საზოგადოების კვლევის ცენტრი
Centre for Social Studies

FRIEDRICH EBERT STIFTUNG

პოლიტიკის კვლევა

საყოველთაო კეთილდღეობისთვის

წინადადება უთანასწორობის შემცირებისა და ინდუსტრიული განვითარებისთვის რესურსების მობილიზების მიზნით, საქართველოში საშემოსავლო გადასახადის რეფორმის შესახებ

Policy Study

STRIVING FOR SHARED PROSPERITY

A proposal for income tax reform in Georgia with the aim of reducing inequality and mobilizing resources for industrial development

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- *Georgia has experienced neoliberal economic experiments during the last three decades. The toolkit for the neoliberalization of the Georgian economy included traditional instruments tested in other developing countries: particularly, massive deregulation, trade and financial liberalization, privatization of public assets and lowering taxes for the rich. All these actions were motivated by the wish to attract Foreign Direct Investments and to raise market efficiency for achieving higher economic growth.*
- *However, these policies did not help to bring about shared economic prosperity to Georgia. While economic growth was high and FDI inflows were increasing year by year, unemployment and poverty rates have remained high. The high rate of self-employment conceals the real level of unemployment or under-employment as a large share of the population is stuck in low-productivity farming. Moreover, Georgia became a leader in the region in terms of income inequality. As a result of these economic and social hardships many Georgians left the country. The population of Georgia has decreased by around 30% since 1989, mainly as a result of migration.*
- *Even though Georgia is currently in the top ten countries with the lowest taxes, Georgia is not able to attract significant FDIs in productive sectors. The manufacturing sector which brings higher value added for the economy and creates better and stable jobs, received only 5 percent of total FDI, while the share of the financial sector and construction sector in total FDI reached 16% and 15% respectively last year. The lack of public resources seriously limits the government's ability to develop a more ambitious industrial policy strategy in order to address the one-sided development of the Georgian economy. In addition, public services are under-financed and public investment in human capital is low. The professions of preschool and secondary school teachers are among the least paid jobs in Georgia.*
- *As a contribution to addressing these urgent economic and social problems, this study suggests a progressive income tax reform combined with increased public expenditures on human capital and industrial development. The current flat income tax system is socially unjust as it excessively benefits the rich and harms the poor and the ever-shrinking middle class. By decreasing the marginal tax rate for the poorest income earners and increasing the rate for top earners, Georgia can mitigate the high level of income inequality and improve the life conditions of lower income groups.*
- *Additional resources (on average 460 million GEL) mobilized as a result of the progressive tax reform could be invested in industrial development and R&D in order to enhance productivity growth in the agricultural and the manufacturing sector and support the creation of more decent jobs. Through active industrial policy, Georgia can tackle problems related to access to finances for businesses and increase R&D capabilities needed for manufacturing and agricultural processing.*

CONTENTS

LIST OF ABBREVIATIONS

CIS The Commonwealth of Independent States
ELA Economic Liberty Act
Eurostat European Statistical Office
FDI Foreign Direct Investment
GDP Gross Domestic Product
GEOSTAT National Statistics Office of Georgia
GFSIS Rondeli Foundation, Georgian Foundation for Strategic and International Studies
IMF International Monetary Fund
OECD Organization for Economic Co-operation and Development
R&D Research and Development
SME Small and Medium Enterprises
UNICEF the United Nations International Children's Emergency Fund
WHO World Health Organization

INTRODUCTION

Since gaining independence, Georgia's economic policies were largely based on the standard neoliberal assumption that abolishing government regulations, privatizing public assets and liberalizing trade and financial flows, would raise GDP growth for the benefit of all. But as in many other developing countries this neoliberal experiment has failed.

The key logic underpinning neoliberal reforms in Georgia was the assumption that by lowering taxes, providing free trade regimes and institutionalizing weak regulatory mechanisms, Georgia would attract FDI and as a result, its economy would grow faster and unemployment would decrease. Even though economic growth in Georgia was high compared to average GDP growth in the EU countries and FDIs skyrocketed, this did not translate into eradicating poverty, lowering unemployment and tackling the grotesque level of inequality. The official unemployment rate is 12%, however, as various studies have indicated, in effect, the unemployment rate is much higher (Kakulia, Kapanadze, Lomjaria, & Kurkhuli, 2016). 6.8% of Georgian children live below the extreme poverty line (which has a threshold of 1.25 USD per day), while the absolute poverty rate is above 21% (UNICEF, 2017). While Georgian leaders have been boasting of high FDI inflows and Georgia's ranking in global economic indicators, Georgia takes the position of the most unequal country in the region with a GINI index for total consumption expenditure of 0.40. The socio-economic experiment taking place in Georgia since gaining independence seriously affected the middle class. The monthly income of around 80% of income earners in Georgia is less than 370 USD.

This policy study analyzes key drivers of structural economic problems in Georgia, particularly, inequality, poverty and underemployment. This study proposes concrete changes to tackle these problems by making taxation policy more just and by introducing a smart industrial policy. The key message of the study is the following: firstly, Georgia needs a progressive tax system to mitigate the high level of inequality. Introduction of a progressive income tax would reduce the existing social injustice of the flat tax model which currently benefits the rich. Secondly, Georgia needs to address problems related to its unbalanced economic development. The suggested tax reform would mobilize more resources for investing in human capital and industrial development.

The first chapter of the study suggests that even the economic mainstream has recently scrutinized key neoliberal assumptions which might have justified Georgian economic policies in the past. The view that the state can play a more active role in the economy in terms of correcting the income distribution and pursuing more strategic industrial policies has become more widely accepted nowadays. The second section of the study provides analytical sketch of the Georgian economy, in particular this section analyzes problems of unemployment, poverty and inequality. The section provides evidence that the current economic model cannot solve problems related with underutilization of labor and low level of „capital development". In the current situation, the study claims, Georgia needs some unorthodox economics tools: such as industrial policy and indicative planning. Besides that, this section of the study examines why the current model of taxation is unjust and how it contributes to the high level of inequality. The third section elaborates on scenarios for improving the current unjust tax system and provides concrete calculations on potential revenue effects and the redistribution of the tax burden. The suggested reform would not only mitigate inequality but also provide additional revenues for public investment in human capital and industrial policy in order to address the problems of underemployment and poverty in a more sustainable way. The proposal for change presented in the third section incorporates the following milestones: mobilizing additional resources through progressive taxation (which raises 460 million GEL on average) and directing additional finances towards investment in human capital (e.g. increasing salaries of teachers at public schools), industrial policy instruments (e.g. providing „patient money" for SMEs) and Research and Development.

The authors hope that the presented study will instigate so far disregarded debates on unequal distribution of income, industrial policy and a fairer system of taxation

1. CHALLENGING KEY NEOLIBERAL ASSUMPTIONS

„The assumption in the past was that a growing GDP would trickle down to the poor – well, now we know that's not always the case". (The World Bank 2013)

Numerous times, more and less progressive authors have augured the end of neoliberalism since the latest world financial crisis. And even though free market ideology has proven to be more versatile and long-lived than often suggested, conventional economic wisdom is slowly changing its face. It is revealing that key international organizations have explicitly or implicitly expressed disbelief in trickle-down economics. A direct consequence was the World Bank's introduction of „Shared Prosperity" as new goal for development (Ibid.). Another example is the OECD questioning the long assumed trade-off between growth and equality (OECD 2015). But also active industrial policy, which used to be a 'no' word in the economic mainstream, has found its way back into the debate. Many scholars have realized that industrial upgrading is key to economic development but that laissez-faire policies would not automatically bring about change. This study argues that in striving for shared prosperity the state should be an active player in the economy. Instead of cutting its activity to a minimum, the state should make sure that the benefits of growth are divided fairly and benefit the largest number of people possible. This requires a progressive tax system in which wealthy individuals contribute a relatively larger share of their income to the common good. If only a minority of the population has access to well-paid formal jobs, pure redistribution in terms of tax and transfers might alleviate inequality in the short term. However, the state should also foster sustained economic growth and integration in the medium term by investing in human capital and engaging in active industrial policy. Financial leeway is key to successfully implement such policies, so the state should not restrain itself with arbitrary budget rules but raise the financial resources needed to reach its policy objectives.

1.1. Inequality can harm economic growth

Economists have long time neglected the detrimental effects of income inequality on social welfare. While they acknowledged that high levels of inequality might be socially undesirable, many scholars assumed a trade-off between growth and equality. From this perspective, adverse distributional consequences of a pro-growth policy seemed acceptable, hoping that a rising tide would ultimately lift all boats. However, recent publications have challenged this view. A number of scholars now suggest that the assumed trade-off can be relaxed from an empirical perspective and some provided evidence that inequality can even be detrimental to economic growth (Ostry et al. 2014). Albig *et al.* (2017) distinguish supply and demand side channels of influence discussed in the literature: On the supply side, the standard view stresses the incentive channel: In a nutshell it says that inequality is a prerequisite for growth because people work harder if they hope to climb up the social ladder. This logic already bears the counter argument: If social mobility is low, a perceived lack of fairness in the economic system may also lead to frustration and reduced efforts by individuals. Another more long-term channel on the supply side is the human capital channel. High inequality can cause underinvestment in human capital as poor households cannot afford longer or better education (ibid.). Indeed, OECD (2015, p. 72) finds that „Across OECD countries, income inequality is negatively associated with average educational attainment". This holds for the quantity of education but even more for the quality of education. Lower investment in human capital can in turn be the reason for low productivity. On the demand side Albig *et al.* (2017) name the savings rate channel. It suggests that inequality can suppress consumer demand because wealthy households tend to save a larger share of their income while poor households may spend their whole income to satisfy their basic needs. If the income is distributed very unevenly, aggregate consumption might thus remain below its potential. A variation of this argument is also taken up by the OECD (2015, p. 61): „The adoption of advanced technologies depends on a minimum critical amount of domestic demand, which might not be sufficient if the poorer sections of society have little resources".

1.2. Redistribution helps

While standard public economics text books acknowledge redistribution as one of the principal functions of a good tax system (Musgrave & Musgrave 1989), in practice much more weight was given to efficiency concerns. Neoliberal economists and policymakers have, in particular, stressed the notion that the progressive income tax distorts economic decisions and is therefore harmful to economic growth. The presumed trade-off between growth and equality was widely used to justify tax cuts for high income earners across the Western world or to abstain from progressive income taxation altogether in the case of many post-socialist countries. However, the underlying economic effects of income tax on labor supply are theoretically ambiguous (see for example Salanié 2011) and empirically small (Evers et al. 2008). Alvaredo *et al.* (2013) suggest that the model of pay determination used in much of the optimal tax literature may be oversimplified. They consider the possibility that top income earners increase their compensation at the expense of other income groups due to their increased bargaining power. This contrasts with the notion that top incomes are only the result of additional economic activity or higher productivity and thus supports the view that progressive taxation is not harmful to economic growth. Today, even the IMF (2017) sees „scope for increasing the progressivity of income taxation without significantly hurting growth for countries wishing to enhance income redistribution" and the OECD (2015) notes that „[r]edistribution through income taxes and cash benefits does not necessarily harm growth" (OECD 2015). But not only did the economic discourse change. A number of countries effectively increased top tax rates or levied temporary surcharges on high incomes in urgent need of additional revenues after the last financial crisis, e.g. Austria, the Czech Republic, Greece, Italy, Slovenia and Spain. Most notably, Slovakia and Albania abandoned their flat tax regimes in 2014 and now levy higher income tax rates on high income earners. These developments show that governments actually do have scope for raising more revenue from top income earners in order to reach their fiscal goals.

