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“Strengthening the Legal Framework for Citizen Action through Freedom of Association” Project

Georgian Not for Profit Legislation Challenges and Perspectives

White Paper

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I. NOT FOR PROFIT LEGISLATION OF GEORGIA

1.1.GENERAL OVERVIEW OF LEGISLATION

In the opinion of majority of experts, legislative framework of not for profit organizations in Georgia by 2007 is quite liberal and substantially does not hinder the creation and operation of civil society organizations (CSOs). However, there are significant problems from the development perspective. From this standpoint, current legislation still is not in full compliance with international standards and best established practice.

Main legislative framework that regulates CSO activities consists of the Constitution of Georgia, Civil Code of Georgia adopted in 1997 (with substantial amendments to it in 2006), the Tax Code of Georgia adopted in 2004, and the Law of Georgia on Grants adopted in 1996.¹

- Constitution of Georgia introduces the fundamental right of freedom of association. The Constitution secures an individual's right to establish and become a member of public union², including labor unions. Suspension and prohibition of the activities of public union's is allowed only under the court decisions as prescribed by the organic law;
- Organic Law on Suspension and Prohibition of Activities of public unions regulates issues related to the suspension and prohibition of activities of such organizations;
- The Civil Code defines organizational legal form and registration procedures of CSOs. Registration aspects of several types of CSOs are regulated under special laws;
- The Law on Grants regulates legal foundations of issuing and receiving a main funding source of CSOs - a grant;
- The Law on the State Support of the Children and Adolescent Organizations singles out the children and adolescent organizations, provides relevant definitions, and sets up a registry of such unions for the state support purposes;
- Independent laws govern the labor unions and the Red Cross Society;
- The Law on the Sports regulates the creation and operation of the sport federations;

¹ Due to the fact that CSOs are not limited in carrying out the type of activities (including the entrepreneurial activities), other legislative pieces of Georgia are applied to them as well. For instance, if CSOs carry out operations subject to licensing, then the licensing legislation is applied with respect to them as well.

² Describing the laws we use terminology defined by them . We use term "CSO" in its generally accepted definition.

- The Law on Creative Personnel and Creative Associations governs the rules of creation and operation of the creative associations;
- The Tax Code defines the taxation mechanisms for activities carried out by the CSOs, as well as issues related to granting the status of a charity organization;
- The Law on Registration Fees defines the amount of state registration fees for the CSOs;
- The Customs Code, the Law on Customs Fees, and respective subordinate legal acts define the customs procedures for goods purchased abroad and the taxation mechanisms;
- The General Administrative Code defines mechanisms for entering into relations with the administrative agencies. It is a significant tool for CSOs in the process of carrying out monitoring-type of activities;
- The Law on State Procurements defines legal, organizational, and economic principles of administering procurements and enables CSOs to participate in the state procurements;
- The Law on the Fees for Notarial Acts defines the fee amount and payments rules for notarial certification of founding documentation, as well as for other notarial activities.

1.2. REGISTRATION, OPERATION, SUSPENSION, AND REVOCATION OF CSOs

The Civil Code of Georgia is a core basis for the creation, registration, and operation of CSOs.³ In 2006, the changes and amendments to the Code substantially altered registration and managerial regulations. Pursuant to the Civil Code currently in effect, legal entities that carry out not for profit activities, are called non-entrepreneurial (non-commercial)⁴ legal entities. Such legal persons are not any more divided into unions and foundations, like prior to changes. However, non-entrepreneurial legal persons may be member-based, dependent on or independent from the members' status. It has to be noted that the changes did not affected clauses about non-registered unions. The code allows establishment of this type of association, which is not legal person. The leaders of non-registered union bear its liabilities.

Non-entrepreneurial legal persons are not the profit-oriented organizations and carry out non-entrepreneurial activities. Nevertheless, it should be noted that they have the right to carry out supplementary entrepreneurial activities, the profits from which should serve the realization of purposes of a non-entrepreneurial entity. Distribution of proceeds gained from

³ Establishment and registration of several types of CSOs are governed under special laws.

⁴ The language of the code - this two terms are always used together.

such activities among the founders, members, donators, as well as the management is prohibited.

Non-entrepreneurial legal entity may establish a branch (representation), which does not represent an independent legal person, but is a separate unit out of the legal person's residence, carrying representative authority, and thus representing (fully or partially) a legal person and carrying out its functions.

Registration of a non-entrepreneurial legal entity is preceded by the adoption of a decision to establish such an entity. Existence of a founder is crucial for establishing a non-entrepreneurial legal entity. A physical person, as well as a legal entity may be a founder. At that, pursuant to the Civil Code currently in effect, only one person may establish a non-entrepreneurial legal entity as well.

The Tax Inspection carries out the registration of a non-entrepreneurial legal entity according to the location of this legal entity (instead of the court and Ministry of Justice, as it was previously regulated). Registration in itself comprises both the civil and tax registrations, i.e. civil and tax registrations take place when registering a non-entrepreneurial legal entity. Registration requires a submission of a notarially certified special registration application and a number of other documentation. Within 3 working days after receiving a registration application and the attached documents, the Tax Inspection makes a decision on registration or refusal to register. If registration does not take place during this period of time or the applicant was not notified about motivated refusal in writing, a non-entrepreneurial legal person shall be deemed registered. Respectively, the Tax Inspection will be obliged to grant an entity the identification number and issue a registration certificate.

If legal grounds for rejecting a registration exist, the Tax Inspection draws up a motivated decision on a refusal to register a non-entrepreneurial legal entity. Request for registration may be rejected, if:

- Objectives of a non-entrepreneurial legal entity to be registered contradict current legislation, recognized moral norms, or the constitutional-legal principles of Georgia.
- A non-entrepreneurial legal entity aims at bringing down the constitutional formation of Georgia or changing it through violence, encroaching on the independence of the country, infringing the territorial integrity of the state, or propagating the war, violence, or ethnic, regional, religious, or social hatred.
- Application on registration and the attached documents presented by a non-entrepreneurial legal entity contains a flaw that was not amended within a deadline given to correct the flaw.

A refusal on registration may be appealed against in the court.

The following registration fees are payable for a registration of a non-entrepreneurial legal entity and a registration of the changes as well:

- Registration of a non-entrepreneurial legal entity – 60 GEL.
- Registration of changes to a non-entrepreneurial legal entity – 25% of a payable fee, i.e. 15 GEL.
- Registration of a foreign non-entrepreneurial legal entity – 40 GEL.

A new version of the Civil Code was deprived of all articles that were governing the regulatory issues of CSOs. Under the new version, a non-entrepreneurial legal entity is authorized to regulate its own organization and structure by a charter, which is subject to notarial certification. However, an entity may not do so, because a charter is not a mandatory document any more.⁵

It is notable also that pursuant to the Code, a founder (member) of a non-entrepreneurial legal entity is authorized to grant one person a power to manage activities at his-her sole discretion, or to establish a joint leadership and representation of two or more than two persons.

