



## REPUBLIC OF ARMENIA

### SELECTED ISSUES

July 2017

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# REPUBLIC OF ARMENIA

## SELECTED ISSUES

June 7, 2017

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Central Asia  
Department**

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## CONTENTS

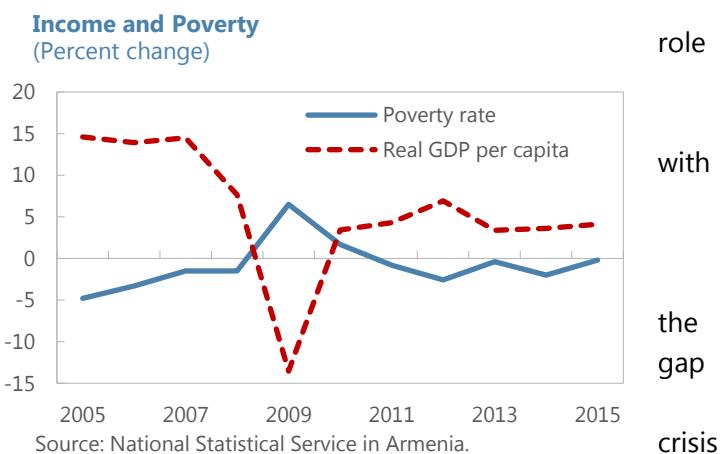
|  |          |
|--|----------|
| <b>GROWTH INCLUSIVENESS IN ARMENIA</b>       | <b>2</b> |
| A. Growth and Poverty                        | 2        |
| B. Inequality                                | 3        |
| C. Unemployment                              | 4        |
| D. Job Creation                              | 7        |
| E. Government's Efforts                      | 8        |
| F. Key Policy Challenges and Recommendations | 8        |

# GROWTH INCLUSIVENESS IN ARMENIA

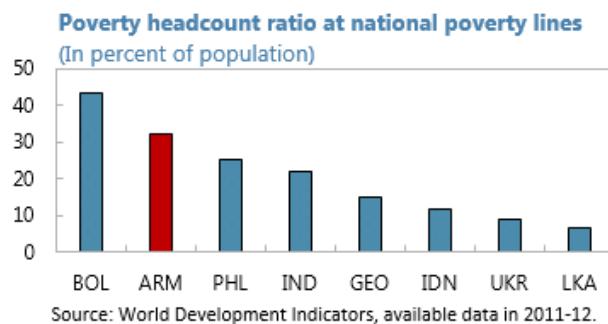
*During the rapid economic growth in the 2000s, Armenia achieved remarkable gains in poverty and inequality reduction. However, with the global downturn in 2007-09, some of these achievements were partially reversed due to severe negative shocks to growth and changes in the composition of growth. While compared to peer countries, inequality in Armenia remains low, it has increased somewhat since 2009. Poverty has marginally declined after the global crisis, but unemployment remains high. Creating jobs, reducing poverty, and higher inclusiveness would require sustained high growth and implementing pro-poor policies. Better-targeted social policies and more attention to the regional distribution of spending would also help reduce poverty and improve inclusiveness.*

## A. Growth and Poverty

**1. Poverty declined during the 2000s, supported by high growth.** Poverty rate decreased by one third and the extreme poverty declined by half during 2004–08. In addition to strong growth which created many job opportunities, higher social expenditures played a key in lowering poverty. However, the global economic crisis reversed the course of poverty reduction in Armenia the poverty rate picking up to 34 percent in 2009 from 28 percent a year earlier. Some of the deterioration of the poverty rate has been partially offset by post-crisis economic growth. Poverty and poverty severity have been decreasing as well reaching their pre-level.



