ECONOMIC AND FINANCIAL ANALYSIS

1. This document describes the economic and financial context and justification of the loan amount of the Asian Development Bank (ADB) Improving Domestic Resource Mobilization for Inclusive Growth program cluster. The loan size reflects Georgia's development financing needs, the breadth of the policy reform package, the expected development impact, and program implementation costs, with reference to specific development expenditures supported by counterpart funds of the loan.[1]

2. **Economic overview.** Gross domestic product (GDP) grew by 2.8% in 2015, a steep decline from 4.6% in 2014, as recession in the Russian Federation and weaknesses in other trading-partner countries slowed investment growth and reduced manufacturing, exports, and remittances. As a result, growth was driven by domestic demand, mainly in the construction and mining industries. Inflation increased in 2015, particularly in the second half (from 3.1% in 2014 to 4.0%) but has eased to 2.1% as of May 2016. Higher import prices resulted from a 26.5% depreciation in the Georgian lari against the US dollar in 2015, which more than offset declines in global food and energy prices. However, rising global oil prices, a weaker dollar, and increasing foreign exchange receipts from tourism and exports contributed to an appreciation of the lari by 17.3% between 15 February and 9 June 2016. The budget deficit increased to 3.8% of GDP in 2015, up from 2.9% in 2014, while total public debt rose to 41.5% of GDP, from 35.6% in 2014, reflecting in part the impact of lari depreciation.

3. The government expects modest annual GDP growth of 3% for 2016. Domestic demand is seen to remain the main source of growth, reflecting fiscal support for consumption and investment. Downside risks relate to weaker-than-expected recovery among trading partners, which would reduce exports, and further lari depreciation, which would lead to inflationary pressures. The expected cut in the profit tax in January 2017 will likely keep the budget deficit above 4.0% of GDP in 2017, even though strong revenue collection will offset higher spending on pensions and other social programs. The revenue base is boosted by (i) higher excise taxes on tobacco and alcoholic beverages, (ii) reform to customs duties, and (iii) more efficient tax administration. Public debt is expected to increase in 2016 before easing in 2017, because of lower foreign currency borrowings.

4. **Development financing needs**. The program cluster provides financing of $250 million equivalent for 2014–2016. Subprograms 1 and 2 disbursed equal amounts of $75 million in September 2014 and September 2015. The size of subprogram 3 is estimated at $100 million equivalent. The government's development-related financing gap is estimated at GEL1,395 million ($655 million) in 2016,[2] a decrease of 4.8% relative to 2015. The government intends to borrow both from domestic (14.3%) and foreign (85.7%) sources to finance the gap. Domestic borrowing comprises issuance of GEL200 million of treasury securities (net). Foreign borrowing comprises financing and long-term investment credits projected at GEL680 million, and anticipated budget support from development partners of GEL515 million equivalent in 2016 (Table 1). ADB's policy-based loan under Subprogram 3 will help narrow the government's development financing gap by 17.0% and accounts for 46.6% of the budget support from development partners in 2016. Public debt is expected to moderately increase to 45.8% of GDP in 2016, as a result of such government borrowing and budget support for programmatic measures, before easing to 44.8% in 2017 as foreign debt decreases. Since total public external borrowing is largely represented by concessional sources (88.1%), and commercially priced

[1] ADB. 2013. Operations Manual Policy-Based Lending (OM Section D4). Manila.
[2] Ministry of Finance (MOF). *Georgia: Basic Data and Directions 2016–2019—supplementary document of 2015 Budget*. Tbilisi.

borrowing via an Eurobond represents only 11.9%, the weighted average interest rate on foreign borrowing was relatively low at 1.9% in 2015. Contractual average maturity of foreign debt is 23.2 years, and average time to maturity is about 10.9 years, providing manageable debt service levels. Seventy-seven percent of the public external debt carries a fixed interest rate. Budget support is necessary to fund part of the development financing needs, especially covering the period from introduction of ADB-supported reforms under the ADB program to realization of fiscal benefits.

