ADB

Report and Recommendation of the President to the Board of Directors

Project Number: 48044-004
August 2015

Proposed Policy-Based Loans for Subprogram 2 Georgia: Improving Domestic Resource Mobilization for Inclusive Growth Program

Asian Development Bank

CURRENCY EQUIVALENTS
(as of 21 August 2015)

Currency unit	–	lari (GEL)
GEL1.00	=	$0.4301
$1.00	=	GEL2.325

ABBREVIATIONS

ADB	–	Asian Development Bank
EDA	–	Entrepreneurship Development Agency
GDP	–	gross domestic product
GITA	–	Georgia Innovation and Technology Agency
MOESD	–	Ministry of Economy and Sustainable Development
MOF	–	Ministry of Finance
PFM	–	public financial management
PPP	–	public–private partnership
SDR	–	special drawing rights
SMEs	–	small and medium-sized enterprises
SOE	–	state-owned enterprise

NOTE

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

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PROGRAM AT A GLANCE

1. Basic Data			**Project Number:** 48044-004
Project Name	Improving Domestic Resource Mobilization for Inclusive Growth Program (Subprogram 2)	**Department /Division**	CWRD/CWPF
Country	Georgia	**Executing Agency**	Ministry of Finance
Borrower	Ministry of Finance		

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	Effective gender mainstreaming (EGM)	✓
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	53.00
Sovereign Program loan: Ordinary capital resources	22.00
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 proposed policy-based loans to Georgia for subprogram 2 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 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 redistributive fiscal policy, specifically in tax and social protection measures.

II. THE PROGRAM

A. Rationale

3. The Georgian economy grew at an annual average of 5.8% during 2004–2014. The growth reflected reforms to liberalize the economy and remove bureaucratic barriers, while strengthening transparency and accountability. Consequently governance and the business environment improved, although significant barriers remain to business operations and private sector competitiveness. The World Economic Forum's Global Competitiveness Report for 2014–2015 ranks Georgia 69th out of 144 countries. Constraints to private sector development include an inadequately skilled workforce, limited access to finance, and gaps in infrastructure.[3]

4. Economic activity in the region has been decelerating as a result of the economic slowdown in the Russian Federation and a significant fall in oil prices. The economic contraction in the Russian Federation has also led to a sharp drop in remittances, erasing any gains from lower oil prices in Georgia, which is a net importer. Overall, the regional outlook has not been this weak since the global financial crisis of 2008–2009.[4] In February 2015, the Georgian government cut gross domestic product (GDP) growth projections by more than half, to 2.0%. The fiscal deficit is expected to rise in Georgia, requiring fiscal consolidation in the short and medium term. The current economic environment is also creating pressure on the country's financial system. Currency depreciation is increasing credit and solvency risks, and slowing economic growth is heightening credit risk.[5] Continuing structural reforms are essential to increase domestic resource mobilization for more inclusive economic growth, while guaranteeing social assistance to the poor and vulnerable during the slowdown and thereafter.

5. **Social expenditures and fiscal pressure**. Georgia's generally strong growth performance has not been matched by commensurate reductions in unemployment and poverty. Despite a decline in the unemployment rate from 16.9% in 2009 to 12.4% in 2014, further reduction is needed. The percentage of the population living below the national poverty line

[1] The design and monitoring framework is in Appendix 1.
[2] The proposed program is included in the country operations business plan, 2015–2017 for Georgia. ADB. 2014. *Country Operations Business Plan: Georgia, 2015–2017*. Manila.
[3] World Economic Forum. 2014. *Global Competitiveness Report 2014–2015.* Geneva. According to the report, Georgia's banking system has much work to do in improving access to credit (ranked 110 among 144 countries compared to Armenia at 97, Azerbaijan at 79, and Kazakhstan at 43) and affordability of financial services (ranked 75 with Armenia at 81, Azerbaijan at 77, and Kazakhstan at 55).
[4] International Monetary Fund. 2015. *Regional Economic Outlook Update for the Caucasus and Central Asia.* Washington, DC.
[5] Since November 2014, the Georgian lari has depreciated by about 31% against the dollar.

(60% of median consumption) was 21.4% in 2014, down from 24.6% in 2004. Beginning in 2012 the government has worked to pair better economic performance with improved social outcomes. Social spending—on health, education, and social assistance—increased to 11.7% of GDP in 2014 from 11.2% in 2013, an increase of nearly 31% over 2012 budgeted expenditure. Growth in social expenditure is pressuring public finance. Pensions are the largest social spending item in the state budget; in 2014 it represented 55% of all social benefits and about 19.9% of public expenditure (4.5% of GDP). These costs are expected to continue to increase due to the growing number of pensioners and the rising cost of pension benefits.

6. **Domestic savings and access to finance**. The fully government-financed universal pension system (pillar zero) is the largest component of the current pension system in Georgia, accounting for almost 84% of total pension expenditure.[6] The system entitles all citizens to receive pension benefits (at 60 years of age for women and 65 for men), making it an important instrument of poverty reduction and income security for the elderly. The flat rate pension has more than doubled over the last 5 years, but is still only marginally above the subsistence level. In the absence of additional opportunities to save, public pressure to raise the universal pension rate will increase the government's financial burden and challenge long-term fiscal sustainability.

7. Development and implementation of a multi-pillar pension system will help achieve key fiscal and social objectives. Incorporating contributory elements in the pension system will (i) increase old-age income from sources outside of the state budget;[7] and (ii) reduce expectations placed on the pillar zero system and (once the new pension system matures) spread the burden of financing future pensions more fairly across stakeholders and generations. There is limited domestic funding capacity in Georgia, with a long-term investment horizon that restrains economic growth, creating an over-reliance on foreign inflows. Pension fund assets have long-term investment objectives, with a primary focus of maintaining real asset values. This can stabilize bond markets and security exchanges, and help finance infrastructure needs. A defined contributory pension system is expected to improve the overall savings rate in the country.

8. **Public debt and capital markets**. Georgia's public debt to GDP ratio was 35.5% in 2014, 75% of which is denominated in foreign currency (largely in dollars). This exposes Georgia to foreign exchange risk, creating a source of vulnerability. Additionally the multilateral concessional windows are closing, raising the average external borrowing rate. A challenging transition from external sources of finance to local currency-denominated government securities will be needed over the medium term. The shift is needed not only to manage the country's foreign exchange exposure, but to support the development of the Georgian bond and capital markets and to sustain public investment plans. Development of the domestic government yield curve is essential for market infrastructure and information, as it sets the pricing and evaluation of domestic credit options for small and medium-sized enterprises (SMEs) and capital markets.

