

INTERNATIONAL DEVELOPMENT ASSOCIATION
AND
INTERNATIONAL MONETARY FUND

REPUBLIC OF ARMENIA

**Joint Staff Advisory Note
on the Poverty Reduction Strategy Paper Progress Report**

Prepared by the Staffs of the International Development Association (IDA)
and the International Monetary Fund (IMF)

Approved by Annette Dixon (IDA)
and Julian Berengaut and Martin Fetherston (IMF)

April 8, 2005

I. Introduction

1. The Armenia Poverty Reduction Strategy Paper (PRSP) was presented to the Boards of IDA and the IMF in November 2003 and focused on the government's commitment to equitable growth and sustained poverty reduction. The Executive Boards and the staffs of IDA and the IMF considered the PRSP to be a significant achievement. In January 2004, the government approved a PRSP Implementation Action Plan, in close consultation with various stakeholders. The authorities' PRSP Progress Report provides results of the PRSP implementation from August 2003 to end-2004. This Joint Staff Advisory Note (JSAN) discusses PRSP implementation to date, reports on progress in addressing issues raised in the previous Joint Staff Assessment (JSA), and provides the staffs' advice on key priorities for strengthening the PRSP process further.

2. Overall, the PRSP Progress Report provides evidence of stronger than anticipated poverty reduction and economic performance, improvement in the labor market, and a number of other accomplishments, particularly in fiscal policy and social service delivery. The Progress Report also indicates that progress has been made on many issues raised in the previous JSA, including on improved monitoring and evaluation, participation, and aligning the budget process with the PRSP. At the same time, there are other areas that require further attention, such as deepening the poverty analysis, reforming tax and customs administrations, and promoting financial intermediation, as well as rural development and private sector development. The poverty reduction strategy that forms the core of the government's reform program has been supported by IDA through a Poverty Reduction Support Credit (PRSC) and the IMF through a Poverty Reduction and Growth Facility (PRGF).

II. Poverty Diagnostic

3. **The Progress Report presents a high quality and updated poverty diagnostic for Armenia.** The staffs commend the government for a detailed poverty assessment and the reduction in overall poverty from around 50 percent in 2000–01 to 42.9 percent in 2003, below the level targeted in the PRSP. Extreme poverty dropped from 16 percent in 2001 to 7.4 percent in 2003. Income inequality also fell during this period, as measured by a reduction in the Gini coefficient of income concentration from 0.535 in 2001 to 0.434 in 2003. The Progress Report credits this faster than anticipated progress to double-digit economic growth, the increase of labor income, and the increase in social transfers through a well-targeted family poverty benefits program. The staffs note the substantial increase in the minimum wage in 2004 and continue to caution the authorities on the risk of linking the minimum wage to the poverty line to avoid distortions in the labor market. The degree to which poverty information is available to researchers and the general public is also commendable. The staffs note that using a somewhat different consumption basket and definition, poverty levels appear to have fallen even further in 2003.¹ IDA is working closely with the National Statistics Service through a joint and programmatic poverty assessment to establish a shared consumption basket and definition, and to further strengthen Armenia's in-house capacity to measure and analyze poverty data.

4. **Based on the Progress Report's findings, the staffs recommend a deepening of analytical work on labor markets, poverty in secondary towns, and migration.** The Progress Report candidly recognizes that poverty reduction has been concentrated mainly in Yerevan, with less progress on poverty reduction in rural areas and secondary towns. Moreover, the Progress Report shows that poverty was reduced for all socially vulnerable groups except households with three or more children. Because of this, the Progress Report appropriately places continued emphasis on the poorer regions and rural areas and improvements in the wellbeing of vulnerable groups. The staffs also note the important role played by diaspora and donor financing, as well as remittances. In light of this, the staffs suggest further analysis is needed on selected topics such as: (i) the role and functioning of labor markets, (ii) the structure of poverty in secondary towns, and (iii) the role of migration and remittances in the economy. While recognizing the efforts taken to date to target vulnerable families with children as recommended in the previous JSA, the staffs encourage the authorities to further analyze and address policies necessary to improve the wellbeing of these and other vulnerable groups.

¹ See the Program Document for the PRSC (October 28 2004) pp 10-12.

