

Rightsizing Fiscal and Monetary Policies

Abstract This chapter discusses the right size of government in fiscal terms – identifying characteristics of Budget Optimum – i.e., the parameters of fiscal policy that should contribute to the fast and sustainable economic growth for the particular country in a particular time period. In the first part of the chapter it is argued that budget deficit is not the main parameter of Budget Optimum, but budget to GDP ratio and public expenditure to budget should be examined much closer in parallel with budget deficit. In its second part, this chapter chronicles Georgia’s economic recovery plan and its impact on key indicators – making the case for anti-austerity. The third part of this chapter lays out the broader institutional implications of the Georgian reform experience and, suggesting that some rules are outdated, offers innovative concepts – from the management of international financial institutions to cooperation between central banks and governments.

Keywords Budget · Fiscal · Expenditure · Crisis · Formula

Governments can influence a country’s economy in two respects: at a financial and at a regulatory level. And I believe that for every country, and at each stage of its development, there is a right size of government in both of these respects. While lessons learned in one country should not blindly be transferred to another, I am convinced that countries at similar levels of

development can and should learn from their peers. In the previous chapter, I discussed the economic benefits of controlled deregulation. In the first part of this chapter (Sect. 3.1), I will examine the right size of the government in its fiscal aspect offering a new concept of Budget Optimum – the main characteristics of the budget (and not only budget deficit) that can ensure best economic outcome for that particular moment of that particular economy. In the second part of this chapter (Sect. 3.2), I will make the case of how focusing on the parameters of the Budget Optimum (and not following austerity measures, as advised by many) helped Georgia to recover from the 2008/2009 recession and how this approach may be useful for many countries currently facing austerity measures. In the third part of this chapter (Sect. 3.3), I will examine some of the institutional implications of the experience in Georgia that may be helpful for many developing as well as developed countries in shaping their fiscal and monetary policies during the new economic realities.

I believe there is a Budget Optimum for any economy and it differs based on its level of development and its position in economic cycle. The parameters of Budget Optimum do not take in consideration many budgetary aspects and do not depend only on budget deficit as a main parameter and main measurement of a healthy fiscal policy, but depend on (1) budget to GDP ratio, (2) public expenditure to budget ratio, and lastly (3) the budget deficit as well. I believe that for any economy Budget Optimum can be identified, which will ensure, *ceteris paribus*, that economy's fastest and most sustainable growth.

3.1 RIGHTSIZING THE GOVERNMENT – BUDGET OPTIMUM

The Georgian case is practical proof that economist Albert Laffer's theory about the relation between taxation and government revenues is right - The bell-shaped "Laffer curve is a representation of the relationship between rates of taxation and the resulting levels of government revenue. [...] One implication of the Laffer Curve is that increasing tax rates beyond a certain point will be counterproductive for raising further tax revenue,"¹ i.e., there is a specific level of taxation that maximizes tax revenue. Others argue that the curve may not be bell-shaped and that it might even have multiple peaks.²

In the 2000s Georgia saw two major tax reforms: one in 2004 and one in 2009. As part of the first reform, the number of taxes was reduced and the rates of the remaining taxes were lowered. Most observers predicted a

decline in tax revenue but the opposite happened. Tax revenue went up, both in nominal terms and as a percentage of GDP. In nominal terms, tax revenue went from GEL 0.6 billion in 2003 to GEL 6.3 billion in 2013. Of course, GDP growth and inflation contributed to this development. But the relative development of tax revenue confirms that the reforms were successful. Tax revenue as a percentage of GDP went from 7 percent in 2003 to 24 percent in 2012. The impact was already apparent within one year of the first round of reforms.

The reasons for this success are two-fold: improved administration,³ namely: the fight against corruption in the revenue service department as discussed in the previous chapter; and a realistic tax burden that reflected Georgia's level of development at the time. Before the reforms, the burden was simply too high. Any company attempting to pay the full amount of their tax liability would either have gone bankrupt right away or dug their own grave by increasing prices to an extent that would eventually have driven customers away. Note that Georgia's GDP per capita only came to about USD 922 at the time (World Bank, 2003). So, paradoxical as it sounds, the reduction of the tax level triggered higher tax revenue in Georgia, indicating that the country's pre-reform tax burden was too far towards the right (or the top, depending on the orientation of the graph) on the Laffer curve (Fig. 3.1).

But how can a government determine the appropriate level of governmental revenue as a percentage of GDP? Conceptually speaking, the suitable tax level for any country is that which minimizes corruption and maximizes long-term economic growth without compromising social or political stability. In Georgia, a new tax code was introduced in 2004. Only 6 out of 21 types of taxes remained: two consumption-based taxes, three income-based taxes, and one property-based tax:

1. Consumption-based: Value-added tax (VAT; 18 percent) and customs clearance tax (0/5/15 percent; more than 80 percent of imported goods were cleared at a customs rate of 0 percent)
2. Income-based: Corporate income tax (profit tax; 20 percent, later decreased to 15 percent), dividend tax (5 percent), and personal income tax (25 percent, later decreased to 20 percent)
3. Property-based: Property tax (land tax; up to 1 percent of the value).

On top of these taxes, duties (levies) were introduced for as few as four types of products: tobacco, gas, alcohol, and scrap metal exports. All of

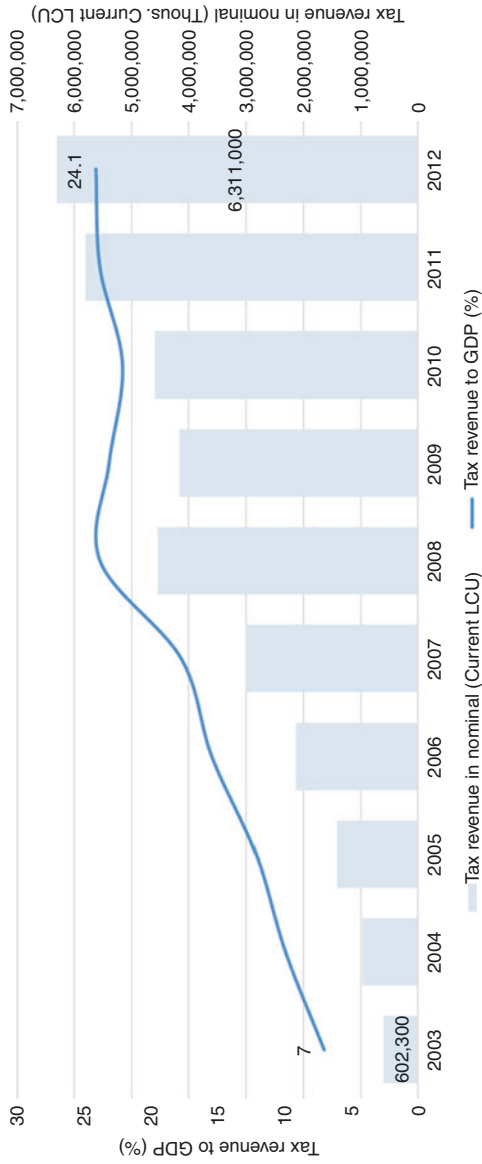


Fig. 3.1 Tax revenue to GDP/tax revenue in nominal. (current LCU) (Source: World Bank Group.)

these taxes were flat to incentivize compliance. Any progressive system (“the more you earn, the more you pay”) eventually gives rise to corruption; both private individuals and companies will get creative to move into lower tax brackets than warranted by their actual income. What is more, a progressive rate punishes success and, hence, discourages citizens from earning more money and companies from generating higher profits. But in a poor country, you need every incentive that rewards productivity and discourages corruption.