9. The SME sector represents nearly 95% of registered businesses and employs 37% of the workforce in Georgia, but accounted for only 16.9% of business turnover in 2014. Firms cite

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[6] Pillar zero is the existing state-run universal pension plan, which offers basic coverage and is primarily focused on reducing poverty.

[7] Contributory elements include a mandatory funded system that recipients and employers pay into (pillar II) through pension funds and defined contribution savings plans, and possibly voluntary privately funded accounts (pillar III) through individual savings plans and insurance. The design details of the proposed pension system are included in Sector Assessment (Summary): Public Sector Management (accessible from the list of linked documents in Appendix 2).

limited access to bank credit, high interest rates, and expensive financial services as major constraints to growth. Underdeveloped securities and capital markets as well as reliance on a fully publicly funded pension scheme prevent higher savings rates and limit the funds available for lending. Increased access to finance, especially for small businesses managed by women, is important for diversification of the economy.

10. **Private finance and fiscal risks**. The government wishes to mobilize private infrastructure investment, highlighting the need to manage fiscal risks. The policy to implement public projects with private sector participation needs to be set up for consistent implementation, because many projects with public–private partnership (PPP) characteristics are being developed. Existing contracts for PPP-type projects, as well as projects currently under development, contain contingent liabilities for the government. The lack of a framework for fiscal risk means that the contingent liabilities of existing and future PPP contracts are not transparent and are not well understood or managed by the government. This exposes ministries, state-owned enterprises (SOEs) and local governments to the risk of entering into new contracts without an accurate assessment of the affordability or fiscal risk. It also makes the market less transparent for the private sector.

11. **Government efforts and development coordination**. The government has initiated a pension reform program to address adequacy, fairness, and sustainability. A Pension Reform Unit was established and staffed in the Ministry of Economy and Sustainable Development (MOESD) in 2014 to design a new defined contributory pension system. The Asian Development Bank (ADB) has been instrumental in facilitating these reforms and in designing the mandatory and voluntary contributory pension schemes. The government is developing the domestic debt market, seeking increased market participation. ADB is working closely with the government to update the regulatory environment, to ensure issuer and trading price transparency and deepen investor protection. The government has undertaken several activities to address fiscal risk management for projects with private involvement, and is increasing the availability of finance to SMEs.

12. Many multilateral and bilateral development agencies are supporting the country's economic development. The World Bank is working to strengthen fiscal oversight of public institutions, upgrade the quality and coverage of social services, and support financial sector deepening through policy lending during 2015–2017. In 2014 the European Parliament ratified the European Union's Association Agreement with Georgia, including an agreement on a deep and comprehensive free trade area spanning 2014–2017, which together with political association and market opening aims for approximation of Georgian systems and norms with those of the European Union. In 2014, Georgia entered into a 3-year standby arrangement with the International Monetary Fund that provides a cushion against external balance of payment shocks, and sets a framework for discipline in macro-fiscal policies.

13. **ADB's value additions and lessons**. The program supports inclusive growth by generating long-term savings and making short-term capital available for small businesses and infrastructure. The programmatic approach adopted for the program-- sequencing of reforms with the flexibility to incrementally change the reforms based on the progress achieved-- allows the government to build on achievements and lessons from the reforms and to steer the next phase of policy reforms accordingly.[8] It allows the government to take on complex reforms in a

[8] ADB. 2014. *Report and Recommendation of the President to the Board of Directors: Proposed Programmatic Approach and Policy-Based Loans for Subprogram 1 to the Republic of Georgia for Improving Domestic Resource Mobilization for Inclusive Growth Program.* Manila.

phased manner that might have been otherwise delayed. For example, the government embarked on reforms to better manage fiscal risks and contingent liabilities, and to contain the burgeoning fiscal costs of the universal pension system. Relevant lessons on the need for policy reforms, a 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, and continue to be applied throughout the program cluster.[9] Relevant lessons from subprogram 1 include the need for longer-term engagement with the government in key policy areas through technical assistance (TA) and sector reforms while strengthening the macroeconomic framework. ADB is providing ongoing TA, and plans to continue working on macroeconomic and public sector issues.

14. **Alignment with ADB's strategy.** The Socio-Economic Development Strategy of Georgia (Georgia 2020) establishes policy directions for sustainable and inclusive economic growth.[10] The proposed program corresponds closely to the core areas of fiscal efficiency, public debt management, domestic savings, access to finance for SMEs, and capital markets. The program also responds to the 2014–2016 National Action Plan for Implementation of Gender Equality Policy in Georgia, which includes support for gender equality in economic and finance sectors.[11] The program is consistent with the ADB country partnership strategy, 2014–2018 for Georgia and the findings from the ADB Midterm Review of Strategy 2020.[12] The country partnership strategy aims to foster inclusive economic growth through measures to enhance private sector competitiveness, improve public sector management, and increase savings and domestic resource mobilization for investment.

B. Impact and Outcome

15. The program impact will be that citizens, particularly women, benefit from higher living standards and more employment opportunities. The outcome will be the effective mobilization of domestic resources for increased public and private investment.

C. Outputs

16. The program comprises three annual subprograms to support the government's reform initiatives. It specifically covers medium-term issues in four areas: (i) improving management of debt, cash, and fiscal risk; (ii) strengthening revenue and public expenditure management; (iii) enhancing generation of domestic savings; and (iv) increasing mobilization of private resources for investment. Subprogram 2 has 27 policy actions, with two additional actions completed that facilitate access to finance for small businesses. Some targets were exceeded: the actual number of female auditors was 147 (versus a target of 110), and the Entrepreneurship Development Agency (EDA) budget allocation stood at GEL21 million (versus a target of GEL20 million). The policy action on submission of a capital market strategy to the cabinet was modified, with review and approval by the Economic Council prior to cabinet deliberations. This ensures that the views of all stakeholders are considered through intensive public–private dialogue sessions. There are 25 indicative policy actions for subprogram 3.

17. **Output 1: Improved management of debt, cash, and fiscal risk**. The objective of this output is to improve fiscal consolidation through strengthened debt, cash, and fiscal risk

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[9] ADB. Evaluation Information System. http://wptamseal.adb.org/lnadbg4/oed001p.nsf/index?OpenForm.
[10] Government of Georgia. 2014. *Socio-Economic Development Strategy of Georgia (Georgia 2020).* Tbilisi.
[11] Government of Georgia. 2014. *2014–2016 National Action Plan for Implementation of Gender Equality Policy in Georgia*. Tbilisi.
[12] ADB. 2014. *Midterm Review of Strategy 2020: Meeting the Challenges of a Transforming Asia and Pacific*. Manila.

management. Subprogram 1 improved debt management capacity by strengthening relevant government processes, increasing transparency and developing analytical and forecasting capabilities, and facilitating introduction of the medium-term debt strategy. Subprogram 1 also strengthened fiscal risk management by drafting a strategy to deal with different types of fiscal risks and by determining the fiscal position of large SOEs, to enable adoption of systematic procedures and resources to better manage fiscal risks and assess contingent liabilities.

