ideas that might shatter their initiatives to be finally adopted. At the same time, policy coalitions are constrained by institutions that may either aid or hinder their efforts for a policy change. I will take up this issue in the following sub-section.

3.7. Institutions as Filters and the Need for Government Support

It should be noted here that the theoretical claim of this dissertation is that tax policy ideas were diffused and internalized in domestic public policy in post-Soviet countries, which ultimately led to a policy change. I take into consideration Campbell's warning (2004:78) that: 'The discussion of diffusion generally ignores what happens when an institutional principle or practice arrives at an organization's doorsteps and is prepared by that organization for adoption. Here the story often ends and it is assumed that the principle or practice is simply adopted uncritically and in toto'. To avoid this shortcoming in my analysis of an ideational policy change I opt to include domestic institutions in the causal frame as other scholars (Campbell 2001; Walsh 2000; Apple 2000). I argue that institutions matter, but do not necessarily cause policy change. However, they can act as filters of policy ideas in the policy change process. Needless to say, the arrow indicating a causal relation between agent and

structure is never unidirectional. There is a reciprocity where institutions constrain or enable actors, however, institutions are man-made and thus not free from the influence of actors. I identify two types of institutions, *formal* and *informal*, which come into the equation between ideas and policy adoption. This stance is shared by scholars from the literature on institutional change, idea diffusion, democratization through linkages and political fragmentation (Frye and Mansfield 2003; Campbell 2001, 2004; Way and Levitsky 2007).

In formal institutions I refer to formal rules on legislative initiation and adoption on one hand, and government support on the other hand. Formal rules on policy making, adoption and implementation as well as procedures have an effect on the degree to which new ideas carried by actors can infiltrate and influence a policy making arena (Campbell 2002:30). Formal rules define the 'rules of the game' in domestic politics. It creates a clear indication of who is the key actor in legislation initiation and adoption in the formal decision making realm. More precisely, I will investigate to whom the constitution and the laws on parliamentary proceedings grant the right to initiate a law or an amendment.

Government support refers to the leadership's support to the policy initiative. Government support in policy change has been emphasized in the process of policy implementation. The theoretical argument that among domestic institutions the government's support is crucial for policy adoption or reform implementation is close to the 'fragmentation of a political power' argument advanced by Frye and Mansfield (2003) in relation to trade liberalization in post-communist states. While investigating the role of the fragmentation of national governments combined with the electoral competition in relation to the promotion of trade liberalization across post-communist states between 1990 and 1998, Frye and Mansfield state that

... domestic institutions strongly influence trade liberalization in the post-Communist world. Extreme concentration of power in non-democracies hinder trade liberalization, while even a modest amount of political fragmentation can promote openness ... Fragmentation of political power has created political space for elite groups with stronger preferences for openness to influence policy outcome (Frye and Mansfield 2003:654-55).

Elaborating on this argument, the authors attribute more to the fragmentation argument that makes it partially coincide with the government support argument that 'removing political power from the hands of bureaucrats appointed by Communist-era politicians has been a common element of reform in many countries ... the dispersion of power from protectionist elites in the post-Communist era has given these groups some leverage to remove commercial

openness' (Frye and Mansfield 2003:655). To reiterate those statements, in order for the liberalization process to kick in in a country with concentrated political power and weak democratic institutions, such as post-communist states, it is crucial that their governments contain reformist-minded individuals who take up posts where they get leverage to influence policy making.

I argue that the political support of the political establishment is important in the post-Soviet realm because it increases the possibility of policy adoption, particularly in countries with centralized decision making systems under strong presidential political regimes. Reformist individuals can influence the policy change process by infiltrating decision making posts and emerge as policy actors which elaborate and/or promote liberalization or, for our sake, new tax policy principles (i.e. 'broad tax base low tax rates'). Or policy actors can form informal links with decision makers and try to involve them in the policy elaboration process, to ensure their support in the process of policy adoption. This type of formal institution in this dissertation is called government support. I now turn to the informal institutions and clarify their role in the ideational policy change.

The limited attention paid to informal institutions in comparative politics was voiced by Helmke and Levitsky (2004), who insisted that in institutional analysis overlooking informal institutions would not provide a complete picture of what affected the actors' behavior. They stated: 'Careful attention to informal institutions is critical to understanding the incentives that enable and constrain political behavior. Political actors respond to a mix of formal and informal incentives, and in some instances, informal incentives trump the formal ones' (Helmke and Levitsky 2004:726). Like them, I distinguish between informal institutions and organizations, clan relations or types of behavior that reside in informal channels of communication and aim to undermine the formal channels (p. 727). The way I see the informal institutions here is the links and ties formed among state and non-state actors (domestic or international) on different level of interaction and communication. For instance, personal contacts between NGO members and state officials are examples of an informal institution as understood in this dissertation. Institutional filter as informal links and ties among policy actors and decision makers is argued to matter in policy change because informal institutions can open the window of opportunity, facilitate 'contamination' of state institutions with new policy ideas and help obtain support in policy adoption process.

Informal rules refer to ties among individuals or organizations that build on personal connections and are sustained behind the formal institutional or organization facade. This form of institutional filter can be tested by reconstructing the narrative and exploring the actors' connections behind the formal deci-

sion making arena. Thus, having discussed the institutional factors that I expect to influence the adoption of new policy ideas into tax policy in post-Soviet Georgia, I stipulate the theoretical expectations that will be further tested in the coming chapters.

Expectation B8: Government support for a policy proposal in the final phase of a policy change (i.e. policy adoption) when the decision making arena is centralized is crucial for the new ideas to be adopted.

Expectation B9: Formal rules and procedures of the legislative initiation constrain actors in bringing policy ideas into the decision making realm.

Expectation B10: Establishing ties and contacts among policy entrepreneurs and decision makers allows policy coalitions to influence the decision makers' policy preferences and increase chances that they will support the new tax policy ideas to be adopted in legislation.

The use of the tax policy change in Georgia as a case to test the theoretical propositions which I advanced in this chapter faces a challenge as taxation falls in the area of economics and material interests and might be less associated with ideas or learning. Moreover, tax policy change within or across countries is by default viewed as the cause of competition driving tax rate reductions or other types of changes for the sake of increasing a country's competitiveness in relation to neighboring countries. To make it clear, I in no way refute that competition and interest-based explanations hold water in terms of tax policy change and that they explain some aspects of the processes related to public policy change patterns across countries. I assert that there are other pathways through which tax policies can be changed and that those pathways are not necessarily materialistic or competition-fever driven, but can be the result of the internalization of new policy ideas. Learning can change the perspective of policy actors so that they see adoption of policy changes as favorable compared to the status quo. Ideas can lead to policy change, but ideas cannot stand alone. They have to be carried and accepted by actors, they have to filter through institutions, and they have to expand the actors' horizons and interests to act in a certain way so that ideas end up in adopted policies. The theoretical propositions that I address below in the empirical analysis of tax policy idea diffusion are summarized in Table 3.2.

Table 3.2: Summary of theoretical expectations for Georgian tax policy formation analysis

Theoretical element	Expectation	General expectation	Specification for case study
Ideas	B1	Ideas act as weapons of policy change. They have to be available to policy actors and have to provide a policy solution (perceived) for the policy problem actors face.	Were tax policy ideas available to the policy actors in Georgian tax policy making processes? Did domestic policy entrepreneurs suggest adoption of ideas on flat tax, low tax rates and a broad tax base as a solution to the policy problems?
Mechanisms	B2	Linkages/channels of communication among domestic and external actors facilitate policy ideas to be channeled and diffused. Yet, in order for diffusion to be horizontal non-state actors need to be part of the policy arena and the process of the policy idea diffusion.	Did non-state actors participate in the policy making process through working groups? Did policy actors in Georgia organize workshops, discussions, knowledge-sharing forums where tax policy ideas were discussed?
	B3	Availability of policy in particular public policy changes can serve as a source of learning for policy actors elsewhere.	Did Georgian policy entrepreneurs refer to examples from neighboring countries as the source of reference when elaborating on the tax policy?
	B4	Not all diffused ideas are important, only those that are internalized, as they change the beliefs of policy actors and empower them to elaborate on policy proposals by policy coalitions.	Were pro-broad tax base, and low tax rate/flat tax rate tax policy ideas introduced in the Georgian policy making arena but rejected by domestic policy makers and/or non-state actors before the adoption of the second tax code of Georgia in 2004?
Actors	B5	Triads of actors (i.e. state, non-state and international organizations) affect policy change in a transnationalized public policy arena.	Were the Georgian and international non-governmental organizations present in drafting and discussing a tax code(s) along with state actors and IFIs?
	B6	Policy coalitions are formed around sets of ideas or policy issues and facilitate learning among their members.	Did policy coalitions in Georgia have concrete policy ideas that would lead to tax policy change?
	B7	The interest of a policy coalition is to have their policy initiatives adopted through coordination and consensus.	Did policy coalitions reach consensus on the policy proposal before its adoption?
Institutions	B8	Government support for a policy proposal in the final phase of a policy change (i.e. policy adoption) when the decision making arena is centralized is crucial for adoption of new ideas.	Were the policy initiatives supported by the political establishment of Georgia? Did the Georgia Ministry of Finance support the domestically initiated policy proposal?
	B9	Formal rules and procedures of the legislative initiation constrain actors in bringing the policy ideas into the decision making realm.	Did the rules on legislative initiation and legislation adoption block new tax policy proposals in Georgia?
	B10	Establishing ties and contacts among policy entrepreneurs and decision makers allows policy coalitions to influence the decision makers' policy preferences and increase chances of their support for the new tax policy ideas to be adopted in legislation.	Did personal contacts between Georgian decision makers and the policy coalition lead to the adoption of new policy proposals?

Chapter 4

Methodological Choices and Research Design

This chapter is crucial for establishing the validity and criteria of the conclusions since it discusses the methods and research design of this dissertation. Why and how was Georgian tax policy adopted and changed – those are the questions I seek to answer. Yet, establishing the link between ideas and policy making and change required some methodological choices. To achieve the goal of this dissertation, I conduct an in-depth case study. Why I do this and what the trade-offs of this choice are, is addressed in detail below. The dissertation takes a deductive approach and tests the theoretical propositions discussed in Chapters 2 and 3.

The backbone of the dissertation is its theoretical argument stating the importance of ideas in policy change and the ability of non-coercive mechanisms to lead to the adoption of tax policy principles. Modern tax policy ideas invite policy actors to form policy coalitions once new ideas are diffused domestically. This process continues and is followed by learning processes within and across policy coalitions. Once new ideas become internalized by domestic actors, policy change initiatives are created and advanced in the national policy arena. However, policy adoption has to pass an institutional filter and has to enjoy the support of decision makers to be finalized in the national legislative bodies of a country. This is easily said, but investigating this mechanism empirically brings considerable methodological challenges.

I choose to use a process tracing method for an in-depth case study where I seek to test the causal model of transnationalization of the public policy arena over more than ten years. Moreover, I investigate whether ideas through non-coercive mechanisms of policy diffusion can lead to a policy change and I do so by testing competing theoretical propositions. The goal is to find whether ideas and not conditionality lead to a policy change in the country in question, and process tracing is considered one of the best methods for theory testing and theory development in the social sciences (George and Bennett 2005:223). It allows you to draw a causal inference on a small number of cases or even on a single case where a great deal of data is generated and analyzed in order to explore a possible causal mechanism.

Chapter 4 is structured as follows: Section 4.1 describes a process tracing method and its actual application in the case study of Georgia. Sections 4.2 and 4.3 describe data resources and semi-structured interviews, and Section 4.4 sums up remarks on the overall validity of the dissertation.

4.1. In-Depth Case Study of Georgia through Process Tracing

Causation is the principal means by which we are able to order and make sense of the humanly constructed world. It is the central explanatory trope by which relationships among persons and things are established ... Without some understanding of who is doing what to whom we cannot make sense of the world that we live in, we cannot hold people and institutions accountable for their actions, and we cannot act efficaciously (Gerring 2001: 128-29).

Small case studies have their own drawbacks, such as limited representativeness due to the limited number of cases. However, they also possess virtues as they allow us to explore complex causal mechanisms. Yet for the conclusions to claim validity in case studies the issue of case selection is vital and so are the reasons for choosing a particular case. Researchers have warned against a selection bias when cases are selected based on the extreme scores on the dependent variable (Collier et al. 2004). Moreover, this is relevant if only one or a few cases are used to generalize findings on a larger universe. Others have tried to tackle this issue by suggesting that selecting cases on their scores on explanatory variables can be the way out of the selection bias curse (King et al. 1994: 137-42). The problem that arises in either strategy for case selection is that a strong theory is assumed while in most cross-country studies it is not present. Qualitative researchers tend to be puzzle driven, which means that they are already aware of the scores of the dependent variables (Lieberman 2005:442). Things get fuzzier when this is not the case.

However, there are ways of addressing this issue in case studies. It is important to keep in mind that the purpose of the study and the theoretical ambitions of the analysis are crucial in the case selection process (Gerring 2001: 163). In this dissertation I choose to apply a deliberate case selection³⁴ when picking Georgia for the further within-case analysis and I justify my choice on the following grounds: First, the theoretical ambition of the dissertation is taken under consideration which is to test a model of transnationalization of public policy arena and the desire to unpack a complex causal mechanism wherein ideas can cause a policy change in developing countries. In a model, testing a case selection on a dependent variable is justified as long as the independent variables are not all settled (Liebermann 2005:442-46). In this dissertation, the Georgian case represents the case of radical tax policy reforms among Commonwealth of Independent States.

³⁴ Some authors refer to the same type of case selection method as a 'purposive', 'non-random' (Gerring 2007:88).

Also, the selection of the Georgian case was based on the grounds of the accessibility of the necessary information and my own extensive knowledge about the Georgian case. Such a decision is justified in case studies if researchers collect 'new information about the particular cases with which the analyst is generally familiar and attempt to "test" the cross-country verified hypothesis with such data' (Lieberman 2005:448). Those considerations are particularly important when the dissertation aims to make sense of complex processes over an approx. ten-year period of tax policy making. Therefore, knowledge of the local language and depth of understanding of the local culture of Georgia were also taken into consideration when in the selection of a case for a process tracing study. I contend that the Georgian case allows us to trace the process over time and identify other pathways than those conventionally explained where ideas can in fact lead to a policy change.

4.4.1. In-Depth Case Study of Georgia

I will now describe the analysis of the causal mechanism. A deductive approach was adopted through process tracing in scrutinizing the Georgian case. Multiple types of evidence were collected and scrutinized in relation to each theoretical proposition (see Tables 2.1 and 3.1) to verify a single inference. Process tracing in the Georgian case allowed me to investigate the relations of independent variables over a long time period. Furthermore, the theoretical propositions derived from the discussions in Chapters 2 and 3 made it possible to falsify them throughout the analysis. Process tracing resembles detective work, where bits and pieces of evidence are collected but prove causality between the theorized variables. There are no strict guidelines on how to conduct process tracing, but we have been convinced of the virtues of this method. This method often leaves researchers with a large vacuum of actual tools (Gerring 2007:181-84). The way I decided to structure the Georgian case study was inspired by John M. Owen (1994), who did an excellent job falsifying theoretical speculations through various types of evidence on democratic peace proposition in Franco-American and Anglo-American crises in the 18th and 19th centuries. Each theoretical proposition is tested on the collected evidence, is either confirmed or disconfirmed and supportive evidence to the statements is provided in the text. This ensured chronology of events studied; in other words the issue of priority (i.e. a cause to be detected prior to the effect) was addressed duly.

The case study of Georgia consists of three parts, each identified as three sequential periods based on the changes made in Georgia's tax policy. Period one studies the creation of the first tax policy from 1991-1997. The second period studies the processes of elaboration of a tax code project known as Orvelashvili's Code, amendments to the existing tax code, and the adoption from 1997-2003, just before the Rose Revolution in November 2003. The final period covers the

processes of the second tax code creation during 2003-2004. (In the sections in Chapters 5-7 where I address the issue of tax collection, I also include data from 2005, a year after the tax code was adopted, to show the effect of implementation in terms of tax collection and effect on state budget). The transnationalization argument was conceptualized into three interconnected sequential phases of a policy change in Chapter 3. Each phase is a building-block of an ideational policy change process that evolves over time. The first phase of a policy change starts with the introduction of new ideas through diffusion. In the second phase, the ideas externally injected become internalized domestically. In the final phase of a policy change through a transnationalization process, the policy ideas are institutionalized in domestic policy. In empirical analyses all three phases are investigated in each period of Georgian tax policy making (i.e. three separate chapters, 5-7).

To make empirical analyses feasible in the case of Georgia over more than a ten-year period, the transnationalization argument is proved if and when evidence identifies the presence of all three phases of a policy change within each policy analysis period in Georgia. Thus, if ideas are identified as being spread in the Georgian policy arena or among policy actors, but there is no indication of those ideas turning into policy suggestions promoted by domestic policy actors, the evidence of internalized ideas will be missing. Since this factor of ideas being internalized is crucial for the transnationalization argument I contend that other mechanisms besides learning were accountable for the policy change.

By investigating the tax policy change in Georgia since 1991 up to 2004, I address the issue of priority, which is hailed to persist as a shortcoming of ideational explanations (Gerring 2001:141). Tracing causation over a ten-year period aims to move the cause far away from the outcome to find the non-obvious explanations, which otherwise might have been overlooked. This decision shall make our theoretical explanations better when there is a distance between X and Y (*ceteris paribus*). Needless to say, this choice comes at its own costs – the larger the distance between the proposed cause and outcome, the harder it is to prove it. However, the value added by addressing the issue of priority in causal analysis is worth the trouble. As Gerring (2001:142) puts it:

... priority often imposes costs on other dimensions. Yet, such explanations will be better insofar as they offer us more power, more leverage on the topic. They are nonobvious.

In my efforts to conduct process tracing in a deductive manner, I had to deal with the high demands of a variety of evidence and richness of data to complete the analysis. More on this is discussed in the following section.

4.2. Selection of Data Sources

The theoretical proposition theorized the importance of ideas, mechanisms, institutional constraints and actors in the policy change process in various phases. In defining these key words, I will investigate their causal relation through two main types of data: written sources and semi-structured interviews with key actors in the tax policy change process. Written data sources are organized in three clusters based on explanatory power since they can supply information from different levels of research or different parts of the theoretical frame. The written sources of information used in the dissertation are summarized in Table 4.1.

Table 4.1. Data sources

Primary sources:	Minutes from the Parliamentary Sessions on Tax Code Discussion (1997, 2004). Policy proposals of working groups and/or individual actors, such as comments on the tax code from Amcham (1998); drafts of the tax code projects by a working group in Gudauri (2004) and/or comments on tax policy by experts (for instance, comments by UNDP-invited expert Robert Conrad (2004); EGYA letters to Parliament with suggestions for tax code amendments.
Secondary sources:	Reports World Bank Report (various years) IMF Reports (various years) USAID Reports on NGOs (various years) GEPLAC reports on Economic Trends (various years) Legislation Georgian Tax Code (1997; 2005) Parliamentary Regulation Law on Legal Acts (various) Georgian Constitution (1997) Printed and online Media Georgian Chronicle by CPDD (1992-1997) Civil Georgia (various) Other Statistical data on and information bulletins of the organizations involved in the tax policy making process.

a. For an exhaustive list, see the bibliography.

The primary source is internal documents from organizations/institutions such as minutes and notes from meetings and policy discussions, policy proposals which are not public. Their main characteristic is that they are not publicly available, yet they are not confidential, so researchers can still request access to them. Being recorded in a closed frame of discussions, it makes them even more valuable for analysis where actors' interests and policy preferences can be exposed. Moreo-

ver, they give an idea of who was allied with whom in the closed discussions. It is equally important to see who were involved in discussions that were not open to public scrutiny. However, it is very challenging for researchers to obtain access to those materials when the internal documents of the organizations (from external or domestic actors) are being requested. Moreover, once the materials are obtained, they can be partial (i.e. they do not provide a clear picture or a whole narrative of a process of discussion or meeting or of the work of a policy coalition) and thus hinder the reconstruction of the narrative of the policy change process. In this case, as well as in general, missing information can be supplemented by semi-structured interviews with key actors in the process of the Georgian tax policy making.

The secondary source of information supplements the primary source by providing facts and information that can help construct a larger picture of the policy making and change process. Moreover, this type of information helps contrast information obtained from the primary sources to see whether actors followed up their statements with action. It makes clear which ideas came from which actors and whether the initiatives on policy change were taken up by their allies or not. In contrast to the primary source, the secondary source is publicly available, including reports by international organizations. For instance, reports by IMF were scrutinized to trace the existence and consistency of conditionality imposed on tax policy changes since it started funding Georgian Government reforms in early 1994. To investigate the extent to which WB was involved in tax policy reforms and by what type of activities it supported the IMF policy stance on tax reforms its reports were also scrutinized. Reports by USAID were a rich source of information on the activities of the organization in economic reforms and its NGO sustainability index reports provided valuable information on how non-state organizations developed over time in Georgia. This information is particularly interesting in this dissertation which sees NGOs as one of the important actors in idea diffusion and internalization in Georgia. The reports by GEPLAC on the Economic Trends of Georgia reconstructed the narrative by providing chronological information on then ongoing political and economic reforms in the country.³⁵

Other secondary sources were legislation, printed/online media and information bulletins of the organizations identified as important actors in this dissertation. Legislation on taxation was reviewed so that the change in law would be compared within Georgia over years to see when and to what extent it reformed. The Constitution, Law on Legal Acts and the Parliamentary Regulations were included to identify which formal rules of legal initiation and law adoption existed and to see whether they constrained or facilitated the process of tax policy initiation and final adoption by various actors. Meanwhile, printed media provided background information on the political environment with particular emphasis on

³⁵ A detailed list of the references is available in the bibliography.

policy debate or policy change. In addition, it gave substantial information on the actors who were actively involved in policy change processes over a long period. For instance, the *Georgian Chronicle*, which summarized printed media topics during 1992-1997, proved to be a great source for the analysis of the tax policy change processes from the early 1990s up to 1997 (Chapter 6). Furthermore, printed media helps reconstruct the precise chronology of facts. Complementary statistical data was extracted from the World Bank Development Indicators, as well as from the website of the Department of Statistics of Georgia.

Finally, information bulletins not only described the capacity of the organizations to be involved in the process of economic reforms in Georgia, but gave a good impression of their financial, technical and intellectual capital along with their connectedness with domestic actors and/or international organizations or counterparts. Information on their funding and participation in information dissemination forums (workshops, conferences) can help establish the argument on non-state actors' transnational linkages. Secondary sources were supplemented by country-specific scholarly studies of political and economic reforms and particular types of state or non-state institutions previously (Aves 1996; Slide 1997; Jones 2000; Wheatley 2005; Nodia 2006).

Despite the richness of the written sources of information, they have two possible shortcomings: (1) They may be biased, i.e. inclined to demonstrate a certain tendency preferable for an organization or institution that does not necessarily reflect reality. (2) They have limited scope, especially technical reports and news digests that may miss relevant information or concrete facts that took place at the same time and were important for the tax policy change process. A useful tool for discovering new facts and verifying information obtained from secondary literature is adopted in this dissertation.

In April 2009, 27 semi-structured interviews were conducted with key policy actors chosen through non-random sampling. Average duration was approx. 60 minutes and general as well as specific questions were asked. General questions were asked to all respondents similarly; specific questions were prepared for each interview considering the organization the informant represented and the information already obtained from the secondary literature (see sample questionnaire in Appendix 4). If and when answers were not concrete or to the point, respondents were asked to clarify. When the questions were formulated, all themes of the dissertation were covered to make further operationalization of the observations possible. The aim of the interviews was also to obtain as much information as possible to see if new facts would be brought up about a particular policy initiative or an event that mattered in this process of policy change. Verification of the information from secondary literature was carried out throughout the interview processes. Since respondents sometimes had to go back in time and revive processes and facts that took place about ten years ago, they were

often helped by being asked concrete questions about particular reports or meetings which took place at that time. All interviews were recorded, transcribed and structured with Nvivo 8. The software was used to identify observations in the transcribed interviews and to see in which contexts particular observations were being used.

4.3. Semi-Structured Interviews

Interviews provide new and additional information on what was already established from other sources. Moreover, interviews are an important part of the process tracing methodology allowing triangulation of the data and limiting the risks of arriving at parsimonious inferences (George and Bennett 2005). Following the logic of process tracing, it is crucial to have a non-probability sampling of potential informants, because it reduces the risk of excluding important respondents from the sample. Therefore, one has to aim to include all key actors in their respondent sample (Tansey 2007:765). To address the issue of informant sampling, important decisions have to be made as to *who* to interview, *what particular information* has to be obtained, *type of questions* to ask and how to double-check the *validity of the information* informants give. All decisions are crucial to avoid looking for inaccurate (useless) information with non-relevant respondents. Moreover, if these issues are settled by the researcher, re-checking the validity of the information is crucial in order not to arrive at an erroneous conclusion or to ascribe exaggerated importance to the informants' words. I will address each question below.

Decisions on how to choose different types of actors derive from studies on transnationalization of public policy, which view multiple actors' involvement in the policy change process (Orenstein 2008). A pilot interview with a tax policy expert and investigation of the secondary literature helped me to settle on four categories of groups for the within-case analysis of Georgia: (1) international organizations, (2) state institutions, (3) political parties, and (4) non-state organizations and experts. The latter were united under two types of actors: domestic and/or external. Clustering various actors into an aggregate type as external and/or domestic urges one to note that each group consists of different types of actors. Moreover, each group has different organizational structures, different resources and mandate, and different roles in the process of policy change. Some are aid organizations; others are promoters of particular interest groups transnationally or domestically. Some have large and others have limited financial and intellectual resources. Some have a mandate to influence policy adoption while others can only participate in debates and offer suggestions on particular policy types. To navigate among large numbers of actors which can be categorized as external or domestic, I will list some considerations that I use to map the actors.

This dissertation aims to identify external and domestic actors which are important in tax policy change. Fiscal policy and economic restructuring have to be in the competence of those actors. The focus is on norms and ideas of actors who can inspire, internalize and translate the ideas into codified norms. Actors who have the capacity to produce and promote norms and/or have legitimacy as knowledgeable and capable of contributing to the process of policy change at any stage are considered important here. Finally, the particularity of the investigated region is considered as it is part of the post-Soviet bloc where norms are promoted by particular organizations of regional membership or unions of developed economies.

The criteria for distinguishing those four groups of actors were rather easy when it came to political parties, state institutions and experts or non-state organizations originated in Georgia. Using the headquarter location as a criterion for separating domestic from non-domestic is not a new strategy in policy research (Orenstein 2008). Following this rationale, organizations with headquarters in Washington DC, Geneva or Brussels are also a clear-cut type of external actors. Among those types of organizations this dissertation, due to its narrow focus on the tax policy, focuses only on aid organizations (such as the United States Agency of International Development (USAID) or the United Nations Development Programme (UNDP)), financial institutions (such as the World Bank (WB) and the International Monetary Fund (IMF)), and on regional unions (such as the European Union (EU)). However, non-state organizations that are interest representatives can sometimes be difficult to categorize, because it depends on the criteria whether one categorizes an organization as domestic or external. For instance, the Eurasian Fund has representative offices in various post-Soviet countries, but its headquarters are in Washington DC. The Open Institute – Soros Fund is similarly represented in multiple post-Soviet countries, but represents the US-based fund of financier and philanthropist George Soros. The American Chamber of Commerce representing business interests within the country were also categorized as external here. Organizations that are established within a country as an independent legal entity and are by a board of directors of only local staff are considered domestic, in this dissertation the Georgian Young Lawyers Association (GYLA) and the Young Economists Association of Georgia (YEAG).

Groups of local experts acting individually as consultants or advisers to state, external or other non-governmental organizations are also categorized as domestic actors. The challenge of this type of categorization is the limited certainty that domestic non-governmental actors are domestically embedded and not transnationally linked with other non-governmental organizations or large external actors through financial and technical assistance they might be receiving from outside. This is the case of caution particularly in transition countries, where non-governmental organizations are a recent phenomenon and are projects in

making with large financial aid from abroad. This problem can only be settled with an in-depth case study and revision of investigated actors' programs and organizational structure. Respondents participating in the semi-structured interviews conducted in April 2009 are listed in Table 4.2.

Table 4.2: Respondents in the semi-structured interviews

International organizations	Maka Dolidze, Economist, World Bank.
	Natalia Beruashvili, Fiscal Reform Team Leader, United States Agency for International Development (USAID).
	Bill Curnow, Team Leader of the Support to Tax Administration Project, EU Delegation in Georgia.
	Nia Sharashidze, Economist, International Monetary Fund (IMF).
	David Gogichaishvili, Executive Director, CIMS Consulting.
	Gigi Bregadze, Programme Officer, United Nations NDP.
	Amy Denman, Executive Director, American Chamber of Commerce in Georgia (AmCham).
	Zaal Anjaparidze, Programme Manager, Eurasia Partnership Foundation.
	Viktor Baramia, Programme Manager, Eurasia Partnership Foundation.
	Mikheil Mirziashvili, Programme Manager, Open Society Fund in Georgia (OSGF).
State agencies	Vazha Petriashvili, Deputy Minister of Finance of Georgia.
	Irakli Siradze, Revenue Agency, First Deputy, Georgian Ministry of Finance.
	Soso Archvadze, Member of the Budget and Finance Committee in Parliament of Georgia.
Political parties	Zurab Tkemaladze, Chairman, Industry Will Save Georgia.
	Irakli Iashvili, Member of New Rightists.
Domestic non-state organizations and experts	Otar Kakhidze, Lawyer and Parliamentary Secretary, Georgian Young Lawyers' Association (GYLA).
	David Narmania, Economist, Association of Young Economists of Georgia (AYEG).
	Aleksi Aleksishvili, Former Chairman of AYEG, the Former Minister of Finance (2005-2007) and Former Minister of Economic Development of Georgia (2004-2005).
	Ani Katamadze, Chairwoman, Association of Young Economists of Georgia (AYEG).
	Miranda Mandaria, Lawyer, Georgian Trade Union Confederation (GTUC).
	Nikoloz Orvelashvili, Economist and Tax Policy Expert.
	Lado Papava, Senior Fellow at Georgian Foundation for Strategic and International Studies (GFSIS), and a Former Minister of Economy (in 1994-2000).
	Zura Nikvashvili, tax policy expert, Partner of Ernst and Young;
	Gia Bazgadze, Director of Ernst and Young in Tbilisi, Georgia.
	Gogi Loladze, Expert and Director of the Georgian Stock Exchange (GSE). Vakhtang Khmaladze, Expert in Tax Administration and a Former Member of the Georgian Parliament.

Although the interviews provided a rich source of information, the issues of interview data validity and credibility were considered during the causal analysis. Interviewing key actors often generates challenges that are well known in the literature on elite interviews (Berry 2002). The themes of the analysis in the within-

case study were operationalized in interview questions. To get a better understanding of each variable and their causal relation with the outcome, similar questions were directed to various actors, regardless of their organizational arrangement or mandate. Questions were general (i.e. open-ended) and related to the policy change, however, some questions derived from the theoretical frame. It is important that informants give their version of the story of a change. However, as historical record, depth and context are at the heart of my research, open-ended questions must be followed by more concrete follow-up questions (Berry 2002:682).

The interview process offered one more challenge to ensure reliability of the information obtained. Informants had to answer questions about a process that took place over many years (since the creation of the new tax code, 1997 till 2007), which means that they viewed it in retrospect and thus might see facts in a slightly different way than in the context when the process was actually taking place. Therefore, meetings, conferences or policy initiatives were referred to along with questions about precise facts. I now move on to discuss the data collection process and provide sources for each type of written material.

4.4. Overall Validity of the Dissertation

The overall validity of the dissertation is determined by its internal validity and reliability. Internal validity refers to the validity of the causal analysis and the descriptive inference. At the same time, both are affected not only by the research design and methodological tools applied in this dissertation, but also by the reliability of the data collected. The dissertation was built so that it tried to address issues of omitted variables, selection bias and parsimonious inferences. An in-depth case study allowed for thorough scrutiny of the causal chain within one country over a long period. Variables derived from competing theoretical speculations were tested side-by-side, conventional as well as alternative theoretical arguments. The causal analysis and descriptive inference in this dissertation was strengthened by triangulation of the collected data. Information collected from the semi-structured interviews was compared with information collected from the written material so that respondents would not wrongly indicate the existence of ideas or their possible influence during the processes of policy making and adoption in Georgia.

Reliability, i.e. replication of the analysis by other researchers, is ensured by describing methodological choices and trade-offs. However, this does not mean that in cases where other researchers obtain similar data they will reach the same results by default. Finally, the issue of the generalizability of the analysis is addressed in Chapter 8.

Chapter 5

Georgian Tax Policy Making at the Dusk of the Soviet Regime

The reasons for scrutinizing Georgia in the in-depth case study were discussed in Chapter 4. I now seek to unpack the causal chain of a public policy arena transnationalization where ideational policy change takes place over a period spanning more than a decade, namely from early independence in 1991 till December 2004. The following questions are answered through the Georgian case study: Did a public policy arena transnationalization occur? Do ideas cause policy change and if yes, how can they lead to tax policy formation and subsequent reforms in post-Soviet Georgia? I have divided the Georgian case study into three chapters, each covering three chronological time periods. The reason for this division is the dissertation's focus on tax policy, its making and adoption. Each chapter's empirical analysis addresses the processes of policy making in Georgia. Note that Georgian tax policy is understood in all three chapters as the tax legislation including tax codes, relevant amendments and tax policy initiatives (such as a tax code project).

This chapter concentrates on the processes before the first tax code was adopted in the summer of 1997. Chapter 6 picks up on the narrative of the Georgian tax policy making and change after the adoption of the first tax code till the Rose Revolution when Edward Shevardnadze was replaced by Mikheil Saakashvili. The chapter scrutinizes the tax code amendments and the tax code project known as Orvelashvili's Code and aims to uncover the factors that led to the policy initiatives and shifts in policy ideas. Finally, Chapter 7 discusses the processes during December 2003 till December 2004 when the new government initiated and adopted a second tax code. In all three chapters competing theoretical propositions are tested to uncover the causal mechanism behind the tax policy change. The overall goal is not to discard the importance of IMF conditionality in the post-Soviet states or the importance of domestic factors and interests of the policy actors to change public policies. Rather, the aim is to support the claim that a third mechanism – ideational policy change – can also lead to policy making and change in post-Soviet states, including Georgia. How this works is scrutinized in the following three chapters.

5.1. What Does this Chapter Investigate?

This chapter tells the story of Georgian tax policy making from the early period of the Soviet Regime collapse till the first tax code adoption in 1997. The ambition is

to unpack the complex process of tax policy making and its subsequent change in Georgia. The goal is to test the theoretical expectations spelled out in Chapters 2 and 3 (see Tables 2.1 and 3.2 for a summary of the theoretical expectations) in a within-case study through the process tracing method. This will allow me to examine the causal chain which previous chapters were not able to illuminate, and it may provide more evidence that supports or rebukes the main argument of this dissertation.

Throughout the analysis and the reconstruction of the Georgian tax policy change narrative this chapter has to provide evidence on two main theoretical speculations to support the transnationalization of public policy argument. One is to prove, within the realm of the transnationalization literature, that the two-level game is replaced by a multi-actor, multi-level game in policy making in Georgia. In practical terms, this means that one has to prove that policy change was not solely externally imposed and did not only take place among state and external actors, and that the policy change process involved multiple actors including state, non-state and international organization representatives. The second challenge, which it is crucial for the main argument, is to prove, that ideas matter and that they under certain conditions account for the tax policy making and adoption in Georgia. It is also crucial to prove that policy change was a result of an internalized policy idea(s). In other words, not all ideas lead to change; only those that are accepted and internalized by domestic actors and ideas that keep being supplied by external actors directly or indirectly throughout the policy change process. The theoretical speculations have to be proved or disproved over the course of a policy change which is here conceptualized as consisting of three phases: policy learning, policy development and policy adoption. Moreover, the conditions and the phases of policy change when those ideas matter will here be uncovered in the case of the Georgian tax policy change process.

The way Chapters 5-7 are structured is inspired by John M. Owen (1994), a fine example of using process tracing to explore complex historical events with the aim to test theoretical expectations. Owen (1994) takes a deductive approach to process tracing and empirical analysis and starts by either supporting or refuting the stipulated and operationalized theoretical speculations. In this chapter, I structure the empirical analysis according to the theoretical speculations summarized in Tables 3.2 and 3.3. Statements that support or reject the presence of the theorized factors in the Georgian tax policy making process are written first and the supporting material to the statements follows in the text. However, the order in which I tackle each theoretical speculation is not necessarily the same as in the tables mentioned above. Hence, one should expect a narrative of a tax policy evolution in Georgia which tests theoretical speculations throughout.

Section 5.2 sets the scene for some political and economic developments in Georgia during the period of 1991-1997. Sections 5.3-5.11 test the competing theoretical expectations, and Section 5.12 summarizes the findings.

5.2. Georgia's Quest for Independence

Table 5.1: Chronology of the main developments in Georgia 1991-1997

1991	The Soviet Regime collapsed
1991	Georgia announced independence and appointed the head of the State, Zviad Gamsakhurdia
1992	Coup d'état overthrows Zviad Gamsakhurdia and a military council takes over the responsibilities of the ruler
1992-1993	Separatist war in Abkhazia
1994	First payment is transferred to Georgia from IMF and WB
1995	Presidential and Parliamentary elections are held. Edward Shevardnadze is elected President
1995	The Georgian national currency, Lari, ^a is adopted
1995	The Georgian constitution is adopted
1996	IMF has introduced a modular tax policy 'Taxastan' to Georgian policy makers
1997	The first tax code of Georgia is completed, adopted, and enforced

a. Georgian currency Lari is interchangeably used in this dissertation with GEL.

In April in 1991, the Georgian Supreme Council announced Georgia's independence after 70 years under Soviet Regime. Alas, the awakening of Georgia did not progress smoothly. Extreme economic and political hardships followed, engulfing the country in a separatist war in Abkhazia, civil war in the capital city of Tbilisi, a self-imposed economic blockade with Russia, and an absence of a state budget during 1992-1993. A coup d'état was masterminded by a military council, which in December of 1992 overthrew the first elected President of Georgia, Zviad Gamsakhurdia. A new state leader, ethnic Georgian Edward Shevardnadze was invited by the Council. He had 30 years of high ranking positions in the Soviet State and an international reputation as a democrat as he supported the demolition of the Berlin Wall during *perestroika* (Dadalaui and Johannsen 2009). However, he did not yet have a strong political basis in Georgia. He was dependent on the goodwill of the Military Council members and had to tolerate a thriving criminal situation that kept the state formation process pending (ibid.).

Less than two years after independence, the Georgian state was politically and economically bankrupt. Tax collection was so poor in the country that general revenues to GDP in 1993 in Georgia were only 2.3%, the lowest ranking among Commonwealth of Independent States (Tanzi 2001:68). External trade

reduction and supply shortage led to the small external revenue flows into the country. The economic policy set by Zviad Gamsakhurdia's government was a type of socialist capitalism with minimal privatized state assets and maximum state involvement in the economy (Gurgenidze et al. 1994:280). It was an enormous task for Georgian politicians to revive reforms to form a market economy and build the political institutions necessary in a democratic state (Papava 1995). The international community was taking its time and waited for the political dust to settle in Georgia. The dire need for financial resources and policy advice was not met until 1994 when the IMF and the World Bank started to fund the Georgian government by supporting structural reforms within the country (Papava 2002). Slowly, other international organizations emerged as contributors to Georgia's struggle to reform its economy and build its political institutions. Meanwhile, multi-party parliamentary elections along with the presidential elections were held in 1995, which provided broad political legitimacy to Shevardnadze's rule and helped him consolidate his political power. Through intrigues and well-planned strategic moves, Shevardnadze managed to weaken his political rivals (Dadalauro and Johannsen 2009). The Georgian constitution came into being that same year and the country began to take shape as a state by forming and affirming its political institutions. At the same time, economic policy making was in full swing, including the formation of a legal basis for the tax system. The policy making process was complex and incorporated various actors and policy preferences. To stick to the main goal of this chapter let us investigate all the building blocks of the process as conceptualized in falsifiable theoretical propositions discussed in Chapter 4; first, the source and availability of tax policy ideas in Georgia.

5.3. Ideas Matter in Policy Change: True or False?

To influence processes of policy making or policy change in general, ideas need to exist and be available to the policy actors (Campbell 2002). In the early transition period tax policy ideas were limited in source as well as availability to the Georgian policy actors. Precedents of successful economic policy reforms among post-Soviet countries were missing (except the Baltic States); economic reform projects funded by international organizations were running slow and in the economic policy area the IMF was the dominant actor among various international organizations. Finally, the number of international organizations and their cooperation beyond the state institutions were limited, which hindered the spread of new policy ideas.

5.3.1. Source of Ideas

The source of ideas flowing into the Georgian policy arena consisted of policy advice from foreign experts to the Georgian government under technical assis-

tance with political and economic structural reforms. International organizations, such as USAID, WB, IMF, EU and UNDP, provided information on policy making processes to domestic decision makers. Their scope and the extent of their activities in Georgia varied, and so did their resources and power to influence reforms. For instance, IMF was directly involved in tax system *re*-formation in Georgia, while USAID and WB contributed indirectly to the fiscal policy reform. Their focus was broader and aimed to help private sector development in Georgia. The EU and UNDP aided the Georgian government with policy advice and funding, but played only a marginal role in the early economic policy formation (Interview 1, 2, 3, 6). However, the organizations shared the following two pillars: (1) they were resourceful in terms of knowhow (on how political and economic systems in capitalist or other reformed states operate and what processes reforming countries have to go through) and (2) finances (their funding was crucial in countries like Georgia where tax collection was low).

The first international organizations in Georgia were IMF and WB. Georgia joined IMF on May 5, 1992 and it has provided substantial financial and technical assistance to Georgia's economic transformation and recovery since then (Branco 1996). Financial support was provided in three types of credits and loans: systemic transformation facility, a stand-by arrangement, and an Enhanced Structural Adjustment Facility arrangement (the latter was granted in February 1996) (Branco 1996). The first program approved and financed by the IMF in Georgia was under the Systemic Transformation Facility in mid-December 1994 (Wang 1999:9). The first funding amounted to 44 mil USD (IMF 1995). The terms were agreed along with IMF staff and the Georgian government as was the target of the anti-crisis program where reduction of fiscal deficit elimination, expenditures, and elimination of budget subsidies to state-owned were included (Papava 1995). The increase of the drastically reduced revenue collection was achieved through tax rate hikes and improvement of the tax administration (Wang 1999:9).

Georgia joined the World Bank in 1992 and the International Development Association (IDA) in 1993 and the residence mission office opened in Tbilisi in 1996 (IMF 2001a:37). In June 1994, five WB missions visited Georgia to study project opportunities for economic revival, aiming to allot 100 mil USD to that cause (GC, June 1994, Vol. 3, No. 6). Two months later, WB provided 15 mil USD in Municipal Credit to modernize water supply systems in the cities of Poti and Batumi and to assist in education and healthcare system reforms in Tbilisi (GC, August 1994, Vol. 3 No. 8). The WB has focused on institutional restructuring that, in the long run, would aid macroeconomic stability in the country. The WB has provided technical assistance to the Georgian government in the areas of privatization, health, education, the financial sector, social safety net, land reform, energy, legal reform and trade (IMF 1997). Implementation of the government's structural reform programs in energy, agriculture and public expenditure sectors

moved forward in 1997 (IMF 1998). From 1994 up to 1997 Georgia already accumulated a debt from WB amounting to 233.7 mil USD (IMF 1998:93). Unlike IMF, WB has not emphasized fiscal policy in its structural adjustment lendings as a priority of its work in the country. However, it has promoted business sector and structural adjustment reforms that indirectly supplemented the economic reforms and the tax system reform as well (Interview 1). The IMF and the WB were working hand in hand and IMF's evaluations on Georgia's economic soundness has often provided the basis for further cooperation and funding from WB with the Georgian government.

