PROGRAM INFORMATION DOCUMENT (PID)
APPRAISAL STAGE

March 2, 2017
Report No.: AB7800

Operation Name	Second Programmatic Inclusive Growth DPO
Region	Europe and Central Asia
Country	Georgia
Sector	Public administration- Education (27%); Public administration- Health (18%); General public administration sector (37%); Public administration- Other social services (18%)
Operation ID	P156444
Lending Instrument	Development Policy Lending
Borrower(s)	Ministry of Finance, Georgia
Implementing Agency	Ministry of Finance
Date PID Prepared	March 1, 2017
Estimated Date of Appraisal	March 23, 2017
Estimated Date of Board Approval	April 28, 2017
Corporate Review Decision	Following the corporate review, the decision was taken to proceed with the preparation of the operation.

I. Country and Sector Background

1. Georgia is a small open economy which undertook several reforms and saw rapid growth over the past decade. The economy grew by an average rate of 5 percent a year during 2006-16, largely powered by services, construction and non-tradables in general. So far, a decade of strong economic growth in Georgia, briefly interrupted by the conflict with Russia and the global financial crisis, has not succeeded in making a significant dent in the unemployment rate. This is largely explained by low net job creation and gaps in skills and overall human capital development. The government was successful in attracting foreign investors through significant improvements in the business environment. Net job creation, however, remained weak and by 2015 the overall unemployment rate was 12 percent. In addition, the existing educational system is not in line with the demands of the private sector and student performance ranks low. Life expectancy in Georgia has improved significantly over the past decade but has stalled at 73 years since 2010. The high levels of neonatal mortality and the poor quality of reproductive health coupled with premature deaths due to Non-communicable Diseases (NCDs) are among major factors contributing to the stagnation in life-expectancy. Making growth more inclusive will, therefore, require investments in human capital as well as reforms to support competitiveness.

2. Macroeconomic stability is a pre-condition for achieving inclusive growth. The main macroeconomic vulnerabilities faced by Georgia include risks to fiscal and external sustainability. With the adoption of the Estonian tax model, corporate income tax revenues will decrease while increased social spending has made the budget more rigid. At 111 percent of GDP in 2016, external debt is high. Low domestic savings and large investments needs result in a high current account deficit, further adding to the external stock of debt. In addition, loan and deposit dollarization is 65 and 70 percent, respectively. The government has prioritized social spending with increases in the level of TSA and pension benefits and the introduction of universal health care in 2013. These increases will certainly help in building human capital but prudent fiscal management will be paramount, both to manage

aggregate demand and to maintain fiscal sustainability. In addition, it will be important for the government to monitor and manage risks arising from State Owned Enterprises (SOEs) through which it undertakes quasi-fiscal operations. Information on SOEs, which was scant and patchy, has improved more recently with support from the recent DPO series.

3. The first generation reforms which started a decade back have helped Georgia improve its business environment, achieve sustained growth rates and maintain low inflation. However, socio-economic vulnerabilities persist. Further improvements in the living standards of Georgians will therefore need to come from other areas. These include investment in human capital, enhanced private sector competitiveness, and fiscal, social and environmental sustainability. A supportive macro-fiscal environment will remain a necessary condition. This Development Policy Operation (DPO) supports government reforms in some of these areas. Private sector competitiveness is being supported by another development policy operation which focuses on improvements in the business environment, deeper access to finance, and enhanced capacity to export and innovate.

II. Operation Objectives

4. The program development objectives are to: (i) Strengthen fiscal oversight of public institutions and improve budgeting and the framework for civil service reform, and (ii) Improve coverage and quality of social services and strengthen monitoring of outcomes.

5. The DPO objectives under the two pillars are anchored in the government's development strategy. Pillar I maps to the pre-condition of macroeconomic stability and effective public administration while Pillar II maps to the priority of human capital development. The policy actions supported by this DPO target the government's most urgent development challenges. Improved public financial management through better monitoring of SOEs and other public entities, improved capital budgeting framework and a strengthened framework for civil service reforms will promote better policy making and fiscal discipline and will contribute to macroeconomic stability as well as effective public administration. In addition, a strengthened education system and increased access to health care and social assistance will help develop human capital and fight poverty in a sustainable manner.