18. Subprogram 2 (i) prepared a medium-term debt management strategy covering the loan portfolio and goals and principles to apply when incurring new debt; (ii) prepared an action plan to strengthen the middle office (analytical) function of the Public Debt and External Financing Department in evaluating and advising on the public debt portfolio; (iii) developed a systematic process for debt and loan guarantee recordkeeping, reporting, and validation; (iv) set up a dedicated analytical function for cash flow forecasting, with budget and personnel; (v) established a dedicated staffed and budgeted function to manage fiscal risks, including contingent liabilities of SOEs and PPP projects; (vi) established procedures, assigned institutional responsibilities, and set aside adequate human and financial resources to monitor and help manage different types of fiscal risk; and (vii) carried out the first complete assessment of (a) macro risk, (b) external debt sustainability, and (c) risk associated with loan guarantees and other similar contingent liabilities.

19. Subprogram 3 will build on the accomplishments of subprograms 1 and 2 by continuing to improve the management of debt, cash, and fiscal risk over the medium term. The legislative amendments required to implement the newly prepared debt strategy will be debated in Parliament. Debt management and risk analysis systems will be upgraded. A systematic process will be developed to track debt and loan guarantees and report the government's financial statements in a timely manner. Information on contingent liabilities related to SOEs and PPPs will be provided.

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 transfers. Subprogram 1 established a new administrative department under the Georgia Revenue Service, enabling recovery of tax arrears and increasing revenue collection. Subprogram 1 devised an action plan to replace external auditors with in-house tax auditors, and provided the requisite training. Budgeting and budget execution functions of government entities were also integrated into the public financial management system and the treasury single account.

21. Subprogram 2 (i) recovered arrears from active taxpayers of GEL80 million in 2015 (to date); (ii) reduced the statutory time limitation of tax notices and taxpayer notices from 6 to 5 years, shortening the tax liability imposition period and providing relief to taxpayers; (iii) increased the number of in-house tax auditors to 286 (versus a target of 275), of which 147 are women (significantly exceeding the target of 110); (iv) moved cash operations of local self-governments and legal entities of public law to the treasury single account, with budgeting and accounting processes handled through the public financial management (PFM) system;[13] (v) MOESD identified gaps in the legal and regulatory framework for preparation, appraisal, and implementation of PPP projects; and (vi) the government submitted to Parliament proposals for amendments to the Budgetary Code defining the separation of revenues among the state, autonomous region, and municipality budgets.

[13] There are more than 2,000 schools and kindergartens, many of them in remote and rural areas, which do not strictly come under the purview of legal entities of public law and are not covered.

22. Subprogram 3 will build on the accomplishments made under subprogram 1 and 2. A reduction in tax notice time limitations, writing off of tax arrears of defunct businesses on the basis of legally approved categories, and increasing the number of in-house tax auditors to the full complement will streamline tax collection efforts. Drafting of regulations to support the preparation, appraisal, and implementation of PPP projects will facilitate participation of the private sector in infrastructure projects.

23. **Output 3: Enhanced generation of domestic savings**. The objective of this output is to reform the existing pension system so that it helps prevent old-age poverty, is affordable for both individuals and society, and is sustainable in the long term. The aim is to streamline the universal pension and create a supplementary private pension savings scheme. Subprogram 1 established a government pension reform unit, tasked with designing a pension system built on a legal and institutional framework covering asset security, consumer protection, professional management of investment funds, and a transparent reporting and information system.

24. Subprogram 2 (i) completed the forecast of the present and future cost of universal pensions under various scenarios, using the Prost Modeling system developed by the World Bank and other approaches; (ii) submitted to the government pension system revisions ensuring continuity of equitable treatment for men and women; (iii) completed analysis of key areas of pension system design and structure, incorporating mandatory and voluntary dimensions; (iv) issued a consensual paper on the nature of the hybrid pillar, including discussion on membership, contributions, tax considerations, benefits, gender, and relationships with the zero pillar; (v) submitted to the cabinet for approval a strategy and time-bound action plan for pension reforms, including legal and regulatory gaps, data privacy, and tax legislation; (vi) developed an approach for public awareness programs for zero and hybrid pillars, outlining specific measures for continuing equitable treatment of men and women; and (vii) completed the review of the existing private pension structure to incorporate any required changes in the related legislation.

25. Under subprogram 3 preparatory steps for implementation will take place, including the development of an individual account system, drafting of legislation for the private pension savings scheme, and launching of a nationwide communication campaign.

26. **Output 4: Increased mobilization of private resources for investment**. The objective of this output is to mobilize long-term finance and enhance access to finance through small business financing, development, and gender targeting. Subprogram 1 established an interagency working group to initiate capital market development. The EDA and Georgia Innovation and Technology Agency (GITA) were also created to provide mini- and matching grants to micro, small, and medium-sized enterprises.

27. Subprogram 2 (i) issued a public notification on the concept and direction of capital market reforms, including corporate securities, expansion of the bond market, and money market instruments for secured interbank trading; (ii) submitted to the Economic Council for approval, as a precursor to cabinet approval, a strategy and time-bound action plan for capital market reforms, that addresses legal and regulatory gaps and improvements to market structure and efficiency; (iii) allocated a budget of GEL21 million to EDA; (iv) allocated a budget of GEL6 million to GITA; (v) expanded, within the existing budget, EDA's matching grant facility for micro, small and medium-sized enterprises by GEL4 million, with 30% earmarked for businesses run by women; (vi) expanded, within the existing budget, GITA's financial instruments to support private sector innovation and technology development by GEL3 million, with 30% earmarked for businesses run by women; and (vii) implemented the gender action plan and publicly reported on results included in the program policy areas, such as small business training and financing.

Additionally, EDA launched a new program "Produce in Georgia" with a component on micro and small enterprise development in rural areas, with a budget of GEL20 million (for 2015–2017). GITA created Geolab—a mobile training and knowledge exchange platform and fabrication laboratory—for research and development, with a budget of GEL1.1 million. In addition three innovation labs were created with GITA support, and construction of the first techno park in Georgia is ongoing.

