

Action Fiche for Georgia

1. IDENTIFICATION

Title	Support to the public finance management reform in Georgia		
Total cost	16 million Euro		
Aid method / management mode	Sector Policy Support Programme: - Sector budget support (centralised management);		
DAC-code	15120	Sector	Public finance

2. RATIONALE AND COUNTRY CONTEXT

2.1 Rationale

The rationale of the EC in providing a sector programme to support improvements in Public Finance Management (PFM) capacity of the partner country *is part of the overall objective of promoting good governance and poverty reduction*. Improving 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 consequent poverty reduction*. Thus the process of improving Public Finance Systems is not an end in itself but a prerequisite to improving overall government performance in terms of delivery of programmes that will impact on poverty reduction. In this context the involvement of the EC in the programme will not only focus on the improvement of systems at central level (Ministry of Finance, Chamber of Control, etc.) but also on selected line Ministries and institutions that are considered key in terms of programme implementation that have a high relevance to poverty reduction.

Economic and social situation

Economic performance in the period since November 2003 has been encouraging with GDP growth rates in the region of 8-9% in the period 2004-2006 and is expected to remain at levels of 7-8% in 2007. The Georgian economy continued to perform very well throughout 2006, despite the gas import price shock and the trade and transport blockades imposed by Russia. Construction, manufacturing and services all performed well while agricultural production fell due to climate factors and the impact of the Russian trade embargo.

Tax revenues continued to grow in line with the legalisation of economic activities and strong enforcement measures by the authorities. The ratio of tax revenues to GDP which was 14% in 2003 reached 21½% in 2006. The fiscal deficit (on commitment basis) increased to an estimated 2.9% of GDP (1.5% in 2005), while on cash basis, the deficit was slightly lower at about 2.3%. Total government expenditure reached 26% of GDP (23.4% in 2005) of which capital spending accounted for about 5.5% of GDP. Privatisation revenues peaked at about 4.5% of GDP in 2006 (3.6% in 2005). The government also received significant grant amounts, including from the EU and the US Millennium Challenge Corporation, totalling 2.5% of GDP (0.9% in 2005).

The main economic policy challenge in 2006 was to keep inflation down. The 12-month inflation peaked at 14.5% in July but fell to 8.8% in December as oil prices declined and the monetary policy stance was tightened whereas fiscal spending was still running ahead of target. The trade deficit is estimated to have widened to around 21% of GDP in 2006 (14.5% in 2005). Despite the closure of the Russian market for Georgian goods, exports in 2006 increased by over 10% in 2006. Imports from Russia, apart from natural gas, were replaced by imports from other countries and import demand continued to grow rapidly (related to strong investment activity in Georgia). According to the NBG, remittances, including those from Russia, increased in 2006, reaching USD 413 million in total (about 5% of GDP). The current account deficit is estimated at around 9½% of GDP (5.4% in 2005), financed by foreign direct investment (including privatisation receipts). Gross international reserves of the NBG increased to USD 880 million at end-2006, covering 2.2 months of imports. Georgia's public external debt is on a sustainable path, having decreased further from 27% of GDP in 2005 to around 22% last year (USD 1.7 billion in nominal terms). According to the IMF/World Bank debt sustainability study of 2006, Georgia's debt distress risk is low.

While recent GDP growth rates have been impressive poverty rates remain stubbornly and unacceptably high. According to recent statistics the number of people living in poverty in 2006 was around 39% of the overall population compared with a figure of 35,7% in 2004. It is clear that continuing difficulties in the agriculture sector, accentuated by the export crisis, is impacting significantly on rural poverty while the impact of economic growth is unevenly spread. Recognising this Government is focusing on improving the social assistance to poor and vulnerable groups with in 2006 a major restructuring of social assistance payments in order to improve targeting and to ensure that social assistance was focused on the most vulnerable groups.

The overall macro-economic situation is sufficiently stable so as to make Georgia eligible for budget support. The Government are following a prudent fiscal programme and have met all relevant IMF criteria. The IMF completed its Fifth Review of the PRGF on March 1st with a very positive view on the overall macro economic performance.

2.2 Cooperation policy of beneficiary country

The Economic Development and Poverty Reduction Programme (EDPRP) was finalised mid-2003 and the priorities remain unchanged. These include achieving and sustaining rapid economic growth (at least 5 percent per year), reducing extreme poverty from 13.5 percent in 2005 to 5 percent or less by 2015 and overall poverty from 39.4 percent in 2005 to half that figure by 2015. The reform program also supports important features of Georgia's Action Plan under the European Neighbourhood Policy (ENP) and its Individual Partnership Action Plan for joining NATO (IPAP).