Table 1: Financing Plan to Narrow the Development Financing Gap

Source	**Amount** (GEL million) **2016**	**Share of Total (%)**
Asian Development Bank	240.0	46.6
World Bank	240.0	46.6
European Union	35.0	6.8
Total	**515.0**	**100.0**

Source: Government of Georgia; Asian Development Bank estimates.

5. **Specific elements of development expenditure on pension reform.** Public expenditure on health and education services and social assistance increased significantly from 9.4% of GDP in 2012 to 11.7% in 2014. Despite the challenging economic environment in 2015, this spending was maintained at 11.4% of GDP, with 21.7% of the state budget allocated to social expenditure. Pension expenditures more than quadrupled (2005–2015) reaching GEL1.39 billion ($579 million) in 2015, equivalent to 4.1% of GDP or 16% of total budget expenditures. Pension expenditure will continue to increase as the number of pensioners is projected to grow in line with population ageing, and because of future increases in the monthly pension rate, which has increased rapidly between 2010 and 2015, from GEL80 to GEL160. The strain of pension costs on the state budget could potentially exceed 10% of GDP by 2050. The budget allocated GEL2.0 billion to pension and social protection in 2015, which is an increase of about 3.5% on 2014. In September 2015, the pension rate rose from GEL150 to GEL160 per person per month, which increased pension costs in the 2016 state budget by GEL180 million ($75 million). This is a specific development expenditure cost incurred under subprogram 3. Given the current trend of regular increases in the universal pension rate and number of beneficiaries, the government will incur estimated costs of GEL7.37 billion over the next 5 years.[3] If the increases in the universal pension rate are indexed to wage growth, the pension bill could be as high as GEL8.29 billion over the same period. The government contribution to the proposed supplementary pension saving scheme is estimated at GEL313 million ($130.4 million) in the first 3 years of implementation (2017–2019), and GEL631 million ($262.9 million) in the first 5 years of implementation (2017–2021).[4] When forgone revenue from a tax exemption on pension contributions is taken into account, the cost of the reforms are even greater, projected at GEL726.2 ($302.6 million) for the first 5 years of implementation. The pension reforms covering the supplementary pension saving scheme over 5 years alone account for more than the total amount of the ADB program loan.

6. **Estimated reform implementation cost.** The costs of the reform program are associated with policy development, capacity building, administration, and implementation of reforms. Building on the progress made under subprograms 1 and 2, ADB will continue to

[3] Government of Georgia–MOF estimates (assuming pension rate growth indexed to inflation).
[4] The cost of pension reforms for the universal pension and the supplementary pension saving scheme are based on a model developed by MOF, National Bank of Georgia, Ministry of Economy and Sustainable Development (MOESD), and ADB technical assistance. Input parameters factor in retirement age; contribution rates of 2% each from employees, employers, and government; inflation; nominal GDP; and wage growth.

support the government in removing key development constraints—e.g., lack of domestic savings and 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 defined as government staff time and expenses.

7. Direct costs of subprogram 3 requiring government financing include (i) institutional and regulatory structures for development of the supplementary private pension saving scheme; (ii) communication campaigns to raise awareness and elicit feedback on pension reforms and capital market development; (iii) capitalization of the Entrepreneurship Development Agency;[5] (iv) capitalization of the Georgia Innovation and Technology Agency[6]; (v) strengthening of systems and procedures of the Middle Office in the Public Debt and External Financing Department of the Ministry of Finance (MOF) for effective debt management; (vi) staff and budget function costs to manage fiscal risks in MOF; (vii) recruitment of the full complement of in-house tax auditors in the Georgia Revenue Service; and (viii) a state budget increase of GEL40 million for intergovernmental transfers.