A new version of the Code contains an interesting article, pursuant to which an alienation of property in the ownership of a non-entrepreneurial legal entity is possible, if such alienation serves the purposes of the entity's activities, its organizational development, promotes the fulfillment of its objectives, or serves the welfare (charitable) objectives.

A liquidation of a non-entrepreneurial legal entity takes place in instances prescribed under its charter, after achieving its purpose, based on a judgment of conviction on a criminal case entered into legal effect, during bankruptcy, or as a result of cancelling the registration. As a rule, leaders of an entity are appointed as liquidators of a non-entrepreneurial legal entity. In special circumstances, based on a motion of the Tax Inspection, liquidation process is carried out by the liquidators appointed by the court.

Pursuant to a general rule, founding members determine the persons authorized to receive assets remaining after the liquidation of a non-entrepreneurial legal entity. If no latter exist, the court orders to transfer the assets remaining after the liquidation to one or several non-entrepreneurial legal entities, which serve the same or similar purpose as the liquidated entity. If no such non-entrepreneurial legal entities exist or it is impossible to identify them, then a decision on transfer of assets to the state can be made.

As to the state control of operations of a non-entrepreneurial legal entity, it is limited to the suspension or prohibition of operations of such an entity through a decision rendered by the

⁵ National sport federations, organizations carrying out managerial functions on a collective basis of property rights, or the labor unions are an exception, registration of which requires a charter.

court in the cases prescribed by and according to established rules under the organic law of Georgia. Pursuant to this law, the court is authorized to suspend operations of a public association for up to 3 months, if such operations have gained substantial entrepreneurial nature. The court may also prohibit the operation of a public association that aims at bringing down the constitutional formation of Georgia or changing it through violence, encroaching on the independence of the country, infringing the territorial integrity of the state, or propagating the war, violence, or ethnic, regional, religious, or social hatred, which establishes or has already established armed formation, or which resumes carrying out entrepreneurial activities after its suspension by the court.

1.3. LEGAL REGULATION OF INCOMES RECEIVED THROUGH GRANTS

The Law on the Grants provides a definition of a grant, defines the issuer and recipient of grants, and governs relations between them. This Law practically sets up a legal basis for a special regime of taxation of incomes received through grants. Logically, these norms have to be incorporated in the Tax Code. Writing up an independent law was triggered by the historic developments. In 1996, when this Law was adopted, tax benefits were imposed through independent laws and might have not been included in the Tax Code. Later, when the first Tax Code was elaborated, grant-related benefits were moved to the Code, while other regulations retained independent standing. In order to avoid political threats, we opted for preserving the Law as is.

The Law defines a grant as monetary or natural means transferred free of charge to grant recipient by the donor, used for implementing specific humanitarian, educational, scientific-research, health care, cultural, sports, ecological, and social projects, as well as the state or public programs. Grants are not given for achieving entrepreneurial or political objectives.

The Law extremely carefully defines a grant issuer and recipient, as well as relations between them, in order to avoid the abuse of imposed tax benefits. The donor and grant recipient conclude a written agreement, which should indicate the purpose of a grant, amount, specific directions of utilization of the received means, deadlines of utilization, and the major requirements that the donor imposes on a recipient. One of the features of a grant is its target orientation, i.e. grants are issued to achieve specific purposes benefiting the public. At that, target of the grant may be changed with the donor's consent and the grant be used for different purposes.

1.4. TAXATION

Existence of a non-entrepreneurial legal entity does not automatically imply the exemption from any taxes. Exemption of non-entrepreneurial legal entities from certain types of taxes is linked to the operations conducted by the entity and the sources of income. If non-

entrepreneurial legal entities carry out economic activities, they fall in general tax environment and incomes received through such activities are subject to general rules of taxation. If the incomes of a non-entrepreneurial legal entity consist of incomes not received through economic activities (e.g. grant, donation, membership fees), such incomes are subject to exemption from certain types taxes.

1.4.1 BENEFITS ON INCOMES RECEIVED THROUGH GRANTS

- **Profit Tax**

Grants received by non-entrepreneurial legal persons are exempt from the profit tax.

- **Social Tax**

Reimbursements paid out of the grant funds by non-entrepreneurial legal persons are exempt from the social tax⁶.

- **Value Added Tax (VAT)**

Import of goods by the grant issuer or recipient within the scope of grant agreements is exempt from the VAT tax. Further, a grant recipient, which purchases goods under the grant agreement conditions and pursuant to the Law of Georgia on Grants, and/or receives services on the same grounds, has the right to reimburse VAT paid for these goods or services or offset it with other taxes, based on presenting the tax invoice to the tax agency or paying according to the rules established by the Minister of Finance of Georgia (document certifying the VAT payment). Registration or return of VAT takes place only if an application is filed with the tax agency within 3 months from carrying out the taxable operation.

- **Income Tax**

Grants received by physical persons are exempt from the income tax.

1.4.2 BENEFITS ON DONATIONS AND MEMBERSHIP FEES

Donations and membership fees received by an organization are exempt from the profit tax.

1.4.3 BENEFITS ON PROPERTY TAX

Non-entrepreneurial legal entities are exempt from paying the property tax, except for the land and property used for economic activities. In other words, non-entrepreneurial legal entities pay a property tax only on:

- Land in its ownership, as well as the land in state ownership being in use or factual possession as prescribed under the law.

⁶ See sub chapter 1.5 of this paper for expected changes.

- Property (fixed assets registered on its balance, uninstalled equipment, unfinished construction, and intangible assets) used for economic activities.

1.4.4 BENEFITS ON CUSTOMS TAXES AND FEES

Pursuant to the rules established by the President of Georgia, import of goods under the grant agreement is exempt from the customs taxes and fees.

1.4.5 STATUS OF CHARITY ORGANIZATIONS AND MECHANISMS FOR STIMULATING CHARITY ACTIVITIES

The Tax Code incorporates one of the important mechanisms stimulating charity activities. Namely, pursuant to Article 186 of the Tax Code, amounts donated to charity organizations by business entities are deducted from the total incomes of an business entity up to 8% of its annual taxable income. This benefit is in effect since 1 January 2005.

It should be noted here as well that use of this benefit is related to granting a charity status to an organization, which requires going through relevant procedures and undertaking additional duties and responsibilities. For an organization to receive a charity organization status, the following requirements should be met:

- It should be created for carrying out charity activities;
- It should be duly registered under the law;
- It should have at least one year experience of conducting charity activities.

Pursuant to the Tax Code of Georgia, charity activity is an activity aimed at assisting persons in need of assistance directly or through the third persons, voluntarily and free of charge. Following this general definition, the Code lists specific instances of charity activities. For example, assisting persons in need of social protection and adaptation and medical assistance, as well as vulnerable physical persons including the disabled, elderly, orphans, persons left without a bread-winner, refugees, internally displaced persons (IDPs), patients, families with many children and their members, victims of wars, armed conflicts, accidents, natural disasters, catastrophes, epidemics, and/or epizootics; organizations caring after or serving the children, elderly, and disabled, including children's houses, boarding schools, pre-school and other children institutions, houses for the elderly, free dining rooms, medical institutions, rehabilitation centers, etc. is considered a charity activity.