III. Priority Areas for Public Actions

A. Macroeconomic Framework and Sustainable Growth

5. **The Progress Report presents a remarkable economic performance—with real GDP growth of 13.9 percent in 2003 and 10.1 percent in 2004, compared with target growth of 6–7 percent per year in the PRSP—and a robust medium-term macroeconomic outlook.** The staffs note that economic growth was driven by a boom in agriculture and continued construction activities. End-of-period inflation declined from 8.6 percent in 2003 to 2 percent in 2004. The Progress Report further notes that external debt indicators have improved, with the present value of debt-to-GDP ratio declining from 28.4 percent in 2002 to about 20 percent in 2004. The authorities are encouraged to remain vigilant to major sources of macroeconomic vulnerability and keep inflation under control. Partly because of remittance inflows, as well as a tighter monetary policy during the second half of the year, the real effective exchange rate of the national currency (dram) appreciated by 6.7 percent in 2004. While the recent dram appreciation is not expected to pose a major risk to export competitiveness—because it follows considerable exchange rate depreciation between 2000 and 2003 (23 percent in real effective terms) and has occurred in the context of productivity gains—exchange rate developments should be monitored and their economic impact assessed in the next Progress Report.

6. **It is also encouraging that the labor market has shown signs of recovery following rapid economic growth, although more focus on private sector development issues is needed.** The Progress Report notes the rise in labor income and the staffs note that the official unemployment rate declined marginally in 2004. However, to generate more jobs and reduce poverty, it is critical to ensure a satisfactory **business environment**, which was an issue noted in the previous JSA but not comprehensively covered in the Progress Report. In this regard, the staffs note that surveys of 300 enterprises in 2003 and 2004, based on the perceptions of the business community, highlighted a reduction in the reported time to complete the business registration process, in the cost of registration and in the time required to receive a business license. At the same time, ensuring fair conditions for competition and equitable treatment from customs and tax authorities remains a problem. The staffs note that the government has adopted a time-bound action plan to further improve the private sector environment, in consultation with private sector representatives, and encourage the government to implement it rigorously and report on it in the next Progress Report.

7. There is limited discussion in the Progress Report on the **financial sector**, but the staffs note that recent steps have been taken to improve the lending environment through improved banking supervision, strengthening creditor rights, clarifying procedures for collateral registration and foreclosure, and enforcing commercial contracts. The staffs urge the government to continue to pursue this agenda with vigor, including strengthening the corporate governance of banks and facilitating the introduction of new financial products such as housing finance. The staffs encourage the government to report on progress on implementing recommendations included in the recent Financial Sector Assessment Program (FSAP) update in the next Progress Report.

B. Fiscal and Budgetary Management

8. **The Progress Report rightly notes the government's accomplishments in the conduct of fiscal policy.** The achievements reported include the introduction of the 2004–06 and 2005–07 Medium-Term Expenditure Frameworks (MTEFs), active participation by the line ministries in the design of the MTEFs, and integration of the MTEFs, based on the PRSP process, in the annual budgets of 2004 and 2005. Fiscal policy has remained sound, with consolidated government deficits of 0.9 percent of GDP in 2003 and 2.2 percent of GDP in 2004. The Progress Report also presents evidence of switching expenditures toward activities with high impacts on poverty reduction.

9. **Although fiscal policy remains sound, and in absolute terms revenues were above targets, revenues remained below targets as a percent of GDP.** The Progress Report indicates that reasons for this include the strong growth in tax-exempt sectors and the non-receipt of external grants. The staffs note that these factors, together with deficiencies in tax and customs administrations (including corruption), are serious impediments to efficient revenue mobilization. The staffs note that tax and customs rates have been relatively stable and collections have improved in 2004 by 0.2 percent of GDP, but urge continued reform of tax and customs administration, as suggested in the previous JSA, to ensure sustainability of fiscal reforms. In light of the importance of tax exemptions in explaining weak revenue performance, the authorities are encouraged to remove the remaining tax holidays and exemptions according to the government's schedule. The government's medium-term reform program gives priority to large taxpayer unit reform; introduction of self-assessment; improvement in tax practices through reduction in arrears; conducting more effective audits, including permitting off-site audits and increasing the time allowed for audits; and introduction of risk-based systems for audits and VAT refund processing. In customs, the reform program is focused on carrying out self-declaration and direct trade data input, selectivity of customs control, improvement in post-control audit functions, and a declining reliance on the use of reference prices for valuation of imports as against transaction prices. The staffs encourage the government to deepen the customs and tax reforms along these lines and reflect on achievements in the next Progress Report.

