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GEORGIA

TECHNICAL ASSISTANCE REPORT—ENHANCING THE FISCAL RULES FRAMEWORK

May 2018

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F I S C A L A F F A I R S D E P A R T M E N T

Georgia
Enhancing the Fiscal Rules Framework

Torben Hansen, Stephen Farrington, Joao Jalles, Isabel Rial, and Sami Yläoutinen

Technical Assistance Report

November 2017

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GLOSSARY

AE	Advanced Economy
BBR	Budget Balance Rule
BDD	Basic Data and Directions Document of Georgia
DR	Debt Rule
ELA	Economic Liberty Act
ER	Expenditure Rule
FAD	Fiscal Affairs Department
FRS	Fiscal Risk Statement
FTE	Fiscal Transparency Evaluation
GFS	Government Finance Statistics
GFSM	Government Finance Statistics Manual
LEPL	Legal Entities of Public Law
LIDC	Low-Income Developing Country
MAFD	Macroeconomic Analysis and Fiscal Policy Planning Department
MoF	Ministry of Finance
MTBF	Medium-Term Budget Framework
MTO	Medium-Term Objective
PBO	Parliamentary Budget Office
PPA	Power Purchasing Agreement
PPP	Public-Private Partnership
SAO	State Audit Office of Georgia
SGP	Stability and Growth Pact
SOE	State-Owned Enterprise
STA	Statistics Department
TSA	Treasury Single Account
USD	United States Dollar
WAEMU	West African Economic and Monetary Union

PREFACE

At the request of the authorities, a mission from the IMF's Fiscal Affairs Department (FAD) visited Tbilisi, Georgia, during September 13 – 25, 2017 to provide technical assistance on enhancing Georgia's fiscal rules framework. The mission comprised Torben Hansen (FAD, head), Isabel Rial (FAD), Joao Jalles (FAD), Stephen Farrington (FAD expert), and Sami Ylaoutinen (FAD expert).

In the Ministry of Finance (MoF), the mission met with Mr. Nikoloz Gagua (Deputy Minister); Mr. Giorgi Kakauridze (Deputy Minister); Mr. Tsotne Kavlashvili (Deputy Minister); and Mr. Lasha Khutsishvili (Deputy Minister). The mission also met with Ms. Ekaterine Mikabadze (Head of Macroeconomic Analysis and Fiscal Policy Planning Department (MAFD)), and her senior staff; Ms. Ekaterine Guntsadze (Head of Budget Department), and her senior staff; Mr. Mamuka Baratashvili (Head of Tax and Customs Policy Department); Mr. Ioseb Skhirtladze (Head of Public Debt and External Financing Department), and his senior staff; Mr. Irakli Katcharava (Head of Domestic Public Debt Instruments Development Division); Mr. David Gamkrelidze (Head of Cash Forecasting and Management Department, Treasury Service); Mr. Zurab Tolordava (Head of Accounting and Methodology Department, Treasury Service); and Mr. Giorgi Pataridze (Head of Administrative Department, Revenue Service).

In addition, the mission met with Dr. Irakli Kovzanadze (Chairman of the Finance and Budget Committee of the Parliament of Georgia); Mr. Archil Mestvirishvili (Board Member, Deputy Governor, National Bank of Georgia), and his senior staff; Ms. Tatia Khetaguri (Head of the Parliamentary Budgetary Office), and her senior staff; and Ms. Marika Natsvlishvili (Director, State Budget Analysis and Strategic Planning Department, State Audit Office of Georgia (SAO), and her senior staff.

The mission would like to thank all these officials for their excellent cooperation during the mission and for the frank and open exchanges of views on all matters discussed. Thanks particularly are due to Ms. Ekaterine Guntsadze and Ms. Natia Gulua for their ongoing support to the mission. The mission would also like to express its appreciation to Ms. Khatia Chanishvili and Ms. Natia Jakhia for their interpretation and translation services. Finally, the mission would like to express its thanks to the IMF Resident Representative in Georgia, Mr. Francois Painchaud, for his support.

EXECUTIVE SUMMARY

Georgia has legislated numerical fiscal rules for the main fiscal aggregates. The Economic Liberty Act (ELA), which was adopted in 2011 and came into force in 2014, defines numerical upper limits for the state debt (60 percent of GDP), the budget balance (3 percent of GDP), and expenditures (30 percent of GDP). While the debt and budget balance rules (BBRs) have been adhered to since their introduction, expenditures have exceeded the legislative limit, albeit by a small margin.

Previous IMF technical assistance (TA) identified several issues in the application of the fiscal rules. A Fiscal Transparency Evaluation (FTE), conducted by the Fiscal Affairs Department in late 2016, found some gaps in reporting of general government revenue and expenditures against the standards set out in the IMF's Government Finance Statistics Manual 2014 (GFSM2014) as well as gaps in the assessment and reporting on compliance with the fiscal rules. The FTE recommended a review of the fiscal rules framework, and this report summarizes the findings and recommendations of this review.

Design of the fiscal rules

Fiscal rules should consider both the overall objectives and the economic context in which they are applied. In Georgia, this would include: (i) the stated primary objective of fiscal sustainability as well as the need for flexibility to respond to economic shocks; (ii) the transitional nature of the Georgian economy; and (iii) the intension to gradually move towards the European Union fiscal governance framework. A premium should also be placed on simplicity of the rules, and, ideally, they should not be pro-cyclical.

On balance, the current debt and BBRs seem appropriate in the Georgian context, but the specification of the expenditure rule (ER) should be reconsidered. The debt and BBRs are closely linked to the primary objective of fiscal sustainability and are compatible with realistic debt and deficit trajectories, and more complex deficit rules, such as a structural balance rule, would be difficult to implement in Georgia at this juncture. On the other hand, the specification of the ER as a percentage of GDP has several issues, including potential pro-cyclical properties, and should be replaced with nominal expenditure ceilings set on a rolling basis as part of the medium-term budget framework, consistent with the debt and BBRs and the medium term fiscal objectives.

The fiscal rules framework embedded in the ELA should be enhanced in three additional ways:

- The current *corrective mechanisms*, which applies to budgetary plans but not the actual outturns, should be strengthened by introducing reporting requirements on compliance with the fiscal rules ex-post, and a requirement that the government put forward a corrective plan in case of non-compliance.

- The current *escape clause* should be strengthened by abolishing the criteria that allows the Parliament to approve a budget that are not compliant with the fiscal rules; adopting a clear definition of economic recession; and specifying who can decide to activate the escape clause, and the associated reporting requirements.
- The legal framework should incorporate clear provisions, which are currently absent, on *independent oversight and verification* of the government's compliance with the fiscal rules.

Coverage and measurement

Some gaps and inconsistencies with the GFSM2014 reporting standards impede the effectiveness of the fiscal rules. General government revenue and expenditures exclude own source revenue and associated expenditures by Legal Entities of Public Law (LEPLs) and public non-market producers currently classified as state-owned enterprises (SOEs), and some transactions carried out between government units and SOEs are not accounted and reported as expenditures in line with the GFSM2014 standards. These gaps in coverage means that the fiscal rules are not fully capturing all general government activities.

The authorities should align their fiscal reporting practices with GFSM2014 by:

- Including all flows and stocks of LEPLs in the recording and reporting of fiscal aggregates;
- Undertaking a case-by-case analysis of the SOE sector, with priority given to those SOEs classified as high-risk, to identify SOEs that are non-market producers and should be reclassified into the general government sector;
- Include in gross debt statistics the liabilities of LEPLs, subnational governments, and any public non-market entity that may be reclassified within the general government sector; and
- Recording transactions with SOEs, including capital injections, that are in practice transfers or subsidies, as expenditures above-the-line.

Making these adjustments would have implications for the fiscal aggregates. Based on data for 2015, the overall deficit would have been 0.6 percentage points of GDP higher compared to the official data.

Implementing the fiscal rules

Fiscal policy targets should factor in potential economic shocks and fiscal risks. The fiscal targets applied in medium-term fiscal policy should provide for adequate buffers to absorb the impact of potential adverse shocks and realization of fiscal risks without compromising the fiscal rules. Simulations made during the mission point to a "safe" debt level—i.e., the level of debt that would ensure that public debt remains below the debt limit with a high probability, even if negative shocks should materialize—for Georgia in the range of 35-40 percent, which would be comparable to current debt levels and consistent with overall deficits of about 2.3–2.7 percent of GDP over the medium-term, broadly in line with the current Fund-supported program.

The implementation of the fiscal rules framework should also be strengthened in several ways. Notably:

- *Reporting on the fiscal rules* should be enhanced through a more in-depth discussion of compliance with the rules ex post and ex ante in the government's fiscal strategy paper, which should also provide a reconciliation and explanation of changes in macroeconomic and fiscal forecasts between successive plans; and
- The *medium-term budget framework (MTBF)* should be strengthened by making the expenditure ceiling for the second year of the rolling four-year MTBF binding; and by undertaking a review of the MTBF to identify any needs for enhancement.

Table 0.1 below provides an overview of the recommendations of the report and indicates a possible timeline for their implementation.

Table 0.1. Georgia: Overview of Recommendations

	Topic	Recommendation	Timeline	Responsible
Design of the fiscal rules				
2.1	Design of the fiscal rules	Replace current ER in ELA with nominal expenditure ceilings as part of the MTBF	2018	MoF (proposal)
2.2	Corrective mechanisms	Introduce in ELA provisions on ex-post reporting on compliance, and a requirement to put forward a corrective plan in case of non-compliance	2018	MoF (proposal)
2.3	Escape clause	Abolish in ELA the possibility to approve a non-compliant budget unless escape clause is triggered	2018	MoF (Proposal)
		Adopt in ELA a clear definition of what constitutes an economic recession	2018	MoF (Proposal)
		Specify in ELA the voting rights for triggering the escape clause	2018	MoF (Proposal)
2.4	Independent oversight and verification	Incorporate in ELA clear provisions on independent oversight and verification of compliance with the fiscal rules	2018	MoF (Proposal)
2.5	Revisions of the rules	Incorporate in ELA a clause that the fiscal rules be reviewed, and if warranted revised, on a periodic basis	2018	MoF (Proposal)

Table 0.1. Overview of Recommendation (Concluded)

Coverage and measurement				
3.1	LEPL	Include all flows and stocks of LEPLs in the recording and reporting of fiscal aggregates	December 2017	MAFD
3.2	Classification of SOEs	Undertake a case-by-case analysis of the SOE sector to identify SOEs that are non-market producers and should be reclassified into the general government sector	December 2018	MAFD
		Update analysis every 3 years to ensure that the classification of each unit remains valid	Ongoing	MAFD
3.3	Coverage of public debt	Include in GFS gross debt statistics the liabilities of LEPLs, subnational governments, and any public non-market entity	End 2018	MAFD
3.4	Budget lending	Record transactions with SOEs that are in practice transfers or subsidies above-the-line as expenditures	March 2018	Treasury + MAFD
Implementing the fiscal rules				
4.1	Reporting on the fiscal rules	Include a more in-depth discussion of compliance with the fiscal rules ex-post and ex-ante in the BDD and the annual Budget Execution Report	July 2018	MAFD
4.2	Macroeconomic and fiscal forecasts	Provide a reconciliation and explanation of forecast changes in successive vintages of the BDD	July 2018	MAFD
		Analyze the sources and causes of forecast errors on a regular basis	End 2018	MAFD
		Strengthen collaboration between MAFPPD and Revenue Department on forecasting of revenue	End 2017	MAFD +RD
4.3	Medium Term Budget Framework	Gradually extend the binding nature of the MTBF, initially by making the expenditure ceiling for the second year of the rolling 4-year MTBF binding	July 2019	BD
		Undertake a review of the MTBF to identify any needs for enhancement	July 2018	BD

I. INTRODUCTION

1. Georgia has taken important steps to enhance its fiscal institutions and fiscal transparency over the past decade. A recent Fiscal Transparency Evaluation (FTE)[1] found that Georgia meets the standard of good or advanced practices against 18 of the 36 principles in the IMF's Fiscal Transparency Code, and the basic standards on a further 10 principles. Among key strengths are the publication of detailed fiscal information in accordance with international standards, presentation of medium-term macroeconomic and medium-term forecasts and spending plans in the budget, and the production of macroeconomic scenarios and specific fiscal risk analyses. Fiscal planning has been strengthened by introducing a MTBF in 2004, enacting a comprehensive Budget Code in 2009, introducing program budgeting in 2012, and establishing an independent Parliamentary Budget Office (PBO) in 2014.

2. Georgia has legislated numerical fiscal rules for the main fiscal aggregates. The ELA, which was adopted in 2011 and came into force in 2014, defines measurable targets for the state debt, budget balance, and expenditures as follows:

- **State debt rule (DR):** the ratio of state debt to GDP should not exceed 60 percent;
- **Budget balance rule:** the ratio of the consolidated budget (central and local government) deficit to GDP should not exceed 3 percent; and
- **Expenditure rule:** the ratio of expenditures plus the increase in non-financial assets of the consolidated budget to GDP should not exceed 30 percent.

3. Fiscal aggregates are further constrained on the revenue side. Article 94 of the Constitution says that no state tax can be introduced (except excise taxes) or increased without first being approved by a referendum, except in cases prescribed by organic law. The ELA, which is an organic law, further clarifies the scope of this provision and the exceptions. While the provision does not constitute a numerical fiscal rule, and therefore is not considered in detail in this report, it nonetheless constitutes an important fiscal constraint that reduces flexibility in fiscal policy formulation. Box 1.1. discusses the provision in more detail and its potential drawbacks from a fiscal and tax policy perspective.

[1] Sayegh et.al.: "Georgia: Fiscal Transparency Evaluation," IMF, 2017.

Box 1.1. Constraints on Taxes in the Constitution and the ELA

According to the Constitution and the ELA, the introduction of new general state taxes (except excise taxes), or an increase of the top rate of an existing general state tax, requires a referendum. General state taxes comprise the income tax, profit tax, value-added tax (VAT), customs duty, and excise taxes, but not the property tax, which is an exclusive local government revenue source and appears unaffected by the referendum requirement. There are some exceptions to the general rule:

- New taxes can be introduced, or top rates increased, if they substitute for an existing tax without increasing the overall tax burden;
- Adjustments to tax rates below the top rates can be made;
- Tax progressivity, the tax regime, or the methodology by which a tax is applied may not be objects of a referendum; and
- The government may request a temporary increase (of up to three years) of general state taxes without a referendum, after which the tax rates must be reinstated to their original levels (this provision has not been used so far).

