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INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

PROGRAM DOCUMENT

FOR

A PROPOSED LOAN

IN THE AMOUNT OF US$60 MILLION

TO

GEORGIA

FOR THE

FIRST PROGRAMMATIC INCLUSIVE GROWTH DEVELOPMENT POLICY OPERATION

March 31, 2015

Macroeconomics and Fiscal Management Global Practice
South Caucasus Country Unit (ECCU3)
Europe and Central Asia Region

GEORGIA –GOVERNMENT FISCAL YEAR
January 1 – December 31

CURRENCY EQUIVALENTS
(Exchange Rate Effective as of March 31, 2015)

Currency Unit = Georgian Lari (GEL)
US$1.00 = 2.2275 GEL

ABBREVIATIONS AND ACRONYMS

AA	Association Agreement
ADB	Asian Development Bank
CIS	Commonwealth of Independent States
CPS	Country Partnership Strategy
CSO	Civil Society Organizations
DCFTA	Deep and Comprehensive Free Trade Area
DPO	Development Policy Operation
DSA	Debt Sustainability Analysis
ECA	Europe and Central Asia
EFTA	European Free Trade Association
EU	European Union
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
GEL	Georgian Lari
GIZ	German Federal Enterprise for International Cooperation
IBRD	International Bank for Reconstruction and Development
IDP	Internally Displaced People
IFC	International Finance Corporation
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
IPSAS	International Public Sector Accounting Standards
LEPL	Legal Entities of Public Law
MOES	Ministry of Education and Science
MOESD	Ministry of Economy and Sustainable Development
MOF	Ministry of Finance
MOLHSA	Ministry of Labor, Health and Social Affairs
NAEC	National Assessment and Examination Center
NBG	National Bank of Georgia
NPLs	Non-Performing Loans
OECD	Organisation for Economic Co-operation and Development
OOP	Out-Of-Pocket
PEFA	Public Expenditure and Financial Accountability
PFM	Public Financial Management
PPP	Public-Private Partnership
SBA	Stand-By Agreement
SDS	Social Economic Development Strategy
SDSS	Special Data Dissemination Standards
SDR	Special Drawing Rights
SMEs	Small and medium-sized enterprises
SOEs	State Owned Enterprises
TPDC	Teachers Professional Development Center
TSA	Targeted Social Assistance
UASCG	United Amelioration Systems Company of Georgia
UHC	Universal Health Care
UNECE	Net Official Flows from UN Agencies
UNICEF	United Nations Children's Fund
USAID	United States Agency for International Development

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GEORGIA

FIRST INCLUSIVE GROWTH PROGRAMMATIC DEVELOPMENT POLICY OPERATION

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LOAN AND PROGRAM SUMMARY

GEORGIA

FIRST INCLUSIVE GROWTH PROGRAMMATIC DEVELOPMENT POLICY OPERATION

<table>
<tr><td>Borrower</td><td colspan="2">Georgia</td></tr>
<tr><td>Implementation Agency</td><td colspan="2">Ministry of Finance</td></tr>
<tr><td>Financing Data</td><td colspan="2">IBRD flexible loan of US$60 million with a variable spread, 25 years maturity, and 14 years grace period. Commitment linked repayment schedule and level repayment of principal.</td></tr>
<tr><td>Operation Type</td><td colspan="2">First in a programmatic series of three Development Policy Operations.</td></tr>
<tr><td>Pillars of the Operation and Program Development Objective</td><td colspan="2">The program supports 2 objectives:
(1) Strengthen fiscal oversight of public institutions and improve budgeting and the framework for civil service reform.
(2) Improve coverage and quality of social services and strengthen monitoring of outcomes.</td></tr>
<tr><td rowspan="10">Result Indicators</td><td>Availability of budget and execution data for municipalities, legal entities of public law and non-profit legal entities</td><td>Baseline: Quarterly (2013)
Target: In real time (2017)</td></tr>
<tr><td>Improved framework reflected in the selection criteria for new capital projects in 6 municipalities and 2 central ministries</td><td>Baseline: Zero (2013)
Target: 100 percent of new investment projects (2017)</td></tr>
<tr><td>Availability of comprehensive financial data on SOEs</td><td>Baseline: Not available (2013)
Target: 2 years of data available (2017)</td></tr>
<tr><td>Pre-qualification test taken by first time entrants to the civil services according to the new hiring rules</td><td>Baseline: None (2013)
Target: 100 percent of new entrants hired in 2017 (2017)</td></tr>
<tr><td>Share of the bottom decile receiving TSA</td><td>Baseline: 60 percent (2013)
Target: 75 percent (2017)</td></tr>
<tr><td>Pharmaceutical expenses as percent of out-of-pocket (OOP) on health</td><td>Baseline: 38 percent (2012)
Target: 36.1 percent (2016)</td></tr>
<tr><td>Reduce maternal mortality rate</td><td>Baseline: 27.7 per 100,000 (2013)
Target: 26.9 per 100,000 (2017)</td></tr>
<tr><td>Reduction in the proportion of teachers in Category 1</td><td>Baseline: 65 percent (2014)
Target: 50 percent (2017)</td></tr>
<tr><td>Number of pre-school educational institutions using the new pre-school curriculum</td><td>Baseline: None (2013)
Target: 20 percent (2017)</td></tr>
<tr><td>Publish data on poverty and unemployment</td><td>Baseline: Annual (2013)
Target: Quarterly (2017)</td></tr>
<tr><td>Overall Risk Rating</td><td colspan="2">Moderate. The main risks arise from external vulnerabilities, fiscal pressures, and weak implementation capacity in some line ministries.</td></tr>
<tr><td>Operation ID</td><td colspan="2">P149991</td></tr>
</table>

IBRD PROGRAM DOCUMENT FOR A PROPOSED FIRST INCLUSIVE GROWTH PROGRAMMATIC DEVELOPMENT POLICY LOAN TO GEORGIA

I. INTRODUCTION AND COUNTRY CONTEXT (INCLUDING POVERTY DEVELOPMENTS)

1. **The first Inclusive Growth Development Policy Operation in Georgia will support the government in its efforts to improve public service delivery and strengthen fiscal oversight.** These objectives will be achieved through reforms in the areas of public financial management, social sectors and the framework for civil services. The proposed policy actions are anchored in the Country Partnership Strategy (CPS) for 2014-17 and are consistent with the government's new development strategy. This is the first operation in the programmatic series of three operations spanning 2015-17, in the amount of US$60 million.

2. **The main development challenge faced by the country is achieving more inclusive growth which will require investments in human capital and improvements in private sector competitiveness.** So far, a decade of strong economic growth in Georgia, briefly interrupted by the 2008 conflict with Russia and the global financial crisis, has not succeeded in making a significant dent in the unemployment rate. This is largely explained by low net job creation and gaps in skills and overall human capital development. The government was successful in attracting foreign investors through significant improvements in the business environment. Net job creation, however, remained weak and by 2013 the overall unemployment rate was 14.6 percent, one of the highest in the Europe and Central Asia (ECA) region. With economic transformation in Georgia, some of the older industries died, shedding their labor force. New industries grew during the same period, but have not been able to absorb the workforce as effectively. New growth sectors, especially in tourism and other service sectors, have not been able to generate sufficient formal employment. In addition, the existing educational system is not in line with the demands of the private sector and student performance ranks low.[1] Life expectancy in Georgia has improved significantly over the past decade but has stalled at 74 years since 2010. The high levels of neonatal mortality and the poor quality of reproductive health coupled with premature deaths due to Non-communicable Diseases (NCDs) are among major factors contributing to the stagnation in life-expectancy. Making growth more inclusive will, therefore, require investments in human capital as well as reforms to support competitiveness.

3. **Macroeconomic stability is a pre-condition for achieving inclusive growth.** A stable macroeconomic environment will be needed for the private sector to survive and thrive and for the government to be able to effectively deliver public services. The main macroeconomic vulnerabilities faced by Georgia include risks to external sustainability and fiscal pressures arising from increased social spending. At 84 percent of GDP, external debt is high. Low domestic savings and large investments needs result in a high current account deficit, further adding to the stock of debt. In addition, loan and deposit dollarization is close to 60 percent. The government has prioritized social spending with increases in the level of TSA and pension benefits and the introduction of universal health care in 2013. These increases will certainly help in building human capital but prudent fiscal management will be paramount, both to manage aggregate demand and to maintain fiscal sustainability. In addition, it will be important for the government to monitor and manage risks arising from State Owned Enterprises (SOEs) through which it undertakes quasi-fiscal operations. Information on SOEs is scant and patchy, thereby, limiting the ability of the government to monitor fiscal risks from SOE operations.

[1] World Bank, Skills Mismatch and Unemployment in Georgia: The Challenge of Creating Productive Jobs, 2012.

4. **There has been a significant progress in poverty reduction and shared prosperity in recent years, but it has been driven by factors other than net job creation.** The poverty rate, according to the national poverty line, fell from 21 percent in 2010 to 14.8 percent in 2012 and the mean consumption of the bottom 40 grew at 5.4 percent annually, exceeding the growth enjoyed by the population overall.[2,3] This was mainly attributable to government transfers, food disinflation and increased earnings. Inequality in Georgia is higher than in the ECA region on average with a Gini coefficient of 40.7 in 2011. In Georgia, episodes of poverty reduction and increase do not closely align with periods of gross domestic product (GDP) growth underscoring the fact that growth has not been inclusive. This dichotomy can be explained by the low net job creation during growth episodes and the employment limitations imposed by the relatively lower educational attainment of the poor. The government has in place a targeted social assistance (TSA) program which provides cash transfers to the very poor. However, the program currently covers only 60 percent of the bottom decile of the population. In addition, the vulnerability to fall into poverty is high in Georgia because of the large share of out-of-pocket (OOP) spending by households on healthcare. Although the government introduced universal health coverage in 2013, a limited number of outpatient drugs are currently covered under the program. In 2013, OOP expenditure by households accounted for 72 percent of total expenditure on healthcare. OOP spending on medicines, especially by people with chronic conditions requiring regular medication, is a major cause of catastrophic and impoverishing health spending, and households in Georgia spend two-thirds of their out-of-pocket healthcare expenses on purchasing drugs.

5. **The proposed operation supports the government in improving its public service delivery and fiscal management to make growth more inclusive.** The first generation reforms which started a decade back have helped Georgia improve its business environment, achieve sustained growth rates and maintain low inflation. However, the country has not yet recovered to its 1990 level of real per capita income and socio-economic vulnerabilities persist. Further improvements in the living standards of Georgians will therefore need to come from other areas. These include investment in human capital, enhanced private sector competitiveness, and fiscal, social and environmental sustainability. A supportive macro-fiscal environment will remain a necessary condition. This Development Policy Operation (DPO) supports government reforms in some of these areas. Private sector competitiveness is being supported by another development policy operation which focuses on improvements in the business environment, deeper access to finance, and enhanced capacity to export and innovate.

6. **Reform efforts supported by this operation have been grouped in two pillars.** Pillar I supports greater fiscal oversight of public institutions (including municipalities, legal entities of public law, non-profit legal entities and state-owned enterprises), and improvements in budgeting and the framework for civil services. Pillar II supports improvements in the coverage and targeting of social expenditures, quality of education and healthcare services, and monitoring of outcomes. Reforms supported by this operation will help both in inclusion and inclusive growth. While private sector development, which is being supported by another DPO series in Georgia, will help create more jobs, this DPO series will help build human capital and support macroeconomic stability and effective policy making. The policy matrix reflects reforms on multiple fronts and at various stages.

[2] Poverty at the ECA regional poverty line of US$2.50 per person per day was 45 percent in Georgia in 2011 and has not changed much over the past decade.
[3] Consumption growth among the bottom 40 percent was 5.4 percent during 2010-12 compared with 3.6 percent for the population as a whole.

II. MACROECONOMIC POLICY FRAMEWORK

A. RECENT ECONOMIC DEVELOPMENTS

7. **After modest economic growth in 2013, output expansion in 2014 was 4.8 percent.** During the first 3 quarters of 2014, GDP grew by 5.9 percent year-on-year, supported by policy certainty and the signing of the Association Agreement (AA) with the European Union (EU). Greater domestic stability was complemented by strong external demand during the first 9 months of the year. The large Russian market which opened up for Georgian products in July 2013 helped increase exports, particularly of wine. However, the spillover effects from the slowdown in Russia and anemic growth in the EU had an adverse impact on the Georgian economy in the fourth quarter. The economy grew by 1.8 percent in the fourth quarter of 2014 and 0.5 percent in January 2015.[4] The slowdown in exports, remittances and tourism impacted both trade and consumption, lowering growth for 2014 as a whole. In 2013, lower private investments attributed to political uncertainty had resulted in a moderation of output expansion to 3.3 percent. Economic growth over the past decade, more generally, was fueled by large foreign capital inflows and significant policy reforms during the pre-crisis years, and by high public capital spending during the post-crisis recovery period. Overall, growth during 2004-14 was largely powered by services, construction and non-tradables in general.

8. **The under-execution of capital expenditures compared with the budget resulted in a fiscal deficit of 2.9 percent of GDP in 2014 compared with an initially budgeted deficit of 3.9 percent.** The increase in fiscal deficit in 2014 comes after four years of successful fiscal consolidation when the deficit was reduced from 9.2 percent of GDP in 2009 to 2.6 percent in 2013. Both current and capital spending picked up during January-September 2014, year-on-year. The full-year impact of the increase in social spending (universal healthcare, targeted social assistance and pensions) along with an increase in the wage bill and election related local government spending raised current expenditures by 14.5 percent in 2014. However, capital expenditures were lower by 6.7 percent, and only 72 percent of the budgeted capital expenditures were executed, highlighting weak implementation capacity. Government revenues in 2014 exceeded last year's collections by 8.3 percent, boosted by stronger economic performance in the first nine months of 2014.

