

## **Budgeting in Georgia**

*by*

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*Following the Rose Revolution of November 2003, the government of Georgia has undertaken large reform initiatives in the area of fiscal policy. These efforts have focused on taxation, tax administration, and the budget process, including cash and debt management. A new budget system law became effective in January 2004, establishing a comprehensive framework for the functions and responsibilities of the Ministry of Finance and the spending agencies via a two-stage prioritisation process guided by the annual “Basic Data and Directions” document. A medium-term expenditure framework was introduced in the budget formulation for 2006, in line with the strategic development plan established by the Ministry of Finance in 2004. Budget execution is characterised by flexibility in spending, control of the cash flow, the use of regional treasuries for the quarterly appropriations to all budget users, and arrangements for service delivery at the central level partly in regular ministerial departments and partly in public law entities. The sub-national government sector is small but could grow through the continuing process of decentralisation. The article concludes with a discussion of accounting policies and procedures, the role of the Chamber of Control for external audit, and the need to develop internal control.*

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## Preface

This review of the Georgian budget system was carried out as part of the Budget Project of the Working Party of Senior Budget Officials of the OECD. The Budget Project aims to initiate and foster regional networks of Senior Budget Officials outside the OECD area. This review served as a basis for the examination of the Georgian budget system at the second meeting of the network of Senior Budget Officials of Central, Eastern and South Eastern Europe (SBO CESEE), held 16-17 February 2006 in Ljubljana. German Technical Cooperation (GTZ) is gratefully acknowledged for its contribution to the review and for its financial support.

The review was carried out in two stages. An initial draft of the review was written by Mr. Michael Ruffner (then at the OECD Secretariat) with the support of Mrs. Anke Scholz (from German Technical Cooperation, GTZ) in connection with a project appraisal mission of GTZ to Tbilisi in late 2004. That mission met with Mr. Roman Gotsiridze, President of the Parliamentary Budget Committee, Mr. Zurab Nogaideli, the Minister of Finance at that time, Mr. Lasha Gotsiridze, first Deputy Minister, Mr. Grigol Gobejishvili, Director of the Budget Department, and their staff.

The final draft was written on the basis of a second visit to Tbilisi, which took place in December 2005. During this visit the mission consisted of Dr. Dirk-Jan Kraan and Mr. Daniel Bergvall (both from the OECD Secretariat). The mission met with Mr. David Khosruashvili, Head of the Budget Department, Mr. Nino Tchelishvili, Deputy Head of the Treasury Service, Mr. Ioseb Skhirtladze, Head of the Foreign Relations Department, Mr. Jacob Meskhia, First Deputy Chairman of the Chamber of Control of Georgia, and their staff.

Both missions would like to thank the Georgian authorities for the frank and open exchange of information. Special thanks go to Mr. Goga Mekvabishvili of the International Department of the Ministry of Finance who co-ordinated the first visit, and to Mr. Hennie Maters, Economic Advisor to the Ministry of Finance, who co-ordinated the second visit. Both put together excellent programmes and provided the missions with many relevant documents as well as practical assistance during their stay in Tbilisi. In addition to the Ministry of Finance and the Chamber of Control, the missions would like to thank the many other government employees, advisors and civil society members who took time out of their busy schedules to meet with them. Finally, special thanks go to Mr. Juergen Schilling, Head of the Georgia GTZ office, for his help and advice to the first mission, and to Mr. Jason Orlando, Resident Budget Advisor of the United States Treasury, for his help and advice to the second mission.

The views expressed in this report are those of the OECD Secretariat and should not be attributed to any organisations or individuals consulted for this review.

## 1. Introduction

To understand the Georgian system one must first understand the context. In November 2003 Georgia went through the peaceful Rose Revolution which unseated an unpopular and largely corrupt government. As with all popular revolutions, there is a united tolerant populace in Georgia with grand ambitions and great hope buffeted against large structural problems.

The populist mandate of the revolution focuses on territorial unification, healing wounds from civil strife, and improvement of living conditions. Two years after the revolution, the Georgian government system is still in the process of total transition, as every facet of society, the economy and government is in flux. Government structures are changing, personnel are being reduced, officials and government employees are being replaced, and new programmes are being created.

Shortly after the Rose Revolution an important constitutional change was enacted (February 2004). This led to a shift in the relations between the major state organs. On the one hand, the position of the president vis-à-vis Parliament was strengthened by broader defined competences, including the right to dissolve Parliament. On the other hand, Georgia moved to a cabinet system of government, which gave Parliament the right to withhold confidence and bring down the cabinet, barring dissolution.

The present government of Georgia is pursuing profound institutional reforms directed at the creation of a market economy and an efficient government. It has embarked on a programme of large-scale privatisation, decreased regulations, and significantly lower tax rates. In the public sphere corruption was a major problem. The government has effected a radical dismissal of government employees that will also achieve the goal of substantial downsizing of the civil service. The new senior management and political control is made up of young, energetic but relatively inexperienced officials. While some functions, like the Chamber of Control, came to a halt during the transition, most of the reformed organisations are now functioning. The inexperience and the weak capacity of the civil service is a main challenge for the planned reforms.

OECD budget reviews look at the budget institutions or the rules of the budget process and the way they function. Since some institutions have been introduced only quite recently, such as the Budget System Law of Georgia

of December 2004 (originally approved in 1996), there is not much experience about the way they are functioning. In such a case assessment necessarily has to be based on comparison with institutional features in other countries and on the accumulated experience in that respect (international best practice). Of course this is also the method used by international organisations such as the IMF and the World Bank when offering their advice to countries in a state of transition. The present review conforms to that approach.

It should also be kept in mind that institutions do not entirely determine policies. This is true of the rules of constitutional law as well as of budget institutions. All these rules are typically of a procedural nature in the sense that they allow different policies based on the political visions of the government and the Parliament of the day. On the other hand institutional rules may also bar or restrict certain policies and in general confine the room for budgetary policy within certain boundaries.

OECD budget reviews look at budget institutions from the perspective of how well they contribute to the fulfilment of the functions of the budget, namely the control of aggregate spending, taxation and borrowing, the efficient allocation of resources, the cost-efficient management of spending programmes, and the democratic authorisation of, and accountability for, taxation, spending and borrowing. For the latter purpose, transparency or clarity about the content of the budget is an important criterion of assessment. Parliament, media and civil society can only participate in the debate about budgetary policies and outcomes if institutional rules guarantee transparency.<sup>1</sup>

### ***1.1. General characteristics***

With 4.3 million inhabitants, Georgia is a relatively small European country. Consolidated general government expenditure, at 19% of GDP in 2005, is relatively small. This is due to the transition status of the Georgian economy and in particular to the underdeveloped system of social security. Social security expenditures in 2004 amount to 4.4% of GDP, which is very low in a European perspective (comparative figures are: France, 17.7%; Germany, 19.2%; the Netherlands, 12.3%; Sweden, 18.0%; the United Kingdom, 13.4%).

During its first two years in office, the Saakashvili administration and its consecutive ministers of finance have achieved remarkable results in the field of economic and fiscal policy. GDP growth has been strong, a large-scale privatisation effort has gained momentum, a zero tolerance attitude towards corruption has taken root, and impressive gains in tax revenues have been achieved.

**Table 1. Real gross domestic product 2002-09**

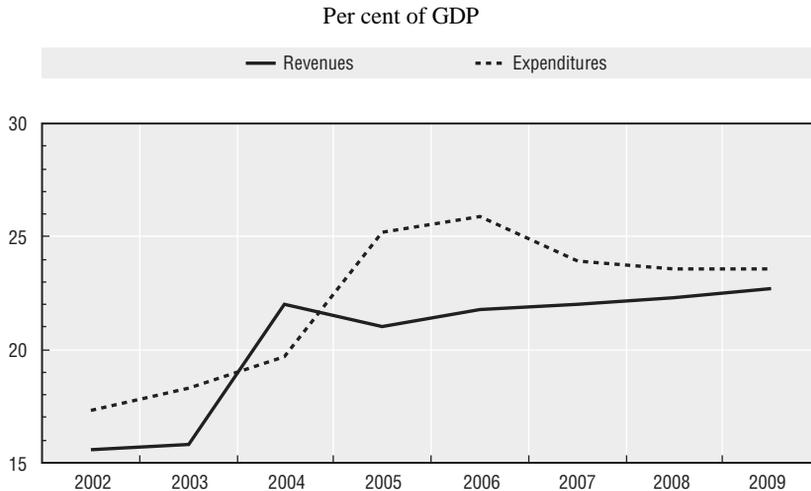
Per cent change on previous period

	2002	2003	2004	2005 <sup>a</sup>	2006 <sup>a</sup>	2007 <sup>a</sup>	2008 <sup>a</sup>	2009 <sup>a</sup>
EU 15	1.1	1.1	2.3	1.4	2.0	2.2	n.a.	n.a.
Georgia	5.5	11.1	6.2	8.2	7.5	7.0	6.0	5.5

a. Forecast.

Sources: Eurostat; Georgian Government, *Basic Data and Directions 2006-2009*, 2005.

In both 2004 and 2005 large expenditure increases were made possible by revenue increases and privatisation receipts. In 2005 autonomous revenue growth was partly compensated by a general tax reform aimed at rate reduction and broadening of tax bases. In 2005 these increases induced a budget deficit of 4.2% of GDP (privatisation receipts do not count as revenues according to Government Finance Statistics accounting standards but are a means of deficit financing).

**Figure 1. General government expenditures and revenues 2002-09**

Note: 2005-09: forecast.

Source: Georgian Government, *Basic Data and Directions 2006-2009*, 2005.

The present macroeconomic and fiscal forecast, established in close co-operation with the IMF, foresees a gradual reduction of the budget deficit in the medium term. Privatisation receipts can increasingly be used for debt

reduction, which will allow room for additional expenditures to the extent that debt service decreases.

**Table 2. General government deficits 2002-09**

Per cent of GDP

	2002	2003	2004	2005 <sup>a</sup>	2006 <sup>a</sup>	2007 <sup>a</sup>	2008 <sup>a</sup>	2009 <sup>a</sup>
EU 15	-2.2	-2.9	-2.6	n.a.	n.a.	n.a.	n.a.	n.a.
Georgia	-1.7	-2.6	2.3	-4.2	-4.2	-1.9	-1.3	-0.9

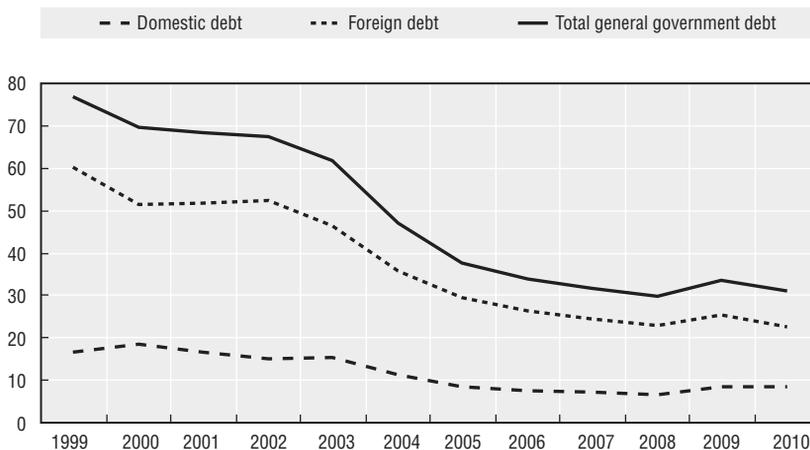
a. Forecast.

Sources: Eurostat; Georgian Government, *Basic Data and Directions 2006-2009*, 2005.