**2. Cross-country comparisons of poverty suggest mixed results.** Poverty rate in Armenia<sup>1</sup> remains among the highest, compared to the peer countries with similar level of GDP per capita, PPP. However, this should be interpreted with caution, since the national poverty lines<sup>2</sup> and measurement approaches can be



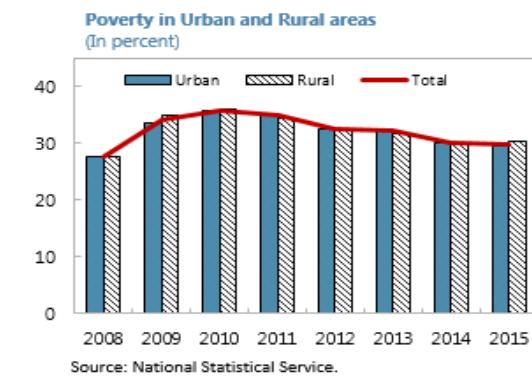
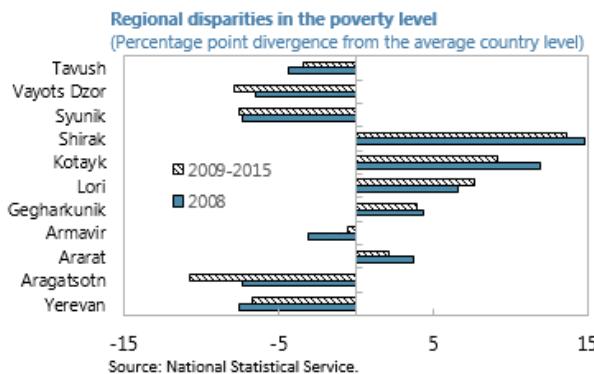
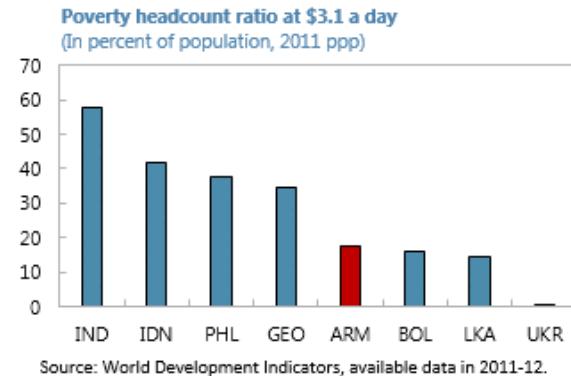
<sup>1</sup> Measured based on the national poverty lines and by the expenditures approach.

<sup>2</sup> For Armenia, this level in 2015 was equivalent to almost \$3 per day in 2015.

different. Based on the standardized levels of poverty lines, Armenia ranks better than many of the peer countries.

### 3. Regional disparities of poverty levels

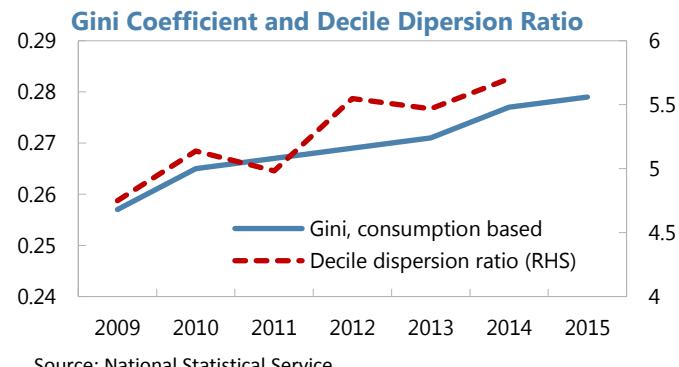
**remain very high.** These disparities, however, are geographical and not across the urban/rural divide. Indeed, contrary to the common perception, poverty rates in urban and rural areas are almost the same. Excluding Yerevan, poverty in the rest of the urban areas is even higher than in rural areas. This results from the fact that employment in agriculture, agro-processing, and mining remains an important source of income in rural areas. Across rural areas, disparities are mainly attributable to access to irrigation water and geographic location. Upland areas with severe weather conditions are often poorer.