9. **With a slowdown in most of Georgia's trading partners, export demand and remittances fell significantly in the fourth quarter and the current account deficit widened to 9.7 percent of GDP in 2014.** The recession in Russia has impacted most of the Commonwealth of Independent States (CIS) countries which are major trading partners of Georgia. Georgia's main export markets in 2014 were Azerbaijan (which has been impacted by a fall in oil prices), Armenia (which is very dependent on Russia and has cut its growth estimates) and Russia. Anemic growth in the EU has also dampened export demand. In addition, Russia accounted for nearly 50 percent of remittance inflows to Georgia in 2014 but with the depreciation of the Ruble and stagnation in the Russian economy, remittance inflows from Russia reduced to only 34 percent of the total in the first two months of 2015. During 2014, goods exports were led by used cars, metals, nuts, wine, fertilizers and mineral water, while import growth was spurred by stronger demand for intermediate goods in manufacturing and an increase in investment. However, export of services lagged during the year because of lower tourist arrivals from Turkey and a contraction in the export of railway services to Azerbaijan. Nearly two-thirds of the current account deficit was financed by FDI which is estimated at 6.6 percent of GDP in 2014.

[4] Rapid estimates of economic growth by GeoStat.

10. **The National Bank of Georgia increased its policy rate by 50 basis points to 4.5 percent in February 2015 in response to higher inflationary expectations.** Inflation averaged 3.1 percent during 2014 and remained below the 2014 target of 6 percent. Low inflation was primarily aided by a strengthening of the nominal effective exchange rate. Monetary policy is geared towards maintaining price stability within an inflation targeting framework. The National Bank of Georgia's (NBG) inflation target for 2015 and 2016 is 5 percent and for 2017 it is 4 percent. Georgia has a floating exchange rate and interventions in the foreign exchange market by the NBG were smaller in 2014 compared with the previous year. International reserves cover 3 months of imports as of end February, 2015. In 2014, the Lari strengthened significantly against the Ruble and also against the Euro although it depreciated against the US dollar. The real effective exchange rate appreciated by 4.9 percent in December 2014 and by 5.3 percent in January 2015, year-on-year. With a decline in external performance in recent months, the Lari has however come under pressure. Between November 2014 and February 2015, the nominal exchange rate depreciated by 23 percent against the US Dollar (reflecting the strong dollar) and by 10 percent against the Euro. During the same period, the nominal effective exchange rate depreciated by 1.7 percent. Inflation has however remained under check, at 1.3 percent in February 2015 year-on-year, because of the decline in oil prices.

11. **Domestic credit growth picked up in 2014 and the banking system is adequately capitalized but vulnerabilities remain.** Credit to the private sector grew by 24 percent in 2014, reflecting low interest rates and the introduction of new Lari denominated instruments. The NBG increased the volume of long-term Lari-denominated resources through the introduction of various instruments such as refinancing loans, deposit certificates, and repo operations. The refinancing by NBG was available for mortgages and to small and medium enterprises (SME) at lower interest rates. As a result, the stock of Lari denominated loans issued by the commercial banks expanded by 29 percent, while foreign currency loans grew by 21 percent during 2014. However, Georgia remains a highly dollarized economy (loan and deposit dollarization is close to 60 percent). The ratio of non-performing loans (NPLs) to total loans was 7.6 percent in December 2014, similar to the end-2013 level of 7.5 percent.[5] The banks remain adequately capitalized with a capital adequacy ratio of 17.4 percent at the end of December 2014. However, the recent Financial Sector Assessment Program showed that there are some weaknesses among smaller banks. The assessment also indicated that with loan dollarization at 60 percent, the banking sector is vulnerable to currency depreciation risk. The loan to deposit ratio remains above 100 percent and more than one-third of banks' balance sheet is externally funded. This makes them vulnerable to volatility in international markets. In addition, weaknesses remain in the safety net and crisis management framework.

B. MACROECONOMIC OUTLOOK AND DEBT SUSTAINABILITY

12. **Economic growth is projected to average 3.6 percent a year over the medium-term but downside risks to growth remain.** The near stagnation in the Russian economy in 2014 and the collapse of the Ruble has had spillover effects in the region. This has lowered export demand for Georgian goods while lower remittances from Russia have reduced consumption. Although FDI inflows, which primarily originate in the EU countries, were stable in 2014, they are likely to reduce going forward. Hence, output expansion is projected at 2 percent in 2015, followed by an increase to 3 percent in 2016. However, downside risks remain, especially, if Georgia's export markets see a protracted period of slowdown. In addition, with Parliamentary elections due in 2016, the efforts at structural reforms could take a backseat. In the outer years, growth prospects factor in improved economic ties with the EU and the reform program outlined in the government's development strategy, which will support growth in private investment. The Deep and Comprehensive Free Trade Area (DCFTA) and the AA with the EU is likely to improve market

[5] According to NBG methodology, a loan is classified as an NPL if it is overdue for 30 days whereas the IMF classifies loans which are overdue for 90 days as NPLs.

access and encourage FDI.[6] However, in the short-term, this transitional process could involve certain costs as producers upgrade their facilities and methodologies to meet the desired quality standards. Gross investment is likely to average 22.8 percent of GDP a year during 2015-18, much lower than the 2004-07 average of 32 percent of GDP a year (Table 1). The government is committed to leverage more private investment through the Public-Private Partnership (PPP) framework that is under discussion.

Table 1: Macroeconomic Trends and Projections

	2011	2012	2013	2014p	2015p	2016p	2017p	2018p
		Actuals				Projections		
	(Percent change, unless otherwise indicated)							
National Accounts								
GDP nominal (in billions of GEL)	24.3	26.2	26.8	29.1	31.2	33.8	37.1	40.8
Real GDP growth	7.2	6.4	3.3	4.8	2.0	3.0	4.5	5.0
Consumer price index	8.5	-0.9	-0.5	3.1	5.0	4.5	4.0	4.0
GDP per capita (in U.S. dollars)	3,231	3,523	3,599	3,687	3,073	3,223	3,434	3,711
Gross investment (in percent of GDP)	26.2	28.9	24.8	25.9	20.6	22.0	23.7	24.8
Gross national saving (in percent of GDP)	13.9	17.3	19.1	16.2	12.2	12.7	15.1	17.2
	(In percent of GDP, unless otherwise indicated)							
General Government Operations								
Revenues and grants	28.2	28.9	27.7	27.9	27.6	27.8	27.9	27.9
Tax revenues	25.2	25.5	24.8	25.1	24.8	25.0	25.1	25.3
Expenditure and net lending	31.8	31.7	30.2	30.9	31.2	31.1	30.8	30.6
Current expenditure	23.0	24.9	24.1	25.4	25.3	25.1	24.7	24.4
Capital expenditure and net lending	8.8	6.8	6.1	5.5	5.9	6.0	6.1	6.3
Overall fiscal balance	-3.6	-2.8	-2.6	-2.9	-3.6	-3.3	-3.0	-2.8
Total public debt	33.6	32.3	32.2	33.4	37.3	37.4	36.7	36.0
	(In percent of GDP, unless otherwise indicated)							
External Sector								
Current account balance	-12.7	-11.7	-5.7	-9.7	-8.5	-9.3	-8.6	-7.5
Exports of goods and services	36.5	38.2	44.7	44.7	46.0	47.2	49.4	51.7
Imports of goods and services	55.5	57.8	57.6	61.6	63.0	64.7	65.7	66.8
FDI (net)	6.2	3.9	5.1	6.6	7.2	7.3	7.3	7.4
Foreign exchange reserves								
(Months imports of goods and services)	4.3	3.8	3.6	3.7	3.2	3.3	3.4	3.5
(In millions of dollars)	2,818	2,873	2,823	2,694	2,492	2,760	3,173	3,449

Source: Georgian authorities; and Bank and IMF staff estimates and projections.

13. **The authorities are committed to prudent fiscal management over the medium-term.** For 2015, the government has budgeted an increase in revenues from higher cigarette and alcohol excise and the introduction of excise on international calls. However, with the projected deterioration in economic performance, revenue collections are likely to be lower than budgeted. There will be a modest increase in health (drug coverage under universal healthcare) and education expenditures (increased teacher salaries) as well as the planned increase in pensions. Other current expenditures will be held constant in real or nominal terms. Various measures are under consideration to improve fiscal outcomes over the medium-

[6] A trade sustainability impact analysis commissioned by the EU suggests a potential increase in GDP growth of 4.3 percent in the long-run.

term. These include increased expenditure efficiencies in social benefits, reforms in public investment management, and limits on other non-essential expenditures, especially administrative expenses. The large infrastructure deficit necessitates large capital spending in Georgia, which is expected at 5-6 percent of GDP. The government has an efficient tax administration and cannot easily increase tax rates.[7] Hence, the fiscal consolidation process falls squarely on the expenditure side. The level of revenues is expected to be maintained at about 27.8 percent of GDP (Table 2). With continued fiscal prudence, the fiscal deficit is likely to come down to 2.8 percent of GDP by 2018 from 3.6 percent in 2015. Fiscal consolidation is a key element of the International Monetary Fund (IMF) Stand-By Arrangement with Georgia. To achieve the desired fiscal outcomes, strengthening the effectiveness of social spending and supporting the government in developing the institutions and capacity for program implementation will be crucial.

Table 2: Fiscal Indicators

	2011	2012	2013	2014p	2015p	2016p	2017p	2018p
	Actuals			Projections				
	(In percent of GDP)							
Overall fiscal balance	-3.6	-2.8	-2.6	-2.9	-3.6	-3.3	-3.0	-2.8
Revenues and grants	28.2	28.9	27.7	27.9	27.6	27.8	27.9	27.9
Taxes	25.2	25.5	24.8	25.1	24.8	25.0	25.1	25.3
Non-tax revenues	3.0	3.4	2.9	2.8	2.8	2.9	2.7	2.6
Total expenditure and net lending	31.8	31.7	30.2	30.9	31.2	31.1	30.8	30.6
Current expenditure	23.0	24.9	24.1	25.4	25.3	25.1	24.7	24.4
Wages and salaries	4.7	4.6	5.2	5.2	4.8	5.0	5.0	5.0
Goods and services	5.0	5.0	3.8	3.9	5.9	6.1	6.1	6.1
Interest payments	1.2	1.0	0.9	0.9	1.0	0.9	0.7	0.6
Subsidies and grants	1.8	2.0	2.0	2.2	1.8	1.7	1.6	1.5
Social expenses	6.8	7.1	8.5	9.6	9.6	9.3	9.3	9.2
Other expenses	3.5	5.2	3.7	3.6	2.2	2.0	2.0	2.0
Capital expenditure and net lending	8.8	6.8	6.1	5.5	5.9	6.0	6.1	6.3

Source: Georgian authorities; and Bank and Fund staff estimates and projections.

14. **Lower domestic demand, the decline in investment, and the impact on imports of the large depreciation of the Lari is likely to reduce the current account deficit in 2015.** In addition, lower oil prices will also reduce the import bill since petroleum products account for the largest share of Georgia's imports (10.7 percent of the total). Georgia's exports are also expected to remain subdued in 2015 because of lower demand from its key trading partners. In addition, there are downside risks to tourism receipts (main tourist arrivals are from Turkey, Armenia, Azerbaijan and Russia) and remittances, nearly 35 percent of which originated in Russia in the first two months of 2015. In 2016, some deterioration of the current account is likely with a pick-up in investment related imports and domestic demand but limited increase in exports. From 2017 onwards, external sustainability will be supported by a larger recovery in export markets and some gains from the continued focus on competitiveness, especially in the context of the DCFTA. The full impact of the improvements on the export front as a result of the DCFTA and other structural reforms will be visible only over the medium- to long-term. Given the high level of external liabilities, a more ambitious reduction in the current account deficit (CAD) is desirable but not very likely with the low domestic savings. Nearly two-thirds of the CAD will be financed from FDI and the rest from loans. Portfolio investments are relatively small in Georgia. Georgia receives most of its FDI from the EU countries and has limited dependence on Russia and Ukraine for direct investment. However, spillover

[7] The Liberty act requires a referendum to increase tax rates with the exception of excises.

effects from geopolitical uncertainties and potentially longer-term stagnation in the EU could dampen investment inflows to Georgia.

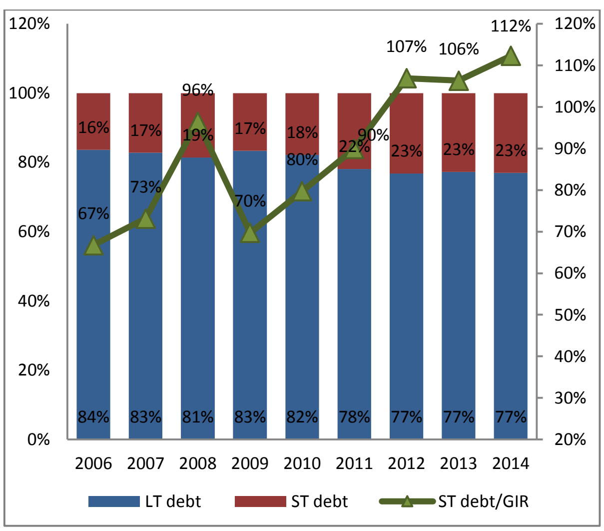
15. **Georgia's public debt remains sustainable.** Total public sector debt is likely to increase from 33.4 percent of GDP in 2014 to 37.3 percent in 2015 with the widening of the fiscal deficit and the depreciation of the Lari against the USD (Table 3). About 80 percent of public debt in 2014 was external and was dominated by long-term multilateral (70 percent) and bilateral (20 percent) debt. Given the highly concessional nature of public debt, interest payments average at around 1 percent of GDP a year. Nearly 75 percent of external public debt is at fixed interest rates, thereby, reducing interest rate risk. The 2014 Debt Sustainability Analysis (DSA) confirms that debt indicators are within prudential thresholds. Public debt is projected to remain sustainable even if large macroeconomic shocks materialize. The Ministry of Finance (MOF), with support from international financial institutions, including the World Bank, is actively working to develop a public debt management strategy by September 2015.

