

The Institutional Characteristics of Government Debt Management and Associated Challenges in Georgia

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Abstract: The paper summarizes certain institutional characteristics of the government debt management process in Georgia. The research aims to identify potential areas for improvement that should support the effective management of public finances and enhance government effectiveness overall. By nature, the paper is primarily based on qualitative research methods, predominantly centered around the analysis of international assessments and the legislative framework. The research reveals that there are some more or less significant challenges in the country that need to be addressed by policymakers.

Keywords: government debt; institutional environment; legislation

1. Introduction

By one of the most formal definitions, government debt refers to the financial obligations incurred by a government to residents and/or non-residents of the country [6]. According to the International Monetary Fund's databases, there has been virtually no sovereign state in recent decades whose government has been without debt [35]. In a broad sense, government debt includes the financial obligations of the government sector, and debt accumulation mainly depends on macroeconomic trends and political decisions. On the other hand, under democratic conditions, governments have a strong tendency toward deficit spending, which ultimately results in debt accumulation. Within the realm of public finance, there is a significant emphasis on establishing an effective debt management mechanism, which delineates the parameters of fiscal policy [4]. The importance of an effective government debt management mechanism is underscored by the fact that its absence is often associated with a heightened rate of debt growth. Numerous studies show that a high and increasing level of government debt is associated with adverse effects on economic growth in the medium and long term. According to Reinhart and Rogoff [18], in developing countries, a debt-to-GDP ratio exceeding 60% significantly impedes the nation's investment activity and economic growth. This threshold is relatively high for developed countries. Pattillo, Poirson, and Ricci [19], drawing on data from 93 countries, showed that the impact of government debt on investment activity and economic growth becomes sharply negative when the debt-to-GDP ratio reaches 35–40 percent. In contrast, Schclarek [20], analyzing data from 59 countries, revealed that government debt, irrespective of its magnitude, exerts a detrimental influence on investment and economic growth.

It is noteworthy that the degree of influence of government debt on economic growth exhibits significant heterogeneity among countries [13, 14]. Some studies attribute this heterogeneity to differences in the macroeconomic, financial, and institutional characteristics among countries. For instance, Chudik et al. [2] suggest that the impact varies between countries due to disparities in their financial systems, historical patterns of debt service, and political systems. Kourtellis argues that the effect of government debt on economic growth is contingent upon a country's democratic institutions. Specifically, in the presence of a weak institutional environment, a negative relationship exists between the mentioned indicators, whereas in the conditions of a robust institutional environment, this relationship dissipates [9].

The study by Teles and Mussolini, which focuses on the productivity of government spending, is closely tied to the institutional environment. The authors conducted an empirical analysis using panel data from 74 countries and found that an increase in government debt can stimulate economic growth. However, a prerequisite for this is the existence of a healthy fiscal situation where the increase in debt is associated with a simultaneous increase in productive government spending [23].

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From this perspective, the study underscores the necessity for the effective utilization of credit resources. Many other researchers emphasize the critical importance of a well-developed institutional environment [10, 15].

These views align with those of researcher-economists, who argue that a generally healthy institutional environment is one of the key factors influencing a country's economic situation [1, 8, 16].

Considering the aforementioned reasons, the presence of a proper debt management mechanism is especially crucial for developing countries, primarily due to their unsustainable macro-fiscal environment [24] and/or relatively high risks of corruption [21].

For these reasons, almost all countries have the appropriate legal environment that, on the one hand, ensures the maintenance of fiscal discipline by limiting debt growth and, on the other hand, creates the institutional basis for managing the accumulated debt. Given the relevance of the issue, the purpose of this research is to study the formal institutional characteristics in Georgia from the perspective of government debt management. Achieving this goal serves the timely identification of existing shortcomings in the country in terms of debt management, the elimination of which should potentially contribute to the effectiveness of the country's fiscal policy.

