

**PROGRAM INFORMATION DOCUMENT (PID)**  
**APPRAISAL STAGE**

February 2, 2015  
Report No.: AB7706

<b>Operation Name</b>	Inclusive Growth DPO
<b>Region</b>	Europe and Central Asia
<b>Country</b>	Georgia
<b>Sector</b>	General public administration sector (45 percent); Health (22 percent); Other social services (11 percent); Education (22 percent)
<b>Operation ID</b>	P149991
<b>Lending Instrument</b>	Development Policy Lending
<b>Borrower</b>	Ministry of Finance, Georgia
<b>Implementing Agency</b>	Ministry of Finance
<b>Date PID Prepared</b>	February 2, 2015
<b>Estimated Date of Appraisal</b>	March 2, 2015
<b>Estimated Date of Board Approval</b>	April 28, 2015
<b>Corporate Review Decision</b>	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 5.7 percent a year during 2005-14, 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 2013 the overall unemployment rate was 14.6 percent, one of the highest in the Europe and Central Asia (ECA) region. 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 74 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 external sustainability and fiscal pressures arising from increased social spending. At 84 percent of GDP, external debt is high. Low domestic savings and large investments needs result in a high current account deficit, further adding to the stock of debt. In addition, loan and deposit dollarization is close to 60

percent. 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 is scant and patchy, thereby, limiting the ability of the government to monitor fiscal risks from SOE operations.

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, the country has not yet recovered to its 1990 level of real per capita income and 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.

## **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. The two DPO pillars map to one of the priority areas (human capital development) outlined in Georgia 2020 (Figure 3), as well as the necessary pre-conditions laid out by the government (macroeconomic stability and effective public administration). 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.

6. The prior actions for this operation and the expected results are mentioned below.

### ***Pillar I***

- (a) **Prior action 1:** The Parliament has approved amendments to the budget code to include revenues and expenditures of municipal governments, legal entities of public law and non-profit legal entities in the Public Financial Management Information System. The expected result of this policy action is that the budget and execution data of municipalities, LEPLs and non-profit legal entities will be available on a real time basis as against the quarterly data that is currently available.

- (b) **Prior action 2:** The Ministry of Finance has established a register of the number of SOEs in Georgia (central, local, Partnership Fund, and SOE subsidiaries). The expected result of the policy actions under the SOE sector is to make available two years of comprehensive financial data on SOEs.
- (c) **Prior action 3:** The Government has issued a Decree adopting the new framework for civil service reforms. The expected result on the policy actions on civil service reforms is that all first-time entrants into the civil services, hired in 2017, take the pre-qualification test.

## ***Pillar II***

- (d) **Prior action 4:** The Ministry of Labor, Health and Social Affairs has issued an Order adopting the new TSA methodology that will improve targeting and coverage of the poor. The expected result of the policy actions on the TSA is to increase the share of the bottom decile receiving TSA from 60 percent in 2013 to 75 percent by 2017.
- (e) **Prior action 5:** The Minister of Labor Health and Social Affairs has issued an Order introducing the requirement to have a doctor's prescription for the purchase of certain drugs to promote the rational use of medicines. The expected result of the policy actions on pharmaceuticals is to reduce pharmaceutical expenses as a percent of OOP on health by 5 percent by 2016 from 38 percent in 2012.
- (f) **Prior action 6:** The Minister of Labor Health and Social Affairs has issued an Order to enhance obstetric and neonatal care in the regions. The expected result of this policy action is to reduce maternal mortality rate by 3 percent by 2017 compared with 2013.
- (g) **Prior action 7:** The Parliament has amended the Law on Education to include higher qualification requirements for entry into the teaching profession, and better regulation of teacher recruitment and professional development process.
- (h) **Prior action 8:** The Government has issued a Decree adopting the framework for Teacher Recruitment, Evaluation, Professional Development and Career Advancement Scheme which includes the 3 modules of categorization of teachers, the credit accumulation manual and the teacher classroom observation tool. The expected result of the policy actions in the education sector (prior action 7 and 8) is to reduce the proportion of teachers in the lowest category, Category 1, from 65 percent in 2014 to at least 50 percent by 2017.
- (i) **Prior action 9:** The Government has approved and submitted to the Parliament its proposals for amending the law on statistics to make the census timely and to specify a minimum pre-census preparation time. The expected result of the policy actions to strengthen monitoring and evaluation is to publish data on poverty and unemployment on a quarterly basis by 2017. Currently, only annual data on these indicators is available.

### **III. Rationale for Bank Involvement**

7. This DPO operation is the first in a series of three operations. The government has already made significant progress on the prior actions supported by this operation. 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 register for SOEs is also in at an advanced stage. The government has also adopted the framework for civil service reforms which will lay the foundation for changes in the law on civil services. In the health sector, Georgians now need to have a doctor's prescription to purchase certain drugs which were earlier available over the counter. Efforts are also underway to revise the methodology for calculating the targeted social assistance, to improve the quality of teachers in Georgia's basic education system and the effectiveness of monitoring and evaluation systems.

8. Georgia's overall macroeconomic policy framework is adequate for this operation. Although there are downsides to growth triggered by external disturbances, the government remains committed to sound macroeconomic management as evidenced by its commitment to fiscal prudence, low inflation and limited interventions in the foreign exchange market. Over the medium-to long-term, the Deep and Comprehensive Free Trade Area (DCFTA) and the Association Agreement (AA) with the European Union, structural reforms and continued macroeconomic stability will strengthen growth prospects and also reduce external vulnerabilities. There has also been a significant progress in poverty reduction and shared prosperity in recent years. The poverty rate, according to the national poverty line, reduced from 21 percent in 2010 to 14.8 percent in 2012. This was mainly attributable to government transfers, food disinflation and increased earnings. In addition, consumption growth among the bottom 40 percent was 5.4 percent during 2010-12 compared with 3.6 percent for the population as a whole. The government remains committed to overall macroeconomic stability which is a cornerstone of the government's socioeconomic development strategy.

