Economic and Financial Analysis

1. This annex describes the economic and financial context and justification of the loan amount of the Improving Domestic Resource Mobilization for Inclusive Growth Program cluster. The loan size is determined by the development financing needs of the country, the breadth of the policy package and potential development impact, with reference to specific elements of the development expenditure programs supported by counterpart funds of the loan.[1] After a brief economic overview, the discussion in the subsequent sections is along four dimensions: (i) development financing needs, (ii) specific elements of development expenditure programs (pension reforms),[2] (iii) estimated implementation costs of the reforms and program activities, and (iv) economic and financial benefits yielded by the program outputs in the short and medium term.

2. Economic growth in 2014 expanded to an estimated 4.7%, up from 3.3% in 2013. The growth was mainly driven by gains in the construction sector, retail trade, and manufacturing. A significant decrease in economic growth began in the fourth quarter of 2014 and continued in 2015, following the economic slowdown in the Russian Federation and slower growth in other key trading partners. The Georgian lari (GEL) depreciated about 6% against the US dollar between October 2014 and year-end, and by a further 25% in 2015. Inflation was 3.1% in 2014. The fiscal deficit reached an estimated 3% of GDP, and public debt was estimated at 35.5% of GDP at the end of 2014.

3. In February 2015 the government reduced annual GDP growth projections by more than half from 5% to 2%, based on deterioration in the fourth quarter of 2014. Downside risks include a further reduction in exports and remittances due to the Russia-Ukraine crisis and oil price declines, or if Euro area growth remains low. For 2015, the budget deficit is likely to expand to 4%, as slowed growth negatively affects revenues. The 2015 draft budget envisages increases in pensions, teacher salaries, drug benefit coverage, and capital spending. To remain within the targeted deficit, the budget raises cigarette and alcohol excises and introduces an excise on incoming international phone calls. At the end of 2014, total public debt amounted to 35.5% of GDP, up slightly from 34.7% at end-2013, but it is expected to increase further.

4. **Development financing needs**. The overall program provides financing of $200 million equivalent for 2014–2016. Subprograms 1 and 2 in equal amounts are estimated at $75 million equivalent each, and Subprogram 3 is estimated at $50 million equivalent. Government's development-related financing gap is estimated at GEL1,625 million,[3] an increase of 2.7% in 2015 relative to 2014. The government intends to borrow both from domestic (30.8%) and foreign (69.2%) sources to finance it. 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 PBL under the Subprogram 2 will help narrow the government's development financing gap from development partners by about 34.1% in 2015 and help meet part of the financing needs. Public debt is projected to increase to slightly over 40.0% of GDP at the end of 2015 as a result of government borrowing and budget

[1] ADB. 2013. Operations Manual Policy-Based Lending (OM Section D4). Manila.
[2] Since pension reforms entail significant budgetary and fiscal costs, they are discussed separately.
[3] MOF. *Georgia: Basic Data and Directions 2015–2018—supplementary document of 2015 Budget*. Tbilisi.

support for programmatic measures before decreasing to 38.5% in the medium term. Budget support is necessary to finance part of the development financing needs, especially covering the period from introduction of reforms to realization of fiscal benefits.

Table 1: Financing Plan for Development-Related Financing Gap

Source	Amount (GEL million)	Share of Total (%)
Asian Development Bank	**172.0**	**34.1**
Asian Development Fund	115.0	22.8
Ordinary Capital Resources	57.0	11.3
The World Bank	**276.0**	**54.7**
The European Commission	**57.0**	**11.3**
Total	**505.0**	**100.0**

Source: Government of Georgia; ADB staff estimates.

5. **Specific elements of development expenditure programs (pension reforms).** The program will finance part of the development financing needs occurring over the program period. Budgeted social spending increased from 11.2% in 2013 to 11.7% of GDP in 2014. Growth in social expenditures is taking up an increasing share of public finances. Financing of pensions constitutes the largest social spending item in the state budget, representing 55% of all social benefits in 2014 and accounting for 19.9% of public expenditure in 2014 or about 4.5% of GDP. With the regular increase in the universal pension rate and the number of beneficiaries, the government will incur GEL8 billion on pillar zero in the next five years.[4] The government contribution to the proposed supplementary pension scheme is estimated at GEL313 million ($136 million) in the first three years of implementation *(2016–2018),* and GEL631 million ($274 million) in the first 5 years of implementation (2016–2020).[5] The pension reforms alone over five years account for more than the whole cost of the programmatic cluster.