2. Materials and Methods

The research, due to its specificity, is mostly based on the methods of qualitative and comparative analysis. It also uses some statistical analysis methods when analyzing the effectiveness of fiscal rules in Georgia. The article discusses some internationally recognized evaluations related to debt management. Specifically, the results from the last reports of the Public Expenditure and Financial Accountability (PEFA) assessment [26, 27] and the Debt Management Performance Assessment (DeMPA) [25]. These two reports jointly evaluate the design and effectiveness of many aspects of the government debt management framework. Additionally, the research goes deeply into the legislation in force in Georgia related to public debt. In particular, the "Law of Georgia on State Debt" [30], "Organic Law on Economic Freedom" [29], "Budget Code of Georgia" [31], and the decree of the Minister of Finance of Georgia N99, "On Approving Budget Classification" [32]. The quantitative data used in the paper comes from the Ministry of Finance of Georgia and the National Statistics Office of Georgia. The conclusion from the study is unique by nature and valuable for further research.

3. Results

Georgia, with a market-based economic system, has a relatively short history of 30 years. The institutional environment of fiscal policy and public finance arrangements is no exception from this history. Furthermore, the institutional design of debt management is one of the micro-components of the general institutional landscape of the country. Therefore, for the analysis of government debt and the comprehensive assessment of its potential impact on macroeconomic parameters, it is important to review the existing institutional environment to detect potential shortcomings.

Before delving into the details of debt management, it is pertinent to analyze the overall framework of fiscal policy and public finance management in the country. In this regard, our focus will be primarily on reviewing the information presented in the 2022 report of the assessment of 'Government Expenditure and Financial Accountability' [27]. This assessment holds particular significance as a diagnostic tool for public finance management, jointly developed by the European Commission, IMF, World Bank, and the governments of France, the UK, Sweden, and Switzerland, aimed at studying reforms implemented in individual countries. The criteria from this assessment collectively form a kind of benchmark for well-designed PFM.

PEFA evaluates the institutional design of public finance management based on 94 indicators categorized into seven groups. Within these groups, government debt management issues are encompassed under the 'Management of Assets and Liabilities' indicator. The evaluation employs a four-point system (A, B, C, and D), where an 'A' indicates the best result while a 'D' indicates the worst. These scores can be equated with numerical scores: A = 4, B = 3, C = 2, and D = 1, to produce comparable statistics.

In Georgia, PEFA assessments were conducted at the central government level in 2013, 2018, and 2022 [33]. The results for 2022, along with the outcomes of the most recent evaluations in other participating countries, are summarized in Figure 1. Notably, the results indicate that Georgia holds an advanced position among the assessed countries in terms of the institutional design of public finance management. A particularly intriguing comparison lies with the ECA countries, predominantly comprising post-communist nations of the Soviet Union and Eastern Europe, which significantly share the same experiences with Georgia in forming a market economy.