The provision in the Constitution does not constitute a fiscal rule as such since it does not provide a firm limit on fiscal aggregates (revenue). For example, revenue could be increased without a referendum through introducing new excise taxes, by applying the exceptions, or through improved revenue collection. Nonetheless, it can be assumed that the provision constitutes an important fiscal constraint due to the relationship between tax rates and tax revenue, which reduces flexibility in fiscal policy formulation that may not be appropriate from an economic and fiscal perspective. For example, it could lead to a situation where a disproportionate part of a fiscal consolidation would need to take place on the expenditure side.

The provision also has several shortcomings from a tax policy perspective:

- It restricts the ability to introduce discretionary countercyclical tax measures to mitigate risks from, for example, a growing property price bubble, such as a transfer duty that could have a stabilizing impact on prices. The ELA's three-year grace period for temporary tax rate increases could to some extent provide for countercyclical measures, but this is only so for the existing four taxes. Sometimes a new tax may be needed.
- The exemption of new excise taxes from the referendum requirement may lead to their extensive use to address revenue shortfalls. This may only be sustainable if neighboring countries' excise rate levels on alcoholic beverages, tobacco products, and fossil fuels are comparable to the Georgian tax burdens. Exceeding these levels would lead to incidence of illegal cross-border shopping, smuggling, and the introduction of counterfeit goods with commensurate erosion of custom-cleared imports and domestic excise collections. In turn, this could also lead to an increase in syndicate crime, which would have staying power long after the excise rate differential may have been removed.
- The reliance on excises—and not being able to increase income based taxes—keeps a key distributional tax instrument out of the authorities' fiscal toolkit. Georgia's Gini Coefficient by total incomes at 0.39 could, inter alia, be addressed by making income taxation more progressive (i.e., a higher marginal personal income tax rate). The efficiency costs of redistribution could also be reduced with tax schedules that entail higher taxes for upper-income groups than for middle-income earners, but the provision in the ELA foreclose that policy option.
- Given the restriction of introducing new taxes, or raising rates of existing taxes on a more permanent basis, the government may be tempted to label taxes as user charges, levies or administrative fees to meet revenue targets. It could do so by putting more administrative units on a self-financing path through administrative fees as a substitute for budget financing. Unless the legislation contains tight definitions to differentiate between taxes and user charges, a proliferation of such instruments could ensue.

4. While the debt and deficit rules have been adhered to since their introduction, expenditures have exceeded the legislative limit, albeit by a small margin.[2] Expenditure plans have generally been within the limit, with only two exceptions, and the debt and BBRs have been adhered to since their introduction (Table 1.1). However, expenditure outturns exceeded the stipulated limit in 2014, 2015, and 2016.

Table 1.1. Fiscal Forecasts and Outturns in Georgia
(Percent of GDP)

a. Vintages of Expenditure Forecasts

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
2014					30.2	29.8	29.7	29.6			
2015						29.9	30.2	29.6	28.8		
2016							30.0	28.7	28.5	27.9	
2017								29.9	29.7	29.5	28.9
Outturn	33.9	30.7	30.6	29.3	30.2	30.4	31.0				

b. Fiscal Outturns and Projections

	2014	2015	2016	2017*	2018*	2019*	2020*
Expenditures	30.2	30.4	31.0	29.9	29.7	29.5	28.9
Deficit	-2.0	-1.1	-0.1	-0.2	-0.8	-0.9	
Debt	35.7	41.4	43.9	44.2	44.4	44.0	

Source: MoF.
* Forecast. Numbers are based on national classifications.

5. The FTE identified several issues in the application of the fiscal rules. The ELA applies the fiscal rules to budget plans, not the actual outturns, and despite publication of detailed fiscal information there is no regular reporting on compliance with the rules. Other issues include the exclusion of extra-budgetary entities (LEPLs) from reported government expenditures and surpluses/deficits, and cases of accounting below-the-line of transfers to public corporations. Similar issues were identified in previous IMF analysis.[3]

6. Against this background, the authorities requested technical assistance (TA) to help review the existing fiscal rules framework. In making the request, the authorities stated the aim of ensuring that the fiscal rules framework supports the government's medium-term fiscal objectives toward fiscal sustainability, while also granting flexibility in formulating fiscal policy over the economic cycle. The authorities in parallel requested TA from the IMF's Statistics

[2] Compliance with the fiscal rules are measured based on budgetary plans, not the actual outturns ex post.

[3] "Strengthening the Fiscal Rules Framework in Georgia" in IMF Staff Report for the 2016 Article IV Consultation – Selected Issues.

Department (STA) to assess the current fiscal reporting practices against the IMF's GFSM 2014 standard.

7. This report summarizes the findings and recommendations of the mission. Chapter II discusses the overall design features of the fiscal rules. Chapter III discusses issues related to coverage and measurement against the standards set out in GFSM2014. Preliminary results from the TA provided through STA were discussed during the mission and have been incorporated in the analysis. Finally, Chapter IV discusses several issues in implementing the fiscal rules, including how to apply the fiscal rules in fiscal policy, reporting arrangements, compliance by subnational governments, and enhancing budget institutions.

II. DESIGN OPTIONS FOR THE FISCAL RULES

A. International Experience

8. The use of numerical fiscal rules has surged over the past two decades, especially in emerging markets economies (EMs).[4] Until the early 1990s, fiscal rules were adopted mostly by advanced economies (AEs) (Figure 2.1). Since then, the number of EMs and low-income developing countries (LIDCs) that have adopted fiscal rules as a constraint on fiscal policy making has increased dramatically and now surpasses that of AEs.[5]

9. Countries typically make use of multiple rules to overcome tradeoffs among alternative objectives, such as fiscal sustainability, economic stabilization, operational guidance, or transparency. Common rules include:

- **Debt rules, or debt anchors,** which set an explicit limit for public debt, either in nominal terms or as percentage of GDP.
- **Budget balance rules,** which set an explicit limit on the fiscal balance as a percentage of GDP and which can be specified in several ways: overall balance (specified in nominal, structural, cyclically adjusted, or "over the cycle" terms); primary balance, which excludes interest payments; or current balance, which excludes capital expenditures (typically referred to as a "golden rule").[6]

[4] Fiscal rules come in two different forms. *Numerical fiscal rules* impose numerical limits on budgetary aggregates. In contrast, *procedural fiscal rules* set out permanent technical, procedural and transparency requirements for the budget process, and are often enshrined in fiscal responsibility laws.

[5] Most of the initial surge among AEs is explained by the adoption of supranational rules by European countries in the context of the 1992 Maastricht Treaty. Similarly, for LIDCs, members of the Eastern Caribbean Currency Union, the West African Economic and Monetary Union (WAEMU), and the Central African Economic and Monetary Community adopted fiscal rules in 1998, 2000, and 2002, respectively.

[6] Budget balance rules for commodity exporting countries, such as oil producers, would typically include additional features, such as non-oil GDP. This is not further discussed in this report.

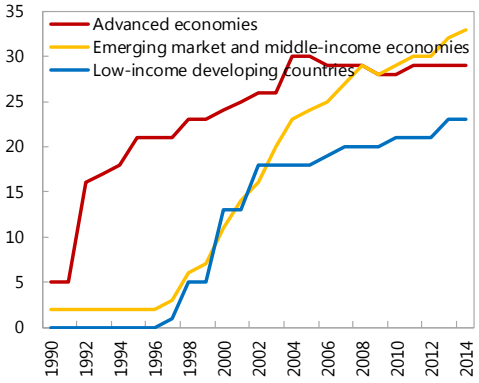
- **Expenditure rules,** which set permanent limits either on total, primary, or current expenditures and can be specified in absolute nominal terms, in percentage of GDP, or in terms of nominal or real growth rates.
- **Revenue rules,** which set ceilings or floors on government revenue either in nominal terms or in percentage of GDP.

10. Most countries with numerical fiscal rules have adopted a combination of debt and BBRs, but ERs are also common in AEs and EMs (Figure 2.1 below). Revenue rules, on the other hand, are relatively rare. Debt and BBRs, either in structural or nominal terms, usually combine the objectives of ensuring fiscal sustainability and providing operational guidance. 18 out of 33 EMs with fiscal rules in 2014 had a combination of such rules in place, and 6 of these also had an ER. Countries increasingly consider the impact of the economic cycle in the design of their fiscal rules, for example by adopting a structural balance rule or by introducing escape clauses, and in 2014 one-fifth of EMs with fiscal rules made some type of adjustment to take this aspect into account.

Figure 2.1. International Experience with Fiscal Rules

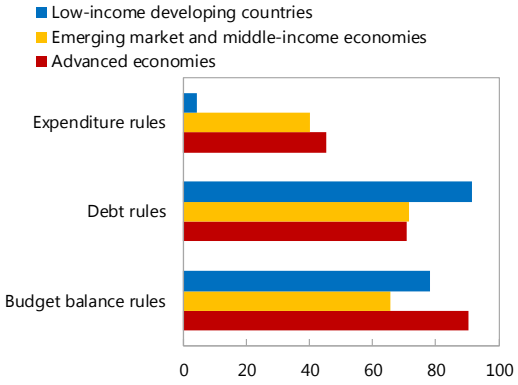
Number of countries with fiscal rules

(a) Number of EMs with fiscal rules has surged in the past two decades



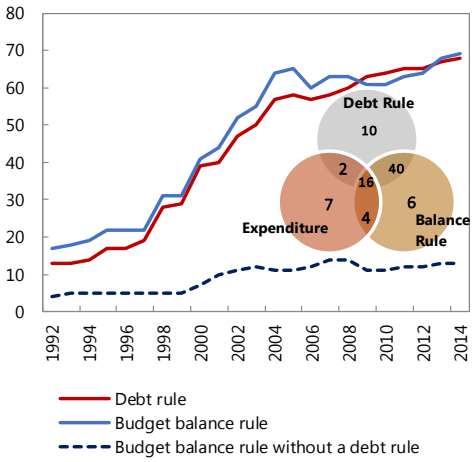
Share of countries with fiscal rules in 2014

(b) Budget balance (deficit) and debt rules are the most commonly adopted national fiscal rules



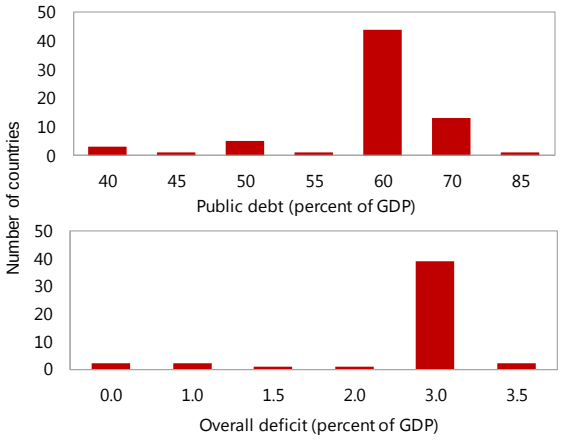
Number of countries with fiscal rules over time, and summary structure in 2014

(c) Countries typically combine budget balance and debt rules, both of which are directly linked to debt sustainability



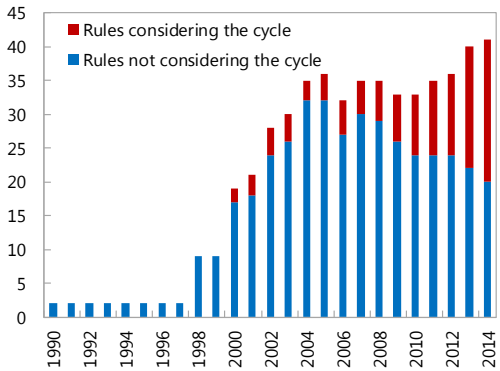
Ranges for public debt and deficit ceilings (% GDP)

(d) Most overall deficit ceilings are less than 3 percent of GDP, and most debt ceilings range between 40-70 percent of GDP



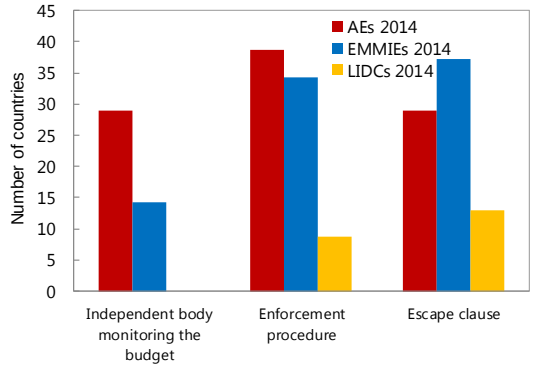
Number of EMDEs that adopted structural rules

(e) Many EMs have adopted structural balance rules or escape clauses to increase flexibility



Main features of PFM frameworks, 2014

(f) Fiscal rule frameworks in EMs are still enforced and monitored weakly



Source: IMF Fiscal Rules, 2014.

Note: The budget balance indicator used in the charts covers both nominal and structural balance rules.

B. Fiscal Rules in the Georgia Context

11. Fiscal rules in Georgia should consider both the overall objectives and the economic context in which they are applied. Designing an optimal set of fiscal rules is not an easy task, as all rules have their virtues and drawbacks (Box 2.1). In Georgia, the fiscal rules should consider the stated primary objective of fiscal sustainability as well as the need for flexibility to respond to unexpected economic shocks. A premium should also be placed on simplicity of the rules, and, ideally, they should not be pro-cyclical. Since Georgia has signed an Association Agreement with the EU in 2014, the fiscal rules framework should also consider the EU fiscal governance framework, or at least not be inconsistent with this framework (see Annex I for a description of the EU framework). At the same time, the fiscal rules should factor in the transitional nature of the Georgian economy, which makes some rules difficult to implement in the short to medium-term, as discussed below.

