Explanatory Note

“Georgia State Budget 2017”

a) General information about the law:

a.a) Main reason for adopting the law

Obligation in accordance with Article 93 of the Constitution of Georgia;

b) Objective of the Draft Law

Approval of the State Budget 2017 revenues and expenditures;

c) Essence of Draft Law

The draft law defines revenues and pending expenditure indicators for the year of 2017. State Budget 2017 entirely serves implementation of the Government Program “Freedom, Rapid Development, Prosperity”, which should ensure social protection of the population and economic development of the country. Maximally effective use of existing fiscal resources is significant for achievement of the activities and the results set by the 4-point reform action plan.

Economic growth rates had been significantly decreasing since 2014 in our region and economic decline was identified in certain cases. Notwithstanding the fact that Georgia is a leader in the region with regard to economic growth, the rate of economic growth is unsatisfactory. According to the assessment by International Financial Institutions (IFIs) significant positive change is not expected in future years. It follows that it would be impossible to achieve high economic growth rates, which is necessary for employment of our population and increase of their income and welfare in our country as well without radical changes. More investment is important for economic growth.

Georgia implemented a very significant change by income tax reform in order to expedite economic growth and promote private investments, which allows the private sector to channel the profit they gain to make investments and create more jobs instead of paying into taxes.

According to the research conducted by USAID this reform will accelerate the economic growth by around 1,5%.

In parallel, significant investment is planned to be made in the state infrastructure. These investments are focused on funding such infrastructure projects which will promote investments and economic activity of the private sector. In addition, the projects will have economic growth facilitating effects not only during their implementation but also after they are completed.

An unprecedented infrastructural projects are planned to be carried out throughout the country (800 km roads, bridges, tunes, airports, resort zones, etc.), which will facilitate improvement of economic condition of the Georgia's regions and the communities living in the regions through creating new jobs.

Further, in order to implement these reforms and ensure fiscal stability and fast economic development of the country it is necessary to obtain additional resources from the budget.

We plan to use all instruments available to us in order to fund the reforms, namely:

- Salary funds and administrative costs are planned to be reduced by 10 percent in almost all budgetary organizations. This reduction will create more than 100.0 mln savings compared with 2016.
- Part of budgetary programs will be reduced or abolished based on the analysis carried out in view of providing social and economic support;
- State-owned motor vehicle fleet will be limited and fuel expenses will be reduced;
- Some of budgetary organizations are planned to be abolished or their funding from the budget will be stopped. Among them:
    - ✓ Investment Agency will be abolished and its functions will be added to the Entrepreneurship Development Agency at the Ministry of Economy and Sustainable Development;
    - ✓ Insurance Supervision Agency will no longer be funded from the state budget;
    - ✓ Funding for the staff of State Security and Crisis Management Council will be significantly reduced;
    - ✓ The Economic Council staff will be abolished.

As a result of these reforms the current expenses of the consolidated budget for 2017-2020 will be reduced significantly, specifically:

26.5% of our economy (nominal GDP) comes on current expenses in the current year. We plan to reduce this percentage down to 21.5% at the same time social expenditures in nominal terms will be increased annually.

Salary costs will be reduced from 5.3% of GDP to 4.7% in 2017 and to 3.9% in 2020.

The current year's goods and services costs will be reduced from 4.3% to 3.2% in 2020.

In regard of increasing **revenues**, we have analyzed various options with the International Monetary Fund and arrived at a decision, which along with obtaining additional revenues, will assists us in reducing the current account deficit and consequently in improving structure of the economy.

The following is planned as of 2017:

- **Increase the excise duty on Tabaco products.** Namely, the excise will be increased by 0,60 GEL on cigarettes with filters, and by 0,3 GEL on cigarettes without filters which will increase revenues by 200,0 mln GEL considering that import will be partially decreased;

  Tobacco products is one of the largest import groups for Georgia. Its import leads to outflow of more than 100 mln USD from the country.

  It needs also to be noted that Georgia has international commitments in regard of taxation of Tabaco. Namely, according to the WHO Framework Convention on Tobacco Control, which Georgia accessed in 2006, its member counties are to implement such tax policies which will reduce consumption (UN, May 21 2003). On the other hand, under the Association Agreement Georgia undertook an obligation to adopt the Directive 2011/64/EU of June 21, 2011 on the Structure and Rates of Excise Duty Applied to Manufactured Tobacco. According to Article 10 of the Directive the overall excise duty on cigarettes in Georgia shall represent at least 60 % of the weighted average retail selling price of cigarettes in Georgia but no less than EUR 90 per 1 000 cigarettes.

