

INTERNATIONAL MONETARY FUND AND
INTERNATIONAL DEVELOPMENT ASSOCIATION

GEORGIA

Joint Staff Assessment of the Poverty Reduction Strategy Paper

Prepared by the Staffs of the International Development Association
and the International Monetary Fund

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I. OVERVIEW

1. **The Economic Development and Poverty Reduction Program of Georgia (EDPRP) is the first full Poverty Reduction Strategy Paper prepared by the government.** It builds on the strategy laid out in the interim Poverty Reduction Strategy Paper presented to the Boards of the International Development Agency and the International Monetary Fund in December 2000. The document is the result of broad-based consultations with civil society. The EDPRP describes these consultations, provides a diagnosis of poverty in Georgia, and presents the government's objectives and program of measures for reducing poverty.
2. **The staffs believe that the EDPRP contains a credible poverty reduction program.** The main strengths of the program are: (i) its comprehensive analysis of Georgia's development challenges; (ii) its stress on the need to improve governance and reduce corruption; and (iii) the involvement of civil society in the development and future refinement of the EDPRP.
3. **During the implementation of the EDPRP the authorities will need to:** (i) improve the consistency of the budget process with the program; (ii) ensure that the Ministry of Finance and other key ministries are centrally involved in implementing and further developing the program; (iii) develop a prioritization of the EDPRP's spending recommendations; (iv) implement measures to improve governance and reduce corruption; and (v) develop more specific, quantified, outcome measures.

II. PARTICIPATORY PROCESS

4. **In developing the EDPRP the government undertook a broad-based participatory process at the national and regional levels, and this has been one of the main achievements of the EDPRP to date.** The participatory process—and the preparation of the program as a whole—was led by a government commission that reported to the president and oversaw the work of five sub-commissions. Each sub-commission included members of civil society and of parliament. The discussion of the full EDPRP began with a series of intensive discussions of the Interim EDPRP both in Tbilisi and in the regions. In October 2001 the government commission published a set of EDPRP discussion materials, both in printed form and on a website, as a way of seeking the broadest possible inputs. Both the printed materials and the website included a form for submitting comments and suggestions.
5. **The key sectoral ministries, however, played a fairly limited role in the development of the EDPRP.** The Ministry of Finance in particular only became actively engaged relatively late in the process. This dissociation, and the weakness of the national budget planning, resulted in the EDPRP not being well articulated with the expenditure planning process. During the implementation of the EDPRP a medium-term expenditure planning framework will, as mentioned below, need to be developed and used to link planned expenditures with EDPRP objectives. This will be facilitated by implementation of the

recently approved budget systems law and progress in ongoing treasury reforms. More broadly, the staffs believe that it will be crucial to ensure greater ownership of the EDPRP within government, so that it can provide a single, overarching, framework for decision-making within the development ministries.

6. **The donor community, including the staffs of the Fund and the Bank, assisted the government by commenting on drafts of the EDPRP and participating in a number of working sessions.** The contributions of the donor community were enhanced by the formation of a UNDP-led Framework Group, which coordinated both donor inputs to the EDPRP and government requests for technical assistance.

7. **The government used varied media to obtain input from civil society.** In addition to the printed and electronic materials mentioned above, the government organized workshops, conferences and public forums. In the process, a database of 750 NGOs was created, which, along with the EDPRP website, allowed a continuous process of consultation with civil society as the program evolved. In addition the ongoing USAID-supported Community Mobilization Project facilitated consultation with almost 400 community organizations. Two coalitions of NGOs organized more than 30 debates and workshops to discuss amongst themselves, and with the sub-commissions, both procedural and substantive issues relating to the development of the EDPRP. Finalization of the program was led by a joint editorial board composed of representatives from the sub-commissions and from civil society. The board held a series of technical workshops with key ministers, members of parliament and NGO experts. To enhance strategic integration all the sub-commissions participated in each workshop.

