

# GETTING CLOSER TO EU STANDARDS - GEORGIA FISCAL GOVERNANCE ADJUSTMENT AND ITS IMPLICATIONS

David OBOLADZE\*

**Abstract:** *This study focuses on fiscal governance from the perspective of developing the public finance management of Georgia. The paper investigates the fiscal governance framework in European Union countries and examines the impact of fiscal rules and budget procedures in EU countries. Well-designed fiscal frameworks are generally associated with better budgetary outcomes in terms of deficit and debt control. Following a thorough investigation of the current stance of fiscal governance in Georgia, the paper analyses the main medium and long-term perspectives for Georgia to approximate with EU fiscal governance. The main objective of this paper is to provide policy guidelines needed for the appropriate and necessary reforms to ensure comprehensive, coherent and consistent fiscal governance framework for Georgia, which will improve the performance of public finance management and national economy of Georgia.*

**Keywords:** *fiscal governance; fiscal policy; fiscal rules; fiscal discipline; national fiscal framework*

## Introduction

The national fiscal governance helps improve the budgetary discipline and supports the sound and sustainable conduct of public finances. Well-designed fiscal frameworks are generally associated with better budgetary outcomes in terms of deficit and debt developments.

The fiscal frameworks can be defined as the set of elements of the institutional policy setting that shape fiscal policy making at the national level. They comprise the arrangements, procedures and institutions governing planning and implementing budgetary policies. The main components of domestic fiscal frameworks are:

- Numerical fiscal rules (NFR);
- Independent fiscal institutions (i.e., specific public bodies acting in the

---

\* PhD Candidate, Ilia State University, Georgia; Assistant Researcher, Institute of Economics and Business at Ilia State University (ISU), Georgia, e-mail: davit.oboladze.1@iliauni.edu.ge



- field of budgetary policy);
- Budgetary procedures governing the preparation, approval, and implementation of budget plans. As part of the latter category:
  - Medium-term budgetary frameworks (MTBFs) for multi-annual budgetary planning are specifically considered apart because of their importance in fostering medium term horizons for fiscal policies.

The policy of the EU countries in the direction of Public Finance Management serves three main objectives:

- Effective budgetary policy, control of deficit and prevention of unsustainable fiscal policies;
- Reducing the fiscal policies cyclic path;
- Increasing the efficiency of public finances expenditure.

Based on the scientific literature and empirical evidence on the domestic fiscal framework, particularly, on existing fiscal rules, the present paper primarily studies the existing evidence and then the major implications of the present framework. The paper uses official data from EU fiscal rules database, IMF and national authorities, regarding both national and supranational fiscal rules, between 1990 and 2012.

The main research questions of this paper are: Is Georgia fiscal governance framework compatible with those of EU countries? What reforms are needed to get closer to the EU standards? What would be the impact of such reforms? What Georgia can learn from past experiences in EU countries and what mistakes should Georgia avoid?

The paper is structured as follows: Section 1 presents a brief literature review regarding the role of fiscal rules. Section 2 provides a critical investigation of fiscal frameworks in EU Member States, using IMF and EU statistical data. Section 3 analyses the fiscal governance framework in Georgia. Section 4 presents policy guidelines for Georgia fiscal governance framework and the last section presents the concluding remarks.

## 1. Literature review

In many studies fiscal rules are found to be important tools for fiscal consolidation (Larch and Turrini, 2008)) and fulfilling medium-term fiscal objectives (von Hagen, 2010) The number of countries using fiscal rules as a fiscal policy device has rapidly increased since the mid-1990s, initially confined to advanced economies and rapidly outnumbered by developing economies (Schaechter *et al.*, 2012).

According to Symansky and Kopits (1998), a fiscal rule is “a permanent constraint on fiscal policy, expressed in terms of a summary indicator of fiscal performance such as the government budget deficit, borrowing, debt or a major component”. According to European Commission, the fiscal policy rules set numerical targets for budgetary aggregates which pose a permanent constraint on

fiscal policy, expressed in terms of a summary indicator of fiscal outcomes, such as the government budget balance, debt, expenditure, or revenue developments, in order to enhance budgetary discipline and foster policy coordination between different levels of government. Additionally, fiscal rules may further contribute to the reduction of uncertainty about future fiscal policy developments (European Commission, 2014).

Regarding the impact of fiscal rules on pro-cyclicality, the literature reveals some divergent views, facing empirical limitations. As suggested by Kopits and Symansky (1998), IMF (2012), Bova *et al.* (2014), etc., fiscal rules are generally established as part of a broad reform of the fiscal framework that seeks to support fiscal credibility and discipline, containing pressures to overspend, especially in good times. Bova *et al.* (2014) found that in contrast with the advanced economies, the adoption of fiscal rules in developing countries has not been associated with more counter-cyclical fiscal policies and concluded that having a fiscal rule does not shield developing economies from pro-cyclicality. Debrun *et al.* (2008) found that fiscal rules tend to encourage higher cyclically-adjusted primary balances in the EU and may reduce pro-cyclicality. On the other hand, Manase (2005) claims that fiscal rules tend to limit the ability of fiscal authorities to react to business cycle fluctuations, thus potentially exacerbating volatility.

More recent economic literature (European Commission, 2014) and country-specific policy experiences provide evidence that well-designed numerical fiscal rules (NFR) significantly enhance fiscal discipline together with independent fiscal institutions (Debrun, 2007).

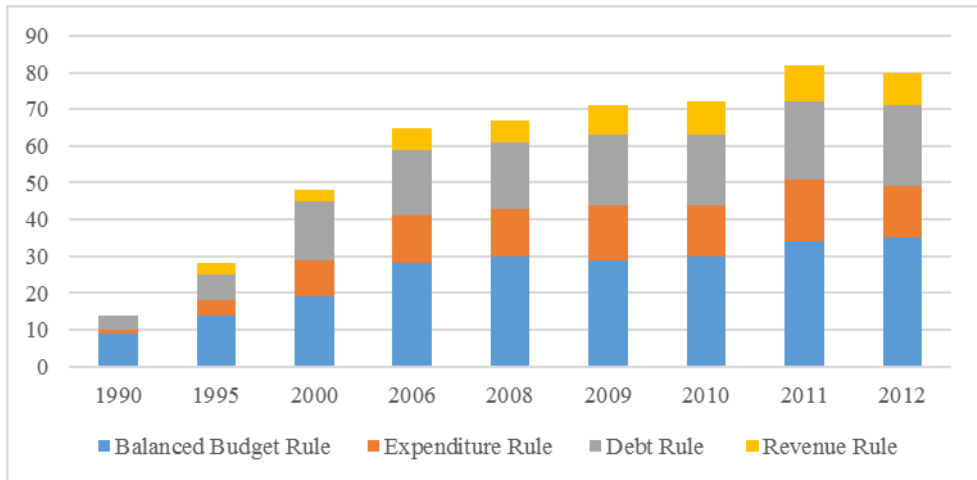
## 2. Fiscal Frameworks in EU – A Critical Investigation

The official data reveals the increasing number of numerical fiscal rules (NFR) used by the EU Member States as fiscal device since 1990s, as shown in Figure 1 and 2. The main types of NFR in EU Member States are the Balanced Budget Rule (BBR), Debt Rule (DR), Expenditure Rule (ER) and Revenue Rule (RR). In 2008, there were 67 rules in place in EU Member States, of which more than one third were budget balance rules; debt and expenditure rules represented about one quarter each and revenue rules accounted for less than 10% (European Commission, 2014).

To capture the influence of the characteristics within the institutional framework of the fiscal policy, General Directorate for Economic and Financial Affairs (DG ECFIN) has constructed an index of strength of fiscal rules (SFRI), using information on (i) the statutory base of the rule, (ii) room for setting or revising its objectives, (iii) the body in charge of monitoring respect and enforcement of the rule, (iv) the enforcement mechanisms relating to the rule, and (v) the media visibility of the rule.

