

# economic

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Policy and Poverty

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# Economic Policy and Poverty

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*The views and opinions expressed in the articles are those of the authors and may not be necessarily reflect the views and opinions of the Editorial Board members or the organizations they represent.*

# Letter from the Editors

Dear Readers,

Welcome to our new periodical, *Economic Policy and Poverty (EPP)*! This periodical is designed to be an independent source of information and analysis about the issues most important in Armenia's economy today. The Armenian economy has performed well over the last few years, achieving high growth rates and low inflation, but it still faces many challenges, particularly the reduction of poverty. The Poverty Reduction Strategy Paper process (PRSP) over the last two years highlighted these challenges and brought together experts from government and civil society to perform in-depth analysis of economic problems and begin to identify strategies for solving them. The goal of *Economic Policy and Poverty* is to contribute to the ongoing process of analysis and debate of economic issues and also to make these analyses and debates accessible to a broad audience of civil servants and civil society members, so that more people can participate in public discussion and influence the decisions of policy-makers. The periodical is not only written *for* Government and civil society; it is also written *by* Government and civil society. We seek contributions from all interested parties.

Each issue of the periodical will comprise a set of articles pertaining to a particular theme of economic policy and poverty. We seek articles that are based on and present careful theoretical and empirical analysis and are written in a language accessible to all professionals. We strive to publish articles with differing viewpoints, but not articles that are only based on opinion. The periodical will solicit and publish articles from various sources including Government, local and international NGOs, International Financial Institutions, donor agencies and their implementers, and others. As explained in the announcement in this issue, we are presenting the themes for the next eight issues now so that we can begin to solicit articles for all these issues. Anyone is welcome to propose an article for one of these issues, and we hope that many of our readers will consider contributing.

In addition, each issue of *Economic Policy and Poverty* will include several regular features. In future issues, in place of this letter *from* the Editors, we will publish letters *to* the Editors—letters from you, our readers, in response to the articles from previous issues of the periodical. As with any publication, we will need to select among those letters that we receive which ones to publish, and we will edit them for length, but our intent is to publish as many opinions as possible, both in support of our work and criticizing it. Another feature will be the Editorial Board column, where in each issue, one of our Editorial Board members will contribute an opinion or analysis article. As you can see from the list of members, we have a distinguished Editorial Board, and we are confident you will find their contributions interesting and thought provoking.

The other three regular features are the Economic Outlook, the Poverty Monitoring Indicators, and the Macroeconomic Modeling and Forecasting report. These features are introduced in this issue, and we hope you will look forward to reading them each month.

*Economic Policy and Poverty* is published by the Economic Development Research Center under contract to the USAID/Armenia Tax, Fiscal, and Customs Reform Project, implemented by BearingPoint, Inc. We hope you find this periodical both interesting and useful, and we welcome your feedback to assist us to improve the periodical over time.

Respectfully,

Mushegh Tumasyan  
Project Director - Editor

Annette N. Brown  
Executive Editor

# Economic Outlook

1. While significant economic growth of recent years is evident, in terms of welfare indicators Armenia remains well below other transition economies. After the decline in output by 53% during 1990-93 and cumulative recovery of 69% in 1994-2002 currently GDP is around 83% of its 1990 level, while per capita income is equal to 1990 level. However, if in 1988 around 20%<sup>1</sup> of population was below poverty line, currently poverty constitutes 50.9% of which 16% are extremely poor<sup>2</sup>.
2. The acceleration of real growth is one of the most evident achievements of the recent years. Real GDP grew by 12.9 % in 2002, which is the highest rate of Armenia's transition period. Growth in construction and industry of respectively 43% and 15% contributed to high growth rate. As the analysis of growth factors shows, 50.4 percentage points out of 69.7% total growth of 1994-2002 was driven by domestic demand, while only 19.3 percentage points – by external demand<sup>3</sup>. Although the external demand growth has significantly contributed to the GDP growth, domestic demand remains the main factor driving economic growth. It is important to note that in 2001 and 2002 external demand had larger contribution to the growth than in previous years.
3. Income inequality in Armenia still remains very high. Gini coefficient for 1999 was 0.57, for 2001 - 0.53, which is mainly explained by considerable reduction of employment, average real salary and state social transfers as compared to Soviet era.
4. Unemployment rate fell by 1-1.4 % during 2002, though, remaining high (according to official statistics 9.4 %, while according to the International Labor Organization's methodology – 31.4 %). A decline in unemployment by only 1 percentage points under impressive 12.9 % economic growth comes to prove that the distribution of the growth is disproportional and so far growth does not contribute to the significant reduction of unemployment. In this respect the issues of labor market needs to be addressed as well.
5. External current account improved significantly in recent years, which is explained by expansion of export oriented industries, such as processing of precious stones, jewelry and mining and also by import substitution of domestic production. Revival of CIS members' economies after Russian crisis of 1998 also contributed to the Armenian export growth (particularly food products). Current account deficit (excluding official transfers) was 9.1 % in 2002 against 27.8 % in 1997 and further contraction of external imbalance is expected in medium term. However, concentration of export oriented industries does not contribute significantly to the large scale poverty reduction.
6. Despite positive developments since 1998, tax revenues are still very low, staying below 15% of GDP. Budget expenditures fell as a percentage of GDP in 2000-2002. Recent improvements of fiscal position allowed to clear most of budget arrears accumulated since 1999.
7. Inflation since 1998 has not exceeded annual 3 percent. Nevertheless, annual volatilities in consumer prices even grew year by year. If in 1999 the standard deviation of monthly inflation rates equaled 1.55, by 2002, it steadily grew to 2.36. Relative changes in prices, though, could be viewed positive. If in 1998-2000 low prices were conditioned by the decline in prices for agricultural production, the increase in agricultural prices in recent years exceeded the growth of consumer price index. Thus a tendency to more balanced price structure per sectors is apparent.
8. Despite apparent success in emergence and development of market institutions, reform package is not fully implemented yet. Corruption, imperfect competitiveness, under-developed financial systems and insufficient juridical and low enforcement practices are the main challenges of further development of market institutions.
9. Financial depth, though improved recently, is not sufficient enough, which reflects issues of banking system developments and business climate. Despite improvements since 2000, real interest rates in loan market are still very high, which prohibits further financial deepening. Domestic credit/GDP ratio was 11.5 % in 2002, which is below of the level of financial depth of most of the transition economies.

<sup>1</sup> Source: "The Social Snapshot and Poverty in the Republic of Armenia" RA Ministry of Statistics, Statistical Analysis and State Register, Yerevan 1999

<sup>2</sup> Source: "The Social Snapshot and Poverty in Armenia" NSS, Yerevan 2002

<sup>3</sup> To simplify the calculations, overall export is considered as an external demand

## General Introduction of PRSP processes

Anahit Petrosyan

The last decade of twentieth century was marked not only by the break up of the Soviet Union and the development of democratic societies in the post-soviet countries, but also by the recognition of poverty as an obstacle for sustainable development. At the end of the twentieth century, the international community led by the United Nations adopted the Millennium Declaration and established the Millennium Development Goals, the road map for the world to provide equal opportunities for all people. The Millennium Development Goals are multidimensional and focus on such areas as elimination of extreme poverty and hunger; achievement of universal primary education; promotion of gender equality and women's empowerment; reduction of child mortality; improvement of maternal health; combating HIV/AIDS, malaria, and other diseases; ensuring environmental sustainability; and developing a global partnership for development. Within this process, significant roles are given to the International Financial Institutions such as International Monetary Fund and The World Bank.

To achieve the Millennium Development Goals, in 1999 the International Monetary Fund and the World Bank adopted the Poverty Reduction Strategy Paper (PRSP) approach in order to "help poor countries and their development partners strengthen the impact of their common efforts on poverty reduction". The PRSP aim is to develop a country's "macroeconomic, structural and social policies and programs over a three year or longer horizon, to promote broad based growth and reduce poverty, as well as associated external financing needs and major sources of financing"<sup>1</sup>. Thus the PRSPs are meant to be focused on three major areas. The first area includes broad-based growth or "pro-poor growth" supported by employment creating policies. The second area covers "good governance" issues coming from anti-corruption and public accountability measures and including, along with others, macroeconomic and fiscal management, and decentralized governance. And last, the third area is focused on investments in human capital, mostly in the health and education sectors, as well special-purpose financing, or "social safety net" arrangements, for the marginal groups of the population.

To support poverty reduction process, in September 1999 the International Monetary Fund also replaced its Enhanced Structural Adjustment Facility (ESAF) with a new lending facility for low-income countries, the Poverty Reduction and Growth Facility (PRGF). The key aim of the new lending facility was not just a change in name but also to integrate the objectives of poverty reduction and growth and be in line with a comprehensive country-owned strategy. Thus, central in the PRGF development process is its association with PRSP elaboration process. The joint assessment of PRSP by The World Bank and International Monetary Fund serves as the basis for concessional lending and the design of an assistance strategy by both institutions. This combination clearly makes poverty reduction a central goal of the PRGF. Association of the PRGF with the PRSP elaboration process contributes other features of PRGF-supported programs as well. In the first place is broad public participation and greater country ownership. An important challenge of the new approach is that more attention is given to the economic aspects of governance, in particularly to measures improving public resource management, transparency and accountability. It is also very important that PRGF-supported programs pay more attention to the poverty and social impact of key macroeconomic policy measures.

