

**Republic of Armenia: Joint Staff Advisory Note on the
Second Poverty Reduction Strategy Paper**

The attached Joint Staff Advisory Note (JSAN) on the Second Poverty Reduction Strategy Paper for the Republic of Armenia, prepared jointly by the staffs of the World Bank and the IMF, was distributed with the member country's Second Poverty Reduction Strategy Paper to the Executive Boards of the two institutions. The objective of the JSAN is to provide focused, frank, and constructive feedback to the country on progress in implementing its Poverty Reduction Strategy (PRS).

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REPUBLIC OF ARMENIA

**Joint Staff Advisory Note
on the Second Poverty Reduction Strategy Paper
(Sustainable Development Program)**

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

Approved by Shigeo Katsu (IDA)
and Lorenzo L. Pérez and Adnan Mazarei (IMF)

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I. INTRODUCTION

1. **The *Sustainable Development Program* (SDP)**, approved by the government in **October 2008, is Armenia's second Poverty Reduction Strategy Paper (PRSP-2)**. The SDP has three key goals covering the period 2009–2021 (with specific medium term targets indicated in 2009–2015): reducing poverty, including the elimination of extreme poverty; ensuring human development; and deepening economic growth and accelerating development of lagging regions. The SDP incorporates important recommendations from previous Joint Staff Advisory Notes (JSANs), including in the areas of fiscal management, economic policy reform, and the social sectors. This JSAN summarizes the results of PRSP-1 implementation, reports on progress in addressing issues raised in the previous JSAN, and provides the staffs' advice on key priorities for strengthening the SDP.

II. ASSESSMENT OF KEY PRSP-1 INDICATORS

2. **The SDP builds on the considerable achievements of PRSP-1.** Armenia's poverty and extreme poverty rates declined in 2006 to 26.5 percent and 4.1 percent of the population, respectively (from 34.6 percent and 6.4 percent, respectively, in 2004), results which surpassed PRSP-1 projections. Inequality also decreased to a rate below the PRSP-1 goal, as measured by a reduction in the Gini coefficient (income concentration) from 0.395 in 2004 to 0.369 in 2006. Prudent fiscal and monetary policies were instrumental in maintaining macroeconomic stability and contributing to poverty reduction. Real GDP grew by

13.1 percent per year on average over the period 2003–07, more than twice as much as the PRSP-1 target. Inflation averaged 3.9 percent during the same period, which was very low compared with similar economies in the region. Social expenditures also increased to 4.7 percent of GDP, well above the projected PRSP-1 goal of 3.0 percent. Increased resources to the social sectors have improved the access to and quality of general secondary education, and have led to improvements in overall utilization and geographic access to basic health services, most notably through the free provision of primary health care to the population.

3. **However, the PRSP-1 underperformed on a number of key fiscal, and economic indicators.** Economic diversification was limited as growth performance remained narrowly based on remittances (the level of remittances to GDP is, at nearly 20 percent, among the highest in the world) and construction. Export performance was disappointing with real growth in exports at less than 2 percent per annum in 2004–07. The revenue to GDP ratio only grew to a less-than-targeted 14.5 percent by 2006 (though reached 16 percent by 2007), reflecting limited progress in reforming revenue administration, whereas total public spending decreased by 0.7 percent of GDP during 2003–07.

III. POVERTY DIAGNOSTIC

4. **The SDP presents a high quality empirical analysis of current poverty and inequality conditions, and shows that Armenia has continued to make impressive gains.** Faster than anticipated progress is credited to double-digit economic growth, the increase of labor income, private transfers from abroad, pensions, and the increase in social transfers through a well-targeted family poverty benefits program. The SDP also provides in-depth analysis of regional poverty disparities, as well as the gender and age dimensions of poverty, which are used to inform the key objectives of the SDP. The regional development objective is informed by the higher poverty incidence in marzes affected by the earthquake, in border regions, in areas with a low share of irrigated agricultural land, and in predominantly urban marzes. The poverty diagnostic shows very little difference in poverty level by gender, and better than average progress among the aged population over the period 2003–06. Going forward the SDP targets a reduction in poverty and extreme poverty incidences (by rural and urban marzes, for children, and for retirees, among others). Keeping the 2004 poverty lines constant in real terms, it is projected that the overall poverty incidence would fall to 8 percent in 2012, while the incidence of extreme poverty (US\$ 1 per day) would decrease to 1.2 percent. If current trends continue, Armenia is likely to meet the MDG 1.