III. Rationale for Bank Involvement

6. This DPO operation is the second and last in a series of two operations. The government has already made significant progress on the reforms supported by this series of operations. The Parliament has already approved the amendments to the budget code to include the revenues and expenditures of the municipalities, legal entities of public law and non-profit legal entities in the public financial management information system. The Ministry of Finance has also adopted the capital budgeting guidelines. The register for SOEs was completed and the government has collected financial information on SOEs for two years. Fiscal risks arising from SOEs was annexed to the 2017 budget. The government has also adopted the new Law for civil service reforms and is now working on secondary legislation to operationalize the law. In the health sector, Georgians now need to have a doctor's prescription to purchase certain drugs which were earlier available over the counter. Also, nationwide roll out of the maternal and neo natal care program is underway. Efforts are also underway to improve the quality of teachers in Georgia's basic education system and the effectiveness of monitoring and evaluation systems.

7. Georgia's overall macroeconomic policy framework is adequate for this operation. The main concern is the possibility of increasing fiscal pressures which could derail the consolidation agenda and impact both fiscal and external sustainability. There are also downside risks to growth arising from a protracted period of slowdown among Georgia's trading partners. Also, lower growth would add strain on the fiscal consolidation plan. The government has, however, reiterated its commitment to sound macroeconomic management with the announcement of the 2017 budget which seeks to reduce current spending and raise taxes. Effective macro management is also evident in the NBG's commitment to a floating exchange rate regime, limited interventions in the foreign exchange market, and adjustment of policy rates in response to inflation expectations. Over the medium-to long-term, the DCFTA and the free trade agreement with China, structural reforms and continued macroeconomic stability will strengthen growth prospects and also reduce external vulnerabilities. There has also been progress in poverty reduction and shared prosperity in recent years. The poverty rate, estimated using the $2.5/day PPP poverty line, fell from 46.7 percent in 2010 to 31.5 percent in 2015 and the mean consumption of the bottom 40 grew by 7.5 percent annually in the same period, exceeding the growth enjoyed by the population overall.[1] Inequality in Georgia is however higher than in the Europe and Central Asia region, on average, with a Gini coefficient of 38.5 in 2014.

8. The IMF has concluded staff-level negotiations for a new Extended Fund Facility (EFF) in the amount of SDR201.4 million with the Government of Georgia. The EFF supports the government's economic program to achieve strong and more inclusive growth, preserve fiscal sustainability, reduce macroeconomic vulnerabilities, strengthen monetary and fiscal institutions, and improve financial and social safety nets. The earlier three-year Stand-By Arrangement (SBA) which was approved in July 2014 was derailed as a result of various policy decisions taken by the government in response to the external shock of 2014 and in the run up to the 2016 Parliamentary elections. The proposed DPO complements the Fund program by supporting structural reforms in the areas of public financial management and improvements in human capital. The World Bank Group closely coordinates with the Fund on macroeconomic developments, debt sustainability analysis, fiscal consolidation, and public financial management.

IV. Tentative financing

Source:	(EUR million)
International Bank for Reconstruction and Development	47.2
Total	47.2

V. Institutional and Implementation Arrangements

9. The Ministry of Finance leads the effort in coordinating the overall implementation of the DPO program. The Deputy Minister of Finance is the main counterpart for this operation and he coordinates with all the line ministries which are involved in the DPO series. The line ministries submit progress reports on the prior actions and result indicators to the Ministry of Finance as and when requested. Given the long history of budget lending operations in Georgia, some institutional capacity and memory

[1] Consumption growth among the bottom 40 percent was 7.5 percent a year during 2010-15 compared with 5 percent a year for the population as a whole.

has been built up on data requirements for monitoring. While there are some variations between line ministries, in general, they have the capacity to provide good and timely data when needed.

10. Regular reviews are carried out by the Bank team to monitor progress on the reforms during supervision missions. Data for monitoring is generally available through special requests made to the respective ministries and is reliable. Macroeconomic data is available through the statistical agency. Georgia subscribed to the IMF's Special Data Dissemination Standards (SDSS) in 2010 and is a compliant country. As a result, timely and good quality data is readily available through the National Bank of Georgia, Ministry of Finance, and the National Statistics Office.