The simple, flat-rate tax system helped Georgia streamline its tax administration and fight corrupt practices in the revenue service department. Also, simplification of the tax system facilitated increase in the degree of compliance and enabled the creation of a relatively level playing field for the private sector. The combined impact of a lower tax burden, a simpler tax code, the successful fight against corruption, and the creation of a level playing field soon led to higher rates of profit and reinvestment. As a result, Georgia attracted foreign investment, GDP rose, and new, higher-paying jobs were created (Fig. 3.2).

Budget to GDP ratio may be the most important aspect of Budget Optimum. When identifying the most optimal Budget to GDP ratio, the factors to be taken into consideration include a country’s stage of economic development, level of corruption, volume of international trade, and GDP composition. Database research spanning two and a half decades, since 1980, shows that none of the 18 countries (mentioned in the first chapter) that at any stage of this period had a fast economic growing decade⁴ has had a general government revenue (Percent of GDP)⁵ to GDP ratio of more than 40 percent; Belarus is the only exception from this rule. Majority of the countries, including Georgia, have had a budget to GDP ratio of below 30 percent, and 5 countries had this ratio between 30 and 40 percent. On the flipside, none of the 23 countries that had a ten-year average general government revenue to GDP ratio of more than 40 percent got anywhere close to doubling GDP per capita in terms of purchasing power parity, or to quadrupling nominal GDP per capita in any ten-year period. These observations might partly be explained by the fact that many of the big spenders are developed countries. The high social obligations that come with their advanced stage of development make it hard for them to keep the budget below 40 percent of GDP, and the maturity of their economies makes it hard for them to achieve fast growth. In any case, a developing country that aspires to catch up with the developed world cannot afford to place a high tax burden on the economy.

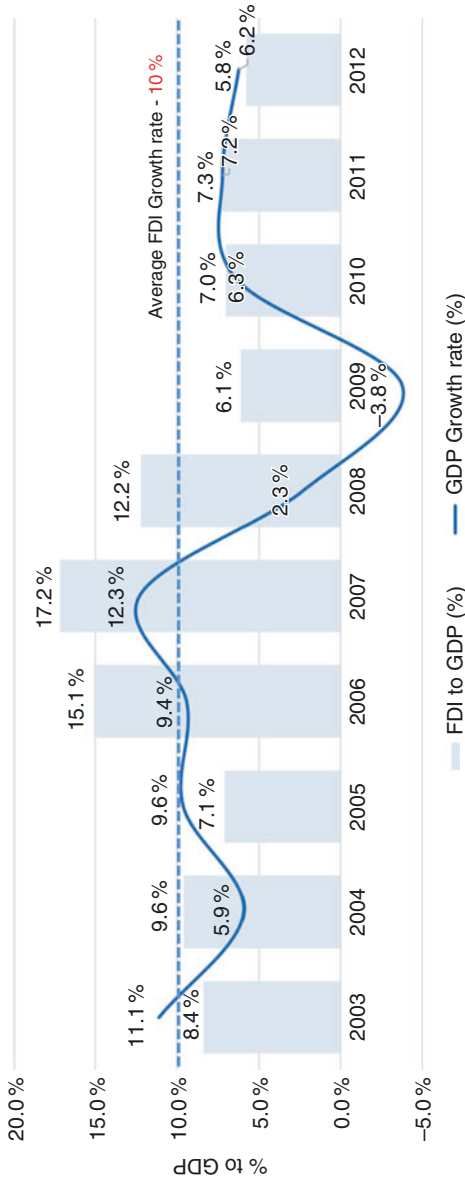


Fig. 3.2 FDI to GDP and GDP growth rate. (Source: Ministry of Finance of Georgia.)

3.1.1 *Forward-Looking Fiscal Policy*

One way of gradually decreasing the tax burden as a percentage of GDP is to increase government expenditure at a rate that is slower than GDP growth. But there is another way of achieving the same objective, and I believe it is more effective in terms of building confidence among market participants and fostering economic growth, an approach I call forward-looking fiscal policy. This requires the government to define and publish a formula according to which the tax burden will be decreased by x percent for every percent of GDP growth for a specified number of years. In other words, all market participants are incentivized to contribute to overall economic growth and are rewarded accordingly. The reduction can be applied, for example, to income tax, corporation tax, or value-added tax.

In some cases, e.g., in an economic crisis, it may be necessary to introduce sectorial taxes, i.e., taxes that only apply to certain industry sectors. In such a situation, I recommend applying the forward-looking approach to the banking sector: decrease the bank tax by x percent for every percent increase in GDP. Why the banking sector? Because banks are enablers of economic growth. Increasing lending and financing activity creates benefits for the economy as a whole. This kind of formula motivates the right people to do the right things, aligning all stakeholders to contribute to increased economic activity. Not only does it help bring down the budget, it also sends a strong signal to the private sector. The formula has not been tested in Georgia, and I am not aware of any country in which it has. Yet I am confident that the forward-looking approach could promote faster recovery from a crisis. Skeptics typically object that banks will always finance sufficiently attractive projects, so why introduce an additional incentive? But forward-looking fiscal policy is not about any particular project. It is about an overall boost to confidence when confidence is needed most. I will explore the economic relevance of psychology and perception in a crisis in more detail in the argument against austerity presented later in the chapter.

3.1.2 *One Budget Principle*

Another important aspect for rightsizing the government, ensuring the most efficient fiscal policy and thus contributing to Budget Optimum is One Budget Principle, which was adopted by the Georgian government in 2004. In most countries, big parts of government income are

earmarked, i.e., reserved for specific types of expenditure. For example, road taxes and levies are often collected based on usage. In France, fees are collected at dedicated toll stations. In Germany, taxes are collected by oil companies through gas stations as a percentage of the price per liter of gas sold. In turn, most countries dedicate taxes collected from road users to the construction of new roads and to the maintenance of the existing network. In Georgia, we opted out of such earmarking of income from specific sources for expenditure in specific areas. All public revenue go into one budget, and all expenditure is financed irrespective of the source of the revenue. The “one budget” principle protects citizens from taxes and levies imposed by competing arms of government, and it increases the agility of government when it comes to public spending.

Take the hotel levy, a duty that is common in many countries. Typically, it goes directly to the ministry or department of tourism, and it is spent to finance advertising campaigns or improve tourism infrastructure. Taken at face value, this allocation appears logical, and it makes it easier to justify a given tax to the public: Tourists should pay for tourism infrastructure, and road users should pay for the road network. But in reality, such levies are rarely sufficient to finance the respective expenditure in full. What is more, roads do not only benefit car owners, but also those who buy and sell any goods that are transported on roads. These effects render the original argument for earmarking practically irrelevant. Moreover, the practice of earmarking has several disadvantages:

- Unhealthy competition among cabinet members and government agencies to create independent sources of income at the expense of the private sector.
- Unnecessarily complex levy systems that give rise to uncertainty and discourage investments – Will there be a new minister who will try to introduce a new levy?
- Inefficient use of government resources – The full cost of administering a complex levy system can easily exceed the revenues it generates.
- Sub-optimal use of government funds – At any given time, there may be more important, or more urgent, projects than the one a given levy is earmarked for at the time.

