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**GEORGIA**

**JOINT IDA-IMF STAFF ADVISORY NOTE**

**ON THE**

**ECONOMIC DEVELOPMENT AND POVERTY REDUCTION PROGRAM**

**ANNUAL PROGRESS REPORT**

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**South Caucasus Country Unit  
Europe and Central Asia Region**

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INTERNATIONAL DEVELOPMENT ASSOCIATION  
AND

INTERNATIONAL MONETARY FUND

GEORGIA

**Joint Staff Advisory Note  
on the Poverty Reduction Strategy Paper Progress Report**

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and the International Monetary Fund (IMF)

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**I. Overview**

1. The Georgian poverty reduction strategy embodied in the Economic Development and Poverty Reduction Program (EDPRP), which was presented to the Executive Boards of IDA and the IMF in September 2003, focused on Georgia's commitment to rapid and sustainable growth and poverty reduction. The Boards and the staffs of IDA and the IMF considered the EDPRP to be a significant achievement, both in its content and in the broad participation in its development. The new government that took office after the November 2003 "Rose Revolution" has been determined to fight corruption and improve governance. Macroeconomic performance has strengthened, timely payment of social transfers and public sector wages was reestablished, and wage and pension arrears cleared to a significant degree.
2. The Annual Progress Report (APR) of January 2005 confirms the commitment of the new government to the EDPRP objectives, provides results of the implementation during its first year, and highlights new elements in the strategy. This Joint Staff Advisory Note (JSAN) discusses the strategy's implementation to date, reports on progress in addressing issues raised in the previous Joint Staff Assessment (JSA), and provides the staffs' advice on key priorities for strengthening the EDPRP further.
3. Overall, the APR provides evidence of strong economic performance. In its first year in office, the new government has taken decisive steps to improve the economic fundamentals and launch important reforms, thereby preparing a solid basis for steady poverty reduction. The government views rapid, sustained, and equitable economic growth in an environment of low inflation as key to reduce poverty. Macroeconomic performance in 2004 and early 2005 has been generally strong, with robust real GDP growth and a significant improvement in the fiscal position, although 12-month inflation has risen over the past several months, to 10.4 percent in April 2005. Moreover, gains in tax collection have provided the government with much-needed additional resources to address pressing social and infrastructure needs. The

poverty reduction strategy has been supported by IDA through a Reform Support Credit (RSC) and by the IMF through an arrangement under the Poverty Reduction and Growth Facility (PRGF).

## II. Poverty Diagnosis

4. **According to the APR, poverty increased during 2001–03, primarily due to non-payment of social transfers and public sector wages, particularly in rural areas.** The nine-month estimate for 2004 in the APR showed that the poverty headcount index fell from 54.5 percent in 2003 to 52.3 percent in 2004. Rural poverty decreased from 56.2 percent to 53.4 percent. The overall decline in the poverty rate is attributed to strengthened macroeconomic performance, timely payment of social transfers and public sector wages, and significant clearance of arrears.

5. **However, poverty developments and characteristics discussed in the APR should be taken as tentative, as they do not reflect adjustments to the poverty measurement methodology currently underway.** These adjustments are made within the scope of the Programmatic Poverty Assessment (PPA) for Georgia, a three-year IDA program conducted jointly with Georgian counterparts. The Georgia PPA joint team should continue to work on the poverty measurement methodology and analyze poverty developments in Georgia as data become available.

6. **In order to move towards an effective poverty monitoring system, the staffs recommend that:**

(i) the comparability of the Household Budget Survey over time needs to be established, given that the survey has been modified over the years; (ii) the equivalence scale coefficient needs to be revised upwards in line with international comparators; and (iii) an appropriate poverty line that better reflects current realities needs to be adopted. The official poverty line (defined in early 1990 as a normative minimum living standard benchmark), as well as the revised official line, are at best outdated and too high. The alternative poverty line also used by SDS needs methodological clarification and possible adjustments in line with the internationally recommended methodology for poverty line estimates (the basic needs approach), including use of seasonal and regional differences in prices. Poverty comparisons over time would be aided by the development of comparable consumption aggregates.

## III. Macroeconomic Policies and Framework

7. **The staffs of IDA and the IMF support the thrust of the macroeconomic policies proposed in the APR.** In 2004, the turnaround in fiscal performance was especially impressive. For the first time since Georgia's independence, the government was able to spend more than envisaged in the original budget, rather than sequester expenditures during the year. As mentioned, the drive to strengthen tax enforcement allowed the authorities to clear the bulk of the arrears on wages and pensions accumulated under the previous administration, thereby making an important contribution to poverty reduction. While noting that defense spending in Georgia is relatively low by international standards, the staffs note that 2004 government spending in some key sectors, including education, was lower than

targeted in the EDPRP because funds were redirected to defense spending. This highlights the need to strengthen the links between the poverty reduction strategy and actual government spending.