Box 2.1. Assessment of Fiscal Rules

Budget Balance Rules	
Overall Balance	*Golden Rule*
+ Easy to communicate/monitor	+ Protect public investment
+ Clear operational guidance	+ Intergenerational equity
- Can lead to pro-cyclicality	- Weak link to debt sustainability
- Could lead to changes in composition	- Creative Accounting
Cyclically Adjusted or Structural	*Over the Cycle*
+ Foster economic stabilization	+ Good stabilization properties
+ Good operational guidance	- May entail too loose/tight stance
- Difficult to compute and monitor	- Difficult to monitor and enforce
Expenditure Rules	
+ Rel. easy to communicate/monitor	- No direct link to debt sustainability
+ Allow macroeconomic stabilization	- Could lead to changes in composition
+ Rel. clear operational guidance	- Can reduce incentive to mobilize revenues
Revenue Rules	
+ Raise revenues or limit tax burden	- No direct link to debt sustainability
	- Can lead to pro-cyclicality

Source: "How to Select Fiscal Rules," IMF (forthcoming)

12. Complex BBRs, such as a structural balance rule, would be difficult to implement in Georgia at this juncture. The ongoing structural changes in the Georgian economy would make such rules difficult to design, monitor, and communicate. The structural balance is an estimated and unobserved fiscal metric that requires the estimation of the output gap and the sensitivity of the budget to cyclical fluctuations in the economy, both of which would be prone to considerable uncertainty:

- The output gap is not directly observable, and the plausible range of estimates could be very wide, rendering a multitude of equally possible and valid outcomes;

- The fiscal position could be affected by events that do not necessarily move in line with the economic cycle, such as one-off fiscal policy adjustments and movements in commodity and asset prices;
- Insofar as the current economic cycle would differ from the average cycle, the relationship between the budgetary position and the output gap over the course of that cycle would be mis-specified; and
- The structural balance could be subject to potentially significant and repeated revisions even several years after the year for which it is estimated, making it difficult to monitor and verify by independent oversight bodies.

13. On balance, therefore, the current debt and deficit rules seem appropriate in the Georgian context, as they are:

- Closely linked to the primary objective of fiscal sustainability, provided they are based on outturns and not just on plans (this is further discussed below);
- Simple; well understood; and relatively easy to monitor and transparently communicate;
- Compatible with realistic debt and deficit trajectories, as further discussed in Chapter IV;
- Consistent with the key debt and deficit measures in the EU fiscal governance framework; and
- Compatible with the need for flexibility to respond to economic shocks if combined with an appropriate escape clause, as discussed below.

14. The ER has several issues and should be reconsidered. Unlike the debt and deficit rules, the ER is not closely linked to fiscal sustainability objectives. The specification of the ER as a percentage of GDP can also lead to excessive pro-cyclicality since a decrease in GDP may require a drop in nominal expenditures to comply with the rule, even if the deficit rule is not compromised. In turn, the rule allows for increases in expenditures if GDP increases, limiting the scope to create fiscal buffers. Further, the ER can discourage public investments if limits are tight since capital expenditures typically are more easily reduced than current expenditures. As noted above, based on outturns, the level of expenditures already exceeds the limit set out in the ELA. Finally, the ER can lead to a reliance on quasi-fiscal spending through public corporations and below-the-line transactions as well as the use of PPPs, as has increasingly been the case in Georgia. This is further discussed in Chapter III.

15. Many countries rely instead on ERs based on multi-year nominal ceilings set out in a MTBF. Based on forecasts of revenue, the MTBF provides the expenditure path that is consistent with the debt and BBRs and the medium-term fiscal objectives. In well-developed MTBFs, this expenditure path would constitute the nominal expenditure ceilings and would be binding in a rolling four or five-year perspective, as further discussed in Chapter IV. In less

mature MTBFs, the ceilings for the outer years would typically be indicative, but with an explanation in fiscal reports of changes between successive plans.[7]

16. Specifying the ER in Georgia in this way would have several advantages. Georgia already has an MTBF with indicative ceilings for the outer years, which could provide the foundation for the rule, and by delinking developments in expenditures in the medium term from developments in GDP and revenue, nominal expenditure ceilings would have better counter-cyclical attributes than the current ER. At the same time, it would allow for adjustments in expenditures over time, for example in case of a structural increase in revenue, provided it would be consistent with the debt and BBRs.

17. The ELA would have to be amended to incorporate this approach. Rather than specifying the ER as a percentage of GDP, the ELA would specify the requirement for the government to propose multi-year expenditure ceilings on a rolling basis as part of the draft budget process, possibly with a reference also made to the Budget Code.

18. In principle, other adjustments to the existing specification of the ER could be considered. Some countries have specified an expenditure *growth* rule. Typically, such a rule includes a requirement that expenditures cannot exceed trend, nominal, potential, or real GDP growth. Due to the transitional nature of the Georgian economy, such as rule, particularly if trend or potential growth is used as a benchmark, would be subject to similar challenges as the structural BBR discussed above. Furthermore, such a rule is conducive to gradually increasing expenditures, sometimes referred to as expenditure drift.

19. Some countries also exclude certain expenditure items from their ERs. These typically relate to cyclically-sensitive expenditures, capital expenditures, or interest payments. There are various reasons for considering these expenditure items (see Box 2.2), and in Georgia it could be relevant to consider excluding interest payments to avoid distortions in the choice between internal and external debt financing. The current rule is favorable to external, low interest rate concessional borrowing but does not factor in the associated exchange rate risk. Exclusion of capital expenditures, on the other hand, should be subject to a strong public investment management framework, which may not yet be in place in Georgia. Cyclically—sensitive expenditures—or automatic stabilizers—in Georgia are negligible.

[7] There is only a limited amount of data on binding versus indicative MTBFs. However, a study for OECD countries showed that out of 24 countries, 8 countries had a binding MTBF, 10 had indicative frameworks and 6 had neither. "Binding MTBF" was defined as a framework that holds government accountable for the multiyear expenditure parameters (estimates or ceilings). Accountability means that some active measure or action is required if there is evidence that the previously set expenditure parameter is going to be exceeded. (Harris et al. 2013).

Box 2.2. Considerations for Expenditure Rule Coverage

Item Most Frequently Excluded	Case for inclusion	Case for exclusion	Countries Where Exclusions Apply (Type of Rule)
Interest Payments	Coverage and credibility	Not required for debt sustainability. Can distort debt funding choices between domestic and external debt (higher interest payments are included but not exchange rate risk).	Finland (ER), France (ER), Spain (ER), Sweden (ER)
Cyclically-Sensitive Expenditure	Avoids incentive for re-classification Difficult to operationalise	Allows automatic stabilisers to operate fully	Denmark (ER), Finland (ER), Switzerland (BBR)
Capital Expenditure	Avoids incentive for re-classification Requires effective PIM framework	Infrastructure 'gap' should be filled if debt sustinability conditions are met Lumpiness of expenditure and possibility for delays can lead to poor value for money choices	National: Brazil (ER, DR), Ecuador, (ER), Hong Kong SAR (BBR), Japan (BBR) Supranational: WAEMU and CEMAC (BBR, DR, foreign financed capital spending excluded)

Sources: IMF fiscal rules dataset

Note: BBR = budget balance rule; DR = debt rule; ER = expenditure rule

C. Corrective Mechanisms

20. Fiscal rules frameworks often incorporate corrective mechanisms to enhance enforceability and credibility. These would be specified in the legislation and would prescribe the action to be taken if fiscal outturns are not in line with the fiscal rules. Some frameworks rely on detailed (or automatic) corrective mechanisms, which prescribe both the size and timeframe for the correction, and in some cases also with some specification of measures. The EU fiscal framework is an example of this. Other frameworks take a more procedural approach, for example a requirement that the government put forward a corrective plan in case of non-compliance with the fiscal rules, but without specifying the size of the correction or the timeline. Annex II provides country examples of corrective mechanisms.

21. Georgia has specified a corrective mechanism in the ELA, but it is not based on outturns. If the approved budget for the current year is not within the specified ceilings for the deficit and expenditures,[8] the government is required to submit to the Parliament a budget proposal for the next year that includes a plan for returning to the ceilings within two years. However, the law is silent on what actions to take if the actual outturns are not in compliance with the ceilings, which is a major weakness in terms of the credibility of the framework. Notably, the corrective mechanism also does not include the current DR.

22. The corrective mechanism should apply to actual outturns, and the related reporting requirement should be specified in the ELA. While automatic corrective

[8] The Parliament can approve a budget that is not within the ceilings in two specific circumstances., as discussed below.

mechanisms are not recommended in the Georgian economic context, the government should be required to report to the Parliament on compliance with the fiscal rules, which should also include an explanation of the causes and nature (for example, permanent or temporary) of any deviations, and a plan with specified measures for the return to the ceilings. This reporting and plan could be incorporated in the Basic Data and Directions (BDD) document, which serves as the government's fiscal strategy paper for the forthcoming year and the medium-term and is submitted to Parliament in July. Reporting on the compliance with the fiscal rules should also be included in the annual Budget Execution Report.

D. Escape Clauses

23. Well-designed escape clauses can provide the needed flexibility to adapt to exceptional and unforeseeable economic shocks. However, to sustain the credibility of the fiscal rules framework, and to avoid potential circumvention of the rules, such clauses should only be triggered in rare circumstances based on specific criteria clearly set out in legislation. Typically, escape clauses include a limited range of factors that allow them to be triggered, and some escape clauses also specify how they can be triggered and/or a pre-determined transition path back to the rules (Figure 2.2). Annex III provides examples of escape clauses from several countries.

Figure 2.2. Fiscal Rules with Escape Clauses

Country (year)	Natural disaster	Economic recession	Banking system bailout, guarantee schemes	Change in government	Change in budget coverage	Other events outside government control	Voting mechanisms defined	Transition path defined
Brazil (2000)	X	X	—	—	—	—	X	—
Colombia (2011)	—	X	—	—	—	X	—	—
Germany (2010)	X	X	—	—	—	X	X	X
Jamaica (2010)	X	X	—	—	—	X	—	—
Mauritius (2008)	X	X	—	—	—	X	—	—
Mexico (2006)	—	X	—	—	—	—	—	—
Panama (2008)	X	X	—	—	—	X	—	X
Peru (2000)	X	X	—	—	—	X	—	X
Romania (2010)	—	X	—	X	X	X	—	X
Slovak Republic (2012)	X	X	X	—	—	X	—	—
Spain (2002)	X	X	—	—	—	X	X	X
Switzerland (2003)	X	X	—	—	—	X	X	X
EU member states (2005)	—	X	—	—	—	—	—	X
WAEMU (2000)	—	X	—	—	—	—	—	—

Source: Budina, Kinda, Schaechter, and Weber (2013)

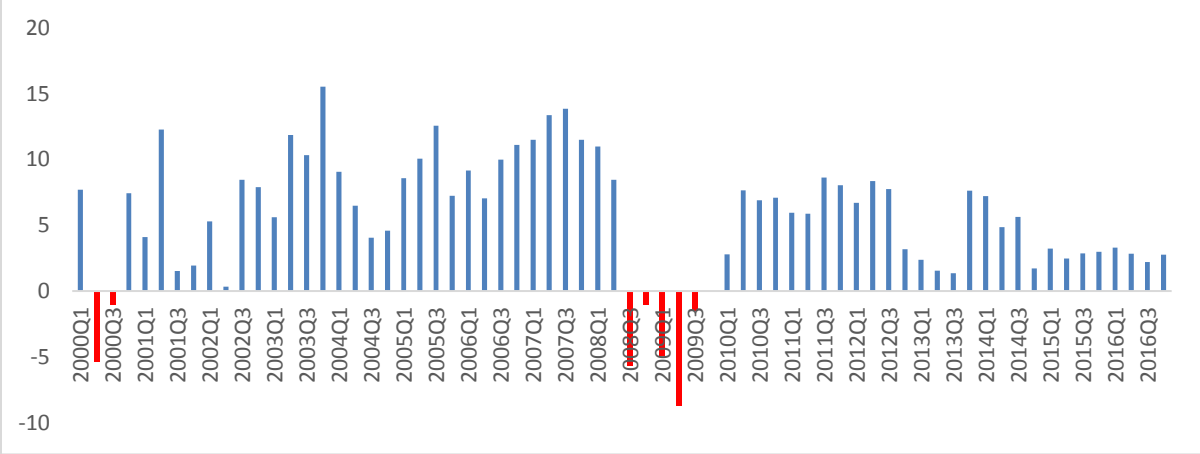
24. In Georgia, the ELA allows the fiscal rules to be waived temporarily in two cases, but these are not well specified. The ELA states that the Parliament can approve a budget that is not in compliance with the deficit or expenditure rule only if: (i) the current year's approved budget was within the limits for deficit or expenditures; or (ii) extraordinary expenditures caused

by military action or economic recession are needed. In both cases, the corrective mechanism mentioned above would apply. These escape clauses suffer from several shortcomings:

- The possibility to approve a budget that is not compliant with the fiscal rules if the current year's budget was within the budget is not linked with any trigger cause and therefore risks impede the credibility of the framework;
- What constitutes an economic recession is not specified and could lead to circumvention of the rules, although this has not been the case so far in Georgia;
- It may not in all cases be appropriate to return to the ceilings within a two-year period as this could lead to a deepening of an economic crisis (pro-cyclicality); and
- A procedure for who can trigger the escape clause (a so-called voting procedure), and the associated reporting requirements, are not specified.

25. A revised escape clause could encompass a clear definition of what constitutes an economic recession, combined with the procedural corrective mechanism described above. An economic recession is often defined as two consecutive quarters of negative real year-on-year GDP growth. Such episodes have occurred three times in Georgia's recent history - in 2001, 2008, and 2009 - indicating that such a criterion would be tight but allow for deviation in exceptional circumstances (Figure 2.3).[9]

Figure 2.3. Real GDP Growth 2000Q1-2016Q4 (year-on-year)



Source: Staff estimates based on official figures.

26. It would also be important to specify procedures around a decision to trigger the escape clause. It could be a decision by the cabinet, based on a proposal by the Minister of Finance, or it could be a decision by Parliament, based on a proposal by the government. In any

[9] Within the EU economic framework, "a severe economic downturn" – which can be used as a justification to trigger an escape clause – is defined as "a negative real growth of GDP or as an accumulated loss of output during a protracted period of very low real growth of GDP relative to its potential."

case, the government should be required to submit a report to the Parliament within a certain timeframe detailing the justification for triggering the escape clause.

