

INTERNATIONAL DEVELOPMENT ASSOCIATION
AND
INTERNATIONAL MONETARY FUND

REPUBLIC OF ARMENIA

Joint Staff Assessment of the Poverty Reduction Strategy Paper

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

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I. OVERVIEW

- 1. The Poverty Reduction Strategy Paper (PRSP) for Armenia builds on the strategy laid out in the Interim PRSP** that was presented to the Boards of the International Development Association (IDA) and the International Monetary Fund (IMF) in March 2001 and May 2001, respectively. In addition to annual progress reports, the Government intends to update the PRSP every two to three years to reflect new developments and ensure that its objectives are achieved. This process will include new annual household surveys and updates of the Medium-Term Expenditure Framework (MTEF).
- 2. The PRSP is a comprehensive poverty reduction program.** It has been prepared through a fairly wide participatory process within the Government (at both national and regional levels) and with civil society and the donor community. It contains an extensive analysis of the causes of poverty and the challenges faced; a comprehensive strategy with short and long-term perspectives; and a set of priority public actions, evaluation plans, costing of programs, and a financing scenario.
- 3. Further efforts are envisaged during the implementation phase and subsequent updates,** including further improving consultation with civil society, developing monitoring indicators, enhancing prioritization of the actions contained in the three-year matrix of reforms, developing more specific and quantified outcome measures, and building capacity within the Government for planning, implementing, monitoring, and evaluating the strategy.
4. The Joint Staff Assessment discusses the PRSP in the following key dimensions: Participatory Process (Section II); Poverty Diagnosis (Section III); Poverty Reduction Strategy (Section IV); Targets, Indicators and Monitoring (Section V); and Risks to the Strategy (Section VI). Section VII presents the conclusions of this assessment.

II. PARTICIPATORY PROCESS

5. **The PRSP was prepared in the context of a broad participatory process at the national and regional levels.** The process was effective in reaching the poor and collected contributions from civil society. It involved consultations within the Government and with members of the National Assembly, nongovernmental organizations, academia, the private sector, trade unions, local communities, farmers, and members of the Armenia Diaspora, as well as public opinion surveys, workshops, and wide dissemination in local mass media. The process was led by a steering committee headed by the Minister of Finance and Economy and coordinated by a working group led by the deputy Minister of Finance. The Committee reported to the Prime Minister and involved line ministries, committees of the National Assembly, political parties, and nongovernmental and donor organizations. The Government also consulted regularly with development partners and donors enhanced their participation effectiveness through provision of technical assistance.

6. **The PRSP views participation in the implementation, monitoring, and evaluation stages as important as in the preparation stage.** In this context, the staffs encourage the authorities to utilize even more intensively the capacity of civil society in assessing the implementation and revising the strategy in years to come.

III. POVERTY DIAGNOSIS

7. **The PRSP provides a sound assessment of the nature and determinants of poverty in Armenia.** The PRSP candidly discusses the factors that have contributed to high levels of poverty in Armenia and analyzes the role of recent economic and structural policies in reducing poverty. Children, women, and rural population with limited access to education and health services are the most deprived. Despite the absence of comparable poverty indicators for the last decade, the analysis makes a good attempt at assessing the impact on the level of poverty of both past policies and adverse shocks in the early 1990s and recent trends in economic growth.

8. **The poverty diagnosis sets out a comprehensive analysis based on a wide range of indicators,** including indicators related to income and income distribution, consumption, health, education, access to water, nutrition, fertility, and regional issues. The analysis relies on data obtained through a wide variety of surveys, including three household surveys conducted in 1996, 1998, and 2001. The results of the 2002 household survey will be reflected in the first PRSP progress report. The staffs commend the Government for this extensive analysis in the face of substantial capacity constraints but urge the authorities to address further the problems of income inequality, high poverty among children and the elderly, and the conditions of people residing in high altitude and earthquake regions in upcoming PRSP progress reports. Lastly, the staffs caution the authorities on the risk that the PRSP's proposed approach of linking the minimum wage to the poverty line could introduce distortions in the labor market and encourage the growth of the unofficial economy.