In 2001 the World Bank introduced its new program, Poverty Reduction Support Credit (PRSC), aiming to support poverty reduction strategies through policy and institutional reforms in low income countries. As PRGF programs supported by IMF, the Poverty Reduction Support Credit is linked to the Poverty Reduction Strategy Paper. The medium-term program supported by a PRSC is based on the reform measures and policy actions set out in the PRSP. Moreover, the possibility for a PRSC-supported program for a country is set out in the Country Assistance Strategy (CAS), which lays out the World Bank's medium-term social and structural policy and institutional reform program focused on capacity building and helping country to implement their poverty reduction strategies.

<sup>1</sup> The World Bank, 2001, *Reviewing Poverty Reduction Strategy Paper*.

The PRSPs' development process is based on important features. It emphasizes that a country should have primary responsibility for its own development, and thus the whole process should be based on ownership, empowerment, participation and accountability principles. The process should lead to improved dialogue between government and civil society within country and made all stakeholders responsible for development process. The cooperation between government and civil society is powerful tool to influence PRSP content and draw attention to social issues, and to strengthen democracy, legitimacy, as well as efficiency of policy measures. The PRSPs' development process also promotes the establishment of new relationships between countries and donor community. Countries implementing PRSPs have moved to better coordination of actions between countries and the donor community and between the different donors as well.

One key factor for sustainable development of countries, particularly small ones, is the development of the export sectors of economy. For this reason, official development assistance needs to be complemented by more open developed countries' markets to exports from developing and transition countries. The IMF and World Bank explain, "Over the past three decades, the HIPC's (Heavily Indebted Poor Countries) share of world exports eroded to a meager 0.7 percent by 1997, down from already low levels of 2.2 percent in 1970. And industrial countries now spend some \$360 billion a year on subsidies to protect their own agricultural sectors, while poverty rates climb in poor countries, especially in rural areas. These subsidies together with direct limitations on market access for developing countries' products inhibit the diversification of these countries' exports toward higher value-added products. Clearly, developed country trade restrictions are a direct blow to the efforts of the poorest countries to earn their own way through trade".<sup>2</sup> Thus, more open markets in rich countries will give additional incentives in developing and transition countries to attract essential long-term private investment flows to promote the growth of export-oriented sectors.

The last decade of the twentieth century made considerable changes in the operations of the International Financial Institutions. They created more partnership relations with member countries and their activities have become more transparent. International Financial Institutions have acknowledged that there is no single blueprint for reforms implemented at the different countries.

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## The PRSP and Its Development process in Armenia

Hovhanes Azizyan

**Initiation of the PRSP:** In 1999, the UN Millennium Summit adopted the Millennium Declaration in which the international community announced that a major goal of international development is the reduction of poverty. Based on the Millennium Declaration, the International Financial Institutions (IFIs) focused their assistance programs on the reduction of poverty as well. In 1999, the Executive Boards of the International Monetary Fund and the World Bank approved a new tool (facility) – the Poverty Reduction Strategy Program – which lies as a basis for the concessional financial assistance programs of the IMF and the World Bank.

**The PRSP in Armenia:** The IFIs suggested that Armenia, as a low-income country, develop and implement a PRSP, the success of which would direct financial assistance. The suggestion coincided with discussions in the Government concerning the methods of poverty reduction (statistical data on poverty was available since 1996 based on household survey results), which the Government had declared its major goal for the coming years.

**Interim PRSP:** In 2000, the Government of Armenia initiated the development of the Interim PRSP (I-PRSP) with the assistance of the international community. A Coordination Board consisting of Ministers, Members of the National Assembly, representatives of international organizations and NGOs was established by the Resolution of the Prime Minister of Armenia, thus providing for the participation of all stakeholders in this process. The I-PRSP was completed and adopted by the Government of Armenia in March 2001. The I-PRSP contained the description and definition of poverty in Armenia, as well as the main directions of poverty reduction policies-including (a) sustainable economic growth, b) public management, c) human development-and adequate measures for their implementation.

<sup>2</sup> *Debt Relief for Poverty Reduction: The Role of Enhanced HIPC Initiative, IMF and The World Bank, 2001*

As in other countries that have undertaken the development of a PRSPs, the participation of the civil society in Armenia was considered insufficient. The lack of participation was due to a few reasons. The most prominent reason was that the civil society lacked confidence toward the Government, as the initiator of the PRSP, with regard to its commitment to the achievement of the PRSP goals and objectives. In addition, the Government itself lacked adequate mechanisms to fully involve civil society in the PRSP development process.

**The PRSP Development Process:** The participation of civil society in developing the final PRSP was on a qualitatively new level. The non-government sector and other civil society actors actively participated in the PRSP development process due to significant efforts in various directions.

The major topical components of the Program were tendered to independent experts from the non-government sector, thus allowing for the expression of the interests of those outside the public sector. This was an important step from the point of view of publicity and participation of stakeholders.

Two organizations—The Institute of Human Rights and Democracy and the Analytical and Information Center of Economic Reforms of the Government of Armenia—were selected in order to facilitate the participation by various stakeholders and contribute to the transparency of the PRSP development process. These two organizations organized public discussions, seminars, TV and radio programs concerning the PRSP and its development. In addition, various articles were published in local (regional) and republican press. As a result, one could state that each stakeholder of the issue could, in one way or another, participate in developing the PRSP.

In the initial stages of the process, the participation of ministries and various government agencies was limited to their representation in the Coordination Board and the Task Force. However, considering that once the PRSP is approved, its implementation will become the responsibility of the ministries and agencies, the Prime Minister (Resolution N 48, January 30, 2002) ordered the creation of Task forces in each Ministry and agency, which would be responsible for collaboration with the Coordination Board and the main Task Force.

The Government also made efforts to coordinate the main directions of the PRSP with the Medium-Term Expenditure Framework (MTEF) for 2003-2005, thus

providing for the allocation of adequate resources for the PRSP measures in 2003 budget.

**Draft PRSP Discussions:** The draft PRSP developed by the expert group was submitted to the stakeholders (ministries and agencies, local governments, experts, donor community, etc.) As was expected, numerous suggestions and comments were received as feedback. The major shortfall of the draft was commented to be the complexity of the program and absence of priorities, which, given the limited resources, could risk the implementation as a whole, making the PRSP another document just full of good wishes.

**The Final PRSP:** The PRSP Task Force discussed the comments and suggestions received and, finally, selected a number of comments which should be reflected in the final document. The most important among them was the identification of sectoral and inter-sectoral priorities. The priorities were selected using a software program assisting decision making processes, which was provided by the German Technical Cooperation (GTZ), and subsequently approved by the Task Force. In order to finalize the PRSP, a special expert group was created, which intends to complete the PRSP in May 2003.

**Conclusion:** It can be stated with all confidence that Armenia has not experienced such a participatory process in the development of a strategic paper during the last 10 years. The process has been appreciated by civil society and created expectations towards the results of PRSP implementation. This compels the Government of Armenia, with the assistance of the donor and civil communities, to put maximum efforts into the accomplishment of the PRSP.

#### The PRSP Development Timetable:

May, 2000 – The Coordination Board of the PRSP Development Activities was created by the Resolution of the Prime Minister N 267.

March, 2001 – Interim PRSP adopted by the Government of Armenia.

April, 2001 – Tenders announced for the PRSP development and provision of stakeholder participation.

September, 2001 – Tender results summarized and the sequence of future steps identified.

October, 2001 – January, 2002 – The PRSP Terms of References developed.

# articles: poverty reduction strategy

January 30, 2002 – Task forces created at the Ministries and agencies under the Deputy Ministers or Heads.

February-October, 2002 – draft PRSP development by independent experts group.

February-November, 2002 – PRSP discussions, seminars held, publication of articles, TV and radio programs broadcast.

June, 2002 – An expert group of PRSP and MTEF coordination established.

August 12-28, 2002 – PRSP Sectoral discussions held at the Ministry of Finance and Economy.

October, 2002 – Draft PRSP presented to stakeholders.