Table 3: Debt Sustainability Analysis

	2011	2012	2013	2014p	2015p	2016p	2017p	2018p
	Actuals				Projections			
	(In percent of GDP)							
Total public sector debt	33.6	32.3	32.2	33.4	37.3	37.4	36.7	36.0
External public sector debt	29.1	27.5	29.5	26.9	30.9	31.5	31.2	30.4
Domestic public sector debt	4.5	4.8	2.7	6.5	6.4	5.9	5.5	5.6
Gross external debt (including inter-company loans)	77.8	82.2	81.8	83.3	95.0	91.6	87.3	81.7

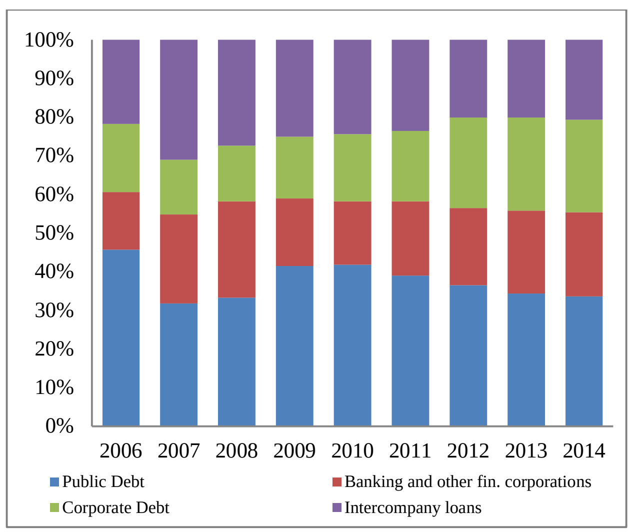
Source: Georgian authorities; and Bank staff estimates and projections.

Figure 1: Maturity of External Debt



Source: NBG, World Bank staff calculation.

Figure 2: Composition of External Debt



Source: NBG, World Bank staff calculation.

16. **Total external debt is however a source of vulnerability.** The high reliance on foreign savings to fuel growth resulted in rapid accumulation of external debt which is estimated at 83.3 percent of GDP in 2014. About 77 percent of external debt is long-term and nearly two-thirds of external debt is held by the private sector (Figures 1 and 2). Inter-company external loans account for nearly 20 percent of GDP and

generally carry lower repayment risks. In addition, 6 percent of the external debt is denominated in local currency. The main holders of Georgia's private external debt include financial institutions (Bank of Georgia and TBC Bank) and non-financial corporations like the Georgian Oil and Gas Corporation (Eurobond of $200 million), the Georgian Railways (Eurobond of 670 million), and Marabda-Kartsakhi Railway ($560 million highly concessional loan from Azerbaijan). Banking supervision norms require banks to keep their positions closed. However, the banks' debtors could face currency mismatches in their revenue streams. The short-term debt mostly consists of trade credits owned by non-financial corporations, deposits of non-residents in the banking sector of Georgia, and short-term intercompany loans by foreign direct investors. For non-resident deposits, banking supervision norms require that if such deposits exceed 10 percent of total deposits of the bank, then the liquidity requirements are much higher (close to 100 percent of the deposits). However, reserves cover only about three months of imports and short-term debt amounted to more than 100 percent of reserves in 2014. This makes Georgia highly vulnerable to exchange rate depreciation. Gross external debt, including inter-company loans, is likely to go down in the medium-term with a decline in the current account deficit. The 2014 Debt Sustainability Analysis (DSA) confirms that Georgia's external debt is vulnerable to exchange rate depreciation.

17. **Georgia's overall macroeconomic policy framework is adequate for this operation.** Although there are downsides to growth triggered by external disturbances, the government remains committed to sound macroeconomic management as evidenced by its commitment to fiscal prudence, low inflation and limited interventions in the foreign exchange market. Over the medium-to long-term, the DCFTA and the AA, structural reforms and continued macroeconomic stability will strengthen growth prospects and also reduce external vulnerabilities.

C. IMF RELATIONS

18. **The three-year IMF Stand-By Arrangement in the amount of SDR100 million (about US$154 million) was approved in July 2014.** The Stand-By Arrangement (SBA) supports the government's economic program to reduce macroeconomic vulnerabilities, increase policy buffers and support growth, while making the economy more resilient to external shocks. The program is on track as per the first review undertaken in November-December 2014. The proposed DPO complements the Fund program by supporting structural reforms in the areas of public financial management and improvements in human capital. The World Bank Group closely coordinates with the Fund on macroeconomic developments, debt sustainability analysis, fiscal consolidation, and public financial management.

III. THE GOVERNMENT'S PROGRAM

19. **The main objective of the Socioeconomic Development Strategy of Georgia, "Georgia 2020," is to achieve faster, inclusive, and sustainable growth averaging 7 percent per annum.** This assumes that structural reforms will support rapid growth in investment, employment, and firm productivity and also ensure the realization of potential benefits associated with the DCFTA in terms of higher exports and FDI. The Socioeconomic Development Strategy (SDS) supports the development of the private sector into the engine of growth and, at the same time, emphasizes the redefined role for the state to facilitate inclusion through better delivery of public services, addressing market failures and cross-cutting constraints. The SDS intends to establish an evidence based policy framework, supported by monitoring and evaluation mechanisms, to ensure that policy interventions are relevant, have impact, and enable course correction.

20. **The strategy is based on three pillars and two necessary pre-conditions.** The pillars include strengthening competitiveness of the private sector, developing human capital and enhancing access to finance while the pre-conditions include macroeconomic stability and effective public administration. The following priorities are highlighted:

- ***Pre-conditions:*** Establishing the pre-conditions for growth in terms of a stable macroeconomic environment including fiscal discipline, low unemployment, price stability, central bank independence, and financial sector stability. Effective public sector management would include enhancements in the capacity of the state agencies to undertake their jobs effectively.
- ***Pillar 1:*** Improving private sector competitiveness by building on past successes and further enhancing the investment climate, facilitating innovation and R&D, promoting exports, developing infrastructure and building on the country's transit potential.
- ***Pillar 2:*** Strengthening human capital - health, education, and social safety nets.
- ***Pillar 3:*** Increasing access to finance.

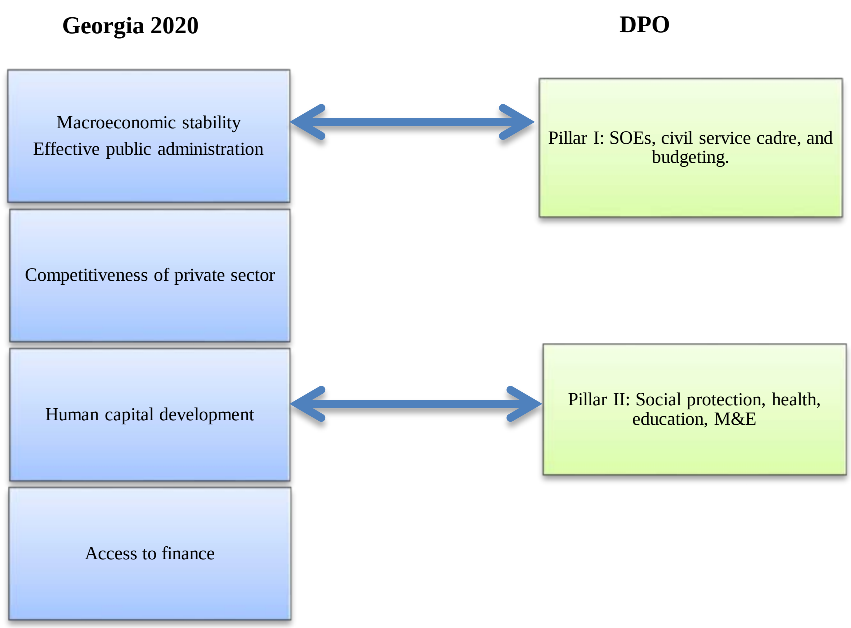
21. **The reforms in the proposed DPO are well aligned with those in the Georgia 2020 strategy.** They include measures in the education, health, and social assistance sectors as well as improved fiscal management and effective public administration. They fully support the government's emphasis on strengthening the social sectors, particularly social assistance, education and health.

IV. THE PROPOSED OPERATION

A. LINK TO GOVERNMENT PROGRAM AND OPERATION DESCRIPTION

22. **The DPO objectives under the two pillars are anchored in the government's development strategy.** Each of the two DPO pillars map to one of the priority areas outlined in Georgia 2020 (Figure 3), as well as the necessary pre-conditions laid out by the government. In addition, the objectives of this operation are also fully consistent with the CPS, approved in May 2014, which focuses on areas in which the World Bank Group has a comparative advantage. These include convening power, rigorous analytical work, and the ability to leverage on assistance from development partners.

Figure 3: Links between Georgia 2020 and the DPO Pillars and Policy Actions



23. **The policy actions supported by this DPO target the government's key development challenges.** Improved public financial management through better monitoring of state owned enterprises (SOEs) and other public entities, improved capital budgeting framework and a strengthened civil service cadre will promote better policy making and fiscal discipline and will contribute to macroeconomic stability as well as effective public administration. In addition, a strengthened education system and increased access to health care and social assistance will help develop human capital and fight poverty in a sustainable manner.

24. **The current DPO builds on previous development policy operations.** The previous series of DPOs concentrated on building competitiveness for sustained growth. The reforms were anchored in public finances (modified cash basis International Public Sector Accounting Standards (IPSAS) and coverage of Legal Entities of Public Law (LEPLs) in the e-budget), social sectors (universal health coverage, upgraded standards for hospitals and primary health care, increased efficiency of pensions), and improvements in competitiveness (adoption and implementation of framework laws on competition, food safety and free movement of products, improved customs efficiency, increased power sector reliability and curricula and related improvements in general education). The current DPO series lays the foundation for inclusive growth by furthering reforms in the areas of public financial management and social sectors. Lessons learned from previous operations have been instrumental in the current series. As a result, the design of the reform program was led by the government, the areas chosen were those where the World Bank Group had a strong track record of engagement and the reform actions were based on a realistic assessment of the country's implementation capacity.

B. PRIOR ACTIONS, RESULTS AND ANALYTICAL UNDERPINNINGS

25. **The policy actions supported by this DPO series are grouped under two pillars and include 9 prior actions for the first DPO, and 11 and 8 indicative triggers for DPO2 and DPO3, respectively.** In parallel with this series, there is another DPO series being prepared by the World Bank Group aimed at improving private sector competitiveness, with particular emphasis on improvements in the business environment, deeper access to finance, and enhanced capacity to export and innovate.

Pillar I: Strengthen fiscal oversight of public institutions, and improve budgeting and the framework for civil service reform.

Budget

26. **The public financial management information system does not include the municipalities and other recipients of budgetary resources.** Local self-governments, legal entities of public law (LEPLs) and non-profit legal entities (NPLEs) in Georgia have their own financial management information systems, some of which do not support electronic payments and are also not synchronized with the central public financial management information system. They are all recipients of budgetary resources with the exception of some NPLEs and they maintain separate revenue and expenditure accounts with different commercial banks. As a result, it is difficult for the Ministry of Finance to monitor their cash balances and collect good quality information on their financial position. In contrast, all financial transactions of the central government are managed through the treasury single account which is maintained at the National Bank of Georgia and is synchronized with the central public financial management information system (PFMIS). To improve timely information availability and facilitate greater fiscal management, this DPO series will support the inclusion of revenues and expenditures of all municipalities, LEPLs and NPLEs (like the

Agricultural Project Management Agency or the Chamber for Trade and Industry) in the central PFMIS.[8,9] This will help the MOF to better monitor and manage its cash balances throughout the budget cycle. It will also help better management of inter-governmental transfers. However, local governments, LEPLs and NPLEs will continue to have autonomy over their spending decisions, as in the past. The MOF will be able to monitor their cash balances but will not have the power to affect spending decisions of these entities.

27. **Fiscal savings from efficiency improvements in government expenditures will play a crucial role in overall fiscal management and prudence.** Capital expenditures are expected to be in the range of 5-6 percent of GDP during this period, lower than the 2007-12 average of 8.7 percent of GDP a year. In 2013, more than 60 percent of public capital expenditure was in roads and municipal infrastructure and another 18 percent was in hydropower rehabilitation and transmission. Currently, the government does not have a systematic way of screening and planning its public investment projects. This DPO series will support the adoption and implementation of a framework for systematic capital investment identification, preparation, appraisal and selection, both for the central and the local governments. As a first step, this framework will be implemented in one central government ministry and in five municipalities.[10]

28. **The proposed DPO1 supports the following prior action:**

- The Borrower has amended the Budget Code to include revenues and expenditures of municipal governments, legal entities of public law and non-profit legal entities in the Public Financial Management Information System, as evidenced by the Borrower's Law No. 2935-Is dated December 12, 2014, which law is in full force and effect.

29. **The proposed triggers for DPO2 and DPO3 are the following:**

- The Ministry of Finance establishes the framework for project appraisal, selection, budgeting, implementation and evaluation for investment projects costing more than an agreed threshold.

- Five municipalities and one central ministry implement the adopted framework for project appraisal, selection, budgeting, implementation and evaluation of investment projects.

Result: The expected result of these policy actions is that the budget and execution data of municipalities, LEPLs and non-profit legal entities will be available on a real time basis as against the quarterly data that is currently available. In addition, the new capital budgeting framework will be reflected in the selection criteria of all new capital projects in six municipalities and two central ministries where they have been piloted.

State-Owned Enterprises

30. **About 400 SOEs operate in Georgia under different institutional arrangements and ownership structures but information on them is scant.** The five largest SOEs are an exception and information on them is available. According to the law on state property in Georgia, the Ministry of Economy and Sustainable Development (MOESD) is primarily responsible for the management and supervision of SOEs. In practice, this oversight function is spread across several ministries. As a result, the

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[8] LEPLs are governed by Georgia's public law and are created by various ministries to provide specific public services for which they can charge service fees. They are allowed to retain these fees for their needs. Such revenues accounted for 10 percent of the 2012 State Budget.
[9] NPLEs are governed by Georgia's private law and can be established by government and non-government entities. Those NPLEs which are established by the central government, LEPLs, self-governing cities (not regional municipalities) and a few others receive budgetary resources.
[10] There are about 80 municipalities in Georgia.