The other external actors, such as the European Union, were less involved with CIS countries and their efforts to build economic and political institutions at the early stage of the transition processes (Papava 2005). From 1992 to 2006, the EU supported Georgia through various programs, mainly development assistance. In the early 1990s, basic humanitarian aid and food assistance were added to the EU programs. EU-TACIS provided technical assistance to the National Bank of Georgia to develop a modern, efficient payment system in 1997 (IMF 1997a). Equally large international organizations with strong humanitarian and development profiles, such as UNDP, have only played an insignificant role in Georgia's economic policy reforms, although the UNDP was involved in state institution restructuring since the mid-1990s (interview 5, 6). Moreover, the UNDP has provided technical assistance along with the OECD in national income statistics reform in 1997 (IMF 1997a). USAID has also provided humanitarian assistance and coordinated distribution of American aid in Georgia. Moreover, it carefully studied the economic reforms and had funding projects in this direction. In February of 1995, USAID was coordinating humanitarian aid amounting to 97 mil USD (GC, February 1995, Vol. 4, No. 2). As mentioned, the international organizations referred to here as external actors contributed to the economic and political reforms in Georgia, but the IMF played the leading role in fiscal policy (Interview 2).

Ideas as precedents of successful reforms were in short supply in the post-Soviet countries. More or less all CIS countries were struggling to overcome economic hardships brought on by the regime change. Most of them fell in despair and struggled with the low economic growth that increased the level of poverty (Hellman 1998). Politicians' rent-seeking behavior and stripped state assets sold among political elite members in post-Soviet countries gave little room for imitating success. The Baltic States chose a different path and pursued accelerated economic and political reforms (Johannsen 2002). Even the IMF had differentiated its policy recommendations to the Baltic States and the CIS countries. For instance, the IMF approved the Baltic States' choice to leave the ruble zone early in 1990s, but encouraged the CIS countries and Georgia in particular to remain in the ruble zone. The argument was simple: it was much easier to deal with one type of currency for the Fund, rather than to deal with 12 different currencies if all

CIS countries would adopt their own money (Papava 2002). The Baltic States were quick to embrace new tax policy ideas which were later referred to as a policy precedent among CIS countries. Yet, there is no evidence that domestic or external policy actors referred to the Baltic States as a success story and a possible model for reforms in the process of economic policy crafting in Georgia. The post-communist world could choose between two models for economic reforms: a slow and gradual model and the 'big bang' model based on the famous shock therapy doctrine.³⁶ Technically speaking, domestic actors could choose between these two models, but in the Georgian case, it was made clear that the IMF favored the 'big bang' approach and not much time was spent rationalizing the alternative to the shock therapy model. It was adopted and pursued in Georgian economic reforms since the early 1990s (Papava 2002).

5.3.2. Availability of Ideas

Availability of ideas from foreign consultants in the Georgian policy arena was limited to individuals working within these international organizations or the state agencies to which foreign consultants were assigned. For instance, IMF consultants providing technical assistance to the Ministry of Finance while working on tax policy creation were placed within the Ministry of Finance, where they had offices and several local experts assisting them in policy elaboration. The crew working tightly with the foreign experts was small and the extent of spreading expert ideas was limited as well. One such IMF expert on tax policy, Victor Turony, an Adjunct Professor of Law at Georgetown University and Senior Consultant in Taxation at the International Monetary Fund, worked in an office in the Tax Revenue building. Turony provided his expertise to the Georgian government during 1997-1999 (Interview 4, 18).

An incident related by of the interviewees demonstrates the limited access of the broad public to the foreign experts and their reports in Georgia and the limited spread of new ideas in the country. One of the Georgian entrepreneurs, who is also a politician, has been representing business interests in the Parliament since 1999 (Interview 14, 25). Since the early 1990s he had been actively involved in Georgia's economic policy creation as a representative of an entrepreneurs' association called Large Taxpayers Union. Regardless of his personal contacts with the political elite and decision makers, he stated that the IMF experts' recommendations or reports were difficult to obtain and not publicly available. In an interview, the politician told a story of how he had managed to have the IMF reports sneaked out from the Minister of Economy's office to copy and read them,

³⁶ On shock therapy vs. gradualism as the speed of a process of liberalization in transition economies, see Popov (2007); for further reading on the positive aspects of the shock therapy, see Åslund (2007), and for failures in meeting the 'doctrine' of a shock therapy in case of Georgia, see Papava (2002, 2005).

just to understand what IMF recommendations were given to the Government during 1995-1996 (Interview 14). The fact that the IMF kept the reports locked away in a cabinet and was not willing to show them to this particular politician does not mean that they were secret documents by default. Yet it does demonstrate two facts: IMF recommendations to the government were voiced as important by domestic decision makers and they were not easily available to the public. The latter limited the spread of ideas in the Georgian policy arena, making it difficult for new ideas to reach a broader spectrum of policy actors.

5.4. Policy Coalitions

Nonetheless, there were policy actors in Georgia who formed a policy coalition and elaborated the first Georgian tax policy in 1996-1997. They were united by a common goal – creating a tax code that was more of a common policy issue, rather than an idea shared by coalition members. At the same time, the policy coalition had an overarching modular tax policy document – ‘Taxastan’ – introduced by the IMF. It was used by the coalition as the frame and source of policy ideas when it wrote the first tax code of Georgia. The actors agreed that a new tax code was necessary, because this was the IMF’s policy recommendation and funding for reforms depended on the fulfillment of this conditionality. The idea of creating one whole document as a tax code that would provide a legal basis for a tax system came from the IMF in its policy recommendations to the Georgian government in 1994. In August, an ad hoc Commission for Economic Problems was created by President Shevardnadze. He appointed Vice-Premier Temur Basilais as head of the commission, challenging him to make sure that the IMF recommendations were followed when Georgia’s economic policy was created, especially the tax code (GC, August 1994, Vol. 3, No. 8). The Commission for Economic Problems was closely collaborating with the newly appointed Minister of Economy, Vladimir Papava.³⁷ Both Basilais and Papava were known for their pro-reformist stances promoting pro-market policy principles when tackling economic problems. This was in contrast with the political forces in Georgia which represented a Soviet nomenklatura³⁸ and were harsh critics of the IMF policy recommendations. The Union of Industrialists had a strong anti-IMF political stance among policy actors in the Georgian policy arena. This Union was created in 1990 by medium-size enterprises which, after the Soviet collapse, continued to harbour non-reformist minded nomenklatura members (Jones 2000). Regardless of their attempts to get their voice through during the tax code elaboration

³⁷ On June 24, 1994 Lado Papava, director of the Institute of Economy, Academy of Sciences, was appointed Minister of Economy (GC, June 1994, Vol. 3, No. 6).

³⁸ Nomenklatura was a small elite group of high ranking officials in the Soviet Union (see Wheatley 2005).

process, evidence shows that the policy coalition working on the new tax code successfully ignored the Industrialists' policy concerns (Interview 14). The evidence suggests that the policy coalition was dominated by the IMF policy prescriptions and the Georgian counterpart, the Ministry of Finance, was closely collaborating with the IMF tax policy experts (Interview 4).

5.4.1. The Process of Georgia's First Tax Code Making and the IMF's 'Taxastan'

When the policy coalition started to work on a Georgian tax code, the legal frame of the tax system consisted of separate laws on taxes on excise, VAT and income.³⁹ Yet, the IMF saw the tax code as an important part of tax system forma-

³⁹ The Georgian government introduced different forms of taxes brought along by the new economy and private ownership: income tax, VAT and excise tax. VAT rate ranged from 28% to 14% when first introduced but was finally set at 20% and constituted 16.7% of the total revenue in 1993 and 52.3% in 1994 (Papava 1997a:43). The laws on separate taxes were created by the Budget and Finance committee of the Parliament chaired by Taniel Glonti in 1991 (Interview 22). The economic policy was led by the economic group created under the president and chaired by Vice-Premier Roman Gotsiridze, who mostly initiated all economic reforms at the early stage of the liberalization process (Interview 22). However, in September 1993 the Vice Premier was replaced by former President of the Caucasus Exchange, Amiran Kadagishvili, and David Iakobidze, an academic economist and former deputy to the President of the Caucasus Exchange, became Minister of Economy (GC, September 1993). From 1992 to 1997, till the first tax code was adopted in Georgia, the legal frame of the tax system consisted of separate laws on new tax types adopted in December 1993 (some sources say it was adopted in 1992 (Papava 1997a:30)).

In December 1993 a package of laws on taxation was presented by the Finance and Budget Commission. On December 4, Bill on the Principles of the System of Taxation was passed; on December 23 and 24, the rest of the package was adopted, containing the laws On Enterprise Property Tax, On Enterprise Profits Tax, On State Taxation Service, On Excise and Surplus Value Taxes, On Real Persons' Property Tax, On Real Persons' Income Tax. These laws were adopted in an unusual spirit of cooperation between majority and opposition. As it was generally assessed, the new system of taxation was rather liberal and intended to encourage private business. The only point of debate was tax control: as Chief of the Control Chamber R. Shavishvili stated, the responsibilities of his office had not been clearly delimited from those of the Inspection Board of Taxation (GC, December 1993).

The tax policy changes from 1994 to October 1997 covered 27 tax policy amendments mostly on excise and VAT; in some cases, they concerned exemption reductions on profit and small income in 1996, including the unification of the profit tax at 20% in January 1997 (IMF 1998:38-41). Though before profit tax rates were differentiated, bank profit was taxed at 35%, industrial enterprise profits at 10%, and the remaining enterprise profits at 20% (IMF 1998:15). The policy changes' inventory and net revenue impact were at first estimated to be positive though declining over time. During the three year period, policy changes concentrated more on tax rate increases and rather little attention was paid to tax base enlargement. However, after 1995 when the tax rate increased and the tax base was enlarged and thus somewhat balanced, the base en-

tion in Georgia. Not only did the IMF impose a conditionality on the creation of a tax code on the Georgian government, it presented a clear policy proposal. In 1996, the IMF representative introduced a modular tax policy document called 'Taxastan' to be used as a guidebook by CIS governments when creating their national tax codes (Interview 22).

'Taxastan' referred to a hypothetical country and the document was meant as a reference rather than a standard in the Commonwealth of Independent States (IMF 2002). The document contained all national taxes but did not touch upon the distribution of authority in tax collection among the national institutions, as it was the issue of the constitutional arrangement of the individual CIS countries (IMF 2002). 'Taxastan' contained 40 chapters and 271 articles covering national tax types such as income tax on legal and physical persons, excise, value-added tax, social insurance contributions, tax on commercial minerals, property of enterprises, ownership of vehicles, taxes on small enterprises and local taxes (IMF 2002). Moreover it defined the concept of tax. For income tax, it specified who a taxpayer is and what is considered an income tax payable by either a physical or a legal person. Interestingly, while allowing personal deductions and exemptions in the physical person's income, the guidelines provided a blank scheme of possible tax rates on the personal income tax. While not suggesting exact tax rates on the income tax, the table showed the progressive income tax system as a tax scheme. There was no hint of a set tax rate – known as a flat tax type – in the document. In fact, some claimed that the IMF did not support the idea of a flat personal income tax rate,⁴⁰ which was a theory in the early 1990s. Corporate income tax was identified as a profit tax and no rate was provided in

largement efforts intensified by 1997 (IMF 1998:38). In the pre-tax code adoption period the main weight of the tax policy was to aid budget deficit reduction by the Georgian government (IMF 1998:35). The laws on personal income tax established a progressive personal income tax system from the very beginning. The income tax rate up to 1993 was 50%, which was reduced to 20% and constituted 32%, 31% and 12% of the total revenue in 1992, 1993 and 1994 respectively (Papava 1997a:46). The standard deduction applied to all income taxpayers until June 1996 was 3.5 Laris per annum, though it increased to 108 Laris per annum which equalled 9 Laris per month (IMF 1998:77).

⁴⁰ In April 2009 during the interview, the Georgian economist and former Minister of Economy in the mid-1990s mentioned that it was he who tried to introduce the idea of a regressive, flat type personal income tax as early as 1991-1992. He said that the flat tax idea was well known among those acquainted with economic theory, including himself. The economic theories that developed the idea of the optimal tax system in western countries were not widespread among post-Soviet policy makers in the early 1990s. At the same time, this idea of a flat tax introduction in Georgia was not backed by the IMF. The argument for not supporting it seemed dubious: the IMF stated that the progressive income tax system was fairer and once it was already in place, it should have been retained regardless of tax rate changes in the system (Interview 22). However, the IMF prioritized implementing urgent fiscal policy measures to reduce the budget deficit and harness a skyrocketing inflation. I was not able to verify this information.

the document either (IMF 2002, article 15). With the 'Taxastan', the IMF had provided an overarching frame for the tax policy with specific parts missing as the details had to be discussed and provided on a case to case basis in the CIS countries (IMF 2002, article 16). However, it contained essential components that modern a tax policy had to have to match western standards (Papava 2002).

The process of the tax code elaboration did not involve the broad public. Local and foreign tax experts worked on one document while the working language often changed between Georgian, Russian and English. The policy actors working on the tax code project saw this as a shortcoming and blamed the many translations for the frequent misunderstandings in the text. The result was that the content of the overall tax code was difficult to comprehend even for tax experts (Interview 4, 14, 24). Several experts involved in the processes of the tax code elaboration and adoption have revealed to me that it was all clear to the Georgian decision makers that a tax code had to be created and adopted because this was what the IMF was willing to have. One of the local experts who, in 1997, represented a state agency involved in setting Georgia's economic policy route stated:

IMF forced a tax code on Georgia ... This modal tax code was translated, 'Georgianized', and harmonized with the rest of the legislations ... IMF provided technical assistance and had an alliance with the Ministry of Finance. The prepared code was sent to the Ministry of Justice and other ministries, Parliament, businesses ... All were discontent with the code. There was a conditionality from IMF to adopt a new code and nobody rejected it (Interview 22).

The policy coalition contained actors who criticized the Tax Code but did not object to its adoption in its final version, because policy actors agreed on one issue – this was the only way to ensure the IMF funding which was so needed to rebuild the wretched economy. Non-adoption was a very small option, if an option at all. By then the legal frame of the tax system consisted of separate laws on taxes on excise, VAT and income. The policy coalition working on the text of the first tax code consisted of Georgian as well as foreign experts.

It seems that during the tax code drafting domestic business representatives, particularly industrialists, were not involved in the process. Their dissatisfaction with the close cooperation between the government and the IMF, which did not allow local business interests to be heard in the tax policy making process, was also mentioned to the Head of the IMF Mission, Shadman Valavi on March 6, 1997 (GC, March 1997). A representative of the industrialist group confirmed this during an interview (Interview 14). The Georgian Chronicle describing the political processes in March 1997 stated that:

At their regular March 17 meeting, the VIPs of domestic business accused the government of being the puppet of the IMF in its policy to make Georgia a place of

realization of overproduction from industrially advanced countries at the expense of suppressing national enterprises through a burdensome taxation policy (GC, March 1997:5).

The 1997 tax code was largely discussed among ministries, entrepreneurs and the parliament and no one was completely happy with the content (Interview 22). The Ministries of Economy and Finance disagreed on specific parts of the tax code. As a representative of the state institutions and experts in the economic matters noted, the tax code draft discussion among the state agencies was a mere façade as it was predetermined that the code would be adopted and most of the recommendations from ministries or interests groups were ignored by the government. The same expert stated that: 'The process of tax code discussions in 1997 was a staged theater because no comments from the ministries were adopted' (Interview 22). The process was underway within the close collaboration with IMF. The IMF representative has confirmed that the IMF was an important actor in the initial tax policy creating process. So did the representative of the Industrialists' group, which was on the sideline of the process and had little impact on the policy making in general. A Georgian politician representing business interests in the Parliament stated that:

IMF entered Georgia, and it started to implement its own policy. I and my political party are big opponents of that institution and always have been. It stated that its policy was to aid Georgia and to finance activities of economic reform, including tax system reform. And we were in opposition to them ... When a new code was being written, when we were giving recommendations, and IMF was giving recommendations there was no discussion. The government would just say, oh, IMF is saying so, IMF said so and so ... (Interview 14).

The IMF even suggested the deadline for adopting a tax code – June 1, 1997 – and the Georgian Parliament aimed to keep the deadline.⁴¹ The first tax code was presented to the Parliament as the Presidential initiative on February 6, 1997. It contained 20 sections, 60 chapters and 577 articles in total. The President's legislative initiative was based on five goals for the tax code: to aid the establishment of a unified and stable tax system, a unified legal base for the tax system, a reduction of the existing tax burden, a sophistication of the sanctioning system for

⁴¹ The parliamentary debate on the bill 'On Value Added Tax' (March 4-7) was marked by lobbying for tax privileges for importers of oil, pharmaceutical supplies and cereals. The bill exempted from VAT Georgian transit fees, reimport operations, and publication and distribution of press materials. In line with IMF recommendations, the bill expands the list of economic and business-like activities subject to VAT. The bill also systemizes the rule of VAT calculation, and imposes VAT on non-resident physical and legal entities operating in Georgia. The bill which was approved by the second reading is expected to be put in effect no earlier than June 1, 1997 – the IMF-fixed deadline to have the new tax code completely approved' (GC, March 1997).

violation of tax rules, and, finally, improvement of the tax administration system (General Principles of the Tax Code, Parliament of Georgia 1997).

5.4.2. Parliamentary Discussions and Adoption of the First Tax Code

The first discussion of the parliamentary session confined itself to introducing the tax code project's main principles. During parliamentary discussions, VAT and excise taxes caused harsh debates mostly among entrepreneur lobbyists (Interview 18). However, with the involvement of the IMF and its conditionality, the bill on VAT was adopted in March 1997. On April 18, 1997 a detailed discussion followed on the articles and terms. The definitions of terms such as resident, income, individual as an entrepreneur were the dominant theme. Also inclusion of income in the form of grants, pensions, scholarships and tax exemptions on the vulnerable were discussed. During the discussions it was revealed that the progressive income tax system was adopted on December 27, 1996. However, it was not clear why those four brackets of the personal income tax rates were chosen, on what calculations they were based or by what rationale, and why the income differentiation was made on those amounts. Parliamentarians expressed their discontent with the brackets, which to them led to hiding income and taxing the poorest (Georgia Parliament, March 18, 1997). Parliamentary discussions took up the tax code project in May 1, 1997. The first tax code of Georgia was finally adopted on June 13, 1997 and enforced the same year.

The corporate income tax rate was set to 20%. The personal tax system was progressive and had four brackets ranging from 12% to 20% depending on total annual income. Table 5.2 illustrates the brackets and taxable income in details.

Table 5.2: Marginal tax rates of personal income tax in Georgia

Annual income		Marginal rate (%)
1994-1996	1997-1998	
Less than Lari 10	Less than Lari 200	12
Lari 10-20	Lari 201-350	15
Lari 20-30	Lari 351-600	17
Lari 30 and above	Lari 601 and above	20

Source: IMF 1998:77.

Some experts observe that Georgia's first tax code was actually forced onto the country by the IMF which made funding conditional on its adoption. Therefore, the tax code was adopted as it was, and no one actually rejected it (Interview 22). The IMF approved the adoption of a new tax code and the creation of one whole document instead of separate legal acts.

The approval of the Tax Code of Georgia in June 1997 served to rationalize the tax system by bringing all tax legislation together into a single legislative document from 29 separate legal acts – the Georgian authorities worked closely with Fund staff legal experts in drafting the Code. The Code came into force progressively and by January 1998 was fully in force. The Code also broadened the tax base by eliminating some exemptions (although many remained, particularly under the VAT), defined taxpayer rights and obligations clearly, and reduced various excessive tax penalties introduced during an earlier period of high inflation (IMF 2001b:25).

The process of the first tax code creation in Georgia demonstrated that the policy coalition shared a policy vision and worked together based on consensus, i.e. the understanding that the Georgian tax code had to be in line with the 'Taxastan' policy principles and that non-creation and non-adoption of a tax policy was not an option. The IMF emerged as one of the key actors of the process, with an interest in keeping the Georgian government in line with its prescribed policy recommendations in economic reforms. The macroeconomic soundness of Georgia and forming a pro-business economic policy were the overall goals of the IMF. State institutions retained a role of followers in this process with little say or leverage to oppose the IMF's conditionality. No evidence indicated participation by third sector representatives in neither the tax code elaboration process nor their importance during public discussions or parliamentary debates. Anti-IMF political forces only played a marginal role in the tax code creation process and government support to IMF recommendations did not leave much room for Industrialists to mould the tax code on their business interests.

5.4.3. Policy Actors and Their Policy Ideas

I will now summarize actors and their policy ideas to get a better grip on who was supporting what in Georgian tax policy making process. The elaboration of Georgia's first tax code involved various actors, such as state representatives, foreign experts and organizations, and some local experts as illustrated in Table 5.3.

Table 5.3: Policy actors and the policy ideas they supported during the mid-1990s in Georgia

Actors	Ideas
<p>External Actors</p> <p>IMF, WB, USAID, UNDP, EU</p>	<p>IMF was the leading external actor in defining the economic policy principles in Georgia, particularly in fiscal policy. It promoted a shock therapy doctrine in structural reforms and supported complex economic reforms in Georgia both financially and through policy recommendations. Other external actors followed the same line of pro-market, pro-business policy ideas and collaborated and enhanced the policy ideas spread under the shock therapy doctrine in Georgia.</p> <p>In tax policy, IMF supported ideas to eliminate exemptions and favorable tax rates to local businesses to broaden the tax base. There were no indications of establishing either a flat tax rate on personal income or anything eliminating or reforming a progressive income tax system incorporated in the first tax code in Georgia.</p>
<p>Domestic state actors</p> <p>Cabinet of Ministers, President, and Parliament</p>	<p>Economic ideas shared by the state actors in Georgia were split between protectionist, non-reformist ministers, pro-business parliamentarians and young, reformist-minded individuals such as the Vice-Premier, Minister of Economy, and parliamentarians such as the Chairman of Parliament and the head of CUG Zurab Zhvania.</p> <p>The President represented a generation of former nomenklatura members in the political establishment in Georgia. His outspoken support of IMF reforms made him look like a pro-reformist actor. However, due to his balanced politics his ideological stance sometimes gravitated towards non-reformist state actors in Georgia.</p>
<p>Domestic non-state actors</p> <p>Local experts, interests groups, e.g. the Large Taxpayers (the so-called Industrialists), and NGOs such as GYLA, YGEA, Horizonti, ICRD</p>	<p>Similar to non-reformist state actors, the Industrialists shared the idea of economic protectionism and opposed the shock therapy doctrine as well as the IMF policy prescriptions. The Industrialists tried to mould the tax policy to the domestic business interests by favoring tax exemptions. However, the rest of the domestic non-state actors in Georgia did not demonstrate a clear stance on economic ideas. In the process of Georgia's tax policy creation there is no indication of a clear, ideological stance.</p>

5.4.4. Gap between Reformists and Non-Reformists among Domestic State Actors

Policy makers in the Parliament and the decision makers in the Cabinet of Ministers were split between two camps: reformists versus former communist nomenklatura members. State enterprise managers had high stakes in the privatization politics and instead of assisting in selling out state property, they distorted the process. Joint-stock companies were instead created where ministries were holding the control package of shares. Among the ministers who opposed pro-market reforms was the Minister of Agriculture, who noted that Georgia was a unique country where privatizing lands was unacceptable (GC, September-October 1994, Vol. 3, No. 9-10). The Prime Minister, in the same line of thinking, allowed a

number of Cabinet decisions to be made for the sake of increasing the regulative role of the state, while the reformist Minister of Economy and Minister of Finance were attending the donor conference in Paris in October 1994.⁴² Non-reformist ministers opposed the implementation of Shevardnadze's decrees, thus hampering reforms and delaying liberalization. In the interview published in the newspaper *Sakartvelos Respublika* one of Shevardnadze's advisers, Henri Kupraishvili, said that 'out of 728 resolutions and decrees adopted by Mr. Shevardnadze so far 287 had been carried out with a delay and 99 had not been fulfilled at all' (GC, September-October 1994, Vol. 3, No. 9-10).

On October 21, 1994 aiming to correct those shortcomings, the Head of State issued a decree to create another committee, the Group for Prompt Analysis and Control of the Proceedings of the Economic Reform, chaired by one of Shevardnadze's advisers, O. Nikoleishvili. The new agency was commissioned to supervise enforcement of the decisions of the Head of State. Economic problems persisted as non-reformists ignored policy initiatives and engaged in a 'double game'. When, in November 1994, the government failed to fulfill the IMF condition on liberalizing bread prices, the Cabinet resorted to Shevardnadze's way of signalling their efforts to follow IMF recommendations. Based on this resolution, the Cabinet initiated a State Commission of Problem Management mainly aimed to ensure fulfillment of Shevardnadze's assignments (GC, November 1994, Vol. 3, No. 11). Reformist ministers voiced their frustration with their counterparts who favored the old way of organizing the economy. They also referred to the international financial organizations which, according to them, would not provide funding when Georgia failed to comply with their requirements.

Deputy Prime Minister Temur Basilia and Minister of Economy Lado Papava, reputedly the two most reform-minded figures in the acting Cabinet, spoke during their press conference of February 10 about obstacles on the way of reforms caused by certain conservative ministers. They demanded a profound reorganization of the government, including reductions in the Cabinet's staff. Mr. Papava also said that from the point of view of the World Bank, Georgia would not be able to use the allotted credits. The Head of State, however, stated that staff reductions do not mean much in themselves ... February 11-20, the Georgian official delegation headed by Deputy Prime Minister Temur Basilia negotiated in Washington DC with representatives of the World Bank. Having returned from the trip, Mr. Basilia stated that the World Bank would allocate \$75 mil in rehabilitation credit, instead of the previously planned \$60 mil, under quite preferential terms. At the same time, the World Bank required from the Georgian government a program of strategic co-

⁴² Prices on bread, gas and power were extremely low and the Cabinet did not allow liberalization. Several wineries were sold with the Cabinet's permission, but it is not known why and on what grounds the ones that were sold were selected. The state power company was transformed into a joint-stock company with 51% shares of the state (GC, September-October 1994, Vol. 3, No. 9-10).

operation. According to the BGI agency, the World Bank expressed its discontent with keeping control packages of shares of privatized units by the Ministries (GC, February 1995, Vol. 4, No. 2).

The relations of Vice-Premier Amiran Kadagishvili, supposedly in charge of economic reforms, and the rest of the Cabinet, as well as the leadership of the National Bank, continued to deteriorate. Mr. Kadagishvili accused the Cabinet of supporting administrative methods of economic management while paying lip service to the market economy. The process of privatization was still suspended and he was not able to push through his plan to reform the monetary policy. He stated that economic reforms would have no chance in Georgia unless the Head of State supported them. The latter, however, abstained from taking sides in the debate, limiting himself to a statement that 'all pros and cons were to be thoroughly weighed before taking any decisions on the monetary policy' (GC, November 1993).

While the gap between reformists and nomenklatura members were growing, on the surface the Cabinet retained the status as a consensual state organ where disagreements were not radical. The Cabinet issued a public statement on September 10, 1994 insisting '... that there were no disagreements in the Cabinet related to the issue of the reforms' (GC, September-October 1994, Vol. 3, No. 9-10). Although the words said differently, the actions proved the diverging policy preferences of the non-reformist decision makers. The initiatives that the *Georgian Chronicle* summarized demonstrate the 'double game' which non-reformist Cabinet members pushed for.

In its resolutions of July 20 the Cabinet approved the program of assistance for pig-breeding industries in Sagarejo and Gardabani districts for 1994-2000, which included requests of favorable credits; requested emission credits from the National Bank in order to boost the tea industry; passed regulations of the State Concern of Mining Metal Industry. In the same period the Cabinet commissioned the ministries to collect scrap metal and deliver it exclusively to the Sakmeolit state concern. Direct deliveries of scrap metal to the manufacturers need approval by the above agency. Mr. Shevardnadze himself also displayed a tendency towards excessive centralization and mixed up functions of state and party agencies when he said to the meeting of the Union of Citizens of Georgia on July 25 that control over the decisions of the Georgian-Russian economic conference (see details in the Economy section) should be assigned to a joint commission of the Cabinet, the Parliament and the Union of Citizens of Georgia. The May 26 decree of the Head of State on 'Regulating and Accelerating the Privatization Process' seemed to really boost the process. The Gulani newspaper reported that the number of state enterprises transformed into shareholders' companies tripled since the decree was signed. The ease can be explained by Mr. Shevardnadze's new philosophy to 'legalize the results of hidden privatization', when the right of ownership over state

enterprises in effect was transferred to their old-time managers (GC, July 1994, Vol 3, No. 7).

Frustrated with the fact that nomenklatura could not feel the wind of change when they had to follow the tune of international financial institutions, Shevardnadze once called his Ministers 'frozen minded' (GC, December 1994, Vol. 3, No. 12). They were neither open to market economy principles, nor willing to rationalize or accept new ideas promoted by international financial institutions. Reform-minded policy makers saw the need to accept conditionalities and at the same time possessed theoretical knowledge of economic theories which preached different models of economic organization.⁴³ A local expert who had participated in such processes before noted that very few actually understood what the IMF 'Taxastan' frame suggested and the few new concepts and all the nuts and bolts of the modern tax system in capitalist countries (Interview 2, 18, 22).

5.5. Conditionality

The creation of a new tax code in Georgia was the result of IMF conditionality. The Georgian state was receiving substantial credits from IMF and its external debt was growing (see Appendix 6 on IMF credits, and Appendix 5 on External debt of Georgia). The importance of the IMF as an influential policy actor in the tax policy creation process in the mid-1990s in Georgia was pointed out by various sources. Former government members (Shevardnadze's period politicians), as well as representatives of the IMF, NGOs and international organizations such as USAID confirmed the active involvement of the IMF in the tax code creation process 1996-1997. As one USAID representative described the IMF's role and organization, it becomes clear that the IMF did play a huge role in the process of tax policy creation in Georgia in 1996.

IMF had a very serious and large role in this process as it was controlling the revenue part of the tax policy, and whether it was a suggestion on reduction of the tax rates, or norms in the code on administering taxes were problematic, we could not do without the IMF's involvement and agreement. We were limited in our scope to give recommendations on tax policy by IMF and this was in fact an unofficial agreement with them. Every type of change that would cause reduction of a tax was taken in a negative way by IMF always. It was giving serious amount funding, supporting budget and currency and was controlling all very strictly and had powerful leverage ... They had their own representatives in the National Bank and also in the sector that would control the budget very tightly (Interview 2).

⁴³ The Minister of Economy was professor of economics and author of numerous scholarly articles and books on the economic transformation in Georgia, also assessing the role of the IMF.

While the country was broke and tax collection was very low creating huge budget deficits, the IMF provided financial resources to implement strict economic restructuring reforms, and offered technical assistance, advice and information to the Georgian officials, who by then were behind the wheels of the great transformation from a Soviet to a post-Soviet regime. At the same time, IMF was explicit in its expectations to the Cabinet of Ministers' activities and dedication to economic reforms. The language used by the IMF representatives was often firm and conditional. On several occasions when the IMF Mission representatives met with the President or the Ministers in Georgia, they presented their conditions to the funding, evaluated the achievements of the government reforms, and, when dissatisfied, did not shy away from saying it in an outright manner. For instance, on October 26, 1994 when the head of the IMF Mission, Shadman Valavi, met with Prime Minister Patsatsia, he said outright that the Cabinet was not fulfilling IMF's recommendations and in order to obtain finances from the Fund the situation had to be remedied urgently⁴⁴ (GC, September-October 1994, Vol. 3, No. 9-10). In a follow-up meeting with the President in November, 1994 Shadman Valavi listed conditions that Georgia had to meet to get IMF funding, including a 40% raise of the price of bread, restructuring of debts, slowing down the pace of inflation, diminishing the share of state-sector shares in the national economy, and creating a legislative basis for the market economy. This meeting preceded the donor conference in Paris on November 19, 1994⁴⁵ (GC, November 1994, Vol. 3, No. 11).

The demanding tone of the IMF representatives continued before the tax policy adoption as well. The Head of the IMF delegation, Shadman Valavi, when negotiating the pace of Georgia's financial-economic policy with the with Georgian officials

⁴⁴ At the same meeting, Shadman Valavi mentioned that the Georgian government's plan to sign a contract with Iran on the supply of natural gas ran counter to the interests of the IMF and that the US government would be particularly displeased with it (GC, September-October 1994, Vol. 3, No. 9-10). After three months, in December 1994, Shevardnadze, when summarizing the revival of financial-economic achievements of the GoG in the light of IMF and WB recommendations, also mentioned that Georgia aimed to improve its natural gas supply by attracting foreign investments in that field (GC, December 1994, Vol. 3, No. 12). This was an indication that IMF's discontent with the Iran-Georgian gas supply agreement was taken into account.

⁴⁵ 'On November 19, a Georgian delegation headed by Prime-Minister Patsatsia went to Paris to take part in the meeting. During the conference where Georgia participated as a recipient-country, it was decided that the World Bank would allot Georgia \$60 mil as a rehabilitation credit; the European Community \$31 mil and 200,000 tons of grain; Japan \$2 mil; the Netherlands \$3 mil; France 10 mil francs; Germany DM 27 mil. The total sum to be allotted in 1995 was \$274 mil, but if the economic reform succeeded the sum might be increased to \$436 mil' (GC, November 1994, Vol. 3, No. 11).

... stressed that if the government failed to improve its tax collection record for January-February, amendments to the law on the state budget would be inevitable. He also negatively assessed the government's attempt to revive the Ministry of Industry and criticized the Customs Department for its delay in submitting a proposal for its IMF-funding technical reorganization. The IMF delegation also demanded that Georgia replace the inefficient staff of the directorate of one of the biggest state-commercial banks Agrobanki. Mr. Valavi demanded that all tax-privilege decisions be made in conjunction with the IMF. He recommended the government reconsider the existing list of goods destined for VAT exemption (GC, February 1997).

Although the IMF had been funding programs in close collaboration with the World Bank, it remained the core actor scrutinizing the macroeconomic stability of the country and relevant policy changes. While IMF's core focus was the macroeconomic policy, the World Bank was dividing its expertise, finances and projects in the economic sphere by allotting rehabilitation credits (at the donor conference in Paris in November 1994, WB agreed to provide 60 mil USD to the Georgian Government) as well as healthcare and education systems (Interview 1, 2, 18). When discontented with the efforts of the Georgian government, representatives of the World Bank, like the IMF delegations, were explicit that their funding was conditional on the performance. The Georgian Chronicle describes two examples of the WB's firm tone with Georgian officials in December 1994 on two occasions:

During their meeting with Vice-Premier Temur Basilia on December 16, the World Bank delegation visiting Georgia expressed its discontent with the failure of the Georgian government to collect payments for consumed electric power. The rehabilitation loan which was given to Georgia was conditioned on transforming the energy department, gas department and grain-products department into joint stock companies. At a meeting with Georgian Ambassador to the USA Tedo Japaridze in Washington DC, the Executive Director of the World Bank, Mr. Hepkins told him that the foreign aid program for Georgia would be specified only after the establishment of reform-minded people in the Georgian government (GC, December 1994, Vol. 3, No .12).

Based on the evidence, Georgia was susceptible to the external pressure of conditionality as its external debt and reliance on IMF credit were growing. IMF played the dominant role in the economic policy directions in Georgia in the mid-1990s, and we can conclude that the creation of a new tax code was largely the result of IMF conditionality.

5.6. Domestic Structural Factors: Budget Deficit and Low Tax Level

This conclusion allows us to reject the theoretical speculation that domestic structural factors are the primary cause of the Georgian tax code creation and adoption in 1997. The domestic factor approach would focus on Georgia's state budget deficit or merely the elite's and the government's hunger for funding and an urgent need to raise revenues to improve public financing and provision of public goods. While the IMF's policy advice aimed to help the Georgian government restructure its economy and improve macro-economic indicators, it was difficult to argue, based on documents and interviews, that structural factors were not considered in speculations or policy elaboration processes at all. Adopting common tax legislation based on the modern tax system principles (i.e. *Taxastan'*) could have enabled better tax collection in Georgia. But this argument was rarely present among the domestic actors. Addressing the difficulties in budget and tax collection was part of the economic restructuring policy that IMF was supervising in Georgia and helping the government to implement. To that extent, structural factors could have contributed in the discussion to promoting the idea of restructuring the Georgian tax system by the IFIs, but as already said, structural factors do not stand out as the cause of tax policy making in by domestic actors. In other words, the first tax code creation of Georgia was 'blamed' on IMF and not on the need to increase revenues or fill up the budget.

The collapse of production and investment along with the government's unwillingness to cut expenditures has added to the state budget deficit. Subsidies and transfers from the state budget were the largest portion of state expenditures, accounting for up to 57% of central government spending in 1993 and up to 70% in 1994. This mix of problems was further deepened due to the low capacity of state agencies to extract taxes from small enterprises, and the latter preferred to operate in a shadow economy (GET 1995-1997). The corruption in tax administration also contributed to the 'disappearance' of up to 50% of collected tax revenues from the taxpayers. The situation was so well known to everybody that even the President pointed out the need to curb corruption in tax administration in his speech in 1996 (GET 1996:23). The tax extraction mode of the SDS and State Tax Service (STS) was often predatory, and application of tax collection rules was arbitrary and disputable. Tax collection improvements were often blamed on the increase in penalties on non-payment or the increase on interest rates on delayed payments or debts in tax payments for the enterprises. It was obvious that the tax collectors' incentive was concentrated on penalizing taxpayers and extracting tax revenues in such a manner (GET 1996:21).

State budgets were adopted late (often in February of the fiscal year) and were often a compromise between the Ministry of Finance and IMF, which had to

agree on the revenue and expenditure targets of the Georgian Government (GET 1996:25). Meanwhile state budget deficits remained high and were financed from abroad (through EU's budget and balance of payments support grant, and IFIs) and were partially financed by the National Bank of Georgia (GET 1996:18). Yet, foreign funding was a significant source of budget deficit funding for Georgia in the second half of 1990s (GET 1995-1997). In 1993 grants mostly received from the sale of food aid (received from the European Council of Ministers) amounted to 76% of the total revenue in Georgia, in 1994 45% and in the first half of 1995 it was already up to 25% (GET 1995:13). In 1996 the budget deficit was calculated to be 249 mil GEL (approx. 125 mil USD) out of which foreign lending had to cover 114 mil GEL (approx. 67 mil USD). However this objective was not met and the deficit ultimately grew to 256 mil GEL (approx. 127 mil USD), equaling 5.6% of GDP and 11.6% higher than planned. Grant revenues also increased to 33% higher than expected to cover this deficit in 1996. Meanwhile the increased deficit was blamed on a lower tax collection than expected (in fact, tax collection was 17% lower than expected for 1996) (GET 1996:18). The following year was no better in terms of the size of budget deficit and trouble finding ways to fund the deficit. In 1997 the budget deficit amounted to 224 mil GEL (approx. 112 mil USD) out of which Central Bank of Georgia financed 116 mil GEL (approx. 58 mil USD), and the World Bank provided further 92 mil GEL (approx. 86 mil USD) financial support through transfers of the Structural Adjustment Credit II (GET 1997:13). This tendency of having high budget deficit and need to raise revenues from foreign loans and grants continued in Georgia, before and after the new tax code was adopted and tax system restructuring started based on the new legislation (GET 1995-1997).

Interestingly, the Ministry of Finance and the State Tax Service (tax collecting agency) did not believe that the tax collection level was due to poor legislation or an ineffective tax administration system. The government looked for the scapegoat elsewhere. The tax agencies blamed low tax collection in 1996 on late approval of the state budget (approved finally on February 20th of 1996). Another problem in tax collection was exemptions on bread and grain after the price liberalization. Finally, tax debts were cancelled or postponed for some enterprises, which reduced tax contributions to the budget (GET 1996:20).

As mentioned, the very beginning of Georgia's economic and political transition from the Soviet system was difficult. Economic indicators showed the dire situation the state found itself in since 1991. High budget deficits, low level tax collection, reduced trade, and, consequently, a low level of external revenue flow were all on the *menu* of Georgia's economy. In 1991 a 'self-imposed blockade' against Russia caused an external trade decrease and supply shortages in the country. The trade deficit in 1992 was almost 10% of GDP, compared to 1-5% in 1989-1991 (Gurgenidze et al. 1994: 280). The external revenue flow was also

reduced in Georgia due to the sharp decline in tourism and transportation services: tourists decreased from 2.5 mil (in 1980) to almost none in 1993, whereas the 'commodity turnover of railway, airline and pipeline services, measured in physical terms, declined during the first 10 months of 1993 by 30.5%, 34% and 80% respectively' (p. 280).

The total fiscal deficit of 16.7 percent of GDP (in 1992) decreased to 11.6 percent in 1994. While in 1990, the budget revenue constituted 104 percent of expenditures, the corresponding figure for 1992 constituted 30.5 percent. Thus, total budget revenues of the 1990 GDP of 37.9 percent decreased to 5 percent in 1994; budget expenditures have also decreased from 36.5 percent on 1990 to 16.7 percent of 1994 GDP (Papava 1997a:43).

The general revenue in Georgia as the GDP percentage was low for overcoming the budget deficit of the country. Georgia was mostly dependent on indirect taxes such as customs tax and tariffs and VAT, and partially on enterprise taxes, while the personal income tax was making the smallest contribution to the general tax collection level (GET 1995-1997). A closer look at the numbers reveals that direct tax income in the total revenue also started to decline dramatically from 1991. In that year tax revenues in the total government revenues were 29.8% of GDP. If we break down the tax structure in Georgia in 1991 the share of the income tax revenues was 3.4% and profit tax was 7.2% of GDP. The decline of the profit tax and income tax continued. The latter was lower in 1993 as it only contributed 0.2% of GDP in total revenues. In the same year profit tax declined to 0.8% of GDP but even less was collected in 1996 when it only was 0.6% of GDP. Further details are given in Table 5.4:

Table 5.4: General government revenue and expenditure (as percentage of GDP)

	1991	1992	1993	1994	1995	1996
Total Revenues	29.8	10.2	2.3	4.2	5.8	7.8
Tax Revenues	22.1	8.2	2.0	3.0	3.8	5.2
Income Tax	3.4	0.9	0.2	0.2	0.6	0.8
Profit Tax	7.2	3.1	0.8	0.8	0.8	0.6
Total Expenditure	26.9	35.2	33.3	23.5	11.1	13.5

Source: Table A7 from the ET Report, 1997.

Note that Georgia was the poorest tax collector among the post-Soviet states and had the lowest profit and income tax shares in its tax revenues as percentage of GDP. Table 5.4 demonstrates that of the 15 post-Soviet countries Georgia had 3.4% of GDP in 1993 while the lowest tax collection was 16.0% of GDP (Armenia) and the highest was 42.8% (Ukraine) and 42.6% (Uzbekistan). Georgia's

poor tax collection capacity has persisted over time including the first and second quarters of 1997. Even though tax collection in 1997 improved and reached almost 9% of GDP, the share of profit and individual income in the country remained low. Profit tax revenue was only 0.7% of GDP, personal income amounted to 1.0%, while Uzbekistan managed to collect 10.6% GDP of profit tax and 4.8% of individual tax in the first and second quarters of 1997 (see Table 5.4).

