

**Economic Development and Research Center
Armenian Budget Analysis Project**



Independent Assessment of the PRSP

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In 2000, the Government of Armenia initiated the development of the national poverty reduction strategy with the assistance of international organizations. These were the first steps to develop national programs in Armenia, which need to be characterized by such components of democratic culture as transparency, accountability, stakeholder participation and nationally-ownership, and others.

The PRSP process became the best experience of collaboration and dialog among authorities, civil society and international organizations in Armenia. The process was open to all stakeholders and nearly all wings of the society participated in strategy development .

The Government of Armenia adopted the PRSP in August, 2003 which in fact initiated the preparation and implementation phases of the PRSP.

The present paper, we try to give an independent assessment of the PRSP document as well as of the PRSP process in Armenia in general. Our primary goal is to contribute to the future improvement of the PRSP document. We believe that although both the Government and civil society made significant efforts, the PSRP has some gaps, and it is necessary to revise and update it during 2004.

Our goal is also to keep the PRSP and its implementation process in the center of society's attention in order to ensure public ownership of the project and to establish a real demand for participatory monitoring of public programs.

We also pursue the objective of providing for public awareness on the PRSP and elucidating it, since, although the PRSP is quite popular and subject to various speculations, there is a fear that very few might be aware of the PRSP, policies and projections.

Therefore, we attempted to summarize and briefly present our recent and relatively old assessment and views on the PRSP.

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INDEPENDENT ASSESSMENT OF THE PRSP

Introduction

The Government of Armenia initiated the PRSP development in 2000 by developing an Interim PRSP, adopted by the Government in March, 2001. In April, 2001, a PRSP working group was created, which included representative from various groups of the society, and was in charge of managing and coordinating the development of the final PRSP document. Initially, an independent expert groups was in charge of the PRSP preliminary development, which completed its task by October, 2002. Subsequently, the document was summarized and approved by the Government on August 8, 2003.

This process contained sufficient possibilities for the participation of the civil society. Representatives of various stakeholders took part in PRSP development, and the program, presumably, expressed the views of not only the Government and donors, but also of the civil society.

By the adoption of the PRSP it is assumed that hereinafter the economic policies implemented in Armenia will be pro-poor. Nevertheless, the assessment of impact of implemented programs on poverty are controversial and do not allow to estimate the poverty incidence by 2015. This facts brings in the necessity of a complex expert analyses of the PRSP document of Armenia.

The evaluation of the document covers the following key elements:

- how compatible are the PRSP macroeconomic framework and fiscal policy measures to the set poverty reduction targets?
- to what extent the policy impact on poverty is assessed?
- how feasible are the estimations of the poverty incidence in Armenia?
- was the PRSP development process sufficiently participatory?

The results of our assessments were then compared with the "Joint Staff Assessment (JSA) of the PRSP for the Republic of Armenia" of the IMF and the WB.

The main findings of the assessment are:

- PRSP contains a thorough and in-depth analyses of reasons for poverty in Armenia;
- The sources of economic growth are evaluated realistically, and the redistribution through the Government budget are more pro-poor than in previous years;
- However, the social budget is rather risky, since the number of possible beneficiaries is underestimated and the per capita benefits are artificially inflated. Under such circumstances, the projected Tax/GDP ratio is not sufficient to ensure enough revenues to comply with the social commitments,
- Quantitative assessment of policy impact on poverty is controversial, consequently, the target of 19.7 percent poverty by 2015 is not clear,
- Participatory process was sufficiently active, however, it significantly decreased in the completion phase:

Macroeconomic Framework

The main macroeconomic projections and policies in the PRSP were taken from the documents supporting the PRGF and SAC-5 projects, which provide preconditions for poverty reduction in Armenia. The macroeconomic framework anticipates a stable external position, a reduction in current account deficit, and a sufficient level of foreign reserves. The PRSP anticipates 5.5% average annual real GDP growth, which will almost double the real GDP by 2015. The economic growth forecasts and the main framework for economic development are realistic, which permits us to assess the magnitude of resources to be created in the Armenian economy during the next 12 years.

PRSP projections envisage annual inflation below 3%, which will contribute to sustaining macroeconomic stability and development of private sector. Nevertheless, PRSP omits the assessment of the impact of regulated tariff increases (utilities). As far as agricultural prices are also projected to grow at annual 3 percent rate and active adjustments in regulated tariffs are projected by the PRSP, 3% headline inflation target becomes less realistic.

The PRSP does not consider the future impact of the most important commitment of the Government to WTO accession - that is - levying VAT on agriculture on prices. In the Tax Policy Section of the PRSP it reads that VAT on agricultures needs to be introduced as smoothly as possible and simplified tax administration shall be exercised. However, to be considered the commitment to the WTO met, VAT introduction need to have also a certain fiscal impact, which consequently implies an extra rise in headline inflation.