8. **The tax reform introduced in January 2005 should support the fight against evasion.** Important poverty reducing measures on the expenditure side of the budget include the increase in minimum pensions effective January 1, 2005 and the proposed introduction of a targeted poverty benefit in the second half of the year. The authorities may also wish to consider higher spending on health and education, provided that adequate budget resources are mobilized.

9. **Monetary policy will need to be tightened in the period ahead to meet the APR's inflation target of 5–6 percent.** Fiscal restraint will also be necessary to bring inflation down. The increase in consumer price inflation to 10.4 percent in the 12 months to April 2005 is a concern, and it places a particular burden on households living on fixed incomes, as especially food prices have increased significantly. To enhance monetary control, exchange rate flexibility could be further enhanced, and the menu of monetary policy instruments strengthened.

10. **The macroeconomic framework presented in the APR is generally in line with staff projections, but could benefit from further elaboration.** The selected economic and financial indicators table attached to the APR offers a glimpse of the government's intentions over the medium term, but it can only be evaluated in greater depth if a more detailed description of the underlying policies is provided. In any event, it is encouraging to note that medium-term indicators of foreign indebtedness have much improved since the new government took office, thereby reducing a major risk to the implementation of the poverty reduction strategy.

11. **The APR would have benefited from a discussion of trade policy options.** Under the terms of the WTO accession, the number of import tariff bands was reduced from 21 in 2004 to 16 as of January 2005. A further reduction in the number of tariff bands and in the maximum tariff rate could be an important element of the government's drive to improve resource efficiency and governance.

#### **IV. Public Expenditure Management**

12. **The staffs support the government's intention to take further steps to improve public expenditure management.** A recent mission by the IMF's Fiscal Affairs Department found that vast improvements have been made in this area. The new Budget Systems Law that became effective January 1, 2004 abolished the system of protected items, thereby facilitating the reorientation of spending to newly identified priorities. The new law stipulates that annual budget laws be considered in the context of a Medium-Term Expenditure Framework (MTEF), which is now under preparation. The staffs recommend that a government strategy for building line ministry capacity for program budgeting, multi-year planning, and identification of performance indicators be completed in 2005, and that health, education, and agriculture be pilot ministries for this strategy. The introduction of a treasury single revenue

account in April 2004 was another important milestone in improving public expenditure management. In 2005, the authorities aim to complete the transition to a treasury single account for all central government revenues and expenditures. The staffs also encourage the authorities to expand the treasury's coverage to local governments during the next few years.

## V. Sectoral Policies

13. **As documented in the APR, significant advances have been made towards a modern education system.** These include passage of two laws on general and higher education, which significantly changed the way that education services will be delivered, placing more responsibility on schools and institutions for accountability and quality improvements. The APR also notes anticipated changes to the financing of higher education, as well as programs addressing teacher training, curriculum development and a significant program of changes to methods of assessment and examination. The staffs note that progress on improvements in efficiency has not been as great as anticipated, and that further consideration should be given both to the rationalization of personnel and facilities and to resources necessary to implement the proposed changes. The statement of sectoral strategy and the expenditure breakdowns required for the MTEF will be an essential and timely tool to assist in operationalizing the education program over the coming years.

14. **In the health sector, the APR indicates the importance placed by the government on revision of the basic benefit package, while simultaneously addressing issues of primary health care needs and resource availability.** The APR notes that a revision of estimated cost of treatment and reimbursement rates of health care services is currently under way, as well as a revision of medical standards in public facilities. The APR also refers to the adoption of measures during 2005 that address maternal and child health care issues. The APR recognizes that health outcomes (e.g., maternal and early childhood mortality, prevalence of vaccine preventable diseases, and tuberculosis cases) have deteriorated alarmingly in the past years and the proposed actions aim at a rapid improvement. The staffs urge the government to continue the revision of the basic benefit package, increase public spending for health under the medium-term expenditure framework, and proceed with the implementation of the hospital optimization program. The staffs welcome the payment of arrears in the health sector and encourage the government to clear all remaining arrears in 2005. Moreover, the APR could have included more information on changes in health care financing already taking place, e.g., canceling of earmarked health payroll tax and the status of the State United Social Insurance Fund. Similarly, it is recommended that subsequent APRs provide more information on the results of maternal and child health measures, such as the voucher program and updates on tuberculosis and HIV/AIDS.