In stable times, such inflexibility may merely be seen as inconvenient. But in a crisis, earmarking can become life threatening for the national economy. Imagine the government urgently needs to stabilize the banking sector, but the substantial funds generated from the hotel levy are reserved for staff training in the hospitality sector.

I do not suggest that all levies or excise taxes should necessarily be abolished, although I am convinced that minimizing the number of taxes and surtaxes is good for any economy. Rather, I recommend allocating all government income to one budget. This central budget should be used for the most efficient, or most urgent projects, irrespective of how the income was originally generated. There is one exception to this principle though: those agencies that are in direct contact with citizens, i.e., providers of public services. Such citizen-facing agencies should be allowed to keep part of their income as it creates incentives for them to improve their performance and additional motivation for their staff to provide better service. This will help them evolve from self-serving civil servants into customer-oriented service providers.

Georgia's implementation of the "one budget" principle immediately had the desired effects. Government agencies stopped competing for ever more creative ways to plague the private sector with new duties and levies. Instead, they started competing for the allocation of funds from the budget by developing, proposing, and executing competitive projects. Government became more efficient, more effective, and generally more results-oriented. And as times got tougher, the government had the extra flexibility it needed to take swift and decisive action. Unfortunately, the one budget principle has since been softened. In late 2010, some government agencies were allowed to keep their surplus and spend it on projects identified by the respective ministers, a change that let sectarianism and inefficiency creep back in.

3.1.3 Public Investment Ratio vs. Budget Deficit

Despite the successful reforms, economic growth in Georgia stalled in 2009. This was due to the combined effects of the world financial crisis that had started in 2007 and the Russian invasion of Georgia in 2008. The influx of foreign capital had gone into a sharp decline. The situation was further aggravated by a local political crisis in early 2009. An opposition rally that lasted almost three months had brought economic activity at the

center of Georgia's capital, Tbilisi, to a virtual standstill. The economy was heading into sharp recession.

As was expected, recommendations came from every corner to start austerity measures. Typically, austerity has two components:

1. Focus on the budget deficit, i.e., the degree to which public expenditure exceeds public revenue, as the principal indicator of economic health.
2. A policy to maintain or decrease the budget deficit level at all cost, typically by increasing taxes and reducing public spending across the board.

Ever since the worldwide financial crisis, budgetary austerity has been widely recommended to troubled countries globally. Many governments have followed this advice, and most of them have paid dearly. Most recently, Princeton economist and Nobel laureate Paul Krugman has argued that “all of the economic research that allegedly supported the austerity push has been discredited.”⁶ Yet austerity still features prominently in recovery plans for countries such as Greece, Portugal, Spain, and the Ukraine.⁷

Based on my experience in Georgia, I argue against both components of austerity as defined previously. In particular, I will demonstrate that undifferentiated austerity is not a suitable course of action for a country in a recession.⁸ More generally, I believe that the budget deficit as an aggregate figure is insufficient as an indicator of economic health. Specifically, I argue that IFIs put too much emphasis on the deficit as an absolute indicator out of context, when they should rather be looking at its development relative to other economic indicators and more importantly at a public investment ratio (public investment to budget). The Georgian experience shows that a high budget deficit is temporarily acceptable and can even be necessary to allow a country recover from recession, provided a substantial share of the budget consists of public investment. In Georgia, public investment accounted for up to 25 percent of the budget. This allowed the Georgian government to increase the budget deficit to 9.2 percent and then to bring it back down to 3 percent within 2 years. In a recession, public investment can be decreased much more easily politically than other budget positions, e.g., by stretching investment projects over a longer period of time than originally foreseen, or by canceling some projects altogether. What is more, public investment

has a much higher multiplier effect on the economy as a whole than other budgetary expenditures, and it contributes to the development of the private sector as well. If external observers and advisers, including the IFIs, assess a country's performance based on the budget deficit alone, they miss out on an important part of the picture. Before putting pressure on a government to reduce the budget deficit, which can have a negative effect on economic development, they should also take into consideration the public investment share in the budget and the effect it has on the economy as a whole.

3.2 TAKING A RISK WITH ANTI-AUSTERITY

When Georgia was on the brink of a sharp economic slump in the beginning of 2009, our government opted against austerity. Instead of raising taxes and cutting public spending, Georgia chose to take the path of controlled expansionary monetary and fiscal policy. In early 2009, the government and the National Bank of Georgia made a joint statement, announcing a tax reduction, an increase of the budget deficit, decrease in social expenditure but significant surge in public investment and a number of banking regulation measures that would make it easier and cheaper for private companies to borrow money (in parallel policy rate was reduced significantly from 12 percent in Q3 of 2008 to 5 percent in Q4 2009). In many ways, this was the direct opposite of austerity – the measure that many had advised. But we felt we didn't have a choice. With memories of the recent Russian invasion still fresh, all the leading players in Georgia's private sector were even more scared than those in neighboring countries. Both the government and the National Bank were convinced that announcing austerity measures would have driven the country into an even deeper recession, and possibly into eventual bankruptcy. That was my crucible as Minister of Finance. I took a chance by decreasing the income tax rate from 20 percent to 15 percent, instead of increasing taxes. My decision was based on meticulous calculations, but many experts had advised me against it. The reduction took effect in 2009, on January 1. Six weeks later, I was appointed Prime Minister. At the time, Georgia's economy was shrinking at a rate of -8.7 percent. I guess this was why nobody else wanted the job.

Georgia opted against austerity and quickly regained its footing. By the end of 2009, GDP decline was down to -3.9 percent, lower than in any other country in the region, and Georgia was the first among its peers to

recover in 2010 with a growth rate of 6.4 percent. What is more, the budget deficit was brought back down to pre-crisis levels within two years' time after the joint declaration of what is now frequently referred to as the Fast Economic Recovery Plan. The debt to GDP ratio, which had temporarily increased to more than 40 percent, was brought back down to 34 percent. When I retired from the position of prime minister in 2012, Georgia's economy (in that quarter) grew at a rate of 8.2 percent. Within three years period a turnaround from -8.7 percent (second quarter of 2009) to +8.2 percent was made (second quarter of 2012) – nothing short of an economic miracle (Fig. 3.3).

3.2.1 *What Georgia Did*

One of the first and most drastic measures we took was to cut taxes. Starting in 2004, the tax code had already been simplified dramatically. But instead of returning to pre-reform tax rates to balance the budget, as many other governments have chosen to do in similar situations, taxes were further reduced (Fig. 3.4).

Additionally, we allowed the budget deficit to increase – not at random or permanently though, but in a highly targeted fashion and for a limited period of time. The deficit went from 4.8 percent in 2007 to 6.4 percent in 2008 and 9 percent in 2009, albeit for one year only. Within two years of reaching its peak, the deficit was brought back down to 3.6 percent in 2011 and to 2.8 percent in 2012. All additional expenditure was allocated to infrastructure, such as highways and high-voltage power lines – projects that had the potential to generate additional private sector activity. Examples include the construction of a new high-voltage power line connecting the Georgian energy grid to the Turkish energy grid, enabling Georgia to export electricity generated from hydropower to Turkey and attract investments in the construction of new power plants in Georgia. Public investment as a percentage of the total budget went from 20 percent in the late 2000s to 25 percent in 2012. At the same time, social subsidies and the government's payroll bill were reduced. Only these cuts were in line with the austerity measures proposed by many, and they were deemed necessary at the time to free up as much capital as possible for public investment.