8. **Major issues raised during the participatory process included (a) the need for government policies designed to address poverty through the maintenance and development of human capital; and (b) the mitigation of social and economic risks, through an improved social safety net and better investment climate.** Civil society organizations successfully advocated during the technical workshops and policy debates for the importance of human capital development and social and economic risk management. These priorities are reflected in Chapter 3 of the EDPRP and constitute major components of the overall poverty reduction strategy for Georgia (Section IV below). The participatory process also provided an opportunity for civil society to argue for, and secure, continued close cooperation and dialogue between the government and society at large during the implementation phase of the EDPRP, as discussed below and reflected in Chapter 5 of the EDPRP.

9. **Implementation and refinement of the EDPRP will use consultative mechanisms similar to those used during the preparation phase, but will also focus on institutionalizing the participation process.** The EDPRP includes specific proposals for monitoring and revision of the strategy. As a first step the government will focus on disseminating the EDPRP, with a simplified summary being prepared for mass distribution, along with key elements of the previous discussion materials. Consultations with the full

range of civil society, including business associations and trade unions, will then be undertaken on a regular basis.

10. **The government proposes an Annual *Economic Development and Poverty Reduction National Conference*.** The conference will include all stakeholders. It will review the successes and failures of program implementation and make recommendations for improvements, as well as for any necessary revision or updating of the targets and outcome indicators. Regional meetings will be organized in advance of, and as an input to, the national conference. Quarterly meetings will be held with key ministries and civil society to assess short-term progress. Each year, after the national conference, a revised program will be submitted to government for approval.

III. POVERTY DIAGNOSIS

11. **The EDPRP provides a sound analysis of poverty in Georgia, based in part on the Household/Labor Survey, which is considered one of the best in the former Soviet Union.** The EDPRP notes that the 1998 Russia Crisis and the 1998 and 2000 droughts increased vulnerability to poverty among the majority of the population. While some 14 percent of Georgians currently may be extremely poor, many more are vulnerable to poverty: the EDPRP estimates the overall poverty incidence in 2001 was 52 percent. The EDPRP provides a good analysis of the particular vulnerability of children, the single elderly, the unemployed, and internally displaced persons. It also analyses well the spatial dimension of poverty: urban poverty is consistently higher than rural, but vulnerability to poverty is higher among those in rural areas.

12. **Future development of the EDPRP should include a greater focus on the links between poverty and economic policy.** The program provides an appropriate analysis of the immediate causes of divergent poverty rates. However, more focus is needed on the links between economic policy choices proposed in the Program—especially in public expenditure allocation—and the structure and magnitude of poverty.

13. **It will be important to insure adequate funding for the continuation of the Household Survey.** Much of the initial finance is being provided by donors (including IDA), on the understanding that the government would gradually assume responsibility. This is not yet occurring at the pace necessary, and the staffs urge the government to increase funding in the 2004 budget to ensure that it maintains a vital analytical and monitoring tool for assessment and revision of the EDPRP. Adequate financial resources will also be needed to improve the quality and the timely dissemination of the macro-economic and socio-demographic data provided by the State Department for Statistics and the Ministry of Finance.

IV. THE POVERTY REDUCTION STRATEGY

14. **The EDPRP's strategic framework rests on two main pillars.** These are: (i) rapid and sustainable economic development, with a target of real GDP growth of 5-8 percent a year; (ii) a reduction in extreme poverty, with a target of a decline from 14 percent now to

4-5 percent by 2015, and a reduction in overall poverty, from 52 percent now to 20-25 percent by 2015. To meet these two objectives the EDPRP focuses on progress in: (a) governance; (b) macroeconomic policies, particularly in the fiscal area; (c) the business environment; (d) human capital; (e) reducing the vulnerability of the poor; (f) development of priority sectors of the economy—energy, transport and communications, tourism and agriculture; and (g) the natural environment. The EDPRP also stresses the importance of addressing the needs of post-conflict zones and of science and information technology.

