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FAST TRACK BRIEF

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Georgia Country Assistance Evaluation, 1993-2007

- Georgia's development path was highly uneven after the country gained independence in 1991. Civil war, secessionist movements, and economic crises resulted in a sharp and protracted fall in output and hyperinflation in the immediate post-independence years. In 1994-96 the country implemented a successful stabilization program, reining in hyperinflation and restoring growth. But in subsequent years the government failed to overcome problems arising notably from economic mismanagement and widespread corruption, leading to poor public services, a deepening energy crisis, and political and economic uncertainty. After the November 2003 Rose Revolution, the new government executed an ambitious reform program that quickly produced results: rapid economic growth, improved governance, and better living conditions.
- During 1994-2007, total IDA lending commitments to Georgia amounted to $940 million (49 credits). These focused on four broad areas, or "pillars": *macroeconomic stabilization and public sector reform; governance; private sector development and growth; and human, social, and sustainable development*. Analytic and advisory activities were relevant, of high quality, and well-connected to the lending program. Three distinct sub-periods are evident in Georgia's development program: (i) *1994-97, characterized by macroeconomic stabilization and resumption of growth; (ii)1998-2003, when the early gains in restoring macroeconomic stability were marred by widespread corruption, a poor business climate, and weak implementation capacity; and (iii) 2004-07, a period of reforms that resulted in faster economic growth, better living conditions, and an improved business climate*. During the initial years (1994-97) the Bank's assistance was relevant and well-targeted and contributed to stabilizing the economy. The approach in subsequent years (1998-2003) of piecemeal lending in many sectors stretched IDA resources and weakened interventions in important areas. The Bank scaled down its engagement in 2002-03 as the governance environment continued to deteriorate, but then quickly boosted its support after the reformist government took office in 2004; thereafter, Bank support to the country's development agenda was generally effective. The overall outcome of Bank assistance in Georgia over the 15-year review period is rated *moderately satisfactory* (an aggregate rating across the four pillars over all three sub-periods).
- With Georgia now on the path to IDA graduation and becoming eligible for IBRD borrowing, the challenge for the Bank is to sustain a strong partnership with an emerging middle-income country. This will require keeping flexibility to respond to client demand in the definition of its program of lending and analytical and advisory services, with a focus on its established areas of expertise that also have a direct bearing on Georgia's development challenge: sustaining growth while ensuring its fruits are more equitably distributed.

Country Background

After gaining independence from the Soviet Union in 1991, Georgia followed a development path that saw many ups and downs. An initial period of high expectations—as Georgia was among the most prosperous and strategically located parts of the Soviet Union—was followed by the catastrophic lows of fratricidal civil war, secessionist movements, economic destruction, and an inflow of hundreds of thousands of refugees (1992-94). Between 1989 and 1994 GDP fell by almost three-quarters, annual inflation reached 15,600

percent, and industrial output fell by more than half. Nevertheless, after implementing a stabilization program in the mid-1990s, the country showed signs of recovery: hyperinflation disappeared, and growth resumed—only to start sliding downward again toward the end of the decade. The government failed to overcome problems associated with economic mismanagement, crony capitalism, and widespread corruption and was slowly losing control over the country. Daily life was marred by corruption, poor public services, a severe energy crisis, and political and economic uncertainty. Yet, against all odds, the country rebounded in a spectacular manner after the November 2003 Rose Revolution that brought to power a team of reformers. The new government rapidly executed an ambitious reform program that quickly produced results. In 2007 Georgia's GDP grew 12 percent, and GNI per capita was about $1,920 (Atlas method). This last chapter took a sudden turn in November 2007, when a political crisis triggered early presidential elections (January 2008). While the immediate impact on growth and reform appears to have been marginal, the longer-term consequences of the protracted political confrontation remain unclear, and progress will depend on the country's ability to resolve it.

World Bank Support

The World Bank's experience in Georgia closely followed the successes and failures of the country's development. Three distinct sub-periods can be identified, based on the timing of the Bank's country strategies, changes in government policy course, and exogenous factors: 1994-97, 1998-2003, and 2004-07.

Georgia joined the Bank in 1992. Political stabilization in late 1993-early 1994 opened the way for launching an assistance program. All three of the Bank's country strategies during the review period (1995, 1997, and 2005) had similar objectives and sought to achieve results in four areas, or pillars: macroeconomic stabilization and public sector reform; governance; private sector development and growth; and human and social development. Overall, the objectives were relevant in that they tried to address the main problems affecting Georgia. The Bank provided about 22 percent of total donor assistance, with total IDA lending commitments of $940 million over the review period. The lending program covered many areas: economic policy, public sector governance, transport, energy, health, education, urban development, agriculture, social protection, private sector development, environmental protection, and cultural heritage and tourism. The Bank's analytic and advisory activities (AAA) were generally relevant, of high quality, and well-connected with the lending program.

