

INTERNATIONAL MONETARY FUND AND INTERNATIONAL DEVELOPMENT ASSOCIATION

ARMENIA

Joint Staff Assessment of the Interim Poverty Reduction Strategy Paper

Prepared by the Staffs of the International Monetary Fund and
The International Development Association

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1. The Government of Armenia is developing a comprehensive and participatory plan for reducing poverty. The Interim Poverty Reduction Strategy Paper summarizes where Armenia stands in developing that plan, and provides an analysis of poverty, and the Government's policies to reduce it. The document also outlines the existing and future participatory process. The I-PRSP has been prepared by a team of officials led by the Ministry of Finance and Economy, and has benefited from consultations with NGOs and donors. Drafts of the I-PRSP were also made available to the public, including through a posting on the Government web site.

2. The I-PRSP was discussed with the key Ministries, in Cabinet, and with parliamentarians. The staffs of the Fund and the Bank assisted the authorities by commenting on the drafts of the I-PRSP; and, in addition, NGOs and civil society groups met on several occasions to contribute to the development of the I-PRSP. The UN, EU, DFID and USAID amongst others have supported, or are interested in supporting, the continuing PRSP process.

Poverty Data and Factors

3. **Poverty Trends.** The I-PRSP contains a candid discussion of the predicament of the poor in Armenia: a sharp increase since independence of those below the poverty line, a steep decline in calorie consumption, a halving of the share of wages in income, and an increase in inequality. At the same time, the document rightly points to an apparent reduction in extreme poverty over the last few years, due in part to the Government's consolidation and targeting of poverty benefits. The overall level of poverty, however, is still high despite relatively strong growth over the last six years. The staffs look forward to a full PRSP that uses the poverty data to ensure a clear setting of priorities between and within sectors, and which provides a fuller analysis of the linkages between growth and poverty. The full PRSP will also need to focus on the quality of the poverty and income inequality data.

4. **Future Targets.** The I-PRSP contains two sets of ambitious macroeconomic targets -- baseline and optimistic -- and also includes some monitorable outcome

indicators of progress in reducing poverty and inequality, and improving health and education. The full PRSP will need to develop more detailed outcome indicators for the major sectors, and to be cast explicitly against the backdrop of the International Development Goals. At the same time the Government will need, as an immediate priority, to remedy the generally poor quality and availability of social data, focusing on improving data collection in key areas as health provision, literacy, and school enrollment. This will allow a more elaborated poverty profile to anchor the poverty strategy. This is especially important given the I-PRSP's observation that 68 percent of the population is below or only marginally above the poverty line.

Poverty Reduction Strategy

5. The I-PRSP has three main pillars: (1) sustainable and equitable economic growth, driven by a more dynamic private sector; (2) public administration reform and an anti-corruption program; and (3) enhanced human development. Staffs fully agree that these elements are central to a successful comprehensive poverty reduction strategy for Armenia. Indeed, these pillars provide the basis for the World Bank's Country Assistance Strategy (CAS), as well as guide the program to be supported by the Fund through its Poverty Reduction and Growth Facility (PRGF).

6. The I-PRSP's "baseline" scenario forms the basis for the PRGF-supported program. There is also an "optimistic" scenario, which assumes progress towards a peace settlement in Nagorno-Karabakh, greater foreign investment and tourism, and reduced emigration. The staffs agree with the Government's view that sustainable growth is a necessary, but not sufficient, condition for reducing poverty in Armenia, and that direct attention also needs to be paid to improving human development and the delivery of essential Government services. Against this background, the staffs would like to highlight the following notable features of the I-PRSP:

- **Macroeconomic Stability.** The I-PRSP's focus on macroeconomic stability is welcome, especially given the need to stimulate saving and investment and to create a favorable overall business climate which would help lay the basis for rapid, sustainable economic growth and poverty reduction. Macroeconomic stability will require both sustained low inflation, and the elimination of existing -- and avoidance of new -- arrears in budgetary expenditures. The staffs agree with the authorities that achieving these objectives is in the interest of the poor.
- **Increased Revenues.** The I-PRSP rightly stresses the importance of higher revenues in relation to GDP so that poverty reduction objectives can be reached without jeopardizing macroeconomic stability. The Government aims to progressively reduce the budget deficit and eliminate the stock of expenditure arrears. This will require meeting ambitious, but the staffs believe attainable, targets for the growth of tax revenues. Higher tax collections in relation to GDP will come largely from improved tax and customs administration, and from better governance, especially increased transparency and reduced corruption. The tax reform that became effective January 1, 2001 was an important step in rationalizing tax rates, especially on wages, and broadening the tax base. It also includes improvements in tax administration.

