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## Annex 2: Action Fiche Georgia

### 1. Identification

Title/Number	Support to the Public Finance Management reform in Georgia, Phase II (CRIS: ENPI/2010/21780)		
Total cost	€11 million		
Aid method / Method of implementation	Sector Policy Support Programme (SPSP): - Sector budget support (centralised management) €10million; - Project Mode for Technical Assistance (centralised management) €1 million		
DAC-code	15111	Sector	Public finance management

### 2. Rationale and country context

The rationale to continue supporting improvements in Public Finance Management (PFM) in Georgia is part of the overall objective of promoting good governance and poverty reduction. Adequate PFM will help to ensure better allocation of scarce resources, improved service delivery, increased accountability and transparency all of which contribute to economic growth and poverty reduction. The upcoming PFM sector budget support will mainly focus on the development of the sector management, of internal and external audit and procurement systems, contributing to bring Georgia closer to EU standards and norms.

#### 2.1. Country context and rationale for SPSP

##### 2.1.1. Economic and social situation and poverty analysis

Georgia is a small transition economy with a population of about 4.5 million people and a gross national income (GNI) per capita of US\$ 2,470. Between 2004 and 2008, Georgia benefited from a high rate of economic growth achieved through rapid implementation of reforms to liberalise economy<sup>1</sup>. Sound fiscal and monetary policies supported by structural reforms to unleash the supply-side dynamics positively impacted economic growth in larger Georgian cities, e.g. Batumi and Tbilisi. The August 2008 conflict and the global economic downturn have altered the dynamic, foreign investments and trade will be lower in the near term affecting GDP growth. Current projections<sup>2</sup> are for GDP to contract by about 5% in 2009, before growth resumes at about 2% in 2010.

Poverty remains high in the country (about 27.8%). The situation worsened after the August 2008 conflict, with 30,000 new Internally Displaced Persons (IDPs) left unemployed. Rural poverty rates are higher than those for urban areas: the incidence of extreme poverty is almost twice that in urban areas. Agriculture is still based on archaic production methods with low, productivity rates, merely allowing for subsistence crops to generate revenues. As a result, agricultural output only accounts

<sup>1</sup> Liberalizing measures concerned: prices, trade, exchange rate and the internal market (first generation reforms)

<sup>2</sup> World Bank, International Monetary Fund figures

for 11%<sup>3</sup> of the GDP but employs almost 60% of the population. The consumer expenditures of over 1.8 million Georgians (40% of the population) are below the official minimum subsistence level. The average consumption of the poor was 14% lower than the subsistence level<sup>4</sup>, with 60% of the poor living in rural areas.

### **2.1.2. National development policy**

The Government's medium term reform programme is described in its poverty reduction strategy entitled "Georgia without Poverty", which was approved on 31 January 2008. While this strategy provides the main directions of the Government's reform programme, the pace of reforms was adjusted to the impact of the 2008 double shocks to the economy, the August conflict and the global economic crisis.

The Government prepares an annual strategy document entitled Basic Data and Directions, which outlines the medium-term reform program and its objectives, provides the mid-term macroeconomic forecasts, including the fiscal resource envelope and fiscal allocations, and includes descriptions of line ministries strategies. The Basic Data and Directions 2010-13 has been prepared and submitted to Parliament as of May 2009. The current Government of Georgia strategy provides an explicit linkage between growth and poverty alleviation. Significant parts of the budget spending are devoted to social and healthcare assistance, but do not fully adequate to address the needs of the poor.

Getting closer to Europe is acknowledged by the Georgian authorities as the first strategic priority of the country, However, a systematic approach to reform is far from being adopted, and effective tools are too often lacking, that should allow for the implementation of otherwise reasonably approximated new legislation. Transparency, civil society participation and involvement of the media are so far a concern.

## **2.2. Sector context: policies and challenges**

In 2009, as a response to the findings of the Public Expenditure and Financial Accountability (PEFA) assessment, the Ministry of Finance revised the Public Finance Management (PFM) Reform Strategy and issued a new Policy Vision paper, which replaced the 2007 PFM Strategy reform. The current Policy Vision focuses only on the areas which are under the mandate of the Ministry of Finance (MoF): Budget preparation, resource management, internal control and accounting and reporting. While there may be some discussion as the appropriateness of the level of details of the vision, Ministry considers it a realistic reflection of what can be done with the existing capacity.

The Vision also includes a plan of actions, implementation of which is spread across 2009 to 2013. So far, main achievements in PFM areas have been: drafting a new Budget Code, implementation of programme and capital budgeting, enhanced transparency of budget execution, development of sub-legislation, establishment of simplified customs procedures for selected entrusted traders, establishment of risk based selection procedures for tax auditing and introduction of e-services. Forthcoming reforms will most probably concentrate in the areas of budget preparation, internal audit and accounting.