E. Oversight Arrangements

27. A well-designed fiscal rules framework should be supported by independent oversight arrangements to enhance accountability and credibility. The appropriate execution of this oversight role would depend on the specific administrative and legal structures in any country, but it should involve the independent verification of compliance with the fiscal rules. An increasing number of fiscal frameworks, including in the EU, have institutionalized this function through the creation of independent fiscal councils. While these take many forms, as discussed in Annex IV and V, they tend to share an explicit mandate, enshrined in legislation, to perform a "watchdog" role through contributions to the public debate on fiscal policy. Typically, these institutions would publish assessments of the government's fiscal performance and plans, and some would also provide or evaluate the macroeconomic forecasts.

28. The ELA should include clear provisions on independent oversight and verification. Currently, the PBO, which was made independent in 2014, publishes an opinion on the draft state budget, which includes an overview of the government's forecasts and other indicators included in the state budget, and an annual fiscal policy review. However, it does not publish a full assessment of each element of the fiscal framework, and it does not have a clear mandate to report on the government's compliance with the rules.[10] Similarly, the SAO is obliged to provide an opinion on the draft budget published in October, but it does not formally verify compliance with the fiscal rules.[11] To fill the gaps in oversight, the ELA should include provisions on independent verification, which should, as a minimum, cover: (i) an assessment of the macroeconomic and fiscal forecasts, including against those of other forecasters; and (ii) a formal assessment of compliance with each of the fiscal rules. At this juncture, the PBO may be best placed to serve this role.

F. Revisions of the Fiscal Rules

29. Fiscal rules should be subject to periodic review to ensure that they remain relevant and appropriate. Periodic reviews, and if warranted, revisions of the rules could ensure their validity and effectiveness as a tool to achieve the objectives of debt sustainability and economic stabilization. For example, it may be warranted to introduce a structural balance rule at a later

[10] The PBO also produced a one-off publication on the design of the fiscal rules framework.

[11] Limited commentary on performance against the fiscal rules is also included in the SAO's annual report on the government's budget execution report. For example, the SAO's 2017 report highlighted the breaches of the 30 percent expenditure ceiling in outturn data and noted the absence of any government commentary on this in its budget reports.

stage, or the fiscal rules framework may need to adapt to progress in EU association. The ELA could set out that such reviews should be undertaken every 5 or 10 years.

G. Recommendations

Recommendation 2.1. Design of the fiscal rules: The government should seek to replace, through an amendment to the ELA, the current ER with a requirement to set multi-year expenditure ceilings on a rolling basis as part of the MTBF, consistent with the debt and BBRs and the medium-term fiscal objectives (2018).

Recommendation 2.2. Corrective mechanisms: The government should seek to strengthen the corrective mechanisms in the ELA by:

- Introducing reporting requirements on compliance with the fiscal rules ex-post; and
- Introducing a requirement that the government put forward a corrective plan to be included in the BDD in case of non-compliance (2018).

Recommendation 2.3. Escape clause: The government should seek to strengthen the escape clause in the ELA by:

- Abolishing the criteria that allows the Parliament to approve a budget that is not compliant with the fiscal rules if the current year's approved budget is within the limits;
- Adopting a clear definition of economic recession, for example two consecutive quarters of negative real year-on-year GDP growth; and
- Specifying who can decide to activate the escape clause, and the associated reporting requirements (2018).

Recommendation 2.4. Oversight arrangements: The government should seek to incorporate in the ELA clear provisions on independent oversight and verification of the government's compliance with the fiscal rules (2018).

Recommendation 2.5. Revisions of the fiscal rules: The government should seek to incorporate in the ELA a clause that the fiscal rules be reviewed, and if warranted revised, on a periodic basis, for example every 5 or 10 years (2018).

III. COVERAGE AND MEASUREMENT

30. Georgia has taken substantial steps over the past decade to improve fiscal statistics compilation in line with international standards. Significant advancements include the adoption in 2008 of a cash based budget classification based on GFSM2001, and the publication of more frequent reports on budget execution in accordance with GFSM2001. Georgia is also implementing accounting reforms, expected to be completed in 2020, which will provide a good basis for the compilation of fiscal statistics in line with GFSM2014.

31. Yet, some gaps remain in the coverage and measurement of fiscal aggregates, which might impede the effective implementation of the fiscal rules. Fiscal reports cover in principle, central and subnational governments but exclude LEPLs and public non-market producers currently classified as SOEs.[12] Reporting on debt has a more limited institutional coverage, focusing on just central government. Similarly, some transactions carried out between government units and SOEs are not accounted for or reported in line with international statistical standards, impacting the measurement of the main fiscal aggregates.[13]

32. This chapter discusses the adjustments needed in institutional and transactional coverage, as well as measurement of government transactions, to align fiscal reporting practices to the GFSM2014 standard. The analysis builds on and extends the initial TA provided by STA, which will be finalized beyond this mission.

A. Institutional and Transactional Coverage

Limited coverage of Legal Entities of Public Law (LEPLs)

33. The LEPLs are large in number and the magnitude of their operations has grown over time. They are public entities created by law to perform public activities outside the government budget. They receive transfers from the budget, but they also collect own revenue to finance their operations. The central government controls 496 LEPLs, while a non-specified additional number of LEPLs are controlled by subnational governments.

34. LEPLs are not fully covered in the main fiscal reports. LEPLs controlled by subnational governments are not covered in government finance statistics (GFS) reports. For LEPLs controlled by central government units, the coverage is partial.[14] Some activities are indirectly included in

[12] The FTE found that fiscal reports provide a fragmented picture of public sector activities, with varying coverage in terms of stocks and flows as well as institutions.

[13] For this reason, the current Fund-supported program is based on an 'augmented budget deficit', which add to net lending/borrowing all budget lending transactions.

[14] Information on LEPLs controlled by the central government is included in the annual financial statements produced by the Treasury. Yet, this information is not used to check compliance with the fiscal rules. The latter is done based on budget execution report and/or GFS reports, neither of which fully cover LEPLs.

GFS reporting to the extent that they are funded by transfers from the central government. However, expenditures carried out by LEPLs that are funded from their own revenues are not incorporated into main fiscal aggregates of GFS reports and therefore not covered by the fiscal rules.

35. The partial coverage of LEPLs has large implications for the main fiscal aggregates. General government revenue and expenditures are underestimated by the LEPLs' own revenue and the related expenditures. By end-2015, LEPLs own revenues represented about 12 percent of general government total revenue, and about 17 percent of total expenditures. If LELPs carry over unused balances, the exclusion of these transactions could also impact the fiscal balance. Based on data for 2015 compiled during the mission, staff estimates that inclusion of LEPLs in general government statistics would: (i) increase revenue by 4.5 percent of GDP; (ii) increase expenditures by 4.3 percent of GDP; and (iii) decrease the general government deficit by 0.2 percent of GDP (Table 3.1). There is no readily available information of the LEPLs stock of liabilities, but the authorities estimate that these are marginal.[15] In turn, LEPLs maintain deposits both in the Treasury Single Account (TSA) and in commercial bank accounts, but data was not available at the time of the mission.

Table 3.1. Georgia: Transactions of LEPLs Controlled by Central Government, 2015–16

(In percent of GDP)	2015	2016
Revenues	**9.5**	
Of which: Own-revenues	***4.5***	***2.8***
Expenditures	**9.3**	
Of which: Funded by own-revenues	***4.3***	***2.7***
Overall balance	**0.2**	
Stocks		
Financial assets	n.a	n.a
Liabilities	0.0	0.0

Sources: FTE staff estimates

36. Given the magnitude of LEPLs own revenue and associated expenditures, the GFS reports should consolidate LEPLs within general government. Detailed data on transactions of LEPLs controlled by the central government is available in a timely manner to allow for its proper consolidation in GFS. For LEPLs controlled by subnational governments, information is also available in the Treasury's information systems, but the quality of the data is lower.[16] LEPLs controlled by subnational governments should be included in the compilation of general government data on a best-effort basis, with revisions to the data once they become available.

[15] The authorities estimate that by end-2015 LEPLs loans account for 2 million Lari.

[16] The Treasury is working to improve the quality of these data in the context of the accounting reform strategy.

Government non-market producer units classified as SOEs

37. Classifying government entities as SOEs outside the general government sector can have significant impact on the fiscal aggregates. This is particularly important for countries such as Georgia that have adopted fiscal rules. If institutional units are incorrectly classified as SOEs, there is a risk of underestimating the size of the general government sector under the coverage of the fiscal rules. Consequently, the government's capacity to impose fiscal discipline and ensure debt sustainability can be substantially reduced.

38. The potential impact on fiscal aggregates is country specific and depends on the size and nature of the activities of SOEs. Yet, international experience suggests that adjustment to the coverage related to misclassification of SOEs can be significant. Changes in the sector classification of SOEs had a significant impact on the 2013 deficit in several EU countries, as illustrated in Table 3.2.[17] For example, Portugal reclassified a few large SOEs in the transport sector —such as *Estradas de Portugal, Metro de Lisboa, Metro do Porto*—into the general government sector after several years of financial difficulties for these entities despite significant

Table 3.2. Revision to Government Deficit due to the Change in Sector Classification, 2013
(In percent of GDP)

BE	BG	CZ	DK	DE	EE	IE	EL	ES	FR	HR	IT	CY	LV
0.0	0.0	0.0	0.0	0.0	0.0	0.7	0.1	0.0	0.0	-0.1	0.0	0.0	0.0
LT	**LU**	**HU**	**MT**	**NL**	**AT**	**PL**	**PT**	**RO**	**SI**	**SK**	**FI**	**SE**	**UK**
-0.4	0.1	0.0	0.0	0.0	0.0	0.1	-0.4	0.0	0.0	0.1	0.0	0.0	-0.2

Source: EUROSTAT. http://ec.europa.eu/eurostat/documents/1015035/2041365/Revisions-gov-deficit-debt-2010-2013.pdf/

39. SOEs that do not satisfy the criteria to be a public corporation should be reclassified within the general government. According to GFSM2014, the delineation between general government and the public corporate sector relies on identifying which units are market or non-market producers, on a case-by-case basis. Only market-producers, meaning that they provide most of their output at economically significant prices, should be classified as SOEs. Determining what constitutes economically significant prices can be challenging, and it is necessary to examine the specific nature of the activities and the specific links that each entity has with the government. The market or non-market nature of a specific public entity should be considered through both qualitative and quantitative tests (see Box 3.1), and only market producers should be classified as SOEs.

[17] The largest impact was observed in Ireland, with a downward impact on the 2013 deficit of 0.7pp of GDP. By contrast, sector classification had a significant deficit increasing effect on the 2013 deficits of Lithuania (-0.4pp), Portugal (-0.4pp) and the UK (-0.2pp).

Box 3.1. Delineation between General Government and SOEs

General government consist of institutional units which are non-market producers whose output is intended for individual and collective consumption, and are financed by compulsory payments made by units belonging to other sectors. SOEs are market producer units; thus, they are classified outside the general government.

To determine the market or non-market nature of a public unit a set of criteria should be applied. First, a qualitative criterion establishes whether the unit is undertaking a market activity. Subsequently, a quantitative criterion determines the conditions under which the unit can undertake a market activity.[1/]

Qualitative criterion. To be considered an SOE, the unit should have the following features:

- *It should be an institutional unit*. It should not be serving the government almost exclusively, in which case it should be considered an ancillary unit and consolidated with the general government unit controlling it.
- *It should sell its output to both the government and other customers.* To be considered a SOE, the unit should sell most of it output to non-government units. If the government buys more than 50 percent of the output, but it does so through open competition (e.g. through one tender procedures), the unit is considered an SOE. Otherwise, it should be consolidated within general government.

If by applying the qualitative criterion there is a presumption that the unit could be a SOE, its market or non-market nature should be determined through the quantitative criterion, as explained below.

Quantitative criterion. It is usually referred to as the **"market test."** It distinguishes market (SOEs) from non-market public units (government) by comparing revenue sales and the average of production costs over the medium term.

Value of revenue sales > 50 percent of average production costs over at least 3 years

Sales: include revenue sales before taxes and excluding payments. Many forms of revenues are not sales, and should be included in the test: property income (for example, interest, dividends, rents); administrative fees; and grants (transfers from government).

Production costs: include compensation to employees, use of goods and services, consumption of fixed assets, and other taxes on production. Own capital formation should be excluded from production costs.

Although the market test can be performed on an annual basis as part of the GFS compilation process, it is recommended to keep the classification of the unit under consideration for at least three years and only reclassify it if: (i) the criteria holds for more than three years; or (ii) if there are clear expectations that it will hold for several years in the future. The quantitative criterion should not be considered the only relevant criterion determining the classification of the entity. It should be used in combination with the qualitative criteria.

Sources: GFSM2014, ESA2010.
1/ The GFSM2014 does not prescribe numerical rules for the delineation between market and non-market producers. EUROSTAT, on the other hand, includes a 50 percent threshold comparing the value of sales and production costs. Both criteria are consistent and can be used to compile GFS both under GFSM2014 or ESAS2010 methodology.

40. Information published in the government's fiscal risk statement (FRS), and analysis carried out in the context of the FTE mission, suggest that some SOEs in Georgia should be reclassified as general government units. Some SOEs operate on non-commercial basis and/or fulfill social functions, such as supplying electricity or gas free of charge or at subsidized prices.

The 2016 FRS classified SOEs into risk categories, following several criteria.[18] Using this information staff estimates that 15 percent of the 65 largest SOEs under the control of the central government would not pass the market test in 2015.[19] Although these are rough estimates, they indicate that evaluating and monitoring the market/non-market nature of Georgia's largest SOEs is warranted.

41. The government has made progress in assessing and reporting the risks arising from SOEs in the FRS. However, the analysis included in the FRS is not sufficient to conclude which corporations should be reclassified into the general government, or what would be the implications for the fiscal aggregates.[20] To ensure that fiscal aggregates cover all transactions from general government units, the government should undertake a case-by-case analysis of the classification of the SOE sector, with priority given to those SOEs already classified as high and middle risks.

Limited coverage of government debt

42. The debt ceiling has a narrower institutional coverage than the other fiscal rules. While the budget balance and expenditures rules cover central and subnational governments, the institutional coverage of the DR is limited to central government. The ELA defines the DR in line with the national definition of State Debt set out in the Public Debt Law. The national debt definition is broadly in line with international statistical standards for the compilation of central government gross debt under cash-based accounting systems.[21]

43. However, data suggest that the magnitude of liabilities not being recorded in gross debt is marginal. The FTE found that total liabilities of subnational governments accounted for 0.1 percent of GDP in 2015 (after consolidation), and while there is no readily available data for the stock of liabilities of LEPLs, authorities' estimates suggest that they are not material.[22] Since 2015, when all LEPLs operations were rerouted through the TSA, the Treasury has good information on their operations, and LEPLs cannot borrow without government approval.

