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# SUBSIDIES IN ARMENIA

White Paper # 1

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## Definition of Subsidies

The comprehensive classification and definition of subsidies is a difficult task. For the purposes of the present paper, we will apply a simplified approach to classifying subsidies according to which all those public funds paid to suppliers/manufacturers are paid either directly or indirectly, in order to maintain the prices of goods and services at a level lower than that of the market. Usually, prices for subsidized goods or services are lower than they would have been without the subsidies.

What are the main reasons for providing subsidies, and what are the approaches to them in economic management models? The most important reason for subsidization, most likely, is the social aspect which attempts to alleviate the affordability of or improve access for large groups of consumers to certain goods and services through lower prices. The Soviet system and its practices are the best illustrations of the afore mentioned, although Soviet era subsidies could not be called subsidies in their classic definition since pricing was set by the government and subsidies did not appear as a separate line in the budget. Therefore, it is extremely difficult to estimate the total value of subsidies in the structure of the GDP of the Soviet Union.

Social problems are addressed through another type of subsidy (with a larger definition) which aims to achieve desirable results for the public. An example of such a subsidy is the subsidization of public transportation which not only ensures affordability of this service for all social groups, but also provides for other public goods like the reduction of air pollution and the reduction of traffic on infrastructure.

Another aspect which triggers subsidization policies is the protection of local suppliers and manufacturers from foreign competition. Such practices are largely applied both by developed (rich) and poor countries. For the first group of countries, subsidization becomes necessary mostly due to the fact that at high welfare levels, some industries, where the role of R&D is not very crucial, become less and less profitable because of high cost (mainly, labor cost) in spite of very low labor cost in poor countries. Low labor cost implies that the production of the same goods and/or services would cost much less in poor countries. Agriculture is the best example of such an industry. Various experts believe that under free international trade, no agriculture sector can survive in developed countries, since the poor countries would be able to export food at lower prices. However, the production of domestic food products is a matter of national security; thus, developed countries tend to subsidize agriculture which is the major reason for those who are employed in agriculture to remain in that sector.

The important aspect is that, on one hand, the necessity to subsidize in developed countries arises from the high standard of living and labor prices. On the other hand, subsidization policies become more feasible and less painful for the economy and government budgets because there are available resources and a general consensus in the society to use those resources for these purposes.

Many poor and developing countries also regularly resort to the temptation of subsidizing certain sectors. In many countries, subsidization is viewed as a tool to preserve and develop strategic industries. Unfortunately, unlike the cases with the developed countries, subsidies in poor countries become a tool to provide resources for a few privileged industries. Subsidies usually become inefficient and do not result in positive achievements in the long term. Often, subsidies assist in developing such sectors and industries that are not sustainable in the long run. As a result, poor and developing economies are subject to severe shocks. On the other hand, the opportunity cost of subsidies in poor and

developing countries is too high. For example, the funds that are spent on subsidies could have been alternatively spent on much more priority problems, such as investments in human capital and physical infrastructure.

The liberal economic model implies total elimination of subsidies. The major argument for that is that subsidies trigger economic distortions and create wrong incentives, which, in the long term, create much more problems than benefits. The classic package of market economy reforms includes abandonment of subsidies to the extent possible and pricing and tariff-setting for goods and services at cost-recovery level.

Another important argument is that lower prices due to subsidies are not the best economic solution for social problems, since all groups of the population benefit from such subsidies including those who are socially well off and can afford fair market prices. For instance, keeping prices for electricity at an artificially low level cannot be justified by the fact that the poor groups cannot afford the cost-recovery price. The non-poor would benefit more from the lower prices due to higher consumption of electricity because they can afford buying more electric appliances than the poor. Thus, the conventional criticism of subsidies suggests that the subsidies should be substituted with targeted social assistance.