5. **However, SDP projections of poverty trends seem optimistic.** Poverty reduction tends to be much more challenging at lower poverty levels, in which case economic growth is necessary but not sufficient for sustainable poverty reduction. More broadly, staffs encourage the government to expand its use of poverty and social impact analyses of key SDP policy measures (beyond pensions and social protection programs). Moreover, given increases in food and energy prices in 2006–08, the progress report would benefit from some discussion

of their overall poverty and distributional impacts. Lastly, it would therefore be useful if the progress reports would present poverty incidence simulations based on other possible macroeconomic scenarios. In particular, a decline in remittances due to a global slowdown could have important consequences on poverty reduction.

6. **The SDP envisages a gradual shift from household survey-based poverty lines to a minimum consumption basket (MCB), which is much higher than currently used poverty lines.** This shift reflects a desire to move from a basic needs approach to one that would better reflect a higher level of income and living standards. The MCB is a normative list of products households should consume at a minimum as determined by government agencies, and as such is subject to political considerations (as it is determined by law). Staffs recommend continuing to use the survey-based poverty line instead of switching to the MCB.

IV. PRIORITY PUBLIC POLICIES

A. Macroeconomic, Fiscal, and Growth Framework

7. **The medium-term macroeconomic framework is consistent with macroeconomic stability and poverty reduction.** The SDP presents an extensive and in-depth coverage of the macroeconomic framework and of macroeconomic policies. Projections are fully in line with the 2009 annual budget and the Medium Term Expenditure Framework (MTEF), and are broadly consistent with the macroeconomic framework underlying staff reports. Overall, growth projections for the medium-to-long-term scenario are plausible, though will need to be updated to account for developments in the external environment.

8. **However, there are downside risks to the growth outlook.** GDP growth is projected to slow down over the period 2008-11, although continued large remittances and capital inflows would contribute to keeping growth at about 9 percent on average. (staffs project average growth to be less than 8 percent over the same period). The worsening international environment and growing domestic imbalances represent significant challenges to this outlook. As financial disturbances spread to the real economy in Europe and Russia, Armenia's external current account deficit, which is already high, is likely to experience more pressure. Inflation may not decline as rapidly as projected, particularly if higher inflation expectations become entrenched and lack of competition prevents a complete pass-through from falling international prices to domestic prices.

9. **Achieving ambitious revenue targets requires that long-overdue tax policy and tax administration reforms are forcefully implemented, as recommended in previous JSANs.** The tax revenue-to-GDP ratio remains very low by international standards, and increases in tax collections in recent years have been accompanied by the accumulation of tax credits. Tax policy deficiencies, such as exemptions and weaknesses in tax and customs administration, continue to hinder efficient and transparent revenue mobilization. The SDP recognizes the importance of strengthening revenue. However, full implementation of

identified reform measures is needed to achieve the average yearly increase in tax revenues of 0.4 percent of GDP. Staffs believe these ambitious targets could be attained if the government: (a) emphasizes the introduction of self-assessment and self-declaration systems in tax and customs administrations, and upgrades its risk-based audit and post-clearance review capacity; (b) modernizes the organization and human resources of the new revenue agency, and strengthens cooperation between the tax and customs functions; (c) introduces an effectively functioning appeal system; and (d) improves taxpayer services. Political resolve will have to undergird all of these efforts to ensure success, especially since some time would be needed before noticeable increases in revenue were achieved.

10. **Permanent expenditure increases introduce rigidities in government spending.** Significant increases in basic pensions and civil service wages are important steps in addressing the SDP objectives of reducing poverty and improving the quality of public services. At the same time, these changes make current spending more difficult to compress were the need for fiscal adjustment to arise. Moreover, the fiscal implications of the pension reform to be implemented in 2010 are not clearly accounted for in the SDP. In particular, the estimates of pension reform costs appear to be based on optimistic assumptions (and exclude administrative costs), given that the introduction of the relatively large second pillar with an expansionary PAYG benefits policy will generate rising deficits, even if the contribution base grows rapidly and overall demographic trends are much more favorable.