There are different ways to support low-income earners in order to reduce income inequality. The provision of public services can be a viable alternative to cash transfers. „This concerns services such as high-quality childcare and education or access to health or housing. Such measures immediately smooth inequality stemming from cash incomes, but they also constitute a longer-term social investment to foster upward mobility and create greater equality of opportunity in the long run" (OECD 2015, p. 80). Also the (IMF 2017) stresses the importance of public spending on health and education for combating inequality. From a supply side perspective, underinvestment in human capital is a convincing explanation for the detrimental effect of inequality on growth. For this reason, public investment in human capital may alleviate inequality and contribute to sustained economic growth and integration in the medium term.

1.3. An active state needs financial resources

In addition to fiscal redistribution and human capital investment, industrial policies can strive to reduce the share of the population stuck in low-productivity sectors or subsistence farming. The creation of more decent job opportunities also for the poor helps reduce inequality and support economic integration. The neoliberal idea that industrial development should be left to the market forces was challenged by a new wave of development thinking that calls for a more active role of government. Recent publications again stress the importance of industrial policy to foster industrial upgrading and diversification and to compensate for negative externalities of the growth process (Lin 2012). Examples of active industrial policies in China, South Korea or Taiwan have shown that governments can successfully change the production structure and upgrade industries and thereby support the economy in creating better employment opportunities. Some proponents of industrial policy still limit the activity of the state to the correction of market imperfections, i.e. when optimal individual behavior leads to suboptimal collective situations. For example, state subsidies could be justified, if the social benefits of investing in the generation of scientific and technological capacities are higher than the benefits for an individual firm (Peres &Primi 2009, p. 22). Other approaches synthesizing Schumpeterian, evolutionist and structuralist ideas more decidedly reject the hypothesis of automatic adjustment through market forces and assume that „the development of production and technological capacities depends on interaction between market and non-market mechanisms" (Ibid., p. 23). Even if theoretical approaches to active industrial policy are diverse, they challenge the view that the state should limit itself to the provision of a favorable institutional environment (e.g. with regard to property rights or market entry barriers) but intervene more strategically in the economic development. This requires adequate financial resources. If the private sector provides decent jobs and incomes only for a small elite, a government's ambition to support the industrial development of the country may thus justify additional public spending and, if necessary, raising additional tax revenue from those who can more easily bear it.

2. THE STATUS QUO OF THE GEORGIAN ECONOMY

Social scientists, including economists, rarely have the luxury of carrying out large-scale economic experiments in real life to test any policy, and then give specific policy advice to overcome economic problems. However, there are exceptions like the 'natural experiment' there is today in Georgia which provides a living laboratory to be studied. During the last 27 years since gaining independence, especially since 2003, Georgia has gone through a number of waves of neoliberal economic reforms, in fact, the Georgian population turned out to be the test subject of neoliberal experiments.

Georgian governments schematically have been pursuing a neoliberal economic doctrine in recent years which included the large-scale privatization of public resources as well as massive deregulation and liberalization of the country's trade policy. The governments hoped that by minimizing the role of the government in the economy, the country would be able to get rid of the extreme poverty that followed the breakdown of the Soviet Union. Over the years, Georgian governments have been actively selling state resources accumulated in Soviet times including high-tech equipment which was even often demolished and sold as scrap.

There are three main factors underpinning the development of unemployment, inequality and poverty in Georgia. First, the deindustrialization of the country led to the demise of the middle class and a precarious labor market. Second, low productive investment and low investment in education and research and development impede the development of a more diversified economy. Finally, there is an unjust tax system that prioritizes the interests of the wealthier class and – in combination with the fiscal rules - limits the scope for public investment.

2.1. Jobless growth

Unemployment in Georgia is the number one problem. This is confirmed by various sociological surveys (NDI, 2017). However, the public discussion and coverage of this issue in the media is not equivalent to the direness of the problem. The lack of discussions has its own inherent reasons that are associated with ideological door-locking. The dominant neoliberal ideology says that the workforce is a scarce resource and only by freeing the market forces from governmental pressure, full employment is guaranteed. One of the main recommendations for tackling unemployment is to lower taxes and reduce state intervention in economic life. Despite low taxes, employment in Georgia is still problematic.

The structure of employment in Georgia is the following: According to the data of 2016, Georgia's economically active population (i.e. the same as workforce) is 1,998,300 people. Out of this, 1, 763, 300 people are employed, while the unemployed are 235,100 citizens. The official unemployment rate is thus 11.8% (GEOSTAT, 2017).

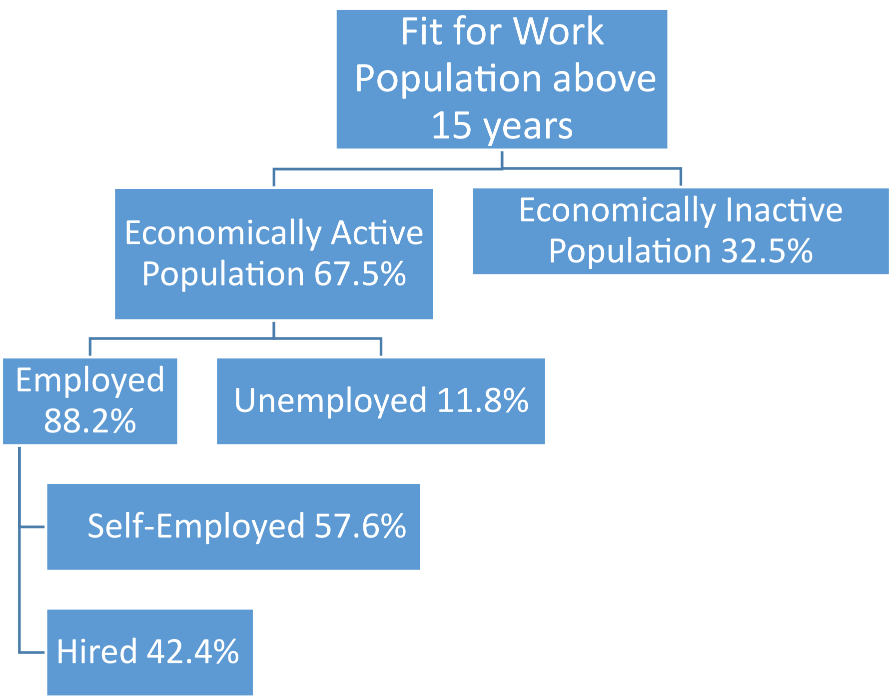


Figure 1. Employment Structure in Georgia, National Statistics Office

However, looking deeper into statistics reveals that unemployment is much higher. Out of the employed, only 42.4% are hired employees, and remaining majority of 57.6% are self-employed which is extremely high in international comparison (see figure 2). Self-employment in developed countries is not considered a priori low-paid and non-prestigious work. Self-employed can be: individual entrepreneurs, consultants, programmers, architects etc. The representatives of these professions may have high pay even though they are self-employed. However, the deregulation of the labor market and the structural change of the organization of labor itself have caused some transformations even in developed countries. In particular, the self-employed are currently not only high-paid financial consultants and programmers, but also cleaners, taxi drivers, car washers, etc. These professions largely consist of migrants in developed countries, as they are less paid and less prestigious. The situation in Georgia is much more acute.

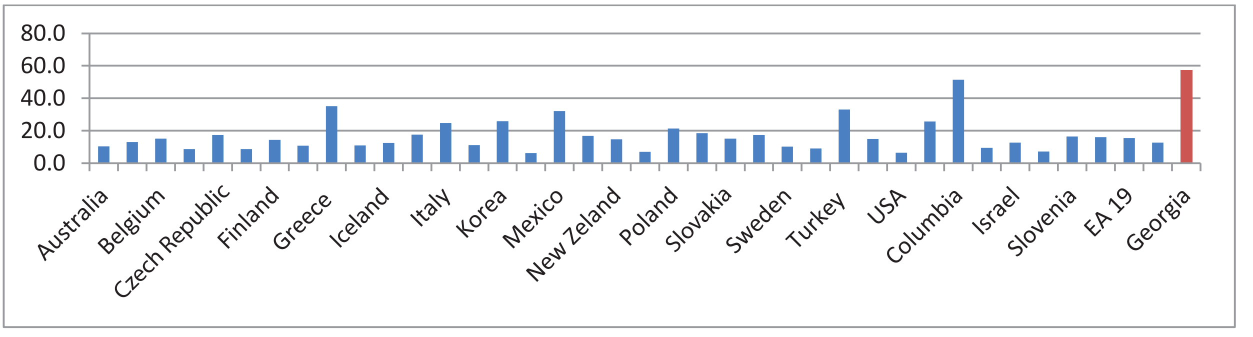


Figure 2. Share of self-employed in total employment, integrated data with EUROSTAT and GEOSTAT

Figure 3 illustrates the sectoral distributionof self-employment in Georgia. As shown in the figure, 83% of self-employed are employed in agriculture. Naturally, a question arises as to what employment means in agriculture? As noted above, the Department of Statistics of Georgia is guided by the International Labor Organization, according to which a person is deemed to be an employee if he or she has worked for a minimum of an hour to earn income in the previous seven days prior to the survey (wages, income from other sources, profit, etc.). The statistics department does not place importance as to the amount earned, whether it is 50 or 100 GEL, they are still considered employed. For example, if one lives in a rural area, has a small piece of land, and on it has corn, cows and sells milk, they are considered employed, more specifically, self-employed.

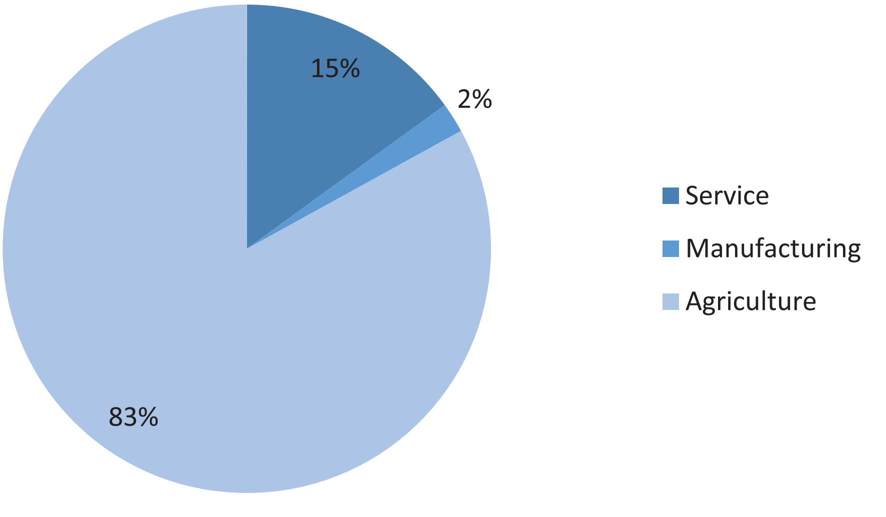


Figure 3. Sectoral distribution of self-employed according to the National Statistics Office of Georgia

Most of the workers in agriculture, to put it softly, do not live so wealthily. This is evident from the fact that according to the statistics department, income from agriculture is the lowest. In addition, agriculture is the least productive sector, the share of which is only 8% of the total economy,when considering that about 50% of those employed are considered self-employed in agriculture (GEOSTAT, 2017).