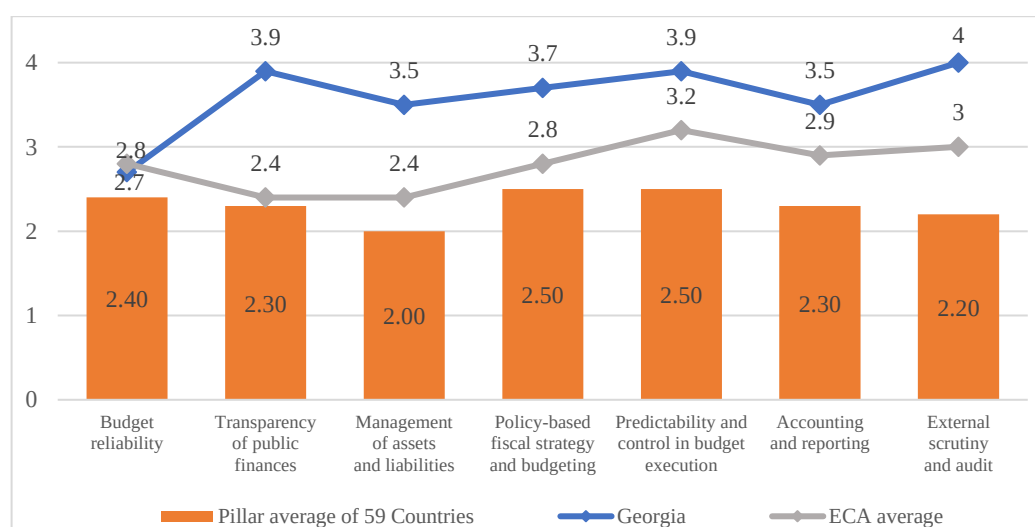


Figure 1. PEFA assessment scores for Georgia, ECA and total 59 countries participating in the program.
Source: Ministry of Finance of Georgia

In the ECA region, institutional design of "asset and liability management" (which also includes debt management issues), Georgia is considered one of the advanced countries with 3.5 points (the ECA countries' average is 2.4 points). A similar situation is true for almost all the other indicators.

It should be noted that, along with significant informative nature, the main shortcoming of PEFA is the fact that it is mainly focused on the assessment of the institutional environment design and pays less attention to its actual performance. Therefore, the positive score obtained in the mentioned assessment does not guarantee high efficiency in the institutional design of the public sector.

In addition to the PEFA assessment, which evaluates various aspects of public finance management, the "Debt Management Performance Assessment" (DeMPA) developed by the World Bank (WB) provides more in-depth and crucial information directly related to the effectiveness of the government debt management mechanism. It not only focuses on institutional design but also observes its performance. This assessment establishes a standard for the design of government debt management institutional framework and its performance.

The assessment was first conducted in Georgia in 2013 and then again in 2020 [25]. Despite significant progress in debt management during this period, certain challenges persisted. Notably, out of the 33 indicators determined by the methodology, 22 indicators received the lowest score, either 'D' or 'C,' in 2013, while the same scores were deserved by 15 indicators in 2020 (Figure 2).

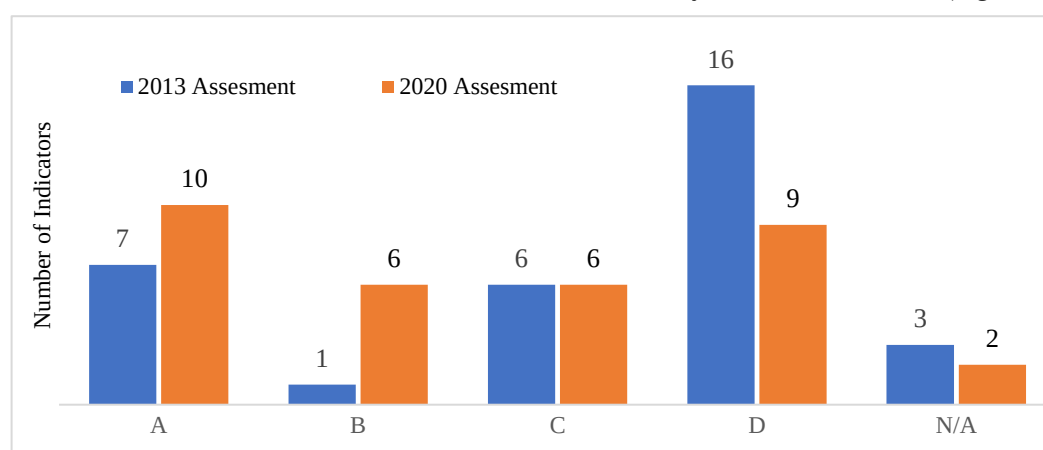


Figure 2. Distribution of the DeMPA scores for 2013 and 2020.
Source: World Bank

Despite progress in certain areas, according to DeMPA's 2020, several issues are still challenging:

- The process and procedures of on-lending;

- Low effectiveness of the debt management strategy document in the process of determining annual credit borrowing needs;
- Challenges in reporting against targets outlined in the debt management strategy.