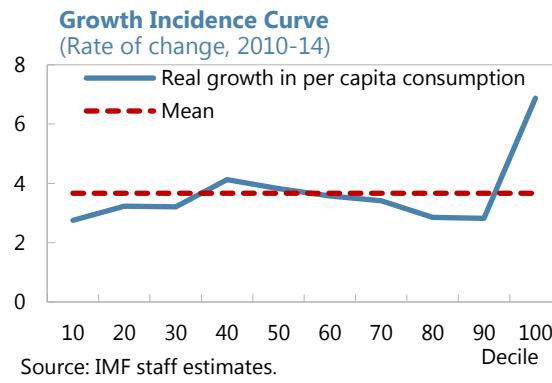
## B. Inequality

### 4. Inequality remains relatively low, although it has somewhat increased

**recently.** Although small, relative inequality as measured by the Gini index and decile dispersion ratio<sup>3</sup> has been constantly worsening since the global crisis in 2009. Interestingly, cross-country data comparison show that the Gini coefficients in some peer countries (Georgia, Ukraine) have fallen somewhat during this period.



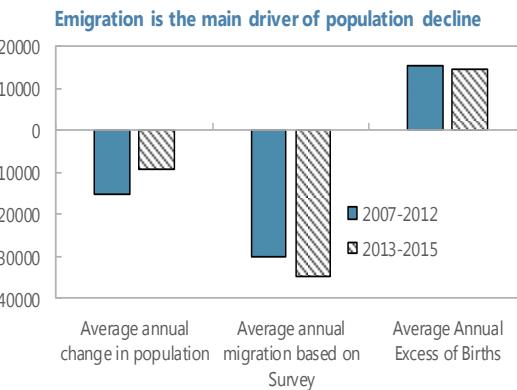
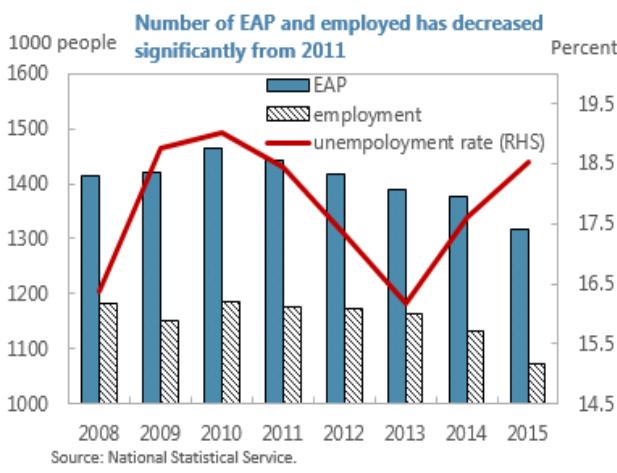
<sup>3</sup> The ratio of the share of income accruing to the top of the distribution (ninth decile) and the bottom of the distribution (first decile).



The growth incidence curve<sup>4</sup> for Armenia suggests that the top decile benefited significantly more from growth than the rest of the population and especially the poorer decile.

## C. Unemployment

**5. Unemployment in Armenia remains high and volatile.** Armenia's unemployment, which reached 19 percent in 2009–10, gradually decreased to 16 percent in 2011–13. This was driven by a decrease in labor force, mainly due to labor emigration. Buffeted by the deterioration in the external environment since 2014, unemployment rate has increased back to its pick level observed in the aftermath of the global financial crisis. This is in contrast with other Caucasus and Central Asia (CCA) countries, which have recorded a noticeable decrease in the unemployment rate in the post-crisis period. Finding jobs have become more difficult with the increasing average duration of job search and the rising share of long-term unemployed in total unemployed.<sup>5</sup>