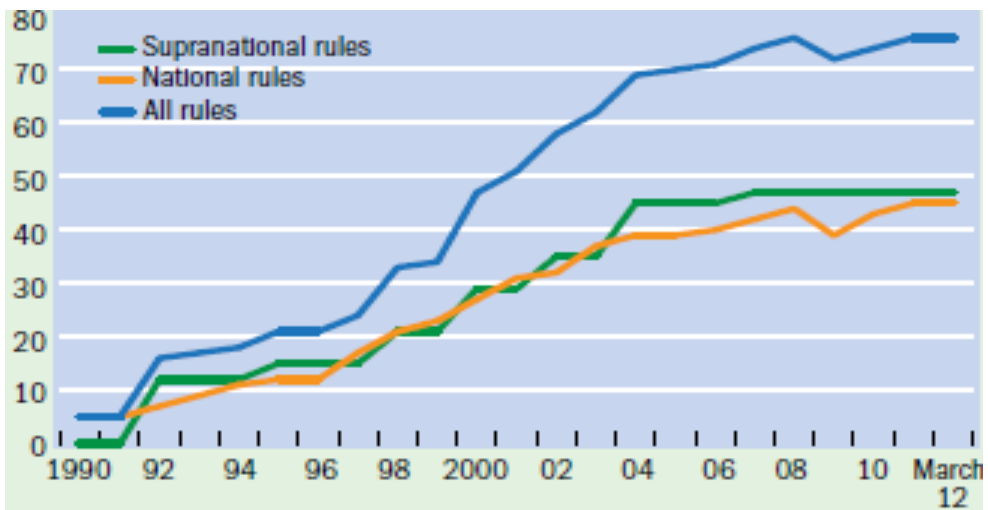


**Figure 1. Number of NFR in force in the EU Countries, by type, 1990–2012**



Source: European Commission

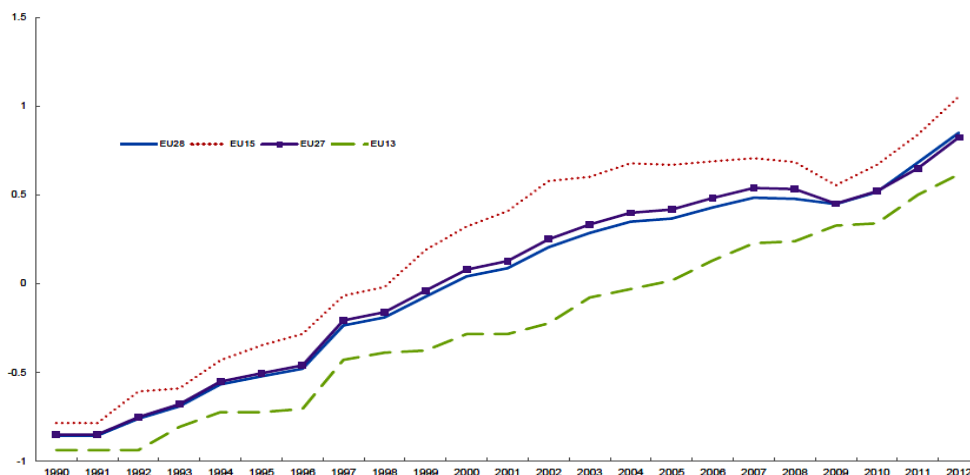
**Figure 2. Number of national and supranational NFR, in the EU, 1990-2012**



Source: IMF Fiscal Rules Database

The fiscal rules database contains the time series for the fiscal rule index 1990-2012 as shown in Figure 3 and 4. This corresponds to the quality of rules-based fiscal governance in EU Member States.

**Figure 3. The FR Index (FRI) in the EU and selected groups of Member States, 1990 to 2012**



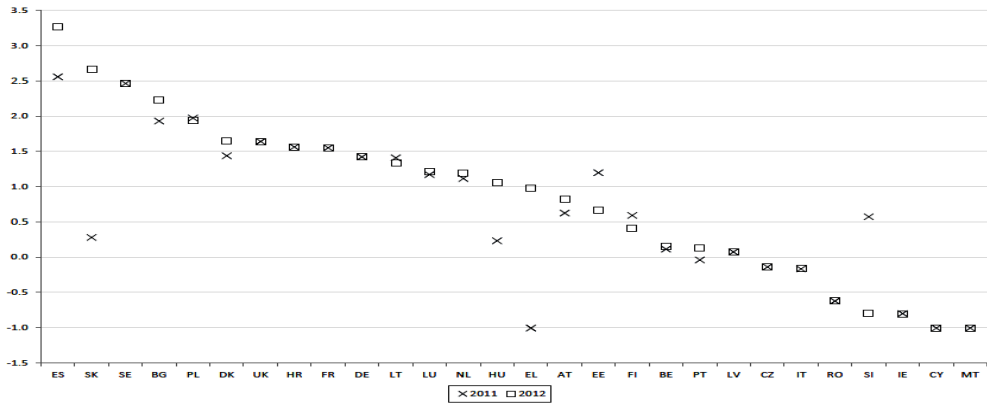
Source: European Commission

Based on the SFRI for each rule, a comprehensive time-varying fiscal rule index for each Member State was constructed by summing up all SFRI in force in that Member State weighted by the coverage of general government finances of the respective rule (i.e. public expenditure of the government sub sector(s) concerned by the rule over total general government expenditure). In the presence of more than one rule covering the same government sub-sector, the second, third and fourth rules obtain weights  $\frac{1}{2}$ ,  $\frac{1}{3}$ , and  $\frac{1}{4}$ , to reflect decreasing marginal benefit of multiple rules applying to the same sub-sector. The assigned weights are mainly determined by the fiscal strength of the rule and its coverage (European Commission, 2014).

The index is improved by means of making numerical fiscal rules stronger along either of the above dimensions and new numerical fiscal rules are introduced. Also, the coverage of general government is extended. The average quality of fiscal governance in the EU-27 has improved during 1990 and 2012, although 2009 marks a decline in the quality of fiscal governance in several EU countries.

As shown in Figure 4, countries with above-average standards of rules based fiscal governance include the Netherlands, Estonia, Denmark, Sweden, Luxembourg, Poland, Germany and Belgium; Bulgaria, Spain and France have joined this group by strengthening their rules-based framework in the time period under review. Slovenia, Hungary, Slovakia, Italy, Latvia, Romania, Austria, Ireland and Portugal have maintained rules-based fiscal governance frameworks with lower than average quality. The Czech Republic, Finland and the United Kingdom have a tradition of sound rules-based fiscal governance in contrast with Cyprus, Greece and Malta, continuously characterized by the absence of numerical fiscal rules.



**Figure 4. The fiscal rule index (FRI) in the EU-28 by country, 2011 and 2012**

Source: European Commission

**Table 1. Credit ratings of Moody's of EU Member States grouped by their strength of rules-based fiscal governance, mid-2009**

Rating	Fiscal rule index			
	below average		above average	
Aaa	AT	(2.2)	DE	(6.9)
	FI	(4.6)	DK	(9.4)
	IE	(2.2)	ES	(9.5)
	IT	(3.7)	FR	(6.9)
	UK	(0.0)	LU	(8.3)
			NL	(9.4)
			SE	(9.1)
		BE	(5.3)	
Aa2	PT	(1.7)		
Aa2	SI	(5.1)		
Aa3	CY	(0.0)		
A1	CZ	(5.2)		
	EL	(0.0)		
	MT	(0.0)		
	SK	(3.8)		
A2				
A3			LT	(9.5)
Baa1	HU	(5.1)		
Baa2				
Baa3	LV	(3.6)	BG	(10.7)
	RO	(2.3)		

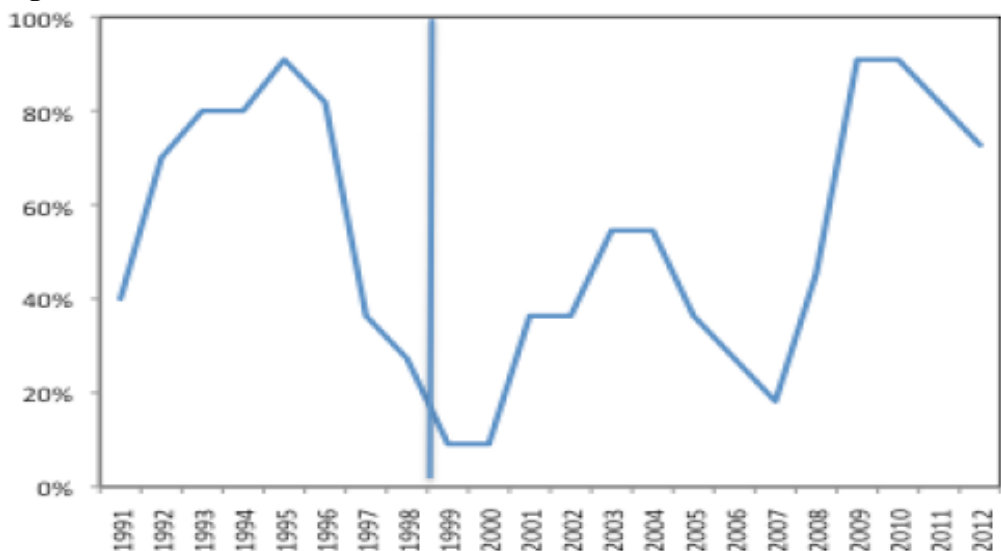
Source: Moody's (credit ratings), Commission services (fiscal rule index)

A more direct indication of a systematic relationship between the quality of fiscal governance and the price of debt – that is determined by the risk of default – can be obtained by looking at the risk of default in groups of countries distinguished by their fiscal governance directly (Table 1).