The Code also qualifies as charity activities any undertakings of an organization for public benefit in the fields such as human rights protection, environmental protection, democracy

and civil society development, culture, education, science, arts, physical training sports, health care, and social protection.

A charity organization status is granted by the Tax Inspection according to the organization's location (tax registration). The Tax Inspection is obliged to make a decision on granting or rejecting the charity organization status within 1 month after filing an application. If no decision is made within this period, the status will be deemed as granted.

Besides receiving the status of a charity organization, an entity is undertaking a number of additional duties, in particular:

1. A charity organization has to provide a relevant tax agency with:
 - Program activity report for the last year, including the description of activities (economic among others);
 - Financial report on received incomes, with indication of sources and relevant expenditures;
 - Financial documentation for last year certified by an independent auditor.
2. A charity organization should ensure the publication of program activity report and financial documentation for the last year (balance and profit/loss report) in the periodic press and its availability for all interested parties.

The Tax Code of Georgia in addition provides instances when a charity organization status is revoked. Namely:

- On the initiative of an organization.
- By deprivation of a status. A charity organization status is deprived, if an organization violates the requirements of the Tax Code of Georgia or the civil (state) registration is cancelled.

A charity organization status is deprived by the Minister of Finances based on the motion of relevant tax inspection, by issuing an individual-legal act. An individual-legal act of the Minister of Finances may be appealed against in the court within 1 month after its receipt by the organization. Organization that is deprived of a charity organization status has the right to file an application on restoring the status not earlier than one year after uprooting the reason for deprivation.

1.5 CURRENT INITIATIVES CONCERNING NOT FOR PROFIT ORGANIZATIONS

In may 2007, on the initiative of the Government of Georgia a draft bill was introduced in the Parliament on changes and amendments to the Tax Code. Draft bill intends to abolish the

social tax and to increase the income tax of physical persons from 12 to 25 per cent. As the explanatory note to the draft bill states, "further liberalization of direct taxes, i.e. reduction of rates on salary and income taxes", which "by its nature, i.e. from the taxation object perspective are often identical to each other" (??), is aimed at maintaining the high speed of economic growth through the increase of competitive abilities of local production goods, reduction of production costs, and re-investing.

Proposed amendment significantly alters the status of not for profit entities on a labor market. These organizations are not social tax payers. Unlike businesses, they do not possess free means and therefore the increase of an income tax places them in unequal position compared to the business, thus creating a danger of losing the qualified staff.

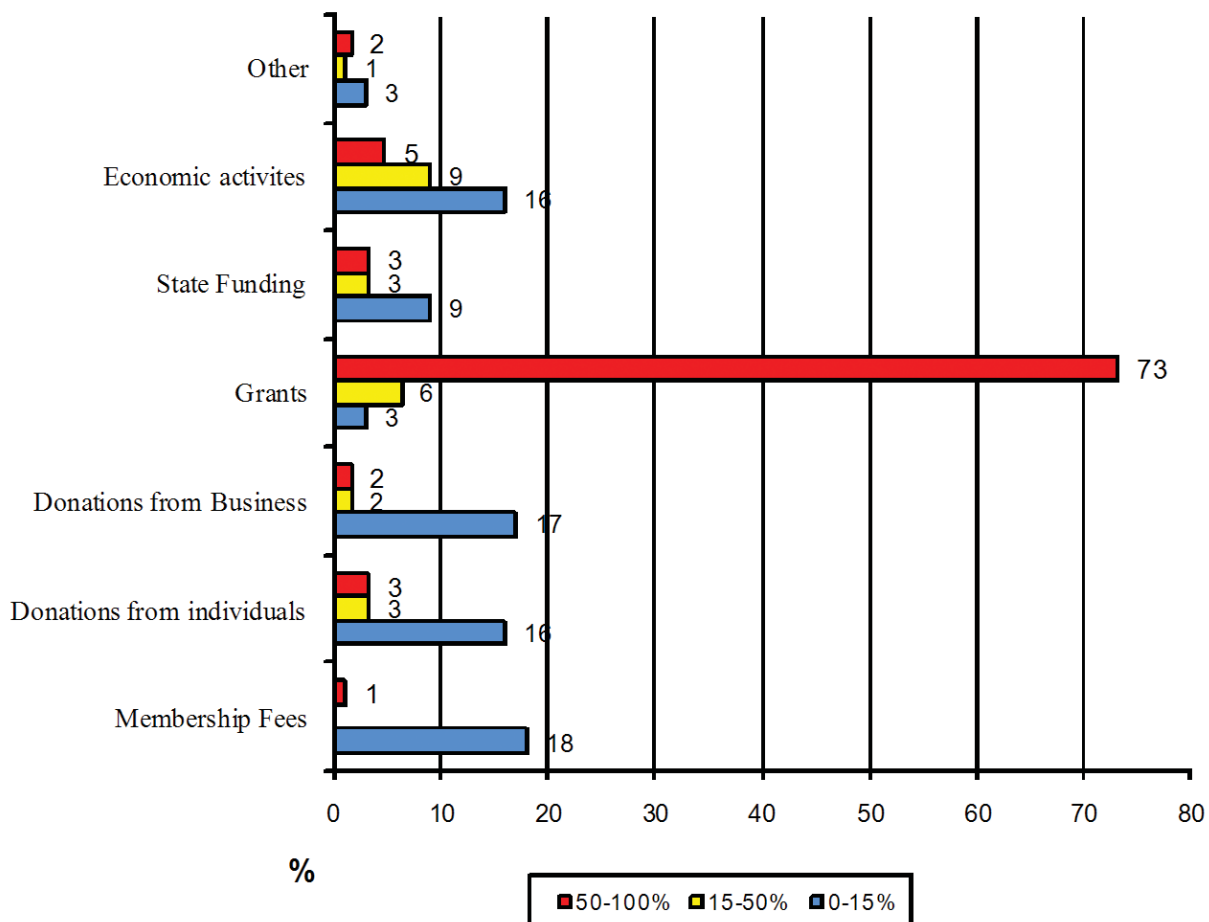
Although the draft bill foresees 3 year moratorium with respect to such organizations (i.e. their employees will retain a 12% tax), this remains to be a temporary benefit.