11. **Large investment projects in energy and infrastructure should be included explicitly in the projections.** The authorities plan to continue their effort to upgrade the country's infrastructure, including the potential replacement of the nuclear power plant and the construction and upgrading of several highways, rural roads, and railways, as well as deployment of a national broadband communications backbone. Staffs also note that a number of high priority investment projects, such as the creation of IT parks, have not been featured in the SDP. Some of these projects will involve a partnership with the private sector, but most of them are likely to involve a substantial participation of the government, either directly or by means of government guarantees. SDP projections do not explicitly include most of these projects, raising the question of affordability. The MTEF and SDP progress reports should include more detailed costing of major investment projects.

12. **The fiscal position is expected to remain prudent in the base case, but less favorable scenarios have not been developed in the SDP.** The overall budget deficit, measured according to GFSM 2001, is expected not to exceed 2 percent of GDP over the projection period. As a result, public debt would increase moderately from 17.8 percent of GDP in 2007 to 23.9 percent of GDP in 2021. The projected fiscal position appears sustainable and well within the limit recently introduced by the State Law on Debt Management. However, it appears that SDP projections do not factor in large anticipated investment projects in energy and infrastructure, which are necessary to boost growth over the long term. This suggests fiscal space will likely need to be made to support higher

investment spending. Overall, risk analysis highlights the need for strengthened expenditure appraisal and prioritization.

13. **The SDP puts forth a second generation economic growth and diversification strategy aimed at deepening competition and fostering private sector development, as urged in the last JSAN.** Ensuring equal conditions for economic competition will require stronger political will as well as legal and regulatory measures. These include: (a) strengthening the law on competition, reinforcing the capacity of the Economic Competition State Commission, and improving conflict of interest laws and implementing them more forcefully; (b) upgrading regulatory frameworks for public-private partnerships; and (c) liberalizing the civil aviation and telecommunications sectors. Greater efforts should be made to ease administrative and legal barriers, including those related to weaknesses in corporate governance, for small businesses and firms located outside of Yerevan. The reduction in costly tax and customs administration barriers would also make Armenian firms more competitive globally.

14. **The financial sector does not present significant vulnerabilities, but the recent strong credit growth has increased banks' exposure to a number of risks.** Capital adequacy is very strong, profitability high, and nonperforming loans remain low (with a share of 3 percent in the first half of 2008). However, deposit growth has lagged behind credit growth during the last three years, and banks had to increase external financing to the equivalent of 17 percent of all bank loans in 2007. External exposure could become a significant source of both foreign exchange and roll-over risks. Moreover, the rapid growth of credit has largely financed household mortgages, increasing banks' exposure to a possible decline in real estate prices.

15. **The nature and likelihood of the downside risks would warrant a cautious macroeconomic and fiscal stance as the SDP period unfolds.** Protracted regional instability, persistent inflationary pressures, further worsening of the external balance, and drying-up of capital inflows all constitute significant downside risks to the growth outlook. There may also be pressures from the expenditure side that might not be realistically budgeted for in the SDP, including pension reforms and various infrastructure projects. On the other hand, removal of existing trade barriers with Turkey and Azerbaijan would have important positive repercussions on growth. A careful consideration of the balance of risks and their implications—the SDP does not provide alternative macroeconomic scenarios nor does it discuss risks to the program—would be needed to assess how the policies presented in the SDP can be adapted to deal with possible alternative scenarios.

B. Governance and Public Sector Reform

16. **The SDP is built on achievements in public administration and judicial reforms initiated under PRSP-1, and proposes ambitious new reform programs in both areas. In**

public administration the SDP focuses on the following areas: (a) increasing the competitiveness of public service pay while improving performance management; (b) further developing and rolling out e-government systems; (c) introducing conflict of interest rules for public servants; and (d) strengthening public expenditure management (PEM) through development of a comprehensive and prioritized strategy.

