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INTERNATIONAL DEVELOPMENT ASSOCIATION

PROGRAM DOCUMENT

FOR A

PROPOSED CREDIT

IN THE AMOUNT OF SDR13.7 MILLION

(US\$20 MILLION EQUIVALENT)

TO

REPUBLIC OF ARMENIA

FOR A

POVERTY REDUCTION SUPPORT CREDIT

October 21, 2004

**Poverty Reduction and Economic Management Department
Europe and Central Asia Region**

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CURRENCY EQUIVALENTS

Exchange Rate on October 20, 2004: US\$1 = 507.61 drams

GOVERNMENT FISCAL YEAR

January 1 to December 31

ABBREVIATION AND ACRONYMS

AR	Armenian Railways
ADC	Agricultural Development Centre
ASC	Agricultural Support Centre
CAS	Country Assistance Strategy
CFAA	Country Financial Accountability Assessment
CIS	Commonwealth of Independent States
COC	Chamber of Control
DFID	UK Department for International Development
DTI	Direct Trade Input
IFRP	Integrated Financial Rehabilitation Plan
JSA	Joint Staff Assessment
LDP	Letter of Development Policy
LTU	Large Taxpayer Unit
MCA	Millennium Challenge Account
MDGs	Millennium Development Goals
MOE	Ministry of Education
MOFE	Ministry of Finance and Economy
MOH	Ministry of Health
MTEF	Medium-Term Expenditure Framework
PCA	Post-clearance Audit
PHRD	Japan Policy and Human Resources Development Trust Fund
PSRC	Public Services Regulatory Commission
SAC	Structural Adjustment Credit
SCC	State Customs Committee
SDR	Special Drawing Rights
SIDA	Swedish International Development Agency
SNCO	State Non-Commercial Organizations
STS	State Tax Services
UNDP	United Nations Development Program
USAID	US Agency for International Development
WRMC	Water Resources Management Committee

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Map of Armenia IBRD 29596

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CREDIT AND PROGRAM SUMMARY

REPUBLIC OF ARMENIA
POVERTY REDUCTION SUPPORT CREDIT I

Borrower	Republic of Armenia
Implementing Agency	Ministry of Finance and Economy
Amount	SDR13.7 million (US\$20 million equivalent)
Terms	Standard IDA terms: 40-year maturity with a 10-year grace period
Objective and Description	<p>The proposed series of three annual single tranche Poverty Reduction Support Credits (PRSCs) is intended to support policy and institutional reforms in furtherance of the official Poverty Reduction Strategy Paper (PRSP). The PRSCs focus on four critical reform themes: (i) consolidating macroeconomic discipline and strengthening of governance; (ii) sharpening competition and entrenching property rights, (iii) mitigating social and environmental risks, and (iv) modernizing the rural economy.</p> <p>The first PRSC is proposed to be extended on the basis of policy and institutional reform actions taken as agreed with IDA. Subsequent PRSCs will be made available as the agreed triggers of policy and institutional reforms are satisfied.</p>
Benefits	The credit will help to sustain economic growth and poverty reduction by advancing high priority reforms identified in the PRSP and by providing resources for the budget.
Risks	First, government capacity and willingness to implement reforms over a three-year period will be necessary; moreover, there is the risk of reform fatigue as the reform agenda begins to enter into difficult terrain. Capacity is being strengthened through reforms and by the active engagement of donors; and the President of the Republic as well as the government continue to show steely determination in implementing the PRSP program. The wide participation through which the PRSP was formulated and the continuing involvement of civic organs in its implementation offer some protection against reform fatigue; nevertheless, the authorities are planning to step up the local dialogue, explanation and dissemination to stakeholders and civil society, especially in rural areas. A second risk relates to exogenous economic shocks reflecting reduction in worker remittances, export earnings, remittances by the Armenian diaspora, or a substantial energy supply or commodity price shock. Shocks could also stem from natural disasters or result from instability in the non-oil segment of international commodity markets. Clearly, each will have to be addressed in its own way, possibly necessitating a change in the content of future PRSP updates and the use of other Bank instruments as envisaged in the CAS.
Estimated Disbursement	SDR13.7 million (US\$ 20.0 million equivalent) will be disbursed in a single tranche following effectiveness.
Project ID Number	P078673

**IDA PROGRAM DOCUMENT
FOR A
PROPOSED POVERTY REDUCTION SUPPORT CREDIT
TO ARMENIA**

1. INTRODUCTION

1. In late 2003, the Armenian authorities published an ambitious *Poverty Reduction Strategy Paper* (PRSP), laying out a comprehensive program stretched over a decade for sustaining high rates of growth and directing public resources sharply towards fighting poverty. Central to this strategy are improvements in core public sector functions and higher investments in human capital and in infrastructure, whilst macroeconomic stability is to be maintained. From the range of interventions proposed in the PRSP, the Bank's *Country Assistance Strategy* (CAS), endorsed by the Bank's Board of Executive Directors in June 2004, focused on three areas that best fit the Group's comparative advantage and complement the activities of other donors: (i) promotion of private sector led growth, through raised efficiency in public services and strengthened competition; (ii) re-orientation of growth to fighting poverty, through accelerated job creation in the private economy, modernization of the rural economy, and effective social protection systems; and (iii) reduction of non-income poverty, through education, health and infrastructure reforms.

2. The CAS identified a program of PRSCs as the central instrument for supporting policy and institutional reforms in these key areas. The proposed three year program of PRSCs, totaling US\$60 million equivalent, is rooted in the three objectives described in the CAS, and is designed around four themes that each encompass several sectors:

- *consolidating macroeconomic discipline and strengthening governance*
- *sharpening competition and entrenching property rights*
- *mitigating social and environmental risks*
- *modernizing the rural economy*

The key features of the PRSC program are presented in Box 1, PRSC-At-A-Glance.

3. The first theme of consolidating macroeconomic discipline and strengthening governance recognizes that a continuation of Armenia's exemplary macroeconomic performance over the past five years is necessary to underpin high rates of growth. Moreover, governance reforms that cut across budget, fiduciary, revenue raising, and public administration institutions and sectors will improve the climate for private sector investment, remove important opportunities for corruption, and enhance revenue mobilization. The CAS notes that a pre-condition for a move from base case to high case performance is an acceleration of public sector management reforms.

Box 1: PRSC AT-A-GLANCE

Themes	Actions Taken Under (PRSC I)	Policy and Institutional Reform Actions (PRSC II and PRSC III)
Governance	Measures to strengthen tax and customs administrations adopted.	The operations of larger tax payers unit strengthened; outstanding VAT refund claims to exporters and tax arrears reduced; and self-declaration system in customs and direct trade input facilities implemented.
	Decision to merge irrigation and drainage authorities.	Well-coordinated irrigation and drainage administration established, with resulting large gains in cost recovery and service quality.
	Budget classifications restructured.	Public sector accounting standards and reporting introduced
	Financial reporting by state Non-Commercial Organizations (SNCOs) implemented.	Sanctions applied for non-compliance with financial reporting for SNCOs.
	Electronic procurement system designed.	Electronic procurement in effect.
Competition	Objective of liberalizing trade in air services and restructuring railway governance adopted.	Trade in air services liberalized and the restructured railways functioning.
	Implemented regulatory regime for utilities.	Service provision, quality, and fiduciary standards in utilities strengthened.
Property Rights	A collateral registry guide and software prepared and a plan established to strengthen creditor rights.	Civil code and related provisions on secured credit amended and civil court procedures and court decision enforcement streamlined Sustained improved secured transactions.
	Prudential standards in insurance industry developed.	Insurance companies complied with prudential standards. An independent insurance inspectorate established and actuarial system introduced.

Themes	Actions Taken Under (PRSC I)	Policy and Institutional Reform Actions (PRSC II and PRSC III)
Mitigating Social Risks	Family poverty benefit revamped to target better; the Public Pensions Law carried out.	Adopted legal framework for private pension insurance
	School rationalization program and health governance program in phased implementation.	School rationalization program and health governance completed.
	Initiated policy formulation on early childhood education; and on tertiary education.	Expanded the pre-school pilot programs. Adopted a 3-year implementation plan for tertiary education.
	Secure financing and management of primary health care.	Implemented the regulatory framework for private health insurance.
Reducing Risks in Natural Resource Management	Adopted measures to strengthen forestry policy and plans to combat illegal logging.	Forestry policy and illegal logging plans implemented. Community forestry pilots expanded.
Stimulating Farm Incomes	Initiated development of an action plan to increase farm incomes.	Action plan implemented.
	Seeds law submitted to Parliament.	Seeds law and seeds certification procedures fully in force.
	Developed plan for harmonizing food safety standards.	Harmonization adopted.
Developing Rural Infrastructure	Diagnostic study on a set of rural infrastructure services completed.	Phased action plan on rural infrastructure services implemented.

4. The second theme of sharpening competition and entrenching property rights – cutting across trade, utilities regulation, property and contract law, banking and capital markets, and rural sectors -- addresses the key weaknesses in the competition environment. Armenia needs to reduce costs and sharpen its competitive edge by complementing its highly liberal regime in trade in goods with liberalization in key services and by consolidating its impressive reforms in state owned utilities. In addition, entrenching property rights through provision of a legal framework for secured transactions, by instilling confidence in the banking sector, and by developing insurance markets is essential to secure growing rates of private investment.

5. Social and environmental risks – the third theme – that cuts across education, health, social risk management and environmental protection sectors – are designed to be mitigated by a program of reforms directed at raising both the share of public spending devoted to these sectors and the quality of spending through changes in their composition and institutional reforms, notably in the private provision of health and pension services. The resulting strengthening of human capital and reduced risks for sustainable livelihoods in natural resource use will greatly assist in the reduction of poverty.

6. Interventions in the rural economy -- the final theme – that cut across the agriculture, non-farm incomes, and infrastructure sectors – are intended to modernize a lagging sector of the economy and one in which the impact of growth on poverty needs to be further strengthened. Greater predictability and sustainability in public services in rural Armenia is expected to strongly benefit the fight against poverty.

II. POLITICAL AND ECONOMIC CONTEXT

Political Background

7. Armenia's birth from the fragmentation of the Soviet Union took place at a time of severe economic difficulty exacerbated by natural disasters and energy shortages as well as by an armed conflict with neighboring Azerbaijan over the territory of Nagorno-Karabakh. In recent years, it has attained political stability – a key factor behind the impressive growth and reform achievements (see below). Presidential and national assembly elections took place in early 2003 with the emergence of a stable coalition government, though not one without the usual stresses associated with a multi-party coalition. The government is firmly committed to the reform program underlying its PRSP, has a sound record of performance, and parliament still has a life of nearly three years to implement the measures agreed to under the PRSC program. The government has sought to engage the population actively in the design and implementation of the PRSP, and, more recently, of its anti-corruption program as well as of the design of public investments to be financed by a large donor assisted program, the Millennium Challenge Account (MCA).

8. Over the past few years, governance can be said to have improved in broad terms. Business environment and enterprise performance surveys (BEEPS) and other business surveys indicate that, between 2000 and 2002, Armenia saw improvements in political stability, government effectiveness, regulatory quality, rule of law, and control of

corruption. However, the country's ratings for voice and accountability fell over the same period. On all measures, except political stability, Armenia performs better than the average for the CIS. Transparency International's Corruption Perceptions Index rates Armenia as 82nd of 146 countries surveyed.¹ Despite improvements in some corruption indicators and stagnation in others, business surveys and popular opinion reveals that corruption remains a serious impediment to private sector growth and a factor limiting competition.

9. Freedom House rated Armenia as registering an improvement in its political rights score since 1996-97 and as maintaining its rating for civil liberties over the same period. BEEPS and some annual business surveys also indicate improvements in governance. For example, the share of firms reporting paying bribes frequently declined from 40 percent in 1999 to 14 percent in 2002, and the average bribe as a share of revenue declined from 4.2 percent to 1 percent over the same period. But since 2002, this trend improvement has not been maintained.

10. Recent events have demonstrated a degree of social unrest. Opposition parties have boycotted parliament since the 2003 elections, alleging electoral fraud and have called for a national referendum of confidence in the government. Social turbulence may have been fed by continuing high rates of unemployment (survey data suggest unemployment ranges at around one-third of the labor force, whereas registered unemployment is closer to 10 percent) and by poverty, especially outside the Yerevan area. The forcible suppression by the government of opposition-led demonstrations in early 2004 was widely condemned; in April 2004, the Council of Europe threatened political sanctions in the event of repetition, but in a more recent resolution, the Council of Europe noted improvements in the human rights climate, whilst it urged the authorities to bring certain laws into full conformity with Council of Europe standards. Rule of law, civic participation, and electoral fairness will remain important indicators in donor support decisions.

11. Armenia's borders with two of its neighbors with which it shares the overwhelming portion of its frontier, Azerbaijan and Turkey, are closed. This imposes costs on the economy, with the main surface trade link being rail and road connections with Georgia and its Black Sea ports. The closed borders also increase the importance of aviation services in the economy. The re-opening of communications and trade links with Azerbaijan and Turkey, when it occurs, will raise the potential rate of growth significantly, particularly as Armenia lies at a hub of linkages between the Middle East and the Caspian Sea states, on the one hand, and Turkey and Europe, on the other.

Economic Background

12. The Armenian authorities carried out a successful stabilization and structural reform program following the hyperinflation, fiscal crisis and severe economic contraction immediately after independence in 1991-93. Trade and prices were liberalized, the legal framework for a market economy was established, most small and

¹ Transparency International Corruption Perceptions Index 2004.

medium-sized enterprises were privatized, and the government intervention in the economy was considerably reduced. Macroeconomic stability was maintained, inflation kept low, structural reforms were carried out successfully, and economic recovery began. Despite being a landlocked country with few natural resources, implementation of economic reforms contributed to an average growth of 5.5 percent per year during 1994-2000. Nevertheless, rapid growth had a small impact on overall poverty (though a significant one on extreme poverty) in the period till the opening of the new century, largely because insufficient progress in improving the business environment and weaknesses in the rule of law, fair competition and rampant corruption blunted the incentives for investment and formation of private companies. From early 2001, the government shifted emphasis to improving business environment and promoting exports, thereby creating the conditions for an acceleration of growth in recent years (Table 1).

Recent Economic Developments

13. ***Economic growth*** accelerated during 2001-2003 rising from 6 percent in 2000 to an annual average of 12 percent in the 2001-03 period. Growth was driven for the first time by a high rate of export expansion (exports doubled in 2001-2003), with significant contribution from construction, industry and service sectors. While the diaspora and other donors financed much of the construction through grants, investment in tradable goods and exports has contributed increasingly to growth in recent years. ***Inflation*** was confined to the 2-3 percent range in 2001 and 2002, but flared-up in 2003 to reach 8.6 percent in December, largely because of cost-push factors.

14. ***Fiscal consolidation*** continued in 2003, with a shrinking of the deficit to the equivalent of 1.1 percent of GDP. While social expenditure targets were attained, tax to GDP rate fell (despite a rise in the real tax yield) due mainly to the share of tax-exempt grant financing in the economy.

15. ***External sector*** has registered an encouraging performance with exports diversifying, and export markets shifting from the CIS to EU countries. Exports of precious stones and metals accounted for more than half of total exports. There has occurred a notable rise in imports of capital and intermediate goods. Current account deficits ranged at around 6½ percent of GDP in 2002-03. The gross international reserves remained at about four months of imports and nominal exchange rate was stable in US dollar terms at an average rate of about 580 drams to the dollar.

16. The economy continued its strong performance during **2004**. During the first nine months of 2004, real GDP increased by 10.2 percent in a broad-based manner, driven mainly by agriculture, services, and construction growth of over 16 percent. During this period, exports and imports showed growth of 1.3 percent and 4.1 percent respectively. The twelve-month rate of inflation increased to 7.9 percent in September. Tax revenues improved during the first nine months of 2004 by 18.4 percent, paving the way for attainment of a projected increase in the tax ratio of 0.4 percentage points of GDP in

Table 1: Armenia - Macroeconomic Trends and Baseline Projections

	Forecast										Projected			
	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2009	2010
Real GDP growth rate	3.3	6.0	9.6	12.9	13.9	8.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0
Inflation (eop)	2.0	0.4	2.9	2.0	8.6	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Exports growth rate	6.5	16.6	20.8	29.3	28.2	12.1	8.9	9.0	9.0	9.0	9.0	9.1	9.0	9.1
Imports growth rate	-8.1	5.1	1.2	13.2	26.2	11.2	8.1	7.7	7.7	7.7	7.7	7.7	7.7	7.7
As percent of GDP														
Total investment	18.4	18.6	20.0	21.0	23.6	23.5	24.2	25.0	25.7	26.5	27.3	28.0	27.3	28.0
Private investment	13.6	14.3	15.2	16.5	18.4	19.5	20.0	20.6	21.2	21.7	22.3	22.9	22.3	22.9
Public investment	4.8	4.3	4.8	4.5	5.2	4.0	4.2	4.4	4.5	4.8	5.0	5.1	5.0	5.1
Fiscal balance	-7.2	-6.2	-3.7	-0.9	-1.1	-1.1	-2.4	-3.3	-2.8	-2.6	-2.5	-2.3	-2.5	-2.3
Current account balance, incl. official transfers (CA)	-16.6	-14.6	-9.5	-6.3	-4.2	-5.7	-4.9	-5.3	-5.8	-6.2	-6.7	-7.2	-6.7	-7.2
Foreign Direct Investment (FDI)	6.6	5.5	3.3	4.7	4.3	4.2	4.2	4.2	4.2	4.2	4.2	4.2	4.2	4.2
External debt-creating flows (CA+FDI)	-10.0	-9.1	-6.2	-1.6	0.1	-1.5	-0.7	-1.1	-1.6	-2.0	-2.5	-3.0	-2.5	-3.0
External Debt	46.3	44.0	41.4	43.3	38.9	34.0	32.7	31.2	28.7	27.4	26.7	26.5	26.7	26.5
In percent														
NPV of debt /exports	144.0	119.0	108.0	96.0	81.5	72.1	63.9	58.2	54.3	52.4	49.8	47.5	49.8	47.5
NPV of debt /fiscal revenue	167.1	176.4	176.8	181.2	156.9	138.4	113.6	103.7	97.6	93.8	89.8	86.5	89.8	86.5
TDS/exports	21.0	14.0	13.5	12.5	17.0	13.0	8.2	7.2	5.7	5.8	5.2	5.1	5.8	5.1
TDS/fiscal revenue	17.0	15.8	15.8	17.0	27.9	24.9	14.6	12.9	10.2	10.4	9.4	9.3	10.4	9.3
Total debt out'g/disbursed (\$m)	855.0	840.4	877.7	1025.0	1086.8	1124.6	1180.1	1230.1	1235.8	1286.8	1371.2	1484.2	1371.2	1484.2

Source: Staff calculations.

2004. The budget deficit is projected at the equivalent of 1.1 percent of GDP in 2004. The dram has appreciated significantly in effective nominal and real terms thus far in the year.

Economic Outlook

17. Economic performance is expected to remain strong in the medium-term with annual growth of 8 percent in 2004 and about 6 percent during 2005-2008 (Table 1). Real **GDP growth** projections (6 percent per annum) over the medium-term represent a slowing from the very high rates of the recent past as “catching-up” effects are assumed to be worn off. The growth outlook is based on the assumption that the government will be able to maintain its strong track record on reforms and economic management, and that Armenia will continue to attract significant volumes of capital transfers, notably through the MCA and private foundations, and will maintain foreign direct investment at current levels in relation to GDP. The government reform program as reflected in the PRSP will continue with measures to enhance investor confidence, improve the business climate, and promote exports. On the basis of structural reforms and external funding, the **investment** to GDP ratio is expected to rise from 23.5 percent in 2004 to 28 percent of GDP by 2010, with the private sector accounting for most of the increase.

18. Over the medium-term, improving **revenue mobilization** to finance poverty reducing expenditures is a major task confronting the government. The attainment of the PRSP target of a rise in the revenues to GDP ratio of 2½ percentage points between 2004 and end-decade will require addressing deficiencies in the tax and custom administrations, especially in the areas of excisable goods, VAT, personal income, profit and property taxes. With expenditures being constrained to aggregate PRSP targets, the fiscal deficit is projected to range between 2½ and 3 percent of GDP, consistent with macro-stability.

19. With **trade flows** (both exports and imports) rising at rates higher than GDP growth, the economy will steadily become even more open. The projections assume a cautious volume of grant inflows from the MCA and from private foundations over the projection period – of the order of 1½ percent of GDP. Grant funding will make possible an increase in the investment share of GDP and raise the medium term growth potential of the economy, whilst ensuring viability in external payments and leading to an even sharper decline in external debt indicators. It would also strengthen fiscal prospects and lead to the generation of additional revenues for poverty fighting ends.

20. Provided foreign direct investment is maintained in relation to GDP at the rates seen over the past three years – a fairly conservative assumption – **debt-creating flows** required to finance the current account deficit after grants and maintain international reserves at the equivalent of four months of imports will amount to an annual average of 2 percent of GDP over the 2005-10 period – an eminently manageable task.

21. The country’s **external debt profile** improved considerably in 2003 as a result of an agreement with Russia to carry out the debt-for-equity swap, under which Russian

enterprises acquired equity in several major state enterprises in exchange for about US\$100 million of government debt. This, in addition to the repayment in kind to Turkmenistan of US\$12 million of outstanding debt, facilitated the near-elimination of non-concessional debt. The net present value of debt to exports ratio is estimated to fall from 82 percent in 2003 to 48 percent by end-decade. Debt service, as percentage of exports of goods and services, is estimated to fall from 17 percent in 2003 to 5 percent at

Table 2: Armenia – Sensitivity of Macroeconomic Projections
(In percent)

(a) Low Case

	2004	2005	2006-09 Annual Average	2010
Growth of real GDP	8.0	4.5	3.0	3.0
Total investment to GDP	23.5	23.2	22.7	22.8
Current account balance to GDP	-6.3	-7.6	-9.4	11.4
External debt to GDP	34.0	35.1	37.6	42.9
Total debt service to exports	13.0	8.8	9.2	11.6

Source: Staff calculations.

(b) Base Case

	2004	2005	2006-09 Annual Average	2010
Growth of real GDP	8.0	6.0	6.0	6.0
Total investment to GDP	23.5	24.2	26.1	28.0
Current account balance to GDP	-6.3	-6.8	-7.6	-8.5
External debt to GDP	34.0	32.7	28.5	26.5
Total debt service to exports	13.0	8.2	8.0	5.1

Source: Staff calculations.

(c) High Case

	2004	2005	2006-09 Annual Average	2010
Growth of real GDP	8.0	7.0	8.0	8.0
Total investment to GDP	23.5	24.8	26.8	30.1
Current account balance to GDP	-6.3	-6.5	-9.4	-8.8
External debt to GDP	34.0	31.3	25.3	22.7
Total debt service to exports	13.0	8.0	6.9	3.7

Source: Staff calculations.

end-decade. Over the same period, debt service, as a percentage of fiscal revenue, is estimated to decline from 28 percent to 9 percent. Multilateral concessional debt today accounts for about 80 percent of external debt, of which debts to IDA stand at 60 percentage points.

22. Two scenarios to gauge the sensitivity of key macroeconomic variables to varying levels of external assistance and domestic policy effort have been developed (Table 2). In the low case, it is assumed that reform efforts flag with the tax to GDP ratio being stagnant and with little progress in structural reforms such as improvements in the business climate or in governance. In response, external transfers fall sharply as Armenia fails to attract bilateral donor financing and diaspora support, and the poorer economic outlook dampens private investment. Public expenditures fall below the MTEF projections to fit resources available. Under these conditions, growth will fall to 3 percent over the rest of the decade, external balances worsen, and the debt and debt servicing burden would rise, but not by unmanageable magnitudes, given the low starting point for debt burdens. Nevertheless, policy slippage would be highly costly for Armenia as measured by output foregone.

23. The high case is driven by stronger improvements in the business climate and resulting greater confidence amongst domestic investors. A resolute implementation of medium term reforms is assumed, together with a less cautious assumption on external grant inflows. Rising openness, externally funded investments, together with progress on raising the tax/GDP ratio, is projected to raise growth rates to annual averages of 8 percent till end-decade – a rate that is still conservative in comparison to that of the past four years. Debt and debt service indicators fall sharply under this scenario, with a clear attainment of creditworthiness for borrowing on commercial terms and on IBRD terms around 2007.

24. The poverty impact of the base case and its two variants are discussed in Chapter VI and in Annex 4 of this document.

III. POVERTY IN ARMENIA

Trends in Poverty

25. In the 1980s, *poverty* in Soviet Armenia is reported to have been virtually non-existent. The end of the decade, however, saw poverty increase sharply as the 1988 earthquake, the break-up of the Soviet Union, and the Nagorno-Karabakh war cost many people their livelihoods. The war also brought an influx of refugees, adding to the ranks of the poor.

26. Although economic growth resumed in the mid-1990s, poverty did not begin to fall until the end of that decade. By 2003, all measures of poverty and extreme poverty had declined significantly compared to their levels in 1998/99 (Table 3).² Extreme poverty fell considerably faster than did overall poverty.

² The incidence of poverty is the share of poor people in the population; the poverty gap indicates how far

Table 3: Poverty Rates
(in percent)

	Extreme Poverty (below \$14 a month)			Overall Poverty (below \$21 a month)		
	Incidence	Gap	Severity	Incidence	Gap	Severity
Total						
98/99	26.1	5.8	1.9	56.3	17.1	7.0
2001	16.2	3.4	1.1	47.0	12.0	4.5
2002	17.0	3.2	1.0	49.3	12.5	4.5
2003*	4.6	0.6	0.1	29.1	5.1	1.4
Yerevan						
98/99	29.6	6.6	2.1	58.7	18.8	7.8
2001	17.5	4.0	1.5	44.5	12.4	5.0
2002	16.5	3.1	1.0	45.4	11.8	4.3
2003*	2.9	0.3	0.0	19.3	3.1	0.8
Other urban						
98/99	34.5	8.2	2.9	66.5	21.6	9.4
2001	19.3	3.7	1.1	50.9	13.3	5.0
2002	21.1	4.1	1.3	59.8	15.5	5.7
2003*	7.6	1.1	0.3	36.7	7.4	2.2
Rural						
98/99	18.0	3.5	1.1	47.7	13.0	4.9
2001	12.8	2.7	0.9	45.7	10.7	3.8
2002	14.4	2.6	0.7	44.7	11.0	3.8
2003*	3.6	0.4	0.1	30.8	5.0	1.3

Note: Consumption is measured per adult equivalent. Poverty indicators are computed using the 1999 minimum food basket. *Poverty rates for 2003 are preliminary estimates.

Source: ILCS 1998/99 – 2003.

27. Data from integrated living condition surveys (ILSC) indicate that the decline in poverty in the four-year period to 2002 was moderate (despite rapid rates of sustained growth), but extreme poverty fell much more strongly over this period. Preliminary estimates based on the ILSC for 2003 show a sharp reduction in both overall and extreme poverty in 2003 as compared to earlier years. While too much should not be read into year-to-year comparisons of poverty, the overall direction is clear: **poverty in Armenia has declined strongly since 1998, with a particularly notable fall in extreme poverty.**

28. The causes of the sharp fall in poverty over this five-year period and, in particular, the role of the labor market will be the subject of joint research between the authorities and the Bank in the coming months. Besides the effects of sustained growth at rates of 7-8 percent per head over eight years, it is likely that the boom in construction in the 2000-03 period and in infrastructure spending, largely financed through donors and private diaspora foundations, with attendant generation of employment (including in rural areas), created multiplier effects bearing down on poverty. The broadening of the growth pattern to embrace services helped to spread the benefits of rising economic activity.

below the poverty line poor households are; and the severity of poverty captures inequality among the poor.

Remittances, particularly from Armenian workers in Russia, may have an important factor as well. Finally, the increasingly important role played by the family poverty benefit, with real increases in the benefit and improved targeting seen in recent years, transferred resources particularly to those in extreme poverty.

29. Household surveys show that *location and household composition* affect a family's likelihood of being poor. In 2003, poverty was most severe in urban areas outside Yerevan, where almost 37 percent of the population lives below the poverty line. Poverty in rural areas and in Yerevan was significantly lower, at 31 percent and 19 percent, respectively, but the rate has been falling much faster in Yerevan than in rural areas. Similar patterns apply to the trends in extreme poverty (see Table 3). Poverty rates were the same for men and women, but higher for children under five, the elderly, and in female-headed households. As in most countries, the higher the education levels of the household head, the lower the household's risk of poverty.

30. *Employment* is a crucial determinant of poverty in Armenia. Unemployment rates remain high despite the accelerating GDP growth. New job creation has yet to fully compensate for the volume of labor shedding, which has taken place as a result of the transition process. According to the household surveys, which are based on self-reporting, unemployment overall was 29 percent in 2002, down only two percentage points from 2001, with most of the decline being in Yerevan, where unemployment fell by seven percentage points between 2001 and 2002³. Official data gives substantially lower rates than the household survey, as many unemployed do not register with the Labor Office.

31. *Social transfers* represent the third largest source of income (after labor income and remittances) for Armenia's poorest households, and the family poverty benefit (budget outlays for this benefit amount to the equivalent of 1 percent of GDP) in particular has proved to be an effective mechanism for reaching the poor. For example, for each percent of GDP spent in 2002 on the family poverty benefit, extreme poverty fell by 3.4 percentage points, and overall poverty by 2.4 percentage points.⁴ In 2002, the government reduced spending on poverty benefits by one-third of a percent of GDP, resulting in an 11 percent fall in the number of beneficiaries, and a 15 percent decline in the average monthly benefit. This may have slowed improvements in poverty reduction between 2001 and 2002. In 2003, however, poverty benefits were restored to their former levels and social assistance arrears were cleared, which had a beneficial impact on poverty in 2003 and 2004.

32. The *health* of the population deteriorated after the economic collapse, but since 2000 there have been indications that conditions are beginning to improve. While data problems make definite conclusions difficult, government figures indicate that under-five mortality fell from 25 per 1,000 live births to 19 per 1,000 live births between 2001 and

³ Individuals are defined as unemployed if they did not work in the week of the survey, were actively looking for a job and were willing to start work immediately if a job became available.

⁴ World Bank Poverty Assessment 2004.

2003.⁵ These trends mask a significant difference between rural and urban areas, with rural infant and child mortality rates exceeding urban rates by 47 percent and 22 percent, respectively, during the 1990s. The government has embarked on a reform program to increase public expenditure on healthcare, improve its targeting, and reduce excess hospital capacity.

33. Access to *basic education* is good, with a net enrollment rate of 92 percent in 2001. In contrast, the net enrollment rate in secondary schools is only 61 percent, and even lower for the poorest quintile (52 percent). Boys are particularly likely to drop out because of problems both of supply (poor quality of teaching), and demand (low expectations of jobs after completing education). The government is working to improve the quality of education, and has begun to make expenditures more efficient, for example by consolidating underutilized schools to improve their effectiveness. Overall public expenditures on education are also rising (by 45 percent between 1997 and 2001), but they are still low by FSU standards. High quality textbooks are now available to all at a reasonable cost. As a result of decentralization initiatives, 40 percent of schools now have some managerial and financial autonomy.