Parliament does not receive any information on these companies as part of the budget preparation and execution process. The SOEs under the central government are broadly classified into three groups. The first group is under the Partnership Fund which includes the assets of the five largest SOEs.[11] The second group of 350 SOEs is under the supervision of the MOESD. The majority of these SOEs do not operate and some are bankrupt. According to MOESD estimates, only 70 of these enterprises are viable and they operate in the health, navigation, and manufacturing sectors. The MOESD is in the process of rationalizing these SOEs and bringing down their number to 200 by the end of 2015 and eventually to 70. A third group consists of enterprises which operate under the supervision of line ministries including the Ministry of Energy, the Ministry of Education and Science, the Ministry of Defense, the Ministry of Regional Development and Infrastructure, the Ministry of Agriculture, and the Ministry of Youth and Sport. The SOEs report to either the National Agency of State Property (NASP) which is an LEPL under the MOESD or the respective line ministries. In addition to central government SOEs, the local governments also have some SOEs operating under them.

31. **Establishing a comprehensive SOE database is essential for monitoring the fiscal risks emanating from them.** This DPO series will facilitate these two objectives. According to some measures, the SOE sector in Georgia contributed to 7 percent of GDP in 2012. Although the share of SOEs is small in terms of output, their contribution to investment in fixed capital is oversized at 24 percent of total corporate investment in 2012. This is essentially because of the sectors in which the large SOEs operate–energy and transport–and the large infrastructure requirements in these sectors. Transfers from SOEs to the budget through dividends varied widely over the years based on performance of the SOEs and their negotiations with the government. While there are no explicit subsidies to the SOEs, the government has assumed responsibility for some of their liabilities. The government also undertakes significant quasi-fiscal operations through the large SOEs which potentially understate the fiscal deficit and the overall debt. Exact costs are not available but the government provides subsidized services to the population (gas, electricity, transport) through its 5 largest SOEs for which it does not compensate them. In addition, these SOEs undertake investment projects on behalf of the government, which are outside the budget. The government also imposes other costs on SOEs like higher than the market wage increases. As a first step for better monitoring the SOEs, the Ministry of Finance is in the process of finalizing a comprehensive list of SOEs which it has built up through information it received from each of the line ministries, local governments and the Partnership Fund and by cross-checking it with the existing (but incomplete) database with the national statistical agency (GeoStat).

32. **The data collection template developed by the NASP will be used to collect the first round of financial data from all SOEs.** The NASP developed a data collection template, which was approved by the MOESD, and was used during 2014 to collect financial and operational data from SOEs operating under the MOESD. This template has been shared with other line ministries and has been sent to all SOEs in early 2015 so that they can submit their financial data which needs to be compliant with the International Financial Reporting Standards (IFRS) or IFRS for SMEs.

33. **This proposed DPO series will support the MOF in institutionalizing financial data collection from all SOEs and in preparing and annexing to the budget the annual reports on SOE fiscal risk assessment.** The DPO series will support the development of a systematic process for financial data collection from all central and local government SOEs in an IFRS compliant standardized format and with regular frequency by a single agency. The MOF will also develop a framework for fiscal risk management with assistance from donors. The objective is to provide an annex on SOE fiscal risk assessment in each

[11] JSC Partnership Fund that was established in 2011, consolidates the ownership of the 5 largest companies and their subsidiaries: Georgian Railway, Georgian Oil and Gas Corporation, Georgian State Electrosystem, Electricity System Commercial Operator, and JSC Telasi

year's budget, starting with the budget of 2017. This endeavor will include all central government SOEs, SOEs under the Partnership Fund and local government SOEs.

34. **The proposed DPO1 supports the following prior action:**

- The Borrower, through MoF, has registered the State Owned Enterprises in Georgia including those in the Partnership Fund and SOEs subsidiaries; as evidenced by the letter from the Borrower's Minister of Finance to the Bank, dated February 20, 2015.

35. **The proposed triggers for DPO2 and DPO3 are the following:**

- The Ministry of Finance with support from the Ministry of Economy and Sustainable Development establishes an SOE financial database.

- The Ministry of Finance incorporates a provision in the 2017 budget law to include the SOE fiscal risk assessment report to the annual budget in 2017 and after.

Result: The expected result of these policy actions is to make available two years of comprehensive financial data on SOEs.

Civil Services

36. **The Law on Civil Service was enacted on October 31, 1997 and was followed by several amendments, most of which took care of immediate needs only.** There was no emphasis on an overarching policy aimed at improving the efficiency of civil services. The structure of the public sector underwent significant changes since 2004 with the conversion of many civil service institutions into legal entities of public law (LEPLs) and non-profit legal entities (NPLEs). These changes were not adequately reflected in the civil service law and made it difficult to ensure uniformity in hiring policies, career development, remuneration packages, and the rights and responsibilities of the employees. The status of the public servant is also vaguely defined in the law.

37. **In an effort to strengthen public administration and caliber and unify human-resource policies across the public sector, this proposed DPO series will support the government in developing a comprehensive framework for the civil service.** This framework will form the basis for the new Law on Civil Service which will then be implemented through the issuance of secondary legislation. The Civil Service Bureau has developed a framework for overhauling the civil service which includes the definition and scope of the service and the hiring, remuneration and professional development of civil servants. It also aims at providing equal opportunities to men and women in the service. In parallel the Bureau is engaged in the process of functional analysis of each entity that delivers public services and implements public policies. This analysis aims at clarifying the functional definition of the status of the civil servant. The development of a universal grading system along with the pay scale is an important part of the reform that will help to improve the planning and budgeting process in the public sector and predictability of the fiscal cost of compensation of employees. The framework has been developed in a consultative manner with inputs from the government, civil society organizations and the donor community.

38. **The proposed DPO1 supports the following prior action:**

- The Borrower has adopted the new Framework for Civil Service Reforms, as evidenced by the Borrower's Decree No 627 dated November 19, 2014 and published in the Legislative Herald on November 20, 2014.

39. **The proposed triggers for DPO2 and DPO3 are the following:**

- The civil service bureau issues an Order to begin public consultations on the proposed new Law on Civil Services.

- The government adopts key secondary legislation to implement the new law on civil services.

Result: The expected result on these policy actions is that all first-time entrants into the civil services, hired in 2017, take the pre-qualification test.

Pillar II: Improve the coverage and quality of social services and strengthen monitoring of outcomes.

Targeted social assistance

40. **Only about 60 percent of the bottom decile of the Georgian population receives TSA.** In addition, some vulnerable groups are also under covered such as poor rural populations and families with many children resulting in high levels of child poverty.[12] The targeting accuracy of the TSA program can be improved by reducing inclusion and exclusion errors. To improve the TSA on these dimensions, this DPO series will support the revision of the existing proxy-means tested methodology for determining eligibility to the TSA which was originally adopted in 2006. In general, proxy-means tested formulas need to be revised every 5 years as the needs and composition of vulnerable groups change. Hence, the change in the formula in Georgia is long overdue. The new methodology will improve targeting efficiency and reduce inclusion and exclusion errors, and thus increase coverage of the bottom decile. The eligibility into the TSA program depends on a score based on a formula that estimates household wellbeing. The new methodology revises the formula to compute the score by changing its components or variables and their weights. The targeting accuracy will improve as a result of easier verification of the new set of variables which will in turn reduce wrongful computation of the score and cheating. In addition, targeting accuracy will also improve because the new set of weights attached to the variables will better compute household wellbeing.

41. **The new methodology will also introduce a differential system for the payment of TSA benefits with the objective of having more impact in closing the poverty gap of the most vulnerable.** The objective of the differentiated levels of benefits is to offer more protection to the most vulnerable groups. To monitor the impact of this measure on poverty reduction, an indicator called the 'squared poverty gap' will be used.[13] If transfers to the poorest households are larger than transfers to less poor households, the poverty gap of the poorest households will decline relatively more than it would with equal transfers. Thus, the squared poverty gap puts more weight to the improvement in the wellbeing of the very poor. The reforms to the TSA are likely to be fiscally neutral. The TSA expenditures currently range from GEL 22-25 million per month. Under the revised methodology, it is likely to cost GEL 24-25 million per month. The government will first pre-test this new methodology and then based on the results of the pre-testing, it will adopt revisions to the methodology and then roll it out throughout the country.

42. **There is limited evidence of work disincentives as a result of TSA in Georgia.** Kits et al (2013) found that only women who are not married and those who have children of school-going age were less likely to work if they received TSA transfers in Georgia. As this group of the population tends to shy away from work for many other reasons, it is preferable to support their employability with childcare and gender

[12] No more than 5 percent of the top quintile receives TSA.
[13] The poverty gap is the average monetary distance between the household consumption (or income) and the poverty line. It is the amount of money that would move a poor household out of poverty.

equality policies, rather than introducing other design features to the TSA. In addition, policies that aim to directly reduce work disincentives by modifying the delivery of the TSA like the "rights and responsibility" approach applied in many European countries might not be suitable for Georgia. This is because they are costly to implement and with the low levels of net job creation in Georgia, they carry the risk of leaving vulnerable groups without TSA and without a permanent job.

43. **The proposed DPO1 supports the following prior action:**

- The Borrower has adopted a new methodology for the Targeted Social Assistance to improve targeting and coverage of the poor, pursuant to the Borrower's Resolution No 758 dated December 31, 2014 and published in the Legislative Herald on the same date.

44. **The proposed triggers for DPO2 and DPO3 are the following:**

- The government adopts revisions to the TSA methodology based on the evaluation of the pre-testing.

- The Ministry of Labor Health and Social Affairs rolls out the revised TSA methodology, based on an evaluation of the pre-testing, throughout the country.

Result: The expected result of these policy actions is to increase the share of the bottom decile receiving TSA from 60 percent in 2013 to 75 percent by 2017.

Health

45. **Georgia's long-term vision to move towards European standards in its health system would require changes in its pharmaceutical policy.** There is a significant amount of self-medication and, in certain instances, drug abuse in Georgia. This is because all drugs are available over the counter and do not require a doctor's prescription. To reduce self-treatment and drug addiction and to promote a rational and doctor-supervised use of drugs, the proposed DPO series will support the introduction of the requirement to have a medical prescription to purchase certain drugs. This is in line with EU requirements under the Association Agreement.

46. **Universal health care (UHC) was introduced by the government in February 2013 but out-of-pocket medical spending by households continues to be high because only a limited number of outpatient drugs are covered by the program.** The existing UHC package includes primary health care, emergency medical care both at the ambulatory and hospital levels, elective surgery, oncology treatment and maternity services, in-patient medications and a limited number of out-patient drugs. In 2013, out-of-pocket (OOP) expenditures by households amounted to 72 per cent of total expenditure on healthcare. Due to these high costs, self-treatment is the main option for 44.3 percent of Georgians suffering from an illness. OOP spending on medicines, especially by people with chronic conditions requiring regular medication, is a major cause of catastrophic and impoverishing health spending. Households in Georgia spend nearly two-thirds of their OOP healthcare expenses on purchasing drugs. Georgians spend in excess of 3 per cent of GDP on medicines annually and this is twice the Organisation for Economic Co-operation and Development (OECD) average. In order to tackle the problem of high OOP expenses in healthcare, the government is planning to increase the number of outpatient drugs that will be covered under the UHC package. For budgetary reasons, this increase will initially target TSA beneficiaries. The Ministry of Labor Health and Social Affairs (MOLHSA) is also reviewing the 20 existing state healthcare programs with a view to consolidate some of them under the UHC and redirect spending on these programs to the UHC program. While a cost estimate of this measure is not available, the MOLHSA has reassured the team that the amount has already been included in the 2015 budget.

47. **Despite measures to strengthen the healthcare system over the past few years, important gaps in the quality of health services remain, particularly for obstetric and neonatal care.** Life expectancy has improved significantly over the past decade although it has stalled at 74 years since 2010. The high levels of neonatal mortality and the poor quality of reproductive health coupled with premature deaths due to Non-communicable Diseases (NCDs), are among major factors contributing to the stagnation in life-expectancy. Infant mortality steadily decreased from 41.6 per 1,000 live-births in 1995-99 to 14.1 in 2005-09 and according to national statistics, it was 10.5 in 2013. Improvements in the quality of healthcare services, particularly focused on obstetric and neonatal care, will be supported by this DPO series through the adoption and implementation of enhanced obstetric and neonatal care. This reform is aimed at improving access to quality healthcare services before, during and after childbirth. This will be done by establishing effective functional links between different levels of perinatal services and ensuring adequate management of obstetric and neonatal diseases, complications and emergencies. All obstetric and peri-natal (anti- and neo-natal) services will be divided into three levels – basic care, specialized care and critical care. For each level, the scope of services, the qualification of medical personnel and the infrastructure requirements of the medical facility will be determined. All healthcare professionals who provide these services will need to follow the criteria for categorizing each pregnancy into the right level and then ensure that the specified level of care is provided to each case. This initiative will first be piloted in two regions and then rolled out throughout the country.

48. **The proposed DPO1 supports the following prior actions:**

- The Borrower, through MOLHSA has established a requirement whereby the issuance of a physicians' prescription is required for the purchase of certain pharmaceutical products, to promote the rational use of medicines, as evidenced by the Borrower's Order No 01-53/n dated July 18, 2014 and published in the Legislative Herald on the same date.
- The Borrower, through MOLHSA has mandated enhancements for the provision of obstetric and neonatal care across the Borrower's regions, to improve access to quality health care services before, during, and after, childbirth; pursuant to the Borrower's Order No 01-2/n dated January 15, 2015 and published in the Legislative Herald on the same date. .