9. **The PRSP recognizes that rural poverty remains a problem and envisions policies to reduce it.** While urban poverty has decreased since the late 1990s, there has been stagnation in rural poverty reduction. The PRSP appropriately identifies several factors responsible for

this stagnation in rural poverty reduction, including underdeveloped rural distribution network and storage facilities, disrupted trading routes and higher transport costs, small land holdings, and falling agricultural prices relative to consumer prices. The authorities are encouraged to continue and expand their reviews of rural poverty, adopt the necessary measures to reverse the deteriorating trends of rural poverty, and reflect these in the next progress report on PRSP implementation.

IV. THE POVERTY REDUCTION STRATEGY

10. **The policy priorities of the PRSP are appropriate.** The PRSP presents coherent and outcome-oriented frameworks for poverty reduction. Five themes emerge as priority areas of action: (i) promoting sustainable economic growth through macroeconomic stability and private sector development; (ii) enhancing human development and improving social safety nets; (iii) implementing prudent fiscal policies and reforming the tax system; (iv) improving public infrastructure; and (v) improving core public sector functions. The policy actions set forth in the PRSP are generally consistent with these themes, although effective implementation of the strategy will require additional refinement of the priorities and a reinforcement of implementation capacity.

11. **While the authorities have made a good attempt at prioritizing, sequencing, and costing the PRSP, further improvements are needed in these areas.** The Public Expenditure Review provides a useful instrument for facilitating these improvements. While the PRSP Annexes present a well-structured set of budget projections, more discussion would be useful of the budgetary impact of the PRSP proposals relative to the baseline. In addition, as discussed in the recent Public Expenditure Review, there is a need for improvements in budget management including better transparency and accountability, reforms of budget administration, and a switch to program budgeting.

A. Macroeconomic Framework

12. **The medium-term macroeconomic framework is consistent with macroeconomic stability and poverty reduction** and is broadly in line with the Poverty Reduction Growth Facility (PRGF). Economic growth and export projections are realistic. The recently prepared MTEF contains the same nominal projections for social spending, but it implies higher current expenditures compared to the PRSP. These expenditures have been largely reduced and understandings reached in the context of recent PRGF discussions. The fiscal deficit envisaged in the PRSP is enough to safeguard debt sustainability, and the mix between current and capital expenditures reflects current priorities. The tax and customs administration reforms discussed in the context of the PRGF-supported program will be necessary to boost revenue and finance the expected increase in total expenditure. The authorities should also stand ready to adopt additional measures to achieve those goals in case of revenue shortfalls. Recent estimates of tax collection potential suggest that the tax revenue targets could be attained or exceeded when such reforms are undertaken. While the paper states that it would be difficult to establish a tax system that is both efficient and progressive at the same time, the staffs urge the authorities to look at possible reforms with both objectives in mind. For instance, the authorities may

usefully explore the possibility of reforming the property tax by raising rates as well as by making it more progressive.

13. **The expenditure plans under the PRSP are generally adequate but should be reassessed frequently to ensure the prioritization of infrastructure needs and the effectiveness of social spending.** The recent MTEF is a tool that should enhance the capacity for pro-poor budgeting over time. The MTEF process should be further advanced to move from the current input-based budgeting to output-oriented budget practice. Sectoral expenditure programs have been appropriately targeted, but most of these programs will be carried out under a recent decentralization reform that has led to the creation of a number of noncommercial enterprises, including hospitals and schools. At present, these entities are not subject to proper reporting requirements, raising concerns about the transparency and effectiveness of their spending which accounts for about 15 percent of the government's budget. Under the PRGF-supported program, the authorities expect to restore comprehensive reporting for these enterprises in early 2004 and subject them to comprehensive audits.

14. **The poverty reduction strategy contains an adequate and realistic financing plan, but further reassurances of commitments by donors and other external development partners are needed to facilitate macroeconomic planning.** While the alternative scenario with lower economic growth presented in the PRSP suggests that public spending could remain unchanged compared to the baseline, the analysis is based on the assumption that external borrowing requirements would also be unchanged. Absent inflationary financing, higher external borrowing may however compromise debt sustainability. If this were the case, the level and the composition of public spending will need to be revisited in order to contain the worsening of the fiscal deficit. In this regard, the authorities would do well to develop a contingency strategy that elaborates on the low-growth scenario and the actions that could be taken to constrain public spending and increase revenues.