As mentioned, the Georgian state's problems with collecting taxes and reducing its large budget deficits with domestic revenues was due to the weak administrative capacity of state agencies in the early transition period. Needless to say, weak state capacity in tax extraction was persistent in all post-Soviet states (except the Baltic countries) compared to the East European countries (Gehlbach 2008). Often their institutional transformation processes and policy advice received from IFIs resembled one another. For instance, Georgia's tax administration reform started early in 1990s when it created a Large Taxpayers Inspectorate (LTI) under the Tax Inspectorate of Georgia⁴⁶ (TIG) on IMF's recommendation. The latter started to provide funding for reforms in tax administration. LTI has been established in other CIS countries where IMF had been providing technical assistance in tax administration reforms and it refers to a division in tax administration agencies dealing exclusively with businesses, which bring considerable tax contributions. The establishment of LTI has been perceived by the international community as a positive move in tax administration in post-Soviet countries as it was believed that such a unit would increase compliance by major taxpayers (Ebril and Havrylyshyn 1999). The rationale behind LTI may have been the old tax structures of the post-Soviet states. The Soviet Union's largest tax income used to be from enterprises, which were easy to tax and controlled by the state. After the economic liberalization, some post-Soviet states chose to develop the economic activities of large enterprises and to make them the major tax income source for the regions or a state budget (like the Russian case described by Gehlbach (2008)). However, in the early transformation period the Georgian state failed to extract from large taxpayers, as profit tax collection generally was very poor due to the lack of state capacity to extract and also partially due to tax favoritism.

After LTI was created it started controlling 140 large taxpayers in Georgia and increased its control over 250 of them soon after. Even though local governments and even Tbilisi City's mayor opposed LTI, it was still seen as a step forward in the tax administration reform in the early 1990s. At the same time, Mkhedrioni's (a

⁴⁶ The Tax Administration came into existence on March 31, 1990 under the Ministry of Finance. In March 1992 it turned into to the independent State Tax Inspectorate, until it was again incorporated under the Ministry of Finance in mid-1997 as the tax administration body – Tax Inspectorate of Georgia (TIG). TIG's task was to reorganize the institution internally, to secure resource extraction and overcome factors that hindered its work, such as inadequate financing and heavy interference from central and local executive bodies the daily work (Tanzi 2001:67-69).

paramilitary grouping outlawed in 1995) racketeering during 1993-1995 was being shut down, which allowed a taxation system to form in Georgia (Tanzi 2001:69-70). Policy makers interfering in tax administration remained a big problem. Besides TIG, the Georgian police, the public prosecutor's office, the Chamber of Control claimed their right to investigate taxpayers' activities in terms of tax payment (Tanzi 2001:69). TIG collected most central and local governments' domestic taxes, the State Customs Department (SCD) was in charge of collecting VAT, excise and customs duties on imports (IMF 1998:18). Payroll taxes were collected by extra-budgetary funds such as the Social Security Fund (SSF) and the Employment Fund (EF). Vehicle and road taxes were collected by the Road Fund. This differentiation of tax collection obligations among various state agencies made tax collection inefficient. The decision to transfer tax collection responsibilities to only TIG and SCD in 1997 was postponed with the excuse of possible organizational problems in merging the tax agencies (IMF 1998:18).

Besides political interference in tax administration, another hindrance to tax legislation implementation in Georgia was lack of knowhow and competences in tax appeals, arrears, enforcement and audit among government officials, and for the citizens tax records and filing returns was a new form of behavior (Curnow 2006:67). Moreover, tax compliance was low while the tax inspectorate and/or customs officials were suspected of having free hands to conduct predatory tax collection. It was disclosed that tax officials' assessments often were not transparent. Also, many businesses found that their bank accounts had been frozen or funds deducted without court order (IMF 1998:43). In the midst of frequent overlapping of obligations and rights of tax agencies to investigate taxpayer compliance, the taxpayers fate was often twisted due to the vagueness' of the tax code regulations. For instance, the Tax Inspectorate was given authority to freeze bank accounts or seize property based on court orders (Article 245 of Tax Code (1997)). However, Article 265(e) entitles tax inspectors to extract taxes not paid in a timely manner directly from taxpayers without stating clearly that that court order was needed (IMF 1998:34, fn.27).

Predatory tax collection was coupled with tax favoritism, meaning that firms with official connections could avoid taxes, particularly importers of manufactured consumer goods, cigarettes, alcohol, oil products, cares and flour (IMF 1998:36). Besides tax collection during 1990-1994 the total contraction in GDP in Georgia was the lowest compared to other former USSR countries, reaching 82.1% of GDP (Tanzi 2001:68). The inflation rate at the end of 1993 reached about 9,000% and the depreciation of coupons (the intermediary currency adopted in Georgia in 1993 after leaving the ruble zone) in April 1993 was almost 11,000% against the ruble (Gurgenidze et al. 1994:272).

This data demonstrates the economic hardships of the Georgian state, but it does not support the domestic structural factor argument directly. Perhaps the

hope was that a Georgian tax code modeled on 'Taxastan' would address the macro-economic indicators by aiding tax collection. However, Georgian decision makers did not refer to the new tax code as a policy solution to their economic hardships. Rather, they often saw a conditionality that had to be met to obtain funding from IMF. One can assume that the Georgian government, which was used to the Soviet tax system with no direct taxation, did not see the tax system as an essential part of a newly emerged state or an integral part of the reforming economic system. However, this does not mean that the budget deficit and poor tax extraction capacity of the Georgian state should be dismissed completely. The reason is that IMF policy prescriptions during the structural adjustment reforms aimed to help the Georgian government address economic problems, including the tax system.

5.7. Number of Veto Players and Party Politics

As the evidence provided below demonstrates, neither the creation nor the adoption of Georgia's first tax code was a result of party politics or number of veto points. There are several observations worth pointing out in this connection. Possible reasons why neither a political party or number of elected legislators in the Georgian Parliament accounted for a tax policy change could be that not only was the IMF a powerful policy actor with strong leverage, but the political parties were structurally underdeveloped and the executive political power had been prevailing over the legislative power under a strong presidential political system. In other words, political parties were leader oriented. They often lacked well-developed party programs as well as a clearly defined ideological stance. Political bargaining among parties and the importance of a strong position on the political spectrum were new to the recently emerged Georgian political parties. The political party politics known to the western world was still being born in Georgia at the early stage of its independence (Nodia and Scholtbach 2006). In terms of number of veto players represented in the Parliament, there are two reasons why, in the Georgian context, tax policy creation and/or adoption cannot be explained with this theoretical speculation. First, when the tax policy was being made in Georgia the political parties supporting Shevardnadze's regime and his legal initiatives formed the majority in the Parliament. The executive power was being consolidated in the Parliament as well as in the executive branch of political power (Nodia 2002). The latter was a mere result of the mechanism of appointments of local representatives across the country – the chain of command that created a chain of executives loyal to the president. Secondly, the 70 year-old practice of having a ruling party entrenched into ruling a state was the way Shevardnadze and his close allies, former nomenklaturamembers, knew how to run a state (Wheatley 2005). Therefore, once Shevardnadze ma-

naged to eliminate his political rivals and gain majority support from the Parliament, the number of veto players was of little importance in the policy making process (Dadalaui 2009). What mattered more was whether the executive had the political will to adopt a certain type of legal initiative or not.

5.7.1. Georgian Political Parties in the Early 1990s

Having said that, it is worthwhile to review the party politics and veto players in the early stage of independence of Georgia. The spectrum of the political parties represented in the Georgian Parliament was broad. Since the first multi-party elections in 1990 the Georgian parliament⁴⁷ (then still called the Supreme Council, the legislative body in the Soviet Republic of Georgia) has contained parties with competing ideologies comprised of dissidents, traditionalists, young intellectuals as well as communist party members.⁴⁸ Out of the registered 29 parties only seven made it to Election Day⁴⁹ (Slider 1997:161-62).

The inclusion of political parties with differing ideologies in the Georgian Parliament continued under the new regime of Edward Shevardnadze from the beginning of 1993 (Wheatley 2005; Dadalaui 2009). For the sake of legitimizing the seizure of power by anti-Gamsakhurdia forces, which supported the coup d'état, new parliamentary elections were held in October 1992. A total of 35 parties were registered (Slider 1997:181). The elections were based on party lists from ten historical regions of Georgia that had to take 150 seats in the 250-seat parliament. The 84 single-member districts (according to the administrative division of the republic) were to be presented by the independent deputies. As a result, the Peace Bloc, a coalition dominated by the Democratic Union (Communist Par-

⁴⁷ The 1990 elections are considered one of the multi-party elections during Soviet existence. Changes in election law adopted in August 1990 combining single/member districts and majority balloting based on party list voting. There were 250 seats in the Supreme Soviet. The minimum threshold in the 1990 elections was 4%. The Round Table-Free Georgia won the majority of seats (155 seats) compared to the Georgian Communist Party (64 seats) in the first multi-party elections in the Soviet Republic of Georgia held on October 28, 1990 (Slider 1997:175, 161-62).

⁴⁸ The Round Table-Free Georgia Bloc was a coalition of the following parties: Helsinki Union, Sait Ilia the Righteous Society, Merab Kostava Society, Union of Georgian Traditionalists, Popular Front-Radical Union, National-Christian Party, National-Liberal Union (Slider 1997:176); The founder of the Popular Front was philosopher and linguist, Nodar Natadze, who tried to shape his party on the Baltic model but no major political movement wanted to go under an umbrella organization (Slider 1997:162); The Rustavi Society was a mainly social and cultural organization registered as a political party and led by Akaki Bakradze (p. 161); the Traditionalists were a party split from the Monarchists who aimed to restore the Georgian monarchy through the royal family now residing in Spain (p. 160).

⁴⁹ Amendments to the election law did not allow candidates to have dual-party affiliation which in the end reduced the chances for communist party members (Slider 1997:174).

ty renamed itself Democratic Union and was led by Avtandil Margiani)⁵⁰ won the majority of seats (35 seats). The October 11 Bloc was the second most important bloc⁵¹ and the third was the National Democratic Party (Slider 1997:180). The newly elected Parliament was charged with writing the Constitution of Georgia within its three-year term. The political discussions in the Parliament were limited mainly to the issues of state territorial integrity and choosing strategic partners such as West or the North (i.e. Russian Federation). The law making process was running slow (Jones 1997:523). Possible membership of the Commonwealth of Independent States was the topic that unified opposition forces against the initiative led by Shevardnadze and his supporters in the Parliament. With little twists of the rules in MP mandates before voting on March 1, 1994 the initiative was settled positively. It was regarded as treason and disastrous by political parties such as National Democratic Party (led by Irina Sarishvili-Chanturia) (GC, February-March 1994 Vol. 3, No. 2-3).

The follow-up to this event demonstrated the weaknesses of the political parties and their ability to unite against a common issue, as they planned to demand cancellation of the ratification votes but never managed to hold a meeting where to discuss this issue (GC, February-March 1994, Vol. 3, No. 2-3). In addition, issues of power sharing among the state institutions and the possibilities of reducing the influence of the state leader for the benefit of the political forces supporting the previous president, Zviad Gamsakhurdia, remained key issues to the political parties in the Parliament. With few exceptions, economic issues occupied little space in the political parties' policy suggestions. For instance, on

January 26 the opposition parties held a conference dedicated to the analysis of the political situation and the development of alternative policies. The Chairman of the Budget and Finance Parliamentary Commission T. Basilia (the Union of Georgian Traditionalists) presented his plan for economic recovery. The opposition parties worked out the following common demands: to curtail the authorities of the Head of State extends the role of the Parliament and to make radical changes in the Cabinet of Ministers. Even more radical groups refrained from more extreme displays of their disagreement with the government (for instance to demand Mr.

⁵⁰ Block uniting six parties including the former Communist Party renamed the Democratic Party and the Union for the Revival of Adjara led by Aslan Abashidze, head of the Adjara Autonomous Region (Slider 1997: 180)

⁵¹ October 11 Bloc consisted of 'moderate reformers who were leaders of the Republican Party, Democratic Choice for Georgia (DCG), the Georgian Popular Front, and the Christian/Democratic Union' (Slider 1997:180). Note also the age difference among members of the October-11 Bloc and the Peace Bloc, the significant differences in their career paths and their affiliation with the Communist party. The October 11 Bloc consisted of young reformers with no connection to the Communist party, with an average age of 37. The Peace bloc was packed by former Communist party members with an average age of 52 (p. 180).

Shevardnadze's resignation, to call for mass manifestations of protest and the like) (GC, January 1994).

5.7.2. Presidential and Parliamentary Elections in 1995

The political scene changed following the Presidential and Parliamentary elections held in 1995.⁵² The elections consolidated President Shevardnadze's power in the parliament under the ruling party, the Georgian Civil Union. Prior to the elections in 1993, Shevardnadze chose to set up his own political party, the Union of Georgian Citizens. It was supported by Green Party created in 1988 by Zurab Zhvania, a young graduate from the biology faculty. Zurab Zhvania was considered a young reformist among the former 'apparatchiks' who surrounded Shevardnadze and his party (Demetriou 2002). Zurab Zhvania's cooperation with Shevardnadze intensified when Zhvania became chairman of Shevardnadze's newly established political party. Later on, Zhvania served as chairman of the Parliament. CUG had one main function – to become a power base for Shevardnadze in his race for the presidential campaign in 1995 (Aves 1996:15). CUG was an example of post-Soviet political parties with weak organizational structures and a lack of clear political program or ideology. Like other parties, CUG was individual-oriented rather program- or ideology-oriented. But unlike its former counterpart, Zviad Gamsakhurdia's power base the Round Table-Free Georgia, it excluded the zeal of nationalism and focused on the citizens of the country. The latter proved to be a winning strategy in the multi-ethnic country, which experienced bloodshed in ethnic conflicts. To sum up, the policy priorities of political parties were concentrated on issues of state formation and territorial integrity rather than putting economic policy on the agenda. Needless to say, business interests represented in the parliament, which often hindered pro-market reforms and tried to mould laws on their business interests (more on these instances below), did have an economic policy agenda, but they never materialized in one clear party program or policy concept.

Moreover, with very few exceptions, CUG had support from political parties representing post-communist nomenklatura in the Parliament, less so before October 1995 increasingly so following the elections. However, it was very often the

⁵² The winners of the parliamentary elections race among the political parties were: UCG (24% of the seats), the National Democratic Party (8% of the seats; led by Irina Sarishvili-Chanturia, the widow of Ghia Chanturia, who was assassinated in 1994,); and the All Georgian Revival Union (7% of the seats led by Aslan Abashidze). The political parties that did take part in the elections but did not get into parliament were mainly communist parties, supporters of Zviad Gamsakhurdia, and former supporters but now opposition, e.g. Charter-11 bloc, and nationalists (Slider 1997: 182-85). As for the presidential elections, Shevardnadze competed with five other candidates (Jumber Patiashvili, Akaki Bakradze, Patneleimon Giorgadze, Kartlos Garibashvili, and Roin Liparteliani) but won 74% of the votes (Slider 1997:90).

case that parties that were loyal to the President would form a majority in the parliament when voting on any bill commissioned by the President. Georgia's legislative body has been dominated by the political will of the executive body, which made veto points of the party members less relevant in the mist of policy adoption. The leading positions in the executive body were distributed to the loyal members of the CUG, the membership of which became a ticket to career advancement and promotion in the state apparatus (Jones 2000:52; Demetriou 2002). While scrutinizing the sources on the centralized policy arena of Georgia in the mid-1990s, no evidence suggests that the initiation of the tax code was due to party politics and that its adoption was affected by the number of parties in the Parliament (opposition vs. ruling party). What made the adoption of the tax code possible in the parliament was the clear signal from the President that this document was to be adopted to meet the IMF conditionality.

5.8. Government Support

Georgia's government unequivocally supported the adoption of a new tax code. The theoretical speculation on the importance of the government support and commitment for the success of reforms and policy adoption was empirically supported in the case of Georgia. Launching and continuing the implementation of pro-market economic reforms since 1994 was made a policy priority by the President himself. As the historical analysis below demonstrates, this was crucial in the preparation and adoption of the first tax code in Georgia. The head of state, Edward Shevardnadze⁵³ stated that Georgia was ready to follow the path of market economy in compliance with IMF recommendations. As the Georgian Chronicle wrote:

In almost all his public statements Mr. Shevardnadze mentioned recommendations of the International Monetary Fund as guidelines of his economic policy. Later on, the same source indicated that the Georgian government was preoccupied with following the path of IMF prescriptions in its economic policy. The government's economic policy was mainly determined by attempts to follow the IMF's recommendations in the hopes of obtaining more foreign credits (GC, November 1994, Vol. 3, No. 11).

A very clear message was sent from the President to the anti-IMF forces among the political elite. Time had changed and so did the government's policy preferences towards the principles of the economic reforms.

⁵³ After the first session of the new Parliament in November 1992, Edward Shevardnadze was voted Chairman of the Parliament and Head of Government (Slider 1997: 188).

The wind of change started to blow in April 1994. Suddenly, the Head of State appointed a reformist, Temur Basilaia, as Deputy Prime Minister, in charge of implementing Shevardnadze's decrees aiming to accelerate privatization, liberalize prices and finally reduce financial volatility caused by soft credits and an irresponsible monetary policy led by the National Bank (this was the first time Shevardnadze acknowledged that the monetary policy was flawed). Basilaia was also in charge of implementing reforms in compliance with IMF recommendations (GC, April 1994, Vol. 4, No. 4). Shevardnadze offered strong support for economic reforms at three meetings, one of which included regional leaders and another the central government. First, on April 22, 1994 during the meeting with the regional leaders and law enforcement representatives, the Head of State criticized the managers of the state enterprises and accused them of hampering the privatization processes on purpose. Five days later, on April 27, 1994 while meeting with the Cabinet of Ministers, he called for full implementation of IMF and WB recommendations (GC, April 1994, Vol. 4, No. 4). Finally, on June 30, 2009 this attitude towards IMF and WB recommendation compliance was sealed before the representatives of the Fund during the extended cabinet meeting.

The meeting summed up functioning of the economy in the last six months, discussed future plans and recommendations of the International Monetary Fund (whose representatives attended the meeting). Prime Minister Patsatsia spoke on the necessity to carry out price reforms worked out in cooperation with the IMF, reorganize the state administration, reduce fiscal expenses and give up an idea to raise salaries without proper economic ground. Mr. Shevardnadze clearly admitted for the first time that the inflation had resulted from the faulty credit policy of the National Bank and unpopular price rises were unavoidable in the future. He expressed hope that the problem of social security would be in part solved at the expense of international humanitarian aid (GC, July 1994, Vol. 3, No. 7).

This was a radical shift in support of the economic policy ideas that Shevardnadze and his political allies favored before. In his speech during that meeting, he also criticized ministers

for not taking enough interest in the anti-crisis program. He also announced forthcoming restructuring of the administration, intended to change functions of the ministries and cheapen the apparatus (also referring to the IMF recommendations). No ministers dared to object, and the Cabinet passed a resolution 'On Specific Measures to Overcome the Crisis' (GC, July 1994, Vol. 3, No. 7).

After 1994, President Shevardnadze was openly committed to the IMF policy recommendations and the formation of a democratic state and his actions and speeches demonstrated the 'balanced politics' that he was trying to lead among reformist and non-reformist groups in the Georgian government. In both the executive and legislative bodies of the state institutions there was a tangible gap

among former nomenklatura members who opposed the IMF pro-market reforms and younger reformists who were committed to market formation. Despite the sudden change of the President's rhetoric from 1994 onwards for pro-reforms, his speeches occasionally contained statements that were oxymoronic and contradictory.

5.8.1. The Executive's Mixed Messages

Shevardnadze's close allies continued to promote non-reformist policies. For instance, Goguadze made a statement on the benefits of joining the ruble zone, while Prime Minister Patsatsia stated that the Georgian economy had to be brought under state control, large scale privatization had to be halted, and tea, food processing, power production and other 'strategic domains' had to be created (GC, January 1994, Vol. 3, No. 1). The anti-IMF attitude was not demonstrated in Shevardnadze's public speeches, but in December 1993 one of his former allies, former Minister of Economy, Sigua, accused him of hiding a letter from the IMF promising to provide 200 mil USD funding if the reform of the National Bank's monetary policy was abandoned. The monetary policy intentionally devalued the coupon (the intermediary currency adopted in 1993 after Georgia left the ruble zone) with the aim to rejoin the ruble zone under the National Bank presidency of D. Dvalishvili. In response to the denial of Sigua's accusations, the actual letter from the IMF to the Georgian government, dated June 15, 1993, was published in the newspaper *Sakartvelos respublika*⁵⁴ (GC, January 1994, Vol. 3, No.1). Shevardnadze responded that he never got that letter from the government (ibid.). It is worth noting that while Shevardnadze and his opponents were exchanging accusations in relation to economic reforms, only one member of the Union of Citizens and its chairman, Zurab Zhvania, stated that the party supported western, pro-market values while criticizing anti-market reform trends in the government (GC, January 1994, Vol. 3, No. 1).

The head of state openly favored the non-reformist part of the political forces in the government on several occasions. For instance, he preserved his support for the flawed monetary policy of the National Bank which benefited state enterprise managers (old nomenklatura members), while stating that his government would support liberalization of prices and creation of a strong, national currency. Meanwhile he called for legalizing 'hidden' privatization and acceleration of the privatization of state assets (GC, August 1994, Vol. 3, No. 8). Another demonstration of Shevardnadze's favoritism towards nomenklatura members of the political elite in Georgia was the decree issued by Shevardnadze on February 7, 1994 'On the Basic Principles and Prognostic Parameters of the Economic and Social Development and Anti-crisis Program for the Years 1994-1995'. It was a new version

⁵⁴ *Sakartelos respublika* in Georgian means a republic of Georgia (author's translation).

of the revised program which in December 1993 was adopted by the Cabinet under the name 'Program of Macroeconomic Stabilization and Systemic Transformation'. The President's decree was elaborated under the auspice of the Ministry of Economy and then led by the former Secretary of the Communist party, Nodar Tchitanava. Although the document included references to market economic reforms and privatization in general, it still supported the idea of a strong role of the state in the economy (GC, February-March 1994, Vol. 3, No. 2-3). On February 9, 1994 the anti-crisis measures in the economy were discussed in the Parliament. Prime Minister Patsatsia repeated his point of view on privatization and the creation of joint stock companies with the controlling packet of shares owned by the state. Moreover, he demanded that the National Bank support the Parliament and the Cabinet, presumably to obtain soft credits for state-managed economy, and therefore the Prime Minister's demands were not honored in the Parliament then (GC, February-March, 1994, Vol. 3, No. 2-3).

5.8.2. The Second Phase of Georgia-IMF Relations

Very soon after those discussions, the head of state shifted his stance on the economic reforms radically and tried to distance himself from the nomenklatura members' vision of Georgia's economic route towards a state-controlled economy. The latter would have more in common with its predecessor, planned economy, which IMF had been preaching in the region. Due to Shevardnadze's support for the reforms dictated from IMF and WB, some labeled this period the second phase of Georgia's economic relationship with international financial institutions (Papava 2005). Changes started to be commissioned by president and cabinet decrees, and state commissions were created to ensure implementation of IMF recommendations. It should not be assumed that once Shevardnadze publicly committed to the economic reforms in line with international institutions his approach to the nomenklatura elite members changed dramatically. It signalled that nomenklatura members had to follow the winds of change and adopt new policies as long as it meant more funding from donors or financial institutions. Among other pro-reformist initiatives by the government and the legislative body was the Cabinet's approval of the law on 'On Investment Activities' on July 6, 1994 providing foreign investors with the same rights as Georgian citizens (GC, July 1994, Vol. 3, No. 7). On February 21, 1997, however, the Parliament adopted a resolution 'requesting the President to improve the work and increase the responsibility of the Georgian delegation in talks with the IMF and other international monetary organizations. According to the resolution, parliamentary committees will be involved in Georgia-IMF interactions, starting next year' (GC, February 1997).

Thus, the Georgian government's support to the implementation of economic reforms in compliance with IMF recommendations was vital in the process of ela-

boration and adoption of the tax code during 1996-1997. This provides empirical support to the theoretical speculation on the importance of the government's commitment and support of reforms for their success (Orenstein 2008). As expected, government support was particularly important for the tax code drafts to pass the formal institutional filter and for its final adoption. More on institutional filters, formal and informal, is provided below.

5.9. Institutional Filters

5.9.1. Formal Institutions

Institutional filters, such as formal rules of decision making and law initiation, were in the making in the early 1990s. Since the initiative came from the government, formal rules did not constrain the policy coalition from neither elaborating nor proceeding with its adoption in the legislative body of Georgia. Institutions such as legal norms on the mechanism of initiating a law or amendment in Georgia were regulated mainly by the Constitution, the Parliamentary Regulations, and Laws on Legal Acts. This legal basis provided rules on who could initiate a law and/or an amendment in Georgia in the 1990s and later on. The right to initiate laws is regulated by the Constitution of Georgia (Article 67) and the formal mechanisms of doing so in the Parliament is determined by the Parliamentary Regulations (Chapter VI, Article XXI) and by the Law on Legal Acts. The right to legislative initiative is limited to the President of Georgia and, in exceptional cases, the government of Georgia, a Member of Parliament, a committee, a faction, the supreme representative bodies of the Autonomous Republics of Abkhazia and Adjara, or at least 30,000 voters. The process of law making starts with drafting a bill and submitting it to Parliament by the subject entitled to launch a legislative initiative. Only the government of Georgia is authorized to submit to Parliament a draft law on the state budget and structure and the authority and rule of activity of the government. Only MPs, committees and factions are authorized to submit to Parliament a draft law on adopting changes and/or amendments to the Rules of Procedure. Subjects entitled to launch a legislative initiative can request public organizations, institutions or NGOs (including organizations of foreign countries), and an expert or a group of experts (including foreign nationals) to draft a bill (Parliamentary Regulations, Chapter VI).

As for tax code amendments, the Code states that amendments to the policy must be approved by the Parliament and signed into law by the President of Georgia. Initiators of amendments can be groups in Parliament or an executive power. Amendments come into force after being published in the Legal Gazette. Executive orders and decrees cannot override a code unless it is clearly stated in it (IMF 2001b:26, fn.16). Issues related to economic policy, proposed laws and amendments were discussed in the Parliamentary Committee on Budget and

Finances chaired by the MP. Oaw projects discussed in the Committee were often scrutinized more closely in their compliance with legislation. It has been stated that policy projects often went through the Committee without major changes as the Committee often reflected the stance of the ruling elite (the ruling party in Parliament). Moreover, it was stated that if the opposition party was to initiate a law or an amendment that did not favor the elite position on the issue, the Committee successfully managed to stop those initiatives in parliament. In the same manner, if policy initiatives were not approved by the Ministry of Finance, the Committee was there to block them. As one of the parliamentarians revealed in an interview for this dissertation, inexplicit discrimination of the opposition parties may occur in committees in terms of reviewing the policy initiatives they submit. The representative of the opposition party claimed that his party members often had their policy initiatives blocked in committees because the Ministry of Finance refused to support them (Interview 13, 14). A review of the amendments reveals that tax codes or related amendments were never initiated by the public or by citizens.

Since the first tax code of Georgia was commissioned by the President and elaborated by the Ministry, which sent the draft to the Parliament, all formal rules were followed. Moreover, law initialization rules made it difficult for non-state institutions to initiate a law or required a state agency to submit it to the Parliament. To conclude, there is no evidence that formal rules hindered or enhanced the process during the first tax code elaboration or adoption.

5.9.2. Informal Institutions

Informal rules are worth investigating in connection with policy change processes. In the Georgian case, informal rules, such as personal contacts between interest groups or third sector representatives with state representatives and/or international organizations were insufficient to influence the tax code drafting and elaboration. Empirical evidence suggests that, firstly, third-sector development was in its infancy during the period covered in this chapter. NGOs that came into existence soon after independence were weakly developed as organizations. Moreover, NGO representatives had knew very little about the mechanisms of influencing the policy making process. Secondly, the first tax code elaboration and adoption process was not open to interest groups and third sector representatives, but was carried out by state and international actors in closed collaboration. In the following, I will address each factor separately. Linkages among domestic state, non-state and external actors were shallow, there were few non-state actors and they had limited influence on policy making processes by 1997. NGO sector development was a slow process in Georgia for a number of reasons. There was little knowledge of and capacity to establish and run a non-government organization, be it an association or a fund; there was a poor legal

basis for establishing or running this type of organization; there was a lack of local financial sources to fund NGO activities (USAID 1998:41-43). The income Georgian NGOs could generate from service provision (such as consulting, publications and training) was minimal and hardly amounted to 10% of their budget (USAID 1999:49). The business sector had no incentive to fund NGOs in the absence of tax deduction for philanthropic activities. Moreover, NGOs did not get tax exemptions for commercial activities aimed at increasing their income. The lack of sources for fundraising within the country made NGOs largely dependent on foreign funding (USAID 1998:43). USAID,⁵⁵ the Soros foundation and the Eurasia Foundation have been long-term donors to local NGOs in Georgia since the early 1990s (interview 21; Wheatley 2005:146). Later on, in the overall evaluation of the NGO sector in 1997 the USAID report concluded:

With the continuous financial support of international donors, it is expected that the number and sophistication (including financial and managerial capabilities) of active NGOs will grow significantly. From the perspective of NGO sustainability, a central priority needs to be to improve the present tax regime's treatment of NGOs. Training on NGO management and development issues, along with individual consultations, still remain a major need. More assistance is needed in regions outside of Tbilisi (USAID 1998:41).

5.9.2.1. Enhancement of the Third Sector's Capacity

In the attempt to enhance the capacity of civil society, intensive training sessions and workshops on how to organize and manage NGOs in Georgia were carried out by a well-established local NGO, Horizonti⁵⁶ (Jones 2000:70, fn.81), which also provided small grants for local NGOs (ISAR-Georgia 1996:5). It has assessed NGO needs on a regular basis since 1996 and began to issue a magazine for the

⁵⁵ USAID has been involved in economic reforms in Georgia along with the IMF and the World Bank. It has collaborated closely with the Georgian Ministry of Finance and has actively promoted pro-market reforms (USAID Georgia, document available on the website: http://www.usaid.gov/locations/europe_eurasia/countries/ge/georgia.pdf).

⁵⁶ Horizonti, the Foundation for the Third Sector, is a Georgian NGO formed in 1994 as a local chapter of ISAR-Georgia under the Washington DC-based ISAR-DC (ISAR-DC 2002:6). ISAR-DC was offered support by USAID in 1993 to start its programs in the former Soviet Union (FSU) (ISAR-DC 2002:7). The initiative was based on shared values, interests and principles between the two organizations. ISAR-Georgia has acquired tremendous experience in civil initiatives through its headquarters. It has received grants from e.g. the Wallace Genetic Fund (1994), World Learning (1995) and later from the Eurasia Foundation, the Soros Foundation and Save the Children (ISAR-Georgia 1996:2-3). It was very active in producing information on Georgian NGOs, their development and the general funding situation. ISAR-Georgia became an independent Georgian NGO in 1997. It continued its activities and retained its original profile from when it was a local representative of ISAR-DC, but now under a new name.

third sector in Georgia in the second half of the 1990s (Jones 2000:68, fn.70, 76, 81; ISAR-DC 2002:6-8).

The number of registered NGOs was growing dramatically. In 1992 there were no non-government organizations in Georgia, but in 1997 their number reached around 3,000 (Jones 2000:61). This number tripled in ten years, reaching 10,000 registered NGOs in 2007 (USAID 2007:107). However, during all those years, only some hundreds have been active, while 'others are involved in political or business activities or have simply become a mechanism for securing foreign funds' (Jones 2000:68). Some even claim that only 20 out of the numerous NGOs in Georgia had any effect on legislation drafting processes (Wheatley 2005:145). The advocacy work of NGOs in the early 1990s was limited. Yet, they were successful in uniting forces to push for several policy amendments in Parliament to include provisions in the Tax Code (adopted in 1997) as well as in the Civil Code (adopted in 1997). Tax code provisions concerning NGO funding were scrutinized by then-active NGOs and their recommendations were presented to the Parliament. As far as revision of the tax code, NGOs mainly had access in Parliament (Interview 18). A report on NGO sustainability by USAID stated that:

Certain NGOs have successfully lobbied for legislation. One noticeable example is the amendment of articles relevant to NGOs in the Civil Code and the Tax Code. NGOs in many different fields are receiving and exchanging drafts with the legislative branches of the Parliament. They are frequently asked for comments and suggestions (USAID 1998:43).

In 1997 GYLA and Horizonti⁵⁷ were involved in proposed amendments to the Civil and Tax Code to accommodate NGO activities in Georgia (ibid.). However, NGOs failed to have a provision in the Civil Code included which would allow organizations classed as think tanks/institutions to establish beyond foundations (property-based union) or associations (membership-based unions) (USAID 1998: 41). Economic reforms in Georgia were conducted with the involvement of NGOs, among which the Young Economists Association of Georgia and the International Center for the Reformation and Development of the Georgian Economy were involved in drafting the first tax code of Georgia in 1997 and continued their involvement in economic policy reforms in the aftermath (Interview 21). There were a few cases of state and NGO cooperation as well. For instance, The Parliamentary Committee on Economic Policy and Reforms worked closely with NGOs on the issues of NGO funding and tax exemption, helping them to guide those laws through the legislative body in the face of resistance from the IMF in the mid-1990s (Jones 2000:69). NGOs, such as the Georgian Young Lawyers Association and the Young Economists Association, had their members working in

⁵⁷ Horizonti is a Georgian NGO which was then called ISAR-Georgia (Jones 2000:69).

various departments in the newly elected Parliament in 1995. Obtaining information on what type of law projects were being discussed or passing down the recommendations from the NGOs to the parliamentarians was therefore conducted through personal linkages that organizations had with the legislative body. The key person in the Parliament who opened the door to the NGO representatives to aid the law makers create laws and work closely in the policy creation process was Zurab Zhvania, the Chairman of the Parliament and former leader of the Greens,⁵⁸ who surrounded himself with young, progressive individuals in the government (Jones 2000:71; Wheatley 2005:146). He was known as a reform-minded member of the political elite, who saw the potential of young and well-educated NGO sector members and was willing to engage them in policy making processes. In 1997, he created an NGO group to advise the government on various policy issues. As one of the NGO representatives in the Parliament in the mid-1990s stated, 'the Chair of Parliament was Zurab Zhvania who attracted a group of young people around him who implemented reforms, young people implemented reforms' (Interview 18). Yet, Zurab Zhvania's attempts at NGO recruitment within state institutions were selective and by no means extensive. Only certain individuals were invited. NGOs benefited from this contact between their members and decision makers. It was easier to gain access to information on policy making, but their influence on decision making or policy drafting did not grow. A representative of an NGO, which had a member in the Parliament committee working on economic policy issues, stated that:

For instance we never had any problem obtaining information under Shevardnadze or Saakashvili. However, this does not mean that the problem of obtaining information did not exist as such in the country. It did. But we had our so-called network, those people who attended our trainings and workshops are now employed in the state agencies ... Under Shevardnadze we had connections up to the State Treasury, heads of departments, ministries, we had contacts with the main carriers of information. The Ministry of Finance has had many of our members. The former minister of finance is the ... is the founder of our organization, also ... the Deputy Minister of Finance, and so on ... But it cannot be generalized to the entire country. We had access because we had connections, but in general one could not access information or obtain it. We never suffered due to a lack of information ... It is the asset of our organization that our members are employed at the state agencies.

Beyond some rare cases of NGO and government sector cooperation or NGO advocacy success stories, NGOs' influence in the policy arena and political

⁵⁸ The Greens were established as an NGO by the young biologist Zurab Zhvania in 1988. Soon after it was turned into a political party and entered the Parliament in the 1992 elections. In 1993, when the Civil Union of Georgia was established, the Greens merged with them in CUG (Encyclopedia Britannica 2008).

processes was still limited in the early 1990s. The government, businesses or even the media did not fully comprehend the role of the third sector and the mechanism of self-promotion and capacity enhancement to introduce important actors into the political process in Georgia was limited during the mid-1990s (USAID 1998:43).

5.9.2.2. Third Sector Involvement in the Policy Making Process

The tax code elaboration process was rather closed and was handled by the Ministry of Finance, its experts and international experts assigned by the IMF. Third sector members were still unaware of how to use lobbying and advocacy techniques long established in the Western NGO world (USAID 1998). Throughout this period young specialists engaged in NGOs like the Young Lawyers Association or Young Economists Association were invited by the Chair of the Parliament to the committees of the legislative body, in the hope that they, with newly obtained knowledge, could aid legislators elaborate the legal norms needed for a democratic country that aspired to a capitalist system. Thus, linkages and informal as well as professional connections that NGO and state institution representatives formed in Georgia were increasing and tightening. Yet, it seems that the policy influence of the individual experts representing the third sector was limited in the face of the government's political will to support or oppose the adoption of a particular policy. As the NGO representatives confirmed to the author, those personal linkages – the personal relationship of their members and law makers – created the *capital* for NGOs that facilitated the access to first-hand information and attendance in the process of policy discussions in a timely manner for the relevant NGO members (Interview 16, 17, 19). However, they were not in a position to push for policy amendments in general except for few cases as described. As a well-established NGO representatives stated, the influence of NGOs was limited in the early 1990s, though their access to information was easier in general.

For instance in the parliament, the information on the committee discussion was available (in the 1990s). The main problem was not to be part of those discussions or to attend them, the problem was to see in fact how many of the recommendations were taken into account and considered. In fact, taking into consideration was not happening, because in those times it was very difficult for the parliamentarians themselves to make sense of the recommendations and issues (Interview 19).

To sum up, the third sector was booming in Georgia in the mid-1990s. The number of registered NGOs grew dramatically, but their activities and influence on the policy making process in general was limited. Some blamed it on inexperience and lack of lobbying culture (USAID 1998:43), others saw it as the result of the government's superficial attitude towards the NGO sector and their policy

advice as well as the lack of political will to change status quo (Interview 16). Only few NGOs were active in the policy arena; their consultation or advice were often heard but not taken into account by the decision makers who seemed to have their own agenda. Representatives of three active NGOs who participated in law making and/or tax policy debates before the first tax code was adopted have confirmed the statement on their limited role. Yet, the growing number of NGOs meant a growing funding resource to the third sector that often foreign funders provided to local organizations. This indicated the growing linkages formed among foreign actors (e.g. funds, NGOs, large organizations supporting particular causes). By the time the first tax code was being elaborated these processes were taking shape but were not providing enough political power to influence policy processes in the mid-1990s. In the following section I discuss how the role of NGOs has increased and how the transnationalization of the public policy arena occurred through learning and idea internalization, which led to a tax policy change in 2004 in post-revolutionary Georgia.

5.10. Tax Competition

The theoretical speculation on the tax competition did not explain to why the Georgian Government modeled its first tax code on the 'Taxastan'. The evidence below points out factors that made the tax competition theory less relevant in the Georgian case. Georgia was very poorly integrated into the global market while it had very tight economic relations with its former comrade states in the CIS club. Table 5.5 shows that the flow of foreign direct investment (FDI) in Georgia was moving at a slow pace and, compared to its resource-rich neighbours, Georgia was less integrated in the global market.

It would be logical to expect that the Georgian government aspired to increase FDI and become competitive against its neighbours by creating an attractive environment for capital. However, there is no evidence that tax competition was considered a possibility for shaping the first tax code. The government did not talk about competing with neighbouring or other countries as a necessary drive of fiscal policy creation. The rhetoric mostly concerned the poor economic conditions and the IMF's requirements to improve activities as a funding conditionality. There is no indication that tax competition played a role in the tax policy making process in the early 1990s up to 1997.

Table 5.5: Foreign direct investment in Georgia 1998-2002

	1985-1995 (annual average)	1998	1999	2000	2001	2000
Georgia						
Inward	1	265	82	131	110	146
Outward	-	-	1	-1	-	-
Memorandum						
Kazakhstan						
Inward	272	1,152	1,472	1,283	2,823	2,561
Outward	-	8	4	4	27	423
Russian Federation						
Inward	424	2,761	3,309	2,714	2,469	2,421
Outward	94	1,270	2,208	3,177	2,533	3,284
Central Asia						
Inward	376	2,997	2,462	1,871	3,963	4,035
Outward	-	179	360	17	201	765
Developing countries						
Inward	50,052	191,284	229,295	246,057	209,431	162,145
Outward	21,517	49,837	72,786	99,052	47,382	43,095
World						
Inward	180,901	686,028	1,079,083	1,392,957	823,825	651,188
Outward	203,414	683,211	1,096,554	1,200,783	711,445	647,363

Source: UNCTAD country fact sheet (2003) available online: http://unctad.org/sections/dite_dir/docs/wir03_fs.ge.en.pdf.

5.11. EU as a Part of Idea Diffusion or External Force of Change

There is no evidence that the EU as policy actor in the tax code creation process mattered as a source of ideas, information or coercion. The EU has been an active actor in the Georgian policy arena but has limited its role to customs and transport policy, while most of its funding came in the form of humanitarian aid to the impoverished state. The EU's role in tax policy reform was limited to particular tax types and avoidance of double taxation. From 1992 the EU supported Georgia through various programs, mainly emphasizing development assistance. It has refrained from policy influence and has provided funding to ongoing government reforms and corn for bread to the country. TRACECA (Transport Corridor Europe Caucasus Asia), the transnational project to connect Central Asia and Europe through Caucasus and the Black Sea was initiated in May 1993 in Brussels under the auspices of the EU. The project intended to build an alternative trade

and transportation route through Russia and was seen as a possible magnet of FDI in Georgia.⁵⁹ In November 1994, the EU provided 31 mil USD as well as 200,000 tons of grain to the government of Georgia (GC, November 1994, Vol. 3, No. 11). In January 1996, Georgia along with Azerbaijan and Armenia finalized a Partnership and Co-operation Agreement (PCA) with the EU that aimed to ensure most favored nation treatment in trade and cooperation in spheres of environment protection, transportation, investment and training (GET 1996:62). The PCA became effective in July 1999, the period when the EU was considered the most important trade partner and source of FDI in Georgia after the CIS countries (GET 1999:34). In 1997, the EU represented 20% (231.2 mil USD) of the total trade turnover in Georgia (GET 1999:43). Table 5.6 summarizes EU funding and the relevant programs provided to the Georgian government during 1992-1997, which confirms the statement above on the limited involvement of the EU as an external actor in Georgia's policy making processes. Most of its funding was provided as food aid amounting to 41 mil in 1994 and 22 mil EUR in 1996. The second area of EU policy priority in Georgia was humanitarian aid provided under the European Commission for Humanitarian Aid (ECHO) amounting to 12 mil, 46 mil, and 16 mil EUR in 1992, 1994 and 1996 (see Table 5.6).

Table 5.6: EU assistance to Georgia 1992-1997

Programs	1992-1993	1994-1995	1996-1997
TACIS	13	10	16
ECHO	12	45	16
FEOGA (food aid)	-	41	22
Exceptional humanitarian assistance	6	-	-
Food Security Program	-	-	34
Rehabilitation in conflict zones	-	-	8
Macro financial assistance	-	-	-
CFSP* and RRM**	-	-	-
European Initiative for Democracy & Human Rights	-	-	-
Other instruments	-	-	-
Total	31	96	96

* Common Foreign and Security Policy; ** Rapid Reaction Mechanism.

Source: EU Delegation in Georgia's official website, online: http://www.delgeo.ec.europa.eu/en/eu_and_georgia/cooperation.html

By the mid-1990s Georgia thus retained strong ties with equally weakly transformed CIS states, countries with their own share of struggles like territorial integri-

⁵⁹ For more on TRACECA see the website: http://ec.europa.eu/europeaid/where/asia/regional-cooperation-central-asia/transport/traceca_en.htm (last visited, June 20, 2010).

ty issues and democratization and reform of economic institutions (various GET reports). As mentioned, Georgia's global market integration level, which was similar to all CIS countries, was insignificant. Global market integration did not form a tax competition race for Georgia, while OECD countries were already working towards policy issues to tackle 'harmful tax competition'. The theoretical speculations which developed on tax competition outside the CIS countries were irrelevant for the emerging markets in the mid-1990s. Cooperation schemes between EU and Georgia, such as ENP, did not yet exist. Furthermore, the Georgian policy arena was split between reformist and non-reformist domestic policy actors. Transnationalization of the policy arena was still starting, while policy ideas were diffused within a narrow circle and the policy change mechanism was primarily coercive due to the IMF conditionality imposition. It is difficult to firmly argue that policy learning was not taking place in Georgia in the mid-1990s. However, we can say with high certainty that a coercive mechanism rather than policy learning accounted for the tax code adoption.