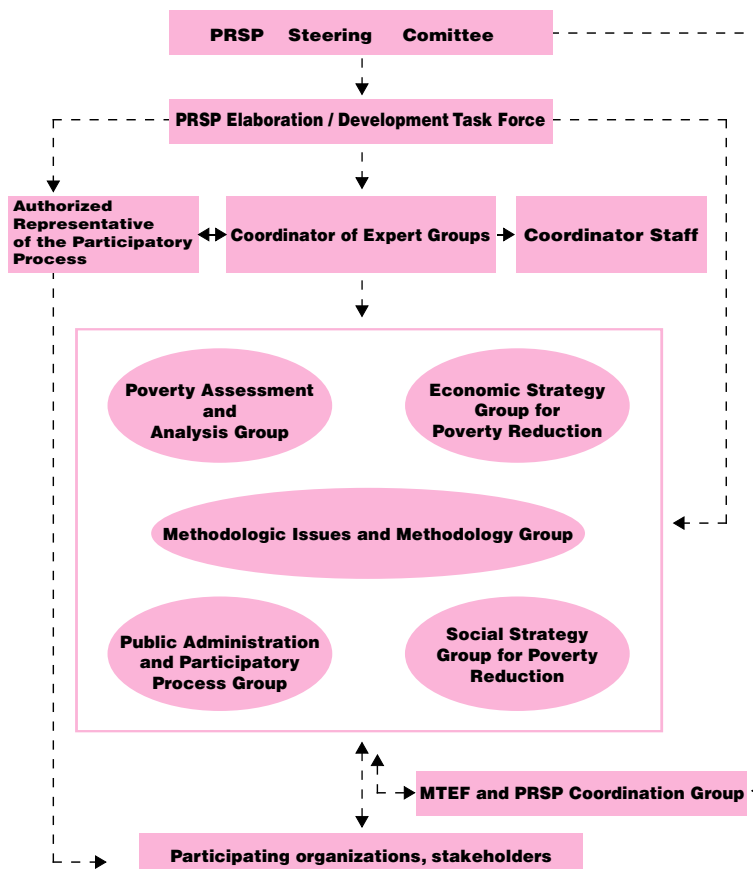
November-December, 2002 – draft PRSP discussions held.

January, 2003 – PRSP priorities identified.

February, 2003 – PRSP finalization group established.

*Hovhanes Azizyan is the Secretary to the PRSP elaboration / development working group, formerly he worked as the Head of the Economic Proportions Department at the Ministry of Finance and Economy of Armenia.*

## Graph of Organizational Works for PRSP Development



## How well did the PRSP process work in Armenia?

The PRSP development and approval process is supposed to involve tight cooperation between the Government and civil society along with a coordination of their efforts. Therefore, we attempted to identify the existing opinions and viewpoints regarding the PRSP process in Armenia by asking several well-known experts to briefly evaluate the process.

The following are the answers to the question "How would you evaluate the PRSP process in Armenia?"<sup>1</sup>

- Overall, I do not trust the Program, since it resembles the programs initiated by the Government previously, which, unfortunately, did not bring the desired results, such as Anti-Corruption Strategy.

**Mikael Danielyan, Helsinki Association NGO, President**

- I believe the PRSP is a very ambitious program, which becomes obvious even from the title, because poverty elimination<sup>2</sup> means eradication of poverty as such, whilst even the UN Millennium Development Goals aim at just a reduction of poverty by half. Second, it views the "socialization" of economic policies as being similar to poverty reduction; meanwhile, riches prevail among those who benefit from social services, e. g. higher education.

**Anna Sargsyan, Yerevan State University, Lecturer**

- The procedures of giving the PRSP legal power are somewhat delayed which might erode the trust of the society in the future of PRSP. It would be very desirable to have the final paper as soon as possible.

**Arthur Nakhshikyan, Central Bank of Armenia, Head of division**

- I am glad that the PRSP process involved not only the Government but also the civil society. I regret, though, that its contents reflect only the range of interests of those who developed the paper. If I am not mistaken, I saw public discussions regarding this document on TV and in newspapers around half a year ago. I hope that after the coming elections this program will be among the top issues on the table of discussions.

**Sevak Lalayan, Ph.D. in Economics, International Center for Human Development, Expert**

- The PRSP is the first coordinated attempt to identify the roots of poverty and factors contributing to its growth. During its implementation, it is necessary to keep in mind the following aspects:

1. Poverty is multi-dimensional (famine, low living standards, insolvency, beggary, poverty, extreme poverty, etc.). We need to clarify which dimensions the PRSP targets.

2. The main features of PRSP should stem from the Strategic Paper on Economic Development of Armenia, which has not been adopted yet by the Government.

In any case, a remarkable work has been accomplished which needs continued and persistent implementation. Good luck! I am looking forward to collaboration with the Armenian Strategic and National Research Center.

**Prof. Tatul Manaseryan, Armenian Strategic and National Research Center**

- The silence during the last 5 months compels one to suppose, unfortunately, that the means of the PRSP process were viewed as its goals, i.e. civil society participation was the objective but not a means to develop a realistic program. If the participatory process was not to lead to its goal – which is a realistic participatory program that would serve the majority of the society – participation in the PRSP process could be deemed as purposeless. Thus, the PRSP process, from our point of view, was:

In the first stage: active participation, publicity, public relations campaign, information;

In the second stage: feedback, discussions, publications, amendments and corrections;

And in the third stage: silence, information famine, indifference, and idleness.

**Hripsime Manukyan, Institute of Human Rights and Democracy**

<sup>1</sup> The responses were received before May 15, 2003

<sup>2</sup> In Armenian, the PRSP is called Poverty Elimination Strategy Program

## Poverty and Social Impact Assessments (PSIA): Both an Old and a New Concept

Lilit Melikyan

The policy reform issues facing Armenia today, as in many other low-income countries, are no longer the same as in the large scale macroeconomic adjustment packages of the 1980-s and early 1990-s. Rather, it is the turn of specific second or third generation reforms, which are more systemic, institutionally complex, and politically more difficult, with significant distributional consequences. This is true of reforms in such areas as restructuring and/or tariff adjustments of state utility companies, the health sector, public expenditure management, and so on. At the same time, widespread poverty and high income inequality, as is the case in many other countries, gives an increased impetus to poverty reduction efforts and culminates in the PRSP development, highlighting the need for understanding the impact of public policies on poverty and social outcomes to (a) provide a basis for considering policy options and/or appropriate sequencing of policies and (b) integrate appropriate risk management systems and/or mitigating measures into the reform program when appropriate.

These developments revitalized the concept of poverty and social impact analysis (PSIA) of public policies. It is not new. Instituted initially in the context of projects, it became increasingly applied also to policies and gained more momentum in 1990s after critical reports on the social costs of early adjustment policies. The past experience of PSIA, however, had a number of weaknesses (e.g. lack of ex-ante analyses and non-transparent identification of risks and the potential losers from the reform), resulting in weak linkages between poverty analysis and policy choices. There were some understandable reasons for these weaknesses in the PSIA: the relationship between policy change and poverty outcomes are not easily understood and analyzed. Recently and increasingly, however, it has been recognized that despite the difficulties, even in the countries with limited data, sufficient tools and methods do exist to assess some of the potential poverty impact and therefore, contribute to a more informed policy debate<sup>1</sup>.

PSIA means the analysis of the distributional impacts, both intended and unintended, of policy reforms before during and after implementation on the well-being or welfare of various social groups, with a particular focus on the poor and vulnerable. Further, a PSIA also addresses the issues of sustainability and risks to policy reform that come with social impacts of policy changes<sup>2</sup>. Welfare is understood in both income and non-income dimensions. The objectives of a PSIA are to support country ownership of policies by informing public debate on the most appropriate policy combination of growth and poverty reduction and the trade-offs between policy choices; to assess the appropriateness, timing and sequencing of reforms; and to better define appropriate compensatory complementary measures if appropriate.

PSIAs could be applied to a wide range of reforms, including macroeconomic reforms, structural and sectoral policy changes, and so on. A PSIA should attempt to analyze all the main transmission channels of the impact: institutional change, labor market outcomes, prices in the markets for goods and services, access to all markets, asset prices, and government transfers and taxes. PSIA analysis should acknowledge that impacts could vary substantially across different groups of society and over time. Understanding and explaining how short-term losses (gains) may result in longer-term gains (losses) for given societal groups is one of the challenges inherent to PSIA. PSIA can help policymakers make decisions about the design, sequencing, timing or desirability/appropriateness of proposed reform, with the aim to minimize the number of losers or the extent of losses. The policy recommendations could be in the form of inclusion of enhancement or mitigation measures in the policy design; different sequencing of public actions; direct compensatory mechanisms; delaying the reform (i.e. re-sequencing) or even abandoning or suspending the policy issue in question.

In a broader sense, PSIA involves the following inputs (not sequential): a process of ongoing dialogue and public debate; identification of stakeholders; identification of the right research question; understanding transmission channels for the potential impacts; assessing institutions; gathering data and information; analyzing impacts; contemplating design and compensatory schemes; assess-

<sup>1</sup>For a summary of the review see, IMF and the WB, 2001, pp10-13, "Poverty and Social Impact Analysis" at <http://www.imf.org/external/np/prsp/2001/091401.htm>.

<sup>2</sup>WB, 2002, "A User's Guide to Poverty and Social Impact Analysis".

ing risks (through social risk assessments, sensitivity analysis or scenario analysis); setting-up monitoring and evaluation systems; and feeding back for policy adjustments. In data analysis the PSIA methodology prefers using mixed methods of quantitative and qualitative analysis. Depending on the nature of the policy reform in question, it could employ a combination of the existing models and techniques, ranging from social impact and participatory poverty assessments, incidence analysis, household models, partial and general equilibrium analyses, micro-simulations and so on.