Table 1 provides some support for the direct relation between a sound fiscal governance and the cost of public debt. In the Maastricht Treaty, fiscal discipline rests mainly on the excessive deficit procedure which led to the Stability and Growth Pact (SGP). The EU fiscal framework, as laid down by the SGP, aims at ensuring fiscal discipline through two main requirements: (i) Member States are required to avoid excessive government deficit and debt positions, less than 3% and 60% of GDP, respectively; (ii) Member States are required by the preventive part of the SGP to achieve and maintain their medium term budgetary objectives (MTO), which are cyclically adjusted targets for the budget balance.

The 2005's version of the pact strengthens the 'preventive arm' by requiring budgets to be significantly improved during boom years in order to leave enough room for deterioration in slow-growth years and not to result in a breach of the 3% limit. The revised pact also specifies that the Commission would base its recommendations on cyclically adjusted budget measures. The very existence of a public deficit crisis, doubled by the sovereign debt crisis in the EU, is just the latest available proof that the European model has failed to establish and enforce fiscal discipline. The 3% and 60% ceilings proved their inefficiency as NFR (shown in Figure 5 and Figure 6).

**Figure 5. Percent of EU countries with deficits above 3% of GDP**

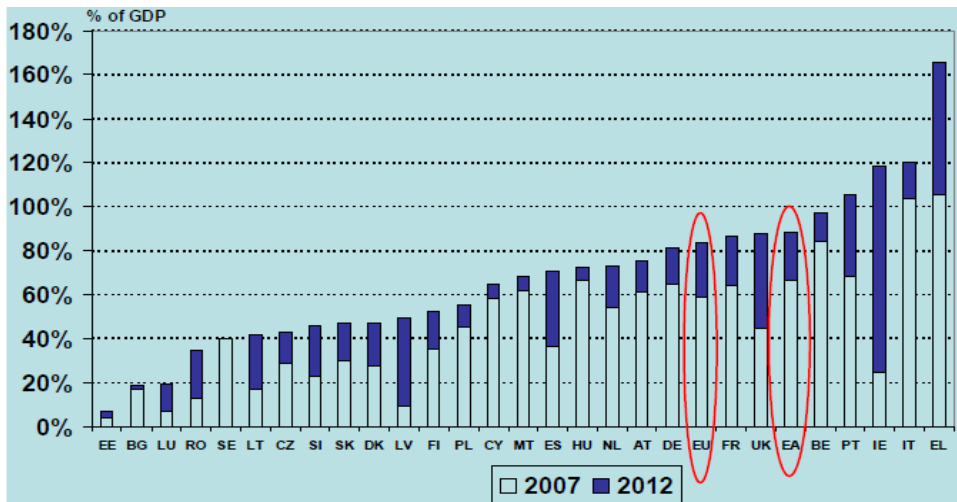


Source: European Commission



According to the Commission services' 2011 spring forecasts, the government deficit exceeded 3% of GDP in twenty-two Member States in 2010. According to the Commission services' 2014, the public debt exceeded 60% of GDP in 14 Member States and on average EU27 and EA17 in 2012 (as shown in Figure 6).

**Figure 6. Public debt (% of GDP) during 2007 and 2012 in EU countries**



Source: European Commission

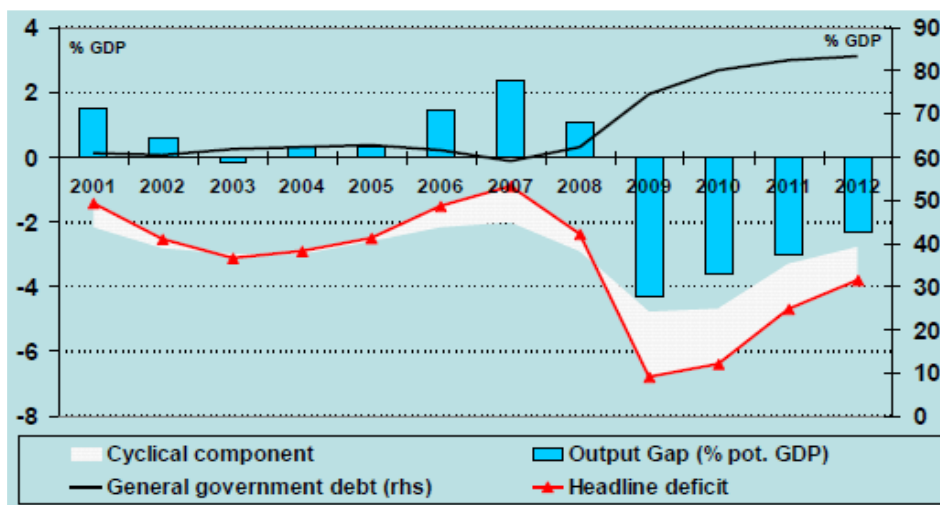
The empirical evidence shows that many governments did not adopt countercyclical policies before the onset of the crisis and, as a consequence, the 3% ceiling rule forced fiscal policy to turn pro-cyclical during the crisis. Moreover, the enforcement mechanism proved to be too weak to exert sufficient pressure on national governments.

Figure 7 shows the cyclicity in EU and indicates the weakness of public finances related to the crisis.

The deterioration of public finances will clearly have negative political and economic consequences while for some countries these are becoming particularly severe. Thus, an obvious lesson learnt from the crisis is that the SGP was not able to ensure sound public finances throughout the EU.



**Figure 7. Public Deficit, Public Debt and Output Gap (% of GDP) in EU countries**



Source: European Commission

### 3. Reforming Fiscal Frameworks in EU

The findings proved that the key features of NFR are as follows: (i) the statutory basis of the rule, (ii) the monitoring of budgetary developments against the fiscal targets and (iii) the existence of corrective mechanisms in case of non-compliance. Monitoring and enforcement could be carried out by an independent body and the actions to be taken in case of non-compliance should always be defined ex-ante, so as to make the rule credible and enforceable. Otherwise, the cost of non-compliance would be only reputational. The sanctions must include personal sanctions as dismissal procedures, obligations to resign, fines, or lower wages. There are important elements to take into account in the design of NFR in order to enhance their influence on fiscal policy. The influence of fiscal rules on fiscal outcomes can be seen under two perspectives i.e. budgetary discipline and macroeconomic stabilization, as a consequence, an appropriate balance between these two objectives needs to be sought.

As it regards the NFR by type, the findings of this research suggest as follows: (i) Budget balance rules (BBR) are by far the most widespread fiscal rules in force across the EU Member States (Figure 1). They are defined in nominal terms with annual time horizons. A major criticism of budget balance rules concerns the risk of pro-cyclicality. BBR should be based on a medium-term perspective. Rules embedded into a medium term budgetary framework, as a part of a comprehensive fiscal strategy, may better adapt to economic and country



specific circumstances; (ii) Debt rules (DR) suffer the same limit as BBR, i.e. the risk of pro-cyclicality. DR should be embedded in a medium-term framework in order to limit their potential pro-cyclical bias; (iii) Expenditure rules (ER) represent around one third of all fiscal rules and predominantly concern central governments and social security spending. Most of these rules are embedded into a medium-term budgetary framework (European Commission, 2010). As suggested by Kopits (2007), binding spending ceilings can play a crucial role in the functioning of the whole fiscal framework. The main limit of ER is the risk of negative effect on the quality of public expenditure; (iv) Revenue rules (RR) are not common rules in the EU. According to European Commission (2012), in 2008, only six EU Member States had such rules.