5.12. Summary

To sum up, tax policy making and adoption processes do not sustain the transnationalization argument. Policy ideas introduced by foreign experts did not empower local policy actors. There was no local initiative to elaborate the alternative tax code model or alternative tax policy principles that would challenge the IMF supported tax code project. And even if learning was taking place at a slow speed during those processes of elaborating the first tax code among domestic actors, it showed no signs of internalizing those ideas and empowering local actors. Moreover, the diffusion of new tax policy ideas and, consequently, the learning process (if it was occurring at all) were limited to individuals who were in close connection with foreign experts and state institutions which worked on economic policy (and tax policy in particular). However, over time the Georgian policy arena evolved and opened up to multiple actors and ideas, and this altered the policy change mechanism from coercive to non-coercive. The details are discussed in Chapter 6 which covers the policy change period of 1998 to 2004.

Chapter 6

Georgian Tax Policy Making during the Period of Grand Reforms before the Rose Revolution

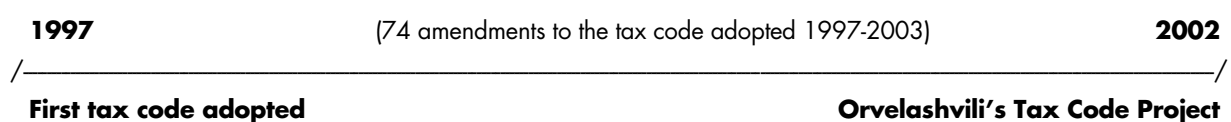
This chapter investigates the causal chain of how tax policy ideas (i.e. broadening the tax base, reducing tax rates, and introducing a flat personal income tax) were internalized by domestic actors and how they subsequently led to a policy change. It explores the processes of tax policy initiation, the actors behind those initiatives and the mechanisms of idea diffusion that were at work when latent concepts turned into codified norms, all of which are summarized in Table 6.1:

Table 6.1: Summary of the time period, policy initiatives, and actors discussed in Chapter 6

Period	Actors	Policy initiatives
June 1997 – November 2003	Non-state organizations International organizations (IMF, WB, EU, USAID, UNDP) State institutions (Parliament, Government) Interest organizations (business interest representatives, political parties, trade unions)	Tax code amendments adopted from June 1997 till November 2003 The Tax Code Project, known as Orvelashvili's Code initiated in 2002

The chapter reconstructs the narrative of the tax policy change process from the adoption of the first tax code to the Rose Revolution in November 2003. This process unfolds in two different political regimes: the period of Edward Shevardnadze's rule and the presidency of Mikheil Saakashvili, the leader who came to power through the Rose Revolution. The path of the policy change (illustrated in Figure 6.1) is described here with focus on policy initiatives and policy coalitions behind that initiative in the tax code.

Figure 6.1: The tax policy making process and important initiatives 1997-2003



There are two types of policy initiatives: the adopted tax code and related amendments by Parliament and the initiated tax policy project which was not adopted in 2002. The latter is an important document as it illustrates how ideas

were slowly taking effect in inspiring domestic actors to create a new tax policy that was beyond the narrow sectoral interests or the force of IMF conditionality.

The structure of this chapter is similar to the previous one and builds on the example of John M. Owen (1994). Like him I take a deductive approach and test falsifiable theoretical propositions stipulated in Table 3.2 while tracing the path of ideational policy change as conceptualized in Chapter 4. Section 6.1 provides a chronology of the main developments in Georgia which were related to the tax policy or had an important effect on policy making in general. Sections 6.2 through 6.11 test the theoretical propositions by stating whether evidence supports or rejects them. Conventional as well as transnationalization theoretical arguments are all tested accordingly, but not necessarily in sequence. Section 7.12 summarizes.

6.1. Political Dust Settling ...

Table 6.2: Chronology of main developments in Georgia 1998-2003

1998	First revision of the Georgian Tax Code initiated by Amchem
1998	IMF and WB threaten GoG with suspending funding if conditionalities are not met
1999	The political party Industry Will Save Georgia is established
1999	Parliamentary elections are held
1999	Partnership and Cooperation Agreement (PCA) between the EU and the Georgian government enters into force
2000-2002	Leszek Balcerowicz acts as economic adviser to the Georgian President
2001	The Cabinet of Ministers is dismissed by the President
2001	The New Rightists political party is established
2001	Edward Shevardnadze resigns from his position as chairman of Civil Union of Georgia (CUG)
2002	A new tax code project known as Orvelashvili's Code is elaborated
2002	Zurab Zhvania creates the opposition party United Democrats
2002	Mikheil Saakashvili forms the opposition party New National Movement
2003	Tax code amendments reach 74 just before the Rose Revolution
2003	The Rose Revolution takes place, Edward Shevardnadze resigns

During the late 1990s, Georgia showed signs of hope to emerge from the ashes as a state and to pursue grand political and economic reforms with financial and technical aid from Western countries. The country needed funding and was rather vulnerable to IFI conditionalities. Meanwhile, political institutions such as elections were slowly institutionalized in Georgia. The presidential and parliamentary elections in 1995, 1999 (parliamentary elections) and 2000 (presidential

elections) established a practice of choosing state representatives and legislators in Georgia. Although those elections strengthened the political power of Edward Shevardnadze and his allies, they were still a step forward in forming a modern state in Georgia (Nodia 2002; Demetriou 2002). At the same time, non-state actors such as domestic NGOs, interest groups and political parties increased in number and improved in their organizational capacity. By the end of the millennium and just before the Rose Revolution political parties, such as Industry Will Save Georgia and New Rightists, with clear business interests emerged and managed to take up seats in the legislative body (Nodia and Scholtbach 2006). The struggle over shaping the tax policy continued among policy actors, some of which supported and promoted new ideas and some of which harshly objected them and strove to mould the tax policy on sectoral interests. The Georgian tax code was undergoing rapid changes throughout this period and strong business interest representatives in the Parliament often managed to offset the IMF imposed policy amendments. The tax base and tax rates were reducing, while the budget deficit remained high and the IMF was frustrated with the Georgian government. Meanwhile, the flow of new tax policy ideas and the forum where those ideas were diffused and communicated to domestic policy actors was growing. The policy arena in Georgia was slowly becoming transnational as it incorporated a triad of actors. However, their influence on tax policy making varied greatly, while the government was split between reformist and non-reformist political forces. Meanwhile the President kept pursuing 'balanced politics' among fragmented political camps which, at the end of 2003, erupted into open conflict and led to the resignation of the President through the event known as the Rose Revolution (Wheatley 2005; Karumidze and Wertsch 2005). Throughout this period, the tax policy underwent numerous changes. Which factors caused the initiation and adoption of tax amendments as well as the non-adoption of the tax code project called Orvelashvilis's Code is investigated below. But first: Were tax policy ideas multiple and available to policy actors?

6.2. Ideas

6.2.1. Source of Ideas

The diffusion of tax policy ideas increased as the source of information diversified and became available to a broader array of policy actors in Georgia. The idea 'pools' that provided inspiration and policy learning possibilities to the domestic policy actors in Georgia were various: foreign experts, success stories of neighbouring countries or 'best practice' examples, as well as research centers disseminating information on economic reform. Experts' advice is a source of ideas and can provide concrete policy solutions. The need for external ideas to flow into the Georgian political arena had been high since the early 1990s for the

simple reason that the state needed to be formed and all its institutions reformed to match two indicators: democratic political institutions and open market economy principles. In both cases, domestic actors, state or non-state, had limited information on how to build those institutions and, needless to say, almost no experience. Therefore, the domestic policy actors' demand for information, advice and concrete policy ideas was large. International organizations such as USAID and UNDP often provided foreign experts for the projects they funded in the midst of the economic and political reforms in Georgia during the policy making period covered in this chapter (Interviews 2 and 6). It is worth noting that during this period WB and IMF provided only little technical assistance to the Georgian government in relation to fiscal policy or private sector development (Interview 1).

New policy ideas were also injected into the political arena by world-famous experts promoting new economic ideas. One of them, Leszek Balcerowicz, the architect of the shock therapy plan for Poland, had visited Georgia in the mid-1990s. The reason for the visit stayed undisclosed even to the representatives of the state agencies, such as the Ministry of Economy. After five years he returned to Georgia as adviser to the President in economic matters for two years during 2000-2002. The IMF financed his stay. A local group was set up to make sure that Balcerowicz' advice was followed in ongoing policy reforms, but his recommendations to the state were secret and were delivered to the president. The Georgian government did not follow the policy prescriptions closely and some analysts argue that they distorted the shock therapy reform framework (Papava 2002). This does not mean that Leszek Balcerowicz' ideas might have not diffused within the state agencies which had tight contacts with his local group, but it would be an exaggeration to ascribe his presence in Georgia a big role in the horizontal diffusion of new ideas. Regardless of the final outcome of Balcerowicz' work in Georgia, it indicates that new ideas were not completely foreign to the Georgian policy actors, be they from the group of supporters or opponents of his shock therapy doctrine, who mostly interacted with policy advisers sharing this ideology and those that represented institutions such as IMF, USAID and WB.

Examples of successful stories on tax reforms among CIS countries started to surface by the end of the millennium. The Russian Federation reformed its tax system and adopted a new tax code in 2000 which was enacted in 2001. Soon more complex administrative reforms improved tax collection in Russia. The IMF has evaluated those reforms as a positive change in Russia's economic reform processes. The Russian example of a successful tax system reform that simplified the tax code and introduced a new tax type, i.e. a flat personal income tax, was referred to by the policy coalition members who elaborated a new, alternative tax code in 2002 known as Orvelashvili's Code. The introduction letter clearly indicated that Russia's success story had served as an example for Orvelashvili's Code:

The following project takes into account existing problems, their particularity and the international experience fully. It is worth emphasizing that the authors of this project were closely followed the results of the tax system reforms of the last two years in Russia (which was highly appraised by the International Monetary Fund in September 2002 at the Third Decade Summit organized by the World Bank) and all the positive conclusions based on its analysis are reflected in this project.⁶⁰

Finally, a policy center established in Tbilisi in the mid-1990s under the auspice of the EU TACIS program facilitated idea diffusion and provided a forum for experts, practitioners and theorists, to exchange ideas. The Georgian-European Policy and Legal Advice Centre (GEPLAC) was established in 1998 by TACIS and had three overall aims: it supported economic and legal reforms in Georgia; it provided economic policy and legal advice to the Georgian government; and it continued to publish the Georgian Economic Trends (GET) and the Georgian Legal Review (GLR). Both GET and GLR were previously run as a program under the TACIS Policy and Legal Advice Center through the European Expertise Service (EES) since 1995. The explanatory note on TACIS and the EES (after 1998 the explanatory letter describes TACIS and GEPLAC) described the mission of this program stating that TACIS provides knowhow to the Newly Independent States (NIS) in the transformation to market economies and democratic societies (GET 1995-2004). Moreover, TACIS was to cultivate 'links and lasting relationships between organizations in the partner countries and the EU to promote understanding of democracy and a market-oriented social and economic system' (GET 1995:1). This mission of linkage formation and knowhow dissemination on the ground was possible via an EES program, which reflected the overall mission of TACIS. The EES was said to provide 'collective experience and expertise of the European Union, including that of public and private sector and that of senior policy makers and experts from academic and research institutions' (GET 1995:1). Its main area of expertise was within macroeconomics, economic restructuring, legal advice and institution formation (GET 1995:1).

After GEPLAC replaced the EES, the program turned into a center which could carry on with the functions and goals inherited from the predecessor. Regardless of this change, TACIS – which was the initiator in the establishment of these entities – has remained and so did its aim in the region of NIS. GEPLAC has continued producing quarterly reports as well as research papers printed and up-

⁶⁰ The original text is as follows: 'proeqti srulad iTvaliswinebs saqarTvelos sinamdvileSi arsebul problemebs, maT specifiurobas da saerTaSoriso gamocdilebas. gansakuTrebiT aRsaniSnavia, rom proeqtis avtorebi mudmivad adevnebdnen Tvals ukanaskneli ori wlis ganmavlobaSi ruseTSi ganxorcielebuli sagadasaxado sistemis reformis Sedegebs (ramac maRali Sefaseba daimsaxura 2002 wlis seqtembris mesame dekadaSi savaluto fondis da msofli bankis xelmZRvanelTa ukanasknel samitze) da maTi analizis safuZvelze miRebuli yvela pozitiuri daskvna praqtikulad asaxulia warmodgenil proeqtSi' (Orvelashvili 2002) Author's translation.

loaded to the program's website so that the availability of the reports was not limited to the published copies only. The quarterly reports have analyzed the ongoing economic reforms in Georgia and provided a platform for Georgian as well as foreign experts to publish their analytical articles on economic reforms or policy initiatives in Georgia. Many articles discussed international norms or existing practice in relation to a particular policy initiative. Taxation was a frequent topic of scholarly discussions in GEPLAC reports, which in 2002 also provided a platform for the policy coalition working on the new tax code project called Orvelashvili's Code. The 'Concept of the New Taxation System of Georgia' was published in 2002 by the team of authors led by Niko Orvelashvili and explained the main principles of the project and how those changes could improve the taxation system in Georgia (GET 2002:62-68).

Thus, the diffusion of ideas and linkage formation between the EU and Georgia started the mid-1990s. The process was continuous and strengthened over time with larger amounts of funding the establishment of a center that replaced the time-limited program of the EES. Like IFIs, EU is promoting new tax policy ideas in its region and in neighbouring countries. Therefore, EU's long-term activities and its role in Georgia's transformation are vital to point out. As we shall see below, the EU was one of the important sources of ideas in the process of economic reforms in Georgia and it made information available to a broader public by distributing it on the internet. Meanwhile, the platform where ideas could be shared among policy actors in Georgia has broadened and diversified compared to the policy period discussed in the previous chapter.

6.2.2. Availability of Policy Ideas

Broad availability of information and linkages (through training, workshops and cooperation) formed among the triad actors who facilitated the policy learning processes. In the process of policy learning and broader diffusion of new tax policy ideas in Georgia, the emergence of the third sector played an important role. The narrative of NGO sector development below describes the gradual increase of its role in the policy arena.

6.2.2.1. Development of the Third Sector in Georgia

In 1997 Georgian NGOs entered the second phase of their existence when they had to be re-registered in compliance with the newly adopted Civil Code. The number of re-registered organizations actually dropped to 1,500 by 1999 (USAID 1999: 48). Over the following two years, the number of registered NGOs again reached the starting point of 3,000 in 2001, but experts acknowledged that the number of the NGOs mattered less in the process of third sector formation in the country. Out of several thousand NGOs, only some 500 to 800 were active and

only 100 operated full time. Moreover, only 20 to 50 NGOs were actually able to take part in the policy formulation and decision making process on the national level (USAID 2001:71).

Obtaining funding within the country for the third sector remained a problem. Only a handful of well-developed NGOs enjoyed diversified funding resources and technically well-equipped offices. In general, Georgian NGOs remained heavily dependent on foreign funds. Approx. 95% of their budgets were made up by donated money from international funding resources and only rarely was 10-20% of their budgets income from their commercial activities (USAID 2001:72). Foreign funds are often directed not to the organizations per se but to particular projects. Project funding often meant that local NGOs did not develop strategies, as they preferred statements of purposes so as not to limit their access to available funds (USAID 2003:82). Few business sector representatives donated to NGOs and wished to keep their names secret to avoid publicizing their philanthropy which could attract unwelcome attention from tax inspectors (USAID 2001:73). The government was prohibited by law from funding NGOs, however, several cases of distribution of funding to NGOs which the government obtained from international organizations have been found. In 2001, UNESCO funds went to some NGOs through the government (USAID 2001:73).

Georgian NGOs provided various services like training, legal counselling, research, policy analysis, public opinion surveys (USAID 2002:77); others advocacy on issues such as human rights and corruption (USAID 2002:74). The flow of information and access to knowhow for Georgian NGOs in certain policy areas, as well as in NGO sector management, were growing. There were more and more possibilities for Georgian NGOs to obtain training, consultations and literature on strategic planning, NGO philosophy, fund raising, finance management and accounting. For that matter, both Georgian and foreign NGOs formed resource centers or Intermediary Support Organizations (ISO) (USAID 1999:50). The number of professional trainers in Georgian NGOs gradually increased. By 1999 Horizonti members obtained certificates as professional trainers after completing a course designed at The Johns Hopkins University. The knowledge of those trainers was in high demand by the newly established organizations in Georgia (USAID 2000:80). Training sessions and workshops where information sharing and knowledge transfer took place among Georgian and foreign NGOs were ongoing by the end of the millennium. In 2001 USAID financed the restructuring of the tax administration in Georgia, which aimed to increase the qualifications of tax inspectors. The inspectors would be tested in tax legislation and this training was provided by the GYLA, a non-state actor subcontracted by the external actor. Although this cannot be generalized to all NGOs in Georgia, it indicates that intellectual expertise and the capacity to train among local NGOs was accumulating and growing. While most NGOs were clustered in Tbilisi, Georgian NGOs slowly started to open

offices in the regions as well. Local NGOs were actively engaged in civic education efforts (USAID 2001:74). The flow of competence and knowledge from the center to the peripheries of Georgia increased by 2003 as the NGO survey showed (USAID 2003:82). Meanwhile, Georgian NGOs formed strong networks with international counterparts. Organizations such as Horizonti, the Young Lawyers Association and ICRDGE were among the strong and active NGOs with close linkages across borders (USAID 1999:50).

NGOs have successfully lobbied some of the laws concerning NGO operations in Georgia. In 2002, under the leadership of Horizonti, Georgian NGOs advocated against a proposed tax on NGO grants amounting to 3%, and succeeded in halting the government plan (USAID 2002:77). Coordinated by a Georgian NGO, the Civil Society Institute (CSI), NGO legal experts engaged in tracking NGO related legal initiatives before they were adopted. In 2003, the effort to block the government's initiative to enact the draft law on 'Prohibition of Extremist Organizations', which could make any NGO with international linkages a potential suspect, was successful. In the same year, NGOs challenged the Ministry of Finance in court, because it required all NGOs to register their grants with the State Treasury, and NGO advocacy activities secured them the same social tax exemption privilege they had before as they successfully lobbied against cancelling this privilege in the Law on Mandatory Social Insurance (USAID 2003:81). The most famous case of NGO advocacy and lobbying capacity was their involvement in monitoring and evaluating the parliamentary elections in 2003. The Young Lawyers Association and the International Society for Fair Elections and Democracy (ISFED) submitted the report to the Constitutional court that annulled the results of the elections. Those events preceded the Rose Revolution. The famous students group Kmara (Enough!) that demonstrated against Shevardnadze's regime in 2003 also involved NGO activists (USAID 2003:84). I will discuss the political processes related to the Rose Revolution below.

Well-established NGOs had clearly defined spheres of operation. For instance, the Young Lawyers Association was involved in legislation monitoring and elaboration processes, while the Economists Association monitored the budget and was involved in economic policy issues, similar to GEDI (Interview 16). Those NGOs cooperated with the government as well as with businesses (USAID 2001:74). In parallel with the enhanced capacity of NGOs, successful cooperation with businesses and governments increased alongside the growing density of linkages with international organizations.

6.2.2.2. Cooperation among Triad Policy Actors through Training Sessions and Consultations

Government cooperation with the NGO sector was not frequent, but there are several cases of successful cooperation at the national as well as the regional

level. Beyond the Parliament where Zurab Zhvania attracted young NGO members, some ministries established collaboration with Georgian NGOs, benefiting from their knowhow and capacity to draft policies and provide recommendations in specific policy spheres. The instances of successful collaborations were not widespread, but they grew in number from late 1999 till 2002, when the environment for NGOs started to deteriorate in the midst of widespread corruption and open confrontation among reform-minded and old guards in the political elite. Cooperation between NGOs and the business sector started to take shape during the same time period. A USAID (1999:50) report summarized those tendencies:

Progressive thinking businessmen and reform-minded officials in government tend to appreciate the activities of NGOs in the establishment of free-market economic principles and liberal-democratic values in Georgia.

Since 1998, a special advisory council in the State Chancellery that mediated relationships between the President and the NGOs existed. One USAID report (2000:79) summarized this collaboration as less effective as NGOs were not listened to. Cooperation between NGOs and the government in 2001 encompasses a variety of issues from law drafting to policy analyses and consulting. The Ministry of Justice was aided by a number of NGOs to provide an overview of the issues of penal reforms. The Unified Election Code draft in the same year was elaborated in the Parliament with the assistance of several NGOs. Also a group of parliamentarians, executives from the State Chancellery, and NGOs created a draft law on Local Self-Governance. The Ministry of Environment and Natural Resources often held consultations with NGOs as well (USAID 2001:73). In 2002, Rustavi Mayor consulted with NGOs aiming to develop citizens' relation facilities and materials, whereas the Governor of Kutaisi (the second largest city in Georgia) had been consulting with NGOs regularly and appointed three former NGO members to the local government (USAID 2002:78).

The business sector and NGOs slowly started to talk in the beginning of the new millennium. The USAID report from 2000 was optimistic about those developments, stating that the business sector acknowledged the potential of NGOs and their knowhow. However, as noted, the business sector had no legal incentive to contribute financially to the NGOs. A well-known business-NGO partnership was between the Industrialists and the GEDI institute working on an alternative tax code project known as Orvelashvili's Code. The collaboration was short-lived and one speculation was the negative stigma that NGOs carried in the eyes of Shevardnadze's government (USAID 2002:78).

6.2.2.3. Parliament and Business Sector

Business representatives were invited to the Parliament to form an *ad hoc* policy working group by Zurab Zhvania, a reformist chairman of the Parliament. The working group was called the Investment Legislative Support Council. It was given mandate to create and provide suggestions and comments on laws concerning the business sector. Some suggestions to the tax code as were made as well, however, focus was on the Law on Entrepreneurs for which they prepared and presented approx. 60 suggestions out of which some were taken into account in the final law draft (Interview 25). The council became large and turned into a bureau soon after the 1999 elections as more business representatives were included. Some of the members were the newly-formed business stratum in Georgia. The new business elite had tight links with the American Chamber of Commerce and their vision of how to run a business did not fully coincide with that of the so-called Industrialists (see Chapter 5). The processes of policy revision or suggesting amendments to the tax code were coordinated among those actors. Their political influence was enhanced by their personal contacts with the influential political elite members, such as the chairman of the Parliament (Interview 25 and 26). Later on, young reformers were appointed to ministerial positions, but their policy proposals and efforts to hinder the distortion of economic reforms in Georgia were falling on deaf ears.

6.2.2.4. AmCham, Local and International Organizations

Cooperation among various actors in working groups (which were also part of policy coalitions) facilitated learning and information sharing. The linkages of NGOs, state organizations and foreign experts were growing. A example is the Georgian tax code revisions led by Amcham (American Chamber of Commerce), a Tbilisi-based business-interest organization. There was a thorough revision of the first tax code by a group of local and international experts, under the coordination of Amcham and with technical support from USAID in 1999. The American Chamber of Commerce which was established in September 1998 gathered foreign experts locally engaged in promoting and lobbying for business interests with an international orientation. The aim was to review the tax code's chapters one by one and to provide contextual and linguistic suggestions to make the code applicable to the business sector and to reduce language ambiguities (Interview 7). The result was a report of over 100 pages containing suggestions to the government on possible changes to the tax code. This effort to revise the tax code exemplified an attempt by non-state organizations, foreign and Georgian, to work together with a single aim while opening up to inputs from and consultations with various business sector representatives and, finally, preparing a report for the government. Sharing experiences and exchanging expert know-

ledge between local and foreign experts was made possible during this four-month period in which the tax code revision group worked (Interview 7).

6.3. Policy Coalitions

Policy coalitions were formed around a common set of ideas, which were reflected in their support and/or initiatives of tax code amendments and/or tax code project. The new tax code project (i.e. Orvelashvili's Code) and the amendments to the first tax code initiated during 1997-2004 allow us to detect the main types of tax policy coalitions in the Georgian policy arena. Some of the lobbyists and beneficiaries of those tax policy initiatives reflected the new tax policy principles (i.e. broad tax base, low tax rates) while others favored a protectionist tax system with low tax rates and various tax exemptions. Among the three policy coalitions one group was led by the IMF and included the World Bank and the USAID. The coalition pushed for market reforms and opposed the tax code initiatives business interest groups were promoting in the Parliament of Georgia. Their policy ideas were to retain a tax code free from excessive tax exemptions so that the tax base would increase. This would increase tax collection, which was needed to cover the budget deficits. The other policy coalition consisted of politicians and political groups with strong business interests in the Parliament. Their policy initiatives indicate particularistic interests limited to their business goals and opposed to what the IMF and its coalition member organizations approved. The third policy coalition was a group of reformist individuals representing the newly emerging business stratum in Georgia, international organizations seeking to promote business interests and representatives of the third sector (NGOs), who were active in policy discussions and text elaboration processes. This coalition distanced itself from business sector lobbyists and the IMF and had its own vision of economic reforms in Georgia.

6.3.1. Orvelashvili's Code and Its Policy Coalition

The policy coalition working on Orvelashvili's Code was gathered around the idea of a need to reform the status quo by creating a simplified tax policy to improve tax administration practice and promote the business sector in the country. The policy coalition comprised the reformist wing of the political elite, international organizations and the new business elite. The tax code was criticized by everybody. Businesses felt it obstructed them in doing 'white' business and blamed complicated tax administration and numerous taxes and high rates for making them go 'underground', hide their profit and avoid tax payments. The IMF viewed the tax code as distorted due to the exemptions that hindered tax collection and contributed to the budget deficit increase. Yet there was no sign of a

new tax code proposal in the legislative body until 2002 when the so-called Orvelashvili's Code was born.

It all started in the first half of January 2002 when the newly appointed State Minister, Avtandil Jorbenadze, invited Georgian economic experts to an informal meeting to discuss Georgia's economic situation. He encouraged the experts to choose different areas of the economy and elaborate concepts for reforms that would address the economy's glaring problems (Interview 21). The meeting encouraged local experts to elaborate their own visions on and suggestions for economic reforms. Problems were pointed out in the Georgian economy, but the search for solutions was left up to the experts.⁶¹ One of them was Niko Orvelashvili, economics professor and founder of the Economic Development Institution. He had established himself as a tax system specialist, he was involved in the creation of the first tax code in 1997 and he established and successfully ran a non-government organization with a strong economic policy profile. He was involved in various projects funded by international organizations that required analyses of economic reforms in Georgia and maintained contacts with foreign experts, some of them involved in his own NGO. The idea of creating a new tax code project was born once the opportunity to propose policy suggestions to the 'government' opened after the meeting with the State Minister. It was up to the policy working group to elaborate the principles of the tax code project, the technical details and the text itself (Interview 14 and 27). Niko Orvelashvili used the technical basis of his own NGO while also raising funds for the policy working group that he formed. The funding came from two sources: the Open Society – the Soros Foundation in Georgia (OSGF) and Gogi Topadze's Fund (Orvelashvili 2002). The beer baron, Gogi Topadze and his allies representing the Industrialist faction took responsibility for lobbying for the final tax code project in the Parliament (Interview 14). The policy group was gathered and coordinated by Orvelashvili and included around 50 Georgian and foreign experts. Among the foreign experts was Steven Tupper, originally assigned to the TACIS projects in Georgia, but knowledgeable about tax reforms and participants in the Russian tax system change in 2001. His knowledge of the tax system was supplemented by his knowledge of the EU tax system which would align the Georgian project with EU principles (Interview 21). The policy group was effective. The main principles of the overall tax system reform was prepared by the spring of 2002 and the whole tax code project and relevant first and second order legal actors, who also had to change due to the tax code change, were all included in one project which was completed in the spring of 2003 (Interview 21).

⁶¹ Avtandil Jorbenadze voiced in January 2002, during the parliamentary session, that budget related issues would hopefully be tackled by the new tax code a special commission was working on (Civil Georgia, January 16-18, 2002).

The overall ambition of the tax code project was to create a document written in such a simple language that everyone could understand, from taxpayers to tax administrators and common citizens. Moreover, norm ambiguity had to be eliminated. The tax code had to be easy to comply with, helping businesses to operate without hiding taxes and avoiding tax payments. The tax code had to simplify the whole tax system in terms of tax types, tax rates and tax administration. The tax code had to establish the relationship between the taxpayer and the tax administration on an equal basis when the taxpayer was not a priori considered a non-voluntary payer. Based on these expectations, the basic principles of the tax code were elaborated by the working group (Interview 27). The new tax policy project incorporated basic principles on broad tax base, low tax rates found in tax systems elsewhere. It promoted the idea that a tax policy should support economic growth while tax administration should service the taxpayers (Interview 2). The four main principles were: (i) to reduce the number of payments and to make the calculation and payment processes transparent; (ii) to ensure that the new tax system suited its environment in order to make it an enforceable legal act; (iii) to sharply reduce tax evasion; and (iv) to set up a tax system that promoted economic growth by stimulating investment (Orvelashvili 2002: 62-67). The project proposed two personal income tax regimes with single rates, thus introducing the notion of a flat tax. One income tax system operated with a tax of 20% including family exemptions, the other with a tax of 10% without exemptions (*ibid.*).

6.3.2. The Tax Code Amendments and the Policy Coalition behind Them

The policy coalition containing state actors and business interest groups shared policy issues such as granting tax holidays and exemptions for local businesses. The policy coalition that pushed for tax amendments in the Parliament in favor of particular sectors consisted of political parties, e.g. Industry Will Save Georgia, the New Rightists and the Civil Union of Georgia (CUG). The tax code amendments promoted the fractions of those parties in the Parliament reflected an ideological stance somewhat different from a broad tax base and low tax rates policy principles. For instance, out of 74 tax code amendments from 1997 up to 2003, the Industrialists as behind only four of them; the ruling party, CUG, initiated eight of them; and the Rightists pushed only one. A summary of the changes and their detailed content is provided in Table 6.3. Here, only amendments initiated by the political parties mentioned above are discussed. The histories of these political parties are worth reviewing as they provide the context of the initiatives they promoted in the Parliament.

6.3.2.1. Industry Will Save Georgia

'Industry Will Save Georgia' was established in 1999 by industry lobbyists under the leadership of Gogi Topadze, the successful Georgian entrepreneur often referred to as the beer baron. The party was built on the ruins of the Union of Industrialists, created in 1990 by medium-size enterprises, which fiercely opposed the IMF tax policy recommendations in the early 1990s (Jones 2000). The main program was to promote national production and a pro-business environment, including changes in tax policy. Its leader, Gogi Topadze, is known as a beer baron and founder of the company Kazbegi (Devdariani 2004:98). The party has been poorly connected with international parties and often relied on its own resources. The party mainly cooperates with locally based international NGOs such as the National Democratic Institute and the International Republican Institute in conducting educational programs (Nodia and Scholtbach 2006:237). Topadze has been unequivocally opposed to IMF economic policy in Georgia, arguing that it destroyed local production by putting it into an equal competitive environment along with foreign companies.

In the 1999 parliamentary elections, Industry Will Save Georgia won 15 seats. Its main political agenda was to support the business environment and influence the economic policies that the government was implementing under the influence of the IMF. During its tenure in Parliament, the Industrialists succeeded in pushing four amendments, starting in 2001 and ending in 2003, introducing exemptions from profit tax on investment in hotel construction in the highlands (Georgian Law #1967) and a tax amnesty on the tax obligations on agricultural land for physical persons (Georgian Law #2495). The Industrialists also managed to push for tax code provisions concerning organization and tariffs on free market places in the capital and vicinities. Moreover, the norms intended to provide favorable tariffs to those using the territory within the free market for products such as agricultural products and construction products (Georgian Law #1313).

Finally, the Industrialists initiated an amendment to the tax code in 2001 which introduced a social tax aimed to become the necessary financial base for establishing a state fund for Social Security and for financing state employment enhancement programs. This tax was paid by employees or by a physical person on income from economic activities. Moreover, the amendment regulated the terms of payment of this particular tax, stating that it had to be transferred by taxpayers to a special account created within the Treasury for this tax (Georgian Law #1088). These policy initiatives demonstrate that the protectionist stance in the Industrialists economic policy has not changed much since the early 1990s. Their ideas on the tax system differed radically from the IMF-promoted norms. In comparison, the Rightists party took a softer stance on economic policy; however, their policy initiatives also reduced the tax base in Georgia.

6.3.2.2. New Conservative Party

The New Conservative Party was formed in 2001 by young businessmen, who were previous members of the ruling party, the Civil Union of Georgia (Shevardnadze's political party). However, internal conflict led to a split from the party and the establishment of a new one. Allegedly, David Gamkhrelidze was promised a position as State Minister because of his generous contributions to the elections in 2000, but powerful members of the ruling party did not allow this to happen. In 2001, Gamkhrelidze and his supporters left the CUG and established the business-interest lobbyist party, the New Conservative Party, which won seats in the parliamentary elections both in 2003 (just before the Rose Revolution) and in 2004. David Gamkhrelidze, the leader of the New Conservative Party (NCP), is founder of the large Georgian insurance company Aldagi, which enjoyed protectionism under Shevardnadze's regime. Established in 1994, Aldagi provided obligatory car insurance for individuals and fire damage insurance for companies (Devdariani 2004:114, fn. 14). The NCP has links to the International Democrats Union and cooperates with parties in Germany (the Christian Democrats), Greece (Nea Demokratia), Poland (the Civil Platform), and Ukraine (Our Ukraine) (Nodia and Scholtbach 2006:249). Like the Industrialists, the NCP supports business interests in the Parliament. However, unlike the Industrialists, it sees economic openness as necessary for Georgia. The New Conservative Party believes that national values have to be merged and preserved in the globally integrated market systems (pp. 119-51). The tax policy amendment pushed by the New Rightists in the Georgian Parliament in 2003 lobbied for VAT exemption on particular product imports. The evidence on their policy initiatives is limited in terms of the tax code amendment. However, the party leader's personal business interests were promoted to the legal initiatives, as stated above, of the insurance company Aldagi. Protectionism of one business and lobbying for tax exemptions obviously contradict the tax policy motto of a broad tax base.

6.3.2.3. Civil Union of Georgia

Compared to those two political parties, the ruling party faction has evidently been even more active in promoting business interests through tax code amendments on tax exemptions. In 2000, a faction of the CUG initiated an amendment to the tax code which introduced an exemption from the social contributions of medical institutions which obtained funding from the state budget in the municipality funded programs (Georgian Law #557). The CUG faction initiated a tax code amendment which introduced an exemption for agricultural land which had been destroyed by a natural disaster or force majeure from January 2002 to January 2003 (Georgian Law #2120). Furthermore, by lobbying on the Georgian Law #1895, the faction pushed for a particular tax regime for individuals with ba-

keries and those who produced and sold confectionary products. Those individuals were exempt from VAT, profit tax, social contributions and taxes for using the roads and were instead given a fixed tax rate depending on the size in square meters of their business. Moreover, there were law initiatives by the faction of the CUG in the Parliament. One initiative introduced VAT exemption on water supply to Engurhes Hydro Power Plant from January 2000 to October 2003 (Georgian Law #1218). Georgian Law #1005 referred to the bonuses in kind to be distributed to the state agencies and, finally, Georgian Law #859 introduced a change in the tax code which granted exclusive right to import liquid products with serial numbers 391190000 and 391190900 to enterprises with the proper license on environmental protection. The amendment introduced a favorable excise tax – 50 GEL on 1 tonne of the liquid product – on those importers. The content of the tax policy initiatives successfully pushed by the CUG faction shows where its interests lay. Moreover, it demonstrates that while the IMF, its policy collaborators and international organizations tried to push for pro-market economic reforms, sectoral interests in the Georgian policy arena were significant and rather powerful. Policy actors representing business interests had support from the non-reformist wing of the Cabinet of Ministers and parliamentarians, which reversed the race towards a protectionist tax policy in Georgia. To see the extent to which sectoral interest representatives managed to prevent adoption of the Georgian tax code in 1997, it is worthwhile to scrutinize the rest of the amendments.

6.3.2.4. Georgian Tax Code Amendments

The policy coalition which pushed for the tax code changes in line with the sectoral interests was strong and successful in reversing the IMF-propagated tax principles of a broad tax base and reduced tax rates. A closer look at the tax code amendments pushed through Parliament 1997-2003 indicates the presence of strong business sectors which managed to influence the policy arena. For instance, the 74 tax code amendments adopted under Shevardnadze's rule predominantly granted exemptions on VAT and excise taxes to various sectors. Mostly agricultural production, imported fuel oil, natural gas and electricity, imported cigarettes, and newspapers and magazines were exempted from VAT. Wheat, domestically produced cigarettes, and electricity other than that supplied to the final consumer were zero-rated. Oil and gas products, electricity import and distribution were included in the VAT exemption list. So was humanitarian aid in the kind of grants, import of materials needed for preparing goods for export, medical equipment for the sick, the handicapped and the old, import of goods for diplomatic entities, etc. (Georgian Tax Code 1997:40-42). Tax holidays were mostly granted to insurance and renewable energy and deductions were bestowed on their income. Tax nepotism was particularly obvious in VAT and excise tax ex-

emptions. However, some of the amendments the tax code affected personal and corporate income tax as well. The increased list of income tax deductions and tax holidays reduced the income tax base dramatically.

Consequently, the tax income base was being reduced before the Rose Revolution. The overall dynamic of the incorporated changes in the tax code from 1997-November 2003 is illustrated Table 6.3. Due to the focus of this dissertation, the emphasis is on the revision of the amendments which falls on two tax types, PIT and CIT, and it is explored from the perspective of the tax base and the tax rate changes. The two indicators show the shift towards competitive tax policy making initiatives over a seven year period.

The table provides the number of tax code amendments and the years they were adopted by the Georgian Parliament. There are two initiators of amendments: the President or the Parliament. Further details on the factions that lobbied for the changes are provided in brackets and the content of those policy initiatives are described in the notes. Only some of the tax code amendments affected the personal or corporate income tax rate or the tax base. The total number of amendments which narrowed the tax base by imposing deductions and exemptions from profit payments as well as on personal income taxes was 22. Sectors favored by the amendments included bread production, medical institutions, renewable energy, as well as some economic activities in the highlands. Moreover, income from property transfer, from activities that increased the value of one's assets, and income received from leasing a property were exempted from personal income tax. The rest of the amendments, besides the 22 mentioned above, granted tax holidays and deductions on two types of taxes: VAT and excise tax. But the amendments did not go unnoticed. Reversing them were one among other policy priorities which the IMF and its collaborators had.

Table 6.3: Dynamics of tax code changes adopted in the period 1997-2003 (before the Rose Revolution)

Year	Number of amendments	Initiator of the amendment: president/parliament	Effect on personal income tax	Effect on corporate income tax
1997	3	0/3		2a
1998	7	5/2	2b	2c
1999	11	7/4 (CUG – 1d)	2e	3f
2000	12	3/9 (CUG – 1g)	2h	1j
2001	12	5/7 (Indus. – 1k; CUG – 3l)		
2002	16	10/6 (Indus. – 1m; CUG – 2n)	2o	2p
2003	14	5/9 (CUG -1q; Indus. – 2r; New Rightists-1s)	2t	2u
Total	74			

- a. This amendment granted tax deductions on profit income to organizations or enterprises which employed individuals with limited capacity (Georgian Law #870, article 47). The amendment introduced by Georgian Law #870, article 47 granted tax deductions on profits made by a physical person from selling material assets.
- b. The amendments introduced tax deductions on income received from a physical person in the form of a gift or heritage (Georgian Law #1666, article 43). Georgian Law #1369, article 43 introduced income tax deductions on income received by a non-resident from renting in the diplomatic representation or in similar institutions.
- c. This amendment introduced a profit tax deduction on profits from economic activities by ship construction enterprises which do not carry out economic activities on Georgia's territory, are established by a non-resident and whose ships do not sail under Georgian flag (Georgian Law #1406, article 47). Georgian Law #1666, article 64 introduced a non-resident's income tax at the source of the activities of international transportation of goods and people.
- d. This amendment aimed to incorporate changes in terms, such as economic activities, instead of entrepreneurs' activities (Georgian Law #2056).
- e. Deductions were introduced on personal income tax for families with more than two children living in the highlands of Georgia on an income lower than 3000 GEL, and families with one or two children in the highlands were to be taxed at 50% less than the personal income tax rate (Georgian Law #2080, article 43); Georgian Law #2180, article 43 introduced a deduction in personal income for families who receive income from selling agricultural products produced on family-owned agricultural land, and for families who adopt a child.
- f. Georgian Law #2080, article 47 introduced a profit deduction on commercial enterprises located in the highlands of Georgia and on the production and selling of equipment for renewable energy or for renewable energy storage. Georgian Law #2343, article 47 added a profit deduction to the part of the income received by an enterprise located and operating in the highlands. Georgian Law #2386, article 64 introduced a 4% tax rate on non-residents' income from economic activities, from TV communication and transportation activities, and on income received from sub-contractors who are non-resident involved in oil and gas business activities.
- g. The CUG-initiated amendment to the tax code introduced an exemption from social contributions on medical institutions which obtained funding from the state budget or, albeit rarely, participated in municipality-funded programs (Georgian Law #557).
- h. Income tax deductions were granted on the compensation for the cost of uniforms, as well as goods given to individuals working with particularly dangerous substances (Georgian Law #470). Income deductions were granted on income Olympic champions and their instructors receive in the form of honorarium or in kind (Georgian Law # 544).
- i. Amendments to Georgian Law #470, article 54 introduced expense deductions on basic means categorized as deductible. The more deductions were introduced the less tax base was left, which in this project is seen as a shift away from the principles of a broad tax base, low tax rates.
- j. The Industrialists initiated an amendment to the tax code in 2001 which introduced a social tax aimed to become a necessary financial base for establishing a state fund for Social Security and for financing state employment enhancement programs. This tax was paid by employers or by a physical person on income from economic activities. The amendment regulated the terms of payment of this particular tax, stating that it had to be transferred by taxpayers to a special account created within the Treasury for this tax (Georgian Law #1088).
- k. The parliamentary fraction of the CUG party made tax law initiatives in 2001. One introduced VAT exemption on the water supply to Engurhes Hydro Power Plant from January 2000 to October 2003 (Georgian Law #1218); also Georgian Law #1005 referred to the bonus that were to be given in kind to the state agencies; and finally, Georgian Law #859 introduced a change in the tax code which granted sole

right to enterprises with a proper license on environment norm protection to import liquid products with the serial numbers 391190000 and 391190900. Moreover, this amendment introduced a favorable excise tax – 50 GEL on 1 tons of the liquid product – on those importers.

l. The Industrialists initiated the tax code amendment, Georgian Law #1313, which mainly referred to provisions concerning organization and tariffs on free market places in the capital and vicinities. Moreover, these norms intended to provide a favorable tariff to those using the territory within a free market for products such as agricultural products and construction products.

m. The CUG initiated Georgian Law #1895, which created a particular tax regime for individuals with bakeries and those who produced and sold confectionary products. Those individuals were exempt from VAT, profit, social contribution and the taxes for using the roads, and were instead given a fixed tax rate dependant on the space in m² of their businesses. Georgian Law #1498 eliminated the provision on electricity to the consumers and the loss in this process.

n. On Georgian Law #1895, article 273 see note below. Georgian Law #1586 introduced a tax deduction on grants, state pensions, state stipends and state allowances.

o. Individuals who own or use a bakery which is under 20 m² is free from the income tax; bread bakeries are exempt from the social contribution, and individuals who receive salary are exempt from income and social taxes (Georgian Law #1895, article 273). Moreover, Georgian Law #1586 introduced a 10% tax rate on the interest taxable at the source and paid by the State on its treasury obligations payable in the form of interest.

p. The CUG initiated a tax code amendment which introduced an exemption from the agricultural land which had been the victim of a natural disaster or force majeure January 2002 to January 2003 (Georgian Law #2120).

q. The Industrialists initiated an amendment introducing exemptions from the profit tax on investment in hotel construction in the highlands as well as on the profits from operating tourist housing (such as hotels). If the investment was 50 mil USD, hotels would be exempt from profit tax for 10 years, those under \$0.25 mil for 2 years and after 4 years the tax rate would be 50%; 10 mil USD investment and the hotel built with that money was fully exempt from profit tax for the first 5 years from its utilization and after that the rate would be 40% for 2 years. Interestingly, the investments eligible for this profit exemption were those which were made before March 15, 2003 (Georgian Law #1967); the Industrialists also initiated Georgian Law #2495, introducing tax amnesty on tax obligations on agricultural land for physical persons.

r. The New Rightists initiated an amendment introducing serial numbers of particular products the import of which was exempt from VAT tax (Georgian Law #2084).

s. Georgian Law #2298 introduced exemptions on income employees receive from an employer either in the form of an insurance premium or in other forms of payment for health and life insurance payment paid by the employer. This insurance premium cannot be considered part of the overall income unless it is more than 30% of the employee's salary and no more than 1200 GEL. The law also introduced personal income tax on grants, pensions and state allowances. Georgian Law #3020 stated that a physical person's income from a non-permanent work place had to be taxed with the highest tax bracket on PIT.

t. On Georgian Law #1967, see fn. q; Georgian Law #2325, article 47 exempted the part of the profit that medical institutions received from economic activities and reinvested either in the rehabilitation of the institutions, the technical base or for the employees in the form of a bonus.