In Georgia foreign debt makes up the largest share of public debt. Foreign debt was strongly reduced in 2004 and 2005 as a consequence of a debt restructuring agreement with Paris Club countries reached in July 2004 and follow-up bilateral agreements. Arrears on domestic debt service have been cleared in the last few years and indebtedness has accordingly been reduced.

**Figure 2. General government debt 1999-2010**

Per cent of GDP



Note: 2005-10: forecast.

Sources: Georgian authorities; IMF, 2005b.

## *1.2. The transition process in Georgia*

The government has undertaken large reform initiatives in the area of fiscal policy. These reform efforts have focused on taxation, tax administration, and the budget process, including cash and debt management.

These efforts have been supported by the IMF, the World Bank, the EU, the United States, and other bilateral donors. Aid to Georgia was coordinated by a consultative group that met for the first time in Brussels in June 2004. At that time it pledged USD 1.1 billion of which two-thirds is in grants. Major donors are the World Bank (USD 235 million), the United States (USD 360 million) and the EU (USD 160 million).

In June 2004 Georgia concluded a three-year arrangement, Poverty Reduction and Growth Facility (PRGF<sup>2</sup>), with the IMF in the amount of USD 141.6 million.<sup>3</sup> This arrangement involved a wide array of quantitative and indicative targets and corresponding performance criteria in the areas of tax revenues, fiscal deficit, domestic expenditure arrears, credit of the banking sector to the general government, external debt, accumulation of external arrears, reserve money, and average monthly cash collections from the electricity and gas sectors. It also involved a number of qualitative targets and corresponding structural performance criteria and benchmarks in the areas of tax reform, tax collection practices, settlement of electricity sector legacy debts<sup>4</sup>, Treasury reform, supervision of public enterprises, collection of fees from electricity users, reform of the private auditing sector, anti-money laundering legislation, auditing of public enterprises, reform of the Budget System Law, auditing of the stock of state arrears, revision of foreign trade tariffs, and a stop on state guarantees on domestic loans.<sup>5</sup> The IMF has stationed an IMF Resident Advisor in Tbilisi.

The World Bank, including the International Finance Corporation (IFC) and the International Development Aid (IDA) Board, is supporting structural reform programmes in a wide range of areas. Georgia has received in total USD 773 million in IDA loans for 37 operations and USD 117 million in investment aid from the IFC for eight projects. IDA loans come in a variety of forms. A reform support credit (RSC) approved in June 2005 supports improvements in the areas of governance and anti-corruption, public finance management, and energy sector bottlenecks. To deepen the assistance initiated with the RSC over the medium term, the first poverty reduction support credit (PRSC) is under preparation. It focuses on public administration reform, energy sector reform, education and training, social protection, and private sector development. Other IDA support has come in the form of project support and analytical and advisory assistance across a broad spectrum: education, health, social protection, energy, roads, water

and sanitation, agriculture, irrigation and drainage, forestry, environment, biodiversity, enterprise development, municipal development, judicial reform, and cultural heritage. A country procurement assessment report was prepared in 2002 and a country financial accountability assessment in 2003. IFC projects include equity and credit provision to local and international companies, including British Petroleum and other sponsors for the construction of the Baku-Supsa Early Oil Pipeline and the Baku-Tbilisi-Ceyhan Pipeline, and various banks specialising in micro-finance. In the housing finance sector, the IFC has provided credit lines to various banks for mortgage lending. Other investments have been in electricity distribution, mineral water, and glass bottle production. The IFC Private Enterprise Partnership is implementing a technical assistance project to develop financial leasing, strengthen corporate governance practices, and assess the business environment for small and medium-sized enterprises. The IDA Board recently approved a USD 24 million RSC, a USD 20 million secondary and local roads project, and a USD 3.6 million electricity market support project. The World Bank continues its discussion with the government on a more comprehensive medium-term reform strategy that would be supported by a series of PRSCs and technical assistance operations such as the public sector management reform programme.

The EU is funding multiple technical assistance projects under several programmes (Tacis, TEMPUS, Policy Advice, etc.), in addition to budget support (Food Security Programme and Macroeconomic Assistance). These technical assistance projects support reform initiatives in various line ministries. In the Ministry of Finance, the EU has supported macroeconomic modeling, the preparation of the new Customs Code, capacity building in the Tax Department (including the inspectorates at central and regional levels), and an initiative aimed at increased public awareness of taxpayers' rights and obligations and dissemination of information about technical aspects of Georgian tax law and the applicable procedures.

The United States government has set up a fiscal reform project in Georgia (through the Agency for International Development, USAID). This project supports reform initiatives in various line ministries and in the Ministry of Finance (especially in the area of information technology development). The US Treasury provides technical assistance to the reform of the budget process and debt management, and has maintained a resident budget advisor in the Ministry of Finance since 1996. The US Treasury presence also includes a resident advisor to provide policy and technical advice in the areas of fiscal policy, monetary policy, and foreign exchange policy to the Ministry of Finance and the National Bank of Georgia (the central bank). The US Treasury also provides technical assistance to the Tax

Department (in the Ministry of Finance) in the areas of audit, tax collection, and taxpayer registration.

The commitments made by Georgia in contracts with the IMF, the World Bank, the EU and the United States cover not only fiscal and structural financial-economic policies but also the reform of budget institutions. These commitments are often the point of departure of the findings in this review.

### ***1.3. Fiscal policy and institutional reform in 2004 and 2005***

In order to put the findings of this review in perspective, it is useful to provide some data at the outset about institutional and fiscal policy in the recent past.

Fiscal performance in 2004 was impressive. Tax revenue grew by 50% (nominally) compared to the previous year (from 14.1% of GDP to 18.3% GDP). This was mainly due to a strong drive to curb tax evasion and to improve tax and customs administration. There has also been a one-off surge in non-tax revenue, stemming from clearance of arrears in fee collection and monies collected from former government officials suspected of corruption. The higher than envisaged growth of government revenues allowed two supplementary increases of spending appropriations, including the clearance of the largest part of domestic wage and spending arrears ahead of schedule. The fiscal balance on a commitment basis, exclusive of quasi-fiscal activities of public enterprises, was improved from –2.5% of GDP in 2003 to 2.3% of GDP (surplus) in 2004. (However, the fiscal balance on a cash basis was –0.3% of GDP, the difference reflecting the net change in expenditure arrears.) Domestic arrears were reduced from 4.7% of GDP in 2003 to 2.1% of GDP in 2004. A debt restructuring agreement, reached in July 2004, consolidated roughly USD 211 million due on debts contracted before 1 November 1999, including USD 161 million from Paris Club member countries. This amount consists of arrears due as at 31 May 2004 as well as maturities falling due from 1 June 2004 up to 31 December 2006. The agreement leads to rescheduling of the maturities and 50% of the arrears and will reduce the debt service to Paris Club creditors from USD 169 million to USD 36 million (which consists mainly of interest on rescheduled amounts and payments on arrears) during the period of the IMF-supported PRGF programme (until 2007). The agreement has also led to the reduction of foreign debt from 43.9% of GDP in 2003 to 34% of GDP in 2004.

Fiscal performance has continued to be strong in 2005. Tax collection increased by 21.9% (nominally) compared to 2004 (from 18.2% of GDP to 19% of GDP). This was due to continuing strong economic growth (8.2% in

real GDP 2005), further improvements of tax and customs administration, a comprehensive tax reform implemented as of January 2005, and large privatisation receipts. This strong performance enabled the government to secure passage of two supplementary budgets in April and May 2005, authorising a large increase in appropriations that would be financed mainly by privatisation receipts.<sup>6</sup> The 2005 budget was further increased through amendments in October and December. Additional expenditures are mainly on defense (as part of Georgia's bid to join NATO) and on rehabilitation of roads and the dilapidated energy sector. The four supplementary budgets have raised the 2005 budget deficit to 3.6% of GDP on a commitment basis (4.8% on a cash basis, the difference reflecting the net change in expenditure arrears). The government has emphasised that two-thirds of the additional outlays will be spent on imported goods and services, limiting the effects on inflation. The government also stressed that continuing accumulation of government deposits at the central bank from privatisation is not politically feasible against the backdrop of pervasive social needs and other priorities. Foreign indebtedness has been reduced from 34.0% of GDP in 2004 to 28.5% of GDP in 2005, partly as a consequence of follow-up bilateral agreements with Paris Club creditors. The stock of domestic arrears has been revised upward by GEL 60 million (0.5% of GDP) as a result of recent audits. The government intends to fully eliminate domestic arrears by end 2006.

Important goals of structural financial-economic reforms in 2004 and 2005 were tax reform, reform of the electricity sector, privatisation, improvement of social protection, civil service reform, and reform of public expenditure management and treasury operations.

Tax reform, coming into effect as of January 2005, involved the adaptation of a new tax code, reducing the number of taxes from 21 to 8, cutting the value-added tax rate from 20% to 18% and the payroll tax (for social security and health care) from 33% to 20%, and setting a flat 12% personal income tax, replacing marginal rates between 12% and 20%. The bases of the value-added and profit taxes were broadened by eliminating certain exemptions and special regimes. The revenue loss (estimated at 3.5% of GDP) would be more than offset by increased excise tax rates on oil and tobacco products, liquor and automobiles, taxation of the electricity sector on an accruals basis, and the enhancement of the revenue administration. To encourage the legalisation of the informal economy, a one-off tax write-off was granted on undeclared tax obligations incurred by end 2003, and regularisation of undeclared property was authorised against payment of a one-time levy of 1% of the value of the property. Under the terms of Georgia's accession to the World Trade Organisation, the number of import tariff bands has been reduced from 21 to 16 as of January 2005. Draft legislation leading to further reduction of the number of tariff bands and

reducing the maximum import tariff rate (currently 30%) is under preparation and will become effective in early 2006. In 2004 and 2005 the government completely overhauled the tax and customs administration, securing impressive gains. Measures included: (1) establishment of an excise tax inspectorate, to bolster collections, and a financial police; (2) reduction of the number of inland tax and regional offices, accompanied by staff retrenchments; (3) integration of the road tax administration and the tax organs of the Adjara region into the national tax department; and (4) re-registration of taxpayers (by March 2005, 60 000 taxpayers had been registered).

Energy sector reforms (electricity and gas) sought to reduce the sector's quasi-fiscal losses (due to subsidised prices, lack of metering, and large-scale electricity theft) and provide reliable power supplies (avoidance of chronic power cuts in winter). In the electricity sector, a review of the tariff methodology will eventually permit introduction of an updated tariff structure at cost recovery levels by mid 2006. A report on the revision of the rate structure is under preparation with the help of the World Bank. Average monthly cash collection rates in the electricity sector improved from 52.4% in 2003 to 64.8% in 2005. Quasi-fiscal losses declined from an estimated 4.9% of GDP in 2003 to 3.4% of GDP in 2005 (from 3.8% of GDP to 2.5% of GDP in the electricity sector and from 1.0% of GDP to 0.9% of GDP in the gas sector). This steady increase in collection rates is mainly due to ongoing extension of metering by the main electricity distribution company in Tbilisi. Non-payment for the use of electricity outside Tbilisi remains the largest source of quasi-fiscal losses.

The government started an ambitious programme of divestiture and operational improvements in state-owned enterprises. The Enterprise Management Agency, which controls 1 800 public enterprises employing 180 000 persons, will be shifting from managing companies to preparing them for privatisation or, at least, to private equity participation and performance-based management contracts conducive to early privatisation. The authorities envisage divestiture or liquidation of the bulk of the enterprises controlled by the Enterprise Management Agency during 2005-06. Most small and medium-sized enterprises would be sold as soon as possible, while the government would restructure larger companies in the energy, transport and telecommunication sector in step with enabling legislative and regulatory reforms. More than 100 full or partial privatisation contracts were reached in 2004 and early 2005. Privatisation proceeds in 2004 amounted to GEL 87 million<sup>7</sup> (0.9% of GDP) and in 2005 to GEL 387 million (4.2% of GDP).<sup>8</sup> Recently the government has invited bids for additional privatisations (likely to begin in 2006), including several energy companies (comprising the main provincial distribution companies),

a number of smaller hydro power plants, the large Rustavi and Madneuli metallurgical plants, and the Batumi crude oil storage complex.