Key Findings of the Evaluation

Pillar I: Macroeconomic Stabilization and Public Sector Reform: The outcome of the Bank's program for Pillar I over the entire review period is rated *moderately satisfactory*. Bank support was effective early on (1994-97). The stabilization program produced the desired results: hyperinflation was eliminated and the economy averaged an annual growth rate of about 8 percent. As a result of the initial success, however, the pressure and urgency to reform abated during 1998-2003. The macroeconomic situation remained stable, but GDP growth slowed to about 5 percent per year. Government revenues fell sharply due to poor tax collection and a slowdown in privatization. In the period after the Rose Revolution (2004-07), two important results stand out: the increase in tax revenues, from 14.1 percent of GDP in 2003 to 24.9 in 2007, and the rapid privatization of large companies that brought in revenues equivalent to about 10 percent of GDP. Growth recovered and capital inflows increased significantly, the latter mirrored in a widening of the current account deficit and increased pressure on domestic prices.

Pillar II: Governance: The overall outcome of the Bank's program for Pillar II for the entire review period is rated *moderately unsatisfactory*. The Bank sought to help improve governance by targeting three areas: anti-corruption, public financial management, and judicial reform. Initially, Bank support focused mainly on public financial management, with some early positive results, notably better tax collection. However, enforcement of newly-enacted reforms was weak, and the momentum for further reform dwindled. Tax collection remained low until 2004. Corruption was rampant. Bank-financed rehabilitation of court infrastructure and training of judges did not translate into improved public trust and judicial independence. The situation turned around following the 2004 change in government. Revenue collection increased and arrears in pensions and salaries were cleared. A successful anticorruption campaign was implemented, leading to a significant amelioration in corruption perception indices. Progress in the specific areas of judicial reform supported by the Bank was less evident, and judicial independence remains a serious concern.

Pillar III: Private Sector Development and Growth: The overall outcome of the Bank program for Pillar III over the entire review period is rated *moderately satisfactory*. Bank assistance was effective, except during 1998-2003. During 1994-97 almost all small and medium enterprises were privatized, banking sector assets grew, a Central Bank Law was adopted, and privatization and registration of land advanced. This progress notwithstanding, unreliable energy supply and limited access to credit continued to constrain private sector development. During 1998-2003, many aspects of the business environment continued to deteriorate. Large-scale privatization virtually stopped. The

electricity sector teetered on the brink of collapse owing to high technical and commercial losses, low tariff collection rates, and widespread corruption. Access to credit continued to be limited. Growth, productivity, and exports in agriculture, the largest sector of the economy, were stagnant. Again, a turnaround is evident after 2004. Privatization of state-owned enterprises proceeded rapidly. The business climate improved significantly. Electricity supply improved and is now close to uninterrupted. Road conditions improved, driving transportation costs down. There are, of course, continuing challenges: despite some growth in exports, unresolved issues remain in agriculture; in particular, access to credit for farmers and sustainability of the irrigation system. And despite the major improvements in the business climate more generally, protection of private property rights remains in need of strengthening.

Pillar IV: Human, Social, and Sustainable Development: The outcome of the Bank program for Pillar IV over the entire review period is rated *moderately satisfactory*. During 1994-97, the decline in living standards and rise in poverty slowed but were not reversed. Among other difficulties, the Government did not succeed in collecting enough revenues and was having difficulty meeting its social transfer obligations. Poverty increased during 1998-2003, affecting about 50 percent of the population. Health indicators and the quality of health services also did not improve during that period. The sector was underfinanced and inefficiencies were rampant. In education, corruption was widespread, and bribes (e.g., to circumvent entrance requirements) were a common practice, especially in higher education. Public spending on the social sectors in general remained low. The Bank's work at the municipal level to help improve basic infrastructure and quality of local services resulted in positive gains for communities, although their sustainability was an issue due to financial insolvency at the local level. Once again, there was a significant turnaround after 2004. Poverty declined, albeit slowly, and a well-designed social assistance targeting mechanism was introduced. Health status indicators generally remained stagnant, but steps were taken to increase efficiency in the sector. Improvements also took place in education. A new, transparent system of university entrance exams was introduced, virtually eliminating corruption. Access to municipal services and local capacity to manage them improved in several municipalities.

To summarize, Bank lending was relevant and well-targeted in the initial period of stabilization (1994-97) and, combined with good-quality policy advice, played an important role in the successful stabilization of the economy. The later approach of piecemeal lending in virtually all sectors (1998-2003) stretched the scarce IDA resources, weakening interventions in important areas. The situation changed after the reformist government took control in 2004. The Bank quickly recognized the potential for change and extended its financial support and advisory services to the new government. With few exceptions, the Bank's lending and AAA work was timely, well-targeted, and effective. Overall, the outcome of World Bank support to Georgia—aggregating all four pillars over the three sub-periods—is rated ***moderately satisfactory***.