It is obvious that there is a contradiction between the conventional reform package and the actual practices of many developed countries. Many politicians suggest that developed countries use subsidies to address their national problems. At the same time, they compel the developing countries through international financial institutions to eliminate subsidies. Such criticism is, to some extent, justified, especially with respect to foreign trade subsidies. However, one should remember that developing countries usually have extremely poor management systems and high levels of corruption deriving from bad management. Such governments usually are not capable of clearly defining the national priorities and efficiently implementing the steps to achieve the set targets. For such a sensitive issue as subsidies, that entails risks of economic distortions, resource abuse, as well as risks of placing private interests over public interests, a much more effective and efficient economic and governance structure, which is capable of implementing these subsidies, is required. Unfortunately, many developing countries, including Armenia, have not reached that level of institutional "maturity"; therefore, decisions on subsidization should be made very carefully.

Let us discuss an example. Public transportation is often owned publicly in developed countries and is largely subsidized. In developing countries, it is recommended to privatize the public transportation system as much as possible, since high levels of corruption in the quasi-fiscal sector make subsidizing of this sector so expensive that it becomes economically non-viable. The same can be mentioned about subsidies in the private sector. It is very difficult to conceive that the relations between the government and economic agents in a corrupt environment can be regulated so well that resource wastages or other unfair treatments can be entirely avoided. Ultimately, subsidies are transfers of resources. The efficiency of these transfers depends on the intentions of those who implement the subsidies and what their incentives and motives are.

### **Progress of Reforms in Armenia since Independence till 2006**

In fact, government policy towards subsidies has become as one of the axes of economic reforms in Armenia over the last 15 years. In the Soviet Union, many goods and services were subsidized; the prices were fixed centrally and did not reflect the cost of production, while the losses were compensated by the government through the allocation of funds for capital replacement and investments. Most subsidies were abandoned in the first stage of market reforms: 1991-92 when prices for majority of goods and services were liberalized.

However, subsidies were not entirely eliminated. Most tariffs for utility services still did not reflect the actual cost of production. Thus, regular budgetary fund allocations were required to keep the utility services afloat. Those services were electricity supply, drinking water, irrigation, and heating.

### **Hidden (Implicit) Subsidies**

Except for low tariffs, which already pre-suppose subsidization, another problem for utility companies is evident in Armenia: collection efficiency for consumed services is low, which directly implies subsidies. Apart from the necessity to support companies as a result of tariffs set lower than cost-recovery level, low collection efficiency implies that companies are not capable of collecting all projected revenues. Thus, they have to accumulate huge arrears.

Since collection of arrears in such cases is hardly probable, the burden of arrears sooner or later falls on the shoulders of the budget, especially since the companies are still government-owned. Thus, these become hidden or implicit subsidies that sooner or later will be reflected into monetary terms and paid by the budget. A good example of this is the AMD 17 bln subsidy paid from the government to the power sector in 1999 (equivalent to 1.7% of the annual GDP; if same proportion kept, this would equal to AMD 50 bln today). This subsidy allowed the power sector companies to pay their payables and debts accumulated over the years. One can re-phrase that the AMD 17 bln was paid to those who previously did not (fully) pay for consumed electricity. The defining characteristic of hidden subsidies is that they are not seen initially since no need for public fund allocation is evident. However, the need for public money from the budget will appear in the future.

### **Privatization as a Major Way out of Subsidization**

Both explicit and implicit subsidies in Armenia were abandoned through privatization. In most cases, the need for subsidization was mostly connected to the type of ownership of companies. Subsidies (mostly - implicit) were used to pay for the huge arrears of state-owned companies. Only in very few cases were subsidies set by the legislation. The majority of these subsidies were paid as a result of poor operation of state-owned companies as implicit subsidies. In such cases, the problems of state-owned companies automatically became the problem of the government. As a result, the government had to subsidize the operation of state-owned companies. Thus, the major recipe for elimination of subsidies was privatization or private management of state-owned companies.

One should, however, take into account that subsidies were not always the consequence of ensuring lower-than-market prices for consumers. In many cases, tariffs were set at full cost-recovery level; however, companies accumulated huge arrears and debts due to corrupt practices since they were not able to achieve the necessary collection efficiency for the services provided. The electricity distribution sub sector is a good example: although the cost-recovery tariff had been enforced since 1999, the system suffered huge losses because of corruption. Thus, the group of consumers that did not pay in full for services benefited the most. This is not a conventional subsidy. The effect can be compared with targeted subsidizing when only a group of consumers benefits from a certain practice and enjoys lower prices or tariffs at the expense of public funds. This situation has been improving since 2002 when the system was privatized.