28. Under subprogram 3, the implementation of capital market development plan will be in an advanced stage, including review of laws and regulations on investment, governance, risk management, and fund managers; approval of account and prudential regulations for repos and securities lending; and expansion of the matching grant facility for small enterprises, with specific gender targets.

D. Development Financing Needs

29. The overall program is estimated to cost $200 million equivalent for 2014–2016. Subprogram 2 comprises single-tranche loans in the aggregate amount of $75 million equivalent. Subprogram 1, with a loan amount of $75 million equivalent, was disbursed in 2014. Subprogram 3, with a loan amount of $50 million equivalent, is subject to further discussion between ADB and the government.[14] To help finance subprogram 2, the government has requested (i) a loan in various currencies equivalent to SDR37,966,000 ($53 million equivalent) from ADB's Special Funds resources, and (ii) a loan of €19,891,500 ($22 million equivalent) from ADB's ordinary capital resources.[15] The Asian Development Fund 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 other terms and conditions set forth in the draft loan agreement. The ordinary capital resources loan will have a 15-year term, including a grace period of 3 years, the straight-line repayment method, an annual interest rate determined in accordance with ADB's European interbank offered rate (EURIBOR)-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 with no maturity premium payable to ADB.

30. The loan size is based on government's development financing needs, the nature and sequence of the required reforms, and potential development impact. The government's development-related financing gap is estimated at GEL1,625 million, an increase of 2.7% in 2015 relative to 2014.[16] The government intends to meet this gap by borrowing from domestic (30.8%) and foreign (69.2%) sources. Domestic borrowing comprises GEL400 million issues of treasury securities (net), with an additional GEL100 million issue deposited with banks. While foreign borrowing comprises financing and long-term investment credits projected at GEL620 million, and anticipated budget support from the World Bank and other development partners of GEL505 million equivalent (equivalent of GEL172 million policy-based loan from ADB, GEL276 million in development policy operations from the World Bank, and GEL57 million in macroeconomic support from the European Union). ADB's subprogram 2 will help narrow the government's financing gap by about 34.1% in 2015 and will help meet part of the financing needs. Public debt is projected to climb slightly over 40.0% of GDP at the end of 2015 as a result of government borrowing and program-based budget support, before declining in the

[14] The significant economic slowdown and currency depreciation pose serious challenges to the government's ongoing reforms with respect to fiscal consolidation, increased domestic resource mobilization, improved financial sector diversification, and guaranteed social protection. To cover the larger-than-expected financing gap, the government has requested that ADB increase the subprogram 2 amount from the original $50 million to $75 million.

[15] The development policy letter from the government is in Appendix 3.

[16] Government of Georgia, Ministry of Finance. 2015. *Georgia: Basic Data and Directions 2015–2018—supplementary document of 2015 Budget*. Tbilisi.

medium term. Budget support is necessary to finance part of the development financing needs, particularly for the period from the introduction of reforms to the realization of fiscal benefits.[17]

E. Implementation Arrangements

31. The Ministry of Finance (MOF) is the executing agency and MOESD and MOF are the implementing agencies for the program. A program steering committee has been formed comprising senior officials from the two ministries, chaired by the deputy minister of finance. The committee meets semiannually to review progress in achieving the program's agreed policy actions. 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.[18] 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 2 is from November 2014 to September 2015.

III. DUE DILIGENCE

A. Economic and Financial

32. The reforms supported by the program entail direct and indirect fiscal costs to the government—the cost of implementing and monitoring the reforms—along with fiscal savings in the medium to long term. The reforms bear both the direct and operating costs of dedicated public functions and agencies established under the program.[19] Higher expenditures are therefore warranted over the short term to realize these savings, necessitating the need for budget support. Over time, these reforms will generate a positive fiscal feedback by creating a wider and more diversified economic base and improved management of macroeconomic risks. The reform program will result in cost savings and additional gains due to (i) declining pension funding costs and a reduced burden on public finances from the introduction of a supplementary pension system; (ii) financial savings from more efficient and effective use of public resources through better cash, debt, and fiscal risk management; and (iii) financial gains from additional revenues due to increased mobilization of private capital for investment.

33. Pension reforms alone will have major budgetary implications. Pension costs increased to GEL1.33 billion (4.5% of GDP) in 2014 and are projected to grow to GEL1.39 billion in 2015. Given regular increases in the universal pension rate and in the number of pensioners, the government will incur GEL8 billion in pillar zero payments for 2016–2020.[20] The government contribution for the proposed pillar II supplementary pension is estimated at GEL313 million in the first 3 years and GEL631 million in the first 5 years of implementation.[21] Development of the medium-term debt strategy under the program aims to meet the government's public financing needs and payment obligations while minimizing long-term costs, with debt ceilings set at 10.5%

[17] Paras. 31–32 and the Economic and Financial Analysis (accessible from the list of linked documents in Appendix 2) discuss and analyze the direct and indirect fiscal costs to the government of implementing and monitoring the reforms, and consequent adjustments to the ongoing policies and programs.
[18] ADB. 1998. *Simplification of Disbursement Procedures and Related Requirements for Program Loans*. Manila.
[19] The costs incurred to public agencies are in terms of administrative and enforcement costs related to monitoring, implementation and enforcement, as well as direct fiscal costs. The latter include the expense associated with establishing statutory agencies, budget increases, staff time, expenditure programs, and foregone revenue.
[20] Calculations are based on fiscal projections developed by National Bank of Georgia and MOESD; the World Bank projects that pension spending under the current universal system will double to 9% of GDP by 2070.
[21] A detailed analysis and calculations are in the Economic and Financial Analysis (accessible from the list of linked of documents in Appendix 2).

of budget revenues, 40% of GDP, and 30% of total borrowing. The reform will lead to additional benefits and savings associated with fiscal discipline and with improvements in core budgetary and fiscal risk responsibilities as a result of increased risk management capacity within MOF. Additional revenues of GEL80 million have been realized and increased intergovernmental transfers of up to GEL40 million are expected through the program. Developing capital markets to mobilize long-term finance will spur growth and increase the efficiency of SMEs through greater access to finance and better gender targeting. Mobilizing private resources for investment is important given the low national savings rate, which compounds the twin deficit of fiscal and external imbalances with a low reliance on internal sources of financing.