In 2004 the authorities raised monthly social security pensions from GEL 14 to GEL 28 (USD 15) at an estimated cost of 0.8% of GDP. The latest data show a somewhat declining share of the population living under the poverty line (about USD 30 per month) from 55.7% in the first half of 2003 to 52.5% in the second half of 2004. This decline partly reflects the recovery in economic activity, timely payment of public sector wages and social transfers, and a significant clearance of domestic arrears. The lay-offs in the public sector in 2004 helped to create a more efficient government but they also appear to have contributed to a rise in the unemployment rate from 11% to 13%. The authorities envisaged the introduction in late 2005 of a streamlined, means-tested poverty benefit targeted at the 600 000 most needy (living under the extreme poverty line and, depending on family size and living conditions, under the poverty line) which would cost about 0.7% of GDP per year. The preparation of draft legislation for this purpose has been delayed because of technical difficulties concerning the eligibility criteria.

The authorities made an ambitious effort to downsize the civil service and to sack corrupt officials with the aim to improve governance. Public employment was reduced by 30 000 positions in 2004 (23% of the workforce), mainly in the areas of defense, internal security, and the Ministry of Finance. Salary savings have been used to improve remuneration of remaining personnel. The fiscal costs of retrenchment were negligible as a result of 2003 legislation temporarily suspending severance payments. In August 2004 the government established a Civil Service Council tasked with co-ordinating civil service reform. In October 2004 the government defined the mandate of the council and its implementing arm, the Civil Service Bureau. Further reforms were envisaged. Emphasis will be placed on creating a professional and efficient civil service, further upgrading remuneration and harmonising it across all branches of central government, and introducing norms and regulations that would ensure accountability of officials.

The new Budget System Law became effective on 1 January 2004. The new law established a comprehensive framework for the functions and responsibilities of the Ministry of Finance and the spending agencies in the budget process. The law introduced a two-stage prioritisation process: first the key directions are determined and then spending agencies present their detailed budget requests within the budget ceilings put up in the first stage. A new commitment verification mechanism for budget expenditures, existing since 2003, has brought order to the spending of public resources, stopped accumulation of arrears, and increased transparency of

expenditures. The verification mechanism was extended to extra-budgetary state funds as of September 2004.

Concerning treasury operations, in April 2004 a single revenue account was established at the National Bank of Georgia. More than 10 000 transit accounts in the bank were closed. All revenue accounts at commercial banks were closed. Budget, tax and customs legislations were amended in view of this reform. Through assistance provided by USAID among others, the computer hardware in the Treasury was upgraded while supportive software was developed by Treasury specialists. These components contributed to the successful implementation of the first stage of Treasury reform. For the second stage of reform, the closing down of all expenditure accounts is envisaged. The completion of the Treasury Single Account (TSA) uniting the single revenue account and all expenditure accounts was planned for 2005 but has not yet entirely been achieved. The establishment of the single revenue account made it possible to develop and implement mechanisms for refunding excessively paid taxes (mainly VAT), which had been an unresolved problem for many years. The new system of refunding became operational in April 2004. The Treasury Service, which operates through a central apparatus and 11 regional treasury services, was re-organised. The Accounting Methodology Administration was transferred to the Treasury Service. A new charter of treasury services, defining the structure of the Treasury Service and the functions and responsibilities of the various divisions, was implemented in October 2004.

## **2. Budget formulation**

### ***2.1. Institutional reform in the run up to budget formulation 2006***

It should be mentioned at the outset that in the run up to the formulation of the 2006 budget some important institutional reforms have been implemented and for the first time applied. These include:

- the formulation of a medium-term expenditure framework;
- a new structure of the “Basic Data and Directions” document.

### ***2.2. The medium-term expenditure framework***

In 2004 the Ministry of Finance initiated a series of reforms. In order to sustain this reform process, the Ministry established its Strategic Development Plan covering the directions of budget management and expenditure policy, debt management, treasury systems, improvement of the investment climate, enhancement of state revenues, and institutional

strengthening. The Plan was updated in September 2005 (Georgian Government, 2005c). The introduction of the medium-term expenditure framework (MTEF) was the driving force of the reform in budget management and expenditure policy. The first MTEF was introduced in the budget formulation process for 2006 and covered the period 2006-09.

The MTEF aims to ensure targeted spending of scarce state resources in line with the government priorities, and to strengthen the link between policies and expenditure estimates over a period of four years (the budget year plus three subsequent years). There are two stages:

- Allocating resources to sectors, based upon overall macroeconomic forecasts and incorporating national and sectoral government priorities. The result of this stage is the annual Basic Data and Directions document;
- Allocating resources within sectors, based upon sectoral strategic priorities and within sectoral ceilings determined in the first stage. The result of this stage is the draft budget to be submitted to Parliament.

Although the introduction of the MTEF process was somewhat disconnected from the regular budget formulation process for 2006, in the course of 2005 both processes became fully integrated, which is of course essential for an effective MTEF. Throughout the public administration the awareness of the MTEF aims and requirements has been greatly increased, and the MTEF became associated with budget reform. This is a solid foundation for the next MTEF cycles.

A major element of the MTEF process was the preparation of documents by the ministries linking policies with expenditure estimates. This was accomplished in both stages of the budget formulation process. In the first stage, the document supported the allocation of resources to the sectors in the Basic Data and Directions document; in the second stage, the document supported the allocation of resources within the sectors in the draft budget.

In both stages the format of the document was prescribed. In each case the prescribed format, called “strategic matrix”, consisted of four columns: (1) current situation, (2) objectives/targets, (3) reform actions, and (4) budget management implications.<sup>9</sup> The first column briefly assessed the existing situation in each programme area in the sector and identified key issues affecting programme performance. The second column stated changes in the delivery of programme activity that were considered as targets for the budget year and the next three years, if possible quantified by indicators. The third column identified programme reform actions to be undertaken in

the planning period. The fourth column specified the implications for funding over the planning period. The task force set up for the MTEF process, chaired by the minister of finance and composed of line ministry representatives, held a series of meetings to assist the ministries in filling in the forms. In addition, two training sessions for line ministry officials were held. Some ministries volunteered to become pilot ministries (Environment, Energy, and Foreign Affairs).

The challenges that were faced in developing the strategic matrices were considerable, particularly in ministries unfamiliar with thinking about their budgets as a tool for policy development. Strategic matrices were to be jointly developed in working groups with policy planning units and budget units, with the former taking the lead. In fact this happened only in one ministry (Agriculture). In all other cases the budget units were charged with strategic matrix development. Political guidance was mostly lacking. In spite of these difficulties, most ministries succeeded in providing the required information, if not always in accordance with set time schedules. Not surprisingly, ministries with well worked out policies, for example Foreign Affairs and Energy, found it easier to complete the matrices and to be concise in their presentation.

One of the major innovations of the MTEF process was the establishment of budget ceilings for a four-year period<sup>10</sup> for the 42 spending agencies (some state organs<sup>11</sup>, the ministries, and the plenipotentiary representatives of the president in the regions). The ceilings were presented to the cabinet according to the timetable prescribed in the Budget System Law (15 June) and subsequently inserted in the Budget Circular to the line ministries. The ceilings were supposed to be based upon the sectoral spending forecasts contained in the Basic Data and Directions document (based in turn upon the strategical matrices of the first stage) as well as updated macroeconomic and fiscal forecasts. In fact the ceiling preparation process was rather *ad hoc*. The ceilings were only loosely connected to the sector forecasts in the Basic Data and Directions document.

The subsequent internal budget preparation process within the line ministries on the basis of updated strategy matrices was somewhat overshadowed by continuing negotiations about the ceilings. The budget process in the line ministries was in many cases not well organised. Although the idea of expanding budget narratives containing explanations about policy and expenditure changes was supported by the line ministries, their major concern during the draft budget preparation stage remained the negotiation of ceilings with the Budget Department of the Ministry of Finance. Therefore the explanations sometimes had to be given at the last moment and received little attention from both the line ministries and the Ministry of Finance.

In spite of some shortcomings in the first year of its application, the MTEF is a major and important step forwards. It brings the consideration of policy and expenditure together in a multi-annual perspective. On the one hand it necessitates the timely consideration of the multi-annual budgetary consequences of new legislation and policy initiatives, and on the other hand it necessitates the timely preparation of new legislation and policy initiatives to achieve medium-term budgetary objectives. These are important improvements, thanks to which Georgia is now pressing ahead of other countries in similar circumstances and even some OECD countries.

The MTEF process is now firmly entrenched in the Georgian public administration, forming a good basis for further improvement in the coming years. The next steps to be considered include the following:

- Closer involvement of policy units in the development of the strategic matrices; more political guidance by line ministers; ownership of the development process by the line ministries;
- A closer and more transparent relationship between the sectoral expenditure forecasts in the Basic Data and Directions document and the sectoral ceilings of the Budget Circular. The sectoral expenditure forecasts would generally have to be understood as preliminary ceilings, only to be adjusted in the Budget Circular in the light of updated macroeconomic forecasts and revenue estimates;
- Earlier definitive decisions on the ceilings in order to avoid ongoing ceiling negotiations after the Budget Circular has been sent out.

An important test will be whether the multi-annual perspective can be maintained over the years – that is to say: whether the ceilings that have now been established for the period 2007-09 can be maintained in the next budget cycles, at least in the sense that the ceilings of the previous year will be taken as the point of departure in the next budget cycle. If this does not happen, the entire reform loses much of its significance.<sup>12</sup> Multi-annual stability in this sense requires that a clear distinction is made between existing policies and expenditure estimates previously approved and proposed changes in policies and their budgetary consequences in both stages of the budget formulation process. This would imply that the strategic matrices used for the preparation of the Basic Data and Directions document and the draft budget would, to a larger extent than has currently been the case, be focused on changes in policies and their budgetary consequences compared to the status quo of existing policies and corresponding expenditures as previously estimated and currently updated.<sup>13</sup> For this purpose it is important that the strategic matrices contain columns for the

approved budget and multi-year estimates for the current year and the next four years as well as for the changes that the line ministries propose in these numbers. Analogously, policy information should distinguish between existing policies and proposed policy changes.<sup>14</sup> This information should also be provided in the Basic Data and Directions document (existing versus new estimates) and in the draft budget (existing versus new policies). Presently neither the Basic Data and Directions document nor the draft budget contains information about approved estimates for the current year at the sectoral and programmatic level (let alone for future years), which makes it very difficult to assess the impact of the new budget.

For a multi-annual approach it is also important to make a distinction between the maintenance of the overall expenditure ceiling and the ceilings at the sectoral levels. In order to maintain multi-annual stability, the former should be as inflexible as possible and only be allowed to change in the light of structural macroeconomic developments. It is a special responsibility of the minister of finance to see to the maintenance of the overall ceiling over the years. The ceilings at the sectoral levels, on the other hand, should be allowed to be adjusted from year to year in order to accommodate cyclical macroeconomic developments and new policy initiatives that cannot be accommodated within the sectoral ceilings.

One of the greatest challenges to successfully implementing an MTEF, and budget reform in general for that matter, is to increase the Budget Department's ownership. In 2005, the first year of MTEF reforms, the Budget Department was involved too little and too late in organising and executing the reform work. If these reforms are truly to take hold and have a lasting effect, the public administration of Georgia needs to be accountable for managing and executing the reforms, and consultants and outside advisors should work to facilitate this. For example, for the 2007 budget the Budget Department staff (*i.e.* the State Budget Division) should take the lead in revising the strategic matrices and working with the line ministries to ensure that the matrices are completed properly.