Until 2006, only a few subsidies were in place in Armenia: subsidies on irrigation, drinking water, and public transportation (mostly underground). For comparison, if implicit and explicit subsidies were equivalent to 6-7% of the GDP in the late-1990s, they were equivalent to less than 0.5% of the GDP in 2005. This trend was accompanied by increases in tariffs for public services which pushed these sectors closer to cost-recovery.

### **Structural Reforms for Budget Stability: Ignoring the Conventional Recipe for Subsidy Elimination**

How can this process be assessed? If we study the statistics, Armenia has recorded huge progress in stabilizing the budget and eliminating fiscal imbalances. On the other hand, another element of the conventional reform recipe was not implemented: the subsidies should have been replaced by targeted social assistance. The elimination of subsidies was followed by the reduction of budget expenditures on arrears only, whilst the poorest groups of the population have not received any adequate compensation. One needs to take into account that the poor also benefited to a certain extent from the low collection efficiency. For example, it was not customary to pay for drinking water services in the 1990s,

which resulted in large arrears. The government wrote-off the debts provided that customers would install water meters and pay for the services thereafter. At the same time, the government paid the debts of water supply companies to their suppliers. Thus, the government broke the previous inefficient chain of subsidies. Households have to pay for water supply services in full; however, the role of the government in ensuring access to drinking water is not clear. In other words, the second important component of reforms – targeted social assistance policy - is not there.

In many cases, it is stated that the Family Benefit system, operable since 1999, serves for the said purpose of assisting the poorest households in a targeted manner. However, the scales are not compatible: only about 1% of the GDP is spent annually on Family Benefits and it cannot be considered as an adequate compensation for the significant increase in tariffs on utilities due to the elimination of subsidies. It is interesting to note that Armenia is in last place among CIS countries for the share of social expenditures in the GDP. This indicator has not changed during the last 7-8 years, whilst many subsidies and mechanisms of implicit subsidization were abolished. The government, although taking the most prudent and sound decision to abolish subsidies, succeeded in implementing it, but did not compensate for increasing social needs in any way.

This forces us to conclude that the structural reforms from the mid-1990s to early-2000s and the significant reduction in implicit and explicit subsidies resultant from reforms was mostly conditioned by the need to improve budgetary discipline and eliminate fiscal imbalances – mostly due to budget constraints. The pace of reforms shows that the goal was not to achieve the best option for using public funds. In fact, the emphasis was placed on reducing current and future budget expenditures. If we add that no major radical improvement was seen in budget revenues during the last 10 years and that Armenia has the lowest share of taxes in GDP among CIS countries and one of the lowest in the world, one can see that the main motivation for implementing structural reforms and eliminating subsidies was to meet the severe budget constraints under low revenue collection capabilities.

This assumption, we believe, is ascertained by 2006 developments, when the government, having obtained large extra-budgetary funds, made the decision not to use it for general budget priorities, but rather for the most efficient subsidization scheme – subsidization of natural gas prices.

### **Recent Developments in Armenia**

Regardless of the path traveled through the last 15 years and their efficiency, it is obvious that minor subsidies for the irrigation sector were in place in Armenia by the end of 2005 (only 0.3% of the annual GDP), along with subsidies in terms of capital investments in the power sector that slightly lowered electricity tariffs and tiny subsidies to the electric transport sector (Yerevan subway).

However, 2006 was marked with a drastic change in the direction of the authorities' policy with regard to investments. The authorities undertook two large-scale subsidization programs which were not initially envisaged or even put on the table of policy discussions. Those two subsidies were for gas prices and agriculture. It is extremely difficult to clearly assess such a drastic shift in policies, since on one hand, gas price subsidies, in our minds, were a step backwards in terms of the efficiency of using public funds, while the initiative on supporting small-sale agricultural farms, if properly implemented, could bring in both direct and indirect positive results for the entire society. Below, the two subsidization programs are discussed in details.

### **Gas Subsidies**

In 2006, in order to alleviate or, rather, neutralize the effects of price increases of Russian natural gas supplies, the Armenian authorities decided to use the Hrazdan-5 power plant privatization proceeds for subsidization of gas supply: To that end, the government allocated about USD 190 mln.

