

SECTOR ASSESSMENT (SUMMARY): PUBLIC SECTOR MANAGEMENT¹

Sector Road Map

1. Sector Performance, Problems, and Opportunities

1. The Georgian economy grew 5.8% on average per year during 2004–2014. The growth reflects reforms to liberalize the economy and to remove bureaucratic barriers, while strengthening transparency and accountability. As a result governance and the business environment improved, although significant barriers remain for private sector development, including limited access to finance. At the same time, reducing poverty and promoting shared growth remain a challenge in Georgia. Income distribution remains relatively skewed, with a Gini coefficient of 0.42. Unemployment continues to be a challenge despite the rapid growth of the economy, and stood at 12.4% of the labor force in 2014. High unemployment contributes to the weak link between growth and poverty reduction, with absolute poverty affecting 21.4% of the population in 2013. This could be aggravated by the recent economic downturn in the region, with the gross domestic product (GDP) growth projections cut by more than half to 2% for 2015.

a. Public Sector Management

2. The program reforms involve public sector management and finance sector areas that are strongly dependent on a well-functioning public sector. The government has made significant improvements in public financial management. Some notable actions include (i) a medium-term budget framework, (ii) program-based budgeting, (iii) a budget classification system of international standard, (iv) a rule-based system for fiscal transfers from the central government to the local governments, (v) a multicurrency treasury single account, (vi) an electronic budget management system, (vii) an electronic treasury system, and (viii) an electronic government procurement system. However weaknesses remain which reduce the efficiency of public resources, pose fiscal risks to macroeconomic stability, negatively affect the business environment, and hinder economic growth and poverty reduction.

3. Georgia's public debt to GDP was 35.5% as of the end of 2014. Foreign currency debt accounted for 75% and domestic currency debt 25%. Given the government's exposure to foreign exchange and floating interest rate risks, any unexpected macroeconomic shocks could negatively affect the budget and put a strain on public investment plans.² A challenging transition from external sources of finance to local currency-denominated government securities will be needed over the medium term. This is important not only to manage the country's foreign exchange exposure, but also to support the development of the Georgian bond and capital markets. The desired change is a gradual increase in domestic currency debt as a percentage of total public debt, taking into account constraints such as market depth.

4. Public investment management and monitoring and analysis of government contingent liabilities are still weak. Georgia has significant public infrastructure plans, including in the transport and energy sectors. Currently the vast majority of capital expenditure of the government is funded from development partners. As a result of positive economic growth Georgia will soon reach upper-middle-income status, which means that the current concessional

¹ This summary is based on: Asian Development Bank (ADB). 2014. *Strengthening Domestic Resource Mobilization*. Manila; draft reports; and finance sector assessment and public sector management assessment linked to the ADB. 2015. *Country Partnership Strategy: Georgia, 2014–2018*. Manila.

² Since November 2014 the lari has depreciated by about 31% against the US dollar.

development funding will no longer be available. Thus the government is focusing increasingly on mobilizing private investment for infrastructure delivery, particularly private participation in public investment projects. Many project contracts and projects currently being developed have public–private partnership (PPP) characteristics, and contain contingent liabilities for the government. The lack of a streamlined policy or framework for PPPs means that the contingent liabilities of existing and future PPP contracts are not transparent, nor are they well understood or managed. Capacity levels within the government are mixed. Strengthening public sector management can increase national savings; improve the legal, regulatory, and institutional framework for private sector development; and help increase domestic resource mobilization.

b. Finance sector

5. Georgia’s finance sector is dominated by banking, which accounts for more than 90% of financial system assets. There is limited domestic long-term capital to finance investment and growth because of underdeveloped local capital markets. The securities market is also at an early stage of development, with a narrow investor base and shallow market liquidity. The main reason for the recent depreciation of the lari relative to the US dollar was a decline in foreign inflows, particularly remittances and export receipts. Lower foreign inflows contributed to a weakening of the lari. This also led to lower domestic demand due to higher foreign currency-denominated loan service costs for households and other borrowers, and slowed GDP growth. A resilient and stable finance sector and a supportive business environment for entrepreneurship development, capital market development, and savings mobilization can strengthen the position of the lari and have a positive impact on economic growth and poverty alleviation.