Source: Tax Code Amendments obtained from the software Codex 2009, Tbilisi, Georgia.

6.3.3. The IMF-led Policy Coalition of International Organizations

The level of Georgia's indebtedness grew over the policy change processes investigated in this chapter (see Appendix 5). Reliance on IMF credits increased as well, not only compared to previous years but also compared to other CIS

countries (see Appendix 6). This meant that Georgia was susceptible to IMF's conditionality and the pressure it could impose on the Government to change tax policy as it prescribed. Meanwhile, in the IMF-led policy coalition with international organizations, e.g. WB, USAID, and UNDP, the common policy issue was to promote the business sector in the country and to reform the economy in line with the tax policy ideas promoted by IFIs across the globe. The overall frame of Georgia's economic policy was more or less put in place once privatization kicked off, prices were liberalized, the Lari was introduced, and a pro-market tax system was established (at least, the tax code was adopted in line with IMF recommendations to aid business sector development in the country). The projects that USAID, UNDP and the WB were financing often promoted small business sectors, aimed to improve the business environment and increase the capacity of the local business sectors to set up and run business (Interview USAID, UNDP, WB). It becomes obvious that all international organizations were coordinating their projects so that they did not contradict the overall policy principles of promoting market economy institutions and capacity in country. The IMF remained a leading international actor with focus on Georgia's fiscal policy. Other international organizations provided financing for projects that directly or indirectly strengthened the overall economic policy in the country. The IMF's dominance in tax policy changes was demonstrated by an incident that followed the recommendation on a particular amendment by USAID to the Ministry of Finance in the late 1990s. The Ministry of Finance asked the IMF to comment on the USAID policy recommendation. The IMF was not happy that USAID recommended a policy change without consulting with the IMF. In the end, the IMF recommended that the initiative be dropped and the Ministry of Finance did so (Interview 2). Apparently, there was an unwritten agreement between the USAID and the IMF that the latter was the leader and that the fiscal policy was its 'territory'. The relationship lasted until the Rose Revolution (Interview 2). Even though IMF did include USAID in its efforts to reform Georgia's fiscal policy and tax administration, it still strived to stay in the driver's seat of the economic reform. The IMF had provided funding to train Georgian officials in the OECD Tax School in Ankara until the end of the Millennium (Interview 4). The IMF and its policy coalition members, such as the WB and USAID, had divided their spheres of focus in economic policy. The World Bank promoted the business sector in Georgia and financed projects to aid property rights enhancement and structural changes in state institutions. USAID advised the government on tax policy and tax administration reforms, but the organization's projects and recommendations were in line with IMF's market economic principles. USAID and the UNDP were involved in restructuring and retraining Georgia's tax administration agency. But as the representative of the international organization which implemented reforms in the tax administration put

it, there was no political will to reform, and all efforts of the international community were in vain (Interview 2).

The policy recommendations that the IMF had been providing to the Georgian government since the autumn of 1997 concentrated on reducing the budget deficit and managing inflation in the country. In tax policy specifically, the IMF tried to reverse the policy changes which strong sectoral groups managed to push through Parliament. For example, the IMF report of 2001 stated that the Parliament reversed a zero-tax on wheat and cigarettes after a demand by the IMF. To meet the IMF's financial support requirements the Georgian government also reversed reduction of the VAT rate from 20 to 7% on bread, pastry and domestic flour production (IMF2001b:27). The granted tax exemptions and tax holidays benefited only certain sectors while they negatively affected the budget deficit and fiscal discipline in the country. Business representatives with little say in tax policy changes often claimed that the tax code was so deficient it drove businesses 'underground' and forced some to hide their income to avoid paying taxes (Chelidze 2003). The IMF's discontent with the tax code amendments that the Georgian Parliament adopted as a result of the strong sectoral lobby was well reflected in the comment the IMF report made in 2001:

An analysis of Tax Code amendments since 1997 indicates that sectoral lobbies can be very effective in influencing tax policy in Georgia, particularly in case-studies presented on VAT exemptions in the oil and gas sector and excise rate reductions in the tobacco sector. However, the precise means of attaining such influence – whether through the legitimate persuasive power of argument or through illicit side payments – is not clearly determined. The influence of vested interests on policy appears strongest when the sectors are highly concentrated. While there is no evidence of direct payments to policymakers there is some correlation between the introduction of tax concessions and either advance payment of tax or a parallel agreement on profit-sharing terms. Overall, Tax Code amendments in Georgia, whether or not a result of state capture or pressure from vested interests, appear since 1997 to have narrowed the tax base and reduced potential revenues. In addition, the frequent recourse to transitional provisions and repeated amendment of the Tax Code has created uncertainty over the legislative environment. Other consequences of tax code amendments, not discussed above, are the occurrence of frequent tax disputes arising from implementation of hastily drafted amendments and inconsistencies between budget revenue estimates and tax policy legislation. Finally, it might be noted that vested interests seeking to reduce tax liabilities often conflict with the advice of international financial organizations which seek to broaden and strengthen the tax base. As in the case of cigarettes in Georgia, this results in tax policy conditionality which is implemented but not sustained over a significant period of time (IMF 2001b:32).

6.4. IMF Conditionality

In its effort to reverse tax policy changes in Georgia, the IMF tried to use a conditionality imposed on the funding that the Georgian government sought to obtain from the Fund. As one can see, conditionality led to policy change in some cases, and those changes were short-lived and only used to pay lip service to IMF representatives. The Georgian government's decisions sometimes contradicted IMF's recommendations to eliminate all policy norms which further contributed to the budget deficit or to refrain from initiatives that would lead to budget spending beyond what was already estimated. In 1998 IMF delayed the release of the agreed ESAF loan amounting to 74 mil USD which would allow the Georgian government to finance its budget deficit. Also in 1998, EU was going to issue a grant of ECU 55 mil to help the country repay EU debt, and the remaining 6 mil USD had to be found by the Government elsewhere. Had the Government managed to get funding from IMF in 1998, it could have paid the 6 mil USD to get the EU grant. However, the Government's decisions went against IMF and delayed accessibility to external funding (GET 1998:11). The ESAF funding was delayed until the beginning of January. Meanwhile the Georgian government was advised to improve tax collection and impose excise tax on petroleum products, VAT on agricultural products and use tariffs on trade in natural gas and electricity (GET 1998:13). In 2000 the external debt payment took up one third of the state budget (GET 2000:3) and amounted to 73.5% of GDP (GET 2000:4). The government was struggling with allocating its scarce budgetary resources for expenditures where external debt payment took up an important part. The situation was getting worse in terms of the state's capacity to meet its expenditures as obligations, and indications on the need to restructure foreign debt were already surfacing among economic policy analysts in Georgia in early 2000 (GET 2000:12). In 2001 Georgia had to allocate 348.2 mil USD for external debt payment, but only managed to allocate 165 mil USD, 14.7% of total budgetary expenditures and way less than needed to meet its debt repayment obligations (GET 2000:12). Outstanding foreign debt in 2002 (by the end of September) was 1,705 mil USD (GET 2002:11). During 2001-2002 Georgia obtained debt relief from creditors, but due to high debt obligations and limited budgetary revenues Georgia decided to apply to creditor countries of the Paris Club for further relief. An extension of the grace period for 2003 enabled Georgia to postpone a 50 mil USD payment (GET 2002:12). In 2003 the country's outstanding foreign debt was 1,849,262 mil USD, equaling 47% of GDP (GET 2004:7).

In July 2001, the President made a decision, which was approved by his economic team and the Ministry of Finance, but went against IMF's policy prescriptions. Just to prove to the population that the economic crisis was being solved, allowances and aid were distributed to the IDP amounting to 6.5 mil GEL on 11

July 2001. However, as an IMF delegation would visit Georgia soon after, it was decided at the Parliament's session on July 18, 2001 to discuss the bill on introducing changes to the tax code as a priority. This visit was crucial for IMF's decision to continue or discontinue implementation of 'Poverty Overcome and Economic Development' in Georgia. The government was keen to demonstrate its attempts to mobilizing finances in the country and increased the amount subject to VAT exemption from 24,000 Lari to 100,000 to facilitate development of small and medium businesses. Moreover, it was believed that this initiative would stimulate VAT payment among businesses and would help increase the budget which the IMF had been demanding all the way through. This initiative was introduced by the Ministry of Finance (Civil Georgia, July 16, 2001).

In the spring of 2001, the IMF had suspended its program in Georgia due to the budget problems. The large difference in expenditure and income on the state budget was the main concern. The Minister of Finance suggested to the Parliament in October 2001 to reduce the government's expense as the IMF Directors were to meet in Washington DC on October 26, 2001 to discuss whether to resume the fiscal aid program in Georgia. This meeting was also important in another respect: the Ministry considered obtaining credits from the WB amounting to 65 mil Lari and that would be directly affected by the IMF decision on whether to resume its programs in Georgia. The Minister's statement in Parliament was summarized by a news agency. 'The Finance Minister states that the request for the Parliament's permission for a budget reduction is made not to adjust expenditure policy but to meet the IMF directorate board on October 26th. The Minister also pledges that there would be no more sequestering (Civil Georgia, October 19, 2001). The Parliament approved the reduction of the budget expenditure with 164 mil GEL, as demanded by the IMF, and in return the IMF program funding of 65 mil GEL was resumed (Civil Georgia, October 20, 2001). After the approval of the expenditure reduction in the state budget, IMF representatives met with the President and the Minister of Finance on December 12, 2001. The government's hope to receive funds within the frame of the Poverty Reduction and Growth Facility (PRGF) program was met with a statement that it would only be possible in the first part of 2002. Since PRGF was approved in January 2001 for 137 mil USD, Georgia only received 34 mil USD by December 2001 (Civil Georgia, December 12, 2001). The IMF and the WB threatened to stop funding in 2001, the IMF threatened to suspend funding for the Georgian government in 1998 and actually did so in 2001 and in 2003 (NT 2001:432; EBRD 2006:50). Also the World Bank suspended funding for its projects in both years. A World Bank representative, Judy O'Connor, Director of the South Caucasus Country Unit, met with the Minister of Finance and adviser to the President on economic matters, Temur Basilava, in March 2002. She confirmed that the WB would reduce funding to Georgia by 20% in 2003 and expressed dissatisfaction with the governments'

incapacity to collect taxes and handle thriving corruption (Civil Georgia, March 7, 2002).

The evidence above demonstrates that conditionality as a factor leading to some policy initiatives (i.e. amendments to the tax code) was present before the Rose Revolution. However, conditionality is not the only factor, as sectoral lobbyists were often so powerful that even the IMF seemed helpless in pushing for overall changes in the distorted tax code. Thus, it is not argued that conditionality did not matter in tax code amendments in Georgia, but the significance of conditionality was sporadic and short-lived, often overshadowed by domestic sectoral interests.

6.5. EU as a Policy Actor in Georgia

In the discussion of the role of the IMF-led policy coalition in the tax policy change in Georgia before the Rose Revolution we have not yet touched upon the EU. The reason is that, since the mid-1990s, the general role of the EU in Georgia's economic policy change remained modest. There is no indication of the EU directly intervening in policy making processes, providing recommendations or trying to impose policy ideas from 1997 up to the Rose Revolution. However, during this period the number of EU-funded projects increased and cooperation schemes became clearer after the PCA was enforced in 1999. The policy center GEPLAC, which closely observed ongoing economic reforms in Georgia from the perspective of the EU and provided policy recommendations to the Georgian government in relation with EU norms, started to include a separate section on EU-Georgian relations in its quarterly reports from 2000 (GET 2000). In February 2001, EU's Ministerial Troika (Javier Solana, Secretary General/High Representative of CFSP, Chris Patten, EU Commissioner for External Relations, and Anna Lindth, Sweden's Minister of Foreign Affairs) visited Georgia and stated the EU's interest in supporting peace, stability and regional cooperation with Georgia. Meanwhile the trade turnover between EU and Georgia had grown to 235.4 mil USD in 2000, i.e. by more than 50.9 mil USD compared to 1999 (GET 2000:6). This section discusses all EU initiatives and projects in Georgia since 2000 (GET 2005). This is of course not enough to state to what extent the relationship between Georgia and the EU has tightened, but it is definitely an indication of more constructive cooperation in various policy areas and evidence that the EU-Georgian relationship evolved and was discussed quarterly by experts analyzing Georgia's reforms. However, the EU's interest in the general tax system was limited. It concentrated on particular tax types, such as VAT, excise and customs duties and aimed to ensure that norms on avoidance of dual taxation were incorporated in the legislation.

EU has been supporting Georgia since 1992 primarily with development assistance and humanitarian aid. The first cooperation frame of EU and Georgia in the form of The Partnership and Cooperation Agreement (PCA) was signed in 1999 focusing on promoting market economy, democratic principles as well as harmonization trade relations with EU (PCA 1999:5). PCA also touched upon the harmonization of legislation in customs and in indirect taxation, which referred to taxes collected through trade (PCA 1999: 13). The PCA framework has been implemented through a Technical Assistance to the Commonwealth of Independent States (TACIS).

TACIS National Program allocated 15 mil EUR during 2000-2001 in Georgia, and 14 mil EUR in the following years up to 2003 for institutional reforms.⁶² In the span of six year, from 1998 till 2004, Georgia obtained 110 mil EUR worth of loans from EU in addition to grants of 65 mil EUR to repay external grants for tax and budgetary issues, business climate, privatization, energy, telecommunications and land ownership (CSP 2001:12). Although EU has provided technical assistance since Georgia's independence, it has not emerged as an important actor in fiscal reforms, unlike the IMF. EU played a minor role in this respect and limited its interests in economic policy to trade and customs legislation. In this respect, the main focus was to avoid double taxation and to harmonize indirect taxation with EU Directives as part of the PCA provisions (article 39).⁶³ These provisions were enacted to initiate and further dialogue on the principles of the EU Code of Conduct for Business Taxation to ensure that Georgian market integration into the EU was included in the ENP Action Plan as well. The aim of the EU was to push for harmonization of Georgian taxation of VAT, excise and customs duties to conform to EU directives to facilitate cooperation between EU and Georgian enterprises and to create a comparable legal environment. The EU has not taken up the issue of personal or corporate income taxes as harmonization of the tax policy entailed only the indirect taxes mentioned above.⁶⁴ Bilateral agreements on double taxation are currently in the process of being negotiated with various EU members such as France, Denmark and Spain (Interview 27). However, EU financed a project to prepare a tax administration restructuring framework by domestic and European experts in 2003-2004, which was implemented in 2005 (Interview 21; APG 2004:8). The project coordinator of the tax administration reform project appointed by the EU Delegation in Georgia reflected on the initiatives,

⁶² EU Assistance online: http://ec.europa.eu/external_relations/georgia/eu_georgia_summary/index_en.htm

⁶³ PCA and Georgia, online: <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:1999:205:0003:0038:EN:PDF>

⁶⁴ Personal communication with a Georgian tax expert working on the tax administration reform, December 10, 2008.

describing their main in an article published in GEPLAC's online research paper section and in the quarterly report in 2006 (Curnow 2006).

Based on the evidence, one can argue that the EU became more involved in the economic reforms in Georgia through its schemes of cooperation and broader range of projects under the TACIS program than it was before 1997, even though no evidence suggests that the EU stood behind any of the tax policy initiatives passed in the Parliament before the Rose Revolution. However, EU's role in fiscal policy change was limited compared to that of the IMF or international organizations with projects in tax administration reforms or business sector development (such as USAID and UNDP) but one can still conclude that EU's role as a policy actor in Georgia increased over time. The political changes that came with the regime shift after November 2003 opened more 'windows of opportunity' for EU and Georgia's cooperation in a broader policy area. I shall come back to this discussion in the following sections.

6.6. Tax Competition

The scrupulous analysis of the data does not provide evidence on whether tax competition played a role in the tax policy amendments during 1997-2003. In this period Georgia's FDI flow was growing slightly, but compared to its neighbours (except Armenia) the FDI inflow was very low. The data on FDI flow from UNCTAD provided in Table 6.4 illustrates Georgia's integration into the global market through investment flow.

The FDI inflows in Georgia were modest in general (see Table 6.4), and the table above shows that, compared to its neighbours, Georgia only surpassed Armenia in FDI inflows while it remained behind Russia and Azerbaijan. Trade relations with the outside world through export and import activities show how well-integrated Georgia was in the global market through trade activities. Table 6.5 illustrates Georgia's export-import volumes to/from the outside world.

It seems that Georgia predominantly exported to CIS states, whereas export to the EU and OECD countries was relatively low and further reduced before 2003 (see Table 6.5). As a country with limited production activities, Georgia seems to have imported largely from OECD and EU states although almost equally from CIS (see Table 6.6).

The pressure to change the tax policy to compete with neighbours or to simply establish a tax haven for mobile capital is not detected in the evidence analyzed in this chapter. Tax competition as a possible factor in shaping the Georgian tax policy was not even mentioned in the introduction of Orvelashvili's Code or during the personal interviews.

Table 6.4: FDI flows in Georgia 2002-2006

	1990-2000 (annual average)	2002	2003	2004	2005
Georgia					
Inward	113	167	340	499	450
Outward	1	4	4	10	- 89
Memorandum					
Armenia					
Inward	57	144	157	217	220
Outward	1	19	-	2	7
Azerbaijan					
Inward	537	1,393	3,285	3,556	1,680
Outward	158	326	933	1,205	1,221
Russian Federation					
Inward	2,373	3,461	7,958	15,444	14,600
Outward	1,582	3,533	9,727	13,782	13,126
Commonwealth of Independent States					
Inward	3,966	9,035	15,736	26,295	27,234
Outward	1,651	4,097	10,558	13,772	14,560
South-East Europe and the Commonwealth of Independent States					
Inward	5,569	12,911	24,192	39,577	39,679
Outward	1,401	4,687	10,731	13,973	15,056
World					
Inward	495,391	617,732	557,869	710,755	916,277
Outward	492,566	539,540	561,104	813,068	778,725

Source: UNCTAD country fact sheet, 2006 available online: http://unctad.org/sections/dite_dir/docs/wir06_fs_ge_en.pdf

Table 6.5: Georgian exports by country group (1000 USD)

	2000	2001	2002	2003
Total exports:	322,748.7	317,636.1	345,933.5	461,405.6
Exports to countries in:				
EU-27	78,874.3	62,254.6	63,431.3	82,715.6
CIS	128,481.0	144,302.1	168,695.4	224,833.1
BSEC	193,668.2	181,874.4	180,228.2	250,317.5
OECD	165,383.8	153,844.2	155,623.5	212,404.9
WTO	178,648.9	162,914.7	165,406.8	228,987.1

Table 6.6: Georgian imports by country group (1000 USD)

	2000	2001	2002	2003
Total exports:	709,376.2	753,227.8	795,539.1	1,141,164.7
Imports to countries in:				
EU-27	217,325.3	268,519.3	251,285.8	439,244.9
CIS	229,300.8	253,973.0	292,219.2	370,103.4
BSEC	348,069.5	367,497.7	389,280.3	499,440.4
OECD	392,037.4	420,189.0	411,389.5	625,334.1
WTO	460,180.1	477,986.1	469,228.5	729,766.1

Source: Revenue Service, Georgian Ministry of Finance; Georgian State Electric System, Ltd.; Georgian Gas Transportation Company, Ltd.

6.7. Domestic Structural Factors: Budget Deficit and Low Tax Level

There is limited evidence to support the theoretical argument on domestic factors such as a budget deficit and/or a low tax collection level as causes for the tax policy initiated in Georgian during the policy period covered in this chapter. Following the theoretical discussions in Chapter 2, one would assume that without the external pressure of IFIs pointing their finger at Georgia's poor tax collection level or a chronic budget deficit, the Government would reform its tax policy so that it would commit to administration simplification, reduction of tax code implementation costs and ensure taxpayer compliance. In a nutshell, economic difficulties and glaring domestic structural factors should have been sufficient for the Georgian decision makers to initiate tax code reforms to make tax collection less costly and improve the overall tax level. Moreover, reforms should have allowed capable and well-functioning administrative institutions to emerge or, in other words, a tax state to have been formed in Georgia.

However, the empirical data provided below demonstrates the opposite. The Georgian government needed to find revenue resources. The Georgian tax state was still in the making in the second half of 1990s, but it lacked full political commitment from the government to reform its tax policy to address the economic problem. Tax collection remained low and tax collection was predatory, leading to low trust among taxpayers and low tax compliance. Meanwhile organized economic interest groups were powerful enough to infiltrate the policy arena and to 'capture the Georgian state', where political protection was provided to economic actors with good connections in the political elite. Thus, by sparing its 'golden goose' which, if treated properly, might have provided sufficient domestic revenues and help from the Georgian tax state, the Georgian government chose to seek revenues from external funders. It chose to forgive tax arrears to its

powerful economic actors, provide tax holidays and exemption while suffering from a low tax collection level and profit tax income in the total tax revenues. And meanwhile it paid less attention to the direct taxation of personal income.

Public financing in Georgia was still struggling to make the ends meet. The donors found the Government's commitment and efficiency in economic policy implementation and improvement of the tax collection as well as macro-economic indicators disappointingly low. Discontent grew and IFIs tightened the screw and started delaying transfers. The Government found itself in a dire financial situation, struggling to find resources to fund budget deficits, while tax arrears as well as expenditure arrears were growing. Public funding of the health, education and pension sector was becoming scarcer year by year; the country was indebted and had to meet the obligations of a debt repayment. The state's internal debt also continued to grow from 20.2% of GDP in 1997 to 24.2% of GDP in 2000 (GET 2000:4). In 1999, state arrears in salaries were GEL 16.6 mil (approx. 8.3 mil USD), 14 mil GEL (approx. 7 mil USD) in pensions, 6.7 mil in the health care system (approx. 3.35 mil USD), and 3.6 mil GEL (approx. 1.8 mil USD) in food procurements (GET 1999:24).

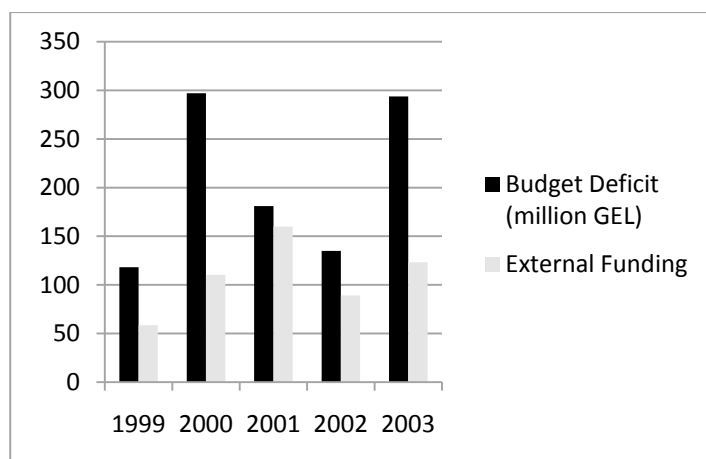
Table 6.7. Georgia's budget deficit and external funding

	1999	2000	2001	2002	2003
Budget Deficit (mil GEL)	118.2	297	181	135	293.8
External Funding	58.5	110.2	160	89.2	123.3

The Georgian budget suffered large deficits, most covered by external funding, while tax collection remained low. The budget deficit in 1997 was 2% of GDP, but lower than in 1996 (approx. 4.4% of GDP). In 1999, the budget deficit amounted to 118.2 mil GEL (59.1 mil USD), while expected total revenue had to be 356.9 mil GEL (approx. 178.45 mil USD) and the expenditure was expected to be 475.2 mil GEL (approx. 237.6 mil USD), but total revenues including foreign grants only amounted to 321.4 mil GEL (approx. 160.7 mil USD). This situation was solved by reducing public expenditure (GET 1999:21), but expenditure arrears were still growing. The country was in violation of its agreement with IMF as it was unable to reduce expenditure arrears by including tax exemptions in the draft budget of the year of 1999, and still had unsettled issues of tariffs on trade in natural gas and electricity (GET 1998:17, 31).

The tendency of large budget deficits persisted for years. Figure 6.2 demonstrates this fact and provides a clear picture of Georgia's dependence on external funding for its revenues.

Figure 6.2: Georgian budget deficit (in mil GEL), 1999-2003^{a)}



a. In 2000, the state budget deficit was estimated to be 389.7 mil GEL (later corrected and reduced to 297 mil GEL). The same year, estimated total revenues reached 840 mil GEL, and expenditures 1,120 mil GEL. Deficit funding was only 64% in 2000 (190 mil GEL raised by the Government with mixed funding). Funding of the deficit came again from external funding (World Bank) 110,200 mil GEL (30% of the budget deficit) and the National Bank of Georgia (GET 2000:4,17). Tax collection continued to be low. In 2001 the state budget deficit of 181 mil GEL was predominantly financed by external resources (160 mil GEL, approx. 80 mil USD), the rest by domestic resources (amounting 21 mil GEL, approx. 10.5 mil USD) (GET 2001:13). In 2002, the budget deficit was 135 mil GEL (approx. 67.5 mil USD). 89.2 mil GEL (approx. 44.7 mil USD) were financed by international financial organizations and the remaining 45.9 mil GEL (approx. 22.95 mil USD) covered by domestic resources (GET 20002:14). In 2003, the state budget deficit required funding of 293.8 mil GEL (approx. mil USD) but managed to get funding for only 186.1 mil GEL. Investment credits funded 123.3 mil GEL, the rest came from privatization of state property (23.6 mil GEL) and loans from the National Bank (40 mil GEL) (GET 2004:22) (see table below).

Source: ET reports 1999-2003.

As the figure demonstrates, the Georgian state was heavily dependent on external funding, which often covered half the budget deficit, whereas the other half was divided in borrowed and collected revenues by the state. When it failed to obtain the necessary revenues to fund the budget, the government was hurt by the increase in expenditures. The gap between total revenues as percentage of GDP and state expenditures is illustrated in Table 6.8, which shows that the budget had far more expenditures than it was capable of funding itself.

Table 6.8: Consolidated budget revenues and expenditures as percentage of GDP, 1998-2003

	Total Revenue and grants	Tax Revenue	Total Expenditure and net lending
1998	15.7	10.5	21.8
1999	15.4	11.5	22.1
2000	15.2	11.7	19.2
2001	16.3	12.0	18.2
2002	15.8	14.4	17.8
2003	16.2	15.0	17.5

Source: IMF report 2006.

Lack of revenues to cover state expenditure persisted as a trend until the end of Shevardnadze's regime. In the post-Soviet realm, Georgia remained the second (in 1998 after Tajikistan) or third (in 1999-2001 after Tajikistan and Kyrgyzstan) worst tax collector in the region (see Appendix 9).

It is worth noting that the 1998 budget was adopted on 12 December 1997 and this was the first time the Georgian Parliament adopted a budget before the calendar year had started (GET 1997:18). This was important for tax collection as well, as it clearly defined some targets, which were extremely important for ensuring tax collection by the tax administration agency. According to a report on the economic trends in Georgia in 1998, those revenue targets were 'particularly important in Georgia where tax collection is still largely driven by revenue targets. Without such targets, many tax collectors do not know how much to demand from taxpayers – or in some cases the problem is that they cannot judge how much revenue to siphon off for themselves' (GET 1998:16).

The statement 'tax collection remains the main problem in public finance' surfaced repeatedly in GEPLAC reports before and after the first tax code was adopted. The poor tax collection urged the Government to address the tax administration sector. In October 1998 the President of Georgia created a Commission headed by the State Minister, which had to meet every second week, increase tax revenue collection and its share in the budget and come up with new proposals if necessary (GET 1998:13). Meanwhile, some political decisions were made in the tax collection agency which contradicted the Government's apparent commitment to increase the tax intake in the budget. It decided to reduce instead of enlarge the Large Taxpayers Unit as had been agreed. The results of this decision were obviously negative as the tax arrears grew. Meanwhile the government delayed implementation of the new system of cigarette excise stamps (GET 1998:13).

It is worth noting that large scale tax administration reform started somewhat late compared to tax policy reforms in Georgia. However, in this process the array of international organizations was more colorful than those involved in advising the Georgian government on tax policy elaboration. In 1999 the Revenue Ministry of Georgia, USAID, US Treasury and Barents signed a Memorandum of Understanding aiming to restructure the Tax Department (Rider 2001:7). The technical assistance from USAID during the tax administration restructuring aimed to help the Georgian Government improve deficient tax collection methods, establish taxpayers' service, train the staff to register taxpayers, provide full-field audit and address the overstaffing of the tax administration offices (Rider 2001:6-7). Fiscal reforms in Georgia after the memorandum was signed entailed two approaches: a comprehensive reform program (concentrated on taxpayer education, establishment of the Internal Audit Unit, restructuring the Tax Administration on a functional basis, and reforming human resources), and a set of measures designed to

realize quick improvements in revenue collections (Rider 2001:7). The Tax Administration reforms thus encompass tax collection and enforcement, sanctions and penalties, filing and payment procedures, and computerization of the tax administration agency (Ebril and Havrylyshyn 1999).

The Tax Administration reform also affected the staffing policy. In 2002 the staff was reduced by 40% nationwide. The Central Office of the Tax Department was changed and out of 78 district zones tax inspectorates, only eight tax inspectorates were left (Curnow 2006:68). However, assessments of the tax administration reforms pointed out backsliding in civil sector reforms, particularly in tax administration (Rider 2001). Human resource reforms aimed to reduce staff and to implement test-based (merit-based) employment at the Tax Administration. Training and re-training of the tax administration staff was conducted by tax specialists in Georgia, provided by, among others, the Georgian Young Lawyers' Association (Interview 16). Barents trained four Georgian trainers and provided facility and materials for further personnel training (Rider 2001:10). However, as local tax experts expressed, the training and the actual tax administration reform did not fix the core of the problem – the low commitment of the political establishment to eradicate corruption and tax collection problems in general (Interview 2). Rider makes the same argument (2001:13) in his fiscal reform assessment of Georgia: 'the reluctance or inability of the GOG to collect excise taxes is due to a political constraint. In short, influential people are using political connections to block tax enforcement to their commercial advantage. Until this political constraint is removed, no amount of technical or financial assistance from donor organizations will improve excise tax collections'.

Tax code implementation was furthered hindered because taxpayers and tax inspectors had difficulty understanding the code and regulations provided in the text. The situation was so serious that technical assistance was provided by Barents to complete the 'Plain Language Guide to the Georgian Tax Code' and a 'Taxpayer Charter' (Rider 2001:10). While tax code administration was problematic, tax inspectorates were put under severe pressure by seniors to meet revenue targets and collect taxes. This fact has often led to bribe taking and arbitrary audit conclusions (Rider 2001: 11; Curnow 2006: Interview AA).

Thriving corruption in state agencies was coupled with a perception among taxpayers that marginal tax rates, for instance on personal income, were so high that employers either did not register employees and paid them in cash or looked for other ways to avoid tax payments. A personal income tax was approx. 40% if one would add up all the payments made by employer and employee: 12% the lowest bracket on labour income, 1% of payroll for Unemployment Fund, 3% tax on payroll for health insurance, 28% tax on payroll for Social Fund (Rider 2001:15). Low tax compliance by taxpayers was also coupled with a low employment level, reducing the personal income tax. The largest share of the per-

sonal income tax was paid by state employees (GET 1998:18). Compared to the personal income tax, profit taxes were the most difficult to extract for Georgian tax agencies. The profit tax collection in 1997 fell 44% below target, while customs duties were 37% above target (GET 1998:17).

Direct tax collection (profit tax and individual income tax) was low in Georgia; profit income tax was 5% of total revenues (0.34% of GDP), income tax 7% (0.51% of GDP) in 2000 (GET 2000:15). Low tax collection continued in 2001, when income tax (together as profit and personal income) amounted to 6% of actual tax revenues and only 0.3% of GDP (GET 2001:12). The trend continued in 2002 when direct tax collection was below target. Of the central budget tax revenues of 415.7 mil GEL (207.85 mil USD) the share of personal income tax was 12.8 mil GEL (6.4 mil USD) in nine months in 2002 and corporate income tax was 6.9 mil GEL (3.45 mil USD).

Low government revenue collection remains the most pressing problem facing Georgia's public finance. The application of tax rules and allowances is often arbitrary since accounting rules remain unclear and there is widespread distrust between tax collectors and taxpayers. Tax collectors tend not to trust the figures that taxpayers present them with, and few taxpayers trust tax collectors to implement the system correctly (GET 1998:16).

Table 6.9: Total revenues and tax revenues (percentage of GDP) 1998-2005

	1998	1999	2000	2001	2002	2003	2004	2005
Total Revenue and Grants	15.7	15.4	15.2	16.3	15.8	16.2	21.7	23.4
Total Revenue	14.7	14.6	14.9	15.6	15.5	15.9	20.5	22.5
Tax Revenue	10.5	11.5	11.7	12.0	14.4	15.0	18.2	19.8
Taxes on Income	1.7	1.8	1.8	2.0	1.9	1.9	2.7	2.5
Taxes on Profits	1.0	1.0	1.3	1.0	1.1	1.2	1.6	1.8

Source: IMF Report on Georgia 2006.

The weak institutional capacity of the Georgian tax administration agencies and the Ministry of Finance was lamented by the donors, who saw no results of their efforts and advice. The fiscal assessment report stated that 'MOF has remained a weak institution that is not in control of fiscal policy nor fiscal implementation. Unrealistic budgets for both revenue and expenditure have been the norm. While the revenue administration has been severed from MOF, no internal capacity for medium-term forecasting or fiscal policy management remains' (Rider 2001:1).

However, shortcomings in tax administration were not unique to Georgia, but were systematic in post-Soviet states where IMF has been operating,⁶⁵ of course with some variation (Ebril and Havrylyshyn 1999). Frequent changes in tax policy and the senior management of tax administration agencies created an instable environment for taxpayers. In addition, the vagueness and uncertainties in legislation created room for arbitrary tax assessments to the benefit of the tax administration agency. Tax administration institutions have remained highly politicized, which has often resulted in tax liability negotiations rather than determining them by law. Lastly, more small and medium size taxpayers and introduction of various tax types made it difficult for the tax agency to enforce a tax policy. Organizational capacity was low and it was even more complicated to create positive changes in tax collection when the political commitment of the highest level of government was missing (Ebril and Havrylyshyn 1999).

The tax favoritism of the politicians and tax administration officials who had economic interests or provided a 'cover' to certain business sectors indicate the existence of what Hellmann (1998) called a captured state, i.e. a state which is entrenched by economic interests groups and where bargaining over taxes takes place with the aim to either avoid paying taxes or pay as little as possible. Table in Appendix 7 shows that enterprise tax (CIT) collection in Georgia since early 1993 through 2000 hardly passed 1% of GDP and remained between 0.6% to 0.8% till 1997. It reached 1% in 1998 and increased to 1.3% in 2000. Georgia was also way behind other post-Soviet states on personal income tax, which reached only 0.2% of GDP in 1993 and managed to reach 1.8 in 2000. Those indicators along with the overall tax collection level as percentage of GDP provided in Appendix 8 made it clear that the Georgian state had a long way to go to qualify for a tax state status – a state capable of collecting taxes and collecting them directly. All in all, during the period after the first tax code adoption and before the political change of 2003, Georgia was far from being a capable tax state which directly extracts revenues from business and individuals, has legitimacy to extract and has knowhow and administrative capacity to identify and collect taxes. During this period Georgian state making resembles the process taking place in Russia described by Easter (2002; 2008), where the economic elite dominated tax system formation excluding society at large outside from bargaining and thus, from the taxation nest. To return to the theoretical speculation on domestic structures as causes of a policy change, evidence in the Georgian case does not support this argument for the period investigated in this section. The policy initiative of the decision makers has often led to introduction of tax loopholes and preferential tax systems on various economic activities, as they choose to address their

⁶⁵ In the second half of the 1990s, IMF provided technical assistance in tax administration reforms to Georgia, Armenia, Azerbaijan, Georgia, Kazakhstan, Kyrgyzstan, Russia, and Ukraine out of 15 post-Soviet states (Ebril and Havrylyshin 1999).

need for financial resources and the need to raise revenues by taking loans from abroad. The prospects of Georgian tax state formation were therefore further postponed and the financial basis of the country was not tax intake as in other Western countries. It was more dependent on easy to 'extract' revenue types obtained through borrowing.

6.8. Number of Veto Players

As far as the relevance of the theoretical expectations based on the number of veto players and party politics in the Georgian tax policy making process, I argue that the former is less relevant, while the latter explains some of the tax policy amendments adopted during the period 1997-2003. The policy arena had been affected by political parties and their ideological stance on economic policy. The discussion on the tax code amendments and the pro-business parties demonstrate the growing role of party politics in the tax policy arena in Georgia. However, to what extent those parties could manage to push for their policy ideas in the legislation is difficult to argue, unless they did not manage to gain the government's support. Government support seems to be of particular importance while Georgia's vulnerability before the IFI conditionality remained high during that period. When it comes to the number of veto players, the evidence suggests that their relevance was limited because with the changes in election legislation and the attempt of the executive to centralize the President's political power, the representation in the Georgian Parliament since the Parliamentary elections in 1999 had been reduced. As in the 1995 elections, 150 members were elected to parliament based on a proportional (bloc members) basis, 72 based on single-member districts (majority members) and 12 members representing Abkhazia's breakaway region.⁶⁶ However, this time the minimum threshold for parties to enter parliament had increased to 7%. Not surprisingly, this prevented pluralistic representation in the Georgian Parliament.

The majority of the votes were won by the CUG. Among three leading parties which obtained 44.5% (85 + 44 seats), number two was the Union for Revival with 26.9% of the votes (51 + 8 seats), and number three was Industry Will Save Georgia with 7.5% of the votes (14 + 1 seats). Two other parties which only had single-member district candidates in Parliament were the Georgian Labour Party with two majoritarian deputy seats and the United Communist Party with 17 majority deputy seats. As a result of the higher threshold, only three large parties, loyal to the President, managed to get into Parliament. The players on the active political arena, i.e. the Parliament and government, were reduced. The result was a consolidation of Shevardnadze's power.

⁶⁶ Legislative Elections of Georgia, November 1999 obtained from the website: <http://psephos.adam-carr.net/countries/g/georgia/> last visited on October 30, 2007.

Political parties' organizational development improved during this period compared to how it was before 1997 and their role in pushing for tax policy initiatives was strengthened. But it is difficult to say how many of the policy changes they can account for and whether the number of political parties in parliament had anything to do with adoption or non-adoption of amendments and the tax code project. The level of democracy, which means more representation and less possibility that new initiatives go through the legislative body, was improving compared to the early 1990s, but it remained a regime mix of weak democratic institutions and a strong presidential system.

6.9. Institutional Filters

6.9.1. Formal Institutions

Institutional filters such as formal rules on policy initiation and adoption did not hinder adoption of new policy in the new tax code before the Rose Revolution; nor did they aid the adoption of those ideas in any way. The rules on who could initiate legal changes or laws have not changed since the summer of 1997. This means that if and when legal norms were initiated by the executive or legislative agencies, they could enter the Parliament and then it would be up to the legislators to pass or drop them. The number of veto players comes into consideration in this case. Yet, as already argued government support carried considerable weight in Georgian law making under a centralized presidential system where the executive branch had strong influence on the legislative body. Once a legal initiative was in the Parliament, the support of the government often mattered most in its final adoption.

6.9.2. Informal Institutions

What played a more important role in policy idea diffusion and promotion in the legislative body were more informal rules, such as personal contacts among state officials and non-state organizations as illustrated by the case of Orvelashvili's Code. Personal (informal) contacts between policy makers and policy coalition members helped the policy proposal advance to the legislative body, but did not aid adoption. Once ready, the project was put on the agenda of the Committee discussion in the Parliament by the Industrialists. The process that followed is rather complex and it is impossible to state how and why the tax code project was dropped and never got to the Parliamentary hearings or, at least as some sources indicate, to the second and third hearings needed for the legal document to be finally adopted by the Parliament and signed by the President. In the search for 'political dividends' the government wanted this project to be seen as its own initiative (Interview 21). Meanwhile, the IMF opposed the initiative. Its representative held meetings with the working group representatives persuading them to

drop the initiative. Nonetheless, the tax code project was submitted to the Parliament in the spring of 2003. The 'tax code working group' representatives state that Parliamentary hearings were held on March 31, 2003 and that the tax code project was adopted with this first hearing. However, they claim that the project was dropped afterwards. The project was not discussed a second time during the Spring Session of the Parliament, and the Autumn Session was so short and so preoccupied with the upcoming parliamentary session that the tax code was not brought up there either (Interview 21, 27). However, when the transcripts from the session were requested from the Parliament, the answer was that the project was dropped in the Parliamentary Committee discussions and that it never made it to the Parliamentary Sessions (personal correspondence with the Parliamentary Representative 2009).

During this period, the project was abandoned by the Industrialists, and there are two opinions as to why this happened. Some argue that the Industrialists were co-opted by the former government designing a legal act to their economic interests (Interview 21). Another version is that support to the ideas presented by NGOs was perceived to be in opposition to the ruling party and government. Therefore, the Industrialists opted to abandon all lobbying in favor of the policy (USAID 2002). It is worth noting that the tension between reformist and non-reformist groups was already getting out of hand. By the time the project was presented to the Parliament, opposition parties were packed with former allies of Edward Shevardnadze and were already going international, stating their vision of reforms and political change. The division among politicians supporting reformists or the 'old guard' was so sharp that being in any way seen or considered as an ally of NGOs already meant being in opposition to the 'old guard', regardless of extent or form of cooperation. At the same time, the political tension was increasing once preparation for the Parliamentary elections planned for November 2003 started. One way or another, this project was halted within the legislative body of Georgia; it shows that the political establishment decided not to support it, even though one year before reform proposals were requested by the State Minister from local experts. If the reason was 'ownership' of the policy proposal, then once the Industrialists dropped lobbying for the project the pro-government party members could have picked it up and ensured its adoption before the parliamentary elections in November 2003. It is also not clear to what extent IMF's negative attitude towards this initiative could affect the non-adoption of the tax code project. By 2002, the relationship between the Georgian government and the IMF was already tense. The threat of non-issuance of funding due to the large budget deficits in Georgia was already voiced by the IMF. Moreover, a number of cases had demonstrated that the government and particularly the President was willing to 'listen' to the threat and follow the recommendations as long as it did not threaten its economic and political supporters' 'well-

being'. The possible political change could have weakened the position of the 'old guard' and their economic supporters were banned from the policy arena, which was still dominated by Shevardnadze's allies. However, it soon became obvious that it was beyond the power of the political establishment to restrain the urge for change that emerged domestically.