B. Structural and Sectoral Policies

15. **While the PRSP adequately addresses the root causes of poverty in Armenia, it will be critical to ensure a consistent improvement in terms of transparency, public resource management, prioritization and sequencing of reforms, and capacity building.** A reduction of income inequality will require courageous reforms to improve accountability in the Government, the legal system, and state-owned enterprises. Such reforms will allow for an improvement in the quality of basic services and release further resources for poverty reduction programs. A successful implementation of the strategy will also hinge on further prioritization and clearer linkages between actions and desired outcomes, the development of contingency measures in the event of adverse shocks, and improvements in monitoring, budgeting, and implementation capacity. The authorities are encouraged to address these issues in their annual progress report on the implementation of the PRSP.

16. **The PRSP recognizes the importance of good governance for poverty reduction and the staffs encourage the authorities to redouble their efforts in this area.** Notwithstanding the importance of increased public sector salaries in fighting corruption and

the ongoing work to finalize an anti-corruption strategy, prompt action is required to increase transparency and governance in tax and customs administration and in the judicial system.

17. **The staffs believe that continued improvements in the business environment are critical to continued job creation and poverty reduction in Armenia.** The PRSP recognizes that output growth in recent years has not been accompanied by sufficient employment generation because the business environment has not been supportive enough for new entrants. In this regard, the emphasis given to plans for supporting the development of small and medium-size enterprises is appropriate. Further improvements in the business environment will also hinge on progress in the governance and public resource management reforms mentioned above and on the successful restructuring of the banking system. The authorities are encouraged to continue their initial efforts in these areas and reflect the progress achieved in the progress report on PRSP implementation.

18. **In the health sector, the staffs agree with the PRSP's focus on increasing accessibility to essential health services.** The PRSP also recognizes that additional budget resources, intra-sectoral reallocation, and improved efficiency of the health system will be needed to achieve this objective. The PRSP emphasizes the importance of improved maternal and child healthcare and suggests measures to achieve the Millennium Development Goals (MDG). While there are measurement issues to be resolved, the staffs believe that the MDG targets for maternal and infant mortality are achievable.

19. **In the education sector, the PRSP establishes that ensuring quality of education and enhancing its accessibility are essential for economic growth and poverty alleviation.** The staffs agree with the proposed strategy to improve the conditions of teachers and upgrade their skills and realign the education system to the needs of the information technology sector. The staffs also agree with the proposed outcome and interim output indicators—increase in years of educational attainment, secondary school completion rates, staff remuneration rates, and efficiency-enhancing measures. To these ends, the Ministry of Education and Science is working on a policy related to student assessment. The staffs encourage the authorities to provide indicators related to student achievement to measure the quality of education and to compare Armenia with other countries in future PRSP updates.

20. **The PRSP pays particular attention to social risk management programs.** It recognizes social insurance and social assistance as key elements of the poverty reduction framework. Targeted cash family poverty benefits—one of the most successful poverty alleviation programs in the region—remains a major pillar of the safety net. The PRSP envisages a range of measures aimed at further improving the administration of these benefits, including better monitoring and evaluation, more streamlined appeal procedures, and a more active role for territorial centers in providing social assistance that reaches out to the poorest. Increased funds and improved administration should ensure achievement of the Government's objective of covering a higher percentage of the extremely poor. The PRSP also envisages a change in the targeting mechanism for the family poverty benefit from proxy-means to income-based eligibility testing. Although the change will be initially piloted, the staffs caution that the benefit is already well targeted and that income-based targeting may not be the best option given the high share of informal economic activity in Armenia. In the area of social insurance,

the PRSP adequately focuses on completing the introduction of individual accounts in the pension system, better collection of social insurance contributions, and increase in pensions. The PRSP also recognizes the importance of implementing the recently adopted state pension law that envisages stronger links between pensions and contributions. Overall, safety net policies and planned resources, if implemented as envisaged, will contribute to improving the welfare of the poor and vulnerable segments of the population.