- **Expenditure Management.** An important ambition of the I-PRSP is to strengthen links between policy objectives and budget allocations. The Government intends to enhance the medium-term focus of budgetary planning, especially by integrating budget preparations into the Medium-Term Expenditure Program. This will allow a resetting of priorities for public expenditures, a better balance between current and capital expenditures, less non-productive spending, and room for an increase in priority social expenditures. Expenditure efficiency will be improved by consolidating the development of the treasury system, improving internal audit within government, strengthening the Government's ability to assess potential investment projects, and improved management of state debt.
- **Governance.** Corruption, particularly administrative corruption, has been a major constraint to Armenia's economic growth and poverty alleviation. Political will to tackle corruption has often been lacking, and the staffs very much welcome the recent high-level initiatives that the I-PRSP reports. These include establishment of a new Anti-Corruption Commission, and the intent to enact a law for full financial disclosure by public officials, and a new Civil Service Law. Also of significance is the I-PRSP's commitment to broader delegation to local governments of responsibility for public services – including general education, social protection, and utilities – through measures such as the Law on Territorial Administration and the amendment to the Law on Local Government. The PRSP will need to present a comprehensive approach to Governance reform, one that will foster greater transparency in Government operations and restrict the opportunities for abuse of discretionary power.
- **Private Sector Investment.** The staffs support the I-PRSP's commitment to improving the business climate, including through efforts by the newly created High Level Business Council to promote foreign investment and reduce the legal and bureaucratic obstacles to business development. The Government intends to continue its privatization program, as well as its efforts to strengthen the banking system and expand availability of banking credit to the private sector. Labor market flexibility is also crucial, and the I-PRSP commits the Government to improving the legislation and institutions regulating labor markets. Also important is an emphasis both on promoting foreign investment through forums such as the forthcoming Investor Conference in New York and through the Armenian Development Agency, and on maximizing the benefits from Armenia's imminent accession to the WTO.
- **Human Development.** The I-PRSP rightly stresses the crucial importance of better human capital development for Armenia's future. It recognizes the damage done by the sharp fall in funding for health and education, and the consequent rise in informal payments, which exacerbates inequality, especially in the medium to long-term, as the human capital of the poor deteriorates further. The predicament of the education sector is especially acute, with children from poor families often receiving an inadequate education, and thus entering the labor force as unqualified or low qualified workers. This deficiency will have

serious long-term implications for Armenia's growth potential as the skill demands of international markets grow.

- **Social Protection.** The staffs also share the document's emphasis on the role of social assistance programs -- and the family poverty benefit in particular -- in alleviating extreme poverty. In the short term, further efforts to reduce poverty will focus on measures to improve social programs and the administration and targeting of poverty benefits, sustainability of public pensions and improvements in their administration, as well as the elimination of remaining implicit subsidies in public service and utility provision which are badly targeted. Resources released through these two measures could then be allocated to increase the real level of poverty benefits and age pensions, as well as for development and introduction of social care services at the local level.
- **Environment.** The I-PRSP identifies the major environmental issues facing Armenia, and correctly notes that environmental protection is significant not only because of the link to economic productivity, but also because the poor are disproportionately exposed to the impact of a deteriorating environment. The strategy also rightly stresses the importance of better public understanding of the links between environment, economic development, and poverty.

Areas of Concern

7. **Government Capacity for Private Sector Development.** The Government has a relatively weak capacity to foster private sector development, including investment and export promotion, deregulation, and the delivery of business development services. Successive governments have failed to give sufficient attention to these issues. Attitudes have changed considerably over the last year, as reflected in the I-PRSP, and the staffs look forward to further discussion of these issues at the Investor Conference in New York in May 9-11, and the proposed Consultative Group Meeting in Paris on July 9-10.