This decision is prominent in several aspects. This subsidization scheme is not only a compromise from the reform direction, but it is also unprecedented because Armenia has never implemented such a poorly-targeted and large-scale subsidization program. The main shortcoming of this subsidy is that it subsidizes a service, the consumption of which is very unevenly distributed among income groups. The major consumers are non-poor. This implies that it cannot be viewed as a poverty reduction tool. Another aspect is that these subsidies are being given to a profit-oriented company beyond the government's control, which does have competitors/alternatives in the market – i.e. electricity suppliers. This is an explicit monetary subsidy vs. an implicit subsidy accumulated through the years that became due today. In other words, we do not have a subsidization program: what is the objective, what will be the consequence if it is abandoned, and will this subsidy will bring benefits or losses to Armenia in the long term.

Let us discuss the above listed issues in detail one by one. Currently, the government pays subsidies to all gas-consumers as part of the full gas tariff: AMD 25 per cubic meter for small (mainly residential) consumers (equivalent to 30% of the gas price) and about USD 50 per 1000 cubic meters for large industrial consumers, which also equals about 1/3 of the total price. Thus, the government has taken the obligation of 1/3 of gas prices at the expense of public funds. As we noted, annually USD 70 mln will be spent on that.

Now, let us discuss how those USD 70 mln are distributed. First, it is reflected in two items: gas and electricity prices, since about 30% of electricity generated in Armenia comes from natural gas. Thus, subsidized gas prices also keep electricity tariffs low which comes as a benefit to those who consume electricity. One can continue this chain and include other goods and services for production of which gas takes a large share. Nonetheless, this would not be quite correct since economic agents and consumers, otherwise, could have adapted their behavior accordingly. I.e., consumers are subsidized through lower gas and electricity tariffs. For the goods and products of the next phase, consumers do not benefit: the beneficiaries are the manufacturers and suppliers of those goods and services that enjoy lower gas and electricity prices and maintain their markets both domestically and in foreign markets.

Calculations based on this logic show that the population receives only about 40% of the total subsidy, while the remaining 60% goes to private companies. It is also worth noting that only 5% of the subsidy goes to poor households. This is because the share of their electricity and gas consumption is very low, and these subsidies go along with consumption volumes. This shows that this subsidy has no relation to poverty reduction and is not pro-poor: in a country that declared poverty reduction its priority goal, only 5% of this subsidy goes to the poor. Most of it goes to large industries that consume energy, such as, cement, metallurgy and chemical industries. It would be more efficient to abandon this subsidy scheme and direct those USD 79 mln annually to a greater priority – social and development issues.

Another important aspect is that extensive resources are spent for an indefinite objective which is not stated in any strategic document in Armenia. Neither PRSP, nor MTEF envisaged such subsidies. The National Assembly did not participate in decision making, while the government, who made the decision, transferred the privatization proceeds to the extra-budgetary account of the Ministry of Defense and started paying the subsidies, has in no way justified their decision or described the next steps.

It is evident that under such subsidies, neither individual nor industrial consumers have been affected from the increased import prices for gas. However, this is a positive effect only from the first sight. The problem is that the government will be financing these subsidies only for 3 years. In fact, no funds are available starting 2009 and consumers will be exposed to the full cost of gas supply. It is important that the import price will be effective until the end of 2008, which is the end-date of the subsidy scheme, too. Thus, a double increase will take place in 2009 due to an increased import

price and the end of the subsidies. According to various estimates, the gas tariff for residential consumers will be in the range of AMD 120-130 after the current AMD 59, while for industrial consumers – up to USD 300, in comparison to the current rough USD 100. Thus, the government does not ensure “real” benefits to gas consumers by subsidizing gas consumption to the point where the price is relatively low and stopping subsidies when the import price increases.

Today, when the government does not have any program to counteract this, consumers cannot create expectations on a gas tariff after 2009. Many do hope that they will always enjoy low tariffs. That is possible only if Russia does not increase its export prices in 2009 which does not seem likely or if the government decides to continue subsidizing the sector, which is also hardly feasible because international donor institutions are not likely to pretend once more they are not aware of it. They are able to influence Armenia with regard to such inefficient use of resources since the international financial institutions do provide concessional credits to Armenia, as a poor country. As a result, many investment projects that are justified based on low gas tariffs may become economically non-efficient. This is an unacceptable waste of resources for a country like Armenia, even if it is financed from private sources. As a matter of fact, a discretionary, temporary and non-sustainable decision taken by the government, which contradicts its strategy, can seriously hurt the economy and business environment of Armenia in the long term.