6.10. The Rose Revolution

The pre-history of the Rose Revolution started early in 2001 when the fragmentation of the political elite started to deepen. Zurab Zhvania's statement on August 29, 2001 demonstrates the escalation of the tension between reformists and the old guard, while the President remained as a mediator. The Chairman of the Parliament asked the President to take measures to address rampant corruption in the country, which also required drastic institutional and structural changes in the government sector. But the request went unheard (Civil Georgia, August 31, 2001). In September 2001, Shevardnadze resigned from his position as chairman of the ruling party, CUG. This was followed by the resignation of Saakashvili as Minister of Justice. After Shevardnadze and his supporters' unsuccessful attempt to silence the pro-reformist, independent TV station, Rustavi 2, open confrontation between Shevardnadze and Zurab Zhvania surfaced and the latter resigned. Soon after, on November 1, 2001, Shevardnadze dismissed the whole cabinet of ministers and while the reformist political elite expected the new cabinet to recruit only few former ministers the opposite happened. In this merry-go-round, reformists lost positions in the Tax and Revenue Ministry where young reformist Mikheil Machavariani was minister, and the Ministry of Justice was already abandoned by Saakashvili. The last reformist member left in the government, Zura Nogaidzeli, was re-appointed to the position of Minister of Finance after considerable speculation among the parliamentarians, who did not have much support. Soon after, on May 2, 2002, Nogaideli was dismissed and the son of Shevardnadze's close friend, Levan Dzeladze, was appointed (Wheatley 2005:173). Shevardnadze merged the Ministry for Tax and Revenues with the Ministry of Finance, reportedly in compliance with the recommendations of the international organizations and appointed Mirian Gogiashvili as head of the merged ministry. Gogiashvili was also son of one of Shevardnadze's close friends and founder of CUG (Wheatley 2005:175). On June 17, 2002, Zurab Zhvania announced the creation of United Democrats, an opposition party. On March 25, 2002, Saakashvili announced the formation of a New National Movement that united the Republican Party, the Union of Patriotic Forces (pro-Gamshurdia group) and Revaz Shavishvili, one of the founders of DASI (Wheatley 2005:174). The Parliamentary elections of November 2, 2003 were soon followed by the Rose Revolution. Ed-

ward Shevardnadze stepped down and let the reformist leaders take over the reins.

6.11. Policy Making Mechanisms

The scrutiny of the public policy in Georgia during the period covered in this chapter demonstrated that phase two of the policy change was present (see Table 3.1). Policy learning and internalization of new ideas by domestic actors was taking place during this period, but new ideas appeared in the legislation and were required to pass through the institutional filters, which they did not. However, policy adoption had not occurred during those processes (i.e. new tax principles were not included in the tax code), which means that this chapter only partially supports the theoretical argument of the dissertation. The analysis demonstrated that policy development (Orvelashvili's Code) had occurred and the ideas incorporated in this policy were clear and specific. The policy coalition working on this particular policy initiative was united around a common idea and understanding of the need for change towards pro-market principles in the Georgian tax system. Finally, institutions mattered in allowing informal connections to promote the new tax code project in the legislative body. However, the role the third sector's linkages with the policy arena and decision makers should not be exaggerated in their capacity to influence a policy change. No direct influence is detected in this period, whereas facilitation of idea diffusion among domestic actors was present.

However, the final stage of the tax policy adoption through Parliament did not occur – which is the final stage of the policy shift process as conceptualized in this dissertation. Reasons for why the pro-market change was neglected and Orvelashvili's Code was dropped in the Parliament in 2002 are difficult to state with high certainty. What is obvious, though, is that the policy coalition which promoted the new tax policy project did not manage to obtain support from the government. And the latter, as argued in Chapter 3, is vital for the final policy. During this period, the executive and a significant number of ministers and legislators shared the stance of the non-reformist policy actors, who primarily were pre-occupied with molding tax legislation to fit their business interests or the interests of their political clientele.

We can conclude from the discussions in this chapter that empowering the domestic actors through learning and infusion of ideas by external actors was reflected in the domestic initiative to create an alternative tax code to change the status quo by the policy coalition of domestic and foreign experts. The policy ideas in the new tax code project were not directed by the IMF nor were they advocated by EU projects in Georgia as policy priorities. The interview with Orvelashvili and the explanatory note attached to the tax code project revealed that

the sources of ideas which inspired the working group in formulating policy ideas were taken from the 'best practice' existing among the tax policy changes in nearby countries (such as Russia) which were positively evaluated by the IMF and considered to be business-friendly. Moreover, the lessons learned from the existing tax code and the factors that hindered its proper function, on the one hand, and the concerns that the business sector had, on the other hand, all contributed to the pool of ideas which appeared in Orvelashvili's Code as codified norms. Orvelashvili's Code was the first of its kind in the Georgian tax policy process. It was the first time a local initiative proposed to change the whole tax code. This fact indicated a sharp shift not only in policy principles, but also in the way the policy arena was operating. Ideas that were considered 'good for the Georgian tax code' were the principles of a simplified tax code, reduced tax rates, and a regressive personal income tax system, such as a flat tax. Moreover, the working group of the tax policy project mainly consisted of local non-state organizations and experts, who formed links with their foreign counterparts and consulted with them. They acted as coordinators and organizers of the working groups and were responsible for delivering the final result. The ideas presented in the project were therefore not forced onto the policy actors but were internalized beforehand. Thus, Orvelashvili's project was an example of idea internalization among domestic policy actors. Although the code was not adopted in the Parliament, it paved the way for future changes as it was already domestically born and not externally injected. The policy shift in the Georgian tax code occurred after the Rose Revolution. The process and the factors that led to it are discussed below.

6.12. Summary

The empirical analysis allows us to conclude that the policy making processes before the Rose Revolution partially support the transnationalization argument as presented in the causal model (see Figure 1.1) when it comes to policy learning and idea internalization. Moreover, the data showed that some factors played an important role in the policy change processes which were not expected through the transnationalization policy argument. For instance, the importance of party politics emerged as a significant factor affecting tax policy modification through tax code amendments passed in Parliament. The argument of domestic factors leading to policy change through political parties' ideological stance and lobbying was conceptualized as a conventional explanation of policy change. Even though party politics do not explain the Georgian tax policy change, it certainly explains the reversed shift of the Georgian tax code towards protectionist principles and is a reflection of strong business interests among Georgian policy makers.

I will now summarize the influential actors during the policy change in Georgia. During the Shevardnadze era, the tax policy change reflected the interests of two types of policy coalitions: one that used conditionality and supported pro-market reforms and changes of the tax code to 'broaden the tax base' and a coalition that reflected the strong sectoral interests. The latter introduced policy changes that reversed the IMF-propagated policy reforms. During this period the policy coalition that elaborated policy proposals that clearly stipulated new tax policy principles and lobbied for policy change, emerged as less powerful. However, the next chapter shows that the policy principles that were dropped during Shevardnadze's regime were picked up again and incorporated into the second Georgian tax code after the Rose Revolution.

Chapter 7

Georgian Tax Policy Making After the Rose Revolution

Just as the previous two chapters, this chapter investigates the path that allowed internalized ideas to lead to a policy change in Georgia. The ambition is to demonstrate under which conditions ideas caused a policy change. The deductive approach of the dissertation is retained, meaning that the theoretical argument of transnationalization along with its competing arguments is tested in the in-depth case study of Georgia. If the ideational policy change argument is to hold water, we have to identify ideas that are internalized and find those ideas in the policy making process to claim that they actually did lead to change. Moreover, the policy change process must be free from coercive mechanisms; otherwise it is difficult to claim that it was ideational.

The policy making process here covers the period after the Rose Revolution from December 2003 to December 2004. The result after one year was the creation of a new tax code. The way falsifiable theoretical expectations are tested throughout the chapter is borrowed from John M. Owen (1994). I was inspired by his excellent process tracing analysis and I aim to address each theoretical speculation here by stating in bold text whether it supports or rejects them plus provide empirical data supporting my statements. The chapter is structured as follows: Section 7.1 provides a chronology and a narrative of the main developments during the period 2003-2004, which summarizes significant events in the tax policy making process after November 2003. Sections 7.2-7.10 test the theoretical speculations and support the statements with empirical data collected through written materials and interviews with key tax policy actors in Georgia. Section 7.11 sums up the key points.

7.1. Political Processes Following the Rose Revolution

Table 7.1: Chronology of the main developments in Georgia after the Rose Revolution till the end of 2004

January	Presidential elections are held and Mikheil Saakashvili wins the majority of votes
March	The government committee is created to coordinate the work of policy actors on the new tax code
June	Georgia is included in the European Neighbourhood Policy of EU
December	The new tax code is adopted

After the Rose Revolution, political and economic reforms were resumed under a new government. In January 2004 the new president was elected. Mikheil Saakashvili won a sweeping victory with 96% of the votes. With the mandate to lead the country his government launched a massive anti-corruption campaign, where former high ranking officials were imprisoned on embezzlement charges and ordered to pay the embezzled money back to the state (Dadalaui 2008). Public sector reforms of the educational system and the police were initiated to reduce corruption and increase the efficiency of both sectors (Papava 2006). Meanwhile, economic reforms included massive state asset privatization and commitment to competition as the future driver of Georgia's economy. The new government welcomed the strengthened ties with the EU by joining the European Neighbourhood Policy agreement on of June 14, 2004 (Civil Georgia, June 14, 2004). The Georgian Government also showed its commitment to the West, as discussed in details below. The initiation and adoption of the second Georgian tax code was one example of the government's stated commitment to new tax policy ideas. However, it is worth scrutinizing how this document came about and which factors accounted for its creation and adoption. I will begin with the tax policy ideas.

7.2. Ideas

7.2.1. Source and Availability

The source of new tax policy ideas as well as their availability did not change dramatically after the Rose Revolution. Experts and consultants from IFIs or other organizations and recommendations and suggestions from the third sector remained in place. What seemed to emerge as a clear source of ideas unlike previous periods of policy making in post-revolutionary Georgia was examples of implemented reforms in former Soviet countries be they members of the CIS or the Baltic countries. The new government visited the Baltic states to see how their tax administration system was built and operated, and the President and his close circle seemed to be impressed with their achievements. During the Parliamentary discussions on October 28, 2004 one of the MPs who debated the tax rates on dividends for individuals referred to the Baltic states, which taxed dividends in the beginning of their economic reforms with 0 to 5% rates, instead of 10% as the Georgian tax code was introducing. Moreover, he indicated that when the President of Georgia was impressed with the economic reforms in the Baltic states, he should also consider the reforms that they had implemented so far (Kovzanadze, I. MP, Parliament, October 28, 2004). The Deputy Minister of Finance confirmed that the new government was looking at the Baltic states as they had a Soviet legacy unlike old democracies such as France and Germany.

Usually we look at the Baltic states. In the beginning the heads of this agency when forming this unit ... were our representatives in the Baltic states ... also in terms of the legislation, we use their example because they are EU members and they entered from here (meaning Soviet Union) ... Because Germany and France are too developed ... they have a standard system in Europe and they have good discipline (Interview 12).

The intensification of EU interests in the region also proved important in policy idea provision. Integrating in the Euro-Atlantic alliance as an ultimate goal and platform for subsequent reforms by the new government was echoed in policy reform frames borrowed from EU policies. The success of the Baltic States in moving away from their Soviet legacy and joining the EU was often referred to when state representatives started to visit those countries to see how their tax systems functioned, claiming to wish to replicate the reforms. It is worth noting that the EU had been present in Georgia for as long as the IFIs. It had been a source of ideas and information through its research center GEPLAC as well as policy recommendations in various spheres, but less so in the tax system. However, after the 'revolution' it surfaced as a much more visible reference and a source of clear policy ideas needed for reform. What had changed after the 'revolution' in terms of the source and availability of ideas was that individuals who before then supported of new ideas and were at the outskirts of the policy making arena or had no political influence in decision making after the 'revolution' managed to infiltrate the state institutions and take decision making posts. For example, the founders and active members of the Liberty Institute (LI), an NGO which opposed Shevardnadze's regime and supported liberty and freedom, took important positions in the state administration and the Parliament. For instance, Giga Bokeria entered the parliament in 2004 and became deputy chairman of the Committee on legal issues, member of a committee on defense and security and head of the ruling party, the United National Movement. Givi Targamadze was the Chair of the Georgian Parliamentary Committee on Defense and Security and had been actively involved in the Rose Revolution. Sozar Subari, another member of LI, was elected ombudsman for a term of five years by the Parliament in 2004. The LI continues its policy advocacy and provides input on draft legislation in the post-revolutionary parliament. Thus, the NGOs were gaining legitimacy as important domestic actors in the policy making arena. Moreover, some new politicians emerged among the post-revolutionary political elite, who had been following new ideas in the economic policy of Georgia. Minister of Economy, Kakha Bendukhidze, promoted deregulation and privatization and maximum liberalization of business-related legislation, including the tax code. His famous motto was: 'Everything is for sale except dignity'. Kakha Bendukhidze strongly supported the new tax code and was along with his working group intensively involved in its drafting. This is discussed further below.

7.3. Policy Coalitions

The policy coalition which initiated and elaborated the second tax code after the Rose Revolution was united around new tax policy ideas and consisted of state, non-state and international organizations. The Prime Minister issued a decree on March 31, 2004 on the government commission to create a tax code draft within a month. The commission was to be chaired by the Prime Minister and would include economic experts, both foreign and Georgian. In three months they had to have a tax code project ready (Civil Georgia, April 6, 2004). The commission working on the tax code under the auspice of the Ministry of Economy and the Prime Minister was united under the name Business Confederation of Georgia. It included the Georgian Taxpayers' Union, Amcham, the European Chamber of Commerce's office in Georgia, the Georgian Employers' Association, and the International Chamber of Commerce's local representation (Interview 26).

Interestingly, some of the individuals who actively participated in the commission's work were representatives of the new business elite in Georgia which had close ties with the Prime Minister. They had been working on the tax code changes and laws on entrepreneurs previously as well. Some of them were part of the business group that Zurab Zhvania created in the Parliament in 1998. This commission was given work space in the Ministry of Economy (Interview 26). The final stage of the commission's work took place in a two week retreat at a ski-resort on the outskirts of the capital. The retreat was financed by the USAID and experts were paid a minimum honorarium (Interview 26 and 25). Those two weeks were very intensive as each article of the tax code was discussed. Also attending the discussions were representatives of the Ministry of Finance (MoF), but some issues were not consolidated between the commission and the MoF representatives. At the end of the two weeks, two tax code projects were prepared: one by the governmental commission and one by the MoF working group. As the Ministry of Finance was the tax policy making organ, its project was advanced in the government session to be discussed.

The final tax code project was presented to the Cabinet on June 13, 2004 (Civil Georgia, August 27, 2004). During government discussions, the Minister of Economy and the Prime Minister were rather influential. For instance, the MoF wanted to keep a personal income tax rate at 16% while Zurab Zhvania wanted it reduced to 12%. The rationale was dual: he wanted to ensure that the new tax code did in fact incorporate radical changes as voiced before and he wanted to make sure that tax rates were the lowest in the region, and a 12% PIT would make Georgia an even lower taxed country than Russia, which had a 13% tax rate on personal income (Interview 18). After almost two months, the Cabinet finalized a tax code draft at the end of August and prepared it for submission to the Parliament (Civil Georgia, August 27, 2004). In this whole process, the two

most influential groups in the government were headed by the Prime Minister and by the Minister of Economy. In the Parliament it was the Budget and Finance Committee (Interview 18). The tax code draft was discussed in Parliamentary sessions in October 2004. On December 28, 2004 the Minister of Finance presented the tax code to the Parliament. He opened his speech by stating the following:

I would like to present Georgia's new tax code project, which is truly revolutionary in our economy ... In coming years it will ensure economic growth. Its aim is to aid economic growth via new taxes and low tax rates ... to ensure a stable investment environment ... Georgia will be only country in the region with few tax types (Zurab Nogaideli, 2004).

The tax code project had two parts: it presented the general norms on taxes, tax types, regulations and it presented concrete tax types, rates and their administration norms (Zurab Nogaidzeli, 2004). In the Parliament, the new tax code project was debated mainly with regards to its basic approach to business and taxpayers, excise tax and its tax base, and local taxes among them usage of natural resources and property tax. Some groups in Parliament demanded agriculture, printed media and publishing activities to be exempt from taxes (Parliament 2004). Other discussions concerned the norms that regulated business dispute settlement procedures. Some MPs feared that the expansion of the tax administration rights might infringe on the constitutional rights of property and the freedom of the individual. Discussions of more concrete tax rates and particular norms as well as humanitarian aid taxation were postponed till the second hearing (Georgian Parliament, 2004).

7.3.1. Parliamentary Discussions and Adoption of the Tax Code

The parliamentary work on the tax code was intensive during the two months from its presentation on October 28, 2004 till its adoption at the end of December. The Committee of Budget and Finance and its expert group were involved in elaborating the final details in the text while coordinating the work with the Ministry of Finance, MPs and the Prime Minister (Gotsiridze, Parliament December 21, 2004). The final compromise between government and parliament was that instead of the one-month delay of the tax code enactment, the reduced VAT rate would be enforced with six month delay (until July 2005) (Gotsiridze, Parliament, December 21, 2004; Wheatley 2005:202).

The final draft of the code was adopted on December 21, 2004 and took effect on January 1, 2005. The new tax code did not change significantly from when it was first presented to the Parliament. The text was already formulated into concrete principles and represented a compromise between multiple actors present at the Gudauri discussions in the summer of 2004. The number of taxes presented the first time had been reduced from eight to seven once usage of

natural resources was removed from tax types and made into a duty collected by local governments (Parliament 2004; GET 2004). The tax policy innovation of a flat personal income tax was taken in. The rate was set lower than in Russia. Corporate income was taxed at 20%, which was low compared to the other CIS countries. Moreover, to make the reform extreme, the non-taxable minimum in the personal income tax was removed as it would potentially create progressivity in the income tax. The final result of the tax code did in fact exhibit the principles of a new tax policy (i.e. broad tax base, low tax rates). The tax code was a domestic initiative and it represented a shift in its principles.

The process of the tax code elaboration and adoption was remarkably swift. The time from the establishment of the tax policy working group until the adoption of the tax code stretched approx. nine months. The policy making process was not closed for public scrutiny, but the speed and the intensity of the process did not leave much room for broad public discussions of the tax code project. It seems that non-government organizations were involved in the process yet with little effect on the policy text or particular norms. Political party representatives who belonged to the Industrialists and some local experts who did not belong to the government commission were unhappy with the policy making process. They claimed that the government acted extremely self-righteous signalling that it was clear in its goals and in its policy preferences and needed no recommendations from 'others'. The role of international organizations, such as the IMF, also seemed rather marginal in the whole process.

The UNDP provided a consultant to the Ministry of Finance from July 25-August 1, 2004 (Bob Conrad, Memorandum 2004). Some funds were saved to pay Bob Conrad, a high-ranking American tax specialist, who had commented on the Georgian tax code for the Ministry. His evaluation of the tax code was positive, however he did make detailed comments on the personal income tax, VAT, depreciation and corporate income tax. His comment on the personal income tax mainly concerning the absence income exemptions, which made PIT administration extremely difficult and likely to encourage tax inspector corruption. He confirmed that the meetings which the Minister of Finance and the Minister of Economy held with private sector representatives working on the tax code were very lively. Yet, his evaluation also made it clear that the government representatives were firm in their policy preferences.

The tone of cooperation between Georgia and the international community had changed, as the latter was impressed with the democratization perspective after a decade of stand-stil. The drive of change was coming from the inside, with a clear goal and a signal of confidence that the 'revolutionary government' knew what it wanted and exactly how to achieve its goal. The initiative was seen as domestically born with no external intervention or pressure. Once the idea of its creation was voiced, with the minimum discussion among domestic policy ac-

tors or consultations with the IMF, the final version of the tax code project was submitted and later approved in the Parliament. The ideological shift in the tax code towards simplified tax norms enhancing a broad tax base and low tax rate principles is viewed here as a result of internalization of new ideas by domestic actors who participated in drafting the new tax code.

7.4. Government Support

The government's commitment to the reforms and the desire to break away from the previous regime's legacy of non-reform were demonstrated by the post-revolutionary government on numerous occasions. The regime change brought a new state leader, the former Chairwoman of the Parliament, Nino Burjanadze. According to the Constitution, once the President stepped down, she was to act as President for 45 days before new elections could be held. During her leadership in December 2003 two tax code amendments were initiated by the President and adopted in the Parliament. One amendment reduced personal income tax on dividends and interests under 3000 GEL earned within one fiscal year (Georgian Law #3175, article 42). Moreover, a new tax type, an advertisement tax payable by residents as well as non-residents, provided that they use advertisement for their work or business activities (Georgian Law #3175, article 213). The introduction of new tax types was a clear move towards a broadening of the tax base, while the reduction of the personal income tax marked the starting point for further tax policy reforms. The principles of a broad base and low tax rates in the tax legislation were the overall frame of the new tax code which was adopted a year after the tax code amendments initiated by the acting President.

After 2004, however, all four tax code amendments initiated by the new President, Mikheil Saakashvili, continued the rationale of improved tax collection, introduction of new tax types and elimination of tax exemptions and tax holidays introduced under the previous regime. For instance, he initiated the creation of a Financial Police unit under the Ministry of Finance which aimed to improve tax collection and reduce tax evasion (Georgian Law #3413). A new type of a tax, a property tax on residents, was introduced (Georgian Law #3020). And with one of the first tax code amendments, the President eliminated provisions which either exempted sectors from VAT or granted favorable tax rates or tax payment schemes (Georgian Law #186). Although those policy initiatives are worth discussing because they have introduced changes which the new tax code was yet to strengthen further, there were no direct changes to the corporate or personal income tax base or rate after January 2004 before the new tax code adoption. The amendments under the new regime after the Rose Revolution are illustrated below.

Table 7.2: Dynamics of tax code changes adopted between December 2003 and December 2004

Year	Number of amendments	Initiator of amendment: president/parliament	Effect on personal income tax	Effect on corporate income tax
December 2003	2	2/0	1a	
2004	4	4/0		
Total	6			

a. Georgian Law #3175, article 42.

The table summarizes the number of tax code amendments from December 2003 through December 2004. The initiator was the President and only one of the amendments directly affected the income tax.

7.5. Domestic Structural Factors: Budget Deficit and Low Level of Tax Collection

A domestic structural factor-centered explanation would argue that the Georgian government had been urged by a low level of tax collection and empty state budget inherited from the previous government to initiate and adopt a new tax policy. A new tax code simplified tax administration, adopted tax types that were less costly to collect and generally changed its tax legislation to liberalize the tax system. Domestic revenue hunger could not have played a role in the Government's decision to reform the tax system. The new Government needed finances to keep its promises to reform the country. However, the empirical data tells a different story. Structural factors do not explain why a country with a positive budget and a good tax collection level would initiate and adopt a new tax code. When the second tax code was complete and adopted in December 2004, the state budget was in the black for the first time in the history of independent Georgia. Surpassing the target revenues, Georgia's 2004 budget managed to raise 1,773 mil GEL (approx. 8,885 mil USD) in revenues which was 31 mil GEL (approx. 15.5 mil USD) higher than the target (GET 2005). Table 7.3 shows that in 2004 total expenditure was lower than the total revenue as percentage of GDP. This was the first time that expenditure did not exceed income in the Georgian budget.

Table 7.3: Consolidated budget revenues and expenditures as percentage of GDP, 1999-2003

	Total revenue and grants	Tax revenue	Total expenditure and net lending
2003	16.2	15.0	17.5
2004	21.7	18.2	18.6
2005	23.4	19.8	24.9

Source: IMF Report 2006.

Tax state-building in Georgia continued after the Rose Revolution and the new government managed to fulfill its state budget. Revenue collection has increased to 18.2% of GDP and the tendency seemed to continue after the new tax code was adopted and enacted in 2005. Taxes finally made a state that could afford to finance its services to the public. The tax base was broadened and tax collection ensured tax compliance from taxpayers. The evidence provided below leaves no doubt that the Georgian state was born out of taxes after the Rose Revolution. However, the new tax code was enacted through a tax administration body; the code did not change rapidly and it created a stable environment for business as well as for tax administration. In the tax collection campaign the government seemed to have its hands-free to extract finances from corrupt officials. Just before the new tax code was elaborated and adopted the new government marked its coming to power with a strong-handed campaign against corruption (Dadalaui 2008). A part of the anti-corruption campaign was to arrest high ranking officials from Shevardnadze's time and make them pay back to the public what they had appropriated by misusing their positions. The former chief of the Georgian Railroad, the former Head of the Chamber of Commerce (State Audit), and the former Minister of Energy were arrested in 2004. Around one year after the arrests it was announced that the state has recovered around 30 mil USD (Civil Georgia, March 1, 2005).

The anti-corruption purge did not stop here. New state agencies were often controlled for bribe taking and when caught, officials were arrested and the case made public to prove that the new government was walking the walk. In the summer of 2005 high-ranking officials in the Tax Department were caught taking bribes, among them the chief of the agency. They were accused of writing off tax arrears as a favor to a private firm which owed 3 mil GEL (approx. 1.6 mil USD) and for that 'small favor' officials were said to have taken some 150,000 GEL (approx. 83,000 USD) (Dadalaui 2008). Following this incident the Minister of Finance stepped down, claiming surprise at how corrupt the tax department was. Soon after, the agency was subjected to systematic reforms (ibid.).

In order to improve the function of the tax administration a second phase of fiscal reforms was launched in 2004 with support from USAID. The overall objectives of the technical assistance from the USAID was to help the Ministry of Finance and its Tax Department to strengthen Taxpayer Service, Revenue Analysis, complete computerization of the Tax Department, and integration of certain tax/customs functions (USAID 2005: 65). The Tax Department was supported by other donors as well such as EU's TACIS program, US Treasury and UNDP. While USAID advised the Georgian government on its strategies and plans on the development of an integrated registration process, US Treasury provided a team of advisors to advise GOG on tax audits, tax collection and enforcement processes. UNDP has been involved in training support of the Tax Administration and the EU

project assisted with capacity building, public awareness and enhancement of structural reforms (Curnow 2006:74; USAID 2005:61-64).

The second phase of the tax administration reforms was soon caught up with a new tax code elaborated within some nine months and adopted in December 2004. It was to be enacted from January 2005 and envisaged a better administration of tax revenues and tax evasion via simplified tax administration procedures and expansion of the the tax administration's power to enforce tax compliance (Curnow 2006:71). The civil service reform restructured the Tbilisi city inspectorate where five inspectorate units were merged into one (Curnow 2006: 69). The Tax Administration staff was also 'shook up' in 2004. Senior staff turn-over was almost 100 percent in 2004, and in the newly restructured tax administration some 65% of the current staff was under age 45. There were staff reductions during 2001-2005, and the age profile of the tax administration staff was lowered in 2004 (Curnow 2006:70).

On August 29, 2004 the Tax Inspectorate and Antimonopoly Service were replaced by the State Agency for Free Trade and Competition (GET 2004:78). The Financial Police was created under the Ministry of Finance to fight economic and financial crime, reduce tax evasion and thus improve tax collection (Georgian Law #3413). While the ruling party and the new government strongly supported the Financial Police in its hunt for smuggled goods or other types of economic crime, the chief of the agency and the actual tax extraction operations were harshly criticized by the ombudsman and the opposition (Civil Georgia, March 1, 2005). The authorities claimed that the state budget increase due to revenue collection was to a large extent due to the Financial Police. Opponents of the agency said that it had been used as 'a vehicle of state racketeering' (Civil Georgia, March 1, 2005). The hard-handed tactics of the Financial Police were demonstrated on June 16 2005 when dozens of armed and masked agents entered two fast-food restaurants simultaneously to confiscate documentation of alleged tax evasion at noon when the restaurants were packed with customers. The action was evaluated as a human rights violation and excessive use of force by the Parliamentary Chairperson and the ombudsman. Next day the Chief of the Financial Police had to apologize publicly for the operation (Civil Georgia, March 1, 2005). Almost a year after, the Financial Police, the Tax Department and Customs Service were merged. Paper files were turned into a digital data set that aimed to make business operation in Georgia easier for entrepreneurs. Re-establishment of the tax arbitration body that was abolished in April 2005 was also promised (GET 2006:10). Meanwhile dubious extraordinary funds created under the new government, where confiscated money from the former high-ranking officials was said to be transferred, were abolished as recommended by the IMF in 2005 (Papava 2006:663).

Beyond those reforms, the post-revolutionary government made a political decision to ensure tax compliance and tax transfers to the central government from the autonomous region of Adjara. As discussed above, the head of this region developed a *modus vivendi* with the central government and refused to transfer local taxes for several years, causing state budget deficits to be filled with loans and grants (the region occupies a large territory on the Black Sea and its ports) (Dadalaui and Johannsen 2009). The new government's decision to use force to re-join the region and ensure tax compliance indicates the state's capacity to extract revenues and ensure compliance from delinquent regions or taxpayers. As already said, the Rose Revolution changed governance and tax policy implementation in Georgia. The tax extraction modes seemed like a mix of coercion and consensus. Significant changes were made to broaden the tax base compared after the second tax code was adopted. One can speculate that the new government had learned a good lesson from the experiences of the previous government. It saw how dreadful financial situation the previous regime was because it did little to fundamentally change its tax practice, its approach to the role of tax collection, and the revenue base by making tax income more important in state financing. However, the evidence in this chapter does not support the speculation that policy change or adoption of the new tax code after the Rose Revolution were caused directly by domestic structures such as a low level of tax collection and/or a large budget deficit.

7.6. Number of Veto Players and Party Politics

A closer look at the tax code change initiated and adopted during 2003-2004 clearly demonstrates that party politics had little to do with it. Only the President (or before January 4, 2004 the acting President) was behind the wheel of the legal initiatives of the tax system reforms. As for the number of veto players as conceptualized by the domestic-factor centered approach in tax policy change, the Georgian case shows little support for this policy change phase. The new government initiated constitutional changes which centralized the presidential power even more than before 2004. As for the party representation in the newly elected Parliament, the majority of seats were taken by the ruling party, thus making the legislative body less fragmented and easier for executive initiated legislative changes to pass through. The evidence below supports these statements. In March 2004 new parliamentary elections were held following the presidential elections in February that gave Mikheil Saakashvili overwhelming support from the electorate.⁶⁷ The election threshold was 7%, similar to the elections in 1999.

⁶⁷ Presidential Elections of Georgia in January 2004 obtained from the website: <http://psephos.adam-carr.net/countries/g/georgia/> last visited on October 30, 2007.

As a consequence, only two blocs managed to take seats in the Parliament: the Bloc of National Movement-Democrats with 67.6% of the votes (135 seats) and the Bloc of Rightist Opposition-Industrialists-Novas with 7.6% (15 seats). Other political parties⁶⁸ won 24.7% but could not get any seats.⁶⁹ In this Parliament, unlike the 1999 Parliament, representation of opposition interests or political views was reduced drastically (Jones 2006: 309). At the same time, the Central Election Commission was said to be dominated by the supporters of Saakashvili and his party. Although the elections were approved as fair and free, there were discrepancies in voters' lists and a lack of trained election officials (Jones 2006: 308).

7.6.1. One Party Dominance and Strong Presidential System

The change in the political landscape did not change the political tendency, i.e. one-party domination of the political spectrum. In past elections, the United Citizens of Georgia was the ruling party in Georgia except in the Adjara region, which was dominated by Aslan Abbassidze's party, the Union of Democratic Revival. Soon after the elections this tendency was confirmed by a new national flag, replacing the three-color flag (red, black, and white) with a five-star flag, which had been the flag of Mikheil Saakashvili's political party for a number of years. The new elections brought in another party which was dominant in the Parliament and possessed enough seats to rule the constitutional changes with a two-thirds majority (Jones 2006: 309, 311).

The constitutional changes ensured the election of the new President in February. Several amendments turned the presidential system into a super-presidential system. The President was bestowed with excessive rights. His rights to issue legal acts or to cancel ministers' decisions or acts and to subordinate the newly created Cabinet of Ministers by summoning it and chairing it left overlapping duties and responsibilities between the Prime Minister and the President. The Prime Minister is appointed by the President and the ministers presented by the latter must have the President's consent to be appointed. The Prosecutor's office was removed from the Parliament's supervision Parliament and placed under the President's without a review of its organization and its role in the political system. The Prime Minister coordinated the work of the ministers, but if the President was unhappy with their work, he had the right to intervene by dismissing or cancelling his/her legal/normative acts (Georgian Constitution 1995:15). The President had the right to suggest the budget scheme to the Parliament, thus interfering with the tax and budget policy that had the power of law once adopted. The confusion in

⁶⁸ Political Movement Tavissupleba- Konstantine Gamsakhurdia (the son of Zviad Gamsakhurdia) won 4.4% and the Labour Party won 6%, thus none of them passed the threshold of 7%. (Slider 1997).

⁶⁹ Legislative Elections of Georgia March 2004 obtained from the website: <http://psephos.adam-carr.net/countries/g/georgia/> last visited on October 30, 2007.

the state executive branch was said to be skewed towards the President, and the Cabinet of Ministers was seen as his advisory body. The super-presidential power was even more enhanced with the President's right to dismiss the Parliament (Georgian Constitution 1995:14). Due to this right, the political system in Georgia created a safe haven for abusing the rule of law and the separation of power – two crucial pillars of pluralistic democracy (Georgian Constitution 1995:15, 18).

The strong presidential political system was replaced with an even stronger one. The existing legacy of weak or multi-party systems was further weakened in the new Parliament, consequently weakening the Parliament as a crucial pillar of power balancing democratic rule. Mixing the symbolism of the ruling party and the state continued the 'tradition' of the Soviet era, the party-state 'marriage'. The system of appointments of local power holders in the regions (regional bosses) by the central authority left the existing patron-clientelistic relationship channels intact, so although the individuals may have changed, the mechanism remained.

After January 2004, Mikheil Saakashvili and his government announced their plan make a new beginning by forgiving non-payment of taxes by Georgian businesses operating in the previous regime and to create an attractive environment for investment. It initiated a law on tax amnesty, which encouraged all businessmen to stop having double records of their finances and to pay taxes honestly from January 2004. The law was enacted in 2005 and forgave non-payment of taxes in previous years until December 2003 only. Their second initiative was to create a new tax code which would be the 'most liberal in the region' and make Georgia an attractive place to invest for foreign investors. 'We will start a new life with this tax code from January', said Mikheil Saakashvili, the newly elected President, at the cabinet session on August 26, 2004 (Civil Georgia, August 27, 2004). As the Prime Minister, Zurab Zhvania, said at a government session, the adoption of a new tax code 'would be a step forward in improving the private sector in the country' (Civil Georgia, April 6, 2004). This line of thinking was re-affirmed by the Prime Minister a month later at a press conference on May 28, 2004: 'the new tax code will be more liberal at the expense of reduction of number of taxes, as well as tax rates' (Civil Georgia, May 28, 2004).

The rhetoric that surrounded the initiation and the process of elaborating the new tax code text emphasized liberalization of the tax system, which was reflected in the number of taxes, the actual tax rates, and in the cooperation between businesses and the tax administration. The emphasis on new liberal principles was voiced both by government representatives and pro-tax code MPs in parliamentary discussions. One MP stated:

Dear colleagues, this decision will be the most liberal in its approach, which I would like to emphasize, among our neighboring countries, and more particularly in the CIS and the Black Sea region. Liberalization (of the tax system) is expressed

in its approach and establishment of a partnership between the state and the private sector (Gvenetadze, Parliament, October 28, 2004).

Moreover, the new government implemented a complex set of initiatives to collect state finances. Under the banner of an anti-corruption campaign a number of high-ranking politicians from the previous regime and close family members of Shevardnadze were arrested and ordered to return 'stolen' money to the state budget. A massive privatization program was initiated by the newly appointed Minister of Economy, Kakha Bundukhidze, a Georgian-born tycoon who made a fortune in Russia and returned to Georgia after the revolution. Bundukhidze was ultra-liberal in economic matters and his motto was that 'everything is for sale except dignity'. The state budget started to grow and for the first time after the independence in 1992, the Georgian budget no longer had a large deficit. In March 2004, the final accord, which allowed a large amount of state resources to flow into the budget, set out to annex the Autonomous Region of Adjara, which was previously led by Aslan Abashidze, who refused to transfer locally collected taxes to the central budget. The new government's ability to mobilize financial resources impressed IFIs. The IMF remained an observer, welcoming radical initiatives from the determined and self-confident government after the Rose Revolution. As one a representative of the ruling party said, the new government's initiatives (e.g. the tax code) were the reason the IMF was so content with the new government:

This is the first time the IMF is content with the executive power, and neither the Parliament nor the executive power causes any serious problems for the Fund's work (Beso Jugeli, MP, Parliament, October 28, 2004).

7.7. Conditionality

During the post-revolutionary economic reforms and particularly in the tax code elaboration and adoption, the role of IMF's conditionality has not been detected. On the contrary, sources from the interviews confirmed that the role of IMF's coercive mechanism was not used in the process of the tax code creation. Moreover, the limited role of this institution in post-revolutionary Georgia was confirmed by various interviewees and comments by post-revolutionary political elite members. The post-revolutionary government needed funds to launch its ambitious reforms. The IMF was there to support. On November 26, 2003, just three days after the Rose Revolution, the head of the IMF mission in Georgia, Jonathan Dunn, said that the Fund was ready to help Georgia overcome the economic crisis and turbulent period (Civil Georgia, November 26, 2003). In February 2004 the new president, Mikheil Saakashvili, and Minister of Finance, Zurab Nogaideli made clear that the new government needed IMF funding of around 30 mil USD to

finance restructuring of the foreign debt to the Paris Club and to implement ambitious plans to increase the number of state supported programs. The IMF stipulated clear demands for its support. It urged the Parliament to adopt a sound budget bill in 2004, to strengthen the tax and customs administration, especially on excisable products, and to enact an anti-money laundering policy. While those demands were not rejected outright, the President made it clear that the new government would cooperate with the IMF but not follow its demands or recommendations blindly:

We should not blindly follow all recommendations given by the IMF or foreign experts if these recommendations are against our economic policy. We only need recommendations which are necessary for Georgia's economy (Civil Georgia, February 4, 2004).

State representatives, local experts and IMF representatives have all confirmed the statement. The IMF stopped funding the Georgian state in 2003 but resumed its programs and relevant funding of the state after the Rose Revolution. Yet, state officials were very direct about the extent to which they would allow the IMF to intervene in domestic economic policy.

The following examples illustrate tax code creation and the marginal role of IMF's conditionality. After the policy coalition elaborated the tax code, a copy was sent to the IMF for consideration in the summer of 2004 and a reply was expected within one month. Yet, the attitude of the new government, and particularly that of the Minister of Finance, demonstrated superficiality towards IMF comments or recommendations. Zura Nogaideli made clear that the government was ready to incorporate the changes suggested by the IMF provided they matched the interests of the country: 'We will take into account those recommendations (by IMF) which we find to be the most acceptable for Georgia' (Civil Georgia, June 29, 2004).

The IMF's involvement in the process of elaboration of the tax code was minimal. This has been confirmed by various individuals involved in the working group and by the representative of the IMF office.

In 1997 IMF was the most active and I don't remember any other international organizations present ... Mostly the consultations with IOs were in relation with the overarching frame and not on the concrete aspects of the tax code ... in 2004 IMF was not involved in the code discussions. We were not present at the discussions. But we would get some written questions that we would send to the Washington DC office and get back the answers on some concrete issues ... it was a legal department sending the questions to us ... those recommendations might be included in the report for 2003. In contrast IMF was actively involved in 1997... well, IMF was involved but its marginal value was small (interview 4).

7.8. EU as a Policy Actor

Similarly, the EU does not seem to have been present in the tax policy making process. However, compared to the previous regime period, the EU's presence in the Georgian political realm has increased significantly. After the Rose Revolution Georgia was included in the European Neighbourhood Policy (ENP) in June 2004, followed by an action plan in 2006.⁷⁰ This step was taken to intensify co-operation and promote democratic values along with market economy principles in non-accession countries. Four areas were identified for special emphasis under the ENP action plan: regional cooperation, rule of law, social reforms, and regulatory reforms.⁷¹ From 1992 to 2006, Georgia received a total of 505 mil EUR in financial assistance from the EU through various programs.⁷² A revised country strategy paper was prepared in 2003 along with an Indicative Program for 2004-2006. Both documents emphasized rule of law, good governance, human rights, and democratic institutions, poverty reduction, conflict resolution and rehabilitation.⁷³

In 2004, Action Program II was created for Georgia with money the Georgian government obtained at a major donor's conference in Brussels. The program included fiscal policy reforms to be achieved by expanding capacity in the tax administration department and by launching a public awareness campaign (APG 2004:5). Under this scheme, a large project on a tax administration reform is currently running in Georgia (under the auspices of the Ministry of Finance) financed by the EU with 1.5 mil EUR in collaboration with Hulla & Co. Human Dynamics KG (Vienna), Louis Berger SAS of Paris and the Center for Social and Economic Research (CASE). The project started in March 2006 and the aim is to facilitate implementation of the new tax code and transform the tax administration into a European-style institution over two years.⁷⁴ After the Rose Revolution, collaboration between the EU and Georgia has increased and intensified. Before the revolution, the EU was less ambitious in helping reform the Georgian tax policy as a whole. The post-revolutionary governments' efforts to reform the tax administration and successfully establish a 'one-stop-shop' system, registration, and customs and tax administration were merged to ease business registration (GET

⁷⁰ http://ec.europa.eu/external_relations/georgia/eu_georgia_summary/index_en.htm

⁷¹ For more on this, see Georgia's ENP Action Plan, online: http://ec.europa.eu/world/enp/pdf/action_plans/georgia_enp_ap_final_en.pdf

⁷² For a detailed account of the financial assistance and programs, see Annex III to the Country Strategy Paper 2007-2013, online: http://ec.europa.eu/world/enp/pdf/country/enpi_csp_georgia_en.pdf

⁷³ EU Assistance, online: http://ec.europa.eu/external_relations/georgia/eu_georgia_summary/index_en.htm; http://ec.europa.eu/external_relations/georgia/eu_georgia_summary/index_en.htm

⁷⁴ European Commission Delegation to Georgia and Armenia, online: <http://www.delgeo.ec.europa.eu/en/press/1March2006.htm>

2006). EU reports commented positively on Georgia's success in implementing the provisions of the ENP action plan (Communication of EU 2008).

Regardless of the long-term cooperation between Georgia and the EU, EU's role in the Georgian tax policy reforms was limited compared to the direct and, at times, intrusive way the IMF and the World Bank influenced the tax policy making. The role of 'passive leverage' cannot be dismissed here. However, as mentioned, it cannot run in parallel with the coercive mechanism of conditionality. Harmonization of particular policies, among which certain aspects of tax policy were included, has not entailed any coercion, and if and when the Georgian government decides not to incorporate the EU's tax policy preferences in its national legislation, it will not face harsh consequences. Nonetheless, 'passive leverage' is present because EU's tax policy priorities on double taxation have been taken up by the current government and bilateral agreements are under negotiation with EU members.

