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GEORGIA

Report on the Observance of Standards and Codes (ROSC)
Fiscal Transparency Module

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September 30, 2003

EXECUTIVE SUMMARY

This report provides an assessment of fiscal transparency practices in Georgia in relation to the requirements of the IMF *Code of Good Practices on Fiscal Transparency* based on discussions with the authorities and other organizations, the authorities' response to the IMF fiscal transparency questionnaire, and other sources of information. The IMF *Manual on Fiscal Transparency* should be consulted (http://www.imf.org/external/np/fad/trans/manual/) for further explanation of the terms and concepts discussed in this report.

Georgia meets some good practices of the fiscal transparency code. The budget preparation process is open and involves the parliament. The national bank is independent, and the government is not involved in the banking sector. Budget coverage includes much of central government fiscal activity including defense expenditures, and a new budget systems law should improve fiscal management. The treasury monitors most expenditures of the central government, and produces regular monthly reports on budget execution that mirror the budget classification main headings. Publication of fiscal data is a legal requirement. The fiscal position of the consolidated central and general government (although not in full accordance with the *GFS* definition of general government), and central government debt are published on a monthly basis. The final accounts are presented to parliament less than four months after the close of the fiscal year. Reforms in progress include plans for the treasury to assume new functions that should lead to a treasury single account, and the introduction of commitment controls, though their effectiveness is not yet clear. In addition, an Anti-Corruption Council with wide representation has been meeting regularly, and far-reaching public sector reforms are under discussion.

However, there are a number of serious weaknesses in fiscal transparency. Highest priority should be given to improving data quality by tackling the enduring problem of unrealistic budget estimates; improving accounting practices and measures to ensure data integrity; developing a legal framework for financial control; and refocusing and strengthening external audit functions. Other recommendations include approving a new, simplified Tax Code; introducing formula-based transfers to subnational governments; improving information on quasi-fiscal activities; expanding coverage of the budget and fiscal accounts to include nonmarket nonprofit institutions and providing a fiscal balance consistent with the *GFS* definition of general government; and strengthening fiscal analysis in order to provide an assessment of fiscal sustainability, medium-term estimates, and an analysis of fiscal risks, especially those associated with QFAs, debt service obligations and contingent liabilities, in the budget document.

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ABBREVIATIONS AND ACRONYMS

BSL	Budget System Law
EUROSAI	European Organization of Supreme Audit Institutions
GCC	Georgia Chamber of Control
GDDS	General Data Dissemination System
GDP	Gross Domestic Product
GFS	Government Finance Statistics
IG	Inspector General
INTOSAI	International Organization of Supreme Audit Institutions
MOF	Ministry of Finance
MSPM	Ministry of State Property Management
NBG	National Bank of Georgia
NFPE	Nonfinancial Public Enterprise
NPI	Nonprofit Institution
QFA	Quasi-fiscal Activities
SDS	State Department of Statistics

I. INTRODUCTION[1]

1. This draft report provides an assessment of fiscal transparency practices in Georgia against the requirements of the IMF *Code of Good Practices on Fiscal Transparency.* The assessment has two parts. The first part is a description of practice, prepared by the IMF staff on the basis of discussions with the authorities and their responses to the fiscal transparency questionnaire, and drawing on other available information. The second part is an IMF staff commentary on fiscal transparency in Georgia.

II. DESCRIPTION OF PRACTICE

A. Clarity of Roles and Responsibilities

2. **General government is defined according to the *GFS* definition except that non-market non-profit institutions (NPIs) are excluded.** The annual budget law includes the central[2] government budget, the separate budgets for the two extrabudgetary funds: the United State Social Security Fund[3] and the Road Fund, and the budgets for special resources (earmarked revenues collected by spending agencies). The treasury produces budget execution reports on the consolidated central government and the main fiscal aggregates for the consolidated general government, but not defined in full accordance with *GFS* (see also paragraphs 17 and 25). General government includes the central government, extrabudgetary funds, special resources and three levels of subnational government: regional, district (rayon) and local governments. At the regional level there are 10 regions, the Autonomous Republic of Ajara (included in fiscal reports) and two "break-away regions"[4] that are fiscally independent. There are 57 districts (rayons) including Tbilisi and around 1,030 self-governing local governments. The main omission in both budgeting and reporting on central/general government are the many non-market NPIs[5] (called public legal entities in

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[1] Discussions on fiscal transparency were held in Tbilisi during January 16–28, 2003. The staff team, comprising Mr. Kohnert, Ms. Parry (both FAD), Mr. Zohrab and Ms. Misra (both Panel experts) met with officials from the Ministry of Finance Budget Department, Debt Department, and State Property Department; National Bank of Georgia, the Treasury, Inspector General, Georgia Chamber of Control, Ministry of Education finance office, Budget Committee of Parliament, Government of Tbilisi and the State Department of Statistics.

[2] Central government consists of the central government administration and judiciary (e.g. State Chancellery, Office of Parliament, Supreme Court, Prosecutor General, Constitutional Court, Georgia Chamber of Control), ministries, state departments, universities, and other entities that are not subordinate to any ministry or state department). The President is the Head of State and exercises executive power in all areas of domestic and foreign policy. According to the Constitution the President appoints government ministers with the consent of parliament, and he submits the draft state budget to the parliament for approval.

[3] The State Medical Company (an extrabudgetary fund) was merged with the Social Security Fund on January 1, 2003. Earlier, the Employment Fund was put on-budget.

[4] South Ossetia and the Autonomous Republic of Abkhazia.

[5] See *GFS 2001 Manual*, p. 10.

Georgia) that perform noncommercial services, are controlled by government units, and receive more than 50 percent of their operating income from government sources. As discussed in paragraph 17, the budget has become more comprehensive in recent years.

3. **Government activities are not clearly distinguished from those of nonfinancial public enterprises.** A number of government agencies, including regulatory agencies such as the Railway Commission and the Communication Commission, are also involved in providing commercial type services for a fee (and the revenue is earmarked for that agency). As mentioned above, non-market NPIs such as hospitals receive transfers for certain expenditures and also charge fees for services. Fees for hospitals are controlled by the Ministry of Health rather than market prices. Finally, some of the nonfinancial public enterprises (NFPEs) continue to provide social services for their employees with no corresponding subsidy from the government. In addition, they may provide goods and services without receipt of payment or at below market rates.[6] For example, regulated prices for electricity have been below cost recovery, and collection rates also have been extremely low. Most NFPEs are not profitable, but do not receive support from the budget except through indirect transfers (e.g., transfers to veterans for heat and electricity). Most of these enterprises have inter-enterprise arrears and complex barter arrangements that pass the losses of some NFPEs throughout the system and affect the more profitable enterprises and negatively impact tax collection.

