

## "SHADOW TAX" - ONE OF THE CHALLENGES OF MANDATORY ACCUMULATIVE PENSION SCHEME OF GEORGIA

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### **Abstract**

*In Georgian pension system the precedent of accumulative pension model indicates on existence of relevant signs of European standards. Until 2018 there was operating only one-stage pension system. So the accumulative pension model is a novelty for any party involved in the process; therefore, in Georgia the challenges accompanying various changes are characterized by a special specificity.*

*We would like to focus on one of the challenges that equally affects all three parties involved in the mandatory funded pension scheme, including state, employer and employee. We must underline the following fact: if we want to overcome this challenge, we must implement changes not only in retirement, but also in the areas of taxation and labor sphere.*

**Keywords:** *Small business, mandatory accumulative pension scheme, shadow tax, non-taxable income*

**JEL Classification:** *E21, E24, H21, H26, I38*

### **I. INTRODUCTION**

The Law of Georgia on Accumulative Pensions can be considered as the end of pension system stagnation lasting nearly 30-years in the country. The Law of Georgia on Accumulative Pensions is based on Estonian law on Accumulative Pensions. Though the legislations of these two countries are not in compliance with certain fundamental issues; In some cases, it can be considered as the reason causing inadequacy of Georgian law on accumulative pensions.

The results obtained on the analysis of the accumulated information of conducted research, indicate the existence of directions requiring refinement in the Law of Georgia on Accumulative Pensions. This is due to the inconsistency with the Estonian legislation and our study on pension reform regarding the perceptions, expectations and attitudes of the Georgian population conducted from September 25 to October 23, 2019.

### **II. GENERAL ANALYSIS**

There are lots of interesting and noteworthy facts highlighted in the research process, but we would like to focus on so-called Small business and the relationship between employee and employer in the sector. According to both Estonian and Georgian models, a total of 6% of the employee's taxable salary is monthly paid to the employee's personal pension account, with regard to the obligation implementing these contributions, but Georgian legislation is based on different principle from Estonian one.

According to the mandatory pension scheme of Estonia, the obligation for contributions applies only to the employee and the state, but as for Georgia, the obligation for contributions applies to three subjects, including employee, employer and the state. According to the Law of Georgia on Collective Pensions, if an individual is not the employer and is hired by another person, the employee transfers 2% of his / her taxable salary to his/her personal account, the employer makes the corresponding contribution of 2% of the employee's taxable salary on the same account, and the state fills the remaining gap by 2%.

The law obliges the parties involved in the accumulative pension scheme to follow the directive. However, due to the fact that the Georgian legislation, like the Estonian legislation, obliges the employer to deduct the relevant percentage of the employee's taxable salary (Estonia - 2% of the taxable salary; Georgia - 2% of the taxable salary) and transfer it to the pension fund on behalf of the employee. It will result the opportunity to misinterpret the directive of Law. The fact is dictated by an unfavorable economic situation in the state. Furthermore, it creates a new reality for pension reform. So, in Georgia the pension scheme has taken a radically different form as well as creates the groundwork for a new model formation. Under the above mentioned model, in small business sector the employer pays the share of both the employer and the employee in the accumulative pension scheme. So in most cases, the employee does not even know about the above mentioned fact. That is, the model formed in a real environment, and considers the following: the formally employed person is a participant of the accumulative pension scheme, under his/her name, funds are transferred into his/her individual pension account, but in reality, because of objective reasons, he fails to fulfill his obligation to the law; So his/her income will not be reduced and until his/her retirement age, he/she may not even realize that he/she has been a participant in the accumulative pension scheme for years.

The above described transformation of the reform contradicts all the fundamental ideas, laying the foundation for the creation of a new pension system. This is also the case which is inappropriate for legal arrangements causing establishment of the so-called a shadow tax, naturally resulted by the economic environment of the country.

The fact is that the emergence of this shadow tax is more beneficial for employers in the small business sector than for the enforcement of directives required by law. It is clear that in the economy there have always been internal flows beyond the framework of the law, which was characterized by various degrees of gravity; But at this point there is arising a legitimate question: what is the role of the state which is a regulator and defender of the rule of law in these processes?!

In this particular case, actually there is no connection with the legal misconduct, but it does not mean that the above mentioned fact does not require a response. The fact is that there is an imperfect enforcement of the law, though it has motivation of caring for the welfare of employees.

Therefore, the state expresses signs of apathy towards the issue, where the main focus is on the result and not on the process. This fact raises reasonable doubts about the promotion of the above-mentioned shadow tax, caused by ignorance of economic situation in the country or its improper study.

### **III. CONCLUSION**

In the small business sector the low rate of wages of employees is the reason for the above mentioned problem. In order to overcome this challenge effectively, we think that Georgian legislative and executive authorities should implement the following changes:

1. In order to support low-income employees, under the pretext of easing the burden of membership of accumulative pension scheme, there must be implemented the principle of non-taxable income for individuals in the tax system of Georgia.

In order to ensure the effective implementation of the above-mentioned recommendation, it is advisable to use the methodology of Estonian non-taxable income in as a guide for the tax system of Georgia;

Or

2. There must be determined the lower limit of the employee's salary; Employers (participating in the accumulative pension scheme) of employees, who have lower limit of the employee's salary, should be instructed to transfer the appropriate amount of 4% of the employee's taxable salary from his/her own income into the employee's personal income account.

Based on the implementation of the above mentioned alternative, an employee with a lower salary will be exempted from the obligation to make contributions to the accumulative pension scheme.

In addition to the second alternative, if desired, the law should not restrict the employer's right to transfer the contribution from his/her own income into employee's individual pension account. In case if he/she wishes to exercise this right, the employer must notify the Pension Agency by an official letter; The employer must indicate the identification data of the employee (s) in whose favor he / she is exercising his / her right. In addition, as a result of the implementation of the 2nd alternative, it will be possible to accumulate information about those fields, where due to low wages accumulated in the pension scheme, the employer has to pay the corresponding amount of 4% of the employee's salary;

In addition, based on the analysis of the accumulated information, in order to increase the efficiency of the accumulative pension scheme, it will be possible to actualize the issue of establishing benefits for the employer working in the identified field.

It is important that the employers' initiative to establish benefits of any content related to the growth of their disposable income, must be based on the obligation aiming to increase wages for employed individuals by a specific percentage. This process aims to raise standard of living in the low-income segment of the Georgian population.

We consider that successful implementation of the practice determining the lower limit for the pension system, will increase probability of successful distribution in the labor market. The above mentioned factors will facilitate both the refinement of the pension system and the compliance of the Labor Code with European standards.

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