IV. POVERTY REDUCTION – OFFICIAL STRATEGY AND IMPLEMENTATION

The Strategy

34. The Armenian authorities have prepared a PRSP that was judged by the Executive Boards and the staffs⁶ of the Bank and the Fund to be a significant achievement based on a highly commendable effort. The PRSP offers a comprehensive poverty reduction program. It has been prepared through a fairly wide participatory process within the government (at both national and regional levels) and with civil society and the donor community. It contains an extensive analysis of the causes of poverty and the challenges faced; a comprehensive strategy with short and long-term perspectives; and a set of priority public actions, evaluation plans, costing of programs, and a financing scenario.

35. The *poverty diagnosis* in the PRSP sets out a comprehensive analysis based on a wide range of indicators, including indicators related to income and income distribution, consumption, health, education, access to water, nutrition, fertility, and regional issues. It provides a sound assessment of the nature and determinants of poverty in Armenia and candidly discusses the factors that have contributed to high levels of poverty in Armenia, analyzing the role of recent economic and structural policies in reducing poverty. Children, women, and rural population with limited access to education and health services are the most deprived. Despite the absence of comparable poverty indicators for the last decade, the analysis makes a good attempt at assessing the impact on the level of poverty of both past policies and adverse shocks in the early 1990s and recent trends in economic growth. Armenia's expected performance with respect to key MDG targets is given in Box 2.

⁵ Other sources indicate higher figures, but also show positive trends.

⁶ See Armenia - Joint Staff Assessment of the PRSP (October 20, 2003).

BOX 2: Expected Performance with Respect to Selected MDG Targets

The target of *halving the level of poverty* by 2015 is projected to be more than achieved by 2015⁷. The economy is currently on track to significantly dent poverty throughout the country. Growth over the past seven years has averaged 6 percent per head per annum; over the past three years nearly 10 percent per annum. Over the 2004-2008 period, growth is projected at 6 percent per head per year, provided macroeconomic stability continues to be maintained and Armenia deepens its structural reforms by addressing the unfinished reform agenda as described in this project document.

The target of *school enrollment* will be achieved with ease; net enrollment currently stands at about 95 percent. The main challenges in education are to improve quality through curricular and textbook reforms, extend education services to encompass pre-school, enhance tertiary and vocational education standards, develop skills more responsive to the needs of the market place, and reshape spending composition to more efficient ends.

The target of *child mortality* could be achieved within the MDG period⁸; it is too close to call at present, but the indicator is clearly falling. Consistent with the PRSP, the budget provides for a doubling of health expenditures in relation to GDP within ten years and a shift within such expenditures towards primary health, with an emphasis on child health (0-5 years) and obstetric health care. One quarter of the reduction is planned for the 2004-06 period through an emphasis on child respiratory diseases and diarrhea.

The achievement of the target on secure *drinking water* in both urban and rural areas will require policy reforms, charges and metering to cover current costs, including O&M, and investments to improve access in urban areas and quality in rural areas. It implies that the proportion of the population served by the centralized water supply network has to rise from 71 percent in 2000 to 86 percent by 2015. The investment costs associated with new pipes and associated infrastructure as well as with reduction of water losses will be met only in part from the budget, but significantly from donor financing, some of which has been identified, and access to the Millennium Challenge Account provides an opportunity for completing the financing required for this purpose.

36. The PRSP recognizes that *rural poverty* remains a problem and envisions policies to reduce it. The PRSP stated that while urban poverty had decreased since the late 1990s, there had been stagnation in rural poverty reduction⁹. The PRSP appropriately identifies several factors responsible for this stagnation in rural poverty reduction, including underdeveloped rural distribution network and storage facilities, disrupted trading routes and higher transport costs, small land holdings, and falling agricultural prices relative to consumer prices. However, the specifics of remedial programs are still being developed. The authorities are encouraged to continue and expand their reviews of rural poverty, adopt the necessary measures to reverse the deteriorating trends of rural poverty, and reflect these in the next progress report on PRSP implementation.

⁷ The PRSP foresees a halving of the year 2000 level of poverty in the year 2011.

⁸ There is a discrepancy between official and survey data; the latter being twice as high. This analysis is based on the PRSP program and the MTEF budget, which relies on official data.

⁹ Note that the PRSP was prepared in 2002-03, i.e., prior to the availability of the most recent preliminary data on poverty for 2003. As reported in this document, most recent data show a sharp fall in rural poverty.

37. As *policy priorities*, the PRSP identifies five themes for action:

- promoting sustainable economic growth through macroeconomic stability and private sector development;
- enhancing human development and improving social safety nets;
- implementing prudent fiscal policies and reforming the tax system;
- improving public infrastructure; and
- improving core public sector functions.

38. The PRSP recognizes that *macroeconomic stability* is essential for continued high rates of growth and poverty reduction. Continued improvements in the business environment are critical to continued job creation and poverty reduction. The PRSP recognizes that output growth in recent years has not been accompanied by sufficient employment generation because the business environment has not been supportive enough for new entrants. In this regard, the emphasis given to plans for supporting the development of small and medium-size enterprises is appropriate. Further improvements in the business environment will also hinge on progress in the governance and public resource management reforms and on strengthening of the banking system.

39. The *switching of budgetary expenditures* towards activities that have a high impact on poverty reduction is the key policy change proposed in the PRSP; and expenditure adaptations are being embodied in the medium term expenditure frameworks and in annual budgets presented to parliament for approval (for details, see below). In addition to sectoral expenditure shifts, a sustainable reduction in poverty can be achieved only if the consistent improvements seen in transparency, public resource management, prioritization and sequencing of reforms, and capacity building are built upon. Indeed, the PRSP recognizes the importance of good governance for poverty reduction, which is a contentious area, given entrenched corruption in public services, where tenacious reform efforts are required. The translation of the adopted anti-corruption strategy into specific actions, especially in tax and customs administration reforms, the strengthening of the judiciary, the development of transparent and independent audit institutions, and the fostering of public vigilance and monitoring are urgent reform measures that are still in their infancy.

40. In *education*, the PRSP establishes that ensuring quality of education and enhancing its accessibility are essential for economic growth and poverty alleviation. The proposed strategy to improve the conditions of teachers and upgrade their skills and realign the education system to the needs of the information technology sector is essential. In this connection, the proposed outcome and interim output indicators— increase in years of educational attainment, secondary school completion rates, staff remuneration rates, and efficiency-enhancing measures are appropriate.

41. In the *health* sector, the PRSP focus lies on increasing accessibility to essential health services. The PRSP also recognizes that additional budget resources, intra-sectoral

reallocation, and improved efficiency of the health system will be needed to achieve this objective. The PRSP emphasizes the importance of improved maternal and child healthcare and suggests measures to achieve the Millennium Development Goals (MDG), which are eminently achievable.

42. The PRSP pays particular attention to *social risk* management programs. It recognizes social insurance and social assistance as key elements of the poverty reduction framework. Targeted cash family poverty benefits—one of the most successful poverty alleviation programs in the region remains a major pillar of the safety net. The PRSP envisages a range of measures aimed at further improving the administration of these benefits, including better monitoring and evaluation, more streamlined appeal procedures, and a more active role for territorial centers in providing social assistance that reaches out to the poorest. Increased funds and improved administration should ensure achievement of the government's objective of covering a higher percentage of the extremely poor. The PRSP also envisages a change in the targeting mechanism for the family poverty benefit from proxy-means to income-based eligibility testing. This change should, however, be considered with caution given that the benefit is already well targeted and that income-based targeting is subverted by the high prevalence of informal economic activity. In the area of social insurance, the PRSP adequately focuses on completing the introduction of individual records in the pension system, better collection of social insurance contributions, and increase in pensions. The PRSP also recognizes the importance of implementing the recently adopted state pension law that envisages stronger links between pensions and contributions. Overall, safety net policies and planned resources, if implemented as envisaged, will contribute to improving the welfare of the poor and vulnerable segments of the population.

43. The PRSP correctly identifies the critical role of *the energy, water, irrigation, and transport sectors* in the country's development prospects. Good progress has been made in these areas in recent years but more remains to be done. In the energy sector, reforms should include the restructuring of the dispatch, transmission, and settlement companies to create a more efficient and transparent sector. In the irrigation sector, reforms will include increases in tariffs for bulk and end-users to attain greater cost recovery. Drinking water tariffs will also need to be increased over the next three years to attain cost-recovery levels and mechanisms need to be designed to mitigate the adverse impact of such increases on the poor.

44. In the transport sector, the reorganization and financing of the road sector needs to be urgently addressed. Improved roads would help provide citizens with better opportunities for sharing economic growth, and special attention to road rehabilitation and maintenance is necessary. In order to put road sector financing on a sustainable and predictable basis, more reliance needs to be placed on user charges. At the same time, responsibility for the administration and management of rural local roads is unclear, and better mechanisms are needed for allocating the road sector budget between main, local, and city roads.

45. On *environmental protection*, the PRSP focuses on management of forest resources; prevention of land degradation; management of water resources; and hazardous industrial waste. Policies on environmental assessment are being developed and a national forestry policy has been prepared with wide participation.

46. The *targets and intermediate indicators* presented in the PRSP are selective, well identified, and consistent with the MDG. Although they appear ambitious, they are achievable: the PRSP contains a range of actions aimed at improving public services delivery in health, education, and social protection and increasing the welfare of the population. Clearly, success in reaching the targets critically depends on timely and successful implementation of the envisaged actions. The policy matrix contained in the PRSP is comprehensive, but would benefit from greater focus.

Implementation

47. In the year since the promulgation of the PRSP, the authorities have taken a number of steps to ensure that the momentum generated in the strategy formulation process is transformed into its implementation. On *process*, the authorities have formalized consultation and participatory procedures that cover the management of PRSP implementation, specialized working groups organized around reform themes, assessing capacity for implementation and addressing deficiencies, and monitoring and evaluation. Local authorities, non-government bodies, civic organizations such as those of the church, of labor, businessmen, the diaspora, apart from the legislative and government organs, are represented in the PRSP implementation process (see paragraphs 187 and 188). The World Bank views the Poverty Reduction Strategy Paper Progress Report for August 2003 - August 2004, prepared in September 2004, as reflecting the considerable progress made to date. An improved English translation of the Progress Report is underway, and the Government expects to publish it before the Board discussion of the PRSC. Once the improved translation is available the Bank and Fund staffs will undertake a formal Joint Staff Assessment.

48. On *policy substance*, the medium term expenditure framework (MTEF) for 2005-07 has been designed within the PRSP objectives and constraints, the annual budgets for 2005 and beyond will conform to this framework. The authorities in spring 2004 approved a supplementary budget to raise (domestically-financed) capital spending to support PRSP targets in education, health and infrastructure. A medium term action plan for policy and institutional reform priorities has been developed to translate the PRSP into results on the ground. Moreover, technical work has been carried out to develop monitoring indicators to track progress. The PRSC program is based on the official outcome and monitoring indicators.

V. THE PRSC-SUPPORTED REFORM PROGRAM

Introduction

49. As noted, the three-year reform program supported by the PRSCs is anchored in the PRSP objectives and action plan and has been developed through extensive consultation with civic society. The PRSP consultation process is being institutionalized and will continue to be active. The relationship between the major PRSP policy priorities and the PRSC-supported program are illustrated below (Table 4). As noted, the Bank envisages providing support for a select sub-set of policy and institutional actions developed in the PRSP in line with its comparative advantage and at the request of the authorities.

50. In keeping with the philosophy of development policy lending, wide societal ownership of the reform program has been assured; moreover, the reform program embraces a variety of approaches. For example, it seeks to open greater share of the economic space to the private sector by tackling barriers created by public sector practices that impede business activity and by increasing opportunities for private activities through liberalization in services. These actions will also help to strengthen transparent governance and fight corruption. A variety of approaches can also be seen in mitigating social and environmental risks, where poverty-targeted budget outlay rises are married to risk-minimizing institutional reforms in social protection, pensions and private health care provision. The reform program promotes the rule of law agenda and strengthened judicial practices in contract and secured transactions, and in reform of administrative court procedures.

51. *Nature of reform actions.* The elements of the reform program supported by PRSCs have been selected by the authorities, in consultation with the Bank, to accord to the agreed country assistance strategy. The first PRSC contains a set of policy and institutional decisions taken by the government in 2004, i.e., in the period following the issuance of the PRSP. It also contains implementation achievements. Given the brevity of the period since the issuance of the PRSP, most of the actions supported by the first operation take the form of government policy decisions, action plans, and strategy formation in support of policy change. Nevertheless, the policy decisions represent significant reform milestones throughout the reform agenda – for example, as related to liberalization in services, utility reforms, re-orientation of fiscal spending, entrenching creditor rights, environmental protection and monitoring. On the social risk agenda, policy implementation on rationalization of schools and hospital services, for example, reinforce the linkage with Bank investment operations in these sectors.

52. The subsequent PRSCs shift steadily towards reform implementation and institution building. Thus, the functioning of strengthened irrigation and drainage management institutions or of the courts in enforcing creditor rights or of the policy on curbing illegal logging are among the key reform actions supported in the later PRSCs. In selected areas, new directions for policy are set as the supporting analytical work matures.

Table 4: Armenia - PRSP-PRSC Links Mapping of the Main Policy Priorities

<i>PRSP Policy Priorities</i>	<i>PRSC Policy Reform Areas</i>
<ul style="list-style-type: none"> Promoting sustainable economic growth through macroeconomic stability and private sector development; 	<ul style="list-style-type: none"> Maintain macroeconomic stability (Matrix 1.1) Liberalization in key services (Matrix 2.1.a) Regulatory reform in state owned utilities (Matrix 2.1.b) Entrenching property rights through (i) secured transactions; (ii) improving confidence in the banking system; and (iii) developing insurance markets (Matrix 2.2, a-c)
<ul style="list-style-type: none"> Enhancing human development and improving social safety nets; 	<ul style="list-style-type: none"> Improving social protection and social risk management (Matrix 3.1) Raising the quality of education (Matrix 3.2) Controlling risks in health (Matrix 3.3) Reducing risks in natural resource management for sustainable livelihoods
<ul style="list-style-type: none"> Implementing prudent fiscal policies and reforming the tax system; 	<ul style="list-style-type: none"> Strengthening tax administration (Matrix 1.2.a) Strengthening customs administration (Matrix 1.2.b)
<ul style="list-style-type: none"> Improving public infrastructure; and 	<ul style="list-style-type: none"> Improving governance in irrigation and drainage (Matrix 1.2.c) Develop rural infrastructure (Matrix 4.2)
<ul style="list-style-type: none"> Improving core public sector functions. 	<ul style="list-style-type: none"> Advancing budget management systems and financial reporting reforms (Matrix 1.3.a) Improving public procurement systems (Matrix 1.3.b) Stimulate farm income by improving research and extension services, and food safety and phytosanitary standards, and certification of exports (Matrix 4.1)

53. **Phasing of reform actions.** Whilst the three year program contains policy and institutional reform measures across all four of the PRSC themes, the weight of the first operation is tilted towards governance and competition, with some elements of the social risk agenda, that of the second and third towards mitigating social and environmental risks and modernizing the rural economy. This phasing reflects the choice made by the authorities consistent with their PRSP action plan, their decisions as to how scarce government and managerial resources can best be deployed, policy work done by the authorities, and the stage of the policy dialogue with the Bank.

54. **Public expenditure environment.** The PRSC will disburse IDA funds to budgets that have been developed in line with the medium term expenditure framework. The MTEF, in turn, has taken on board the lessons of the Bank's public expenditure review (2002). The quality of public expenditures is envisaged to be raised through several channels. First, in the opening years of the PRSC-supported program, large increases in salaries of public sector workers, especially in education and health, are planned to bring salaries closer to comparable civil service salaries, to attract qualified staff, to reduce incentives for informal payments by service users, and to enhance service quality. Second, expenditures will shift towards non-salary components once this adjustment is complete. Third, subsidy expenditures have fallen sharply with energy sector reforms, and are projected to fall further with the achievement of cost recovery in irrigation. Fourth, the share of domestically financed capital spending will rise in the medium to long run, although a burst of donor-provided assistance such as the MCA may reduce this share in the initial years. The sharp fall in the fiscal burden of debt service (Table 1) over the rest of this decade provides the room to increase capital spending.

55. Moreover, improvements in public expenditure management institutions and practices detailed in this document will also raise the quality of public spending. The Bank's public modernization project, with its focus on institutional reform, will also help to ensure that the public expenditure environment will remain a sound one.

56. It is notable that the program being supported by the PRSC takes care to achieve a balance in expenditures that are pro-growth and those that are pro-poor. In the former category, measures intended to sharpen competition, raise standards in governance, and entrench property rights are prominent; in the latter, measures to diminish social and environmental risk and develop rural infrastructure will disproportionately benefit the poor, whilst also strengthening the productive base of the economy.

57. **Development outcomes.** The major development outcomes of the reform program are summarized in the table below; these are consistent and aligned with the CAS indicators.

Table 5: Armenia - Key Development Outcomes Supported by the PRSC

PRSC Area	Key Monitoring Indicator	Status in 2003	2007 Outcome
I. Consolidating macroeconomic discipline and strengthening governance			
Maintaining macroeconomic stability	• GDP growth, inflation, and fiscal deficit	• 13.9%, 8.6%, and 1.5%, respectively	• 6.0%, 3.0%, and 2.8%, respectively
Strengthening tax and customs administration	• Tax revenue, % of GDP	• 14%	• 17%
Advancing budget management system and financial reporting	• Budget classification based on GFS 2001	• Budget classification based on GFS 1986	• GFS 2001 operational in all ministerial budgets
Improving public procurement system	• Procurement systems modernization	• Centralized public procurement • Weak standards for procurement practices	• Introduction of e-procurement in the public sector • Public sector procurement documents according to standards, the differences between privately and publicly procured good declined, and transparency increased
	• Reduction of non-competitive procurement	• Very high level of single source procurement (80%), and low level of procurement through open bidding procedures	• Single source open procurement (outside the natural monopoly sector) 20 percent
II. Sharpening competition and entrenching property rights			
Sharpening competition	• Share of private sector, % of GDP	• 80%	• 85%
Secured transactions, confidence in the banking system, and insurance markets	• Commercial bank loans to private sector, % of GDP • Volume of short-term rural lending by microfinance institutions • Deposits (from resident physical and legal entities), % of GDP • Number of personal bank accounts • Insurance prudential standards	• 6% • US\$8 million • 8.7% • 406,802 • Weak prudential standards; and US\$4.5 million premiums	• 10% • US\$12 million • 10.5% • 490,000 • Strengthened prudential standards; and US\$15 million premiums
III. Mitigating social and environmental risks			
Improving social protection and social risk management	• Poverty incidence, and extreme poverty • Share of labor income in total income of two poorest quintiles • Share of extremely poor households receiving family poverty benefits • Share of family poverty benefit expenditure leaked to non-poor • Ratio of average pension in	• 29%, and 5%, respectively • 39% • 33% • 27%	• 25%, and 2%, respectively • 50% • Not less than 70% • Not exceed 25%

PRSC Area	Key Monitoring Indicator	Status in 2003	2007 Outcome
Raising the quality of education	average wages	• 20%	• Not below 25%
	• Primary net enrollment rate (MDG)	• 93%	• 100%
	• Public spending in general education per pupil	• 100 (Index)	• 268 (Index 2003=100)
	• Proportion of children participating in pre-school services, and proportion of children from poorest quintile of families participating	• 0%, and 0%, respectively	• 30%, and 50%, respectively
Controlling risks in health	• Rise in non-salary recurrent and in capital expenditures	• 100, and 100, respectively	• 128, and 473, respectively
	• Infant, and maternal mortality rates	• IMR 12 per 1000 births, MMR 22 per 100,000	• Approach mean OECD levels or MDGs
	• Utilization rate of health care services by bottom quintile*	• 22 %	• 33%
	• Number of hospital contracts issued by the State Health Agency	• 135	• 94
Mitigating environmental risks	• Share of health expenditures in GDP, and share of PHC expenditures in total budget**	• 1.2%, and 33.0%, respectively	• 1.8%, and 42.3%, respectively
	• Illegal logging indicator	• Damage caused annually by illegal logging estimated at \$5.0 million.	• Damage reduced to \$2.0 million
	• Community forestry indicator	• No community forests exist	• Between 4 and 6 community forests
IV. Modernizing the rural economy			
Stimulate farm incomes	• Promote productivity increases using mass media, and intensified village coverage served by regional ASC's	• Diluted coverage, 6-9 villages per ASC extension agent	• Intense coverage, 2-3 villages per agent
	• Average productivity increase per hectare in ADC service areas	• 2%	• 5%
	• Percent of national herd protected by MoA's vaccination and disease inspection programs	• 50%	• 90%
	• Share of seed imports with certificates of (seed) quality, and share of sales of domestic seeds by registered retail inputs suppliers	• 0%, and 0%, respectively	• 100%, and 80%, respectively
	• Share of agri-food exports certified as conforming with ISO 1700 standards	• <5%	• 70%
	• MTEF's irrigation cost recovery target	• Not satisfied	• Target (70%) fully satisfied
	• Share of WUAs training services, outreach and contract services meeting targets	• Some training and not meeting targets	• 90% of target
	• Cost recovery via subscriptions and users fees: from previously established enterprises and repeat users of DNCs' training and information services	• 20%	• 40%
Develop rural infrastructure	• Share of secondary roads in rural areas to be reconstructed/rehabilitated	• 61%	• 56%

*/ Utilization rate of health care services by bottom quintile is as of 2001.

**/ The definition of PHC budget category will be revised to reflect the PHC reform, as agreed under the PRSC.

Theme 1: Consolidating Macroeconomic Discipline and Strengthening Governance

Maintaining Macroeconomic Stability¹⁰

58. **Key policies.** Armenia has a creditable record of economic stability, as noted in the opening sections of this Program Document. Over the medium term, the macro-economic program underlying the PRSP calls for *fiscal deficits* in the range of 2½ to 3 percent of GDP, i.e., what can be financed by concessional borrowing from IDA and other donors and from highly limited volumes of domestic debt issues as the authorities try to develop a capital market for long term debt. Such domestic debt will be used to finance long-term capital investments. *Monetary policy* is intended to be geared to keeping inflation low and the *exchange rate* regime would be a floating one. The *external debt* burden is low and is projected to fall in relation to domestic output over the medium term. Debt and debt service indicators in relation to GDP or exports or government revenues are projected to decline sharply over the medium term as Armenia continues to maintain a hospitable environment for foreign investment and attract capital transfers from donors. By the standards of CIS or of emerging economies, the economic record is remarkable and the medium term outlook robust. Armenia could expect to attain *creditworthiness* for IBRD lending and for judicious commercial borrowing for high return projects over the medium term.

59. **Major policy challenges.** Nevertheless, the authorities have to remain vigilant to the major sources of *vulnerability* to economic performance. Challenges over the near to medium term arise from two sources: keeping inflation in check and the narrowness of the fiscal base. Cost-push factors may have accounted for acceleration in prices in 2003, and *inflation* has continued to exceed targets thus far in 2004; the twelve-month rate to September was 7.9 percent. To bear down on inflation, particularly in the face of large projected external inflows, the authorities will need to hold monetary stance prudent and to develop monetary policy instruments designed to sterilize external inflows. It will be important to maintain a flexible exchange rate system, recognizing that, in a rapidly growing economy with productivity gains, the dram will appreciate in real terms. Intervention should be limited to smoothing short run volatility in the exchange rate.

60. The narrowness of the *fiscal base* and insufficient reliance on direct taxes leads to lack of balance in the tax structure and to a mobilization ratio that is too low to fund priority social expenditure needs. Changes in tax policy to enhance the role of direct taxes¹¹ and in tax administration to ensure minimal evasion and fair treatment of all taxpayers will go a long way to stabilizing the fiscal base. Any temptation to relax on tax reforms against a background of large donor grant inflows should be resisted.

61. Questions also arise as to the capacity of the economy to efficiently *absorb a large volume of external grant funds flow* from the MCA and other sources. Constraints

¹⁰ Matrix 1.

¹¹ Indirect tax rates are high (VAT is levied at 20 percent) and the tax base commendably broad; thus the scope for further action on indirect taxes is small.

to efficient absorption arise from macroeconomic factors, institutional and managerial factors, and infrastructure. The projected inflows of the order of the equivalent of 2 percent of GDP will not be inconsistent with macro-stability provided the monetary and exchange rate stance is as discussed above, the import content of the counterpart to grant financing is high (as would be the case for energy and other infrastructure capital spending), and domestic spending (e.g., on salaries) is controlled. In this manner, the inflationary impact and the real appreciation of the dram will be minimized. Macroeconomic challenges will also arise if grant financing is used to substitute for domestic revenue mobilization or if it leaks into public consumption – these would pose a danger to fiscal sustainability over the medium term.

62. On the institutional side, the appropriate budgeting of inflows and the selection of projects to reflect high priority needs as identified in the PRSP action plan as well as careful management of the public investment program are essential if absorption is to be efficient and not wasteful. Moreover, infrastructure constraints to efficient absorption will be eased if priority is given – as envisaged – to addressing needs in the transport and water sectors (especially in rural areas) and to addressing risks in the energy sector.

63. There is a concomitant need to ensure high *quality in public expenditures*. Over 2005-06, a large increase in teacher salaries will take place, as current salaries are grossly inadequate to attract quality services. This increase is related to productivity increase (pupil-teacher ratio rises). In subsequent years, expenditures must shift from wages to items that enhance service quality, as envisaged in the medium term expenditure framework, such as curricular reform and education aids, broadening of education services, primary health care, and the real rate of the poverty benefit and its sharper targeting. A strategic approach to capital spending based on an overall public investment plan that explicitly makes sector choices is also necessary, particularly in the context of the MCA disbursements.

64. **The budget for 2005.** The draft of the budget prepared by the government that will be presented to parliament in early November is consistent with the MTEF and with the goals of the PRSP. The budget envisages a rise in the tax ratio by 0.4 percent of GDP, provides for a switch in expenditures towards education, health and social protection, and limits the deficit to around 2½ percent of GDP. However, as the share of capital spending in the budget is estimated to fall in relation to 2004, the authorities would be advised to scrutinize whether some lower priority current expenditures could be reallocated to investment. The budget does not contain estimates of donor financed capital spending as these are as yet not known, but as earlier noted, these could be expected to be substantial in 2005.

Strengthening Governance and the Fight Against Corruption

65. The ranking of Armenia in Transparency International's corruption perception index – 82nd out of 146 countries in 2004, whilst creditable among the CIS group, is still disappointing as Armenia performs more poorly than its transition peers in the Baltics, Hungary or Slovenia. Corruption remains a serious constraint to efficiency in private

sector activities and to a distortion-minimizing and fair revenue raising. Moreover, it distorts competition and incentives to efficient resource use. In public belief and in government reports, fighting corruption is reckoned to deserve high priority.

66. Corruption as measured by frequency of bribes has diminished mildly between 1999 and 2002, but not corruption as indicated by degree of state capture by vested interests. Costs of corruption are particularly high where the tax and customs authorities or the courts are involved and in the issuing of permits. The indirect costs of corruption (i.e., expenditures excluding bribes) are perceived to have risen in the 1999-2002 period.

67. At end-2003, the authorities adopted an anti-corruption strategy with a three year action plan with the principal measures proposed being legislative (penalties for corruption), tax and customs administration reforms, reforms in the judiciary, and raising of public financial audit standards with a greater role for parliament over audit. A high level council has been established to ensure implementation of the action plan, and participatory consultations and monitoring are envisaged.

68. As measured by the Bank's recommended practice on combating corruption¹², the overall approach of the official anti-corruption strategy is a sound one. The strategy covers key issues in public sector management reforms, in actions on building up a competitive private sector and addresses elements of the political and public accountability and the civil society voice and participation agenda. But there are gaps. Specificity in measures will be essential, and ways of effective implementation and monitoring will have to be found. Tracking progress on the anti-corruption agenda will remain a key part of the dialogue with the Bank now and over the medium term.

69. An important anti-corruption measure would be the introduction of electronic (digital) signatures and the legal acceptance of *electronic documents and signatures*¹³. This would reduce the interface between public officials and individuals or companies, reduce the role for the exercise of discretion and diminish corruption opportunities, besides increasing efficiency within the public sector and the economy as a whole. In 2004, the government submitted to parliament a Law on Electronic Document and Signature; upon its passage, the drafting of secondary regulations would follow. It is expected that the law would be in implementation by PRSC-II.

70. The *four major areas of reform in public administration* to be supported by the PRSC have been selected by the government for the expected impact of reforms on diminishing corruption, easing the burden of mal-governance on business activity, and raising the quality of public services – tax administration, customs administration, irrigation and drainage, and fiduciary functions of the government.

71. *Strengthening tax administration*¹⁴. Despite steps taken in the recent past to strengthen tax administration – introduction of tax manuals, identification numbers, an

¹² See, for example, "Anti-Corruption in Transition 2", (ECA Region, World Bank, 2004), Box 4.1.

¹³ Matrix, 1.2.

¹⁴ Matrix 1.2 (a).

information website, revisions to the criminal code and to audit practices – tax administration represents a serious impediment to the efficient raising of revenues, to probity in government and to business activity. The three key reform actions to be supported by PRSC have been chosen on the basis of the expected impact on the criteria outlined above – efficiency, probity, and business impact.

72. The large taxpayer unit reform. A Large Tax Payer Unit (LTU) was established in early 2003 to administer about 200 taxpayers based on the size of their turnover and taxes paid. Improvements in the functioning of this unit are necessary, particularly in the areas of audit function and collection enforcement and other operations. Moreover, management practices and the culture in the tax authority should be directed towards making more intensive use of this unit, particularly as the tax yield from the large tax payers accounts for a large share of revenues. It is intended to build up audit capacity through merging the central audit operations in the LTU, to establish a program of comprehensive audits that will give appropriate attention to significant issues such as tax losses, transfer pricing and foreign ownership concessions, to develop expertise in arrears management and to refine VAT refund processing based on risk profiling of claimants. Moreover, it is necessary to remove the restrictive limitation on the time period in which tax compliance audits of large taxpayers have to be completed in the interests of effective tax enforcement.

73. Introduction of self-assessment. The government has adopted a strategy for the development of a self-assessment tax system and its introduction over the next year. Through self-assessment, direct contacts between tax collectors and taxpayers will be reduced or eliminated and timely tax payments fostered. This reform will require taxpayer education and assistance – additional tasks for the tax administration – as well as the development of selection criteria for initiating risk-based audits and the analysis of results of risk-based audits of selected sample of taxpayers in order to identify noncompliance factors.