### ***2.3. The Basic Data and Directions document***

Georgia has a two-stage budget process (Article 17 of the Budget System Law). The first stage leads to the Basic Data and Directions document<sup>15</sup> which is submitted to Parliament (Article 17, paragraph 7 of the Budget System Law). The Budget System Law also anticipates the establishment of an MTEF (Article 17, paragraph 3) and prescribes that the Basic Data and Directions document shall be based on the MTEF (Article 17, paragraph 4). This general arrangement allows the government

and Parliament to consider and discuss the general outlines of budgetary policy in advance of budget preparation at the line item level.<sup>16</sup>

Whereas in previous years the Basic Data and Directions document had been quite short (two pages for the 2005 budget), during the budget preparation for 2006 an effort was made to produce a document that could really function as a budgetary strategy paper. It contains: a macroeconomic overview; a forecast of macroeconomic indicators (GDP, inflation, balance of payments deficit, exchange rate, monetary indicators); a sustainability analysis concerning macroeconomic shocks; detailed estimates of tax, non-tax and donor grant revenue; a brief review of 2004 budget execution; and an analysis of domestic and foreign debt sustainability. It also contains the MTEF (overall and sectoral expenditure forecasts for the medium term) as well as statements of main sector aims and objectives – all in all a quite substantial document of 27 pages and eight annexes.

Both revenue forecasts and expenditure forecasts are supposed to be based on policy priorities and on past budget trends and cross-country comparisons. Expenditure forecasts should make use of the national strategy as described in the March 2005 updated *Economic Development and Poverty Reduction Program* (IMF, 2005c) – basis for the Poverty Reduction and Growth Facility mentioned above in section 1.2 – as well as the sectoral strategies as described in the strategic matrices provided by the line ministries. The Basic Data and Directions document does not make very clear whether and to what extent the updated national strategy and the sectoral strategies have caused changes to previous revenue and expenditure forecasts (in total and by sector). As to the analysis of past budget trends and cross-country comparisons, some work was done by the Budget Department, but this was not completed and hence not used in the Basic Data and Directions document.

Although the timetable for the document preparation process was followed only to a limited extent, it was a major achievement that the Basic Data and Directions document was submitted in time to the government (15 April) and Parliament (1 May).

The Financial Policy Department of the Ministry of Finance has the lead during the preparation of the Basic Data and Directions document. This department is responsible for macroeconomic and tax policies and tax estimates. The Budget Department of the ministry is responsible for the analysis of the expenditure outturns of the preceding year, and it should also play the main role in the development of the sectoral expenditure forecasts on the basis of the strategic matrices. In fact the Budget Department has only been involved to a small extent in the expenditure forecasts, and the

actual effect of the strategic matrices on the expenditure forecasts has been small.

Additional reasons for the limited impact of the strategic matrices on the expenditure forecasts were the prescribed sectoral and programmatic expenditure classification and shortcomings in the way the matrices were filled in. The initial idea was that sectors could be wider than single ministries, more or less corresponding to the functional classification of the Government Finance Statistics (GFS), and that they would encompass not only policies and expenditures of the central government but also those of sub-national governments (so that expenditures would be forecasted at the general government level). Each sector thus defined was to be subdivided into programme areas, and in each programme area the most important ministry would take the lead. Although the ministries have tried to follow up on this idea, the incompatibility of the proposed programme areas with the conventionally used organisational budget classification made the exercise exceedingly difficult and to some extent artificial.

In spite of the shortcomings during the first year of application, the new structure of the Basic Data and Directions document has been an important step forward. Macroeconomic forecasting has improved, tax revenue estimates over the medium term have been produced, and clear decisions about the total expenditure envelope for the budget year and the medium term have been taken based on the national development strategy and sectoral priorities. Further improvements in the next budget cycle would be possible in the following areas:

- A more transparent distinction between existing policies and budget estimates on the one hand and budgetary consequences of policy changes on the other hand. This applies to the impact of updated national development strategies as well as sectoral strategies.
- The Budget Department of the Ministry of Finance could take more responsibility for expenditure forecasts and ensure that national and sectoral policy changes are adequately reflected in the forecasts.
- Analysis of past expenditure trends and cross-country analysis could play a larger role in the development of the expenditure forecasts and should be conducted by the Budget Department.
- The expenditure classification of the strategic matrices could be brought in line with the regular organisational budget classification. Sectors could coincide with ministries, and programmes could be identified by the highest level of the regular organisational budget classification.

- It could be made clearer to the line ministries that the matrices are the main vehicle for their budgetary requests and that the sectoral expenditure forecasts in the Basic Data and Directions document will function as preliminary sectoral ceilings and main input to the definitive ceilings in the Budget Circular.

### Box 1. The budget timetable

1 March	The Ministry of Finance begins budget preparations, the macroeconomic framework, and the Basic Data and Directions document.
15 April	The Basic Data and Directions document is sent to cabinet for agreement, then sent to Parliament.
1 June	Parliament Finance Committee issues a report on the Basic Data and Directions document.
15 June	The Ministry of Finance issues a Budget Circular, including budget ceilings per spending agency.
15 August	Line ministries submit detailed budgets to the Ministry of Finance and begin negotiations.
5 September	Cabinet finishes discussing spending disagreements.
15 September	The Ministry of Finance submits the budget bill to cabinet.
1 October	The budget bill is sent to Parliament for review, recommendations and approval.
1 January	Start of the budget year.

## 2.4. Annual budget process

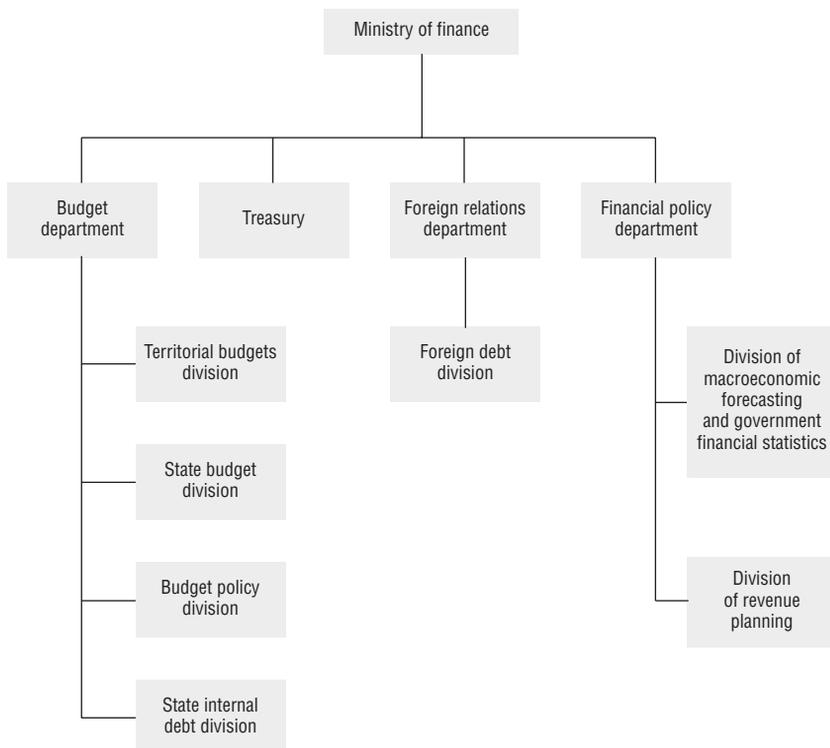
The first step of the budget process is the development of macroeconomic forecasts. Before 2003 the quality of estimates was poor, especially for tax revenues, which made budgets largely unrealistic and led to high deficits and arrears for salaries and other contractual obligations. Since 2004 the situation has very much improved. Formally macroeconomic forecasting is a shared responsibility of the National Bank, the Ministry of Economic Development and the Ministry of Finance. In practice the Ministry of Finance takes the lead and compares its results with those of National Bank models. Within the ministry this task is performed by the Division of Macroeconomic Forecasting and Government Financial Statistics (see Figure 3). The division has developed a macroeconomic model, partly with donor assistance, partly by the staff itself, and expanded it over the years. The model still shows weaknesses which are due to unreliable and insufficient data as well as inherent deficiencies.<sup>17</sup>

Macroeconomic forecasts are updated in the spring to be used as input to the ceiling-setting exercise for the Budget Circular. Macroeconomic forecasts are monitored, with help and analysis from the IMF. There is little capacity outside the government – financial institutions, civil society or academia – for providing a check or other analyses of the macroeconomic forecasts.

The next step is the development of tax revenue estimates for the budget year and over the medium term. This is the task of the Division of Revenue Planning (see Figure 3). These forecasts are developed from detailed realisation data, macroeconomic forecasts, and policy impact analysis only for the budget year. Broad forecasts (tax revenues as a percentage of GDP) have been agreed upon with the IMF in the context of PRGF.

**Figure 3. Organisation of the Georgian Ministry of Finance**

(not all departments and subunits listed)



## Box 2. The Economic Development and Poverty Reduction Programme

The EDPRP originated in 2000 when a designated secretariat in the president's administration was created to develop a strategic poverty reduction strategy. The ideas in this paper were discussed with various ministries and other stakeholders, including civil society, which led at the end of 2002 to the EDPRP document. The paper was the basis for subsequent negotiations with the IMF and the World Bank. The role of elected bodies such as Parliament and local councils was only marginal.

In order to achieve the general goal of raising the welfare of the population of Georgia, two strategic objectives were defined:

- Fast and sustainable economic development (average growth rate of real GDP at 5-8% per annum, which means two to threefold growth of real GDP by 2015 in comparison to 2001);
- Reduction of poverty (extreme poverty from 14% to 5% and poverty level from 52% to 25% until 2015).

The EDPRP was supposed to be a “live” document, subject to ongoing revision. The latest revision took place in March 2005.

The EDPRP was not a core issue in the political changes at the end of 2003. After the Rose Revolution, the lead role of further developing and implementing the EDPRP was given to the Ministry of Economic Development. The cross-governmental ownership of the strategy in the new administration has been problematic, perhaps partly because of the strong connection of the programme to former President Shevardnadze. On the other hand the involvement of the IMF and the World Bank brought a new urgency to the implementation of the programme.

Perhaps partly because of IMF involvement and partly because the past and present ministers of economic development had other priorities (privatisation, improvement of business climate), the focus of the EDPRP has shifted under the new administration from poverty reduction *per se* to general economic development. The EDPRP has now evolved into the main national economic strategy plan, with economic growth and structural reform as its main focus.

Until the budget formulation for 2006, the national economic strategy was not well integrated into the budget process. With the new structure of the Basic Data and Directions document the integration has improved, but the precise role of the national financial-economic strategy plan in the development of the medium-term expenditure framework and the sectoral expenditure forecasts remains somewhat unclear. Since the national economic strategy should lay the foundation for sector-specific reforms and be linked to the budgetary process, it is important that in the coming years the Basic Data and Directions document becomes more transparent about the impact of the updated national economic strategy upon the expenditure framework.

Macroeconomic forecasts and tax estimates are input into the medium-term expenditure framework which defines the overall expenditure ceiling and the sectoral expenditure forecasts for the budget year and the next four years. The framework is laid down in the Basic Data and Directions document. The framework is also supposed to integrate the national and sectoral policy strategies, but this integration can still be improved as indicated above.

