ADB

Report and Recommendation of the President to the Board of Directors

Project Number: 48044-001
October 2014

Proposed Programmatic Approach and Policy-Based Loans for Subprogram 1
Georgia: Improving Domestic Resource Mobilization for Inclusive Growth Program

Asian Development Bank

CURRENCY EQUIVALENTS
(as of 27 October 2014)

Currency unit	–	lari (GEL)
GEL1.00	=	$0.5693
$1.00	=	GEL1.756

ABBREVIATIONS

ADB	–	Asian Development Bank
ADF	–	Asian Development Fund
GDP	–	gross domestic product
IMF	–	International Monetary Fund
LEPL	–	legal entity of public law
MOF	–	Ministry of Finance
OCR	–	ordinary capital resources
SDR	–	special drawing right
SOE	–	state-owned enterprise
TA	–	technical assistance

NOTES

In this report, "$" refers to US dollars.

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PROGRAM AT A GLANCE

1. Basic Data				**Project Number: 48044-001**
Project Name	Improving Domestic Resource Mobilization for Inclusive Growth	**Department /Division**	CWRD/CWPF	
Country	Georgia	**Executing Agency**	Ministry of Finance	
Borrower	Georgia			

2. Sector	**Subsector(s)**	**ADB Financing ($ million)**
✓ **Public sector management**	Public expenditure and fiscal management	38.00
Finance	Finance sector development	14.00
	Insurance and contractual savings	15.00
	Money and capital markets	8.00
	Total	75.00

3. Strategic Agenda	**Subcomponents**	**Climate Change Information**	
Inclusive economic growth (IEG)	Pillar 3: Extreme deprivation prevented and effects of shocks reduced (Social Protection)	Climate Change impact on the Project	Low

4. Drivers of Change	**Components**	**Gender Equity and Mainstreaming**	
Governance and capacity development (GCD)	Institutional development Public financial governance	Some gender elements (SGE)	✓
Knowledge solutions (KNS)	Knowledge sharing activities		
Partnerships (PAR)	Implementation Private Sector		
Private sector development (PSD)	Conducive policy and institutional environment		

5. Poverty Targeting		**Location Impact**	
Project directly targets poverty	No	Nation-wide	High

6. Risk Categorization: Complex

7. Safeguard Categorization **Environment: C** **Involuntary Resettlement: C** **Indigenous Peoples: C**

8. Financing

Modality and Sources	**Amount ($ million)**
ADB	**75.00**
Sovereign Program loan: Asian Development Fund	59.00
Sovereign Program loan: Ordinary capital resources	16.00
Cofinancing	**0.00**
None	0.00
Counterpart	**0.00**
None	0.00
Total	**75.00**

9. Effective Development Cooperation

Use of country procurement systems	Yes
Use of country public financial management systems	Yes

I. THE PROPOSAL

1. I submit for your approval the following report and recommendation on (i) a proposed programmatic approach for the Improving Domestic Resource Mobilization for Inclusive Growth Program, and (ii) proposed policy-based loans to the Government of Georgia for subprogram 1 of the Improving Domestic Resource Mobilization for Inclusive Growth Program.[1]

2. The proposed program aims to improve domestic resource mobilization to help achieve more inclusive growth in Georgia.[2] The programmatic approach will finance three subprograms to be implemented during 2014–2016.[3] The program supports improved debt and fiscal risk management, more efficient revenue and public expenditure management, generation of domestic savings, and mobilization of private resources for investment. Inequality of income and opportunity will be addressed through the redistributive role of fiscal policy in tax and social protection measures.[4]

II. THE PROGRAM

A. Rationale

3. Growth of the Georgian economy since the Rose Revolution in 2003 has averaged nearly 6% annually during 2004–2013, leading to an increase in per capita gross national income by three times in current US dollar terms.[5] While Georgia advanced rapidly on the Doing Business rankings, growth stemmed mainly from capital inflows before the twin crises of 2008 (the global financial crisis and the conflict with the Russian Federation) and from high public capital spending thereafter. In 2008, the crises sharply reduced capital inflows, and private investment and growth contracted by 3.8% in 2009. The government launched countercyclical fiscal measures to spur growth, increasing public expenditure from 34.0% of gross domestic product (GDP) in 2007 to 38.4% in 2009. The fiscal stimulus paid off, with growth rebounding and averaging more than 5% during 2010–2013.[6] The share of foreign direct investment in GDP declined from 7.7% in 2011 to 5.8% in 2012. However, by the first quarter of 2014 it had increased to 7.2%.

4. Reducing poverty and promoting shared growth remain challenges in Georgia. Income distribution is relatively skewed, with a Gini coefficient of 0.42. Unemployment is still a challenge despite the rapid growth of the economy, and was 14.6% of the labor force in 2013, from 15.0%

[1] The design and monitoring framework is in Appendix 1.

[2] Domestic resource mobilization refers to the generation of savings from domestic resources and their allocation to socially productive investments. The public sector mobilizes domestic resources through public revenue generation for social service and infrastructure investment. The private sector mobilizes the savings of households and firms through financial intermediaries, which lend for investment in productive activities.

[3] The proposed program is not included in the country operations business plan, 2014–2016 for Georgia. The program was requested by the government in late 2013, when it asked for programmatic assistance to improve the macrofiscal framework and to increase domestic resource mobilization from public and private resources.

[4] International Monetary Fund (IMF). 2014. *IMF Policy Paper*. Washington, DC. To enhance the role of fiscal policy for inclusive growth, the paper recommends (i) well-targeted public spending on social assistance programs, pensions, and infrastructure; and (ii) increased resource mobilization from tax revenue and social contributions.

[5] Georgia's gross national income (Atlas method, current dollars) was $3,570 in 2012, approximately three times the Asian Development Fund (ADF) eligibility threshold of $1,215. Georgia crossed the ADF eligibility threshold in 2003 and has remained above such threshold every year since. As a result and positive assessment of Georgia's creditworthiness, in August 2014, the Asian Development Bank (ADB) Board of Directors approved the reclassification of Georgia as a group C country for accessing ordinary capital resources, to be effective from 1 January 2017. ADB. 2014. *Georgia: Review of Classification under ADB's Graduation Policy*. Manila.

[6] IMF. 2013. IMF Country Report No. 13/264. *Georgia 2013 Article IV Consultation.* Washington, DC.

in 2012. High unemployment contributes to the weak link between growth and poverty reduction. Average monthly incomes per household increased during 2006–2013 from GEL385.3 to GEL887.2, with a corresponding decline in the relative poverty level (share of population under 60% of median consumption) from 23.3% to 21.4%. Nevertheless, poverty indicators are still high.

5. With the change in government in 2012, public finances came under pressure because of a large increase in social expenditure and limited scope to raise revenues, resulting in a fiscal deficit of 2.6% of GDP in 2013. The deficit is expected to widen to 3.7% in 2014 with a surge in social expenditures and lower revenues due to the slowing of growth in preceding years. The composition of central government expenditure will be changing over time with subsidies, transfers, compensation of employees, and interest payments taking up increasing budget shares at the expense of goods and services. In 2013 public capital expenditure, a significant driver of Georgia's economic growth during previous years, declined to below 6.0% of GDP from the 2008–2011 level of 7.5%–8.0% due to project implementation delays. Weaknesses have been identified in the selection, preparation, and appraisal of investment projects.[7] Infrastructure investment needs, including those emerging from decentralization, will require a strong public investment management system to contain fiscal risks and maintain existing infrastructure.

6. Maintaining sound macroeconomic and prudent fiscal management is critical for inclusive growth, requiring the government to exercise expenditure restraint as well as to increase revenues. The planned increase in social expenditure in the medium term is consistent with the government's push for inclusive, equitable growth for all citizens, as well as for gender-equitable growth. In this situation, maintaining capital expenditure requires careful prioritization of spending and improved expenditure efficiency and effectiveness to ensure fiscal sustainability. The government plans to develop public–private partnerships to leverage public resources and increase private participation, which can also strengthen its fiscal position.

7. The government confronts different types of fiscal risk—macroeconomic, debt, and contingent liabilities—as well as those risks arising from state-owned enterprise (SOE) operations and the finance sector. The present capacity to monitor and deal with these different risks is limited. Recent reviews have put particular emphasis on the risks associated with the quasi-fiscal operations of SOEs, as some implicit subsidies are not reflected in the budget and the accounts of the central government. The SOE sector in Georgia contributed to 7% of gross GDP in 2012, accounting for 24% of total corporate investment.