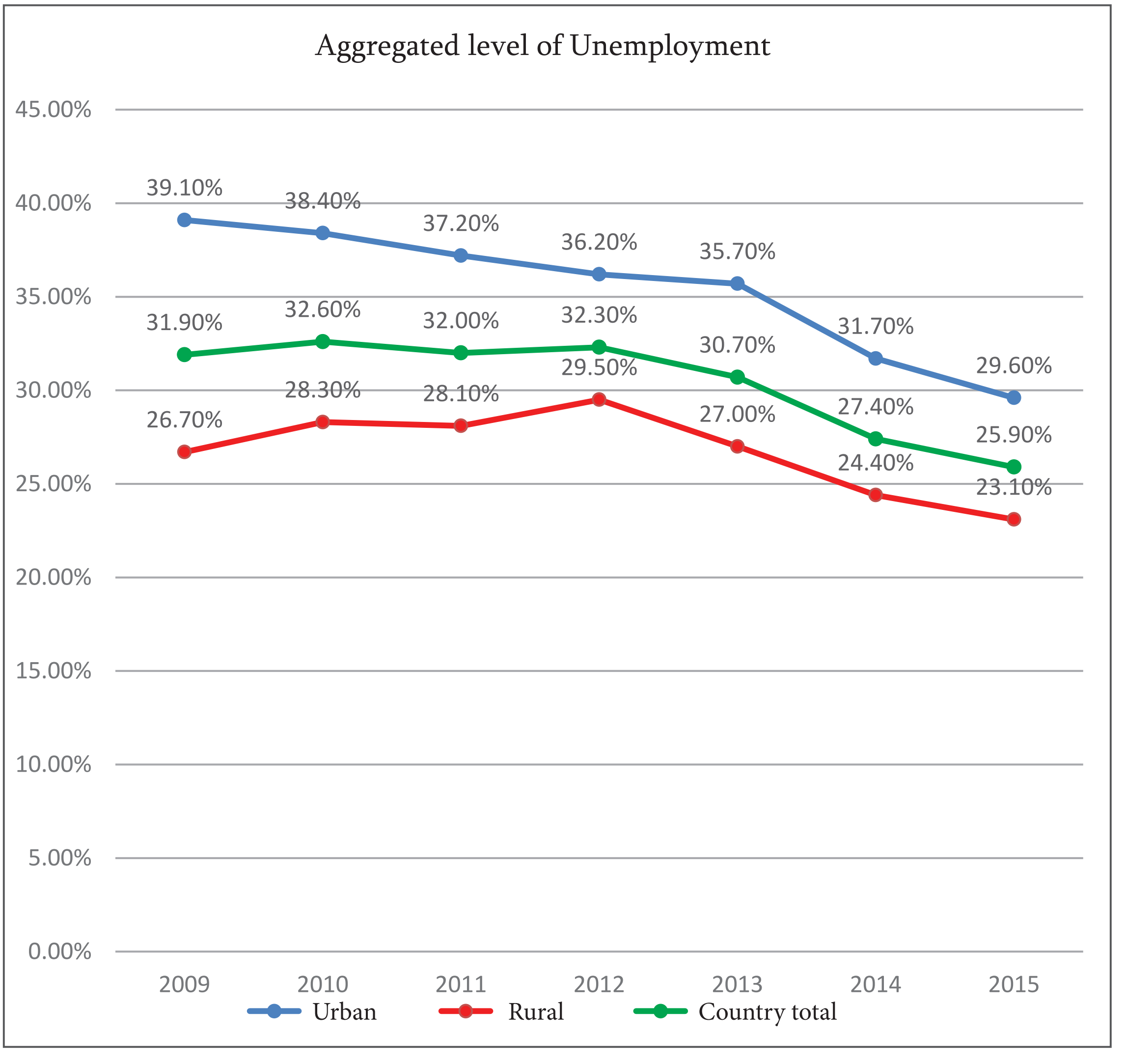


Figure 4. Aggregated level of unemployment , the data is taken from the study „Unemployment Structure and Structural Unemployment"

To sum up, the official statistics on employment, which Georgian state agencies offer, are far from reality because of the fact that the government may consider a citizen employed if she simply owns one cow. And such cases are not an exception: in effect about one third of the population is unemployed. This is confirmed by a survey conducted by GFSIS, from which figure 4 is taken. The figure illustrates aggregate unemployment data, which includes precarious workers and hidden unemployment (Kakulia, Kapanadze, Lomjaria, & Kurkhuli, 2016).

2.2. The need for economic diversification

Georgia confidently pursues neoliberal economic policies with the hope that with fewer regulations, maximum free trade and low taxes, a large amount of Foreign Direct Investments will enter the country. This will increase the economic growth and accordingly general welfare will increase. But as it was shown above, such policies have not solved the problem of unemployment. Since independence, Georgia has had a current account deficit problem, which is equivalent to 12% of GDP in the last 15 years. Thecurrent account deficit is mainly caused by the negative trade deficit that runs consistently high (figure 5).

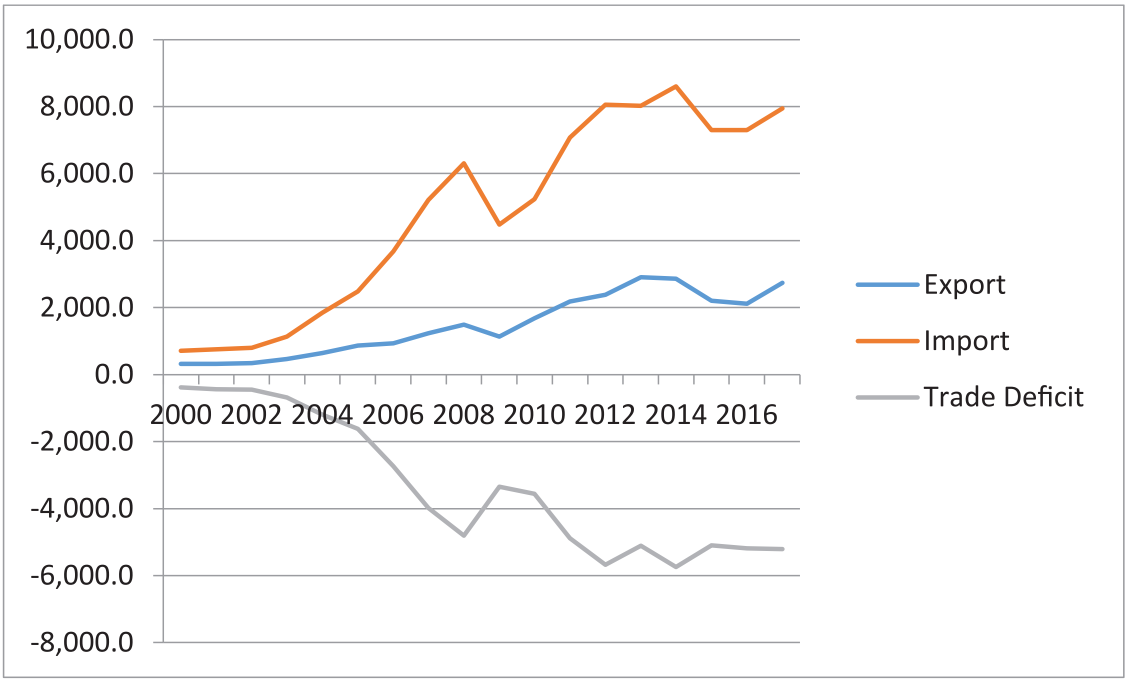


Figure 5. Trade Deficit in Georgia in Million USD, GEOSTAT

Georgia has signed free trade agreements with the European Union, Turkey, the CIS countries and China, and is currently working on a new free trade agreement with India. The main logic of these trade policies lies in that the existing neoliberal economic regime will directly attract foreign investments, which will improve the economy, create job opportunities, and generate technological expansion. Indeed, the share of direct foreign investments is consistently high in GDP, although there is effectively no correlation between FDIs and employment (Janiashvili, 2017). The same can be said about the correlation between poverty and inequality on the one hand and foreign direct investment on the other hand.

The main reason that could help to explain this fact is the type of direct foreign investment itself and the sectoral distribution of the FDI sector. The manufacturing sector which brings higher value added for the economy and creates better and more stable jobs, received only 5 percent of total FDI, while the share of the financial sector and the construction sector in total FDI reached 16 and 15 percent in 2017, respectively. It is noteworthy that even with the neoliberalization of the economy, the share of the manufacturing sector in total FDI has declined, which is well illustrated by figures 6 and 7, shown below.

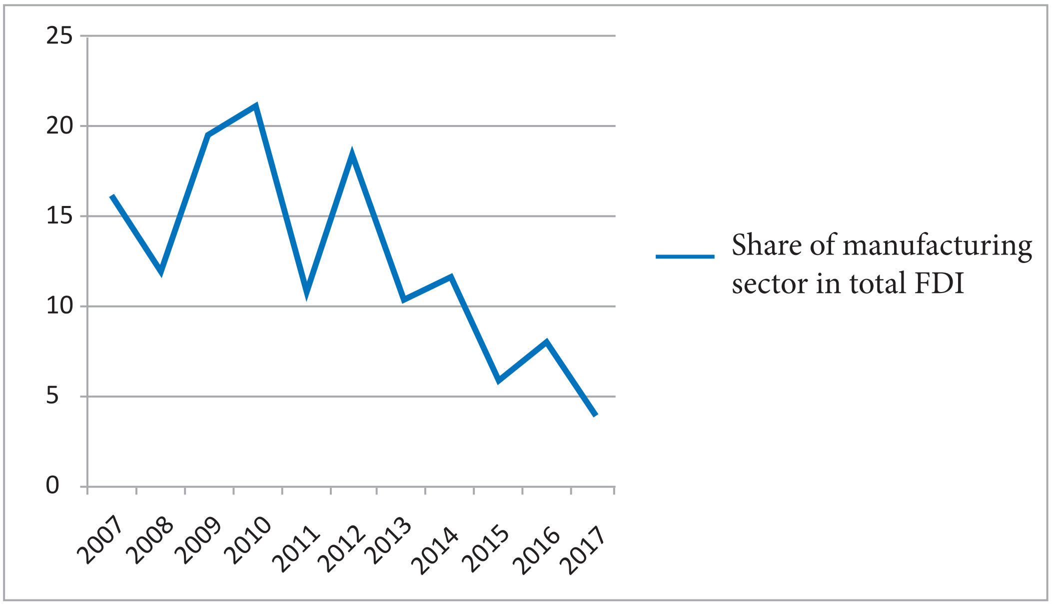


Figure 6. Foreign Direct Investments in the manufacturing industry, Statistics National Office

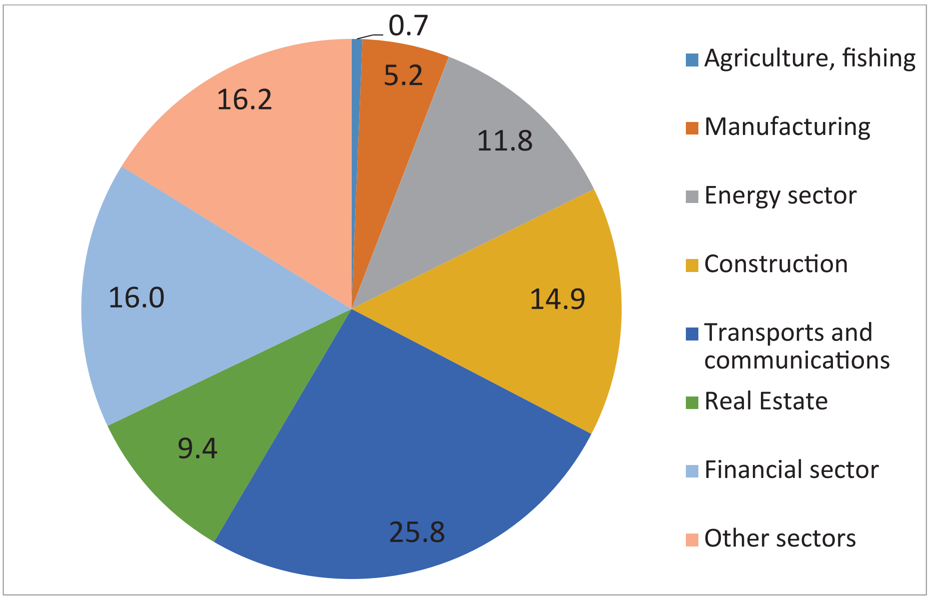


Figure 7. FDIs by major economic sectors in 2017 (GEOSTAT, 2017)

Another measure stipulating failure of the economic strategy is the export diversification and sophistication indicator. It should be noted that Georgia is largely exporting goods that do not have a high value added. Besides this, the jobs are precarious in the manufacturing sector and are based on extraction of natural resources. Moreover, the largest export products are not characterized by high levels of sophistication, and they lack the potential of spillover effects. Two indicators can be used to measure the export diversification level of the country as well as the sophistication of the export basket. According to the International Monetary Fund's research, Georgia's export basket diversification is far behind, even in comparison with countries with similar economies (International Monetary Fund, 2018). The same can be said of export sophistication. The low level of sophistication of export products indicates that Georgia is largely „specialized" in poverty.