44. Nonetheless, the institutional coverage of gross debt should be extended to general government to make it consistent with international standards. This would require

[18] See FRS, "Analysis of Macroeconomic Risks in the Fiscal Sector, 2016-2020," 2016.

[19] Staff performed a rough estimate (total income over total costs) of the market test using 2015 data. SOEs that do not pass the market test would include: LLC Marabda-Kartsakhi Railay; LLC State Service Bureau; LLC Solid Waste Management; Company of Georgia; JSC Akura; LLC United Water Supply Company of Georgia; LLC Mountain Resort Development Agency; JSC Borjomi Likani International; LLC Imereti Greenery; JSC Vanrik Agro, and JSC Aero Structures Technology (Cyclone).

[20] At the time of the mission there is no sufficient information to apply the criteria detailed in previous sections to all SOEs controlled by central and subnational governments.

[21] Gross debt in Georgia is compiled on a cash basis; therefore, it does not include accounts payable and is compiled in nominal values.

[22] Approximately 2 million Lari at end-2015, close to zero in percent of GDP.

the compilation of general government gross debt statistics in line with GFSM2014 and the principles prescribed by the Guide for Public Sector Debt Statistics (2011). In practice, the authorities should add to current gross debt statistics: (i) debt liabilities of subnational governments; (ii) debt liabilities of LEPLs; and (iii) debt liabilities of any SOEs reclassified into the general government.

B. Measurement of Government Transactions

45. Some transactions carried out between general government units and SOEs are not correctly recorded in the fiscal accounts. The implications for the fiscal aggregates are significant, particularly in the case of on-lending and capital injections to SOEs.

On-lending and capital injections

46. Government support to SOEs can come in different forms and should be recorded differently (Box 3.2). According to GFSM2014, transfers or subsidies to SOEs should be accounted as expenditures, whereas loans and capital injections to SOEs that generate financial assets for the government should be recorded as financial transactions below the line, i.e., they would not affect the overall deficit.

Box 3.2. Accounting Government Support to SOEs in Fiscal Statistics

Governments can support SOEs typically in three ways:

- Providing a **transfer/grant/subsidy**. These are unrequited payments where the government is expecting nothing in return. International standards prescribe that capital transfers should be recorded as expenditures, impacting the overall deficit (reducing the balance) of the government;
- Providing a **capital injection**. This would be an addition to equity. Capital injections are financial transactions recorded below line, thus not affecting the overall fiscal balance. To be classified as a capital injection, the government should provide funds under the following conditions (i.e., "capital injection test"):
  - The government expects to receive *something of equal value in exchange* (usually financial assets, such as shares or debt instruments);
  - The government expects to earn a *sufficient rate of return on its investment* (usually in the form of dividends and interest);
  - The government provides funds to a *SOE that is profitable*, one which has not shown a series of losses.
- Providing **loans**. As a lender, the government is expecting that the SOE, as a borrower, will be able to repay the loans according to a schedule agreed at the inception. Loans are financial transactions recorded below the line, thus not affecting the overall fiscal balance.

Sources: GFSM2014, ESA2010.

47. In Georgia, the government has supported SOEs mainly in two ways, which are both referred to as budget lending (Table 3.3):

- *On-lending* to SOEs comprises the transfer of external funds obtained by the central government through borrowing from international organizations and international financial institutions (IFIs). On-lending of these external funds to SOEs is typically done at similar

financial conditions as the original loans. The management and monitoring of these loans is the responsibility of the Public Debt and External Financing Department at the MoF, and clear repayment conditions are agreed in memoranda of understanding signed between the central government and the SOEs.[23]

- *Capital injections* include transfers to SOEs of budget resources. These transfers to SOEs are mainly for two purposes: (i) to finance specific projects or activities at the request of, or after negotiating with, the central government; and (ii) to support loss-making SOEs in the case of financial distress.

Table 3.3. Georgia: Composition of Budget Lending Operations, 2013–16

Percent of GDP	2013		2014		2015		2016	
Total Budget Lending	**1.0**	**100%**	**0.9**	**100%**	**1.4**	**100%**	**1.4**	**100%**
On-lending (external)	0.7	70%	0.7	73%	0.6	46%	0.7	49%
Capital injections	0.3	30%	0.3	27%	0.7	54%	0.7	51%
Sources: Staff estimates based on official data.								

48. On-lending of external funds to SOEs appear to comply with the definition of loans in GFSM2014. Overall, on-lending of external funds to SOEs has a contractual nature with clear conditions and repayment that take place on a regular basis. Consequently, they should be treated as financial assets for the government and not affect the overall deficit. Based on information obtained during the mission, the repayment of these loans by SOEs seems to take place on a regular basis. Table 3.5 shows that for the average of the last three years, the actual service of on-lending to SOEs represent 92 and 94 percent of the planned repayments for principal and interest, suggesting that there is a reasonable probability of repayment of these loans by SOEs.[24] It should be noted that this overall assessment does not preclude the need for a more detailed evaluation, on a case-by-case basis, of the nature of transactions made between the government and SOEs benefiting from on-lending activities.

Table 3.4. Georgia: On-Lending Debt Service Payments, Planned vs. Actual, 2013–16*

	2013			2014			2015			2016			Av.
(Million Lari)	Plan	Actual	%	Plan	Actual	%	Plan	Actual	%	Plan	Actual	%	%
Principal*	26.8	27.4	102	67.6	55.4	82	78.7	68.7	87	88.3	85.7	97	92
Interest* and commissions	8.8	9.6	109	23.2	17.8	77	26.1	25.4	97	28.7	26.2	91	94
Sources: Staff estimates based on official data * Including arrears.													

[23] It should be noted that government on-lend not only to SOEs. Particularly, the EIB lends money to the central government to be on-lent to banks, so that they provide financing to targeted sectors.

[24] This does not eliminate the possibility that the government would be making transfer to these SOEs to allow them to service their own debt. In addition, the FTE found that around a fifth of the loans have been restructured or reorganized, by extending grace periods around interest and principal repayments.

49. However, the distinction between capital transfers and capital injections is unclear. Currently, the authorities account two types of transactions as capital injections: (i) government transfers to SOEs earmarked to specific capital projects; and (ii) transfers to SOEs that are under significant financial stress (i.e., have been loss-making for several years).[25] None of these transactions would pass the "capital injection test" detailed in Box 3.3 above since the government is not expecting to receive a financial asset of equal value in exchange[26] and the value of the shares of loss-making companies would be significantly lower than the government transfer. Nor does the government expect to earn a sufficient rate of return for its investment, given that these are transfers to non-profitable SOEs that have been loss-making over several years.

50. Preliminary analysis suggests that capital injections would fall under the definition of capital transfers and should, therefore, be recorded as expenditures. In 2015, about half of the 65 largest SOEs under the control of the government were loss-making, and one-third were found to be experiencing some form of financial difficulty and therefore classified as high-risk. At the same time, the central government provided support to high-risk SOEs of about 0.8 percent of GDP, mostly in the form of capital injections, despite around one third them also having received capital injections in each of the preceding years. The combined liabilities of the high-risk SOEs accounted for 9 percent of GDP in 2015.

C. Implications for the Fiscal Aggregates

51. Improving the coverage and measurement as outlined above would have implications for the fiscal aggregates (Table 3.7). Based on the data for 2015, the overall deficit would have been higher compared to the official data. The adjustment is explained by the inclusion of LEPLs and the reclassification of capital injections. While all budget lending (on-lending and capital injections) currently are recorded below the line in the official data, the analysis based on GFSM2014 made by this mission would maintain on-lending below the line but reclassify capital injections as expenditures above the line.

[25] Examples of earmarked transfers for policy purposes are capital injections to vineyards, ski resorts, sport infrastructure. An example of capital injections to long a loss-making company is the one provided to the State Construction Company.

[26] The assets developed by earmarked capital projects remain in the balance sheet of the SOE.

Table 3.5. Georgia: Implications for Fiscal Aggregates of Aligning Coverage and Measurement with GFSM2014, 2015

2015 In % GDP	General Government	Adjustment for coverage		Adjustment for Measurment		Adjusted General Government (Staff)
		LEPLs	Non-market producers	On-lending	Capital injections	
Revenues	**28.1**	**4.5**	NA	**0**	**0**	**32.6**
Of which:						
Own revenues		4.5				
Expenditures	**29.4**	**4.3**	NA	**0**	**0.6**	**34.3**
Of which:						
Funded by own revenues		4.3				
Transfers					**0.6**	
Overall balance (NLB)	**-1.3**	**0.2**	NA	**0**	**-0.6**	**-1.7**
Adjusted Overall balance (program)						
Financial assets						
Of which:						
Budget lending	**1.4**					
On-lending	**0.8**					
Capital injection	**0.6**				**-0.6**	
Liabilities						

Sources: Staff estimates

D. Recommendations

Recommendation 3.1. Legal Entities of Public Law (LEPLs): The MoF should include all flows and stocks of LEPLs in the recording and reporting of fiscal aggregates in line with the GFSM2014 standards (December 2017).

Recommendation 3.2. Classification of SOEs: The MoF should undertake a case-by-case analysis of the SOE sector, with priority given to those SOEs classified as high-risk, to identify SOEs that are non-market producers and should be reclassified into the general government sector according to GFSM2014 (December 2018). The assessment should be updated every three years to ensure that the sectorization of each unit remains valid (ongoing).

Recommendation 3.3. Coverage of public debt: The MoF should include in gross debt statistics the liabilities of LEPLs, subnational governments, and any public non-market entity that

may be reclassified within the general government sector, in line with GFSM2014 and the Public Sector Debt Guide (2018).

Recommendation 3.4. Budget lending: The MoF should record budget lending to SOEs, including capital injections, in accordance with GFSM2014. Particularly, transfers or subsidies should be recorded as expenditures above-the-line (December 2017).

IV. IMPLEMENTING THE FISCAL RULES

A. Applying the Fiscal Rules in Fiscal Policy

52. While the fiscal rules provide an overall constraint on fiscal policy, medium-term fiscal targets should also factor in potential economic shocks and fiscal risks. A well designed fiscal framework would aim at maintaining appropriate buffers below the debt ceiling and would target a deficit consistent with this. With high economic volatility, and exposure to external and fiscal shocks, governments should create fiscal buffers by aiming at a "safe" debt level that can accommodate unexpected shocks. Operationally, a "safe" debt level should ensure that public debt remains below the debt limit with a high probability, even if negative shocks materialize. In turn, a consistent "safe" deficit target can be derived.

Estimating a "safe debt" level for Georgia

53. Based on Georgia's historical distribution of shocks, staff's simulations point to a "safe debt" level of about 45 percent of GDP, which is close to current levels. Stochastic simulations used to project future debt trajectories are presented in Figure 4.1 (panel a). The simulations suggest that under a plausible set of assumptions,[27] and given the probability distribution of past shocks, Georgia's public debt seems to be sustainable, remaining below the debt ceiling with a high probability, and consistent with an overall deficit target close to 3.0 percent of GDP. In the event of a severe economic shock, public debt could exceed the 60 percent of GDP ceiling by 2019 with a 10 percent probability. Annex VI provides more detail on the underlying methodology for the analysis.

54. Yet, the assumptions underlying the baseline scenario may be somewhat optimistic. Both the percentage of debt denominated in foreign currency, and favorable average interest rates of foreign loans are assumed to remain constant, with no volatility of the exchange rate. Given the currency composition of government debt, Georgia remains highly vulnerable to exchange rate risks. In turn, exchange rate risks could also impact debt dynamics through the

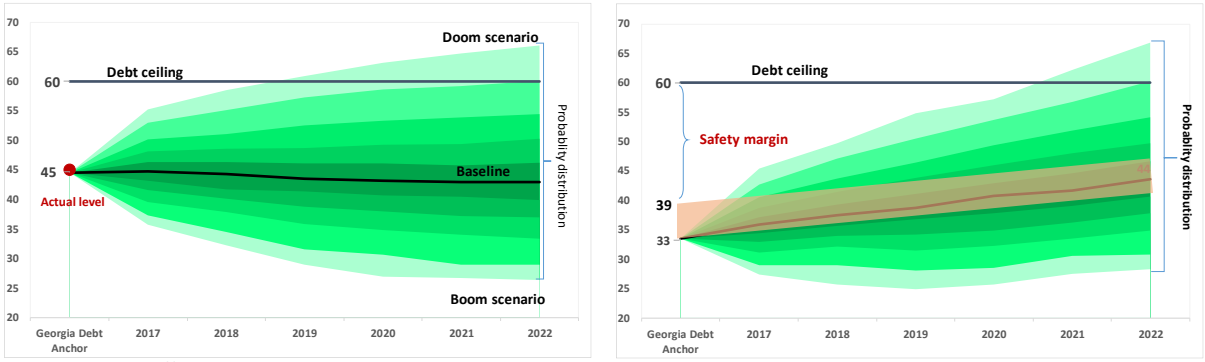
[27] The assumptions for the baseline scenario are consistent with those used by Georgia's IMF surveillance team in the context of the Fund-supported program. This scenario foresees Georgia growing at 8 percent in nominal terms, and getting foreign financing at 4 percent nominal, inflation at 3 percent, and no significant changes in the nominal exchange rate. Projections of the fiscal stance are based on the augmented primary balance (i.e., the primary balance augmented for budget lending, following the program definition).

interest rate, once Georgia increases market borrowing and moves away from concessional external borrowing rates.

Figure 4.1. Georgia: Debt Trajectory and Safe Debt Level

a. Debt trajectory, Optimist scenario
(% GDP)

b. "Safe" Debt Level
(% GDP)



Source: IMF staff estimates.