8. Total public debt amounted to 34.4% of GDP in 2013, of which 27.2% was denominated in foreign currency. Borrowing procedures are generally well developed, but they are poorly documented in case of external borrowing. A defined debt strategy is needed, as is more detailed analysis of external borrowing proposals. Operational risk management procedures are well developed, but documentation is again lacking. Presently, debt management and cash management in Georgia are two separate activities. Cash management is weak, since the government relies on a non-remunerated cash buffer in the National Bank of Georgia, the central bank, to ensure that payments can be made when due. In modern treasury management these two functions are merged and managed by one single entity, using financial market instruments to meet the government's immediate and longer-term cash needs. To reach this stage, a two-pronged approach is required: developing the local financial markets, and establishing a modern treasury function in the Ministry of Finance (MOF).

[7] World Bank. 2013. *Public Expenditure and Financial Accountability (PEFA) Assessment 2012*. Washington, DC.

9. Local governments account for approximately 7% of GDP and for 30% of consolidated government expenditure, with costs increasing steadily since 2012 in real terms and relative to GDP. In addition to the provision of housing, utilities, and communal services, local governments may execute investment projects with allocated central funding. Determinants of fiscal efficiency include appropriate assignment of responsibilities between the different levels of government, and the degree of revenue autonomy of the subnational levels. In Georgia, the only tax source presently available to local governments is the property tax, and local governments consequently depend heavily on grants from the central government.

10. Tax policy and administration reforms serve as part of wider improvements of the business and investment climate. Total taxes in Georgia amount to 24.8% of GDP, of which indirect taxes make up 13.6% and direct taxes 11.2% in 2013. A notable feature is the constitutional ban on increasing various tax rates. The Georgia Revenue Service is responsible for collecting taxes for both levels of government as well as customs duties. High levels of old arrears impair the smooth functioning of tax administration.[8] Selective writing-off of tax arrears is needed, with improved capacity for risk analysis to guide audit targeting and current controls.

11. Pensions constitute the largest social spending item in the state budget, accounting for 18% of public expenditure in 2013 and 4% of GDP. This cost is likely to increase over time because of population aging. Social security is presently noncontributory. The current pension system needs revision to ensure both fiscal sustainability and adequate pension levels over the medium term. More expansive and efficient capital markets will be necessary to absorb pension inflows and allow pension funds to responsibly invest in equities. Capital markets, including money markets, can also provide funding for banks and nonbank financial institutions in Georgia through equity raising and bond issuance. In the design of a new pension system, it is essential to take gender issues into account, as women are less likely to work in formal sectors, generally earn lower wages, and may perform other nonpaid labor. The current pension eligibility age is 65 for men and 60 for women, and is paid to all citizens regardless of marital status.

12. The small and medium-sized enterprise sector represents nearly 96% of registered businesses and employs 42.0% of the workforce in Georgia, but accounted for only 17.7% of business turnover in 2013. Firms cite high interest rates, risk-averse bank lending policies, and absence of venture capital as major constraints to growth. Small businesses currently rely on owner resources or on retained earnings for investment. Poor development of securities and capital markets and long-term financial instruments, and reliance on a fully publicly funded pension scheme, prevent higher savings rates and limit the funds available for lending. Increasing access to finance, especially for small businesses managed by women, is an important policy consideration. Limited support for and use of innovation and technology also hampers small business development, with Georgia ranking 73 out of 142 on the World Economic Forum’s Global Innovation Index.

13. The Socio-Economic Development Strategy of Georgia—Georgia 2020—establishes policy directions for sustainable and inclusive economic growth under four pillars. The proposed program corresponds closely to the four pillars.[9] The program also responds to the 2014–2016

[8] Tax arrears have been accumulating since the 1990s; many businesses owing the old tax arrears are no longer operating. Focusing the collection efforts on active taxpayers and businesses will lower costs and improve results.

[9] Government of Georgia. 2013. *Socio-Economic Development Strategy of Georgia, 2020*. Tbilisi. Pillar 1 establishes the preconditions for growth through fiscal efficiency, sustainable management of public debt, financial stability, and improvement of public policy management. Pillar 2 enhances private sector competitiveness by improving business and investment environment (especially for small and medium-sized enterprises), strengthening innovation capacities, and developing infrastructure. Pillar 3 addresses human capital issues through development

National Action Plan for Implementation of Gender Equality Policy in Georgia that supports gender equality in the economic and finance sectors.[10] The program is consistent with the country assistance to Georgia from the Asian Development Bank (ADB) and with government policy. The draft country partnership strategy, 2014–2018 is aligned with Georgia 2020, fostering inclusive economic growth while enhancing regional connectivity and environmentally sustainable growth.[11] The country operations business plan, 2014–2016 for Georgia enhances inclusive growth by improving access to finance.[12]

14. The program will enhance inclusive growth options by opening up the fiscal space for the government to meet its planned significant funding of inclusive social and economic services. To achieve this, the program will support fiscal consolidation, improve revenue management, strengthen public expenditure management, enhance the generation of domestic savings, and increase private resource mobilization for investment opportunities, especially for micro, small, and medium-sized businesses. The programmatic approach adopted for the program--sequencing of reforms with the flexibility to incrementally change the reforms based on the progress achieved-- will allow the government to build on achievements and lessons from the reforms and to steer the next phase of policy reforms accordingly. Separate policy and advisory technical assistance (TA) will provide support to the government in the areas of capital market development, pension reforms, public–private partnerships, and public debt management.[13] These actions help the government to achieve its medium-term sector policy objectives for public sector management and finance sector development. Women will benefit from the program through targeted financing opportunities for their small businesses, equitable treatment in business opportunities, and pension reforms. Relevant lessons on the need for policy reforms, stronger focus on inclusive growth, and longer-term engagement in public sector reforms have been incorporated from the evaluation findings of Georgia's country program portfolio.[14]

B. Impact and Outcome

15. The program impact will be citizens, particularly women, benefiting from higher living standards and more employment opportunities. The outcome will be the effective mobilization of domestic resources for increased public and private investment. The program will help enable improved fiscal space, better business opportunities and pension arrangements for women, more sustainable social service delivery, and a better environment for economic growth.

C. Outputs

16. The program comprises three annual subprograms to support the government's reform initiatives as outlined in Georgia 2020 and the national action plan on gender (see footnote 10), and specifically covers medium-term issues in the following four areas: (i) improving management of debt, cash, and fiscal risk; (ii) strengthening revenue and public expenditure

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of a labor-market-oriented workforce, strengthening social security, and ensuring high-quality health care. Pillar 4 increases access to finance by promoting retirement savings, strengthening the financial architecture by developing capital markets, and expanding access to finance for small and medium-sized enterprises.

[10] Parliament of Georgia. 2014. *2014–2016 National Action Plan for Implementation of Gender Equality Policy in Georgia*. Tbilisi.

[11] The country partnership strategy, 2014–2018 for Georgia is expected to be endorsed in January 2015.

[12] ADB. 2013. *Country Operations Business Plan: Georgia, 2014–2016*. Manila.

[13] ADB. 2014. *Technical Assistance to Georgia for Strengthening Domestic Resource Mobilization.* Manila. The $500,000 TA will provide critical support for the achievement of policy actions under subprograms 2 and 3.

[14] Independent Evaluation Department's (IED) Evaluation Information System accessed at http://wptamseal.adb.org/lnadbg4/oed001p.nsf/index?OpenForm

management; (iii) enhancing generation of domestic savings; and (iv) increasing mobilization of private resources for investment. Subprogram 1 has 20 policy actions, all of which were completed by 15 September 2014, and there are 27 and 25 indicative policy actions for subprograms 2 and 3, respectively.[15]

17. **Output 1: Improved management of debt, cash, and fiscal risk**. The objective of this output is to strengthen debt, cash, and fiscal risk management. Debt management will be strengthened by improving relevant government processes, increasing transparency, preparing and implementing strategies, amending legislation and developing analytical and forecasting capabilities. Fiscal risk management will be strengthened by drafting a strategy for dealing with the different types of fiscal risks and conducting risk assessments for risks, including those associated with loan guarantees and other contingent liabilities. The requisite in-house capacity will be developed to monitor such risks on an ongoing basis.