4. **The current number of NFPEs is not known and many of those registered are inactive.** The MOF Department of State Property Management estimated that around 1,650 NFPEs (though maybe only about 1400 majority-owned by central or local governments) operate in the health, transport, communication, energy, industrial and agriculture sectors of the economy. Oversight and financial control of public enterprises is weak: data is based on unaudited financial statements, there is no centralized database on public enterprise performance, and accountability has been shared between the MOF and the Ministry of State Property Management (MSPM).[7] Only about 300 public enterprises have registered a profit in 2002.[8] The MOF believes the number should be much higher and has encouraged the MSPM to investigate certain enterprises. Some of the most important public enterprises include the Georgian Railroad, the Poti Port, and the Madneuli Mining Company. They provide financial reports to the Ministry of Finance, but until recently they did not make a profit transfer to the budget. At least one of them is involved in some quasi-fiscal investments.[9] The government has initiated the process to have these three companies audited

[6] Also, the provision of a number of local services is highly subsidized either by not charging (garbage collection), under pricing (water, local transport), and/or by not collecting (collection rates for utilities are extremely low in most cities). Most local budgets include subsidies to utilities.

[7] The MSPM was recently dissolved and responsibilities are now shared between the MOF, the Ministry of Economy, and the new State Property Management Agency.

[8] Recently it was decided that 70 percent of profits would go to the enterprise for reinvestment and 30 percent would be transferred to the budget as dividends.

[9] The Railroad company has used its own resources to invest in a sports stadium.

by an international firm to uncover more details about their operations. Information on government equity holdings in private firms is available, though not comprehensive.

5. **Privatization processes have been carried out in a moderately transparent manner.** Holdings of small and medium size NFPEs were reduced considerably through privatization in recent years. The pace of privatization has stalled given an inability to attract potential buyers for large enterprises. As a result, the privatization process encountered problems with a lack of credible bidders and insider deals. After the recent dissolution of the MSPM the Ministry of Economy is now in charge of privatization, which is carried out under the Law on Privatization. This law provides clear procedures for privatization, but in some cases they have not been adhered to completely. Nearly all proceeds have been transferred to the budget, but in some cases the revenue was earmarked to the ministries of health and defense. More progress has been made with closure of unprofitable enterprises in the past year. The new State Property Management Agency will now assume responsibilities for rehabilitation and management of public enterprises. However, it is not clear how progress with privatization or liquidation will be affected by the recent changes in institutional responsibilities.

6. **The central bank is legally independent, and does not carry out significant QFAs.** Article 3 of the Law on the National Bank of Georgia provides that the national bank shall be independent in its operations and that no legislative or executive body shall have the right to interfere in its activities. In addition, all members of the Council of the National Bank of Georgia (NBG) are elected by parliament (by majority of full membership) to a seven year term (but are eligible for reappointment). The president of the NBG is chosen by the President of Georgia from the members of the Council of the NBG.[10] The amount of central bank financing of the government is negotiated annually, and in general the central bank pursues its policies without interference from the government. Bi-monthly bulletins on Monetary and Banking Statistics and the Annual Reports of the NBG are published in English and additional data can be found on the central bank website (www.nbg.gov.ge). The annual report includes a chapter on the macroeconomic environment including a detailed description of government finances and aggregate data on the state budget execution for the last five years. According to Article 67 and 68 of the Law on the NBG, the accounts and records of the NBG must be audited by an external auditor appointed by the parliament of Georgia. The law also requires a copy of the certified financial statements to be submitted to parliament within three months of the close of the financial year, and upon submission, the NBG shall publish its financial statements and a report on its annual operations.

7. **Mechanisms for the coordination between the MOF and the central bank are well defined.** Chapter VII of the Law on the NBG governs the relations between the NBG

[10] The President of Georgia may dismiss the NBG president at the suggestion of the Council of the NBG and dismiss any of the vice-presidents of the NBG at the suggestion of the president of the NBG. The Law on NBG provides specific criteria for dismissal, and the Constitution (article 64) describes the process for impeachment of Council members which requires a majority of the total members of parliament. At present no members of the Council are from within government.

and the State, but these interactions are not on market terms. For instance, the MOF determines which state agencies have accounts at the NBG, but government accounts are not interest-bearing. On the other hand, the MOF is not charged for the banking services provided by the NBG. There are clear limitations on lending to the government in terms of maturity and aggregate principal.[11] According to the Law on the NBG, its loans to the government should be at market interest rates. However, the current interest rate (9 percent) charged on all NBG loans to the government is much lower than either commercial bank interest rates (18–20 percent) or the prevailing treasury bill rate of return (around 40 percent). The NBG is also in charge of monitoring government debt and therefore, all state agencies must report any borrowing activities to the NBG. Articles 24–26 of the Law on the NBG define net profits and require profit to be paid to the MOF within four months of the end of the financial year of the NBG. If the NBG is in deficit, the MOF must provide debt securities on terms and conditions similar to other government securities in sufficient amount to cover the deficit. There are no public financial institutions nor any overt government interference in the operations of the financial sector.

8. **Implementation of government regulations of the nonbank private sector is not free from discretion.**[12] A recent survey of domestic and foreign businesses describes business regulations as bureaucratic, non-transparent and open to corruption.[13] Although regulations are generally modern, they are adjusted frequently making it difficult to understand the various administrative procedures required for business establishment and operation.[14] Poor enforcement undermines their effectiveness and officials often seek to maintain discretion in administrative procedures. In addition, gaps in understanding the actual regulations expand opportunities for corruption.

9. **The allocation of responsibilities between different levels of government is not clearly defined and inter-governmental fiscal relations are not based on stable principles.** The 10 regions do not have a budget or any authority to provide public services.

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[11] The aggregate principal amount disbursed and outstanding on NBG loans to the MOF cannot exceed 5 percent of the annual average State's revenue for the previous three financial years; "revenue" is defined as excluding borrowings, grants and other financial assistance. A temporary waiver to the limit may be granted, but cannot permit aggregate principal to exceed 8 percent of annual average State's revenue for the previous three years.

[12] Legislation covers business registration requirements with the courts, tax office and national statistics bureau. The Law on Land Registration and the Law on Geodesic and Cartographic Activities (land cadastre) define property, property rights and transactions. Other legislation affecting businesses include the Civil Code (1997), the Law on State Complex Examination and Approval of Construction Projects, the Law on State Supervision of Architectural-Construction Activity (amended 2001), the Law on Environmental Protection (1996), and the Law on Cultural Heritage (for historical preservation).

[13] *Georgia: Study of Administrative Barriers to Investment*, Foreign Investment Advisory Service (a joint service of the International Finance Corporation and the World Bank), December 2001.

[14] Amendments to laws are printed in an official newspaper and can be found on parliament's website: www.parliament.ge.