A. Governance

15. **The EDPRP has a welcome emphasis on the links between improved governance and poverty reduction.** The document also includes a frank acknowledgement that the Anti-Corruption Program has yet to achieve intended results to date. Given this state of affairs, the staffs would expect to see significant focus during the implementation phase of the EDPRP on specific measures to reduce corruption. Private sector development has been severely hampered by the pervasive climate of corruption, crime and weak governance. Likewise, weak governance affects the poorest segments of the population disproportionately. Arrears have accumulated in pensions and social transfers. Almost 40 percent of rural households report paying bribes, while less than 20 percent of urban households report paying bribes.¹ Traffic police extract payments when farmers travel to markets to sell their produce. Similarly, small enterprises have a much higher incidence of paying bribes than large, again affecting the poor disproportionately.

16. **The government needs to put its full authority behind the anti-corruption program.** While the anti-corruption program clearly identifies the problems and needed reforms, the implementation mechanisms still need to be specified. More importantly, successful implementation of the program requires explicit and public endorsement—and leading by example—of officials across the full spectrum of government. Without this the credibility and effectiveness of the program will be undermined.

17. **Civil service reform needs to be accelerated.** A draft strategy has been prepared (and is summarized in paragraphs 312 and 313), but implementation of a comprehensive reform has yet to begin. Lack of progress in this area has caused significant problems: politicization of the civil service, abuse of the meritocracy principle in selections and promotions, lack of delegation, weak professional capacity, poor training and development, lack of accountability, and inadequate pay. A consistent reform strategy and effective implementation, championed by political leaders, is needed to improve civil service morale and the credibility of public administration reform.

¹ World Bank (2000a) “Corruption in Georgia: Survey Evidence,” Report 19276, Washington, DC.

B. Macroeconomic Policies

18. **The PRSP presents two macroeconomic scenarios, a “realistic” one and an “optimistic” one.** The “realistic” scenario is fully in line with the medium-term assumptions and projections incorporated into Georgia’s current PRGF-supported arrangement. The “optimistic” scenario projects a sustained real GDP growth rate of 8 percent over a twelve-year period, which will be very difficult to achieve given the radical transformation in governance and the business environment that would be required to achieve this.

19. **The projects envisaged for 2003 and listed in Table 2 are consistent with the 2003 budget regarding their costing and financing.** The staffs consider the assumptions made about privatization proceeds and external grants in the 2003 budget to be overly optimistic. Consequently, implementation of the economic development and poverty reduction programs planned for 2003 could be constrained by the available resources.

20. **Georgia’s monetary and exchange rate policies have been sound in recent years, and the EDPRP continues the government’s commitment to those policies.** The National Bank of Georgia (NBG) will continue to conduct monetary policy so as to maintain price stability while allowing for the continued remonetization of the economy. The EDPRP targets a rate of inflation of 5-6 percent over the next 5-7 years, which does not appear to be sufficiently ambitious given the progress already made in lowering inflation to the 4-5 percent range. The current floating exchange rate policy will remain in effect, along with the goal of continued accumulation of international reserves under favorable conditions in the foreign exchange market. It should be noted, however, that the stated goal of raising the level of international reserves to 2.5 months of non-pipeline imports by 2004-05 is desirable but not likely to be achieved in the specified time frame.

21. **The presentation of fiscal policy objectives in the EDPRP suffers from lack of specificity on the main components of future tax reform.** While the strategy describes a single, consistent approach to tax reform that recognizes the need to simplify taxes for small business and to strengthen tax administration, it does not identify the main components of future tax reform as embodied in the new tax package recently presented by the Ministry of Finance to parliament. Passage of this package, which includes measures to strengthen VAT administration (including raising the VAT threshold), the introduction of a simplified small business tax, and the elimination of several “nuisance” taxes, should be secured shortly. It would also have been desirable to see specific measures aimed at increasing the tax to GDP ratio by at least 0.5 percentage point of GDP per year and explicit references to specific targets to raise collections of taxes on key excisable products, such as petroleum products and cigarettes. Improvements in tax policy and administration are particularly important to demonstrate government’s commitment to improve the tax environment for the private sector, and to fight corruption. Strengthening the VAT as indicated above and implementing the recently issued VAT refund regulations will be essential to ensure smooth operation of the VAT refunding system.