VI. Risks and Risk Mitigation

11. The main risks to the operation and mitigating measures are summarized below.

(i) Macroeconomic risks: Low growth, limited fiscal consolidation, a large current account deficit, and high external debt are the main risks to the economy. With subdued growth prospects in the economies of key trading partners, output expansion in Georgia is likely to be moderate. Most of the impact on Georgia will be through lower export demand and reduced remittances which impacts consumption growth. The impact of geo-political shocks on the EU and global growth also adds to the risk of slower growth. This risk is mitigated, to an extent, by the structural reforms being undertaken by the government to improve competitiveness and the investment climate in the country. Fiscal risks largely emanate from pressures to further increase social spending, limited consolidation of expenditures and lower than expected increase in excise collections. With higher deficits in the past two years and the decline in corporate income tax revenues, the deficit is likely to decrease only gradually over the medium-term and will add to external vulnerabilities. Mitigating factors include the government's commitment to fiscal consolidation as evidenced by the 2017 budget and the requirement of macroeconomic adequacy for programs supported by donors. On the external front, the country continues to be vulnerable given its high current account deficit (because of low savings) coupled with low export demand and remittances, high level of dollarization, large external debt, and low level of reserves which heightens foreign exchange risks. With low export earnings, a further depreciation of the Lari, and a slow adjustment in imports, the current account deficit has widened. As a result, the external debt has climbed up to 111 percent of GDP in 2016. While FDI inflows have so far been maintained (largely because of the British Petroleum financed investment in the gas pipeline, from Azerbaijan and inflows from Turkey), there are downside risks given the economic prospects for these two countries. The cost of servicing foreign-currency denominated debt has increased and with loan dollarization of 65 percent, there could be an adverse impact on the stability of the financial system. In addition, continued disturbances in some of Georgia's key export markets and longer-term stagnation in the EU could further impact external performance. The main channels of transmission of external disturbances are through lower FDI, exports, remittances and other capital inflows, and this could impact overall macroeconomic stability, a pre-condition for program performance. Mitigating factors include a flexible exchange rate policy, the proposed new program with the IMF, and market access.

(ii) Geopolitical risks: The tensions in the broader region add to geopolitical risks. Any further escalation in the broader region could lead to further tensions with a significant impact on the Georgian economy.

VII. Poverty and Social Impacts and Environment Aspects

Poverty and Social Impacts

The overall poverty, social, and gender impact of the actions supported by this operation are expected to be positive. Under the first pillar, most of the prior actions will not have any distributional impact. Under the second pillar, the reform of the TSA formula, a prior action under DPO1, is expected to have an overall positive distributional impact by expanding coverage to the poorest segments of the population. Three outstanding issues related to this reform will be evaluated and discussed by the government by the end of 2017. The resolution of these issues will have a net positive impact compared to 2015. The revision of the needs index for the single elderly pensioners could exclude up to 18,000 people from TSA coverage (less than 5 percent of the beneficiaries). The government is examining options such that they would roll it back for younger pensioners only. Inclusion of changes in the subsistence minimum income and old age pensions will have a positive distributional impact by improving the accuracy of the income component in the formula. The possible impact will be calculated after the reassessment is over. The adjustment in the formula to reflect real utility consumption instead of tariffs should also have a positive distributional impact by continuing to include the poor who need to pay more because of an increase in tariffs. Enhanced obstetric and neonatal care will have a positive distributional and gender impact by reducing the incidence of maternal and infant mortality. It will also have a positive gender impact through improved health outcomes for women. Periodic census every 10 years and availability of more frequent data on the labor market and living conditions will also have a positive distributional impact, although not directly. The effect will come through a better government monitoring and evaluation system which should lead to better targeted and more effective social policies. In addition, both the household and labor force surveys could consider survey instruments that strengthen the monitoring of labor market outcomes and poverty patterns for important sub-groups such as TSA recipients or those living in sparsely populated regions.

Environmental Aspects

The proposed prior actions for the second operation will have an indirect positive impact on the environment and will carry no environmental risks. The prior actions under the first pillar include adoption of capital budgeting guidelines, establishment of a financial database for SOEs and SOE fiscal risk assessment. The inclusion of environmental and social assessment criteria in the capital budgeting framework will have a positive impact on the environment. The prior actions under the second pillar include piloting and nationwide rollout of the enhanced obstetric and neonatal care, adoption of the new law on pre-school education, a resolution to hold the census every 10 years, to conduct a separate labor force survey and adopt a framework for the two surveys. A timely census will lead to improved planning and management of natural resources like fuelwood and water.

VIII. Contact point

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