In Georgia there is no general fiscal rule applicable (such as the Maastricht treaty limits on deficits as a percentage of GDP, or the “golden rule” in the United Kingdom), nor are there plans to create a fiscal rule. Like many OECD countries, Georgia relies instead on overall medium-term expenditure ceilings that are targeted at an acceptable deficit over the economic cycle. In this connection it should also be mentioned that expenditure ceilings, tax revenue estimates and deficit forecasts play a central role in the ongoing monitoring process in co-operation with the IMF.

By 15 April, the Basic Data and Directions document is presented to cabinet for approval. A major change from the previous regime is the formation of a cabinet and the delegation of executive power from the president to cabinet. Because the Basic Data and Directions document is transmitted to cabinet for agreement, there is a collective decision and responsibility for the estimates.

The Basic Data and Directions document is presented to Parliament for discussion. The Finance Committee of Parliament receives the document, holds hearings and discussions, and finally produces a report back to government. It is possible that Parliament as a whole discusses the document but parliamentary approval is not a requirement. Formal submission to Parliament is only for information purposes.

After Parliament’s work on the Basic Data and Directions document, the Ministry of Finance sets ceilings for each spending agency. These ceilings are presented to cabinet for approval. In view of the still underdeveloped process of sectoral expenditure forecasting in the MTEF, this has so far been the first opportunity for ministers to formally ask for changes in allocations. The line ministries negotiate bilaterally with the finance minister while the usual process of hierarchical decision making, with issues being resolved at staff, management and political levels, culminates in matters of large policy being determined by the prime minister. According to the Constitution, the president is responsible for the budget. Under current power-sharing arrangements, the president has given the prime minister the responsibility for resolving disputes. The president does on occasion chair meetings of the cabinet, and some spending issues can ultimately be decided by the president. In practice, this has only rarely happened.

Shortly after 15 June, the Ministry of Finance issues the Budget Circular which includes the budget ceilings and explains the required processes and procedures. Spending agencies must submit their draft budget (including strategic matrices at the programme level) as well as an explanatory note to the Ministry of Finance by mid August. The estimates must respect the ceilings of the Budget Circular but this has in fact not been the case in recent years. Also, in 2005 negotiations over the ceilings continued through September, which has diminished the attention for policies and expenditures at the programme level. The Budget System Law states that the draft budget should go to cabinet by 15 September.

The budget for 2006 contains good information on the economic and functional classification of expenditures. This is a considerable achievement. However, information on current estimates and multi-year estimates (as previously approved) at the programme level and line item level is still largely lacking. This makes it hard to assess the significance of the budget compared to the existing situation (policies and expenditure estimates). The budget for 2006 lacks good information about the nature and size of domestic debt. Information about the use of reserve funds could also be improved (expected use in the budget year in the light of use in prior years and the current year). A final matter that deserves attention for next year is public access to the draft budget and related materials. It is important that these materials can be easily purchased from the public printing office. It would also be a good idea to publish a “citizen’s guide to the budget” or “budget in brief” which could be made available to the press and citizens at a low price.

The president formally submits the draft budget to Parliament on 1 October. Before 2003 this requirement was never adhered to, and budgets were not submitted until after the beginning of the year<sup>18</sup> and often not formally approved until much later. In 2004 and 2005, budget submissions have respected the deadline.

## ***2.5. Conclusion***

In spite of some shortcomings in the first year of application, the introduction of the MTEF in the Georgian budget process is a major step forwards. It brings the consideration of policies and expenditures together in a multi-annual perspective. This is an important improvement, thanks to which Georgia is now pressing ahead of other countries in similar circumstances and even some OECD countries.

The MTEF process is now firmly entrenched in the Georgian public administration, forming a good basis for further improvement in the coming years. Next steps to be considered include closer involvement of policy units

of line ministries and more political guidance during the development of policy and expenditure proposals that are inputs to the MTEF process, a closer and more transparent relationship between the sectoral expenditure forecasts in the Basic Data and Directions document and the sectoral ceilings of the Budget Circular (“preliminary ceilings” versus “definitive ceilings”), and earlier definitive decisions on the ceilings.

An important challenge for the future will be the maintenance of the multi-annual perspective over the years. This requires that the overall and sectoral ceilings of the previous year are taken at least as a point of departure for the ceilings in the next year. Multi-annual stability in this sense can be enhanced if, during the entire budget formulation process, a clearer distinction is made between existing policies and budget estimates on the one hand and changes in policies and their budgetary consequences on the other. Presently neither the Basic Data and Directions document nor the draft budget contains information about approved estimates for the current year at the sectoral and programmatic level (let alone for future years), which makes it very difficult to assess the impact of the new budget.

The overall expenditure ceiling should be as inflexible as possible and only be allowed to change in the light of structural macroeconomic developments. The ceilings at the sectoral level should be more flexible and adjustable to accommodate cyclical macroeconomic developments and new policy initiatives.

The new structure of the Basic Data and Directions document is an important improvement. Macroeconomic forecasting has improved, tax revenue estimates over the medium term have been produced, and clear decisions about the total expenditure envelope for the budget year and the medium term have been taken early in the budget cycle, based upon the national development strategy and sectoral priorities. Shortcomings in the first year of application have to be addressed in the coming years. Next steps to be considered include a clearer explanation of the impact of the national development strategy and sectoral strategies on the sectoral expenditure forecasts, a larger role of the Budget Department in the preparation of the document, a larger role for the analysis of past expenditure trends and cross-country analysis, an adjustment of the expenditure classification in accordance with the regular, organisational classification (per spending agency and programme area), and more emphasis on the policy and expenditure proposals of line ministries as the main vehicle for budgetary requests.

Macroeconomic forecasting and tax revenue estimation by the Ministry of Finance has improved substantially in recent years. It is important to develop the capacity outside government – financial institutions, civil

society, and academia – for providing a check or other analyses of the macroeconomic forecasts.

The Economic Development and Poverty Reduction Programme has recently evolved into the main national economic strategy plan, with economic growth and structural reform as its main focus. It is important that in the coming years the Basic Data and Directions document becomes more transparent about the impact of the updated national strategy upon the expenditure framework.

### 3. Parliamentary approval

#### 3.1. Constitutional provisions

According to the Constitution, Parliament has to approve the budget, which has the legal character of a draft law or bill. For that purpose Parliament must receive the budget bill at least three months prior to the beginning of the fiscal year. The Budget System Law states that the fiscal year is the calendar year, so the budget must be submitted on 1 October.

#### **Box 3. Structure of Parliament**

The Parliament of Georgia is unicameral. Parliamentarians are elected for four years through a combination of proportional representation and majority voting. (The president is elected for five years for a maximum of two terms.) 150 Members of Parliament are elected through proportional voting from election lists with a minimum 5% threshold for gaining a seat. 85 Members of Parliament are elected directly according to majority votes. The current government has a very large majority in Parliament of over 85%. The prime minister is appointed by the president. Ministers need not be Members of Parliament.

Budgetary legislation and tax legislation are delegated to the Finance Committee before they are discussed in plenary session. The Finance Committee is assisted by a small number of permanent staff. The original idea to establish an independent budget office under the authority of Parliament has recently been abandoned.

A fundamental change to the Constitution concerning the role of Parliament in budgetary decision making was made in February 2004 (*i.e.* after the Rose Revolution). It entails that Parliament can no longer make amendments to the budget bill. It is now entitled to an up-or-down vote on the budget bill and may be dissolved if it rejects the government's

bill three consecutive times. However, Parliament can make recommendations that have to be considered and decided upon by the government.

### ***3.2. Spring review of aggregates***

Parliament has an early role in the budget process. By May, the president is required to submit the Basic Data and Directions document. Many countries have a two-step budget process where Parliament votes on aggregate spending (and thus the government's activity in the economy) some months before it votes on the draft budget. This permits Parliament to participate in fiscal discipline by endorsing the total numbers.

In the case of Georgia, the Basic Data and Directions document is not voted on by Parliament. It is only published for information purposes. Nevertheless, the Finance Committee holds hearings and discussions on the document. By 1 June, Parliament issues a report on its views to the president, with comments and suggestions on the overall fiscal stance.

Members of Parliament noted that, in the past, this review of the aggregates was a mere formality and essentially pointless. This was because the aggregate totals discussed in the spring bore no relation to what was then released in October with the draft budget. In 2005 the situation improved somewhat, but not much, since the expenditure forecasts were hard to interpret, as noted before. The adjustment of the expenditure classification of the Basic Data and Directions document in accordance with the regular budget classification (per spending agency and programme area) would not only contribute to a better internal process within the government but also to more effective parliamentary oversight.

### ***3.3. Submission and review of the budget bill***

The Constitution requires the president to submit the budget bill to Parliament by 1 October. Historically, the bill has not been submitted on time and often, even when it was submitted on time, the documents were merely summaries, and details of the budget followed later. In 2004 and 2005, compliance with the submission date has largely been adhered to, although some documents were sent in late.

Following the submission of the budget bill, it is divided by chapter and sent to the sectoral committees for review. The sectoral committees hold hearings on the chapters and then draft recommendations. The hearings are open to the public and the media. There are no limits on the hearings.

Committees may ask for testimony from ministers, interest groups, the Chamber of Control, and actors in civil society.

Significant innovation has taken place during the presentation of the 2006 budget to Parliament. After the initial introduction of the budget by the prime minister, each minister, beginning with the minister of finance, made a presentation about his/her proposed budget and operational plans. This is an improvement over the previous process in which only the prime minister and the minister of finance were responsible for explaining the government's proposed budget to Parliament. By involving different ministers in this process, the accountability and profile of the line ministries in the annual budget process is strengthened. Ministers now have a stronger interest in making sure that their budgets are developed properly with justifiable proposals, as they will have to explain their plans to Parliament in person. Another improvement in the government's budget presentation to Parliament was the use of detailed presentation materials, including PowerPoint presentations, to better describe the proposals for each of the main line ministries. While the quality and content of the presentations and the budget document need significant improvement, the use of more detailed information for 2006 has contributed to a more open and transparent budget process.<sup>19</sup>

### ***3.4. Making recommendations***

Each committee drafts a report and recommends changes in its chapter and submits the report to the Finance Committee. The recommendations for changes are reviewed by the Finance Committee; however it must transmit all sectoral committee recommendations. The Finance Committee has no right to modify, approve or reject the budget bill, only to comment on it. The Finance Committee compiles its report and forwards it to the government.

Any committee or Member of Parliament may submit a recommendation to the government on the budget. There are no requirements that the recommendations identify financing for the recommended changes. Since there are no offsetting changes attached to the recommendations, and because of the weak constitutional position of Parliament, there is little effect from these recommendations.

The number of recommendations is often quite large, perhaps 1 000. The recommendations are usually small individually: they tend to be for local projects (*e.g.* construction). Yet, when summed up, they are often more than the entire budget.

Any changes or amendments to the budget after submission on 1 October must come from the government. After Parliament has issued its

recommendations and the government has modified the budget, Parliament must approve the budget bill by 31 December.

### ***3.5. The consequences of not passing the budget bill***

If Parliament does not pass the budget bill, the minister of finance can automatically fund central government operations each month by not more than one-twelfth the amount of the previous year's appropriations.

If Parliament rejects the budget bill three times, the president can call for the dissolution of Parliament. Thus not only can the government start funding in the absence of approval, but Parliament can also be dissolved for not agreeing with the proposed budget bill.

### ***3.6. Reports to Parliament***

In addition to the budget documents, Parliament is entitled to receive other reports on budget execution, accounting and auditing. Parliament receives monthly and quarterly reports on budget execution, a more detailed mid-year report on budget execution, and a mid-year and annual report from the Chamber of Control. In addition to these reports, Parliament is not constrained in its oversight and may hold hearings on any issue it deems necessary.