A review of the EDPRP was carried out in early 2006 (assessing progress to the end of 2005) and a further review is underway. A further important development in terms of planning, implementing and monitoring EDPRP priorities is the Basic Data and Directions (BDD) document. This has been prepared as part of the process of developing MTEF and attempts to link overall national policies to sector strategies and the budget. The first BDD was for the period 2006-2009 and it has subsequently been revised for the period 2007-2010.

In November 2006 Georgia endorsed the ENP AP laying out the strategic objectives of the political and economical cooperation between Georgia and the EU. Under the ENP AP Georgia has expressed its readiness to approximate further to EU norms and principles and to gradually integrate to economic and social structures, building from the provisions of the PCA

but enlarging the cooperation also in other areas. Georgia is engaging itself in fulfil all commitments set forth in the ENP AP in three years and for this end is preparing an ENP AP implementation strategy. The main priorities identified in the ENP AP in the area of good governance and public finance are: *Proceed with implementation of reforms in PFM including the MTEF; Implementation of the Anti-corruption strategy; Strengthen management and control of public finances; Public internal financial control.* All of these priorities will be progressed under the proposed programme.

2.3 Government Sector Programme

Until 2002, Georgia was one of the poorest performing economies with one of the weakest governance frameworks of Europe and Central Asia region. This was symbolised by pervasive corruption, with negative repercussion on government revenues. On taking office in January 2004 the new Government responded decisively to its mandate to improve overall performance and governance. In the area of economic liberalisation the results achieved have been encouraging. A new tax code reduced the number of taxes collected and their percentage rates, simplified the process for registering a business, and eliminated close to 90% of previous licensing requirements. These changes have enabled the Government to curb economic corruption and increase the state budget of several times. As a result of the improvement in State's revenue-collecting capacity, the State budget has indeed tripled, increasing to 1.5 billion dollars in the period 2003-2006. The 2007 budget projects expenditure of 4 billion Gel (approx 1.8 billion euro)

In the area of public finance management, the Government has outlined a strategic vision for Public Finance Management Reform with ambitious goals. This Strategic Vision, is an expression of the Government's ownership of the reform agenda, and acts as an anchor for the overall reform process in Public Finance. The focus of the reforms have been on the following main areas: *Budget system, treasury system, financial policy, tax and customs department and financial police, external audit.* The main achievements achieved since 2004 have been the adoption and enactment of the new budget systems law and the introduction of the Single Treasury Account. In 2005 a start was made to improve the link between "strategic planning" and 'budget preparation' in a medium term perspective with the introduction of the Medium Term Expenditure Framework (MTEF). The MTEF process will be significantly strengthened in 2007.

In 2006 a new law on State procurements became effective. The new law extends its coverage to state owned enterprises and streamlines procurement procedures. At the same time the Government recently launched the State Procurement Agency website in order to publish tender announcements and improve transparency. The government is also planning to produce annual consolidated financial statements in accordance with international accepted accounting and reporting standards and to introduce the GFS 2001 – compliant budget classification by 2009. While acknowledging what has been achieved in an often difficult environment and with limited resources and experience it is also accepted that significant further reforms are required to ensure that an efficient, effective and transparent public finance system (PFS) exists, one that all stakeholders can have confidence in.

This is recognised by government and shortcomings are being addressed on a number of fronts. In March 2007 the Ministry of Finance has produced a document "*Strategy 2007-2011 and priorities for cooperation with development partners*". This document summarises reforms already undertaken and the plans for further reforms and the roles that donors will play in the reform process. It also identifies areas where external assistance is still required. It thus presents an overall framework towards reform of the PFM system. A significant element of the reform programme is the considerable resources provided under the umbrella of the

World Bank supported Public Sector Financial Management Reform Support Project (PSFMR-SP)⁶. This project is currently underway and is scheduled for completion in March 2010. The EC together with the World Bank and the Ministry of Finance are working for the definition of a single policy matrix for measuring results in PFM reforms based on the existing Government's policy documents as the Strategic Vision of 2005, the "*Strategy 2007-2011 and priorities for cooperation with development partners*" and ENP AP Implementation Plan.

A more comprehensive update of strengths and weaknesses of the public finance system will be available when a planned Public Expenditure Financial Accountability (PEFA) assessment is completed in June/July 2007.

2.4 Lessons learnt

The lessons learned from the previous Budget Support Programme (EC FSP 1996-2006) has shown that Georgia fully qualifies for budgetary support and that the system is well understood by the Government. The FSP provided €88 million over a ten year period as budget support and focused on reforms in Public Finance, Agriculture and the Social Sector. Experience from the FSP highlights the need for a strong integrated public finance system and strong institutional capacity if budget support is to achieve its objectives. While improvements have been made in the process of linking policy to budget through the MTEF process the link is still not sufficiently strong. However, the experience of the FSP is, that the Georgian Government are willing and able partners in the implementation of a budget support process and the lessons learned from the FSP can be usefully used in the design of future budget support programmes.