Lessons

Several lessons (conclusions with potentially broader applicability to other country programs) emerge from the review of the Bank's Georgia program since its inception in the early nineties. In the main, these lessons confirm extant wisdom, although one—on the potential for rapid successes in addressing corruption—is more unique to the Bank's experience in Georgia.

In the absence of government commitment, external support cannot buy reforms and may, in fact, have the perverse effect of delaying them. The Bank overestimated the government's willingness to reform in the late 1990s and continued lending despite clear indications of spreading corruption and declining central government capacity. Its piecemeal lending in a large number of sectors may have obscured major issues, but more importantly its continued support may have strengthened the capacity to postpone necessary reforms.

It is possible to address successfully even the most pervasive and entrenched corruption when the government has the public mandate, political will, and capacity to do so. Georgia's experience demonstrates convincingly that results–notably in the form of more favorable perceptions—can be achieved quickly. External support can help, but is not decisive. Supporting specially-designated anti-corruption structures (commissions, councils, etc.) is not an institutional prerequisite for a successful anti-corruption campaign. Judicial independence is a political issue that calls for political remedies, which are generally outside the Bank's mandate, and upgrading hardware is of little use if the objective is judicial independence.

Small-scale investments, combined with institution building at the local level, can produce results even in the presence of poor governance and limited central government capacity. In Georgia, the Municipal Development Fund (MDF) was able to continue its activities and achieve tangible gains when the central government was all but paralyzed.

Recommendations

Georgia has seen impressive gains under very difficult conditions in recent years, and is today well-placed to continue on a path of development towards greater prosperity. Nevertheless, the country's development

agenda is not without its challenges, notably the dual challenge of sustaining economic growth while also ensuring its greater inclusiveness in order to reduce poverty (especially in the rural areas) and reverse widening inequality. The agenda is a complex one that calls for attention to many areas, including continued attention to areas—such as governance and private sector development—where the country has made great strides in recent years.

As Georgia moves closer to "graduation" from IDA and officially becomes eligible for IBRD financing beginning in FY09, the challenge for the Bank is to adapt its role as a development partner to the country. To a large extent, the required shift has already been taking place in the past few years, against a backdrop of steady erosion in IDA's traditional place as a primary source of budget and balance of payments financing, towards a middle-income country partnership with the Government firmly in the driver's seat and client demand driving the Bank's program.

Looking forward, IEG has the following recommendations:

General. That the Bank continue consolidating and codifying the demand-driven nature of its program, with the choice of its lending and AAA activities kept flexible in order to respond to client demand, subject to two broad criteria—which are unlikely to be confining—on the areas of focus. The first is that these should be central to Georgia's development agenda, specifically the dual challenge of sustaining economic growth while ensuring that the fruits of growth are more equitably distributed, particularly in favor of the poor. The second is that the areas of focus should be within the Bank's established fields of expertise, such that it can realistically mobilize the skills needed to respond to client demand. Beyond this, the Bank will need to ensure that its lending and AAA remain selective. The client perspective would ensure complementarity with other development partner support, although the country may initially require assistance with the relatively complex task of coordination among development partners. Finally, the Bank should consider joint work that involves other World Bank Group institutions—IFC and MIGA—where such work can provide a more complete set of services to the client.

Lending: Within the areas of focus identified by the client, given Georgia's relatively advanced state of development, lending operations—either in the form of development policy lending or project lending—would best be geared towards building or strengthening systems, institutions, and associated technical capacity (i.e., predominantly "software"), including, for example, monitoring and evaluation (M&E) systems in order to enhance transparency and accountability. This need not, of course, rule out investment projects that are predominantly geared towards physical investment, particularly where these have "demonstration" value, potential for scaling up, and/or impact on poverty or employment creation among low-income groups. To support institution-building, the Bank should ensure that new investment operations do not lead to the establishment of additional *ad hoc* project implementation units, but rather help the relevant government structures take on project management responsibilities.

Analytical and Advisory Activities: The selection of formal AAA, whether self-standing or complementary to (planned) lending, should also be driven by client demand. Given the strong demand for policy advice, the selection of AAA will likely include topics on which the client country authorities face imminent decisions and consider alternatives when making recommendations. In addition, the Bank would be well-advised to maintain some "space" in its informal AAA program in order to maintain and update its knowledge or keep a watching brief on other areas which, while central to Georgia's development agenda, may not immediately be covered in lending or formal AAA.

About Fast Track Briefs

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