It is worth noting here that during the last few years, consumers had accepted the fact that there would be no subsidies in the future and they would have to pay the full price of goods and services they consume. The decision by the government to subsidize the gas sector significantly undermines the public consensus on no-subsidy policy which suggests that the political prices for implementing any reforms in the future will also include the political price to be paid for the decision to eliminate the gas subsidy.

As a summary to this section, it is worth mentioning that the decision on subsidizing can be a proof of the fact that the reforms in 1990s and early 2000s were mostly implemented to address the issue of severe budgetary constraints, when authorities, in fact, did not have any other choice. In other words, it was not the explicit intention of the government to implement reforms, but rather a forced choice. In fact, because of increased budgetary revenues during the last few years, the government took the opposite direction and made a decision that was difficult to even think of several years ago. This entails serious problems in the view of the future pace of reforms, since acceleration of economic growth in short and medium terms results in larger public funds available for public spending. If resources are spent in such a non-sustainable and inefficient manner, it may have serious negative effects on the long-term outlook of the country.

### **Agricultural Subsidies**

In 2006, the government made a decision to initiate a large-scale subsidization program in agriculture. The program envisages providing a certain amount of money transfers to agricultural farms starting from 2008 or 2009. The amount of the subsidies was set at AMD 35 000 per 1 hectare of cultivated land. The idea is that the government seeks to stimulate the usage of currently non-cultivated land lots and simultaneously improve the competitiveness of small farms. Currently, a pilot subsidization program is implemented in several provinces (Marzes) of Armenia: it is anticipated that the government will start subsidizing small farms covering 330 thousand hectares in one or two years.

In contrast to the above discussed gas subsidies, such agricultural subsidies, in general, do not contradict the logic of reforms, especially, if we take into account that the aim is to support cultivation of land which is not currently cultivated. This is a clear strategic issue for Armenia which can benefit the society. On the other hand, these subsidies will contribute to the improvement of competitiveness of farms which also implies benefits to the society, since it will prevent the centralization of land in hands of large farms on unequal and unfair bases which is considered to be undesirable from the developmental perspective of the country. At the same time, one needs to take into account that, as part of the WTO agreement and measures involved in it, Armenia will enter into a phase soon where competition pressures in the

international agricultural product markets will be much stronger. Thus, the subsidization program is an acceptable and moderate response to such new challenges.

Nonetheless, it is still too early to comprehensively assess this program due to certain factors: ignoring those factors may decrease the importance of this initiative and result in wastage of public funds. We believe that it should be first discussed whether all small farms shall receive subsidies. The matter is that farms in fertile and highly-productive areas of Armenia receive relatively high incomes, and subsidies will not be a significant support to that; therefore, subsidies spent for those farms will not be considered as efficient use of public money. For example, if we assume that about 20% of small farms in the country do not need such assistance, the total budget for the program can be reduced by 20%, which is equal to AMD 2-3 bln per year.

Another important aspect of the subsidization program is the mechanism for providing them. Since subsidies fall into the field of public and private sectors' relations, large risk and potential for corruption exist. It is very possible that the land area may increase "artificially" very fast: i.e. increased area will allow receiving more subsidies from the government. Prevention of such possible developments is essential to the overall efficiency of the program. The efficiency of this program may also be affected by the underdeveloped land market where large numbers of land lease transactions are not properly registered. In such circumstances, conflicts may arise during subsidization, since the subsidies should be paid to those who cultivate the land who, in this case, have no official grounds to prove that they use the land lot. On the other hand, many farms have leased numerous small lots and no longer can be considered small farms. In this case, again, the subsidies given to such farms or real land-owners will imply inefficient use of public funds.