The quality and timeliness of the expenditure reports were called into question by parliamentarians. Expenditure reports were characterised as more often late and not very specific. Reports were not useful for holding the government to account. It should be emphasised, though, that this referred more to historical fact than current practice. Thus it remains to be seen what reports will be released in the future.

### ***3.7. Conclusion***

A fundamental change to the Constitution concerning the role of Parliament in budgetary decision making was made in February 2004 (*i.e.* after the Rose Revolution). It entails that Parliament can no longer make amendments to the budget bill. Instead it can make recommendations that have to be considered and decided upon by the government.

Parliament has an early role in the budget process. By May, the president is required to submit the Basic Data and Directions document containing macroeconomic forecasts and revenue and expenditure estimates. The document is not voted on by Parliament, but Parliament does react to it by a report to be issued by 1 June. Parliamentarians noted that, in the past,

this review of the aggregates was a mere formality because of deficiencies of the Basic Data and Directions document. This year (budget for 2006) the situation has improved considerably, but further improvements of the document are possible and will contribute to parliamentary oversight.

In recent years the budget bill has been submitted in time and has allowed Parliament to structure its review activities more thoroughly.

Parliament has used its position in the budget process to make many recommendations. There are no requirements that the recommendations identify financing for the recommended changes. The parliamentary approval process could be strengthened and the effectiveness of parliamentary recommendations improved if Parliament would revise its procedures and provide offsets or financing sources for its recommendations.

Reports to Parliament on budget execution have come late in previous years and have lacked sufficient specificity to allow effective parliamentary oversight. In this area there is ample scope for improvement.

## **4. Budget execution**

### ***4.1. The organisation of budget execution***

Budget execution in Georgia is very much based on controlling the cash flow. This reflects previous experiences in Georgia with revenue shortfalls and expenditure overruns and the government's need to meet them with cash limits.<sup>20</sup> Although cash control is a tool for keeping spending in line with revenues, it has a negative effect on financial management and the government's reliability in the eyes of contracting partners and citizens.

Previously, budget and revenue forecasts were poor and budget ceilings were often changed after the beginning of the year. The combination of inaccurate budgets, often too positive revenue forecasts and *ad hoc* cash controls resulted in a substantial build up of arrears – typically back salaries, unpaid contracts and back funding of schools and hospitals. The situation has improved substantially in the last two years. Like other parts of the budget process in Georgia, the execution phase of the budget has been profoundly overhauled. Due to enhanced tax collection and sale of government assets, domestic arrears have mostly been cleared. The bad experience with arrears – as well as pervasive corruption – has driven many of the changes undertaken in the budget execution process.

The basic principles of budget execution are laid down in the Budget System Law of 2004. The law is not an organic act in the sense that it has

legal priority over other laws; this drawback is important for budget execution. The aim of the government is to upgrade the Budget System Law to an organic law.

The Budget Department (*i.e.* the State Budget Division) of the Ministry of Finance has the main responsibility for budget execution (see Figure 3). It has to approve all spending before commitments are made. The Treasury (part of the Ministry of Finance<sup>21</sup>) is responsible for cash and debt management and is the main contact point between the Budget Department and budget users.

In addition to Budget Department control and Treasury procedures, the minister of finance must approve all spending in person (except for wages, utility services and transfers). This is largely a formality, and the ministerial power to disapprove spending is more theoretical than practised. Yet on a daily basis, the minister must sign for spending. When asked if the minister would ever disapprove spending, the reply was that if there were large treasury imbalances, the minister might not give approval.

#### ***4.2. Spending flexibility***

The new Budget System Law abolished many earmarking practices, thereby improving the possibilities to redirect spending according to changing political preferences both from year to year and during budget execution (IMF, 2005a).

Rules for reallocating appropriations are set in the Budget System Law and do not differentiate between the reasons for reallocation, such as changed macroeconomic conditions, forecast errors, etc. The general rule is that a budget user, after the approval of the minister of finance, can reallocate between line item appropriations as long as the total change per appropriation remains within a 10% band of the appropriation in the budget. In this case the relevant line ministry sends a letter to the Ministry of Finance explaining the reason for, and the amount of, reallocation. After approval the Treasury is notified. The procedure is described by the Treasury as simple, and small reallocations occur on a regular basis. Reallocations of more than 10% or reallocations between budget users require supplementary budget legislation.

The minister of finance has very strong powers in budget execution: all basic spending disbursements themselves must be signed personally by the minister of finance. Also, the minister of finance can withhold up to 10% of a ministry's funds without notifying Parliament.

The president and the government of Georgia each have small reserve funds within the state budget. According to the Budget System Law, the

funds may not exceed 2% of total appropriations. In 2006, the appropriations for the president's reserve fund and the government's reserve fund amount to GEL 30 million and GEL 25 million respectively. Parliament recently approved a government proposed amendment to the Budget System Law that specifies that the funds are for "unexpected state expenses" and that the "directions for the Georgian state budget reserve funds shall be determined by the president of Georgia and the government in accordance with the amounts and conditions set out in the annual budget law". Funds from this reserve are allocated for contingencies of national significance, such as natural disasters and contingent liabilities. Line ministries can apply for resources from this fund with approval of the president or the government.

Carryovers from year to year of unused appropriations are not allowed.

### ***4.3. Cash and debt management***

The budget execution process starts when the annual budget bill has been approved by Parliament. Appropriations are normally apportioned on a quarterly basis, with the default distribution being four equal parts. If a budget user wants another division of its appropriation, it has to get approval from the Budget Department of the Ministry of Finance.

The quarterly division of appropriations applies to all budget users, which correspond roughly to offices. For example, the Irrigation Department has 68 offices or budget users. In total, there are about 2 300 budget users.

To combat the arrears and overspending problems, Georgia implemented a new Treasury system in 2005 that includes a registry for all transactions. The system requires that all intended commitments shall be approved and registered at the Treasury prior to entering into the commitment.

For a budget user to be able to enter into a commitment, the budget user's regional treasury (line ministries' treasuries either in Tbilisi or located in the regions) has to create a commitment document, which is sent to and registered with the Treasury. The Treasury approves or disapproves the budget users' commitment request. The decision is forwarded to the budget user by the Treasury, through the budget user's regional treasury.

Regional treasuries cannot register more commitments for a budget user than are available within the current quarterly cash apportionment, not even if the payment of the commitment is due in a future quarterly period. When a budget user receives an invoice, it contacts its regional treasury which sends a verification document to the Treasury. The Treasury then orders the payment, which has to be approved by the minister of finance. Without a

recorded commitment, the Treasury will not pay the claim and will not pay more than was originally recorded.

#### **Box 4. The budget execution process**

1. Budget bill approved by Parliament.
2. Appropriations divided quarterly for all budget users.
3. Budget users send request for entering commitments to be registered by Treasury.
4. Ministry of Finance approves budget user commitments.
5. Treasury forwards decision to budget user.
6. Payment request from budget user to Treasury.
7. Ministry of Finance approves spending.
8. Treasury sends payment orders to the central bank.
9. Central bank pays contractor/supplier/etc. directly or via budget user accounts.

According to the Budget System Law, budget users must have the approval of the Treasury before entering into a contractual agreement, but this procedure is hard to apply in practice. Instead, budget users normally enter into contracts before they have the agreement of the Treasury, and it is only afterwards that agreement from the Treasury is sought. According to the Treasury, this is not a major problem, as suppliers know about the procedure. But still, budget users could run into problems if the Treasury does not accept commitments, especially if contracts do not contain a clause that makes their validity conditional on Treasury agreement.

The registration and payment system is only available for the Treasury. Line ministries, regional treasuries or budget users cannot enter commitments into the Treasury registration system themselves. Instead, the process of developing commitment documents by regional treasuries is done by hand. Couriers often physically go to the Treasury with forms to be recorded in the system. Communications between the Treasury and the regional treasuries is only partly automated. There are plans to make the whole process automated in the coming years as part of the information technology master plan of the Ministry (Georgian Government, 2005c).

Concurrently to the adoption of the Treasury registry system, Georgia has started implementing a Treasury Single Account (TSA) system. Previously budget users operated their own bank accounts outside central control. The problems with budget users having their own accounts are well

documented – little transparency, corruption, hoarding funds, etc. – and Georgia was no exception.

### **Box 5. Systems of cash management**

There are basically three models of cash management in central governments.

In the decentralised model (in place in Georgia for expenditures), all budget users have their own account with the commercial banks (in Georgia, most of these accounts are in the National Bank, but not yet part of a Treasury Single Account). These accounts are funded by periodical cash advances supplied by the Treasury on the basis of cash flow estimates and cash allotment decisions. Budget users make payment orders by drawing on their own accounts.

In the centralised model (now mainly in place in Georgia for revenues) budget users are not allowed to have their own accounts with the commercial banks. There is only a single account (with sub-accounts) usually kept at the central bank, which is under the Treasury. Since the Treasury is not allowed to borrow from the central bank, the Treasury handles short-term borrowing by auctioning securities among the commercial banks. All budget users have to send payment orders to the Treasury in order to draw upon their sub-accounts.

In the hybrid model, budget users are allowed to have their own bank accounts with a single commercial bank, but the positive balances on these accounts are daily transferred to the Treasury account with the central bank and daily supplied with cash advances. The contract with the commercial bank is auctioned. Similarly, short-term borrowing is centralised at the Treasury. Budget users make payments by drawing on their own account with the commercial bank.

Both the centralised and the hybrid model realise efficiency gains through consolidation of balances and centralisation of short-term borrowing at the Treasury.

With IMF and USAID assistance, Georgia started consolidating separate accounts into a single account in 2003. The introduction of a TSA is being done in two steps. In the first step of April 2004, more than 10 000 transit accounts for revenues at the central bank were closed and all budget revenue since then is recorded in a Treasury Single Revenue Account (TSRA). The TSRA is located in the Georgian National Bank and has approximately 300 zero-balance sub-accounts for transaction purposes. The second step will be to close all expenditure accounts and create a fully operational TSA. The aim of the Treasury is to fulfil the second step in 2006.

Since April 2005, all central and local revenues go to the TSRA. Tax revenues that belong to sub-national governments are then transferred to the sub-national governments. Since January 2004, budget users' non-tax revenues are estimated on a gross basis at the revenue side of the budget and are paid into the TSRA. For expenditures there is still no single account. Approximately 30 expenditure accounts exist, most of them at the National Bank, but if no regional National Bank office exists where budget users are located, budget users use accounts in commercial banks. According to the Budget System Law, budget users are not allowed to have bank accounts without the specific permission of the Treasury. The Treasury may authorise accounts in banks if they are deemed necessary for operational purposes. The Treasury also have the authority to withdraw previously given authorisations for own bank accounts.

In accordance with the quarterly division of appropriations, budget users have to report their needs for the coming month, divided per week, before the 25<sup>th</sup> of each month to their local treasury which then submits this information to the Treasury. The cash planning process is regulated in the "regulation on operative planning of cash release and cash management for the budget organisation" of the Ministry of Finance.

For operative cash planning, the Treasury uses the information from the local treasuries and revenue forecasts to determine if cash will be available to meet expected payments. It determines the daily amounts of expected payments one week in advance. If expected payments exceed revenues, the Treasury notifies the Ministry of Finance (State Internal Debt Division) which decides on adequate financing.

Local treasuries ensure that budget users' payment requests are within their weekly limits, and forward the payment requests to the Treasury which then orders payments from the accounts in the National Bank. The Treasury also monitors overall development of local treasuries' payment requests to make sure that they are within limits.

According to the Treasury, for the last 18 months there has been no need for short-term debt financing, as the government has had a positive cash balance at the National Bank large enough to meet payments. This situation is dependent on the size of the balance which has been approximately GEL 100 million on average. This capital lies idle in the government accounts at the National Bank. More advanced cash management methods would make it possible to reduce the positive average balance (and/or to receive interest on it<sup>22</sup>).