Price and exchange rate projections for 2004-2015 under PRSP imply a real exchange rate appreciation of 6 percent. Other things being equal, this implies decrease in international competitiveness of a country.

It is anticipated that the number of employed will grow by 20%, that is - by 248 000 jobs by the year of 2015, of which the number of employed in agriculture will increase by additional 17 000, while in non-agricultural sectors - by 231 000. Overall, these projections can be viewed as realistic, although projections for the agricultural employment require more discussions. To our view, projections of growth rates of labor productivity in agriculture are underestimated, especially, considering the current trends in land merging, capital inflow and anticipated "industrialization" of agriculture. Productivity growth in this sector is projected two times lower than the average productivity growth rate during the 1998-2002: this contains a certain risk of employment reduction in agriculture, which is not discussed in the PRSP².

Average nominal wages projections are quite realistic considering the projections of productivity growth and inflation rate. In the meanwhile, the projections of the minimum wages are questionable: while in 2004 minimum salaries are lower than average salaries 2.7 times, in 2015 they are lower 4.2 times. This is explained by the fact, that during 2004-2015 the minimum wages are envisaged to stay at the level of official poverty line and thus are adjusted by expected inflation rate only. Considering that the gap between minimum and average salaries will definitely widen, adjustments of the minimum wages only by inflation will diminish the regulatory role of minimum wages as productivity increase will not be at all reflected in wage policy. We believe that the macroeconomic framework, especially productivity growth projections, allow for a higher minimum wages, without causing economic distortions.

¹ Tentative calculations by authors of the paper.

² Agriculture employs about 44.4 percent of total employed population in Armenia.

Fiscal Framework

PRSP mentions that in Armenia, it is not feasible to implement a tax policy that has a significant distribution impact and at the same time remains efficient. Basing on this assumption, the PRSP shows that the Government has two options: either choosing an efficient (least distorting) tax system with little re-distribution impact, or attempting to have a highly-redistributive tax system which creates various distortions. In this regard, supposedly PRSP opted for the first option, since it envisages tax/GDP ratio to increase by 4.7 percentage points during 2003-2015, which is a modest increase since current level is extremely low.

We believe, projections of tax/GDP ratio are underestimated in two aspects: first, the estimate of the number of retired people is not sufficiently reliable (see below), which then brings to the underestimation of the social spending and financing requirements. Second, to our view, if considering the significant measures described in the PRSP for 2004-2015 to fight shadow economy (public sector reforms, increasing civil servants' remuneration), as well as anti-corruption programs, additional increase in tax revenues of the Government Budget can be substantiated without increasing PRSP risks. A scenario of curtailing shadow economy by half would imply a tax/GDP ratio of 25%³, while the PRSP envisages 22.6% for 2015 (for 2002 this ratio equaled 17.9 %).

Increase in tax revenues is anticipated to be attained through improved tax administration, since the PRSP supports the strategy of keeping tax rates at their current levels. Apart from tax administration, most likely, another source for tax revenues improvement is the growing share of non-agricultural production in GDP during 2004-09. However, the Tax Revenues section in the PRSP does not describe the fiscal impact of the anticipated VAT introduction on agricultural production in 2009.

PRSP does not provide quantitative estimates for direct and indirect tax proportions. Without such estimates it is not possible to fully assess the pro-poor options of tax policy. The PRSP does not envisage progressive tax collection, while the main emphasis is put on maintaining low tax rates and taxing the so-called shadow economy. It is even suggested to replace the current slightly progressive income tax rates with constant rates. The only suggestion to move towards progressive taxation refers to the social insurance payments: that is to replace the current regressive system with constant one, which is a more pro-poor option.

PRSP outlines the expenditure policy that can be evaluated as pro-poor use of available resources and general more social orientation of the budget. The PRSP envisages significant increase in education financing, which will bring the ratio of public expenditures to GDP closer to the OECD average. A modest increase is anticipated in health financing, which will comprise 2.5% of GDP by 2015 (the same ratio is above 6 percent in OECD countries on average).

A small increase is envisaged in social security spending, which will bring these expenditures to 5.5% by 2015, compared to current 4.5%. In this regard, significant increase in per person benefits is projected based on decreasing both the number of beneficiary families and pensioners during 2004-2015. We find the projections of the number of pensioners to reduce by 1/3 or by 124 thousand pensioners as non-realistic⁴. Such a decline in the number of pensioners is not consistent with sustainability of the mortality ratio. As for family benefits, we believe that the projected decrease⁵ in the number of beneficiary families is too optimistic.