  To achieve this condition (in order to approximate with the price defined by the Directive, the Ministry of Finance of Georgia has relevant estimates as to which periodicity and in what amount it shall increase the excise duty to achieve the budget stability so that it does not hamper activities of businesses operating in this area and to avoid potential threat of increased illegal trade in tobacco products. (The excise of duty on 1 package of cigarettes shall be at least EUR 90/50=1,8 (1,8X2.7=4.86 GEL). At present the rate of excise per package amounts to 1.35 on average.

  Consuming cigarettes in Georgia is a major public health issue in Georgia. According to the WHO surveys and those of other organizations at present 40% of the population of Georgia are smokers.

  Increasing the excise duty is a common practice all over the world to decrease tobacco consumption. In the recent years, the excise duty has been increased several times in Georgia, which lead to decrease of 5% tobacco consumption. According to our estimations applying new rates of the excise will decrease tobacco consumption by around 8-10%.

- **The excise duty on motor vehicles will be increased, which will increase revenues by 45,0 mln GEL along with partially decreased the import in 2017.**

  The net import (the difference between the import and re-export) of motor vehicles in Georgia has doubled in the recent years. In 2015 the net import (excluding re-export) increased by 21.4 % compared with the previous year and amounted to 288 mln USD. The increasing trend continues in 2016 as well.

  The present draft envisages exercise rates on motor vehicles by taking into consideration equal tax burden and the environmental policy which means that a higher tax burden will be introduced for old and environmentally harmful motor vehicles.

  It is to be noted that compared with its neighboring countries, the tax burden on import of motor vehicles is significantly lower, namely:

- ✓ In the Ukraine an average tax burden amounts to 50-90 percent of the customs value of a motor vehicle;
- ✓ In Azerbaijan an average tax burden amounts 20- 50 percent of the customs value of a motor vehicle;
- ✓ In the Eurasian Union countries motor vehicles are taxed by a single customs rate, which is 54% of the customs value but no less than EUR 2.5/cm.

Under the draft law the taxes on most of imported motor vehicles amounts to 8-10 percent of their price which is several times lower than the rates in the countries of our region notwithstanding increasing the rates.

- **The excise duty on oil products will be increased** which will increase revenues by more than 250,0 mln GEL in 2017 along with decreasing the import.

Given the situation that the civilized world makes attempts to obtain alternative energy sources and reduce dependency of the transportation on oil, the number of motor vehicles in Georgia increases from year to year and consequently the volume of oil products consumed and their import increases. The import of oil and oil products in Georgia amounted to approximately 660 bln USD in 2015.

Consumption of imported fuel in Georgia continuously increases. In the first 10 months in 2016 the import in real terms (in tons) increased by 35 percent compared with the relevant period in 2014. It means that pollution increased by 35% and traffic jams by 35%, etc.

This situation negatively affects the environment and hampers transportation in large cities, and impacts the health of citizens, especially that of children. Along with introducing various types of taxes on motor vehicles, the developed counties replace vehicles with gasoline engines with hybrid and electronic means of transportation.

Significant steps have been made in this regard in Georgia: the excise tax on hybrid cars was reduced by half and now it will be reduced by 60%, while no tax duty is applied on imported electronic cars.

Gasoline prices are significantly low in Georgia compared with the EU counties and even in its neighboring country Turkey. Therefore, often citizens with average income do not avoid purchasing used motor vehicles with high capacity engines, which eventually reflects on the environmental situation. By increasing the excise duty on gasoline the volume of gasoline consumed in the country will be decreased which will stimulate purchase of smaller, hybrid and electronic vehicles, that will subsequently positively impact the environmental condition in the country.

Main Macroeconomic Indicators

Current economic growth indicators of the country and forecast for the next year were considered when preparing the draft State Budget 2017. Detailed information regarding current economic trends is provided in the materials attached to the state budget (budget 2016 execution progress). Conservative approach was used in planning fiscal and macroeconomic indicators for the next year and real GDP growth rate and GDP deflator forecast is 4%. Real economic growth forecast is estimated at 6% for medium term period while GDP deflator is estimated at around 3.0%.

Based on the macroeconomic indicators nominal GDP of 2017 is GEL 35.9 billion and is forecasted to increase to GEL 45.2 billion by 2020.

With consideration of the macroeconomic forecasts tax revenue of the consolidated budget 2017 is GEL 9,540.0 mln, which is 26.6% of GDP.