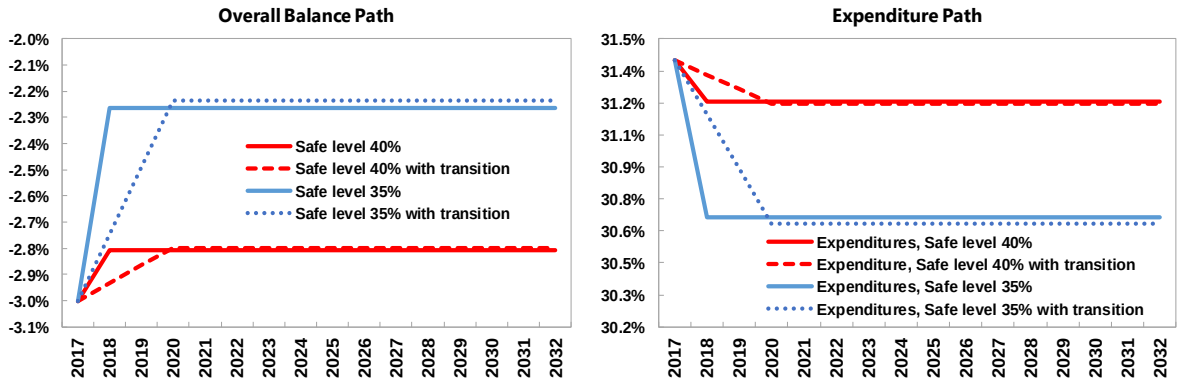
55. Future risks could also be higher than those faced in the past. The probability distribution is based on the modelling of past events. Yet, the government is engaging in new activities that may be associated with higher future fiscal risks. The 2016 FRS highlights that Georgia's fiscal stance is vulnerable to the realization of contingent liabilities stemming from the government's exposure to power-purchase agreements (PPAs) of SOEs in the energy sector as well as other quasi-fiscal activities of SOEs. Moreover, the government is promoting the use of public-private partnerships (PPPs) in several sectors of the economy, which most likely will entail increased fiscal risks in the future. Similarly, the potential reclassification of SOEs within the general government sector due to their non-market nature could increase gross debt levels on a permanent basis.

56. Given these enhanced risks, a more prudent scenario points to a "safe" debt level in the range of 35–40 percent of GDP. Estimations in the FRS suggest that the government net fiscal exposure to existing PPAs in the energy sector is about 5 percent of GDP. Similarly, while there are no firm estimates of the potential magnitude of reclassifications of SOEs into the general government, the FRS reports that total liabilities of high-risks SOEs account for 9 percent of GDP by end-2015. Accounting for a shock in the range of 5–10 percent of GDP distributed evenly over a 6-year horizon would point to "safe" debt level in the range of 35–40 percent of GDP (Figure 4.1, panel b).

57. A safe debt level range of 35–40 percent of GDP would be consistent with overall deficits of about 2.3–2.7 percent of GDP, broadly in line with the Fund-supported program (Figure 4.2). Simulations suggest that convergence to a safe debt level of 35–40 percent of GDP would require a consolidation of about 0.3–1.0 percent of GDP over the medium-term relative to

a current overall deficit of 3.0 percent of GDP.[28] Similarly, under an assumption of a fixed level of revenue in percent of GDP,[29] a consistent level of expenditures is estimated at around 31 percent of GDP. It should be noted that these estimates are sensitive to the assumptions on long-term growth, exchange rate depreciation, and financing conditions. For example, a higher depreciation rate or a higher average interest rate would require lower deficits to remain in the "safe" range level. Conversely, a higher long-term growth rate would provide space for higher deficits, while still guiding debt to a "safe" level.

Figure 4.2. Debt and Deficit Paths Under Alternative Options
(In percent of GDP)



Source: IMF staff estimates.

B. Reporting on the Fiscal Rules

58. The government provides an abundance of fiscal information but does not report on compliance with the fiscal rules, ex ante or ex post. The BDD, which is presented to Parliament in early July of each year, includes four-year forecasts for the main macroeconomic variables, their components, and underlying assumptions. Fiscal forecasts are also presented, and updated if necessary, in subsequent iterations of the BDD, which are presented to Parliament at the end of October and end of November alongside the second and third draft of the budget proposal.[30] The fiscal aggregates defined in the fiscal rules are included in a summary table in an annex to the budget. However, there is no discussion in the BDD detailing whether the fiscal projections contained in the budget are in line with the fiscal rules.

59. The BDD and the annual Budget Execution Report should provide a more in-depth discussion of compliance with the fiscal rules. This would enhance transparency and the

[28] Corresponds to the augmented net lending borrowing, in line with program definition.

[29] Simulations assume a total revenue to GDP ratio of 28.4 for 2016.

[30] The forecast tables include outcomes for the three previous years, and forecasts for the current year, the budget year, and the three following years.

credibility of the fiscal rules framework and would serve to demonstrate the government's commitment to fiscal prudency. This discussion in the BDD could include:

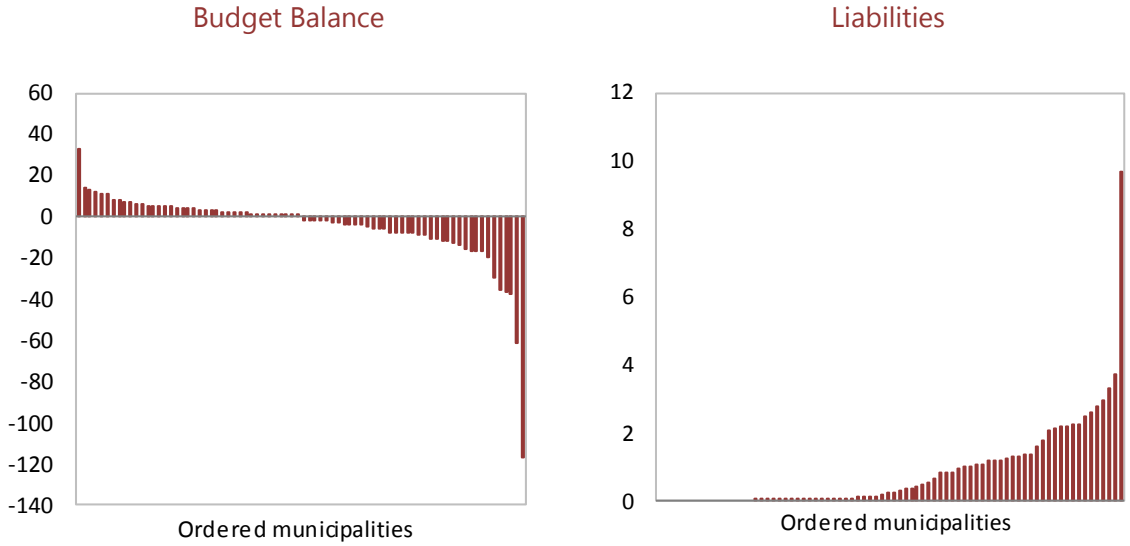
- An evaluation of economic and fiscal outturns for the previous year against the government's published forecasts and plans, including performance against the fiscal rules;
- A more detailed presentation of key forecasting judgements, including a comparison with other forecasting institutions; and
- A discussion of the consistency of the projections with the fiscal rules and the margins for error in meeting in the rules.

C. Compliance by Subnational Governments

60. The fiscal position of subnational governments can impede compliance with the fiscal rules if they are not appropriately constrained and monitored. This risk will depend on the degree of fiscal autonomy given to subnational governments, and the appropriate constraint will be country-specific. In practice, few countries apply fiscal rules directly to subnational government expenditures, choosing instead to apply simultaneous limits to the subnational budget balance or borrowing, and to tax autonomy. This combination should restrain subnational government spending while retaining a degree of local autonomy. However, local expenditure is not always sufficiently controllable to prevent ex post breaches of fiscal rules, and effective monitoring of local government finances is therefore required.

61. Risks to the fiscal rules in Georgia are mitigated by the relative small size of local governments and borrowing restrictions that are in place. As discussed in the FTE, subnational government expenditures are equivalent to only 4.5 percent of GDP, and subnational governments are highly reliant on central government transfers, with own source revenue making up only 30 percent of their funding. There are limits on local government borrowing from non-public entities, and borrowing can only take place with the approval of the MoF. These rules are largely adhered to, and scattered information on local government debt indicates that it is relatively low, with central government on-lending from international financial institutions forming the largest portion of this. However, there are some individual municipalities that are running large deficits and liability ratios relative to their own source revenue, though these are negligible from an economy-wide perspective (Figure 4.3).

Figure 4.3. Municipal Budget Balance and Liabilities
(Percent of Revenues)



Source: MoF

62. Nonetheless, the MoF should closely monitor their fiscal position. The recent inclusion of municipalities within the TSA is a major improvement and will allow stronger monitoring to be applied. Fiscal reporting on subnational governments should also be enhanced in line with the recommendations in the recent FTE.

D. Enhancing Budget Institutions

63. Rules based fiscal frameworks require strong supporting budget institutions. The effective implementation and monitoring of fiscal rules often requires several supporting arrangements and good institutional capacity. Particularly, these include strong institutions for macroeconomic and fiscal forecasting, medium-term budget planning, and fiscal risk management and disclosure.

Macroeconomic and fiscal forecasting

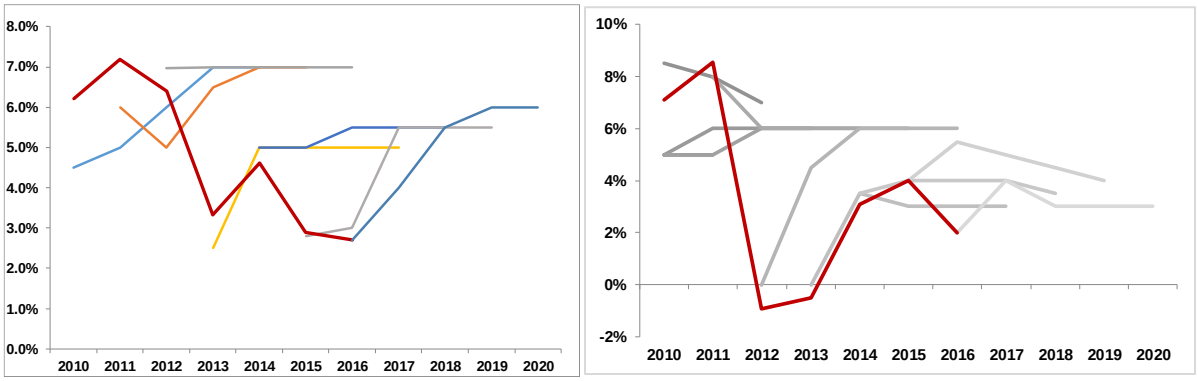
64. Georgia's macroeconomic forecasts have been relatively inaccurate but have improved significantly in recent years. Since 2004, the average absolute real GDP forecast error for the current budget year has been around 4 percent,[31] which is relatively large compared to other countries, even when factoring in the relatively high economic volatility in Georgia (see Annex I). However, the accuracy of the macroeconomic and fiscal forecasts has improved since 2010, with the current year forecast error falling to around 2 percent, partly because of reduced economic volatility in the aftermath of the global financial crisis:

[31] See Georgia: Fiscal Transparency Evaluation, IMF, 2017.

- Real GDP forecasts for the medium term have tended to be too optimistic, while inflation has been considerably lower than forecast (Figure 4.4);
- Fiscal forecast errors for the current budget year have decreased but are still present, as evidenced by expenditures exceeding the 30 percent of GDP limit in each of the last three years; and
- Medium-term expenditure forecasts errors have been larger when policy lending is considered, suggesting that there has been a tendency for policy lending plans to be revised upwards during the budget year as well as between successive medium-term plans.

Figure 4.4. Successive Real GDP and Inflation Forecasts 2010–16

a. Real GDP **b. Inflation**



Source: staff estimates based on official data.

65. The budget documentation should explain changes between successive forecasts and medium-term plans. The relative volatility of the Georgian economy makes forecasting challenging and puts a premium on clearly explaining the source of revisions. A reconciliation and explanation of forecast changes in successive vintages of the BDD would substantially increase the transparency and credibility of the forecasts.

66. A systematic review and explanation of the sources of forecast errors could also help to improve forecast accuracy. Forecasts are surrounded by significant uncertainty and will inevitably prove to be wrong in many respects. Identifying and explaining forecast errors would help improve understanding of the ways in which the economy and public finances behave, and could help to improve judgements and forecast techniques in the future. Concentrating on forecast errors that exhibit persistent optimism or pessimism should prevent the distribution of risks around the forecast becoming skewed to the upside or downside.

67. Finally, fiscal forecasting could be improved by through closer cooperation between forecasting and revenue departments. The revenue department's role is currently limited largely to legal and operational implementation of tax measures. Increasing their involvement in the forecasting process could help to improve understanding of revenue

elasticities and forecast accuracy. Given limited resources, greater collaboration would make better use of available expertise.

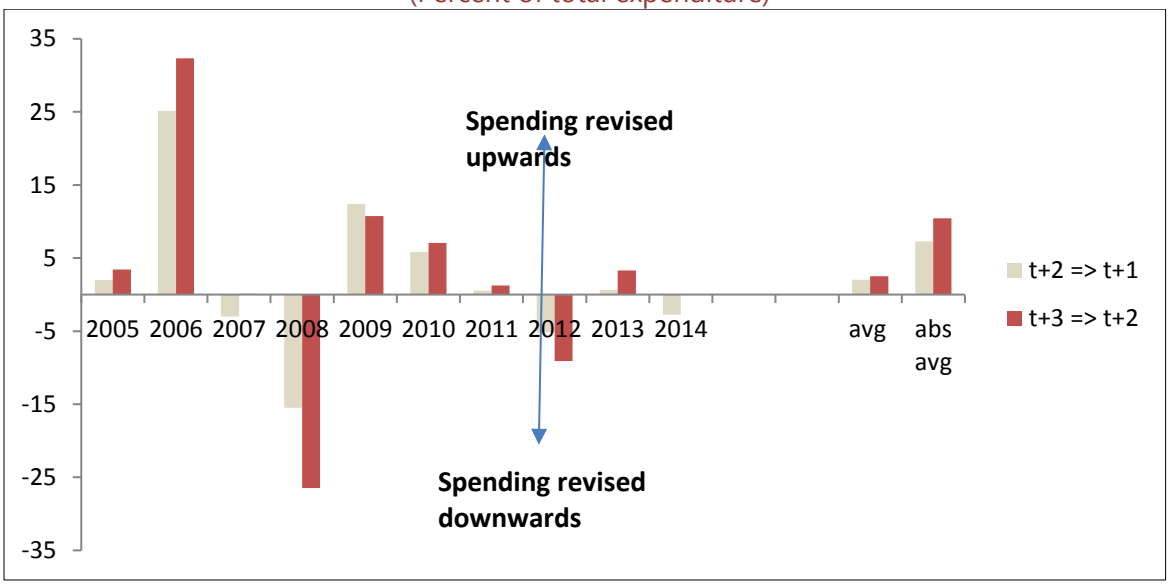
Medium-term budget framework

68. As discussed in Chapter II, fiscal rules frameworks should be supported by a strong and credible MTBF. A well-designed and well-implemented MTBF is essential to translate fiscal objectives and aggregates into numerical ceilings to constrain the budget process in a multi-year perspective. An MTBF also facilitates policy prioritization consistent with the fiscal objectives and enhances control over the path of public expenditure in the medium term.