Their governors are appointed directly by the President and are influential in intergovernmental relations. Although the districts have elected councils and their own budgets, in practice the central government can exert strong influence on district budgets.[15] There are no clear criteria for determining the amounts of central government transfers to district and local governments negotiated on an annual basis as part of the budget approval process.[16] The self-governing local governments (cities, towns and villages) are governed directly by elected local councils and the elected Heads of the Councils. Few revenues are assigned exclusively to local governments and they are not permitted to introduce new taxes or to borrow (with the exception of Tbilisi). The Tax Code (1997) establishes local government tax bases,[17] regulates all exemptions and fixes a ceiling on rates. Laws on System Fees and Local Fees (both 1998) regulate local government fees. According to new tax sharing arrangements adopted in 2001, the central budget keeps 15 percent of the proceeds from the personal income tax and the corporate income tax, and 85 percent is assigned to the territorial unit where it was collected.[18] Other shared taxes are 100 percent local but are regulated and administered by the central government: in effect they are another type of transfer mechanism.[19] The district administration is responsible for approving transfers to local budgets as well as determining local tax shares and fees. The Organic Law on Local Governance and Local Self-Governance (1997, amended 1999, 2000, 2001) prescribes the functions of districts and local governments. In August 2001 health and education services were assigned to the district level of government. The assignment of functions to the district and local levels of government overlap in some areas.[20] Furthermore,

[15] For example, in 2003 a presidential decree requires teacher wages to be raised 30 percent even though education including teacher wages is a district responsibility. Nearly all districts will receive additional transfers from the central government to cover the wage increase, but at least Tbilisi will be expected to cover the increase from their own revenues.

[16] Districts perform only "delegated" functions for which the central government is supposed to financially compensate for their cost. Local governments have some delegated and some exclusive functions. In practice, the delegated functions are under-funded with transfers set mainly to cover protected items (these are expenditures that cannot be sequestered). They negotiate the level of employment required for delegated functions to determine wage expenditures (a protected item) and hence the transfer amount. Own revenues may also be taken into consideration in setting the transfer amount (see preceding footnote).

[17] Six local own-source taxes are on entrepreneurial activity, gambling, health resorts, hotel accommodations, advertisements, and on use of local symbols.

[18] As an exception to this rule, Ajara is entitled to 99 percent of the profit and income tax collected on its territory. On VAT and excises Ajara enjoys similar preferential treatment.

[19] These include the land tax, property tax, inheritance and gift tax, motor vehicle transfer tax, natural resource exploration tax, and environmental protection tax, but their combined revenue amounts to only 1 percent of GDP according to the World Bank *Public Expenditure Review* (*PER*), June 14, 2002, p.74.

[20] According to the *PER* (p. 64) overlapping responsibilities include provision of primary healthcare, police, veterinary and agricultural services, investment in infrastructure, environmental protection, and land use decisions.

due to weak capacity at the local level, the district governments may ultimately be responsible for delivering services that are legally a local government responsibility.

10. **In most respects the roles of the executive, legislative and judicial branches are clearly defined in the Constitution.** According to the Constitution of Georgia, the President submits a draft budget no later than three months before the end of the current budget year. The President must also submit a preliminary report on the implementation of the budget for the current year with the annual budget and the final accounts are submitted to parliament three months following the end of the budget year. Changes cannot be introduced to the draft budget by parliament without the consent of the President, but the budget cannot be approved without a majority vote of parliament. These provisions balance the power between the executive and legislative branches and force both to make compromises in order to approve the budget.[21] In practice the parliament is very active in the formulation of the budget. A document containing an overview of macroeconomic conditions, a three-year forecast of budget aggregates, the proposed total resource envelop for the budget, and expected distribution of resources by function is prepared by the MOF and sent to parliament in spring for comments by the beginning of June. The Budget Committee of parliament is active in reviewing the budget and prepares an annual report that may be critical of the realism of the proposed budget. However, the Constitution's provision that the executive may finance necessary expenditures in the event that the annual budget law is not approved by the legislature is unclear.

11. **Fiscal management is defined by a legal and administrative framework that is clear in most respects.** The Constitution determines the timing for submission of the draft budget, the framework for budget approval, and the reporting requirements of the President to parliament on budget execution. Other provisions to prepare, approve and implement the state budget are found in the new Budget System Law (2003) which becomes effective on January 1, 2004. This law provides for the budgetary relations and responsibilities of the central authorities, local authorities, and the extrabudgetary funds. This law introduces a number of improvements in the budget system regulations by preventing any expenditure without appropriation, eliminating special resources (or any earmarking of resources), forcing donor financed expenditure to be treated as any other budget expenditure, requiring the use of a treasury single account and requiring the development of a medium-term fiscal forecasts with a medium-term macroeconomic framework. The new BSL does not mention protected items (items that cannot be sequestered) or sequestration with the aim of eliminating their use in public expenditure management.[22] However, the new BSL is not an organic law and therefore will not have superiority over other laws. The annual budget law

[21] If the annual budget is not approved before the beginning of the new fiscal year, spending agencies are entitled to spend up to 1/12 of their last budget appropriation.

[22] Under current law, the Minister of Finance can sequester expenditure only with parliamentary approval, except for non-core expenditures which can be sequestered up to 10 percent. The new BSL does not contain this provision.

could contain instructions that are contrary to the BSL.[23] Another legal ambiguity arises from expenditure commitments created by law (such as social security legislation) that may not be fully funded by the annual appropriation (for the United State Social Security Fund). Currently, these unpaid commitments are not recognized as expenditure arrears.

12. **Mechanisms for the coordination and management of budgeted and extrabudgetary activities are not well defined or effective.** The budgets of the two remaining extrabudgetary funds are passed at the same time as the annual budget. In the past two years extrabudgetary spending has been around 19 percent of general government expenditures. The main problem with the management of both budgeted and extrabudgetary activities is the existence of a large number of spending agencies that have a narrow area of expenditure responsibility and are not subordinate to any ministry or department.[24] This creates a situation where there is no coordination in spending or policy decisions between the Road Fund and Ministry of Transport, or between the Ministry of Culture and other agencies that provide cultural or related expenditures—to give just two examples. Analogous considerations apply in respect of coordinating the budgets for special resources and targeted expenditure programs with other budgeted expenditures.

13. **The legislative basis for taxation, regulation and administrative procedures can be found in the Tax Code,[25] but frequent and numerous amendments to the code have blurred the clarity of tax legislation.** More than 30 packages of amendments to the Tax Code have been passed, amounting to well over 100 amendments to the Tax Code. A large number of amendments are specific tax exemptions. These changes are reported in an official newspaper and in tax journals, and there is a handbook that is issued annually with amendments to the Tax Code. The Tax Code also contains procedures for appeal if a taxpayer disputes a tax assessment. Unless the taxpayer is willing to pay the tax up front, the process for appeal is quite lengthy with the option to appeal to the court only possible at the end of this process. In addition to a complex Tax Code, customs regulations leave considerable room for discretion by the customs officials. Both the Tax and Customs Departments have a reputation for arbitrary and inconsistent administration that supports an entrenched system of bribe taking.[26] Pressures to meet monthly revenue targets has also

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[23] The MOF is in favor of making the new BSL an organic law, even though this would require an amendment to the Constitution which requires a two-thirds majority vote in parliament.