18. Subprogram 1 (i) established an internal procedures manual for external borrowing for investment financing and budget support; (ii) developed procedures manuals for public debt service processing, debt data recording, and validation for an efficient debt management and monitoring process; (iii) put into place a system of regular website posting of information on projects and programs financed by external sources covering total loan amounts and disbursed amounts reflected in the state budget, as well as a statistical bulletin on public debt presenting overall performance, treasury securities issuance, and transactions on primary markets; (iv) carried out an inventory indicating the fiscal position of large SOEs and their audited financial situation; and (v) developed a strategic template for monitoring and dealing with all types of fiscal risk confronting the country.

19. Subprograms 2 and 3, building on the accomplishments under subprogram 1, will continue to improve management of debt, cash and fiscal risk over a medium term. On the basis of the newly prepared debt strategy, the required legislative amendments will be submitted to the parliament. The debt management and risk analysis systems will be upgraded and a systematic process developed for tracking debt and loan guarantees and their timely reporting in the government's financial statements. A dedicated function will be established to manage fiscal risks from contingent liabilities related to SOEs and public–private partnership projects.

20. **Output 2: Strengthened revenue and public expenditure management**. The objective of this output is to increase the effectiveness and efficiency of revenue collection, improve public expenditure management, and strengthen local government finances. Because of lack of internal capacity, the government in the past relied on external tax auditors under the umbrella of the Alternative Audit Program. Through increased recruitment and training efforts, these external auditors will be replaced by in-house tax auditors. Increased efforts will be made to collect tax dues and arrears, and write off certain categories of old tax liabilities deemed uncollectable Budgeting and budget execution functions of government entities will be increasingly integrated into the public financial management system and the treasury single account. The quality of public capital investments will be improved by strengthening the project investment framework, especially private sector participation through PPPs.

21. Subprogram 1 (i) implemented strengthened tax collection procedures by establishing a new administrative department; (ii) approved a strategy to reduce the statutory time limit of tax notices and taxpayer notices incrementally from 6 years to 3 years to shorten the tax liability imposition period and provide relief to taxpayers; (iii) approved an action plan to phase out the

[15] The policy matrix setting out the policy actions for each of the three subprograms is in Appendix 4.

Alternative Audit Program and to increase in-house audit capacity in specialized sectors; (iv) prepared amendments to the budget code to allow the finances of local self-governments and legal entities of public law (LEPLs)[16] to be managed through the public financial management system, with payments and receipts through the treasury single account; (v) provided detailed supplementary information on types and funding of capital projects in the state budget documents; and (vi) paved the way for approval of the Local Self Governance Code by Parliament, resulting in reforms in intergovernmental finances including transfers.

22. Subprograms 2 and 3 will build on the accomplishments under subprogram 1. Recovery of arrears of at least GEL80 million from active taxpayers, reduction in time limitation of tax notices, and writing off tax arrears of defunct businesses on the basis of legally approved categories will streamline tax collection efforts. The cash operations of local self-governments and LEPLs (except schools and kindergartens)[17] will be channeled through the treasury single account and budgeting and accounting processes through the public financial management system. The identification and addressing of gaps in the legal and regulatory framework for preparation, appraisal, and implementation of public–private partnership projects will facilitate participation of the private sector in capital projects.

23. **Output 3: Enhanced generation of domestic savings**. The objective of this output is to streamline the government's universal pension or "pillar zero"[18] and to establish a sustainable private pension savings system with quasi-mandatory elements, the so-called hybrid or joint pillar combining elements of pillars 2 and 3.[19] The government will calculate the present and future costs of providing universal pensions to its citizens, and devise an improved pension plan to make the cost fiscally sustainable. The key areas of the pension structure under the hybrid or joint pillar will be designed defining issues such as membership contributions, investment of benefits, tax considerations, beneficiary arrangements, and relationship with the existing pillar zero. The introduction of pension plans is a long and involved process and needs careful understanding of the economic and social environment of the country, presence of capital markets for investment, and drafting of legislation. The program will develop and launch a public awareness and communications campaign that explains the benefits and roles of individuals in the new pension plan, with inclusion of gender aspects.

24. Subprogram 1 (i) established a pension reform unit with adequate budget and staff and an interagency working group to devise a time-bound action plan to develop the new pension plan, and (ii) issued a public notification on the broad concept and direction of pension reforms, both mandatory and voluntary systems.[20]

25. Subprograms 2 and 3, building on subprogram 1, will further expand the pension reforms by completing the analysis of key areas of pension system design and structure, with revisions ensuring continuity of equitable treatment of men and women. The individual reporting, record

[16] A number of general government functions are carried out by LEPLs. They collect and are allowed to retain income from services they provide. LEPL finances historically have been managed outside the treasury system. Payments by and to them flow through individual accounts held in commercial banks.

[17] There are more than 2,000 schools and kindergartens, many of them in remote and rural areas. Integrating these in the treasury system is costly. The government is exploring options to improve school expenditure efficiency.

[18] Pillar zero is the existing universal pension plan of the government.

[19] Pillar 2 is the occupational mandatory defined contribution savings that provides pensions. Pillar 3 is voluntary pensions. Hybrid or joint pillar is the term given to a pension plan that combines elements of pillars 2 and 3.

[20] The interagency council for pension reform has representation from the Ministry of Economy and Sustainable Development (MOESD), Ministry of Finance (MOF), the Ministry of Labor, Healthcare and Social Affairs (MOLHSA), the Office of the State Minister for Diaspora Issues, the National Bank of Georgia (NBG), the Budget and Finance Committee of the Parliament, and the National Statistics Office of Georgia.

keeping, and accounts system for the new scheme will be developed and implemented. The legislative amendments to the Basic Law on Pensions for the hybrid or joint pillar and to the law on voluntary savings covering private pensions will be drafted.

26. **Output 4: Increased mobilization of private resources for investment**. The objective of this output is to develop capital markets to mobilize long-term finance, and to enhance access to finance through small-business financing, development, and gender targeting. Capital market reforms will include bond market development, legal and regulatory reforms, and money market instruments so they can contribute to pension reforms under output 3.

27. Subprogram 1 (i) built on the policies laid down under Georgia 2020 for the development of financial intermediation and mobilization of private investments; (ii) established an interagency committee and working group to devise a time-bound action plan on capital market reform and development;[21] (iii) established the Entrepreneurship Development Agency with staffing and allocated budget of GEL110 million for 2014–2018; (iv) established the Georgia Innovation and Technology Agency with staffing and allocated budget of GEL20 million for 2014–2016; (v) earmarked GEL3 million from its budget for a matching grant facility for micro, small, and medium-sized businesses with 20% reserved for businesses owned by women; (vi) earmarked GEL2 million from its budget for mini grants and innovation vouchers for private sector innovation and technology development with 20% reserved for businesses owned by women; and (vii) adopted a gender action plan to ensure equal participation of men and women in economic and business activities.

28. Subprograms 2 and 3, building on subprogram 1, will continue reforms related to long-term finance and availability of finance. The review of laws, bylaws, and regulations on investment, governance, risk management, and fund managers will be completed as well as approval of account and prudential regulations for repos and securities lending. The two agencies, established under subprogram 1, will provide additional funding, expanding the matching grant facility for micro, small, and medium-sized enterprises with specific gender targets. The government will implement the gender action plan and publicly report on results.

D. Development Financing Needs

29. The overall program is estimated to cost $200 million equivalent for 2014–2016. Subprogram 1 comprises single-tranche loans in the aggregate amount of $75 million equivalent. Subprogram 2, with a loan amount of $50 million equivalent, and subprogram 3, with a loan amount of $75 million equivalent, are both subject to further discussion between ADB and the government. The subsequent subprograms will be submitted for ADB Board consideration upon completion of the policy triggers. The policy matrix provides actions to be taken prior to Board consideration for subprogram 1, and proposed policy actions for subsequent programs.