All abovementioned factors may risk the social security budget and, under insufficient additional funds, may result in decline in per capita benefits. A more rapid productivity growth scenario in agriculture will bring in lower-than-projected net job creation and lower-than-anticipated reduction of beneficiary families' number, thus additional social spending requirements may emerge.

³ Calculated under the most conservative assumption of shadow economy share of 40 percent

⁴ This cannot be realistic, even when considering the birth rate decline in 1941-1945.

⁵ The PRSP estimate of beneficiary families' number in 2015 is not clear: Table 7.2 indicates 87 thousands, while paragraph 258 – 42.3 thousand.

Government Budget Deficit projections incorporated in the PRSP are consistent with macroeconomic and external debt stability targets. PRSP says that external borrowing will be conducted mainly through concessional loans.

As for external grants, which are scheduled in the budget framework (2.1% in GDP in 2004, then gradually declining to 0.7%), PRSP does not specify the sources of these funds, so they could be both budget support and project funding like recent Lincy foundation.

Poverty and Inequality Indicators

The PRSP presents a thorough and in-depth analysis of the causes of poverty in Armenia; however the impacts of policies on poverty are contradictory. In spite of valuable poverty analysis, the estimates of the projected policy impact are not reliable. There are serious inconsistencies in quantifying inequality and poverty reduction estimates in the PRSP. The annual income projections for the population in 2004-2015 are not consistent with the estimated poverty incidence: the projected per capita income of the lowest quintile (the poorest 20% of population) is much higher than the poverty line. Table 3.2 in the PRSP indicates that the average per capita monthly income in the lowest quintile will reach 11.7 thousand AMD in 2006, 16 thousand AMD in 2009, and 26 thousand AMD in 2015, while the per capita poverty line for 2006 is 13.4 thousand AMD, for 2009 is 14.4 thousand AMD, and for 2015 is 16.6 thousand AMD. This apparently implies, given the targets for inequality, that the poverty level will be less than 20 percent in 2009, and in 2015 officially defined poverty will not exceed 7-8 percent, while the PRSP sets the target at 19.7 percent.

There are also major inconsistencies between poverty incidence projections for 2004-2015 estimated using poverty lines of USD 1, 2 and 4 a day and those estimated using the official poverty line. These inconsistencies are evidence of inaccuracy in the empirical methodology used. In the chapter "PRSP Goals", the Poverty calculated by poverty lines of USD 1 and 2 a day decline more rapidly than those of the official poverty line (which is USD 0.8) for 2004-2015 (see also Table 3.1, p.48). This implies that if the poverty level calculated at the official poverty line was 50.5 percent for 2001 and 58.6 percent at the poverty line of USD 2 a day, then in 2015 poverty level calculated at official poverty line will be 19.7 percent while calculated at poverty line of daily USD 2 it will constitute only 6.8 percent. It is quite strange even in the PRSP calculations will be made on the base of PPP adjusted by real exchange rate appreciation instead of constant PPP.

The abovementioned quantitative problems, in general, make the poverty reduction projections less realistic and shade the credibility of the stated PRSP goals. Inconsistencies between the macroeconomic framework and income distribution make the GINI coefficient projections doubtful.

Ownership and support by broad participation

In order to provide for the public awareness and participation in the final PRSP development process two CSOs were selected to organize discussions, seminars, prepare TV and radio programs, publish analytical-informational brochures, etc.

In addition, participation in the PRSP process was ensured thanks to various international agencies and their partner NGOs.

Seminars and workshops were organized with the participation of different groups of the civil society, feedback was ensured, thus providing for adjustments and amendments. PRSP has fully taken into account almost 40% of recommendations, and 1/3 of recommendations were partly accepted.

Although the first draft PRSP was prepared in a sufficiently participatory environment, in order to be adopted by the Government, it needed serious editing and review in the final stage of development. However, the final stage of review and editing did not provide for sufficient participation. The policy parameters suggested in the final PRSP were not discussed, and, overall, the process was not open enough. In principle, it can be argued whether the macroeconomic framework, in particular, budgetary framework, was developed in participatory environment.

In the first stage of PRSP development, parallel to the PRSP working group, the Government initiated the development of the Medium-Term Expenditure Framework (MTEF) by a separate expert group. The latter was not a participatory process, and consequently, at the end of 2002 two different frameworks, macro and budgetary, according to PRSP and MTEF, were revealed for discussion. The MTEF was approved by the Government at end-2002, thus leaving the PRSP-suggested policies without proper attention.

