NEWSLETTER
Issue No. 14 | January - February 2017

Fiscal policy after the parliamentary elections

Economic reforms announced in the run-up to the parliamentary elections in October 2016 raised concerns about whether Georgia was departing from its path of prudent fiscal policy. A reform of the corporate profit tax and increased infrastructure investment were driving expectations of a 6% of GDP budget deficit in 2017, endangering Georgia's macroeconomic stability and its reputation with investors.

After winning the elections, the "Georgian Dream" coalition has undertaken significant efforts towards keeping the budget deficit at bay. The deficit in 2017 is now expected to remain at around 4% of GDP and to decrease in the coming years. This was achieved by increasing excises on goods such as fuel, cars, tobacco and gas and by further savings in administration expenditures. Immediate worries about Georgia's economic stability are hence allayed. At the same time it is important to monitor the economic and the fiscal effect of the new fiscal measures in the coming years.

Economic reform plan for the elections

In the parliamentary elections in Georgia at the end of last year, the governing "Georgian Dream" coalition won a clear victory. Before the elections, Prime Minister Giorgi Kvirikashvili had announced a "four points" plan for economic reforms:

- A fundamental reform of the corporate profit tax, only taxing dividends instead of profits
- Almost USD 3.5 bn investment in infrastructure for regional development until 2020
- A one-stop-shop "business house" to serve all public administration needs of companies
- Reform of the (vocational) education system according to the German model

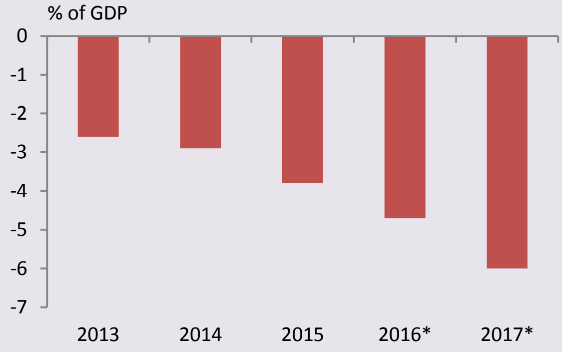
Some elements of this plan were already implemented before the election. The reform of the corporate profit tax according to the "Estonian model", which aims at simplification of procedures and increasing investments by taxing disbursed profits (dividends) instead of retained profits, was already signed into law in May 2016, but application has commenced in January 2017.

Impact on budget was seen with concern

Although most elements of the reform plan were seen favourably in the policy community, the budget impact of the fiscal measures raised concern. The impact of the corporate profit tax reform alone is estimated at around GEL 700 m in 2017, corresponding to 1.9% of GDP or 8% of 2016 tax revenues.

In the October 2016 "Regional Economic Outlook", where the announced fiscal plans were taken into account, the IMF expected the budget deficit to deteriorate from 2016 onwards, unless significant efforts would be undertaken towards a sustainable fiscal policy. The impact of announced policy changes led to an expectation of a deficit of 4.7% of GDP in 2016, rising up to 6% in 2017, significantly above the ceiling of 3% enshrined in the "Economic Liberty Act", Georgia's deficit limit with constitutional status.

Budget deficit forecast for 2016/2017 before elections



*Source: IMF, *Forecast from October 2016*

Risk of twin deficits and for Georgia's reputation

Such a widening of the public deficit would have had potentially harmful consequences. Firstly, Georgia would have entered a dangerous situation of "twin deficits": The combination of large government budget and current account deficits implies extensive needs for financing from abroad, which can threaten the sustainability of external debt. As a large expansion of the budget deficit endangers support from international institutions such as the IMF and the World Bank, this threat was not to be taken lightly.

Secondly, Georgia's reputation was at stake. Over the past years, Georgia has acquired a reputation for strong institutions and cautious policies with investors, leading to a good investment climate and strong inflows of foreign direct investment (FDI). A loss of investor confidence could have led to a reduction in investment, impairing the growth prospects of Georgia and worsening the impact of the current account deficit, which is largely financed by FDI at present.

Return to a sustainable fiscal policy after elections

However, after the elections, concern about the budget deficit development has been allayed. Turnout of the 2016 budget was better than anticipated and the final budget deficit for 2016 was at 4.2% of GDP (as measured by international institutions). Furthermore, the Georgian government appears to take on the challenge of maintaining a solid government budget. The government's budget for 2017 was passed, envisaging a deficit of 4% of GDP. This is to be achieved by two means:

- A substantial increase in excises
- Savings in (local) administration expenditures

Excises for fuel, cars, tobacco and gas have been significantly increased. The magnitude of the increases ranges between slightly more than 50% for cigarettes and 167% for diesel fuel. From the higher excises alone, the government expects additional revenues of ca. GEL 495 m, almost fully offsetting the fiscal effect of the corporate profit tax reform. Furthermore, a property tax on cars is expected to yield additional revenues of around GEL 150 m. Savings in administration expenditures are expected to yield around GEL 70 m in 2017, with further savings planned for future years.

Fiscal plans met with approval

Although the deficit has not been reduced to the previous level of below 2% of GDP, the measures towards a sustainable fiscal policy have been met with approval by observers, including most donor organisations. As real GDP growth is expected to be at around 4% this year, the current level of the deficit appears compatible with a sustainable trajectory of the public debt stock.

The future path of the budget is not fully certain yet. The announced infrastructure investment might require additional expenditures, although the announced new investment of USD 4 bn most likely includes co-financing by donor organisations or the private sector. Whether further savings in public administration are feasible without compromising administration quality and whether the property tax increase yields the expected revenue remains to be seen. Another question is how much revenue will arise from the new corporate tax on dividends in future years. And a pension reform towards a partly capital-funded system might also require expenditures. Nevertheless, the government has succeeded in reinstalling confidence in their commitment to prudent fiscal policy.

Effectiveness of economic reforms

What remains to be seen after the return to a sustainable fiscal policy is, whether the reform measures necessitating the consolidation will be successful. Firstly, evidence on the effectiveness of a taxation of corporate dividends instead of profits (the so-called "Estonian model") is not fully conclusive. Whether administration will be easier and increased liquidity of companies will trigger more investment is to be seen in the years to come and will be relevant also for Ukraine, where such a reform is under discussion right now.

Infrastructure spending for Georgia can definitively boost growth rates, but it should be ensured that regional development objectives do not override economic growth objectives in allocation decisions. Finally, a comprehensive reform of the education system, especially the vocational education system, appears very important for Georgia's future growth as there is a clear need for qualified workers in areas such as construction. It should be ensured, that the German model, which relies heavily on training in companies, is aptly modified to suit the Georgian point of departure.

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