74. Improving tax practices through reduction in arrears. A large stock of VAT refund obligations to exporters has been built up, largely in order to help bolster tax revenues, and it is the intention of the authorities to permit no buildup in fresh arrears and to gradually diminish the stock in line with a quantitative program agreed with the Bank. This task will require skill at dealing with fraudulent claims, but the elimination of such arrears will help exports and benefit their competitiveness. In addition, a large stock of tax arrears (\$200 million), with 17 enterprises accounting for about 70 percent of the arrears, have been tolerated by the authorities over a prolonged period. The quantitative program agreed with the Bank reflects write-offs of uncollectible claims and measures to deal firmly with the emergence of new arrears.¹⁵

75. Other measures. In addition, the authorities intend to take supporting measures¹⁶ over the reform period to address the weaknesses in tax administration identified through annual business surveys. Most burdensome are the extra-legal demands on businesses for

¹⁵ Letter of Development Policy, paras 12-13.

¹⁶ Letter of Development Policy, para 31.

advance payment of taxes, the frequent changes in rules and rates, inadequate information, and capricious inspections and audits by tax authorities. Surveys have highlighted as problems bureaucratic foot-dragging and rent seeking, lack of competence of officials and excessive paperwork. Measures proposed to address these weaknesses are (i) the adoption of legislation to establish a system of on-line company registration, and to integrate the business registration, tax registration and social insurance registration procedures into a single registration form; (ii) the abolition of the illegal practice (currently widespread) of the tax authorities forcing companies to make advance payments with respect to future tax obligations; and (iii) government commitment to consult with business and civil society in advance of tax changes, wherever possible.

76. ***Strengthening customs administration***¹⁷. Though various structural improvements have taken place in customs administration – salary rises to attract higher quality and honest staff, information outreach, modern software – the system is plagued with inefficiencies and a high degree of discretion in service provision. Clearance procedures remain archaic, staff productivity low and obtaining certificates or permits is costly. The reform program introduces transparent and swift procedures destined to facilitate trade while safeguarding revenue collection. The key steps supported by the PRSC are:

77. Implementation of self-declaration and direct trade data input, through which the direct interface of traders and customs brokers with customs officials will be reduced. Under the PRSC supported program, the government has introduced the ASYCUDA broker and Direct Trade Input (DTI) modules. For those operators without the possibility of handling DTI from their premises, a kiosk facility is to be shortly established in all Customs houses networked into ASYCUDA. The system provides for immediate validation of acceptable declarations.

78. Selectivity of customs control. This is a measure intended to reduce discretion and lower business costs. Through the introduction of the ASYCUDA selectivity module at all networked customs locations and the adoption of a green channel (i.e., release without any checks subject to criteria determined by customs), it will be possible to give automaticity and predictability in clearance of goods. Targets for the green channel are 60 percent of declarations immediately, 70 percent after one year, and at least 80 percent after two years.

79. Post-control audit functions. To support the above reforms whilst safeguarding revenues, it will be necessary to establish risk management systems and practices and to strengthen skills in the post control audit unit of customs. The government has strengthened the Post Clearance Audit (PCA) unit in customs by increasing its current staffing and by providing training.

80. Reference prices. The customs service relies to an undue degree on the use of reference (or minimum) prices for the valuation of imports as opposed to transactions prices. Whilst such a step is necessary to counter fraud and false declarations, there is the

¹⁷ Matrix, 1.2 (b).

danger of abuse of discretionary power. Valuation is subject to WTO guidelines. The government is committed to increasing the share of imports for which the approved customs value is determined on the basis of the declared transaction price.¹⁸ The valuation unit in customs has to be strengthened in order to administer the reformed process, carry out research on price ranges, and support the Post Clearance Audit unit.

81. Other measures. The authorities have announced additional measures¹⁹ intended to raise customs efficiency and fight corruption. These relate to streamlining procedures, such as for obtaining certificates of origin for exporters by: introducing a single nominal fee to reflect the administrative cost of issuing the certificate of origin for all goods, decreasing the number of trade and simplifying the current requirement of examining and testing goods. The use of standardized metrological certification will facilitate exports.

82. ***Improving governance in irrigation and drainage***²⁰. Given the importance of irrigation for growth of agriculture -- a key sector of the economy -- efficient public administration in irrigation and drainage is of particular importance. Within the government, management of the existing irrigation infrastructure (that supports irrigation of 190,000 ha) has been separated from responsibility for the primary and secondary drains. At present, responsibilities for irrigation development, operations, maintenance and rehabilitation resides with the inter-governmental Water Resources Management Committee (WRMC), which plans and programs new investment and maintenance activity, as well as oversees construction and contracts. Responsibility for drainage works, however, resides with the ministry of agriculture. This bifurcation of responsibilities has bedeviled coordination, with the result that drainage works are underfunded and under-invested in.

83. Authority to manage the irrigation system (primary, secondary and tertiary canals) has recently been devolved to 54 regional water users associations, aiming to provide users with more control and to improve accountability. However, the transition from centralized management is proving difficult, given the limited technical and financial capabilities of these groups. Especially needed are training in water management and systems O&M, basic accounting and financial management and control. The government is committed to: (i) merge state-level responsibilities for irrigation and drainage to a single central agency – a process that will be completed in early 2005, and (ii) commence implementation of the training program for the management and staff of Water Users' Associations.

84. ***Improve public expenditure management functions.*** The reforms supported by the credit represent a continuation of efforts of the recent past and aim at achieving greater budget transparency and accountability, improving budget planning and expenditures; and strengthening the public procurement system.

¹⁸ Letter of Development Policy, para 14.

¹⁹ Letter of Development Policy, para 14.

²⁰ Matrix 1.2 (c).

85. **Budget management**²¹. The government in recent years has eliminated budget arrears, improved the classification of expenditures, including the multi-sectoral donor program, and completed an assessment of the utilization of extra-budgetary funds. It has also amended the law to integrate the Medium Term Expenditure Framework (MTEF), based on the PRSP process, in the annual budget in order to strengthen the links between policies and expenditure allocations more explicit and facilitates the expenditure rationalization process. Despite good progress in budget management system, the government reform program aims at further improvements in: (i) budget classifications and public sector accounting standards, (ii) program budgeting, (iii) financial management and reporting by the State Non-Commercial Organizations (SNCOs), (iv) institutional arrangements for internal and external audits, and (v) local government budget management system. The proposed PRSC supports reforms in these areas.

86. Budget classification and public sector accounting and reporting standards. The government plans to improve the quality of budget reporting through adoption of new structure of budget classification based on GFS 2001 principle and develop new chart of accounts, accounting standards and reporting for the public sector; the 2007 budget will be based on these principles and accounting standards.

87. Internal audit. Currently, internal audit functions are absent in line ministries; they are carried out by the finance ministry. The government plans to prepare and adopt a strategy and an action plan for internal audit structures within the executive branch of the government aimed at establishing a system of internal audit and control in line ministries and agencies. The government plans to choose pilot line ministries where pilot internal audit units, with new functions and responsibilities, will be established; and internal audits will be fully mainstreamed over about four years.

88. External auditing. The roles of various agencies involved in external oversight are mixed. In addition to the Chamber of Control (COC), which is the main external audit agency under the national Assembly, there are at least three other important control agencies. These are the Supervision Service of the President (SSP), the Supervision Service of the Prime Minister (SSPM) and the Financial Supervision Department (FSD) of the MOF. The government intends to develop a concept paper to improve the legal and operational framework of the public external audit and control systems. It will enhance the independence and effectiveness of the parliamentary COC as the main external audit agency, and streamline the existing systems of oversight functions of other supervision services. This initiative will be largely strengthened by the revision of some provisions of the law on the COC that will strengthen its independence. The PSMP will provide the necessary technical assistance and office equipment to strengthen the capacities of the COC.

89. Non-commercial enterprises. Following recent decentralization reforms in the social sector, a large number of budgetary institutions in education, health and cultural sectors have been granted autonomy and have left the Treasury financial accounting net. This implies an *ex ante* loss of control by Treasury on commitments and expenditures and

²¹ Matrix 1.3 (a).

also, in the absence of an adequate financial reporting system, an *ex post* lack of supervision and control. The need to introduce a comprehensive reporting system for NCOs and to minimize the potential fiscal risks while benefiting from the decentralization reforms was highlighted in the World Bank Public Expenditure Review and Country Financial Accountability Assessment reports.

90. The government is committed to minimize the potential fiscal risks of the NCOs through improvements in their financial reporting and monitoring systems. The necessary legal framework for NCOs reporting has been established and the administrative responsibility of monitoring these reports has been given to the finance ministry. The government plans to adopt a strategy for sanctions of non-compliance with financial reporting requirements of the NCOs and issue warnings to non-complying NCOs. The interim and annual financial statements of all NCOs will be published in the MOFE's website and sanctions will be introduced on non-complying NCOs.

91. Other measures. Additional reforms²² relate to (i) *program budgeting*, where the government has taken some initial steps in 2003-04 budgets to introduce elements of social sector program budgeting through collection of information on program descriptions and performance indicators. The government adopted a time-bound action plan to pilot program redefinition in several ministries and intends to extend this to all budget agencies by the 2007 Budget; and (ii) strengthen the capacity of *local governments* in budgeting, execution and reporting the government plans to develop and implement a strategy on local-self-government budget management system. Some of the issues planned to be addressed by this strategy include: (a) enhancing accountability and transparency in local governments budget execution; (b) strengthening the legal framework to improve local government budget management systems, (c) assessing the possible financial impact of the ongoing transfer of the full property and land tax to local self-government; and (d) regulating the incentives for the formation of sustainable inter-community unions (ICUs) as public entities, and their fiduciary responsibilities.

92. **Improving public procurement systems²³.** The public procurement system remains highly centralized and all public procurement above certain levels is coordinated and carried out through the State Procurement Agency (SPA). It suffers from considerable potential risks of reduced transparency. The government has already established a procurement website where most of legislative documents are placed. However, publication of procurement notices and contract award notices are in paper form through the Bulletin. The government plans to create an e-procurement system and a unified automated procurement system, including an electronic version of SPA's catalogue for periodic procurement. The government also plans to make these documents available in the MOEF's website and establish a registry system for contractors in goods and works and post these in the website. The technical assistance requirements for introduction of and implementation of the e-procurement program will be provided through a combination of support provided under the World Bank IDF grant on public procurement, World Bank PSMP, other donors, and in light of experience with e-

²² Letter of Development Policy, paras 18 and 21.

²³ Matrix 1.3 (b).

procurement in other countries, through appropriate twinning arrangements other procurement agencies.

Expected Results

93. National output is projected to grow by 25 percent over the 2004-07 period, with income per head approximating \$1250 in constant 2004 dollars. Inflation is expected to be kept below 3 percent (end of period basis) throughout 2004-07, consistent with fiscal deficits in the 2-3 percent of GDP range, on the basis of tax revenues rising from the equivalent of 14 percent of GDP in 2003 to 17 percent of GDP in 2007.

94. Key institutional outcomes are expected to be the attainment of international standards in customs control, the adoption of GFS budget definitions, the internal audit system being fully in place, external audit being functioned, non-commercial organizations complying with financial reporting requirements, and electronic procurement introduced.

Theme 2: Sharpening Competition and Entrenching Property Rights

95. The private sector – amounting to 80 percent of GDP today – has been the locomotive of stellar growth over the past near-decade. Its performance has benefited from macroeconomic stability and infusion of external investment and technology, as well as from a liberal trade regime in goods and from improvements in the cost of doing business. The maintenance of growth at the potential rate of the economy over the medium term will require gains in competitiveness. The major sources of such gains are those arising from liberalization in key services (aviation, railways, telecommunications) and in continued reform in public utilities – both of which will have an important effect in lowering costs of production and export. Gains will also arise from higher confidence in property rights that is importantly expected to lower the cost of financing for firms, from further development in banking and capital markets, and in addressing the remaining constraints to business.

Sharpening Competition

96. There remains a serious lack of competition in some sectors of the Armenian economy, particularly in sectors that relate to imports and distribution. Excess regulatory and administrative costs and inspection are still major problems. The authorities have set in place the basic elements of protection of economic competition in the Commission for Protection of Economic Competition, but this body lacks powers to enforce its own judgments except through the courts. The government is committed to strengthening the Commission²⁴.

97. Liberalization in civil aviation. Armenia has experienced a sharp drop in its trade transported by air in recent years, despite its landlocked nature and closed borders with two of its neighbors. The cost of air cargo in Armenia is much higher than that in other

²⁴ Letter of Development Policy, para 24.

landlocked countries such as Kazakhstan, Kyrgyzstan or Mongolia or the semi-landlocked Turkmenistan. Such high costs have caused a relative shift towards road transport (despite poor infrastructure) and even railways. Exporters are placed at a disadvantage, particularly in, for example, the apparel and textile sectors.

98. A reform of the restrictive aviation policy would greatly assist the competitiveness of exports, generate new output in goods and services (such as tourism) and may lead to the emergence of the country as a regional transport hub. The authorities have announced their decision to liberalize civil aviation services by widening participation of carriers and other services, cutting costs and thereby raising efficiency in the provision of services. This policy declaration will be translated into the adoption of liberalization policy measures upon the completion of studies of policy options, with the assistance of the Bank, within a year. Existing commercial contracts with private air carriers will be respected. In the implementation of liberal air services policies, particular attention will have to be paid to airport economic regulation (tariff setting and competition policies in airport related service, including cargo terminals), air navigational services (e.g., determination of user charges) and institutional capacity building. The liberalization of air services is expected to generate employment on a significant scale, not only in civil aviation and airport and ancillary services, but economy-wide through economic activity (especially export) generation.

99. Liberalization in railways. Railway services suffer from serious inefficiencies -- poor service quality, low speed, and non-transparent and non-flexible tariff-setting practices as well as costs associated with dilapidated infrastructure -- to the detriment of competitiveness. The company suffers from the dominance of non-commercial factors in its operation, lack of clear delineation in policy-making, regulatory and management functions, and related lack of incentives for improving efficiency and profitability. In cooperation with the Bank, the authorities have developed a business plan for strengthening railway services. They now intend to take steps in the critical areas of corporate governance and tariff setting.

100. The government has taken a decision to accord managerial and operational autonomy to the railway company by severing its reporting requirement to the ministry of transport and to constitute an independent board of directors representing a cross-section of society that will exercise oversight and ensure adherence to management contracts. Tariff setting will take place on an objective, auditable method, utilizing the point-to-point cost model, for passenger and freight services, with the method being publicly available. Discounts for large customers would be permitted. The railway company would file tariffs and proposed tariff changes with the Public Service Regulatory Commission (PSRC) at least six days in advance of changes taking effect. The PSRC may hold public hearings on tariff changes and, ultimately, propose remedies if it is not satisfied with the tariffs proposed. Any subsidies granted for social reasons or to take account of externalities would be financed from budgetary transfers. The ministry will be responsible for sector policy making and ensuring compliance with safety and security requirements. A thriving railway will be positioned to attract investment and prepare for the rich prospects once borders are allowed to be fully open.

101. **Regulatory reform in state owned utilities²⁵.** The utility sectors have undergone deep reforms in recent years, and there is today extensive private sector participation. Following the successful experience with the energy regulation, regulatory functions in the drinking water, irrigation and telecommunication sectors were transferred to PSRC – there is thus a unified regulatory body that will also be responsible, as noted, for rail tariff setting. The Integrated Financial Rehabilitation Plan (IFRP) for public utilities (electricity, drinking water, irrigation and urban electric transport), recently adopted, is intended to guide policy and reforms. It envisages ultimate commercialization of the utilities.

102. In the power sector, the successful privatization of the distribution company has led to large reduction in sector losses and elimination of quasi-fiscal subsidies. However, transparency is lacking in the mid-stream of the power sector (mainly the wholesale purchasing company, Armenergo). As a result, despite timely payments for electricity by the privatized distribution company to Armenergo, payments of Armenergo to the generating plants have been non-systematic and often delayed, with the related accumulation of debts.

103. The regulatory framework. The PRSC supports the implementation of the IFRP, with particular emphasis on corporate governance, independent internal and external audit mechanisms, establishment of rules for service provision and of mechanisms to monitor service quality, and the publication of performance data of these entities by the PSRC. The reforms provide for the removal and subsequent liquidation of Armenergo and establishment of a direct contracting mechanism between the electricity distribution company and the generators to enhance the transparency of the sector operation, ensure timely payments to generators and prevent future accumulation of debts.

104. Telecommunications. Telecommunications infrastructure is currently one of the least developed in the CIS, despite having been amongst the earliest of the CIS to privatize. Indeed, the 15 year monopoly granted to the private investor, coupled with the government's ineffective regulation of the operator, has led to severe underinvestments and stifled growth even in mobile, where penetration ratio in Armenia is one-tenth that of its neighbors. The extremely high cost and poor quality of telecom services has handicapped the country in production and exports. However, the government is now intent on ending Armentel's monopoly and issuing a new mobile license. In parallel, the government has drafted a new telecommunications law, which will open up some segments of the market to competition, notably in the areas of mobile telephony and Internet, and has tasked the PSRC with telecom regulation.

105. To ensure that implementation of all these reforms is well-directed and clearly communicated to the public, it is important for the government to develop a new telecommunications sector policy and reform strategy, to guide the implementation of all these reforms. Once this policy has been widely discussed, the main policy and

²⁵ Matrix 2.1 (b).

regulatory principles guiding the licensing and regulation of new operators will become clear, leading the way to a smoother implementation of new legislation and the necessary implementing regulatory instruments. A modern regulatory framework will do much to remove the competitive disadvantage faced by the country today.

106. Other measures. The authorities are taking a range of *additional measures*²⁶ to strengthen the business climate. The recent business survey²⁷ highlighted that, in spite of reduction in the amount of time and money necessary for official *registration and licensing*, these do not yet correspond to the requirements for a modern business environment and are substantial factors limiting the entry of new enterprises and new investments. Based on the results of the survey the authorities are in process of developing a time-bound action plan in consultation with the private sector representatives²⁸ to remove administration barriers in the Armenia.

107. Armenia has developed a framework for *private sector financial accountability* including: Accounting Standards of Republic of Armenia (ASRA), new accounting and auditing laws, transparency rules for publishing financial statements, and legislation on penalties for false accounting and non-compliance with reporting requirements. However, the compliance remains a problem mainly due to: (i) capacity weaknesses as it relates to weak accounting profession, (ii) lack of educated users of financial information, and (iii) weaknesses in the present regulatory system and institutional enforcement capacity. In this context, over the medium term, the government aims to initiate steps to update the ASRA in accordance with recent changes in the International Financial Reporting Standards (IFRS), and require listed companies on the Armenian stock exchange and insurance companies to be subject to IFRS by 2006. In addition, the government is now committed to development of a set of *auditing standards*, which will closely reflect International Standards of Auditing (ISA) and promoting the development of audit associations to carry out the education, training and discipline of professional auditors.

108. The just-promulgated *Labor Code*, which corresponds to the international best practice, regulates the relations between employees and employers. To implement it, the government needs to develop and adopt the secondary legislation, which includes detailed regulatory procedures. In addition, despite the significant growth of exports from Armenia to non-CIS countries, lack of adequate *standards, and metrological certification* remains an impediment to access to these markets, especially for food and agro-processed products. At the same time, the government is in the process of adopting a package of law on standards and metrological principle. The World Bank Public Sector

²⁶ Letter of Development Policy, para 31.

²⁷ Fourth administrative regulatory and administrative costs survey was developed in partnership with the FIAS. The survey conducted research on two levels: 1. Desk research, to identify existing legislative requirements related to the main regulatory fields of the study, also to present any legislative changes that have occurred since the previous Armenia Regulatory and Administrative Costs Survey, October – December 2002; and 2. Field research, to gather and analyze primary data from 300 Armenian enterprises.

²⁸ The forum used for the development of action plan is the Investment Commission, chaired by the Prime Minister.

Modernization project will support the authorities with the development of secondary regulations and the implementation of the standards and purchase of equipments.

Entrenching Property Rights²⁹

109. The chief deficiencies in the area of property rights stem from weaknesses in the enforcement of collateral – a factor that has hobbled the development of the financial sector and raised the cost of capital for firms. Moreover, financial intermediation has been damaged by inadequate confidence on the part of deposit holders arising from inadequate supervision over banks and non-transparent corporate governance in banks. The share of banking system assets and liabilities in relation to GDP in Armenia is amongst the lowest in the CIS countries. Business surveys reveal that nearly three-quarters of firms report lack of financing as a major constraint to growth. Property rights will also be bolstered by capital market growth, particularly, insurance products. The key reforms being supported by the PRSC are:

110. Secured transactions³⁰. Credit risk is still a disproportionate impediment for lenders, and banks are constantly in search of ways to manage the level of risk – through high collateral requirement, guarantors, and short lending periods, and risk is priced into a high bank premium on the lending rate. Through legal and judicial reforms directed at strengthening the procedures and shortening the timeline for collateral registration and foreclosure, the authorities aim to improve the lending environment. Today, arbitration decisions are not effectively implemented and judiciary lacks capacity in the realm of commercial contracts.

111. The principal reform actions being taken, in line with the Model Law of 1994 of EBRD, are far reaching amendments on: (i) procedural rules for the creation, registration and enforcement of security interests over property; (ii) civil procedure court with respect to court proceedings for debt collection, to protect creditors' rights and prevent debtors from unduly delaying execution; amendments to the Law on Compulsory Enforcement of Court Decisions and Law on Public Auctions to improve enforcement of court decisions; and (iii) legislation to simplify procedures for certification by notaries of property sales and registration of secured credit.

112. Over the medium term, the authorities are committed to establishment of a centralized registry for collateral to be used by courts by: (i) developing the Registry Law (Regulations), (ii) implementing the infrastructure for a viable secured interest registration, (iii) training of judges, and (iv) undertaking a public awareness campaigns. Policymakers have recognized the importance of credit registry and bureaus to establishing credit history for borrowers and reducing the credit risk for lending institutions.

²⁹ Matrix 2.2.

³⁰ Matrix 2.2 (a).

113. Banking system.³¹ Despite recent improvements in banking supervision, there remain a major set of unfinished tasks, comprising (i) shifting the primary approach of bank supervision from compliance-based supervision to the evaluation of risks undertaken by banks and risk management systems; (ii) strengthening communication with bank management and monitoring bank operations on a continuous, proactive basis; (iii) introducing and developing an early warning system; (iv) integrating all aspects of banking supervision (off-site, on-site, licensing, etc.); and (v) implementing consolidated supervision of financial groups that include banks.

114. To support this set of tasks, the authorities have requested an FSAP update in early 2005 to follow a donor-financed selective review of supervision currently under way. Reform steps will be developed in light of the FSAP update.

115. Corporate governance in the banking system in Armenia is particularly weak. Governance is often not institutionalized but depends on one person, usually the CEO, who heads the management board if there is one, or the chairman of the board of directors, typically the dominant shareholder. The authorities have initiated a dialogue with the banking community to bring the laws, procedures and policies in line with the basic rules on corporate governance based largely on the OECD Principles, which at the minimum require independent directors, committees of the board—audit, governance, compensation, adequate information to the board from management on bank activities, the publication of timely information on material developments affecting a bank and shareholder approval of equity compensation of management.

116. These rules seek to enhance accountability, integrity and transparency that could benefit many Armenian banks. A proper system of corporate governance depends importantly on the competence and integrity of directors and the new rules introduce checks and balances, give directors better tools to enhance proper performance, and allow shareholders to more easily monitor the performance of companies and their directors.

117. Insurance markets.³² The insurance sector in Armenia is as yet small and an underdeveloped sector will handicap growth. There is a latent demand for basic insurance products and for liability insurance, some of which is served through imports of services. The task of government is to create the regulatory and supportive environment for the emergence of a private industry and the authorities are committed to this objective. The government has recently adopted a new Law on Insurance which sets the basis for further reforms in the insurance legislation. The next step is the development of prudential regulations as well as returns and quarterly interim financial statements for insurance companies reflecting international best practice but also respectful of the current nascent state of the insurance sector in Armenia.

118. The insurance inspectorate is understaffed and under-funded and has no formal training program. This limits the range and quality of services rendered to the industry. Few actuaries are available in the country and current funding would not allow the

³¹ Matrix 2.2 (b).

³² Matrix 2.2 (c).

Inspectorate to retain highly skilled staff. No dedicated software is available for the analysis of the market and all information is paper-based. To strengthen the Insurance Inspectorate, efforts should be made to introduce a new set of skills among supervisory personnel and to recruit and train a more qualified and professional staff of insurance supervisors. As an institution, the inspectorate should be independent of government influence and should operate as an autonomous public agency; the government intends to establish an independent insurance inspectorate by 2007.

119. Other measures. In addition,³³ the authorities intend to develop the *electronic payments system* by designing the legal framework for electronic transactions, fraud prevention, risk management, and clearing and settlement as well as rules governing access to the retail payment system and clearing and settlement. A draft law is under study.

120. Furthermore, initiatives are being taken to widen the provision of *micro-finance services*, especially in rural areas. In recent years, micro-finance operations have expanded quickly (disproportionately in urban areas) and are already demonstrating a potential for channeling rural household and micro-enterprise resources into non-farm investments and employment generation. Small businesses and households make up the bulk of borrowers, seeking loans to serve working capital, small investment and supplementary household liquidity needs. To create a sound enabling environment and more secure bases for micro-finance operations, the central bank has made the regulatory regime less burdensome. In practice, however, there remain several constraints to effective microfinance. The government will encourage micro-finance institutions to establish their lending arms as “credit institutions” within the framework of existing legislation, under the corresponding oversight of the central bank. The central bank in turn will ensure that its supervision of MFIs, under CB Regulations 14 and 15, will conform to standards set forth by the Consultative Group Against Poverty.³⁴

Expected Results

121. The improved competition environment will be evident in a sharp fall in transport costs in aviation and rail services and in quality gains in utilities services in line with quantitative indicators (to be specified at appraisal). The entrenchment of property rights is expected to lead to an expansion of financial intermediation with increases in credit extended (as costs and risks associated with secured transactions fall) and in deposit mobilization by banks (as confidence grows). A near four-fold rise in insurance activities is expected.

Theme 3: Mitigating Social and Environment Risks

122. The period of early transition saw Armenia face social and environmental risks of unprecedented magnitudes – the collapse of Soviet institutions and fiscal transfers

³³ Letter of Development Policy, paras 38 and 40.

³⁴ CGAP Donor Resource Information Center: “Guiding Principles on the Regulation and Supervision of Micro-finance”, Washington: June 2003

together with natural disasters led to a sharp rise in poverty and declines in human capital formation, social protection, and quality of natural resource use. Public spending on social sectors fell drastically, energy shortages and rise in unemployment, together with a shift to subsistence farming, placed great strains on natural resources, particularly forests. In the current late transition phase, these problems have evolved such that policies now have to address not the acute, initial adverse impacts, but rather the need for sustainable solutions over the long term.

123. Thus, despite strong gains in poverty reduction, vulnerable population groups will continue to require well-designed social protection programs and key medium term challenges lie in ensuring adequate functioning of the public pension program and devising the environment for private pensions. The second generation reforms in education and health lie in ensuring rising quality of service provision, aiding human capital formation in high pay-off areas such as early childhood education or an attack on communicable diseases and in creating the conditions for private participation in insurance. The mainstreaming of environment factors into sector policy formulation and re-shaping policies to reduce degradation and reduce the vulnerability of the poor to natural calamities lie at the heart of reducing environmental risks. The consolidation of macro stability and poverty reduction has reduced pressures on non-sustainable exploitation of resources for subsistence, but were forest legislation not enforced, risks would worsen.

Improving Social Protection and Social Risk Management³⁵

124. The steps taken in the recent past to focus social protection system on the most vulnerable and to improve efficiency and affordability – the replacement of a fragmented system by a proxy means tested cash family poverty benefit; significant rise in resources to finance this benefit; adoption of a pension reform strategy; and various administrative reforms – has greatly heightened the effectiveness of the social protection system in assisting the poor and vulnerable cope with economic and social hardship. The family poverty benefit is a well-targeted and administered benefit. The PRSP and the MTEF give importance an efficient, well-administered and adequately funded social protection system for poverty alleviation and reduction. Accordingly, the PRSC-supported reform program envisages a range of measures, including commitment to a significant shift in budgetary outlays for social protection that would substantially enhance the ability of the system to alleviate poverty alleviation through improving service delivery and building up monitoring and evaluation capacity.

125. Family poverty benefit. In the area of *social assistance* the policy focus remains on the family poverty benefit as the most important poverty alleviation tool through: (i) rise in budgetary allocation over 2005-2007; (ii) differentiation of the benefit amount according to family social parameters; (iii) a review of the targeting formula, so as to allow for improvements in the benefit targeting efficiency and effectiveness; (iv) continued monitoring and evaluation of the program's poverty impact; and (v) further

³⁵ Matrix 3.1.

improvements in benefit administration, including staff training and improvements in the management information system.

126. **Pensions.** The reform program focuses on improvements in service delivery through capacity building of the public pension's administration, including introduction of the MIS with individual records, improvements in financial management, development of the policy analysis and modeling capacity, and improvements in the governance of the State Social Insurance Fund. It also envisages a real increase in pensions, so as to ensure that public pensions play adequately its role as a poverty protection instrument in the old age. In addition, the authorities will develop the legal and regulatory parameters for voluntary private pension plan provision -- an important step towards the pension system diversification.

127. Despite a doubling of pensions in nominal terms during the last three years, pensions remain low in comparison to wages. A key to sustainable increase in public pensions is implementation of recently adopted Public Pensions Law and successful completion of a comprehensive set of measures currently under implementation aimed at improving capacity of the State Social Insurance Fund, including introduction of the MIS with individual records as its key element. The sound design and adoption of a law on private pensions is an important element of overall pension reforms.

Raising the Quality of Education³⁶

128. Access to basic education is good, with a net enrollment rate of 92 percent in 2001. In contrast, the net enrollment rate in secondary schools is only 61 percent, and even lower for the poorest quintile (52 percent). In tertiary, enrollment is high relative to other countries at this level of GDP per head, at 38 percent. Enrollment in early childhood education has fallen dramatically since independence, with approximately 18 percent of the age group enrolled, almost exclusively from affluent families.

129. Education spending, though rising, is low by international and even CIS standards. High quality textbooks are now available to all at a reasonable cost, due to an innovative textbook rental scheme, but otherwise the quality of physical inputs (infrastructure, equipment and learning materials) is poor because of the historically low levels of public investment. Overall incidence of public spending is remarkably equitable, being progressive at most levels of education and only slightly regressive in higher education.

130. The government has taken significant steps in the last few years to address some of the deep-seated problems in the education sector. The PRSC-supported reform program focuses on increasing educational attainment, raising the completion rate of secondary education and boosting teacher salaries. In this connection, the proposed outcome and interim output indicators—increase in years of educational attainment, secondary school completion rates, staff remuneration rates, and efficiency-enhancing measures are appropriate.

³⁶ Matrix 3.2.