30. To help finance subprogram 1, the government has requested (i) a loan in various currencies equivalent to SDR39,286,000 ($59 million equivalent) from ADB's Special Funds resources, and (ii) a loan of $16,000,000 from ADB's ordinary capital resources (OCR).[22] The Asian Development Fund (ADF) loan will have a 25-year term, including a grace period of 5 years, an interest rate of 2.0% per annum during the grace period and thereafter, and such

[21] The interagency committee and working group for capital market reform has representatives from the Ministry of Economy and Sustainable Development, the Ministry of Finance and the National Bank of Georgia.
[22] Development policy letter from the government is in Appendix 3.

other terms and conditions set forth in the draft loan agreement. The OCR loan will have a 15-year term, including a grace period of 3 years, straight-line repayment method, an annual interest rate determined in accordance with ADB's London interbank offered rate (LIBOR)-based lending facility, a commitment charge of 0.15% per year, and such other terms and conditions set forth in the draft loan agreement. Based on this, the average loan maturity is 9.25 years and there is no maturity premium payable to ADB. Subprograms 2 and 3 will be financed from OCR or a combination of ADF resources and OCR, subject to the availability of ADF resources.

31. The loan size is based on government's financing needs, the nature and sequence of the required reforms, and potential development impact. The government's development-related expenses associated with the program are estimated at GEL757.3 million ($440.3 million),[23] leaving a shortfall of approximately GEL300.0 million ($174.4 million) for 2014 in unfunded liabilities that are envisaged to be financed through development partner assistance. Georgia's gross financing needs continue to be high. In 2014, with the fiscal deficit amounting to 3.7% of GDP, the government intends to borrow both from domestic (28.7%) and foreign (71.3%) sources to finance the deficit. The public debt level is expected to increase to 33.6% of GDP in 2014 from 32.9% at the end of 2013 as a result of government borrowing for budget support.

E. Implementation Arrangements

32. The MOF will be the executing agency and the Ministry of Economy and Sustainable Development and the MOF will be the implementing agencies for the program. A program steering committee will be formed comprising senior officials from the two ministries, chaired by the deputy minister of finance. The committee will meet semiannually to review progress in achieving the agreed policy actions for the program. The proceeds of the policy-based loan will be disbursed to Georgia in accordance with the provisions of ADB's Simplification of Disbursement Procedures and Related Requirements for Program Loans.[24] The loan proceeds will be used to finance the cost (excluding local taxes and duties) of items produced and procured in ADB member countries, excluding ineligible items and imports financed by other bilateral and multilateral sources. The implementation period for the overall program is from January 2014 to December 2016, while the implementation period for subprogram 1 is from January 2014 to December 2014.

III. DUE DILIGENCE

33. The beneficiaries will primarily be the taxpayers, pension recipients, small businesses, women entrepreneurs, and local constituents who will gain from improved revenue and public expenditure management. Citizens will benefit from improved investment management practices of the government. Taxpayers and recipients of government services will benefit from reduced fiscal costs of investment projects. Small businesses, particularly women entrepreneurs, will benefit from improved availability of financing and increased opportunities to introduce innovation and technology in businesses.

A. Economic and Financial

34. The reform agenda supported by the program is economically viable. The reforms will mobilize public and private resources, creating investment and employment opportunities while

[23] MOF. *Georgia: Basic Data and Directions 2014–2017—supplementary document of 2014 Budget*. Tbilisi.
[24] ADB. 1998. *Simplification of Disbursement Procedures and Related Requirements for Program Loans*. Manila.

maintaining fiscal space to support economic growth. The economic benefits will accrue from enhanced operational and allocative efficiencies from the program reform areas. The benefits are expected from better management of debt and fiscal risks confronting the country, increased inflows of tax revenues and better expenditure allocative efficiency by establishing a strengthened legal and regulatory framework for investment and public-private partnership projects. The program beneficiaries will include the working population, especially the pensioners who stand to gain from a sustainable and reformed new pensions system. The enhanced generation of domestic savings will be productively used in stimulating investment and furthering entrepreneurial activities for micro, small, and medium-sized enterprises.

B. Governance

35. In line with the Second Governance and Anticorruption Action Plan, a governance risk assessment was conducted as part of the draft country partnership strategy for Georgia, 2014–2018. The draft assessment notes the significant advancements that Georgia has made in budgetary and financial management systems. A basic set of systems is in place for strategic budget planning and budget formulation and execution, key modules of an integrated public financial management system have been launched, the treasury information system is operational, and electronic government procurement has been introduced. Complementary reforms are being rolled out to line ministries and sectors. Risks identified include weak public investment management, inadequate monitoring and analysis of government contingent liabilities, non-inclusion of LEPL revenues and expenditures in budget execution reports, and inadequate predictability and transparency of intergovernmental transfers. The proposed program and related TA project are addressing these areas. ADB's Anticorruption Policy (1998, as amended to date) was explained to and discussed with the government. The government is acting against corruption, including ongoing monitoring and reporting work by the public accounts committee of the Parliament. The government's fiduciary arrangements for budget support and relevant public financial management systems are considered sound.

C. Poverty and Social

36. The reforms supported under the program will accelerate economic growth and help create jobs, which are keys to reducing poverty and ensuring inclusive growth. Domestic resources for public and social expenditure will increase through more domestic savings, better income generating opportunities will be provided through improved access to finance, and enhanced protection against life and economic risks will be available through pension and social assistance reforms. Increased domestic resource mobilization will also benefit small businesses, especially those owned or run by women. The program addresses women's empowerment by narrowing gender disparities through improved access to financial resources and opportunities, as well as through better representation on the tax audit teams. The program will also take an equitable approach for both men and women in the reformed pension system, consistent with the current arrangements under pillar zero.

D. Safeguards

37. The policy-based loan will not trigger safeguard policies and is categorized C for environment, involuntary resettlement, and indigenous peoples.

E. Risks and Mitigating Measures

38. Of the potential risks identified for the program, the key risks are that (i) the external environment deteriorates and delays fiscal consolidation reforms, and (ii) weak economic growth affects expenditure efficiency. The mitigation measures for these risks are that (i) ADB will facilitate effective and coordinated donor support to ensure reform consistency; and (ii) through policy dialogue and the TA (see footnote 13), ADB will support the MOF in improving debt and fiscal management, strengthening public expenditure management, and increasing domestic savings and private resources for investment. These risks and mitigating measures as well as other additional risks and mitigating measures are described in detail in the risk assessment and risk management plan.[25] The integrated benefits of the program are expected to outweigh the costs.

IV. ASSURANCES

39. The government has assured ADB that implementation of subprogram 1 shall conform to all applicable ADB policies including those concerning anticorruption measures, safeguards, gender, procurement, consulting services, and disbursement as described in detail in the loan documents.

40. The government has agreed with ADB on certain covenants for subprogram 1, which are set forth in the loan agreements.

V. RECOMMENDATION

41. I am satisfied that the proposed programmatic approach and policy-based loans would comply with the Articles of Agreement of the Asian Development Bank (ADB) and recommend that the Board approve

(i) the programmatic approach for the Improving Domestic Resource Mobilization for Inclusive Growth Program;

(ii) the loan in various currencies equivalent to SDR39,286,000 to Georgia for subprogram 1 of the Improving Domestic Resource Mobilization for Inclusive Growth Program, from ADB's Special Funds resources, with an interest charge at the rate of 2.0% per annum during the grace period and thereafter; for a term of 25 years, including a grace period of 5 years; and such other terms and conditions as are substantially in accordance with those set forth in the draft loan agreement presented to the Board; and

(iii) the loan of $16,000,000 to Georgia for subprogram 1 of the Improving Domestic Resource Mobilization for Inclusive Growth Program, from ADB's ordinary capital resources, with interest to be determined in accordance with ADB's London interbank offered rate (LIBOR)-based lending facility; for a term of 15 years, including a grace period of 3 years; and such other terms and conditions as are substantially in accordance with those set forth in the draft loan agreement presented to the Board.

Takehiko Nakao
President

28 October 2014

[25] Risk Assessment and Risk Management Plan (accessible from the list of linked documents in Appendix 2).