10. **Substantial progress has been made in public expenditure management, but much remains to be done.** The authorities have implemented many of the recommendations of the 2003 Public Expenditure Review as recommended in the JSA of the PRSP. The Progress Report notes that the government has adopted an action plan for structuring the budget around programs, and is piloting this plan in four ministries. It also notes that it is developing a process of ensuring accountability in noncommercial organizations. However, going forward, it is essential to improve the consistency of the annual and quarterly budgets with the actual outturns, prepare a public investment plan (PIP) to improve strategic planning of capital expenditure, and implement the action plan to improve the monitoring system for the noncommercial organizations (NCOs). The staffs encourage the government to take further steps to improve budget management systems and transparency in public resource management, as suggested in IDA's Public Expenditure Review and the previous JSA. The staffs also suggest that additional attention is needed in: (i) improvement in public procurement; (ii) translation of the adopted anti-corruption strategy into specific actions,

especially in tax and customs administration reforms, (iii) improvement in judiciary independence; and (iv) development of transparent internal and external audits systems and further upgrading of the public sector accounting and reporting systems. In addition, the staffs suggest that the government continue reducing nonpriority current spending and correspondingly increase priority public investments. This should be accompanied by an improvement in expenditure classification in line with best international standards.²

C. Delivering Social Services

11. **The Progress Report indicates that while the absolute value of social sector funding has increased significantly, as a percent of GDP it dipped below the target in 2003, although this has recovered roughly to the target level in 2004.** While emphasizing the importance of maintaining adequate levels of social spending, the staffs also encourage the authorities to improve their ability to track pro-poor funding to improve the targeting of social spending.

12. In **education**, the Progress Report describes satisfactory progress in the school rationalization program and increased spending in 2003 and 2004, including higher teacher salaries and increased training. Education spending, as a percent of GDP rose, from 2.2 percent in 2002 to 2.7 percent in 2004 (which was the PRSP target). The government also initiated policy formulation on early childhood education with wide participation and plans to ensure that the policy formulation remains financially sustainable with a focus on those in general need. The staffs note the government's intention to further develop new financing mechanisms in tertiary education in order to increase access and improve financial transparency and efficiency. The Progress Report notes the importance of addressing problems in facilities, including heating, and the staffs encourage the government to report on this area in the next progress report. The staffs also note that further increases in education spending are necessary as GDP grows, in order to reach the PRSP target for education spending of 3.0 percent of GDP in 2005.

13. In the **health** sector, the Progress Report indicates that the government adopted an action plan on hospital governance, increased spending in 2003 and 2004, and took measures for secured financing and management of the primary health care departments of Polyclinics. The Progress Report notes that health spending as a percent of GDP rose from 1.2 percent of GDP in 2002 to 1.3 percent in 2004, but this falls short of the 1.5 percent target. The Progress Report also notes the process of merging facilities to improve efficiency. The staffs urge the government to continue implementation of the hospital rationalization program, improve health care worker training, and develop options for private insurance to cover certain health risks. The staffs applaud the reported reduction in child and maternal mortality and note the intention of the government to strengthen the accuracy of these statistics. As in education, the staffs note that further increases in health spending are necessary in order to reach the PRSP target for health spending of 1.8 percent of GDP in 2005.

14. On **social assistance**, the Progress Report notes that targeted cash family poverty benefits remain a major pillar of the safety net. The government introduced measures aimed at

² *Government Finance Statistics Manual 2001* (IMF, 2001).

further improving the administration of these benefits, including better monitoring and evaluation, and a more streamlined appeals procedure. In social insurance, the government has made satisfactory progress in introducing individual accounts in the pension systems, improving collection of social insurance contributions, and increasing pensions. The government also began implementing the state pension law that envisages stronger links between pensions and contributions. The government is encouraged to maintain the targeting of family benefits and further strengthen the focus on the most vulnerable.

D. Improving Infrastructure and Modernizing Rural Areas

15. **The staffs note good progress has been made in infrastructure in recent years through both investments and moving towards sustainable tariff structures in water supply and energy.** The staffs particularly note the improvement in energy efficiency in irrigation systems and the increased budget for roads construction. At the same time, the staffs suggest that more needs to be done in developing market rules in the energy sector as well as service and quality standards, and publishing financial results of operating companies. The Progress Report notes the particular importance of strengthening **rural development**, including rural roads and water supply. The staffs note that the government has completed a diagnostic study on rural infrastructure services (drinking water, roads, gas, electricity, and telecommunication) and stress the need for the government to clarify policies, ownership of assets, responsibilities for service provision and operations and maintenance in order to facilitate investment in rural services. The staffs also encourage the government to build innovative private-public partnerships in infrastructure, given the limits on public investment in the economy.