6. **Capital market development.** The securities market in Georgia is at an early stage of development. The market infrastructure consists of the Georgia Stock Exchange (GSE), the Georgia Central Securities Depository, and three independent securities registrars. There are five active brokerage companies. This configuration is separate from the secondary market for treasury securities, which is operated by the central bank. As of 31 December 2014, three securities were listed on the GSE’s A Listing tier and one security was on the B Listing. A further 128 companies were “admitted” to trade to the GSE; 118 of these were placed onto the system in 2000 as part of the mass privatization program. In 2014, six securities traded on the GSE with a total volume of \$501,333. Meanwhile in the over-the-counter market, 34 securities were traded for a total volume of \$22 million. A further \$3.6 million in securities trading was handled directly at the securities registrars. By contrast, in the centralized government securities operation auctions placed a net increase of \$510.0 million of treasuries into the system; trading was \$38.6 million.

7. The low levels of corporate securities activity and the highly fragmented nature of trading is the result of 2007 amendments to the legislation which deregulated the securities markets. The results are minimal price discovery, low issuer transparency, and deteriorating financial condition of the infrastructure institutions. This has driven Georgia’s quality issuers to raise capital outside the country. During 2007–2014 there was a total of \$161 million in domestic offerings and \$1.6 billion in foreign offerings by Georgian corporations. The demand for capital by the Georgian private sector is healthy but the capital market system, undercut by the current legal and regulatory regime, does not meet this need. The introduction of the pension system should act as a driver to address some of the challenges. But without a focused intervention to consolidate trading, increase transparency and investor protection, and adjust government policies (such as taxation) that have an asymmetrical impact within the finance sector, the Georgian capital market will not be able to support desired savings levels and access to finance.

8. **Pensions and contractual savings.** National savings are ranked as one of the lowest in the region at 16.7% of GDP in 2014, and are insufficient to finance investments, resulting in over-reliance on foreign investment and remittance inflows. One reason for the low savings level is that private pension saving is voluntary and underdeveloped. Financing of the basic pension constitutes the largest social spending item in the state budget, accounting for 19.9% of public expenditure in 2014 and 4.5% of GDP. The basic pension is the main component of the current pension landscape. It entitles all citizens to receive pension benefits after the age of 60 for women and 65 for men. It is an important instrument of poverty reduction and old-age security. The basic pension has nearly doubled since 2010, from GEL80.0 per month in 2010 to GEL150.0 per month, but it still barely provides a subsistence level of income, which is currently GEL161.4 per month. It will be further increased to GEL160.0 per month in September 2015.

9. The government's social expenditure will constantly increase because of the aging population and public pension financing, raising the question of long-term fiscal sustainability. The gradual introduction of an additional private pension savings scheme is therefore necessary, reducing the fiscal pressures on the state budget caused by unsustainable increases in the basic pension. It will allow employees to build a pension with an adequate replacement rate, especially for those on or above the average wage. The introduction of a contributory pension will facilitate the growth of savings in the country and will create an additional source of funds for investment. These long-term funds could be invested to stimulate development of capital markets, especially interbank money markets and secondary debt markets, which is critical for domestic resource mobilization. More expansive and efficient capital markets will be necessary to absorb pension inflows and generate reasonable returns. In the design of a new pension system it is also essential to take gender into account, as women are less likely to work in formal sectors, generally earn lower wages, and may perform other nonpaid labor.