It should be mentioned that significant changes were made in terms of the debt management process in 2021–2022, following the assessment. In particular, in 2021, for the first time since 2019, the government's debt management strategy was updated, outlining the main directions and targets of debt management. Additionally, based on the new regulation, the strategy must be updated annually. Considering the changes, it is likely that as of the end of 2022, the DeMPA assessment indicators have improved compared to the previous assessment, although challenges persist.

Alongside the assessments based on the aforementioned methodologies, it is crucial to delve into the legal framework in Georgia relating to government debt management and the associated challenges. The legal framework is a vital component that determines the formal institutional design.

The formal institutional design of public sector debt management in Georgia, along with other indirectly connected regulatory acts, mainly relies on the "Law of Georgia on State Debt" [30], "Organic Law on Economic Freedom" [29], "Budget Code of Georgia" [31], and the decree of the Minister of Finance of Georgia N99 "On Approving Budget Classification" [32].

"The Law of Georgia on State Debt" [30] defines the concept of state debt, categorizing it into two major components: state domestic and state foreign debt (the foreign debt component also includes the debt of the National Bank's debt to the IMF). According to the law, credit resources mobilized in national currency by the Ministry of Finance on behalf of the state, or with the approval of the Ministry of Finance (including resources mobilized by issuing securities denominated in national currency), belong to the state domestic debt. State external debt includes credit resources mobilized in foreign convertible currency by the Ministry of Finance on behalf of the state or with the approval of the Ministry of Finance (including resources mobilized by issuing securities denominated in foreign convertible currency). The mentioned law assigns exclusive responsibility for the management of public debt to the Ministry of Finance of Georgia, a practice considered the best internationally by the IMF [6].

Issues related to government debt are also defined by the "Organic Law of Georgia on Economic Freedom." [29] The law determines the definition of government debt and the fiscal rules applicable in Georgia. In particular, the law defines government debt as follows:

Government debt	=	State debt defined by the "The Law of Georgia on Public Debt"	-	Debt of National Bank of Georgia to IMF	+	Debt of budgetary organizations
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Figure 3. Definition of Government debt in Georgian legislature.

Source: *Organic Law of Georgia on Economic Freedom*

It should be noted that from 2023, the debt of budgetary organizations includes the financial obligations of those state-owned enterprises, which were classified as a government sector based on the IMF's recommendation [34].

As for fiscal rules, two quantitative fiscal rules are defined by the law. In particular:

1. **Debt Rule** - The ratio of (Government debt + PPP)/GDP shall not be more than 60%;
2. **Budget Balance Rule** - The ratio of the consolidated budget deficit/GDP shall not be more than 3%.

The existence of mechanisms for deviating from fiscal rules is one of the crucial parts of anti-crisis policy in many countries. However, for the credibility of fiscal rules, it is important that deviations occur only in necessary situations and are fully explained by these situations [11].

Quantitative fiscal rules determined by organic law align with the practices observed in many other countries. These rules include the so-called "debt ceiling" used as a medium-term fiscal sustainability indicator and the budget balance limit as an operational indicator for planning fiscal policy at the operational level [3]. Furthermore, the limits established by the fiscal rules are in accordance with those defined by the Maastricht Treaty in the European Union.

Adherence to fiscal rules plays a crucial role in promoting a stable economic situation in any country. Consequently, it is essential to assess the current situation in Georgia in this context. The comparative analysis of the limits set by law and corresponding factual figures reveals that Georgia falls within the group of countries exhibiting high fiscal discipline. Specifically, over the ten-year period of the fiscal rules' existence, the debt rule ratio exceeded the limit only once, in 2020. However, the deviation occurred in compliance with the exit clause defined by Article 7 of the organic law (Figure 4 (a)) and the indicator returned within the limits at a fairly fast pace and created a significant "fiscal space" for the state's anti-crisis response.