Nonetheless, despite these technical problems, it is evident that this subsidization program does have a clear strategic justification; and if the society considers it a budget priority, it is feasible to implement it without putting the future pace of reforms in the country under risk. It is very important that only small farms are intended to benefit from this program and one can assume that the use of public funds will be pro-poor in this case. One cannot state the same for gas subsidies which, as noted above, contradicts all principal factors and justifications.

### **Subsidies in PRSP Review Process**

The Poverty Reduction Strategy Paper (PRSP) adopted in 2003 replaced the economic strategy of Armenia and mostly described the economic policies implemented in Armenia, including the priorities for public expenditures, relations between the public and private sectors, as well as directions of social assistance. We believe the PRSP gives the optimum solutions for Armenia. According to the PRSP, all subsidies should be abandoned from 2004-2015 whilst the targeted social assistance system should be improved. The PRSP budgetary framework did not envisage any major subsidy other than that meant for the irrigation sector. The only exception, probably, is the subsidies to small farms which will pass the stage of large-scale discussions and comprehensive analyses in order to be included in the PRSP.

Here, it is worth mentioning that the social burden due to the elimination of subsidies has only merely been alleviated through targeted social assistance during the past 15 years. Acknowledging the overall logic of abolishing subsidies put in the PRSP, we believe that the current PRSP does not envisage adequate resources for the mitigation of social and development risks from 2004-2015, especially considering the immense deficit of attention to social issues until 2004 which is currently reflected by the weak social capital of the country, weak civil society organization and weak communities. This, to a certain extent, can be compensated by the government's initiative to subsidize small farms; however, the government should be very cautious to avoid potential corruption risks.

In the PRSP review process, it is crucial to take into account the significant compromises and deviations from the PRSP principles in the past years that have moved the country to a new, lower institutional level. Today, one can state that the

recent steps of the government with regard to gas subsidies contradict the PRSP budgetary framework and logic which, unfortunately, is risky. Apart from the fact that about 1% of the GDP is allocated to an unexpected general gas subsidization scheme, the logic of the PRSP on allocation of the scarce resources onto pro-poor policies has been distorted.

This situation is dangerous from the viewpoint that, while enjoying economic expansion, Armenia is experiencing alleviation from resource scarcity. This may result in increases in inefficient and distorting elements in overall policy which will devalue the social sacrifices born by the population of Armenia during the past years. Armenia is entering into a stage when budget constraints are less severe as previously, on the other hand – decision-making on that background becomes more and more discretionary, non-participatory and contradictory to the main strategy adopted by the country.

### **Recommendations on Approaches to Subsidies and Related Issues during PRSP Review Process**

The PRSP Review process is a good opportunity to include crucial adjustments in the country's strategy, as well as identify the shortcomings that were seen during the PRSP implementation in 2004-2006.

As it can be seen from previous sections, the major omission when implementing the subsidy abolishment policies was that these policies were mostly pursued due to severe budget constraints but not in the light of increasing economic efficiency and more targeted use of public funds. In the latter case, significant reduction of subsidies would result in the broadening of the public fund's base and neutralization of increasing social needs. Immense social problems remain unaddressed in Armenia which poses a serious threat to national security. In that respect, we believe that PRSP Review should necessarily address those problems. The Revised PRSP should define a new budgetary framework where increased social expenditures would be placed on an optimum level, where free economy and social consensus, as well as short-term expectations from economic growth and long-term economic development perspectives of the country would be in balance so there would be individual responsibility and public goods. This refers to expenditures in education, health and social protection sectors: they should have a higher share in the annual GDP in the Revised PRSP as compared to the current level.

The next important issue is that significant deviation was recorded in both PRSP implementation and in the policies pursued by the government prior to that due to subsidization of gas supply. This results in inefficient utilization of large amounts of public funds, mostly benefiting the non-poor, especially the very rich – those who own power-intensive businesses. During the PRSP Review process, it is necessary to analyze the political and economic motivation that lead to such a decision. If there are arguments that justify the efficiency of the decision taken (which seems unlikely), relevant amendments need to be made to the PRSP to reflect the justification of the measures proven during the time passed. Otherwise, if, when analyzed, these deviations from PRSP-approved policies are not justified by the need to make pro-poor adjustments in the economic and social policies, the budgetary framework should be strengthened so as to avoid such deviations in the future and put firm political constraints in place.