69. Georgia has already introduced a multi-year perspective to its budget planning. It introduced a MTBF in 2004, based on four-year fiscal projections and expenditure plans. These plans are updated and presented alongside the draft budget law presented to Parliament in October and November.

70. Expenditure plans have been revised from year to year, reflecting the non-binding nature of the existing multi-year expenditure forecasts, but less so in recent years. Over the past decade, the absolute average of revisions to the second year's expenditures in successive plans have been around 7 percent, and the third-year expenditure revisions around 10 percent.[32] However, the revisions have been substantially smaller since 2011 (Figure 4.5).

Figure 4.5. Revisions to Medium-term Plans
(Percent of total expenditure)



Source: IMF staff estimates (years refer to the year when the medium-term plan was made).

[32] This revision refers, for example, to the difference between the respective 2008 expenditure forecasts made in the 2006 and 2007 Budgets

71. Gradually developing the MTBF into a more binding direction would increase its effectiveness to implement fiscal policies consistent with the fiscal rules. Particularly, in the absence of an ER, as discussed in Chapter II, the aggregate expenditure ceilings embedded in the MTBF would become the numerical constraint on expenditures over the medium-term, and the binding nature of the framework should be enhanced. One option could be to make the ceiling for the first outer year binding, as illustrated in Box 4.1 and gradually make more outer years binding as the framework matures.

Box 4.1. Illustrative MTBF Model

	t	t+1	t+2	t+3	t+4	t+5
Ceilings for year t	Binding	Binding	Indicative	Indicative		
		↓	↓	↓		
Ceilings for year t+1		Binding	Binding	Indicative	Indicative	
			↓	↓	↓	
Ceilings for year t+2			Binding	Binding	Indicative	Indicative

72. It should be considered if the current MTBF could be strengthened in some areas to become even more effective. While it is understood that many key features of a good MTBF are already in place, for example a well-developed framework for budgetary planning of public investments in a multi-year perspective, some key questions to consider could include:

- How to develop a clearer distinction between baseline estimates and new policy initiatives (work on this is already underway);
- How to introduce explicit multi-year planning and contingency margins into the framework;
- How to further strengthen the top-down nature of the MTBF, including through endorsement of the aggregate expenditure ceilings by the cabinet early in the process and applying these in the budget process;
- How to enhance reporting on the MTBF, as discussed above; and
- How to further strengthen the strategic dimension of ministries' budget planning in a multi-year perspective (work on this is also already underway).

Fiscal risk management

73. The fiscal rules framework should be supported by a strong framework for disclosing and mitigating fiscal risks. Key sources of fiscal risks in Georgia relate to SOEs and PPPs, including PPAs. The FTE estimated that Georgia's gross exposure to SOEs by end-2016 accounted for 17 percent of GDP, while the gross exposure to PPP and PPAs combined accounted for about 20 percent of GDP (Table 4.1).

Table 4.1. Georgia: Summary of PPPs and PPAs Exposure

(percent of 2016 GDP)

	Project value	NPV exposure		Other risks	Reported
		Gross	Net		
Legacy	0.8	0.8	-	Not known	No
PPA Agreements	66.4	16.2	4.6	Forex, power sale price	FRS
Nenskra PPA	6.2	6.2	-	Forex, power sale price, volume	No
Nenskra specific	-	0.2	-	Construction and hydrology	No
Gardabandi TPP	5.4	2.4	0.1	Forex, domestic power price, volume	Partly in FRS
Anaklia Deep Water Port	4.6	0.2	0.2	Government decision	No
Total	**77.2**	**19.8**	**4.9**		

Source: FTE report, and FRS where reported, IMF estimates otherwise.

Note: Net exposure for PPAs is calculated assuming a market price of USD 5 cents. Changes in this assumption would impact on the overall net exposure.

74. Disclosure of fiscal risks from SOEs has improved substantially over time. The FRS accompanying the 2017 budget now provides detailed analysis of risks arising from the SOE sector. It includes an assessment of the links between the government and SOEs, a financial analysis with consolidated financial indicators, as well as a discussion of the factors affecting SOEs financial position.

75. Efforts are also underway to strengthen the disclosure of fiscal risks associated with PPPs and PPAs. The FRS includes a description of existing PPAs, some preliminary estimates of the stock of government commitments related to PPAs, as well as main sources of risks. In addition, to improve the assessment of fiscal risks of PPAs, the authorities are working with World Bank specialists in the electricity sector to develop a risk-based model to better inform expansion decisions in the sector on a cost-effective basis. It is expected that results from this model will be included in future vintages of the FRS and used in monitoring of fiscal risks from PPAs.

76. A new framework for managing PPPs and PPAs is also being developed. The current Fund-supported program include an end-December 2017 structural benchmark related to the inclusion of a ceiling on overall PPP/PPA government exposure to be included in a new PPP Law, which is currently being drafted, as a general risk mitigation instrument. Such ceilings can be expressed in several ways (Box 4.2), either as a nominal cap (Peru); as a percentage of the government's capacity to repay (Brazil or Hungary); or as a percentage of GDP (Panama).

Box 4.2. Country Examples of Ceilings in their PPP Laws

Many countries have included ceilings for PPPs in their PPP laws:

United Kingdom. Payments in PPPs are limited to £70 billion over the five-year term of the current parliament, or £14 billion a year on average. This amounts to 0.8 percent of the GDP of the first year of the parliament. In addition, some PPPs in the United Kingdom are treated as on balance sheet in the measure of the debt that is subject to fiscal targets.

Hungary. The Public Finance Act limits the nominal value of new long-term commitments to 3 percent of total state budget revenues in any given budget year.

India. The State of Karnataka limits the stock of guarantees at the beginning of the financial year to 80 percent of the government's revenue two years before.

Brazil. The PPP law sets a ceiling on current spending from PPP contracts of 1 percent of net current revenue applicable to all levels of government. New subnational PPP commitments cannot be guaranteed by the federal government if: (i) existing commitments already amount to 5 percent of net current revenue or (ii) the new contract would entail commitments in excess of 5 percent of net revenues at any time during the forthcoming 10 years.

Perú, El Salvador, and Honduras. In Peru, the net present value of the government's explicit spending and guarantees in PPPs is limited to 7 percent of GDP. The limit also takes account of the revenue that the government may derive from revenue-sharing arrangements in concessions. Similar limits are set at 3 percent and 5 percent of GDP in El Salvador and Honduras, respectively.

Other countries. Some governments do not have PPP ceilings per se, but set limits on total government debt and government-guaranteed debt, which includes government explicit guarantees on PPPs. Examples include **Poland**, **Jordan**, **Indonesia**. **Turkey** sets similar limits on guarantees and on-lending in the coming year in each year's budget.

77. While ceilings on the size of PPPs/PPAs can be a useful tool for managing fiscal risks, there are no simple rules of thumb for the level at which PPP ceilings should be set. Ceilings, while not a substitute for medium-term planning and a strong public investment framework, can help contain fiscal risks and limit overall government commitments for PPPs to levels that are fiscally affordable. This is especially the case in countries where the institutional, legal, and reporting frameworks for PPP/PPA transactions are still in need of significant strengthening. However, the assessment of the maximum size of a PPP/PPA program should be guided by the MTBF and the debt sustainability analysis and should also capture the capacity to formulate and implement high-quality projects. The effectiveness of a PPP ceiling in supporting short-term budget affordability and long-term sustainability will depend on the type of projects that comprise a PPP portfolio. A PPP portfolio with a high share of government-funded PPPs/PPAs (for example, linked to some type of availability payments by government) will have larger short-term implications in terms of budget affordability than a portfolio mostly comprising user-funded PPPs/PPAs (for example, concessions). Box 4.3 discusses some key considerations in the design of PPP/PPA ceilings.

Box 4.3. Considerations for the Design of PPP/PPA Ceilings

In countries with a debt ceiling, a separate ceiling on PPPs/PPAs overall government exposure can support the effective implementation of the main fiscal rule. In most countries, fiscal rules only apply to traditional government debt in the form of debt securities and loans. Moreover, even when the coverage of the rule could potential include government' commitments on PPPs/PPAs, the national accounting and/or reporting systems may not be advanced enough to incorporate complex long-term contracts as PPPs/PPAs, resulting in practice in its exclusion from fiscal rules. Therefore, a separate PPPs/PPAs ceiling can help prevent the circumvention of the main fiscal rules through PPPs.

Ceilings can cover the stock and/or the annual flow of PPPs/PPAs. Ceilings on the overall size of the PPP program (stocks) and the annual PPP-related payments (flows) can increase the predictability of the government's exposure to PPPs and allow for a ready implementation of affordability tests. However, ceilings can be specified either in stocks or flows depending on the objective that they want to achieve. If the main fiscal concern is debt sustainability—either because debt is on an unsustainable trend or the current level is dangerously approaching a debt ceiling—a ceiling expressed in terms of stock of PPPs/PPAs tends to be more effective. If the main fiscal concern is the government's capacity to repay—either due to cash liquidity issues, or due to a large number of government-funded PPPs (for example, roads, prisons, or hospitals that require government payments for a period of 15–25 years)—then, ceilings expressed in flows tend to be more effective in safeguarding long-term fiscal affordability.

A PPP/PPA ceiling should be simple and measurable. It is important for the ceiling measure to be unambiguous, so that it is credible and can be verified by independent experts. This means that caution should be used in employing complicated measures based, for example, on the option value of the PPP portfolio. If such more complicated measures are used, clarity should be provided on the parameters (e.g., the discount rate and probabilities of contingencies) and methods used. Simpler methods may be preferable initially. For example, the PPP/PPA ceiling could be based on the capital investment under these contracts, or the sum of known government commitments (e.g., availability payments) and a simple measure of contingent liabilities (e.g., face value). As more sophisticated and reliable valuation methods are developed, the ceilings can be broadened to cover other expected costs of contingent liabilities.

E. Recommendations

Recommendation 4.1. Reporting on the fiscal rules: The MoF should include a more in-depth discussion of compliance with the fiscal rules ex-post and ex-ante in the BDD and the annual Budget Execution Report (July 2018).

Recommendation 4.2. Macroeconomic and fiscal forecasts: The MoF should enhance the quality and credibility of macroeconomic and fiscal forecasts by:

- Providing a reconciliation and explanation of forecast changes in successive vintages of the BDD (July 2018);
- Analyzing the sources and causes of forecast errors on a regular basis to help improve judgements and forecast techniques (2018); and
- Strengthening collaboration between the MAFD and the Revenue Department on forecasting of revenue.

Recommendation 4.3. Medium-Term Budget Framework: The MoF should further develop the MTBF by:

- Gradually extending the binding nature of the MTBF, initially by making the expenditure ceiling for the second year of the rolling 4-year MTBF binding (2019); and
- Undertaking a review of the MTBF to identify any needs for enhancement in some areas to become even more effective (2018).

Annex I. Fiscal Governance in the European Union

The rapid deterioration of the fiscal positions of European countries in the wake of the global financial crisis, has, since 2011, led the EU to introduce several reforms to strengthen member states' fiscal discipline and the enforcement of the Stability and Growth Pact (SGP). The SGP requires that general government deficits do not exceed 3 percent of GDP and that public debt do not exceed 60 percent of GDP. To strengthen the fiscal framework underpinning the European monetary union, a new Fiscal Compact came into force in January 2013 as part of the Treaty on Stability, Coordination, and Governance in the Economic and Monetary Union. Formally 20 countries (18 euro members plus Denmark and Romania) are part of the Compact which adds to and reinforces the SGP. The Fiscal Compact builds on the earlier "Six Pack" of five new EU regulations and one EU directive designed to strengthen the SGP, which took effect in December 2011. Finally, in February 2013 agreement was reached on the "Two Pack" which added two additional regulations to strengthen surveillance mechanisms for the euro area. The reforms mandated by these instruments include:

Revised Fiscal Rules: The Fiscal Compact requires signatories to modernize their fiscal frameworks by giving effect in national legislation to a structural balance budget rule, an automatic correction mechanism to be triggered in the event of deviations from the rule, and an escape clause for exceptional economic circumstances, all by January 2014. The structural BBR must limit annual structural deficits to a maximum of 0.5 percent of nominal GDP and ensure convergence towards the country's medium-term budgetary objective (MTO), adopted by the government, and assessed by the European Commission. The Fiscal Compact and the "Six Pack" also introduced two additional guidelines to ensure consistency with supranational fiscal rules: a debt reduction rule and an expenditure benchmark. Under the debt reduction rule, countries with debt above the 60 percent of GDP limit are required to continuously reduce their debt levels by at least 1/20th of the distance between the current level and 60 percent of GDP until the latter is reached. The expenditure benchmark requires that countries which have reached their MTO keep annual growth of primary expenditure (excluding unemployment benefits) at or below long-term nominal GDP growth.

Reformed National Budgetary Frameworks: Recognizing that rules require supporting budget institutions, the "Six Pack" requires improvements to countries' national budgetary frameworks including making medium-term budget frameworks more binding, preparing budgets in a more top-down sequence, and frequent, timely, and comprehensive reporting on general government fiscal developments and risks.

Improved Surveillance and Monitoring: The "Two-Pack" requires that a national independent institution either produces or endorses official macroeconomic forecasts and monitors the government's compliance with the fiscal rules. In addition to the existing surveillance mechanism under the SGP, the "Two Pack" introduces a new ex ante procedure. All euro area countries must submit their draft budgets prior to enactment to the European Commission to ensure

appropriate integration of euro area policy recommendations. If the Commission finds that a draft budget is not compliant with the SGP, it will issue an opinion to ask for revisions before it is enacted.