8. Table 2 provides a breakdown by subprogram of estimated implementation or adjustment costs under the four policy output areas. The implementation costs factor in staff time spent on various reform actions, administering and financing budgets of reformed functions and entities, system integration, gender targeting, drafting of legislation, and communication campaigns. The government contribution to the supplementary pension savings scheme, projected to be GEL631 million in the first 5 years (para. 5), is not included in this estimate. The total cost to the government in 2016 from implementation of the reforms under subprogram 3 is estimated at GEL303.1 million ($126.3 million) (Table 2).

9. MOF and the Ministry of Economy and Sustainable Development (MOESD) are responsible for implementing and monitoring program reforms.[7] The budget allocation for MOF is GEL496.6 million for 2014–2018, with GEL91.0 million funded in 2015 and GEL90.0 million budgeted for 2016. The estimated allocation for MOESD is GEL617.6 million for 2014–2018, with GEL85.4 million funded in 2015 and GEL95.1 million budgeted for 2016. Under the program reforms, the Georgia Revenue Service has written off GEL1.102 billion ($459 million) in tax arrears classified as uncollectible. While this represents forgone government revenue, it is expected to improve the accuracy of collectible tax and the efficiency of collecting tax arrears. A waiver of the administration fee on financial securities issues until 2021 will reduce the cost to bond issuers and support capital market development, but will also result in forgone revenue to the government.

10. **Economic and financial benefits in the short and medium term**. Georgia and the European Union started executing the Deep and Comprehensive Free Trade Area agreement in September 2014, moving Georgia closer toward European integration. This requires continued reforms as initiated under the ADB program cluster, especially in deepening domestic financial markets for both capital market reforms and private pension development. In parallel to

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[5] GEL110 million for 2014–2018, with a budget of GEL25 million allocated for 2016 and GEL5.8 million for the Produce in Georgia program launched in 2015. The Produce in Georgia program aims to promote innovative business initiatives for small and micro businesses. The program supports online registration of business ideas, training in business plan preparation, advisory services, and funding. In 2015, the program financed 1,500 entrepreneurs and trained 3,118 beneficiaries.

[6] GEL20 million for 2014–2018, with a budget of GEL8.5 million allocated for 2016 and GEL1.1 million for the 2015 Geolab program.

[7] MOESD is responsible for pension reform, capital market reforms, and development and finance for small business.

increased European integration, the government sees the value of the program reforms in realizing its Socio-Economic Development Strategy, Georgia 2020, by establishing the conditions for free private activity with an efficient and transparent government.[8]

11. The program reforms are expected to yield immediate positive economic and financial benefits. In 2015, GEL80 million was 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, intergovernmental transfers will increase by up to GEL40 million—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 more effective management of macroeconomic risks. The reform program will result in cost savings and additional gains realized thanks to (i) declining costs of funding pensions and less strain on public finances after introducing a supplementary private pension saving scheme; (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 stronger mobilization of private capital for investment.

13. The introduction of the new pensions system will entail significant budgetary costs in the short term (as outlined in section B), but substantial benefits will accrue from savings of about 2.5% of GDP in the long term. Pension costs increased in nominal terms in 2015, totaling GEL1.39 billion or 4.3% of GDP. Further growth of costs to GEL1.57 billion is projected in 2016. Once the supplementary pension saving scheme begins to mature and provides reasonable levels of income replacement, the pressure on government to increase the universal pension will decline, and it could be either scaled down or converted to a targeted (means-tested) system, further reducing costs to the budget.

14. The program will catalyze more savings. The supplementary private pension saving scheme will encourage a culture of deferring part of current consumption to accumulate long-term assets to meet income needs in old age. This should result in greater confidence in formal saving systems and also improve non-pension savings. Mature pension funds provide substantial pools of money with 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 the supplementary pension saving scheme (matching contributions from the government) could encourage some of the enterprises in the informal economy to formalize so that they can participate and take advantage of these incentives. This would result in better tax collection and could help offset the transitional costs of the pension reform. Supporting innovation and investment in SMEs will contribute to growth and diversification, with more resilience and greater tax inflows.

