

ECONOMIC DEVELOPMENT AND RESEARCH CENTER (EDRC)



Growth with Equity

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Executive Summary

In the last decade of transition Armenia faced poverty, which became a new phenomenon of the social-economic situation. It is obvious that the fight against poverty requires comprehensive strategy rather than discrete measures. The situation becomes more dramatic as despite continuing economic growth there is no indication of a decrease of poverty incidence so far¹. Poverty becomes a persistent structural challenge impeding social-economic development.

The reasons for poverty in Armenia are multi-layered. They are conditioned by social relations and are derived from characteristics of decision-making and behavior of different social groups and institutions, as well as individuals. The main reason causing poverty in Armenia at large relates with shocks of the transition period. Generally, poverty is explained by two factors:

1. reduction of the gross product and consequently, reduction of level of real consumption;

In 1991-1993 economic decline was so deep, that continuing economic growth since 1994 was not sufficient to reach the 1990 output level: the average annual economic growth for 1990-2001 is still negative (-2.9 percent). Sharp decline in real income and depreciation of wealth of many households resulted in quantitative and qualitative reduction of consumption and, hence, depreciation of human capital and resulting poverty. In this respect, the economic reason for poverty is limitation of an individual's self-realization as an economic resource.

2. increase of distribution inequality;

Apart from the fact that gross output is significantly below the pre-transition level, the generated income is distributed very unequally². Decline of the share of wages and increase of the share of profit in total income worsened income distribution, as equal distribution of wages between households, as opposed to profit, is more likely, since labor market smooths wage discrepancies (however, given the current structural problems wage discrepancies are quite large). Not only the share of corporate profit is significant in GDP, which by itself is a characteristic of unequal distribution, but also profit is very concentrated, meaning concentration of business activity and high level of social polarization. At first sight one may assume that the most productive economic resources (including those in labor force, means of production, management, information, etc.) in Armenia are possessed by a small number of enterprises, representing the most efficient units. However, such concentration can not be explained only by market mechanisms. Studies show that current structural issues, such as corruption, protectionism and other challenges create privileges for a few enterprises, while restricting the potential of development for others: this is estimated as the main factor for business concentration.

¹ According to the survey of NSS, the poverty incidence was 54.7 percent in 1996, and 55.05 percent in 1998-99, while cumulative economic growth in 1996-99 was around 21.3 percent.

² Gini index by income is estimated 0.27 for 1987-90, while according to the survey of NSS it is 0.59 in 1996-99.

High level of corruption in tax administration and budget expenditures facilitates the increase in inequality. As a result of corruption, the tax system actually becomes regressive, which directly increases income inequality. Investments in human capital and social programs financed from the budget are biased in favor of financing projects (for example investment projects) where the level of corruption tends to be high.

Thus, unequal distribution of income in Armenia is due to a set of problems such as market imperfection, governance and management inefficiency and constraints of economic freedom.

Below are groups of factors that caused poverty and contributed to its further increase:

- sharp economic decline and increase of shadow economy;
- inefficient governance (high level of corruption, inefficient tax administration and public expenditure policy, etc.);
- challenges of structural policy and imperfect markets;
- knowledge based constraints of labor.

The analysis show that economic policy was not focused on poverty reduction issues so far and it failed to address institutional challenges. However we should consider many non-economic factors, such as earthquake, blockade, regional conflicts, etc. that had negative impact on policies.

In the framework of this study some analyses have been performed, results of which describe the picture of income distribution and poverty. **First, poverty incidence in Armenia would amount to 44%, instead of 55%, if income were distributed as it is distributed in the Russia, a country with very unequal income distribution. Second, there would not be a poverty problem in Armenia if income were distributed as it is distributed in Poland or in Latvia (given the current official poverty line).**

These analyses not only prove that income distribution in Armenia is acutely polarized, but it also shows that much lower level of poverty is attainable. Next argument supporting the idea that the country may overcome poverty is the small population of Armenia, which implies that relatively moderate financial resources are needed to overcome poverty at the current poverty line. Particularly, we have estimated that:

- the income deficit in Armenia³ is more than 60 percent of the disposable income of the poor, which is approximately USD 170-200 mln. annually.
- to finance income deficit of the poor (in other words-to overcome poverty) through economic growth, 10 percent of GDP growth is sufficient, if this growth is distributed only among the poor.