Enhanced Enforcement: The European Court of Justice can impose a financial penalty (up to 0.1 percent of GDP) if a country fails to properly implement the legislative changes required by the Fiscal Compact. The Compact and "Six Pack" also strengthened the excessive deficit procedure (EDP) for sanctioning noncompliance with the fiscal rules. In cases of non-compliance of a Euro Area Member State with the deficit rule, a recommendation of the Commission is required to be supported by other Euro Area Member States in the European Council, unless a qualified majority votes against it. Fines are imposed progressively starting at 0.2 percent of GDP and can reach 0.5 percent of GDP.

Source: IMF (2013), Reassessing the Role and Modalities of Fiscal Policy in Advanced Economies

For detailed information about the EU fiscal framework, see Vade Mecum on the Stability and Growth Pact: https://ec.europa.eu/info/sites/info/files/ip052_en_0.pdf

Annex II. Correction Mechanisms: Country Examples

Within the EU, the Fiscal Compact specifies the automatic correction mechanism. If the structural balance of a country deviates significantly from the medium-term objective or the adjustment path towards it, a mechanism will be automatically triggered to correct these deviations. The cumulated impact of deviations on government debt dynamics should also be automatically corrected. The common principles regarding the nature, size and time frame of the corrective action to be undertaken, also in the case of exceptional circumstances, have been determined by the European Commission.

The Swiss and German structural BBRs contain automatic correction mechanisms known as "debt brakes." In both countries, deviations from the structural BBR (positive or negative) are stored in a notional account. When the accumulated deviation exceeds a threshold, improvements in the structural balance are required within a defined time frame to reverse the deviation. The main differences between the two countries are the thresholds (1.0 percent of GDP in Germany per ordinary law and 1.5 percent per constitution; and 6 percent of expenditures in Switzerland) and the type of deviation that needs to be corrected. In Germany, only those deviations that did not result from errors in real GDP growth projections enter the notional account, whereas in Switzerland all errors are tallied. The latter course is more transparent but provides less flexibility to accommodate errors outside the control of government. In Switzerland, the excess amount must be eliminated within the next three annual budgets. In Germany, overruns only need to be reduced during an economic recovery to avoid procyclical tightening and can be corrected via expenditure and revenue measures.

Poland's and the Slovak Republic's DRs, which set a 60 percent debt-to-GDP ceiling, include thresholds that trigger actions to prevent the rule from being missed. In the Slovak Republic, when the debt-to-GDP ratio reaches 50 percent, the minister of finance is obliged to explain the increase to parliament and suggest measures to reverse its growth. At 53 percent of GDP, the cabinet is required to pass a package of measures to trim the debt and freeze wages. At 55 percent, expenditures are to be cut automatically by 3 percent, and the next year's budgetary expenditures would be frozen, except for co-financing of EU funds. At 57 percent of GDP, the cabinet must submit a balanced budget. Ideally, the later trigger points would not be needed if effective action is taken earlier.

In **the United States**, a sequestration refers to automatic spending cuts that occur through the withdrawal of funding for certain (but not all) government programs if the Congress enacts annual appropriations legislation that exceeds pre-set caps on spending. Sequesters tend to have the disadvantage of creating a bias against capital spending, which is the easiest item to cut quickly, as experienced in the United States in the 1990s.

Annex III. Escape Clauses: Country Examples

Brazil (since 2000): Real GDP growth below 1 percent over four quarters, and natural disaster but can only be invoked with Congressional approval.

Colombia (since 2011): In case of extraordinary events threatening the macroeconomic stability of the country, enforcement of the fiscal rule may be temporarily suspended, subject to the favorable opinion of CONFIS (an internal fiscal council headed by the Finance Minister).

Germany (since 2010): Natural disasters or unusual emergency situation which are outside government control and have major impact on the financial position of the government. Absolute majority of parliament is needed to trigger the escape clause. Parliament must approve an amortization plan with a specified timeframe for reducing the accumulated deviation. Until 2010, escape clause in case of a "distortion of the macroeconomic equilibrium."

Jamaica (since 2010): The targets may be exceeded on the grounds of national security, national emergency, or such other exceptional grounds, as the Minister may specify in an order subject to affirmative resolution.

Mauritius (since 2008): Temporary deviations in case of emergencies and large public investment projects.

Mexico (since 2006): If non-oil revenues are below their potential due to a negative output gap, there can be a deficit equivalent to the shortfall.

Panama (since 2008): If real GDP grows by less than 1 percent, the non-financial public sector deficit ceiling can be relaxed to 3 percent of GDP in the first year, followed by a gradual transition to the original ceiling (1 percent of GDP) within 3 years.

Peru (since 2000): If real GDP declines or in case of other emergencies, declared by the Congress at the request of the Executive, the deficit ceiling can be relaxed up to 2.5 percent of GDP. The Executive must specify deficit and expenditure ceilings to be applied during the exception period. In both cases a minimum adjustment of 0.5 percent of GDP is required until the 1 percent deficit ceiling is reached.

Romania (since 2010): In case of a government change, the new government will announce whether its program is consistent with the Medium-Term Budgetary Framework (MTBF) and if not the MoF will prepare a revised MTBF, to be approved by parliament and subject to the review and opinion of the Fiscal Council.

Slovakia (since 2012): Escape clauses for a major recession, banking system bailout, natural disaster, and international guarantee schemes.

Spain (since 2002): In case of natural disasters, exceptional slowdown, exceptional budget deficits are accompanied by a medium-term financial plan to correct this situation within the next 3 years (to be approved by a majority vote by the parliament).

Switzerland (since 2003): The government can approve by supermajority a budget deviating from the BBR in "exceptional circumstances," which are defined in Budget Law as natural disaster, severe recession, and changes in accounting methods.

EU member states/euro area (since 2005): An excessive deficit procedure may not be opened when the 3 percent deficit limit is exceeded only temporarily and exceptionally, and the deficit is close to the deficit limit (both conditions need to apply). Deadlines for excessive deficit correction can be extended in case of adverse economic developments.

WAEMU (since 2000): Temporary and pronounced shortfall of real GDP (at least 3 percentage points below the average of the previous three years) and budget revenue (at least 10 percentage points below the average of the previous three years average).

Source: National authorities; and IMF staff assessment.

Annex IV. International Experience with Fiscal Councils

Fiscal councils are independent public institutions aimed at promoting sustainable public finances through various functions, including public assessments of fiscal plans and performance, and the evaluation or provision of macroeconomic and budgetary forecasts.

Fiscal councils are uniquely positioned to foster transparency and accountability, and trigger reputational effects. Unlike other institutions commenting on fiscal policy, the official mandate to contribute to the public debate and the budget process magnifies the reputational impact of the council's assessments and analysis. The mandate also carries a degree of legitimacy that encourages government to "comply or explain," even if it is not legally compelled to do so.

Around one quarter of emerging market economies and close to half of advanced countries with fiscal rules invite an independent body to verify that fiscal rules have been met. Recognizing that biased budget assumptions can weaken the public finances, even if the approved headline numbers are consistent with the fiscal rules, some countries have also institutionalized the use of independent macroeconomic assumptions for the budget, e.g. Canada and the UK. The table below shows that the precise remit of fiscal councils in the EU differs across countries, reflecting the country-specific impetus for its creation, but there are several common responsibilities.

Overview of fiscal councils in the EU

	Name	Year of establishment[1]	Attached institution[2]	Compliance fiscal rules	Correction mechanism	Macroeconomic projections *Produced*[3]	*Endorsed*	*Assessed*[3]	Appointment[4]	Comply or explain
Belgium	High Council of Finance	2014 [1989]		x	x	S			G	x
Denmark	Danish Economic Council	2014 [1962]		x		x			G	x
Germany	Stability Council/ Council of independent experts	2013 [2010]		x					G/O	
Estonia	Fiscal Council	2014	Central Bank	x	x		x		O	x
Ireland	Irish Fiscal Advisory Council	2012		x			x		G	x
Spain	Independent Authority of Fiscal Responsibility	2014		x	x		x		P	x
France	High Council of Public Finances	2013	National Audit Office	x	x			x	P/O	x
Croatia	Fiscal Policy Committee	2013		x	x			x	P	x
Italy	Parliamentary Budget Office	2014		x	x			x	P	x
Cyprus	Fiscal Council	2014		x	x		x		G	
Latvia	Fiscal Council	2014		x		x			P	
Hungary	Fiscal Council	2008							O	
Netherlands	Independent Budgetary Authority	2014	Council of State	x		S			G	x
Austria	Fiscal Advisory Council	2013 [1970]	Central Bank	x	x	S			G/O	
Portugal	Public Finance Council	2012		x	x				G/O	
Romania	Fiscal Council	2010		x	x		x		P	x
Slovakia	Council for Budget Responsibility	2012			x				P	
Finland	National Audit Office	2013		x				x	P	x
Sweden	Fiscal Policy Council	2007		x					G	
United Kingdom	Office of Budget Responsibility	2010		x		x			G	x

Source: ECB, Monthly Bulletin, June 2014

Note: 1) Year of creation of the fiscal council, with the year given in brackets if the mandate has been broadened.

2) In case the fiscal council is attached to another public institution, such as the central bank, national audit office, etc.

3) Marked with "S", if done by a separate institution. For example, in Belgium, the Netherlands and Austria, macroeconomic projections are produced by a separate independent institution.

4) Relates only to appointments of fiscal council members. "G" stands for appointed by the government/ministry; "P" stands for appointed by the parliament; "O" stands for others (e.g. the central bank).

Annex V. EU Requirements for Independent Oversight Bodies

Several European legislative acts require that fiscal rules be monitored by "independent bodies," including fiscal councils. According to the Council Directive on budgetary frameworks of November 2011, "independent bodies or bodies endowed with functional autonomy vis-à- vis the fiscal authorities of the Member States" should carry out "the effective and timely monitoring of compliance with the rules" (Chapter IV, Article 6b). This obligation was reaffirmed by the Treaty on Stability, Coordination, and Governance (TSCG) (Title 3, Article 3.2) without being further spelled out. This Directive entered into force in November 2011 as part of the "the six-pack" and applies to all EU27 member states.

The regulations forming the two-pack provide additional details about the role of the council in case of "significant deviation from the medium-term objective or the adjustment path towards it." In particular, the council should advise on the activation and operation of the correction mechanism, and provide an assessment about the circumstances allowing temporary deviations from targets (Chapter II, Article 4).

The two-pack specifically requires that "independent macroeconomic forecasts" be "produced or endorsed" by "independent bodies" in the context of the budget preparation (Chapter I, Article 2.1.2). FCs can indeed address the tendency in some finance ministries to produce over-optimistic macro forecasts either by providing unbiased forecasts themselves or by exposing the bias to the public.

The two-pack also stipulates that "given the diversity of possible and existing arrangements, while not the preferred option, it should be permitted to have more than one independent body in charge of monitoring compliance with the rules as long as there is a clear allocation of responsibility and as long as there is no overlap of competencies over specific aspects of the monitoring. Excessive institutional fragmentation of monitoring tasks should be avoided" (Article 7 of the preamble).

Annex VI. Underlying Methodology Using Stochastic Simulations

This Annex presents the methodology used to estimate the safe debt level, of which a full description can be found in IMF (FAD How to Notes, 2017 – "*How to Calibrate Fiscal Rules—A Primer*"). This stochastic approach generates macroeconomic and fiscal shocks and simulates the corresponding public debt paths, using a debt accumulation equation and a fiscal reaction function.

First, we estimate the joint dynamics of the macroeconomic (non-fiscal) variables from either a quarterly, unrestricted vector autoregressive model (VAR) or a multivariate normal distribution at annual frequency. We have a relatively short balanced dataset—limited annually to 1994–2016. This gives us the joint distribution of shocks on real domestic and foreign interest rates (r_t and r_t^*), real GDP growth (g_t), and the exchange rate (e_t). In other words, we are able to calibrate not only shocks on the various variables that matter for debt dynamics, but also the correlation between these shocks. We yield a random shock sequence using the distribution estimated on the past.

Second, a fiscal reaction function aimed at capturing the main features of fiscal policy is estimated for a panel of 74 emerging market economies in a panel estimation with country and time effects (see Afonso and Jalles, forthcoming for details).[33] The fiscal reaction function captures the government's response to public debt—a semi-elasticity of the primary balance to the debt ratio. The estimated equation takes the following form:

$$pb_{i,t} = c_i + h_i + \beta pb_{i,t-1} + \zeta d_{i,t-1} + \varepsilon_{i,t}$$

where $pb_{i,t}$ denotes the ratio of the primary fiscal balance to GDP; $d_{i,t-1}$ the gross public debt-to-GDP ratio at the end of the previous year; and c_i, h_i are the country and time fixed effects, respectively. To account for the fact that fiscal policy outcomes are not necessarily in line with plans, we include fiscal policy shocks $\varepsilon_{i,t} \sim \mathcal{N}(0, \sigma_i)$, with country-specific variance.

Third, debt trajectories are obtained for each macroeconomic scenario by combining the macro-fiscal shocks, the fiscal policy response, and the debt accumulation equation. Stock-flow adjustment shocks are also included; they notably account for the realization of contingent/implicit liabilities. A projected debt path is computed for each set of country-specific shocks, taking into account the share α_{t-1} of foreign-currency-denominated debt:

$$d_t = -pb_t + sfa_t + \frac{(1+r_t)(1-\alpha_{t-1}) + \alpha_{t-1}(1+r_t^*)e_t/e_{t-1}}{1+g_t} d_{t-1}$$

[33] Due to the limited time series for Georgia, country-specific estimates are not precise and hence are unreliable for our purposes. Moreover, authorities confirmed that employing a more general set of estimates based on an emerging markets wider sample was appropriate.

The algorithm generates a large number of random shock sequences over the 6-year forecasting period and computes for each sequence of shocks the corresponding debt paths. This allows for a probabilistic analysis of debt trajectories—it is thus possible to compute the share of the debt paths that cross a given debt limit at a certain date. The validity of this approach is conditioned on the quality of the statistical model used to produce the forecasts. Important shortcomings include the possibility that relationships estimated using past data may not be relevant for the future if structural breaks are present and the importance of a satisfactory goodness-of-fit of the model.