Other components of the recovery plan included the privatization of state-owned enterprises and the issuing of Eurobonds on international financial markets to attract more foreign funds and accelerate the modernization of Georgia's economy. For example, state-owned companies, such as

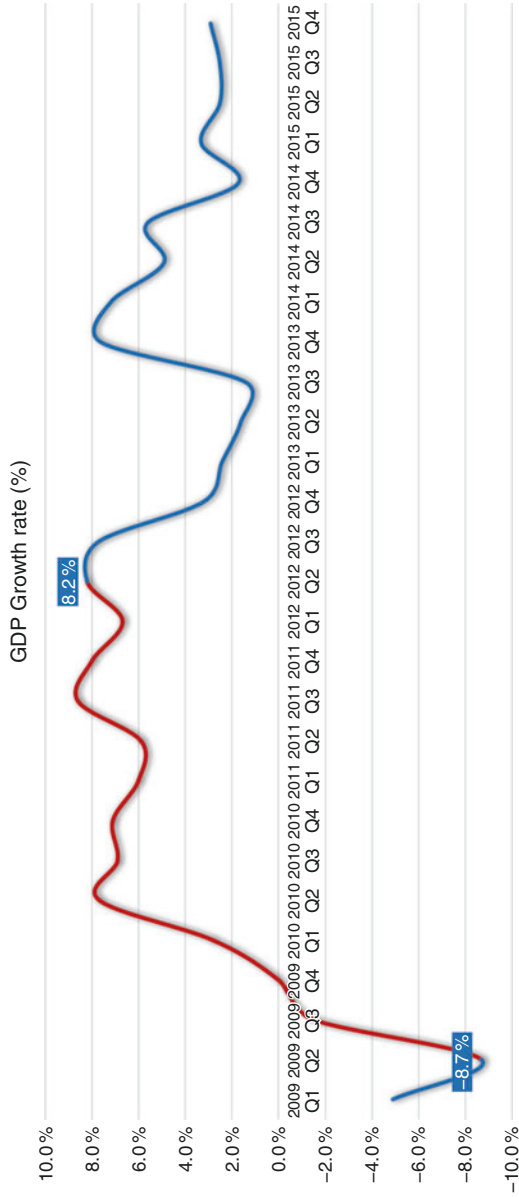


Fig. 3.3 GDP growth rate in Georgia. (Source: Georgian National Statistics Office.)

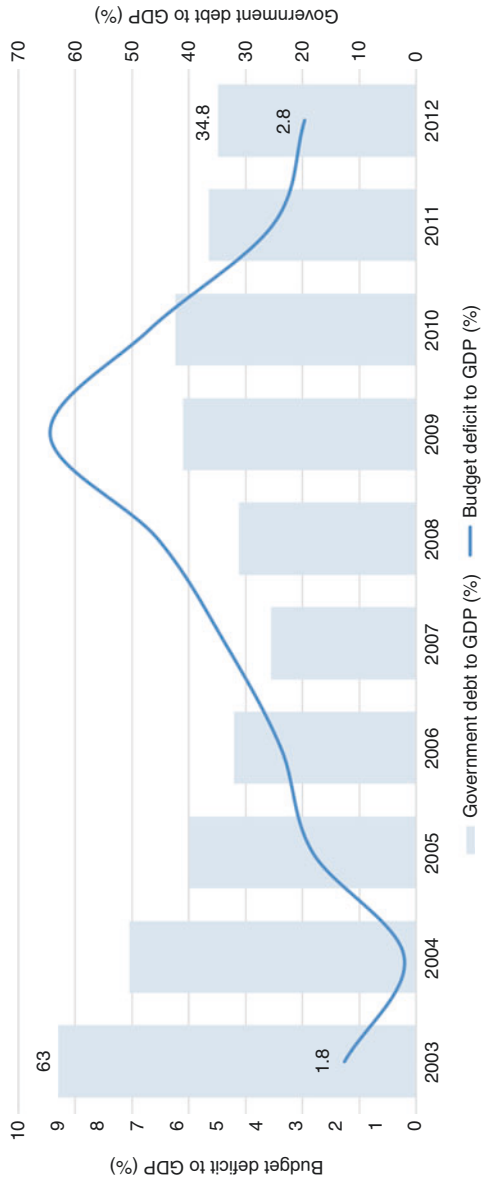


Fig. 3.4 Budget deficit to GDP/government debt to GDP. (Source: National Bank of Georgia; Ministry of Finance of Georgia.)

Georgian Railways and the Georgian Oil and Gas Corporation issued Eurobonds at the London Stock Exchange. The proceeds helped us finance additional infrastructure projects and draw more international capital.⁹ In parallel, banking sector regulation was loosened to make it easier for Georgian banks to finance recovery at first and then renewed growth.

3.2.2 *Why It Worked*

The Fast Economic Recovery Plan was a resounding success. Georgia quickly came out of the recession. I believe that this lasting success owes as much to psychology as it owes to economics. In a recession, everybody is scared. Consumers fear unemployment and tax increases. As a result, they stop spending and start saving, reducing the size of the economy almost immediately. Private sector players, fearing instability, will hold off on major investments and postpone new hires, curbing GDP growth and driving up the unemployment rate. Foreign investors fear for their capital and flock to other countries. In other words, fear is the biggest enemy of the national economy in a recession.

While I respect all economic theories, and the sophisticated concepts economists have come up with to explain economic development, I am convinced that the behavior of individuals and markets is best explained by looking at their perceptions. The economy is driven by the perception of its participants, and the most important participant is the private sector. I believe that governments cannot create jobs in the long term or drive economic growth all by themselves. But what governments can do is create an environment in which entrepreneurs have the confidence to invest and create jobs. So the best thing the government can do in a recession is to foster stability, or at least the perception of stability. A recession can have many causes – an ineffective government; inadequate regulation; or external factors, such as geopolitical issues or trade wars. Regardless of what those reasons are, the best thing the government can do is to create a sense of stability and predictability. In a recession, entrepreneurs are especially scared, and they have every right to be scared. They don't know to what extent the economic decline will affect their companies, their personal income, and their lives. They don't know how long the situation will last. They don't know how the government will react. Many theorists will say that this is precisely what being an entrepreneur is all about – dealing with uncertainty and hedging risks. But why create additional uncertainty when the government can contribute to engendering stability?

Consumer confidence is a crucial driver of recovery. But most consumers don't pay much attention to government policy, let alone GDP growth rates. Their perception of the economic situation is shaped by the private sector. Are the revenues of the companies they work for declining? Do they see worried looks on the faces of their bosses and colleagues? Is there talk of downsizing? Are their friends and family members losing their jobs? Are they personally in danger of being let go by their employers? Any of these signs will cause them to stop spending and start saving. The same is true for public servants. If they see budgetary revenue go down and the government start making budget cuts, they will fear for their jobs.

So nerves in the private sector are understandably frayed in a recession. Entrepreneurs need to adjust to a new reality, and their main concern is the lack of predictability. Consumers are apprehensive too. They start saving instead of spending. This triggers a vicious circle of economic decline. If, on top of all this, the government announces austerity measures, even more uncertainty, and ultimately chaos will ensue.