The Chamber of Control has developed its own strategy. The activities envisaged for upcoming years are: the establishment of a sustainable training system for auditors; development of audit methodology in line with the International Organisation of Supreme Audit Institutions (INTOSAI)

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<sup>3</sup> Ministry of Economic Development of Georgia, Department of Statistics, Quarterly Bulletin 2009.I.

<sup>4</sup> According to the data of the first three quarters of 2008, *Regional Development in Georgia - Diagnostic Report*, June 2009.

standards; improvement of the relations/communication with the Parliament, Ministry of Finance and the broader public.

Amendments to the State Procurement Law are also ongoing. The development of e-procurement by September 2010 and the implementation of data exchange to replace paper procedures should generate an improved audit trail for procurement and enhance its anti-corruption role and transparency. Other developments include the use of a Common Procurement Vocabulary and Dispute Resolution to include wider participation of Civil Society Organisations.

The main challenge to PFM is the lack of a systematic approach to reforms as well as institutional and human capacity of beneficiary institutions. The Government of Georgia does not use any unified methodology for assessing progress in different sectors and little systematic follow up and reporting on planned PFM reforms takes place. The vision and the action plan are not sufficiently well defined and underpinned with measurable indicators to serve as a basis for an effective monitoring system.

### **2.3. Eligibility for budget support**

After several years of strong economic growth, albeit with increasingly high inflationary pressures, Georgia's economic prospects were severely affected in August 2008 by the conflict with Russia, and by the subsequent loss of business confidence. In spite of substantial support from the donor community, Georgia experienced negative growth through the second half of 2008 and in 2009.

Last forecasts for 2009 predict a fall in GDP from 4% to 5.5% for the year as a whole. Cuts in capital inflows and remittances caused a fall in imports and narrowed the payments deficit, easing foreign currency demand and inflation. Reduction in capital inflows also impacted negatively on budgetary revenue, however, the IMF's latest Review Mission concluded: "Georgia's strong record of reform and good performance under the stand-by agreement give confidence about the authorities' ability to steer the economy through a difficult adjustment period". Despite risks to mid-term sustainability of growth the general condition of macroeconomic stability is satisfied, having the Government of Georgia operational programmes ongoing with IMF and other IFIs, including the World Bank and the Asian Development Bank.

The latest assessment of the status of PFM reforms was updated by the EU Delegation in Tbilisi in November 2009, followed by the last review mission to assess compliance with conditions of the ENP AAP2007 SPSP for PFM. Both the review mission and the Delegation report on PFM positively assessed the status of sector policy reforms in PFM. Therefore, the general condition on satisfactory PFM is satisfied.

### **2.4. Lessons learnt**

The lessons learned from the previous Budget Support Programmes (EC FSP 1996-2006, EC SPSP 2007-2009) have shown that Georgia qualifies for budgetary support and that the system is understood by the Government. Experience from the SPSP 2007-2009 highlights the need for a strong integrated public finance system and strong institutional capacity in beneficiary institutions if budget support is to achieve its objectives.

The Public Expenditure and Financial Accountability (PEFA) assessment, conducted jointly by the European Commission and the WB, shows that the reform of the PFM system has been a priority for the Georgian Government. Reforms in the areas of tax and customs administration and in particular the creation of a new Revenue Service, combined with successful anticorruption measures and improvements in the business environment have raised revenue outcomes considerably and improved Georgia fiscal position.

The Government of Georgia commitment to the PFM reforms has been compromised during 2008 by more urgent political issues. During 2009, with the changes brought in by the August war, and the Financial Crises followed, the MoF has engaged in a more constructive dialogue with donor community and stakeholders allowing for a better understanding and progress in the PFM reforms. This is proved by the recent developments in the sector. It is expected that PFM reforms continue to have strong support from the political leadership. To accelerate the progress in efficiency, transparency and accountability of public finances reform should focus more on improvement of external audit and state procurement systems.

## **2.5. Complementary actions**

The activities foreseen under this programme will be complemented by on going activities under TACIS and ENPI, including also sector budget support in selected line Ministries. During the last 4-5 years, many state institutions received donor technical and financial assistance for the implementation of PFM reforms.