17. Staffs acknowledge the importance of a broad-based governance and public administration reform program for strengthening state capacity to deliver on the SDP's objectives. Conflict of interest rules are important not only for public servants, but also for high level executive, legislative, and judicial officials, and should be developed as a priority. Measures to make public service pay more competitive are also critical, and should be developed to target pay for strategic and functional priority areas, and to link increased pay to performance appraisal as a first step toward instilling a more robust performance management framework for public servants. Expansion of e-government functions and services will depend on both development of the broadband backbone and meeting the targets set for 'Government to Citizen' and 'Government to Business' services. However, the SDP only addresses Government to Government (G2G) and Government to Employees (G2E) systems that already exist or are under construction, and does not set targets or propose a strategy for developing an integrated system. Efficient and integrated G2G and G2E systems will also require automation of key "back office" functions.

18. Legal and judicial reform is also critical for economic development as well as citizens' welfare, yet the SDP does not provide evidence of an increased budget allocation sufficient to implement the proposed reforms. For motivational impact it is essential that an increase in judicial salaries is sustainable over the long term, and that proper capacity is built for training judges and fully developing the Judicial School. Funding is also needed for the on-going development of the arbitration and private bailiff systems, as well as for the supervision of these new systems by the Ministry of Justice. Commitment to development and implementation of an automatic and random case assignment system is very important.

19. Armenia's challenge in PEM is to move beyond fragmented initiatives to craft an integrated program. In terms of strategy, strengthening the PEM system's basic processes suggests deepening the budget's performance orientation while strengthening fiduciary accountability with a focus on financial control and integrity. Deepening the budget's performance orientation will entail strengthening the MTEF and planning processes and further rolling out and consolidating the program budgeting reform. Strengthening fiduciary accountability would entail focusing on reporting and monitoring (including for non-commercial organizations), internal audit, external audit, and parliamentary oversight. Many reforms are already underway in most of these areas, and the challenge is to continue implementing while closely monitoring impact. Armenia should also build on technical progress and the wide public availability of budgetary data and information by facilitating

greater involvement of external stakeholders—from the National Assembly to the public—in the budget monitoring process.

C. Social Services and Protection

20. **In the health sector the SDP envisages a considerable increase in the budget allocation from 1.5 percent of GDP in 2006 to 3.5 percent of GDP in 2021 in order to increase access to and quality of healthcare services.** Over the medium-term the further development of the primary health care system will continue to remain among the key priorities in order to complete the transformation to a more efficient, family medicine-based system. Staffs are of the view that while the SDP sets the right priorities and, in general, strategically aligns the increased public resource allocations to intra-sectoral priorities, as recommended in previous JSANs, the document lacks a description of: (a) concrete actions and measures for reaching the strategic goals of reducing out-of-pocket payments and providing financial protection to the most vulnerable groups of the population from catastrophic health expenditures; (b) cost-effective preventive measures adequately covered through the public budget with target indicators related to non-communicable diseases; (c) anticipated intra-sectoral allocations to priorities; and (d) outputs/outcomes targets for other priorities besides maternal and child health. It would be important to further elaborate on these issues in the anticipated SDP action plan.

21. **In education, it is particularly welcome that public expenditure is projected to reach 4.5 percent of GDP by 2021.** The explicit commitment to improving the quality and accessibility of preschool education is highly important, as it responds to the serious deterioration and increasing inequity of the preschool sector over the last ten years. However, the SDP does not provide concrete references to the financing of preschool, inclusive education initiatives, or quality assurance and international accreditation of higher education institutions. In higher education, the political will to align Armenia with the Bologna process goals is a critical first step in reforming the governance of the system, increasing transparency and accountability, and eventually improving quality. If Armenia aims to raise enrolment in tertiary education to 33 percent by 2012 and to improve the quality of education at that level, total spending on tertiary education would likely need to increase beyond current projections.

22. **Perhaps the most significant new policy in the SDP is the considerable real increase in state pensions.** This reflects the objective of providing minimum income security against poverty in the old age, and the introduction of a mandatory funded pension pillar in 2010. The pension system comprises state insurance pensions for employed persons and social pensions for specific cases not eligible for the former. The average insurance pension is expected to reach 150 percent of the MCB by 2018 and its ratio to the projected average wage is expected to settle at 30 percent in the long run. Spending on state pensions is

projected to increase from a current 3 percent of GDP to 5.4 percent in 2021. The funded pillar is estimated to generate an additional fiscal burden of 0.2-0.4 percent of GDP.