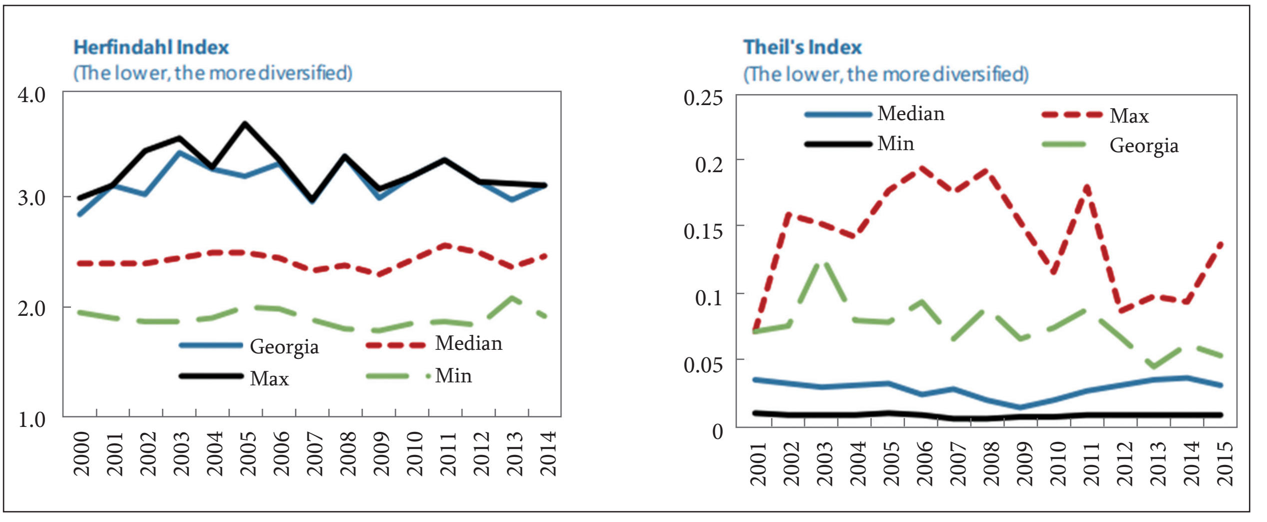


Figure 8. Georgia's Export Product Diversification, calculations of the World Bank and International Monetary Fund, Figure is taken from the study „Georgia's Path to Economic Diversification."

Georgia had high hopes for free trade with the EU, but as shown below in table 1, Georgia exports mainly raw materials or primary manufactured products to the EU. Of the 11 most important export products, three are not Georgian, i.e. re-exported. In addition, the products of Georgian origin are quite low in terms of sophistication in the export basket. If we extrapolate from the results of the World Bank's research (Reis, Reyes, & Varela, 2013) on exports to the EU, we will see that the EXPY index is low, compared with economies similar to Georgia, particularly Ukraine and Moldova, where diversification and sophistication are high.

Key Export Products	**2012**	**2013**	**2014**	**2015**	**2016**
Ores and concentrates of copper	53.5	161.6	180.2	153.1	173.1
Nuts and other nut products	51.1	116.4	143.6	149	145.5
Crude oil and oil products, obtained from bituminous minerals	26.8	40.7	33.2	77.9	26.8
Fertilizers are mineral or chemical, nitrogenous	40.8	51.7	32.3	65.9	24.1
Ferroalloys	1.5	25.1	25.9	21	17.9
Ethyl alcohol, spirits	11.9	29.8	24.3	13.7	21.8
Grapes natural wines	9.1	10.7	13.8	12.5	14.2
Cars	57.2	51.6	32.6	11.3	4.7
Mineral and fresh water	7.5	8.6	11.3	10.7	12.2
Fruit and vegetable juices	9	2.7	5.7	3.4	2.1
Rubber pneumatic rods		6	9.6	10.4	15.2
Exports to the EU	**352.9**	**607.1**	**624.1**	**646.4**	**571**

Table 1. Georgia's export structure to the EU in million US dollars, the table is prepared in accordance with the reports of the Ministry of Economy and Sustainable Development of Georgia (Ministry of Economy and Sustainable Development, 2017)

Studies on industrial development reveal three major structural problems that need to be addressed in order to create stable and well-paid jobs and to make economic growth of the country more inclusive. These problems are the following:

1. Low Investment in Knowledge and Human Capital:

Investments in research and development in Georgia are quite low. According to world statistics, the share of expenditures on research and development in Georgia constituted 0.32% of GDP (in 2015), while at the same time, the rate was 2% in the EU, 3.3% in Japan and 2.8% in the US. Various studies have shown that the existing problems facing investment in human capital and the process of producing knowledge are major hindrances to firms. Such a reality does not only stop the creation of innovation but also creates a serious knowledge crisis in the adaptation of existing innovation and establishing innovative businesses.

2. Lack of Institutional Expertise in Industrial Planning:

There are several programs and state institutions working in the field of industrial development, but the level of coordination is quite low and often the activities are duplicated. For instance, the program, „Enterprise Georgia" by the Ministry of Economy and the Partnership Fund share similar functions. Despite the existence of these institutes and programs, they do not have the relevant institutional knowledge to implement effective industrial policies in Georgia. For example, the Ministry of Economy does not actually conduct sectoral analyses, existing research so far has been superficial and fragmented. It is doubtful whether business can use them effectively. In the Ministry of Economy there was a group of twelve people tasked with industrial development, but this unit was abolished in 2016. Therefore, virtually all sectoral planning and new business projects that this tiny group was implementing with scarce resources came to a halt. This stage necessitates the consolidation of state institutions for industrial development and allocation of relevant financial resources to enable them to plan the country's industrialization.

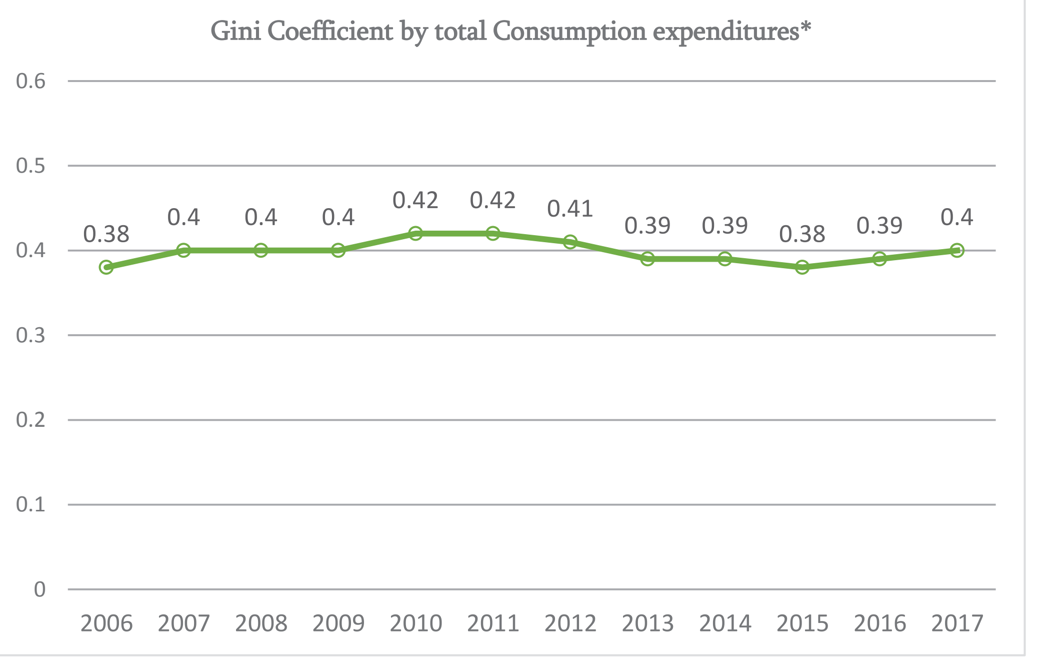
3. Access to Financing for Local Manufacturers:

Several polls and research confirm that financial accessibility for business is a huge problem in Georgia. For example, according to the World Competitiveness Index, access to finance is second on the list of challenges.Commercial banks dominate the Georgian financial system, while the two largest banks in the banking sector hold about 70% of the total market. This creates the threat of an oligopoly and increases the price of money for business. The German KFW study says that the local banking sector fails to provide sufficient credit for SME and that this problem of taking out loans is most acute for businesses between $200,000 and $5 million (Frankfurt School of Finance & Management, 2015).

2.3. Inequality and poverty

Georgia is in eighth place worldwide with respect to low taxes (The Wolrd Economic Forum, 2017) but what is the economic and political price of this? First of all, it should be interpreted that the low taxes a priori do not indicate the well-being of the country. The argument that low taxes promote rapid economic growth is not empirically proven (Besley & Persson, 2011). The Nordic countries have had much higher marginal income tax rates for higher income earners from the beginning of their catch-up (Genovese, Scheve, & Stasavage, 2016), however, this did not stop them from becoming prosperous countries. Still, low taxes for the rich are negatively associated with economic equality. The example of Georgia clearly exposes the vicissitudes of this approach.

Since 2006, Georgia has adopted a flat income tax and has abolished social contributions in an effort to decrease the tax burden and broaden the tax base (Akitoby, 2018). In effect, by turning the progressive income tax into a flat income tax, the former Georgian government increased taxes for the lower income earners from 12% to 20% while maintaining the 20% income tax for the higher income earners. Partially, as a result of these policies, since 2006, inequality (as measured by the GINI coefficient of total consumption expenditure) increased until 2011. The biggest share from the gains of economic growth in 2003-2009 went to the richer strata of Georgian society, in particular, income and consumption of the top quintile (20%) of Georgian society increased by 26%, whilst income and consumption of the bottom quintile of society increased by only 10% (Asian Development Bank, 2014). In 2012, the new Georgian government, introduced a universal healthcare system, which partially contributed to the reduction of inequality and poverty in Georgia, however, income inequality continues to be higher as in the EU and the CIS average (WHO, 2017).



*Total consumption expenditures include cash and non-cash expenditures.

Figure 9. GINI Coeficient by Total Consumption Expenditures, the graph is taken from the GEOSTAT (National Statistics Office , 2018)

Georgia is leading in the post-Soviet countries in terms of inequality. According to the data of 2017, the GINI index of Georgia reaches 0.40 (see figure 9). If it were not for the most minimal equalizing tools, such as pensions and social transfers, inequality in Georgia would be even more dramatic. The figure below shows the difference between inequality without pensions and social assistance after receiving these benefits (Kakulia, Merab; Kapanadze, Nodar; Khurkhuli, Lali, 2017).