DESIGN AND MONITORING FRAMEWORK

Design Summary	Performance Targets and Indicators with Baselines	Data Sources and Reporting Mechanisms	Assumptions and Risks
Impact Citizens, particularly women, benefit from higher living standards and more employment opportunities	Fiscal deficit reduced to 1.5% of GDP by 2020 (2012 baseline: 3.0%) Absolute poverty reduced to 18.0% of population by 2020 (2012 baseline: 22.4%) Gini coefficient reduced to 0.35 by 2020 (2012 baseline: 0.42) [a]	MOF public notification MOF public notification MOF public notification	**Assumptions** Government remains committed to reforms promoting inclusive public investment Effective donor coordination to further public sector management reforms **Risk** External environment deteriorates and delays reforms to improve fiscal consolidation
Outcome Effective mobilization of domestic resources for increased public and private investment	By December 2016, domestic savings as a percentage of GDP increased to at least 21.6% (2012 baseline: 10.2%)	National Statistics Office of Georgia	**Assumption** Effective interagency coordination **Risk** Weak economic growth impacts expenditure efficiency
Outputs 1. Debt, cash, and fiscal risk management improved	By September 2016, a medium-term public debt management framework is implemented By September 2016, assessment of fiscal risks conducted for large SOEs to determine contingent liabilities	Government decree Public notification on MOF website	**Assumption** Effective and timely collaboration of stakeholders
2. Revenue and public expenditure management strengthened	By September 2016, tax arrears collection increased by at least GEL80 million By September 2016, the number of in-house tax auditors increased to 330 from the current 230, of which 150 are women By September 2016, draft amendments prepared to cover gaps in the legal and regulatory framework of PPPs	Annual report published on Georgia Revenue Service website Annual report published on Georgia Revenue Service website Annual report published on MOF website	

Design Summary	Performance Targets and Indicators with Baselines	Data Sources and Reporting Mechanisms	Assumptions and Risks
3. Generation of domestic savings enhanced	By September 2016, pension system revisions implemented which ensure continuity of equitable treatment of men and women By September 2016, changes instituted to basic pension law and law on voluntary savings	Annual report published by MOESD, MOLHSA, and MOF Annual report published by MOESD, MOLHSA, and MOF	
4. Mobilization of private resources for investment increased	By September 2016, at least GEL12 million provided to small and medium-sized businesses as matching facility to spur investments, with 30% allocated to women entrepreneurs By September 2016, at least GEL9.5 million provided to small businesses for encouraging innovation and technology, with 30% allocated to businesses owned or run by women	Annual report published by MOESD and MOF Annual report published by MOESD and MOF	

Activities with Milestones	Inputs
1.1 MOF establishes internal procedures for external borrowing for investment financing and budget support (July 2014) 1.2 MOF prepares and approves a debt strategy covering loan portfolio, goals, and principles of incurring new debt and issues of debt sustainability (March 2015) 1.3 MOF submits to Parliament required amendments to the public debt legislation underpinning the debt strategy (September 2015) 1.4 MOF establishes a staffed and budgeted function to manage fiscal risks, including contingent liabilities of state-owned enterprises and PPPs (November 2015) 1.5 MOF strengthens the middle analytical office with an upgraded debt management and risk analysis system integrated with the e-budget and e-treasury systems (September 2016) 2.1 GRS implements strengthened tax collection procedures by establishing a new administrative department (July 2014) 2.2 GRS approves a strategy to reduce statutory time limitation of tax notices and taxpayer notices (July 2014) 2.3 GRS completes the phasing-out of alternative auditors by increasing the number of in-house tax auditors to at least 330, out of which 150 are women (September 2016) 2.4 MOF prepares amendments to the budget code to allow for LSG and LEPL finances to be managed through the electronic PFMS, and their payments and receipts through the TSA (July 2014) 2.5 Government agencies identify gaps in the legal and regulatory framework for preparation, appraisal, and implementation of PPP	**ADB** Subprogram 1: Ordinary capital resources: $16 million; Asian Development Fund: $59 million equivalent Subprogram 2= $50 million Subprogram 3= $75 million

Activities with Milestones	
projects (September 2015) 2.6 Government agencies draft legal amendments to address identified gaps in the legal and regulatory framework for PPPs (September 2016) 3.1 MOESD establishes a pension reform unit with adequate budget and staffing, and an interagency working group to devise a time-bound action plan (July 2014) 3.2 MOESD issues consensual paper on the nature of hybrid and joint pillar including issues such as membership, contributions, tax considerations, benefits, gender, and relationship with the universal pension system (August 2015) 3.3 MOESD seeks Cabinet approval for a strategy and time-bound action plan for pension reforms including legal and regulatory gaps, data privacy, and tax legislation (October 2015) 3.4 MOESD launches a communication campaign on benefits of the hybrid pillar, including gender aspects (September 2016) 3.5 MOESD drafts amendments to the law on voluntary savings and submits to Parliament for approval (September 2016) 4.1 MOESD together with NBG establishes an interagency working group on capital market reforms (September 2014) 4.2 MOESD issues a public notification on the concept and direction of capital market reforms including corporate securities, expanding bond market, and money market instruments for secured interbank trading (September 2015) 4.3 MOESD establishes EDA and GITA (July 2014) 4.4 EDA launches matching grant facilities and other financial products for small and micro enterprises (July 2014) 4.5 GITA launches mini grants and innovation vouchers to support private sector innovation and technology (July 2014) 4.6 Government implements the gender action plan and publicly reports on results included in the program policy areas (September 2016)	

ADB = Asian Development Bank; EDA = Entrepreneurship Development Agency; GDP = gross domestic product; GITA = Innovation and Technology Agency; GRS = Georgia Revenue Service; LEPL = legal entity of public law; LSG = local self-government; MOESD = Ministry of Economy and Sustainable Development; MOF = Ministry of Finance; MOLHSA = Ministry of Labor, Health and Social Affairs; NBG = National Bank of Georgia; PFMS = public financial management system; PPP = public–private partnership; SOE = state-owned enterprise; TSA = treasury single account.

[a] Sex-disaggregated data will be collected during implementation of subsequent subprograms to define the indicator further.

Source: Asian Development Bank.

LIST OF LINKED DOCUMENTS

http://www.adb.org/Documents/RRPs/?id=48044-001-3

1. Loan Agreement: Special Operations
2. Loan Agreement: Ordinary Operations
3. Sector Assessment (Summary): Public Sector Management and Financial Sector Development
4. Contribution to the ADB Results Framework
5. Development Coordination
6. Country Economic Indicators
7. International Monetary Fund Assessment Letter[1]
8. Summary Poverty Reduction and Social Strategy
9. Gender Action Plan
10. Risk Assessment and Risk Management Plan
11. List of Ineligible Items

[1] The linked document is the press release dated 31 July 2014. According to the International Monetary Fund (IMF), responses to the multilateral development banks' requests for the IMF assessment of a country's macroeconomic conditions and policies will be conveyed whenever possible through the most recent press release, chairman's statement produced in the context of Article IV surveillance, IMF-supported program, or staff monitoring program, or a previous assessment letter, if it remains valid. Barring any major changes in the country circumstances, the public information notice, chairman's statement, or previous assessment letters are expected to remain valid for a period of up to 6 months. An assessment letter would only be called for if either (i) the most recent assessment is more than 6 months old, or (ii) IMF staff considers that there have been material changes in the country's circumstances that call for an updated assessment.

DEVELOPMENT POLICY LETTER

PRIME MINISTER OF GEORGIA

18 September 2014

Dear President Nakao,

Let me begin by thanking the Asian Development Bank for its strong and continued support to Georgia's successful development efforts in the recent past. Our objective is to ensure sustained economic growth that is comprehensive and inclusive, and uniformly benefits citizens of the country.

The Georgian economy has grown by nearly 6% on average annually between 2004 and 2012, although it was not translated in eradication of poverty. After declining by 3.8% in 2009, GDP has rebounded to 6.3% in 2010, reaching 7.2% in 2011. In 2013, GDP growth slowed to an estimated 3.2% from 6.2% in 2012, largely due to a reduction in public investments, as the government audited procurement contracts and rationalized public outlays. After peaking at 10% in 2008 inflation has been contained in single digits, with consumer prices falling by 0.5% in 2013. Public debt, which had peaked at 42.4% of GDP in 2010, has been steadily declining to a manageable 34.4% of GDP in 2013. Foreign direct investment, which had reached $1.6 billion in 2008, fell by more than 50% to an average of $700 million in 2009 and 2010. While investor confidence has not fully recovered to what it was prior to the conflict and global crisis, foreign direct investment has increased steadily to about $1 billion per annum in 2011-2013, suggesting that confidence is improving. The current account deficit narrowed significantly to about 6% of GDP in 2013 from 11.7% in 2012, as the trade balance improved substantially, due to a strong recovery in merchandise exports and a decrease in imports. Improved trade relations prompted a fourfold increase in total exports to the Russian Federation.