22. **The link between the budget and the EDPRP is weak.** This partly reflects the lack of a strategic phase in the preparation of the budget itself, and the fact that the budget covers only a one year cycle. As a result, overall resource allocation is only loosely linked to sector objectives, programs or policies. Indeed the three major planning tools—the PRSP, the medium-term Indicative Plan, and the annual budget—are in practice developed in parallel rather than through an integrated cycle of policy formulation, budget preparation and decision-making. The costing of the EDPRP was mostly carried out by consultants under the direction of the EDPRP secretariat, rather than as an exercise directly integrated in the budget process, under the direction of sector agencies. As the EDPRP is implemented, the government will need to establish a medium-term expenditure planning framework which allows planned expenditures to be linked much more closely to program objectives in budget preparation. In keeping with the new budget systems law, there will need to be far-reaching, concrete changes in budgetary formulation and execution. These include extending the horizon of the budget framework to three years, increasing the depth of sectoral analysis and engagement of sectoral ministries in the formulation process, and making explicit the links between the budget and the EDPRP.

23. **The staffs have advised strongly against the EDPRP proposal to set up a special Poverty Alleviation Fund within the regular state budget.** By making poverty-related expenditures subject to more strict control and monitoring than other expenditures, this proposal appears to revive the practice of including “protected items” in the budget, thereby contradicting the principles of the new budget systems law. It is important to properly monitor and control all expenditures, not just those targeted to poverty alleviation. In addition, the proposal to finance this poverty fund “on the basis of the replenishment principle” appears to earmark certain revenues for poverty-related expenditures, again contradicting the principles of the new budget systems law. Earmarking of revenues reduces budget flexibility in the short term and the strategic reallocation of resources towards newly identified priorities in the medium term.

24. **The EDPRP indicates that treasury bills will become the main domestic source of finance for the budget deficit,** but commits the government to minimize crowding out of credit to the private sector. The Government will need to bear in mind that the cost of finance will be an important consideration in determining the pace and scope of treasury bill financing. Because of Georgia’s heavy external debt burden, greater reliance on treasury bill financing of the budget can only be justified if it is fiscally sustainable. At current domestic rates, this type of borrowing is very expensive at a time when public resources are highly constrained. In addition, the government will need to redouble its efforts to obtain grants and concessional finance, including by implementing a credible macroeconomic adjustment program.

C. The Business Environment

25. **Given the constrained resource envelope in which the authorities must operate, the EDPRP should focus on creating more opportunities for private sector activity of all kinds by addressing critical problems in the business climate such as corruption,**

inefficient financial intermediation, lack of security, inadequate infrastructure, and shortcomings in the legal, regulatory, and fiscal regimes. As the EDPRP acknowledges, faster private sector growth would depend in large measure on success in reducing pervasive climate of corruption. As noted above, the government will need to be more decisive in its efforts to reduce corruption, and will also need to reduce administrative barriers to efficient business operation. This will entail improving the effectiveness of the interaction of the public and private sectors—including streamlining registration, licensing, controlling bodies, and certification—and reducing opportunities for rent-seeking and corruption. The EDPRP also proposes other measures to improve the business environment. However, the strategy presented for promoting development in some sectors is unduly interventionist. Proposals for export promotion programs, direct government support of the tea industry and subsidized credit for small and medium-sized enterprises and for the housing sector are all expensive endeavors providing uncertain benefits and creating scope for rent-seeking if they are not tightly controlled.