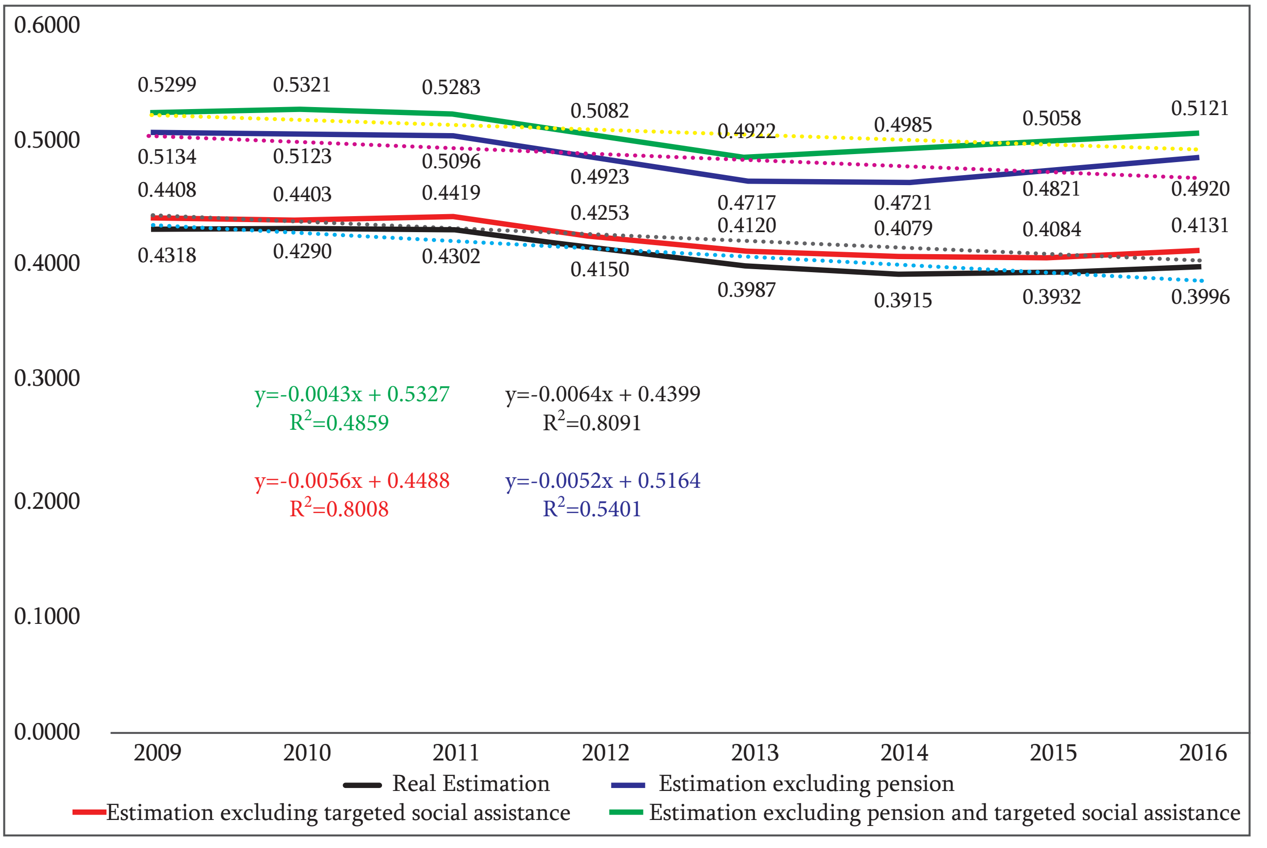


Figure 10. Panel dynamics of impact of public social payments on GINI index of distribution of total income, the figure taken from the paper Chronic Poverty and Income Inequality in Georgia (Kakulia, Merab; Kapanadze, Nodar; Khurkhuli, Lali, 2017)

Wage inequality is quite high in Georgia. Below, figure 11 shows that those with monthly income up to 0-500 GEL generate 6.7% of total income (wage income and income generated by individual entrepreneurs), while this group constitutes 34.7% of the wage earners. At the same time, the group of income earners, whose income is more than 16,000 GEL, generates for 20.4% of total income. This group comprises 0.4% of the income earners.

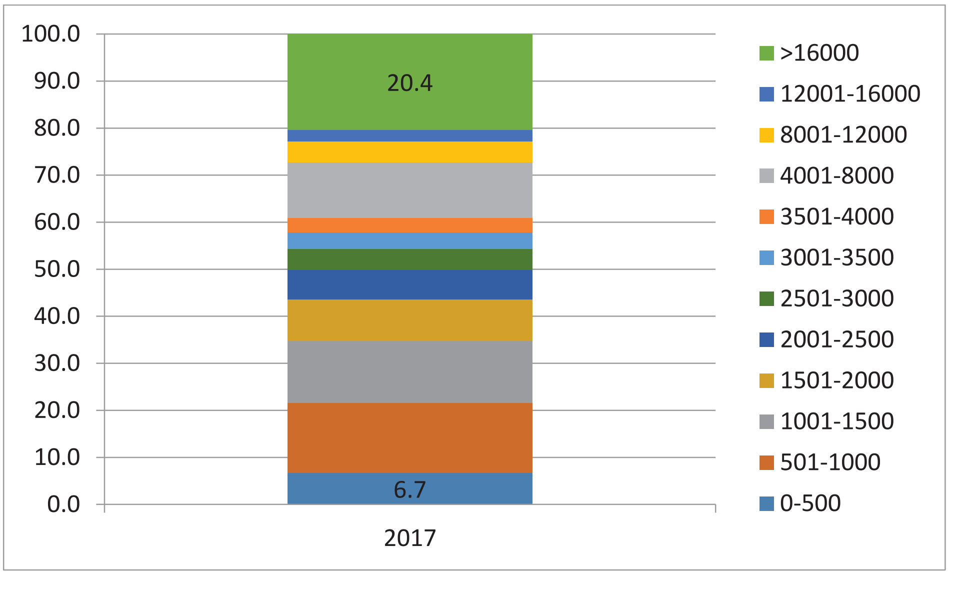


Figure 11. Income Distribution among different income groups, (author's own calculation from data provided by the Revenue Service of Georgia)

Figure 12 also shows the outcome of the Georgian economic model: the virtual disappearance of class. 90.4% of income-earners in Georgia have less than 2500 GEL. Given the high level of unemployment and the fact that hired employees make up only 48.2% of the total employees, the picture of inequality of incomes gets even worse.

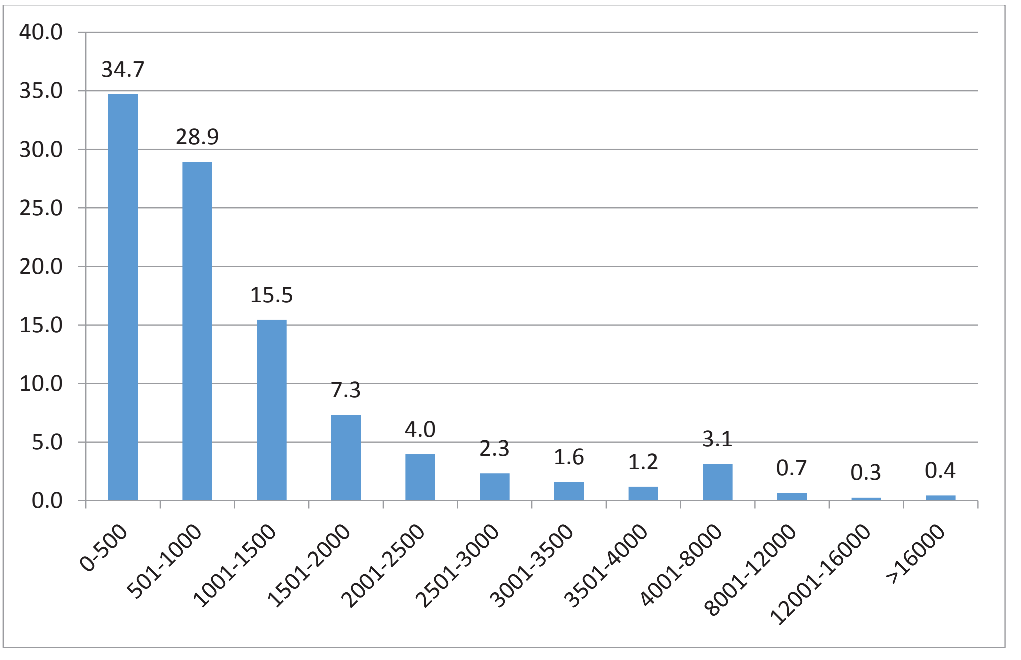


Figure 12. Distribution of Individuals according to different income groups, (author's own calculation from data provided by the Revenue Service of Georgia)

The issue of inequality in Georgia was neglected since attaining independence. However, this was not just a Georgian phenomenon, but it was considered globally that economic growth at some point would be the prerequisite for achieving maximum welfare of the population. However, the expectation that „a rising tide lifts all boats" (economic growth is beneficial for everyone) was not justified. According to the data from the Brookings Institute it is clear that in 2017 Georgia was ranked 8th in unequal distribution of revenue (Chandy & Seidel, 2017). The data from the Brookings Institute provides two main sources, household surveys and the national accounts, which gives a more complete picture. The data regarding inequality of the National Statistics Office of Georgia is based on the household survey, which is an important source, but as researchers of inequality note, it has many shortcomings (Atkinson, 2015). For example, participation in household surveys is often avoided by rich households, which artificially reduces the inequality index.

According to the World Bank data, Georgia is leading all its neighbors, in terms of the share of people living on less than USD 1.90 a day (poverty headcount ratio at $1.90 a day, 2011 PPP). For instance, even in Armenia people living below the aforementioned poverty line accounted for 1.8% of its population, while in Georgia this rate accounted for 4.2% in 2016 (The World Bank, 2018). 6.8% of Georgian children live below the extreme poverty line (which has a threshold of 1.25 USD per day). While the absolute poverty rate has been declining since 2012 as a result of massive government investment in healthcare, it is still high and exceeds 21%. Unemployment among other causes plays an important role in contributing to the high poverty rate (Asian Development Bank, 2014). On average in households, where there is no employed member, the poverty rate is 10-11% higher (Kakulia, Merab; Kapanadze, Nodar; Khurkhuli, Lali, 2017). According to the UNICEF's last Welfare Monitoring Survey, the absolute and relative poverty rate of children is associated with the degree of an adult's education in the household, i.e. there is a lower risk of child poverty in households where adults have good quality education (UNICEF, 2017).

3. PUBLIC UNDER-INVESTMENT AND LIMITED FISCAL SPACE

3.1. Low investment level in education

The educational system of Georgia since independence has been characterized by instability and constant replacement of ministers and development strategies. Since 1991, Georgia has had 15 Ministers of Education, which means that ministers never retained their positions for more than two years. Together with the revolving door of ministers, the vision and strategies for developing education were changing.

According to the Global Competitiveness Index, Georgia occupies the 106th position in secondary education and has even lagged behind its neighboring countries Armenia and Azerbaijan. Georgia is ranked 101 in higher education (The World Economic Forum, 2018). According to the same index, the main problem for Georgian business is the lack of an educated workforce. It would be surprising if there was a different situation in a country where the profession of a teacher is one of the lowest paid jobs. According to the findings of international organizations, it shows that the problem is considerable in the quality of primary school and preschool education. For example, according to „International Student Assessment" (PISA), Georgia ranks significantly lower than the OECD countries. For example, more than 50% of the 15-year-olds interviewed in Georgia by PISA do not satisfy the basic levelsin natural sciences, literature and mathematics (OECD, 2015). Such problems are also present in preschools, which UNICEF studies actively cover. For example, UNICEF's latest research says that, along with other problems, the problems of pre-school education are significantly correlated with low pay for teachers in preschool institutions(UNICEF, 2017).