[24] The MOF deals directly with the budgets of more than 70 spending agencies including 21 ministries, 14 State Departments, and around 40 other entities.

[25] The Tax Code of 1997 covers the income tax, tax on profits, value added tax, excise taxes, property taxes, tax on the use of land, motor vehicle tax, tax on the transfer of property, social tax, tax on the use of natural resources, tax on pollution, tax on overloaded motor vehicles entering the territory, and local taxes.

[26] The report *Georgia: Study of Administrative Barriers to Investment,* Foreign Investment Advisory Service, written in cooperation with the Presidential Commission on Support of Private Businesses (December 2001) provides a detailed description of these activities and asserts there is little evidence that such behavior is discouraged or punished. There are accusations that well-connected firms influence the tax administration to

(continued...)

resulted in a system of tax prepayments. Businesses comply with such requests for prepayment to avoid harassment or to receive tax reductions (usually for local shared taxes). Furthermore, local governments bear the brunt of revenue shortfalls as local revenues are not turned over to them (all revenues are collected by the central tax authorities) in order to meet revenue targets. Tax arrears amount to more than 1,000 million lari, though the estimated collectable amount is only around 400 million lari (around 5.5 percent of GDP in 2002).

14. **The tax administration was merged with the Ministry of Finance in 2002 and has no legal protection from political interference.** The Constitution of Georgia (Article 94) makes tax exemptions permissible only by law. However, an informal agreement with the power company in Tbilisi, AES, has given them a large tax exemption in addition to a budget subsidy in order to keep them in operation.

15. **Although public servants are subject to an Administrative Code and a Civil Code of behavior that include provisions on the conduct and accountability of public officials, these provisions are not always enforced.** Similar codes have been introduced for the conduct of tax and customs officials, but they too have had limited effect.

16. **The authorities are open about problems of corruption and have made some recent efforts to reduce corruption, including the creation of the Anti-Corruption Council and the Anti-Corruption Bureau in 2001.** Members of the Council include members of parliament, government officials, nongovernmental organizations and journalists. The Council has met frequently in the past year and made recommendations to parliament including in support of the effort to restructure government and raise public wages. The authorities believe this will diminish one of the reasons for corruption. Other efforts to reduce corruption include a committee established to reform the State Customs Department.

B. Public Availability of Information

17. **Except in respect of non-market NPIs, budget coverage has recently expanded to cover nearly all central government fiscal activities and monthly budget execution reports provide comprehensive information on central government and aggregate reports on general government fiscal activity.** If NFPEs receive a foreign grant or loan, or if budget units receive grants-in-kind, then they may not be in the budget. Otherwise all foreign grants and loans are included in the budget and in budget execution reports. In the past, special resources (earmarked revenues collected by the spending agencies) were shown in the budget, but they were not appropriated. Though they were still earmarked, in 2002 all special resources were appropriated. Information on public debt, annual budget execution data, and cumulative revenue collection is available on the MOF's website (www.mof.ge). The State Department of Statistics (SDS) also publishes monthly reports (based on MOF

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harass their competitors. In addition, certain sectors that are politically connected escape revenue collection despite monthly revenue targets.

data) that provide the main aggregates (cumulative) for revenue, expenditure and the deficit[27] for the central government budget, extrabudgetary funds, local government, and consolidated general government, excluding non-market NPIs. One problem in reporting general government fiscal activities is related to the Autonomous Region of Ajara. The Georgian authorities record a considerable amount of central government revenue that is collected by Ajara[28] even though in reality this revenue has been retained by Ajara in recent years. As a result, the central government appears to have received more revenue than it has, and if any of these funds are spent by Ajara, this is not captured in general government expenditure.

18. **Defense expenditures are comprehensively reported in the budget with the exception of aid-in-kind.** However, the final accounts contain an appendix that provides information on all aid-in-kind received by the government during the year.

19. **A statement that qualitatively discusses contingent liabilities is included in the explanatory note to the budget, and a more detailed list of government guaranteed loans is presented to parliament.** Reporting on external debt includes all foreign loans and government guaranteed loans, and this report is sent to parliament and other government offices on a monthly basis. The only recent guarantees have been renewal of old guaranteed loans. Only the Minister of Finance can approve a loan guarantee. A significant area of contingent liabilities is the public enterprise sector, particularly the energy sector where important clients have not paid for consumption, requiring the government to compensate them with subsidies.

20. **There are no official estimates or statements on tax expenditures or quasi-fiscal activities.** The constant changes to the Tax Code make it difficult to know the full range of tax expenditures let alone develop a system for estimating and monitoring them. The MOF does perform some analysis of foregone revenues from specific tax exemptions, but this is not done on a systematic basis. There is little information available concerning quasi-fiscal activities.[29] Audits of the largest NFPEs will be an important start to disentangling the various relationships between the NFPEs and the government.

21. **Information on gross public debt is published and information on external and domestic financing is produced regularly during the year.** A monthly report on external debt gives details on loan amounts and creditors. This report is sent to the parliament, the State Chancellery, and the Anti-Corruption Bureau. It is also produced in English and shared with the IFIs. The monthly publication of the SDS provides data on the stock of government

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[27] Note, however, that the definitions of main categories do not appear to be consistent with GFS. (See footnote 33.)

[28] Ajara contains two of the four main entry points in Georgia for customs clearing.

[29] Recent estimates by World Bank and IMF show annual quasi fiscal subsidies related to the energy sector of about 6.5 percent of GDP.

debt (end of period) with domestic (bank system and other) and external debt components as well as cumulative data on domestic and external financing for the current year. Domestic debt consists of treasury bill issues, loans from the NBG, and historical debt (from government obligations from the Soviet era). The annual report of the NBG provides information on all treasury bill auctions to date, and monthly loans of the NBG to the government in the past year. Information on financial assets is not published, but the new BSL requires estimates in the annual budget of state financial assets and liabilities at the beginning and end of the fiscal year.

22. **Formal commitments for regular publication of fiscal data have been made, but there is no advance release date calendar.** The new Budget System Law requires publication of the budget as well as regular publication of the budget outturn. The MOF compiles central and general government financial statistics and provides them to the SDS which is legally required to publish monthly and annual statistics on government financial operations. Sometimes fiscal tables are not included in the monthly publications if there are lags in receipt of information from the MOF. Georgia does not currently participate in the General Data Dissemination System (GDDS), but the SDS is interested in initiating the procedures necessary for participation.