The government projects growth to accelerate to 5.0% in 2014. A higher growth forecast is probable due to a number of factors: the consolidated government in power now is set to implement its reform program and higher government investment spending is likely to ensue. There is greater clarity in the policy and political environment, greater emphasis in agriculture and manufacturing sectors, and continued strength in trade and tourism. Improvements in investor sentiment are acting as catalysts to the reform agenda of the government. Given this growth momentum, maintaining growth at 6.0% over 2015-2017 is an achievable target.

Since 2003 the government has implemented a series of structural and institutional reforms, still, more needs to be done on structural and institutional front especially on property rights, justice and competition. Government has shown a progress to deregulate the economy, remove bureaucratic barriers, and combat corruption, while strengthening transparency and accountability. The government has streamlined business licensing, reduced the size of the civil service, liberalized trade, simplified the tax system, and privatized government assets. As a result, governance and the business environment improved significantly, and Georgia's ranking in several international indices rose. Georgia ranks 8th among 189 countries in the 2014 World Bank's Doing Business Report. Factors related to business operations and private sector competitiveness are captured in other international indices, such as the World Economic Forum's Global Competitiveness Report (GCR) for 2014–2015. The GCR ranks Georgia at 69 out of 144 countries. Despite this laudable progress, the reforms have not entirely led to inclusive growth in Georgia, and growth has not led to creation of sufficient jobs.

The fiscal deficit narrowed to 2.6% of GDP in 2013, compared to 2.8% in 2012. Revenues fell by 1.7%, reflecting slower growth. Total expenditure also declined by 1.7%. The projected fiscal deficit at around 3.7% of GDP in 2014 and even less than 3% in the subsequent years is a realistic target, given prudent expenditure rationalization and cutbacks in non-essential public spending. Such a deficit would be compatible with projections in inflation and GDP growth, as no burdensome social liabilities will be assumed. The 2014 General Government budget envisages an increase in total revenues by 6.4% to GEL7.9 billion, while current expenditures are projected to increase by 11.2% to GEL7.2 billion, and total expenditure is planned to go up by about 12.6%.

The government intends to finance the fiscal deficit from a number of domestic and foreign financing sources. This includes issues of treasury securities in an amount of GEL400 million, long-term investment credits (predominantly for infrastructure) estimated at around GEL 600 million, and World Bank's Third Competitiveness and Growth Development Policy loan in an amount of $92.7 million. The government has identified a shortfall of about GEL300 million that will be financed on concessional terms from international financial institutions. ADB's proposed program loan of $75 million is expected to bridge this gap. These borrowings are expected to slightly increase public debt to 35.6% in 2014 from 34.4% of GDP at the end of 2013.

Georgia is expected to graduate from ADB's concessional lending window from 1 January 2017 and the 2015–2016 ADF country allocations will complete this borrowing cycle. Georgia's eligibility for borrowing on IDA terms of the World Bank ended in the bank's fiscal year 2014 (1 July 2014). In March 2013, the IMF Board approved the removal of Georgia from the list of countries eligible for concessional funds. According to the IMF's last Debt Sustainability Analysis (April 2012), Georgia's public debt ratios will not be significantly affected even under extreme scenarios and will not exceed 60% of GDP. Total gross external debt amounted to 62.3% of GDP in 2013, of which external public debt accounted for 26.8% of GDP. The weighted average interest rate is only 1.9%. External public debt amounts to more than 78% of total public debt; 70% is denominated in fixed interest rates. The commercial component of external public debt amounts to only 10% (Eurobond), with the remainder comprising highly concessional multilateral or bilateral loans.

The government is proactively responding to the current challenges. The government approved a new socio-economic development strategy (Georgia 2020) in June 2014 that focuses on social needs and business development of Georgia. To address large unmet social needs, the government has introduced universal health insurance and increased social sector funding significantly. The government increased pensions to GEL150 by September 2013 (close to the subsistence minimum for working age male), and aims to implement comprehensive pension reforms. The government has made substantial efforts to significantly improve the business environment and to ensure a level playing field for all business participants. The government has made plans to deepen government debt markets, and extended concessional credit to thousands of farmers and to new startups in the micro, small and medium size enterprise (MSME) sector with a particular focus on women. This is in line with the 2014-2016 National Action Plan for Implementation of Gender Equality Policy in Georgia that binds the government to proactively seek gender equality in the economic field.

The government has undertaken structural reforms to enhance competitiveness. The government implemented measures to strengthen competition, and maintain a stable and predictable business environment to support long-term economic growth. The competition agency has been established to oversee implementation of competition policies, and enforcement of competitive market practices. The State Audit Office has played a stronger role in the budget process and public procurement has been streamlined.

The Government identified limited access to financial resources as a critical obstacle to the country's economic development due to insufficient savings and internal resources necessary for investments, and inadequately developed financial institutions. To this end, the government has been implementing measures recently to boost the MSME sector and increase availability of funding to this sector. Two new agencies have been established under the Ministry of Economy and Sustainable Development (MOESD) to promote financial support, development and ease market entry for small businesses as well as to support businesses in adaptation of DCFTA requirements and enhancement of export potential. The Entrepreneurship Development Agency was established in February 2014 to promote development of entrepreneurial culture and financially support start-ups during the incubation period, and to help businesses increase their export potential. The Innovation and Technology Agency also created in February 2014, promotes application of innovative technologies in business activities, and helps to commercialize innovative R&D for a knowledge-based economy. Both agencies have a special gender focus by providing increased financing and entrepreneur training opportunities to women's businesses.

Another program, "Produce in Georgia" began in June 2014, with a budget allotment of GEL46 million to provide funding to startups in agriculture and in other sectors of the economy, in an effort to bolster domestic production capacity. Although the number of new businesses is quite impressive, the share of MSMEs in GDP remains below 20%, a much smaller share than in the region.

In recent years, the government has made great strides in improving public financial management processes and systems. These include the implementation of results-based budgeting and performance management; the move to accruals and IPSAS compliant reporting; improved local government financing; and modern treasury management, establishing stronger linkages of treasury with the debt management. Tax revenues as a share of GDP have been increasing consistently from only 12.0% in 2003 to 21.6% in 2007, and 24.8% in 2013. The state's dominant role in the dispute resolution has been curtailed.

In 2014, the Ministry of Finance (MoF) introduced internal procedures for external borrowing, and increased debt information availability through regular statistical bulletins and explanatory notes on public debt as part of the state budget. The MoF enhanced its tax collection systems by upgrading the analytical capacity of the Revenue Service. A new Administrative Department was established in the Revenue Service to strengthen tax collection efforts. The State Audit Office now plays a stronger role in the budget process by assessing the reasonableness and legality of the state budget revenues and expenses.

Significant progress was made in the formulation of the program budget which underpins a disciplined budget process. The Basic Data and Directions (BDD), a companion document to the state budget, presents government priorities and programs within a 4-year rolling timeframe. The overall and sector strategies are, for the most part, cost and translated into expenditure ceilings for each of the coming four years. The government recognizes that the quality of some public capital investments has not been of acceptable standard. It has therefore begun to identify gaps in the regulatory framework for the preparation, appraisal, and implementation of public and public-private partnership (PPP) investment projects. We consider close collaboration of public and private partners in designing and implementation of projects in the area of infrastructure and social services to be critical for delivering efficient public services.

As the government confronts different types of fiscal risk, such as macro, debt, contingent liabilities, SOE operations, financial sector, and other miscellaneous risks, it plans to establish a dedicated function to manage these risks. The equalization formula for intergovernmental transfers has been put in place, highlighting direct linkage of volume of transfers to the economic development strategy and priorities, but it needs to be reformed and consistently fine-tuned to maintain a stable macro-fiscal environment. National accounting standards for the public sector comply with IPSAS.

Georgia's financial system is represented mainly by the banking sector, while capital markets are nascent. The banking system is privatized, well capitalized and sufficiently liquid with a stable asset base. Banking system assets as a share of GDP amounted to 64.4% of GDP in 2013. Georgia has 21 banks; the top five banks controlled 76.4% of assets in 2013, showing that the banking sector is highly concentrated. There is no deposit insurance system, which makes Georgia an outlier in the region and internationally. The microfinance sector has been one of the fastest growing sectors of the economy. The size of private pension funds remains negligible as a share of GDP, and the private insurance sector is small and unprofitable. The stock market remains underdeveloped.