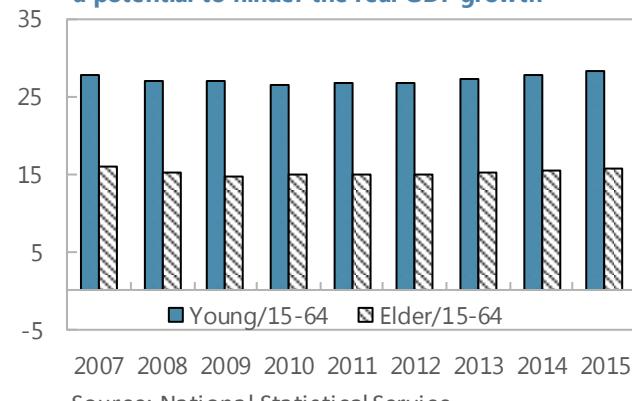
<sup>4</sup> Growth incidence curve identifies the extent to which each decile of households ranged by their income or consumption level benefits from growth.

<sup>5</sup> Long-term unemployment includes unemployed people searching for job more than one year.

**6. The intensification of emigration flows has led to significant demographic changes with significant implications for labor market developments and growth.** Although excess births<sup>6</sup> were positive and significant, population has decreased by 4.4 percent over the past 10 years. Emigration is the driving factor behind the decrease in economically active population. The official surveys conducted by the State Migration Service point out that emigration has not only remained high, but also intensified during 2013–15 reaching an annual average of 35,000 people.<sup>7</sup>

**7. Age structure of the population has also changed significantly.** The dependency ratio<sup>8</sup> has worsened, reflecting an increase in the share of population under 16 and above 65. The increasing share of children under 16 implies that a high proportion of economic resources need to be devoted to their care, which potentially can depress growth in the future. Also, the rising share of the elderly can have similar effects. For instance, Armenia's pay-as-you-go system of pensions is under pressure with the increasing share of the elderly in the population. Population aging affects consumption negatively, because of the elderly's lower propensity to consume. The contributions of the working age population (the so-called demographic dividend) and the labor force participation have been negative since 2011. Although the contribution of the employment rate to per capita GDP growth varies over time, it was negative over the past two years. As a result, GDP growth registered in the last 5 years was mainly driven by the increase in labor productivity and number of actual working hours.

Recent increase in the dependency ratio has a potential to hinder the real GDP growth



Source: National Statistical Service.

#### Potential demographic dividend and labor force participation (In percentage changes) 1/

|                                       | 2009  | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 |
|---------------------------------------|-------|------|------|------|------|------|------|
| Real GDP/labor Force (1)              | -15.8 | -0.8 | 5.8  | 8.7  | 5.0  | 4.2  | 7.9  |
| Labor Force/Population 15-64 (2)      | 0.4   | 4.2  | -1.6 | -1.6 | -1.4 | -0.2 | -3.3 |
| Population 15-64/Total Population (3) | 0.6   | 0.1  | 0.0  | -0.2 | -0.4 | -0.5 | -0.7 |
| Real GDP per capita growth (1+2+3)    | -14.8 | 3.4  | 4.1  | 7.0  | 3.2  | 3.5  | 3.9  |

1/ Labor force participation represents the share of economically active population to population aged 15 to 64.

<sup>6</sup> Excess birth represents the difference between births and deaths.

<sup>7</sup> "Migration Policy Strategy for 2017–21," approved by the RA Government in 2016.

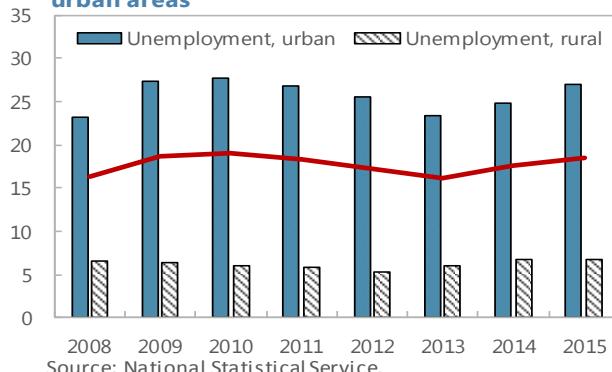
<sup>8</sup> "Dependency ratio" represents the proportion of young (younger than 15) and old people (older than 64) to working age population.