2. Government's Sector Strategy

10. The Socio-Economic Development Strategy of Georgia (Georgia 2020), approved by the government in June 2014, establishes policy directions for sustainable and inclusive economic growth, macroeconomic stability and effective public administration, human capital development, access to finance, and private sector competitiveness.³ A guiding principle of the country's strategy for economic development is establishing the necessary conditions for a free private sector operating under an optimal, efficient, and transparent government. It calls for enhancement of public management, strengthening of human resource management in the public sector, increased transparency of public management, e-government development, greater efficiency of public financial management, and improved public service delivery. To increase the efficiency and effectiveness of public expenditure, the government is expanding the coverage of the treasury single account and strengthening public investment management.

11. The government has initiated a pension reform program to address the issues of adequacy, fairness, and sustainability of old-age income planning in Georgia. A Pension Reform Unit was established and staffed in the ministry of economy and sustainable development in 2014 to design a new contributory pension system. In addition to the Pension Reform Unit, an inter-ministerial working group has been formed to ensure the viewpoints of all stakeholders are taken into account during the policy formulation process and that the outcome will fit into the wider economic policies of government. The pension reform system being considered by the government includes the following design features: (i) there will be an initial contribution rate of 2% each from employers, employees, and government; (ii) participation in the system will be

³ Government of Georgia. 2014. *Socio-Economic Development Strategy of Georgia, 2020*. Tbilisi.

mandatory for employees up to the age of 40 and then quasi-mandatory with an opt-out principle; (iii) the pension system is to be of a defined contribution type, i.e., the future amount of the pension will depend on contribution and return of the pension fund; (iv) contributions, returns, and pension benefits are to be tax free; (v) asset management is to be through a noncommercial independent fund managed by professional fund managers; and (vi) investment instruments are to be defined with both domestic and international investment opportunities.

3. ADB Sector Experience and Assistance Program

12. ADB has been active in providing loans and technical assistance (TA) for finance sector development in Georgia since the country became an ADB member in 2007. In 2010, a loan of \$100 million was provided to support social services delivery.⁴ Through the Municipal Services Development Project (approved in 2008) and the Municipal Services Development Project Phase 2 (approved in 2009), ADB has helped the Municipal Development Fund of Georgia and local governments enhance their capacity to implement public investment projects.⁵ ADB has engaged in knowledge work in the pension sector and has prepared a financial sector assessment on capital market development and agricultural finance.⁶ In addition, ADB is providing non-sovereign support to finance the Adjaristsqali hydropower project and to provide senior loans to onlent to small and medium-sized enterprises.⁷

13. ADB's planned support to Georgia's finance sector during the new country partnership strategy period (2014–2018) is a continuation of its ongoing assistance to domestic resource mobilization. ADB supports private-sector-led inclusive economic growth through increased access to finance and business development opportunities for low-income groups, including women, particularly in small cities and rural areas. TA on strengthening domestic resource mobilization addresses public sector management and finance sector issues.⁸ The outputs include developing capital markets, pension reform, increasing PPPs, and strengthening public debt management. The TA is supporting the government in setting up legal, regulatory, and institutional frameworks to facilitate availability of long-term capital for productive business and infrastructure investments. The TA also supports development of a pension reform strategy and preparation of a public debt management system for better public financial management.

14. Some of the lessons from ADB's work in the finance and public sectors include (i) longer-term and sustained engagement with the government on pension reform and on developing securities and money markets is critical; (ii) the design of a fiscally sustainable pension scheme must not only provide a social safety net but must also be affordable for the government in the long run; and (iii) heightened government awareness of fiscal risks and contingent liabilities is essential to assess and manage fiscal risks arising out of PPP projects and state-owned enterprise operations. These lessons have been incorporated in the proposed policy-based program and TA. ADB's strategic interventions in the sector will be closely aligned and coordinated with those of other development partners.

⁴ ADB. 2010. *Report and Recommendation of the President to the Board of Directors: Proposed Loan to Georgia for Social Services Delivery Program*. Manila.