It is important that upon identifying and designing reform based on ex-ante PSIA, early-stage systems for ex-post monitoring, social accountability and evaluation of the impacts be set up. Monitoring and Evaluation (M&E) in the context of PSIA may be seen as a sub-set of a national poverty monitoring system and as having several characteristics, including a focus on monitoring impacts specific policy reforms, a special role for monitoring for purely practical purposes, and so on.

Ideally countries should undertake PSIA as part of their early PRSP preparations so as to inform the choice of the policy mix. Indeed, increased country ownership of policy choice calls for informed national debate and discussion of the poverty and social outcomes as trade-offs that underlie that choice. The PRSP, in turn, could present various aggregate spending scenarios to reveal trade-offs between different options, and with this information groups can bargain over the allocation of resources—a process that should feed formulation of MTEFs and influence annual budgets. This does not mean that it is ever late to start adopting the PSIA practices, and this is true both for the countries themselves and for the donor community. The World Bank (WB) and the International Monetary Fund (IMF) on their part have committed to grounding their PRSCs (WB) and PRGFs (IMF) in sound poverty and social impact analysis<sup>3</sup>. More importantly, however, PSIA(s) should become a part of countries' ongoing public policy dialogue and M&E system (such as those established for poverty monitoring, the budget process and PRSP implementation).

The understanding of the increased role of PSIA for policy design and implementation has led a major initiative funded by the WB and DFID recently. The WB is now undertaking PSIA in six case study countries, including Chad (cotton sector), Malawi (agriculture marketing board reform), Kyrgyz Republic (electricity sector reform), Guyana (reform of bauxite, sugar and water sectors), Mongolia (cashmere and energy tariff reform), and Pakistan (energy tariff reform). In addition, DFID has piloted PSIA in five countries: Mozambique (petroleum taxes), Uganda (trade diversification), Rwanda (fiscal policy), Armenia (water pricing), and Honduras (electricity privatization). The results of these studies should be useful in guiding the program design and implementing countervailing measures in the context of sustainable macroeconomic framework.

As discussed in the beginning, the reforms on the agenda of the Government of Armenia justify the need for conducting fully fledged PSIA(s) of the major policy reforms. The pilot PSIA conducted in Armenia with DFID funding of water (both municipal and irrigation) sector reform (summer 2001) stressed this urgency<sup>4</sup>. It is rather unfortunate that fully fledged PSIA(s) for the major reform programs planned did not precede or accompany the PRSP Armenia in 2001.

The expert groups involved in PRSP preparation can recall heated debates about prioritization of the needed programs/projects, which, in many cases, lacked analytical papers to provide a sound basis for these discussions. However, undertaking such analysis in the near future will still be very much needed in order to inform the PRSP updates and to inform the MTEF and budget processes. PSIA will stimulate the public discussion of policies, which in itself is valuable. To overcome the constraints that PSIA efforts will face (data, analytical capacity and time), current efforts should concentrate on building the national capacity, including identification of data sources available and needs and measures for their development, needs assessment for training on PSIA methodologies, and the institutionalization of the PSIA process. To be able to take over the ownership of the PSIA process, Armenia would need carefully designed support from the main donors.

<sup>3</sup> IMF Working Paper WPO3/43. C. Gobb: "Poverty and Social Impact Analysis—linking Macroeconomic Policies to Poverty Outcomes: Summary of Early Experiences".

<sup>4</sup> DFID/ERI, *A Polit PSIA of Water Sector Reform in Armenia, upcoming*

## Pilot PSIA of Water Sector Reforms in Armenia: A Brief Description

In the summer 2001 Economic Research Institute (ERI) in cooperation with Oxford Policy Management Ltd. (UK) and with funding from the UK Department for International Development (DFID) conducted a pilot Poverty and Social Impact Assessment (PSIA) of water sector reforms in Armenia.

An additional component the task was an assessment of the readiness for conducting PSIAs in Armenia. For this component, the research team documented (a) an increased awareness on behalf of both the government and the international financial institutions of the importance of a better understanding of the relationship between poverty and reforms, and (b) little evidence as yet of robust methodologies for routinely making the analysis of this relationship one of the foundations of policy making.

Water sector reforms were chosen as the subject for the pilot PSIA after several discussions the team had with the Government representatives, research institutions, civil society organizations and representatives from the international community. The choice was a result of the fact that water sector reform is high on the agenda of the government at the moment and the acknowledgement of the heavy distributional consequences for these reforms.

Due to limited resources and a short time frame (1,5 month) the team limited its strategy to the following: (a) a survey of the existing studies available, (b) a qualitative study of selected stakeholder groups and in-depth interviews with expert practitioners, (c) quantitative inferences regarding the impact of the imposition of a stringent payment discipline for the municipal water on the extremely poor using new available data, and (d) forecasts of the impact of increased tariffs for irrigation on the water sector using data on agricultural commodities production by marzes.

A few of the main conclusions of the study were:

- 1) While in the municipal water sector, the reforms were preceded by a number of studies analyzing the possible alternative reform scenarios (the main one being "Utility Pricing and the Poor" World Bank, 2001), the reforms in irrigation lacked such an analytical background.
- 2) Reforms, including elimination of subsidies, tariff increases and imposition of a stringent payment discipline, are very much needed since maintaining the status-quo would lead to further deterioration of the entire water delivery system.
- 3) Through careful design of reforms, parallel reform measures, and strategic investments in infrastructure, the cost-recovery efforts can be maintained, and the impact of these efforts on the poor minimized.
- 4) The reforms are taking place in a rather difficult socio-political environment.
- 5) The reforms as they are now would have a rather significant negative impact on the poor and in particular with regards to the reforms in the irrigation sector
- 6) To mitigate these negative poverty and social impacts, and to ease the task of making the reforms politically deliverable, a number of measures were recommended, including:
  - . the need to design specific assistance programs for the poor both in municipal and irrigation water sectors;
  - . increased attention to community level projects aimed at the development of rural infrastructure and non-farm rural economies - ideally to precede any drastic increases in irrigation tariffs;
  - . further reforms in local self government increasing their financial sustainability and decentralization.

The study recommended that the planned schedule for increasing the irrigation tariffs to meet the zero-subsidy level be revised (subsequently the time line was prolonged from 2005 to 2007). The study also concluded that increased efforts aimed at the development of the non-farm rural economy ideally should precede drastic increases in irrigation tariffs.

A yet another conclusion of the study was that a fully fledged PSIA is needed for the irrigation reform program. This would be at least a year-long study with significant resources to be allocated to it, to enable conducting a comprehensive survey of farms/rural households, building micro-simulation models, and so on.

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## Household Survey Finds Significant Improvement in the Standard of Living of Armenian Households

Hasmik Ghukasyan

The Armenia Social Transition Program (ASTP) is supporting the Government of Armenia's program of reforms aimed at improving the delivery of social and health care services to vulnerable people. The program is funded by the United States Agency for International Development and the contract was awarded to PADCO inc. a Washington based contractor in July 2000. To monitor and evaluate the effectiveness of these reforms, PADCO<sup>1</sup>, through its subcontractor QED, conducted surveys of Armenian households in November 2000, May 2001, November 2001 and November 2002. The surveys are conducted under contract by the National Statistics Service of the Republic of Armenia.

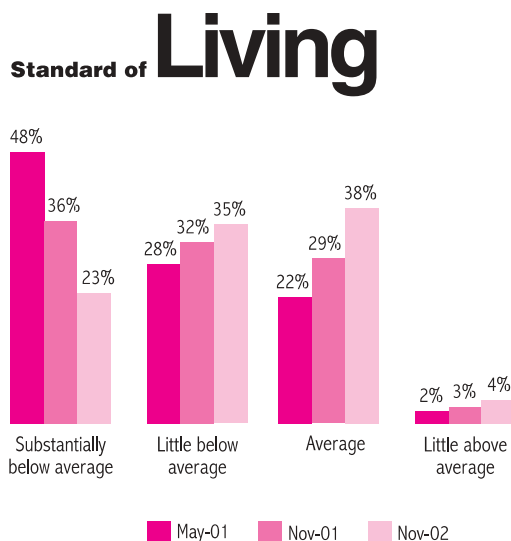
A panel of 1,300 households was randomly selected from Yerevan, Shirak, Lori, Syunik and Gegharkounik marzes and surveyed in order to gather panel data and measure changes in the delivery of social and health services. The distribution of survey respondents among the marzes and between urban and rural communities was proportional to the general population of these marzes and was kept unchanged during all the surveys. 1000 households were randomly selected based on proportionally weighted probability from the five survey Marzes. An additional 300 households were selected at random from the Poverty Family Benefit<sup>2</sup> (PFB) database in order to ensure adequate representation of vulnerable groups. The overall characteristics of the panel are typical of the population of Armenia.

### Standard of Living Is Improving

The November 2002 survey found a significant improvement in the standard of living of households from the November 2001 survey according to multiple indicators. The proportion of households who rated their standard of living as substantially below average declined from 48 percent in May 2001 to only 23 percent in November 2002.

The proportion of households who stated that their income is sufficient for food and necessities increased from 14 percent in May 2001 to 26 percent in November 2002 and there was a corresponding decline in the

proportion of households reporting that they need to borrow to purchase bread and basic necessities from 44 percent in May 2001 to 24 percent in November 2002. The proportion of households in the lowest reported income brackets (15,000 AMD or less) declined from 57 percent in May 2001 to 42 percent in November 2002, while the percentage in the highest income bracket (60,000 or more AMD) increased from 3 percent to 7 percent.