II. PRIORITY TRENDS OF NOT FOR PROFIT LEGISLATIVE DEVELOPMENT

2.1. LEGISLATIVE CHALLENGES

As already noted in part one of this study, Georgian not for profit legislation requires further improvement in order for it to comply with international standards and best established practices. We can identify four major issues that in our opinion are most problematic at the current development stage. Three out of these four issues concern the financial stability and sustainability of CSOs. Unfortunately, Georgian organizations still are greatly dependant on the funding from foreign donors. Empirical observations show that 95% of their incomes is generated from this type of funding. The national survey conducted in 2005 demonstrated that the grants constitute from 50 to 100 per cent of incomes of 73% of CSOs (Chart 1).⁷

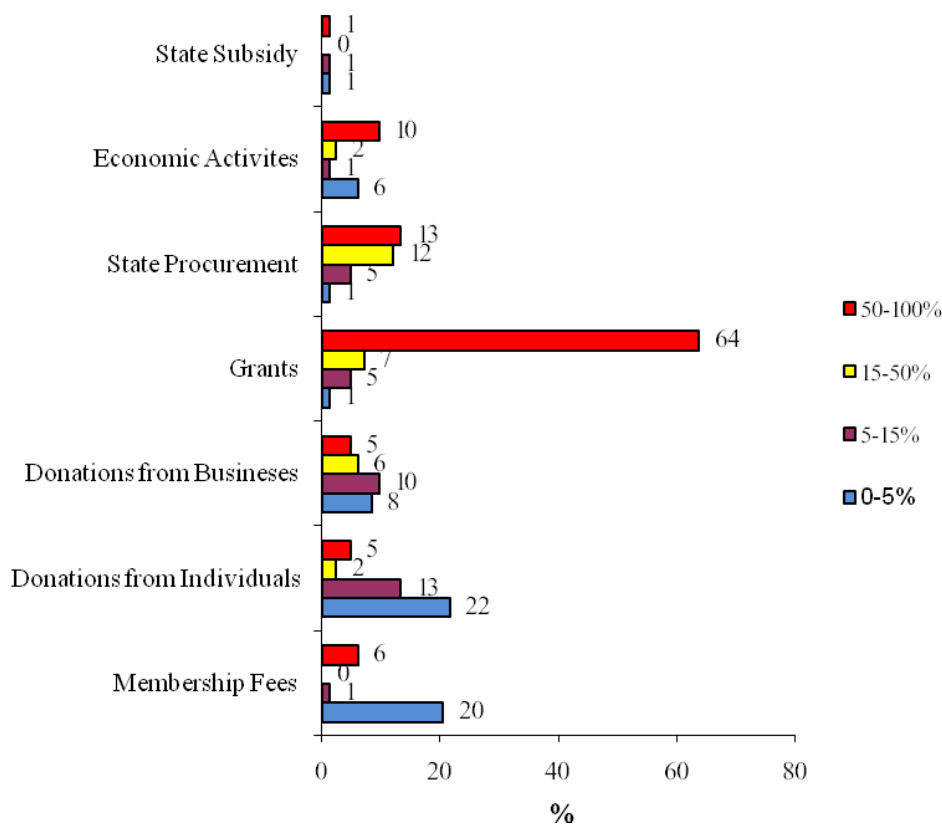
Chart 1. Share of funding sources of CSOs in the total budget



⁷ National Survey of CSOs, Tbilisi, Georgia, 2005.

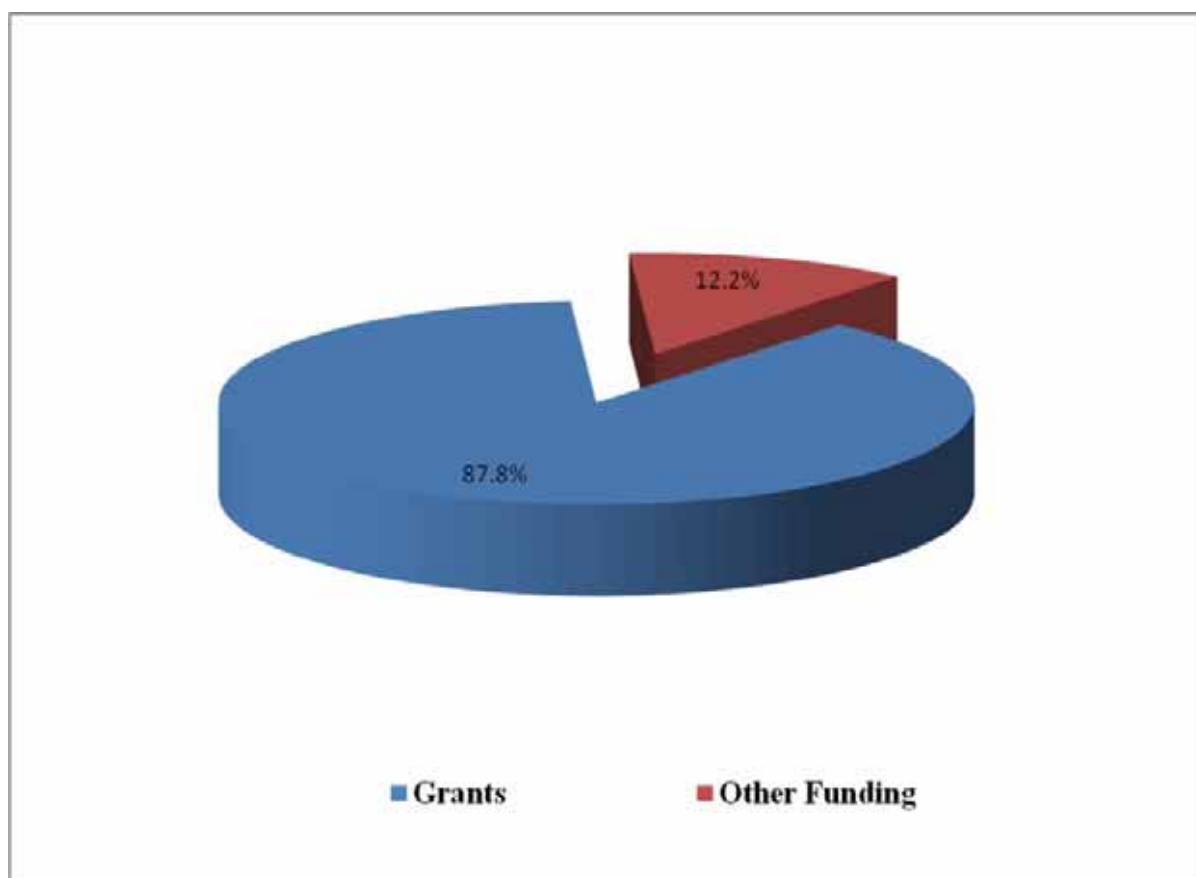
The national survey conducted by our organization in 2007 demonstrated that even in the welfare organizations, incomes of which are diversified the most, grants constitute from 50 to 100 per cent of incomes of 64% of organizations (Chart 2). The same survey showed that a share of foreign donors in the gross incomes of welfare organizations is 87,8% (Chart 3).⁸ Thus, the mobilization of local resources and promotion of adequate legal environment is crucial for the Georgian organizations.

Chart 2. Share of funding sources of welfare organizations in the total budget in 2005-2006



⁸ National survey of Welfare Organizations, Civil Society Institute, Tbilisi, Georgia, 2007.