8. **Clear Priority Setting.** The I-PRSP does not detail how the Government plans to set priorities for budget expenditures. The full Strategy will need to look very carefully at how best to allocate the very limited resources available to the Government, and how to improve the costing of development programs. Analysis of allocation decisions will be greatly facilitated when the 2002-2004 Medium-Term Expenditure Program is ready.

9. **Fiscal Policy.** The I-PRSP does not discuss what the potential sources are for the planned increases in spending on priority items such as primary health, general education, old age pensions, and critical infrastructure maintenance. The Bank and IMF staffs believe that only part of this increase could derive from improved revenue collection, and some further cuts in low priority sectors would be necessary, with savings reallocated to priority sectors. An additional reduction in subsidies in energy and infrastructure is especially important. The authorities also need to undertake a critical evaluation of the current high level of military expenditures. Another concern is to improve the mechanism for distributing resources between local communities. The World Bank has agreed to help the Government in these areas through joint preparation of the Public Expenditure Review.

10. **Decentralization.** While the I-PRSP rightly emphasizes the need for an expanded role for local administration in the delivery of core public services, it does not detail the requisite institutional and financial mechanisms. Local governments in Armenia are excessively fragmented and small, and hence face major shortages of managerial capabilities. It may take some time and considerable technical assistance to ensure a real shift of responsibilities to them. In addition, administrative reform and greater use of community-driven development may be required to back up the Government's decentralization strategy. A specific area of concern is the proposed expansion of local governments' involvement in the delivery of heating services. In the staffs' assessment, delivery of heat should be increasingly provided by the private sector.

11. **Human Development.** While overall the document makes a strong case for focusing health and education expenditures on the most important areas (primary health and general education), the I-PRSP is not fully consistent in this respect. The staffs are concerned at the suggestion that the scope of publicly financed medical services be expanded. Indeed given the tight fiscal situation free medical services may need to be better targeted to make them genuinely free and financeable. Similarly in education, the provision of free textbooks for all first graders should not compromise the existing system of subsidized and targeted textbook loans, which is effective and cost-efficient.

12. **Gender.** The I-PRSP notes that relatively more women than men have lost their jobs since independence, and that this has contributed to greater poverty among women, but does not otherwise provide any significant analysis of gender issues. The document does, however, commit the Government to developing a program to ensure women's full-scale participation in social and economic life, and the staffs look forward to discussing the program and its implementation in the context of the full PRSP.

13. **Energy Strategy.** Energy production and distribution has been a major source of quasi-fiscal losses. The full PRSP will need to set out a strategy that facilitates private investment and management in the energy sector, especially after the closure of the Medzamor nuclear power plant. The World Bank has been supporting improved efficiency of the power sector through both rehabilitation and privatization, and the Government has asked it to continue its support, including for investments in more efficient alternatives to electric heating.

14. **Agriculture.** The sustainability of the irrigation sector largely depends on a continuation of tariff and institutional reform and an improvement in payment discipline, both of which have been problematic to implement in the past. The I-PRSP does not provide a clear Government commitment to resolute action on these issues. In addition, the important issue of rural land markets is not addressed -- Armenian agriculture remains excessively fragmented, and higher productivity will require farm consolidation, for which an efficient land market is critical.

15. **Timetable for the Full PRSP.** The full PRSP will need to be informed by the Medium-Term Expenditure Program. With the draft MTEP due only in September 2001, finalizing the full PRSP in December, as currently projected, will be difficult. Other key inputs, such as the census and studies on health care and children's nutrition, will also not be ready in time for the PRSP to be finalized in December. The staffs urge the Govern-

ment not to rush the PRSP if that means compromising on its main building blocks, including the analytical foundations and the process of creating broad consensus in Armenia on the key elements of the strategy.

Next Steps

16. The I-PRSP presents -- with the caveats noted above -- a credible program for reducing poverty. Successful implementation will depend on Government commitment, civil society involvement, and a strict prioritization of the scarce resources -- human and fiscal -- available to implement the program.