26. **Inefficient financial intermediation and low public confidence in the Georgian banking system has constrained business investment.** Recent efforts by the National Bank of Georgia to strengthen the legal and regulatory basis for banking supervision and to encourage sectoral consolidation have helped to improve the situation. While this has resulted in some reduction in spreads between deposit and lending rates, uncertainty regarding future macroeconomic developments and limited public confidence in the government's economic policies have kept lending rates relatively high. Legal and judicial reform (including strengthened bankruptcy and loan recovery procedures) and appropriate accounting and auditing practices are needed to improve the environment for financial intermediation. In addition, the number of banks in Georgia remains too large relative to the size of the economy, and continued inefficiencies in the management and branch structure of some banks also hinder further decreases in lending rates. More efforts will be needed to address these problems, including through encouraging additional consolidation of the banking sector by increasing the minimum capital requirement. While the EDPRP indicates that minimum capital requirement will rise to €5 million by 2015, the National Bank of Georgia has already initiated this process and plans to reach that target over the next 2-3 years, in line with reforms in comparable countries of the former Soviet Union. The recently adopted Anti Money Laundering law represents an important step in the right direction, but it will need to be amended further to fully meet international standards, especially on property confiscation for violators.

D. Human Capital

27. **The EDPRP rightly identifies human capital development as key to achieving sustained poverty reduction.** Accordingly, it envisages a wide range of measures to improve the efficiency and effectiveness of education, health and social protection programs. It also focuses on measures to improve access to health and education. However, given the broad scope of the planned measures, and their complexity, the government will need to prioritize and sequence them in more detail, and to budget fully the required resources. If insufficient resources are allocated to public health, education, and social protection,

achievement of the EDPRP's goals will be compromised. Furthermore, the government should be more clear in specifying the measures aimed at improving access to health and education for the poorest of the poor. Those should include measures to ensure that (i) children from poor families are immunized; (ii) the percentage of children not attending classes due to absence of the teachers or due to poverty is reduced substantially; (iii) children do not drop out of school because of poverty; and (iv) poor mothers have better access to prenatal care.

28. **The EDPRP envisages a three-pronged approach to reducing the vulnerability of the poor:** (i) better access to employment through private sector job creation; (ii) improved human capital development, and (iii) better targeted social transfers. As the EDPRP is implemented, it will need to specify in more detail how the proposed improvements in human capital will be achieved. The EDPRP's approach to social transfers rightly targets clearing pension arrears, increasing the level of pensions, and better targeting social assistance. The government is now drafting legislation to securitize pension and wage arrears. In order to avoid accumulation of additional pension arrears, clear the existing stock as called for by the terms of the planned securitization, and raise the level of pensions, it will be critically important for the government to improve tax collection. More generally, efforts to better target social spending will have to be accompanied by increased resource mobilization, creating scope for greater cash allocations directed toward assisting the poor.

E. Physical Capital

29. **The EDPRP proposes a focus on energy, transport and communications, tourism, and agriculture.** In the *energy* sector the program's proposals are generally sound, although some elements may be too optimistic. Specifically, the EDPRP details a transfer from the current structure of a single buyer wholesale market to a system of direct contracts. In the view of both staffs, these changes should only be implemented after improving corporate governance of generation companies, solving the problem of accumulated debts, and improving the transmission and dispatch system. Cash collections will also have to show continued improvement. In *transport and communications* the EDPRP rightly recognizes the constraint to development imposed by the very poorly maintained road system. Significant improvement may, however, need to wait for a more robust budget which includes regular and substantial allocations for road maintenance. In *telecommunications*, the program stresses privatization, but it may be wise to put an equal emphasis on new market entry, which has proved highly successful to date in the Georgia telecommunications market (four private mobile operators and numerous long distance carriers, with tariffs among the lowest in the world). In the staffs' view, the proposal to create a nationwide digital network is not a priority at this point. The EDPRP rightly sees *tourism* as having significant potential, but the proposals would need to be more tightly focused on the obstacles posed by factors such as the high crime rate and poor infrastructure. In *agriculture* the EDPRP recommends that one of the Ministry of Agriculture's top priorities should be sector services, including business facilitation, scientific development and staff training. This is a welcome recommendation, but the staffs believe that the Ministry of Agriculture needs to involve a broad range of

stakeholders, including the Academy of Agrarian Services, the Agrarian University, NGOs, the private sector and farmers' associations in the provision of such services.