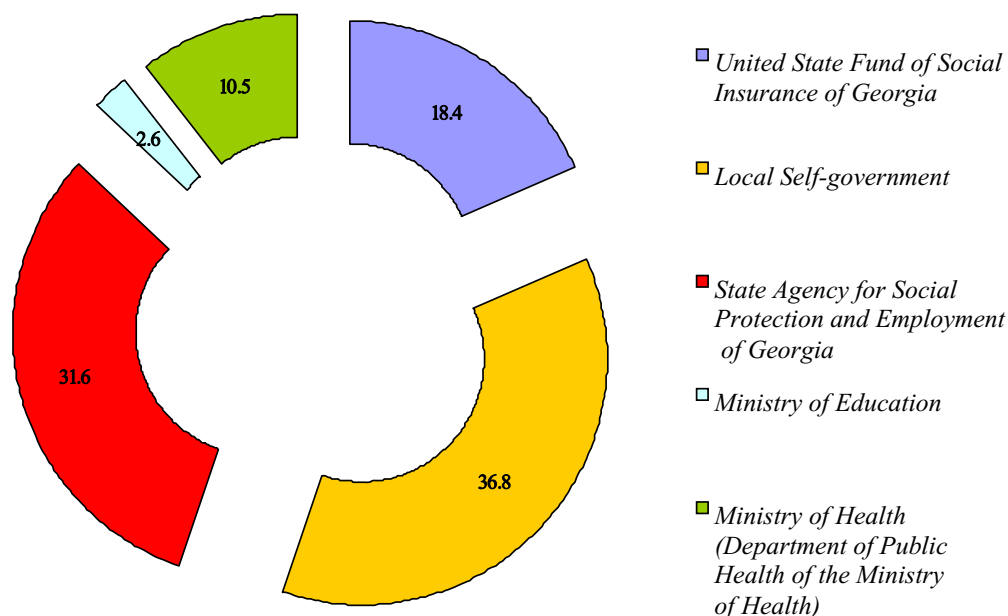
Chart 3. Funding structure of welfare organizations



2.1.1 STATE FUNDING OF CSOs

In many countries over the world the state represents one of the chief sources of incomes of CSOs. In Georgia, the state share in funding the CSOs is miserable. The studies demonstrate that even in welfare organizations, whose services are vital for the state, the state share in funding is very low. Only 3 out of the interviewed 101 organizations mention the state subsidies and only 13 organizations have received more or less tangible incomes through the state procurements (Chart 2). However, it should be noted that the process is commenced and further developments are expected. Chart 4 demonstrates major state agencies that subsidize welfare organizations and procure services from them.

Chart 4. Allocation of projects implemented by welfare organizations through state funding with respect to state structures



Nonetheless, interviewed organizations believe that effective mechanisms of relations between the state and CSOs are still underway in Georgia. The state still does not trust service providers, on one hand due to an adverse effect in previous years of tax benefits of organizations oriented on social care for the state;⁹ on the other hand, the state is not fully aware of the effectiveness of outsourcing, and has not designed an effective mechanism governing the relations between the state and CSOs. Therefore, an increase of state funding share in the financial incomes of CSOs is an important reserve, whereas a selection of effective funding model is a precursor to the success of this idea.

⁹ State officials would enter into corrupt deals with the management of organization and huge amounts of money would be misappropriated.

The world practice is familiar with several alternative models of state funding of CSOs: direct subsidies, so-called "one per cent model", state grants, state procurements¹⁰, as well as the so-called voucher model.

In light of the Georgian reality, following alternatives should be of interest:

- One per cent model;
- State procurements;
- State grants and subsidies.

❖ One Per Cent Model

The "one per cent model" incorporates many aspects and can be considered from various perspectives. With the opinions of Nilda Bullain¹¹ and Fishman and Schwarz¹² in mind, we view the one per cent model in light of this study as an indirect mechanism of funding the CSOs by the state, as in this model the state gives up a certain portion of budget receipts for the benefit of CSOs.

After Hungary adopted a law, pursuant to which tax payers had the right to give up one per cent of income tax for the benefit of funding the CSOs, this model has become a subject of discussion in many countries. Georgia was not an exception. However, this idea was not firmly supported either by the state authorities or the civil society. The issue never was on a political agenda and there were no serious attempts to elaborate any legislative initiatives adapted to the country. Currently situation is the same. Discussed below are the policy rationales applied in the world practice¹³ when examining this issue and the major arguments that make us deem the introduction at this stage of one per cent model in Georgia as unreasonable.

Taxation Self-determination

Individual tax paying culture of physical persons is very low in Georgia, because under the legislation in effect the employer deducts the tax from employees salary and pays it to the budget. There are very few examples when a physical person (except for an individual

¹⁰ Юридические механизмы государственного финансирования некоммерческих организаций, ICNL(2002), page 11.

¹¹ Nilda Bullain: *Percentage Philanthropy and Law* (2007); available at www.icnl.org, page 11.

¹² Fishman and Schwarz: *Non-profit Organizations: Cases and Materials, Second Edition, 2000*, page 332.

¹³ Nilda Bullain: *Percentage Philanthropy and Law* (2007); available at www.icnl.org, pages 14-16.

entrepreneur) has to register as a tax payer and have relations with the tax agencies. Therefore, many tax payers are aware of their net salaries and ignore a portion of salary that goes to the budget as a tax. For that reason, big efforts are required to make the one per cent model work, for the tax payer to familiarize with this seemingly simple mechanism and to have a desire to use a granted right. In our opinion, costs for popularizing the model will significantly prevail over the gained benefit.

Civil Society Development

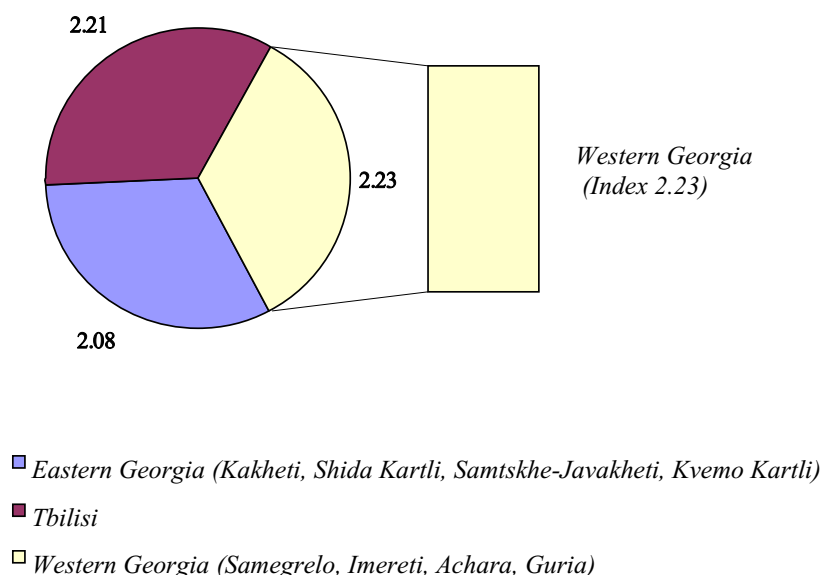
As a rule, three aspects are discussed in this respect:

(a) Providing new resources to the CSOs; as the world practice demonstrates, a volume of funding received by CSOs under this model is rather small and does not live up to expectations existing at an initial stage. For instance, even in Hungary, where this model was introduced for the first time, an average annual income of CSOs from this source does not even constitute 1% of their incomes.¹⁴ According to our prognosis, this indicator in Georgia will be even lower. It can reach a level of European indicators only after substantial improvement of tax administration and culture.