15. **The APR reflects good progress in the energy sector under the new government.** Payment collections for electricity were substantially increased outside Tbilisi during 2004. The government is stepping up funding to the sector, has passed important legislation to financially protect energy utilities during a bankruptcy rehabilitation process, and is cooperating with consultants to find solutions to the debt overhang in the power sector. Nevertheless, the power and gas sectors are still in a crisis situation, with continued insolvency and poor service. Going forward, the government needs to focus on major issues

relating to the financial flows in the power and gas sectors and develop a plan for technical rehabilitation of the power and gas transmission systems. Privatization of utility companies, which is under preparation by the government, could become a useful tool for sector improvements, but will not be a substitute for difficult decisions by the government relating to collections, tariffs, debt overhang, and investments.

16. **The APR also reports on several recent initiatives in the transport sector.** The staffs recommend that in-depth analysis be conducted on the technical condition of the railways, the characteristics of the market demand for rail transport, and private sector participation in railway operations. Staffs commend the liberalization of motor transport, including simplification of administrative transit procedures. Air traffic services have improved substantially since the Rose Revolution. Several new carriers have started serving Georgia and ground services at Tbilisi Airport have become better organized. However, there is a need to revise the civil aviation licensing law; examine how the Air Traffic Control, both regionally and at all the airports, is organized, priced and financed; and how airport management and traffic safety can be improved. In maritime transport, continued development of the landlord port concept both at Poti and at Batumi should be pursued. In the road sector, the new management of the Roads Department of the Ministry of Economic Development (RDMED) has embarked on an ambitious program to rehabilitate the road network, and much has already been accomplished. While the road sector budget has been doubled, it is important to set priorities on the basis of engineering and economic considerations.

17. **The APR reflects the authorities' commitment to gradually pursue the fiscal decentralization agenda.** Recent accomplishments include improvements in the revenue structure of local budgets under the new tax code; ratification of the European Charter on Local Self-Government, which makes the government accountable to Council of Europe and European Commission standards; and adoption of the Law on Transfer of State Properties to local governments. However, the draft law on Local Budget submitted in September 2004 was not aligned with technical advice provided by the World Bank. Staffs found that the draft law provides little information about the actual proposed size of local government revenues, the degree of local government discretion in its choice of revenues, and the ability to raise local own source revenues.

18. **The APR suggests moves toward a more deregulated agricultural economy.** However, it is important that deregulation be considered in an orderly and measured way, and that it ultimately puts in place a licensing and inspection process that meets international norms and WTO requirements, while continuing to provide a safe environment for Georgian citizens. In addition to extensive, systematic legal and regulatory reform, deregulation will require substantial retraining of the remaining government monitoring and regulatory staff, effective engagement of private sector service providers and the education of agri-business management and the broader community in modern approaches to sanitary and phyto-sanitary protection and food safety and quality management. A more deregulated environment will also require vastly better information management and communication systems across the regulatory/monitoring agencies and the agro-food industry as a whole. Staffs also have concerns about the sustainability of the irrigation and drainage sub-sector. Service fees

continue to be very low and the Ministry of Agriculture is reducing budget support for the Melioration System Management Department by about 40 percent. The government decision to shift all collected service fees to the central budget (with no clear arrangement that the fees will be returned to the service area) will likely discourage water users from paying fees, further jeopardizing proper operation and maintenance.

19. **The APR notes a range of activities underway in environmental protection, but presents limited information on results to date.** The staffs recommend that future APRs endeavor to provide a clearer assessment of the impact of environmental protection activities on the health of the environment, on natural resource use patterns, and on the immediate livelihood of the poor.

## VI. Transparency and Accountability

20. **Efforts to date to reduce corruption and improve the business climate are commendable and should be further strengthened.** Policies already implemented include the prosecution of high-profile former government officials suspected of corruption and drastic retrenchment in the civil service (accompanied by a rise in remunerations), which resulted in clearly visible improvements in governance, including a sharp reduction in the extortion of bribes by the traffic police; approval of new tax code that significantly reduces number of taxes and tax rates; and adoption of a new law on financial amnesty. The authorities are encouraged to accord due process to all individuals and enterprises charged with corruption. Much remains to be done, nevertheless, to further improve the business climate and promote rapid, sustained economic growth. Key challenges include the provision of reliable electricity supplies to all paying customers, the development of deeper financial markets and a credit culture, and the simplification of procedures for business registration, licensing and inspection. The APR rightly identifies these challenges and contains concrete reform proposals.