Additionally, kernel density estimation methodology is applied to estimate the distribution of the frequency of deviations from the limits (Figure 4 (b)). Deviations are calculated in the following manner:

$$\text{Deviation from the limit in year } t = \text{Factual figure of the indicator for year } t - \text{Limit set by the law}$$

For the calculation of deviations, the first-generation fiscal rules and corresponding indicators were applied to the 2013–2018 period, while the current fiscal rules and corresponding indicators were used for the 2019–2022 period. The analysis indicates that debt rule ratio over the considered period was more than 20 percentage points below the limit.

It is noteworthy that a similar analysis, using the same methodology, was conducted previously [22]. However, the mentioned analysis has covered the 2011–2021 period, while this study covers the 2013–2022 period. The decision to take 2013 as a starting point is more relevant, considering the fact that the first-generation fiscal rules were enacted this year.

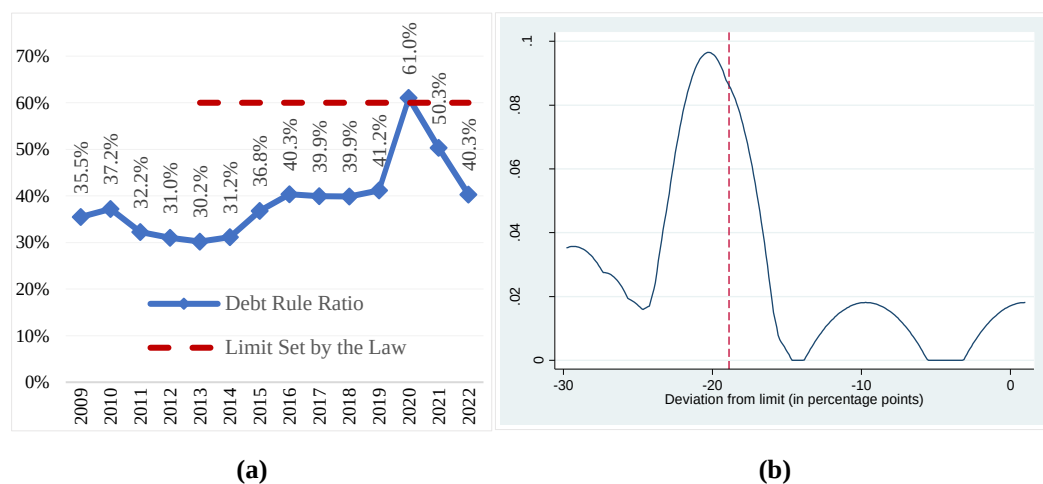


Figure 4. (a) Compliance of debt rule ratio to the limit set by the Organic Law of Georgia on Economic Freedom; **(b)** kernel density estimation for deviations.

Source: Ministry of Finance of Georgia and authors calculation

A similar conclusion can be drawn regarding the behavior of the budget balance rule over the last decade. However, it should be mentioned that unlike the debt rule ratio, this indicator is characterized by a longer and larger deviation from the limit. Nevertheless, the aforementioned dynamics of deviations, like the debt rule, comply with the exit clause defined by the organic law (Figure 5 (a)).