B. Governance

34. Public financial management risks are manageable for this program. Following the 2003 Rose Revolution, far-reaching structural reforms were introduced, strengthening PFM and reducing corruption. The integrated PFM system was implemented and state financial transactions unified under a single treasury account. However challenges remain, including inadequate monitoring and analysis of government contingent liabilities, the failure to include the revenues and expenditures of some legal entities of public law in budget execution reports, inadequate predictability and transparency of intergovernmental transfers, limited internal audit capacity, and weak legislative scrutiny of external audit reports.[22] Fighting high-level corruption is a government priority. Aggressive enforcement of anticorruption policies has largely eliminated petty corruption. The State Procurement Agency continues to improve transparency in public procurement processes by adopting international standards. A new electronic module was recently integrated into the e-procurement system that provides a platform for meeting the procurement requirements of multilateral development banks. ADB's Anticorruption Policy (1998, as amended to date) was explained to and discussed with the MOF and MOESD.

C. Poverty and Social

35. The basic pension plays an important role in poverty reduction and serves a valuable welfare distribution function. Without the basic pension, poverty would increase from 24% to 33%, and inequality would increase the Gini coefficient from 37.7 to 40.9.[23] Subprogram 2 is categorized as effective gender mainstreaming. It will address the unequal access to assets and resources, and the insufficient attention paid to gender in economic development policy. The Georgia Revenue Service is hiring an equal number of women and men as in-house tax auditors. Pension reforms will ensure equitable treatment of men and women, allowing both to accumulate sufficient pension assets to ensure an adequate income during old age while maintaining prevention of old age poverty through the universal pension. EDA has allocated 30% of matching grants to women entrepreneurs for business development. GITA has funds earmarked to support private sector innovation and technology development, with 30% for women entrepreneurs. The government will continue implementing the gender action plan and supporting increased participation of women in economic and business development.

D. Safeguards

36. Program activities are confined to policy and institutional reforms. None of the activities will result in or lead to involuntary resettlement or affect indigenous peoples. No adverse environmental impacts have been identified. Safeguard categories for environment, involuntary

[22] ADB. 2015. *Country Partnership Strategy: Georgia, 2014–2018*. Manila; Sector Assessment (Summary): Public Sector Management (accessible from the list of linked documents in Appendix 2),

[23] World Bank. 2009. *Georgia Poverty Assessment*. Washington, DC.

resettlement, and indigenous peoples are all C.

E. Risks and Mitigating Measures

37. Georgia's economy has been hit by several severe external shocks: the Russia–Ukraine crisis, the deepening recession in the Russian Federation, and currency devaluations in trading partner countries. Macroeconomic management is generally sound. Because of its solid fundamentals, reform-minded authorities, and improved market access to the European Union,[24] Georgia is well placed to overcome the current challenges. Weak monitoring of contingent liabilities and limited coverage of PFM are risks. PFM-related risks are being addressed with support provided under the program and by the TA.[25] The integrated benefits of the program are expected to outweigh the costs.[26]

IV. ASSURANCES

38. The government has assured ADB that implementation of subprogram 2 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.

39. The government has agreed with ADB on certain covenants for subprogram 2, which are set forth in the loan agreements.

V. RECOMMENDATION

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

(i) the loan in various currencies equivalent to SDR37,966,000 to Georgia for subprogram 2 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

(ii) the loan of €19,891,500 to Georgia for subprogram 2 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 European interbank offered rate (EURIBOR)-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

26 August 2015

[24] On 27 June 2014, Georgia and the European Union signed an Association Agreement, including a deep and comprehensive trade area, leading to increased European integration and providing export and investment opportunities.

[25] ADB. 2014. *Technical Assistance to Georgia for Strengthening Domestic Resource Mobilization*. Manila (TA 8716-GEO).

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

DESIGN AND MONITORING FRAMEWORK

Impact the Program is Aligned with: Citizens, particularly women, benefit from higher living standards and more employment opportunities.

Results Chain	Performance Indicators with Targets and Baselines	Data Sources and Reporting	Risks
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 20.2% (2012 baseline: 18.1%)	National Statistics Office of Georgia	External environment deteriorates and reforms are delayed to improve fiscal consolidation.
Outputs 1. Debt, cash, and fiscal risk management improved	1a. By September 2016, a medium-term public debt management framework is implemented 1b. By September 2016, assessment of fiscal risks conducted for large SOEs to determine contingent liabilities	1a. Government decree 1b. Public notification on MOF website	Lack of assessment and monitoring of contingent liabilities causes fiscal risk.
2. Revenue and public expenditure management strengthened	2a. By September 2016, tax arrears collection increased by at least GEL80 million 2b. By September 2016, the number of in-house tax auditors increased to 330, of which 150 are women 2c. By September 2016, draft amendments prepared to cover gaps in the legal and regulatory framework of PPPs	2a. Annual report published on Georgia Revenue Service website 2b. Annual report published on Georgia Revenue Service website 2c. Annual report published on MOF website	Limited coverage of public financial management affects expenditure and fiscal consolidation.

Results Chain	Performance Indicators with Targets and Baselines	Data Sources and Reporting	Risks
3. Generation of domestic savings enhanced	3a. By September 2016, pension system revisions implemented that ensure continued equitable treatment of men and women 3b. By September 2016, changes instituted to basic pension law, and the law on voluntary savings	3a. Annual report published by MOESD, MOLHSA, and MOF 3b. Annual report published by MOESD, MOLHSA, and MOF	
4. Mobilization of private resources for investment increased	4a. By September 2016, at least GEL12 million provided to small and medium-sized businesses as a matching facility to spur investments, with 30% allocated to women entrepreneurs 4b. 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	4a. Annual report published by MOESD and MOF 4b. Annual report published by MOESD and MOF	

Key Activities with Milestones

1. Debt, cash, and fiscal risk management improved

1.1 MOF prepares and approves a debt strategy covering the loan portfolio, the goals and principles of incurring new debt, and issues of debt sustainability (July 2015)

1.2 MOF prepares an action plan to strengthen the middle office (analytical) function of the PDEFD for advising on funding terms for government projects and evaluating the public debt portfolio (June 2015)

1.3 MOF establishes a staffed and budgeted function to manage fiscal risks, including contingent liabilities of SOEs and PPPs (June 2015)

1.4 MOF carries out a first complete (i) macro risk assessment, (ii) external debt sustainability analysis, and (iii) review of risk associated with loan guarantees and other similar contingent liabilities (August 2015)