131. The school rationalization program. The success of reforms in general education will depend critically on increases in education spending accompanied by improvements in efficiency and effectiveness of that spending. The PRSC-supported program will closely monitor the level and composition of educational spending from the public budget. Very low levels of public spending have begun to be reversed, and the 2005-2007 MTEF proposes significant, real increases in spending for each year, aggregating to 75 percent from 2004 to 2007. This is a substantial increase. Even so, at a projected 2.9 percent of GDP in 2009, education spending would be low in international terms. The effectiveness and efficiency of spending is also improving *inter alia* through the reduction of teacher numbers by close to 9,000 in the past two years. A key element of the rationalization program is further redundancies of 6,000 teachers over the next two years. The pupil-teacher ratio is expected to not fall below 14 as a result of the reforms. The government has also consolidated underutilized schools. These two steps have enabled teacher salaries to rise from their appallingly low levels, helping to motivate teachers to support reforms. Moreover, as a part of the reform program by the end of 2005 all schools will have been given financial and management autonomy.

132. Critical to sustained rise in the quality of education spending are keeping the teacher redundancy program on track with respect to its targets, adhering to (or surpassing should revenues allow) budgeted public spending increases, and ensuring significantly raised allocations in quality-enhancing spending on capital investment and non-salary expenditures. These indicators will be monitored throughout the PRSC program.

133. Early childhood education. The government has realized the importance of early childhood education to improve the life chances of young children, especially the poor. The education and health ministries have begun to develop a joint strategy, with technical assistance organized by the Bank. The PRSC would assist the government to ensure that the reform strategy was financially sustainable and focused on those in greatest need. The PRSC program would support strategy development, piloting and evaluation, and then rollout of the strategy.

134. Tertiary education. The reform challenge lies in developing sustainable mechanisms for financing institutions and students. In particular, the student financing reforms are intended to help increase access to tertiary education and target state resources at those most in need, while the institutional financing reforms will improve transparency and efficiency of spending. The PRSC program would support strategy development and then phased implementation of the strategy.

Controlling Risks in Health³⁷

135. The post-transition drastic drop in public spending on health care with an associated sharp decline in health care has meant that health facility use is one-third of that in countries with similar epidemiological profiles. Health care utilization varies

³⁷ Matrix 3.3.

significantly across income groups: is higher among urban than rural households; only 26 percent of the poorest population quintile accessed health services compared to 51 percent in the richest quintile; moreover, the poorest quintile captured only 13 percent of public health spending compared to 39 percent for the richest. The key reasons for lack of access for the poor are the overall low level of spending and lack of targeting. In 2001, Armenia's public expenditures on health care accounted for 1.3 percent of GDP that is lower than the average share of lower income countries (2.5 percent in 1999-2000). The challenge for Armenia is to provide adequate financial protection for the poor so that they could access health services when needed. To do so would require increased public funding and better targeting.

136. The central objective of the reforms being supported by the PRSC program is to enhance accessibility and quality of health services, especially for the poor. This is expected to be achieved by increasing spending in real terms on a sustainable basis (with significant part of the increased resources being devoted to raises in the reimbursements given to service providers to better cover the cost of services, thereby reducing the need for informal out-of-pocket spending by the patient), intra-sectoral reallocation of resources towards more cost-effective care modalities (such as primary health care), and through optimization and efficiency improvements in the hospital sector. The reforms also encompass strengthened governance of the health system; supporting legislation is currently under preparation.

137. Rationalization and management reforms in hospitals. Ratios of hospital beds and physicians per population remain significantly higher than in rich countries, while hospital efficiency is extremely low. The hospital sector continues to waste resources with quality of care being hampered by low service volumes and deteriorating infrastructure. In response, the government has adopted a hospital optimization plan with the aim of reaching the needed capacity with fewer hospitals. It has also recognized the need to strengthen its role in policy setting and monitoring and oversight function. The PRSC-supported program includes measures to enhance the efficiency of the planning, budgeting, and oversight functions of medical institutions. The ministry of health has prepared an action plan to improve governance in public hospitals.

138. Primary health care. Chronic under-funding of the network of rural ambulatories and urban polyclinics that provides primary health care has meant that the system is unable to the needs of population for essential health services. The strengthening of the primary health care system as an effective and affordable alternative for hospital care is a high policy priority. In this area, the PRSC supports (i) completion of the training of family physicians and nurses to ensure coverage for the entire population with family medicine teams; (ii) further improvements in provider payment mechanisms to increase incentives for provision of quality care by PHC; and (iii) integration of outpatient specialist services with hospital services and with social care providers. The authorities have undertaken to implement measures for secured financing and management of independent family medicine group practices and introduction of choice of family physicians.

139. Private insurance. The authorities intend to develop options for private insurance to broaden the range of financing option. Such schemes could cover certain health risks or certain population pools. Should the affluent be attracted to private risk pooling options, the government would be better enabled to target public resources disproportionately to the poor.

140. Non-communicable diseases constitute the bulk of the burden of ill health. Access to essential drugs is critical in this context. Armenia lacks a policy to ensure access to essential drugs; rather, reliance has been made to humanitarian assistance, with state procurement being limited to few drugs (anti-tuberculosis and anti-diabetes). About 80 percent of drugs used in hospitals are procured by patients. The state-approved reimbursement rates do not cover the real costs of pharmaceuticals. The PRSC-supported program will provide for the development of a list of essential drugs and its sustainable financing, effective price regulation, quality control, and distribution. Ensuring adequate access of the poor to essential drugs will be an important aspect of this reform.

Reducing Risks in Natural Resource Management for Sustainable Livelihoods³⁸

141. Armenia still faces daunting environmental challenges such as deteriorating forest stock, inadequate water supply and solid waste services, pollution of water resources, poor urban air pollution, significant soil erosion and increasing vulnerability of rural population to natural hazards. The country's forest resources have been put under increased pressure for fuel wood, non-forest timber products, grazing and hunting. Institutional and administrative imperfections led to weak enforcement and low environmental compliance. The right of public to participate in the process of decision-making and access to environmental information is largely recognized by the current legislation. However, the systemic lack of effective implementation of these principles has undermined the credibility of environmental enforcement agencies. The role of the public, industry and other stakeholders in inducing compliance is an important part of the current plan of the government to find an effective way to strengthen the implementation of the Law on Environmental Impact Assessment.

142. The reform strategy recognizes that in the long run environmental damage will undermine the country's resources base and competitiveness of the economy. The areas of environmental vulnerability in Armenia centre on water, forests, biodiversity and access to water and sanitation to the poor in rural areas. Reforming and building a solid environmental planning and enforcement capacity of environmental institutions remains a challenge. The government has now launched systemic efforts to reverse natural resources degradation focusing on forests and protected areas. There is an increasing attention to increased participation of rural population in the management of common resources and protected areas. Thus, the national environment action plan has been prepared with extensive consultation, and wide participation has also been built into its implementation.

³⁸ Matrix 3.4.

143. Environmental impact assessment. The ministry of nature protection is committed to prepare a detailed plan which outlines the sequence of steps, main legal documents and timing for their approval. The schedule, now adopted, will include preparation and adoption of the new Environment Impact Action Law and the new Law on Environmental Supervision and Inspectorates, with critical supporting regulations.

144. National forestry policy. The preparation of the national forest policy and strategy, with wide public and user/beneficiary participation, has been completed and, following public consultations, adopted by government. A ministerial working group has been established to monitor progress with implementation and to ensure that a new law on forest code is developed. Work on adoption of regulations on forest management planning and community forest management will start soon after the forest code is adopted. The government will have to pay particular attention to linking action priorities with specific environmental goals and outcomes.

145. Illegal logging is associated with the subsistence use of firewood, largely for heating, and is linked to poverty. The net present value of the loss of wood is estimated at nearly \$100 million per year, with the true economic cost being much greater if the costs of erosion, down stream damage, lost fertility, biodiversity and forest products are taken into account. The national action plan for combating illegal logging has been approved by the government. The plan provides for incentives to switch from firewood to other fuel sources such as natural gas, biogas, and electricity; in areas where such switch is not feasible, greater efficiency in the use of fuel wood through improved wood burning stoves and improved insulation will be supported. At the same time, increased sustainable production of legitimate fuel wood in targeted communities and the planned establishment of plantations on bare lands will increase fuel wood supply and lower prices. Clearly there are close linkages in government policy between combating illegal logging and the national forest policy and codes (see above) and community forestry (see below).

146. Community forestry. The reform program provides for the establishment of community managed forests where communities are granted user rights provided sound management plans are agreed with pilot communities. The PRSC livelihood approach is to put people in the center of development thereby increasing the effectiveness of support to rural communities and tackling the non-transparent and insecure access to forest goods and services, and improve forest condition. The new forest policy of the government envisages transformation of forest resources close to communities into more manageable resource for local people when they are willing to involve themselves in activities for forest stock rehabilitation and get equitable access to resources. Local people will be given specific rights over forest management decisions and sustainable harvesting of products and will be working based on agreements between users and forest authority. The state will retain its role as a regulator and specifically will deal with externalities associated with the use of forest or forest land.

Expected Results

147. Improvements in the social risk protection framework are expected to lead to a coverage of not less than 70 percent of poor households with the family poverty benefit and a significant reduction in the leakage of this benefit brought about by greater differentiation of benefits and changes in the targeting formula. The continuation of rationalization and quality enhancement programs in education and health is expected to sharp rises in expenditures per pupil or per patient and the attainment of higher service provision standards. Legal and regulatory frameworks for the private provision of pension services and health insurance will be in place. Environmental risks will be reduced through sustainable community forestry programs being in place (along a quantitative target to be set at appraisal) and with a sharp reduction in illegal logging.

Theme 4: Modernizing the Rural Economy

148. At the beginning of transition, the implosion of political authority, decollectivization and a spontaneous, hasty land reform led to fragmentation and the rapid emergence of small mixed crop/livestock producers, operating on semi-subsistence levels and with vastly reduced commercialization. As incomes fell, in-migration from urban areas placed severe strain on the rural economy. Especially disruptive in the years immediately following independence was the unraveling of Armenia's network of agro-processors and inputs suppliers and the disintegration of state marketing agencies. The loss of assured input and output markets in the former Soviet Union severely affected farms and the residue of the agro-industrial complex.

149. Today, agriculture "employs" 500,000 people, which is nearly half of total employment and three times as many people as the sector employed prior to independence. The processing industries have begun to recover, a result of new investments, restructuring by privatized processors and some foreign direct investment. Though its sectoral share has declined as a percentage of GDP, from almost 40 percent in the early 1990s to about 20 percent today, agriculture nonetheless remains important for the national economy and, together with the associated agro-processing, accounts for much of the country's employment and non-gems export earnings. It is the main source of rural livelihoods, with farm income accounting for 51 percent of total income of rural households. Agriculture shields rural people from poverty. Food accounts for 59 percent of total rural household consumption expenditures, and much of it is self-produced or locally traded.

150. ***Stimulate farm incomes***³⁹. The reform strategy supported by the PRSC is anchored in securing farm productivity gains. Small farms can be highly efficient, but require access to productivity-enhancing inputs and technologies that also promote sustainability of land, water, pasture and forest resources. Effective market links for small farmers – to service providers and input suppliers, to traders and to the processing industry, and, to financial service providers are essential for achieving these gains.

³⁹ Matrix 4.1.

151. Productivity enhancement. The four main areas for reform are strengthening the de-centralized advisory services system, bettering the livestock services, improving access to planting material, and strengthening the management of the country's irrigation infrastructure and investments. Central to these four tasks is development of agricultural extension. The authorities recognize the need to mainstream both the provision and the financing of publicly organized farm extension. To this end, the government has established an inter-agency working group to prepare action plans to: (i) reform the organization of the applied research and agriculture extension delivery system, aiming to "mainstream" the regional and national Agricultural Support Centers and the central level PIU; (ii) improve links and information transfers between the research establishment and agricultural extension agents; (iii) augment the role of fee-for-service advisory services sourced from the private sector; and (iv) make viable the extension system over the longer-term, including the drafting of changes to the legal and regulatory framework.

152. Seeds law. No seed regulations exist today; an uncontrolled seed import and multiplication regime has ensued. In a move to restore quality, order and regularity to seed imports and distribution, and to restore internationally recognized seed certification procedures, a draft seeds law was approved by government and submitted to parliament; approval is expected by end-2004. The government will ensure that the new seeds certification procedures are put fully in force.

153. Food and phytosanitary standards. The government has not yet harmonized its food safety standards with the Codex Alimentarius, nor has it systematically encouraged wider use of internationally recognized certificates of conformance by agri-food exporters. As a result, few exporters enjoy access to EU markets, and increasingly will face difficulties exporting to their traditional markets in the CIS as CIS member states (particularly Russia) adopt the Codex and ISO certification. The government is forming a task force to develop an action plan for harmonizing food safety and phytosanitary standards with the Codex Alimentarius, while promoting the use by exporters of internationally recognized certificates of quality, especially to ISO 1700 standards.

154. Other measures. The authorities also intend to take measures to boost *off-farm employment opportunities*.⁴⁰ The rural business environment not improved apace with the urban environment, however, for reasons more related to implementation than to the absence of enabling legislation and regulations. The main constraint appears to be the perceived complexity and non-transparency of government policies, a perception that is considerably more pronounced in rural areas than in urban locales. In addition to sometimes onerous dealings with licensing agencies and local tax inspectors, the main business environment related problem that is unique to rural industries and especially to agro-processors, is the unavailability of market information and general business advisory services for new firms and emerging entrepreneurs. In particular, rural enterprises neither enjoy ready access to the (i) information and training services of the ministry of trade & industry's SME Development National Center(s) (SME/DNCs), nor to (ii) financial and legal advice of the sort available to their better located urban counterparts, nor to (iii) the Armenian Development Agency's (ADA) one-stop shopping

⁴⁰ Letter of Development Policy, paras 49 and 50.

services for new registrants. The government is committed to taking action in all these areas.

155. ***Rural infrastructure***⁴¹. One of the legacies of the Soviet Union is an extensive, and now decaying, network of rural infrastructure -- roads, telecommunications, water, and energy. Throughout the transition period, minimal recurrent expenditure on the networks has taken place, with a deleterious impact on their condition. The problem has been compounded, as in many cases, by the absence of clear lines of ownership and, hence, responsibility for the different levels of networks. The outcome is a broad mix of network quality, ranging from a small proportion of networks in a reasonable condition, usually reflecting the capacity of the local community for self-governance, to those which are completely ineffectual. Despite receiving substantial financing from donors, there is a high rate of failure among rural infrastructure interventions. This is because they are generally implemented at a local level, independently from similar, or previous, initiatives in the same or other areas of the country – a fatal defect in network activities.

156. ***Infrastructure reforms***. The improvement of rural infrastructure is recognized explicitly by the government as a key element for rural poverty alleviation, acting as a catalyst for development and enhancing access for rural communities to a broad range of essential social and commercial services. A diagnostic study approved by the government addresses the key reform actions necessary – these will be implemented in a phased manner over the medium term as a part of the PRSC-supported program. Plan implementation will be greatly assisted by the importance being given to rural infrastructure in the Millennium Challenge Account investments and through donor and private foundation programs. The investment and rehabilitation plan recognizes the need to (i) improve capacity to better coordinate with donors under government ownership and leadership; (ii) identify the appropriate and affordable levels of community access and associated technical design standards; (iii) place emphasis on improving the quality of service delivery; (v) introduce simplified standards and new technologies; and (vi) provide the correct incentives to ensure that the private sector contribution is maximized.

157. With the objectives of improving the transparency and the targeting of subsidy delivery for social reasons that are budget funded using either own resources or donor grants as well as of maximizing private sector provision of services, the potential for exploring output based aid schemes would be explored. The reform plan also calls for the involvement of the PSRC in the development of quality standards and their monitoring. This will require further institutional strengthening of the PSRC as it will need to have adequate capacity and clout to implement this set of delicate tasks, whilst also being responsible for cross-sector utility regulation at the national level.

Expected Results

158. A rural economy on the path of modernization will see, by 2007, an acceleration in productivity growth in areas served by extension services and an expansion of these services themselves in accordance with a decentralization plan. Farm output will benefit

⁴¹ Matrix 4.2.

by raised standards in seed quality and improved veterinary coverage. Both food quality and export prospects will be raised by applying the Codex Alimentarius and internationally recognized certification of exports. Farm incomes are expected to rise by a cumulative 10 percent from 2003-2007. The shift in emphasis in infrastructure services to the rural economy with associated tilt in donor financing will result in a convergence of quality standards in utilities throughout the country and, in particular, in a fall in secondary rural roads awaiting reconstruction or rehabilitation.

VI. IMPACT ON POVERTY OF REFORMS

159. An attempt has been made to simulate the impact of the reform program (being supported by the PRSC) on poverty indicators over the period to the end of the decade. Details can be found in Annex 4. The two major channels for the transmission of the effects of reforms are (i) macroeconomic and (ii) social spending. The analysis of cross-country experiences, which is consistent with the Armenian experience, suggest that high rates of growth in income per head, low inflation and rising trade openness contribute powerfully to poverty reduction. The maintenance of macroeconomic discipline together with reforms stimulating private investment will make a large contribution to continued fall in poverty in Armenia.

160. The simulations suggest that the incidence of poverty will fall from 29 percent in 2003 to around 12 percent by 2010, and the infant mortality rate will fall from 15.6 in 2003 to 14.4 in 2010 as measured per 1000 live births (Table 6). Poverty reduction effects have also been simulated for a low growth variant and for a variant with higher private investment in a stronger reform environment, corresponding to the macroeconomic scenarios presented in the economic outlook section of this report. In the low case, poverty reduction to end-decade is muted; in the high case, much sharper.

161. The transmission mechanisms between reforms and growth, on the one hand, and poverty impact, on the other, will be the subject of analytical work conducted with partners in the country over the current fiscal year. The functioning of labor markets, in particular, will be studied, using household survey data now being collected, as growth acceleration could have been expected to have had a bigger impact on employment, and poverty fall to have relied more heavily on employment generation.

Table 6. Armenia: Simulation of PRSC Impact on Poverty

	Avg.	Est.	Simulation						
	1997-2002	2003	2004	2005	2006	2007	2008	2009	2010
Base Case									
Assumptions				PRSC I	PRSC II	PRSC III			
Per capita GDP growth	7.5	13.9	7.9	5.9	5.9	5.9	5.9	5.9	5.9
GDP Inflation	5.5	4.7	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Trade Openness	72.3	81.3	78.4	79.2	80.2	81.3	82.4	83.5	84.7
Urbanization Rate	67.0	67.0	67.0	67.0	67.0	67.0	67.0	67.0	67.0
Gini Coefficient (tied to per capita GDP growth)	55.0	40.1	38.5	37.4	36.3	35.2	34.2	33.2	32.2
Education Expenditures in % of Total Expenditures	9.5	10.3	11.7	12.0	12.0	13.1	13.0	13.0	13.2
(Real change in percent)		18.8	19.8	20.0	8.0	14.0	6.0	6.5	7.0
Health Expenditures in % of Total Expenditures	5.6	6.3	7.4	7.6	7.9	8.7	9.1	9.1	9.1
(Real change in percent)		19.3	23.9	19.6	12.7	14.9	11.5	6.0	6.0
Simulation Results									
Poverty Incidence	51.8	29.1	28.3	25.6	22.8	20.0	17.2	14.4	11.7
Llteracy Rate	98.4	98.6	99.7	100.0	100.0	100.0	100.0	100.0	100.0
Infant Mortality Rate	15.4	15.6	15.3	15.1	14.9	14.8	14.6	14.5	14.4
High Case									
Assumptions				PRSC I	PRSC II	PRSC III			
Per capita GDP growth	7.5	13.9	7.9	6.9	7.9	7.9	7.9	7.9	7.9
GDP Inflation	5.5	4.7	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Trade Openness	72.3	81.3	78.7	79.8	81.0	82.2	83.4	85.0	86.7
Urbanization Rate	67.0	67.0	67.0	67.0	67.0	67.0	67.0	67.0	67.0
Gini Coefficient (tied to per capita GDP growth)	55.0	40.1	38.5	37.2	35.7	34.3	33.0	31.6	30.4
Education Expenditures in % of Total Expenditures	9.5	10.3	11.7	12.9	13.0	14.3	14.6	15.0	15.4
(Real change in percent)		18.8	19.8	29.7	12.1	17.8	11.6	11.5	11.4
Health Expenditures in % of Total Expenditures	5.6	6.3	7.4	8.3	9.0	10.0	10.3	10.8	11.2
(Real change in percent)		19.3	23.9	30.9	20.7	19.4	13.1	12.9	12.7
Simulation Results									
Poverty Incidence	51.8	29.1	28.0	24.8	21.2	17.7	14.2	10.5	6.8
Llteracy Rate	98.4	98.6	99.7	100.0	100.0	100.0	100.0	100.0	100.0
Infant Mortality Rate	15.4	15.6	15.3	15.1	14.9	14.7	14.6	14.4	14.3
Low Case									
Assumptions				PRSC I	PRSC II	PRSC III			
Per capita GDP growth	7.5	13.9	7.9	4.4	2.9	2.9	2.9	2.9	2.9
GDP Inflation	5.5	4.7	3.0	3.5	3.5	3.5	3.5	3.5	3.5
Trade Openness	72.3	81.3	78.0	77.6	77.7	77.8	77.9	78.2	78.4
Urbanization Rate	67.0	67.0	67.0	67.0	67.0	67.0	67.0	67.0	67.0
Gini Coefficient (tied to per capita GDP growth)	55.0	40.1	38.5	37.7	37.1	36.6	36.1	35.5	35.0
Education Expenditures in % of Total Expenditures	9.5	10.3	11.7	10.7	9.9	9.8	9.7	9.7	9.7
(Real change in percent)		18.8	19.3	0.0	0.0	0.0	3.0	3.0	3.0
Health Expenditures in % of Total Expenditures	5.6	6.3	7.4	6.8	6.3	6.2	6.2	6.2	6.2
(Real change in percent)		19.3	23.3	0.0	0.0	0.0	3.0	3.0	3.0
Simulation Results									
Poverty Incidence	51.8	29.1	28.6	27.3	26.3	25.2	24.1	23.0	21.8
Llteracy Rate	98.4	98.6	99.7	100.0	100.0	100.0	100.0	100.0	100.0
Infant Mortality Rate	15.4	15.6	15.3	15.1	15.0	14.9	14.8	14.7	14.6

VII. THE BANK GROUP STRATEGY

Lessons Learned

162. The main sources of lessons learned from past operations are the OED Country Assistance Evaluation (2004) and the region's CAS completion report (2004), included in the CAS documentation discussed by the Executive Board in June 2004. The principal lessons that arise and are reflected in the design of the PRSC program are:

163. First, the need to pay more explicit attention to ensuring broad access to the benefits of growth given some disparity between high growth and poverty reduction. As noted, data obtained since the issuance of the CAS – the latest household survey – points to a substantial narrowing of the gap between growth and poverty reduction. Nevertheless, the PRSC operations are built upon strengthening the transmission channels of growth to poverty reduction (the linkages between poverty and policy actions are discussed above; see also Annex 4). Furthermore, the tilting of the AAA agenda this fiscal year and beyond precisely towards growth-poverty linkages and studies of the labor market are evidence of taking this lesson on board.

164. Second, that best results were achieved when IDA was able to exploit the synergies between **well-sequenced analytical work and lending** and when it was able to **leverage trust funds and other donors' support**. The PRSC actions are based on economic and sector studies – growth study and PER completed last fiscal year and sector studies as well as policy work underlying sector operations, e.g., in competition policy, trade in services, efficiency and equity effects of possible changes in the tax system, social protection, education, health, rural infrastructure, the agriculture sector reforms. Linkages with donors are described in a separate section (see below); suffice to note here that the Bank has actively sought to assist the authorities obtain donor financing (e.g., the Millennium Challenge Account) and technical assistance. In PRSC-supported activities, Armenia has benefited from a number of donor trust funds, notably the Japanese PHRD grant. Donor policy advice and technical assistance complementarities will remain vital to the success of the PRSC program throughout the next three years.

165. Third, OED found that IDA lending should have focused earlier and more intensively on improving the **business climate and public sector management**. The evaluation also concluded that Armenia needed to strengthen its aid coordination capacity. The report recommended: (a) preparing a strategy for an eventual transition to IBRD lending; (b) continuing to focus on improving the environment for private sector development; and (c) following through on support for public sector reform. The PRSC program has a notably strong focus on competition and the business climate, particularly at the initial stages of the reform period, as well as on strengthening public management.

Linkages to the CAS

166. As noted in the opening paragraph of this document, the fiscal year 2005-08 CAS, discussed by the Board in June 2004, built on the PRSP of late 2003. The CAS

envisaged the three-year PRSC program as the flagship for policy and institutional reforms across the sectors critical to the sustenance of high rates of growth and the strengthening the transmission of growth effects to reduction of poverty. The proposed PRSC is fully consistent with the CAS, and complements other IDA assistance program envisioned in the CAS. The PRSC program is perfectly aligned with the CAS cycle (FY2005-08) as well as with the MTEF for 2005-07, just issued by the authorities, and the country's annual budget cycles. Finally, the PRSC preparation is closely coordinated with the IMF Poverty Reduction and Growth Facility (PRGF).

167. Other key features of the CAS that are embodied in the PRSC program are:

- Strong promotion of **government and societal ownership** of the reform actions (see earlier sections of the document – the PRSP process (Chapter IV), and the introduction to the reform program (Chapter V) for details.
- Maintenance of the reform thrust by presenting credits to the Board only upon complete **fulfillment of actions** agreed between the authorities and the Bank (for PRSC I) and of **triggers** (for subsequent PRSCs). This helps to provide incentives for continued reforms, guard against slippages and condition future PRSCs to the build up of results from policy and institutional actions taken.
- The **thematic orientation of reforms** makes possible measurement and assessment of results across a range of sectors with a common underlying purpose.
- The **triggers for transition to a high case for IDA lending** are synchronized with PRSC-supported reforms. As the CAS notes, Armenia became a high case performer during the 2002-2004 CAS period, having achieved the highest IDA performance coefficient in the ECA region. It has now entered the new CAS in a base case scenario for IDA support. If Armenia makes further improvements in public sector management – as measured by a strong performance in raising the tax to GDP ratio, and satisfactory progress with reform of the civil service (being addressed by the IDA-public sector modernization credit) and reforms in education and health sectors (being addressed in the PRSC-supported program) -- it will move into the high case. In the high case, additional IDA resources will be made available for the PRSC program of credits, for accelerated reforms of the public sector through an additional public sector modernization credit, and additional funding for rural development and infrastructure.
- PRSC supported reforms are also closely linked to **potential IBRD loans** towards the end of the current CAS cycle were creditworthiness to be attained. Qualification for IBRD qualification would require, *inter alia*, sound macro-economic performance, sustained progress in economic, fiscal and financial reform, improvements in the business and financial climate leading to steady private sector growth, and reduced reliance on preferred creditors to satisfy

financing needs. Preparing the way for IBRD lending is particularly important given Armenia's rapidly rising income per head, which could lead to a blend (IDA and IBRD) status in the next CAS period.

Linkages to Other Bank Operations

168. The lending activities contained in the CAS are aligned with PRSP objectives with a sharpening of the anti-poverty focus towards rural development, water, urban heating, and infrastructure. The proposed PRSC will build on the achievements of two previous adjustments credits, SAC4 and SAC5. The first of these credits focused on improvements in the business environment; the second supported public sector reforms (e.g., the medium-term expenditure framework), strengthening financial sector and establishing the legal framework for labor markets

Table 7: Relationship to Other Bank Operations

	PRSC1	PRSC2/PRSC3
Consolidating Macroeconomic Discipline and Strengthening Governance		
Maintaining Macroeconomic Stability	Public Sector Mod.	Public Sector Mod.
Advancing Budget Management System	Judicial reform	Public Sector II
Improving Public Procurement System		
Sharpening Competition and Entrenching Property Rights		
Sharpening Competition	Enterprise incubator	Enterprise incubator
Entrenching Property Rights	Investment and export	Investment and export
Confidence in the Banking System	facilitation	facilitation
	Enterprise development	
Mitigating Social and Environment Risks		
Improving Social Protection and Social Risk Management	Social Investment Fund	Educ. Qual. & Relevance
Raising the Quality of Education	Education	Health System Mod.
Controlling Risks in Health	Educ. Qual. & Relevance	Social Protection Admi.
Reducing Risks in Natural Resource Management	Health	Natural resource management
	Health System Mod.	
	Social Protection Admi.	Social Investment Fund III
	Natural resource management	
Modernizing the Rural Economy		
Stimulating Farm Incomes	Irrigation rehabilitation	Agric. reform support
Developing Rural Infrastructure	Highway	Title registration
	Earthquake rehabilitation	Irrigation dam safety
	Power maintenance	Transport
	Agric. reform support	Irrigation development
	Title registration	Yerevan Water
	Irrigation dam safety	Rural development I
	Transport	Yerevan Water II
	Irrigation development	
	Urban Heat	
	Yerevan Water	

169. The proposed PRSC is envisaged to play a strong role in complementing investment lending across several sectors (Table 7). By strengthening the institutional capacity to implement reforms in internal and external audits and electronic procurement, the objectives of the public modernization and judicial reform project would be assisted. The PRSC sharpens competition and enterprise property rights, thereby adding to the effectiveness of the enterprise incubator and investment and export facilitation projects, in strengthening the mitigation of social and environment risks, the proposed PRSC provides the incentives and means for policy reforms and rationalization in institutions in education, health and social protection, and in environment – thus complementing the investment operations in these sectors which provide resources for capacity building. Similarly, with regard to modernization of the rural economy, the proposed PRSC provides the policy reform support for a number of investment operations in these areas.

Linkages with Analytical and Advisory Services

170. The preparation of the PRSC has been informed by the growth study (2002) and the public expenditure review (2003), and by Bank analysis of the PRSP and the associated MTEF. Work to support the components of the PRSCs is summarized in Table 8.

171. The current and near term AAA program centers on poverty analysis, functioning of labor markets, and strengthening the policy basis for reforms to ensure growth. These, together with an updated poverty assessment will also be used in policy dialogue, monitoring policy design, and defining the policy details of the second and subsequent PRSCs.