C. Open Budget Preparation, Execution, and Reporting

23. **The annual budget preparation process is open and the budget is prepared according to a clear timetable.** As noted above, parliament is involved in budget preparation as well as approval, and all discussions in parliament are open to the public. The Administrative Code of Procedures requires that draft legislation that does not have national security implications be available to anyone. However, since parliament's comments on the general budget parameters are not due until June, the budget call has been delayed leaving spending agencies short notice to prepare their budget requests. According to the new BSL the budget call will be issued by June 15, and agency requests will be due August 15, but only two weeks are allowed for review of budget submissions. An initial draft budget is presented to the President on September 15, and the final draft budget must be submitted to parliament before October 1. The budget documentation that is presented to parliament includes the budget estimates, ten appendices, and an Explanatory Note (discussed further in paragraph 28). These documents disclose the main fiscal aggregates for the preceding year, estimated outturn for the current year, and projections for the budget year. Estimates are presented for the central government budget including special resources, and for the budgets of the two extrabudgetary funds. The new BSL requires the annual budget law and all attachments to be published and made accessible to the public.

24. **Efforts are under way to give spending agencies greater input into budget decisions, but fragmentation of the budget limits their ability to develop a unified policy and a rational prioritization of expenditures.** At present the central government budget has three distinct types of expenditure: regular budgeted expenditures, expenditures under

targeted programs, and expenditure from special resources.[30] Targeted programs[31] are proposed to the Ministry of Economy (MOE) which undertakes its own review of these programs. Proposed programs are generally approved by the MOE which are listed in a Presidential decree issued at the end of May. However, since the budget will normally fund only around 10 percent of the targeted programs, the analysis performed by the Ministry of Economy has limited relevance since the MOF has the final decision on which targeted programs will be included in the budget. Expenditures of special resources (earmarked revenues) are appropriated using the same classification as regular expenditure. The MOF requires that special resources only be used for items that are not in the regular budget. In addition to these three categories of expenditure, there is a list of protected items, including wages, pensions, social allowances, and debt service, that cannot be sequestered.[32] This has encouraged spending agencies to distort the composition of inputs toward protected items, since they represent assured funds. Finally, as noted above, the numerous ministries and state departments lead to fragmentation of expenditure decisions within one policy area.

25. **The budget classification partially meets GFS standards and has improved.** The budget classification includes administrative, economic and functional classifications. In 2003 targeted programs were classified by the economic classification for the first time. Before this targeted programs were listed as one item under the heading of goods and services so there was no detailed breakdown of this expenditure. Therefore, it has been impossible to get a complete picture of spending under any one heading in the economic classification. In 2003 the annual budget will also include for the first time the list of donor financed projects rather than one line item for these projects. The presentation of budget aggregates (revenues, expenditures, and financing) is not exactly according to the *GFS* methodology and definitions are not published.[33] The economic classification is also different

[30] The relative share of each type of budgeted expenditure is 80.6 percent for the regular central budget (excluding targeted programs. Note, the central government budget includes transfers to other levels of government), 8.7 percent for targeted programs (including foreign financed expenditures), and 10.6 percent for special resources.

[31] Targeted programs are a subset of the indicative five year plan which is updated annually. The programs can be annual or multi-year and usually include both current and capital expenditures. They can be financed by external financing as well as budgetary funding. In 2002 targeted programs amounted to about 4 percent of total expenditures.

[32] Protected items (also called core expenditures) are defined in the annual budget law and can vary from year to year. In addition to the four main categories mentioned, in recent years they have also included stipeds, food, maintenance of military personnel during compulsory service, obligations of international agreements, electricity for ministries, support for refugees, measures financed by the President's Fund and the State Reserve Fund, and healthcare programs.

[33] The recent Data ROSC (May 2003, page 13) notes that while the analytic framework is generally consistent with the GFS (1986), definitions are not in accordance in some significant respects: "revenue includes repayments of loans previously extended by government, expenditure includes amortization of foreign loans, and foreign financing is defined on a gross basis." The ROSC recommends that the MOF formally establish fiscal data that fully correspond with international standards by ensuring that concepts, definitions,

(continued...)

from the *GFS* (e.g., travel expenditures are a separate heading from goods and services), although plans are underway to revise the economic classification in accordance with *GFS*. Postings according to the detailed economic and functional[34] classifications may not be fully accurate.

26. **Budget estimates are clearly presented in the budget documents, but the economic classification in the annual budget appropriation is not detailed.** Budget estimates are classified by major headings of the economic classification for each administrative unit. Virement of up to 10 percent is permitted between these major headings. Furthermore, each year the annual budget lists a number of funds (all on-budget) that are used for expenditures that are still uncertain. They have included contingency expenditures (1.5 percent to 2 percent of total expenditures) but also investments, small business support, and a number of other purposes. The supporting documents in the budget department employ a more detailed economic classification that can also be monitored by the treasury. Therefore, during budget execution, spending is authorized and monitored at a greater level of detail by the government than by parliament.

27. **During the year the consolidated central government and the general government balance are the main indicators of the fiscal position.** The subnational governments[35] provide monthly and quarterly reports on their budget outturn, but the classification is not consistent with the central government's. Therefore, only the main fiscal aggregates of the general government are monitored during the year. Reports from local governments are not always received on a timely basis.

28. **The macroeconomic assumptions are disclosed in the budget documentation submitted to parliament.** Both the MOF and the Ministry of Economy are involved in developing revenue and expenditure forecasts. The Ministry of Economy has taken the primary responsibility for developing macroeconomic forecasts, but the MOF is proposing to develop a new macroeconomic division to promote its capacity for forecasting. The Explanatory Note to the State Budget provides a detailed discussion on the macroeconomic environment, including sources of growth, estimates (for the current year and the budget year) of GDP, trade volume, trade balance, current account deficit, inflation, and the exchange rate. The Explanatory Note also includes a summary of changes in tax policy for each type of tax, and a discussion and forecast for each type of tax revenue, state budget expenditure aggregates, the deficit and its financing. In addition, there is some discussion of fiscal policy in sections describing and justifying transfers to territorial units (district and

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classification, and basis for recording revenue, grants, expenditure and lending minus repayments, and financing are defined according to the GFS (1986).

[34] In addition, the functional classification is missing nearly one third of expenditures, most of which are transfers to the district and local governments.

[35] Subnational governments represent around 24 percent of general government expenditure with expenditure amounting to more than 4 percent of GDP in 2001.

local budgets) and increases, maintenance, or decreases in the budgets for the various ministries and budget institutions. In 2003 for the first time the Explanatory Note includes a discussion of proposed expenditure priorities.