2. Revenue and public expenditure management strengthened

2.1 GRS recovers arrears from active tax payers amounting to at least GEL60 million for the current tax year (June 2015)

2.2 GRS increases the number of in-house tax auditors to 286, of which 147 are women, with a

Key Activities with Milestones
corresponding decrease in the number of alternative auditors (July 2015) 2.3 All cash operations of LSGs and LEPLs are channeled through the TSA; and the budgeting, budget execution and accounting processes through the electronic PFMS (March 2015) 2.4 Government agencies identify gaps in the legal and regulatory framework for preparation, appraisal, and implementation of PPP projects (August 2015) **3. Generation of domestic savings enhanced** 3.1 MOESD and MOF complete a forecast of the present and future cost of a universal pension under various scenarios using Prost Modelling and other approaches (January 2015) 3.2 MOESD issues a consensual paper on the nature of hybrid and joint pillars, including issues such as membership, contributions, tax considerations, benefits, gender, and the relationship with the universal pension system (July 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 (August 2015) 3.4 MOESD develops public awareness programs for zero and hybrid pillars outlining specific measures regarding the continuing equitable treatment of men and women (August 2015) **4. Mobilization of private resources for investment increased** 4.1 MOESD issues a public notification on the concept and direction of capital market reforms, including corporate securities, bond market expansion, and money market instruments for secured interbank trading (July 2015) 4.2 MOESD submits to the Economic Council for approval a strategy and action plan for capital market reforms, including improving the structure and efficiency of the market infrastructure (August 2015) 4.3 EDA expands the matching grant facility for small and micro enterprises by GEL4 million, with 30% earmarked for businesses run by women (July 2015) 4.4 GITA expands financial instruments to support private sector innovation and technology development by GEL3 million, with 30% earmarked for businesses run by women (June 2015) 4.5 The government implements the gender action plan and publicly reports on the results, including in areas such as small business training and financing (July 2015)
Inputs Subprogram 1 = $75 million Subprogram 2 = $75 million (loan) Subprogram 3 = $50 million
Assumptions for Partner Financing Not applicable.

ADB = Asian Development Bank, EDA = Entrepreneurship Development Agency, GDP = gross domestic product, GITA = Georgia 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, PDEFD = Public Debt and External Financing Department; PFMS = public financial management system, PPP = public–private partnership, SOE = state-owned enterprise, TSA = treasury single account.
Source: Asian Development Bank.

LIST OF LINKED DOCUMENTS

http://www.adb.org/Documents/RRPs/?id=48044-004-3

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

Supplementary Document

13. Programmatic Approach Concept Paper

PRIME MINISTER
OF GEORGIA

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 5.8% on average annually between 2004 and 2014. GDP expanded by an estimated 4.8% in 2014, up from 3.3% in 2013. The recovery was driven by construction, financial intermediation, communication and tourism. On the demand side, growth was driven by increased domestic demand linked to an expansion in consumption spending, and increased private sector investment. A preliminary growth estimate for the first quarter of 2015 is 3.2%. In 2014, state budget revenues recovered and registered year-on-year growth of 8.3% while current expenditures grew by 12.2%, albeit from a lower base. The fiscal deficit amounted to an estimated 2.9% of GDP, which was less than budgeted because revenue exceeded the planed figure while expenditure fell short of planned outlays. The revenue performance continued to be strong in the first quarter of 2015, exceeding the target by 4.3%, while expenditure reached 96.9% of the target. At the end of 2014, total public debt amounted to 35.5% of GDP (up slightly from 34.7% at end-2013). Average inflation rate amounted to 2.9% by June 2015. Due to mounting exogenous shocks, inflationary expectations have been increasing since November 2014, given a 31.3% depreciation of the lari against the US$. The current account deficit widened to 9.7% in 2014 from 5.7% in 2013. The widening was mainly a result of high growth in imports which was attributable to the low base in 2013 and a sharp slowdown in exports in the fourth quarter of 2014 due to a deteriorating external environment.

In 2015, the Georgian government cut down GDP growth projections down to 2.0% based on deterioration in fourth quarter of 2014, economic performance results in the Q1 of 2015, and the overall economic downturn in the region. In a medium term, 6% economic growth is a baseline estimate backed by our reform agenda.

Since 2003 the government has implemented a series of structural and institutional reforms 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 state assets. As a result, governance and the business environment improved significantly, and Georgia's ranking in several international indices rose. The World Bank's *Doing Business* 2015 survey, which is based on a new methodology, ranked Georgia 15 among 189 countries. According to the survey, starting a business encompasses only two procedures and takes an average of two days compared with the global average of 35 days (in practice registration of business requires one procedure and takes one business day). Georgia maintained its first position in Registering Property; is in top 10 in Dealing with Construction Permits (3rd position), Getting Credit (7th position) and Starting a Business (5th position).

According to the World Bank, Georgia is the top improver since 2005 in Eastern Europe and Central Asia and globally. The World Economic Forum's Global Competitiveness Report for 2014–2015 ranks Georgia 69th out of 144 countries. Constraints on the private sector include an inadequately educated workforce, limited access to finance, and gaps in infrastructure. Despite the laudable progress, the reforms have not entirely led to inclusive growth in Georgia, and growth has not led to creation of sufficient jobs.

The government set out its state budget expenditure target at GEL9.6 billion in 2015, up 6.2% from 2014. The budget deficit is expected to remain under 3.0% of GDP in compliance with the Liberty Act. The government will finance the budget deficit through (i) GEL400 million issues of treasury securities (net), among other sources of domestic financing; and (ii) foreign financing and long-term investment credits (predominantly for infrastructure) that are projected at GEL620 million. The government anticipates budget support from the World Bank and other development partners of GEL505 million or $220 million at the programmed 2.30GEL/$ exchange rate (GEL172 million PBL from ADB, GEL276 million DPO from the World Bank, and GEL57 million macroeconomic support from the EU). Deficit financing through foreign and domestic credits amounts to GEL1,625 million. ADB's PBL under the Subprogram 2 will help to fill the gap in the fiscal deficit, which amounts to 3.0% of GDP in 2015, according to the amendment to the Budget Law.

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 2014), Georgia's public debt ratios will not be significantly affected even under extreme scenarios and will not exceed 60% of GDP. External debt totaled an estimated 64.0% of GDP (excluding intercompany loans) at end 2014. External public debt amounts to 75% of total public debt. Public debt was estimated at 35.5% of GDP at the end of 2014. While Georgia's debt is largely owed to multilaterals on favorable terms with long maturities, some 75% is denominated in foreign currency, which subjects Georgia to foreign exchange risk.