The main weakness of NFR in EU countries are, in our opinion, the absence of independent monitoring and regular reporting, together with the absence of corrective mechanisms. All these shortcomings should be addressed in order to increase the effectiveness of NFR.

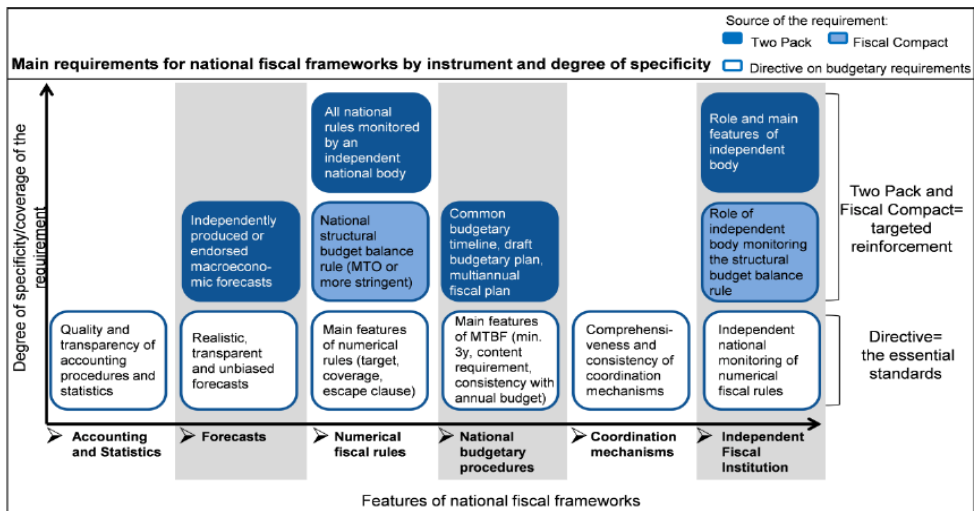
Given the variety of national situations and institutions, a one-size-fits all policy would not have warranted results. The large specificity of the institutional environment, fiscal policy and economic development across the EU Member states requires specific adapted design features; it means more flexible numerical fiscal rule adapted to the practical reasons of member states, but defined at EU level. Effective and timely monitoring of the rules by independent bodies must be ensured. Overall, Member States must transpose the fiscal rules into their national legislation to strengthen the enforcement mechanism. This requires that Member States adhere to certain minimum standards for domestic fiscal frameworks. Research has shown that the best performing countries meet certain minimum standards (European Commission, 2011). The use of a directive rather than a regulation is in recognition of the fact that the optimal procedural and institutional set-up for fiscal policy-making will depend on the different characteristics of Member States, meaning that there is no one model that can or should be applied in all cases.

The interaction and mutually reinforcing provisions of the EU fiscal rules on national budgetary frameworks (NFF) are presented in Figure 8.

By requiring that all Member States adhere to them in their specific way, the quality of national fiscal policy can be enhanced even for the worst performers. It is true that fiscal policy is supervised at European level, but it is set at national level. As the total fiscal harmonization remains an impossible goal at EU level, adhering to certain minimum standards for domestic fiscal frameworks can also foster policy coordination between different levels of government depending on their institutional coverage. Additionally, fiscal rules may further contribute to the reduction of uncertainty about future fiscal policy developments. However, fiscal rules can only yield these benefits if appropriate institutions for monitoring and enforcement mechanisms are in place, or if they are supported by strong political commitment.



**Figure 8. Main requirements for NFF by legal instrument and degree of specificity**



Source: European Commission

#### 4. The Fiscal Governance Framework in Georgia

The Eastern partnership (EaP), a key policy initiative in the Neighbourhood, aims to bring Georgia closer to the European Union. EU budget support is the main form of EU assistance in the Eastern Partnership region. It involves dialogue, financial transfers to the partner country, performance assessment and capacity development, based on partnership and mutual accountability. Budget support is used to support reforms in mutually agreed sectors, as well as in macroeconomic and public finance policy. The EU's annual budget support programme started in 2007 and since then it has been growing. The first tranche amounted to EUR 14 million in 2007, and was increased to EUR 65.5 million in 2014.

EU assistance to Georgia in 2007-2014 focused on four areas: democratic development, the rule of law and good governance; trade and investment; regional development and sustainable development, poverty reduction; support for peaceful settlement of conflicts.

EU supported public finance management (PFM) reform's build to enhance good governance and reduce poverty. By encouraging essential reforms in areas ranging from budget planning, execution and monitoring, to internal and external audit and public procurement, this programme promotes transparency and accountability. It also contributes to the increased efficiency and effectiveness of the budgetary process and the alignment of Georgia's regulations with EU standards and norms.



On 29 November 2013 the EU and Georgia initialized an Association Agreement - including provisions on establishing a Deep and Comprehensive Free Trade Area (DCFTA) - forging a closer political and economic relationship between the two. The Association Agreement was signed on 27 June 2014 and it aims at gradually integrating Georgia into the EU Internal Market, the largest single market in the world. The Agreement includes a comprehensive reform agenda aimed at approximation of Georgia's legislation to EU norms being built on enhanced cooperation in some 28 key sector policy areas, including: economic dialogue; management of public finances; public financial control; taxation; accounting and auditing; financial services etc. Reforms in these areas will aim at gradual approximation with the EU acquis and also, where relevant, with international norms and standards.

In Georgia public finance management institutions and fiscal rules are determined by the Constitution of Georgia, the Budget Code and the Organic Law of Economic Freedom. Fiscal rules were introduced with the organic law of "Economic Freedom" under the Georgian constitution. The rules were introduced in 2011 and came into force on 31 December 2013 and their adoption was a part of the reform in the public finance management. The rules are based on the Maastricht criteria and aims to establish fiscal discipline and legal guarantees, setting the national framework for the public finance management. Fiscal rules in Georgia are presented in Figure 9.

**Figure 9. Fiscal rules in Georgia. Key Characteristics (start date in brackets if different from implementation)**

Type of National Rules	Statutory Basis	Coverage	Formal Enforcement Procedure	Independent Body Sets Budget Assumptions	Independent Body Monitors Implementation	Well-Specified Escape Clauses
Expenditure rule (2013)	Constitutional	General government	Yes	No	No	Yes
Revenue rule (2013)	Constitutional	General government	Yes	No	No	Yes
Budget balance rule (2013)	Constitutional	Central government	Yes	No	No	Yes
Debt rule (2013)	Constitutional	General government	Yes	No	No	Yes

*National rules* (dates in brackets):

- **ER (since 2013):** The ratio of ‘expenditures and increase in non-financial assets’ to GDP of the consolidated budget to the GDP shall not exceed 30 percent.
- **RR (since 2013):** The organic law of “Economic Freedom” prohibits the growth of any tax rate, except excise tax.
- **BBR (since 2013):** The ratio of the consolidated budget deficit to GDP shall not exceed 3 percent.
- **DR (since 2013):** The ratio of the State Debt to GDP shall not exceed 60 percent.

---

Source: Georgian Legislation

Although the main fiscal rules (expenditures, balance, public debt, revenue rule) and the macro- economic indicators defined in the Georgian legislation are consistent with the determined macroeconomic parameters, it is important to keep the main macroeconomic and fiscal indicators in the medium and long term period of time, to introduce proper analysis tools to insure correct projections.