(b) Increasing the skills of CSOs in communication and community outreach; it is obvious that an introduction of this model will stimulate CSOs to have better contacts with the public. Nevertheless, this is a quite expensive delight for our reality. Currently contacts between the organizations and the public are rather weak. As a result of studies conducted by us, “integration in society” index falls within a 2.08-2.23 range in a 4-mark system according to the regions of a country (Chart 5).

¹⁴ Nilda Bullain: *Percentage Philanthropy and Law* (2007); available at www.icnl.org, page 15.

Chart 5. "Integration in Civil Society" index of regional and Tbilisi-based organizations



As a rule, awareness about organizations is limited to a narrow circle of beneficiaries these organizations serve. Only a very limited circle of organizations is known to the general public (approximately 5-10 organizations, mainly watchdogs), which are actively involved in the political processes and therefore their representatives are well recognized. Based on a current situation, these very organizations will become chief beneficiaries of one per cent model, resulting in apparently unequal distribution of the amounts. Welfare organizations, financial sustainability of which is a main target of this model, will end up in a rather disadvantageous position. Level of awareness among public about these organizations is quite low currently, while serious financial and human resources are required to raise this level. This type of organizations lacks such resources.

(c) Raising awareness about CSOs; based on the abovementioned, we believe the one per cent model in Georgia will not substantially raise the level of awareness about CSOs.

Development of a Philanthropic Culture

An impact of one per cent model on the development of philanthropic culture in the country will not be so strong. In Georgia, just as in other post-communist countries, specific forms of individual philanthropy are established. Giving up a portion of an income tax as a donation to CSOs, as already mentioned above, is extraneous for our reality and rather hard to implement. Viewing this model as a means for impact on philanthropic culture is a rather weak argument in favor of the model.

Administration

A degree of difficulty of administering the model in Georgian reality is one of its strongest anti-arguments. Georgian tax administration is still in the formation process. Three years after the revolution were not enough for the establishment of a well-functioning and effective system. This system has many flaws that obviously are not discussed here, but we would like to mention that ensuring the administration of one per cent model under this system is practically impossible. Imposing additional tax obligation on an employer is problematic as well (tax administration of transferring a portion of an income tax of employees to certain organizations).¹⁵

Political Feasibility

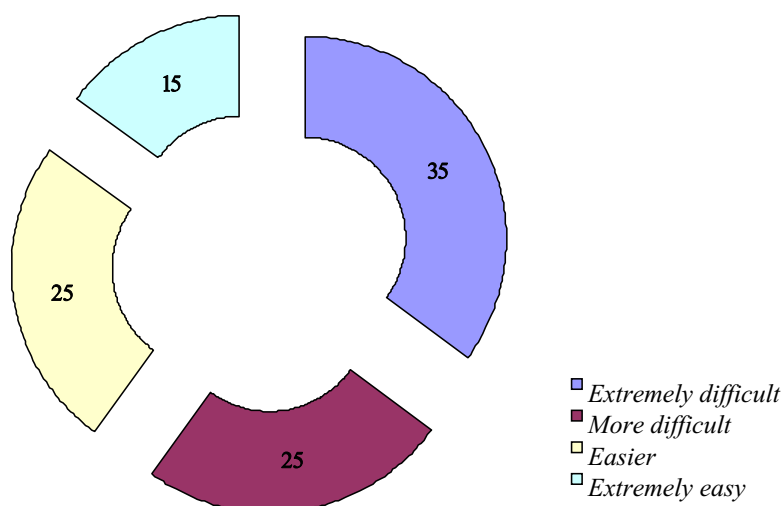
Political feasibility is another argument against introducing the model. This issue was never seriously raised among the politicians. Based on existing ultra-liberal, business-oriented political attitudes, we believe it will be difficult to gain required political support for this idea and subsequently lobby it successfully.

❖ State Procurements

Procurement of goods and services (including social services) by the state is carried out based on the Law of Georgia on State Procurements. This Law allows non-commercial organizations to participate in the procurement process. However, it should be noted that the Law is less fit to the specifics of this type of organizations. A majority of welfare organizations interviewed by us believes that the procurement process is ineffective. Among the stated reasons were non-flexibility of the Law with respect to not for profit organizations, taxation regime they fall in due to the involvement in procurements, difficulty of preparing the tender documentation, flawed tender procedures. 25.4% of the interviewed organizations have participated in the state procurement procedures. 60% of organizations believe this process was associated with obstacles (Chart 6).

¹⁵ As mentioned above, under the Georgian legislation an employer is obliged to deduct and transfer an income tax.

Chart 6. Evaluation of state procurement procedures



Despite all the above mentioned, we think revising the Law on State Procurements to a certain degree can be an alternative that might ensure the creation of effective mechanism of state funding of CSOs. In the first place, due to ultra-liberal political attitudes existing in Georgia, a possibility of lobbying such amendments equals practically to zero and any resources spent in this respect will be futile. In the second place, fitting the Law to not for profit organizations requires its substantial revision, leading potentially to a negative impact on business organizations, unfair competition, and the distortion of a market. Solutions should be sought in other models. As for the Law on State Procurements, it should be viewed as one of the means of not for profit organizations for participating in state procurements under equal conditions with business organizations.

❖ State Grants and Subsidies

Under the Georgian legislation in effect, the state, its agencies, and self-governance bodies do not have the right to issue grants, whereas all over the world, state funding occupies a second place (after self-generated incomes) in the formation of CSOs' incomes.¹⁶ Direct budgetary

¹⁶ David Moore: *Laws and other Mechanisms for Promoting NGO Financial Sustainability*, (2007), available at www.icnl.org, page 4.

subsidies, grants for special projects, and the service contracts are models of direct state funding. Direct budgetary subsidies and grants are of interest for our purposes.

Background

Due to the joint efforts of the Civil Society Institute and ICNL, working on the draft Law on Grants in Georgia began back in 2001. Working on the Law lasted until the summer of 2005. During this period of time, 5 different versions of the draft Law were elaborated in line with changing political environment. Active cooperation with the authorities has taken place. Several times we almost reached a final goal. In 2005, the Georgian cabinet of ministers examined a draft law, approved it, and decided to introduce it to the Parliament. Unfortunately, political changes that occurred later left the draft Law in the shade and then suspended its consideration entirely. We were obliged to postpone the issue to a politically adequate period of time.