A number of relevant studies and assessments of the Georgian Public Finance system have been carried on in recent years, some of which have been undertaken by the EC reported positively on then recent developments in regard to the development of the necessary legal framework and the Budget System Law as well as the positive developments in terms of revenue collection. Also relevant is an analysis of the administrative procedures and financial circuits of organizations (Ministry of Finance & Central Bank) involved in the European Commission's Macro-Financial Assistance (MFA), which was commissioned by DG ECFIN and carried out by Deloitte & Co ("framework for sound financial management"). This study concluded "*that the framework for sound financial management of the Ministries of Finance is effective with regard to budgetary control, but needs to be strengthened and developed with regard to internal control within budget organisations and internal and external audit. The framework for sound financial management within the National Bank of Georgia is effective.*" This still remains the picture and a mission to assist with the ENPI process in February 2007 has identified many of the same weaknesses. In summary it can be said that while many important reforms of systems and processes have been implemented a substantial amount of work remains to be done both at MoF and spending institution level before the public finance system is adequately strengthened and robust.

2.5 Complementary actions

The activities foreseen under this programme will complement on-going activities under TACIS in selected line Ministries (Health, Justice and Agriculture). The PFM project will aim at improving the budget planning and financial management capacities of these line Ministries, thus, preparing the ground for sector budget support operations from 2009 onward.

⁶ This project is supported by the Netherlands, Swedish and UK governments.

The programme will be complementary as well to the programmes of the World Bank and other donors involved in PFM namely the Poverty Reduction Support Operations (PRSOs) of the Bank and the Public Sector Financial Management Reform Support Program (PSFMRS). The latter has a budget of 15 MUSD, co-financed under a pooling arrangement by WB, DFID, Dutch Government and SIDA. The EC programme will bring additional leverage and resources in support of the Government reform agenda as identified in the “Strategic Vision for Public Finance Management Reform” of the Ministry of Finance. A Joint Steering Committee will be established for the oversight of the entire process and the PRSO and EU PFM project will closely coordinate and align to the Government reform agenda.

2.6 Donor coordination

Donor coordination within the MoF is reasonably strong and a number of steering committees exist to oversee various aspects of the PFM reform process. The recently elaborated Strategy 2007-2011 and priorities for cooperation with development partners sets out in some detail the role different donors are playing and also where donor support is required.

In the field of PFM, the main donors are those involved in the “Public Sector Financial Management Reform Support project” (WB, DFID, NL, SIDA), IMF (advisory service to Treasury), USAID (procurement system, custom and revenue administration), US Treasury (TA to the MOF on budget) and the EC. The EC has supported reforms in PFM through conditions that have to be fulfilled (i.e. budgetary support operation under the Food Security Programme). GTZ and UNDP provided support to the Chamber of Control. The MoF has established a steering committee to oversee the PFM reform process and the EC as a result of this project, will be represented on this committee.

3. DESCRIPTION

3.1. Objectives

General Objective

The proposed programme contributes to the higher level objective of improving efficiency in public service and thereby contributing to poverty reduction. Reform of the Public Finance System is seen as an essential part of the overall process of improving Government accountability and transparency.

The expected impact of the programme is an enhanced public finance environment that will contribute to improved efficiency and transparency of government spending. This is expected to lead to increased donor and investor confidence, improved service delivery and the development of a public finance environment in Georgia that more closely approximates to that which exists in EU member states

The programme will impact at two key levels:

1. At the level of the Ministry of Finance and Chamber of Control who are operationally responsible for overall implementation of the reform programme.
2. At line Ministry level where improvements in the budget process should lead to improved resource allocation, better service delivery and improved reporting and monitoring of programmes

The “*Strategy 2007-2011 and priorities for cooperation with development partners*” is a very comprehensive document and addresses a wide range of reforms over the period to 2011. While the proposed project will support the overall reform process, it will focus on specific areas where weakness are identified and that are considered a priority for both the European Commission and the Government. The programme therefore will support the MoF in guiding the reforms as well as on strengthening the capacities of selected line ministries in implementing them especially in the areas of policy formulation and sector MTEF, budget planning and execution and in financial management and reporting.

Specific Objective

The specific objective of the programme is to enhance Government’s accountability and public finance management capacity.