6. **Estimated implementation cost for reforms.** This section reviews costs of implementation of program activities excluding the budgetary and fiscal costs associated with implementation of pension reforms that have been covered in para. 5. The costs of the reform program are associated with policy development and capacity building as well as administrative and of implementing reforms. Building on the progress made under the first subprogram, ADB will continue to support the government in removing key development constraints such as the lack of domestic savings and lack of local currency-denominated government securities through pension reform and capital market development. The program supports the direct and indirect costs to the government of implementing and monitoring the reforms. Indirect costs are the staff time and expenses.

7. Direct subprogram 2 costs requiring government finance comprise the following: (i) institutional and regulatory structures for development of the contributory pension scheme, (ii) communication campaign to raise awareness and elicit feedback on pension reforms, (iii) capitalization of the Entrepreneurship Development Agency (GEL110 million for 2014–2018 and GEL225 million for "Produce in Georgia" program launched in 2015), (iv) capitalization of the Georgia Innovation and Technology Agency (GEL20 million for 2014-2018 and GEL1.1

[4] Government of Georgia/ MOF estimates

[5] Calculations and projections based on an elaborate model jointly developed by MOF, NBG, MOESD and ADB TA 8716. Input parameters factor in retirement ages (65 for men and 60 for women with alignment in the future), contribution rates of 2% each from employees, employers and government, and enrollment options of mandatory participation till 40 and then opt-out options. Cost of pension reforms has been calculated for pillar zero alone, pillar II alone and combined pillar zero and pillar II for five years of implementation factoring in inflation, nominal GDP and wage growth. Supporting excel sheet available on request.

million for 2015 program Geolab), (v) strengthening of systems and procedures of the Middle Office in the Public Debt and External Financing Department for effective debt management, (vi) staff and budget function costs to manage fiscal risks in MOF, and (vii) recruitment of the full complement of in-house tax auditors in Georgia Revenue Service. The cost of the reforms for 2015 is estimated at GEL160.1 million ($78.3 million) (see Table 2).[6]

8. Table 2 also provides a subprogram-wise breakdown of estimated implementation or adjustment costs under the four policy areas. The implementation costs factor in staff time spent on various reform actions, administrative and financing budgets of reformed functions and entities, system integration, gender targeting and communication campaigns.[7] Government contribution to implementation of pension reforms (GEL631 million in the first 5 years, as mentioned in para 5) is not included in this estimate.

9. The Ministry of Finance (MOF) and the Ministry of Economy and Sustainable Development (MOESD) are responsible for implementing and monitoring the majority of, and the most needed, reforms.[8] The budget allocation for MOF is GEL496.6 million for 2014-2018. The estimated allocation for MOESD is GEL617.6million for 2014-2018. Further, Georgia and the European Union started applying the Deep and Comprehensive Free Trade Area agreement in September 2014, moving Georgia to increased European integration. This requires the continuation of the reforms initiated under the program, especially the reforms leading to deepening of domestic financial markets—both capital market reforms and private pension development.

10. **Economic and financial benefits in the short and medium term**. In parallel to increased European integration, the government sees the value of the reforms in realizing the commitments under the Social-Economic Development Strategy of Georgia, Georgia 2020. The guiding principle of the country's strategy for economic development is establishing the necessary conditions for free private sector operations under an optimal, efficient and transparent government.[9]

11. The program reforms are expected to yield immediate positive economic and financial benefits. In 2015 GEL80 million has been recovered from tax arrears. In 2016, the recovery of tax arrears will further increase to GEL100 million. This is a financial benefit directly arising out of the program. For subprogram 3, increased intergovernmental transfers of up to GEL40 million will be transferred to local self-governments—a cost for the central government and a direct benefit to local self-governments.

12. Other benefits arising out of the program will accrue in the medium to long term. The 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 realized due to (i) declining costs of funding pensions and reduced burden on public finances due to introduction of a contributory and 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 more revenues due to increased mobilization of private capital for investment.

---

[6] Supporting Excel sheet available on request.

[7] Development partners including World Bank, IMF, EU, and EBRD are also working on reform areas that complement reform areas covered under the ADB program.

[8] MOESD is the responsible agency for pension reform, capital market reforms and providing access to finance for small business financing and development.

[9] Government of Georgia. 2013. *Socio-Economic Development Strategy of Georgia, 2020* Tbilisi.

13. The introduction of the new pensions system will have significant budgetary implications in the short term, but substantial benefits will accrue in savings of approximately 2.5% of GDP in the long term. Pension costs increased in nominal terms in 2014, comprising GEL1.33 billion or 4.5% of GDP. Further growth to GEL1.39 billion is projected in 2015. As a result of the reform, pension costs are expected to drop to GEL1.1 billion by 2020 or 2.5% of GDP, generating savings of an estimated GEL180.1 million ($78.3 million).[10] Thus cost of pensions will be contained, as the government plans to introduce a defined contribution mandatory occupational savings plan in 2016. Once the contributory pension system begins to mature and provide reasonable levels of income replacement, the pressure on government to increase the zero pillar benefits will reduce, and it could be either scaled back or converted to a targeted (means tested) system.