Table 8: Analytical and Advisory Activities

	PRSC1	PRSC2/PRSC3
Overall	CEM Growth Study Public Expenditure Review Poverty Study Knowledge Economy Report Armenia Growth & Poverty	CEM on Pro-Poor Growth Programmatic Poverty Assessment
Consolidating Macroeconomic Discipline and Strengthening Governance		
Maintaining Macroeconomic Stability	Study on Efficiency and Equity in Armenia's tax system	Programmatic Public Expenditure Review
Advancing Budget Management System	A Note on Customs Administration Anti-Corruption IDF	Strengthening Policy Capacity in Treasury
Improving Public Procurement System	Institution and Governance Review Country Procurement Assessment Review Country Financial Accountability Assessment Strengthening Policy Capacity in Treasury Internal/External audit Review An Assessment of the Reporting of the Non-Commercial Organization	
Sharpening Competition and Entrenching Property Rights		
Sharpening Competition	A study on strengthening competition	Civil Aviation Study
Entrenching Property Rights	Armenia's Integration into Global Economy (Trade Services Study)	Competition Policy IDF
Confidence in the Banking System	Trade Facilitation Study Railway Business Plan Business Surveys Creditor Rights Study Bank Corporate Governance Study	Business Surveys Private /Financial Sector Services FSAP Update
Mitigating Social and Environmental Risks		
Improving Social Protection and Social Risk Management	Growth - Poverty linkages note Financial Reporting for hospitals and higher education institutions	Programmatic Poverty Assessment Labor Market Dynamics
Raising the Quality of Education	Household Surveys	Programmatic Public Expenditure Review
Controlling Risks in Health	Social Protection Report	Social Protection study
Reducing Risks in Natural Resource Management	Concept Note on Pension reform	Review and assessment of the family poverty benefits Country Environment Assessment
Modernizing the Rural Economy		
Stimulating Farm Incomes	Rural economy strategy study	
Developing Rural Infrastructure	Rural infrastructure study	

Linkages to Partners

172. In the context of the preparation and implementation of the PRSP, the government has developed an active role in coordinating the large number of donor programs in Armenia. The PRSP process has helped clarify policy priorities, and the government is increasingly using it to attract financing for priority investments and activities. UNDP and IDA are helping strengthen this function. The high degree of donor support for the PRSP is notable; both donor technical assistance and donor financing is framed in the PRSP context. For example, proposals being currently developed for MCA funding are based on the PRSP. Specifically in the context of policy reforms, key external partners are the Fund, the UNDP and various bilaterals. The Bank is in active dialogue with all of them. The **Fund** is expected to provide a successor arrangement to the current PRGF.

173. The **IMF** PRGF, approved by its Executive Board in 2001, supports the government's medium-term growth and poverty reduction objectives through measures aimed at strengthening public finance, maintaining a monetary policy consistent with price stability, improving regulation of banking sector and eliminating losses by the state-owned enterprises. The PRGF-supported program is consistent with the PRSP and the PRSC and is on track. The Executive Board concluded the fifth review of the PRGF in May 2004, thereby making available a disbursement of SDR10 million and bringing the accumulated disbursements to SDR60 million (87 percent of the total PRGF). The final review is expected to be completed in the Executive Board in December 2004 with the release of the remaining drawing of SDR9 million. The Board will also consider an ex-post review of Armenia's prolonged use of Fund resources. A successor to the current PRGF could be in place in spring 2005.

174. **UNDP** has a program helping the government develop systems to monitor development results. It also assists in improving delivery of public services at central and local levels, including governance, judicial reform, local government strengthening and improvement of social protection administration. **UNICEF** is assisting with the development of pre-school education.

175. **USAID** focuses primarily on public sector management and private sector development. To improve central government functions, a major program to improve tax and customs administration, and to strengthen the bar and judiciary; improve public sector accounting; improve the transparency of national accounts, and strengthen the payment and accounting systems for healthcare are under implementation. USAID is helping Armenia's private sector development improving access to finance and improving the capacity of small and medium sized enterprises, and is currently designing a program of additional support to private enterprise. It is also currently undertaking a review of banking supervision – this review will provide a building block to the joint Bank-Fund update of a financial sector assessment paper (FSAP) planned for early 2005.

176. The **EU** provides financial assistance for macro-economic management, as well as technical assistance to improve public administration, particularly tax and customs administration, and has detailed programs to help improve local government in two

marzes (counties). The EU has a private sector development program, and also operates a Food Security Program, which essentially offers technical assistance to the Ministry of Agriculture. **DFID** focuses on major programs on public sector reform and on integrated regional development in two marzes. It has supported both the PRSP and MTEF process, including through initiatives to develop marz level poverty reduction strategies in the two poorest marzes. **KfW** routes funds through the central bank to support micro-finance lending by four commercial banks and is also assisting in the provision of drinking water in two major cities.

177. **In summary**, the Bank is the lead partner on the governance agenda, with two key bilaterals (UK, US) and the EU playing an important role. The Bank shares with the Fund responsibility for advice on macroeconomic policies and structural reforms in taxes, as well as in financial sector reforms, where USAID has also been prominent. The Bank is also the lead advisor on reforms in sharpening competition, helping devise policies on liberalizing trade and utility services, removing barriers to investment and enterprise and developing creditor rights. The Bank is also the lead partner in social sector reforms, but in certain aspects of these reforms the UN agencies have played a notable role as has DFID. In the dialogue on environment and the rural economy, the Bank has forged partnerships with SIDA (forestry), US government agencies (agriculture), EU (food security), IFAD (irrigation policy) and UN agencies (crop development, crisis management, and work for food programs).

VIII. THE PROPOSED CREDIT

Description of the Operation

178. As noted, a series of three annual PRSCs, all single tranche operations that will disburse upon satisfaction of effectiveness conditions, will support implementation of critical reforms underlying the PRSP. PRSCs II and III will be brought for Board presentation upon satisfaction of the policy action measures that have been identified and are presented in Annex 2 and in the letter of development policy.

179. The proposed credit will improve the targeting poverty benefits to the poorest groups, will support measures to expand the public provision of basic education and health, and will improve equitability of access to those services, especially for the poor. It will also expand employment opportunities and increase incomes, through reforms to strengthen the business environment for private sector development and improve competitiveness, promote the shift to a more specialized and commercialized agriculture, broaden the reach of the financial sector and the services it offers, and promote the development of internal market access and Armenia's international trade.

180. All the prior actions for Board approval of the first PRSC have been met. The government's program to be supported under the PRSC program and triggers for Board presentation of future PRSCs have been clearly identified and are elaborated in the letter of development policy and in the policy and institutional reform matrix underlying the operation. The letter and the matrix provide the government with a coherent and unified framework for the coordination of the work of different ministries and agencies under the

leadership of the prime minister and the finance ministry. It also provides the economic cabinet (chaired by the prime minister) with an instrument for the continuous development of reforms and policy and institutional steps and for monitoring progress; and this instrument is expected to play the central role in the policy dialogue with the Bank.

Major Accomplishments Prior to Board Presentation of PRSC I

Theme 1: Consolidating Macroeconomic Discipline and Strengthening Governance

Maintaining Macroeconomic Stability

- Falling inflation, fiscal deficits below 2.5 percent of GDP and budget for 2005 satisfactory to the Bank.

Public Administration Reforms

- Agreed a quantitative schedule with IDA for reduction of outstanding VAT refund claims to exporters and for reduction of tax arrears.
- Introduced a self-declaration system at all Customs houses and extended Direct Trade Input facilities to importers and custom brokers.

Theme 2: Sharpening Competition and Entrenching Property Rights

Liberalization in Key Services

- Government adopted decision announcing its intention to widen participation in the provision of international civil aviation services, raise efficiency and cut costs (without prejudice to the implementation of already existing commercial agreements with private carriers in the field of aviation), and initiated policy work; and decision taken to accord managerial and operational autonomy to the railway company, to constitute an independent board and reform tariff-setting.

Entrenching Property Rights

- Established plan to (i) strengthen creditor rights, (ii) improve civil procedures for debt recovery, and (iii) simplify procedures for certification for property sales and registration of secured credit.

Theme 3: Mitigating Social and Environmental Risks

Improving Social Protection and Social Risk Management

- Introduced differentiation of benefits within the family poverty benefit.

Theme 4: Modernizing the Rural Economy

Stimulating Farm Incomes

- Task force established to develop plan to, (a) strengthen applied research and agriculture extension delivery system, (b) improve the links and information transfers between research and extension services, (c) augment the role of private advisory services and (d) make viable the official extension system.

Proposed Triggers for PRSC II and PRSC III

Theme 1: Consolidating Macroeconomic Discipline and Strengthening Governance

For PRSC II

- Strengthen operations of larger taxpayers unit, especially audit, collection and enforcement, in line with a program satisfactory to IDA.
- Implement self-declaration system in customs and direct trade input facilities.
- Develop sanctions for non-compliance with financial reporting for state non-commercial organizations.

For PRSC III

- Replace the present customs selection system by an intelligence-based system based on risk assessment.
- Apply sanctions for state non-compliance with financial reporting for non-commercial organizations.

Theme 2: Sharpening Competition and Entrenching Property Rights

Liberalization in Key Services

For PRSC II

- Government implements measures to liberalize trade in air services satisfactory to IDA; and railway company reforms in full implementation.

For PRSC III

- Trade in air services to be fully liberal; and satisfactory performance of railway reforms.

Regulatory Reform in State Owned Utilities

For PRSC II

- Strengthen utilities regulatory framework, (a) adopt rules for service provision and procedures for monitoring quality in energy and drinking water, (b) publish performance-monitoring data for energy and water, (c) publish results of financial performance of PSRC-regulated irrigation companies, (d) adopt power market rules for trade, dispatching, safety of the grid.

For PRSC III

- Continued implementation of the regulatory framework

Entrenching Property Rights

For PRSC II

- Amend civil code and related provisions on secured credit and streamlining of civil court procedures and court decision enforcement as agreed with IDA.

For PRSC III

- Sustain improved secured transactions conditions.

Theme 3: Mitigating Social and Environmental Risks

Improving Social Protection and Social Risk Management

For PRSC II

- Draft law on private pension insurance and develop action plan on supervisory and regulatory capacity building satisfactory to IDA.

For PRSC III

- Adopt the law on private pension insurance and implement the action plan to develop supervisory and regulatory capacity.

Raising the Quality of Education

For PRSC II

- Continue the school rationalization program, with MTEF pupil-teacher equivalent ratio targets and raise teacher salaries by 9 percent

For PRSC III

- Complete the school rationalization program reaching a full-time equivalent teacher-student ratio of over 14 and raise teacher salaries by 9 percent

Controlling Risks in Health

For PRSC II

- Adhere to the rationalization program in the hospital sector.

For PRSC III

- Adhere to the rationalization program in the hospital sector.
- Implement the regulatory framework for private health insurance.

Reducing Risks in Natural Resource Management for Sustainable Livelihoods

For PRSC II

- Implement the forestry policy, *inter alia*, by adopting forestry codes and institutional restructuring plan for the sector.

For PRSC III

- Control illegal logging and forest removal within targets agreed with IDA.

Theme 4: Modernizing the Rural Economy

Sustaining Farm Incomes

For PRSC II

- Action plan on extension, research and information implementation satisfactory to IDA Rural infrastructure.

For PRSC III

- Satisfactory progress with implementation of the above action plan.
- Seeds law and seeds certification procedures fully in force.

Developing Rural Infrastructure

For PRSC II

- Implement phased action plan on infrastructure services to encompass, (i) universal access, with supporting financing mechanism, (ii) clear delineation of ownership and operational responsibilities, (iii) private-public partnership.

For PRSC III

- Satisfactory implementation of the above action plan.

Credit Administration

181. **Borrower, Credit Amount and Tranching.** The Republic of Armenia will be the Borrower. The proposed single-tranche credit of SDR13.7 million (US\$20.0 million equivalent) will be made to the Republic of Armenia, represented by the Ministry of Finance and Economy (MOFE), upon credit effectiveness expected in December 2004. The effectiveness condition will be the provision of a legal opinion by Armenia that it has followed its laws and procedures for the ratification of the credit agreement. The proposed credit will be on standard IDA terms, including 40-year maturity and a 10-year grace period. Over the next two years, two additional PRSCs are envisioned to support implementation of the PRSP.

182. **Disbursement Arrangements.** Disbursement under the proposed PRSC will be made to the Deposit Account of the MOFE established at the CBA. Upon notification by the Association of the release of each single tranche, credit proceeds will be deposited in this account. The disbursement will not be linked to specific purchases, save for the usual “negative list”. If, after deposit in this account, the proceeds of the credit are used for ineligible purposes (i.e., to finance items imported from non-member countries, or for goods or services in the standard negative list), the Association will require the government to either: (a) return that amount to the account, for use for eligible purposes; or (b) refund the amount directly to the Association, in which case the Association will cancel an equivalent sum of the undisbursed amount of the credit.

183. The MOFE’s account will be credited with the *dram* equivalent at the official exchange rate on that day. The official exchange rate to be applied will be determined by the inter-bank foreign currency auction market. The government will thereby receive non-inflationary budgetary support. The government intends to use the proposed credit proceeds to help meet its general budget expenditures, including debt service payments.

The foreign exchange proceeds of the proposed PRSC will be sold by the CBA or held in reserves, in accordance with the objectives of monetary policy. The MOFE and the CBA will have adequate financial management systems in place, including accounting, reporting, auditing, and internal controls for the Deposit Account, and will maintain records of all transactions under the credit in accordance with the sound accounting practices. The procedures used by the CBA for sales of its foreign exchange are viewed as transparent and the safeguards have been recognized as being adequate. The CBA adopted the IAS in 1996 and has been audited by internationally recognized auditing firms. The Association will receive an audit report from an independent auditor after each tranche has been disbursed, certifying that the foreign exchange proceeds were used by the CBA according to the objectives of the adopted monetary program. The IMF has intensified its safeguards assessments, and there will be consultations with the IMF, and disbursements under the credit will depend upon a continuing favorable assessment by the IMF of the country's reform program.

184. The Armenian Public Expenditure Review of September 2002 has provided recommendations to improve the budget management system. An IDF grant is supporting further capacity building in the design and implementation of the pilot expansion in the existing treasury system, to complement the previous support provided to the CBA and the treasury. The review of the Observance of Standards and Codes was completed by the IMF in February 2002, and the Country Financial Accountability Assessment of 2003 concluded that although considerable progress has been made to improve fiscal transparency, a number of weaknesses remain in audit functions. Clearer rules on public procurement system are needed, and are supported by the Country Procurement Assessment Review of 2004 and the proposed PRSC.

185. **Reporting, Auditing Arrangements and Closing Date.** The Association reserves the right to request an audit of the Deposit Account, in accordance with Section 3.02 of the Development Credit Agreement, by independent auditors acceptable to the Association. Audit reports should be furnished to the Association as soon as possible, but not later than four months after the date of Association's request for such audit. Terms of reference for independent auditors and financial reports will be submitted to the Association and discussed with the government. The closing date of the proposed credit will be December 31, 2005.

186. **Implementation.** The government has taken the lead in the preparation of the PRSC policy matrix and will continue to coordinate its implementation along the PRSP Implementation Action Plan. The PRSP Implementation Action Plan was approved in January 22, 2004 in close consultation with stakeholders, civil society, trade unions, business groups, NGOs, the Church, local governments, and the donor community. The implementation plan included some 300 policy actions envisioned for the 2004-2006 period. The authorities further created a public participatory body to help guide the PRSP implementation process and provide equal voice to key stakeholders on the future development of the PRSP. This new body will elaborate new proposals for PRSP implementation, coordinate international cooperation around PRSP goals, and design a PRSP management and M&E strategy.

187. The government reflected its medium-term priority policy actions in the proposed PRSC action plans. The ministry of finance has been given primary responsibility for coordinating the government's inputs and actions from all the relevant ministries and agencies in implementing the PRSC action plans. Several working groups will review, prepare, and follow up on implementation of the action plans and timetables. The government will closely monitor and evaluate through periodic surveys and assessments implementation of the PRSC in the context of the overall monitoring of the PRSP process. A set of performance indicators drawn from a broader set of proposed PRSP monitoring indicators, as reflected in Annex 3 and agreed during negotiations, and quarterly monitoring reports in implementation of the key policy measures produced by the ministries and agencies will guide the supervision and impact assessments of the proposed credit.

188. The proposed PRSC reform program encompasses a wide range of policy measures. Some of the required technical assistance has been provided by a PRSC PHRD grant, PRSP grants, PPIAF grant, and through several World Bank projects, including the PSMP and the second education and health projects. Implementation of the proposed PRSC would also benefit from the new Dutch Government's grant in support of tax and customs administrations. World Bank related projects and supporting grants would be complemented by technical assistance financed by other donors. Some of these donors, including USAID, have already financed technical assistance to strengthen the Government capacity to carry out specific elements of the PRSC program. Additional budget support from the European donors, in the form of PRSC co-financing, based on previous experiences with similar arrangements under SAC3, SAC4 and SAC5 will be requested if necessary.

Environmental Aspects

189. The proposed PRSC supports a broad program of institutional and policy reforms in environment. As described in the document, policy and institutional reforms are being supported in environmental assessment, policy development and capacity building, with special emphasis on forestry policy and sustainable livelihoods. Prior to Board presentation of PRSCs II and III, the Bank will undertake further analytical work in environment with respect to the policies and institutional changes being proposed in the forestry sector and in rural infrastructure services, in cooperation with the authorities.

Risks

190. The proposed credit is subject to several risks. First, government capacity and willingness to implement reforms over a three-year period will be necessary; moreover, there is the risk of reform fatigue as the reform agenda begins to enter into difficult terrain. Capacity is being strengthened through reforms and by the active engagement of donors; and the President of the Republic as well as the government continue to show steely determination in implementing the PRSP program. The wide participation through which the PRSP was formulated and the continuing involvement of civic organs in its implementation offer some protection against reform fatigue; nevertheless, the authorities

are planning to step up the local dialogue, explanation and dissemination to stakeholders and civil society, especially in rural areas.

191. A second risk relates to exogenous economic shocks reflecting reduction in worker remittances, export earnings, remittances by the Armenian diaspora, or a substantial energy supply or commodity price shock. Shocks could also stem from natural disasters or result from instability in the non-oil segment of international commodity markets. Clearly, each will have to be addressed in its own way, possibly necessitating a change in the content of future PRSP updates and the use of other Bank instruments as envisaged in the CAS.

192. A final risk arises from regional instability. Clearly, Armenia's continued economic progress is linked to growth and neighborly cooperation with adjacent states, two of which provide critical energy and transport links. A resolution of the Nagorno Karabakh conflict and an opening of the borders with two neighboring states would raise confidence in economic prospects, lower costs, and attract investment.



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ԿԱՐԶԱՊԵՏ
PRIME MINISTER
OF THE REPUBLIC OF ARMENIA

1/1-020
19.10.2009

Mr. James Wolfensohn,
President of the World Bank

LETTER OF DEVELOPMENT POLICY

Republic of Armenia

Dear Mr. Wolfensohn,

1. The main objective of the government's medium-term economic reform program is to reduce poverty, lower inequality and improve human development. The government aims to build on its past achievements and to sustain the recent high level of economic growth with low level of inflation in the medium-term by remaining fully committed to macroeconomic stability, structural reforms and liberal economic policies.

2. In this Letter, we describe the government's reform program that is proposed to be supported by the series of Poverty Reduction Support Credits. This program is rooted in our Poverty Reduction Support Strategy and consists of a sub-set of actions under that Strategy that have been identified by the government as high priority actions that have a large impact on poverty reduction. Moreover, these set of actions lie within the comparative advantage of the Bank and conform to the areas of Bank support for Armenia outlined in the Country Assistance Strategy document of June 2004. The government has taken the initiative to identify the themes of the PRSC and of the specific measures proposed and is grateful to the Bank for its cooperation in helping us to develop these measures.

Poverty Reduction Strategy

3. Reducing poverty is the main pillar of the economic strategy, as reflected in the Poverty Reduction Strategy Paper (PRSP) published in October 2003. The government considers the PRSP as an essential guide in its efforts to foster growth and reduce poverty. The PRSP has been prepared in the context of a broad participatory process at

the national and regional levels, in close consultation with members of the Parliament, nongovernmental organizations, the private sector, academia, trade unions, local governments, farmers and members of the Armenian diaspora.

4. The government is firmly committed to effective implementation of the main themes emerging as PRSP priority areas. These include: (i) promoting sustainable economic growth through macroeconomic stability and private sector development, (ii) enhancing human development and improving social safety nets, (iii) implementing prudent fiscal policies and reforming the tax system, (iv) improving public infrastructure, and (v) improving core public sector functions.

5. Since its inception in August of 2003, the PRSP has been shaping the government's vision of development and poverty reduction. On January 22, 2004, we approved the PRSP Implementation Action Plan, in close consultation with stakeholders, civil society, trade unions, business groups, NGOs, the Church, local governments, and the donor community. We included detailed policy actions in the implementation plan for 2004-06, established a PRSP Steering Committee and a PRSP working group, comprising the original PRSP preparation members. We debated each action carefully before agreeing upon them. Once agreement was reached on actions to be taken, the next set of questions concerned methods of implementation and capacity to accomplish specific actions, as well as the timetables that would guide PRSP implementation.

6. Recognizing these new challenges, we embarked upon the concept of public partnerships agreements with the objective of creating a negotiation table in which all segments of society and international donors could participate with an equal voice in the negotiations of PRSP implementation and its future development—thus making the document a live document. Due to this approach, the interests of the many stakeholders were grouped into eight chairs at the negotiation table. In July of 2004, representatives of the eight parties involved in the negotiating table signed a joint communiqué, launching the partnership negotiations process for implementing the PRSP. This joint communiqué ensures proper supervision of the PRSP implementation process and its future evolution.

7. We have prepared a comprehensive set of monitoring indicators that will be reflected in our first annual implementation progress report, which is currently under preparation. This report will include a detailed assessment of the 2005-07 Medium-Term Expenditures Framework (MTEF), prepared in consultation with the World Bank and IMF staff.

Macroeconomic Stability

8. Armenia's medium-term economic performance is expected to remain strong, with real GDP growth of eight percent in 2004 and six percent per year during 2005-08. Annual inflation of three percent per year is projected during this period. With the support of World Bank and IMF, the government intends to maintain a strong track record of reforms and economic management in order to sustain gross investment at a level of over 25 percent of GDP in the medium-term. Because the private sector will

play a major role in this expansion, we are determined to place a high priority upon the development of a more dynamic and competitive private sector, with our own role being more focused upon promoting a better business climate, improving the level and efficiency of social sector expenditures and reducing waste and corruption. Our economic reform program, as reflected in the PRSP, will continue to give a central position to private sector development and export promotion as the main driving forces for sustainable growth. We plan to maintain the current account deficit at about six percent of GDP, while gross international reserves will be kept at a level of not less than four months of imports. The government's firm commitment to carry out prudent fiscal and monetary policies and our determined adherence to a flexible exchange rate regime will ensure the attainment of these objectives.

9. Improving revenue mobilization to finance poverty reduction expenditures is an important element of our core reform program. The government is committed to deepening fiscal reforms with a focused approach to strengthening the tax and custom administrations, and achieving the expected increase in tax revenues of about 0.4-percent of GDP per year in 2004-2008, as reflected in the PRSP. We are confident that, in line with the PRSP, we will limit the overall annual budget deficit to a range of 2-3 percent of GDP and will eliminate the quasi-fiscal deficits in the energy and infrastructure sectors in the medium-term. Armenia's external debt profile has improved considerably in recent years following the successful implementation of the debt-for-equity swap with Russia in 2003. This has reduced considerably the share of non-concessional external debt and has greatly strengthened Armenia's prospects for creditworthiness. The net present value of the external debt to the exports ratio is expected to decline from 81 percent in 2003 to around 50 percent in 2008.

10. We welcome the prospect of a follow up IMF Poverty Reduction and Growth Facility (PRGF) arrangement in 2005. Given the importance of macroeconomic stability for effective poverty reduction program, the new IMF program is expected to strengthen our efforts in maintaining policies aimed at overcoming the weaknesses in tax and customs administrations and completing the remaining banking sector reforms.

Improving Tax and Customs Administrations

11. The government is deeply concerned about the current weaknesses in tax revenue collection and is firmly determined to introduce priority reform measures to advance tax and customs administrations. To improve the tax administration, we intend to focus on three main areas. The first of these is the development and implementation of a self-assessment tax system, under which taxpayer determine tax obligations themselves, without face-to-face contacts with the tax collectors. We are planning to introduce a system of risk-based audits for a selected sample of taxpayers in order to ensure full compliance with tax declarations and obligations before its introduction throughout the country.

12. Second, we are making serious efforts to reduce the stock of tax arrears and intend to strengthen the operations of the larger taxpayer unit in the State Tax Services

(STS), especially in audits, collection and enforcement. In support of this objective, we have adopted the following quantitative targets: (i) in the course of 2005, an amount of 4 billion drams will be realized in the form of cash payments out of the stock of tax arrears to the budget, with the amounts being realized in the four quarters of that years being, respectively, 700 million drams, 900 million drams, 1.1 billion drams and 1.3 billion drams; and (ii) the stock of arrears with respect to all entities and individuals, except for companies covered by the IFRP will be reduced by at least 8 billion drams between September 1, 2004 and end-2005. The authorities will make every effort to prevent a fresh accumulation of tax arrears.

13. Third, we place a high priority upon an assessment of the nature and composition of the stock of VAT refunds claims to exporters. We plan to streamline the administration of refunds, will introduce a time-bound action plan for orderly repayment of the outstanding VAT refund claims, and are determined to prevent additional arrears from occurring. In support of this objective, we have adopted the following quantitative target: the stock of VAT refunds owed to exporters will not exceed 5.1 billion drams at end-2004 which corresponds to the amount of this stock at end-2003. We intend to agree the targets for 2005 with the Fund.

14. With regard to customs administrations, our program aims at introducing the best international practice in four main areas. First, we plan to launch a self-declaration system at all Customs houses and employ a Direct Trade Input (DTI) facility in order to enable the importers and Customs brokers to reduce the interface with the customs officials. We have adopted the target of signing on at least 50 customs brokers to direct trade input by providing them with the codes for access directly to the Asycuda system and will extend similar facilities to companies within the coming weeks, once these brokers and other importers have acquired the necessary, simple technical skills. Second, we will adopt a system of selectivity of customs control based on risk criteria, and apply the green channel concept to its full extent in line with international best practice. The quantitative targets on selectivity with respect to the green channel will be agreed with the Bank prior to Board presentation of this credit. Third, we intend to strengthen the Post Clearance Audit (PCA) unit by increasing significantly its current staffing and training, expanding its mandate, and establishing a desk review function. Finally, we will advance our previous efforts in developing a quantitative program for reducing the role of reference prices and will closely adhere to the WTO principles.

Improving the Management of Irrigation and Drainage

15. The current management of the country's irrigation and drainage infrastructure has proved to be less than effective. The responsibilities for irrigation development, OM&R resides with the inter-governmental Water Resources Management Committee (WRMC), which plans and programs new investment and maintenance activity, as well as oversees construction and contracts. Responsibility for drainage works, on the other hand, resides with the Ministry of Agriculture. Coordination between the two has been problematic, and we are planning to take steps to merge these responsibilities into a single central agency. Authority to manage the irrigation system (primary, secondary and

tertiary canals) has recently been devolved to 54 regional Water Users Associations, which aim to provide users with more control and to improve accountability. However, the transition from centralized management is proving difficult, given the limited technical and financial capabilities of the Water Users Association. Especially needed is training in water management and systems O&M, as well as financial management, basic accounting, and control. Following the merger of the responsibilities for irrigation and drainage into a single central agency, we will commence the implementation of a training program for the governing and management bodies of the Water User Associations.

Improving Budget Management Systems

16. The government is committed to further strengthening the budget management systems and refraining from allowing any build-up of the budget arrears. Based on the expanded government capacity, we are determined to effectively integrate the MTEF into the annual budgets and to further strengthen the associations between policies and expenditure allocations. Based on our experience with the 2003-05 MTEF and its relations with the annual budget preparation, we have made considerable progress in using the 2004-06 MTEF to prepare the 2004 budget. Similarly, we plan to direct the 2005 budget based on the 2005-07 MTEF, which was approved in June 2004. Over the medium-term, we are committed to achieving progress in budget management systems by focusing on the following areas:

- Budget classifications and public sector accounting and reporting standards;
- Program budgeting;
- Financial management and reporting by State Non-Commercial Organizations (SNCOs);
- Institutional arrangements for internal and external audits; and
- The budget management system of local governments.

17. Concerning budget classifications and public sector accounting standards, the government is committed to strengthening the quality of fiscal information required for expenditure analysis. We shall pay special attention to adoption of the structure of budget classification based on GFS 2001 principle and will develop new chart of accounts and accounting and reporting standards for the public sector. We intend to apply the adopted new structure of budget classifications and the accounting and reporting standards in the public sector to the 2007 budget.

18. With regard to program budgeting, we plan to assess the initial steps taken in the 2003-04 budgets and improve budget formulation, execution and reporting of social sector in 2005 budget. We will publish the revised service-oriented program structure and information for the ministries of Labor and Social Issues, Health, Education and Culture in the 2006-08 MTEF and the 2006 budget law. Contingent upon these developments, we expect that all budget agencies will prepare their 2007-09 MTEF and 2007 budget submissions upon the basis of the redefined program. Our report on budget

execution to the National Assembly for the 2007 budget will include outcome indicators on performance indicators.

19. In the area of financial reporting by state Non-Commercial Organizations (SNCOs), we have focused during the first implementation stage of the decentralization reform of the social sector upon improved service delivery and have not paid commensurate attention to financial management, supervision, monitoring and reporting arrangements of the SNCOs. We are fully aware of the fact that the absence of an adequate financial reporting system may confront us with some potential fiscal risks and therefore intend to minimize these through improvements in financial reporting and monitoring systems, while benefiting from the decentralized social sector reforms. We have introduced the necessary legal framework for SNCOs reporting and have assigned the administrative responsibility of monitoring these reports to the Privatization Policy and Dividend Department (PPDD) in the MOFE. We plan to develop and take initial steps to implement the SNCOs financial reporting. A time bound action plan will be developed for recruiting and training of PPDD staff, preparing and monitoring of SNCOs financial reports, establishing a data base, training SNCOs staff on a pilot basis, drawing audit programs based on risk assessment, publishing SNCOs reports and reviewing their achievement. We also plan to develop a strategy for sanctions upon non-compliance with financial reporting requirements of the SNCOs and issue warnings to non-compliant SNCOs. The interim and annual financial statements of the largest SOEs and SNCOs will be published on the MOFE's website. We intend to apply sanctions to non-compliant SNCOs.

20. The government is determined to strengthen the institutional arrangements for internal and external audits. Concerning internal audits, we plan to prepare and adopt a strategy and an action plan within the executive branch of the government. We have arranged to carry out the strategy in the medium term, possibly beginning with two pilot line ministries. With regard to external audit reforms, the plan is to clarify the roles and responsibilities of various agencies involved in external oversight. In this connection, we will prepare, in close cooperation with the Chamber of Control (COC) of the National Assembly, a concept paper to include an action plan to improve legal and operational framework of the public external control system. This should enable us to clarify the role of supervision services under the President, the Prime Minister and the MOFE. We will commence the implementation of the action plan in order to improve the external control framework.

21. In order to create a self-government budget management system at the local level, we anticipate strengthening the capacity of local governments in budgeting, execution and reporting through development and implementation of a strategy on local-self-government budget management system. The main objectives of this strategy are enhancing the accountability and transparency of the local government budget execution, the costing of the assigned responsibilities, the training of local governments and the strengthening the MOFE to better coordinate, compile, consolidate and periodically publish local government fiscal accounts and performance. The strategy will also address the legal framework in order to improve local government budget management systems,

and the formation of sustainable Inter-Community Unions (ICUs) as public entities, and their fiduciary responsibilities.