21. **The PRSP correctly identifies the critical role of the energy, water, irrigation, and transport sectors** in the country's development prospects. Good progress has been made in these areas in recent years but more remains to be done. In the energy sector, reforms should include the restructuring of the dispatch, transmission, and settlement companies to create a more efficient and transparent sector. In the irrigation sector, reforms will include increases in tariffs for bulk and end-users to attain greater cost recovery. Drinking water tariffs will also need to be increased over the next three years to attain cost-recovery levels and mechanisms need to be designed to mitigate the adverse impact of such increases on the poor.

22. **In the transport sector, the reorganization and financing of the road sector needs to be urgently addressed.** The staffs agree with the PRSP that improved roads would help provide citizens with better opportunities for sharing Armenia's economic growth, and the authorities are encouraged to pay special attention to road rehabilitation and maintenance. In order to put road sector financing on a sustainable and predictable basis, more reliance needs to be placed on user charges. At the same time, responsibility for the administration and management of rural local roads is unclear, and better mechanisms are needed for allocating the road sector budget between main, local, and city roads.

V. TARGETS, INDICATORS AND MONITORING

23. **The targets and intermediate indicators presented in the PRSP are selective, well identified, and consistent with the MDG.** Although they appear ambitious, they are achievable: the PRSP contains a range of actions aimed at improving public services delivery in health, education, and social protection and increasing the welfare of the population. At the same time, the success in reaching the targets critically depends on timely and successful implementation of the envisaged actions.

24. **The policy matrix contained in the PRSP is comprehensive, but it also needs to be developed to ensure a focused implementation of the strategy.** The outlined objectives are appropriate but could be more detailed, and a list of specific measures and actions, monitoring indicators, target dates, and source of financing should be added. Otherwise, it will be difficult to gauge progress toward the PRSP objectives and whether public expenditures are effectively used. The staffs welcome the emphasis given to monitoring and evaluation based on statistical reporting systems, sample surveys, and civil society participation, but emphasize the need for clarification of the administrative mechanisms for undertaking such tasks, including the production of a more comprehensive baseline data set against which progress on the PRSP can be monitored. In this regard, the staffs welcome the plan to set up an implementation and monitoring committee that will further develop indicators to measure progress on PRSP implementation.

25. **Further improvements in budget classification, expenditure management, and reporting systems with emphasis on poverty-related expenditure monitoring will also be important.** To this end, the staffs encourage the Government to implement the recommendations of the Public Expenditure Review, which include expanding budget coverage to include extra-budgetary and special funds, quasi-fiscal subsidies, accelerating introduction of international accounting standards in budget institutions, and expanding the role of line Ministries in budgeting and monitoring. Lastly, every effort should be made to expand the coverage of budget execution reports to the level of the general government including full details on the activities of noncommercial enterprises.

VI. RISKS TO THE STRATEGY

26. **The success of the strategy will depend on the external environment and the Government's commitment and capacity to implement it.** The fragility of the external environment is highlighted by the difficulties in resolving the conflict with Azerbaijan, the lack of trade relations with Turkey, and intermittent political and economic instability in some countries of the region. Adverse developments in the market for precious stones and related metals, Armenia's main source of export revenue, could also hamper growth prospects. Another important risk arises from the unpredictability of private remittances and official grants and concessional loans; this could be partly offset by seeking more actively commitments from donors to ensure the financing of the strategy. Lastly, failure to improve tax and customs collections, strengthen the legal and banking systems, and root out corruption (including forceful implementation of the forthcoming Anti-Corruption Strategy) will impede a meaningful reduction in poverty rates and perpetuate an unequal distribution of income. Effective political leadership and strengthened capacity will be required to neutralize vested interests and minimize these risks.

VII. CONCLUSIONS

27. **The authorities' PRSP represents a significant achievement.** The Government's efforts in preparing the PRSP are highly commendable. However, further work will be required to refine the proposals and facilitate their implementation. The risks outlined above constitute a reminder of the need for strong political leadership, ownership of the strategy, and continued efforts to adapt it in light of new developments. At the same time, the PRSP's challenging agenda will require considerable assistance and firmer commitments from Armenia's development partners to finance the strategy.

28. **In light of the above, the staffs of the World Bank and the IMF consider that the authorities' poverty reduction strategy provides a sound basis for IDA and Fund concessional assistance.** The staffs recommend that the Executive Directors of the World Bank and the IMF reach the same conclusion.