Georgia operates a cash management system with extensive preventive controls (by the Budget Department, the Treasury and the minister of finance). The need for preventive cash control is a consequence of a lack of

budgetary discipline. If the budget cannot be relied upon as a tool for spending control, the Ministry of Finance has to pursue control through the cash management process. However, this leads to bureaucratic costs and in general diminishes the financial reliability of the government in the eyes of contracting partners and citizens. Preventive cash control can be reduced or eventually abandoned to the extent that budgetary discipline in line ministries improves. For that purpose it is important that the budget is continuously monitored and updated during budget execution and that the Ministry of Finance ensures that line item estimates are timely adjusted and accommodated within the agreed sectoral ceilings or, in the ultimate case, within the overall ceiling with cabinet approval. Monitoring of the budget during its execution is a task for the Budget Department, not for the Treasury. Monitoring requires sufficient oversight capacity by the sector specialists.

The responsibility for debt management is divided between the Budget Department and the Foreign Relations Department, both in the Ministry of Finance. Domestic debt management is the responsibility of the State Internal Debt Division of the Budget Department, and foreign debt – mainly loans from international financial institutions – is managed by the Foreign Debt Division of the Foreign Relations Department (see Figure 3).

Government debt is mainly foreign debt, but approximately 10% of GDP is borrowed in the domestic market. The recording of domestic debt used to be deficient, but that has now mainly been corrected. In November 2004, the State Commission for Studying the Issues of Accumulated Internal Debt (the so-called “historical debt”) was set up. By 1 May 2006 the Commission has to develop recommendations on the strategy and mechanisms for clearance of recognised internal debts, which will subsequently be submitted to the government and Parliament. The interest rate on domestic borrowing peaked at rates as high as 80% but has now stabilised at around 10%. The practice of Treasury borrowing from the National Bank has been abandoned. Instead, deficit financing will henceforth be carried out by the issuance of securities and bonds. This is expected to contribute to the development of a Georgian capital market. It should be noted, though, that the 2006 budget includes no issuance of securities and bonds as a source of deficit financing.

Projects that are to be financed by loans from donors are discussed by the Ministry of Finance and line ministries. The Foreign Relations Department of the Ministry of Finance then negotiates and manages these loans. A rescheduling of debt by Paris Club creditors was agreed in 2001, but lax policy kept the debt burden high, and arrears on foreign debt accumulated in the following years (IMF, 2004). A new rescheduling arrangement with the Paris Club was completed in July 2004 (see

section 1.3 above) and discussions with other bilateral creditors (Armenia, Azerbaijan, China and Kazakhstan) are currently in a final stage (IMF, 2005b). The aim of the Ministry of Finance is to conclude these discussions before the end of 2005.

#### 4.4. Service delivery

Service delivery in Georgia is to a large extent concentrated at the central government level. In 2004, sub-national government expenditure amounted to 15% of general government expenditure. Service delivery at the central level is partly organised in regular ministerial departments and partly in **public law entities** (PLEs). These agencies are publicly funded but have considerable management autonomy and legal personality. PLE formation started in 1998. Presently there are more than 500 PLEs (Table 3).

**Table 3. Public law entities created 1998-2004**

Year created	Number of PLEs created
1998	3
1999	14
2000	39
2001	43
2002	27
2003	504
2004	2
<b>Total</b>	<b>632</b>

Source: Gentry (2004).

Since PLE budgets are separate from ministerial budgets, PLE formation can be seen as a step towards improvement of cost information and programme budgeting. However, in order to reap the benefits of better cost information, it is also necessary to collect information about outputs and efficiency, for instance through benchmarking of PLEs with comparable tasks (schools, hospitals, etc.). Output monitoring of PLEs is still in its infancy in most line ministries.

Public procurement has traditionally not been well regulated in Georgia. This has been one of the main reasons for widespread corruption. From 2006 a new law on procurement will be in force. It specifies thresholds for public tenders and describes tendering procedures. The value threshold differs between regular goods (value of tender more than GEL 10 000) and construction (more than GEL 300 000). The law also specifies that a public procurement agency is to be set up to monitor compliance and regulate appeal procedures.

### Box 6. Public law entities

Since 1998 the government has pursued a policy of converting units that provide government services into public law entities (PLEs). These agencies can generally be described as a way to contract out public service provision. PLEs are run by a board of supervisors and are funded by public payments and user fees. PLE expenditures are entered on a net basis in the budget (only public payments; user fees are considered as own revenues of the PLEs, not as non-tax revenue of the government).

Before 2003, just over 100 PLEs existed. Spurred by the present government's privatisation efforts, more than 500 were created in 2003, and the aim is to continue this process.

The general aim of the government's PLE strategy is to reduce costs of service provision. PLEs exist in a number of areas of government service delivery, for example hospitals, schools, nursing homes, and cultural institutions such as museums and theatres.

In 2003, an "Association for Competition and Development in Georgia" was set up by five former employees of the Ministry of Finance, the State Chancellery, and the National Bank. It has provided privatisation advice to the government and now organises training courses on the management of PLEs. The Association currently employs around 30 staff.

Problems that have been identified in the present functioning of PLEs are: insufficient monitoring of outputs, leading to inefficiency; and insufficient regulation of service quality and access, leading to deficient services and possibly corruption.

Sources: Gentry, 2004; Zohrab, 2005.

#### 4.5. Sub-national governments

Except for the autonomous republics of Abkhazia and Adjara, Georgia is a unitary state with three layers of sub-national government: regional, district, and municipal. The highest level in the sub-national structure is the regional level with nine administrative regions plus Tbilisi and the autonomous republics of Abkhazia and Adjara. The district level (rural districts and cities, *rayons*) consists of 65 units and, in budgetary terms, is the most important level. Closest to the citizens are the 966 municipalities (villages and towns). The only sub-national level with direct representation is the municipal level. The districts have no directly elected council. Instead, district councils consist of delegates from the municipal level. There is currently a debate in Parliament about merging sub-national units. The following text refers to districts and municipalities.

The sub-national government sector is quite small, and its expenditure share of general government expenditure amounts to approximately 15%. Given the relatively small size of the sub-national sector, its tasks are quite limited – mainly parts of the educational and health system, local infrastructure, water, sewerage and street lights. Another responsibility for the sub-national level of government is capital expenditures for schools. From 2006, more responsibility is to be transferred in the educational area. In 2003, excluding the regional level, the districts' share of sub-national spending was 60% with the remaining 40% at the municipal level (UNDP, 2005).

The main revenue source for sub-national governments is taxation. Sub-national tax bases are income (from 2005), property and gambling. Property tax and tax on gambling are sub-national own tax revenue, but the central government sets the floor and ceiling for tax rates. Property tax is shared with the central government. The size of tax bases varies considerably between regions. Tax collection is done by the central government. Revenues collected are transferred to the districts where some are kept and the rest is distributed to the municipal level. Tax shares of regions, cities and villages do not need to coincide with tax collection shares. The tax-sharing arrangement contains elements of tax base and cost equalisation.

Taxes finance between 50% and 100% of sub-national activities, reflecting significant horizontal imbalances in own resources between sub-national government units. The rest is mainly made up by grants from the central government. Due to improvements in tax collection, tax revenue has increased in recent years, and the number of sub-national units in need of grants to finance their basic activities has decreased from 60% to 45%. Sub-national governments are allowed to borrow with approval of the Ministry of Finance. Loans are provided or guaranteed by the central government and is restricted to cases where the government sees that the sub-national unit has budgetary resources available to repay the loan. Sub-national government borrowing is not common, and the debt-stock of sub-national governments is not seen as a reason for concern by the Ministry of Finance.

Grants from the central government are mainly of two types: special purpose grants and grants to fill the fiscal gap between own (mainly tax) revenue and spending need. In total GEL 110 million, or almost 1% of GDP, was transferred in 2005. The division of total grant expenditures between the two types is around 50% for each type. Special purpose grants are distributed according to political priorities of the central government. The fiscal gap grants are not formula-based but distributed by a commission with representatives from the Ministry of Finance and the districts. The gap-filling and discretionary nature of the grant system can provide negative incentives for own revenue collection at the sub-national level and brings an

unpredictable element into the budget planning of sub-national units. Even though grants are supposed to equalise revenues, there is still a large variation in per capita expenditure between districts (UNDP, 2005), implying that equalisation does not cure differences in own revenue-raising capacity.

The legal framework for the sub-national part of Georgia's government sector is regulated mainly in the organic Law on Local Self Government from 1997. In addition, there is also a Local Budget Law. According to UNDP (2005), there is still an unclear delineation of responsibilities for regulating, financing and implementing tasks assigned to sub-national governments. Together with limited expenditure autonomy, discretionary distribution of grants from the central government and the ambiguous budgetary relationship between districts and municipalities highlights the need for clearer legislation in this area. The State Committee for Decentralisation, formed in 2004 and led by the president, presents a forum for further work in this area. There is currently a new law being discussed, with possible implementation from 2007, for introducing a formula-based equalisation system for the fiscal gap grants, this would probably solve at least part of the ambiguities mentioned.

After the Saakashvili administration came into power, the break-away autonomous republic of Adjara has been brought back under government control. Georgia still faces a problem with two other break-away regions: the autonomous republic of Abkhazia and the region of South-Ossetia. The government continues to seek a peaceful settlement of these conflicts.

#### ***4.6. Conclusion***

The Georgian procedure of budget execution leans heavily on preventive cash control. This leads to bureaucratic costs and in general diminishes the financial reliability of the government in the eyes of contracting partners and citizens. The need for preventive cash control is a consequence of a lack of budgetary discipline. Preventive cash control can be reduced or eventually abandoned to the extent that budgetary discipline in line ministries improves. Monitoring of the budget during its execution is a task for the Budget Department, not for the Treasury. Monitoring requires sufficient oversight capacity by the sector specialists.

According to the Treasury, the current procedure for reallocation is working well, but it could be enhanced by introducing a facility that enables budget users under appropriate conditions to transfer unused appropriations from one budget year to another.

At the moment the Treasury registration system is only available to the Treasury itself and not to the local treasuries in the line ministries. This is mainly because communication between the Treasury and the local treasuries is only partly automated. It is important that further information technology improvements are pursued energetically and that the Treasury registers become accessible to the local treasuries.

The Treasury Single Account is operational for revenues since January 2004. The expenditure side of the system is under development and will become operational soon. This will contribute to the efficiency of cash management. Further efficiency gains in cash management are possible by improving cash flow forecasts.

Domestic lending plays a lesser role in Georgia than foreign lending. The Ministry of Finance has abandoned the practice of borrowing from the National Bank and will henceforth issue state securities and bonds to cover its financing needs. It is expected that this will foster the development of the domestic capital market. It is noteworthy that the budget for 2006 does not include any issuing of securities or bonds to finance the fiscal deficit.

The international indebtedness of Georgia is gradually decreasing due to consolidation and rescheduling of existing debts and future maturities in the Paris Club agreement of July 2004, follow-up agreements with individual creditors, and better debt service discipline. Discussions with non Paris Club creditors are in the final stage and will, if successful, lead to further reduction of foreign debt.

The creation of PLEs is an interesting development in Georgia. It is in line with the government's efforts to reduce the size of government. The creation of PLEs raises some questions, however. The government has so far made efforts to bring extra-budgetary funds on budget. To make PLEs successful, it must be ensured that they do not become a new kind of extra-budgetary fund. Legislation is now in place to provide a general framework for PLEs but this legislation can be further improved. In particular, the separation between financier and service provider should be enhanced, and systems for collecting information on PLE performance should be established.