State Budget Revenue

Revenue forecast of Georgia's state budget 2017 is GEL 11,457.2 mln, including:

- **Revenue – GEL 9 489,5 mln;**
  - Tax revenue – GEL 8 820,0 mln (24,6% of GDP), including:
    - Tax revenue forecast is estimated at GEL 2 570.0 mln, which is 7.1 percent of GDP;
    - Income tax is forecasted at GEL 681.0 mln, which is 1.8 percent of GDP (beginning 2017 only distributed profit will be taxed, which reduces revenue forecast in this category, it will be possible to collect income tax in the amount exceeding GEL 1 200.0 mln if the reform is not implemented);
    - VAT forecast is estimated at GEL 3 779.0 mln, which amounts to 10.5 percent of GDP;
    - Excise tax is forecasted at GEL 1 627.0 mln, which is 4.5 percent of GDP;
    - Import tax is forecasted at GEL 76.0 mln, which is 0.2 percent of GDP;
    - Other tax is forecasted at GEL 87.0 mln.
  - Grants – GEL 284.5 mln, including budget grants GEL 130.0 mln and investment grants (linked to expenditures) is GEL 154.5 mln.
  - Other revenue is GEL 385,0 mln, including GEL 40,0 mln, which is the amount of funds to be received from LEPLs as administrative expenses will be reduced at the LEPLs operating with their own income;
- Receipt of the funds in the form of reduction of **non-financial assets** is defined at GEL 90.0 mln;
- **Reduction of financial assets** is defined at GEL 85.0 mln;
- Receipt of the funds in the form of reduction of **liabilities** is defined at GEL 1 792.7 mln, including:
  - Long term beneficial credits received for financing investment projects - GEL 922.7 mln;

- Budget credits to be received from the World Bank and the European Union - GEL 470.0 mln;
- Net increase of internal state liabilities due to emission of treasury bills and treasury bonds and their redemption - GEL 400,0 mln;

State Budget Expenses

State Budget Allocations

State Budget Allocations is defined in the amount of GEL 11 415.5 mln, including: budget recourses amount to GEL 10 338.3 mln, grants amount to GEL 154.5 mln and credits amount to GEL 922.7 mln.

Total amount of state budget expenditures is GEL 9 121.2 mln, including:

- Compensation of employees - GEL 1 393.5 mln;
- Goods and services - GEL 1 144.3 mln;
- Interest - GEL 503.0 mln;
- Subsidies - GEL 419.9 mln;
- Grants - GEL 1 020.3 mln;
- Social security - GEL 3 313.2 mln;
- Other expenditures - GEL 1 327.0 mln.

Line item **Increase in Non-Financial Assets** is GEL 999.0 mln and **Increase in Financial Assets** is GEL 810.7 mln.

Reduction in Liabilities is GEL 526.2 mln including GEL 431.0 mln for payment of foreign state liabilities and GEL 95.2 mln for payment of internal state bills and bonds.

The allocations under the draft budget are distributed among the spending units as follows:

- Funding for the Ministry of Health is increased by GEL 253.8 mln compared to that of 2016 and amounts to GEL 3,415.8 mln (29.9% of total budget expenditures). The following is envisaged:
  - *Social Security and Pensions – GEL 2,438.0 mln. Social expenses in line with the Law of Georgia on Development of High-mountainous Regions will be financed under this item;*
  - *Healthcare Programs – GEL 894.5 mln;*
  - *Rehabilitation of Medical Institutions and Provision of Equipment – GEL 30.0 mln;*

- Funding for the Ministry of Education and Science is increased by GEL 144.8 mln and amounts to GEL 1,116.2 mln, including:
  - *General Education – GEL 655.9 mln (envisages increase of salaries for certain categories of teachers. Also, financing additions for teachers working in high-mountainous regions in accordance with the Law of Georgia on Development of High-mountainous Regions);*
  - *Vocational Education – about GEL 29.6 mln;*
  - *Higher Education and Scientific Programs – GEL 128.9 mln;*
  - *Development of Education Facilities Infrastructure - GEL 88.8 mln;*
  - *Channeled to donor funded projects (including Millennium Challenge Georgia – Grant) GEL 98,1 mln;*

- GEL 258.0 mln is allocated to the Ministry of Agriculture. The following is envisaged under this item:
    - *Development of Amelioration and Irrigation Systems – more than GEL 78.0 mln;*
    - *Beneficial Agro-credits – GEL 47.0 mln;*
    - *Grape Harvest Supporting Activities – GEL 35.0 mln;*
    - *For Payment of Agricultural Machinery Loan and Leasing Liabilities – GEL 20.0 mln;*
    - *Agricultural Cooperative Supporting Cooperatives – about GEL 4.9 mln;*
    - *Agro-insurance Provision Activities – GEL 7.0 mln;*