29. **A statement on medium-term fiscal policy objectives is not included in the budget documents nor is there any analysis of fiscal sustainability.** The annual budget places annual quantitative limits on borrowing, government guarantees, and debt, but there is no overall limit on debt (e.g., in relation to revenue or GDP). Objectives of major programs are not discussed in the budget and estimates of new initiatives are not clearly distinguished from ongoing costs of government policies in the budget document. However, new initiatives are generally costed separately and analyzed as part of the budget preparation process. No efforts are made to analyze the sensitivity of the estimates to changes in economic assumptions, and the main fiscal risks, such as the ability to service debt, are not disclosed with the budget. The new BSL requires the development of a medium-term macroeconomic framework to develop three-year rolling fiscal forecasts.

30. **Objectives of major programs are sometimes announced through the development and description of the targeted programs, but there are no performance indicators to measure actual progress against these objectives.** The external auditor (Georgia Chamber of Control) is given authority to perform value-for-money audits. The Chamber of Control audits targeted programs and projects financed by foreign loans and evaluates them against program/project objectives. Efforts are being made to improve both the selection and analysis of targeted programs.

31. **Budget execution is characterized by procedures developed to manage under continued revenue shortfalls.[36]** Nearly all central government expenditures including targeted programs, special resources and extrabudgetary funds pass through the treasury, thus providing it considerable expenditure control.[37] The MOF has controlled spending through monthly cash releases and sequestration of budget authority by up to 10 percent for unprotected items. However, about 85 percent of expenditure falls under the category of protected items. As a result of these cash controls, arrears for both protected items and unprotected items have been a serious problem in the past, though data on arrears are not published, some information can be found in published IMF staff reports.[38] The stock of arrears is estimated at around 4 percent of GDP. A new system for monitoring and controlling expenditure commitments has been developed and was initiated in January 2003.

[36] Prior to 2002 significant revenue shortfalls required supplemental budgets for the previous three years.

[37] The main exceptions are universities, which are permitted to have their own bank accounts, donor financed projects, and non-market NPIs.

[38] As with the central budget, local budget revenues are persistently overstated which leads to arrears at the local government level.

It is early to judge its effectiveness, but at present these procedures can only be effectively applied to the unprotected items in the budget.

32. **Internal control procedures are fragmented and not effective, but a new legal framework for internal control is under development.** Some spending agencies have their own internal audit functions that are subject to their own regulations, but generally they have not been active. After the merging of the Tax Revenue Ministry with the MOF in 2003, the MOF has an Inspector General's Office (IG) that will be responsible for internal audit of both revenue and expenditures. Staffing of the IG is adequate but under qualified. At present it has no relationship with the Chamber of Control nor with the internal audit functions of the spending agencies. The MOF wishes to give the IG legal authority to carry out investigations in other ministries or spending agencies and to be able to take cases to the court without involvement of the Ministry of Interior or Ministry of Internal Security. The treasury also has an internal audit office, but its focus is exclusively on treasury operations. On the revenue side, both the Monitoring Bureau and the Extraordinary Legion carry out investigations and monitor shipments to prevent smuggling, but neither have a strong reputation for effective control. The MOF is currently considering consolidation of some of these functions. In addition, the legal framework for internal control is under development. First, two draft Laws on the Inspector General are currently before parliament; one supported by the Ministry of Justice and one supported by the Ministry of Finance. Second, the draft State Financial Control Law has the potential to make a major contribution to strengthen internal controls, but also has some serious flaws.[39] Most importantly, it assigns functions to the external audit institution that are not consistent with international standards for a supreme audit institution including ex-ante expenditure controls and oversight and training of internal auditors.

33. **The clarity of procurement and employment regulations has improved, but enforcement has been weak.** The Law on Public Procurement (1999; revised 2001) creates the Agency for Public Procurement and requires public agencies to organize tenders according to internationally accepted standards. Although practices are improving, weaknesses in enforcement due to poor training and a lack of awareness of the requirements of the law continue to be observed.[40] Employment and pay regulations[41] are well defined, but it is not clear how well they are enforced in practice.

34. **The treasury is capable of producing regular monthly reports on central government budget outturn, but the quality of data is weak.** Monthly reports are generated by the treasury for use by the Budget Department in the MOF. The reports provide

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[39] These flaws are documented by the World Bank draft Country Financial Accountability Assessment report (April 2002).

[40] See also the Word Bank Country Procurement Assessment Report (June 2001).

[41] See the Law on Public Service (1997).

data at the main headings of the economic classification used in the budget even though spending is authorized according to detailed subcategories of these headings. However, weaknesses in the accounting system of the treasury call into question the accuracy of budget execution data. At the detailed level of economic classification, discrepancies arise between the budget classification and the chart of accounts due to frequent changes to the budget classification for expenditure. Furthermore, accounts are maintained according to a single-entry system of bookkeeping. The treasury accounting system is on a cash basis and is not capable of generating reports on accounts payable. However, the spending units maintain their own parallel accounting system that is modified from the Soviet era accounting system. This system uses an accrual basis of accounting and is used to generate information on accounts payable that is periodically reported to the MOF. The MOF agrees that new accounting standards are needed and plans to seek assistance from donors on this issue. In addition, work is underway to move the functions related to revenue accounting in the NBG to the treasury with the eventual aim of creating a treasury single account.

35. **Parliament receives monthly reports on consolidated government revenue and quarterly reports on budget execution.** A mid-year review takes place when the President submits a report on budget execution in September at the same time the draft budget is submitted to parliament. If the shortfall in revenue plus grants is greater than 10 percent, a revised budget will be presented for parliament's approval.

36. **The final accounts are sent to parliament within four months of the end of the fiscal year.** These are reviewed (but not certified) by the Georgia Chamber of Control (GCC). They are presented to parliament at the beginning of April, and the GCC presents its own report on budget execution to parliament within two weeks. However, given the tight deadline, the GCC does not have sufficient time to perform an effective audit of the final accounts.

D. Assurances of Integrity

37. **Budget data have generally not been reliable, but the realism of budget estimates was improved in 2002.** Supplemental budgets have been common in previous years. Outturn can also vary even without a supplemental budget given the broad categories of expenditure in the appropriation bill and permissible virement up to 10 percent for each category. The variance between budget estimates and actuals has not been shown in the budget document. Budget outturn is recorded according to the cash basis of accounting which is stated in the final accounts document.

38. **The processes of accounts reconciliation are not effective.** At the moment the NBG regularly reconciles its record of revenues with those of the commercial banks from which the revenues are transferred, but not with the records of the tax or custom authorities. The treasury does not reconcile bank accounts of the treasury and field treasuries with accounting data. The central treasury reconciles its accounts with that of the regional treasuries, but since

the treasury accounts are derived from the regional treasuries, this is not a reconciliation of two independent data sources. The spending agencies receive regular information from the treasury on budget execution and they can reconcile this data with their own accounts in order to compile data on accounts payable. The treasury reconciles accounting data with budget appropriations and variances between actual and budgeted expenditures are disclosed in reports to the parliament. However, despite these checks (and the internal audit in the treasury) recently discovered missing revenues were not detected for more than a year and a half. Fiscal and monetary data are generally fairly close, but not routinely reconciled.