F. The Natural Environment

30. **The EDPRP provides a good overview of the natural environment, but it could bring out more clearly the linkages between the environment and poverty.** While the document rightly emphasizes monitoring and control of natural resource use, it would have been useful to include a discussion of ways to ensure regulated access to resources by the poor, and to detail policies for reducing the unsustainable exploitation of resources by those who make their livelihoods from their extraction. As the EDPRP is implemented, the staffs would welcome support for sustainable livelihoods for residents who are in or close to protected areas, and for sustainable development in mountainous areas.

31. **The EDPRP proposes mitigation of the effects of natural risks by creating reserve stocks of food, petroleum and gas.** In assessing the priority of this proposal, it should be noted that to date shortages have been caused by the inability to pay for fuel, rather than the unavailability of fuel. Likewise, food products, especially grain and flour are readily available in Georgia. The staffs therefore believe that maintaining strategic reserves should not be treated as a priority.

V. TARGETS, INDICATORS, AND MONITORING

32. **The EDPRP provides a very comprehensive set of proposed actions, with target dates, and outcome indicators of progress in implementing the program.** Explicit links are made with the Millennium Development Goals. The staffs welcome the emphasis on monitorable goals and indicators. The proposed actions, however, are very extensive, especially relative to Georgia's implementation capacity and revenue position. The present deficiencies in budget management complicate any systematic prioritization, but it is hoped that, as the program moves forward, budget outlays can be more closely linked to EDPRP objectives. Toward this end, the government would benefit from additional technical assistance aimed at improving budget design and management. Similarly, the outcome indicators need to be complemented by specific measurable interim targets. As the EDPRP develops further, a set of such measurable targets will be important to guide policy makers and society as a whole in understanding which areas of the program are proceeding well and which need to be adjusted.

33. **The participation and communication program is thorough and detailed.** As the EDPRP is implemented, the government will need to ensure that all key ministries and agencies are involved in the communication program. This will help enhance ownership within government, and will facilitate a genuine two-way dialogue, with an effective feedback mechanism.

VI. RISKS

34. **Implementation of the EDPRP faces a number of risks, of which poor governance is the greatest.** If the governance climate does not improve, it will be very difficult to undertake many of the reforms proposed in the EDPRP. It is therefore critical that the government focus on combating corruption, reducing harassment of the private sector, building the population's confidence in the state, and strengthening the capacity and accountability of public institutions.

35. **Given Georgia's shallow financial markets and limited availability of external resources, improved revenue collection will be critical, both to avoid inflationary financing of the fiscal deficit and to generate resources for priority programs.** Bolstering tax collections, in turn, will require renewed efforts to strengthen tax and customs administration. In view of Georgia's high level of external debt and limited access to financial markets, public debt dynamics remain subject to significant risks.

36. **Georgia remains vulnerable to both internal and external conflicts.** Any renewal of domestic conflict would seriously limit the government's ability to undertake meaningful reforms. Lingering regional tensions will also negatively affect program implementation if they are left unresolved. These include the problem of revenue sharing between the central government and the Adjara region, as well as the question of payments for energy consumed, but not paid for by Abkhazia, where a viable formula for resolving the latter issue needs to be developed. Similarly, enhanced regional cooperation will be an important factor if Georgia is to maximize its potential as a transit economy, and to strengthen foreign investment, tourism and trade.

VII. CONCLUSION

37. **The EDPRP is a significant achievement, both in its content and in the broad participation in its development.** During its implementation the government will need to: (i) focus on developing an expenditure planning framework that links planned expenditures more closely to EDPRP objectives, with active participation of the Ministry of Finance; (ii) show real leadership in improving governance, reforming the civil service, and reducing corruption; and (iii) further refine the specific and measurable outcome targets by which to assess intended outcomes.

38. The staffs of the IMF and the World Bank consider this EDPRP a credible poverty reduction strategy which provides a sound basis for access to Fund and IDA concessional financial assistance. The staffs recommend that the respective Executive Directors of the IMF and the World Bank reach the same conclusion.