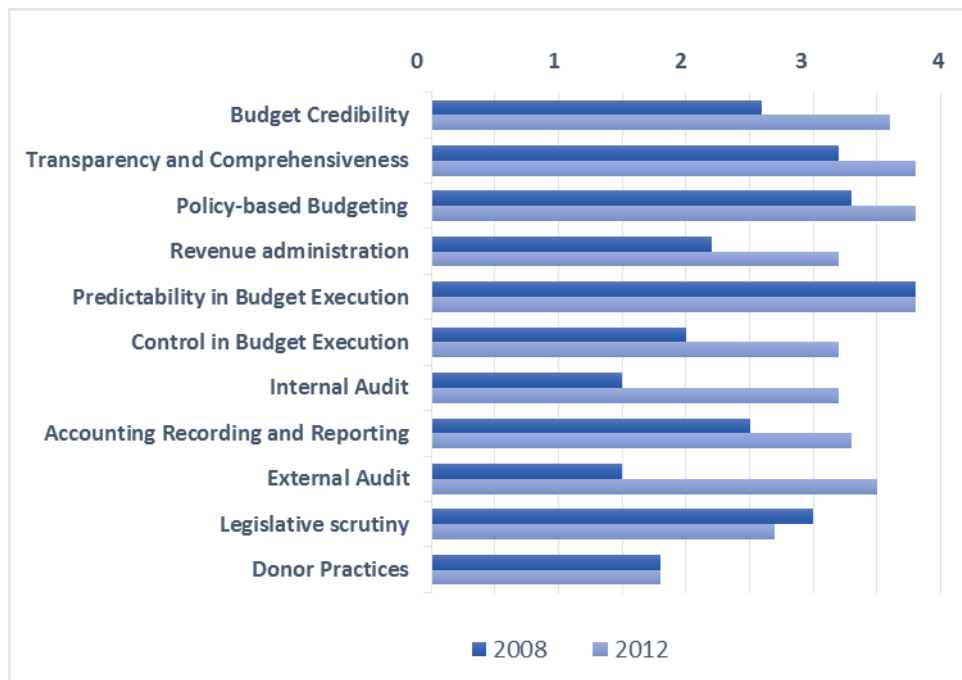
#### ***4.1 The Reform of PFM in Georgia***

In accordance with EU-supported reforms, Georgia has significantly improved its budgetary and financial management systems since the previous Public Expenditure and Financial Accountability (PEFA) assessment Report of 2008. In the World Bank’s PEFA assessment from September 2013, Georgia has been noted for significant advancement in its budgetary and financial managements systems. The budget classification system captures all administrative, economic and functional elements. There are no unreported government operations, and all programmes funded by major donors are part of budget appropriations and fiscal reports. Georgia scores among the highest PEFA marks on inter-governmental fiscal discipline. The basic set of systems is in place for strategic budget planning, budget formulation and execution. The introduction of international good practice in the budget cycle of the Government is well advanced, including robust systems for budget preparation, adequate chart of accounts, reliable execution (including accounting and reporting) and sufficient controls. Important progress has been achieved on programme-based budgeting, furthering the Government’s objective of greater results-focus in fiscal planning. The concept of programme-based budgeting was adopted in the 2009 Budget Code, and significant advances have been made since then - reaching all the way to the full presentation of the 2012 draft budget in programme forms to Parliament. The legal framework governing public procurement was further amended; Electronic Government Procurement was introduced in 2011, and linked to the Treasury’s information system thus providing for full information sharing. All the above reform initiatives were implemented to address the weaknesses identified by the 2008 PEFA assessment in such areas as



external control system, personnel and payroll, public procurement, and reporting of high quality consolidated financial statements (Figure 10).

**Figure 10. PFM performance changes based on PEFA assessments 2008-2012**



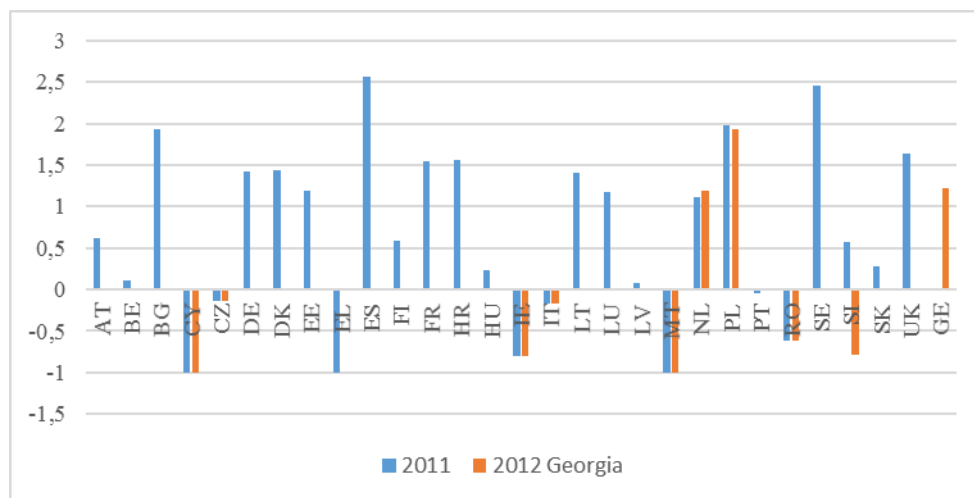
Source: European Commission; PEFA 2008 and PEFA 2012.

Note: The D, C, B and A scores were converted to numerical scale 1 to 4 respectively.

When analysing performance changes based on the PEFA assessments, performance improved for all PEFA dimensions except in the area of legislative scrutiny. As can be concluded based on the analysis above, performance is relatively better for the ‘upstream’ functions of PFM, and relatively lower for the ‘downstream’ PFM functions. The least-performing areas according to the latest PEFA were internal control and legislative oversight. Also, donor performance continues to have an adverse impact on the functioning of the government PFM systems in Georgia.

According to positive PEFA (2012) assessments, the Fiscal Rule Strength Index in Georgia also shows encouraging picture based on the SFRI for Georgia as shown in Annex (Fiscal Rule Strength Index in Georgia) and in Figure 11 (see the fiscal rule index (FRI) in Georgia and the EU-28 by country 2011 and 2012 below).

**Figure 11.** The fiscal rule index (FRI) in Georgia and the EU-28 by country 2011 and 2012



Source: Author's representations

In addition, Government of Georgia plans to take the following actions for strengthening fiscal policy. (See Table 2 Required and Planned Activities for Strengthening Fiscal Policy below).

**Table 2. Required and Planned Activities for Strengthening Fiscal Policy**

#	Activities	Responsible Body	Partner Body	Timeframe
1	At least 5 line ministries develop medium term strategies and action plans according to the revised format, action plans are costed	MoF Georgia	Spending Units	2015
2	All line ministries develop medium term action plans according to revised format, that are costed	MoF Georgia	Spending Units	2016-2020
3	Public Finance Reform (PFM) Action Plan is prepared; Action Plan is costed	MoF Georgia		since 2015
4	Costings of Sector Strategies (besides: Public Administration Reform (PAR), Government Action Plan (AGWP), Migration Action Plan, Livelihood Strategy and Action Plan) are prepared	Spending Units	MoF Georgia	since 2015
5	Based on experience Instruction for Costing is prepared and approved	MoF Georgia		2016
6	The Methodology for Capital/Investment project Management is established	MoF Georgia		2016



7	Piloting and Implementation of the Methodology for Capital/Investment project Management	MoF Georgia	Spending Units	2016-2020
8	Improving program budgeting	MoF Georgia	Spending Units	since 2016 (current)
9	Improving the reporting system of program budgeting – Reports of the Programs	MoF Georgia	Spending Units	since 2016 (current)
10	State Budget Citizen’s Guide is updated	MoF Georgia		since 2015
11	Remedy of identified gaps of the Open Budget Survey process and improving Open Budget Index results	MoF Georgia		2016-2017
12	Improving the mechanism for responding to the State Audit Office findings	MoF Georgia		2015-2017
13	Improving fiscal expenditure document and reflect contingent liabilities	MoF Georgia		2015-2017
14	Analyse fiscal rules and define sub regulations if necessary	MoF Georgia		2016-2018
15	Regulate the participation of interested stockholders in the budget process	MoF Georgia		2016-2018

Source: Ministry of Finance of Georgia

Following the 2009 Budget Code reform in Georgia, the budgeting processes at central and municipal levels are based on programme and capital-based budgeting. This step should allow for better planning and co-ordination between line ministries activities in the regions. The entry into force of programme budgeting in all self-government units of the country, complemented by a progressively implemented decentralization process, including fiscal, should on its part contribute to increase the consistency of expenditures for local and regional development. However, the programme budgeting initiative needs further development to achieve its full potential for being a useful tool for making policy decisions and adding real value in the prioritization and allocation of constrained resources.

Programme budget methodology has been updated. The 2016 State Budget is prepared according to the new methodology. Work is in progress on detailed Action Plans of five pilot ministries, which contains the information of programmes/sub-programmes/activities of the ministries and costing that is relevant to Annual budget law and Basic Data and Direction document (BDD) document. Active work should continue to further improve programme budgeting process and implement new methodology.

In respect with strengthening fiscal institutions, the reform was introduced in 2014 considering the functions of Budget Office implementation in practice to form the institute as an independent and impartial structure. For the correct planning of the above-mentioned economic and fiscal parameters the alternative forecasts prepared by independent institutions is important which excludes the



influences of naturally typical ‘positive’ perceptions on fiscal policies of all governments.