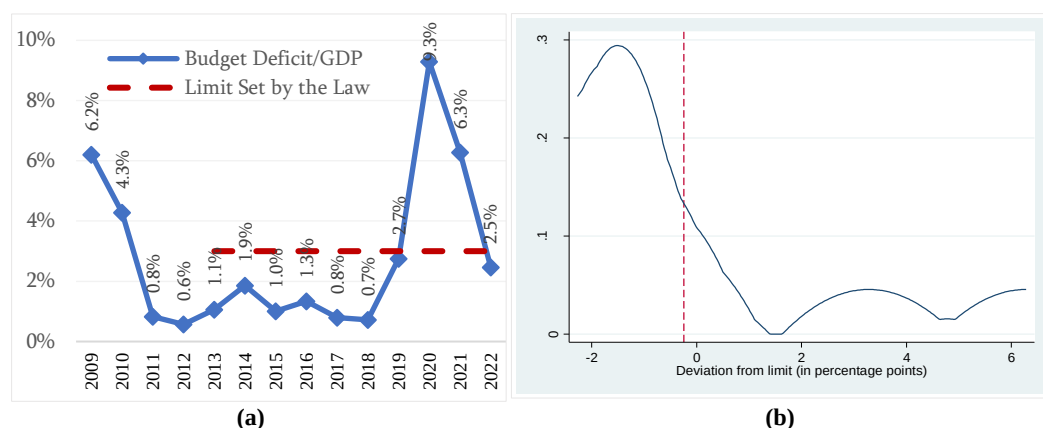


Figure 5. (a) Compliance of budget balance rule ratio to the limit set by the Organic Law of Georgia on Economic Freedom; **(b)** kernel density estimation for deviations.

Source: Ministry of Finance of Georgia and authors calculation

In contradistinction to the debt rule ratio, the mean density of deviations in the budget balance demonstrates a negative tendency, albeit approaching zero (Figure 5 (b)).

To summarize, it can be asserted that according to current practice, performance of the fiscal rules in Georgia is significantly better than the global average tendency discussed by Davudi et al. [3].

In addition to the Organic Law of Georgia "On Economic Freedom," the "Budget Code of Georgia" [31], and the decree of the Minister of Finance of Georgia N99 "On Approving Budget Classification" [32], it determines the institutional segmentation of the state and regulates the public finances management process, including state/government debt accounting and reporting issues in accordance with the principles of GFSM 2014 [5, 6].

Despite the fact that the existing institutional design in the country in terms of debt management is mostly in line with international best practices, analysis of the existing legal framework reveals certain challenges. In particular:

- 1) Georgia belongs to the group of countries that produce public finance statistics based on the GFSM 2014. Nevertheless, the criteria for classifying domestic and foreign debt in the "Law of Georgia on State Debt" are not in compliance with the "Public Sector Debt Statistics Guideline" developed by the IMF based on the GFSM 2014. In particular, the classification of debt into domestic and foreign components in Georgia is based on the currency of the debt denomination as mentioned above, while according to the mentioned guideline, it should be classified into domestic and foreign debt according to the residency of the creditor [5, 6].
- 2) Article 48 of the "Law of Georgia on State Debt" defines the various components of the debt, which until 2020 were recorded under the general name "historical debt" in the state domestic debt statistics, and its amount was estimated at 672 million GEL [34]. Despite the entry in the law, from 2020 on, the mentioned component is no longer recorded in the state and government debt statistics and, therefore, is not used for the calculation of the "debt rule" indicator either.
- 3) The legislative framework in Georgia, unlike other types of budgetary organizations, does not regulate the borrowing authority of those state-owned enterprises that were classified as general government sector in 2022. This fact, at least, creates a risk for debt sustainability.

4. Discussion

Historically, Georgia has been characterized by a low level of government debt, which to some extent indicates the high efficiency of the fiscal rules in force in the country. Nevertheless, there are certain shortcomings in the existing legislative environment in terms of government debt management that somewhat limit the full accounting and reporting of the debt. In order to overcome the mentioned shortcomings, it is important that the agencies responsible for debt management in Georgia ensure the full accounting of the debt in accordance with the current legislation, which will allow the stakeholders to use comprehensive and accurate information.

Additionally, taking into account the existing shortcomings, appropriate changes should be made to the existing legislation in Georgia, which will guarantee the accounting and reporting of government debt in accordance with internationally recognized best practices. In particular, the classification of government debt in the context of domestic and foreign debt should be done according to the residency of the creditor. In addition, the issue of borrowing authority for state-owned enterprises belonging to the general government sector should be regulated by the legislation.

Finally, agencies responsible for debt management should ensure full implementation of the recommendations outlined in the World Bank's Debt Management Performance Assessment.

Consideration of the mentioned issues will significantly support the preparation of comprehensive information regarding government debt and its usefulness for stakeholders.

It should be noted that in the paper, government debt management and its institutional issues were isolated from other macro-fiscal parameters. The logical continuation of the research is a discussion of the mentioned findings in relation to general fiscal policy efficiency.

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