The likelihood of opposition to disintermediation is compounded in Georgia by the level of concentration in the banking sector since the more concentrated this sector, the greater the capacity to deter bond market development. Under these circumstances there may be a need for the government to play a more active supporting role. There is also a need to increase the total volume of government bonds on issue and consolidate outstanding issues with a view to building a benchmark yield curve. The government is keen to embark on a capital market development program by addressing gaps in legal and regulatory framework and improving market infrastructure.

The government has also initiated pension reforms. The principal focus is on the introduction of an occupational mandatory defined contribution pension plan (Pillar II), combined with voluntary pension arrangements (Pillar III). The existing universal pension plan or Pillar Zero will also be reviewed to make it compatible with the new scheme. Necessary amendments to appropriate legislation will also be introduced. The current subsistence minimum for a working age male is similar to the old-age pension benefit. We fully appreciate that the universal pension plan is a powerful poverty reduction and prevention tool. As such, we will continue with our targeted social assistance programs. At the same time, we are cognizant of the fiscal pressure and sustainability of these benefits in the long run. For this reason, the government will design and implement a retirement savings plan which complements the public pension system.

There are a number of pressing challenges Georgia needs to address to improve domestic resource mobilization for inclusive growth. The legal and regulatory framework to support capital market development needs to be improved and the current pension system does not provide acceptable replacement rates. The stock market is small and the corporate bond market virtually non-existent. The securities market in Georgia is at an early stage of development. The regulatory framework is still evolving, there are gaps in the required capacity and technology to trade equities and bonds, and demand is rather weak. A limited investor base due to the absence of institutional investors, dollarization of the financial market, lack of trust in the local currency and institutions, and poor liquidity all combine to constrain market growth. Reforms of the pension system will, once implemented, address some of the challenges this creates. But without development in the capacity of the local fixed-income market, fund managers would be forced to invest in foreign currency.

Given the ageing population, the number of pensioners is sizeable and increasing (e.g. in 2013 a total of 857,000 pensioners were registered, 19.1% of the population). The World Bank projects that pension spending will double by 2070, to 9% of GDP compared with the current rates of about 4.5%. The government plans to make a decision on the financing aspect of the defined contribution pension plan—whether through a tax hike on taxable income, or through existing payroll tax contributions without significantly altering the underlying tax provisions. A challenge for the introduction of private pension plans is a high level of unemployment, which limits potential contributions to a pension plan.

The present capacity to monitor and manage fiscal risks is limited. While the volume of extra-budgetary expenditure is insignificant, the operations of Legal Entities of Public Law have, hitherto, been managed outside the Treasury System. But that will change starting in 2015. The government is preparing an action plan to create the required in-house capacity for audits, and strives to improve the efficiency and effectiveness of Local Self Government funding.

Georgia's debt is well-managed, but the procedures were poorly documented. The new procedures manual will make the process more transparent. Of greater concern is that there is no explicit debt strategy. To manage this more complex situation, MoF intends to develop a modern treasury function. An interface will be created to link the debt and cash management system to the treasury system. This will facilitate consolidation, and the move to full accruals and IPSAS compliant reporting.

We have been working closely and efficiently with all development partners, including ADB, to mobilize resources allowing us to plan and execute the public expenditure projects with tangible impacts. At this stage the government priority is budget support given a still-weak external environment, and the increasing need to support social and investment activities through the budget. The World Bank, ADB and EU have provided budget support to Georgia. The World

Bank has approved on 26 June 2014 the third competitiveness and growth development policy operation in Georgia in the amount of $92.7 million, the last in a series of three DPOs, to strengthen competitiveness and improve social and fiscal outcomes. The EU has undertaken macro-financial management, exceptional financing and sector budget support operations. On 6 May 2014, the EU has announced a support package for Georgia of €30 million, which is focused on modernization of public institutions linked to the implementation of the Association Agreement, competitiveness of rural business and trade opportunities with the EU. In 2014 Georgia has a new program with the IMF to borrow in the amount equivalent to GEL260 million. The IFC and the EBRD are active financiers of the private sector, with particular focus on commercial banks, agri-processing, retail operations, and renewable energy.

The proposed program aims to improve domestic resource mobilization to help achieve inclusive growth in Georgia. The program supports more efficient revenue and public expenditure management, generation of domestic savings, and mobilization of private resources for investment. Inequality of income and opportunity will be addressed through the redistributive role of fiscal policy in designing, for example, tax, social protection and public spending measures. The program will assist the government in maintaining macroeconomic stability, streamlining public spending and establishing access to finance. These efforts to facilitate investment are accompanied by measures to further strengthen public financial management through improved accountability and greater transparency of the government's fiscal accounts.

The programmatic approach and associated policy-based loans will finance three subprograms to be implemented from 2014–2016 in the amount of $200 million equivalent. We deeply appreciate the support of ADB in the implementation of the strategic actions outlined above. We are looking forward to our continued successful partnership with ADB, including in the context of the proposed policy based program on improving domestic resource mobilization for inclusive growth.

Mr. President, I take this opportunity to extend my esteemed regards.

Sincerely,

Irakli Garibashvili

Mr. Takehiko Nakao
President of the Asian Development Bank (ADB),
Chairperson of ADB's Board of Directors
Mandaluyong City, Philippines

CC: Permanent Mission of the Asian Development Bank to Georgia N31782

POLICY MATRIX

Policy Actions	Subprogram 1 2014	Subprogram 2 2015 (Indicative)	Subprogram 3 2016 (Indicative)
Output 1: Improved Management of Debt, Cash and Fiscal Risk			
Strengthened debt and cash management	MOF approves internal procedures manual for external borrowing for investment project financing and budget support describing the scheme of process including roles of NBG, MOESD, Ministry of Justice and the parliament for signing, ratification and effectivity	MOF prepares and approves a Debt Strategy for medium term debt management covering loan portfolio, goals and principles of incurring new debt and issues of debt sustainability	MOF submits to parliament any required amendments to the public debt legislation underpinning the Debt Strategy
	MOF approves procedure manuals for the processing of public debt service, debt data recording and validation for efficient debt management and monitoring process	MOF prepares an action plan to strengthen the Middle Office (analytical) function of the PDEFD for advising on terms of funding for government projects and evaluating public debt portfolio	MOF strengthens Middle Office with an upgraded debt management and risk analysis system integrated with the e-budget and e-treasury systems
	MOF publishes on its web site: (a) information on projects and programs financed by external sources covering total loan amounts, disbursed amounts and reflected in the State Budget, and (b) a statistical bulletin on public debt presenting overall performance, treasury securities issuances and transactions on primary markets	MOF develops a systematic process for debt and loan guarantees recordkeeping, reporting and validation	MOF reports on guarantees in government's financial statements covering face value
		MOF sets up a dedicated analytical function for cash flow forecasting with adequate budget and personnel	

Policy Actions	Subprogram 1 2014	Subprogram 2 2015 (Indicative)	Subprogram 3 2016 (Indicative)
Strengthened management of fiscal risk	MOF conducts an inventory indicating fiscal position of large SOEs and their audited financial situation MOF develops a strategic template for monitoring and dealing with all types of fiscal risk confronting the country	MOF establishes a dedicated staffed and budgeted function to manage fiscal risks including contingent liabilities of SOEs and PPP projects MOF establishes procedures, assigns institutional responsibilities, and sets aside adequate human and financial resources to monitor and advise on the management of the different types of fiscal risk confronting the government MOF carries out a first complete assessment of: (i) macro risk assessment; (ii) external debt sustainability analysis; and (iii) review of risk associated with loan guarantees and other similar contingent liabilities	MOF provides information on the debt of SOEs and contingent liabilities of SOEs and PPPs as a supplement to the state budget documents MOF carries out a first complete assessment of: (i) financial sector risks; and (ii) assessment of fiscal risks SOEs represent
Output 2. Strengthened Revenue and Public Expenditure Management			
Increased effectiveness and efficiency of revenue collection	GRS implements strengthened tax collection procedures by establishing a new dedicated and budgeted Administrative Department GRS approves a strategy to reduce the statutory time limitation of tax	GRS recovers arrears from active tax payers amounting to at least GEL80 million for the current tax year GRS reduces the statutory time limitation of tax notices	GRS starts the process of writing off tax arrears of defunct businesses on the basis of legally approved categories GRS reduces the statutory time limitation of tax notices and