The government is proactively responding to the current challenges. The government approved a socio-economic development strategy (Georgia 2020) in June 2014 that focuses on business development and social needs 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 current subsistence minimum for working age male of GEL155.6), 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 improve access to finance, 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. It 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 as an independent body to oversee implementation of competition policies, and to enforce 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 non-banking financial institutions. To this end, the government recently has been implementing measures 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 provide financial support, promote development and to ease market entry for small businesses as well as to support businesses in adaptation to the Deep and Comprehensive Free Trade Area Agreement (DCFTA) requirements and enhancement of export potential. The Entrepreneurship Development Agency (EDA) was established in February 2014 to facilitate SME development, growth and enhancement of competitiveness via financial and non-financial instruments, such as improvement of business skills, development of entrepreneurial culture and support in access to finance for SMEs and start-ups during the incubation period, as well as to help businesses increase their export potential. The Innovation and Technology Agency (GITA), as well created in February 2014, promotes application of innovative technologies in business activities, and helps to commercialize innovative R&D for a knowledge-based economy. In 2015, GITA in cooperation with private sector and academia created a mobile and web-based applications laboratory, Geolab, which is a teaching and training knowledge-exchange platform for individuals wishing to pursue the mastery of development of software products and services. Another related project on startup accelerators allows students and individuals to explore entrepreneurial ideas and launch business ventures. In December 2014, GITA at a local university opened a fabrication lab (fablab), which is equipped with modern technologies (3D printers, google glasses, laser jets, etc), and is a breeding ground for developing prototype products and transformative ideas, with the ultimate goal of commercializing innovations. In addition 3 Innovation Labs (Ilabs) were created by GITA's support, and construction of the first Techno Park in Georgia is ongoing. 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 support for SMEs in agricultural and in industrial production, in an effort to bolster domestic production capacity. A total of 92 beneficiaries, more than half of them in the regions of Georgia, were supported under the "Produce in Georgia" program by July 2015 with a total volume of expected investment of GEL256.4 million, and about GEL123 million in loans approved by commercial banks. EDA is involved in the implementation of 70 projects of industrial profile, and 22 projects are in the agriculture sector. Under this program the government granted state owned property on preferential terms for 37 projects with investment obligations. Under the "Produce in Georgia" Program, a new compact "micro and small enterprise development" was launched in November 2014, implemented by EDA with a budget of GEL20 million (for 2015-2017). The 26-month program is aimed at reducing rural and urban inequality in Georgia. The project also involves a training component in helping to develop commercially viable business proposals during the first 4 months from the launch of a project and need-based technical consultations thereafter for 12 months. The program foresees co-financing by a beneficiary in the amount of 20% of the total project cost, and funding of GEL5,000 per entrepreneur and GEL15,000 for a group of entrepreneurs is envisaged. Under this compact, EDA will provide matching grants for starting micro businesses in the regions together with consultancy services. 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, consolidating debt and cash management. Tax revenues as a share of GDP have been increasing consistently from only 12.0% in 2003 to 21.6% in 2007, 25.5% in 2012, 24.8% in 2013, and 25.2% in 2014. 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, presenting overall performance, treasury securities issuances and transactions on primary markets as well as information on projects and programs financed by external sources, covering total loan amounts, disbursed amounts and sums reflected in the state budget. Approval of a debt strategy for medium term debt management, covering loan portfolio, goals and principles of incurring new debt is fulfilled. 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 department introduced eCloud technology in December 2014 comprising more than 1,000 system servers ensuring unified access to real-time data for speedy information processing and interpretation. 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. The 2014 World Bank Public Expenditure Review highlighted the need for an efficient Public Investment Management (PIM) system, the importance of the role of the State Audit Office, legislative and civil society oversight, and the critical nature of investments in human capital to fill significant human resource gaps.

The Revenue Service has written off declared tax arrears of defunct businesses while recovering accrued arrears from active taxpayers. A total of GEL334.3 million was written off against 3,612 taxpayers by March 2015. A cumulative amount eligible for write-offs stands at about GEL1 billion. This measure allows businesses encumbered with hopeless tax liabilities to have a clean slate and re-start operations. The Finance Minister has been empowered to issue a public decision on provisions of the tax code susceptible to vagueness and dual interpretation. This enhances government sector transparency in tax administration by making the Ministry's position publically known, thereby removing confusion in tax compliance for businesses.

Amendments to the Budget Code defining more fiscal decentralization of revenues among the budgets of state, autonomous regions and municipalities were adopted in December 2014, allowing municipalities to get more tax revenues.

A more conducive tax administration regime was established for vehicle importers as car re-exports, Georgia's top export item, to Azerbaijan and other countries were significantly down due to global economic factors and more stringent vehicle condition standards. Fines and penalties for the late payment of customs duties were lifted and the tax compliance period was extended to 1 September 2015. More concessional tax treatment was also put in practice in respect of income from property rent. Refunds on non-taxable minimum income and pre-paid taxes are in effect, such as VAT prepayments and other advance tax payments that are returned to taxpayers on a rolling basis. About GEL128 million was returned to taxpayers eligible for exemptions in 2014.

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, costed 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 70.6% of GDP in 2014. Georgia has 19 commercial banks; the top five banks controlled 75.8% of assets in 2014, indicating that concentration in the banking sector is relatively high. There is no deposit insurance system, but as part of approximation with EU Directives (according Association Agreement), introduction of deposit insurance is committed. 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 also small. The potential of securities market in Georgia is not well utilized. The 2015 IMF FSAP report noted that financial sector intermediation in Georgia will need to play a central role in promoting investment, employment and economic growth. Further, the FSAP mission positively assessed the National Bank of Georgia's (NBG) planned adoption of the Liquidity Coverage Ratio (LCR), the countercyclical capital buffer regime, readiness for further strengthening of Basel II/III implementation. Moreover, in order to further enhance financial supervision and ensure its full independence in line with the requirements of the EU-Georgia Association Agreement, it is intended to create Financial Supervisory Agency of Georgia in the system of the NBG. This institution will be solely responsible for the supervision of the financial sector (except for the insurance market) in the country, including banking sector, micro-finance organizations, the stock exchange, etc. This will support the development of financial markets (apart from the banking sector) and enhancement of financial intermediation. As the securities market has further room for development, there may be a need for the government to play a more active supporting role. 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 development of the capital markets as a source of stable and long-term private financing is very important for economic growth. Dollarization is the main challenge to the financial sector. Over two-thirds of housing loans are denominated in US dollars, and around 75% of Georgia's public debt is in foreign currency. The Georgian authorities continue to promote the use of the lari in the financial system. In 2013 the NBG started encouraging lari lending. Floating rate mortgage loans increased lari-based lending. Furthermore, the NBG imposes higher risk weights on foreign currency loans and maintains higher reserve requirements on banks' foreign currency deposits. The domestic bond market remains undeveloped, shallow, and insufficiently liquid, with few institutional investors. Banks are the main purchasers of public debt. Low domestic savings limit nonbank financing for the budget or the private sector, leaving the economy overly reliant on inflows from abroad. Little long-term financing in lari is available.