³ The income deficit is the difference between income necessary to go above the poverty line (or to become non-poor) and the actual income of the poor (in cumulative terms).

If the 9.6 percent actual economic growth of 2001 were distributed only among the poor, theoretically the poverty problem would have been solved.

However the prospectives of overcoming poverty may be less optimistic if we revise the current official poverty line, which will significantly rise the poverty incidence in Armenia. The current official poverty line, which is USD 22.4 per person per month is too low: if we use USD 45 (USD 1.5 per person per day) instead of USD 22.4, according to the results of our model currently the poverty incidence in Armenia is 70 percent.

It is important to mention that all transition countries faced increase of income distribution inequality in the early 90-of last century. However most of Eastern European transition countries experiences opposite tendencies since mid 90-s, when income distribution improved and in some cases it reached the pre-transition level. In contrast to those countries Armenia is experiencing countinuing deterioration of income distribution since end 80-s and so far there is no indication of its improvement.

Summarizing, we may conclude that currently Armenia is characterised by a specific social-economic structure, which facilitates the increase in inequality of income distribution and formation of persistent long term poverty. This study is aimed at analysing economic causes of the poverty and at development of a set of policy directions that will contribute to poverty reduction through improvement of income distribution and sustainable economic growth. The key conclusions of the study are:

1. Economic growth is not enough for poverty eradication in Armenia. The key focus of economic policy should be the improvement of income distribution, which implies explicit redistribution policy. Sustainable economic growth should be considered as an additional key source of poverty reduction.

Until recently, the opinion that economic growth is able to overcome poverty was dominant and was expressed in the policies of a number of transition countries, especially in the policy programs recommended by international financial organizations. However, a number of studies have proven that growth does not always facilitate poverty reduction. Years of economic growth in Armenia come to support this alternative view, as the distribution of income became worse in the period of growth.

Parallel to rather high pace of economic growth in Armenia during recent years, income distribution has polarized, causing an increase in poverty. Furthermore, according to our estimates, economic growth may limit the potential of poverty reduction in the future. This is explained by the fact that due to high level of business concentration, economic growth is limiting the potential usage of available resources by other economic agents, particularly poor, which are not involved in current economic activity. Therefore policies should support economic growth driven by equal opportunities, which will contribute to poverty reduction. It should be noted that the improvement of income distribution and redistribution function of the state is also important in terms of sustainability of growth.

2. To avoid long-term and persistent poverty and to overcome the current poverty in Armenia challenges in development of human capital, economic freedom and equal opportunities must be addressed.

In this respect policy should be aimed at improvement of governance, fight against corruption and protectionism, investment in human capital.

3. The current economic policy is not focused on poverty reduction issues. The forecast of income distribution presented in IPRSR is not realistic, which questions the efficiency of measures presented in this document.

The Government drafted an Interim Poverty Reduction Strategy Paper (IPRSP) in 2001, where the main emphasis is on the measures facilitating economic growth, which is seen as a precondition for poverty reduction. However along with growth, a sharp improvement of distribution is forecasted in this program as well, as it is assumed that in 2003 the Gini index will be reduced to 0.44 and 0.38 under the baseline and optimistic scenarios respectively⁴. Our studies on the current character of distribution in Armenia and international experience as well (see Box 1) has shown that no market economy has yet succeeded in reducing the Gini index in a short period to such an extent. Evenmore, measures that may significantly improve the distribution are not scheduled in the Paper. As our study shows the main direction of economic policy should be the measures aimed at improvement of distribution and re-distribution.