The PRSP Macroeconomic Framework Section, built on the basis of the World Bank SAC and the IMF PRGF programs⁶, implies the "comprehensive and thorough implementation of the outlined policies and measures" of the said programs⁷. This can be qualified as an example of donor influence.

In the framework of the PRSP implementation monitoring, currently the Government initiated the institutionalization of participatory process through social partnership mechanism.

Taking into consideration the problems arisen during the PRSP development and implementation, assistance in capacity strengthening of stakeholders is still necessary. In particular, strengthening of capacities in the non-government sector is crucial, which will ensure the participatory PRSP monitoring and evaluation processes.

Conclusions and recommendations

Thus, the first attempts of emerging democratic culture in Armenia should be welcomed, and as part of this, PRSP development process should be noted. Meanwhile, it is necessary to strengthen the participatory institute in developing and implementing public programs. Possibly, deficiencies in this regard are evidenced by the omissions and technical errors that can be found in the PRSP.

Our key finding is that the PRSP should be revised and updated in the shortest possible period of time. Particularly, we suggest revising the following main omissions before budget discussions for 2005:

- Make consistent main targets for income distribution and poverty incidence (PRSP, p. 48 and 49, Tables 3.1 and 3.2).
- Revise and correct forecasts and targets for poverty reduction (PRSP, p. 48, Table 3.1).

⁶ Frequently, in developing (poor) countries the macroeconomic scenarios and programs of the PRSP are taken from the PRGF (e.g. Tanzania)

⁷ See PRSP, Yerevan, May 2003, page 51, paragraph 110.

- Apply the models that allow simulation of the link between poverty and income distribution to avoid further mistakes⁸.
- Revise the estimation of the sharp decline (by 1/3 or 124 thousands) in the number of age pensioners.
- Correct and clarify the number of beneficiary families for 2015 and revise the dynamics of their decline taking into account poverty forecasts.

We also suggest the implementation of the following poverty and social impact assessments (PSIA) to revise the PRSP during the coming year and a half: (i) impact assessment of increase in regulated prices (tariffs) on anticipated level and sustainability of consumer prices as well as on the development of different sectors of economy and on the welfare of the poor, (ii) impact of introduction of VAT on agriculture on consumer prices and the welfare of the poor, (iii) impact of structural changes and productivity growth in agriculture on employment in this sector and its social outcomes, (iv) quantitative estimation of impact of tax policy (changes in shares of direct and indirect taxes) on poverty, (v) impact of real exchange rate appreciation on the international competitiveness of the country, and on the development of particular sectors, and the welfare of poor.

References:

- Appreciation of the PRSP-Armenia, Prepared on behalf of the Dutch Embassy in Tbilisi, December 2003
- Poverty Reduction Strategic Paper, Government of Armenia, Yerevan, September 2003
- Joint Staff Assessment of the Poverty Reduction Strategy Paper for the Republic of Armenia, Prepared by Staffs of the International Development Association and the International Monetary Fund, November 4, 2003

⁸ For this purpose Growth and Distribution model of the EDRC that was used during preparation of the PRSP draft.

About EDRC

Economic Development and Research Center (EDRC) is an independent public policy research institute, established in 2001 in Yerevan, Armenia. It is dedicated to addressing the economic and social challenges that Armenia faces.

The mission of EDRC is to promote economic and social development, to influence policymaking and to raise public awareness of economic, social and demographic issues by providing analyses, developing analytical tools and facilitating policy discussions.

EDRC focuses on supporting economic freedom and democracy as decisive conditions for the successful development of the Armenian economy. Believing that the future growth of Armenia requires transparent processes in government and society, EDRC promotes these ideas as well as fosters mutual understanding between Armenia and other countries.

EDRC is a member of Armenian CSOs network (<http://www.cso-network.am>) and actively participate in CSO efforts of advocating the concept of poverty reduction. In recent years the organization was involved in PRSP development in Armenia, mainly concentrating on policy design and economic forecasting issues.

The staff of EDRC consists of experts who have been actively involved in economic research activities and policy design since the beginning of reforms in Armenia. Our experts have gained a profound experience of working both in the government and non-government organizations, as well as international organizations. Projects implemented by EDRC are in the field of economic analysis and development of macroeconomic modeling tools, as well as budget analysis and advocacy of budget transparency and sustainable development.

Since July 2002, with cooperation of Oxfam GB, EDRC is implementing "Armenian Budget Analysis" Project (ABA Project). The overall goal of the ABA project is to increase the efficiency of public polices through the effective participation of civil society groups and poor people in the process of the design, implementation and evaluation of public polices and programmes affecting their lives. During this period, a set of analysis of budgets were conducted; simplified budgets and guides were issued, which are available also in our web site at www.edrc.am

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