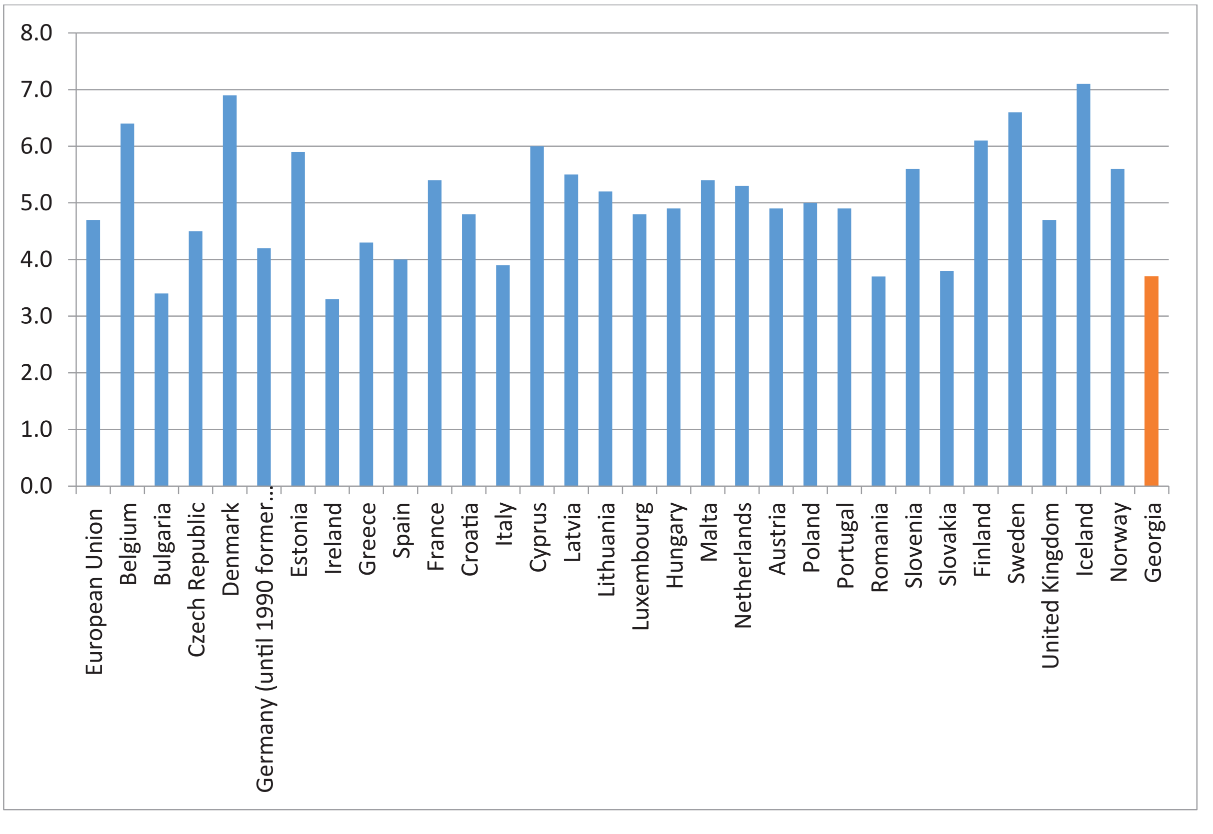


Figure 13. Government Education Spending-to-GDP in EU countries and Georgia (Eurostat 2017)

State spending on education is relatively low in Georgia. If one compares spending on education in Georgia to the average spending on education in the EU , then we can clearly see that Georgia spends less than 3.7% of its GDP on education (i.e. by one percentage point less than the EU average). Considering the collapse of the education system and its active commodification, the low spending on education cannot correspond to the two main goals of education: firstly, education fails to provide social equality, and secondly, education fails to concur with the economic development processes of the country.

The increase of wages for teachers is not a capital expenditure and thus, this component cannot be considered as an investment, in an original meaning of this concept. Nevertheless, wages for teachers is an investment in human capital contributing significantly to the economic development and happiness of the country in the medium and long run. The importance of investing in education is even endorsed by such conservative financial institutions, like the International Monetary Fund. In particular, according to IMF research in low-income countries, the constant growth of investments in social services (mostly education) by 1 percent, constitutes a 25% increase in GDP in the long run, whereas allocating the same number of investments in infrastructure will result in only 5% growth of the GDP (Atolia, Li, Marto, & Melina, 2017).

According to the data of 2017, there are approximately 60,000 public school teachers in Georgia. 70% of teachers („practitioner" teachers' category) are paid 612 GEL for full-time work. However, only 35% of these teachers work full-time. That is to say, 70% of teachers employed in public schools are paid less than 612 GEL, while considering the fact that the average nominal salary in Georgia is 1067 GEL according to 2017 data. The data of the National Statistics Office does confirm that the education sector in Georgia is the lowest paid field in the country.

The low wages are even more disturbing at the preschool level. In the public kindergartens of the capital, the full-time salary for a teacher is 660 GEL. Nevertheless, it is to be underlined that only 20% of teachers work full-time in the capital. A morning shift salary of a teacher consists of 440 GEL, and asecond shift salary averages 220 GEL. It turns out that second shift preschool teacher's taxed wage (176 GEL) is actually equal to the subsistence minimum. The subsistence minimum accounted for 170 GEL according to the National Statistics Office in 2017. It should be noted that wages in the public kindergartens of the capital exceed the wages of preschool teachers in the regions,which makes the national picture even more serious.

3.2. Unfair tax system

The Georgian tax system thoroughly fits in the neoliberal discourse that has dominated in economic thinking and practices since the 1980s. The logic is simple: enriching the wealthy in the long run will increase the economic „pie" for everyone, thus the wealth will trickle down. In order to achieve this goal, all previous and current governments of Georgia have tried to have a tax system that imposes less tax on the rich. In order to achieve this goal, Georgia operates a flat tax system with respect to the income tax.

Since 2003, the number of taxes have been reduced to a minimum in order to achieve tax efficiency in Georgia. The tax system has been largely regressive, which means that low and middle-income households spend a relatively higher share of their income on taxes. This is because a high share of revenue is collected through indirect taxes. As poorer households tend to spend a larger share of their income on consumption than wealthy households, they tend to spend a relatively larger share of their income on VAT and excise taxes. Figure 14 below displays the tax revenues collected according to the types of taxes, which clearly show that in 2017, 57.7% of revenues were collected from regressive taxes as VAT, excise and import taxes.

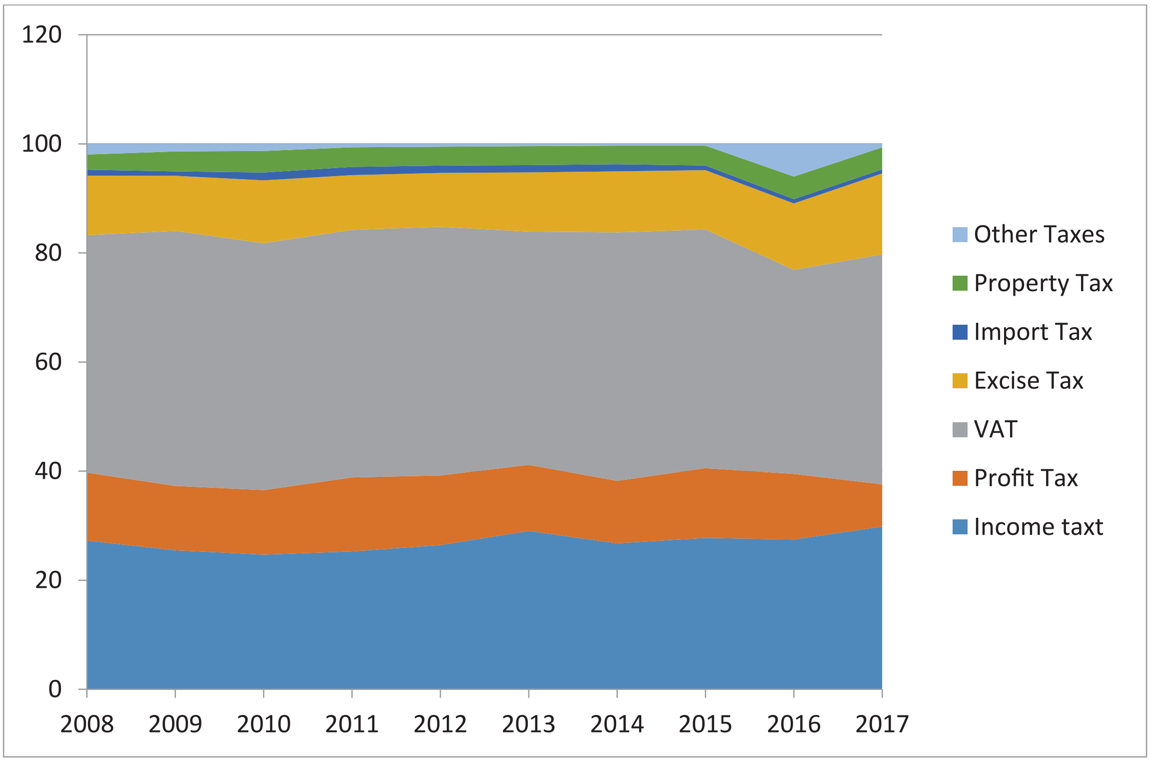


Figure 14. the share of various taxes in total tax revenue (The Ministry of Finance of Georgia, 2018)

Taxes in Georgia (2018)
• Income Tax: 20% • Profit Tax: Distributed profit is taxable by 20%, reinvested profits are not taxed; • VAT: 18% • Excise Tax • Property Tax <1% • Import Tax: 5%, 12%, or fixed on certain goods

Table 2. Taxes in Georgia

An increase in top income tax rates in order to make the income tax progressive, is actually prohibited by Georgian legislation.With zealous insistence of Georgia's third President Mikheil Saakashvili, Article 94 was added to the constitution in 2010 which forbade the introduction of a new tax or increases in taxes by the parliament and gave that power to referendum, which the government has to initiate. In general, according to the Georgian legislation, a referendum may be introduced if supported by 200,000 signatures. However, it is not surprising that this rule does not apply to taxes, where the referendum can only be introduced by the government. Despite the recommendations of the International Monetary Fund and the Venice Commission, the current Georgian government did not remove this article from the new constitution which entered into force on March 2018, but this article has moved into the transitional provision, and it will automatically lose power after 12 years.

Excerpt: Transitional provision of the Constitution of Georgia (Matsne.ge, 2018)[1]
"6. From the enforcement of this law to the next 12 years, the introduction of a new kind of taxation, except for excise, or the increase of the general taxes existing, may be raised only through the referendum, except for the cases envisaged by the fundamental Law. Only the Government of Georgia has the right to initiate a referendum. The introduction of a tax or change, which is an alternative to the existing tax or replaces it and does not increase the tax burden, shall not be considered as the introduction of a new type of public tax or increase in marginal rate. Changing the rate of tax rate within the existing marginal rate according to the type of tax shall not be considered as the introduction of a new type of common state tax or a margin rate. Pension and insurance contributions are regulated by law and they are not taxes and fees".
Excerpt: Economic Liberty Act (ELA)
"5. It is prohibited that the subject of the referendum should be progressive taxation principle or methodology/taxation regime. 6. The Government of Georgia has the right to request temporary increase of taxes - not more than 3 years. In this case referendum is not held".

Table 3. Excerpts from the Constitution and Organic Law of Georgia on Economic Freedom

3.3. Limited fiscalspace

In addition to the restriction of taxes, the Georgian government is limited in spending, i.e. by the fiscal rule regulated by the law of the Economic Liberty Act. This fiscal rule largely determines the size and revenue of the state government. For example, the total general budget expenditures and non-financial assets cannot exceed 30% of GDP. In addition, there are limitations on the budget deficit, governmentdebt and tax increases, which is shown below in the table 4.