Below are the main directions of public policy that are crucial for poverty reduction strategy:

- institutionalization of the fight against poverty
- fiscal policy and public expenditure programs
- labor market regulation
- investment in human capital
- regional development priorities
- price mechanisms

Institutionalisation of the Fight Against Poverty: Poverty eradication should be enatiled by formation of explicit public demand for poverty reduction, that is, the society or certain strata of the society should demand and be willing to pay for such policy. Development of institutions and institutionalization will address issues like corruption, further reforms in the court system and increase of trust in the courts, fight against shadow economy, increasing the efficiency and purposefulness of state social policy, etc.

Fiscal Policy and Public Expenditures Programs: As the main tool of economic policy fiscal policy has a significant role in adjustment of income distribution and therefore the design of the tax system and the structure of public expenditures should focus on poverty eradication issues. Social programs are the most direct fiscal tool for poverty reduction, and the government should increase allocations on social spending either through re-allocation from other programs or by increase of total expenditures through improvement of tax administration. We should note that

increase of allocations for social programs through debt accumulation may not serve as a stable mechanism. Moreover, if speaking about balanced fiscal policy we should consider the need for restraining public debt growth, i.e. the need for gradual reduction of budget deficit.

Labor Market Regulation: Labor market regulation should be aimed at improvement of primary income distribution. As the survey results show about 45.7 percent of employed populations are poor and 17.3 percent are very poor, which is explained by low wages and inefficient employment. Labor market regulations, such as minimum wage policy may decrease the number of employed poor. As the public sector is the biggest employer, low public service wages, are another important factor prohibiting the potential increase of wages. According to estimates salaries in public service have significant impact on the labor market and Government should undertake public sector reforms, which will be able to seriously adjust wages. It is should be noted that Government should focus on employment active policy as well, which includes training and retraining of employees.

Investment in Human Capital: As normally the only resource of the poor is human capital, participation of the poor in primary income distribution is possible only through investment in human capital and through increase in the value of human capital as a productive factor. In this respect revision of social and structural policies is crucial, especially in terms of improvement of education, health care, and environment to provide for efficient utilization of human capital. The latter implies improvement of labor quality, support of small and medium entrepreneurship, and development of business infrastructures.

Regional Developments Issues: There is a certain relation between income distribution in terms of different groups of population and regional distribution of income. The relative centralization of business in a certain region of the country implies greater possibility for concentration of income in hands of a small group of people as the chances for more people to be involved in business activity are decreasing. Thus geographical distribution of income also should be a subject for study. There are several economic indicators showing substantial differentiation of business activity in the regions of Armenia. In a number of regions unemployment rate is significantly diverging from the average (Table 4), especially in the earthquake zone (Shirak and Lori). The unemployment level still remains high in Syunik Marz, which is near-border region. These are official indicators, while the results of alternative survey of households conducted by the NSS in 1998-99 show that actual picture is much worse. Thus, the regional development is very important for overcoming poverty. In this respect a set of measures should be implemented aimed at strengthening of communities and introduction of mechanisms for good governance in regions. Taking into account that poverty incidence is higher in earthquake zone and near-border regions, Central Government should diversify policies, particularly in terms of tax administration and budget allocations.

Price Mechanisms and Income Distribution: Macroeconomic management may address income distribution issues through price indicators, as relative prices, interest rate and exchange

rate have impact on income distribution. Along with macroeconomic stability macroeconomic management should be focused on price indicators which will contribute to poverty reduction.

Forecasts and Policy Recommendations

The main source of poverty reduction should be pro-poor economic growth and targeted distribution of income. In order to eradicate poverty it is necessary to involve poor in income generation, contributing to the improvement of primary income distribution.

“Macroeconomic Adjustment and Growth Model for Armenia”⁴ (hereafter MAGMA) has been developed and applied for the forecast of economic trends and appropriations of the policies. In this model external environment is taken as a constant, which implies that we have skipped assessment of various scenarios of development that might result from solutions of Nagorno Karabakh conflict and other likely changes in the region.