It is my firm belief that the worst thing that any government can do in a recession is to create or increase uncertainty. When some European countries announced austerity measures during the financial crisis, they set off a downward spiral even before the measures were enacted. Fear of tax increases, instability, and unemployment turned into a self-fulfilling prophecy.¹⁰ Examples include Greece, Portugal, Spain, and many other countries.

During a recession, governments should not be forced to decrease their budget deficit by cutting expenditure and increasing taxes. Budget cuts will only aggravate the situation, chiefly because governments will be inclined to decrease public investments rather than social expenditure because social cuts are unpopular with the electorate. Tax increases also have a detrimental effect, since they make it even harder for private enterprises to generate a profit and stay in business without succumbing to illegal practices. Higher taxes also make the economy as a whole less efficient by shifting funds from the more efficient private sector to the less efficient public sector. Instead, governments should decrease social expenditure, and they should be allowed to increase their budget deficits temporarily, even through higher debt, to finance public investment that drive additional private sector activity and reduce taxes. Depending on a country's debt profile, the higher budget deficit could be financed through international financial institutions or financial markets. This will initially increase a country's debt to GDP ratio, but the recovery typically brings it back to a healthy level within few years. Sadly, many countries were forced

to decrease budget deficits expecting their debt to GDP ratios to fall in the last financial crisis. This led to a decline in economic activity and negative growth or stagnation. As a result, debt to GDP ratios are not coming down as quickly as they would have with the help of temporary expansionary policies. In many cases, the debt to GDP ratio actually increased because of the decline in economic activity (Fig. 3.5).

In Georgia's case, the decision to keep spending even under duress sent a signal of stability and engendered confidence among all market participants.¹¹ By decreasing taxes and focusing public expenditure on infrastructure, rather than social subsidies, we sent a clear message: the government is committed to the creation of a stable environment for domestic enterprise, foreign investment, and private consumption. We even loosened banking regulations and monetary policy. We issued Eurobonds to finance more infrastructure projects and compensate for the foreign direct investment that had dried up in the aftermath of the Russian invasion. The perception these measures created were at least as important as their direct economic impact: we have reached the low point. From now on, we are on the way up. Good times are ahead of us, and we will come out of the recession very soon. In record time, this perception became the new reality. The recession lasted only a few months. Businesses started to invest in growth and hire more people. Consumers became more confident and started to spend money again, rather than hoard it. As a result, Georgia averted bankruptcy and came out of the recession within just one year, faster than any other country in a similar situation. The psychological effects of the government's actions helped Georgia overcome its double trouble long before our investments could have taken actual economic effect. Of course structural reforms, cutting red tape, improving government services, increasing state institutions' efficiencies that had already been government's priority has also contributed significantly to the fast recovery.

In other countries facing similar challenges, talk of austerity measures created a growing fear of budget cuts, higher taxes, less economic predictability, increased unemployment, and declining consumer spending. By announcing austerity measures, governments in those countries set off a vicious cycle of negative perception, often before the measures were even implemented. Had the International Monetary Fund (IMF) and its associates been less concerned with the sheer short-term budget deficit and more mindful of the total structure of the budget (including budget to GDP and public expenditure to GDP – Budget Optimum) and simple structural reforms, the situation would have been very different in many

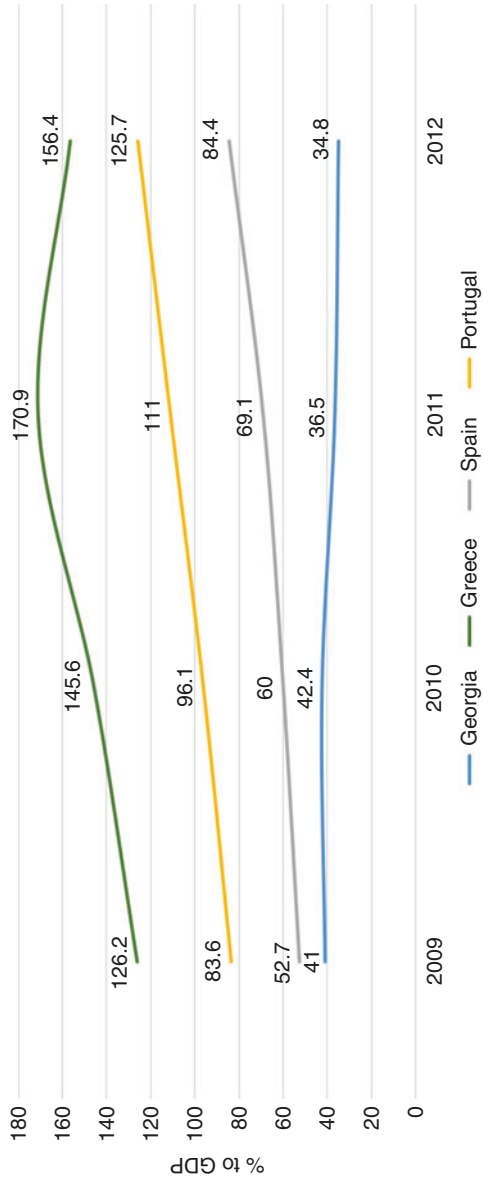


Fig. 3.5 General government gross debt to GDP. (Portugal, Greece, Spain, and Georgia – comparison) (*Source: IMF, Ministry of Finance of Georgia.*)

countries still stuggling with economic recovery. Looking ahead, my advice to governments is to exercise prudence and create a financial cushion by keeping the deficit low when the economy is growing.

In a nutshell, here is how Georgia overcame the recession without submitting to blunt austerity as recommended by IFIs:

- Repeated tax and customs simplification and reduction
- Controlled, temporary budget deficit increase despite the crisis and adopting One Budget principle
- Re-allocation of funds from social expenditure to investment in infrastructure
- Focus on the ratio of investment to budget, rather than on budget deficit alone
- Privatization of state-owned enterprises
- Issuing Eurobonds for remaining public assets to raise additional funds
- Deregulation of the private sector and structural reforms
- Special rules for the banking sector to increase its lending capabilities

While governments may not be able to create jobs in the long run, government policy can create an environment in which entrepreneurial activity will flourish and consumers will be sufficiently confident to spend what they make. Whatever the cause of a given recession, the best any government can do is help create a sense of economic stability. When people panic, things start falling apart.

3.3 INSTITUTIONAL IMPLICATIONS

Based on the experience of fighting recession, creating new formulas for economic recovery and growth, and analyzing the fast changing economic environment, few innovative concepts can be shaped in regard to fiscal and monetary policies. Most theoretical economists purport that foreign financial aid is a good thing for a country in distress, that there must be a Chinese Wall between central banks and governments, and that inflation is a bad thing. Practical economists, however, should be prepared to challenge such textbook paradigms in light of the real-life situation in a given country at a given time. Based on my experience in Georgia, I show in what follows that sometimes foreign aid comes with so many strings attached that it is as much a burden as it is a blessing, at least until the

government takes control to shape the agenda and coordinate the contributions of foreign donors. Furthermore, I argue that, although the independence of central banks must be preserved, some measure of official cooperation between central banks and governments can be beneficial, and that moderate inflation (higher than most of the Central Banks currently are targeting for) can be a good thing.