PADCO has developed an index to identify "vulnerable" households reflecting the emphasis in ASTP of improving the welfare and services to this group. Households were categorized as "most vulnerable" if they reported that they needed to borrow for basic food and necessities, if they reported experiencing a medical problem but could not afford to visit a doctor, and are receiving Poverty Family Benefits. Using these definitions only 35 percent of households were identified as vulnerable based on the findings from the November 2002 survey. This compares with 45 percent of households in November 2001. Although female-headed households continue to be more vulnerable than male-headed households, the percentage of such households classified as most vulnerable has fallen. In May 2001, 60 percent of female headed households were "most vulnerable" compared with 42 percent for male headed households. By November 2002, 31 percent of female headed households were classified as most vulnerable compared with 19 percent for male headed

<sup>1</sup>www.padco.am

<sup>2</sup> Poverty Family Benefit is the main social assistance program in Armenia. It is paid to families who are deemed to be vulnerable according to a set of criteria which includes the status of the members of the household, elderly, disabled, young children etc. and a number of other factors. Currently 145 families receive the PFB.

households.

Among those households reporting an improvement in their standard of living, 14 percent reported that a household member had found a job during the previous year, while the rest reported an increase in incomes.

Despite these overall improvements, poverty remains a problem. 73 percent of households have no sufficient income to provide their basic needs. A substantial minority 21 percent of households reported that their standard of living had declined in the past year.

### Public View of the Quality of Healthcare Improves

In addition to asking households about their perception of their overall standard of living, they were also asked about their use of and evaluation of health and social services. The November survey found that the public view of these services has shown significant improvement. Households reported that healthcare is becoming more accessible, fewer households reported experiencing medical problems, and more of those who sought medical attention reported that it cured their problem.

A vital indicator of the accessibility of health care is the number of households reporting that they experienced an illness but did not seek medical consultation because it is either too expensive or not easy to reach. Between November 2001 and November 2002, the number of households reporting that they sought medical attention for a medical problem increased from 53 percent to 65 percent. Among those not seeking medical treatment, the number reporting that they were unable to afford medical treatment fell from 82 percent to 71 percent. The number of households reporting they could afford to purchase their prescribed medicine rose from 76 percent in May 2001 to 84 percent in November 2002.

Satisfaction with health care is very high: 87 percent of households who had sought medical care reported that the facility provided sufficient care and services and 95 percent stated that doctors were well qualified and explained the problem clearly.

One of the reasons for the improved accessibility of health care is that more households particularly poor households are aware of their rights to receive free medical care under the Basic Benefits Package program that reimburses health care providers for treatment provided to the poor, pensioners and other population categories. The number of people reporting that they received medical treatment free of charge increased from 17 percent in November 2001 to 35 percent in November 2002.

### Regional Social Services Centers are Providing a Better Services

Visits to the local offices (RSSCs), 55 countrywide, which administer the Poverty Family Benefits program have increased and there has been an increase in the overall satisfaction of services rendered at these offices more reporting that staff were polite, information was readily available and other qualitative indicators (see Figure 2).



The proportion of households aware of the complaints and appeals process has increased from 45 percent in May 2001 to 71 percent in November 2002. Improvements were noted by households in the program's targeting of the vulnerable population and accessibility of information on the rules.

The number of customers at social service offices who considered that waiting times were too long also declined by 19%.

A large proportion - 89% of the households who knew about the PFB program and 93% of households who are receiving benefits- felt that the PFB system is important.

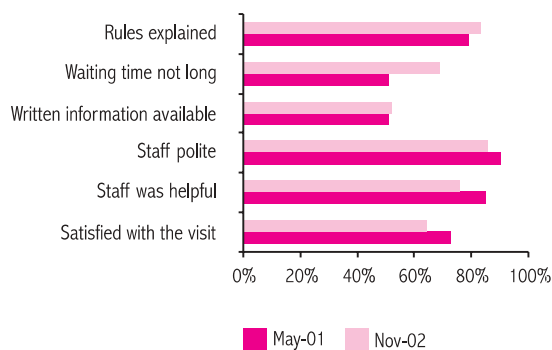
There has been a comparable improvement in the perceptions of the quality of services in local pension offices (see Figure 3). However, an overwhelming majority of households (93 percent) both pensioners and non-pensioners felt that the social insurance system needed reform. A high proportion (95 percent in November 2002) of households said that the pension system did not provide reasonable payments.

<sup>3</sup>Extreme poverty was defined – for a family of 4 – as monthly income of less than 7,000 AMD.

## Summary

These results indicate that the decline in extreme poverty between 1999 and 2001 noted by the National Statistics Service (NSS) of RA in reporting on the results of the Household Income and Expenditure Survey (HIES) for these years from 22 percent to 16 percent- appears to have continued through 2002<sup>3</sup>. It is anticipated that the results from the 2002 HIES will be reported by the NSS.

## Satisfaction with the regional SIF office



PADCO supports the NSS in conducting the household income and expenditure survey of 4000 households by providing interviewer training and assisting in data cleaning. The results of this survey also indicate that the standard of living is rising in Armenia and that the number of extremely households is dropping.

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## Poverty Reduction as a Warranty for Sustainable Economy

Sisak Sargsyan  
Sasun Muradyan

### Transition Economy or Structural Reforms

The major idea of this article is to a certain extent controversial: do the recent economic reforms and growth pattern ensure the emergence of a more efficient economic system? Could we state that the emergence of the market economy is just a matter of time?

Economic transition is characterized as a systemic adjustment process, thus, we need to discuss it under "systemic approach" theory. According to that theory, a transition from one system to another can prove to be accomplished

only if the main efficiency indicators achieved under the second system are exceed or at least close to the levels of those indicators under the first system<sup>1</sup>.

In general, welfare is viewed as a proxy for the efficiency of a economic system. It can be measured by various indicators. If we take per capita GDP indicator, Armenia currently has presumably reached its pre-transition point<sup>2</sup> of development, and, basing on that, one could state that the systemic changes are almost completed. Nevertheless, some other indicators (poverty, employment, income distribution, etc.) are still well below their pre-transition levels. That is, there is a certain "stability" of processes, although we have not yet achieved the new system. The latter statement is controversial, since transition process itself does not imply sufficient stability. This should, again, be discussed under the systemic approach theory.

### Transition Phases and Behavior of the Reformers

The behavior of a system, including an economic system, under transition is subject to certain rules and evolves under certain patterns, according to which any economic system has a certain degree of stability resulting from the strength of the links between the components of the system.

Transition from one system to a second occurs in two phases. In the first phase, the impulses are directed to the destruction of the system, while in the second phase – to the establishment of the new system.

The beginning of the 1990s in Armenia could be identified as the first phase of transition, when reforms face huge resistance. The old economic system, striving to retain its parameters and responding to reform influences, drastically worsened its own performance. The economy shrank by 55 percent during 1990-93, which was followed by a "dead season" presenting a unique paradox. The system was taken out of its stability range in order to establish a more efficient system instead. Meanwhile, the economic system was ready to stabilize at any point of its decline – but, now, at a lower level of efficiency. The reformers in this phase are divided into two groups: those who overcame the resistance of the old system and continued the reforms, and those who obeyed the resistance, and, trying to avoid further deterioration, slowed down the reform pace. The duration of the so-called "dead season" is conditioned by the choice of behavior by reform leaders. It can last an unpredictably long period, when all the negative aspects of both the administrative and market systems appear, while, at the same time, all the advantages of the new system are reduced to zero.

<sup>1</sup> It is supposed, that the system is viable as long as it does not hinder the progress. Each subsequent system is inevitably more efficient the previous one. It is understood, that while moving from one system to another certain efficiency indicators temporarily may drop down.

<sup>2</sup> 2002 real GDP constituted 83.2 percent of 1990 GDP. Taking into account the decline in population during 1990-2002, 2002 per capita GDP equals to 99.12 percent of per capita GDP in 1990. Population is assumed 3 mln in 2002.

## Development Expectations

The transition process in Armenia resulted in a drop of welfare indicators, including a drastic growth of poverty and inequality<sup>3</sup>. Despite relatively fast economic growth since 1994 (average 6.7 percent annually), which was the highest among CIS countries, poverty did not decline significantly. The society is divided into two strata: the poor and the rich, and the differences in the lifestyle, values, priorities and interests between these two strata continue to grow. Under such social tension, it is extremely hard to state that we have achieved the stability of the system or that the emergence of a market economy is only a matter of time.

The differences between the poor and the rich created aggression and resistance that puts at risk the economic safety of the country<sup>4</sup>.

Today, it is not easy to unambiguously state whether the Armenian economy has grown out from the “dead season” or it is still in the middle of it. The duration of the “dead season” increases the risk of the non-evolutionary transition to the new system, or in other words – the probability of a “disaster”.