For the period of 2002-2010 the macroeconomic framework is forecasted, which has pro-poor direction and meets a balance between sectors of the economy (see Appendix 3). The proposed macroeconomic framework includes the following main macroeconomic indicators and policy targets:

- 5% average annual economic growth
- 1,238 USD per capita GDP in 2010
- 3% average CPI inflation:
- 0.9% average depreciation of AMD real exchange rate:
- 10.8% private savings as percent of GDP in 2002 and 16% in 2010
- 16.6% private investments as percent of GDP in 2002 and 20% in 2010
- -9.0% current account deficit as percent of GDP in 2002 and -4.0% in 2010
- 41.4% external debt as percent of GDP in 2002 and 19.3% in 2010.

According to our estimations, the following major directions should characterize pro-poor economic policy:

- Increase of tax revenue in GDP at least to the level of 21.4% percent by the 2010, through reduction of shadow economy and increase of efficiency of tax administration (State revenue program are presented in Table 16 and 17). We consider this scenario as quite realistic, as it is consistent with current tax legislation of the country.

- Gradual reduction of state budget deficit as percent of GDP in coming years and zero-level deficit by 2010, as a balanced budget is an important condition for the sustainability of government programs, including social programs. Also, zero-level budget deficit is an impetus for enhancing financial discipline in the country, as well as for a more efficient utilization of domestic savings.

⁴ “Macroeconomic Adjustment and Growth Model for Armenia” is constructed by “Economic Development and Research Center” NGO for the purpose of developing public expenditure programs and macroeconomic policy.

- Gradual increase of current public transfers as a share of GDP in coming years to achieve at least 5.8% level by 2010.

- Increase of wages and salaries in public sector by 27% in 2003, and its 2.6% level as percent of GDP by 2010 through gradual growth. This will bring about a raise in the quality of public services and in the level of income of the socially insecure strata (particularly, teachers).

- Increase of financing of education and healthcare and achievement of, correspondingly, levels of 1.2% and 1.6% of GDP in 2010 (instead of 0.6% and 0.8% in 2002), which is important precondition for human capital sustainable development and poverty eradication in long run.

- Reduction of state capital expenditures and its level of 1.5% in GDP by 2010, instead of the current 3.4%. This implies a decrease in absolute value by 30%. Generally, the capital expenditures are inefficient as a considerable level of corruption characterizes it. The reduction of state capital expenditures will serve as a complimentary way of financing of social-programs. This should be supplemented by increase of efficiency of public investment programs, which will maintain the necessary level of infrastructure development.

Poverty in Projected Perspective

According to the results of the model, in 2002-2010 cumulative economic growth will be 54% and the nominal GDP will double by 2010. Economic growth will be driven by growth in nearly all sectors of economy: it is forecasted that services will provide 23% of total growth; 22% will be achieved due to industrial growth, 19% - due to agriculture, and 13% of the growth will be contributed by the growth in construction. Unemployment will decrease by only 5-6 percent points and will reach 14% in 2010. This is due to an existing potential of productivity increase, which assumes that economic growth would not be accompanied by an identical increase of number of employees. In particular, numbers of employees may increase in industry after 2005 and in agriculture-after 2009 only. By estimates unemployment along with structural challenges and low productivity will be main factor determining low level of wages.

According to suggested macroeconomic framework and policy priorities, the “Income Distribution Matrix” is projected for 2010, which is the key source for Gini index prediction (see Appendix 2). According to the Matrix, Gini index will equal to 0.49 in 2010. To assess the poverty incidence for this scenario, we should decide which poverty line may be used or, in other words, who are the poor? Given the current official poverty line, which is USD 22.4 per person, poverty incidence will be 13% in 2010. In case of USD 30 and USD 45 poverty lines poverty incidence will be 35% and 54% respectively (see Tables 5 and 6). Such significant difference among various estimates of poverty line and poverty incidence corresponding to them is explained by specific character of income distribution in Armenia. As the 60-70 percent of population is getting approximately similar low income, a minor change of poverty line may cause significant change in poverty incidence.

We may conclude that even the proposed pro-poor economic policy is not sufficient for overcoming poverty in Armenia by 2010. Therefore all structural challenges should be addressed by a comprehensive strategy on poverty reduction which will require a strong political will.