9. The three-year IMF Stand-By Arrangement in the amount of SDR100 million (about US\$154 million) was approved in July 2014. The Stand-By Arrangement (SBA) supports the government's economic program to reduce macroeconomic vulnerabilities, increase policy buffers and support growth, while making the economy more resilient to external shocks. The program is on track as per the first review undertaken in November-December 2014. The proposed DPO complements the Fund program by supporting structural reforms in the areas of public financial management and improvements in human capital. The Bank closely coordinates with the Fund on macroeconomic developments, debt sustainability analysis, fiscal consolidation, and public financial management.

### **IV. Tentative financing**

Source:	(\$m.)
International Bank for Reconstruction and Development	50.0
Total	50.0

## **V. Institutional and Implementation Arrangements**

10. 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 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.

11. 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**

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

### **(i) Political and governance risks**

- A return of political instability would weaken program performance; in addition, geopolitical risks remain elevated. After some changes in key ministerial positions in November 2014, the government is stable and no further changes are expected. Political risk is mitigated by the government's demonstrated commitment to the reforms under this new DPO series. The Bank team is in constant dialog with the authorities to ensure that the reform measures supported by this operation are sustained. In addition, relations with Russia continue to be fragile and there has been a recent escalation of regional tensions which adds to geopolitical risks.

### **(ii) Macroeconomic risks**

- Low growth, a large current account deficit, high unemployment, and fiscal pressures are the main risks to the economy. With a contraction in the Russian economy and a slowdown in the neighboring countries, Georgia's growth prospects have also been revised downwards. Most of the impact on Georgia has been through lower export demand and a fall in remittances. Given its low domestic savings, a large part of the growth in Georgia is financed through foreign savings, particularly FDI. Most of the FDI flows in from the European countries which are also seeing slower growth. Hence, there could be further downsides to economic expansion in Georgia. This risk is mitigated, to an extent, by the structural reforms being undertaken by the government to improve competitiveness and the investment climate and the government's efforts to

maintain macroeconomic and policy stability. On the external front, the country continues to be vulnerable given its high current account deficit (because of reliance on foreign savings) coupled with prospects of lower export demand and lower remittances, high level of dollarization, large external debt, and low level of reserves which is heightening foreign exchange risks. A further depreciation of the Lari would increase the cost of servicing foreign-currency denominated debt. In addition, 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 IMF SBA, market access, and good relationships with donors who could ramp up their programs if needed. Fiscal risks could emanate from further increasing the scope of public health services and ineffective use of the increased budget allocation to social benefits. This could impact program performance in terms of the population effectively covered by publicly funded health and social sector programs. In addition, low net job creation even during high-growth periods led to high and sustained unemployment levels in the country which in turn have had a negative impact on poverty and shared prosperity. Mitigating factors include continuous dialog with and technical assistance from the World Bank and other donors in the health and social assistance sector, and the IMF's SBA which aims to support the government's economic program to reduce macroeconomic vulnerabilities. The government's commitment to efficient public financial management and fiscal consolidation over the medium-term while maintaining capital expenditures, and adherence to Georgia 2020, which focuses on increasing competitiveness, human capital development and access to finance, will help address medium- to long-term growth and employment concerns. This will also ensure that Georgia reaps the benefits from the DCFTA.

(iii) Operational design, implementation and sustainability

- Weak implementation capacity, especially in the line ministries, could undermine the benefits of the reforms. Implementation of this DPO series spans several ministries and capacity is limited in some of them. This risk has been mitigated through technical assistance provided by the World Bank and other development partners. Donor supported programs are providing assistance in key policy areas covered by this DPO series like the social sector (World Bank and UNICEF), public financial management (World Bank and the EU), civil service reforms (EU and UNDP) and statistics (EU, Eurostat, and Net Official Flows from UN Agencies (UNECE)).

## **VII. Poverty and Social Impacts and Environment Aspects**

### **Poverty and Social Impacts**

13. The overall poverty, social, and gender impact of the actions supported by this operation are expected to be positive. In particular, the change in the TSA calculation formula and the adoption of enhanced obstetric and neonatal care will have a positive distributional impact. The latter will also have a positive gender impact. The impact of the change in the methodology to calculate the TSA will most likely be positive as the coverage of the TSA will increase to include individuals who do not currently benefit but should and also by providing a greater level of benefit to the very poor. However, there will also be households which will no longer receive TSA and an assessment of their welfare should also be weighed in. The adoption of enhanced obstetric and neonatal care will most likely have a positive distributional impact as it will improve the standards for the provision of obstetric and neonatal care, which can impact positively on the incidence of maternal and infant mortality and on the incidence of other complications related to childbirth. It will also have a positive gender impact through improved health outcomes for women. The adoption of the civil service reform can potentially have a positive gender effect, depending on the specific actions that will be implemented. The proposals for amending the law on statistics 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.

### **Environment Aspects**

14. **The proposed prior actions for the first operation carry no environmental risks because they will not cause any direct or indirect negative impact on the natural environment.** The prior actions under the first pillar include changes in the public financial management information system, establishment of a register of the number of SOEs and the adoption of the framework for civil service reforms. None of these measures is likely to have any environmental impact. The prior actions under the second pillar include revision to the TSA methodology, the introduction of the requirement to have a doctor's prescription for certain drugs, enhancement of obstetric and neonatal care, amendments to the law on education, adoption of the framework for teacher professional development and the amendment of the law on statistics. These actions are also unlikely to have any environmental impact.

## **VIII. Contact point**

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