49. **The proposed triggers for DPO2 and DPO3 are the following:**

- The Ministry of Labor Health and Social Affairs expands the list of outpatient medicines for TSA beneficiaries under the UHC package.
- The Ministry of Labor Health and Social Affairs pilots the enhanced obstetric and neonatal care in 2 regions.
- The Ministry of Labor Health and Social Affairs implements the enhanced obstetric and neonatal care throughout the country.

Result: The expected result of these policy actions is to reduce pharmaceutical expenses as a percent of OOP on health 36.1 percent by 2016 from 38 percent in 2012. In addition, the maternal mortality rate will be reduced by 3 percent by 2017 compared with 2013.

Education

50. **Improving teacher quality and student performance have been identified as major challenges in the education system.** The basic education system is failing to provide functional literacy to an overwhelming majority of students. Based on the Program for International Student Assessment (PISA 2009 Plus) results, only a small percent of Georgian 15-year-olds (30 percent to 40 percent depending on the subject) scored level 2 or above, the threshold for functional literacy. The gap between Georgia and the OECD countries on the reading scale is approximately three years of schooling. The key factors

contributing to low teaching quality in Georgia include too many low-paid teachers teaching too few hours and issues concerning teacher recruitment, deployment, performance evaluation, professional development, and career advancement opportunities. Teaching is not an attractive career path in Georgia and low salaries make teaching an unpopular choice. The country's brightest students rarely choose teaching as their profession. This is evident from the test scores of university entrants where education students have one of the lowest average scores according to the fields of study (National Assessment and Examination Center (NAEC, 2011)). The poor management of the demand and supply of teachers and teacher deployment across the country has resulted in shortages of teachers by teaching subject and geographic location despite the overall surplus of teachers in the country. The existing teacher pre-service and in-service training system does not produce the intended results. The teacher certification rates have been very low with only about 25 percent of teachers certified till date.

51. **To improve teacher quality, this DPO series will support the adoption and implementation of the scheme for teacher entry into profession, professional development and career advancement.** This new scheme is aimed at attracting motivated and qualified staff into the teaching profession, improving competencies of the existing teachers and enhancing professional development opportunities tailored to individual needs of teachers. The Teachers Professional Development Center (TPDC) has the primary responsibility for the development of the new scheme in collaboration with other education agencies, particularly, the NAEC under the overall supervision of the Ministry of Education and Science (MOES). The new scheme will evaluate teachers on various parameters and classify them into four different categories: (i) teacher practitioner (lowest level); (ii) lead teacher; (iii) senior teacher; and (iv) mentor teacher (highest level). The teachers will have to accumulate credits (through various programs which will be spelt out in detail along the process and in which the World Bank will be involved) in order to remain in their category and to get promoted to the next category. On the requirements for remaining in the profession, one of the provisions is that if a teacher remains in Category 1 for three consecutive years, then she/he will be asked to leave. The requirements for entry into the teaching force have also been raised. The new scheme also envisages significant changes to the existing teacher evaluation system, which is currently based on teacher certification examinations only. The new evaluation system will be based on teacher self-assessment, school-based assessment, and external assessment. Enrolment in the new scheme is mandatory for all teachers and the results of the existing teacher certification will be reflected in the new system (in the categorization). In addition, teacher salaries (which were recently increased) will increase progressively as they move from one category to the next. Preliminary estimates show that at the end of 2014, nearly 65 percent of the teachers would be in Category 1 while the remaining 35 percent would be in Category 2.

52. **The management and delivery of pre-school education in Georgia is with the local authorities which have limited institutional capacities.** The lack of supervision, monitoring, and quality assurance leads to wide differences in the quality of pre-school service across the country.[14] The majority of children who attended preschool show very low school readiness. One of the major constraints facing preschools is the lack of education standards and instruments for their enforcement. To improve the quality and monitoring of pre-school education, this DPO series will support the approval of the national standards and curriculum for pre-schools and the approval of a monitoring framework to assess pre-school curriculum implementation.[15]

53. **The proposed DPO1 supports the following prior actions:**

- The Borrower has amended the "Law on General Education" to: (i) include higher qualification requirements for entry into the teaching profession, and (ii) improve the regulation of teacher

[14] 5 year old children

[15] Improvements in tertiary education and vocation education and training (VET) are being led by other donors.

recruitment and professional development process; as evidenced by the Borrower's Law No. 2822-Is dated November 18, 2014, which law is in full force and effect.

- The Borrower has adopted the "Framework for Teachers' Entry into the Profession, Professional Development and Career Advancement Scheme", as evidenced by the Borrower's Decrees No 68,69,70,71,72,73,74,75,76,77, all dated February 20, 2015 and published in the Legislative Herald on February 23, 2015.

54. **The proposed triggers for DPO2 and DPO3 are the following:**

- The Ministry of Education and Science completes the categorization of all general education teachers into the four categories based on qualifications, experience and certification.
- The Ministry of Education and Science adopts the credit accumulation manual for teachers.
- The Ministry of Education and Science approves the national standards and curriculum for pre-school education.
- The Ministry of Education and Science rolls out the teacher evaluation system using the classroom observation tool throughout the country.
- The Ministry of Education and Science approves the monitoring framework for pre-school curriculum implementation.

Result: The expected result of these policy actions is to reduce the proportion of teachers in Category 1 from 65 percent in 2014 to 50 percent by 2017. In addition, at least 20 percent of the pre-school educational institutions will be using the new curriculum for pre-schools by 2017.

Monitoring and evaluation

55. **High quality, reliable, and frequently available data is critical for monitoring outcomes and the effectiveness of government spending.** In Georgia, the national statistical office (Geostat) is responsible for collecting data on labor market outcomes (unemployment, underemployment), poverty, and other socioeconomic outcomes.[16] Each year, Geostat collects data on these topics through an integrated household survey. The data on the socioeconomic indicators are published annually and made available through the Geostat website. Geostat is also responsible for organizing and conducting population and housing census.

56. **Timely collection of population and housing census ensures high quality of survey data on development outcomes; although censuses are recommended to be conducted at ten year intervals, Georgia's 2014 census took place after a gap of 12 years.** The last census in Georgia took place in 2002 and the next one, which was expected in 2012, got delayed and was conducted in November 2014 (results will be available by early 2016). The estimates of Georgia's population are computed annually, anchored in the last available census of 2002 and by making adjustments for births, deaths and net migration. As the 2013 Eurostat-led Global Assessment of Georgia's Statistical System pointed out, the absence of an updated census affects the quality of key indicators such as per capita GDP and birth and death rates. Another implication of outdated population census is deterioration in the quality of the sampling frame used to design the household survey – the main source of data on socioeconomic development outcomes.

57. **The current DPO series will support the amendments to the Law on Statistics aimed at ensuring timely implementation of future censuses, giving at least 3 years preparation time to Geostat prior to implementation.** The population census is implemented by Geostat and is governed by the Law

[16] The National Bank is the other official data producer under the Law on Statistics.

on Statistics (2009). The law outlines the key steps in implementing and processing the census but leaves the frequency of census unspecified. The date of the census is to be proposed by Geostat and approved through a governmental coordination commission on census (article 20). The amendments supported by this DPO series will help prioritize the census and safeguard financial resources for conducting this activity in the future. Preparation for the population census is a complex exercise and includes the development of detailed digital maps and questionnaires, field testing of questionnaires, comprehensive publicity campaign, recruitment and training of analysts, supervisors and field staff and the development and testing of procedures and programs for data processing and analysis. These are important pre-requisites to conduct a good quality population census which will serve as the base for an accurate count of the population, baseline data for planning in a large number of areas, basis for regional statistics and for developing the sampling frame for household surveys. Therefore, it is important to give adequate preparation time to Geostat and make the census data available in a timely manner.

58. **The DPO series will also support a split of the integrated household and labor force survey into two separate surveys, the adoption of a revised framework for both the surveys and the completion of the labor force survey using the revised framework.** Splitting the integrated survey into a household budget survey and a labor force survey will support the government in the implementation of its labor and employment policy and will also provide more robust and frequent data on labor force dynamics. In light of the 2014 census data, which will become available in early 2016, the DPO series will also support the adoption and implementation of a revised framework for the household survey and the labor force survey. This framework will include updating the sampling frame, increasing the sample size, improving the sampling design, and undertaking changes so as to improve the quality of all socioeconomic indicators and increase the frequency of collection and production of data on select indicators from annual to quarterly (mainly, labor market outcome indicators). Frequent and robust data on households' poverty status and employment/unemployment outcomes will enhance the quality of the government's monitoring of the effects of social spending and inform policy dialog.

59. **The proposed DPO1 supports the following prior action:**

- The Borrower's Cabinet has approved and submitted to the Parliament for approval thereby, a bill of law to amend the Law on Statistics No 2291/RS dated December 11, 2009, mandating the preparation time for the population census as three years, aiming to ensure census' timely implementation and the production of high quality survey data; as evidenced by the Borrower's Decree No. 346 Dated March 4, 2015.

60. **The proposed triggers for DPO2 and DPO3 are the following:**

- The borrower adopts a regulation to ensure that the census is conducted at least every 10 years.

- The GeoStat adopts a Board Resolution to (i) conduct a separate labor force survey; and (ii) adopt a revised framework for the household budget survey and the labor force survey to increase the sample size, improve the sampling design and publish data with higher frequency.

- The GeoStat completes the collection of data for the first month under the labor force survey using the revised framework.

Result: The expected result of these policy actions is to publish data on poverty and unemployment on a quarterly basis by 2017. Currently, only annual data on these indicators is available.

61. **The policy actions in the 2015-17 DPO series in Georgia are underpinned by substantive analytical work.** Details for the first operation are presented in Table 4 below.

Table 4: DPO Prior Actions and Analytical Underpinnings

Prior Actions	Analytical Underpinnings	Progress
	Pillar I	
Prior Action 1: The Borrower has amended the Budget Code to include revenues and expenditures of municipal governments, legal entities of public law and non-profit legal entities in the Public Financial Management Information System, as evidenced by the Borrower's Law No. 2935-Is dated December 12, 2014, which law is in full force and effect.	Georgia PEFA Assessment (2008) recommended improvements in the availability of systematic information on service delivery units. It also suggested that reporting should be carried out either through the accounting system or by routine data collection. Public Expenditure Review (2014) suggests that more effective fiscal management at the local level will require the institutionalization of an incentive mechanism to raise local revenues and reduce local expenditures.	**Fulfilled.**
Prior Action 2: The Borrower, through MoF, has registered the State Owned Enterprises (SOEs) in Georgia including those in the Partnership Fund and SOEs subsidiaries; as evidenced by the letter from the Borrower's Minister of Finance to the Bank, dated February 20, 2015.	Public Expenditure Review (2014) recommended the creation of a comprehensive SOE database to better monitor fiscal risks emanating from the SOE sector.	**Fulfilled**.
Prior Action 3: The Borrower has adopted the new Framework for Civil Service Reforms, as evidenced by the Borrower's Decree No 627 dated November 19, 2014 and published in the Legislative Herald on November 20, 2014.	Public Expenditure Review (2014) suggests that there is a need to regulate and unify the compensation policies in the public sector which vary very dramatically. In addition, improvements in public financial management will require investments in the capacity and skills of the public sector employees.	**Fulfilled.**
	Pillar II	
Prior Action 4: The Borrower, has adopted a new methodology for the Targeted Social Assistance (TSA) to improve targeting and coverage of the poor, pursuant to the Borrower's Resolution No 758 dated December 31, 2014 and published in the Legislative Herald on the same date.	Georgia Demographic Change: Implications for Social programs and Poverty (2012) recommended improvements in the coverage of social safety nets and the need to ensure wider access to health care services. Public Expenditure Review (2012, 2014) also recommended improvements in the targeting of social spending and the need to avoid work disincentives.	**Fulfilled.**
Prior Action 5: The Borrower, through MOLHSA has established a requirement whereby the issuance of a physicians' prescription is required for the purchase of certain pharmaceutical products, to promote the rational use of medicines, as evidenced by the Borrower's Order No 01-53/n dated July 18, 2014 and published in the Legislative Herald on the same date.	Public Expenditure Review (2012) recommended higher coverage under the medical insurance plan and improvements in the quality of health care provided. Public Expenditure Review (2014) suggested covering more out-patient drugs to reduce out-of-pocket spending.	**Fulfilled.** **Fulfilled.**

Prior Actions	Analytical Underpinnings	Progress
Prior Action 6: The Borrower, through MOLHSA has mandated enhancements for the provision of obstetric and neonatal care across the Borrower's regions, to improve access to quality health care services before, during, and after, childbirth; pursuant to the Borrower's Order No 01-2/n dated January 15, 2015 and published in the Legislative Herald on the same date.		
Prior Action 7: The Borrower has amended the "Law on General Education" to: (i) include higher qualification requirements for entry into the teaching profession, and (ii) improve the regulation of teacher recruitment and professional development process; as evidenced by the Borrower's Law No. 2822-Is dated November 18, 2014, which law is in full force and effect. **Prior Action 8:** The Borrower has adopted the "Framework for Teachers' Entry into the Profession, Professional Development and Career Advancement Scheme", as evidenced by the Borrower's Decrees No 68,69,70,71,72,73,74,75,76,77, all dated February 20, 2015 and published in the Legislative Herald on February 23, 2015.	The Education Sector Policy Review (2014) suggested improvements in teaching quality through the development of a professional development scheme and provision of incentives to attract qualified professionals into teaching. Public Expenditure Review (2014) pointed out to the problem of the poor quality of teachers which was affecting students' educational outcomes. It recommended improvements in the quality of teachers and to make teaching a more attractive profession.	**Fulfilled**.
Prior Action 9: The Borrower's Cabinet has approved and submitted to the Parliament for approval thereby, a bill of law to amend the Law on Statistics No 2291/RS dated December 11, 2009, mandating the preparation time for the population census as three years, aiming to ensure census' timely implementation and the production of high quality survey data; as evidenced by the Borrower's Decree No. 346 Dated March 4, 2015.	Global Assessment of the National System of Official Statistics of Georgia (EFTA-Eurostat-UNECE, 2013) suggests that it is crucial to have up-to-date census information for good quality data. The South Caucasus Programmatic Poverty TA (2014) also recommended having up to date information on the census.	**Fulfilled.**

C. LINK TO CPS AND OTHER BANK OPERATIONS

62. **The current DPO series is an essential part of the CPS for 2014-17.** The CPS focuses on: (i) strengthening public service delivery to promote inclusive growth, and (ii) enabling private sector-led job creation through improved competitiveness. The current DPO series supports the first pillar of the CPS on strengthening public service delivery while the second pillar of the CPS is supported by another DPO in Georgia on enhancing private sector competitiveness. The CPS for 2014-17 is fully consistent with the government's socioeconomic development strategy and the Basic Data and Directions (2015-18).