3.3.1 *IFI Assistance Can Be a Liability*

IFIs have fairly deep pockets. If their resources are put to good use, they can make a huge difference for a developing world – improve existing infrastructure, boost private sector activity, and increase the confidence of entrepreneurs and investors. And working with IFIs is not only a source of financing, it also provides an opportunity to learn from international experience. Unfortunately, many governments do not fully understand the mechanisms of IFI financing and fail to utilize it properly. Without proper coordination by the government of the receiving country, IFI projects have a tendency to take on a life of their own. In fact, the bureaucratic burden can outweigh the actual benefit. This is what happened in Georgia in the early 2000s. But when the government took control of the agenda and started pulling the right levers in a coordinated fashion, the productivity of the assistance soared. After the Russian invasion of Georgia and the donor conference held in Brussels in October 2008, IFI assistance was handled with aplomb and efficiency by everyone involved, resident IFI representatives and members of government alike. It was a successful joint effort. Although it took more than half a decade for the aid to take effect, the political and economic support was a major factor in getting the country back on track. But this was years later, and Georgia had to climb a steep learning curve to get there.

3.3.1.1 *Lack of Coordination*

As soon as the new Georgian government was appointed in 2004, we realized that IFIs had set aside substantial financial resources for Georgia but that these resources were not used efficiently. The reason for the inefficiency was two-fold: IFIs were not sufficiently coordinating their work with the government, and each IFI wanted to participate in as many projects as possible. Unless the government takes charge and defines the agenda, IFIs end up competing with each other, or even with themselves internally, trying to maximize

everything that will make them look active and involved: the number of loans and grants they disburse, the number of areas pre-approved for assistance, and the number of conditions and stipulations imposed on a given loan or grant. Without proper oversight and coordination, this tendency can turn foreign aid into a race that is more about the formal scores and check marks than about the actual outcomes. Even today, many governments are struggling with this issue.

3.3.1.2 Conflicts of Interest

In Georgia, we found that representatives of different IFIs went from door to door at ministries and government agencies, trying to persuade them to take advantage of yet another loan or grant. In many cases, different IFIs offered funding to the same institution to address the same issue, only under different titles. Initially, the members of the new government were more than happy to accept such grants or special loans. But after a few months, we began to understand that there were many strings attached to these apparent acts of charity. In my own experience, grants can do even more harm than loans if they are not managed properly. This is because grants are typically contingent on the introduction of new regulation or changes to existing ones. These regulatory initiatives are driven by an IFI's own policy, rather than by the agenda of the government of the receiving country. Once a given policy has worked in one country, decision makers at IFI headquarters are inclined to prescribe it to every other country. Resident representatives of IFIs, eager to please their higher-ups by promoting the in-house agenda, will push such policies onto the government. In Georgia, this often led to conflicts of interest. IFIs would advocate one thing, but Georgia needed another.

When we brought up the issue, IFIs said that their grants were not part of the government's budget anyway. Their representatives promised they would do the necessary research, pay for the experts, and even draft the required legislation or regulation. At first sight, it's a compelling argument: advanced regulation, based on best practices, is introduced at no cost to the state. But when you take a closer look, this arrangement is not such a good deal. The opportunity cost is substantial:

- The funds allocated to a project driven by an IFI's agenda could be used for another cause that is in line with the agenda of the elected government. But if the government doesn't make a dedicated effort

to coordinate and prioritize, IFIs will proceed with their projects based on approval from a particular institution, agency, or official, rather than from the government per se.

- Each additional project takes up a little more of the government's human resources. What is more, high-caliber civil servants often quit their jobs to join the ranks of IFIs, which pay higher salaries than the governments of most developing countries can afford, often for less work. Both effects weaken the government.
- The urge to introduce new regulation puts an additional burden on the government itself. Once their money is spent, IFIs will lobby to have the new regulation signed into law and bring up the issue at any meeting with officials. Resident IFI representatives themselves are often under pressure from their respective headquarters to deliver on a given cause or policy change, regardless of the actual value it creates for a country's economy in a given situation.

That said, governments are at least as much to blame for these problems as the IFIs. It is the responsibility of the government to make sure that IFIs work closely with them and align their efforts with the governmental agenda. If this process of coordination and communication is not sufficiently clear and determined, IFIs will take things into their own hands.

As soon as these hidden costs and side effects were properly understood, the Georgian government started making a big effort, and spent a lot of time and resources, pushing back against regulations that were in conflict with the government's agenda, or not sufficiently aligned with Georgia's stage of development. Sometimes we succeeded, sometimes we didn't. Examples include:

- An IFI had dedicated financial resources to drafting a law that makes third-party insurance obligatory. While such regulation may be relevant and beneficial in other countries, Georgia at the time was not at the stage of development that would have warranted the introduction of obligatory third-party insurance. What is more, we were opposed to any obligatory schemes as a matter of principle.
- Another IFI had drafted regulation regarding deposit insurance. Georgia had never had deposit insurance regulation before, and it was not introduced despite the IFI's continued efforts and

warnings. Nevertheless, thanks to sound banking regulation, Georgia was one of very few countries that did not suffer a single bankruptcy of a bank during the world financial crisis (2007–2009). Almost every other country in the region experienced such bankruptcies, and many of them had trouble protecting or refunding deposits, although they had deposit insurance schemes in place.

- In another case, an IFI spent USD 40 million on what their representatives referred to as business environment support. But none of the members of the Georgian government involved in improving the business environment can recall any contribution from this project. What everybody remembers, however, is that the project absorbed massive financial resources and kept many of Georgia’s finest civil servants occupied for almost four years.
- There was also an IFI that proposed a new law that would govern tourism, including a long tail of regulations and guidelines, such as Western-style certification standards for hotels and restaurants. At the time, however, Georgia’s tourism infrastructure was not ready for such regulation. All it would have brought is additional obstacles for investors in the hospitality sector, additional expenses for existing businesses, and additional need for government oversight that might well have given rise to a new wave of corruption. We stopped the introduction of this regulation, and the development of the tourism sector has proven us right. Today, tourism is widely regarded as one of Georgia’s most dynamic sectors. The number of visitors to Georgia increased from 350,000 in 2004 to 5 million in 2012 – without any complex tourism legislation.

Of course, there were also some examples of effective IFI initiatives in Georgia. Whenever IFI efforts were closely coordinated with the government, and the government was able to implement the respective reforms, the results were very positive. For example, the voucher financing scheme for schools had been suggested by IFIs as early as the year 2000. But the government at the time was unable to conduct the deep reforms that were required for the scheme to succeed. When the new government made education reform one of its top priorities and reversed the flow of financing from schools to students, the scheme was a big success.

3.3.1.3 Issues with Loans

As far as IFI loans are concerned, there are two main issues: competition and fragmentation. As investors, IFIs partly compete with the private sector and local financial institutions, instead of cooperating with them, as they should. What is more, their activity is often all over the place, rather than focused on the areas that are most important to the development of a given country. In Georgia, the IFIs were so eager to utilize the resources they had set aside for the country that they started to compete with and crowd out the private sector, thereby disrupting the market and hindering the development of a free economy. Because they have access to substantial funds at low interest rates, IFIs can afford to cherry-pick the most promising projects, often snatching them from local financial institutions. But the idea is for IFIs to cooperate with the local economy, not to compete with it. Additionally, IFIs strive to build as diverse a portfolio of relatively small loans as possible, sometimes regardless of the real priorities for a given country at a given time. In many cases, multiple IFIs were pushing loans on the government in the same area. And they all wanted to have their own, dedicated project implementation unit and get involved in as many regulatory discussions as possible. From the perspective of resident IFI employees, this behavior is quite understandable: they were simply hedging their bets. By investing in as many projects as possible, they would always be able to report some success to their respective headquarters, even if the majority of projects fell through. This proliferation created a lot of friction, distraction, and inefficiency at a time when what Georgia needed most was focus.