**Employment contribution to growth (In percentage changes)**

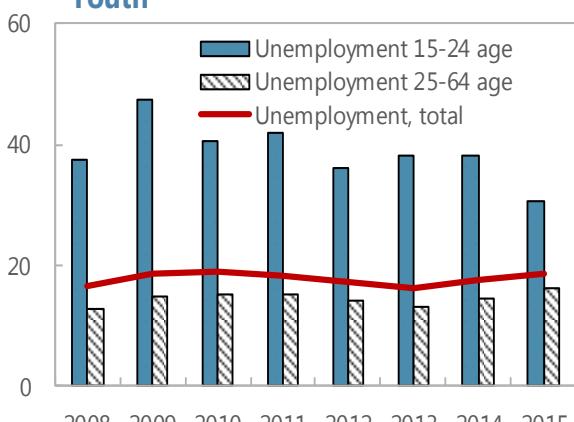
|                                    | 2009  | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 |
|------------------------------------|-------|------|------|------|------|------|------|
| Real GDP per worker (1)            | -12.9 | -0.5 | 5.1  | 7.3  | 3.7  | 5.9  | 9.0  |
| Labor Force/Total Population (2)   | 1.0   | 4.3  | -1.6 | -1.8 | -1.8 | -0.7 | -4.0 |
| Employed/Labor Force (3)           | -2.9  | -0.3 | 0.7  | 1.4  | 1.4  | -1.7 | -1.1 |
| Real GDP per capita growth (1+2+3) | -14.8 | 3.4  | 4.1  | 7.0  | 3.2  | 3.5  | 3.9  |

**8. Unemployment is mostly concentrated in urban areas, among the young and women.**

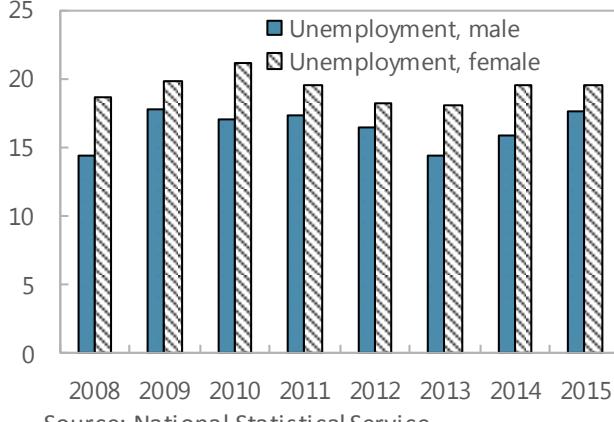
Unemployment in urban areas is four time higher than in rural areas.<sup>9</sup> Youth unemployment is twice that of the population aged 25 to 64 and the differences between men's and women's unemployment rates are significant at around 3 percentage points over the past 5 years.

**Unemployment is more concentrated in urban areas**

Source: National Statistical Service.

**Youth**

Source: National Statistical Service.

**Gender unemployment GAP**

Source: National Statistical Service.