The Twinning/TAIEX modalities and expertise from EU Member States shall be proposed where the needs are clearly identified at the beneficiary institutions. The Comprehensive Institutional Building mechanism under the Eastern Partnership Initiative can be also of interest for core institutions that are central in preparing the ground for and implementing a future Association Agreement and Deep and Comprehensive Free Trade Agreement (DCFTA)

The programme will also be complemented by the World Bank (WB) Development Policy Operations (DPO) series. The first DPO, implemented in 2009-2011 is focusing on three policy areas: i) Efficiency and Effectiveness of Public Finances, ii) Effectiveness of the Social Safety Net and iii) External Competitiveness. In the area of PFM the main focus is on 1) introduction of results oriented and budgeting in public sector, 2) development of multi-year investment plans which will lead to capital budgeting.

The DPO programme will be complemented by another programme supported by the World Bank and other donors - the Public Sector Financial Management Reform Support Programme (PSFMRS). The latter has a budget of USD 15 million, co financed under a pooling arrangement by WB, DfID, the Dutch Government and Sida. The expected end date is March, 2010 but it might be extended for another two years. The major activity envisaged under the programme is the establishment of the integrated Public Finance Management System (PFMS) in the MoF/Treasury Service. In order to implement the PFMS, MoF should make a decision to purchase the software from international companies (eg. SAP, Oracle) or develop/integrate different IT modules to the existing ones.

According to World Bank Strategy for 2010-2013 years, the bank will also facilitate improvement of the effectiveness of the Revenue Administration. The assistance will include support for strengthening the use of e-filing payment system and risk-based tax and customs auditing. The "Structural Benchmarks" under the IMF programme also make clear reference on more strategic and inclusive budgeting with budget execution monitoring mechanism.

## **2.6. Donor coordination**

Sector and donor coordination is important in the context of PFM reforms. Even though the capacity to coordinate reforms is weak, the Government of Georgia stays in the driving seat for PFM reform definition and implementation. In the field of PFM, the main donors are those involved in the "Public Sector Financial Management Reform Support Project" (WB, DFID, NL, Sida), US treasury (TA to the MoF on budget) and the European Commission. GTZ, since 2002 is supporting the Chamber of Control to develop an Audit methodology and manuals. However, due to frequent changes in the management, progress is limited. Recently, the Chamber of Control of

Georgia signed a memorandum with the Swedish National Audit Office. The latter will help the Chamber to develop the Audit Methodology and Code of Ethics for auditors.

Discussions and consultations are ongoing with the Government of Georgia and other donors (WB, the Netherlands, Sida USAID and IMF) on the possibility of creating a joint mechanism to improve the policy dialogue between the Government of Georgia and at least donors closely supporting these reforms. Some progress has been made on coordination on PFM Reform; for example it was agreed to prepare a joint matrix which will include and coordinate different donor activities in the sector. Furthermore, a joint EU-USAID-World Bank working group has been formed and will have meetings with the Government to coordinate the starting of a WB financed revenue modernisation project, building upon an EU-funded project diagnostic report on tax administration.

### **3. Description**

#### **3.1. Objectives**

The proposed sector programme is to support the Government of Georgia to further strengthening public sector accountability, efficiency and transparency, and its overall objective is to enhance good governance and poverty reduction by promoting essential reforms of the Public Finance Management (PFM) System, in areas ranging from budget planning, execution, monitoring, as well as internal and external audit and public procurement, this programme will promote transparency and accountability, while increasing efficiency and effectiveness of planning and governmental spending.

#### **3.2. Expected results and main activities**

1. Further improvement of the Government of Georgia capacity to manage, coordinate and monitor the reform of the PFM system, enhancing the link between policy and budget programming
2. Further improvement of the budget preparation, execution, monitoring and evaluation processes at MoF and Line Ministries, primary focusing on strategic planning and budgeting
3. Enhance the revenue function and establish modern framework for debt management
4. Establishment of modern ex ante and ex post monitoring and evaluation systems of the spending of public finances.
5. Further harmonize procurement system with the EU best practices to improve the transparency and efficiency of public procurement.

Given the limited institutional capacity of the public institutions, some ad hoc technical assistance and capacity building activities could be needed. This is especially true in relation to the development of external and internal audit, where current numbers of qualified auditors are low. International expertise is needed to facilitate drafting of modern management and procedural guidelines, helping in setting up certain structures/functions and for staff training

#### **3.3. Risks and assumptions**

The main risks are associated to external political challenges and unresolved conflicts, which undermines the Government of Georgia capacity to focus on structural reforms. It is assumed that with the help of the international community a more stable political and financial environment will exist, compared to that which has prevailed over the last three years. The European Union and its structures, including the EU Monitoring Mission are playing important role to mitigate the external political risks. Other types of risks are the high turnover of staff and weak institutional capacity within the public administration. Public Institutions lack capacity to design and assess performance measurement indicators vis-à-vis programs and action plans. Monitoring and evaluation is not done on a regular basis.