23. **The projected pension policy reforms are expected to generate significant fiscal costs and will require major administrative changes before implementation can commence.** There are three critical downside risks that bear mentioning. First, given the potentially large fiscal deficit impact, should either macroeconomic (GDP growth or investment rates of return, for example) or demographic variables (such as, lower population or contribution base growth rates) deviate from the SDP baseline scenario, risk analysis should be conducted and used to inform policy design in terms of affordability and sustainability. Second, the target implementation date of January 2010—requiring complete implementation of IT systems for collection, distribution, data reconciliation, and account management—seems unrealistic. As the SDP does not provide sufficient detail to assess the feasibility of reaching critical implementation milestones, an action plan should be developed to indicate a credible path for launching the second pillar. Third, the development of the government debt market is an essential component for the success of the pension reform, yet is also an element whose success has eluded many other countries. Lastly, given the current state of global financial markets, a highly cautious stance is warranted.

24. **The SDP pays significant attention to the social protection system and lays out ambitious objectives on benefit levels, targeting, and moving toward European Union standards.** However, except for pensions, resources projected to be allocated to finance social assistance are kept unchanged relative to GDP (at 1.7 percent) until 2018 with a sharp drop to 1.4 percent in 2021. At these levels, budgets may not be sufficient to adequately cover envisaged safety net programs. The progress report would benefit from a discussion of risks, such as higher food and energy prices (and possible increases in energy tariffs), and the risks of increasing unemployment and declining remittances resulting from the international financial crisis.

D. Improving Infrastructure and Energy

25. **Staffs note good progress in transportation, telecommunications, and energy, and highlight several sectoral recommendations to improve policy and implementation.** Though the government increased the allocations for road construction and routine maintenance, they are not sufficient to meet the current backlog of investments, particularly with regard to rehabilitation and periodic maintenance. As roads deteriorate further this will lead to even greater investment demands in the future, as well as reduced levels of service for current road users. Staffs therefore recommend that the government develop a road infrastructure improvement strategy for balancing capital and recurrent expenditures. Traffic congestion is also becoming a major issue in Yerevan, where there is an urgent need to invest in improved traffic management and road infrastructure. Lastly, there is a need to establish an appropriate institutional framework to oversee railway concessionaire operations.

26. **An important achievement has been made in liberalizing the telecommunications sector, which would have benefited from a dedicated discussion in the SDP.** It is noted, however, that the current radio frequency spectrum policy still allocates excessive economically valuable spectrum to possibly low value public sector uses, creating hurdles for further liberalization and retarding efforts to improve service quality. Staffs recommend completing an independent audit of spectrum uses as a first step, to be followed by a policy to allow smooth transitioning of allocations and assignments to commercial allocations and users. Furthermore, given the accelerating pace of liberalization in the sector, it is expected that the added demands on spectrum will require the establishment of an enhanced institutional and regulatory framework.

27. **Government has also made notable efforts to diversify the sources of energy supply and increase the utilization of indigenous energy resources.** In view of the rising import price of natural gas, it becomes increasingly important to ensure that the structure of end-user tariffs for natural gas and for electricity reflect the true costs of supply to allow for efficient allocation of resources and encourage energy efficiency. To this end, staffs recommend that government and the regulatory agency consider setting gas tariffs based on actual costs of gas delivery to different consumer groups and consider introducing seasonal electricity tariffs that would reflect the actual costs of electricity supply during the winter peak. Lastly, staffs urge the government to address barriers to energy efficiency, which could bring significant savings to Armenian economy.

V. PARTICIPATION, COORDINATION, AND MONITORING

28. **The SDP process largely benefited from the institutional framework created after the approval of PRSP-1.** The partnership arrangements, which consisted of the PRSP Steering Committee, Working Group, Secretariat, and the Open Forum, established a precedent for effective implementation and monitoring. The framework also facilitated highly participatory consultations on preparation of the SDP. The SDP process benefited from brain-storming discussions throughout the country, Voices of Poor and other surveys, and from consultations with development partners. The staffs commend the government for new institutional arrangements that would allow for even greater engagement of civil society organizations (CSO) through a CSO board and secretariat with direct and regular access to the SDP Steering Committee. The framework encourages direct participation by CSOs in the process of SDP implementation, monitoring, and evaluation. It should be noted, however, that controls over the electronic media limited the reach and impact of the consultative process.