In conclusion, it is worth noting that despite certain stability of the current economic system of Armenia, we cannot assert that the systemic changes are completed. Only easing the social tensions and reducing poverty can provide for the emergence of a new economic system and its long-term stability. In this regard, the PRSP process of the Government of Armenia becomes of top priority from the perspective of the evolutionary development and successful transition.

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## Transition Democracy: Is It Feasible to Reduce Poverty under Pending Democratization?

Varazdat Karapetyan

The Eastern European and former Soviet Union countries are currently undergoing two parallel transitions: from central planning to the free market (economic transition) and from authoritarianism to democracy (political transition). Some of them have succeeded in both economic

and political transition (Hungary, Poland), while some still resemble the old Soviet system (Belarus, Uzbekistan). This article discusses interrelations between political and economic transition processes, and, in particular, emphasizes the importance of the political transition with regard to the success of the economic transition.

Theoretical studies have not yet fully answered this question: does political liberty support economic transition, or does it hamper the economic reforms to a certain extent.

There is a viewpoint that an autocratic leader, being free of political risks, can promote fast and purposeful reforms in early stages of transition. Meanwhile, an adequate political base is necessary for the economic reforms and liberalization.

However, our society and the state have chosen both a market economy and a democracy. A question arises whether it is feasible to implement radical reforms and provide for the successful implementation of the defined strategy if the democratization processes are somewhat delayed. The problem is unique, since the country has a high degree of inequality and poverty and its economic strategy is aimed at poverty reduction.

## Transition Democracy: Historical Aspect

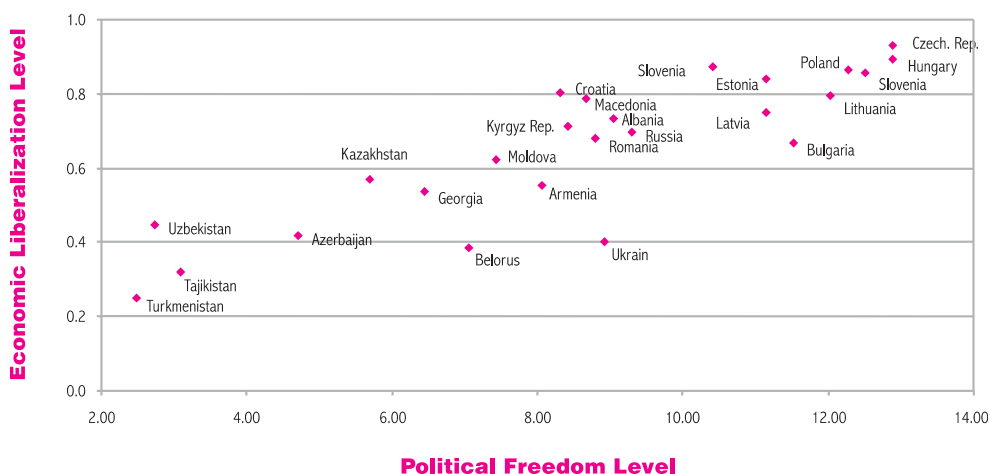
Each of the transition countries certainly has an historical basis for the current development path. The Eastern European countries had experienced democratic governance and market economy in the first half of the 20th century. People in these countries still remembered the moral norms characteristic of a democratic society. In their case, the transition is based on restoring and further developing those norms and values and establishing adequate institutional structures. Currently, developments in these countries are influenced by large-scale democratization and continuous growth of the middle-class.

The CIS countries never had capitalism (free market) and democracy and, starting the second decade of the last century, were forced to develop under socialism, whose totalitarian system has many things in common with Asian civilization. The former strong governance mechanism was totally rejected in the transition process. The people, still not having adequate voting culture, went on with the old mentality and lifestyle – characterized by inertia of the social conscience. As a result, the centralized governance structure was replaced with bureaucratic proprietorship and/or clan (oligarchic) structures.

<sup>3</sup> Poverty in Armenia in 2001 constituted 50.9 percent, while the Gini coefficient – 0.528.

<sup>4</sup> Generally, the maximum level of the poverty acceptable from the perspective of the economic safety is assumed 35 percent.

## Liberalization and **FREE**dom<sup>1</sup> (average 1992-1997)



### Democracy as a Factor of Economic Strategy

Some studies<sup>1</sup> reveal that a strong correlation exists between the political and economic development of a country. In general, from the viewpoint of the political science, for a society to be identified as democratic, it needs to comply with the following requirements:

- there must be representation of the will of voters through the mechanism of free elections when each member of the society expresses his or her will;
- an individual is the basis of society, its primary and major entity;
- the development of the society is preconditioned by the development of the majority of its individual members, and the middle class becomes the one that leads the society;
- moral values of individuals and the enforcement of laws are regulated through the "freedom of conscience" criteria.

From the economic point of view, a democratic society provides for the adequate supply of public services, economic freedom, and public decision-making on the trade-off between short-term and long-term alternatives<sup>2</sup>. Moreover, provision of the above-mentioned and other economic factors at the adequate (according to demand) level is not feasible under lower stages of democratization.

The Government of Armenia has adopted poverty reduction as its strategic goal. Consequently, we need to focus on issues such as public services provided to the society, income distribution and re-distribution in the economy, as well as policies for the poor and the overall efficiency of the strategy. In this regard, below we address the issues of supply of public services, microeconomic environment and strategic management.

**Provision of Public Services:** High levels of poverty in Armenia evidence that the poor and socially vulnerable are more sensitive to changes in provision of public goods and services. That is, the lifestyle of a wide stratum of society largely depends on the volume and quality of public services. Under insufficient democratization, the absence (or disfunctioning) of adequate political mechanisms hinders transmission of the public demand to the decision-making level and its subsequent accomplishment. On the other hand, the real power, as a rule, is centralized in the hands of a rich minority. Thus, the state programs and public services hardly would stem from the interests of the poor.

Under democracy, the society will make its voice (i. e. the public demand) heard to the government, simultaneously creating adequate mechanisms for the fulfillment of its will.

<sup>1</sup>See: *Does Democracy Facilitate the Economic Transition? An Empirical Study of Central and Eastern Europe and the Former Soviet Union*, The World Bank, 1989

<sup>2</sup>E.g. public decisions on exploitation of natural resources, incurring public debt, etc.

**The Microeconomic Environment:** The best historical precondition for the competitive economy is democracy, as long as the hegemonic stratum of the society – the middle class – dictates its will to the entire system. Various researches have identified the factor most hindering the economic development – clan systems. Only a democratic system and participatory governance can provide for an objectively self-optimizing economy, which, in its turn, provides for the efficient utilization of resources and distribution of income.

Thus, insufficient democratization results in growth of the monopolistic clan structures, hampers emergence of the competitive markets, and leads to political and economic polarization within the society as the clans rely on shadow economies and black markets, lobbies, etc, and the monopolistic branches experience “clan inheritance” syndrome.

**Strategic Management:** Under transitional democracy, society does not possess enough tools to influence the elaboration and/or adjustments of efficient strategic development policies. Simultaneously, those who possess political power are often incapable of adjusting the economic policies, even if they want to. For transitional democracies some “strategic adjustments” are feasible. This implies that the political leaders overcome the clan pressure through adopting laws regarding future, thus compelling the future leaders to implement reforms. This approach provides for the solution of current problems in the long run, although, leaving them insufficiently resolved in the short run.

### Conclusions

Thus, the pending democratization risks the poverty reduction process in Armenia, even under an efficient strategic plan of the process. We suggest three factors for that. First, there are no adequate mechanisms to ensure the elaboration and implementation of efficient programs (especially with regard to human development and social security) by the government. Second, the restriction of economic freedom through monopolistic and clan markets hinders the access of the poor to economic resources and the benefits of growth. Third, structural problems of public governance and clans – as the actual bearers of the power – do not allow initiating “strategic adjustments”. That is, since there are no changes in real power and interests are feasible, it is impossible to develop efficient policies even for the future (through legislative changes and strategic deci-

sions).

Today, the government should put efforts toward democratization, while the population, half of which is the target group for the current Poverty Reduction Strategy Program, should actively participate in its elaboration and implementation.

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## Poverty Monitoring and the Main Requirements to It

Sasun Muradyan

Tigran Kostanyan

The efficiency and success of a poverty reduction strategy largely depends on the monitoring system it uses. This article will try to establish the preconditions for the application of a reliable monitoring system. We address here issues such as: why a monitoring system is required, what needs to be monitored, and how the monitoring should be performed.

### Why a monitoring system is required?

Monitoring is one of the components of a poverty reduction strategy, and it aims at identifying the fundamental reasons for poverty and following the pace of its reduction process. Monitoring is also necessary because poverty is multi-dimensional, thus its reduction requires various programs and participants. Poverty monitoring is a complicated and expensive process; however, rejecting its need may risk the overall success of the strategy implementation process.

Poverty monitoring is aimed at revealing poverty's causes, controlling the process of implementation, and assessing the efficiency of poverty-reduction strategies. Ultimately, monitoring involves the measurement of the processes being implemented and leads to an evaluation of whether the pursued policies reduce the level of poverty in the country.