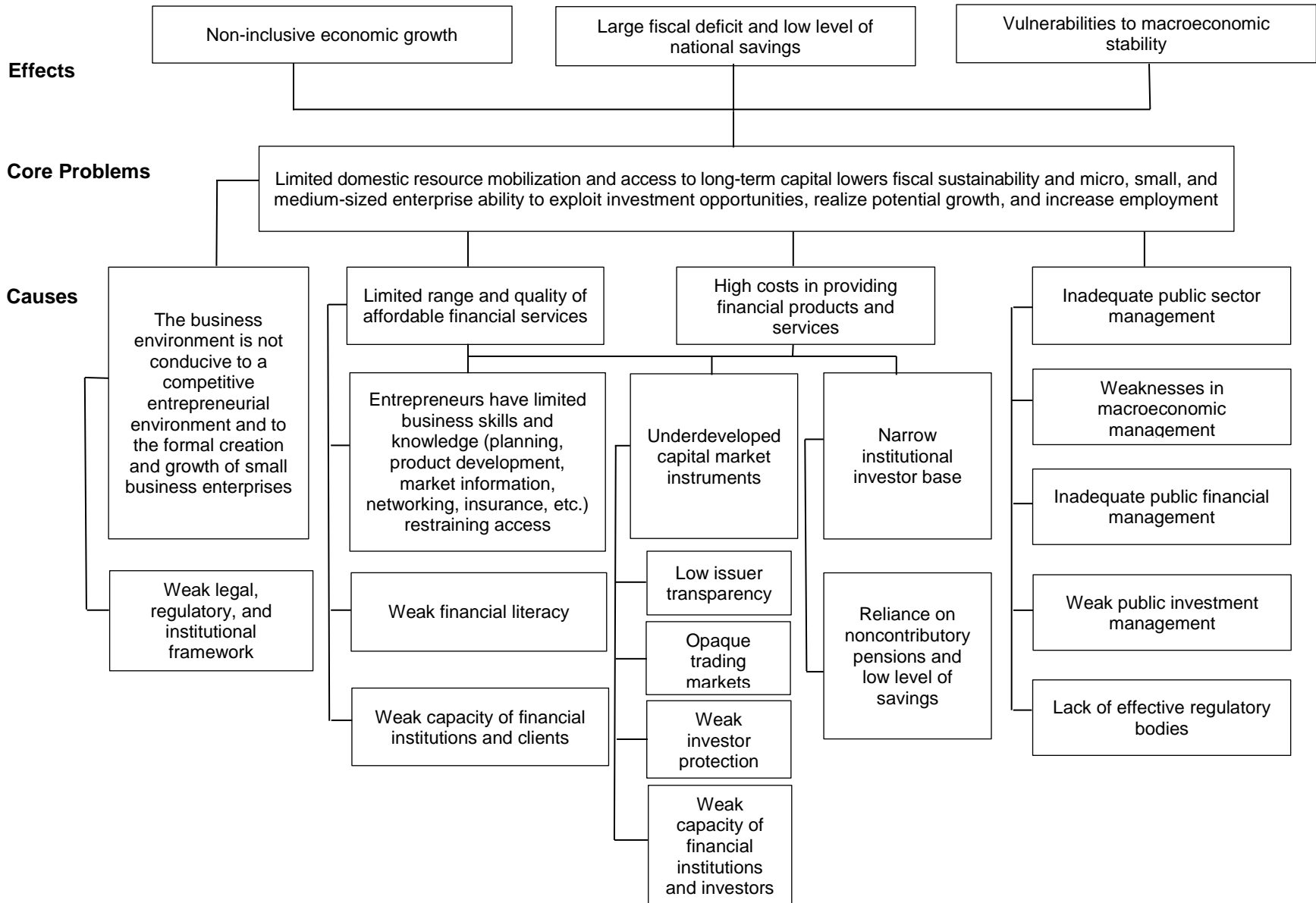
⁵ ADB. 2012. *Completion Report: Municipal Services Development Project in Georgia*. Manila; ADB. 2013. *Completion Report: Municipal Services Development Project Phase 2 in Georgia*. Manila.