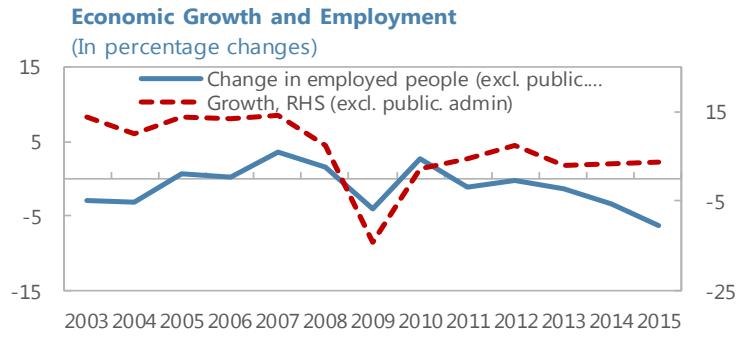
<sup>9</sup> This should be interpreted with caution. Based on household's labor survey by NSS, the employed people in the farms do not have any legal-organizational status. Therefore, based on ILO methodology, they are considered as non-formal employees.

## D. Job Creation

**9. The growth and employment have been highly correlated, but the linkage between them has weakened recently.** The weakening link between growth and employment after the global financial crisis has been driven by a structural transformation of the economy. With a sharp downturn in the construction sector, employment in this sector has decreased significantly during 2009–15 (by almost 70,000 people). Although industry and services sectors continued to grow, the over-supply of labor force in the construction sector has not been absorbed by these sectors. In addition, the gap between output and employment in industry and services has also increased due to the capital-intensive sub-sectors (mining, energy, transportation, information communication and technology (ICT)). While a third of the labor force work in the agriculture sector, the employment in agriculture has been continuously falling. This reflects a combination of factors, including the increase in productivity and working hours. Overall, due to the recent structural changes in the economy, displaced workers from declining sectors without the right skills find it hard to get jobs in emerging sectors.<sup>10</sup>

**10. Employment prospects are not likely to improve much over the medium term.** Although the

government expects the unemployment rate to gradually decline, there are significant challenges in reducing the unemployment rate below 15 percent in the medium term. Given the current

**GDP structure by the main sectors****Employment Structure by the main sectors**

<sup>10</sup> According to the survey by Enterprise Incubator Foundation of Armenia in 2015 ("Examination of Information and Communications Technology Sector"), almost 60 percent of the surveyed managers of ICT companies indicate the lack of highly qualified employee as a main constraint.

demographic developments, about 20,000 people are estimated to enter the labor market over the next five years, while real GDP is projected to grow on average by only 3–4 percent over the same period. Against this backdrop, the unemployment rate is envisaged to decrease marginally by 0.4 percentage points per year in 2017–21. Achieving the 13 percent unemployment target<sup>11</sup> by 2021 requires 6 percent annual GDP growth.

## E. Government's Efforts

### **11. Authorities have made major efforts to make growth more inclusive, particularly through:**

- Introduction of the Integrated Social Services provisioning of cash and non-cash benefits. This aims at a more comprehensive social welfare system in the country. 19 centers out of the planned 54 have been established.
- Increase in the social spending in the state budget. In recent years, the social spending budget has strengthened, focused on raising family benefits<sup>12</sup> and better targeting the poor families. The authorities use also indirect instruments to support poor families. For instance, lower gas tariffs for the vulnerable social groups were introduced in January 2017.
- Tax exemptions of the micro self-employed people to support employment. This should not only create incentives for the start-ups but also encouraged people to register with the tax authorities.<sup>13</sup>
- Special employment promotion programs. State employment agencies are implementing comprehensive programs to match jobseekers with employers including by providing vocational trainings for the unemployed and people in vulnerable employment, and assisting the unemployed in finding jobs in public works and seasonal agriculture.
- Financial equalization subsidies to local and certain tax privileges. This measure was designed for reducing regional income disparities.

## F. Key Policy Challenges and Recommendations

### **12. Despite the government's efforts, important challenges remain, given the still high poverty, rising young and female unemployment, regional disparities, and unfavorable demographics.** This strengthens the case for further policy considerations.

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<sup>11</sup> Target envisaged in Armenian Development Strategy for 2014–25.

<sup>12</sup> There are also other social assistance programs in place, including unfunded pensions (social, age and disability), childbirth lump-sum benefits, maternity benefits, up to 2 years old childcare benefits, free health care and social care services for poor.