Sustainable medium term planning is an important element for strengthening fiscal policy and management. Therefore, in order to achieve this objective, the government has to develop tools for implementing medium term and action plans as well as other sector action plans according to BDD. This also applies to preparing costing and estimates for the implementation of action plans and developing adequate mechanisms to implement performance indicators.

Basic budget scrutiny and oversight of financial statements are already in force but they need further strengthening. Taking into account all abovementioned issues, additional work is needed in the following directions:

- Strengthening medium-term planning;
- Strengthening fiscal forecasting;
- Improvement of programme budgeting;
- Strengthening independent fiscal institutions;
- Developing fiscal discipline.

#### ***4.2. Shortcomings and development of fiscal rules in Georgia***

Since 2014, the Georgian Law on “Economic Freedom Act” was enacted and budgeting during the planning process considers the limits imposed by the law. The law defines general principles of the framework, but planning fiscal policy correctly in different aspects is also required in order to ensure the fulfilment of the law. Not only the amount (limit) of deficit or the debt to GDP ratio but also the structure of all these elements is important. To develop sound budgeting principles in practice is very important, because not only general principles have to be ensured during the budget planning process but also the budget in its main content should have to reach the main objectives, as social and economic stimulus direction.

Generating growth and creating jobs within a sustainable fiscal framework is Georgia’s biggest macroeconomic challenge. Tackling the growth and jobs agenda in Georgia will require significant investment in human and physical capital and the government has a large role to play here. Additional spending, where it is needed, should be undertaken within the fiscal consolidation agenda of the government, designed to help restore the macroeconomic buffers needed to secure stability and sustain confidence in the future.

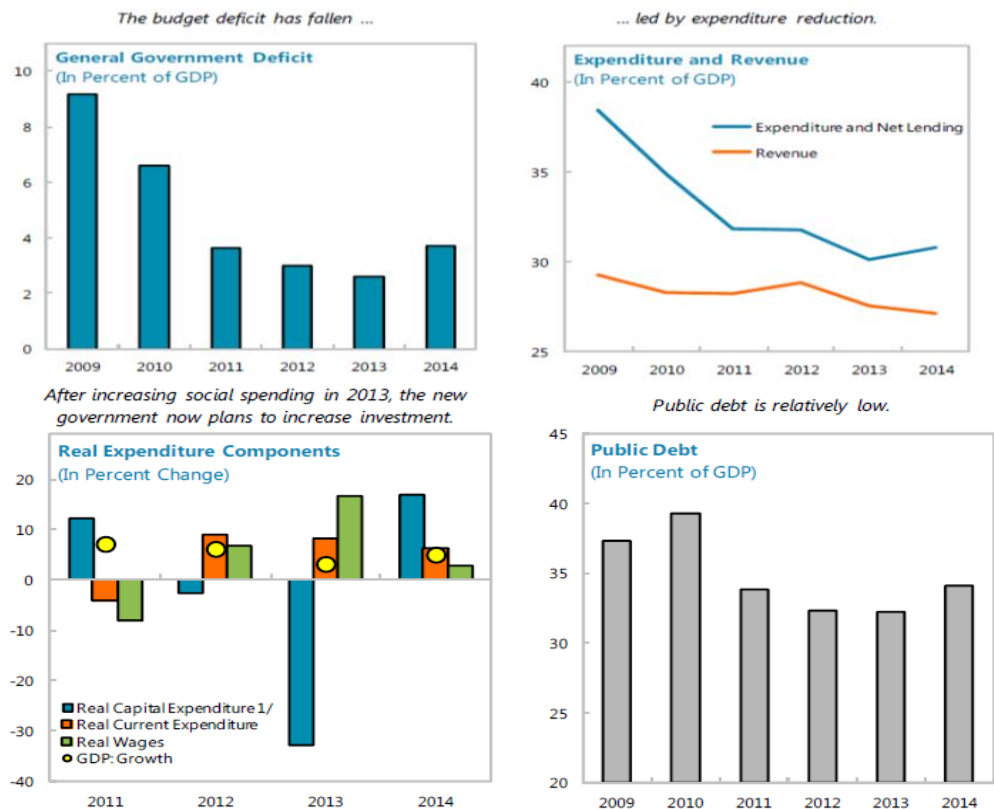
Public finances in Georgia are likely to come under pressure over the short to medium term in the context of large increase in recurrent expenditures and the limited scope to raise revenues. A constitutional ban on increasing tax rates limits upsides on fiscal revenues. In July 2011, the parliament had established fiscal rules for a number of fiscal indicators through amendments to the constitution. One of the provisions of this amendment was that the introduction of any new general state tax, except excises, or an increase in the upper rate of any existing general state tax



would be possible only through a referendum. This legal clause has been enacted from 1 January 2014. This limitation of tax revenues along with the increase in social benefits is likely to put pressure on the government's finances.

Fiscal policy in 2013 became pro-cyclical, which increased macroeconomic volatility. In recent years, fiscal policy has been relatively prudent, with the deficit steadily declining, expenditure as a share of GDP also falling, a changing of real expenditure components and a stable government debt to GDP ratio (See Figure 12).

**Figure 12. Expenditure components**



Source: National authorities

To keep government finances on a sustainable path along with sustainable growth and job creation is vital. Strengthening the efficiency of expenditures to improve outcomes, especially, in the areas of education, capital spending and inter-governmental finances are also very important.

Fiscal rules are still a new topic for the budget process in Georgia. In that direction it is rarely discussed in the budget processes and the topic is not covered in the media. At the moment, these rules are under discussion within the Ministry

of Finance and the participants in the budget process. It should be noted that, until the fiscal rules are the subject of discussion in the general public, it is necessary to raise awareness in this direction. The terms of fiscal policy, the deficit and the public debt to GDP ratio are not so explicit notions to the big majority of the population.

Establishment of sub-regulations of fiscal rules is planned by the Government or the Ministry of Finance in Georgia (with the consent of the Government), which will provide the legal framework in the medium-term, additional to the regulation of the parameters of the fiscal budget. This rule will be prepared and distributed in 2016 in the medium term period and will be periodically reviewed and be facing the challenges of the present reality. A number of issues will also be regulated by this rule especially in terms of budget planing. To be more specific, some of the regulations will be determined on the increase of current expenditures, opportunities of creation of new Legal Entity of Public Law (LEPL) and new staff positions should be regulated more and certain limits will be determined for expenditures on social programmes. The rule also will regulate the basic approach in the point of the investment projects and the share of these types of payments in total expenditures.

The main principles have been developed which provides proper activities to make administrative expenditures lower in 2016, defines the share of capital/infrastructural projects in total expenditure, during the year limits budget adjustments so that planned capital expenditures can be changed and add to administration expenditures only when government permits.

Approving sub-regulations of the fiscal rules will allow further regulation of the general framework of parameters considering the existing macroeconomic and fiscal parameters. Later on, the Government may to pro-cyclic or contra-cyclical fiscal policy if needed.

The rule should prepare for medium-term period and, if required, the rule should be the subject to change/review in parallel with the changes in the basic data and direction document. It is possible that sub regulation's rules set certain thresholds for different levels of budget, which is totally consistent with the parameters of the law, or impose a lower limit than is required by law for compound parameters.

The legislation specifies the general framework of the so called 'escape clauses'. It may determine more specific and limited conditions for using this regulation for a specific year and/or medium term period and determine more details about what might be planned for going back.

Quantitative fiscal rules defined by the law and the above-stated sub-regulations for monitoring purposes some changes will be made in reporting on the implementation of the budget process. A review of the annual report of the Budget will be added to the Appendix, which describes the annual and the medium-term periods quantitative fiscal risks. This information, along with the quarterly and annual reports submitted to the Parliament, in turn, the parliament of committees,



the Budget Office and the State Audit Office will be subject to discussion.

The report submitted to the Parliament provided appropriate indicators and the activities planned, if the monitoring result prejudice the established limits fulfilment and if sub-regulation deviation from the rule is inevitable - a reasonable explanation of what caused the results. In practice, using more fiscal rules will increase the role of fiscal policy planning; this also influences the type of regulations of the budgetary process to increase the interest of the parties involved. These parameters must become the subject of extensive review and discussion at legislative level and by independent fiscal institutions. Independent fiscal institutions provide independent analysis and review on economic and budgetary data projections by governments (to avoid optimistic growth forecasts), assess compliance with rules and procedures and sometimes enforce them, and provide long-term sustainability assessments, or recommendations on specific items of budgetary policy. From this point of view, two institutions play a very important role: The Parliamentary Budget Office of Georgia and The State Audit Office of Georgia. The Parliamentary Budget Office of Georgia, as a fiscal institution, establishes the role of the current fiscal architecture in Georgia. The Office will fully work out its mandated independent mechanisms in practice; according to this, the Parliamentary Budget Office aims to establish the office as an independent institution.