16. **The Progress Report indicates that growth in the agriculture sector was 14.5 percent in 2004, although rural poverty remains a key concern.** The staffs suggest that the next Progress Report discuss in greater detail the role of agriculture in reducing rural poverty, including more analysis of the proposed system of crop insurance, the functioning of land markets, and the use of land as collateral in rural areas. The Progress Report lacks information on government actions in the area of the **environment**. The staffs encourage the government to take steps in monitoring the environmental actions proposed in the PRSP and, in particular, the issues related to Lake Sevan, forests, and land degradation.

IV. Participation, Coordination, and Monitoring

17. **The staffs commend the authorities for having further deepened consultation and participation during PRSP implementation.** The Progress Report notes that the government has continued to organize regional workshops and specialized working groups around reform themes, and in the fall of 2004, the government revamped the PRSP steering committee into a participatory steering committee with participation of government, parliament, civil society, and donors. The government has also established an Open Forum to hear the voices of a wider range of stakeholders. The participatory and transparent process is a highlight of the Armenia PRSP process, and the staffs encourage the government to maintain this emphasis, including reaching out to those with limited voice.

18. **The staffs note that donors have generally integrated their efforts behind the PRSP, although coordination remains largely led by donors.** German technical assistance (through GTZ) is supporting the PRSP secretariat in the Ministry of Finance and Economy. Other donors, such as the UN and EU, also provide financial support for PRSP activities. The same is true for the United States through USAID and now through the Millennium Challenge Corporation (MCC), for which Armenia has become eligible. Nevertheless, despite efforts by the Ministry of Finance and Economy and various line ministries to coordinate external assistance, most coordination is still led by donors through various donor sectoral working groups. The staffs emphasize the importance of donors continuing to harmonize their activities and for the government to take a more active role in donor coordination, including strengthening the administrative setup in the government to undertake this task effectively.

19. **The Progress Report describes good progress on monitoring and evaluation.** The government created a Monitoring Task Force in November 2003, with independent expert participation, and established a set of 177 indicators, harmonized to the extent possible with the Millennium Development Goals. This is complemented by the fifth annual publication of a larger analysis of data as a Social Snapshot in November 2004. The staffs commend the government for their strong emphasis on monitoring and evaluation and for making data widely available, including through the web (www.prsp.am). The staffs encourage the government to complement quantitative measures with quality indicators, particularly for health and education services, as well as present how indicators compare with other countries.

V. Conclusions

20. Armenia has had a successful first year of PRSP implementation in which most of the targets have been met or exceeded and which was marked by a high level of consultation and participation. The policies and priorities envisaged in the PRSP have been progressively integrated into the MTEF and the annual budget process. The PRSP Progress Report provides a rich set of information on PRSP implementation, and should therefore help donors to assess the progress made by the government in carrying out its poverty reduction strategy. At the same time, there are a few areas where greater effort will be required. These include (i) strengthening the business environment and promoting financial intermediation; (ii) deepening analysis of poverty, particularly with regard to secondary towns and rural areas; (iii) continuing to implement tax and customs reform to further increase tax collections; (iv) deepening reforms in health and education oriented toward raising the quality of services; and (v) further strengthening the approach to rural development including the provision of infrastructure and social services.

21. The staffs also note that Armenia has put into place a comprehensive MTEF process and is preparing an action plan for modernizing its laws and regulations under the European Neighborhood Policy (ENP). The government could benefit from bringing together the PRSP implementation processes with the ENP action plan. Given the progressive integration of the PRSP process into the MTEF and budget process, the staffs suggest that future PRSP Progress Reports could take the form of a brief document that assesses progress and is attached to the MTEF documents, rather than prepared separately. Finally, the current Progress Report recognizes the need to revise original PRSP targets and target indicators by the end of 2005,

given that many of them have been significantly exceeded. The staffs welcome the planned update, and consider it important to maintain the PRSP expenditure targets for the social sectors as a percent of GDP.