16. Building on Subprograms 1 and 2, the Medium-Term Debt Strategy 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. Servicing external public debt will cost GEL628.7 million in 2016, of which GEL360 million will be channeled for covering the principal amount of the debt, and GEL268.7 million will be used for interest payments. The reforms will

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

result in additional benefits and savings associated with fiscal discipline. Building the risk management capacity of MOF should lower core budgetary and fiscal risk.

17. Developing capital markets to mobilize long-term finance will contribute to growth and boost efficiency thanks to greater access to finance for SMEs, and better gender targeting. Mobilizing private resources for investment is important given the low gross domestic savings rate of 12.3% of GDP in 2015. Low savings compound the twin deficit of fiscal and external imbalances, undermining the already narrow internal financing base. The local currency bond issues late in 2016 by the European Bank for Reconstruction and Development ($49 million), the Black Sea Trade and Development Bank ($20 million) and ADB ($30 million) are expected to further support capital market development and enable local banks to increase their lending portfolios. The bond issues will benefit SMEs by increasing access to finance in local currency, and reducing their exposure to foreign exchange risk.

Table 2: Program Reform Costs
(GEL million)

Policy Action	2014 SP1	2015 SP2	2016 SP3	Amount
A. Debt, Cash, and Fiscal Risk Management	**8.5**	**8.5**	**10.5**	**27.5**
1. Debt and cash management	3.2	3.2	10.2	11.6
Staff time to (i) prepare and approve debt strategy (ii) strengthen the Middle Office, (iii) report on guarantees, and (iv) forecast cash flows and integrate debt with budget and treasury systems				
2. Fiscal risk management	5.3	5.3	5.3	15.9
Staff time to (i) manage SOE risks, (ii) assess risks, and (iii) manage contingent liabilities				
B. Revenue and Public Expenditure Management	**65.8**	**74.2**	**57.4**	**197.4**
1. Improved revenue collection	17.8	14.2	14.4	46.4
Additional staff for tax collection				
Staff time of 275 in-house tax auditors				
2. Improved public expenditure management	8.0	30.0	3.0	41.0
Staff time to manage LSG and LEPL finances				
Systems integration of LSGs and LEPLs				
3. Strengthened local government finances	40.0	30.0	40.0	110.0
Increased intergovernmental transfers				
C. Generation of Domestic Savings	**7.2**	**42.1**	**188.2**	**237.5**
1. Universal pension system		33.9	180.0	213.9
Staff time to (i) forecast present and future cost, and (ii) prepare and approve pension system revisions				
2. Setting supplementary private pension system[a]	7.2	8.2	8.2	23.6
Staff time to (i) analyze and implement new pension (ii) prepare legislation				
Financing of public awareness campaign				
D. Mobilization of Private Resources for Investment	**33.2**	**55.3**	**47.0**	**135.5**
1. Capital market development	7.2	8.2	8.2	23.6
Staff time (i) to conceptualize capital market reforms, and (ii) implement capital market reform action plan.				
Financing of public awareness campaign				
2. SME access to finance and gender targeting	26.0	47.1	38.8	111.9
Budget for EDA			25.0	25.0
Budget for GITA			8.0	8.0
Produce in Georgia program			5.8	5.8
Subprogram totals	**114.7**	**180.1**	**303.1**	**597.9**

EDA = Entrepreneurship Development Agency, GITA = Georgia Innovation and Technology Agency, LEPL = legal entity of public law, LSG = local self-government, SMEs = small and medium-sized enterprises, SOE = state-owned enterprise, SP = subprogram.

Corresponding US dollar amounts for the totals are $49.9 million (SP1), $78.3 million (SP2), $126.3 million (SP3) and $254.5 million.

[a] Implementation costs to the government for the private pension system are estimated at GEL726.2 ($302.6 million) for the first 5 years of implementation (2017–2021), including forgone tax revenue from pension contributions and withdrawals.

Sources: Government of Georgia and Asian Development Bank estimates.