Improving Public Procurement Systems

22. We have made considerable progress in establishing a legal framework for public procurement through adoption of the Procurement Law in line with the recommendations of the Country Procurement Assessment Report (CPAR). However, we are aware that the public procurement system is highly centralized, with all public procurement above certain levels coordinated and conducted by the State Procurement Agency (SPA). This has many benefits, but at same time suffers from some potential risks of reduced transparency. To overcome some of these potential impediments, we plan to prepare an action plan and cost estimates for establishing an e-procurement system. We will also prepare catalogues for the procuring entities on technical specifications for goods and services of common use and will publish these on SPA's website. We plan to establish a registry system for contractors in goods and works and prepare bidding and standard documents and post these on the website. In light of experience with e-procurement in other countries, we plan to use appropriate twinning arrangements with other procurement agencies. We also plan to amend the Public Procurement Law to reflect that all state entities from all sources--both budgetary and extra--or off budget would be subject to the procurement Law. We are also committed to establishing a satisfactory procedures and mechanism to address complaints and arbitration in the context of the Procurement Law.

Liberalization in Key Services

23. The government places a high priority upon improving competition in the Armenian economy, particularly in those sectors involved in imports and distribution. The government medium-term reform program aims at strengthening private sector competition by:

- Improving competition policy;
- Improving public sector utilities;
- Strengthening competition in the railway, air services and telecommunications sectors;
- Reducing regulatory and administrative costs;
- Improving the reliability of enterprise financial reporting; and
- Advancing the legislative frameworks for the labor market, electronic signature and documentation and standards and metrological system

24. To accomplish the first of these goals, we have created the basic framework for protecting economic competition and have established the Commission for Protection of

Economic Competition (CPEC). We intend to enhance the capacity and provide more human and financial resources to the CPEC.

25. Concerning utility reforms, we plan to implement the Integrated Financial Rehabilitation Plan (IFRP) for public utilities (electricity, drinking water, irrigation and urban electric transport) adopted in December of 2003. We shall focus upon several important reform elements, which include the following:

- Setting up the necessary corporate governance structures with boards of directors, independent internal and external audit mechanisms for all of the publicly owned utility entities, in order to improve the commercialization, efficiency and financial viability of these entities;
- Establishing rules for service provision, introducing effective mechanisms to monitor service quality of utility entities and publishing the performance data of these entities; and
- Changing the power market structure, with the removal and subsequent liquidation of Armenergo, and establishing a direct contracting mechanism between the distribution company and the generators in order to enhance the transparency of the sector operation, ensure timely payments to generators and prevent future accumulation of debts.

26. The government recognizes the promising potential of the railway network to the economy once the external blockade imposed on us is lifted and intends to improve efficiency of the railways company. Based upon the five-year business plan, the government's reform program emphasizes the need for a clear delineation of policy-making, regulatory and management functions in the railways in order to ensure improved commercialization, transparency and accountability. The government has taken a decision to accord total managerial and operational autonomy to the railways company to be run along commercial lines and to establish an independent board of directors for the railways company that would play an oversight role. The board members would be appointed from the cross-section of society with strong consumer representation and small minority participation from the government. We intend to maintain the role of the Ministry of Transport and Communication in policymaking and regulating compliance with safety and security requirements. Railway tariffs would be set by the company in accordance with objective, transparent criteria (using the point to point cost methodology), and bulk purchasers would be eligible for discounts. These tariffs would be vetted by the PSRC. Railway services may be offered at below-cost tariffs for social reasons; for such services, the company would receive an explicit transfer from the national budget to fully reflect the costs of operation.

27. We are concerned that Armenia has experienced a sharp drop in its trade transported by air in recent years, despite its landlocked nature and its subjection to a blockade by two of its neighbors, and the cost of air cargo faced by Armenia is much higher than by other countries. The high costs have caused a relative shift towards road transport (despite poor infrastructure) and even railways. Armenia's commendably liberal trade regime for goods has now to be complemented by a liberal services regime.

We recognize that the competitive position of the economy and its growth potential is being significantly held back by our current air transport regime.

28. The government has taken a decision announcing its intention to widen participation in the provision of international civil aviation services, to cut costs and thereby raise efficiency (without prejudice to the implementation of already existing commercial agreements with private carriers in the field of aviation). This intention will be translated into policy upon the completion of studies and policy analysis being conducted by the government and by the Bank over the next twelve months. The policy aim is to liberalize international civil air service for passenger and cargo traffic by modifying government imposed entry restrictions to aviation services in a manner calculated to maximize the long term benefit to Armenia, taking into account national security considerations and the behavior of Armenia's partners. The policy details and the shape of the new aviation regime will be settled over the next year and put into effect in accordance with a timetable that will be agreed with the Bank. We will examine the merits of being a part of a multilateral arrangement for aviation services built on the EU single air market as this allows airlines to provide cargo and passenger services, subject to safety and security requirements, on a network basis in the most cost-effective manner. We will examine how best to progress to this outcome. Progress will depend on the willingness of partner countries to also eliminate such restrictions so that Armenia based airlines have an opportunity to serve foreign markets.

29. Policy reforms will strengthen competitiveness of exports and generate new output in goods and services, especially in tourism. We will respect and take care not to damage existing commercial contracts and aviation agreements and refrain from entering into new ones that contravene the purpose of this reform. Specifically, in keeping with our market orientation of reforms and the privatization policy, we will not establish any civilian air services to be owned or managed by the state.

30. The government intends to improve the telecommunications infrastructure. The 15 year monopoly granted to the private investor has led to severe underinvestment and stifled growth even in mobile, where our neighboring countries have seen a boom in investment and now count with roughly 10 times more subscribers than Armenia. The government is intent in ending Armentel's monopoly for breach of its license obligations. The case is now in the London Court of Arbitration and the government is readying itself for the issuance of a new mobile license. In parallel, the government has drafted a new telecommunications law, which will broadly open up some segments of the market to competition, notably in the areas of mobile telephony and Internet, and has established a multi-sector regulator, which will be tasked with regulating the telecommunications sector, in addition to the energy and water & sanitation sectors. To ensure that implementation of all these reforms is well directed and clearly communicated to the public, we plan to develop a new telecommunications sector policy and reform strategy, to guide the implementation of all these reforms. Once this policy has been widely discussed, the main policy and regulatory principles guiding the licensing and regulation of new operators will become clear, leading the way to a smoother implementation of new legislation and the necessary implementing regulatory instruments. A modern

regulatory framework will thus emerge, which, coupled with a capable regulator, will even the playing field and for all market participants and provide certainty to investors, leading to more competition, investments and overall growth in the sector.

31. With regard to reducing the regulatory and administrative costs and inspections, we are determined to continue the advancement of our progress. The recent survey of 300 enterprises in 2003 was the fourth of a series of surveys, which provided important information about the business community's perception of our reform program. The survey has highlighted that while the business community has a positive perception of reduction of the cost and time of doing business, further improvements in other areas is still necessary. Based upon the results of the survey, we have developed and adopted a time-bound action plan, in consultation with the private sector representatives, and are determined to carry out the following reform measures:

- Establishing a system for all large taxpayers for submission of tax declarations by e-mail or on-line through a specialized secure web site. Until the law on electronic signatures is approved, such submissions will have to be supported by hard copy documents with a hard copy signature (Under this proposal, large tax payers will be able to reduce the direct interface with tax officials and begin to reap benefits of the electronic age.)
- Permitting adequate consultation with business and civil society in advance of tax changes, wherever possible. This is needed for private businesses to be able to make an input into discussions on tax design and rates and to start adjusting their operations to adequately reflect the changed tax legislation.
- Abolishing the illegal practice (currently widespread) of the tax authorities forcing or "persuading" companies to make advance payments with respect to future tax obligations.
- Reviewing the current practices of business operations inspections by tax inspection through strengthening the inspection procedures for large tax payers, permitting much greater maximum day limits for audit of large tax payers where warranted, possibly even abolishing such a time limit.
- Streamlining the procedure for obtaining certificates of origin for exporters by:
 - (i) introducing a single nominal fee to reflect the administrative cost of issuing the certificate of origin for all goods,
 - (ii) simplifying the current requirement of examining and testing goods.
- Decreasing the number of documentation needed for foreign trade operations, in particular export operations, in line with common international good practice.
- Approving and submitting to the Parliament a Law on Electronic (digital) signature and electronic document.

- Undertaking a new business survey and developing additional recommendations for further improving the business climate.
- Adopting a relevant legislation to establish a system of on-line company registration, and integrating the business registration, tax registration and social insurance registration procedures into a single registration form.

32. Given the importance of adequate financial reporting by the private sector, we accord special attention to a program for improving the accounting profession, enhancing users' knowledge of financial information, and strengthening the regulatory system and the institutional enforcement capacity. The government is determined to update the Armenian Accounting Standards and intends to require the listed companies on the Armenian stock exchange and insurance companies to comply with the international accounting standards by 2006. Concurrently, we are determined to advance the state of the auditing profession. We are aware that the market for international auditing services is relatively new (and thus rather thin), and many stakeholders are not fully able to differentiate between auditing, and control/supervision activities conducted by the State. Moreover, most accounting staff and government agencies are not familiar with international accounting, the auditing standards and the overall quality of professional auditing is weak. Furthermore, the system of monitoring the quality, independence and ethics of the auditors is not in place. Although the recent Law on Auditing Activities is a step in the right direction, nevertheless we are determined to take the necessary steps to strengthen the auditing standards in line with International Standards of Auditing (ISA) and promote further development of audit associations in order to enhance the education, training and discipline of professional auditors. We will introduce the necessary checks and balances to strengthen supervisions and the monitoring of the auditing organizations.

33. As concerns the labor market, we are determined to support the newly adopted Labor Code and are in the process of developing various secondary legislations and detailed regulatory procedures. With regard to the electronic documents and electronic signature, we are aware of the fact that one of the main impediments to development of e-commerce and e-government remains lack of a legal framework for electronic contracts and electronic signatures. In connection with this, the newly adopted Law on Electronic Document and Signature will provide the necessary legal framework, and we will draft the secondary regulations necessary for effective implementation of this law. Finally, with regard to standards and the metrological principle, we recognize that lack of adequate standards and metrological certification impedes Armenia's access to export markets, especially for food and agro-processed products. Therefore, we are determined to address these issues and adopt a package of appropriate regulations for standards and the metrological principle.

Entrenching Property Rights

34. One of the major challenges faced by the Armenian economy is the high cost of business borrowing, due to the considerable risk premium, which is measured by high spreads between the lending and deposit rates. This is due mainly to deficiencies in our

property rights and weaknesses in the ability of commercial banks to enforce collateral. The government is determined to improve the lending environment through strengthening the procedures for collateral registration and foreclosure and enhance the knowledge of judiciary concerning commercial contracts. The government places a high priority on development and implementation of an action plan for strengthening the legal and institutional bases for creditor rights, in order to bring the secured interest regulations in line with the international best practices. Specifically, we are determined to take steps to amend (a) procedural rules for the creation, registration and enforcement of security interests over property; (b) civil procedures court with respect to court proceedings for debt collection, to protect creditors' rights and prevent debtors from unduly delaying execution; amendments to the Law on Compulsory Enforcement of Court Decisions and Law on Public Auctions to improve enforcement of court decisions and (c) legislation to simplify procedures for certification by notaries of property sales and registration of secured credit. In the medium-term, the government is committed to establishing a centralized registry for collateral that courts can utilize by (a) developing the Registry Law; (b) implementing the infrastructure for a viable secured interest registration; (c) training of judges; and (d) undertaking a public awareness campaigns.

Increasing Confidence in the Banking Sector

35. The government is determined to enhance the public confidence in the banking sector through improvements in banking supervision, the corporate governance of banks, and the payment system.

36. In the area of banking supervision, the government plans to introduce further improvements. In this context, the USAID funded study and the forthcoming FSAP update will play important roles in the design of an improved banking supervision plan. The plan will describe the necessary steps to be introduced in order to remove the obstacles to the development of new financial sector products, including those that concern housing finance.

37. The government is also determined to strengthen the corporate governance of the banking sector. We recognize that the application of good corporate governance principles is lacking in the banking sector where governance is often not institutionalized, but rather depends on one person, usually the CEO, who heads the management board (if one exists), or the chairman of the board of directors who is a dominant shareholder. We believe that banks should recognize the depositors as important stakeholders in the banks' performance, and good corporate governance should protect their interests, as well as the interests of the shareholders. Therefore, we intend to initiate a dialogue with the banking community to facilitate the design of procedures and policies for achieving corporate governance, based upon international best practice.

38. We are aware that a modern payments system can play an essential role in supporting private sector development. We plan to take some steps in this direction by strengthening the regulatory framework for new payments system. The CBA has recently initiated a law concerning Payment and Settlement Systems and Payment and

Settlement Organization, which specify the responsibilities and obligations of the CBA and payments system participants. Further actions will be undertaken during the next few years in order to consolidate the legal framework in this area, with the objective of starting implementation of new payments system in the medium-term.

Strengthening the Insurance Sector

39. The government reform program accords an important role to the development of the insurance sector in order to ensure that adequate coverage of the economic and financial risks is provided for the enterprises and households. Although the insurance sector in Armenia is small, our plan is to enhance its role in economy over the medium-term. We plan to develop prudential standards in line with the new law on insurance and set minimum capital requirements for insurance companies. We will ensure that insurance companies will comply with the normative requirements of the prudential standards and expect proper quarterly reporting and financial statements to be prepared by the insurance companies. We will ensure that in line with the new Law on Insurance to set minimum capital requirements for insurance companies at AMD 100 million (US\$200,000) as of January 1, 2005 and to increase this to AMD 350 million by January 1, 2007. We plan to establish an independent Insurance Inspectorate outside the Ministry of Finance and Economy by 2007.

Improving Micro-finance Operations

40. We recognize the importance of micro financing and are aware of the fact that small-scale businesses and households make up the bulk of their clientele, which seek loans to serve working capital, small investment and supplementary household liquidity needs. In order to create a sound-enabling environment for micro-finance operations, the government is committed to strengthening the legal framework for their operations by encouraging MFIs to establish their lending arms as "credit organizations" within the framework of the recently enacted legislation on Non-Bank Financial Intermediaries, under oversight of corresponding Central Bank regulations (viz. nos. 14 as amended and 15).

Improving Social Protection and Social Risk Management

41. The government recognizes the importance of an efficient, effective, well administered and adequately funded social protection system for poverty alleviation and reduction. In line with the PRSP, the plan is to introduce a range of measures, including a commitment to significant resources allocation that would allow the social protection system to continue play its poverty alleviation role, while improving service delivery and monitoring and evaluation capacity. In order to attain a family poverty benefit in line with the PRSP, the government intends to accomplish the following:

- Improve resource allocation during 2005-2007;
- Differentiate the benefit amount, depending on the family social situation
- Continue with monitoring and evaluation of the program's poverty impact
- Review the targeting formula, so as to allow for improvements in the benefit targeting efficiency and effectiveness; and
- Continue with improvements in the benefit administration, including staff training and improvements in the management information system.

42. In the sphere of pension reform, in line with the PRSP, the government is focusing upon improvements in service delivery through capacity building of the public pension's administration. Improvements planned by the government include the introduction of the MIS with individual records, improvements in financial management, the development of policy analysis and modeling capacity, and improvements in the governance of the State Social Insurance Fund. We envision a real increase in pensions, in order to ensure that public pensions adequately play their role as a poverty protection instrument for the elderly. A key factor in the sustainable increase in public pensions is the implementation of a recently adopted Public Pensions Law and the successful completion of a comprehensive set of measures currently under implementation. The latter is aimed at improving capacity of the State Social Insurance Fund, including the introduction of the MIS with individual records as its key element. Development and adoption of the Private Pensions Law is an important element of the implementation of the Pension Reform Strategy.

Education

43. The government has taken significant steps in the last few years to address some of the deep-seated problems in the education sector. We are aware that achievement of the PRSP agenda, and the reforms in general education, will depend critically on increases in education spending, accompanied by improvements in efficiency and effectiveness of that spending. We intend to keep the teacher redundancy program on track with its targets, budget public spending increases, and ensure significant increases in quality-enhancing spending on capital investment and non-salary expenditures.

44. With regard to early childhood education, we recognize its importance and plan to develop a strategy and ensure that the strategy will remain financially sustainable and focused on those in greatest need. In the area of tertiary education, we are aware that significant work remains ahead, especially in the development of new mechanisms for financing institutions and students. In particular, the student financing reforms are intended to help increase access to tertiary education and target state resources at those most in need, while the institutional financing reforms will improve transparency and efficiency of spending.

Health

45. The government aims to advance the health sector reforms by enhancing the accessibility and quality of health services, especially for the poor. We expect to achieve this by ensuring sustainable public financing at a level affordable for the economy, reallocating resources within the sector towards more cost-effective care modalities, and through optimization and efficiency improvements in the hospital sector.

46. We intend to meet the yearly targets for health sector expenditures as set out in the PRSP. We are also determined to enhance the efficiency of the health care system through further efforts at optimization and management reforms. In line with the PRSP, the government emphasizes the importance of special measures to be taken to enhance the efficiency of the planning, budgeting, and oversight functions of medical institutions. The government plans to adopt an action plan for hospital governance and will monitor the achievements in the hospital rationalization program. The government will also undertake measures for secured financing and management of independent family medicine group practices and will introduce a free enrollment scheme with regard to choice of family physicians.

47. Armenia still lacks a policy to ensure access to essential medication and drugs for the population, in particular for the poor. The key measures applied so far have focused upon the distribution of humanitarian assistance and state procurement of selected items such as anti-tuberculosis and anti-diabetes drugs. Although the physical availability of medication and drugs on the market has considerably increased in recent years, these are still not affordable, especially for the poor segments of population. The government intends to develop a strategy to ensure the affordability of essential medication and drugs for the poor population, including defining the list of essential medication and drugs, effective price regulation, quality control, distribution system and instruments to ensure that the poor will have financial access to essential medication and drugs.

Reducing Risks in Natural Resources Management for Sustainable Livelihoods

48. The government intends to focus more fully upon the country's environmental challenges. These include inadequate water supply and solid waste services, urban air pollution, pollution of water resources, deteriorating forest stock, significant soil erosion and other forms of land degradation, accelerating desertification, and vulnerability to climate change and natural hazards, such as earthquakes, floods, landslides, and drought. The government is committed to adopting a schedule for improving the legal and institutional framework for strengthening environment impact assessments and supervision. We will also adopt a national forestry policy and a national action plan to combat illegal logging. We intend to support the adoption of the new environmental impact assessment law and the law on environmental supervision and inspections. We will also attempt to facilitate the adoption of a new forestry code, supporting regulations on forest management planning and community forest management and a plan for institutional restructuring of the forest sector. Over the medium-term, we are determined

to establish an efficient system for monitoring of illegal logging and forest exploitation and pilot community forestry in four targeted communities.

Stimulating Farm Incomes

49. The government recognizes that farm productivity gains will be essential if those dependent on farming are to be able to sustain their livelihoods and escape poverty. Small farms are – or can be – highly efficient, but require access to productivity-enhancing inputs and technologies that also promote sustainability of the use of land, water, pasture and forest resources. Effective market links for small farmers – to service providers and input suppliers, to traders and to the processing industry, and, not the least, to financial service providers – are essential for achieving these gains. To realize these objectives, four main areas for programmatic reform have been identified, including strengthening the decentralized advisory services system, bettering the livestock services, improving access to planting material and strengthening the management of the country's irrigation infrastructure and investments.

50. To achieve the four main objectives in agricultural development, several actions are envisioned. First, the government will ensure that the new seeds certification procedures are fully in force. In the area of agricultural extension, the government has established an inter-agency working group, which will prepare action plans to address reforms in order to strengthen the organization and management of the applied research system, and the agriculture extension delivery capabilities of the central and regional agricultural support centers (ASCs). The government will take steps to augment the role of fee-for-service advisory services sourced from the private sector, including the drafting of changes to the legal and regulatory framework, as may be needed. With regard to food safety and phytosanitary standards, the government has formed a task force charged with developing action plans to harmonize food safety and phytosanitary standards with relevant chapters of the Codex Alimentarius, and to encourage the utilization of internationally recognized certificates of conformance (eg. With ISO-1700 standards), by Armenian agri-food exporters. The government also intends to improve the performance of rural industries in parallel with other reform measures to improve the overall framework for strengthening competition and reducing constraints to private sector development. In particular, we will continue to expand and strengthen the business development services offered to rural enterprises by the official network of Small & Medium Enterprise Development Centers.

Rural Infrastructure Reform

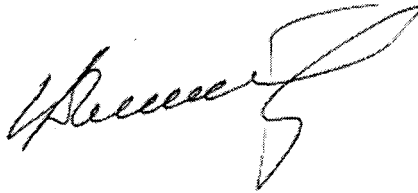
51. The government has recognized the importance of improving the rural infrastructure as a key element for rural poverty alleviation, acting as a catalyst for development and enhancing access for rural communities to a broad range of essential social and commercial services. The government plans to develop and carry out a rural infrastructure strategy in order to take maximum advantage of the limited available resources. The strategy will (i) address the need for greater coordination among donors under government ownership; (ii) designate a government institution to coordinate donor

funded activities; (iii) identify the appropriate level of universal access and quality infrastructure services; (iv); (iv) introduce simplified standards and new technologies; and (v) provide the correct incentives in order to ensure that the private sector contribution is maximized.

Program Monitoring and Evaluation

52. We are determined to monitor and evaluate the medium-term reform program to be supported by PRSCs through targets and benchmarks, including those reflected in the attached annex to this Letter of Development Policy. The government plans to make a comprehensive evaluation of the progress in the reform program, within the context of the agreed reform targets, during 2004-06 to assess the need for revised priorities. We are fully committed to implement effectively, consistently and on a timely basis our economic reform program based on the PRSP and as supported under the proposed PRSC.

With kind regards,



**Prime Minister,
Republic of Armenia**



**Minister of
Finance and Economy,
Republic of Armenia**

**ARMENIA: POVERTY REDUCTION SUPPORT CREDIT
MATRIX OF POLICY AND INSTITUTIONAL ACTIONS AND EXPECTED OUTCOMES**

GOALS	PRSC1 (Actions Taken)	PRSC2 (Reform Actions, with Triggers in bold)	PRSC3 (Reform Actions, with Triggers in bold)	EXPECTED OUTCOME in 2007
<i>THEME 1: Consolidating macroeconomic discipline and strengthening governance</i>				
1. Maintaining macroeconomic stability.	Falling inflation, fiscal deficits below 2.5 percent of GDP and satisfactory budget for 2005.	Macroeconomic performance in line with MTEF targets.	Macroeconomic performance in line with MTEF targets.	GDP expands by 25 percent over 2004-07; inflation kept below 3 percent and fiscal deficit in 2-3 percent range.
1.2 Public administration reforms.	Submitted to Parliament a Law on Electronic (digital) Signature and Electronic Document.	Implement the Law on Electronic Signature and Electronic Document.		
(a) Strengthening tax administration.	Adopted a strategy to introduce self-assessment in tax returns.	Strengthen operations of larger tax payers unit, especially audit, collection and enforcement, in line with a program satisfactory to IDA.	Start implementation of self-assessment systems to cover 25 percent of tax payers.	Tax revenue increases from 14% of GDP in 2003 to 16% of GDP in 2007.
	Agreed a quantitative schedule with IDA for reduction of outstanding	Reduce outstanding VAT refund claims to exporters and tax arrears in	Adhere to reform plan for the large taxpayer unit.	

GOALS	PRSC1 (Actions Taken)	PRSC2 (Reform Actions, with Triggers in bold)	PRSC3 (Reform Actions, with Triggers in bold)	EXPECTED OUTCOME in 2007
(b) Strengthening customs administration.	VAT refund claims to exporters and for reduction of tax arrears.	accordance with a quantitative schedule agreed with IDA.	Continued adherence to good practices on VAT refunds and tax arrears.	
	Introduced a self declaration system at all Customs houses and extended Direct Trade Input facilities to importers and custom brokers.	Implement self-declaration system and direct trade input facilities.	Maintain system.	
	Improved implementation of selectivity of customs control based on risk criteria and of green channel; and established a risk management unit.	Introduce green, yellow and red channel processing according to international standards.	Replace the present customs selection system by an intelligence-based system based on risk assessment.	Discretionary inspections reduced by 80 percent.
	Established a quantitative program for reducing the role of reference prices.	Implement according to timeline reduction of the role of reference prices consistent with WTO undertakings.		
	Strengthened Post Clearance Audit (PCA).	Satisfactory functioning of the PCA in line with plan.		

GOALS	PRSC1 (Actions Taken)	PRSC2 (Reform Actions, with Triggers in bold)	PRSC3 (Reform Actions, with Triggers in bold)	EXPECTED OUTCOME in 2007
(c) Improving governance in irrigation and drainage.	Decision taken to merge state-level responsibilities for irrigation and drainage within WRMC.	Irrigation and drainage merged under WRMC and functioning satisfactorily.		Irrigation cost recovery rises from 50% in 2003 to 70% in 2007.
1.3 Public Management	Restructured budget classifications along GFS 2001 principles.	Develop public sector integrated chart of accounts, accounting and reporting standards.	2007 Budget to fully adhere to GFS classification and chart of accounts.	GFS 2001 becomes operational in all ministerial budgets.
(a) Advancing budget management system and financial reporting.	Adopted a strategy to develop internal audit functions within Government.	Implement actions on internal audit functions.	Implement actions on internal audit functions.	Internal audit system fully functional in all ministries.
		Develop action plan to establish legal and operational framework for external audit in public sector.	Implement the external audit action plan.	External audit system functional.
(b) Improving Public Procurement	Implemented financial reporting by state Non-Commercial Organizations (SNCOs).	Develop sanctions for non-compliance with financial reporting for SNCOs and issue warning to state non-complying SNCOs.	Apply sanctions for non-compliance.	Eighty percent of SNCOs accounting for not less than 75% of aggregate income of SNCOs in compliance.
	Prepared an action plan and cost estimates for	Prepare catalogues for procuring entities on		Electronic procurement system introduced in the public sector;

GOALS	PRSC1 (Actions Taken)	PRSC2 (Reform Actions, with Triggers in bold)	PRSC3 (Reform Actions, with Triggers in bold)	EXPECTED OUTCOME in 2007
System.	introduction of an electronic procurement system.	technical specifications for goods and services of common use and publish these on the website.		and public sector procurement documents adhere to standards, and transparency increased. Single source open procurement (outside the natural monopoly sector) 80%, to be reduced to 50% and 20% by 2005 and 2006, respectively.
THEME II: Sharpening competition and entrenching property rights				
2.1 Competition (a) liberalization in key services.	Government adopted decision announcing its intention to widen participation in the provision of international civil aviation services, raise efficiency and cut costs (without prejudice to the implementation of already existing commercial agreements with private carriers in the field of aviation), and initiated policy work; and decision taken to accord managerial and operational autonomy to the railway company, to	Government implements measures to liberalize trade in air services (without prejudice to the implementation of already existing commercial agreements with private carriers in the field of aviation) satisfactory to IDA; and railway company reforms in full implementation.	Trade in air services to be liberal (without prejudice to the implementation of already existing commercial agreements with private carriers in the field of aviation); and satisfactory functioning of reforms in railways.	Air passenger and freight rates in line with most liberal comparable rates in Europe and Middle East; and objective and transparent rate setting in effect in railways in line with international practices.

GOALS	PRSC1 (Actions Taken)	PRSC2 (Reform Actions, with Triggers in bold)	PRSC3 (Reform Actions, with Triggers in bold)	EXPECTED OUTCOME in 2007
(b) Regulatory reform in state owned utilities.	constitute an independent board and reform tariff-setting.			
	Implemented Integrated Financial Rehabilitation Plan (IFRP) for <i>state owned utilities</i> (including energy, irrigation, drinking water companies, and Yerevan Metro), with strengthened corporate governance, creation of electricity market, and cessation of operations of the state electricity wholesale company.	Strengthen utilities regulatory framework, (a) adopt rules for service provision and procedures for monitoring quality in energy and drinking water, (b) publish performance-monitoring data for energy and water, (c) publish results of financial performance of PSRC-regulated irrigation companies, (d) adopt power market rules for trade, dispatching, safety of the grid.	Continued implementation of the regulatory framework.	Regulatory framework has led to quantitative improvements in outcome for quality, competition and rates of financial return (to be specified at appraisal).
		Introduce a telecom policy and a modern regulatory framework for the telecom sector that would allow for progressive licensing of additional service providers.	Maintain liberal telecom policy and regulation regime.	Multiple service providers active.

GOALS	PRSC1 (Actions Taken)	PRSC2 (Reform Actions, with Triggers in bold)	PRSC3 (Reform Actions, with Triggers in bold)	EXPECTED OUTCOME in 2007
2.2 Entrenching property rights (a) Secured transactions.	Established plan to (i) strengthen creditor rights, (ii) improve civil procedures for debt recovery, and (iii) simplify procedures for certification for property sales and registration of secured credit. Prepared collateral registry guide and software.	Amend civil code and related provisions on secured credit and streamlining of civil court procedures and court decision enforcement as agreed with IDA.	Sustain improved secured transactions conditions.	Commercial bank loans to private sector increase from 6% of GDP in 2003 to 10% of GDP in 2007.
(b) Confidence in the banking system.	Initiated a review of off site monitoring systems and on site supervision systems, procedures and practices.	Implement the supervision review. Enact regulations to improve corporate governance for banks in consultation with commercial banks.	Implement the supervision review.	Volume of private sector deposits rises from 9% of GDP in 2003 to 11% of GDP in 2007.
(c) Insurance markets.	Developed prudential standards, acceptable to IDA, in line with the new law on insurance and set minimum capital requirements for insurance	Ensure compliance with: (i) prudential standards (ii) quarterly reporting and (iii) financial statements based on ASRA and Chart of Accounts.	Establish: (i) an independent inspectorate, (ii) increase the minimum capital requirement for companies to AMD 350 Million and (iii) establish an appropriate	Level of premiums increases from US\$4.5 million in 2003 to US\$15 million in 2007.

GOALS	PRSC1 (Actions Taken)	PRSC2 (Reform Actions, with Triggers in bold)	PRSC3 (Reform Actions, with Triggers in bold)	EXPECTED OUTCOME in 2007
	companies at AMD 100 Million.		actuarial system.	
THEME III: Mitigating social and environmental risks				
3.1 Improving social protection and social risk management.	Introduced differentiation of benefits within the family poverty benefit.	Based on the 2004 household survey results evaluate effectiveness of the family poverty benefit, (including the targeting formula) and make corresponding policy changes.		At least 70% of poor households receive family poverty benefit; leakage from this benefit falls from 27% in 2003 to 25% in 2007.
	Implemented Public Pensions Law in accordance with timeline.	Draft law on private pension insurance and develop action plan on supervisory and regulatory capacity satisfactory to IDA.	Adopt the law on private pension insurance and implement the action plan to develop supervisory and regulatory capacity.	Average pension to average wages ratio rises from 22.6% in 2003 to 27.5% in 2007.
3.2 Raising the quality of education.	Made satisfactory progress in the school rationalization program, raising the ratio of pupils to full-time equivalent teachers to over 14 and raising 2005 teacher salaries by 65 percent.	Continue the school rationalization program, with MTEF pupil-teacher equivalent ratio targets and raise teacher salaries by 9 percent.	Complete the school rationalization program reaching a full-time equivalent teacher-student ratio of over 14 and raise teacher salaries by 9 percent.	Public spending in general education per pupil increases by 60% over 2003-07. Attainment standards improvements for secondary school students as measured by international test methods (PISA, TIMSS) – to be specified at appraisal.