To demonstrate the commitment of the new Georgian Government to form tight relations with the EU, some steps were made in this direction. Mrs. Tamara Beruchashvili, a former TACIS National Coordinator, was appointed State Minister for European Integration (APG 2004:2). In addition, the speedy process of drafting and adopting a new tax code in 2004 included EU experts who were consulted along the way. Meanwhile the financial involvement of EU as well as its framework of cooperation have increased and become more clear-cut than in previous years.

Table 7.4: EU programs in Georgia from 1998-2006 (Program – Traceca, Inogate, Natural Resources)

	1998 1999	2000 2001	2002 2003	2004	2005	2006	1992 2006
TACIS	16	15	14	27	0	20	131
ECHO	13	4	4	4	1	-	99
FEOGA (food aid)	-	-	-	-	-	-	63
Exceptional humanitarian assistance	-	-	-	-	-	0	6
Food Security Program	12	13	-	12	10	10	91
Rehabilitation in conflict zones	4	5	-	2	2	2	23
Macro-financial assistance	19	6	-	7	-	33	65
CFSP* and RRM**	-	2	2	5	-	-	9
European Initiative for Democracy & Human Rights	-	-	2	2	2	3.9	9.9
Other instruments	4	-	-	2	1	2	9
Total	68	45	22	61	16	70.9	505.9

Source: EU Delegation in Caucasus, website: http://www.delgeo.ec.europa.eu/en/eu_and_georgia/cooperation.html

7.9. Formal and Informal Institutions

Formal rules of policy initiation and adoption allowed the new tax code to be adopted and thus allowed new ideas filter into national legislation. As mentioned, formal rules had little importance in blocking or adopting the legal initiative this time as well. Two important factors allowed filtering of new ideas were: The initiative came from the executive power in Georgia. In the Georgian reality this meant that a legal initiative which had the support of the executive would most likely be adopted in the Parliament which was dominated by ruling party members and which, historically, had only been mildly resistant to the executive power. A strong presidential system allowed the executive power to strengthen its position through appointments in high-ranking positions and by having the majority of seats in the Parliament. The executive power was backed by the ruling party in the legislative body; therefore, the good will of the President was often necessary to find support for legislative initiatives in the Parliament. Those who fell out of favor risked becoming politically marginalized. This fate was shared by the third policy coalition of reformists. Secondly, individuals who supported the new tax policy ideas and were involved in the process of tax code elaboration had been involving state representatives along the way through consultations. Informal linkages formed with the policy working group and state representatives allowed innovative ideas in the tax code to be accepted and embraced. New tax policy ideas gained legitimacy by being internalized and in this way supported the policy working group as well as the decision makers representing the new political elite in the executive as well as in the legislative body.

7.10. Tax Competition

Tax competition as a reference for the new government while reforming the tax system has been voiced after the Rose Revolution. The current policy discourse in taxation is driven by the tax competition rhetoric across developed countries. Meanwhile, the indicators on Georgia's FDI inflow (see Table 7.5) as well as its trade relations showed an increase since 2003. Trade relations with various regions are summarized in Tables 7.5 and 7.6.

The tables show that the rates of export and import between Georgia and the CIS as well as western countries have increased (see Tables 7.5 and 7.6). The increase is significant compared to the years before the Rose Revolution. Yet, it is worth noting that while the import rates from the CIS and the EU are practically identical, Georgia is still tightly connected to the CIS in terms of exports (see Table 7.6). In fact, Georgia's economic integration through FDI inflows and trade relations brought up the issue of tax competition in post-revolutionary Georgia. As for the flat tax rate, the interviewees referred to the already implemented reform

on personal income tax in the Baltic States and later in Russia as the source of information for the tax code project.

Table 7.5: Georgian exports by country group (1000 USD)

	2004	2005	2006
Total exports:	646,903.0	865,454.2	936,172.1
Exports to countries in:			
EU-27	128,204.3	216,756.4	225,353.7
CIS	327,638.7	407,173.6	390,875.0
BSEC	343,214.3	498,834.0	499,029.5
OECD	271,971.2	360,677.3	390,496.4
WTO	306,037.8	429,555.7	495,041.3

Table 7.6: Georgian imports by country group (1000 USD)

	2004	2005	2006
Total exports:	1,845,554.9	2,489,953.4	3,677,744.7
Imports to countries in:			
EU-27	657,248.1	740,323.0	1,104,127.2
CIS	654,925.2	996,777.4	1,401,501.1
BSEC	853,175.7	1,295,302.6	1,953,040.6
OECD	946,837.1	1,094,036.6	1,708,931.4
WTO	1,126,295.6	1,399,985.2	2,090,287.6

Source: Revenue Service, Georgian Ministry of Finance; Georgian State Electric System, Ltd.; Georgian Gas Transportation Company, Ltd.

7.11. Policy Change Mechanisms

Policy learning and empowerment of the domestic policy makers who internalized new ideas led to the adoption of the second tax code of Georgia in 2004. The Rose Revolution brought a drastic change to the political scene of Georgia. Political change led to a reshuffling of the decision makers and changed the extent of influence of the previously discussed policy coalitions. The new government was represented by a reformist wing of the former political elite as well as individuals who supported reforms and represented the third sector. Individuals who embraced new ideas and supported democratic reforms dominated the post-revolutionary government. The latter became unequivocal about the planned economic and political reforms projecting initiatives as domestically bred and more drastic than the IFIs could have projected for the impoverished state of Georgia. The political influence of the international organizations slowly diminished as a result of the government's capacity to implement reforms and

collect the necessary financial resources without being deeply dependent on IFI funding. Unlike before, the new government received tripled financial support from the EU, which had initiated a new cooperation scheme under the European Union Neighbourhood Policy. Thus, alternative sources of funding and policy programs entered the Georgian policy arena. Another factor that reshuffled the policy coalitions was the intensified process of third-sector representatives' recruitment within the state agencies. As mentioned, particular individuals with third-sector affiliation were involved in the policy making processes in the first half of the 1990s, but less in the second half. However, recruitment of new blood into the state agencies was not as extensive as it was after the reformist wing of the former political elite took over the reins of the state. The post-revolutionary government representatives were eloquent in their desire to break away from former corrupt methods of running and extorting businesses and to create an attractive environment for investment in Georgia by adopting the 'most liberal tax policy' in the region.

Based on the discussion above, the effect of conditionality on the tax policy change as a theoretical argument in the case of Georgia can be dismissed. It is not to disregard conditionality as a cause of change in Georgia's path towards a policy change, particularly in the early 1990s or even later, just before the Rose Revolution. The close observation of the amendments implemented as a result of the conditionality-based recommendations from the IMF shows the selective obedience to the leverage by the Georgian government. In its game of 'balance politics' policy choices were often made among three main policy coalitions' initiatives, and the IMF was one them. Conditionality mattered. It led to policy change, but not to a sustainable shift. Moreover, changes made in the tax code due to the conditionality were reversed afterwards and there several such cases. However, in the period of policy making following the Rose Revolution, the role of conditionality diminished significantly.⁷⁵ Moreover, conditionality was not im-

⁷⁵ Local experts have provided their version of why the IMF chose to observe rather than aggressively intervene in the fiscal policy of post-revolutionary Georgia. In the article, which was published in 2005, economic expert Vladimir Papava stated that IMF representatives in Georgia were disliked by the state officials due to their firm position on the needs for a reform of the Georgian economy to make it more attractive for FDI, while ensuring higher tax collection and elimination of the budget deficit. Therefore, the Minister of Finance at a meeting in Washington DC in 2004 demanded a new IMF representative in Georgia. Papava concluded that having learned the lessons from his previous colleague, the new IMF representative chose to remain in the shadow and avoid confronting state policy initiatives. However, the IMF representative saw the role of the Fund reduced as Georgia's state financing had improved, inflation was under control and the economy was growing quickly due to administrative reforms and the government's desire to sustain the economic achievements. It is difficult to settle on any of those three possible reasons IMF's role had reduced in the tax policy of Georgia. However, the evidence confirms that IMF conditionality was not the factor leading to the second tax poli-

posed on the tax policy change after the Rose Revolution and a policy program was not presented with concrete changes from IFIs to the government. IMF seems to have been an observer rather than a player in the process.

7.12. Summary

The aim of this chapter was to trace the path of the Georgian tax policy change towards new policy principles and to open a Pandora's Box to see which causal chain led to this outcome. Based on the discussions of the tax code amendments, the policy initiative of Orvelashvili's Tax Code and the new tax code adopted in 2004, there is no evidence that new policy principles incorporated in the last tax code were externally imposed on policy actors in Georgia. Yet, there is evidence that those policy ideas that flowed into the policy arena were internalized by local actors, turned into 'locally initiated policy proposals', and pushed through the legislative body until adoption in 2004. Thus, one may conclude that the Georgian tax policy change was a result of ideas rather than conditionality or market integration as such.

The process described in this chapter supports the dissertation's transnationalization argument. Transnationalization of the policy arena was conceptualized into three phases and in order for the argument to be sustained, all three phases of idea infusion, internalization and new idea adoption had to be present in the process. Unlike in the previous chapter where policy learning and internalization of new ideas were present but policy adoption did not occur, post-revolutionary processes demonstrate otherwise. Comparing processes from before and after the Rose Revolution, process tracing tools allowed detection of several factors that were either missing or present in the periods investigated. It seems that in the period when policy ideas were already widespread and internalized by the politically less influential policy coalition, policy adoption did not occur as there was a lack of government support to innovative ideas and the power of IMF's conditionality was tangible and still strong. During this period, domestic policy actors, who were pro-reform and insisted on a new tax system, moved from the non-influential position of domestic actors to having influence on the new government. As stated, reformist policy actors marginalized under Shevardnadze's rule managed after the Rose Revolution to infiltrate the state institutions and take up important positions. By moving up the political power pyramid, the policy actors carrying new ideas managed to obtain the government's support for their policy ideas. This was an important factor during the 2003-2004 policy making periods,

cy adoption in Georgia. Neither was the Fund an important policy actor in setting the tax rates or tax structure of the new code. This confirms that the second tax code was a domestic initiative and not the result of external coercion.

as the final tax code project emerged as a consensual policy proposal among various policy actors.

Finally, the tax policy project managed to go through the institutional filter, as it was supported and promoted by the Ministry of Finance, which had the right to legal initiative, according to the law making rules in Georgia. Meanwhile, informal links among various policy actors ensured strengthened support for the policy proposal and the participation of various policy actors in the process. To conclude, the new tax policy adoption in Georgia in 2004 demonstrated that internalized ideas can under certain conditions find their way into domestic public policy.

Chapter 8

Conclusion

This dissertation has told the story of Georgian tax policy making and reforms. The main objective was to unpack the causal factors behind the diffusion of the tax policy ideas in Georgia – the country which, less than two decades ago, started to form a market economy and made attempts to integrate into the global market. While concentrating on the tax policy adoption as the object of investigation, the focus was not to investigate tax policy equity, fairness, or the shift of tax burden from capital to labor. Needless to say, those issues are relevant to tax policies and are ingrained in theoretical debates on the consequences of the adoption of a Georgian tax policy. However, as mentioned, the dissertation aimed to unpack the causal process which policy ideas pass through and end up in the national tax laws. The theoretical claim was that ideas, once internalized, can lead to a policy change in developing countries and the dissertation investigated counter-theoretical arguments, such as domestic and external factor-centered propositions, here labeled *conventional theoretical arguments*.

Conventional explanations are divided into two groups according to their focus on external or domestic factors. External factor-driven theoretical arguments primarily view the tax policy change in general as a matter of external pressure, be it due to tax competition, EU membership conditionality or IFI imposed conditionality (Ganghof 2006; Swank and Steinmo 2002; Vachudova 2002; Stones 2002). As for domestic factor driven explanations, number of veto players, structural factors and the political bargaining between state and business interest groups are seen to lead to tax policy formation and/or change (Hallerberg and Basinger 1998; Basinger and Hallerberg 2004; Frye and Mansfield 2003; Loung and Weinthal 2004). In contrast to those theoretical stances, this dissertation claims that externally infused ideas can lead to a policy change through learning if and when new ideas are internalized by domestic policy makers. The theoretical argument of this dissertation was pinned as transnationalization of the policy arena where domestic meets external and where new ideas are introduced, learned and internalized among multiple actors who in the various phases of the policy elaboration and/or adoption play different roles. This theoretical argument was tested along with competing conventional theoretical arguments on Georgia through an in-depth process tracing method (see Chapters 5, 6 and 7). As a consequence, both theoretical and empirical findings are drawn on in the analyses and are discussed in detail below. The summary of the theoretical expectations and empirical finding are provided in Table 8.1 in Section 8.2. Section 8.1 summarizes the theoretical findings and the dissertation's contribution in this re-

gard. Section 8.2 brings summarizes the findings of the in-depth case study. Section 8.3 concludes.

8.1. Theoretical Findings

The ambition of this dissertation was to contribute on a theoretical level to the scholarship of transnationalization, ideational policy change, as well as the region specific theories of transition. One of the theoretical contributions of this dissertation lies in its attempt to theorize the causal mechanism through which ideas can lead to policy change. The theorized mechanism of ideational policy change contributes to the literature which aims to capture processes of institutional and policy change through ideas (Blyth 2001; Apple 2000; Hall 1993; Campbell 2004). The second theoretical contribution is the variable – internalized policy ideas – which in the causal mechanism of ideational policy change can lead to the institutionalization of new ideas. Thirdly, the argument of the dissertation that in developing countries, and particularly in post-Soviet states, policy making and change processes are not a two-level game among state and international actors but rather a multi-level game. The latter involves non-state, state and international actors. This argument tested throughout the dissertation contributes to the theory of transition in post-Soviet states. By placing external and domestic factors side by side within the transnationalization framework, the dissertation makes us more knowledgeable on the complex processes that go beyond diplomatic relations of state officials with powerful states, financial institutions, or unions of countries. Finally, the theoretical contribution lies in the dissertation's attempt to conceptualize what transnationalization is and which existing claims of the transnationalization studies were sustained in the empirical analysis.

Theorizing a causal mechanism is a challenge for any researcher and yet it is the prerogative of any in-depth case study. Scholars studying the role of ideas in institutional or policy change often point out that the validity of those types of studies very much depends on the ability of the researcher to conceptualize and empirically prove the causal channel through which ideas diffuse (Campbell 2002, 2004; Blyth 2001). This requires not only a clear definition of what ideas are but also a specification of other factors that connect ideas with the outcome. This task was undertaken in Chapter 3, where ideational policy change studies were combined with policy learning literature and built within the frame of transnationalization of the policy arena. This causal mechanism theorized factors such as policy coalitions, policy change mechanisms and institutional filters which connected tax policy ideas to their adoption in the country of question. The theorized mechanism of ideational policy change made it possible to answer questions about who carries ideas and how they are diffused, learned, internalized and promoted in the local policy making arena, as well as what hinders and en-

hances ideas entering the legislation. This detailed causal chain which can be empirically examined and analyzed has enriched the theory of ideas in the institutional and policy change scholarship.

Not all ideas matter, however; only internalized ideas do. The argument that ideas matter has been the leitmotiv of this dissertation. Yet, the result found by testing its theoretical claim was that not all ideas which diffused externally into the domestic policy arena mattered. Only ideas that were learned, accepted and, over time, internalized by multiple policy actors played a role. The finding of the variable of internalized policy ideas sheds light on the way ideas which might be forced on individuals or forcefully taught fail to lead to a policy change or at least to a sustainable policy change. Orvelashvili's Code was a good example of how externally injected ideas can be internalized. The theoretical findings have provided refreshing insights on the modes of policy change in developing countries that do not have to be conditionality-based coercive mechanisms. The dissertation explored the process and demonstrated that instances when conditionality is expected to lead to a policy change can fail. In some instances it may only lead to a short-lived policy change, which mostly serves as lip service to the IFIs by national governments. I label my theoretical findings ideas vs. conditionality and discuss them in further detail below.

The theoretical claims on the vital importance of conditionality as leverage in developing countries and an important factor in a domestic policy change were challenged by the argument on the importance of internalized policy ideas. The theoretical findings under the heading ideas vs. conditionality can be summarized in three points:

- Internalized ideas contribute to the feeling of ownership and thus acceptance of a change. This is illustrated by the work of the policy coalition before the Rose Revolution on Orvelashvili's Code and, later on, the work of the post-revolutionary government-initiated tax code working group which further developed internalized tax policy ideas.
- Internalized ideas ensure a sustainable policy change which continues beyond external intervention and conditionality imposition. Post-revolutionary tax policy changes confirm the belief of the policy makers that tax policy principles will lead to competitiveness, economic growth and integration in the global market. The further reduction of tax rates and broadening of the tax base in Georgia confirm the speculation that beliefs and not external pressure led to reforms after 2004.
- Conditionality is not always systematically enforced by IFIs. This factor often leads to selective obedience by countries receiving funds. The threat and actual suspension of funds from the IMF and the WB, in 1998 and 2002, did not lead to fundamental changes in the government's economic

policy or its commitment to reform according to IMF/WB recommendations. Tax policy changes in compliance with IMF recommendations were often reversed soon after adoption or were simply ignored before the Rose Revolution. The importance of conditionality in post-revolutionary Georgia was offset by the government's determination to initiate economic reforms on its own and the achieved economic growth and macroeconomic stability in the country.

Transition theories are urged to go beyond developments where only external actors take up a leading role or domestic actors forge the democratization or economic reform processes. Orenstein et al. (2008) and Shields (2004) have argued that the notion of quadrant transition needs to be brought into the transition literature. The role of external actors has to be viewed alongside the role of domestic actors, which will make us more aware of which of their ideas and policy initiatives caused what types of changes. The dissertation empirically supports the new theoretical stance in transition literature. It theorized and further investigated complex policy change processes, where the role of international organizations was scrutinized along with that of domestic state and non-state actors. One of its conclusions is that transition in post-Soviet countries is no longer a two-level game where only state actors are involved with international organizations, or state actors are dealing with a strong business sector. It involves non-state actors, such as NGOs, experts and think-tanks, and makes the transition to a multi-level game.

The dissertation built its theoretical frame on the emerging studies on transnationalization. Theorizing the notion of transnationalization and the transnationalization of the public policy arena provided empirical support for some of the key postulates within this theory's claims. The Transnationalization Integration Regimes (Bruszt and McDermott 2009) create a framework that combines development and market integration studies from the perspective of transnationalization. Bruszt and McDermott (2009) argued that transnationalization in fact upsets the usual hierarchical power relations within a country and empowers its actors. Moreover, what matters is a combination of non-coercive mechanisms of policy learning rather than well-defined programs or incentives by international institutions. All these arguments were empirically supported by the findings through the Georgian case study as summarized below:

- TIRs empower domestic actors and alter or reinforce their power balance and transnationalization of the policy arena has provided empirical proof of this fact – Orvelashvili's Code, non-state actors emerge as powerful actors in tax policy elaboration in 2002 and 2004. Their linkages with international organizations empowered them by providing knowledge and

access to information that state actors often lacked. The contacts those non-state actors had with state actors made them even more important in the policy elaboration process.

- Instead of incentives or well-defined programs, what matters is combining monitoring and learning mechanisms with important links and ties – now evidence shows that the idea of a flat tax was not included in international organizations' recommendations in Georgia. In 2004 the position of the international organizations was rather marginal and they only reviewed the elaborated tax code project rather than participated actively in its creation. Evidence suggests that a flat tax notion or the tax rate cuts and tax number reduction were not clearly defined in the policy program handed to the Georgian government by international organizations, but was a domestic policy actor's idea. The role of institutions such as the IMF or the WB was more that of observer. However, learning and internalization of new ideas was in motion and resulted in two domestic tax code projects. So the combination of horizontal idea diffusion mechanisms mattered rather than incentives and well-defined programs; at least both were absent and the result was still achieved.

I do not claim that mine is the only valid explanation of the tax policy variance and the mechanisms of the diffusion of tax policy ideas across post-Soviet countries. But I do insist that the role of ideas and non-coercive policy mechanisms with the involvement of non-state actors along with state agencies and international organizations offer a powerful perspective on post-Soviet developments.

The ambition was to contribute with empirical findings through an in-depth case study to explain the pathways through which ideas enter and grow in the policy making arena and are finally adopted in the national legislation. Below I address each analysis.

8.2. In-Depth Case Study Findings

In the in-depth case study a number of theoretical expectations, drawn from conventional (theoretical expectations A1-A5) as well as the transnationalization perspective (theoretical expectations B1-B10), were analyzed. Table 8.1 summarizes the results.

Applying the process tracing method in the Georgian tax policy analysis showed that ideas matter in policy change and, under certain conditions, they can account for policy adoption. Instances when ideas can lead to a change through non-coercive mechanisms of policy diffusion or conditions under which they fail to do so were detected in the Georgian case study which stretched over a period of more than ten years. The empirical analysis in Chapters 5-7 covered

the period of the first tax code adoption 1991-1997 (Chapter 5), the period of tax code amendment adoptions and preparation of the tax code project before 2002 (Chapter 6), and the period 2003-2004 when the second tax code was adopted (Chapter 7). Tax policy ideas promoting tax rate reductions and a broadening of the tax base, among which the innovation of a flat tax on personal income is also conceptualized, were traced in the Georgian case. As mentioned, the empirical analysis also provided longitudinal data on Georgian tax collection and changes in tax extraction trends over time, allowing us to address the issue of Georgian tax state emergence during 1991-2005. The empirical analysis led to the following conclusions:

The analysis of the first tax code preparation and adoption period 1991-1997 demonstrated that tax policy ideas were introduced to the Georgian policy arena by IMF's reform programs. The tax policy model called 'Taxastan' was introduced in 1996 to the national policy actors and tax code adoption was one of the conditions for further funding. Thus, the mechanism in the early tax policy making process in Georgia was coercion rather than horizontal diffusion of ideas. There were few non-governmental organizations in Georgia, but even fewer active and functional third sector representatives in the decision making process. Linkages among state and non-state actors, as well as international organizations were still emerging. Tax policy ideas were introduced to a small group of local policy makers which were involved in tax policy elaboration. Examples of tax policy making from neighboring countries or alternative tax policy ideas were scarce for local policy actors (theoretical expectation B1). The only clear alternative to the existing separate tax laws was 'Taxastan'. Meanwhile, the country's vulnerability to the IMF conditionality was serious (theoretical expectation A2). Other factors which might have affected the policy change were either absent in the Georgian context or were in their infancy, and thus had limited influence on the process. Among the missing factors were EU in an active policy role (theoretical expectation A3) and the country's economic integration into the global market (theoretical expectation A1).

Domestic factors such as the number of veto players or party politics (theoretical expectation A5) had no influence on the policy initiation, preparation, or adoption processes. What mattered was that the government supported the adoption of a new tax code, understood the need to meet the IMF conditionality and consequently obtained funding to continue economic reforms. Moreover, the policy coalition that acted under the auspices of the Ministry of Finance consented to prepare the new tax code in accordance with IMF's 'Taxastan'. Informal connections (theoretical expectation B10) among policy actors from state, non-state sectors, and international organizations were limited in density and frequency. The objective reason was simply the limited number of international organizations as well as active (functional) third sector representatives (theoretical expectation

B5). As for the formal rules, the creation of a policy coalition or the process of initiating an adoption of a policy were not hindered by laws on legal acts or the parliamentary regulations themselves (theoretical expectation B8). Formal institutions were yet in the making and had little leverage to block policy preparation or adoption once it was undertaken by the government itself (theoretical expectation B9). To sum up, the transnationalization argument is not sustained by the empirical findings for 1991-1997. The policy learning that had to enhance the capacity of a larger array of policy actors beyond the state agencies was not present in this process (theoretical expectation B2-B4). On the other hand, policy learning is the first phase of policy change within the transnationalization argument presented in this dissertation.

The analysis of the period up to 2002 from the adoption of the first tax code in 1997 does not provide such a clear-cut picture of the policy diffusion mechanism type as both non-coercive and coercive mechanisms were present. A coercive mechanism affected certain instances of amendment adoption (theoretical expectation A2), however, learning was the policy diffusion mechanism that led to internalization of new ideas and the preparation of the tax code project in 2002 (theoretical expectations B2-B4). With the adoption of the first tax code in June 1997 the overall frame of a modern tax system aiming to reduce tax rates and broaden the tax base was institutionalized in the country.

The empirical findings showed three main policy coalitions which differed on their stance on tax policy ideas: a reformist group united under the tax code project known as Orvelashvili's Code, powerful local business groups who opposed the reforms and pushed for narrow-interest driven policy changes and international organizations that pushed for reversing the policy amendments that reduced the tax base, favored certain business sectors, and distorted competition on the domestic market (theoretical expectations B6-B7). Evidence showed that IMF conditionality mattered in the tax policy changes (theoretical expectation A2). IMF documents and comments from state representatives refer to the need for IMF funds which were conditional on tax code amendments. However, reversed changes that opposed the IMF stance but favored local business also indicate that the local business sector was influential on the policy arena while coercion as a policy change mechanism was in place. The coercion mechanism was illustrated by the fact that the IMF in unison with the WB threatened to suspend funding to Georgia in 1998 and 2002. However, compliance with the conditionality was short-lived and the tax code amendments were quickly reversed to particularistic interests.

While some policy changes, such as amendments, were forced on the Georgian government by the IMF programs (theoretical expectation A2), a simultaneous process of policy learning was in motion (theoretical expectations B2-B4).

Table 8.1 Summary of theoretical expectations and empirical findings

Theoretical perspective	Expectation	Specification for case study	Section where theoretical expectations were analyzed	Empirical Conclusions
Competition	A1	Were references to tax competition and/or the situation of other small countries within the former Soviet space made in the process of policy preparation and adoption?	5.10, 6.6, 7.10	Tax competition was not referred to by the policy actors in the process of a tax code elaboration or in tax amendment initiation during 1991-2003. During those years Georgia was also poorly integrated in the global market, be it through FDI inflow or trade relations. However, tax competition was voiced as worth considering by the new government in 2004. This was when the initiative of the Georgian second tax code was said to be an ambition of the new government to create one of the most liberal tax policies in the region. Interviewees confirmed the new government's aspiration to have lower taxes than its neighbors, thus setting a flat personal income tax on a statutory 12% rate, which was lower than the Russian tax (13%).
IMF Conditionality	A2	Were references to mandatory IMF requirements made in the process of policy preparation and/or adoption?	5.5, 6.4, 7.7	IMF conditionality has been a powerful factor in Georgian tax policy making and reforms before the second tax code adoption in 2004. When the first period tax code making (1991-1997) is compared to the period of tax code amendments (1998-2003) it becomes obvious that IMF conditionality was obeyed sporadically and often served as lip-service to obtain funding rather than reflecting a commitment of the policy makers to reform the tax system. In 1997 the IMF conditionality was the vital factor leading to the tax code modeling on 'Taxastan' and its speedy adoption by the Georgian Parliament. However, IMF conditionality did not surface as an important factor in policy reform after the Rose Revolution from November 2003.

EU Cooperation	A3	Was the EU involved in tax policy making and/or were references to EU standards made in the process of policy preparation and adoption?	5.11, 6.5, 7.8	<p>EU has been a passive policy actor in the process of Georgia's tax policy creation compared to IMF or state and some non-state institutions. When involved, EU has limited its focus to double taxation and trade related tariffs rather than direct taxes or the overall tax policy principles in Georgian tax policy making (this limited scope was reflected in the PCA). However, it provided very important input in terms of EU norm diffusion through its efforts to establish a local policy analysis center (such as GEPLAC) and by broadening its scope in terms of cooperating with the Georgian government through ENP. It provided technical assistance in late 2003 and after the second tax code was adopted brought EU norms closer to the domestic policy actors. As a consequence, domestic policy actors were no longer estranged from EU norms and were willing to consider them as part of their EU accession aspirations.</p> <p>The empirical data did not demonstrate that domestic structures were the cause of tax policy initiatives by the Georgian decision makers. However, the indirect link between domestic structures and tax policy reforms cannot be dismissed completely. IMF policy recommendations often referred to the poor tax collection and large budget deficits and urged reforms to tackle these problems. Budget deficit or tax level did little to explain the timing of or particular policy choices in the tax policy reforms especially in 2004, when the budget deficit was eliminated and the tax level was higher than ever before in the country. Nonetheless, radical reforms were initiated and adopted by the decision makers.</p> <p>The number of parties represented in Parliament did not seem to have mattered in hindering or promoting new tax policy initiatives over the policy period discussed here.</p>
Domestic Structures	A4	Did the level of the budget deficit and/or the level of tax extraction affect policy preparation and adoption?	5.6, 6.7, 7.5	
Domestic Actors	A5	Did the number of parties in the Georgian parliament affect policy preparation and adoption?	5.7, 6.8, 7.6	

Ideas	B1	<p>Were tax policy ideas available to the policy actors in Georgian tax policy making processes?</p> <p>Were ideas on flat tax, low tax rates, and a broad tax base suggested to be adopted by domestic policy entrepreneurs as the solution to the policy problems?</p>	5.3, 6.2, 7.2 5.4.1, 6.3.1	<p>The source and availability of Georgian tax policy ideas were extremely limited in the early 1990s up to the first tax code adoption in 1997. With the increase of the number of international organizations and non-state organizations in Georgia the situation has changed and policy ideas started to diffuse and become available to a larger array of policy actors at the end of the millennium and onwards.</p> <p>A flat tax was projected as fair and easy to administer and collect in Orvelashvili's Code and in the second tax code adopted in 2004. So were policy principles referring a tax base enlargement and tax rate reduction.</p>
Mechanisms	B2	Did non-state actors participate in the policy making process through working groups? Did policy actors in Georgia organize workshops, discussions, knowledge-sharing forums where tax policy ideas were discussed?	5.4.1, 5.4.2, 6.11, 7.11	Non-state actors did participate in working groups and facilitated knowledge-sharing by cooperating with international experts, attending trainings and training domestic actors.
	B3	Did Georgian policy entrepreneurs refer to examples from neighboring countries when elaborating on the tax policy?	5.4.1, 5.4.2, 6.11, 7.11	References were made to the initiatives of the Russian Federation tax reform executed in 2000 in Orvelashvili's Code. The tax reforms in 2004 were said to follow the examples of the Baltic States.
	B4	Were pro-broad tax base, and low tax rate/flat tax rate tax policy ideas introduced in the Georgian policy making arena but rejected by domestic policy makers and/or non-state actors before the adoption of the second tax code in 2004?	5.4.1, 5.4.2, 6.11, 7.11	<p>Orvelashvili's Code introduced a flat personal income tax notion that was rejected in the Parliament in 2003.</p> <p>As for the tax base broadening and tax rate reduction initiatives, the tax code amendments promoted by IMF 1998-2003 were often in this direction. The initiatives were sometimes adopted by the parliament but often reversed by particularistic interests. This tendency continued before the second tax code was not adopted which eliminated a handful of tax exemptions, introduced flat personal income tax, and reduced tax rate and tax number in general.</p>

Actors	B5	Were Georgian and international non-government organizations present in drafting and discussing a tax code(s) along with state actors and IFIs?	5.4.3, 5.4.4, 6.3, 7.3	<p>Non-government organizations were present in creation of tax codes in Georgia. Their influence and number increased over the years since the first tax code was adopted in 1997. Their importance has been rewarded by including them in policy creation and discussions from the mid-1990s up to the second tax code adoption. However, their influence on decision making was limited compared to state institutions. Over time, non-state actors have developed personal contacts with state institutions that allowed them to obtain information and push for their ideas through the official channels of policy making, particularly after the Rose Revolution.</p> <p>The three policy coalitions representing reformists, non-reformists, and IMF-led international organizations had their concrete policy preferences and policy initiatives reflected in tax code amendments and tax codes or tax code projects.</p> <p>Policy coalitions did not have internal conflicts but were tightly united around a common policy idea or policy issue. The policy coalition had a problem pushing a consensual policy proposal through the state institutional filter (i.e. the Georgian Parliament) in the case of Orvelashvili's Code, which was dropped by the Industrialists.</p> <p>The support of the political establishment, particularly the Ministry of Finance, was crucial in the adoption process of a tax policy initiative, be it a tax code project or a mere amendment to the tax code in all periods. When initiatives contradicted the policy stance of the political establishment as was the case with the Orvelashvili's Code they were rejected and never made it through the institutional filter.</p>
	B6	Did policy coalitions in Georgia have concrete policy ideas that would lead to tax policy change?	5.4.3, 5.4.4, 6.3, 7.3	
	B7	Did policy coalitions reach consensus on the policy proposal before its adoption?	5.4.3, 5.4.4, 6.3, 7.3	
Institutions	B8	Were the policy initiatives supported by the political establishment? Did the Ministry of Finance support the domestically initiated policy proposal?	5.8, 6.3.2.4, 7.4	

B9	Did the rules on legislative initiation and adoption block new tax policy proposals?	5.9.1, 6.9.1, 7.9	<p>Legal norms regulating policy initiation in the parliament or outside did not block new tax policy proposals. However, they did limit the type of policy actors who could officially initiate a legal norm or represent the new initiative in the state institutions, such as the Parliament.</p>
B10	Did personal contacts between Georgian decision makers and the policy coalition lead to the adoption of new policy proposals?	5.9.2, 6.9.2, 7.9	<p>Personal contacts were seen as an asset by non-state organizations in decision making processes in all periods of Georgian tax policy making starting in early 1990s up to 2004. It seems that when policy coalitions had support in developing particular policy types or a policy sphere, it made it easier for elaborated policy initiatives to pass through the institutional filter and be adopted by the national parliament. Support from the decision makers in the initial stage of developing a policy initiative ensured consensus among policy coalition members and made adoption a mere formality.</p>

The difference in influence which led to a policy change between the coercive and the non-coercive mechanism of policy idea diffusion in Georgia was that the adopted legal norms were the result of coercion. However, policy learning up until the Rose Revolution had only led to internalization of new ideas (theoretical expectation B1). The lack of government support proved decisive in the policy adoption process. Policy initiatives, either forced by IMF or lobbied by the business sector, were adopted by the legislative body if and when government support was present. Moreover, as the empirical findings show, not only was government support important for the policy change, it is also vital for sustaining the change (theoretical expectation B8). In the Georgian case this is illustrated by the frequent reversals of IMF-lobbied changes.

During the period analyzed in that section, circumstances changed and factors which were absent in the previous period started to emerge. For instance, the number of NGOs in Georgia increased. So did their involvement in the policy arena and the instances of sharing ideas and knowledge with international and domestic policy actors (theoretical expectation B5). Formal institutions were put in place and institutionalized (theoretical expectation B9), yet informal rules emerged as more important in promoting policy ideas among local policy actors (theoretical expectation B10). The case of informal contacts as important ties among various actors proved useful when Orvelashvili's Code had to be promoted in the Georgian Parliament in 2002. International organizations beyond the IMF, USAID and WB did not engage directly with tax policy or business sector development in Georgia. At least on the policy level, the analysis found no involvement by other international organizations. The EU had retained a limited role on trade related tax norms, such as double taxation (theoretical expectation A3). It had mainly funded tax administration reforms, just like the UNDP did. However, information sharing forums among domestic policy actors from the third sector and international organizations or individual experts increased over time (theoretical expectation B2). This process facilitated the policy learning process where domestic actors were empowered to initiate their own policy proposals in the taxation system.

Thus, the empirical findings confirm that policy learning was present 1997-2002 in the Georgian tax policy making process. However, the argument of transnationalization as conceptualized in all three phases was not completed, since learning only led to the internalization of new ideas but not to their institutionalization into national legislation.

In the period 2003-2004 after the Rose Revolution and when the second tax code was adopted, tax policy ideas were communicated through policy learning among policy actors and the final policy change phase of the transnationalization argument was actually achieved in this period. The result was a non-coercive mechanism of tax policy idea diffusion and a tax policy reform (theoret-

ical expectations B2-B4). Ideas can lead to a policy change once externally injected ideas are broadly diffused and internalized by local policy actors. When novel ideas turn into common sense for policy makers, who either have the power to ensure government support or represent the government, then internalized ideas can actually pass through the institutional filter and end up as legal norms adopted by the Parliament. The factors which changed in the policy making period of 2002-2004 was that the policy coalition which initiated and created the new tax code had the support of the central government and the Parliament (theoretical expectation B8). The latter was dominated by the ruling party members and supported legal initiatives by the central executive power, such as the Ministry of Finance.

As the discussion in Chapter 7 showed, carriers of reformist ideas took over the decision making positions after the Rose Revolution, which made it easy for new ideas to pass through the institutional filter (theoretical expectations B8-B10). The fact that they were internalized and not externally injected by international organizations shows the limited involvement of the IMF, EU and USAID in the policy elaboration process (theoretical expectation B1). However, what was found was involvement by a large array of tax experts in the tax code project preparation process, both foreign and Georgian, but the latter made up a core group. It is also worth noting that the non-governmental organizations in this process were involved as experts and played an important role in providing knowhow on tax policy, while some of their former colleagues (i.e. representatives of the NGO sector) had been recruited into the state institutions and pursued tax policy reforms as state representatives (theoretical expectation B5).

The analysis of the post-revolutionary tax policy change period supported the transnationalization argument as it completed all three phases of the policy change. The main factor in this process was the institutional filter, which with the support of the government was easily passed (theoretical expectations B8). A new tax code project which incorporated the novel flat tax rate on personal income tax, a broad tax base and a reduced number and rate of other taxes beyond income tax was initiated and elaborated by a policy coalition of predominantly local experts. As far as how and under which circumstances ideas lead to a policy change, the Georgian case study demonstrates that ideas can and do lead to policy change. However, the process stretches over several years as idea internalization is a precondition for ideas to influence policy making and further policy adoption (theoretical expectation B1). The second main factor of government support and passage through the institutional filters follows this (theoretical expectation B8). These factors within the transnationalization argument were also found in the cross-country comparison discussed above.

Finally, it is worth summarizing empirical findings concerning Georgia's extractive capacity and the emergence of a tax state. The empirical data for the tax

state formation analysis was provided under the sections of Domestic Structural Factors in Chapters 5-7, which analyzed Georgia's budget deficit and tax collection 1991-2005. It was striking how low capacity the Georgian state possessed in tax collection starting from independence in the early 1990s. The revenue flows into the state budget were heavily dependent on external funding and when we look at the data on tax revenue collection, it becomes obvious that direct taxes contributed very little to the overall tax collection level. Georgian tax collection capacity was weak and remained so due to various factors such as lack of government commitment and political will to impose tax obligations on economic actors with political connections, inability of the tax administration to identify and register small enterprises emerging in the free market, complicated administrative rules, and lack of competences among tax administration staff to audit economic actors.

The data on tax collection and budget deficit in Chapter 6 has also demonstrated that the tax collection mode has remained predatory over the years resulting in low trust of the state administration agency from the taxpayers' side and low tax compliance. A high level of embezzlement and corruption along with complex tax rules and high tax rates made businesses go 'underground' and hide taxes throughout Shevardnadze's rule. This situation damaged Georgia's administrative capacity enhancement to extract taxes and become a self-sufficient state that would not be dependent on external funding or rely mainly on 'easy-to-collect' tariffs and VAT tax.

Interestingly, when the Georgian state started to demonstrate its extractive capacity and emerged as a tax state in 2004, the state budget was for the first time in the black and the income tax percentage in the total tax revenues had also increased, but the old tax code was still in place. The chronology of events does not prove that the new tax code led to the emergence of the Georgian tax state. However, it was obvious that Georgia's weak tax collection capacity was taken into consideration when the new tax code was drafted aiming to simplify the tax administration, tax rules and reduce taxes in general. Besides the pro-business orientation of the new tax policy, flat tax rates and elimination of tax exemptions were part of the new government's efforts to enhance Georgia's tax extractive capacity. The dramatic increase in the tax collection over one year was sustained over the years following the government change in 2004. The new tax state emerged over one year, but the tax policy changes by the end of 2004 continued to increase the country's extractive capacity and made the Georgian tax state competitive across borders for foreign capital and capable of raising revenues and reducing the state budget deficit.

What surfaces as an important factor helping the state to collect higher level of taxes was the new government's commitment to extract more and ensure tax compliance, even if it included predatory tax collection (the anti-corruption

campaign and the re-annexation of the Adjara region). Government support was as also an important factor in the tax policy reforms after the Rose Revolution. The new government understood that being a competitive and business-friendly tax state is possible if predatory tax collection is replaced with quasi-voluntary tax collection when tax rules are simplified and easy to comply with, and when tax rates and structures do not force businesses to act in a 'shadow economy'.

8.3. Concluding Remarks

Having discussed the empirical and theoretical contributions of the dissertation, I will now turn to its shortcomings, as well as the prospects it opens for further research. The main issue is generalization of the findings of the in-depth Georgian case study.

Generalizing findings is often the called the 'Achilles heel' of case studies. The Georgian case investigated a set of theoretical expectations over a ten-year period scrutinizing the possible factors accounting for the tax policy formation and change. This allows me to claim that the findings can be generalized across countries with weak democratic regimes, a low level of global market integration, and strong presidential systems which are the characteristics of the CIS countries. Future research may test the theoretical and empirical findings of this dissertation on a larger sample of countries in the post-communist region or beyond. This will not only broaden our understanding of non-coercive policy change mechanisms but will also refine the set of conditions and factors that may play important roles throughout those processes.

Translating norms into practice in the tax policy reform discourse is an equally interesting terrain for future investigation, but left out in this dissertation due to its limited scope on policy adoption. In other words, studying the policy making and adoption processes did not further our understanding of how, once adopted, a newly internalized policy idea will be translated into action. This will bring to our attention other complex processes of implementation of national policy and the role and capacity of national and international actors to influence the process. Moreover, it will expose the extent of commitment of national governments to new policy ideas once observed whether they try to implement them. Though this point was emphasized in the empirical analysis of Georgian tax state formation, the focus of this dissertation did not allow a thorough investigation of this process.

It is worth noting that the ideas are relevant to other types of social and public policies besides taxation. The policy change and market reforms could be traced in policies of spending and redistribution in Georgia or beyond. Studying other policy types than tax policy within the same country sample over the same time period could serve two purposes: it could see how, over a long time period, ideas

could enter other policy making arenas and which actors would emerge as important, less influential and marginal; and it could test the theoretical transnationalization argument where government support, linkages across borders, non-state actors, idea internalization as well as membership of democratic clubs are argued to affect diffusion, internalization and institutionalization of ideas in national legislation.

Appendix 1. Classification of Taxes and Description of Tax Types (Tax Handles)

Table A1: Historical overview of the income tax introduction in Europe

Country	Year
Britain	1799
Switzerland	1840
Austria	1849
United States	1862
Italy	1864
Japan	1887
Germany	1891
New Zealand	1891
Canada	1892
Netherlands	1892
Australia	1895
Sweden	1897
Denmark	1903
Norway	1905
France	1909
Finland	1917
Belgium	1922
Ireland	1922

Source: Table 7.1 in Peters (1991:230).

Table A2: OECD classification of taxes

Income taxes	Personal
	Corporate
Social security contributions	Employees
	Employers
	Self-employed
Payroll taxes	
Property taxes	Immovable property
	Net wealth
	Death and gifts
	Financial and capital transactions
Goods and services	Consumption
	General (mostly VAT)
	Selective (mostly excise)
	Permissions and use
Other taxes	

Source: Messere et al. (2003:8).

1.2 Description of Tax Types (Tax Handles)

Taxes have particular characteristics which make them unique, but some tax types share common features, such as *visibility or lack thereof*, *repressiveness or progressivity*, *easiness* to collect, and *acceptability* by the public (Peters 1991:50-58; Lieberman 2004:105; Shah and Whalley 1991:537-38; Messere et al. 2003; Soest 2006; Fauvelle-Aymar 1999). Those characteristics also translate into tax policies which incorporate different tax types and their features.