- More than GEL 1,258.0 mln is allocated to the Ministry of Regional Development and Infrastructure, which exceeds 2016 indicator by GEL 308.0 mln. The following is envisaged with the allocated amount:
    - *Development of Road Infrastructure – GEL 849.2 mln;*
    - *Rehabilitation of Regional and Municipal Infrastructure – about GEL 176.2 mln;*
    - *Restoration-Rehabilitation of Water Supply Infrastructure - GEL 183.9 mln;*

- *About GEL* 370.5 mln is allocated to the Ministry of Economy and Sustainable Development (including about G*EL 41.7 mln* for program "Produce in Georgia" -*, redemption of land for Anaklia Port GEL 96 mln, GEL 30 mln for adding a terminal to Kutaisi airport and runway, GEL 111 mln for mountain skiing resorts);*

- GEL 748.0 mln is allocated to the Ministry of Defense;
- GEL 585.0 mln is allocated to the Ministry of Internal Affairs;
- GEL 118.0 mln is allocated to the State Security Service of Georgia;
- GEL 139.1 mln is allocated to the Ministry of Corrections of Georgia;
- GEL 132.3 mln is allocated to the Ministry of Energy (including GEL *20.5 mln for gasification works)*;
- GEL 110.0 mln is allocated to the Ministry of Foreign Affairs;
- GEL 99.6 mln is allocated to the Ministry of Culture and Monument Protection;
- GEL 62.0 mln is allocated to the Ministry of Justice;
- GEL 84.8 mln is allocated to the Ministry of Internally Displaced Persons from the Occupied Territories, Accommodation and Refugees;
- More than GEL 136.8 mln is allocated to the Ministry of Sport and Youth;
- GEL 35.7 mln is allocated to the Ministry of Environment and Natural Resources Protection;
- Financing for the Ministry of Finance is GEL 82.3 mln;
- Financing for courts is increased by GEL 17.0 mln and amounts to GEL 69.0 mln;

- GEL 260.0 mln is allocated to the fund for implementing projects in regions;

- GEL 20.0 mln is allocated for development of high-mountainous settlements in line with the Law of Georgia on Development of High-mountainous Regions;

- The Government's reserve fund is GEL 40 mln and the President's reserve fund is GEL 5 mln.

Transfers to Local Self-governing Units amounts to more than GEL 675.1 mln.

The draft includes GEL 65 mln for supporting activities aimed at conversion of foreign currency loans of physical entities to national currency. This amount will be used for subsidizing conversion of foreign currency loans under

GEL 100.0 thousand of those physical entities who received loans before January 1, 2015. It is estimated that the program will impact about 33.0 thousand physical entities.

b) Financial substantiation of the draft law:

b.a) Source of financing expenses necessary for adoption of the draft law

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b.b) Impact of the draft law on the budget revenue

_ Draft laws concomitant to this draft law are draft law on “Amendments to the Tax Code of Georgia” and draft law of Georgia on “Gambling Business Fees”, which envisages changes for mobilization of additional revenues.

b.c) Impact of the draft law on the budget expenditures

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b.d) New financial liability of the state

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b.e) Expected financial impact of the draft law for those persons who are under the scope of the draft law

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b.f) Regulation (principle) for defining amount of tax, fee or other type of payment set by the draft law

Draft laws concomitant to this draft law are draft law on “Amendments to the Tax Code of Georgia” and draft law of Georgia on “Gambling Business Fees”, which envisages changes for mobilization of additional revenues.

c) The draft law with regard to international legal standards

c.a) The draft law with regard to the European Union directives

The draft law does not contradict directives of the European Union.

c.b) The draft law with regard to Georgia’s obligations related to membership of International Organizations

Adoption of the draft law does not contradict to the obligations of Georgia related to membership in international organizations.

c.c) The draft law with regard to bilateral and multilateral agreements of Georgia

Adoption of the draft law does not violate and does not contradict to the obligations of Georgia under its bilateral and multilateral international obligations.

d) Consultations during preparation of the draft law:

d.a) Non-government and/or international organization/institution, experts who participated in preparation of the draft law, if any

Main macroeconomic indicators used for preparation of the draft law were agreed with International Monetary Fund.

d.b) Assessment of organization (institution) and/or expert participating in preparation of the draft law in relation with the draft law

The draft law was approved by the Government of Georgia.

d.c) Author of the draft law

Ministry of Finance is author of the draft law.

d.d) Initiator of the draft law

The Government of Georgia is the initiator of the draft law.