The government has taken some steps to address narrow reliance on domestic sources of funding. To promote commercial lending in lari, in 2014 the government issued GEL200 million in Treasury securities, depositing the proceeds in commercial banks for onlending. A similar operation is planned for 2015. In addition, international financial institutions issued bonds denominated in local currency in March 2014 and February 2015. Bond issues such as this support the development of the local capital market and helps attract the diversified investor base necessary to provide sufficient liquidity and demand in the domestic market.

The government has also initiated pension reforms. The principal focus is on the introduction of a defined contribution pension system (Pillar II), which will provide strong financial incentives for participants. The existing universal pension plan or Pillar Zero will also be reviewed to make it compatible with the new scheme. Necessary amendments to relevant legislation will also be introduced. The current subsistence minimum for a working age male is GEL155.6 similar to the old-age pension benefit. We fully appreciate that the universal pension system 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 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 long term poor liquidity still represent a constraint for 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.

To address the lack of internal resources, the government aims to improve the mobilization of domestic savings. Ongoing pension reform and the planned development of private pension funds will help in this regard, as private pools of savings promise to create demand from sources other than banks for government securities in local currency. In addition, these pools of savings will provide longer-term private sector financing, including bond issuance. Developing secondary markets for government bonds and other fixed-income securities would help develop capital markets, including nonbank sources of government finance. Measures such as these would strengthen demand for local currency securities while promoting a financial system better able to channel resources toward productive uses that support investment and growth.

The budget allocated GEL1.9 billion for pension and social protection in 2014, which is an increase of about 18.8% relative to 2013. Since 1 September 2013 pension increased to GEL150 for all groups of pensioners. By end-2014, there are a total of 697,240 age pensioners and an average annual monthly outlay on pensions constitutes GEL110 million. The current pension system is more like social aid, which is not comprehensive and does not provide adequate income replacement rates to the retirees. In a no-reform scenario, old-age pension spending will double to 9% of GDP compared with the current rate of 4.5% by 2070. New pension system will help to alleviate in the long run fiscal pressure on the government finances while significantly improving pension replacement rates. A challenge for the introduction of new pension system is a relatively high level of unemployment, which limits potential participation in the system.

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 changed starting in 2015. The MoF strengthened systems for internal financial management and control via harmonizing its systems and procedures with the EU best practice, and also bolstered its in-house tax audit capacity by hiring and training an additional 275 auditors given the phase-out of the alternative audit.

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. In April 2014, the World Bank approved $60 million Inclusive Growth Programmatic Development Policy Operation (DPO), a part of a series of three DPOs over 2015-2017, aimed at strengthening fiscal oversight of public institutions and upgrading quality and coverage of social services and monitoring of outcomes. Another DPO of $60 million in programmatic private sector competitiveness supports reforms in the business environment to allow firms to innovate and export abroad and to enable greater financial sector deepening and diversification. In December 2014, the European Parliament ratified the EU's Association Agreement with Georgia, including DCFTA, which builds on the European Neighborhood and Partnership (ENP) Instrument, with cumulative financing of €452 million (2007-2013) and further allocations of up to €410 million in 2014-2017. The Association Agreement is regarded as a major step in Georgia's long-range pursuit of EU membership. In July 2014, Georgia entered into a 3-year standby arrangement with the International Monetary Fund that provides a $155 million cushion against external shocks and sets a framework to discipline macro-fiscal policies. The main part of the AA, including provisions for the DCFTA, entered in force on September 1, 2014 opening the market of 28 countries and 500 million consumers to Georgia. The agreement allows Georgia to export to the European market almost all products at the zero customs duty. The agreement covers goods, services and unfettered capital movement. 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, Asian Development Bank
Manila, Philippines

POLICY MATRIX

Policy Actions	Subprogram 1 2014	Subprogram 2 2015	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	
Strengthened management of fiscal risk	MOF conducts an inventory indicating fiscal position of large SOEs and their audited financial situation	MOF establishes a dedicated staffed and budgeted function to manage fiscal risks including contingent liabilities of SOEs and PPP projects	MOF provides information on the debt of SOEs and contingent liabilities of SOEs and PPPs as a supplement to the state budget documents
	MOF develops a strategic template for monitoring and	MOF establishes procedures, assigns	MOF carries out a first complete assessment of:

Policy Actions	Subprogram 1 2014	Subprogram 2 2015	Subprogram 3 2016 (Indicative)
	dealing with all types of fiscal risk confronting the country	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	(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 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	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 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 **286*** (out of which **147 are women**), correspondingly decreasing the number of alternative auditors	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 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	All cash operations of LSGs and LEPLs (except schools and kindergartens) are channeled through the TSA and the budgeting,	

Policy Actions	Subprogram 1 2014	Subprogram 2 2015	Subprogram 3 2016 (Indicative)
	through the TSA MOF provides supplementary information on types and funding of capital projects in the state budget documents	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 transfers and special transfers	Government submits to parliament proposals for amendments to the Budgetary Code defining the separation of revenues among the budgets of state, autonomous regions and municipalities	Government ensures that intergovernmental transfers increase in line with GDP growth or at least by GEL30-40 million in the current budget year
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 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 develops and implements personified reporting, recordkeeping and individual account system to make the new scheme operational

Policy Actions	Subprogram 1 2014	Subprogram 2 2015	Subprogram 3 2016 (Indicative)
	MOESD issues a public notification on the broad concept and direction of pension reforms including mandatory and voluntary systems	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 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 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 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	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 the Economic Council, as precursor to Cabinet, for approval a strategy and time-bound action plan for capital market	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

Policy Actions	Subprogram 1 2014	Subprogram 2 2015	Subprogram 3 2016 (Indicative)
	development	reforms, including addressing legal and regulatory gaps and improving the structure and efficiency of the market infrastructure	for 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 and innovation vouchers to support private sector innovation and technology development with GEL2 million, with 20% earmarked for women businesses	MOESD allocates a budget of **GEL21 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 sector innovation and technology development with GEL3 million, depending on performance/fund utilization, with 30% earmarked for women	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 innovation and technology development with GEL4.5 million, depending on performance/fund utilization, with 40%

Policy Actions	Subprogram 1 2014	Subprogram 2 2015	Subprogram 3 2016 (Indicative)
		businesses	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
		Additional. EDA launches a new program "Produce in Georgia" targeting micro and small enterprises development in rural areas with an allocated budget of GEL20 million (for 2015-2017)	
		Additional. GITA creates a training and knowledge-exchange platform Geolab and a research and development fabrication laboratory with a budget of GEL1.1 million	

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.
* Bold text shows additional or overshot targets.