Decentralisation can provide benefits in government service provision. Georgia has started a process of decentralisation which will be further developed in the coming years. The proposed law on improving equalisation transfers is a good step and a precondition for further steps.

## 5. Accounting and auditing

### 5.1. Accounting

The Treasury of the Ministry of Finance is responsible for developing the chart of accounts as well as accounting policies and procedures. The Georgian government reports its accounts on a cash basis in accordance with IMF standards and partly on a commitment basis (at present the main difference being the clearance of domestic arrears). Work is under way to adjust the functional and economic classifications from the 1986 Government Finance Statistics to the GFS 2001 standards. According to plan, the GFS 2001 standards will be applied to the 2007 budget. The level of reporting in Georgia is relatively extensive and comprehensive. The budget documents now cover most of the central government expenditures, including extra-budgetary funds, and the reports show appropriations versus realisations. The Treasury generates reports on daily, weekly, monthly, mid-year and annual budget outturns. The daily reports are purely for the Ministry of Finance. The weekly and monthly reports are sent to the government and Parliament.

The establishment of a TSRA for revenues has improved accounting and information at the revenue side of the budget. The next step is the development of a TSA for expenditures in 2006. Another important step in this area is the development of a new Treasury ledger for all budget users. The Treasury indicated that this work had to be completed by 2007. The Ministry of Finance has adopted a long-term reform strategy in the accounting area covering these and other future reforms (Georgian Government, 2005c).

The annual accounts are published very quickly after the end of the year, but they are audited only later in the year by the Chamber of Control. International practice suggests that audited accounts should be presented to Parliament within three months of the end of the fiscal year.

### 5.2. External control: The Georgian Chamber of Control

The Georgian Chamber of Control has a history dating back to the early 20<sup>th</sup> century. Since 1926 a Public Control Office existed. Before that, from 1918 to 1922, there was already an independent Chamber of Control in Georgia. The Georgian Chamber of Control exists in its present form since 1993. It was then staffed by 100 people. By 2004 staffing had increased to 800. About one and a half years ago the Chamber went through fundamental change. Management was replaced and 300 staff at all levels were laid off. The move was made to prepare the Chamber to concentrate on

combating corruption and to make its reports more reliable and effective. Since then moderate growth has been allowed and the Chamber now employs 700 staff.

The law providing for the foundation of the Chamber is Article 97 of the Georgian Constitution, adopted in August 1995. According to the Constitution, the Chamber of Control is independent, accountable only to Parliament, and exercises control of the use of government assets and expenditures. All reports by the Chamber are published and made available to the public. Twice a year the Chamber has to submit a report about the national budget and once a year it has to submit a report about its activities to Parliament.

The Constitution refers to the “Law of the Georgian Chamber of Control” which defines its authority, structure, and functions, and guarantees its independence. The main duties of the Chamber are the following:

- Supervision of the budget process and use of government funds;
- Control of the regularity, expedience and effectiveness of the utilisation of government expenditures, state-run capital, property, and foreign credit and loans;
- Preparation of conclusions of the state budget, including tax legislation;
- Examination of proposed laws, both before and after they go to Parliament;
- Delivery of an expert opinion by order of Parliament concerning legislative plans and finance programmes;
- Co-ordination of the activities of other elements of financial and economic control in the financial-economic field.

The Chamber of Control has the authority to audit all units that receive government funding or use government property, including all elements of the legislature, the executive, and the judiciary, elements of local administration, extraordinary governmental funds, the National Bank of Georgia, and other organisations and authorities. It is generally prohibited from examining private firms, but if private units receive government funds or use government property, the use of these funds and property can be audited by the Chamber. The Chamber is funded through the national budget of Georgia.

The Chamber of Control makes yearly and quarterly plans of its activities. The Chamber has its own right to initiate audits; it can also be

asked to initiate audits by Parliament and by the president of Georgia. Apart from scheduled audits, the Chamber also carries out “unplanned” audits.

Audits are generally financial audits. Performance audits are not carried out at present, but training has been started, in co-operation with donors, to improve the competence in this area. Audits are carried out *ex post*. Preventive control and system control are planned, and training for staff has also begun in this area.

The Law of the Georgian Chamber of Control specifies the rights and duties of the members of the Chamber. The chairperson is appointed by Parliament for five years adapting to the proposal by the chairperson of Parliament. The chairperson of the Chamber proposes the candidates for the deputies and other members of the presidium. Apart from the chairperson and his/her deputies, the presidium contains other members such as the Chamber’s heads of departments and other senior staff. The chairperson is allowed to hire and fire employees of the Chamber, and is granted immunity. The law defines some minimum standards for qualification of the chairperson and his/her deputies and does not allow them any party affiliation. For the other civil servants of the Chamber, preconditions concerning their qualification are regulated by law.

The Chamber of Control performs its tasks by prompt controls, general audits, focal point audits and expert opinions. Time limits are defined for the information about public revenue and spending. The extent, limits and places of audits and revisions in the whole national territory are defined by the chairperson of the Chamber or the chairpersons of the sub-units (territorial units and autonomous republics). In four cities small teams are established which carry out regular controls. To implement audits and revisions, experts can be invited.

The official responsible for the unit being audited has to answer questions concerning the audit in written form within two weeks. The Chamber of Control informs the responsible official afterwards about the results of the audit. Any materials of the audit which may contain characteristics of felony are assigned to agencies of prosecution (Office of the Public Prosecutor).

The Chamber performs approximately 300 audits each year, of which 15-20% are “unplanned” audits. It is noteworthy that around one-third of the annually performed audits are referred to the Office of the Public Prosecutor.

The Chamber makes two types of comments about audited units. The first are recommendations, the second are instructions. The latter must be signed by the chairperson of the Chamber and must be followed up.

The reports and recommendations are also sent to responsible ministers who must reply to the Chamber with comments on the recommendations. The parliamentary Finance Committee also receives the recommendations and reports and can hold hearings. Sometimes the reports and recommendations are sent to the government.

The Chamber of Control is obliged to work closely with other state organs. Agencies of prosecution, the national tax office, national agencies of financial and economic control and other state agencies are obliged to support the Chamber of Control. The Chamber is responsible for the co-ordination of control agencies in the financial economic area. Furthermore it is supposed to develop standards and instructions for auditing, which apply to all control agencies in the financial-economic area.

### ***5.3. Internal control***

A problem emphasised by the staff of the Chamber is the lack of internal control by budget users. Very little progress has been made in this area, and the Chamber staff mentioned that further progress would be most welcome not only to improve the quality of accounting and administrative organisation in government but also to facilitate the work of the Chamber.

A few ministries like Justice and Finance have internal inspectorates but they do not carry out formal internal audits. The internal inspectorates enjoy a certain independence, and support the ministers in a number of investigatory capacities which can include payment monitoring and other anti-corruption efforts.

### ***5.4. Conclusion***

The quality of financial reporting has greatly improved since 2004. The annual accounts are published very quickly after the end of the year, but they are audited only later in the year by the Chamber of Control. International practice suggests that audited accounts should be presented to Parliament within three months of the end of the fiscal year.

Although the Chamber of Control still needs to improve its capacity in fields such as performance audit and preventive control, the Chamber seems to be functioning relatively well, and it plays an important role in the government's attempt to improve the functioning of the public sector, improve the quality of the use of public resources, and fight corruption. Continued training of staff in the mentioned areas should be a priority. Training in performance auditing is especially important as more and more services are provided through PLEs.

While internal control is a stated priority of the Ministry of Finance, it has not yet been fully launched. This is an important priority for the coming years, not only in view of the effects of internal control on the quality of accounting and administrative organisation, but also because it will facilitate the work of the Chamber of Control.

### Notes

1. Transparency principles are developed in the *OECD Best Practices for Budget Transparency* (OECD, 2002).
2. The PRGF is a low-cost facility, which carries an interest rate of 0.5% and is repayable over ten years with a 5.5 year grace period on principal payments. PRGF-supported programmes are based on country-owned poverty reduction strategies adopted in a participatory process involving civil society and development partners, and articulated in a poverty reduction strategy paper.
3. Earlier IMF arrangements were made in February 1996 (USD 240 million, fully drawn) and December 2001 (USD 70 million drawn to date).
4. At end 2002, legacy debt comprised an estimated GEL 1.2 billion (Georgian lari) in past obligations of the electricity sector that cannot be serviced in the light of short and medium-term cash flow prospects of the sector. (The value of one Georgian lari in 2002 was USD 0.46. In January 2006, the value of the GEL was about USD 0.55.)
5. Thus far the IMF has reviewed the progress on the PRGF programme twice, namely in January 2005 (IMF, 2005a) and in August 2005 (IMF, 2005b).
6. According to GFS standards, privatisation receipts do not reduce the deficit since they are a means of financing rather than a source of revenue.
7. The value of the Georgian lari in 2004 was USD 0.51.
8. Major sales included the Ocean Shipping Company and a major industrial complex in Western Georgia including the Vartsikhe hydro power station.
9. The terminology differed somewhat in both stages. In the second stage the document was called “strategic sectoral expenditures matrix”, its second column “objectives/prospects”, its third column “priority reforms”, and its fourth column “budget implications”.

10. In previous years there had also been ceilings in the Budget Circular, but only for the budget year.
11. The budgets of Parliament and the Chamber of Control are decided by the president and exempted from the process.
12. In some countries, including some OECD countries, medium-term expenditure frameworks are established from year to year without much consideration of the ceilings of the previous year. This does not make the exercise entirely senseless, because it still focuses attention on the multi-annual budgetary consequences of policy changes from year to year, but it removes the stability enhancing effect over the years and it hampers transparency, especially if the new ceilings are not explained in relation to the previous ones.
13. Multi-annual stability in this sense requires, in addition to a clear distinction between existing policies and policy changes, a clear distinction between expenditure changes following from policy changes and from updating of estimates on the basis of existing policies.
14. This distinction is partly the case already, since the matrices have columns for the current situation and for reform actions. However, it could be made more explicit, and the link with existing and new expenditure estimates could be emphasised.
15. The Budget System Law refers to the Basic Data and Directions document as “The Basic Directions for Budget and Tax Policy”.
16. The submission of the document to Parliament is a democratic feature of the process which contributes to transparency. This feature is in accordance with the *OECD Best Practices on Budget Transparency* (OECD, 2002).
17. The EU Policy Advice project developed an alternative model, which however showed other weaknesses in its technical specifications and forecasting capabilities and was not used during the budget cycle for 2006.
18. The fiscal year corresponds to the calendar year in Georgia.
19. In addition to this new way of presenting the budget, for the first time the Ministry of Finance organised a retreat with Parliament to discuss the government’s proposed budget for 2006. The retreat was held outside of Tbilisi over two consecutive weekends. In attendance were the finance minister and his senior team, the Speaker of Parliament, and 13 MPs, including the heads of the finance, procedures, and foreign affairs committees. Parliamentarians of the opposition were not invited to attend. During the sessions, there was disagreement and constructive debate

between the government ministers and the parliamentarians of the governing coalition. A benefit of this type of retreat is that the government is forced to justify and defend its proposals in a less politically charged environment than would be possible in Parliament, either in committee or on the floor. It allowed for a more “technical” debate on the merits of the proposals, which may translate into better understanding, if not agreement, between the government and the legislature (at least the majority) regarding the government’s plans.

20. In 2001, actual budget expenditures amounted to 82% of what was originally budgeted. This was an improvement from the previous year, when final expenditures amounted to only 63% of what was originally budgeted (World Bank, 2002).
21. When the Treasury is mentioned, it refers to the Treasury of the Ministry of Finance as opposed to treasury units in line ministries.
22. The government receives no interest on this balance, but on the other hand, it pays nothing to the National Bank for its role in collecting revenues and executing payments. The Treasury has stated that it is quite satisfied with this situation.

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