63. **The proposed DPO builds on previous Bank operations and complements existing operations by supporting improvements in key sectors.** The policy dialogue underlying the proposed operation was greatly facilitated by the previous two DPO series, the 2005-08 Poverty Reduction Support Credits, and technical assistance provided by the bank in various sectors like education, public financial management and strengthening of monitoring and evaluation systems. The current portfolio of Bank investment projects

in Georgia is concentrated on transport and urban development. International Finance Corporation (IFC) investments are largely in the areas of airport infrastructure, hydro power, real estate, banks, agriculture, and micro-finance. In addition, IFC is also providing advisory services on taxation, customs and investment legislation.

D. CONSULTATIONS, COLLABORATION WITH DEVELOPMENT PARTNERS

64. **The government has undertaken broad-based consultations with all relevant stakeholders on many of the prior actions supported by this operation.** This is particularly relevant for the education, social protection, and civil service reforms related prior actions where extensive consultations and outreach activities were held by the government. On the other prior actions, the consultations were limited to main stakeholders, largely within the government. In addition, the Bank team has met with civil society organizations (CSOs) and has continued this engagement through sectoral work, especially in the areas of public financial management, education, and social protection.

65. **The Bank has active collaboration with the UNICEF and the EU on their programs.** The EU is providing both financing and technical assistance on public financial management (program budgeting) and civil service reforms in the context of the AA. The German Federal Enterprise for International Cooperation (GIZ) is also helping the government with public financial management (PFM) issues while the United Nations Development Program (UNDP) has also been engaged in civil service reforms. The United Nations Children's Fund (UNICEF) has been actively involved in the strengthening of the methodology to calculate TSA, in close collaboration with the Bank. In addition, the Asian Development Bank (ADB) has also provided budget lending to the Government of Georgia and is supporting the government in the development of a medium-term debt management strategy.

V. OTHER DESIGN AND APPRAISAL ISSUES

A. POVERTY AND SOCIAL IMPACT

66. **The probability of being poor or among the bottom 40 percent is strongly associated with labor market status, gender and limited access to economic opportunities.** The poor and those in the bottom 40 percent are more likely to live: (i) in larger households with greater number of dependents, and headed by someone with less than secondary education and/or a woman; (ii) in households suffering larger unemployment and inactivity rates, and headed by a self-employed individual; and (iii) in rural areas. Furthermore, Georgia has one of the highest incidences of Internally Displaced People (IDPs) in the world (estimated at 5.6 percent of the population). Rates of employment and economic self-reliance are low among IDPs. More than 17 percent of IDPs are unable to afford nutrition or suffer from systematic starvation while only 48 percent claim average or above average nutrition levels. [17]

67. **The overall poverty, social, and gender impact of the actions supported by this operation are expected to be positive.** In particular, the change in the TSA calculation formula will most likely be positive as the coverage of the TSA will increase to include individuals who do not currently benefit but should and also by providing a greater level of benefit to the very poor (a large proportion of which are female-headed households). However, there will also be better-off households which will no longer receive TSA and an assessment of their welfare should also be weighed in. The adoption of enhanced obstetric and neonatal care will have a positive distributional and gender impact. It will improve the standards for the provision of obstetric and neonatal care, which can impact positively on the incidence of maternal and infant mortality and on the incidence of other complications related to childbirth. It will also have a positive

[17] World Bank, 2013, "Supporting the Livelihoods of Displaced Persons in Georgia."

gender impact through improved health outcomes for women. The adoption of the civil service reform can potentially have a positive gender effect, depending on the specific actions that will be implemented. The framework for civil services stipulates that the government will provide equal opportunities for men and women in the civil service cadre. The proposals for amending the law on statistics will also have a positive distributional impact, although not directly. The effect will come through a better government monitoring and evaluation system which should lead to better targeted and more effective social policies. A summary of these effects is presented in Table 5.

Table 5: Summary of Poverty, Social, and Gender Impacts

Prior Actions	**Expected Distributional, Social, and Gender Impact of Reforms**
Pillar I	
Prior Action 1: The Borrower has amended the Budget Code to include revenues and expenditures of municipal governments, legal entities of public law and non-profit legal entities in the Public Financial Management Information System, as evidenced by the Borrower's Law No. 2935-Is dated December 12, 2014, which law is in full force and effect.	Distributionally-neutral
Prior Action 2: The Borrower, through MoF, has registered the State Owned Enterprises (SOEs) in Georgia including those in the Partnership Fund and SOEs subsidiaries; as evidenced by the letter from the Borrower's Minister of Finance to the Bank, dated February 20, 2015.	Distributionally-neutral
Prior Action 3: The Borrower has adopted the new Framework for Civil Service Reforms, as evidenced by the Borrower's Decree No 627 dated November 19, 2014 and published in the Legislative Herald on November 20, 2014.	Distributionally-neutral. Positive gender impact by providing men and women with equal opportunities in the service.
Pillar II	
Prior Action 4: The Borrower, has adopted a new methodology for the Targeted Social Assistance (TSA) to improve targeting and coverage of the poor, pursuant to the Borrower's Resolution No 758 dated December 31, 2014 and published in the Legislative Herald on the same date.	Positive distributional impact via increase in TSA coverage and assistance for the very poor, many of which are female-headed households.
Prior Action 5: The Borrower, through MOLHSA has established a requirement whereby the issuance of a physicians' prescription is required for the purchase of certain pharmaceutical products, to promote the rational use of medicines, as evidenced by the Borrower's Order No 01-53/n dated July 18, 2014 and published in the Legislative Herald on the same date. **Prior Action 6:** The Borrower, through MOLHSA has mandated enhancements for the provision of obstetric and neonatal care across the Borrower's regions, to improve access to quality health care services before, during, and after, childbirth; pursuant to the Borrower's Order No 01-2/n dated January 15, 2015 and published in the Legislative Herald on the same date.	Distributionally-neutral Positive distributional impact via reduction in maternal and neonatal mortality. A positive gender impact as well through improvements in the health condition of women and reduction in maternal mortality.
Prior Action 7: The Borrower has amended the "Law on General Education" to: (i) include higher qualification requirements for entry into the teaching profession, and (ii) improve the regulation of teacher recruitment and professional development process; as evidenced by the Borrower's Law No. 2822-Is dated November 18, 2014, which law is in full force and effect.	Distributionally-neutral. Distributionally-neutral.

Prior Actions	Expected Distributional, Social, and Gender Impact of Reforms
Prior Action 8: The Borrower has adopted the "Framework for Teachers' Entry into the Profession, Professional Development and Career Advancement Scheme", as evidenced by the Borrower's Decrees No 68,69,70,71,72,73,74,75,76,77, all dated February 20, 2015 and published in the Legislative Herald on February 23, 2015.	
Prior Action 9: The Borrower's Cabinet has approved and submitted to the Parliament for approval thereby, a bill of law to amend the Law on Statistics No 2291/RS dated December 11, 2009, mandating the preparation time for the population census as three years, aiming to ensure census' timely implementation and the production of high quality survey data; as evidenced by the Borrower's Decree No. 346 Dated March 4, 2015.	Positive distributional impact via better monitoring capacity of population living conditions.

B. Environmental Aspects

68. **The proposed prior actions for the first operation carry no environmental risks because they will not cause any direct or indirect negative impact on the natural environment.** The prior actions under the first pillar include changes in the public financial management information system, establishment of a register of the number of SOEs and the adoption of the framework for civil service reforms. None of these measures is likely to have any environmental impact. The prior actions under the second pillar include revision to the TSA methodology, the introduction of the requirement to have a doctor's prescription for certain drugs, enhancement of obstetric and neonatal care, amendments to the law on education, adoption of the framework for teacher professional development and the amendment of the law on statistics. These actions are also unlikely to have any environmental impact.

C. PFM, Disbursement and Auditing Aspects

69. **The public financial management risks in Georgia are acceptable for this operation.** The 2012 Public Expenditure and Financial Accountability (PEFA) showed significant improvements in the country's budgetary and financial management systems compared with the 2008 PEFA. The basic set of systems for strategic budget planning, budget formulation and execution has been put in place. Government budgets are published on the MOF website. The integrated public financial management system has been fully implemented. Significant progress has been made in the area of program budgeting with assistance from the EU. All state financial transactions have been unified under a single treasury account. The previous DPO series supported the government's efforts at moving to modified cash basis IPSAS and increased coverage and transparency of the budget with an emphasis on the e-budget. The 2012 consolidated financial statements prepared by the Treasury were in line with modified cash basis IPSAS and were published on the Treasury's website. The current DPO will further strengthen the public financial management arrangements by including the expenditures of municipalities in the treasury single account and also integrating municipalities with the central financial management information system.

70. **The State Procurement Agency continues to improve transparency in public procurement processes by adopting international standards.** The Law on State Procurement was enacted in 2009 and provides a good legal framework for second generation reforms, including introduction of e-procurement. The unified e-procurement system was launched in 2010 and a user manual was developed to ensure effective functioning. All documents needed in the process of public procurement are uploaded into the system electronically which makes them accessible to all interested parties. The current system has reduced the volume of paperwork and has increased transparency. In addition, the state procurement agency recently modified the e-procurement system to meet the procurement needs of multilateral development banks. As

a result, the government's e-procurement system is being used for Bank projects using the national competitive bidding process for contracts estimated to cost less than US$10 million for civil works, US$1 million for goods, and US$100,000 for simple goods following shopping procedures.

71. **As per the August 2014 IMF staff report for a SBA, the NBG's foreign exchange management system and safeguards are adequate.** The September 2014 safeguard assessment showed that NBG's overall governance framework is broadly appropriate. Since 2009, the majority of the NBG's systems have been upgraded, and many key operations are now largely automated. Controls have been strengthened in key areas relevant to safeguards, in particular foreign reserves management, government banking, and currency and vault operations. The *de facto* and *de jure* exchange rate arrangement in Georgia is floating. Although the NBG intervenes in the foreign exchange market, it does not make a commitment on the exchange rate target. The March 2013 amendment to the 2010 agreement between the NBG and Treasury Service of the Ministry of Finance ensures that foreign exchange transactions between the government and the NBG are priced at the market exchange rate of the day when the foreign exchange order is submitted to the NBG.

72. **Borrower and credit amount:** The Borrower will be Georgia. Upon effectiveness of the Financing Agreement, which is subject to ratification by Parliament, the proposed IBRD loan of US$60 million will be made to Georgia, represented by the Ministry of Finance. The IBRD loan will have a maturity of 25 years including a 14-year grace period.

73. **Disbursement:** The proposed DPO will be disbursed in US dollars into the Treasury department's foreign currency account maintained at the NBG. The disbursed proceeds of this development policy operation will form part of the country's official foreign reserves. The recipient, the Government of Georgia, shall ensure that upon deposit of the loan proceeds into the said account, an equivalent amount in Georgian Lari (GEL) at the official exchange rate will be deposited within 30 days of disbursement in the Treasury Single Account in the NBG and accounted for in the Recipient's budget management system. The proceeds of the operation deposited at the Treasury Single Account with NBG will be available to finance budget expenditures. The Ministry of Finance will be responsible for the operation's administration, for preparing the withdrawal application, and for maintaining the Treasury Foreign Currency Account at the NBG. The Ministry, with the assistance of the NBG, will maintain records of all budget transactions under DPO1 in accordance with sound accounting practices.

74. **Confirmation and eligible expenditure:** The Ministry of Finance will provide to the Bank a confirmation that the amount of the operation has been credited to an account that is available to finance budget expenditures (the format of the confirmation letter should be acceptable to the Bank). This confirmation letter is required within 30 days of receipt of the amount. If, after the proceeds are deposited in the NBG account, the proceeds of the operation are used for ineligible purposes as defined in the Loan Agreement and the Financing Agreement, the Bank will require the Government of Georgia to promptly, upon notice from the Bank, refund an amount equal to the amount of said payment to the Bank. Amounts refunded to the Bank upon such request shall be cancelled.

75. **Reporting, auditing and closing date:** Given the improvements in Georgia's public financial management system, the IMF's positive assessment of the NBG, and unqualified audit opinions in the NBG's recent financial statements, no additional fiduciary arrangements including audit will be required for the proposed DPO. Audits of the earlier Poverty Reduction and Support Operations were also unqualified and revealed no issues of concern. There were also no audit requirements under the previous DPO series. The closing date of the proposed credit will be December 31, 2015.

D. MONITORING, EVALUATION AND ACCOUNTABILITY

76. **The Ministry of Finance leads the effort in coordinating the overall implementation of the DPO program.** The Deputy Minister of Finance is the main counterpart for this operation and he coordinates with all the line ministries which are involved in the DPO series. The line ministries submit progress reports on the prior actions and result indicators to the Ministry of Finance as and when requested. Given the long history of budget lending operations in Georgia, some institutional capacity and memory has been built up on data requirements for monitoring. While there are some variations between line ministries, in general, they have the capacity to provide good and timely data when needed.

77. **Regular reviews are carried out by the Bank team to monitor progress on the reforms during supervision missions.** Data for monitoring is generally available through special requests made to the respective ministries and is reliable. Macroeconomic data is available through the statistical agency. Georgia subscribed to the IMF's Special Data Dissemination Standards (SDSS) in 2010 and is a compliant country. As a result, timely and good quality data is readily available through the NBG, MOF, and the National Statistics Office.