29. **The staffs fully support the government's intention to produce a time-bound action plan that spells out specific measures, responsible agencies, agreed indicators, and accountability arrangements for SDP implementation.** To effectively monitor implementation, the SDP translates goals and strategic priorities into actionable measures and

performance targets. However, this should be further strengthened in the action plans, which should present: (a) a time-bound matrix of key policy actions and institutional reforms, anchored in the MTEF, over a medium-term horizon; and (b) a selected set of corresponding core indicators to measure performance against targets. Moreover, there are several SDP priority areas for which existing reporting arrangements are inadequate to provide sufficient information. In these cases collection of supplementary information will need to be improved. In other cases, a mismatch between reporting and evaluation cycles will need to be rationalized. As the budget system has been further strengthened, staffs recommend that the monitoring of the SDP be fully integrated into the budget process, which would prove more sustainable. Specifically, performance budgeting reforms are sufficiently advanced such that they provide an opportunity for the full integration of SDP indicators with agency performance indicators. In sum, the reporting, monitoring, and participation arrangements should be clarified and codified, in order to allow all stakeholders to offer focused feedback on a timely basis.

VI. CONCLUSIONS, RISKS, AND SUGGESTED ISSUES FOR DISCUSSION

30. **Overall, PRSP-1 has gone a long way toward attaining its objectives of growth and poverty reduction, and the SDP is a worthy and credible successor.** Nevertheless, non-trivial risks exist that could impinge on the successful implementation of the SDP. First, the deteriorating external environment could widen further the external current account deficit; inflation may also prove harder to reduce. This would require additional policy tightening, which could impact negatively on growth and poverty reduction. Second, there are risks to the fiscal framework on both the revenue and expenditure sides. Underperformance on tax reforms could reduce revenue, while higher than expected spending on pensions could strain the budget. These possible developments, both singularly or jointly, could impair the fiscal framework and lead to scaled down spending, which in turn could negatively affect growth and poverty reduction. Third, political risks could materialize in the form of resistance to the ambitious reform program laid out by the government.

31. **There are also a number of areas where significant efforts are needed to strengthen the SDP:**

- a. **Extraction of priority medium term policy actions:** Further clarifying the priority medium-term policy and institutional reform program and the corresponding funding requirements in the SDP action plans would strengthen implementation. The action plan and progress reports would also benefit from greater selectivity among core monitoring indicators.
- b. **Economic policy reform:** The SDP intends to roll out a battery of economic policy reforms while scaling up productive investment in the economic and social sectors to meet this challenge. The economic policy reform program, however, would benefit

from greater prioritization and sequencing of key measures over the medium term. It would also benefit from laying out in more detail some of the key measures, especially in the area of competition policy.

- c. **Investment program:** The investment program would benefit from a more detailed exposition of expenditure levels and key projects by sector. Moreover, the government will need to strengthen its investment planning and appraisal capacity in order to be able to develop a convincingly pro-growth capital investment program.
 - d. **Tax and customs administration reform:** SDP implementation depends to a large extent on successful implementation of tax and customs administration reforms. Should these reforms falter once again, the credibility of the SDP could suffer. The recent formation of the State Revenue Committee could aid the reform process, but is not a substitute for solid implementation of existing reform programs, which have the backing of the full development partner community. Steady high level political support is needed to improve tax and customs administration while combating corruption.
 - e. **Pensions reform:** The government's pension reform proposal should be reviewed in light of macroeconomic, fiscal, and institutional risk, and, if necessary, should be reformulated to reduce risk and improve sustainability. The risks inherent in the scale and scope of the pension reform merit further consideration.
32. In considering the SDP and the JSAN, the Executive Directors may wish to focus on the following issues:
- a. Do Directors concur with the staffs that the SDP focuses on the appropriate areas for poverty reduction?
 - b. Do Directors concur with the staffs' views on risks and core areas that would benefit from further strengthening?