⁶ ADB. 2011. *Pensions and Pension Reform in Georgia*. Manila.

⁷ ADB. 2014. *Adjaristsqali Hydropower Project*. Manila. (\$75 million); ADB. 2013. *Financial Sector Growth and Service Diversity Project*. Manila (\$50 million); ADB. 2010. *Senior Loan to Bank of Georgia*. Manila (\$50 million)

⁸ ADB. 2014. *Technical Assistance to Georgia for Strengthening Domestic Resource Mobilization*. Manila.

Problem Tree for Public Sector Management and Finance Sectors in Georgia



Sector Results Framework (Public Sector Management and Finance, 2014–2018)

Country Sector Outcomes		Country Sector Outputs		ADB Sector Operations	
Outcomes with ADB Contribution	Indicators with Targets and Baselines	Outputs with ADB Contribution	Indicators with Incremental Targets	Planned and Ongoing ADB Interventions	Main Outputs Expected from ADB Interventions
Increased fiscal consolidation and efficient utilization of public resources	Fiscal deficit reduced to 2.5% by 2018 (2013 baseline 2.7% of GDP)	Improved public sector management	Government conducts assessment of fiscal risks for large SOEs to determine contingent liabilities by 2016 (baseline: none)	Planned key activity areas Public expenditure and fiscal management (51% of funds) Finance sector development (19% of funds) Insurance and contractual savings (20%) Money and capital markets (11%)	Pipeline projects Required amendments to the public debt legislation, supporting the Debt Strategy, submitted to Parliament Phasing out of alternative auditors by increasing the number of in-house auditors to 330, out of which 150 are women
Effective mobilization of domestic resources for more public and private investment	Domestic savings as percent of GDP increase to at least 21.6% by 2018 (2012 baseline: 18.2%) ^c	Insurance and contractual savings improved	Government implements medium-term public debt management framework by 2016 (2013 baseline: none)	Pipeline projects with estimated amounts Development for PPPs PATA (\$500,000) Support for Financial Sector Supervision and Corporate Governance S-PATA (\$200,000) Support for Financial Inclusion PATA (\$1.5 million)	Contributory private pension system designed and implemented Legislation updated and harmonized to reflect best practice for emerging markets and compliance with international standards
Increased use of efficient and reliable financial services by SMEs	Access to financing through local equity markets rank improves to at least 100 by 2018 (2013 baseline: 126) ^b	Financial system access improved	Government implements changes to basic pension law and institutes law on voluntary savings (2013 baseline: none) Number of depositors in commercial banks increases to at least 950 per 1,000 adults in 2018 (2012 baseline: 845 per 1,000 adults) ^a	Nonsovereign financial institution investments to support financial inclusion and literacy of MSMEs, with particular focus on regions Ongoing projects with approved amounts Senior Loan to Bank of Georgia (\$50 million) SME Inclusion S-CDTA (\$150,000) Promoting Financial Sector Resilience S-CDTA (\$150,000) Strengthening DRM PATA (\$500,000)	Information on debt of SOEs and contingent liabilities of SOEs and PPPs as a supplement to the state budget documents provided Ongoing projects 30% more SME loan accounts opened

ADB = Asian Development Bank; CDTA = capacity development technical assistance; DRM = domestic resource mobilization; GDP = gross domestic product; MSMEs = micro, small, and medium-sized enterprises; PATA = policy and advisory technical assistance; PPP = public–private partnership; S-CDTA = small–scale capacity development technical assistance; SMEs = small and medium-sized enterprises; SOE = state-owned enterprise.

^a World Bank. *Country statistics* <http://data.worldbank.org/country/georgia>; and Asian Development staff estimates.

^b Global Competitiveness Report ranking and ADB staff estimates.

^c Government of Georgia. 2013. *Socio-Economic Development Strategy of Georgia, 2020*. Tbilisi.

Source: Asian Development Bank.