The budget office has prepared a medium-terms strategic plan. The Budget Office will implement measures around a strategic goal in the medium term period, which provides the main mission of the Parliamentary Budget Office in the process of strengthening the parliamentary oversight growth fiscal management transparency and accountability and accordingly, sustainability of fiscal measures to be implemented in two main directions:

- Increased efficiency of the core functions in accordance with the mandate of the Budget Office as an independent fiscal institution in the fiscal architecture;
- Strengthening institutional capacity activities to ensure effectiveness.

Parliamentary Budget Office will also implement a number of measures in order to be independent, objective and a highly professional institution to increase publicity by strengthening communication – privately, parliament, the media, international and local partner organizations. The Office, as a fiscal institution for directing the work, provides communication mechanisms to improve fiscal management system for major institutions – to achieve this aim Parliamentary Budget Office must have working mechanism to communicate with all those agencies which are essential to work together with the proper conduct of its activities.

The State Audit Office of Georgia is also an important tool in the public financial management and in the fiscal policy and its role is the most important in the management of the public finance reform. The State Audit Office will also act according to medium term development strategic plan, which includes the following goals:



- Promoting the parliament of the control government activities;
- Promoting the government to improve the level of accountability/quality to implement the reforms;
- Development of institutional opportunities to improve quality of activities;
- Maximize the results of the audit activities;
- Increase the role of the state audit office in permanent improving of the public finance management process;
- To establish the state audit office with the highly professional staff, with the modern management systems and processes which provides high quality of working, working within time and reliability.

## 5. Policy Guidelines

The public finance reform of the country has a two-fold objective. One is to make Georgia capable of implementing the EU requirements on identification, prevention and management of fiscal risks, excessive fiscal deficits and harmful macroeconomic imbalances. On the other hand, it must ensure that public spending is structured in the way that maximizes the development impact on the national economy and ensures better quality of life for the citizens. As discussed earlier, many reforms are needed to ensure fiscal sustainability and sound management of public finances in line with EU legislation, standards and fiscal rules. In our opinion, the policy should be based on the following guidelines:

**Table 3. Policy guidelines**

Reform priorities	Recent progress	Recommendations
<b>- Strengthening the fiscal framework</b> <b>- Developing fiscal discipline</b>	- Approximation of Georgia's legislation to EU legislation; - Main fiscal rules (expenditures, balance, public debt, revenue rule) and the macro- economic indicators defined in the Georgian legislation	- Enhance enforcement, fiscal policy monitoring; - Promote using concrete and measurable outcome-based indicators ("benchmarks"); - Analyze fiscal rules and define sub regulations; - Improving the mechanism for responding to the Parliamentary Budget Office and State Audit Office findings
<b>- Strengthening medium-term planning</b>	-line ministries develop medium term action plans; -The integrated public financial management system was launched	-Develop tools for implementing medium term plans and action plans and other sector action plans according to BDD; -Preparing costing and estimates for implementation of action plans; -Develop mechanism to implement performance indicators to achieve objectives of action plans.



<b>- Strengthening fiscal forecasting</b>	-The basic set of systems has been put in place for strategic budget planning, budget formulation and execution; -The Methodology for Capital/Investment project Management is established	-Strengthening forecasting and analytical tools; -Develop ex ante and ex post analytical tools; -Relevant staff training of the Ministry of Finance of Georgia
<b>-Improvement of Programme budgeting</b>	-Programme budget methodology has been updated; -2016 State Budget is prepared according to the new methodology.	-Develop programmes and their expected results; -Develop performance indicators; -Improving the reporting system of programme budgeting;
<b>-Strengthening Independent fiscal institutions</b>	-The Parliamentary Budget Office and The State Audit Office has prepared a medium-terms strategic plan.	-Increased efficiency of the core functions in accordance with the mandate of the Budget Office and State Audit Office as an independent fiscal institutions in the fiscal architecture; -Developing Parliamentary Budget Office and State Audit Office institutional capacities to ensure the effectiveness of its activities; -Increase the role of the legislative activity of the Parliamentary Budget Office to support the management of the budgetary funds.
<b>-Strengthening the efficiency of expenditures</b>	-Positive PEFA (2012) assessments	-Improve the efficiency and effectiveness of expenditures; -Intensive monitoring of social expenditures; -Enhance the information content of budget documents pertaining to capital expenditures; -Strengthen the PIM process, especially at project identification and appraisal stage.

Source: Author's representations

- A more effective and simpler governance framework that would contribute, in our opinion, to the advance of structural and fiscal reforms. Given the mixed record of adherence to EU targets and recommendations, a stronger framework to monitor, incentivize, and enforce reforms and sound fiscal policies could foster convergence within the approximation to euro area. Such a framework should promote increased ownership, transparency and accountability.

- 'Outcome-based' area-wide structural benchmarks, which could improve transparency and incentivize reform implementation. Current peer review practices under the European semester could be strengthened by using concrete and measurable outcome-based indicators ('benchmarks') to define the reform agenda. Their use could improve transparency, simplify implementation, and promote

innovation.

- Creation of an independent fiscal council, which could improve fiscal discipline, transparency and accountability. An EU-level ‘structural council’ of experts could be created to assess ex post the EC’s prioritization and enforcement of structural reforms. A Georgian ‘national fiscal council’ with wide representation is needed, in our opinion, to assist ex ante in translating euro area-wide reforms into a national reform agenda, and thereby fostering ownership and innovation.

- Simplifying and strengthening the fiscal framework (NFR, MTBFs,) which could enhance its effectiveness. While successive reforms have improved some elements of the EU’s fiscal framework (e.g., taking greater account of the economic cycle), they have increased its complexity, hampering effective monitoring, public communication, and compliance. The framework could be simplified by focusing on two main pillars: a single fiscal anchor (public debt-to-GDP) and a single operational target (an expenditure growth rule, possibly with a debt correction mechanism) linked to the anchor. To enhance enforcement, fiscal policy monitoring could be improved through better interaction between national fiscal council and the EC, possibly facilitated by the EU Network of Independent Fiscal Institutions (EUNIFI), or through an independent fiscal council at the EU level to assess application of fiscal rules.

- The establishment of an effective public investment management (PIM) system, which could maximize the effectiveness of the lower level of public investments, is also crucial. On this front, Georgia has made some progress, especially on capital budgeting, and the new government is committed to implementing deeper reforms in this area. Efforts have been made to enhance the information content of budget documents pertaining to capital expenditures and to initiate more systematic processes to raise the overall efficiency and effectiveness of public investment. Nevertheless, more needs to be done to strengthen the PIM process, especially at project identification and appraisal stage.

- Intensive monitoring of social expenditures, which is crucial to maintain fiscal sustainability and to achieve better social outcomes. The increase in social benefits and assistance was a core part of the new government’s election manifesto. The government has followed through on its election promise and has raised social benefits considerably. However, implementation capacity in the social sectors is constrained and needs to be enhanced. Monitoring of social expenditures/programmes information, together with the quarterly and annual reports should be submitted to the Parliament and, in turn, the Parliament of committees, the Budget Office and the State Audit Office.

- Further cuts to capital expenditures need to be guarded against as this would impact growth. The increased current expenditures are likely to generate fiscal pressures over the short- to medium-term. In our opinion, expenditures should be cut regardless of the fiscal outlook. Certain expenditures, to be sure, are vital to a country’s success and survival, but excessive current expenditures may actually lower the economy’s productive capacity. Thus, expenditure cuts can



simultaneously improve fiscal balance while enhancing economic growth. With limitations upsides on revenues and difficulties in scaling back recurrent expenditures, the government could resort to lower spending on public investments. However, since Georgia has a large infrastructure deficit, such a measure could impact short- and long-term growth.

- A better cooperation between the Ministry of Finance and other public agencies responsible for implementation of the key social and infrastructure programmes, which could improve the efficiency and effectiveness of public finance management. Since Georgia follows programme based budgeting, it will be important to evaluate the performance of social benefit programmes during each budget cycle to improve the efficiency and effectiveness of these expenditures and also to ensure fiscal sustainability.