Need in State Funding

A need for replacing international funding by a local funding became an especially acute problem for Georgian organizations since 2006, when a number of donors made first statements about phase-out from Georgia. Situation is especially grave for welfare organizations, which serve the most vulnerable beneficiaries for who the financial stability of service providing organizations is, without exaggeration, a matter of life and death. As our study demonstrates, a quarter of interviewed welfare organizations practically did not have any funding in 2006, and a budget of a small portion (13.6%) of organizations did not exceed 10,000 GEL per annum. Annual budget of funded organizations was mostly within the 10,000-50,000 GEL range. Although, there are organizations able to receive funding for full-fledge activities. Funding of more than fifth of organizations (23.5%) is more than 100,000 GEL (Chart 7). As for the cuts in funding, a majority of organizations periodically has to operate without funding. Only a third of organizations (34%) did not have any cuts in funding for the last three years (Chart 8).

Chart 7. Annual budgets of organizations in GEL for 2006

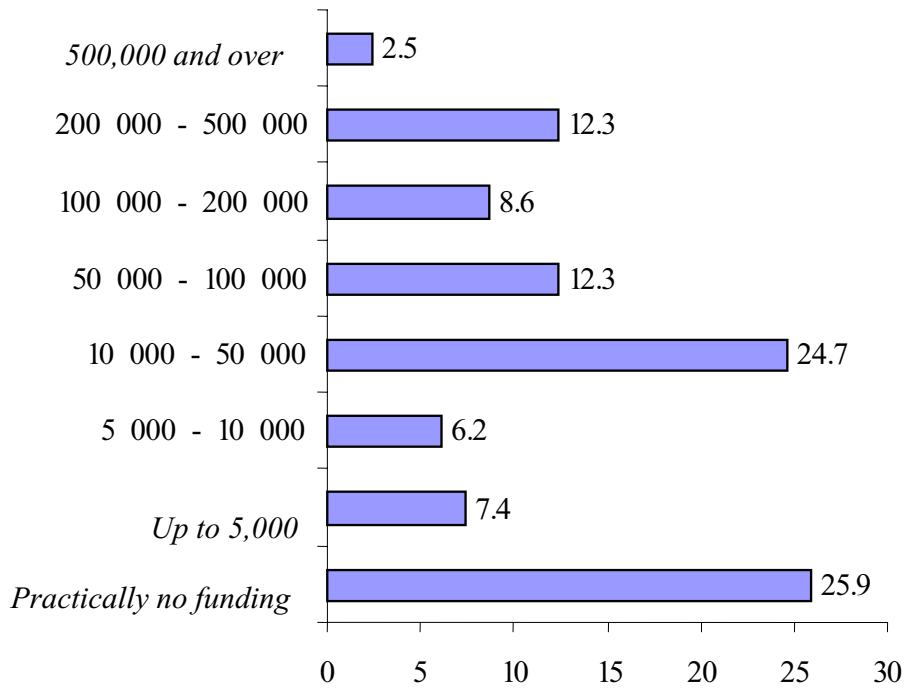
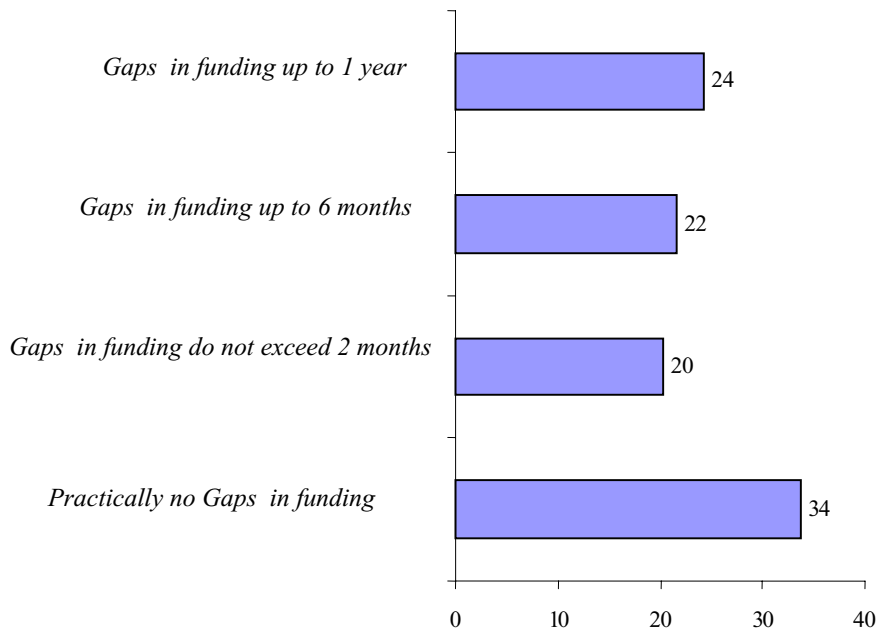


Chart 8. Gaps in funding



With respect to state funding, we put special emphasis on welfare organizations, since this type of organizations are major providers of social services to the state and therefore a selection of effective state funding alternative and its legal provision are as important for them - service providers, as well as the state in need of effective and efficient service providers. The issue has become of concern especially after the process of deinstitutionalization has commenced in accordance with the EU standards.

Notably, state demand on other types of services has increased lately also. In particular, on development of different policies, various types of trainings, provision of expert services, etc.

Concept of the Model

Obviously, this study does not aim at processing in details the alternative to state funding policy, but we believe it is important to convey our view of the model. We think a framework law on state grants and subsidies should be drafted. The law should be built on several key principles. Specifically, it should:

- Define the state/self-governance bodies issuing the grants/subsidies and the types of recipient organizations (organizations with a welfare organization status);
- Define the spheres and types of activities/organizations eligible for receiving the grant/subsidy;
- Establish fair contest as a mechanism for issuing grants/subsidies;
- Determine framework conditions and mechanism for holding the contests;
- Grant a high level of independence to the issuing agencies in determining specific conditions and criteria for issuing the grants/subsidies by their own legal acts;
- Establish effective monitoring and control mechanisms for using the grants/subsidies and ensure purposeful and effective use of the issues amounts.

Assessing Political Feasibility

As already noted, a process of deinstitutionalization is underway in the country, which by its nature requires the outsourcing of social services. A number of state agencies have now a demand for receiving certain services from CSOs. However, the effective outsourcing policy is not yet developed, when a need for such a policy becomes crucial on a daily basis. In current situation, we think it is really possible to obtain necessary support among the authorities and politicians and to place the issue on a political agenda. Preliminary meetings and discussions around this topic provide a serious ground for saying the above. It should be taken into consideration as well that there are individuals among the authorities, who had been involved in elaboration of old draft laws on state grants and obtaining their support

should be much easier. Based on all the above mentioned, we believe the prospects for lobbying and advocacy are quite high.

Tax Environment for State Funding

Adoption of the law on state grants/subsidies will automatically place the monetary means issued by the state in beneficial tax regime (refer to Section 1.4.1 of this study), which is one of the strongest arguments in favor of this model. Taxation grant regime will enable organizations to conduct operations in usual tax environment and utilize the funds to achieve main objectives to a maximum extent.

Easy and Flexible to Administrate

The model we propose, in comparison with other alternatives, is much easier from administering perspective. Each state agency will be able to define the effective and efficient mechanism of administering grants/subsidies within the legal framework established under the law.