39. **External audit is independent of the executive branch.** The Georgia Chamber of Control (GCC) is given independence in the Constitution as well as in the Law on the Chamber of Control of Georgia which states that it shall operate independently and be responsible only to parliament. The chairman of the GCC is nominated by the President of Georgia and appointed by a majority vote of the full membership of the parliament. The chairman nominates a deputy and the other members of the Board who are appointed by the parliament. The GCC chairman is protected from detention, search of property, or arrest without permission from parliament.

40. **The Chamber of Control has a broad range of responsibilities that include collection of fines and forfeitures resulting from their investigations.** Revenue collected is a source of special revenues that are earmarked for the GCC. In recent years this source of revenue has grown to equal a large portion of their annual budget. This role gives rise to a conflict of interest in performing its duties since it gives the GCC an incentive to identify irregularities, but not to make recommendations to prevent it from recurring. In addition to revenue collection, the responsibilities of the GCC also include assessing tax policy, assessing the realism of the budget, and evaluating the efficiency of public expenditures including projects financed by foreign loans. These responsibilities, particularly investigative powers that are normally assigned to the internal audit units and collection of penalties, are not consistent with internationally recognized standards for a supreme audit institution.

41. **The GCC is a member of INTOSAI and EUROSAI.** It determines its own audit plan each year but will also audit entities selected by parliament or the President. It submits two reports to parliament each year. The April report gives its opinion on the execution of the budget and how its data differs from that in the final accounts. The other report, submitted in June, is a report on the activities of the GCC. The GCC also produces a quarterly journal that summarizes the findings of audits and is available free of charge. The GCC also makes recommendations at a broader level.[42] The GCC does not retain evidence needed to certify that the financial statements of the government are a true and fair representation of government finances. Such certification is required under the new BSL.

[42] The GCC recommended amending the Tax Code to prevent cases where tax inspectors are wrong in certifying a balance sheet is correct, and as a result the organization pays a small fine rather than its actual tax liability.

42. **The legislature does not always follow up on the recommendations of the external audit reports.** The parliamentary Budget Committee reviews the reports of the GCC, and parliament gives a statement that either approves or disapproves of the findings. The GCC estimates that in about 60 percent of the cases their recommendations are followed up by parliament. It estimated that 189 people lost jobs in 2002 and 50 criminal cases were filed as a result of audit findings. The parliament can require the executive branch to respond to accusations and answer questions before the parliament. The Budget Committee said that when problems are uncovered in a ministry, they take this into account in determining its budget allocation.

43. **Macroeconomic assumptions are included in the budget document, but external scrutiny is not invited in producing these forecasts.** Macroeconomic forecasting is performed by the Ministry of Economy and does not involve analysis from independent experts outside the government.

44. **Although the national statistics office does not have a legal assurance of independence, it operates independently in practice.** The Law on Statistics states that one of the basic principles of state statistics is independence. The head of the State Department of Statistics (SDS) is appointed and released from office by the President of Georgia. The law also requires state bodies and other legal entities to provide complete and reliable statistical data to the SDS, which has the right to check the precision of primary data necessary for statistical observations. Article 17 makes the SDS responsible for ensuring the objectivity, reliability, and timeliness of statistical data; ensuring confidentiality in the collection of primary data; and promoting accessibility and publicity of consolidated statistical information.

III. IMF STAFF COMMENTARY

45. **Georgia meets a number of good practices in the fiscal transparency code.** The budget preparation process is open and involves the parliament. The national bank is independent and there are no public financial institutions or any overt involvement of the government in banking sector decisions. The coverage of the budget has recently been widened to include nearly all fiscal activity, except in respect of non-market NPIs. With this exception, the fiscal position of the consolidated general government and information on government debt are published monthly. Also with this exception, the treasury monitors nearly all expenditures of the central government and produces regular monthly reports on budget execution that mirror the budget classification main headings. The final accounts are presented to parliament three months after the close of the fiscal year. The State Department of Statistics has a legal requirement to publish data, and laws and data are available at government websites. Finally, the implementation of the new budget system law (May 2003) should improve fiscal management.

46. **Other improvements are in progress.** The treasury is taking on new functions from the NBG that should ultimately lead to the establishment of a treasury single account. Commitment controls have been introduced to reduce the extent of expenditure arrears,

though it is not yet clear how effective they will be. In addition, an Anti-Corruption Council has been created that has wide representation and has been meeting regularly. Finally, there is evidence of a commitment to implement far-reaching public sector reforms that should reduce the number of ministries and departments and reduce government employment. This should enable a more strategic allocation of public resources by confining expenditures related to one policy area under one ministry, and may also have an impact on reducing corruption by improving the wage structure.

47. **However, there are a number of serious weaknesses in fiscal transparency.** Most importantly, while availability of data is good, the quality of data is weak, both in terms of budgetary and accounting data. Second, a framework for financial control and internal audit is absent and leadership in this area is lacking. In addition, the external auditor is involved in practices that are not consistent with international best practices, and that lead to conflicts of interest. Additional weaknesses in fiscal transparency include unclear tax legislation due to the number of amendments to the Tax Code; nontransparent negotiation of tax shares and transfers to subnational governments; lack of coverage of non-market NPIs by the budget and treasury systems; and extensive quasi-fiscal activities within the nonfinancial public sector that have a detrimental impact on the economy and government finances. In addition, a stronger analytical capacity within the MOF would enable it to improve the quality of information in the budget document. To address these weaknesses a formal reform strategy should be prepared under the leadership of the MOF with the strong support of the President.

48. **Highest priority should be given to improving data quality.** A three pronged approach is suggested that includes tackling the enduring problem of unrealistic budget estimates, developing the accounting system and strengthening measures to ensure data integrity, and developing a consistent financial control framework. These three priorities are discussed further below.

49. **A strong focus on improving budget preparation is needed in order to develop more realistic budget estimates and ease the problems associated with cash controls.** Immediate attention should be given to the following actions:

- Approve the BSL as an organic law as soon as possible so that the other laws cannot override the requirements that are needed to improve fiscal management. Implementation of this law should eliminate the use of protected items and minimize the use of revenue earmarking.

- Budget for unreliable revenues (particularly customs revenue collected in Ajara) through greater use of contingency funds and/or planning for possible service reductions to cut spending if needed. This should be a different exercise than simply cutting "unprotected" expenditure as done currently. The spending agencies should assist in the process of identifying nonessential services during budget formulation.

In the medium term the authorities should consider the recommendations from recent FAD technical assistance related to budget preparation including:

- Placing full responsibility for budget preparation with the MOF, and developing a strong capacity for macroeconomic analysis within the MOF;

- Communicating budget parameters and expenditure ceilings to the spending agencies in spring, giving more time to review budget requests in late summer;

- Moving away from "cost norms" to pursuing policy objectives; and developing better cost estimates of current policies while costing new policies separately; and

- Extending the planning horizon by increasing the involvement of the line ministries in the preparation of three-year forward estimates as well as their annual budget request.