GOALS	PRSC1 (Actions Taken)	PRSC2 (Reform Actions, with Triggers in bold)	PRSC3 (Reform Actions, with Triggers in bold)	EXPECTED OUTCOME in 2007
3.3 Controlling risks in health.	Initiated policy formulation on early childhood education with wide participation.	Develop and adopt a 3-year implementation plan for tertiary education, including sustainable financing and piloting, then expanding the course credit system.	Make satisfactory progress on implementing the tertiary education plan.	
	Adopted an action plan on hospital governance.	Pilot in two marzes the strategy for early childhood education, targeted towards the poorest families. Adhere to the rationalization program in the hospital sector as measured by target beds ratio and physicians ratio.	Expand the pre-school pilot programs to an agreed number of marzes and based on an evaluation of the pilot. Adhere to the rationalization program in the hospital sector as measured by target beds ratio and physicians ratio.	Pre-school services cover 30% of the 5-year age group and at least 50% of the poorest quintile of families by 2007. Between 2003 and 2007, infant mortality to fall from 12 per 1000 births to approach mean OECD levels or MDGs.
	Undertook measures for secured financing and management of Primary Health Care departments of polyclinics that are included in the hospital networks.	Develop options for private insurance to cover certain health risks and/or population pools.	Implement the regulatory framework for private health insurance.	Maternal mortality from 22 per 100000 to approach mean OECD levels or MDGs.

GOALS	PRSC1 (Actions Taken)	PRSC2 (Reform Actions, with Triggers in bold)	PRSC3 (Reform Actions, with Triggers in bold)	EXPECTED OUTCOME in 2007
3.4 Reducing risks in natural resource management for sustainable livelihoods	<p>Adopted a schedule for strengthened Environmental Impact Assessment and Supervision.</p> <p>Adopted a National Forestry Policy satisfactory to IDA.</p> <p>Adopted a National Action Plan to combat illegal logging.</p>	<p>Develop a program on non-communicable diseases.</p> <p>Implement the forestry policy, <i>inter alia</i>, by adopting forestry codes and institutional restructuring plan for the sector.</p> <p>Establish an efficient system for monitoring of (i) illegal logging and (ii) forest removal/exploitation.</p> <p>Adopt a supporting regulations on forest management planning and community forest management.</p>	<p>Implement the program on non-communicable disease.</p> <p>Control illegal logging and forest removal within targets agreed with IDA.</p>	<p>Utilization rate of hospital and PHC by bottom two quintiles to rise from 22% in 2003 to 33% in 2007.</p> <p>To be developed at appraisal.</p>

GOALS	PRSC1 (Actions Taken)	PRSC2 (Reform Actions, with Triggers in bold)	PRSC3 (Reform Actions, with Triggers in bold)	EXPECTED OUTCOME in 2007
THEME IV: Modernizing the rural economy				
4.1 Stimulate farm incomes.	Task force established to develop plan to (a) strengthen applied research and agriculture extension delivery system, (b) improve the links and information transfers between research and extension services, (c) augment the role of private advisory services and (d) make viable the official extension system.	Action plan implementation satisfactory to IDA.	Satisfactory progress with implementation of the plan.	Villages served by regional ASCs decrease from 6-9 villages in 2003 to an average of 2-3 per marz extension agent. Average productivity growth per ASC-served hectare rises 2% in 2003 to 5% in 2007.
	Government submitted seeds law to Parliament.	Seeds law approved, seeds certification procedures drafted by MoA and approved by Government.	Seeds law and seeds certification procedures fully in force.	Share of seed imports with certificates to rise from nil in 2003 to 100 % in 2007; of share of sales of domestic seeds by registered retail inputs suppliers rises from nil in 2003 to 80% in 2007.
	Task force formed to develop action plan for (a) harmonizing food safety and phytosanitary standards with relevant	Action plan developed and reviewed with IDA, harmonization underway at an advanced stage; implementation of part (b)	Harmonization completed and part (b) of the action plan being implemented in full.	Share of agri-food exports recognized as conforming with ISO 1700 standards rises from less than 5% in 2003 to 70% in 2007.

GOALS	PRSC1 (Actions Taken)	PRSC2 (Reform Actions, with Triggers in bold) of the action plan begun..	PRSC3 (Reform Actions, with Triggers in bold)	EXPECTED OUTCOME in 2007
4.2 Develop Rural Infrastructure	<p>chapters of the Codex Alimentarius and (b) to stimulate the use of internationally recognized certificates of conformance (e.g., with ISO 1700 standards).</p> <p>Completed a diagnostic study on a set of rural infrastructure services (drinking water, roads, gas, electricity, telecommunication).</p>	<p>Implement phased action plan to encompass, (i) universal access, with supporting financing mechanism, (ii) clear delineation of ownership and operational responsibilities, (iii) private-public partnership.</p> <p>Public Service Regulatory Commission (PRRC) to develop quality standards for rural infrastructure services and mechanisms for monitoring their quality.</p>	Satisfactory implementation of the action plan.	Share of secondary roads in rural areas to be reconstructed/rehabilitated declines from 61% to 56%.

ANNEX III

PRSC MONITORING INDICATORS⁴⁰

PRSC Area	Key Monitoring Indicator	Status in 2003	Est 2004	Est 2005	Est. 2006	2007 Outcome
I Consolidating Macroeconomic Discipline and Strengthening Governance						
Maintaining macroeconomic stability	<ul style="list-style-type: none"> GDP growth, inflation, and fiscal deficit 	<ul style="list-style-type: none"> 13.9%, 8.6%, and 1.5%, respectively 	<ul style="list-style-type: none"> 7.0%, 3.0%, and 2.7%, respectively 	<ul style="list-style-type: none"> 6.0%, 3.0%, and 3.0%, respectively 	<ul style="list-style-type: none"> 6.0%, 3.0%, and 3.0%, respectively 	<ul style="list-style-type: none"> 6.0%, 3.0%, and 2.8%, respectively
Strengthening tax and customs administration	<ul style="list-style-type: none"> Tax revenue, % of GDP 	<ul style="list-style-type: none"> 14.1% 	<ul style="list-style-type: none"> 14.8% 	<ul style="list-style-type: none"> 15.5% 	<ul style="list-style-type: none"> 16.2% 	<ul style="list-style-type: none"> 17%
Advancing budget management system and financial reporting	<ul style="list-style-type: none"> Budget classification based on GFS 2001 	<ul style="list-style-type: none"> Budget classification based on GFS 1986 	<ul style="list-style-type: none"> Restructure budget classifications along GFS 2001 principles 	<ul style="list-style-type: none"> Develop public sector integrated chart of accounts and accounting standards 	<ul style="list-style-type: none"> 2007 Budget to fully adhere to GFS classification and chart of accounts 	<ul style="list-style-type: none"> GFS 2001 becomes operational in all ministerial budgets
Improving public procurement system	<ul style="list-style-type: none"> Procurement system modernization 	<ul style="list-style-type: none"> Centralized public procurement 	<ul style="list-style-type: none"> Prepare an action plan and cost estimates for introduction of electronic procurement system 	<ul style="list-style-type: none"> Prepare catalogues for procuring entities on technical specifications for goods and services of common use and publish these on the website 	<ul style="list-style-type: none"> Implement electronic tendering permitting consolidation of procurement system, which allows electronic transmission of information on contract administration to the Treasury 	<ul style="list-style-type: none"> Electronic procurement system introduced in the public sector
		<ul style="list-style-type: none"> Weak standards for procurement practices 	<ul style="list-style-type: none"> 25% of documents follow standards 	<ul style="list-style-type: none"> 50% of documents follow standards 	<ul style="list-style-type: none"> 75% of documents follow standards 	<ul style="list-style-type: none"> Public sector procurement documents adhere to standards, the differences between privately and publicly procured goods declined, and

⁴⁰ These monitoring indicators are based on those developed by the government for the PRSP. The government has established an information collection and monitoring system to track progress with respect to the implementation of the PRSP.

PRSC Area	Key Monitoring Indicator	Status in 2003	Est 2004	Est 2005	Est. 2006	2007 Outcome
	<ul style="list-style-type: none"> Reduction of non-competitive procurement 	<ul style="list-style-type: none"> Very high level of single source procurement (80%), and low level of procurement through open bidding 	<ul style="list-style-type: none"> Single source procurement reduced 	<ul style="list-style-type: none"> Single source procurement reduced to 50% 	<ul style="list-style-type: none"> Single source procurement reduced to 20% 	<ul style="list-style-type: none"> transparency increased Single source procurement reduction trend sustained
II - Sharpening Competition and Entrenching Property Rights						
Sharpening competition	<ul style="list-style-type: none"> Share of private sector, % of GDP 	80%	82%	83%	84%	<ul style="list-style-type: none"> 85%
Secured transactions, confidence in the banking system, and insurance markets	<ul style="list-style-type: none"> Commercial bank loans to private sector, % of GDP 	6%	7%	8%	9%	<ul style="list-style-type: none"> 10%
	<ul style="list-style-type: none"> Volume of short-term rural lending by microfinance institutions 	US\$8 million	US\$9 million	US\$10 million	US\$11 million	<ul style="list-style-type: none"> US\$12 million
	<ul style="list-style-type: none"> Deposits (from resident physical and legal entities), % of GDP 	8.7%	9.5%	9.5%	9.6%	<ul style="list-style-type: none"> 10.5%
	<ul style="list-style-type: none"> Number of personal bank accounts 	406,802	425,000	440,000	470,000	<ul style="list-style-type: none"> 490,000
	<ul style="list-style-type: none"> Insurance premiums 	US\$4.5 million	US\$6 million	US\$9 million	US\$12 million	<ul style="list-style-type: none"> US\$15 million
III - Mitigating Social and Environmental Risks						
Improving social protection and social risk management	<ul style="list-style-type: none"> Poverty incidence, and extreme poverty 	<ul style="list-style-type: none"> 29%, and 5%, respectively 	<ul style="list-style-type: none"> Poverty incidence, and extreme poverty trends sustained Not less than 42% 	<ul style="list-style-type: none"> Not more than 27%, and 4%, respectively Not less than 45% 	<ul style="list-style-type: none"> Poverty incidence, and extreme poverty reduction trends sustained Not less than 47% 	<ul style="list-style-type: none"> 25%, and 2%, respectively 50%
	<ul style="list-style-type: none"> Share of labor income in total income of two poorest quintiles 	39%	Not less than 40%	Not less than 50%	Not less than 60%	<ul style="list-style-type: none"> Not less than 70%
	<ul style="list-style-type: none"> Share of extremely poor households receiving family poverty benefits 	33%	27%	26%	26%	<ul style="list-style-type: none"> Not exceed 25%
	<ul style="list-style-type: none"> Share of family poverty benefit expenditures leaked to non-poor 	27%	21%	22%	23%	<ul style="list-style-type: none"> Not below 25%
	<ul style="list-style-type: none"> Ratio of average pension in average wages 	20%				

PRSC Area	Key Monitoring Indicator	Statutes in 2003	Est 2004	Est 2005	Est. 2006	2007 Outcome
Raising the quality of education	<ul style="list-style-type: none"> Primary net enrollment rate (MDG) Public spending in general education per pupil Proportion of children participating in pre-school services, and proportion of children from poorest quintile of families participating Rise in non-salary recurrent and in capital expenditures 	<ul style="list-style-type: none"> 93% 100 (Index) 0%, and 0%, respectively 	<ul style="list-style-type: none"> 95% 156 0%, and 0%, respectively 	<ul style="list-style-type: none"> 97% 195 5%, and 10%, respectively 	<ul style="list-style-type: none"> 99% 226 15%, and 25%, respectively 	<ul style="list-style-type: none"> 100% 268 (Index 2003=100) 30%, and 50%, respectively
Controlling risks in health	<ul style="list-style-type: none"> Infant, and maternal mortality rates Utilization rate of health care services (PHC) by bottom two quintiles* Number of hospital contracts issued by the State Health Agency Share of health expenditures in GDP, and share of PHC expenditures in total budget** 	<ul style="list-style-type: none"> IMR 12 per 1000 births MMR 22 per 100,000 22% 135 1.2%, and 33.4%, respectively 	<ul style="list-style-type: none"> Improvement 23% 125 1.38%, and 34.9%, respectively 	<ul style="list-style-type: none"> Improvement 25% 118 1.56%, and 39.3%, respectively 	<ul style="list-style-type: none"> Improvement 28% 100 1.66%, and 41.9%, respectively 	<ul style="list-style-type: none"> Approach mean OECD levels or MDGs 33% 94 1.81%, and 42.3%, respectively
Mitigating environmental risks	<ul style="list-style-type: none"> Illegal logging indicator Community forestry indicator 	<ul style="list-style-type: none"> Damage caused annually to illegal logging estimated at \$5 million No community forests exist 	<ul style="list-style-type: none"> No change No change 	<ul style="list-style-type: none"> No change No change 	<ul style="list-style-type: none"> Damage caused annually to illegal logging estimated at \$3¼ million Between 2 to 3 community forests 	<ul style="list-style-type: none"> Damage caused annually to illegal logging estimated at \$2 million Between 4 to 6 community forests
IV Modernizing the Rural Economy						
Stimulate farm incomes	Promote productivity increases using mass media, and intensified village coverage served by regional Agriculture Support Centers (ASCs)	7-9 villages per ASC extension agent	Less intense coverage, 6 villages per agent	Better coverage, 5 villages per agent	Good coverage, 4 villages per agent	Intense coverage, 2-3 villages per agent

PRSC Area	Key Monitoring Indicator	Statuses in 2003	Est 2004	Est 2005	Est. 2006	2007 Outcome
	<ul style="list-style-type: none"> • Average productivity increase per hectare in ASC service areas • Percentage of national herd (ruminants, swine, and flocks) protected by MoA's national vaccination and routine inspection programs • Share of seed imports with certificates of (seed) quality, and share of sales of domestic seeds by registered retail inputs suppliers • Share of agro-food exports and imports certified as conforming with ISO 1700 Standards • MTEF's irrigation cost recovery target • Share of WUAs training services, outreach and contract services meeting targets <p>Cost recovery via subscriptions and users fees: from previously established enterprises and repeat users of DNCs' training and information services:</p>	<ul style="list-style-type: none"> • 2% • 50% • 0%, and 0%, respectively • <5% • Not satisfied • Some training and not meeting targets • 20% 	<ul style="list-style-type: none"> • 3% • 60% • 25%, and 20%, respectively • 20% • 55% • 20% • 25% 	<ul style="list-style-type: none"> • 4% • 70% • 50%, and 40%, respectively • 35% • 60% • 40% • 30% 	<ul style="list-style-type: none"> • 5% • 80% • 75%, and 60%, respectively • 50% • 65% • 60% • 35% 	<ul style="list-style-type: none"> • 5% • 90% • 100%, and 80%, respectively • 70% • Target (70%) fully satisfied • 90% of target • 40%
Develop rural infrastructure	<ul style="list-style-type: none"> • Share of secondary roads in rural areas to be reconstructed/rehabilitated 	<ul style="list-style-type: none"> • 61% 	<ul style="list-style-type: none"> • 60% 	<ul style="list-style-type: none"> • 59% 	<ul style="list-style-type: none"> • 57% 	<ul style="list-style-type: none"> • 56%

*/ Utilization rate of health care services by bottom two quintiles is as of 2001.

**/ The definition of PHC budget category will be revised to reflect the PHC reform, as agreed under the PRSC.

POVERTY IMPACT OF THE PRSC-SUPPORTED PROGRAM

This Annex examines the channels through which growth and public expenditure policies supported by the proposed program of Poverty Reduction Support Credits (PRSCs) may affect the poor. The analysis of the poverty and social impact of the various PRSC policy reforms are captured in a set of poverty equations estimated using variables and coefficients found to be significant from pooled data for a group of low-income countries. The poverty equation links the incidence of poverty to inflation, the literacy rate, real GDP per capita, the degree of trade openness and income inequality. The simulation exercise for Armenia shows that social expenditure measures supported by the PRSC program, in support of the overall PRSP, may have a higher impact on poverty and social conditions than in the absence of the reform program.

I. Introduction.

1. The purpose of this note is to explore the poverty linkages of the growth enhancing and public expenditure reforms contained in the three-year PRSC program in support of the PRSP. It does not intend to claim a direct one-to-one attribution of PRSC program impact on poverty reduction, but merely a simulation exercise of the possible links of the operation to poverty and social trends using recent World Bank analytical tools. Since the data sample for Armenia is short, a meaningful estimation of long-term parameters for the Armenian economy and its poverty evolution is not attempted. Instead, the analysis will draw on recent cross-country experiences and panel regression results on the determinants of poverty in a panel of low-income countries to make poverty and social impact simulations for Armenia—all in the context of the proposed policy actions underpinning the PRSC program in support of the PRSP.

2. The Annex will use a poverty module adapted to the Bank's macro projections RMSM-X model, following recent econometric work done by World Bank economists.⁴² The poverty module is made of three regression equations, one each for education, health, and poverty, respectively. Following this work, the Annex will describe the applicability of the poverty module for the Armenia experience and will simulate the possible contribution of PRSC program actions on future poverty trends under the macroeconomic scenarios envisioned by the PRSC (low, base, and high case scenarios).

3. The main findings are as follows:

- Since the late 1990s, higher per capita income growth, lower inflation, and trade openness have contributed to poverty reduction in Armenia. Improvements in income distribution have also played a significant role in reducing the incidence of poverty and the rising share of public education spending in total spending has had a beneficial impact on infant mortality as higher levels of educated female has lead to better infant health status. (However, the share of health expenditure in total expenditures is small,

⁴² Derek H.C.Chen, Thilak Ranaweera, and Andriy Storozhuk, The RMSM-X+P: A Minimal Poverty Module for RMSM-X, May 2004, The World Bank.

compared to other transition economies, and has fluctuated widely in the past with direct repercussions on infant mortality.)

- Using the simulation tool, PRSC-supported growth enhancing and social expenditure measures in support of the PRSP may result in poverty incidence of around 12 percent by 2010, from 29.1 percent in 2003 (based 2003 household survey results). Infant mortality under the PRSC program would fall slowly from 15.6 per 1000 live births in 2003 to around 14.4 per live births in 2010. This outlook is based on the assumption of strong GDP growth over the medium term (6 percent p.a.), on continuous improvement in the Gini coefficient based on private sector enhancing reforms, and on strong government commitment to implement the social sector reforms planned under the PRSC, which would increase education and health spending significantly, by around 125 percent, between 2003 and 2010. Inflation would remain under control (3 percent for the entire period) and trade openness would remain close to 85 percent of GDP by the end of the simulation period. The high case simulation would yield lower poverty levels (7 percent) by 2010, while the lower case simulation, including no real increase in education and health spending during the PRSC program, would result in a muted reduction of poverty (22 percent) by 2010.

4. The rest of the Annex is structured as follows: Section II describes recent trends in macroeconomic and social outcomes since the mid-1990s with a focus on poverty; Section III describes the main elements of the PRSC social program to be simulated; Section IV describes the analytical framework used to explore the impact of PRSC actions on poverty; and Section V summarizes the simulation results.

II. Recent Trends in Macro Performance, Social Outcomes and Poverty Reduction

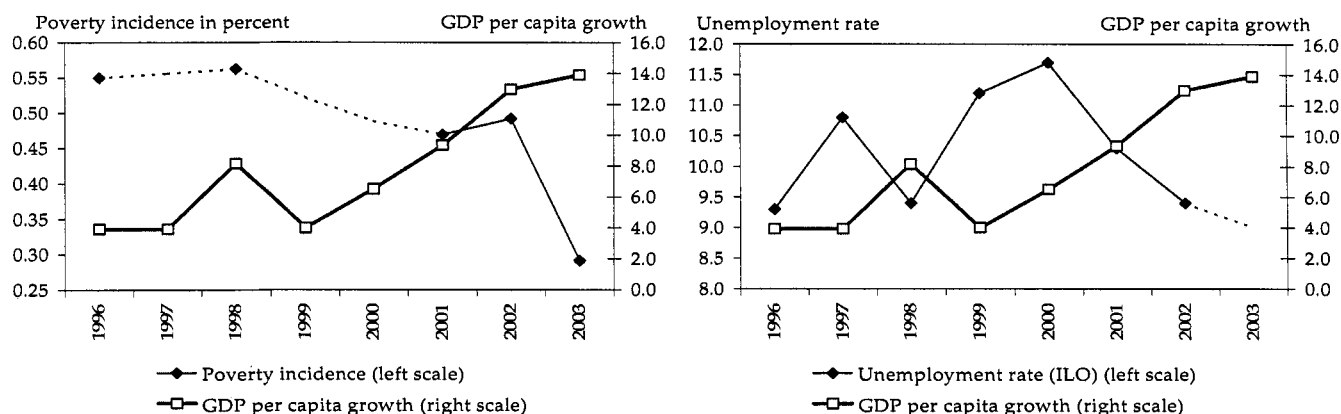
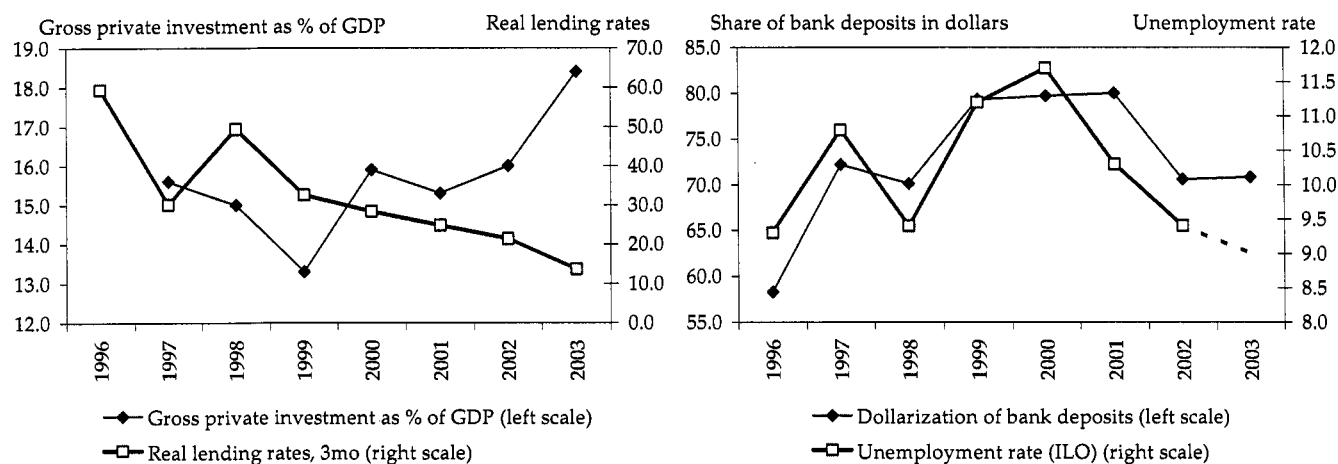
5. Armenia's growth performance since 1994 has been outstanding—8 percent per annum on average for the last seven years. A series of wide-ranging stabilization and structural reform measures implemented with support of the World Bank and the IMF contributed to Armenia's impressive growth performance of the late 1990s and early 2000s. Alongside the economic front, poverty and social performance also witnesses important achievements during this period. This section describes some of the recent trends in macro and social outcomes since the mid-1990s, with a focus on how they might have contributed to poverty outcomes.

6. **Growth and Poverty.** In 1988, only 20 percent of the population in Armenia received salaries below the poverty threshold. Income inequality was one of the lowest in the world, with the Gini coefficient estimated at 0.27 in beginning 1987-1990 (PRSP, 2003). Beginning in 1991, the newly independent Armenia entered a period of radical changes that involved political, social, and economic systems. An unprecedented energy crisis and the continued social effects of the devastating earthquake of 1998 exacerbated the impact. In addition, the Karabakh conflict, which resulted in closed borders with Azerbaijan and Turkey, displaced thousands in homes bordering the conflict region. As a

result, agricultural and non-agricultural production declined, unemployment and poverty increased, and income inequality widened. However, economic growth resumed in 1994. On average, Armenia has continued to outperform most post-conflict countries, averaging 8 percent GDP growth in the 1994-2003 period. Macroeconomic stabilization and adoption of economy wide structural reforms underpinned this growth with support from the World Bank and IMF, together with strong official and private transfers. By end 2003, the poverty incidence had declined to around 29 percent, from around 56 percent in 1998. Thus, sustained economic growth during recent years has had a positive impact on poverty reduction and on the improvement of income inequality.

7. ***Per Capita Real GDP.*** Higher standards of living and higher levels of economic output per person typically lead to lower poverty rates, holding other things constant. In Armenia, increases in real per capita income since the late 1990s has had a positive effect on poverty reduction, except in 2002 when poverty increased slightly compared to 2001, but resumed its downward trend in 2003 (see Figure 1). Income growth also helped to boost aggregate demand, decreasing unemployment rates to pre-Russia crisis levels. The Russian crisis of 1998 led to substantial decrease in industrial employment during 1999 and 2000. However, unemployment began declining in 2001 as the economy stabilized. Per capita real GDP is also an important factor affecting educational attainment (literacy) and the general health level (infant mortality) in the economy. Given that there exist significant opportunity costs associated with educational attainment, an increase in the average level of income may also increase the probability that individuals are able to shoulder these opportunity costs, thus leading to higher levels of literacy. Thus, higher per capita real GDP will have positive effect on literacy rates in years to come—although literacy levels are already high in Armenia, at 98.6 percent in 2003. On the health side, an increase in per capita income represents an increase in the ability to afford better nutrition, better housing, better sanitation, and higher levels of health care. As such, it is expected the infant mortality rate to decrease with higher levels of per capita income.

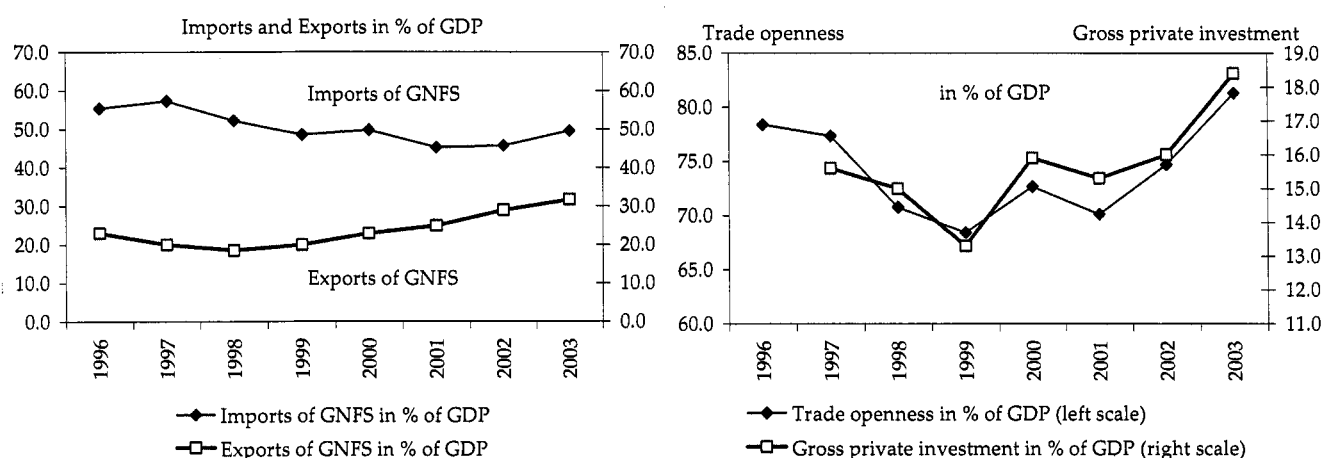
8. ***Inflation.*** Inflation tends to have adverse effects on low-income groups, particularly when the real value of their savings plummets as inflation rises. Inflation in Armenia has remained low and under control in recent years. Lower uncertainty in relative prices has led to lower real lending rates, lower risks, and higher private gross investment and per capita growth (see Figure 2). Gross private investment as a share of GDP has increased to around 19 percent in 2003, from 13 percent of GDP in 1999. Another sign of the positive effects of low inflation for the private investment is the increasing shares of domestic bank deposits in drams, away from dollars, which may have driven the increase in private investment instead of an increase in consumption. In fact, lower bank deposits in dollars correlates closely with lower unemployment, implying that an increase in labor income is having a positive effect on savings and investments, and eventually on growth. (see Figure 2).

Figure 1: Armenia: Poverty, GDP Per Capita, and Unemployment, 1996-2003**Figure 2: Armenia: Poverty, Private Investment, GDP Per Capita and Real Lending Rates, 1996-2003**

9. **Trade openness.** International trade and specialization in activities in which a country has comparative advantage leads to a relatively more efficient allocation of resources and an eventual positive impact on poverty. Workers that are relatively less mobile also benefit from trade in the end due to trickle-down effects. International trade can also have an indirect effect on poverty via economic growth. Trade openness (export GNFS + imports GNFS) may facilitate the acquisition of less expensive or higher quality intermediate goods, and improved technologies, which enhance the overall productivity of the economy and promote exports. This has been the case for the diamond and precious metal industry in Armenia. In 2003, trade openness in Armenia reached 82

percent of GDP compared to 68 percent of GDP in 1999. This was the result of continuous increases in exports of good and non-factor services (including diamonds), while imports remained relatively stable during the period (see Figure 3). In addition, trends in private investment relate closely to trends in trade openness, reflecting the positive impact of trade as an engine of growth, investment and poverty reduction. Economic growth in non-agricultural sectors in 1994-2001, in turn, was principally the result of a growth in labor productivity and shifts in employment towards paid work and self-employment. In other words, trade openness contributed to substantial improvements in opportunities for receiving incomes from employment or entrepreneurial activities of the population, including its poorest segments.