Friendly to CSOs

Due to the fact that the model will entirely fit the specifics of CSOs, it will create a legal environment easy for the organizations to operate in. Unlike the mechanisms established under the law on procurements, this model will not set requirements impossible for CSOs to meet.

Improving State-CSO Cooperation

Finally, the proposed model will significantly promote and deepen the state-CSO cooperation. By setting the precedents of effective activities, mutually acceptable mechanisms will increase the trust between these two public actors and will further strengthen and broaden the cooperation.

2.1.2 CHARITY REGULATION

In 2004, the experts of the Civil Society Institute developed and subsequently lobbied the norms regulating charity activities and the right of the businesses to deduct on charity donations (in details refer to Section 1.4.4 of this study). Regulation entered into force since January 2005. According to the data of the Ministry of Finances of Georgia as of March 2007 (i.e. over a period of two years), 39 organizations were granted a status of a charity organization, 31 out of which, i.e. 80% operate in the capital. Through this channel, business

donations generated 3,000,000 GEL (approximately 1,800,000 GEL). These data and the national survey of charity organizations conducted by us provide grounds to make certain conclusions:

- A majority of organizations is not aware of existing benefits and is not registered as a charity organization. Out of 101 organizations interviewed, 50-100 per cent of incomes of 5 organizations constitute business donations, in 6 organizations - from 15 to 50 per cent, while in 10 organizations - from 5 to 15 per cent (Chart 2). Out of the interviewed organizations, only 9 are registered as charity organizations.
- A big portion of amounts through this channel has not been utilized for financing the welfare organizations, since only 9 organizations are registered as charity. It is even more doubtful that this money was used to fund other types of CSOs, because the 2005 national survey demonstrates that only 21 CSOs had such incomes, which constituted only 5-15% of gross budget for 17 organizations.

Abovementioned conclusions give raise to a number of questions, namely:

- Which factors have triggered over 2 years such a low number of registrations of charity organizations?¹⁷
- What are the charity donations used for?
- What has to be done in order for a volume of these donations to grow and be utilized for the development of public benefit organizations?
- Is the registration of charity organizations carried out correctly? Are there any obstacles?
- How well do the transparency and accountability mechanisms work?
- How well do the tax administration mechanisms of this regulation function?
- Are the improvement of legislative mechanisms or elaboration of additional subordinate regulations necessary?

2.1.3 AMENDMENTS TO THE CIVIL CODE

As already mentioned above, substantial amendments were made to the Civil Code in 2006. These amendments are liberal to a maximum extent, simplify the registration of CSOs, and governs the activities of CSOs to a least possible extent. A major problem linked to this issue lies in the fact that legal environment of CSOs has substantially changed over last 15 years for the third time. The first Law on Public Associations of Citizens was adopted in 1994. This was a transitional model characteristic to post-Soviet countries. In 1997 this Law was replaced by the regulations of the Civil Code, which were similar to European, and specifically German system. Current amedments enable us to approach the American model and reflect the liberal attitudes of current authorities. Obviously, each amendment seriously affected the CSO activities. They had to shift from one model to another and therefore needed serious

¹⁷ Approximately 20 organizations annually.

assistance from the lawyers. This is still a problem. Despite the fact that the model is very liberal and easy to fit to, it is yet unknown what results did it yield for the CSOs. Amendments to the Civil Code entered into legal effect in December 2006. By the end of this year, it is recommended to research what impact did the new regulations have on CSOs and how well do these regulations operate.

2.1.4 TAX BENEFITS ON ECONOMIC ACTIVITIES OF CSOS

As the world and especially Eastern European practice demonstrates, tax benefits on economic activities of CSOs is one of the most significant mechanisms for achieving financial stability of these organizations. During the past decade, this issue has not been discussed much. As noted above, Georgian organizations are not prohibited from carrying out economic activities. But in this case they are considered as commercial entities and are subject to current tax regime, which seriously distimulates them. At that, this problem is multi-faceted. In the first place, Georgian organizations seriously lack local resources and require additional means. Secondly, in most of the cases organizations' economic activities are small-scale and therefore establishment of an independent enterprise as a legal entity is not reasonable (as a rule, CSOs have neither knowledge, nor experience of managing business entities, as well as relevant resources). If an organization carries out economic activities without establishing an enterprise, it is very difficult to draw a boundary between various expenses and calculate the profit accordingly. Ascribing indirect expenses to entrepreneurial or non-entrepreneurial costs is extremely difficult, thus creating serious problems in relations with the tax agencies. Due to the latter fact, economic activities of CSOs are mostly underground.

This issue is widely discussed in Georgian public for a long time, but it has never been on a political agenda either before or after the revolution. Chief argument of the authorities both before and after the revolution (political feasibility of this issue was studied in the fall of 2004) is that these types of benefits could be abused for tax evasion purposes. Therefore, at this stage we do not find it reasonable to examine the tax benefit models on economic activities and draft relevant legal regulations. Nevertheless, it is necessary to conduct a feasibility study in order to identify the attitude of current authorities toward this issue.

III. RECOMENDATIONS

Based on our study and analysis we developed two sets of recommendations: general recommendations and policy specific recommendations for improving legal environment in the country.

3.1 GENERAL RECOMMENDATIONS

To improve general legal environment for CSOs and ensure proper enforcement of the legislation we recommend:

- Conducting wide awareness campaign to increase CSO credibility among general public;
- Educating media about CSOs, focusing on welfare organizations and organizations with charity status;
- Consulting and training of CSOs on legal compliance;
- Capacity building of organizations working on not for profit law in regions.

3.2 POLICY RELATED RECOMMENDATIONS

3.2.1. STATE FUNDING

To implement this policy option we recommend:

- Developing state outsourcing policy paper;
- Drafting law on state grants and subsidies;
- Conducting awareness campaign among CSOs;
- Conducting awareness campaign among Government and gaining political support;
- Mobilizing CSOs to bring the issue on political agenda;
- Lobbying for the draft law on state grants and subsidies;

3.2.2 CHARITY REGULATION

To improve charity regulation in Georgia we recommend:

- Designing and conducting study of the organizations having charity status;
- Designing and conducting study of the business benefiting from tax deduction for charity contribution;
- Designing and conducting study of the tax authorities charged with granting charity status;
- Based on the study drafting appropriate changes and amendments to the tax code if required;
- Conducting awareness campaign for CSOs, focusing on welfare organizations;
- Conducting trainings on charity regulations;

3.2.3 AMENDMENTS TO THE CIVIL CODE

To ensure CSO friendly legal environment for registration and operation we recommend:

- Designing and conducting nation-wide survey on new regulations introduced by the civil code;
- Based on the survey drafting appropriate changes and amendments to the civil code if required;
- Conducting awareness campaign for CSOs;
- Consulting CSOs on new regulations;
- Conducting trainings on new regulations.

3.2.4 TAX BENEFITS ON ECONOMIC ACTIVITIES OF CSOS

To ensure CSO friendly tax environment for economic activities we recommend:

- Conducting feasibility study on tax exemptions on economic activities of CSOs;
- Conducting targeted awareness campaigns for politicians;