## Conclusion

The traditional domestic fiscal framework based on simple numerical fiscal rules is discussed in the recent literature in relation to its limitations when used as a measure to strengthen the fiscal discipline. Proposals in the literature go in the direction of using a more complex approach for fiscal rules, together with stronger enforcement mechanisms.

The present paper suggests that compliance with a well-designed fiscal framework contributes to the policy credibility, to boost economic growth and to dampening the output volatility. More complex and flexible rules, multiannual medium term national fiscal framework and more supportive institutional arrangements could help reduce the pro-cyclical bias associated with rules. Such flexible rules also call for higher-quality institutional arrangements that strengthen monitoring and enforcement mechanisms.

Since 2014, Georgian Law on ‘Economic Freedom Act’ enacted, and budgeting during the planning process considers the limits imposed by the law. The law defines general principles of the framework and to ensure the fulfilment of the law it is necessary to plan fiscal policy correctly in different aspects. Not only the amount (limit) of deficit or the debt to GDP ratio is important, but the structure of all these elements. Having sound budgeting principles in practice is very important because not only general principles should be ensured during budget planning process but budget in its main content should reach the main objectives, as social and economic stimulus direction.

Generating growth and creating jobs within a sustainable fiscal framework is Georgia’s biggest macroeconomic challenge. Tackling the growth and jobs agenda in Georgia will require significant investment in human and physical capital and the government has a large role to play here. Additional spending, where it is needed, should be undertaken within the fiscal consolidation agenda of the government, designed to help restore the macroeconomic buffers needed to secure stability and sustain confidence in the future. Public finances in Georgia are likely





to come under pressure over the short to medium term in the context of large increase in recurrent expenditures and the limited scope to raise revenues.

A more effective and simpler governance framework may contribute to the advance structural and fiscal reforms. Such a framework will promote increased ownership, transparency and accountability, through the significantly enhance of fiscal discipline. A Georgian ‘national fiscal council’ with wide representation is needed, in our opinion, to assist ex ante in translating euro area-wide reforms into a national reform agenda, and thereby fostering ownership and innovation.

Basic budget scrutiny and oversight of financial statements are already in force in Georgia, but they need further strengthening. Additional work on reforming is needed in the following directions: Strengthening medium-term planning; Strengthening fiscal forecasting; Improving programme budgeting; Strengthening independent fiscal institutions; Developing the fiscal discipline.

## References

- Bova, E., Carcenac, N. and Guerguil M. (2014), Fiscal Rules and the Procyclicality of Fiscal Policy in the Developing World”, Working Paper, No. 14/122, IMF-Fiscal Affairs Department, Washington, USA.
- Debrun, X. (2007), “Tying hands is not commitment: can fiscal rules and institutions really enhance fiscal discipline?”, *Bruegel working paper*, No. 2007/01.
- Debrun, X., Moulin, L., Turrini, A., Ayuso-i-Casals, J. and Kumar, M. S. (2008), “Tied to the Mast? National Fiscal Rules in the European Union, Economic Policy”, Vol. 23, Issue 54, pp. 298-362.
- European Commission (2010), “Europe 2020” - Fiscal frameworks, available at: [http://ec.europa.eu/europe2020/pdf/themes/06\\_fiscal\\_frameworks\\_02.pdf](http://ec.europa.eu/europe2020/pdf/themes/06_fiscal_frameworks_02.pdf) (accessed 12 September 2016).
- European Commission (2013), *Report on Public finances in EMU*, European Economy 4, Bruxelles.
- European Commission (2011), *Report on Public finances in EMU*, European Economy 3, Bruxelles.
- European Commission (2014), *National fiscal frameworks and database on numerical fiscal rules*, available at: [http://ec.europa.eu/economy\\_finance/db\\_indicators/fiscal\\_governance/fiscal\\_rules/](http://ec.europa.eu/economy_finance/db_indicators/fiscal_governance/fiscal_rules/) (accessed 12 September 2016).
- Larch, M. and Turrini, A. (2008), “Received wisdom and beyond: lessons from fiscal consolidation in the EU”, European Commission, European Economy - Economic Papers 320, Brussels.
- Manasse, P. (2005), “Deficit Limits, Budget Rules and Fiscal Policy”, *IMF Working Paper*, No. 05/230, Washington.
- Symansky, S. and Kopits, G. (1998), “Fiscal policy rules”, *IMF Occasional Paper*, No. 162, Washington.



- Schaechter, A., Kinda, T., Budina, N. and Weber A. (2012), “Fiscal Rules in Response to the Crisis – Toward the Next-Generation Rules. A New Dataset”, *IMF Working Paper*, No. 12/187, Washington.
- Von Hagen, J. (2010), “Sticking to fiscal plans: the role of institutions”, *Public Choice*, Vol. 144, Issue 3, pp 487–503.
- Wyplosz, C. (2013), “European Economy. Europe’s Quest for Fiscal Discipline”, *Economic Papers*, No. 498, European Commission, Brussels.
- Eyraud, L. and Wu, T. (2015), “Playing by the Rules: Reforming Fiscal Governance in Europe”, *IMF Working Paper*, available at: <https://www.imf.org/external/pubs/ft/wp/2015/wp1567.pdf> (accessed 12 September 2016).
- Wyplosz, C. (2012), “Fiscal Rules: Theoretical Issues and Historical Experiences”, NBER Working Paper No. w17884, available at: <http://www.nber.org/chapters/c12656.pdf>
- European Commission (2015), “Evaluation of the European Union's co-operation with Georgia (2007-2013)”, *Directorate General for Development and Cooperation – EuropeAid*, available at: <http://www.oecd.org/derec/ec/Strategic-evaluation-cooperation-ec-georgia-annex1.pdf> (accessed 12 September 2016).
- “Fiscal Governance in Georgia and its compatibility with EU practice” (2015), Ministry of Finance of Georgia, *Working Paper*, available at: [http://mof.ge/images/File/biujeti/Fiscal\\_Governance-EN.pdf](http://mof.ge/images/File/biujeti/Fiscal_Governance-EN.pdf) (accessed 12 September 2016).
- Georgian Constitution (1995), Chapter six; State Finances and Control; Article 93; paragraph 7; available at: <http://www.parliament.ge/uploads/other/28/28803.pdf> (accessed 12 September 2016).
- Organic law of Georgia on “Economic Freedom” (2011), Article 2 - Determination of maximum limits of macroeconomic parameters; available at: <https://matsne.gov.ge/ka/document/download/1405264/0/en/pdf>
- Budgetary Code of Georgia (2009), available at: <http://www.mof.ge/en/4549> (available only in Georgian)



## Annex 1. Fiscal Rule Strength Index in Georgia

Country		Type	Sector	Target/constraint	Description	Accounting system	Time frame (years)	Statutory base	Monitoring body	Enforcement body	Non-compliance actions	Exclusions	In force since	Additional information	Coverage of GG finances	C1 - Statutory base	C2 - Adjustment margin	C3a - Monitoring body	C3b - Alert mechanism	C3c - Enforcement body	C4a - Non-compliance actions	C4b - Escape clauses	C5 - Media visibility	In force	Fiscal Rule Strength Index
GEO	RR	GG	GG	Budget Balance % of GDP		GFSM1986	A	L	Parliament	MF	In case of Non-compliance, plan should be	Y	2014		100.0 %	3	2	1	0	2	2	0	1	Y	5.75
GEO	ER	GG	GG	Expenditure ceiling as % of GDP	Ceiling on the size of the general government Current and	GFSM 2001	A	L	Parliament	MF	In case of Non-compliance, plan should be submitted to the Parliame	Y	2014		90.0 %	3	2	1	0	2	2	0	1	Y	5.18
GEO	DR	GG	GG	Debt rule as % of GDP	Public sector net debt must be no more than 60%	GFSM 2001	A	L	Parliament	MF	In case of Non-compliance, plan should be	Y	2014		100.0 %	3	2	1	0	2	2	0	1	Y	5.75
GEO	RR	GG	GG	Limits on direct or indirect tax rates	Increase of rates on taxes (except excise tax) is subject to referendum	GFSM 2001	A	C	Parliament	MF		Y	2014	Temporary increase in taxes is possible for no more	89.0 %	4	2	1	0	2	2	0	1	Y	6.75

Source: Ministry of Finance of Georgia