<sup>13</sup> Self-employed taxpayers need to get registered with the tax authority and receive a certificate of exemption.

- Tax and expenditure policies help mitigate income disparities. Enhanced revenue base of local authorities through reforms of property taxes, increased efficiency of equalization subsidies and better targeted tax privileges across the regions are needed to decrease regional disparities.<sup>14</sup>
- Creating new jobs, reducing the poverty and inequality require enhanced economic diversification by promoting private sector investment. To this end, the government should attract more and better foreign direct investments. This calls for measures to invest in education,<sup>15</sup> skills and infrastructures, encourage competition, and strengthen governance.
- More active labor market policy (ALMP) measures and deepening structural reforms are essential to creating jobs, reducing unemployment, and lowering poverty and income inequality. ALMPs work by enhancing the employability of job seekers, more aptly connecting workers and jobs, and promoting job creation and labor force participation. If designed appropriately, they cannot only reduce unemployment, but also reduce poverty and improve equity as well. ALMPs typically fall into the following five categories: (i) training and retraining programs to improve the employability of workers through providing skills; (ii) intermediation services to reduce information asymmetries in the labor market; (iii) wage or employment subsidies to foster the employment of individuals with lower productivity; (iv) public works programs to provide temporary employment with a training element; and (v) self-employment programs to provide technical and financial support to unemployed persons to set up their own businesses.<sup>16</sup>
- Given the increasing dependency ratio, higher participation of female can boost the output supply side through an increase in labor supply. The participation of women in the labor force is an important social and development goal, but it is also crucial from growth and stability perspectives. For many women, part-time employment is a useful entry point to the labor market, as it allows them to combine labor force participation with family responsibilities. Family-friendly policies and flexible work arrangements could enable more women to balance their work and family lives. Currently, long and inflexible working hours associated with full-time employment prevent well-qualified women from taking up regular employment.
- In designing policies to promote inclusive growth, the experience of some Asian countries over the last two decades is also worth noting. The Philippines implemented a range of measures during the 2000s to alleviate poverty and inequality. In 2002, the Comprehensive and Integrated

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<sup>14</sup> For example, Kazakhstan increased the taxes on real estate, properties and luxury goods in 2014 and strengthened the progressivity of the income tax. On the expenditure side, the Kazakh government increased the social orientation of the national budget to improve access to education and health for low-income families. To tackle the youth unemployment, Kazakhstan greatly expanded vocational and training system to create employment opportunities for youth.

<sup>15</sup> Recent IMF study by D. Coady and A. Dizioli ("Income Inequality and Education Revisited: Persistence, Endogeneity, and Heterogeneity") suggests that income inequality is lower at higher education levels (consistent with decreasing returns to education) so investments in education could also have spillover effects on reducing inequality.

<sup>16</sup> Several ALMPs has enjoyed success in both developed countries (Job Corps in the United States and New Deal for Young People in the United Kingdom) and developing countries in Latin America. Among these different types of ALMPs, training programs are the most popular and commonplace in the Middle East and North Africa region, because they can develop job seekers with the specific skills and training that employers are looking for.

Delivery of Social Services Project was implemented (with assistance from the World Bank) with the objective of strengthening local communities' participation in community governance, and developing their capacity to design, implement, and manage development activities that reduce poverty. Additionally, conditional cash transfers to improve health and education was introduced in 2008. During the same period, Thailand also undertook various initiatives, for instance, by introducing the Universal Health Coverage Scheme which has been targeted to the poor.

Malaysia, compared to many of its ASEAN peers, massively invested in infrastructure which helped not only to sustain high growth but also to spread the benefit of growth more evenly. In addition, the Government Transformation Program was launched in 2009 to improve public service delivery especially to extreme poor. All these countries also either reduced or removed fuel subsidies by replacing them with targeted transfer programs.