Expected results

The expected results of the programme are:

- Improved budget process from formulation to reporting including MTEF
- Accounting and treasury systems improved in line with international standards
- Development of a harmonised internal control and audit framework in line with international practice
- Improved and more transparent public procurement environment
- Capacity of the newly established “Department of revenue services” strengthened

Indicators

Suitable indicators will be identified that will facilitate measurement of progress in meeting overall programme objectives. These indicators will be developed with the MoF and will be an integral part of the Ministry’s own monitoring process. Indicators will combine actual outputs with relevant benchmarks, keeping in mind that the reforms are part of a process rather than once off actions.

3.2. Stakeholders

The main stake holder is the Ministry of Finance as it has primary responsibility for reforms in the PFM system and also many of the reforms will take place within the Ministry. However all organs of government are stakeholders to the extent that the proposed reforms should impact positively on them. In particular key institutions such as the Chamber of Control and the State Procurement Agency are key players in the process. At line Ministry level the role of the Ministries of Agriculture, Justice, Health and Education are important from an EC perspective.

The absence of adequate institutional capacity is an issue in Georgia, both at Ministry of Finance and line Ministry level. The public finance reform agenda is very substantial by any standards and to be successfully implemented will require adequate numbers of well trained and motivated staff. This is especially true in relation to the development of audit and internal audit where current numbers of qualified personnel are low. Problems of capacity are not

helped by inappropriate recruitment and retention policies throughout the public service. Changes at Ministerial level are often accompanied by major staff changes at senior and middle management level. This often results in the loss of capacity and institutional memory—capacity sometimes developed through donor supported projects. System developments in themselves will not improve the overall public finance system and the reform agenda must address the issue of capacity at all levels.

3.3. Risks and assumptions

The main risks envisaged are:

- Lessening of commitment to the reform process in face of emergence of short term problems in other areas
- Possibility of inadequate capacity to adequately cope with the increased volume of work that will arise during the reform process.
- Further external shocks that could impact on the macro economic situation

. With respect to eligibility criteria for budget support no significant risks are anticipated. The stable macro economic environment is expected to continue and the impact of the embargo on exports to Russia is expected to be successfully absorbed. The overall programme is based on the assumption that the commitment to the reform process is maintained and that the required political commitment and allocation of resources will be forthcoming. It is assumed that a more stable environment will exist in terms of personnel changes than what has prevailed over the past two years, and that the importance of institutional stability is appreciated by Government.

3.4. Crosscutting Issues

By definition the improvement of the PFS will impact positively on overall good governance. There are no specific issues within the programme that relate to environment, gender or human rights though all of these areas can be supported by the prospect of a better and more transparent use of public resources.

4. IMPLEMENTATION ISSUES

4.1. Implementation method

Centralised management.

As the proposed Programme is budgetary support, the method of management is centralised i.e. the budgetary support operation in itself is managed solely by the Commission. The budgetary support will be untargeted and as such will be channelled directly into the *Unified Treasury Account* of the Government of Georgia. Once released, the funds will be used as all other normal budgetary resources of the Government, and managed in compliance with the laws and regulations of Georgia.

4.2. Procurement and grant award procedures

For the complementary technical assistance component, the Commission will directly manage and award the contracts 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.

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.

4.3. Budget and calendar

The programme has a budget of €16 million, out of which, indicatively, €1 million will be used for technical assistance and €15 million for budgetary support.

The budget support component will be disbursed through 3 instalments of an equal amount. The first instalment will be payable to the Georgian State budget after the signature of the Financing Agreement. The balance will be paid in 2 equal instalments in 2008 and 2009, against conditions and indicators to be identified and agreed upon by the Commission and the Government of Georgia, and subsequently laid down in the Financing Agreement.

The technical assistance component will be used for the management of the programme, for the external review missions and for ad-hoc policy advice support if requested by the Beneficiary.

4.4. Performance monitoring and criteria for disbursement

The conditions will be based on a number of key indicators for the assessment of progress in the reform process in accordance with the priorities identified in GoG's policy documents such as the PFM Strategy of March, 2007 and the ENP AP. Considering the current stage of reforms, it is envisaged that the conditions will be mainly "process related" more than real outcome based conditions. Conditions are envisaged in areas such as development of audit, improvement in public procurement, and overall budget process including the MTEF

4.5. Evaluation and audit

The programme will be subjected to one annual review. The review will assess compliance with conditions and make recommendations on the appropriate level of disbursements. Where feasible the review will be co-ordinated with World Bank reviews.

4.6. Communication and visibility

Communication and visibility will be organised in conjunction with the MoF. Currently a donors committee exists within the MoF and from 2007 the EC will be represented on this. As the programme develops the EC will, in conjunction with the MOF, organise appropriate public relations activities so as to keep the general public informed of developments.