Policy Actions	Subprogram 1 2014	Subprogram 2 2015 (Indicative)	Subprogram 3 2016 (Indicative)
	notices and taxpayer notices incrementally from 6 to 3 years to shorten tax liability imposition period providing relief to taxpayers GRS approves an action plan to phase out the Alternative Audit Program and to increase capacity of in-house audit, including in specialized sectors	and taxpayer notices from 6 to 5 years, shortening tax liability imposition period providing relief to taxpayers GRS increases the number of in-house tax auditors to at least 275 (from the current 230, out of which 110 are women), correspondingly decreasing the number of alternative auditors	taxpayer notices from 5 to 4 years, shortening tax liability imposition period providing relief to taxpayers GRS completes the phasing out of alternative auditors by increasing the number of in-house tax auditors to at least 330, out of which 150 are women
Improved public expenditure management	MOF prepares amendments to the budget code to allow for LSG and LEPL finances to be managed through the electronic PFMS and their payments and receipts through the TSA MOF provides supplementary information on types and funding of capital projects in the state budget documents	All cash operations of LSGs and LEPLs (except schools and kindergartens) are channeled through the TSA and the budgeting, budget execution and accounting processes through the PFMS The relevant government agencies identify gaps in the legal and regulatory framework for preparation, appraisal and implementation of public private partnership projects	The relevant government agencies prepare drafts of regulations to address any identified gaps in the legal and regulatory framework of public-private partnership projects and any required legal amendments
Strengthening of local government finances	Parliament approves the Local Self Governance Code in February 2014 paving the way for reforms in intergovernmental finances including capital	Government submits to parliament proposals for amendments to the Budgetary Code defining the separation of revenues among	Government ensures that intergovernmental transfers increase in line with GDP growth or at least by GEL30-40 million in the current budget year

Policy Actions	Subprogram 1 2014	Subprogram 2 2015 (Indicative)	Subprogram 3 2016 (Indicative)
	transfers and special transfers	the budgets of state, autonomous regions and municipalities	
Output 3. Enhanced Generation of Domestic Savings			
Streamlining Universal Pension–Zero Pillar		MOESD, MOF, and MOLHSA complete forecast of present and future cost of Universal Pensions under various scenarios using Prost Modeling and other approaches MOESD, MOF, and MOLHSA submit to government pension system revisions which ensure continuity of equitable treatment for men and women	MOLHSA and MOF submits to Cabinet for approval the overall policy on future Zero Pillar Government approves the pension system revisions which ensure continuity of equitable treatment of men and women
Establishing sustainable private pension savings system with quasi-mandatory elements – Hybrid or Joint Pillar (combination of pillars 2 and 3)	MOESD establishes a pension reform unit with adequate budget and staffing and an interagency working group to devise a time-bound action plan on designing a new pension system MOESD issues a public notification on the broad concept and direction of pension reforms including mandatory and voluntary systems	MOESD completes analysis of the key areas of pension system design and structure, including continued equitable treatment of men and women, and hybrid/ joint nature incorporating mandatory and voluntary dimensions MOESD issues consensual paper on the nature of hybrid pillar including issues like membership, contributions, tax considerations, benefits, gender, and relationships with zero pillar MOESD submits to	MOESD develops and implements personified reporting, recordkeeping and individual account system to make the new scheme operational MOESD drafts legislation either as amendments to Basic Law on Pensions for Hybrid or Joint pillar or through introducing independent legislation, allowing for subsidiary legislation to be introduced later

Policy Actions	Subprogram 1 2014	Subprogram 2 2015 (Indicative)	Subprogram 3 2016 (Indicative)
		Cabinet for approval a strategy and time-bound action plan for pension reforms, including legal and regulatory gaps, data privacy and tax legislation MOESD and MOF develop approach for public awareness programs for zero and hybrid/joint pillars, outlining specific measures for continuity of equitable treatment of men and women MOESD completes the review of existing structure of private pensions to incorporate any required changes in the related legislation	 MOESD launches communication campaign with nation-wide public awareness drives on benefits of hybrid pillar, including gender aspects MOESD drafts amendments to the Law on Voluntary savings covering private pensions and submits to Parliament for approval
Output 4. Increased Mobilization of Private resources for Investment			
Developing capital markets for mobilizing long-term finance	Government approves Socio-Economic Development Strategy of Georgia 2020 in June 2014 committing to policies to mobilize investments and develop financial intermediation Government together with NBG establishes an interagency working group to devise a time bound action plan on capital market reform and development	MOESD issues a public notification on the concept and direction of capital market reforms, including corporate securities, expanding bond market and money market instruments for secured interbank trading MOESD submits to Cabinet for approval a strategy and time-bound action plan for capital market reforms, including addressing legal and regulatory	MOESD launches a public awareness campaign on benefits of capital market reform plan including investor protection, financial instruments for investment, long-term savings, gender aspects and close link with pensions reforms MOESD completes the review of laws, bylaws, regulations on investment, governance, risk management and fund managers essential for

Policy Actions	Subprogram 1 2014	Subprogram 2 2015 (Indicative)	Subprogram 3 2016 (Indicative)
		gaps and improving the structure and efficiency of the market infrastructure	managing investments, including private pension savings captured in a policy brief MOESD contributes to money market development by approving accounting and prudential regulations for repos and securities lending
Enhancing access to finance for small business financing and development with gender targeting	MOESD establishes the Entrepreneurship Development Agency with adequate staffing, work plan and budget of GEL110 million for 2014–2018 allocating GEL19 million for 2014 MOESD establishes the Innovation and Technology Agency with adequate staffing, work plan and allocated budget of GEL20 million for 2014–2016 allocating GEL6 million for 2014 EDA (within its budget) establishes a concept for a matching grant facility and other financial products for micro, small and medium-sized enterprises with GEL3 million with 20% earmarked for women's businesses GITA (within its budget) establishes financial instruments like mini grants, matching grants	MOESD allocates a budget of GEL20 million to the Entrepreneurship Development Agency MOESD allocates a budget of GEL6 million to the Georgia Innovation and Technology Agency EDA (within its budget) expands matching grant facility for micro, small and medium-sized enterprises by GEL4 million, depending on performance/fund utilization, with 30% earmarked for women businesses GITA (within its budget) expands financial instruments to support private	MOESD allocates a budget of GEL25 million to the Entrepreneurship Development Agency MOESD allocates a budget of GEL8 million to the Georgia Innovation and Technology Agency EDA (within its budget) expands matching grant facility for micro, small and medium-sized enterprises by GEL5 million, depending on performance/fund utilization, with 40% financing earmarked for women businesses GITA (within its budget) expands financial instruments to support private sector

Policy Actions	Subprogram 1 2014	Subprogram 2 2015 (Indicative)	Subprogram 3 2016 (Indicative)
	and innovation vouchers to support private sector innovation and technology development with GEL2 million, with 20% earmarked for women businesses	sector innovation and technology development with GEL3 million, depending on performance/fund utilization, with 30% earmarked for women businesses	innovation and technology development with GEL4.5 million, depending on performance/fund utilization, with 40% earmarked for women businesses
	Government adopts Gender Action Plan, which ensures equal participation of men and women in economic and business activities, equal participation in professional and business educational programs. Special attention is paid to business training for women that will increase access to finance for female entrepreneurs	Government implements the gender action plan and publicly reports on results included in the program policy areas such as small business training and financing	Government implements the gender action plan and publicly reports on results included in the program policy areas such as small business training and financing

EDA = Entrepreneurship Development Agency, EU = European Union, GDP = gross domestic product, GEL= Georgian Lari, GITA= Georgia Innovation and Technology Agency, GRS = Georgia Revenue Service, LEPL = legal entities of public law, LSG = Local Self-Government, MOESD = Ministry of Economy and Sustainable Development, MOF = Ministry of Finance, MOLHSA= Ministry of Labor, Health and Social Affairs, NBG= National Bank of Georgia, PFMS = public financial management system, PDEFD = Public Debt and External Financing Department, PPP = public–private partnership, SOEs = state- owned enterprise, TSA = Treasury Single Account.