14. The program will catalyze enhanced mobilization of savings. The introduction of contributory pension system (pillar II and pillar III) would encourage a culture of deferring part of current consumption to accumulate long-term assets to meet income needs in old age.[11] This should result in greater confidence in formal saving systems and also improve non-pension savings. Mature pension funds provide substantial pools of money that have long-term investment horizons seeking stable returns. This would assist the Government in its efforts to create and deepen both the bond market and the securities market.

15. Successful implementation of program reforms could assist in reducing informality in the economy. The incentives being considered for pillar II pension system, i.e. matching contributions from Government, could encourage some of the enterprises in the informal economy to formalize so that they can participate and take advantage of these incentives. If combined with other measures to reduce informality the economy could formalize more rapidly. This would result in enhanced tax collection, potentially helping to offset the transitional costs of the pension reform. Supporting innovation and investment in SMEs will contribute to growth and diversification, with more resilience and tax inflows.

16. Building on Subprogram 1, the Medium Term Debt Strategy (MTDS) aims to meet public financing needs and payment obligations of the government while minimizing costs in the medium-to-long-term. The government has set public debt ceilings of 10.5% of budget revenues, 40% of GDP, and 30% of total borrowing. The reform will result in additional benefits and savings associated with fiscal discipline. There will also be improvements in core budgetary and fiscal risk due to risk management capacity building within the MOF.

17. Developing capital markets to mobilize long-term finance will contribute to growth and result in efficiency enhancements, due to greater access to finance for SMEs with improved gender targeting. Mobilizing private resources for investment is important given that national savings at 16.7% of GDP in 2014 is low. Low savings compounds the twin deficit of fiscal and external imbalances, aggravating the already narrow reliance on internal sources of financing.

[10] Government of Georgia estimates.

[11] 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.

Table 2: Program Reform Costs
(in GEL Million)

Policy Action	2014 SP1	2015 SP2	2016 SP3	Amount
A. Debt, Cash and Fiscal Risk Management	**8.5**	**8.5**	**24.5**	**41.5**
1. Debt and cash management	3.2	3.2	19.2	25.6
Staff time to prepare and approve a Debt Strategy				
Staff time to strengthen the Middle Office of PDEFD				
Staff time to report on guarantees, forecast cash flow				
Integration of debt with budget and treasury systems				
2. Fiscal risk management	5.3	5.3	5.3	15.9
Staff time to manage fiscal risks of SOEs				
Staff time to carry out assessments				
Staff time to manage fiscal risks of contingent liabilities				
B. Revenue and Public Expenditure Management	**65.8**	**74.2**	**54.4**	**194.4**
1. Improved revenue collection	17.8	14.2	14.4	46.4
Additional staff employed for tax collection				
Staff time of 275 in-house tax auditors				
2. Improved public expenditure management	8.0	30.0		38.0
Staff time to manage LSG and LEPL finances through PFMS and TSA				
Systems integration of LSG and LEPL				
Staff time on legal and regulatory framework for PPP				
3. Strengthened local government finances	40.0	30.0	40.0	110.0
Increased intergovernmental transfers	40.0	30.0	40.0	110.0
C. Generation of Domestic Savings	**7.2**	**42.1**	**59.6**	**108.9**
1. Universal Pension System		33.9	51.4	85.3
Staff time to complete forecast of present and future cost				
Staff time to prepare and approve pension system revisions				
2. Setting up Pillar 2 and Pillar 3 joint/hybrid system	7.2	8.2	8.2	23.6
Staff time to analyze and implement key areas of new pension system with gender considerations				
Cost of institutional development				
Staff time to identify parameters of hybrid system and to prepare legislation				
Financing of public awareness campaign				
D. Mobilization of Private Resources for Investment	**50.2**	**51.2**	**51.2**	**152.6**
1. Capital markets development	7.2	8.2	8.2	23.6
Staff time to prepare capital market reform concept				
Financing of public awareness campaign				
Staff time to implement capital market reform action plan				
2. SME access to finance and gender targeting	33.2	57.3	34.2	124.7
Budget for EDA				
Budget for GITA				
Staff time to implement Gender Action Plan				
Subprogram Total in GEL	**114.7**	**180.1**	**172.7**	**467.5**

SME = small and medium-sized enterprise, SP = subprogram.
Corresponding USD amounts are $49.9 million (SP1), $78.3 million (SP2), $75.0 million (SP3) and $203.3 million total.
Sources: Government of Georgia and ADB Staff estimates.