3.3.1.4 The Special Coordination Team

How did we solve the problem? By creating a clear format for cooperation. We set up a special coordination team as the sole gatekeeper for all IFI projects. The team consisted of members of all ministries and agencies receiving IFI grants or loans, as well as of all IFI representatives. It was headed by the minister of finance. In special cases, the prime minister himself got involved. Based on negotiations in the coordination team, specific projects were assigned to specific IFIs, and these IFIs were discouraged from participating in other projects. For example, it was agreed that most of the World Bank's funds would be spent on road infrastructure in East Georgia. JICA, the Japan International Cooperation Agency, was asked to focus on road infrastructure in West Georgia, i.e., the coastal region. ADB, the Asian Development bank, would make the renewal of

regional water utilities its priority. EBRD, the European Bank for Reconstruction and Development, would focus on the energy and financial sectors, while KfW, the Kreditanstalt für Wiederaufbau, would help reform and rebuild the energy sector infrastructure. If any of these institutions chose to get active in other areas, it was at their own risk. The government would take no responsibility for such off-agenda initiatives, neither for the projects themselves nor for the loans used to finance them.

Initially, the IFIs were opposed to this approach. They would have preferred a diversified portfolio of projects and regulatory debates so they would always have something to report to headquarters. But eventually, they saw that our clear-cut approach was more effective and more efficient. Because they devoted their full attention to the areas of priority we had assigned them, all the resident IFI representatives soon had major success stories to report. It's simple really: if you are placing one big bet, rather than a large number of small ones, you will do everything to see it succeed. But coordination was only one aspect of how the government took control of IFI aid. Additionally, the relevant minister had to demonstrate to the government, for every proposed grant or loan, that the respective project would benefit the country and would not cause any additional regulatory burden. During the first few months after this rule was put in place, almost 90 percent of all such proposals were rejected. But before long, both the IFIs and the relevant government agencies understood that proposing a project that would not advance the government's agenda was futile.

In fact, the system worked so well that it attracted additional funds to Georgia. After a while, IFIs offered to increase their investment in Georgia in case any of the neighboring countries did not fully utilize their allotted funds. In the end, Georgia received more financing from IFIs than it was pledged during the 2008 donor conference in Brussels.

3.3.1.5 Lessons Learned

The energy sector is, perhaps, the most instructive example of how IFI projects can add value when the government coordinates them. When I became Minister of Energy, I found that IFIs had written up a number of development plans for the energy sector. These plans, however, partly contradicted each other and none of them was applicable to the situation in Georgia. Had Georgia followed one of these plans, it would still be a blacked-out country today. But when we, as the government, sat down

with IFI representatives to discuss and determine the real needs of the energy sector in Georgia, the results were outstanding. Examples of successful projects that drove sustainable change in the sector include:

- Renewal of hydroelectric power plants
- Construction of new transmission lines
- Metering program for distribution companies
- Implementation of management contracts

The reform of the energy sector was a major driver of change for the better in Georgia. Examples of similarly successful IFI-backed projects include the construction of highways and local regional roads, water utility renewal, and the injection of capital into Georgia's banking sector to offset the effects of the world financial crisis and the Russian invasion. These were all landmark projects that prepared the ground for private sector development, jumpstarted the economy, and gave confidence to investors. All successful projects had three things in common:

1. Close coordination between IFIs and the government
2. Focus of each IFI on a specific sector or major project
3. Full commitment of the government to these projects

Can our experience in Georgia help shape IFI activities in other developing countries? I believe that it can. IFIs have huge financial resources that can make a big difference in the developing world. I believe that such aid is most effective, and most efficient, when IFIs ask a few fundamental questions before they start spending money. Why not cooperate with a country's elected government instead of pushing a particular agenda? Why not focus on major infrastructure projects that will accelerate private sector development and attract further investments, rather than build a huge portfolio of sub-critical projects? Why not pursue broad objectives, such as GDP growth and a decrease in unemployment, instead of pushing a particular regulatory agenda? Why not hire top consultants for specific studies, rather than try to do everything in-house?¹² Why not support the implementation of new management contracts for state-owned enterprises to fight corruption, introduce a modern management style, nurture new generations of leaders, and import know-how from other countries? And finally, why not take civil servants from developing countries on study tours to other countries to enable them to learn from successful reformers,

rather than offer grants to write new regulation? Once civil servants see with their own eyes what a specific reform is all about, they will be in a great position to adapt the underlying principles to their own country. I believe that enabling local officials to turn things around is a much more sustainable form of assistance than writing laws. If you give people a fish, you feed them for a day. As the saying goes: if you teach them how to fish, you feed them for a lifetime. I believe that reflecting on these questions will help IFIs in their efforts to make the world a better place.

3.3.2 *No More Chinese Walls?*

Time and again, careless governments have allowed inflation to run wild by printing money, especially prior to elections, when economic growth and decreasing interest rates are more important than the fight against inflation. As a direct result of such shortsighted, irresponsible behavior, central banks have gained positions of total independence as guardians of the currency. Ever since Paul Volcker, Chairman of the U.S. Federal Reserve under Jimmy Carter and Ronald Reagan, successfully battled the surging inflation by increasing the policy rate against the expectations of the government in the 1980s,¹³ few people have challenged the independence of central banks and their right to oversee monetary policy.

However, economic challenges are changing, and economic policy should evolve in step with these changes. Today, inflation is not the biggest issue anymore in most of the developed world. Instead, many countries are facing a threat of deflation and struggling with a demand-driven deceleration of the economy. While I don't suggest that governments return to a regime of printing money at will, I think it's time to tear down the Chinese walls that have been erected to limit cooperation and let central banks and governments work together in the best interest of their countries. In some cases, the independence of central banks is very useful, especially to prevent dangerously high inflation rates. In other cases, however, close cooperation between a country's central bank and its fiscal authority (typically the ministry of finance) can be much more effective than the independent actions of either entity. May be it is time to break down taboo and consider the following policies:

1. Expand the objectives for central banks from inflation prevention to inflation prevention and economic growth.

2. Establish a council consisting of the heads of fiscal and monetary authorities and maybe even the head of government. Have the council convene regularly to review the development of the national economy.
3. Every two to three years, put in place an agreement between the central bank and the ministry of finance, outlining the key parameters of fiscal and monetary policy.
4. Empower this council to implement all necessary measures needed for the given stage of development of the economy, may it be managing the supply of money through coordinated measures or giving funds directly to the government, provided there is consensus among the members of the council (so-called helicopter money).

Currently, many countries have no mechanism to fund the government's budget directly by printing money, even if all parties agree that this is the right thing to do in a given situation. But why punish future generations for mistakes governments made decades ago?