Direct taxes include income, profit, capital gain tax, and property tax. They are extracted directly from a physical or a legal entity, and they expose who in the economic systems bears the greatest tax burden (Lieberman 2004:105). Direct tax such as income tax can be progressive or regressive (such as a flat tax). The notions of *visibility* and *acceptability* are tightly connected and affect the importance of tax types in a particular taxation system.

Moreover, direct taxes are a cornerstone in the growing tax policy debates in light of market integration and tax competition. Indirect taxes, which are value-added tax, excise tax and trade taxes, are considered to facilitate a broadening tax net (Shah and Whalley 1991:537-38). All *indirect* taxes are regressive. They are important taxes in developing countries, which often rely on those types of taxes as they lack the capacity to raise revenues from direct taxation (Soest 2006; Fauvelle-Aymar 1999).

Tax Handle One: Income Tax

Personal Income Tax

Income tax collection is often one of the largest sources of income for industrialized countries (Peters 1991:29). However, the amount of the income tax to the total tax revenue varies among countries (in the 1990s it constituted one-third of the total tax revenues in OECD countries) (Peters 1991:29). However, since the devil is in the detail, the difficulties of collecting income tax lie in its definition, i.e. how governments define income and which parts of it are subject to taxation. These definitions provide loopholes that citizens can use to avoid paying taxes. For example, if pensions and social security allowances are exempt from income tax employees may receive extra income in the form of retirement fund contributions which are not taxed (Peters 1991:30). The simple logic behind the income tax is the *right* of the government to tax citizens if they receive income.

One characteristic of income tax is its progressivity, i.e., the higher your income the more you pay in income tax. However, to broaden the tax base during the tax reform wave of the 1980s, some countries started to use a flat tax, which is regressive, i.e. the lower your income the less you pay in taxes. Income tax is often the *victim* of different social group interests that push for and obtain income deductions and exemptions. As Peters (1991:31) observes, tax 'loopholes' often exist in countries with high income tax rates.

Corporate Income Tax

Corporate income taxes (i.e. income and profit) are easier to administer than personal income tax. Corporations make profits and the temptation to increase their tax rates is high for politicians. However, corporate income taxation is a coin with two sides. Corporations do not affect the government's taxation system through their votes as taxpayers (individuals) do, but they possess organizational and financial resources to mobilize and lobby politicians (Peters 1991:31). On the other side, corporations contribute to a country's economic growth and overtaxing them might mean killing the goose that lays golden eggs (Peters 1991:32).

Social Insurance Tax

A social insurance tax is paid to governments by employers or employees and is often referred to as a *contribution* rather than a tax to make it more appealing for taxpayers to actually pay it. Peters (1991:32) argues that social insurance contributions share characteristics with corporate income tax in the sense that while the employer pays the *contribution*, a fiscal illusion is created that lower taxes are imposed on individuals. Social insurance contributions often create administrative problems because some countries ascribe collection of this particular type of tax

to specially set up funds, which are private organizations but who enjoy the legal authority of the state entities that collect taxes. It is also argued that social insurance taxes tend to be higher in countries with widespread tax evasion. Moreover, the practice of extracting income tax from payrolls in some industrialized countries reduced the viability of social insurance tax. However, it remains one of the three main forms of income tax that states attempt to collect from citizens or organizations (Peters 1991:33).

Tax Handle Two – Consumption Tax

Sales and Value-Added Tax

The main arguments in the debate on the consumption tax are the following: Some consider it regressive and unfair, because individuals with higher income pay the same consumption tax on a purchase as those who earn considerably less (Peters 1991:35). At the same time, consumption taxes treat all individuals equally by taxing them with the same amount for the same purchase (ibid.). Consumption taxes somehow close the circle of two main taxation forms imposed by governments, i.e. taxes on earned income and taxes on the spent amount.

Sales taxes and value added taxes are both consumption taxes. Though they have some common characteristics, they differ in significant ways: (1) the way (stages) they are collected: for example, sales tax is a single stage tax meaning that it is levied at the wholesale level (similar to VAT) or at the retail level (Peters 1991:37). VAT is levied on each stage of production and the difference between the price of materials and the final price of the commodity is the amount that is being levied by VAT. (2) VAT is less visible and causes fewer political liabilities compared to a sales tax. Apart from that, a sales tax is often charged at a lower rate and is easier to administer than VAT.

Tax Customs and Excise

Excise taxes and customs duties share function of raising taxes for governments. Customs duties also regulate inflows of goods and services in countries through imports (Peters 1991:39) and have historically generated most of the tax revenues for governments (in USA it was the main source; in UK and Sweden it amounted to 40% of the total income in the 1850s) (Peters 1991:39). For some governments, especially in developing countries, they still generate large tax revenues and are often used to restrict the import of specific goods to protect domestic production (Peters 1991:40).

Excise taxes also generate revenue for governments. They are usually imposed on commodities that governments choose to levy for different purposes and reasons. Luxury goods and alcohol and tobacco are often subject to excise tax, hence the term 'sin taxes'. Collection of excise tax is similar to that of VAT and

is thus less problematic due to its *invisibility*, which deters potential resistance among taxpayers. Different countries put excise taxes on different commodities, and the rates differ as well. Excise taxes are often justified by a moral dimension as they are often levied on 'sinful' commodities such as alcohol, gambling, and tobacco (Webber and Wildovsky 1985:334). Collected taxes are often redirected to government expenditures associated with the commodities. For example, excise taxes collected on alcohol can be redirected to state-financed rehabilitation institutions; excise taxes collected on gasoline can be used for road repair (Peters 1991:38-39).

Tax Handle Three – Property Tax

Taxes on Real Estate

Property taxes on land and buildings are often the sole or one of the main taxes for local governments (Peters 1991:40). The logic is that property owners are the main beneficiaries of government services such as fire and police departments, sanitation, water supply, and additional services provided by the local governments (Peters 1991:43). Properties are assessed every year and taxed according to their value, which may change depending on the annual assessment. This characteristic of the property tax makes it visible and more susceptible to popular discontent and upheavals. In California, for example, discontented property owners created Proposition 13 and 'revolted' against the imposed property tax (Peters 1991:43). However, some argue that this 'revolt' had almost no positive consequences for the property owners, who had to continue to pay high property taxes (Genschel 2002).

Wealth, Estate and Gift Taxation

Wealth, estate and gift taxes are another way for governments to extract revenues and collect money for the services they provide. These taxes are often related to administrative difficulties due to the elusive nature of gifts or properties that are to be evaluated in order to be properly taxed. Owners of luxury goods or estates often consult experts who find legal ways to *evade* these taxes. However, when wealth, estate and gift taxes are collected by the governments, the sense of 'fairness' is attributed to this action so that the general public sees that no one can evade taxes and that the costs of government services are being equally distributed among all citizens (Peters 1991:43).

Non-Tax Revenues

Non-tax revenues earn financial resources through loans or fees charged for governments services (Peters 1991:43-46). The central government may borrow

money to fund a budget deficit or the local governments may borrow funds for capital (roads, water systems, schools etc.) improvements. 'While borrowing is a simple expedient for governments in need of money in the short-run, the difficulty is that those loans will have to be repaid, and repaid with interests. This commitment to repay will limit the capacity of the borrowing government to undertake new programs' (Peters 1991:43). Fees and charges are another financial resource for states. Fees are paid only by those who use the government services.

Appendix 2: Country Size of Post-Soviet States

Country	Population Size (In Mil) in Post-Soviet States
Armenia	3.0
Azerbaijan	8.0
Belarus	9.6
Georgia	4.6
Kazakhstan	15.3
Kyrgyzstan	5.3
Moldova	4.3
Russia	140.7
Tajikistan	7.2
Turkmenistan	5.1
Ukraine	46
Uzbekistan	28.2

Source: CIA Factbook 2007.

Appendix 3: Statutory Corporate and Personal Income Tax Rates in CIS Countries 1992-2006 (%)

	1992			1997		2001		2004		2006	
	CIT	PIT	VAT	CIT	CIT	PIT	CIT	PIT	CIT	PIT	
Armenia	25	NA	20	30	20	20	20	10, 20	20	10, 20	
Azerbaijan	35	55	29	32	27	35	24	14, 35	14, 35	22, 35	
Belarus	30	50	20	30	30	9, 30	24	9, 30	24	9, 30	
Georgia	NA	NA	20	20	20	12, 15 17, 20	20	12	20	12	
Kazakhstan	35	30	20	30	30	5-30	30	5-20	30	10	
Kyrgyzstan	35	NA	20	30	10	20	20	10, 20	10	10	
Moldova	48	NA	20	32	28	9, 14, 20	20	8, 13, 18	15	8, 13, 18	
Russian Federation	18	40	20	35	24	13	24	13	24	13	
Tajikistan	45	NA	20	40	30	10, 20	25	8, 13	25	8, 13	
Turkmenistan	NA	NA	20	25	25, 35	25	8, 20	12	8, 20	10	
Ukraine	18	50	20	30	30	10, 40	25	13	25	15	
Uzbekistan	45	50	17	37	26	15, 45	20	36	10	13, 18, 25	

Source: Fritz (2007:87); various country reports of 'Doing Business' 2007; Worldwide Tax Summaries by PricewaterhouseCoopers, 2007; DFK International, Worldwide Tax Overview 2008; KPMG 2008; IMF's Article IV Consultation 2006 on various countries; World Development Indicators, World Bank, 2008.

Appendix 4: Interview guide

Theoretical dimensions	Interviews questions
Ideas	<p>Why was the tax policy changed in 2004 (whose idea was the policy change)? What was the difference between the previous version (adopted in 1997) and the new version (adopted in 2004)?</p> <p>Why was a flat personal income tax introduced?</p> <p>Why were corporate tax rates lowered?</p> <p>What can be achieved by (what was the aim of) introducing a flat tax and of reducing corporate tax rates?</p> <p>Which particular international and Georgian organizations or state organs stood behind the ideas of a new tax policy and, in particular, behind a flat personal income tax?</p> <p>In the CIS (Commonwealth of Independent States), several countries adopted a flat personal income tax (for instance, Russia, Kyrgyzstan, Ukraine), but the majority still did not, what role did the previous examples play in pushing for a flat tax in Georgia?</p> <p>Was this idea imposed on the new administration from the IMF/WB and the EU, or it was the initiative of the new government?</p>
Policy process and involvement of actors	<p>Let's go back in time and start with the processes of the tax code creation in 1997/2004. Was it an open process where any interested party, be it a business sector, labor, non-state organization or individual expert, could participate?</p> <p>Did this process go on behind closed doors where discussions could not be attended?</p> <p>Was it based on a decree?</p> <p>Did the working group on the tax code before 1997/2004 cooperate with the IMF and the EU?</p> <p>Was USAID actively involved in this process?</p> <p>How about NGOs in Georgia, did they have a say in this process in 1997/2004?</p> <p>Was the new tax code in 1997/2004 adopted quickly in the Parliament?</p> <p>What influenced the speed of the adoption of the code?</p> <p>And if we compare the process of the previous tax code making and adoption, was the case of 2004 more broad and inclusive of different interested parties?</p> <p>What was the difference between the processes in 1997 and in 2004?</p> <p>Were the IMF, the WB, and the EU more involved in 2004 than in 1997? And if so, why was the level of involvement different?</p>

Institutions as filters (formal rules)	<p>What particular rules exist for initiating a new policy and for suggesting amendments to an existing policy?</p> <p>What are the procedures for an informal policy coalition (i.e. not based on a decree or order, but based on a common policy interest) to push for their policy proposal in the Parliament?</p> <p>What concrete state organs have to support a policy initiative from the grass-root level to have it adopted?</p> <p>In the case of tax policy, let's say a business sector or a non-state organization initiates a new policy (as in 2002), what concrete steps do they need to take in order to push for a policy change in the Parliament?</p>
Policy coalition	<p>Why did your organization decide to join the policy working group?</p> <p>Which particular policy proposal did your organization support in 1997 and in 2004 and why?</p> <p>Which other organizations (such as Georgian NGOs, international organizations such as IMF, USAID, WB, EU, and state organs) shared your policy stance in 1997 and in 2004?</p> <p>What was the frequency of meetings of the policy group your organization was part of in 1997 and in 2004?</p> <p>What was the procedure your organization had to go through to be part of those policy working groups?</p> <p>Former domestic businesses, such as Gogi Topadze, were often opposed to the IMF and its ideas in economic policy. What influenced their interest in supporting the new tax policy?</p> <p>How does the new tax code benefit the Georgian business sector?</p> <p>How does it benefit foreign capital willing to invest in the country?</p> <p>Do employees benefit more from the present tax code than from the old one and more than corporations do?</p> <p>Who among foreign and domestic businesses, corporations and labor benefits from the current tax policy?</p> <p>What was the stance of your organization in relation to a flat tax and low corporate tax and why?</p> <p>Some aspects of the current tax policy were elaborated earlier in 2002 by Georgian and international experts, but their policy project was blocked in the Parliament. Why did the previous project not receive support in earlier the Parliament? Was it because the introduction of a flat tax on personal income was not acceptable to the business sector and the population in general?</p>

Linkages	<p>Does your organization cooperate with international organizations? Which ones? What type of cooperation do you have?</p> <p>How many projects have you completed with the cooperation of international organizations?</p> <p>Do your organization representatives attend workshops and conferences organized by international organizations? How often per year?</p> <p>Does your organization obtain funding from international organizations?</p> <p>Is this funding substantial, meaning that without it, you would stop functioning?</p> <p>How about particular policy ideas and information on particular topics, do you have mentors who could help elaborate policy projects?</p> <p>Do you exchange knowhow with international organizations?</p> <p>Can you give concrete examples of when their knowledge has been used by your organization members and which particular policy ideas they were?</p> <p>Which other Georgian non-state and state institutions do you have tight contacts with in general?</p> <p>Was there a case when your partner international organizations disagreed on a policy aspect which your organization thought was crucial, and whose idea was finally taken into consideration?</p> <p>Which organizations does your organization seek cooperation with when you decide to elaborate a policy proposal or an amendment? And why?</p>
Government support	<p>Let's imagine a situation where Georgian and international organizations form a group that will elaborate on a tax policy but do not find support among state officials. What are the chances that they can push for their proposals in the Parliament?</p> <p>When one talks about government support, what matters most: the support of the ruling party, the ministries or the President, or all of the above?</p>

Appendix 5. External Debt, total (% of GNI) among CIS Countries, 1997-2006

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Armenia	37	41	47	47	48	56	61	52	38	32
Azerbaijan	13	16	24	27	24	25	25	24	16	11
Belarus	15	16	19	17	19	20	18	17	16	17
Georgia	40	43	56	51	53	53	48	40	30	26
Kazakhstan	19	28	37	72	71	76	78	81	84	103
Kyrgyz Republic	79	96	148	142	117	120	109	100	85	86
Moldova	54	64	85	129	104	102	88	66	61	64
Russian Federation	32	69	93	63	50	43	42	34	31	26
Tajikistan	119	97	121	115	101	97	79	50	46	42
Turkmenistan	74	91	108	92	66	46	30	23	14	9
Ukraine	22	32	45	40	55	52	48	47	39	48
Uzbekistan	20	23	29	34	44	50	49	40	30	23

Appendix 6: IMF Credits^a in Thousand USD Provided to Post-Soviet States from 1992 to 2006

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Armenia	-	0	24,635	70,237	116,475	132,058	190,440	201,232	175,454	172,613	194,803	214,640	217,630	176,398	163,671
Azerbaijan	-	0	0	100,873	174,971	266,787	321,228	407,267	335,800	295,203	278,850	259,250	208,380	163,626	134,236
Belarus	-	96,287	102,335	282,730	273,500	256,627	242,557	178,072	114,167	80,755	55,593	26,042	9,073	0	0
Georgia	0	0	40,511	115,500	191,536	254,604	303,791	320,249	278,400	287,352	310,005	288,669	265,973	232,314	236,351
Kazakhstan	0	84,989	289,050	432,301	551,601	511,310	652,850	459,991	0	0	0	0	0	0	0
Kyrgyz Rep.	0	60,244	77,839	124,322	139,625	164,879	175,202	190,348	188,023	179,336	185,238	201,902	206,937	177,897	163,068
Latvia	34,599	106,829	160,292	160,383	129,928	85,905	63,881	47,095	34,772	23,957	15,550	5,666	0	1,000	2,000
Lithuania	23,719	120,839	196,423	261,548	273,369	270,469	253,207	230,247	191,601	151,208	121,363	44,858	26,120	0	0
Moldova	0	86,534	164,160	230,183	247,743	233,049	176,787	175,261	154,138	146,149	151,971	142,577	126,362	95,451	141,075
Russian Fed.	988,625	2,468,665	4,197,872	9,617,293	1,2507,608	1,3230,629	19,335,057	1,5237,993	1,1612,557	7,433,367	6,481,185	5,068,933	3,562,248	0	0
Tajikistan	0	0	0	0	21,569	30,358	98,985	100,481	110,787	110,159	94,031	99,798	122,222	127,074	44,229
Turkmenistan	-	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Ukraine	0	0	363,977	1,541,936	2,262,343	2,402,423	2,795,004	2,806,254	2,073,183	1,911,162	1,876,129	1,835,882	1,605,311	1,187,512	830,244
Uzbekistan	0	0	0	0	237,551	222,896	232,607	201,531	127,013	78,350	62,156	43,233	19,364	0	0

a. Including purchases and drawings under Stand-By, Extended, Structural Adjustment, Enhanced Structural Adjustment, and Systemic Transformation Facility Arrangements, together with Trust Fund loans.

Source: World Bank Data available online: <http://data.worldbank.org/indicator/DI.DOD.DIMF.CD>.

Appendix 7: Corporate Income Tax Revenues of Post-Soviet Countries (as percentage of GDP), 1993-2000

	1992	1993	1994	1995	1996	1997	1998	1999	2000
Estonia	5.9	4.6	3.4	2.5	1.7	1.9	2.6	2.2	1.0
Latvia	4.2	7.3	3.6	1.9	1.9	2.4	2.6	2.5	1.7
Lithuania	5.8	5.3	2.5	1.8	1.9	1.6	1.3	0.8	0.7
Armenia	-	4.5	5.7	4.6	2.5	2.0	1.3	2.2	2.0
Azerbaijan	-	8.5	5.2	3.8	4.3	2.8	2.0	2.2	-
Georgia	-	0.8	0.8	0.8	0.7	0.6	1.0	1.0	1.3
Kazakhstan	5.1	4.0	3.3	2.2	2.9	2.4	2.2	2.7	6.3
Kyrgyz Republic	-	4.3	3.5	2.6	1.6	1.1	1.3	1.2	0.9
Moldova	4.8	4.6	4.5	4.9	4.1	2.4	1.8	1.7	1.5
Ukraine	-	9.4	12.6	8.9	6.8	6.1	5.5	4.9	4.5
Uzbekistan	5.3	7.5	6.1	8.5	9.9	7.2	5.9	4.4	3.6
Russia	8.2	9.8	8.0	7.6	4.6	4.1	3.5	4.6	5.6
Tajikistan 1/	-	-	-	-	2.2	1.1	1.1	1.3	0.6
Unweighted average	5.6	5.9	4.9	4.2	3.5	2.7	2.5	2.4	2.5

Source: *Recent economic developments, IMF*

1/ Data is not available for Belarus and Turkmenistan; only partial data is available for Tajikistan.

Source: Stepanyan (2003:18).

Appendix 8: Personal Income Tax Revenues of Post-Soviet Countries (as percentage of GDP), 1992-2000

	1992	1993	1994	1995	1996	1997	1998	1999	2000
Estonia	7.0	8.2	7.9	8.7	8.3	8.1	8.5	8.7	7.8
Latvia	2.7	3.6	4.6	5.1	5.4	3.8	4.4	4.7	4.3
Lithuania	5.7	5.0	5.4	5.4	6.6	5.1	8.0	8.5	7.8
Armenia	-	1.6	1.2	1.3	1.3	1.8	1.6	1.9	1.4
Azerbaijan	-	2.4	1.5	1.1	1.6	2.1	2.5	2.7	-
Georgia	-	0.2	0.3	0.6	0.8	1.1	1.7	1.9	1.8
Kazakhstan	2.5	2.4	1.8	2.0	2.2	2.4	1.7	1.8	2.0
Kyrgyz Republic	-	1.3	1.9	1.8	1.2	1.0	1.2	1.1	1.3
Moldova	1.8	1.6	1.7	2.5	2.5	2.8	2.2	1.6	1.5
Ukraine	-	2.0	3.0	2.9	3.3	3.5	3.5	3.4	3.8
Uzbekistan	2.5	2.8	2.6	2.8	3.6	4.0	4.0	4.1	3.6
Tajikistan 1/	-	-	-	-	1.1	1.2	1.0	1.1	1.2
Russia	2.3	2.6	2.8	2.4	2.6	3.1	2.6	2.4	2.5
Unweighted average	3.5	2.8	2.9	3.1	3.1	3.1	3.3	3.4	3.2

Source: *Recent economic developments, IMF*

1/ Data is not available for Belarus and Turkmenistan; only partial data is available for Tajikistan.

Source: Stepanyan (2003:16).

Appendix 9: General Government Tax Revenues of Post-Soviet Countries (as percentage of GDP), 1993-2001

	1993	1994	1995	1996	1997	1998	1999	2000	2001
Estonia	39.4	41.7	38.2	37.0	37.6	36.9	35.9	35.4	34.5
Latvia	36.4	36.1	33.0	33.7	34.8	36.0	33.9	31.4	30.4
Lithuania	30.2	31.7	31.5	28.8	31.5	31.2	30.4	28.4	-
Armenia 1/	28.9	27.7	12.7	12.9	16.3	16.9	16.1	14.7	14.3
Azerbaijan	40.5	33.8	12.3	15.1	15.6	13.9	14.2	14.5	14.7
Georgia	-	11.7	7.0	10.6	12.7	12.8	13.8	14.2	14.3
Kazakhstan	21.1	18.5	11.0	11.4	12.2	16.2	16.0	20.0	22.0
Kyrgyz Republic	25.1	20.8	15.0	12.7	12.5	14.2	12.3	11.7	12.4
Moldova	22.8	33.6	28.8	27.4	29.9	28.3	21.8	22.3	22.4
Ukraine	42.7	41.9	34.8	34.7	35.6	34.3	32.0	29.7	29.9
Uzbekistan	35.3	32.3	27.7	32.3	27.7	29.4	27.9	26.2	23.2
Russia	36.2	34.6	23.5	22.5	33.0	28.6	28.8	31.3	33.4
Belarus	44.8	47.5	34.2	29.0	27.6	32.0	26.6	37.6	37.6
Tajikistan	-	-	-	-	-	11.7	12.8	12.9	14.1
Turkmenistan	12.8	8.1	9.1	13.6	18.6	18.5	20.2	25.8	25.1

Source: Stepanyan (2003:20).

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Interview 21: Nikoloz Orvelashvili, Economist and Tax Policy Expert.

Interview 22: Lado Papava, Senior Fellow at Georgian Foundation for Strategic and International.

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English Summary

Chapter 1

This dissertation seeks answers to its main research question: Why and how did Georgia establish and reform its tax policy 1991-2005? The main argument is that an idea that is internalized by domestic actors can lead to policy changes in developing countries. The dissertation challenges theoretical perspectives that focus exclusively on domestic-actors or structure, relate to external pressure through tax competition, or international financial institutions' (IFIs) conditionalities imposed on post-Soviet governments. It argues that such theoretical perspectives (here referred to as conventional theoretical perspectives) are limited in their capacity to explain cases among post-Soviet states, such as Georgia. Georgia, like all countries in post-Soviet bloc, had more or less similar external pressure to reform its economic policies and it had inherited similar institutional structures from the Soviet regime. However, it initiated and managed to implement radical reforms of its tax system. The question is why and how? How can we explain that when the country was subject to external pressure from IFIs and had domestic financial constraints it did not initiate radical changes, but only later on when economic indicators were improving and the country collected taxes so that its budget was in the black for the first time. The dissertation challenges existing theoretical explanations and stresses the importance of ideas in policy change processes in post-Soviet states. It develops a theoretical model where ideas are the independent variable and calls it transnationalization of a public policy arena. The competing theoretical claims (i.e. conventional theoretical expectations) and the transnationalization argument are tested on the case of Georgia over the period 1991-2005. Although the focus is on policy change, the empirical part takes one step further and investigates whether new policy principles were implemented and whether it led to increasing tax intake and establishment of a Georgian tax state.

Chapter 2

The three main theoretical approaches that explain the policy change and the spread of the ideas of a tax policy are: market integration and globalization theory, aid and membership conditionality, and domestic actor- and structure-centered explanations. I call these theoretical approaches conventional and propose them as alternatives to my own theoretical argument (which is discussed in Chapter 3). Conventional explanations give a great deal of information about what influences policy change and what type of mechanisms are behind those processes. However, they have some shortcomings. They imply that external

pressure (through tax competition, conditionalities for support or membership from certain international organizations) or domestic institutions' capacity to resist changes (e.g. internal decision makers or institutional structures) is of utmost importance. Theories focusing on external factors seek to explain policy convergence, while those focusing on domestic issues try to disprove the convergence theory. There are four key factors to understanding what leads to policy change in post-Soviet states: (1) ideas (2) institutions, (3) internal stakeholders and (4) external stakeholders. It is emphasized that different schools have benefited from borrowing elements from each other instead of trying to distance themselves from one another. I contend that the use of several different schools can increase the overall explanatory power. Given the regional focus of this dissertation, the theory review includes transition literature that studies taxation and tax policy in this region.

Chapter 3

This chapter theorizes a causal mechanism behind an idea-based policy change. The model is called trans-nationalization of the public policy arena. The theoretical argument incorporates elements from the trans-nationalization literature, policy learning, policy coalitions and institutions. The way transnationalization is understood in this dissertation is that boundaries between internal and external actors are increasingly disappearing in the explanation of internal and supranational institutional changes. While diverse non-state actors are emerging as new players in the supranational arena, external actors also play a large role in changes at the national level. The causal chain in transnationalization theory is that policy ideas are taken up by policy coalitions through policy learning mechanisms, new ideas are internalized and pushed through domestic institutional filters. To complete the chain, internalized policy ideas pass through institutional filters and are adopted by the national legislature, i.e. parliament. In this dissertation transnationalization of the public policy arena is conceptualized to take place in three phases: policy learning, policy development and policy adoption. Each phase consists of four main variables: ideas, institutional filters, policy coalitions and policy change mechanism. All three phases must be completed to prove the theoretical argument about transnationalization of the public policy arena. This theoretical argument generates ten theoretical expectations which are empirically tested in Chapters 5-8 together with theoretical expectations from the five conventional approaches. The overall summary of the theoretical expectations and the empirical conclusions are provided in Table 8.1. The methodological approach to investigating the theoretical expectations (in total 15) is described in Chapter 4.

Chapter 4

This chapter discusses the methodological choices made in the dissertation and describes in detail the data and data collection process. The project used an in-depth case study method called process tracing method to investigate the Georgian case. The rationale is to test the theoretical considerations discussed in Chapter 2-3 in the case of Georgia, a member of the Commonwealth of Independent States (CIS). The advantage of the small N study is its capacity to explore the causal mechanisms in a case over time and complex mechanisms where ideas lead to policy change. The method makes it possible to test the importance of factors that arise from competing theoretical speculations. Data from the case study comes from written materials and includes information from semi-structured interviews with key actors who were involved or represented the institutions which were involved in the process of Georgian tax policy elaboration and/or adoption.

Chapter 5

This chapter examines the process of the Georgian tax policy creation from the early 1990s, when the Soviet regime collapsed, until the adoption of the first tax code in 1997. The theoretical expectations derived from conventional and alternative approaches are examined to see whether internalizing new policy ideas through learning led to the introduction of the first tax law in Georgia in 1997. The results show that policy ideas were actually introduced to the Georgian policy actors by IMF, and the introduction of a new tax was a conditionality imposed by IMF on its funding to the Georgian government. Ideas for tax policy actually came from the modular tax policy document called 'Taxastan', which was introduced by IMF experts. Thus, policy ideas were not internalized by Georgian policy actors but were imposed by external actors. This chapter concludes that even if policy learning could have taken place in the elaboration process of the Georgian tax policy from the early 1990s until 1997, this mechanism fails to explain the introduction of the first Georgian Tax Code. The theoretical argument about transnationalization of the public policy arena was not supported for the period examined. At the same time, Georgia has remained the poorest tax collector among the CIS countries and its low extractive capacity did not allow a tax state to emerge. However, over time the Georgian policy arena started to become more developed and open to a wide range of policy actors and ideas. The policy change mechanism changed from coercive to non-coercive. The details of the Georgian tax policy change process are discussed in Chapter 6, which covers the policy change from 1998 to 2004.

Chapter 6

This chapter reconstructs the story of the Georgian tax policy change process following the first tax code adoption until the Rose Revolution, the regime change in November 2003. The chapter investigates processes taking place under two different political regimes: Edward Shevardnadze's and Mikhail Saakashvili's, who came to power through the Rose Revolution. The road to policy change is here described with a focus on policy initiatives, such as amendments to Georgian tax laws adopted by parliament and a tax law project known as Orvelashvili's Code. The latter did not pass through the institutional filter in 2002 and was dropped by parliament. However, it is an important document because it illustrates how new ideas were internalized and strengthened by domestic policy actors in Georgia. The internalized tax policy ideas led to the development of a policy proposal, Orvelashvili's Code, and therefore allows the empirical analysis to conclude that policy learning was taking place in Georgia before the Rose Revolution. The transnationalization argument is thus partially supported in this chapter: new policy ideas were translated into a tax code project but were not adopted by the legislative body. Meanwhile, the Georgian tax state was still in the making. The country was highly dependent on external funding and its extraction capacity remained low.

Chapter 7

This chapter examines the causal mechanism behind the Georgian tax policy change. It covers a policy elaboration process after the Rose Revolution, from December 2003 to December 2004, and further till the end of 2005 when examining the emergence of Georgian tax state. During this period a new tax code was elaborated and adopted. The empirical data does not suggest that the change was due to external pressure or domestic structural factors. The tax code was initiated by the new government and in a speedy manner created by multiple policy actors. However, there are indications that new policy ideas that were diffused in the Georgian tax policy arena were internalized by domestic policy actors and incorporated into their policy initiatives. The new tax code adopted in 2004 was solely a domestic project, it was supported by the government and it managed to pass through the institutional filter quickly. We can thus conclude that the Georgian tax policy change was a result of ideas rather than conditionalities or tax competition factors. In addition, the empirical analysis supports the transnationalization theoretical argument. Furthermore, the empirical data showed that by 2005 the Georgian tax state had emerged. Reforms in tax policy and tax administration increased the capacity of the tax collection agencies to ensure quasi-voluntary compliance by taxpayers.

Chapter 8

The theoretical and empirical conclusions are summarized, and the chapter offers concluding remarks on the shortcomings of the dissertation and provides ideas for future research. The main theoretical conclusion is that internalization of new ideas creates a feeling of ownership and therefore acceptance of change. Moreover, it ensures greater stability and durability of a policy change than changes caused by external pressure. Post-revolutionary tax policy change confirms the decision makers' belief that policy principles will increase competitiveness, economic growth and integration in the global market. The empirical findings from the in-depth Georgian case study show that ideas in Georgia's tax policy came from the outside, but over time were integrated by domestic policy actors. The condition that allowed new ideas to be assimilated by the Georgian parliament was that the policy coalition that worked with the new code in 2004 had power to secure government support for the tax code and thus its passage through the institutional filter.

Kapitel 1: Introduktion

Denne afhandling undersøger to hovedspørgsmål: Hvorfor og hvordan udarbejdede og reformerede Georgien sin skattepolitik? Hovedargumentet er, at en ide, som er internaliseret af interne aktører, kan føre til policyforandringer i udviklingslande. Forklaringer, som knytter sig til betingelser fra de internationale finansielle institutioner ved finansieringen af de postsovjetiske regeringer, kan ikke forklare forskelle på skattepolitikker på tværs af den postsovjetiske blok. Som alle lande i denne blok, har Georgien haft mere eller mindre lignende ydre pres for at reformere sin økonomiske politik. Men det viser sig, at Georgien igangsatte radikale reformer i sin skattepolitik. Så spørgsmålet er, hvorfor og hvordan det skete? Hvordan kan vi forklare det? Afhandlingen udfordrer de eksisterende teoretiske forklaringer og fremhæver vigtigheden af ideer i policyforandringsprocesser i de postsovjetiske stater. Kapitel 1 introducerer postsovjetiske skattepolitikker i postsovjetiske stater i løbet af det sidste årti. Eksisterende teorier kan ikke fuldstændig forklare forskellen på skattepolitikker i denne region.

De følgende kapitler opstiller teorier og undersøger empirisk de faktorer, som fører til variationer i indoptagelse af ideer om skattepolitikker på tværs af den postsovjetiske blok specielt i Georgien.

Kapitel 2: Bestilling fra menuen af konventionelle forklaringer: fordele og ulemper.

De tre vigtigste teoretiske tilgange som forklarer policyforandring og spredningen af ideen om skattepolitik er: markedsintegrations- og globaliseringsteori, hjælpe- og medlemskabsrelaterede betingelser og forklaringer, som fremhæver interne aktører og/eller strukturer. Jeg kalder disse teoretiske tilgange *konventionelle* og foreslår dem som alternative forklaringer til mit eget teoretiske argument (som bliver diskuteret i kapitel 3). De konventionelle forklaringer giver en stor mængde information om, hvad der styrer politisk forandring og mekanismerne bag den. De forudsætter imidlertid alle, at eksternt pres (gennem skattekonkurrence, betingelser for hjælp eller medlemskab af bestemte internationale organisationer) eller at interne institutioners evne til at modstå ændringer (for eksempel interne beslutningstagere eller institutionelle strukturer) er af største vigtighed. Teorier med fokus på eksterne faktorer søger at forklare policykonvergens, mens fokus på interne forhold prøver at modbevise konvergensteorien. Imidlertid viser nuværende tendenser inden for skattepolitikken i de postsovjetiske stater, at man må inddrage fire vigtige faktorer for at forstå, hvad der leder til policyforandring: (1) Ideer,

(2) institutioner, (3) interne aktører og (4) eksterne aktører. Det fremhæves, at forskellige skoler har gavn af at låne elementer fra hinanden i stedet for at prøve at lægge afstand til hinanden. Gennem brug af flere forskellige skoler kan man øge den samlede forklaringskraft. Med tanke på det regionale fokus i denne afhandling inddrages også noget af transitionslitteraturen.

Kapitel 3: Transnationalisering af den offentlige policy-arena

Dette kapitel teoretiserer over den kausale mekanisme bag en idebaseret policyforandring. Teorien bliver kaldt *transnationalisering af den offentlige policy-arena*. Den teoretiske påstand inkorporerer elementer fra transnationaliseringslitteratur, policy-læring, policykoalitioner og institutioner. Transnationalisering er i denne afhandling forstået sådan, at grænser mellem interne og eksterne aktører i stigende grad forsvinder i forklaringen af intern og overstatlig institutionel ændring. Mens forskelligartede ikke-statslige aktører dukker op som nye spillere på den overstatlige arena, så spiller eksterne aktører en større og større rolle i forandringer på det nationale niveau. I teorien om *transnationalisering af den offentlige policy-arena* fremstilles en kausalkæde, hvor udefrakommende ideer bliver taget op af policy-koalitioner, som gennem policylæringsmekanismer inkorporerer de nye ideer og skubber dem gennem de interne institutionelle filtre. Hvis transnationaliseringsargumentet skal holde, så skal inkorporerede ideer passere gennem de institutionelle filtre og blive vedtaget af den nationale lovgivende magt, dvs. parlamentet. I denne afhandlings teori finder *transnationalisering af den offentlige policy-arena* sted i tre faser af policyforandring, som er policylæring, policy-udvikling, og policy-adoption. Hver fase består af fire hovedvariabler; ideer, institutionelle filtre, policykoalitioner og policyforandringsmekanismer. Alle tre faser skal fuldføres, hvis den teoretiske påstand om transnationalisering af den offentlige policy-arena skal opretholdes. Dette teoretiske argument genererer otte teoretiske forventninger, som bliver empirisk efterprøvet i kapitlerne 5-8 sammen med teoretiske forventninger fra de konventionelle tilgange. Disse påstande bliver opremset i slutningen af dette kapitel. Efterprøvningen af de teoretiske forventninger kræver metodiske overvejelser, som bliver præsenteret i kapitel 4.

Kapitel 4: Metodiske overvejelser.

Dette kapitel diskuterer de metodiske valg, som er blevet taget i denne afhandling og beskriver i detaljer data og dataindsamlingen. Denne afhandling har indoptaget brugen af et detaljeret casestudie via process tracing-metoden på Georgisk case. Rationalet bag af denne metode er at teste de teoretiske overvejel-

ser diskuteret i kapitel 2-3 i case af Georgien som er medlem af Commonwealth of Independent States (CIS). Fordelen ved fordelene ved studier med lille N er at udforske de kausale mekanismer i en case over tid. Endvidere bliver de kausale mekanismer, som skal forklare skiftet mod de skattepolitikker i de postsovjetiske stater, og specielt i Georgien, undersøgt gennem process tracing-metoden. Denne metode tillader udforskning af komplekse mekanismer, hvor ideer fører til en policyforandring. Herudover giver metoden mulighed for at teste vigtigheden af de faktorer, som stammer fra konkurrerende teoretiske spekulationer. Data fra casestudiet i denne afhandling stammer fra tekstmateriale og også inkluderer information fra semistrukturerede interviews med nøglepersoner i udarbejdelsen af skattepolitik i Georgien.

Kapitel 5: Georgisk skattepolitikplanlægning (I)

Dette kapitel undersøger planlægningsprocessen af den georgiske skattepolitik fra de tidlige 1990'ere, hvor Sovjet-regimet kollapsede, frem til vedtagelsen af den første skattelov i 1997. De teoretiske forventninger, som stammer fra konventionelle og alternative tilgange (for eksempel *transnationalisering af den offentlige policy-arena*), bliver testet i dette kapitel. Målet er at se, om inkorporerede ideer var årsagen til indførelsen af den første skattelov i Georgien i 1997. Resultatet viste, at policy-ideer rent faktisk blev introduceret til georgiske policy-aktører af IMF og at indførelse af en ny skattelov var betingelsen pålagt af Fonden ved finansieringen af den georgiske regering. Ideer til skattepolitikken fra det ideale skattepolitikdokument 'Taxastan', som kom fra IMF-eksperter, blev ikke indoptaget af georgierne. Dette kapitel konkluderer, at selv hvis policylæring kunne have fundet sted i planlægningen af skattepolitikken i Georgien fra de tidlige 1990'ere indtil 1997, så kan denne mekanisme ikke forklare indførelsen af den første georgiske skattelov. Det teoretiske argument om transnationalisering af den offentlige policy-arena blev således ikke understøttet for den periode, som blev undersøgt i dette kapitel. Imidlertid udviklede og åbnede den georgiske policy-arena sig for flere forskellige aktører og de ideer med tiden. Dette ændrede også policyforandringsmekanismen fra tvangspræget til ikke-tvangspræget. Detaljerne i den proces er diskuteret i det følgende kapitel, som dækker policyforandningsperioden fra 1998 til 2004 i Georgien.

Kapitel 6: Georgisk skattepolitikplanlægning (II)

Dette kapitel rekonstruerer fortællingen om forandringsprocessen af den georgiske skattepolitik fra indførelsen af den første skattelovgivning til Rose-revolutionen i november 2003. Processen finder sted under to forskellige politiske regimer: Perioden med Edward Shevardnadzes styre og Mikheil Saakashvilis præsidentperiode, lederen som kom til magten gennem Rose-revolutionen. Vejen til policyfo-

randringen er her beskrevet med fokus på policy-initiativer, såsom tillæg/rettelser til Georgiens skattelov indført af parlamentet og et skattelovsprojekt kendt som 'Orvelashvilis Lov'. Det sidstnævnte opnåede ikke at passere gennem det institutionelle filter i 2002 og blev ikke vedtaget af parlamentet. Imidlertid er det et vigtigt dokument, da det illustrerer, hvordan nye ideer blev inkorporeret og styrkede indenlandske policy-aktører i Georgien. De inkorporerede ideer førte til udviklingen af et policyforslag, og derfor tillader den empiriske analyse i dette kapitel mig at konkludere, at policyplanlægningsprocessen før 'Rose-revolutionen' delvis støtter transnationaliseringsargumentet, hvad angår policylæring og indoptagelsen af ideer. Det næste kapitel viser imidlertid, at over tid blev de skattepolitiske ideer, som blev introduceret i 'Orvelashvilis Lov', genoptaget og inkorporeret i den anden georgiske skattelov efter Rose-revolutionen.

Kapitel 7: Georgisk skattepolitikplanlægning (III)

Dette kapitel undersøger den kausale mekanisme bag skiftet mod en skattepolitik i Georgien. Det dækker en etårs periode af en politikplanlægningsproces efter Rose-revolutionen, fra december 2003 til december 2004. Resultatet efter denne etårs periode var skabelsen af en ny skattelovgivning. Baseret på diskussionerne af rettelse til skatteloven, policy-initiativet fra 'Orvelashvilis Lov' og den nye skattelovgivning, som blev vedtaget i 2004, er der ikke noget, der peger i retning af, at principperne for den skattepolitik i den sidste skattelov blev påtvunget policy-aktørerne i Georgien udefra. Dog er der tegn på, at skat policy-ideer, som strømmede ind på Georgiens policy-arena, blev indoptaget af lokale aktører, omdannet til 'lokalt igangsatte policyforslag' og skubbet gennem den lovgivende forsamling, indtil de blev vedtaget i 2004. Derfor kan man konkludere, at den georgiske skattepolitik forandring var et resultat af ideer snarere end betingelser eller markedsintegration som sådan. I øvrigt støtter processen beskrevet i dette kapitel transnationaliserings – argumentet i denne afhandling. Alle tre faser i argumentet om transnationalisering af den offentlige policy-arena blev understøttet i dette kapitel. Vedtagelsen af den skattepolitik i Georgien i 2004 demonstrerede altså, at indoptagede ideer under visse betingelser kan finde deres vej ind i indenlandsk offentlig politik.

Kapitel 8: Konklusion

Dette kapitel præsenterer de teoretiske og empiriske konklusioner fra afhandlingen. Herudover slutter det med konkluderende bemærkninger om afhandlingens mangler og ideer til fremtidige undersøgelser. Den teoretiske hovedkonklusion er, at indoptagede ideer bidrager til følelsen af ejerskab og derfor til accept af forandring. Herudover sikrer indoptagede ideer en stabil policyforandring, som fortsætter længere end ekstern intervention og opstilling af betingelser. Post-revolu-

tionære skattepolitiske forandringer bekræfter beslutningstagernes tro på, at de policyprincipper er dem, som vil føre til øget konkurrenceevne, økonomisk vækst og integration på det globale marked. Den yderligere reduktion af skattesatser og udvidelsen af skattegrundlaget i Georgien bekræfter spekulatjonen om, at overbevisninger og ikke eksternt pres førte til reformerne efter 2004. De empiriske konklusioner fra de dybdegående georgiske case-studie viser, at ideer i den skattepolitik i Georgien kom udefra, men at de over tid blev indoptaget af indenlandske policy-aktører. Betingelserne, der tillod de nye ideer at blive indoptaget af det georgiske parlament, var at policykoalitionen, som arbejdede med den nye lov 2004 havde haft magt til at sikre regeringsstøtte idet regeringsrepræsentanterne var inkluderet blandt policy-aktørerne. Således var de indoptagede ideer allerede båret af policy-aktørerne, som kunne sikre, at policy-initiativet, en ny skattelovgivning, kom gennem det institutionelle filter og blev vedtaget af parlamentet.