17. **Government Commitment.** Strong commitment throughout the Government will be a key to success. All three components of the I-PRSP -- private sector growth, better governance and reduced corruption, and rationalization and improved funding for the social sectors -- will face strong resistance from vested interest groups. The PRSP Working Groups and Units, and the Steering Committee which oversees them, will have a central role in ensuring that the Government has a genuine and cohesive commitment to these reforms. The Working Groups will need to have a clear mandate, and explicit terms of reference, to ensure that they have the necessary authority and incentives to carry out their work.

18. **Building Country Ownership.** The I-PRSP sets out a detailed agenda for civil society involvement in the full PRSP, with a mixture of information dissemination and consultation. It will be important to ensure that civil society is not just informed and consulted, but is directly involved in the preparation and implementation of the strategy. A World Bank mission recently visited Armenia to join discussions of these issues with a wide range of stakeholders, and good progress was made in helping the Government develop a comprehensive strategy for civil society involvement in the full PRSP.

Risks to the Strategy

19. While the development of the PRSP as a whole is on the right track, there are a number of risks:

- **Revenues.** Many of the recommendations likely to come out of the PRSP will require significant increases in Government revenues to finance them, as well as a resolute approach to prioritizing public expenditure. This will require a new sense of purpose in the Government in tackling tax evasion and theft of Government revenues, and will depend on a considerable improvement in institutional capacity.
- **Governance and Institutional Capacity.** Armenia has only a decade of experience with democratic government, regulation of a market economy, and open dialogue between government and civil society. This makes implementation of the I-PRSP and subsequent PRSP programs more difficult, and to help mitigate this risk the Bank and the IMF will support the Government's continuing efforts to improve governance, institutional capacity, public expenditure management, the quality and efficiency of the judiciary, and anti-corruption safeguards. Bank and

IMF staffs will also need to help catalyze integrated donor support for the capacity building necessary to successfully implement the PRSP.

- **Regional Instability.** Armenia has throughout its history seen its development compromised by military and political conflict. Any renewed political instability could divert attention and resources from pressing social and economic reforms. The PRSP could thus usefully examine how best to maintain poverty alleviation objectives in the event of any renewed instability, especially strengthening broad ownership of PRSP goals and priorities.
- **Exogenous Shocks.** Armenia has suffered from a number of other unanticipated setbacks -- the devastating earthquake of 1988, the closure of rail links, the Russia crisis, drought -- and there is unfortunately no certainty that similar shocks will not occur in future. This, and uncertainty over the level of external aid flows, mean that there is considerable downside risk, and the PRSP will need even tighter prioritization of public expenditures and policies than would otherwise be the case.
- **Aid Flows.** The authorities have demonstrated a strong commitment to maintaining macroeconomic stability, and are expected to continue to do so. The main risk to macroeconomic stability would arise if the projected large amounts of external financing from the donor community were to be delayed.
- **Debt Sustainability.** Armenia's current overall debt burden is modest in terms of the size of the economy, but it is high relative to expected export earnings and revenues. Any of the risks mentioned above could result in an unsustainable level of debt. This reinforces the need to maintain reform momentum, and for the Government to strengthen its management and coordination of external assistance, and its promotion of export-oriented private investments.

Overall Assessment

20. The staffs of the World Bank and IMF consider that this I-PRSP provides a sound basis for the development of a fully participatory PRSP, and for Bank and Fund concessional assistance. The staffs recommend that the respective Executive Directors of the World Bank and the IMF reach the same conclusion.

Annex: Key Bank/Fund Events Related to PRSP

| Institution | Event | Expected Date |
|--------------------|-------------------------|----------------------|
| IMF | PRGF Board Presentation | May 2001 |
| IMF/World Bank | JSA of I-PRSP | May 2001 |
| World Bank | CAS | May 2001 |
| World Bank | SAC IV | May 2001 |
| IMF | PRGF Review | September 2001 |
| IMF/World Bank | JSA of PRSP | 2002 |
| World Bank | CAS Update (if needed) | 2002 |