78. **Grievance Redress**. Communities and individuals who believe that they are adversely affected by specific country policies supported as prior actions or tranche release conditions under a World Bank Development Policy Operation may submit complaints to the responsible country authorities, appropriate local/national grievance redress mechanisms, or the WB's Grievance Redress Service (GRS). The GRS ensures that complaints received are promptly reviewed in order to address pertinent concerns. Affected communities and individuals may submit their complaint to the WB's independent Inspection Panel which determines whether harm occurred, or could occur, as a result of WB non-compliance with its policies and procedures. Complaints may be submitted at any time after concerns have been brought directly to the World Bank's attention, and Bank Management has been given an opportunity to respond. For information on how to submit complaints to the World Bank's corporate Grievance Redress Service (GRS), please visit http://www.worldbank.org/GRS . For information on how to submit complaints to the World Bank Inspection Panel, please visit www.inspectionpanel.org

VI. SUMMARY OF RISKS AND MITIGATION

79. **The main risks to the operation and mitigating measures are summarized below (table 6).**

(i) Political and governance risks

- **Political instability would weaken program performance; in addition, geopolitical risks remain elevated.** After some changes in key ministerial positions in November 2014, the government is stable and no further changes are expected. Political risk is mitigated by the government's demonstrated commitment to the reforms under this new DPO series. The Bank team is in constant dialog with the authorities to ensure that the reform measures supported by this operation are sustained. There has been a recent escalation of tensions in the broader region which adds to geopolitical risks.

(ii) Macroeconomic risks

- **Low growth, a large current account deficit, high unemployment, and fiscal pressures are the main risks to the economy.** With a contraction in the Russian economy and a slowdown in the neighboring countries, Georgia's growth prospects have also been revised downwards. Most of the impact on Georgia has been through lower export demand and a fall in remittances. Given its low domestic savings, a large part of the growth in Georgia is financed through foreign savings, particularly FDI. Most of the FDI flows in from the European countries which are also seeing slower growth. Hence, there could be further downsides to economic expansion in Georgia. This risk is mitigated, to an extent, by the structural reforms being undertaken by the government to improve competitiveness and the investment climate and the government's efforts to maintain macroeconomic and policy stability. On the external front, the country continues to be vulnerable given its high current account deficit (because of reliance on foreign savings) coupled with prospects of lower export demand and lower remittances, high level of dollarization, large external debt, and low level of reserves which is heightening foreign exchange risks. A further depreciation of the lari would increase the cost of servicing foreign-currency denominated debt. In addition, disturbances in some of Georgia's key export markets and longer-term stagnation in the EU could further impact external performance. The main channels of transmission of external disturbances are through lower FDI, exports, remittances and other capital inflows, and this could impact overall macroeconomic stability, a pre-condition for program performance. Mitigating factors include a flexible exchange rate policy, the IMF SBA, market access, and good relationships with donors who could be approached for additional funding, if needed. Fiscal risks could emanate from further increasing the scope of public health services and ineffective use of the increased budget allocation to social benefits. This could impact program performance in terms of the population effectively covered by publicly funded health and social sector programs. In addition, low net job creation even during high-growth periods led to high and sustained unemployment levels in the country which in turn have had a negative impact on poverty and shared prosperity. Mitigating factors include continuous dialog with and technical assistance from the World Bank and other donors in the health and social assistance sector, and the IMF's SBA which aims to support the government's economic program to reduce macroeconomic vulnerabilities. The government's commitment to efficient public financial management and fiscal consolidation over the medium-term while maintaining capital expenditures, and adherence to Georgia 2020, which focuses on increasing competitiveness, human capital development and access to finance, will help address medium- to long-term growth and employment concerns. This will also ensure that Georgia reaps the benefits from the DCFTA.

(iii) Institutional capacity for implementation and sustainability

- **Weak implementation capacity, especially in the line ministries, could undermine the benefits of the reforms.** Implementation of this DPO series spans several ministries and capacity is limited in some of them. This risk has been mitigated through technical assistance provided by the World Bank and other development partners. Donor supported programs are providing assistance in key policy areas covered by this DPO series like the social sector (World Bank and UNICEF), public financial management (World Bank and the EU), civil service reforms (EU and UNDP) and statistics (World Bank, EU, Eurostat, and Net Official Flows from UN Agencies (UNECE)).

Table 6: Systematic Operations Risk Rating (SORT)

Category	Risk	Rating (High, Substantial, Moderate, Low)
1	Political and governance risk	Moderate
2	Macroeconomic	Substantial
3	Sector strategies and policies	Moderate
4	Technical design of project or program	Low
5	Institutional capacity for implementation and sustainability	Moderate
6	Fiduciary	Low
7	Environment and social	Low
8	Stakeholders	Moderate
9	Others: Geopolitical risks	Substantial
	Overall	Moderate

Source: Bank Staff

Annex 1: Policy and Results Matrix

	Prior Actions for DPO1 (Jan 2015)	Triggers for DPO 2 (Jan 2016)	Triggers for DPO 3 (Jan 2017)	Result Indicators (2017)
Pillar I: Strengthen Fiscal Oversight of Public Institutions, and Improve Budgeting and the Framework for Civil Service Reform				
Budget	The Borrower has amended the Budget Code to include revenues and expenditures of municipal governments, legal entities of public law and non-profit legal entities in the Public Financial Management Information System, as evidenced by the Borrower's Law No. 2935-Is dated December 12, 2014, which law is in full force and effect.	The Ministry of Finance establishes the framework for project appraisal, selection, budgeting, implementation and evaluation for investment projects costing more than an agreed threshold.	5 municipalities and 1 central ministry implement the adopted framework for project appraisal, selection, budgeting, implementation and evaluation of investment projects.	Availability of budget and execution data for municipalities, LEPLs and non-profit legal entities: Baseline: Quarterly (2013) Target: In real time (2017) Improved framework reflected in selection criteria for new projects in 6 municipalities and 2 central ministries: Baseline: Zero (2013) Target: 100% of new investment projects (2017)
State Owned Enterprises (SOEs)	The Borrower, through MoF, has registered the State Owned Enterprises (SOEs) in Georgia including those in the Partnership Fund and SOEs subsidiaries; as evidenced by the letter from the Borrower's Minister of Finance to the Bank, dated February 20, 2015.	The Ministry of Finance with support from the Ministry of Economy and Sustainable Development establishes an SOE financial database.	The Ministry of Finance incorporates a provision in the 2017 budget law to include the SOE fiscal risk assessment report to the annual budget in 2017 and after.	Availability of comprehensive financial data on SOEs: Baseline: not available (2013) Target: 2 years of data available (2017)
Civil service	The Borrower has adopted the new Framework for Civil Service Reforms, as evidenced by the Borrower's Decree No 627 dated November 19, 2014 and published in the Legislative Herald on November 20, 2014.	The civil service bureau issues an Order to begin public consultations on the proposed new Law on Civil Services.	The government adopts key secondary legislation to implement the law on civil services.	Pre-qualification test taken by first time entrants to the civil services according to the new hiring rules: Baseline: none (2013) Target: 100% of new entrants hired in 2017 (2017)
Pillar II: Improve the Coverage and Quality of Social Services and Strengthen Monitoring of Outcomes				
Social Protection	The Borrower, has adopted a new methodology for the Targeted Social Assistance (TSA) to improve targeting and coverage of the poor, pursuant to the Borrower's Resolution No 758 dated December 31, 2014 and published in the Legislative Herald on the same date.	The government adopts revisions to the TSA methodology based on the evaluation of the pre-testing.	The Ministry of Labor Health and Social Affairs rolls out the revised TSA methodology, based on an evaluation of the pre-testing, throughout the country.	Share of the bottom decile receiving TSA: Baseline – 60% (2013) Target – 75% (2017)
Health	The Borrower, through MOLHSA has established a requirement whereby the issuance of a physicians' prescription is required for the purchase of certain pharmaceutical products, to promote the rational use of medicines, as evidenced by the Borrower's Order No 01-53/n dated July	The Ministry of Labor Health and Social Affairs expands the list of outpatient medicines for TSA beneficiaries under the UHC package.		Pharmaceutical expenses as percent of OOP on health: Baseline: 38% (2012) Target: 36.1% (2016)

	Prior Actions for DPO1 (Jan 2015)	Triggers for DPO 2 (Jan 2016)	Triggers for DPO 3 (Jan 2017)	Result Indicators (2017)
	18, 2014 and published in the Legislative Herald on the same date.			
	The Borrower, through MOLHSA has mandated enhancements for the provision of obstetric and neonatal care across the Borrower's regions, to improve access to quality health care services before, during, and after, childbirth; pursuant to the Borrower's Order No 01-2/n dated January 15, 2015 and published in the Legislative Herald on the same date.	The Ministry of Labor Health and Social Affairs pilots the enhanced obstetric and neonatal care in 2 regions.	The Ministry of Labor Health and Social Affairs implements the enhanced obstetric and neonatal care throughout the country.	Reduce Maternal Mortality Rate: Baseline: 27.7 per 100,000 (2013) Target: 26.9 per 100,000 (2017)
Education	The Borrower has amended the "Law on General Education" to: (i) include higher qualification requirements for entry into the teaching profession, and (ii) improve the regulation of teacher recruitment and professional development process; as evidenced by the Borrower's Law No. 2822-Is dated November 18, 2014, which law is in full force and effect.	The Ministry of Education and Science completes the categorization of all general education teachers into the four categories based on qualifications, experience and certification. The Ministry of Education and Science adopts the credit accumulation manual for teachers.	The Ministry of Education and Science rolls out the teacher evaluation system using the classroom observation tool throughout the country.	Reduction in the proportion of teachers in Category 1: Baseline: 65% of teachers (2014) Target: 50% of teachers (2017)
	The Borrower has adopted the "Framework for Teachers' Entry into the Profession, Professional Development and Career Advancement Scheme", as evidenced by the Borrower's Decrees No 68,69,70,71,72,73,74,75,76,77, all dated February 20, 2015 and published in the Legislative Herald on February 23, 2015.	The Ministry of Education and Science approves the national standards and curriculum for pre-school education.	The Ministry of Education and Science approves the monitoring tools for pre-school curriculum implementation.	Number of pre-school educational institutions using the new pre-school curriculum: Baseline: None (2013) Target: 20% (2017)
Monitoring and Evaluation	The Borrower's Cabinet has approved and submitted to the Parliament for approval thereby, a bill of law to amend the Law on Statistics No 2291/RS dated December 11, 2009, mandating the preparation time for the population census as three years, aiming to ensure census' timely implementation and the production of high quality survey data; as evidenced by the Borrower's Decree No. 346 Dated March 4, 2015.	The borrower adopts a regulation to ensure that the census is conducted at least every 10 years. The GeoStat adopts a Board Resolution to (i) conduct a separate labor force survey; and (ii) adopt a revised framework for the household budget survey and the labor force survey to increase the sample size, improve the sampling design and publish data with higher frequency.	The GeoStat completes the collection of data for the first month under the labor force survey using the revised framework.	Publish data on poverty and unemployment: Baseline: Annual (2013) Target: Quarterly (2017)

Annex 2: Letter of Development Policy

PRIME MINISTER
OF GEORGIA

LETTER OF DEVELOPMENT POLICY

Georgia First Inclusive Growth and Private Sector Competitiveness Development Policy Operations

Tbilisi, March 3, 2015

Dear President Kim,

Allow me to begin by thanking the World Bank Group for strong support of Georgia's successful development efforts that have been underway in all the recent years. One of the main objectives of the government of Georgia as stated in our Socio-economic Development Strategy Georgia 2020 (Georgia 2020) is to identify key constraints to inclusive growth and define priority directions to eliminate them. To achieve this goal we have been focusing on ensuring private sector competitiveness, fostering human capital development and facilitating access to finance.

Our aim is to integrate with the European and international markets. We stand ready to design and implement reforms in compliance with the EU-Georgia Association Agreement (AA), including Agreement on Deep and Comprehensive Free Trade Area (DCFTA), which was signed in June 2014. AA envisages gradual approximation of Georgian legislation and systems with the European norms and best practices. DCFTA, which is in force since September 2014, opens new trade and investment opportunities and easier access to the EU market. The Government of Georgia adopted DCFTA Action Plan for 2014-2017, which includes all actions and measures to be implemented during this period. At the same time with the help of the donor community the government is taking steps to support the private sectors' adaptation to the DCFTA requirements. We recognize that a dynamic and vibrant private sector needs to be in the driver's seat with the state playing a facilitating role.

The reforms launched in 2004 were focused on market liberalization and resulted in economic growth but a number of challenges remain for achieving inclusive growth. As far as strong and competitive private sector plays a vital role in achieving sustainable economic development and inclusive growth, enhancement of private sector competitiveness is among the priorities of the Government of Georgia. Our Government is paying particular attention to improving the business environment, promoting savings mobilization, diversification of the financial sector as well as upgrading innovation, ICT sector and national quality infrastructure. These policies will help to achieve the goals of creating more and better jobs and promoting inclusive growth.

We have achieved several milestones in transforming Georgia into a modern democracy with increased accountability and transparency. The parliamentary elections in 2012, the Presidential elections in 2013, followed by local elections in 2014, marked the country's first democratic transfer of power. We are continuing the reforms on anti-corruption measures, aiming at further strengthening governance mechanisms. As a result of past reforms, Georgia has made a substantial improvement in Corruption Perception Index ranking 50th in 2014 as opposed to 133rd ten years ago.