Georgia's Fiscal Rules According to the Economic Liberty Act (ceilings)
• Government Debt-to-GDP: 60 percent of GDP; • Budget Deficit-to-GDP: 3 percent of GDP (Budget Balance Rule); • Government Spending-to-GDP: 30 percent of GDP;

Table 4: Georgia's Fiscal Rules According to the Economic Liberty Act

Such fiscal rules, *a priori*, limit the scope of a welfare state. Moreover, these rules force governments to act according to the neoliberal economic model. For instance, after 2012, the Georgian government tried to take more responsibility for the welfare of the population. Implementation of the universal health care program can be considered a historic step in this regard, and has saved many people from extreme poverty. However, due to the lack of ideological compatibility between Georgian economic policy and social policy, the Government of Georgia expectedly retreated regarding the universality of universal healthcare. Since May 2017 the Government of Georgia launched a new wave of universal health care reform (Khe-

[1] Transitional provision of the Constitution of Georgia, chapter 8, (unofficial translation, by author of the research).

laia, 2017), in which the Georgian health care system has become more targeted. The main argument of the government was, naturally, saving money, as the state spending on healthcare increased by two and a half times after 2012. In addition, the country had taken another step towards liberalization of economic policy, namely the Estonian tax model took effect in May 2017 in which firms are exempt from the profit tax regarding reinvesting retained profits. This step further increased fiscal insecurity since the budget was lacking a sufficient level of revenues, which the government of Georgia tried to fill through excise taxes. Due to the above mentioned fiscal rules, the Georgian government has only one instrument to mobilize additional budgetary funds, since the existing legislative space only allowed for an excise tax increase. The World Bank report says that under the current fiscal rules, the above mentioned changes benefit wealthier strata of society (by lowering the corporate income tax), while the increased level of excise tax would affect the poor population, since „higher fuel excises would translate into higher transportation costs and prices for necessities, leading to higher living cost which will weighs more heavily on the poor." (World Bank, p. 28).

Fiscal rules legislated by the Economic Liberty Act have become an anachronism for Georgian macroeconomic stability. While Georgia has adhered to the budget balance rule since enactment of the ELA, the government expenditure rule (30% threshold) was mostly breached by the Georgian government. In addition to that, the fiscal deficit is characterized by an increasing trend. In 2013, the deficit to GDP-ratio (GFSM methodology) was at 2.7%, while it increased to 4% inthe last 2 years. As for the government debt to GDP, it is true that Georgia has not reached the limited ceiling under the ELA year. Government Debt to GDP ratio was 44.6% in 2017, while the ceiling is 60%. However, government foreign debt has an increasing trend. For Instance, in 2014 the foreign debt to GDP was 27%, in 2017 it reached 35.3%. Under the floating exchange rate and a constant current account deficit, the increasing foreign debt burden may create macroeconomic risks in mid-term perspective.

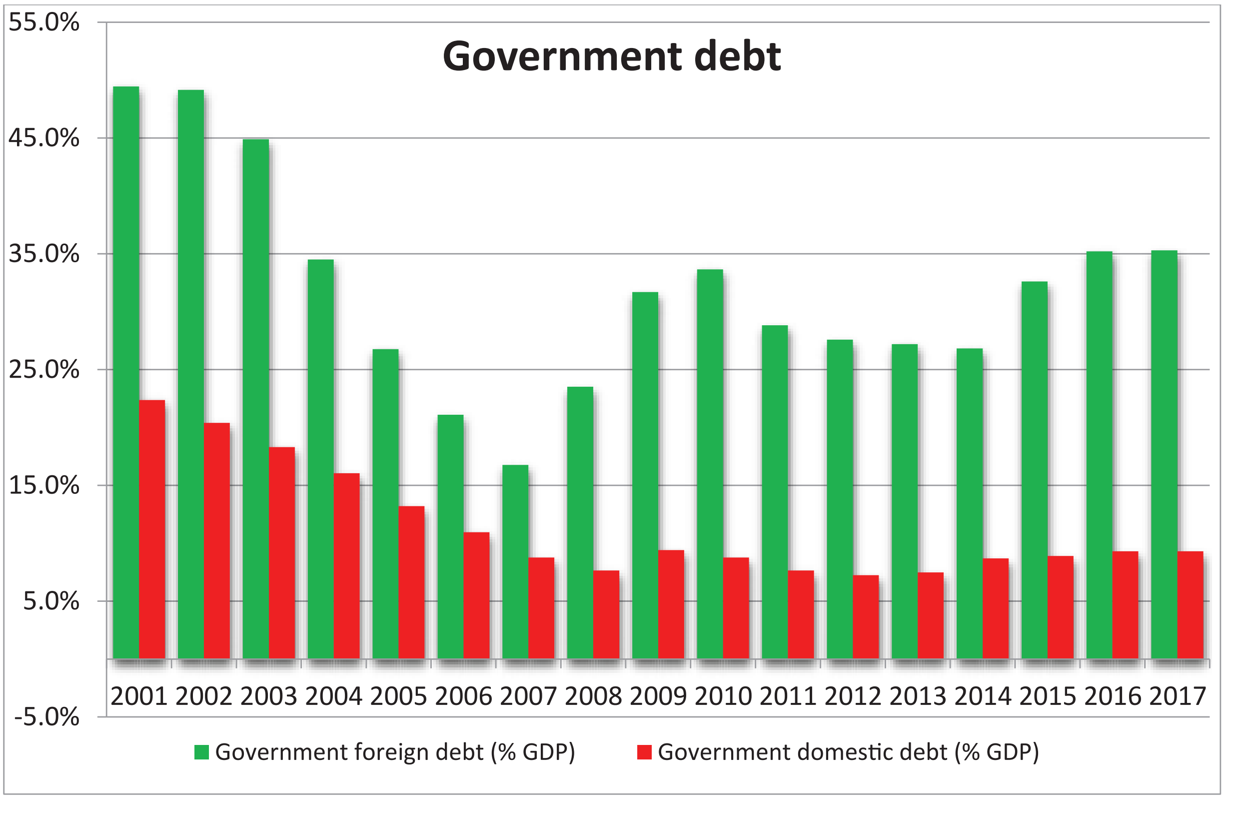


Figure 15. Government debt to GDP, the graph taken from the statistical overview of the Ministry of Finance of Georgia

To recap, current constitutional regulations and fiscal rules legislated by the ELA became an impediment for tackling income inequality and achieving inclusive economic growth in Georgia. Even the IMF criticized the reliance of Georgian government on the excise taxes and limitations on increasing government spending through raising marginal income tax for higher income earners. The IMF report on the Fiscal Rules Framework of Georgia says that „Georgia's GINI Coefficient by total incomes at 0.39 could, inter alia, be addressed by making income taxation more progressive, i.e. a higher marginal personal income tax rate" (Hansen, Farrington, Jalles, Rial, & Yläoutinen, p. 13).

4. REFORM AGENDA

The Georgian economy seems to be stuck in a situation of high unemployment and persistent income inequality despite acceptable overall GDP growth rates and impressive FDI inflows over the last decade. Investment has primarily been diverted to the financial and the construction sector while the agricultural and the manufacturing sector seem to be stagnating at low productivity levels. This development seems to have benefitted only a small share of the population as unemployment, under-employment and poverty remain high. As the provision of an investment-friendly climate in terms of low taxes and a highly developed financial sector has not been sufficient to stimulate inclusive growth, more government action is needed. In the short-term, fiscal redistribution might alleviate inequality of disposable incomes. For example, more investment in public education can alleviate the underinvestment in human capital. In the medium to long term, a more comprehensive development strategy is needed to improve job opportunities for people stuck in precarious work conditions and in the informal sector. An active industrial policy enhancing productivity growth in the agricultural sector and exploring potentially competitive sectors would require sufficient funding either by means of increased government debt or increased tax revenues. The suggested policy package of an income tax reform combined with additional public expenditures in the areas of public schooling, research and development, institutional strengthening and access to finance for SME would be an important step on the way to more actively shaping the development of the Georgian economy and ensuring macroeconomic stability.

4.1. Options for income tax reform

The income tax base for individuals makes it possible through Georgian income tax reform to attain the following two goals:

A) Firstly, to make income taxation more fair, so that the poor pay less and the richest pay proportionally more so that the tax burden is more fairly and efficiently distributed for all income groups;

B) Secondly, the mobilization of additional funds for the budget will allow the government to indirectly distribute funds from high income individuals to low income individuals. Furthermore, this would enable the government to allot such additional accumulated funds to economic development.

The data from the Georgian Revenue Services, where the time series for different income groups is given between 2015 and 2017, enables us to present several scenarios that will answer the issues mentioned above. In the opinion of the authors, the following options are best suited, although it is possible to consider other alternatives.

Option 1

0-500	20%
501-1000	20%
1001-1500	20%
1501-2000	20%
2001-2500	20%
2501-3000	30%
3001-3500	30%
3501-4000	30%
4001-8000	30%
8001-12000	30%
12001-16000	30%
16000 **or more**	30%

The first option envisages income taxation in the following manner: taxable incomes up to 2500 GEL will be taxed at the existing tax rate, i.e. 20%. From 2500 GEL and above a marginal tax rate of 30% will be introduced. The marginal tax principle implies that each additional GEL will be taxed at an appropriate rate above the specified margin. For example, if the individual's income is 2600 GEL, one has to pay 20% of the income of 2500 GEL, which is 500 GEL and 30 GEL for the remaining 100 GEL. Overall, the total amount of income tax will consist of 530 GEL leaving an individual with 1930 GEL net pay. If one was taxed on a current 20% tax,the income tax would be 10 GEL less thus amounting to only 520 GEL.

According to this scenario, it would be possible to mobilize 477 million GEL more in revenues rather than with the current flat taxation in 2017 (plus 1.25% of GDP). In this scenario, the income tax remains the same for 90.4 percent of the employed (as well as individual entrepreneurs). The tax rate increases to 30% for the remaining top 9.6%. In particular, the income tax will increase to approximately 80,000 people, and the income tax will remain the same for about 750,000 people.

The strong part of the first option is that it is simple to implement at the first stage and it is easily comprehensible for taxpayers. However, in the medium run, as the companies will adapt from the accounting perspective, this strong side of the first option would be leveled up. The strong side of the first option would be also that, in case of its implementation, 88 million more GEL would be collected as a revenue to the budget than in the third option. The main weakness of this option is that income taxes are not reduced for 90.4% of taxpayers and income taxes are increased for 9.6%. Hence, it would be sufficiently complicated for the taxpayers to comprehend the rationality behind this option, as they would not get a direct benefit. This means that the first option cannot address the above-mentioned task and fails to ensure the fairness of the tax system. Moreover, the first option does not reduce the tax burden for taxpayers, thus making it politicallyless viable as well.

Option 2

0-500	18%
501-1000	20%
1001-1500	20%
1501-2000	20%
2001-2500	20%
2501-3000	30%
3001-3500	30%
3501-4000	30%
4001-8000	30%
8001-12000	30%
12001-16000	35%
16000 or more	35%

In the framework of this scenario, 515 million GEL more could be mobilized in revenues in the budget in 2017, rather than with the current flat taxation (plus 1.35% of GDP). With this scenario, the tax rate is reduced by 2 percentage points for 34.7% of the employed (as well as individual entrepreneurs). The tax rate of 20% remains the same for 55.7% of the employed (however, for the first 500 GEL the tax is also reduced for this group). Taxes would increase for 9.6% of the employed. Specifically, 8.9% of the taxpayers would get the tax increase to 30%,while 0.7% of taxpayers would see their taxes increase to 35%. In this scenario, the tax burden would be reduced by 2 percentage points for about 286,000 people, the tax burden would be the same for 460,000 people (although they would have been taxed less up to 500 GEL), the income tax increase to 30% would touch approximately 73,000 people, and 35% to 5,800 people.

The strength of the 2nd option is that in this case the tax burden is decreased for 90.4% of the population (the tax reduction would be more significant for the lowest 34.7% and less significant for the remaining 55.7%). Furthermore, it is to be stated that the second option gives the most extra revenue from all the discussed options. The extra income will consist of 515 million GEL in this option. Nevertheless, this option has two weaknesses. Firstly, the reduction of taxes by 2 percentage points does not significantly reduce the tax burden on the low-income group (up to 500 GEL). Secondly, the highest income group (12,000 GEL plus) tax increases up to 35%. Despite the fact that this group is quite small, it is possible to assume that their influence on political processes exceeds the influence of the other income groups. Therefore, it might be considered politically complicated to implement this option as well, but in comparison with the first option it would be more acceptable.