In order to address the problem of weak institutional and human capacity the targeted technical assistance will be provided to the beneficiary institutions. The upcoming SPSP programme will also highlight the importance between the policy programming and budget formulation. It is expected that newly enacted Budget Code, which obliges ministries to switch to programme based budgeting from 2012, will stimulate the public servants to switch from to day-to-day management to policy programming. In order to mitigate the risks associated with staff turn-over the donor community and especially the EU Delegation is engaged in the intensive dialogue with the government.

### **3.4. Stakeholders**

The main stakeholder is the Ministry of Finance as many of the reforms take place within the Ministry, but central piece of the reform will be also key institutions such as the Chamber of Control and the State Procurement Agency. However, all organs of government are stakeholders to the extent that the proposed reforms should impact positively on them.

The Budget Committee of the Parliament of Georgia is another important player, especially in monitoring the PFM reform implementation process. Other stakeholders include donors and IFIs, who are involved in a support to PFM reforms: WB, IMF, DFID, NL, Sida, GTZ, US treasury.

### **3.5. Crosscutting Issues**

PFM is crosscutting per definition. Improvements in the Public Finance Management system will positively affect Governance. A better PFM system would make the government more accountable and reduce room for corruption, which will in turn positively affect the governance and, possibly human rights situation in the Country.

With a better use of public finance, citizens will receive improved public services, including services to meet the economic and social needs of the poor people. Good governance principles (in particular: ownership, organisational adequacy, transparency/accountability and anti-corruption) will be observed during implementation. Engagement with Non-State Actors will be encouraged, especially regarding their potential contribution to make public administration more transparent and responsive to citizens. The possibility of gradually introducing a "gender budgeting" concept in Georgia will be explored during the programme implementation.

## **4. Implementation issues**

### **4.1. Method of implementation**

Direct centralised management.

### **4.2. Procurement and grant award procedures**

All contracts implementing the action must be awarded and implemented in accordance with the procedures and standard documents laid down and published by the Commission for the implementation of external operations, in force at the time of the launch of the procedure in question.

Participation in the award of contracts for the present action shall be open to all natural and legal persons covered by ENPI Regulation. Further extensions of this participation to other natural or legal persons by the concerned authorising officer shall be subject to the conditions provided for in article 21(7) of the ENPI Regulation.

### **4.3. Budget and calendar**

The sector programme will have a budget of €11 million, of which €1 million will be allocated for Technical Assistance (TA) and the remaining resources will be channelled through budget support. Tentatively, this will be done in two subsequent instalments of an equal value. The funds will be disbursed into the Georgia State Budget upon compliance of agreed conditions.

Each instalment will be composed of a fixed (30% of total budget support value) and a variable (70%) component. The foreseen operational duration as from signature of Financing Agreement is 36 months.

### **4.4. Performance monitoring and criteria for disbursement**

The proposed SPSP will be subject to a number of agreed conditions and benchmarks, all of which will be based on the agreed strategy of the beneficiaries for reforms of public finance, and which will be laid down in the Financing Agreement (FA) for this programme.

The fixed component will be linked to general conditions on: sound macroeconomic framework, satisfactory progress in PFM reform and satisfactory implementation of PFM Strategies (including those of the Ministry of Finance, the Chamber of Control and the State Procurement Agency).

The specific conditions for the disbursement of variable tranches will be based on a selection of the items listed in Section 3.2 above. The variable component indicators will indicatively cover: External and internal Audit, State procurement rules and arrangements, budget predictability and transparency. Attention will be paid to avoid duplication in areas already addressed by the WB-led "Public Sector Financial Management Reform Support Project". Conditions for the variable tranches will be discussed and agreed with the Ministry of Finance, Chamber of Control and the State Procurement Agency during 1<sup>st</sup> quarter of 2010 and will be laid down in the Financing Agreement implementing this programme.

TA, in accordance with the Backbone Strategy and Guidelines on Technical Cooperation, will be used to monitor and review the progress of the reforms and the fulfilment of the conditions for payment. If needed, part of the TA can be used to assist in further strengthening the institutional capacity such as drafting of modern management and procedure guidelines, helping in setting up certain structures/functions and for the training of the staff.

### **4.5. Evaluation and audit**

An evaluation of the programme as well as external audits may be carried out if so decided by the European Commission. In such a case, they may be entrusted to independent consultants and financed from the technical assistance component of the SPSP.

### **4.6. Communication and visibility**

Communication and visibility will be organised in close cooperation with the Ministry of Finance and in accordance with the orientations of the Manual on Visibility of External Actions (e.g., press release at the signature of the FA, visibility for reports and studies, etc). Communication and visibility actions will be financed from the technical assistance component of the SPSP.