Yet, global economic outlook remains uncertain. We thus need to continue building safety buffers to make sure that macroeconomic stability, which is one of the key preconditions of our strategy, is preserved. To this end, we are on the right track with our policy of fiscal consolidation and we continue to manage our public debt in a conservative manner. With these policies we will maintain adequate fiscal space to react if needed on exogenous shocks. We undertook significant reforms to reinforce public financial management, improve business environment and social services. Public expenditures were reprioritized since 2013. Expenditures on education, health and social protection were scaled-up with the fiscal space for these increases coming from the reduction of non-recurrent expenditures. At the same time revenue collections improved. The resulting lower fiscal deficits allowed us to sustain favorable public debt situation. According to rapid estimation, in 2014 real GDP growth is 4.7 percent despite challenging external environment, with solid performance across the board.

Since 2012 we have successfully implemented several reforms aimed at increasing competitiveness of the Georgian economy, and we will roll out further reforms in coming years to further improve the business environment, strengthen the financial sector and increase private sector capacity to innovate and export. Along these lines, we have suggested including a number of important reform measures in the Private Sector Competitiveness Development Policy Operation, which targets our most urgent development needs.

We are taking significant steps to foster second-generation business environment reforms and to establish a closer public-private dialogue and communicating the expected results of the reform to the public and stakeholders to build trust in reforms and make policymaking more inclusive. The Economic Council under the Prime Minister was created in 2013 and plays a crucial role in providing a forum to discuss economic policies with stakeholders before these are considered by the Government and Parliament and strengthen intra-governmental coordination during the design and implementation of critical reforms. We are establishing Investors Council, which will serve as a platform for dialogue between government and business community and aims at improving the business environment and investment climate. Another important initiative in this area is our plan of introducing Regulatory Impact Assessments (RIA) for priority economic legislation.

We have prioritized SME development as we expect this to be the main source of private sector growth, jobs creation and innovation. In February 2014, the Entrepreneurship Development Agency (EDA), the first public entity solely dedicated to supporting the development of private sector, increasing competitiveness of SMEs and facilitating export activities was established. EDA will play a crucial role in creating a favorable business environment for SMEs through the provision of various non-financial support schemes and financial instruments aimed at business development, enhancement of its competitiveness and export promotion. For facilitation of economic activities in the regions, new program, which considers provision of matching grants together with consultancy services for micro and small businesses in the regions was launched. To enhance results, EDA is planning to regularly evaluate the effectiveness of its programs. To further strengthen SME development, Government of Georgia, in close cooperation with OECD is preparing a medium-term SME development strategy and action plan.

The Government has achieved significant progress in the field of state procurement during previous years. Owing to continuous upgrading, Georgia's State Procurement Agency (SPA) is already a regional leader in integrating modern procurement practices. A transparent electronic procurement system makes public tenders largely available for everyone to submit bids and considerably simplifies the procurement procedures. SPA is currently putting its efforts to raise awareness of contracting authorities and suppliers, especially SMEs, as well as improve procurement practices and review the tendering techniques and legal framework to bring them in compliance with the EU legislation and best practices according to DCFTA.

The Government is committed to creating an effective competition policy and an institutional framework that promotes competition in key product markets. Developing an effective competition policy is one of the priorities of Georgia 2020 and a commitment under the DCFTA. The Georgian Competition Agency (GCA), as an independent institution was established in early 2014 following the adoption of amendments to the Law on Free Trade and Competition, which had been supported by the World Bank under the previous Development Policy Operations. The GCA is working on further approximation of competition policy framework with the European best practices.

In the financial sector, the Government is taking important steps to deepen and diversify the financial services available to the population and companies, and strengthen financial safety nets. Government efforts will help to develop financial markets, accumulate longer-term savings, and social protection. Under the AA, we are committed to creating a Deposit Insurance System (DIS) to increase the confidence of depositors and investors and deepen the savings market. We are also planning to further approximate insurance legislation with the EU directives according to AA to facilitate sector development and strengthen institutional capacity of the insurance regulator.

Pension reform is a critical element of the economic reform agenda, as it will improve the social safety nets and support fiscal stabilization. In March 2013, an interagency working group on comprehensive pension reform was established by Government of Georgia's decision. Working Group is chaired by the Vice Prime Minister, Minister of Economy and Sustainable Development of Georgia (MoESD). A pension reform unit created at the MoESD started operation in 2014. It will design the changes in the pension system and build consensus among stakeholders. Capital markets development is a complementary reform area as it will support the pension reform and improve access to capital for Georgian enterprises. Once the strategy for capital market development is ready, the Government will prepare a package of legislation to promote the development of a more vibrant capital market that can improve access to new financial instruments.

We are also enhancing the financial reporting systems and collateral registries to make it easier for firms, and especially SMEs, to access credit. The Accounting and Auditing Law that was adopted in 2012 significantly strengthens the statutory framework for accounting and auditing. The Georgian law governing secured transactions incorporates many modern features, and scores well in the World Bank's Doing Business Report 2015. In addition, Georgia has an efficient immovable collateral registration regime. National Agency of Public Registry under the Ministry of Justice of Georgia is working on strengthening secured transactions on movable property regime, in accordance with international best practices.

Wide-ranging efforts to spur investment and raise productivity are accompanied by longer-term measures that will increase firms' capacity to innovate and to export. In February 2014, the Georgian Innovation and Technology Agency (GITA) was established with the aim of implementing the Government's innovation policy reforms and providing services and programs to intensify the innovation process in Georgian companies and academia. To achieve this goal, GITA will be providing financial support (matching grants) and non-financial support (Technology Park, venture accelerator, innovation and fabrication laboratories, education programs) to the most promising entrepreneurs and companies. One of the most important results in this area will be faster knowledge transfer and technological absorption by Georgian firms, establishment of connections between scientific and business circles, orienting Georgian exports towards high-tech products.

We are putting significant efforts in improving the efficiency, affordability and regional access of telecommunication services. Parliament approved amendments to the Electronic Communications Law in 2014 to enable upgrading of mobile broadband from 3G to 4G and promote competition in the telecommunications market. We believe that widespread availability of high-quality broadband Internet connectivity can underpin Georgia's transformation into a knowledge-based economy.

Significant reforms have taken place to modernize the Georgia's National Quality Infrastructure. Through the investments in the Georgian National Agency for Standards and Metrology and institutional strengthening, which have led to international recognition of its calibration and measurement capabilities in several fields, companies in Georgia will reduce their costs of entering new export markets. In parallel, the Georgian Accreditation Center, which is an associate member of the EA, is modernizing its regulatory framework in line with European best practices, which will further increase the quality of services for exporters. These actions will help companies in Georgia to benefit from the steps taken towards European integration, and reduce technical barriers to trade.

In addition, through the Inclusive Growth Development Policy Operation, we are undertaking several measures to strengthen macroeconomic management and Georgia's human capital.

The Government is adopting measures to further strengthen public financial management through improved accountability, broader coverage and greater transparency of the government's fiscal accounts. In particular, we amended the budget code to integrate Legal entities of Public Law (LEPLs), non-entrepreneurial (non-commercial) legal entities (NELEs) and local municipalities into the system of Single Treasury Account (STA). Our in-house IT system and relevant modules were fully upgraded to handle budgets of over 600 newly defined budgetary entities at the budget planning and execution phase. This reform will support the strategic allocation of available public resources to finance state's priorities and create long-term stable funding package to finance those priorities. To manage existing resources better, we will also adopt improved capital budgeting guidelines.

In order to improve fiscal management we will continue strengthening our macro-fiscal analysis and forecasting capacity. We introduced the information annex on macroeconomic risks to the Budget Law 2015 for the first time and estimated upsides and downsides that would affect key macro variables that are statistically significant for fiscal management. Going forward we plan to enhance the analysis of the fiscal risks by assessing contingent liabilities stemming from the State Owned Enterprises (SOEs) and attaching an SOE risk assessment report to each year's budget as an annex. Over the last decade, the Government has successfully transformed a loss-making, heavily indebted large state-owned enterprises sector into a profitable, growing segment of the economy. Building on these successful reforms our government will streamline the accounting and monitoring mechanisms to aggregate the financial and non-financial information of the whole SOEs sector contributing to the quality fiscal risk assessments.

Creation of the effective and comprehensive civil service system is an integral part of our public sector reform agenda as it echoes to our commitment to integrate into the European and Euro Atlantic structure. Georgia took a firm commitment to create a civil service model that would ensure more transparency and effectiveness of public sector. The new law that is under development will be adopted soon and will be based on international best practices. The support of international partners was critical for us in developing and approving the conceptual framework for civil service reform. As a result we already made good progress in strengthening the mandate of the civil service bureau, its capacity and infrastructure. A number of regulations were issued to support initial steps for these changes. We will continue our efforts to establish an efficient regulatory and institutional framework for the efficient civil service system by adopting and implementing the amended Civil Service Law.

Georgia has developed strong and well-targeted social safety nets including both the targeted social assistance program (TSA) and the Universal Health Care system (UHC). While advancing on fiscal consolidation front we have been able to maintain and even expand spending levels on health, social assistance programs and education to ensure that our objectives of protecting vulnerable groups of population are not compromised. As part of these efforts we are increasing coverage and improving targeting of the TSA program through the introduction of a new methodology that is based on differential benefit packages, reduced subjective judgment and improved social information management system. We therefore expect to reduce the poverty gap considerably and improve the coverage of the bottom decile from 60 to 75 percent over the next 2 years. In addition, work disincentives, if any, will be discouraged through the adoption of specific measures. We are also improving further the Universal health care (UHC) program that was introduced by the government in February 2013 by including certain drugs in the package, initially for TSA beneficiaries. This will help to address, among others, the problem of high out-of-pocket medical spending by households. In addition, the Ministry of Labor Health and Social Affairs has also introduced the requirement to have a doctor's prescription for the purchase of certain drugs to promote the rational use of medicines. We expect this measure to considerably reduce self-medication practice in Georgia. We plan to improve the quality of healthcare services before, during and after childbirth through establishing effective functional links between different levels of perinatal services and ensuring adequate management of obstetric and neonatal diseases, complications and emergencies.

We are committed to boost employment generation and support the formation of innovation-based economy. Our Strategy of Georgia 2020 identifies a number of main priorities for further development of education and research. These broad objectives include improving the quality and accessibility of education, increasing motivation and qualification of teachers, increasing participation in preschool and vocational education and training sector, improving learning outcomes for students, and supporting internationalization of higher education. In particular, we have developed a new teacher policy framework aimed at attracting high-caliber teachers into the profession and supporting professional development of the existing teaching force. We will implement the new Teacher Recruitment, Evaluation and Professional Development scheme to ensure that Georgian students will benefit from better teaching and learning environment. The Government is committed to both improving equity in access to quality of preschool education and therefore, the future reform efforts will focus on adoption of national preschool education curriculum and introduction of instruments to monitor preschool curriculum implementation across the country.

Georgia's 2014 census took place after a gap of 12 years and it has immense implications for policy making and the accuracy of indicators that we set to monitor and evaluate outcomes of the reforms under Georgia 2020. A review of the sampling frame for the household survey and respective analysis is underway to develop a new common survey framework for Georgia. As part of this new framework we plan to conduct two separate surveys, the household survey and the labor force survey, and adopt a revised framework for both of them. The objective is to increase the sample size, improve the sampling design and publish data with higher frequency. Meanwhile we are mindful of the UN recommendation to conduct census at ten year intervals. Therefore going forward we plan to make the census timely, implementing it at least every ten years, and to specify a minimum pre-census preparation time, which is required for the preparation of detailed digital maps, developing and extensive field testing of questionnaires, a comprehensive publicity and public relations program, the recruitment and training of enumerators, supervisors and other field staff and the development and testing of procedures and programs for data processing and analysis. Going forward, we will conduct two separate surveys – the household survey and the labor force survey – and will also adopt a revised framework for both the survey to strengthen evidence-based policy making.

We deeply appreciate the support of the World Bank in the implementation of the strategic actions outlined above. We are looking forward to our continued successful partnership with the World Bank, including cooperation in the context of the proposed two development policy operations.

Allow me, Mr. President, to take this opportunity and extend my regards and esteem.

Sincerely,

Irakli Garibashvili

Mr. Jim Yong Kim
President of the World Bank
Washington, DC

Annex 3: Fund Relations

IMF Executive Board Completes First Review of Stand-by Arrangement with Georgia, and Approves US$58.1 Million Disbursement

Press Release No. 14/597

December 19, 2014

The Executive Board of the International Monetary Fund (IMF) today completed the first review of Georgia's economic performance under the three-year Stand-By Arrangement (SBA). The completion of the review enables the disbursement of SDR40 million (about US$58.1 million), bringing total disbursements under the arrangement to SDR80 million (about US$116.3 million).

The Board's decision was taken without a meeting.[1] The SBA with a total access of SDR100 million (about US$145.4 million) was approved by the Executive Board on July 30, 2014 (see Press Release No. 14/377).

Despite a challenging external environment, macroeconomic developments in 2014 continue to be in line with the program. Growth of 5 percent is expected, helped by strong domestic demand and the fiscal expansion. Inflation has gradually increased but remains below the target of 6 percent for 2014. The current account deficit has widened to 8.5 percent of GDP as expected with this year's economic recovery. Although fiscal policy remains supportive to growth, the fiscal deficit is expected to come in lower than the 3.7 percent of GDP projected in the program.

Program performance is on track with all criteria and indicative targets met as of the end-September 2014 test date. Inflation has also been well within the bands set by the program. However, the study of possible obstacles to access to finance was not completed by September as expected under the program. It will instead be completed in 2015, to allow more time to incorporate inputs from key development partners and to make a deeper assessment.

The program's strategy of medium-term fiscal consolidation, inflation targeting with central bank independence, strengthening resistance to external shocks and improved competitiveness remains appropriate. Structural reforms remain essential to sustain growth. The authorities continue to be committed to fiscal adjustment, as evident by a 2015 budget that reduces the deficit to 3.0 percent of GDP. External adjustment remains a priority, and the flexible exchange rate regime helps to preserve competitiveness, as exchange rates in partner countries adjust. Although there are downside risks, the recent fall in oil prices could boost growth and reduce the current account deficit.

[1] The Executive Board takes decisions under its lapse of time procedure when it is agreed by the Board that a proposal can be considered without convening formal discussions.