Option 3

0-500	15%
501-1000	20%
1001-1500	20%
1501-2000	20%
2001-2500	20%
2501-3000	30%
3001-3500	30%
3501-4000	30%
4001-8000	30%
8001-12000	30%
12001-16000	35%
16000 or more	35%

In accordance to this scenario, 389 million GEL more could be mobilized in revenues in the budget in 2017 (plus 1% of GDP), rather than with the current flat taxation. With this scenario, the tax rate is reduced by 5% to 34.7% of the taxpayers. The tax rate of 20% remains the same for 55.7% of the employed (however, for the first 500 GEL the tax is also reduced for this group). Taxes will increase for 9.6% of the employed. Specifically, 8.9% of the taxpayers will get the tax increase to 30%. While the 0.7% of taxpayers will see their taxes increase to 35%. In this scenario the tax burden would be reduced by 5 percentage points to about 286,000 people, the tax burden would be the same for 460,000 people (although they would have been taxed less up to 500 GEL), the income tax increase would increase up to 73,000 people to 30% and approximately 5,800 up to 35%.

The third option could be perceived as the most politically acceptable between all three examined options for achieving fair taxation. The strength of the third option is that in this case the tax burden is decreased for 90.4% of the population (mostly for the poorest 34.7% and to a lesser extent for the remaining 55.7%). The tax burden for low-income groups is lowered by 5%. That is to say, the lowest income group in the state budget will contribute 47 million GEL less than with the flat taxes. The negative side of the third option is the mobilization of the lowest revenues in the budget. However, the fact that the tax rate will be reduced by 5 percentage points, significantly increases the political viability of the third option and significantly compensates the plausible discontent that may result in an increase in income tax to 35% for the highest paid individuals.

Income is very unequally distributed in Georgia. The tax system relies heavily on indirect taxes and lacks significant redistributive elements. Raising the tax rates for the wealthy and lowering the rate for the lowest income segment would compensate to some extent for the otherwise regressive nature of the Georgian tax system. Redistribution is a key function of a good tax system and the previously assumed trade-off between equity and economic growth can be relaxed both from a theoretical as well as an empirical perspective. Opponents of progressive income tax usually argue that higher marginal tax rates have detrimental effects on labor supply, work intensity or career decisions of the top-income earners. However, these effects build on the assumption that top incomes are only derived from very extensive or intensive economic activity. In reality, they might also be the result of higher bargaining power and rent appropriation by the economic elites, in which case economic activity would be unaffected by marginal tax rates. It is thus not surprising that historical cross-country comparisons have not found any correlation between top tax rates and economic growth (Alvaredo et al. 2013). Even the IMF has recently suggested that governments might increase the progressivity of their income tax without significantly harming growth. The suggested reform would not only correct the distribution of disposable income but also set the following positive incentives: First, abandoning the flat tax regime and introducing a lower minimum tax rate might reduce the disincentive to declare formal income at the lower end of the income distribution. Second, the tax savings are most likely to immediately flow back into the economy as low-income households' consumption tends to be constrained by a lack of income. As pointed out by the Feasibility Study (Frankfurt School of Finance & Management, 2015), it seems that the private banking system currently fails to channel the savings of the wealthy to productive investments by domestic SME. Potential contractionary effects of increasing the tax burden on the wealthy might thus be marginal and would be outweighed by tax relief for low and middle-income households and by increased public spending. The tax reform canthus be expected to be at least growth-neutral.

4.2. Spending Policy of Additional Revenue

As noted above, Georgia has two major economic challenges requiring immediate government intervention:

- Low state investments in education.
- Total deindustrialization of the country.

Certainly, with the progressive income taxes, these two problems cannot be fully addressed, but the possibility of additional state investments in the medium-run will significantly change the economic picture.

The table below shows the structure of the additional spending on the basis of the three scenarios described above.

Additional mobilized sums of scenarios	Share	Scenario 1 Million GEL	Scenario 2 Million GEL	Scenario 3 Million GEL	Responsible Institution	Results
School and preschools teachers	45%	214.65	231.75	175.05	Ministry of Education / Municipalities	Increasing salaries for preschool and school teachers by 200 GEL
Research and development	10%	47.7	51.5	38.9	Ministry of Education, Ministry of Agriculture, Ministry of Economy	60% increase in expenditure on research and development
Institutional strengthening	5%	23.85	25.75	19.45	Ministry of Economy	GEL 23 ml. Additional resources for planning and implementation of industrial policy

Access to finance	40%	190.8	206	155.6	Partnership Fund, Ministry of Economy	13-32 medium business project and an average 1150 startup project
Total		477	515	389		

Table 5. Spending according to different scenarios, (authors' calculations)

Increasing salaries of school teachers

In case of all categories, public school teachers would receive additional basic salary of 200 GEL, this will result in an additional 144 million GEL for the government budget. From the state budget with an increase of 144 million GEL, 70% of teachers' salaries will be increased by at least 32%.

According to the data, there are 2,277 preschool teachers and 1,833 preschool teacher assistants in Tbilisi. In case of full-time work their salaries are 660 GEL and 550 GEL, respectively. According to the statistical data, the total number of teachers in Georgia is 12,394 including preschool teachers and assistant teachers. Raising the monthly salary by 200 GEL would cause additional budgetary expenses of 29,745,600 GEL. Increasing salaries by 200 GEL for the preschool teachers in Tbilisi would amount to a 30% increase of salaries and it would be 36% for preschool teacher assistants. In the regions, the salary will be increased proportionally, even more in regional kindergartens than Tbilisi.

An increase in expenditures on public schooling addresses the problem of under-investment in human capital frequently diagnosed in countries of high-income inequality (OECD 2015). Even though increased teachers' salaries cannot be regarded as investment expenditure in a narrow sense, the very low salaries negatively affect the quality of primary education and the attractiveness of the profession for skilled graduates. A well-educated workforce is, however, key to increasing the productivity of labor and enhancing the industrial development of the economy.

Expenditures on Industrial Policy and Development

In order to solve the three problems mentioned earlier, an additional amount of revenue received through the progressive income tax can be distributed by the following logic:

- In order to increase public investments in research and development for industrial development, it is possible to spend 10% of the additional money received by appropriate scenarios, enabling 60% increase of spending on average in the science development and encouraging applied and innovative researches by the Georgian government. For instance, by the internal calculations of the National Food Agency of the Ministry of Agriculture, they will pay about 150 million GEL additional investments in order to advance to the next stage of the sanitary and phytosanitary norms. These funds are essential for purchasing of laboratories (also corresponding reagents) and retraining the staff. This additional investment will give Georgia the opportunity to take advantage of the free trade with the EU and to increase agricultural exports. The additional incomes earned by progressive taxation in this direction will facilitate export growth and diversification of the Georgian export basket.

- 5% of additional mobilized funds for the institutional development, allocated for the development of the institutional base of the Partnership Fund and the Ministry of Sustainable Development and Economy. With the consideration of various scenarios, this amount is approximately 20-25 million GEL. This amount can be utilized by the corresponding institutions in the following directions: to strengthen planning and management, to carry out sectoral studies, to encourage export and to substitute import, as well as to coordinate between sectoral businesses and to encourage export promotion measures.
- 40% of additional budgetary revenue may be used to increase access to finance and the provision of „long-term money" to the economy. These finances can be divided into two parts:

  1) The amount of funds may be directed to financing projects from $200,000 to $5 million, this has the potential to consist of 35% of additional revenue; with such distribution, on average between 13 and 32 business projects could be financed with different scenarios. The State may use the subsidy for credit, participate in capital and use subordinated loans instrumental for distributing this money.

  2) The remaining revenue could be used to finance start-ups and agricultural cooperatives that would account for 5% of the additional amount. If an average amount of 20,000 GEL would be considered for financing start-ups, then according to different scenarios it could become possible to fund the 1,150 start-up projects in Georgia.

In order to tackle inequality and poverty in the long term, the economy needs to provide better job opportunities in the formal sector. As a large share of current investment is directed to the real estate sector and household equipment, the government needs to more actively explore and support opportunities for more productive investment in other sectors. The private sector has so far failed to incite sufficient industrial development so government intervention might be needed to initiate the generation of scientific and technological capacities in certain sectors so that private investors can join in. Important measures could include the building up of an infrastructure to satisfy the EU standards for food exports to the European Union and for the further processing of agricultural products. The potential for competitive manufacturing activities needs to be explored. Industrial policies cannot be expected to immediately deliver relief for the poor, but the additional resources invested can be regarded as a small contribution to reaching the medium to long-term goal of a more diversified economy and more sustainable economic growth. There are concerns that the persistent current account deficit might undermine the sustainability of the current Georgian growth model in the future. The poor industrial development identified as the root of Georgia's insufficient export performance needs to be addressed. The mobilization of domestic revenues for public investment may counterbalance the private sector's excessive dependence on foreign debt and reduce Georgia's vulnerability to an unexpected slow-down of capital inflows. The wealthy who have benefitted most from the current economic development can be expected to contribute their share to making economic growth in Georgia more sustainable and inclusive.

CONCLUSION

A decade after the world financial crisis, the belief in free markets has increasingly come under scrutiny. In the face of rising income inequality in many countries, even leading international organizations such as the World Bank and the IMF, which tended to promote free market policies, have explicitlyor implicitly acknowledged the failure of trickle-down economics and recommended more active redistribution by the state in order to achieve more inclusive growth. In addition, the recognition that FDI does not automatically bring about industrial upgrading and employment growth has incited debates on more strategic industrial policies in the economics profession.

Also in Georgia, the neoliberal policies of privatization, trade liberalization, low taxation and the general cutting back of state activity have failed to deliver shared prosperity. Despite rising inflows of FDI, unemployment, inequality and poverty persist at high levels. FDI is strongly concentrated on the financial, construction and energy sectors and has not contributed much to the upgrading of the Georgian manufacturing sector or export diversification. Accordingly, the Georgian economy faces a persistent trade deficitand has become highly dependent on foreign capital inflows. A high share of the population is stuck in precarious jobs and low-productivity farming. In addition, the Georgian constitution imposes a regressive tax system and strict fiscal rules which limit the government's ability to alleviate inequality and poverty by fiscal redistribution and public investment.

As a contribution to addressing these urgent problems of the Georgian economy and society, this study suggests a progressive income tax reform combined with increased public expenditures on human capital and industrial development. Higher top tax rates and a reduction of the basic rate should contribute to curbing inequality of disposable income in the short term. The additional revenue would be used to finance a public investment program. The spending program would address the key factors which impede a more diversified industrial development, in particular, the low investment in knowledge and human capital, the lack of expertise in industrial planning, and the access to financing for local manufacturers.The suggested measures include higher salaries for school teachers in order to improve the quality of public education and thus human capital. Additional resources would be spent on Research and Development, institutional development, and access to finance and provision of long-term credit for business projects and agricultural development.

The private sector alone has so far not been able to incite sufficient industrial development. Therefore, government intervention is needed in order to initiate the generation of scientific and technological capacities in certain sectors so that private investors can join in. The mobilization of domestic revenues will help the government to overcome the current situation of limited fiscal space and theresulting public under-investment. In addition, it might counterbalance the private sector's excessive dependence on foreign debt and reduce Georgia's vulnerability to an unexpected slow-down of capital inflows. The suggested reform package is thus expected to contribute to more inclusive growth and stability of the Georgian economy. This includes redistribution of the very unequal market incomes, increased productivity and more formal-sector jobs, as well as a diversification of exports to make the economy less vulnerable in case of an unexpected reversal of international capital flows.

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