### What needs to be monitored and how the monitoring should be performed?

Not only economic, but also social programs and indi-

cators should be monitored in the framework of the Poverty Reduction Strategy. In this regard, it is crucial to clearly identify those indicators that are not feasible or difficult to monitor.

The experience of various countries has shown that, as a rule, Poverty Reduction Strategies:

- tend to be over-optimistic and ambitious;
- have feeble links between their goals and suggested programs;
- include programs and measures that do not properly consider the availability of resources;
- are highly influenced by donors;
- involve insufficient participation of and impulses from the civil society, although formally it is involved in the PRSP development process.

Monitoring systems should consist of several sub-systems. In particular, the experience proves that an efficient poverty monitoring system should have the following sub-systems:

- Poverty indicators monitoring;
- Social impact monitoring;
- PRSP sub-projects monitoring;
- Budget analyses subsystem;
- Macroeconomic modeling and analyses of poverty;
- Participatory monitoring.

Analyses of poverty trends based only on household surveys cannot be sufficient for having a useful monitoring tool in place. Poverty indicators need to be regularly adjusted according to the census results and/or participatory process estimates.

Although the final goal of the poverty reduction strategy is improvement of limited indicators, namely, income indicators, the roots of poverty come from inconsistencies between economic relations, institutional systems and, especially, social situation. Thus poverty monitoring systems should include indicators describing those too, provided that their links to the final target of poverty are explained.

Taking into consideration that the Government is responsible for the implementation of PRSP, it is crucial to link the monitoring system to the government programs and the budget. PRSP sub-components are usually reflected in expenditure items of the state budget. Consequently, reforms in public expenditure management become highly relevant in this regard, particularly, the implementation of the

Medium-Term Expenditure Framework and Program Budgeting. Simultaneously, participation of non-government sector in the budget analyses process becomes a very important factor.

Macroeconomic modeling and analyses should also be viewed as a monitoring subsystem that provides a broader picture to help assess the impact of the pursued policies and perspectives of poverty reduction.

### The main monitoring levels

Normally, three monitoring levels can be identified: target indicators, intermediate indicators and policy impulse indicators. Each level should be characterized by its indicators which, then, will form the chain from policy impulses to changes in poverty. Changes in poverty levels can be best assessed through monitoring of target indicators, i.e. poverty incidence. This method is not flexible enough, though, and requires substantial investments of time and financial resources. It presents the situation with the poverty indicators in the country and normally is conducted on an annual basis.

The second level of monitoring assesses and analyses the intermediate indicators. If the first level monitors the level of poverty, its depth and acuteness, and income distribution, the second level could, for example, analyze the income and expenditure components of GDP, budgetary financing of education, healthcare and social sectors, etc. The choice of intermediate indicators can vary depending on the peculiarities of poverty in each country. In other words, the appropriateness of the second level indicators depends on how correctly the causes of poverty are defined.

Monitoring of policy impulses measures those policy tools that affect the directly the intermediate indicators, and through them result in changes in the overall picture of poverty.

Generally speaking, a monitoring system can be considered successful if required resources (including time) are defined for each of the indicators, the necessary information is available, measures to improve the efficiency of information uses and expected results are outlined.

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## Economic forecasting in Armenia

Agassi Mkrtchyan

The existence of reliable forecasting models is very important for the efficiency of economic policymaking. Activities to create forecasting models in Armenia started in 1994-95, after the country began to implement its own economic policy. Since then important steps have been undertaken to develop and strengthen forecasting models. Very important contributions were made by international financial institutions and different technical assistance projects. However, despite efforts toward development of reliable economic modeling tools in Armenia, relatively slow progress has been recorded. The lack of proper economic statistics and time series that properly cover only last 6-7 years are the main obstacles that economic modeling faces.

Currently four different models are used for economic forecasts in Armenia. These are the financial programming model of the Government and the Central Bank, a RSMS model of the World Bank, a structural economic model created by Barents group (now BearingPoint) in the scope of USAID Tax, Fiscal, and Customs project model, and the "MAGMA" model developed by Economic Development and Research Center NGO (EDRC). With the exception of the structural model all models are non-econometric<sup>1</sup>. This is mostly explained by the current status of data availability that prohibits econometric analysis of good quality.

Recently some efforts have been made to establish communication and coordination among different institutions involved in development of economic models in Armenia. In particular, a forecasting working group was formed in 2002 upon initiative of the Ministry of Finance and Economy and the USAID Tax Fiscal and Customs Reform Project. The Group addresses challenges that economic forecasting currently faces. As a result of intense meetings of the working group in the last year, a report was prepared that provides in depth characteristics of each model used in Armenia<sup>2</sup>. The report also provides description of weaknesses and prospects for further development.

The most widely used model in Armenia is the financial programming model. It is the main tool for the construction of the medium term macroeconomic framework and is based on the financial programming principles used in most IMF programs. The Ministry of Finance and Economy and the Central Bank of Armenia cooperate in the use of this model. The model generates forecasts of the expenditure side, or uses side, of GDP from a set of behavioral relationships. These focus on the balance of payments and on private consumption. There is no production side to the model as it is assumed that a production function would not be representative of the Armenian economy and there is also no good measure of capital in the economy. One of main characteristics of the model is that GDP, velocity and the money multiplier are all exogenous. This makes monetary analysis relatively unimportant, as the setting of the GDP target automatically implies money supply. For further improvements of the model, a system of equations may be estimated, which would allow the model to forecast some interesting dynamics of the economy. It should be mentioned that the Central Bank of Armenia already conducts some independent estimates of money demand for which the monetary approach to the balance of payments and an error correction model are used.

As EDRC has been engaged in the development of Poverty Reduction Strategy of Armenia, the Macroeconomic Adjustments and Growth Model (MAGMA) model, combined with the "Income Distribution Matrix" and "Growth and Distribution" Models, also developed by EDRC, produces the primary forecasts for the long-term macroeconomic framework, income distribution patterns and poverty indicators. The model relies on estimates of independent sectoral growth (e.g., industry, trade, construction, agriculture and services), along with

<sup>1</sup>However, all models use econometric analysis to support their estimates.

<sup>2</sup>See "Forecasting Working Group Report", prepared by King Banaian, Barents Group, Yerevan, 2002

projections or assumptions about relative prices between the sectors (expressed as price indices for each sectoral output). The real exchange rate is programmed at a mild depreciation over the forecast period. The model takes taxes and most expenditure items as exogenous-policy indicators (either as a share of GDP or in terms of the structure of expenditures). On the expenditure side, the model uses an exogenous average propensity to consume and average propensity to import to allocate real GDP. Private investment is treated as a balancing item.

Avag Solutions LLC uses a modified World Bank's RMSM-X model (reduced minimum standards model), which has some differences from the original approach of the World Bank model, and, at the same time, the model has similarities with the MAGMA of EDRC. As in the case of MAGMA, the model is based largely on disaggregated projections of growth in each sector. The model uses some assumptions about the structure of the economy to construct detailed forecasts and analysis of the Armenian economy, using a consistent flow-of-funds framework. RMSM-X models can be closed in one of three ways. One may project values for the private sector and all other values except for government spending and borrowing (called a "public sector closure"), or specify government spending and borrowing and allow private consumption to be set to close the system (a "private sector closure"). When one uses these types of closures, inflation and real GDP growth are assumed values, perhaps set by government policy in advance. The model also uses assumed values of incremental capital-output ratio (ICOR) and the velocity of money. One may also choose to project both private and public sector consumption and investment and exports. The model will then be closed to generate a level of imports, a trade balance, and inflation and output growth rates (a "policy closure".) One can therefore obtain a consistent set of "forecasts" from RMSM-X, but only as a result of assuming all of sectoral growth and expenditure values in advance. Currently the model is used in its public sector closure mode, as its use is for support of long-run economic policymaking such as the PRSP.

The structural model of Armenian economy was created by BearingPoint during an earlier USAID project. This

model is the only one intended to be a structural econometric model of the Armenian economy. Unlike other models, this model has advantage of not using an "assumed" or exogenous GDP growth rate, rather forecasting growth is one of its goals. The model predicts GDP by summing up the expenditure components of consumption, investment and the trade balance. By assuming a constant real exchange rate, it models monetary policy as taking a reactive role to movements in the external sector; these external movements and projections for private consumption and investment determine real GDP. Public consumption and investment are assumed exogenously, which is quite normal, as these are policy tools of the government. The structural model uses seasonally adjusted data. For that purpose the Census X-11 ARIMA method is used.

To summarize the current status of economic forecasting, a number of findings must be highlighted. First, production side forecasting is not developed yet. As a result of poor statistics and difficulties in measuring capital and resource utilization, expert opinions are generally used to project sectoral production. Thus, without more rigorous analysis we can not be sure that assumed growth rates in each sector are consistent with the available resources. Second, given that econometric analysis is fundamental in the construction of forecasting models, the quality of statistics, in particular seasonality and stationary data issues needs to be seriously addressed. The seasonal patterns in the production series are sufficiently large and a significant improvement in forecasting can be achieved by using seasonally adjusted time series. As for the issue of stationary data, it is very important to note that if there are time-series that are non-stationary in Armenia, traditional regression analysis may give very misleading estimates of the real relationships between economic variables. With very short time series and a changing economic structure, any estimation of these relationships should be treated with great caution, and careful analysis is required.