50. **High priority should be given to strengthening the treasury accounting system and the quality of data reported by the treasury. Needed actions include:**

- Amending the BSL to require that budget execution data and the final accounts be prepared **in compliance with** international accounting and reporting standards;

- Developing accounting instructions that are fully compliant with international accounting and reporting standards, and providing training in these new practices;

- Developing a standard Treasury General Ledger for recording both the revenue and expenditure on a cash accounting basis using double-entry bookkeeping;

- Ensuring that both the budget classification and chart of accounts are consistent with each other and fully compliant with the *GFS*;

- Developing procedures for reconciliation of accounting and banking data and routinely disclosing any unexplained discrepancies in accounting statements and fiscal reports;

- Producing and publishing more detailed reports on budget outturn that permit a closer monitoring of budget execution; and

- Producing reports on general government revenue, expenditure and fiscal balance that are consistent with the *GFS* definition of general government.

51. **Immediate attention should be given to developing the legislative basis for a financial control framework that meets international standards.** Improvements in the various related laws that have already been drafted can be made immediately, and that would go a long way towards meeting this goal. The following amendments are needed to ensure a consistent financial control framework, and to assign the MOF, not the GCC, responsibility for developing and implementing a system of internal control and audit:

- Approve the MOF version of the Law on Inspector General with an amendment to establish a strong role for the MOF in internal audit and to provide for international best practices in the planning, conducting and reporting of internal audits.

- Approve the State Law on Financial Control with the amendments (as recommended in the World Bank's CFAA) to remove GCC oversight responsibilities related to internal audit, remove any external or internal auditor involvement in ex ante expenditure controls, assign the MOF responsibility for the development of internal financial controls, and give internal audit the role of independent advisor on the effectiveness of these controls.

- Approve amendments to the BSL that would include a definition of internal control and the role and scope of internal audit; mandatory use of international auditing standards; and a requirement that the MOF monitor performance of internal audit units across the government.

Once a consistent, coordinated legal basis for financial control exists, supporting policies and guidelines will be required, and additional resources will be needed for staffing and training of new internal auditors. Strong high-level support from the government will be required to successfully implement this reform.

52. **The effectiveness of the external audit institution should be improved as follows:**

- The Law on the Georgian Chamber of Control should be amended to restrict its duties to those of a modern supreme audit institution. In particular the GCC should not have a role in enforcement, internal audit, or collection of fines or penalties. Its primary activities should be to undertake regularity audits of budget institutions and NFPEs, certify the final accounts, and report its findings to parliament with appropriate recommendations. Audit plans should be based on an assessment of fiduciary risk, and the executive branch should not be able to intervene in these plans.

- Mechanisms are needed to ensure systematic follow-up by parliament and the executive on the recommendations of the GCC. One possibility is the creation of a Public Accounts Committee in parliament that is assigned the function of investigating and monitoring responses to the external audit recommendations. The GCC should also monitor the government's implementation of its recommendations.

- The incentives of the GCC would be improved by abolishing the earmarking of resources collected in connection with their audit activities. In light of the loss of earmarked resources, one mechanism to consider that could allow a more secure budget for external audit activities would be giving a legislative committee the responsibility for proposing the GCC's annual budget.

- Finally, the GCC will need to develop new procedures, such as documentation of errors and irregularities, in order to support the certification of the final accounts as required in the new BSL.

53. **Current efforts to reduce corruption would be supported by simplifying the Tax Code and reducing discretion in customs administration.** Simpler legislation and less discretion will reduce confusion and make tax assessments a more automatic process. Changes to a new simplified Tax Code should be resisted to prevent the re-emergence of this problem. However, eliminating entrenched problems in tax administration will require a strong political commitment to prosecute all cases appropriately. The tax and customs administration should have legal protection against political interference.

54. **Relations with subnational governments need clarification.** Negotiated transfers to local governments that are based on protected items tend to be non-transparent. The authorities should consider developing a formula-based transfer policy that takes into account a clear measure of need based on population, local resources and other characteristics. The distribution of shared taxes should also be subject to clear criteria, and requirements to ensure the timely transfer of shared revenues to the district and local governments are needed. The practice of reducing local taxes as an incentive to pay central government taxes should also be ended.

55. **Better monitoring of the large number of NFPEs is required so that the costs of a wide range of QFAs can be made more transparent.** These QFAs disguise subsidies given through below market pricing and a government policy, intended apparently to safeguard employment, that permits inefficient and unprofitable NFPEs to continue in operation by spreading their losses through inter-enterprise arrears. These arrears undermine the healthier enterprises and negatively affect government revenues as large tax arrears develop when firms claim they have no cash due to inter-enterprise arrears or barter transactions. Continuing current efforts to investigate and liquidate the most unprofitable NFPEs and to privatize the healthier ones will better clarify the roles of government and the private sector. In addition, the present initiative to contract external audits of the more important NFPEs should be continued and expanded to make their operations more transparent. In particular, efforts are needed to investigate, quantify, and report on the costs of QFAs. The publication of these costs could garner more support for their eventual elimination. Finally, the MOF and NBG should consider putting their relations on market terms to improve the transparency of government operations. The MOF should pay the NBG for its services and pay the market rate of interest on its loans from the NBG; and the NBG should pay interest on all government accounts.

56. **The capacity for fiscal analysis in the MOF should be strengthened to enhance the quality and transparency of fiscal decisions.** The public will be better informed when the explanatory note and appendices are published with the annual budget. As the capacity of the MOF improves, the budget documentation should include the following additional information:

- Medium term budget estimates including information on the assumptions made for their estimation,
- Separate cost estimates of new and existing policies,
- Budgeted as well as actual outturn for previous years, as well as an analysis of deviations.
- A statement on fiscal sustainability that includes both data on, and analysis of, public debt,
- An analysis of risks to the achievement of budget targets, including the use of sensitivity analysis to evaluate the impact on the budget of a change in key macroeconomic assumptions,
- A statement on contingent liabilities including some discussion or analysis of the probability of any guaranteed loan defaults and other possible contingencies during the budget year,
- A statement on tax expenditures with estimates of revenue foregone from the most significant tax exemptions, and
- An appendix showing the budgets of at least the most significant NFPEs and nonmarket NPIs. Their audited financial statements should also be published. Gradually budget coverage and treasury reporting should be expanded to include nonmarket NPIs.

57**.** **The transparency of government statistics should be strengthened by joining the GDDS.** The General Data Dissemination System (GDDS), introduced by the IMF in 1997, provides a guidance in the provision to the public of comprehensive, timely, accessible, and reliable economic, financial, and socio-demographic data.