21. **In the financial sector, the APR discusses the lowering of minimum reserve requirements for local currency deposits that took place in 2004.** The staffs also note other results achieved under the EDPRP that are not reported in the APR, including passage of anti-money laundering legislation and the initial stage of its implementation, and the introduction of internal control systems in commercial banks. The staffs advise the authorities to implement measures to enhance creditor and property rights, establish a Credit Bureau, develop the legislative framework for housing finance, and improve risk management.

22. **The EDPRP highlights the government's desire to accelerate privatization while adhering to the principles of transparency and fair treatment.** The APR does not elaborate on the extent to which these principles have been followed during the recent privatization operations,<sup>1</sup> but the staffs believe that more extensive advertising would have made these operations more transparent. Nevertheless, the staffs consider that the overall process was broadly acceptable, and they support the government's effort to establish a web site to advertise the small and medium SOEs selected for privatization.

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<sup>1</sup> This includes the Ocean Shipping company, the Chiaturmanganetsi mining complex, the Tkibulnakshiri coal mine, the Vartsikhe power station, the Tbilaviamsheni aircraft company, and the Krtsanisi government residence.

## VII. Participation, Coordination, and Monitoring

23. **The staffs commend the authorities for their continued efforts to deepen civil society consultation and participation during EDPRP implementation.** The new government drew many of its top officials from the ranks of civil society organizations that had participated actively in the preparation of the EDPRP under the previous government, and these officials have maintained close, though informal ties to these organizations. Moreover, the government has engaged in broad-based consultations on key reform initiatives, including most notably, the tax and education reforms. It has included key stakeholders in current efforts to develop strategic priorities for the medium term and it is completing work to establish a joint commission with the business community to discuss economic policies. Finally, the government sought close involvement of civil society in the preparation of the APR.

24. **The poverty reduction strategy has been an important vehicle for donor coordination.** The new government has consulted regularly with donors, both bilaterally and in the context of the Donors Framework Group, which had been established in support of the preparation of the EDPRP. The early consultations culminated in a Donors' Conference in June 2004 co-sponsored by the World Bank and the European Commission, with aid pledges in excess of US\$1.0 billion for the three year period 2004–06. The government's presentation at the conference was firmly grounded in the EDPRP. Following the donors' conference, the government has continued to consult regularly with the donor community at the sectoral level, notably on reforms of the revenue collection and budget management systems of the Ministry of Finance, and on the situation in the energy sector. Moreover, the government held two meetings with donors on the preparation of the progress report. These efforts have led to a high degree of donor coordination in the implementation of their assistance programs.

25. **Monitoring of the poverty reduction strategy's implementation can be strengthened,** and as mentioned above, there are several issues related to poverty monitoring itself. The EDPRP is emphasizing monitorable goals and indicators, but concerns were raised in the JSA over institutional capacity constraints to prioritize and measure these goals. Staffs are encouraged by the recommended focus on capacity building, the more systematic prioritization being undertaken with the ongoing strategic framework exercise, and the stated objective of moving to program budgeting during the next couple of years. These efforts should lead to specific measurable interim targets, which in turn would guide policy makers and society as a whole in identifying areas of the program that are proceeding well and those which need to be adjusted. In this respect, the government also needs to work with the donor community to assure careful monitoring and reporting of the utilization of aid flows.

## VIII. Conclusion

26. **In sum, the implementation of Georgia's poverty reduction strategy over the past year has been successful, owing in large part to an impressive improvement in the public finances.** The authorities have taken bold steps to tackle corruption, in keeping with their

intention to consolidate democracy and improve the business climate. Participation of stakeholders in the poverty reduction strategy process has been satisfactory.

27. As the Government strengthens the strategic focus and implementation of its poverty reduction strategy, there are four challenges:

- (i) The links between the poverty reduction strategy and annual government budgets need to be strengthened by the timely development of a Medium-Term Expenditure Framework aligned with the strategy, and by ensuring that the Ministry of Finance has a key role in implementing and further developing the poverty reduction strategy (a concern noted in the last JSA);
- (ii) The growth basis for the strategy needs to be strengthened through the construction of a financially-viable power grid with reliable supply of electricity to all regions of Georgia; through expediting privatization in a transparent and fair manner; and through adequate resource allocations for health and education sectors;
- (iii) Social protection needs to be strengthened through rapid progress with a targeted social safety net; and
- (iv) Governance and public service delivery improvements need to be promoted through the further empowerment of civil society.