Critics will say that governments might be tempted to abuse the controlled collaborative approach I propose, especially in developing countries, where checks and balances are not well developed and institutions are relatively weak. That may be the case, and I'm all for precautions that will help avoid such abuse. But what critics don't see is that it is already going on – behind closed doors anyway. Formally, central banks in many developing countries are independent, in line with the rules and regulations that have been established in compliance with the requirements of IFIs or developed countries. But in reality, central banks and governments in many countries are cooperating closely, often, but not always, with the best interest of the national economy in mind. I believe that such off-the-record dealings should cease, and that they should be replaced by clear, transparent rules and regulations for cooperation. I am convinced that all parties would benefit from such an arrangement, including the central banks. Specifically, formalized cooperation would lead to more balanced decisions and shared responsibilities. Today, the heads of central banks often act as lone warriors, even where supervisory boards exist. As a result, decisions that might be perceived as painful or unpopular are frequently delayed or avoided. The joint council that I propose would be better equipped to deal with challenges that affect not only the currency but also the entire economic stance of a country, in a timely and effective fashion.

This was the case in Georgia, and it helped us overcome multiple crises and challenges. Even though there was no legally established council between the government and the National Bank of Georgia, and no contracts had been signed by these institutions, cooperation was very close. In many cases, fiscal and monetary policies were coordinated. This approach was particularly useful during the economic growth period and when the world financial crisis hit Georgia in the aftermath of the Russian invasion (2009 and 2010). Joint efforts by the government and the National Bank of Georgia helped Georgia emerge from the crisis faster, and in better shape, than any other country in the region.

3.3.3 *Inflation Can Be an Asset*

Even though inflation targeting is the main policy of many central banks, still the targets themselves mostly are not derived from the best possible mix of economic growth and acceptable level of inflation. As it has already been mentioned previously, central banks are charged with a gatekeeper-from-inflation role, and for them keeping inflation as low as possible is the top priority – not taking in consideration the economic growth forgone due to such policies. Let me take the argument against overly rigid inflation control one step further. I believe that moderate inflation can be a good thing – not any kind of inflation, and not in all situations of course. In the twentieth century, inflation has wrecked many economies and inflicted incredible hardship on many people. But I have also seen inflation act as an investment accelerator, and I think governments should take advantage of this phenomenon. While high inflation is bad, deflationary pressure can also have detrimental effects on the economy – less dramatic perhaps, but potentially more prolonged. And if demand-driven economic slowdown and deflationary pressure coincide, even strong economies can suffer and find themselves facing a recession. Examples include Japan, for the past three decades, and the European Union, for almost past decade.

Look at it this way. Assume you want to buy a house. Prices go down, so you decide to wait a while. You want to get a good deal, and what is the harm in holding out for a few weeks? An investor considering to buy another company will behave in much the same way, hoping that the valuation of the target will decrease. Or put yourself in the shoes of a manufacturing company. You need to buy materials, but consumer prices are now lower than they were when you made your profit calculations, and

they are still declining. Assume that manufacturing the finished products takes some time. Won't you hesitate to buy those costly materials when you don't know whether you will be able to generate enough revenues to cover your costs and turn a profit in the end? In a deflationary period, economies frequently slow down because of the cumulative effect of such delayed decisions ("investment decision gap").¹⁴ During a period of moderate inflation, this effect is reversed. The house buyer, the investor, and the manufacturer will all seek to move quickly and close their deals when they see prices going up.

The case for an acceptable level of inflation – see following text for what I consider "acceptable" – is even stronger for developing countries. They benefit from nominal GDP growth, if only because of the psychological effect it has on market participants. Of course, inflation does not bring real GDP growth. But let's face it: many international investors look at nominal GDP per capita as their most basic indicator of whether a given country even deserves their attention. Because of such filtering, it can make all the difference for a developing country to which nominal GDP per capita bracket it is allocable: Below USD 1000? 1000 to 5000? 5000 to 10,000? Above 10,000? Many investors will not give a second thought to why exactly a given country suddenly pops up on their GDP radar as a middle-income country, or even a higher middle-income country. Is it due to a slightly higher inflation rate, or because of real economic growth?

An additional benefit of moderate inflation is the fact that it can lift part of the burden of social expenditure. Inflation increases nominal tax revenue. And if a country's formulas for welfare and social support do not account for inflation, social expenditure stays the same, leaving the government with additional funds. The surplus can be used for investments or increases in social assistance, as warranted by the political situation.

So what is an "acceptable" level of inflation? I believe that the acceptable rate is contingent on a country's specific situation and recent economic history. If market participants have had – and still remember – an experience of an inflation rate of x percent hurting their businesses and their livelihoods, then x is too high a rate. Generally, the highest acceptable level of inflation is the rate beyond which savings increase only because of inflation. It is the level beyond which individuals and business grow fearful of hyperinflation and start spending less, consuming less, and saving more. It is the level beyond which market participants lose their

faith in a stable future. For Georgia, that rate is somewhere under 9–10 percent. When inflation exceeded that level in the past, we saw decreased consumption, decreased economic activity, and increased uncertainty. And uncertainty, as I have demonstrated previously, is the biggest enemy of sustained economic growth in any country.

NOTES

1. https://en.wikipedia.org/wiki/Laffer_curve (retrieved in June 2016).
2. Uriel Spiegel and Joseph Templeman, A Non-Singular Peaked Laffer Curve: Debunking the Traditional Laffer Curve, *The American Economist*, Vol. 48, No. 2 (Fall, 2004), pp. 61–66 (Spiegel and Templeman 2004).
3. For example, new technology was implemented to support the reforms; examples include compulsory e-filing and proprietary software to spot irregularities and trigger tax audits. These audits were outsourced to the private sector. To soften the bureaucratic burden for small businesses, simplified tax keys were introduced, e.g., based on the number of chairs at a barbershop or the number of tables at a restaurant.
4. Defined as a country that has had a “fast growth decade,” i.e., a ten-year period during which nominal GDP per capita in terms of purchasing power parity doubled and average real growth was at least 6 percent, based on data from the International Monetary Fund and the World Bank. Oil-exporting countries and countries with the population of less than one million were excluded from the analysis.
5. Revenue consists of taxes, social contributions, grants receivable, and other revenue. Revenue increases government’s net worth, which is the difference between its assets and liabilities (GFSM 2001, paragraph 4.20). Note: Transactions that merely change the composition of the balance sheet do not change the net worth position, for example, proceeds from sales of nonfinancial and financial assets or incurrence of liabilities.
6. www.theguardian.com/business/ng-interactive/2015/apr/29/the-austerity-delusion (retrieved in 2015).
7. www.bloomberg.com/news/articles/2015-09-17/greece-hints-at-end-of-europe-s-anti-austerity-revolt (retrieved in September, 2105).
8. With additional income from privatization and reduction of social subsidies as exceptions.
9. See [Chap. 6](#), Privatizing State-Owned Enterprises, for details.
10. Some experts attribute the obsession with austerity to the “political dominance of financial interests.” See, for example, Robert Kuttner, *Debtors’ Prison: The Politics of Austerity Versus Possibility*, Knopf, New York 2013 (Kuttner 2013).

11. Georgia was promised special aid from IFIs after the Russian invasion, an important factor that helped uphold national morale and instill confidence in investors. However, the bulk of the funds that IFIs had promised did not actually reach Georgia until late 2010, or even early 2011, when Georgia was already on a path to recovery of its own accord.
12. The best experts in many technical areas are typically employed by private sector companies, often simply because IFIs cannot pay top salaries for political reasons.
13. <https://www.bloomberg.com/view/articles/2012-08-20/how-volcker-launched-his-attack-on-inflation> (retrieved in May 2016).
14. This slowdown can be further aggravated by the slightly higher costs of loans in a deflationary economy. In an inflationary economy, however, devaluation will eat up part of the loan itself.

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