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## Projections of Main Macroeconomic Indicators for 2003-2005

Each year, the Government of Armenia submits the projections of the main economic indicators for the next 3 years to the National Assembly, as well as the main trends and directions of the government fiscal policy as part of the draft Annual Budget submission. Below the main trends of 2003-2005 are presented.

### Income in the Medium Term

An average annual 6 percent rate of real economic growth is projected for 2003-05, which is 0.7 percentage point lower than the average growth rate for 1994-2002. It is worth mentioning, that GDP grew by 9.6 percent in 2001 and by 12.9 percent in 2002. If the projected growth pattern materializes, the 2005 GDP will reach the level of 90 percent of 1990 GDP. At the same time, many consider that an even faster economic growth is feasible.

### Prices

The prices are envisaged to remain quite stable in the same period – at a forecasted 3 percent annual inflation rate. Monetary policy will still be pursued under floating exchange rate regime. In this regard, the exchange rate for the local currency is forecasted to depreciate in real terms 1.0-1.8 percent annually.

### Fiscal Policy

There are no planned changes in fiscal policy towards increasing the tax burden, while the budget revenues are expected to rise due to better tax administration. The ratio of revenues from taxes and duties of the Government budget to GDP is forecasted to grow by 0.3 percentage points annually for the same period.

The Government expenditures policy will be directed to increasing social spending.

The Government plans to gradually reduce the deficit/GDP ratio to 2.5 percent by 2005, while the concessional borrowings will still remain prevalent in the structure of deficit financing sources.

## Macroeconomic Indicators Forecast: 2003-05

	2003	2004	2005
Nominal GDP (AMD bln)	1434.9	1566.6	1710.4
GDP real growth rate (%)	6.0	6.0	6.0
Nominal GDP (USD mln)	2446.9	2618.7	2802.9
GDP Deflator (%)	2.4	3.0	3.0
End-of-period Inflation (%)	3.0	3.0	3.0
Average inflation (%)	2.5	3.0	3.0
AMD/USD Exchange rate (period average)	586.4	598.2	610.2
AMD/USD Exchange rate (end period)	594.7	602.5	614.5
Total Budget Revenues (AMD bln)	287.0	261.5	290.3
Total Budget Revenues/GDP (%)	20.0	16.3	16.38
Tax Revenues (including State Duties) /GDP (%)	15.36	15.46	15.78
Total Budget Expenditures (AMD bln)	334.2	305.5	333.4
Total Budget Expenditures/GDP (%)	23.2	19.5	19.5
Total Budget Deficit/GDP (%)	3.3	2.81	2.52
Balance of Goods and Services (USD mln)	-312.5	-286.4	-254.8
Imports of Goods and Services (USD mln)	-873.5	-903.5	-933.6
Imports of Goods and Services / GDP (%)	-35.7	-34.5	-33.3
Exports of Goods and Services (USD mln)	561.0	617.1	678.8
Exports of Goods and Services / GDP (%)	22.9	23.6	24.2

\*) Source: 2003 Budget Message of GOA

## Research Resources and the Progress

Heghine Manasyan

I would like to confess that I was very enthusiastic from the very beginning about the proposal to write about the Caucasus Research Resource Center in Armenia in the first issue of the “Economic Policy and Poverty” Periodical. My motivation is the belief caused by the experience of a research economist and instinct of a pedagogue that science and education are the powerful forces of the progress, and that the increase of the social capital is the main way for reducing poverty.

It is evident today that the majority of transition problems would not arise and poverty would not grow so severe if the economists (both Soviet and Western) could clearly define and identify the essence of the transition process and understand the trajectory and extent of the reforms involved, which started in early 1990s, and if the politicians could afford using the consultations of the few non-politicized economists. When there is no profound research available, even experts well familiar with reform processes cannot tell the difference between the large-scale and fast privatization and the rapid collectivization performed by Stalin<sup>1</sup>, to say nothing about whether the large strata of society can distinguish between the effects of the two processes and accept the new reforms.

Being on the crossroad of the paths to a free market economy and to an information-based society, we still have not developed our own, Armenian, way of efficient development. Among the reasons for that is the underdevelopment of social sciences as compared to both Western countries and the needs of the progress. In this regard, it is not just a coincidence that the lion's share of the technical assistance provided to the transition economies still remains the transfer of the research results and expertise in social sciences<sup>2</sup>.

In order to be able to understand the society in the transitional countries and identify their current problems and outline the possible developments, it is expedient to, at least, have collaboration between the scholars and policy makers while “speaking the same language” on the same issue. And while the western economists need to get familiar with the peculiarities of the transition process, the post-Soviet economists need to study the market mechanisms, their influence on the social life, as well as the role of the state in establishing a democratic and civil society.

However, as in other former Soviet Union countries, the social sciences in Armenia need to be pulled out from the backyards. The Economics and Sociology, being extremely politicized in the Soviet era, used to be very theoretical and abstract: evidences for certain hypothesis were cited from the well known sources, such as speeches during the plenary sessions of the Communist Party. Now, hypotheses need to be tested with statistical data using the empirical analyses.

<sup>1</sup> János Kornai, *Ten Years After 'The Road to a Free Economy': The Author's Self-evaluation. Paper for the World Bank Annual Bank Conference on Development Economics – ABCDE' April 18-20, 2000, Washington D.C.* [http://orion.forumone.com/ABCDE/files.fcgi/235\\_10years.pdf](http://orion.forumone.com/ABCDE/files.fcgi/235_10years.pdf)

<sup>2</sup> One of the issues of “Comparative Economic Studies” periodical was completely dedicated to the development of economics in the post-Soviet area (VolXLII, no 2, 2000).

<sup>3</sup> American Library association. *Presidential Committee on Information Literacy. Final Report: ALA, January 1989;* <http://www.infolit.org/documents/89Report.htm>

Such analysis requires adequate research resources, including literature, reliable statistical data, computers and software, and access to the Internet; training on quantitative analyses methods; and information literacy defined as skills to recognize when information is needed and have the ability to locate, evaluate, and use effectively the needed information. According to the American Library Association, even in American society "no other change has offered greater challenges than the emergence of the Information Age".<sup>3</sup>

Despite the apparent recent progress of Armenia in both mentioned fields, surveys show that we are far from the level of developed countries. It is sufficient to state, that among people under 33 with higher education, only 9.7% regularly accesses Internet, and 10% does it from time to time<sup>4</sup>. A survey conducted by the "Internet" company revealed that only 10.6% of the respondents uses Internet (12% does not know what it is), 12% uses electronic mail (17% is not familiar with), and 13.2% uses IP telephone (30% is not know what it is)<sup>5</sup>. For comparison it is worth mentioning that 54% of U.S. citizens have Internet access at home, while unlimited dial-up access to Internet costs USD 50 in Armenia and USD 20 in the U.S.<sup>6</sup>.

It is clear that in order to perform fundamental research, the lacking components of research resources need to be replenished mainly with the help of institutionalized, free-access common centers. This exactly is the idea of the Eurasia Foundation project being implemented with financial assistance from the New York Carnegie Corporation to create a Caucasian net of Research Resource Centers. The Armenian Research Center is being hosted by the Yerevan State University (YSU) where the accessibility idea is shared. That will, of course, contribute to the overall efficiency of the center. Moreover, moving ahead to reform the role of universities, the YSE re-established its leading role and the commitment to remain as such.

Similar centers have been established and operate successfully in other CIS countries, for example the Economic Education and Research Consortium in

Moscow ([www.eerc.ru](http://www.eerc.ru)) and the Central Asian Education Network under USAID financing, the members of which include about 270 higher education Institutes of Kazakhstan, Kyrgyzstan, Tajikistan and Uzbekistan ([www.career.kz/index.htm](http://www.career.kz/index.htm)). Virtual Resource Centers play an important role in information dissemination (e.g. [www.trainet.org](http://www.trainet.org) targeting at Russian NGOs, <http://eric.uoregon.edu> – Educational Resource Center of the Oregon University) simultaneously serving as an efficient tool for communication among professionals. In the case of Armenia, the issue of educational and research resources is even more relevant taking into consideration the existence of the Diaspora.

Coming back to the Caucasus Research Resource Centers, I would like to note that they will be able to host visitors this summer – by providing resources to researchers, access to various statistical data, making available electronic versions of professional magazines and periodicals, as well as data processing software, proposing trainings and opportunity to cooperate with foreign colleagues and participate in various regional projects, etc. The Staff of the Armenian Research Center will be pleased to assist you at 52, Abovyan str. (3-rd floor).

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<sup>3</sup> "Education, Poverty and Economic Activity in Armenia" UNDP, Yerevan 2002, p. 62

<sup>4</sup> "Priorities in the Telecommunication sector in Southern Caucasus" ([www.pressclubs.org](http://www.pressclubs.org), 6<sup>th</sup> issue)

<sup>6</sup> See *Washington Profile* ([www.washprofile.org/aboutproject.html](http://www.washprofile.org/aboutproject.html)), April 25, 2003, #48/278

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