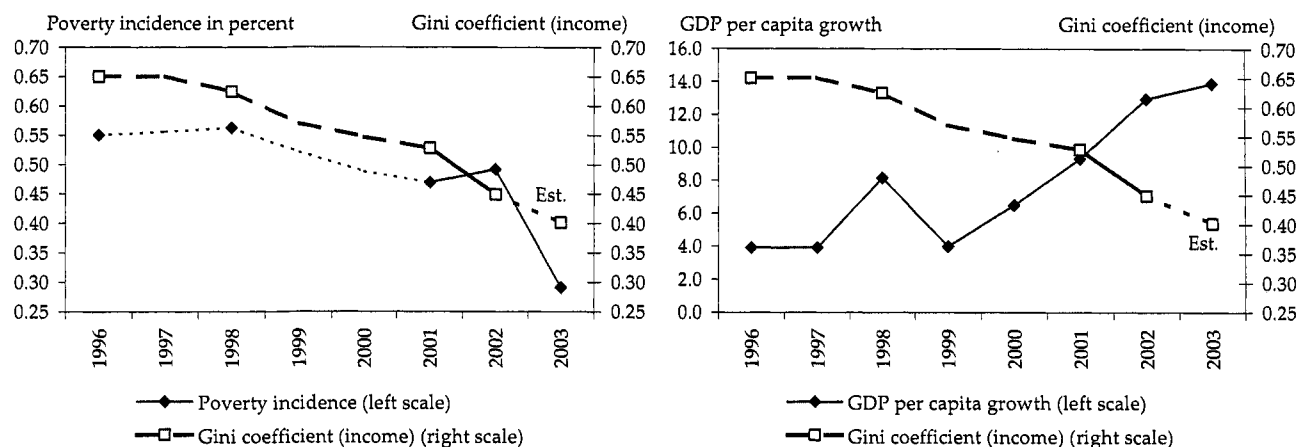
Figure 3: Armenia: Trade Openness and Private Investment, 1996-2003



10. **Income Distribution.** Typically, there are large differences on how much poverty alleviation countries can reap from economic growth, even if growth was distribution-neutral. Gains to the poor from growth tend to be lower the more unequal the income distribution. As such, initial income distribution is likely to be a significant determinant of the strength of the positive effects economic growth has on the incidence of poverty. Income distribution can also have indirect effects on poverty if severe income inequality leads to political instability and thus have perverse effects on investment and economic growth. Income inequality can also lead to less economic growth if it leads to inequality in access to investment opportunities, due to market imperfections such as collateral effects. This consequently leads to persistent and large cyclical fluctuations in credit that are detrimental to growth. Despite certain decrease from 1999 to 2003, inequality in Armenia is still at high levels, with the Gini coefficient at 0.44 in 2002 and an estimate of 0.40 in 2003 (see Figure 4). This reflects a certain degree of disproportionate distribution of income among the poor, and in particular, among the rural poor who rely on agricultural income. However, in recent years, the share of labor income and self-employment income has begun to replace agricultural income as the main source of

income (For more on poverty and income inequality see Armenia: Poverty Assessment. The World Bank, 2002, update 2003).

Figure 4. Armenia: Poverty, Income Inequality, and Per Capita Income, 1996-2003



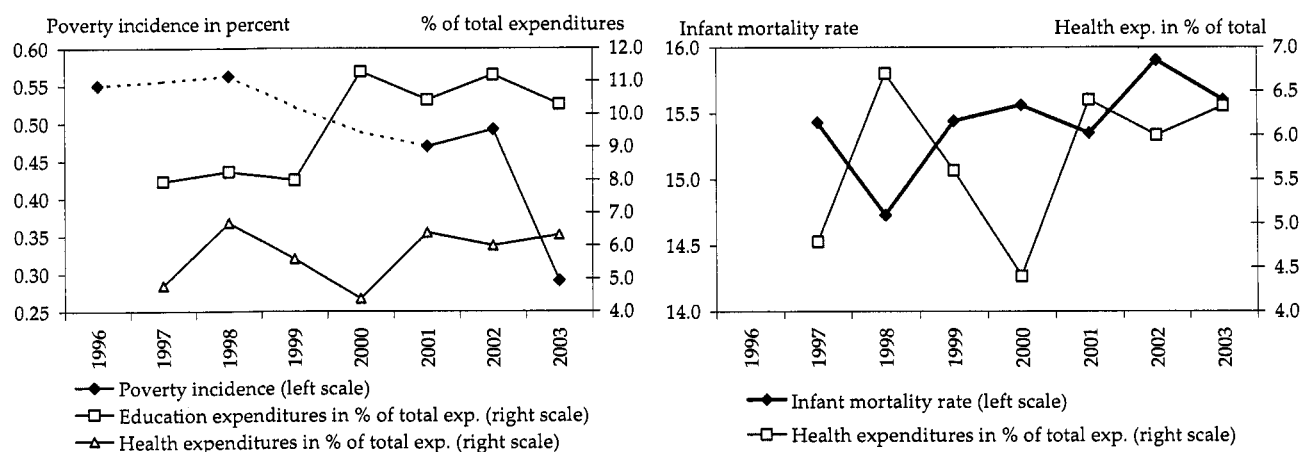
11. **Education and Infant Mortality.** Many studies have emphasized the importance of education in the development process. Human capital is the main asset of most poor people, so investment in the human capital of the poor should be an appropriate and efficient method of poverty reduction. Higher level of schooling tends to reduce income inequality, which consequently tends to reduce the incidence of poverty. For the simulation model developed below, adult literacy rate is a proxy for the stock of general education that exists within a low-income country. The higher the adult literacy rates in a country, the higher the general level of education, and the lower the incidence of poverty, holding other things constant. As in many transition countries, adult literacy is also high in Armenia, predicated largely upon the operation of the educational system formed during the Soviet era. Thus, the impact of adult literacy on poverty will be small if not nil. In the case of Armenia, enrollment at various levels of the educational system would have proven to be more useful, but the cross-country regressions regrettably did not consider this variable in the analysis for lack of sufficient data. However, it has been widely documented that the education level of women has a significant negative influence on infant and child mortality rates. The reason is that educated mothers are more able to take care of their children, providing them with better nutrition, having higher hygiene standards and being more knowledgeable about health care for children. Both aggregate and household level studies show that higher levels of female education are associated with better health status. In the case of Armenia, infant mortality has remained high (above 15 percent per 1000 live births) despite its high literacy rates. Adult literacy rate is used to proxy for the effects of education on the infant mortality rate.

12. **Education and the Urbanization Rate.** Given that most schools tend to be situated in densely populated areas, increased accessibility to schools for children

residing in urban areas is an important factor affecting illiteracy rates as it increases the tendency for children to attend school, and consequently to be literate. Also, there is a greater tendency for individuals residing in rural areas to be heavily involved in family-owned enterprises and farming, thereby increasing the opportunity costs of educational attainment, and leading to a smaller probability of such children being enrolled in schools. In view of the above, the urbanization rate or the share of total population residing in urban areas in Armenia (67 percent) should have had a positive effect on the literacy rates.

13. **Education and Health Expenditures.** An increase in public education expenditure should increase the number of schools and the quality of teachers, which consequently increases the accessibility to formal education and the capacity of the school education system to accommodate more students and expose them to higher teacher quality. It thus follows that public education expenditure should bear a positive effect on the general education and consequently on lower poverty levels. A higher share of public education spending in total spending in recent years correlates to improvements in poverty reduction and income inequality (see Figure 5). However, the share of health expenditure in total expenditures is small and has fluctuated widely during this period, with direct impact on infant mortality. An increase in public health expenditures in principle should lead to a larger number of medical facilities and personnel as well as the quality and quantity of medicine, resulting in a higher level of health care, and a more productive workforce. There is also evidence that the number nurses and physicians play a significant role in decreasing infant mortality rates. Higher per capita public health expenditures tend to increase life expectancy at birth and decrease the infant and under-five mortality rates (see Figure 5).

Figure 5: Armenia: Poverty and Spending in Health and Education, 1996-2003



III. The PRSC Program

14. This section briefly describes those social policy measures supported by the PRSC and how the Government of Armenia envisions their development for the next three to four years. As the PRSC documentation clearly describes, the authorities are implementing an ambitious range of actions to raise the efficiency in education and health sectors and to improve social protection administration. In this regard, the overall volumes and direction of public spending in these areas will be critical inputs into the simulation exercise developed below.

15. **Education spending.** Armenia's MTEF envisions a real increase in education spending of around 20 percent in 2005, of 8 percent in 2006, and of 14 percent in 2007. Expenditure measures planned for 2005 will focus on general service delivery, teacher salary increases, the school rationalization program, and the early childhood education program. Measures planned for 2006 and 2007 will further complete the school rationalization program, begin piloting the early childhood education program in two Marzes, and continue implementing the tertiary education plan.

16. **Health spending.** Health sector reforms include an increase in the 2005 budget of no less than 0.18 percent of GDP compared to 2004 budget results, including a shift towards increasing spending to primary health care (PCH) and adopting a hospital governance action plan. The MTEF plan for 2006 is to see an increase in health expenditures of no less than 0.1 percent of GDP compared to 2005, including the adoption of PCH budgetary category distinguishing pharmaceuticals from doctor services. In addition, there are plans to adopt a hospital rationalization program and develop options for private insurance to certain health risks and/or population pools. There are also plans to developing a strategy to provide access to essential drugs for vulnerable populations and elaborate a non-communicable diseases program. For 2007, the budget increase for health expenditures will not be less than 0.15 percent of GDP compared to 2006 and the programs begun in earlier years will continue their implementation.

IV. Empirical Framework of the RMSM-X Poverty Module

17. The previous section outlined the policy reform areas underpinned by the proposed PRSC program. Given the short availability of long-term data to provide a useful guide to future trends, the use of the poverty module of the RMSM-X will make it possible to draw on empirical analysis of the relationship between growth and poverty reduction. Following Chen et al., poverty analysis will be done using a poverty equation where poverty is a function of several macroeconomic and structural factors. Poverty incidence will depend on the inflation rate, the general level of education, the level per capita real GDP, the degree of openness to international trade, and income inequality. Adult literacy rate will be used as the measure of general education, while the degree of income inequality will be given by the Gini coefficient. The magnitude of the effects of the macroeconomic and structural variables on poverty was estimated using a pooled regression with actual data from low-income countries. The resultant estimated

coefficients of the independent variables would then be used in the poverty equation to project the level of the incidence of poverty for Armenia.

18. The education and health indicators were constructed in a similar manner in the education and health sheets of the Poverty Module. The general level of education prevailing in the population will be dependent on the level of per capita GDP, the urbanization rate and the level of per capita public education expenditure. Likewise, the general level of health will depend on the level of per capita GDP, the level of per capita public health expenditure, and the general level of education. As with the poverty equation, the magnitudes of the effects of these macroeconomic and structural variables on each social indicator are estimated using cross-country time series regressions based on historical data from low-income countries. The resulting parameter estimates were then combined with macroeconomic projections from the RMSM-X model and assumptions about other exogenous (structural) variables to obtain projections for the social indicators.

19. Projections for public education and public health expenditures are obtained using total government expenditure (obtained from the RMSM-X) and auxiliary assumptions for the shares of public education and health expenditure in total government expenditure. Projections for the urbanization rate, used in the education equation, are determined exogenously. Lastly, projections for the literacy rate, used in the health equation, are obtained from the education equation of the education sheet.

20. **Data.** The data used to build the poverty regression was based on results from a pooled cross-section of 52 observations including 24 low-income countries for the 1980-98 period. The sample data for the education and health regressions is much larger, at 229 observations spanning 32 countries covering 1983-98 for the education regression and at 174 observations spanning 43 countries covering 1990-99 for the health regression. For a description of their estimation methodology and exact definition of the variables please refer to the Chen et al. paper. For purposes of this analysis, we will take those coefficients as given and fit the Armenia experience, except for the per capita real GDP coefficient in the Poverty regression which I have modified slightly after running the regression with actual data for the 1996-02 period.

21. The following three subsections present the empirical framework postulated by the RMSM-X to derive the potential impact of PRSC actions on poverty, education, and health equations for the 2004-2010 period.

22. **The Poverty Equation.** Macroeconomic and structural factors influence the incidence of poverty in an economy. These factors include the prevailing inflation rate, the adult literacy rate, the level of per capita real GDP, and the level of openness to international trade, trade openness squared, and the degree of income inequality. Equation 1 shows the poverty incidence equation followed by the numerical description of the poverty linkages.

$$(1) \text{ Poverty Incidence} = 49.6446 + 0.1883 \text{ Inflation} - 0.3176 \text{ Literacy Rate} - 0.166 \log(\text{per capita real GDP modified to fit the Armenia experience}) - 0.7585 \text{ Openness} + 0.0046 \text{ Openness Squared} + 0.9534 \text{ Gini}$$

23. **The Education Equation.** Similar to the case of the incidence of poverty, the level of general education that prevails within a country, as measured by the adult literacy rate, is influenced by macroeconomic and structural factors. These factors are the level of per capita real GDP, the urban share of total population (or urbanization rate) and per capita public expenditure on education. The education equation is specified below.

$$(2) \text{ Log of Literacy Rate} = 0.0229 \log (\text{Average per capita Public Education Expenditure in current and previous 3 periods}) + 0.088 \log (\text{per capita real GDP}) + 0.8455 \log (\text{Urbanization Rate})$$

24. **The Health Equation.** The general level of health that prevails within a certain population also depends on certain macroeconomic and structural variables. In the poverty module, the infant mortality rate is postulated as the measure of health and Chen et al. assert that infant mortality is affected by per capita real GDP, per capita public health expenditure and the adult literacy rate. The health equation is as follow:

$$(3) \text{ Log of Infant Mortality Rate} = -0.0218 \log (\text{per capita Public Health Expenditure}) - 0.1131 \log (\text{per capita real GDP}) - 0.6004 \log (\text{Literacy Rate})$$

V. Simulating the Poverty Impact of Armenia's PRSC Program

25. Based on the above equations, this section presents the simulation exercise for the three macroeconomic scenarios of the PRSC. Table 1 and Figure 6 show the results.

A. Base Case Simulation

26. Under the base case simulation exercise, poverty incidence may decline steadily in the medium term to around 12 percent by 2010 from 29.1 percent in 2003 (based on 2003 household survey results). This implies a yearly decline of around 12 percent or a cut in the poverty rate of close to 2.5 percentage points every year for the 2004-2010 period. Infant mortality is expected to fall slowly from 15.6 per 1000 live births in 2003 to around 14.4 per live births in 2010. This outlook is based on the assumption of strong GDP growth over the medium term (6 percent), on a much improved Gini coefficient (0.32 percent in 2010 compared to an estimate of 0.40 in 2003), and on strong government commitment to implement the social sector reforms planned under the PRSC, which are expected to increase social sector spending by around 125 percent in real terms between 2003 and 2010. As planned, the increase in real education spending of around 14 percent in the between 2005-2007 period would include all measures planned and supported by the PRSC (see Section III). The health spending increase during the 2005-2007 period (a 0.4 percent of GDP increase) would support primary health care services reforms. Health spending would reach 9 percent of total spending by

2010 from 6.3 percent of total spending in 2003. Inflation would remain under control (3 percent for the entire period) and trade openness would remain close to 85 percent of GDP by the end of the simulation period.

B. High Case Simulation

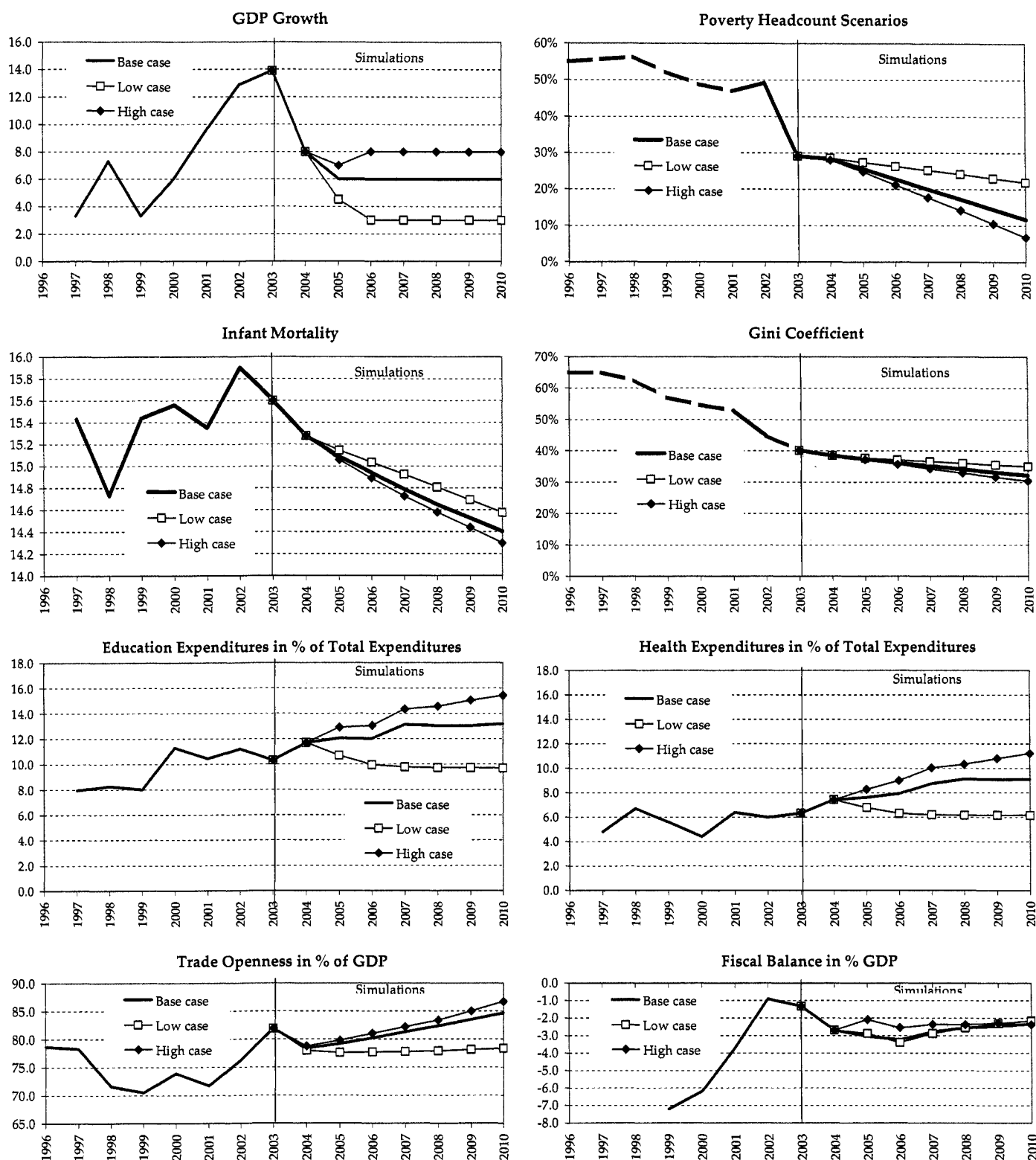
27. Under the high case simulation, fast-action pro-poor policies would result in poverty incidence of 7 percent by 2010 compared—a sharp decline in poverty. This implies a yearly decline of around 18 percent or a cut in the poverty rate of close to 3.2 percentage points every year. Infant mortality would not fall faster than in the base case, remaining at around 14.3 per live births by 2010, reflecting the difficulty of quantifying the impact of important PRSC measures (e.g., institutional and governance reform measures) other than financial flows, on the health status of infants. Health sector reforms must be seen on a much larger time scale and quantifying these will remain a challenge for future work in this area. This outlook is based on the assumption of high GDP growth over the medium term (8 percent in 2005-10), on a somewhat more improved Gini coefficient than in the base case (0.30 percent by 2010), and on extreme government commitment to implement the social sector reforms above levels planned for the PRSC, which should yield a 200 percent increase in real education and health spending between 2003 and 2010. By 2010, education spending would reach 15.4 percent of total spending and health spending would reach 11.2 percent of total spending by 2010, compared with 10.3 and 6.3 percent respectively in 2003. As in the base case, inflation would remain under control (3 percent for the entire period) and trade openness would be well above 85 percent of GDP by the end of the simulation period.

C. Low Case Simulation

28. Under the low case simulation, poverty incidence would remain relatively high in the medium term, not lower than 20 percent by 2010 from 29.1 percent in 2003. This implies a yearly decline of around 4 percent or a cut in the poverty rate of close to 1 percentage points every year. Infant mortality would remain high, closer to 15 per 1000 live births during the simulation period. This outlook is based on the assumption of weak GDP growth over the medium term (3 percent in 2005-10), on a much stagnant Gini coefficient (0.35 percent by 2010 compared to an estimate of 0.40 in 2003), and on weak government commitment to implement the social sector reforms planned under the PRSC, which would result in no real increases in education and health sector spending during the PRSC program years. During the simulation period, education and health spending would remain flat in percent of total spending, at 2003 levels. Inflation would be somewhat higher (3.5 percent for the entire period) and trade openness would remain below 80 percent of GDP—below 2003 levels.

Table 1. Armenia: Simulation of PRSC Impact on Poverty Reduction

	Avg. 1997-2002	Est. 2003	Simulation						
			2004	2005	2006	2007	2008	2009	2010
Base Case Simulation									
Assumptions			PRSC I	PRSC II	PRSC III				
Per capita GDP growth	7.5	13.9	7.9	5.9	5.9	5.9	5.9	5.9	5.9
GDP Inflation	5.5	4.7	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Trade Openness	72.3	81.3	78.4	79.2	80.2	81.3	82.4	83.5	84.7
Urbanization Rate	67.0	67.0	67.0	67.0	67.0	67.0	67.0	67.0	67.0
Gini Coefficient (tied to per capita GDP growth)	55.0	40.1	38.5	37.4	36.3	35.2	34.2	33.2	32.2
Education Expenditures in % of Total Expenditures	9.5	10.3	11.7	12.0	12.0	13.1	13.0	13.0	13.2
(Real change in percent)		18.8	19.8	20.0	8.0	14.0	6.0	6.5	7.0
Health Expenditures in % of Total Expenditures	5.6	6.3	7.4	7.6	7.9	8.7	9.1	9.1	9.1
(Real change in percent)		19.3	23.9	19.6	12.7	14.9	11.5	6.0	6.0
Simulation Results									
Poverty Incidence	51.8	29.1	28.3	25.6	22.8	20.0	17.2	14.4	11.7
Llteracy Rate	98.4	98.6	99.7	100.0	100.0	100.0	100.0	100.0	100.0
Infant Mortality Rate	15.4	15.6	15.3	15.1	14.9	14.8	14.6	14.5	14.4
High Case Simulation									
Assumptions			PRSC I	PRSC II	PRSC III				
Per capita GDP growth	7.5	13.9	7.9	6.9	7.9	7.9	7.9	7.9	7.9
GDP Inflation	5.5	4.7	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Trade Openness	72.3	81.3	78.7	79.8	81.0	82.2	83.4	85.0	86.7
Urbanization Rate	67.0	67.0	67.0	67.0	67.0	67.0	67.0	67.0	67.0
Gini Coefficient (tied to per capita GDP growth)	55.0	40.1	38.5	37.2	35.7	34.3	33.0	31.6	30.4
Education Expenditures in % of Total Expenditures	9.5	10.3	11.7	12.9	13.0	14.3	14.6	15.0	15.4
(Real change in percent)		18.8	19.8	29.7	12.1	17.8	11.6	11.5	11.4
Health Expenditures in % of Total Expenditures	5.6	6.3	7.4	8.3	9.0	10.0	10.3	10.8	11.2
(Real change in percent)		19.3	23.9	30.9	20.7	19.4	13.1	12.9	12.7
Simulation Results									
Poverty Incidence	51.8	29.1	28.0	24.8	21.2	17.7	14.2	10.5	6.8
Llteracy Rate	98.4	98.6	99.7	100.0	100.0	100.0	100.0	100.0	100.0
Infant Mortality Rate	15.4	15.6	15.3	15.1	14.9	14.7	14.6	14.4	14.3
Low Case Simulation									
Assumptions			PRSC I	PRSC II	PRSC III				
Per capita GDP growth	7.5	13.9	7.9	4.4	2.9	2.9	2.9	2.9	2.9
GDP Inflation	5.5	4.7	3.0	3.5	3.5	3.5	3.5	3.5	3.5
Trade Openness	72.3	81.3	78.0	77.6	77.7	77.8	77.9	78.2	78.4
Urbanization Rate	67.0	67.0	67.0	67.0	67.0	67.0	67.0	67.0	67.0
Gini Coefficient (tied to per capita GDP growth)	55.0	40.1	38.5	37.7	37.1	36.6	36.1	35.5	35.0
Education Expenditures in % of Total Expenditures	9.5	10.3	11.7	10.7	9.9	9.8	9.7	9.7	9.7
(Real change in percent)		18.8	19.3	0.0	0.0	0.0	3.0	3.0	3.0
Health Expenditures in % of Total Expenditures	5.6	6.3	7.4	6.8	6.3	6.2	6.2	6.2	6.2
(Real change in percent)		19.3	23.3	0.0	0.0	0.0	3.0	3.0	3.0
Simulation Results									
Poverty Incidence	51.8	29.1	28.6	27.3	26.3	25.2	24.1	23.0	21.8
Llteracy Rate	98.4	98.6	99.7	100.0	100.0	100.0	100.0	100.0	100.0
Infant Mortality Rate	15.4	15.6	15.3	15.1	15.0	14.9	14.8	14.7	14.6

Figure 6: Armenia: Simulation of PRSC Impact on Poverty Reduction, 1996-2010

RELATIONS WITH THE FUND

May 3, 2004

IMF Completes Fifth Review Under PRGF for the Republic of Armenia, Approves Request for Extension of the Arrangement Through December 2004

The Executive Board of the International Monetary Fund (IMF) today completed the fifth review of the Republic of Armenia's economic performance under a three-year Poverty Reduction and Growth Facility (PRGF) arrangement, and approved a request for the extension of the arrangement by seven months to December 31, 2004. The completion of the review enables Armenia to draw an amount equivalent to SDR 10 million (about US\$15 million).

Armenia's PRGF arrangement for the equivalent of SDR 69 million (about US\$100 million) was approved on May 21, 2001 (see [Press Release No. 01/25](#)). So far, the equivalent of SDR 50 million (about US\$73 million) have been disbursed.

The PRGF is the IMF's concessional facility for low-income countries. PRGF-supported programs are based on country-owned poverty reduction strategies adopted in a participatory process involving civil society and development partners, and articulated in a Poverty Reduction Strategy Paper, or PRSP. This is intended to ensure that each PRGF-supported program is consistent with a comprehensive framework for macroeconomic, structural, and social policies, to foster growth and reduce poverty. PRGF loans carry an annual interest rate of 0.5 percent, and are repayable over 10 years with a 5 ½-year grace period on principal payments.

Following the Executive Board discussion, Agustín Carstens, Deputy Managing Director and Acting Chair, said:

“The Armenian authorities should be commended for the satisfactory implementation of macroeconomic policies and structural measures under the PRGF-supported program. These policies have contributed to an improved business environment and a strong economic performance in 2003.

“Raising revenues and reforming tax and customs administration remain critical objectives in the period immediately ahead. The recent reduction in VAT exemptions and reform of the profit tax are welcomed steps in this regard, but further efforts are needed to improve the tax system and generate resources for poverty reduction. In particular, it will be important to improve the transparency of tax and customs operations, ensure the equal treatment of taxpayers, and implement risk-based audit systems. Additional steps

are needed in the medium term to strengthen the overall coherence of the tax system and the management of the tax and customs agencies.

“Recent increases in bread and utility prices pose the risk of rekindling inflationary expectations, and the central bank will need to maintain a tight monetary policy to bring inflation down to its goal of 3 percent by end-2004. To further develop Armenia’s financial system, it will be important to build capacity and promote sound corporate governance in the banking system, and strengthen the legal framework and the judiciary.

“The recent process of fiscal decentralization has the potential to improve the quality and efficiency of services delivered by state-owned noncommercial organizations in the health, water, and education sectors. Complementary capacity building initiatives and a properly functioning reporting framework remain essential to ensure transparency and accountability in the operations of these entities.

“Other structural reforms will be important to sustain growth and reduce poverty in the medium term. The anti-corruption strategy needs to be implemented forcefully and in consultation with civil society. The authorities are encouraged to move forward with their plans to reform the energy and water sectors, including establishing market rules for electricity trading, and liquidating the state-owned company Armenergo,” Mr. Carstens said.

9/29/04

Armenia at a glance

POVERTY and SOCIAL

2003

Population, mid-year (millions)	3.2	473	2,655
GNI per capita (Atlas method, US\$)	910	2,570	1,480
GNI (Atlas method, US\$ billions)	2.9	1,217	3,934

Average annual growth, 1997-03

Population (%)	0.8	0.0	0.9
Labor force (%)	-4.3	0.2	1.2

Most recent estimate (latest year available, 1997-03)

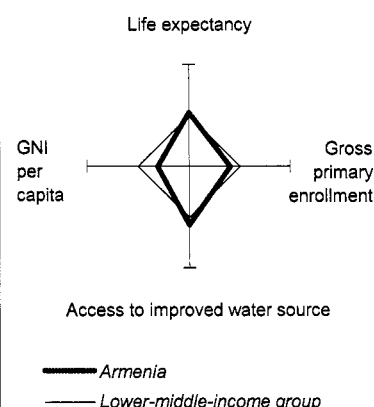
Poverty (% of population below national poverty line)	43
Urban population (% of total population)	64	63	50
Life expectancy at birth (years)	73	69	69
Infant mortality (per 1,000 live births)	12	31	32
Child malnutrition (% of children under 5)	3	..	11
Access to an improved water source (% of population)	93	91	81
Illiteracy (% of population age 15+)	1	3	10
Gross primary enrollment (% of school-age population)	92	103	112
Male	..	104	113
Female	..	102	111

KEY ECONOMIC RATIOS and LONG-TERM TRENDS

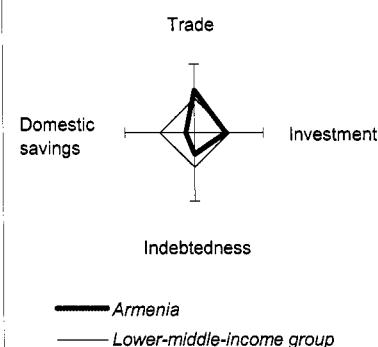
	1983	1993	2002	2003
GDP (US\$ billions)	..	2.2	2.4	2.8
Gross domestic investment/GDP	..	9.9	21.7	24.7
Exports of goods and services/GDP	..	47.2	29.4	31.9
Gross domestic savings/GDP	..	-3.7	4.9	7.2
Gross national savings/GDP	15.9	18.5
Current account balance/GDP	..	-8.8	-6.3	-6.7
Interest payments/GDP	0.8	0.4
Total debt/GDP	44.6	40.3
Total debt service/exports	7.8	11.9
Present value of debt/GDP	28.6	26.2
Present value of debt/exports	79.9	69.3

	1983-93	1993-03	2002	2003	2003-07
(average annual growth)					
GDP	..	6.8	13.2	13.9	..
GDP per capita	..	7.1	13.2	6.5	..
Exports of goods and services	..	3.0	29.3	28.2	..

Development diamond*



Economic ratios*

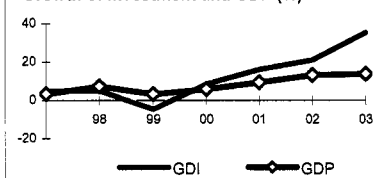


STRUCTURE of the ECONOMY

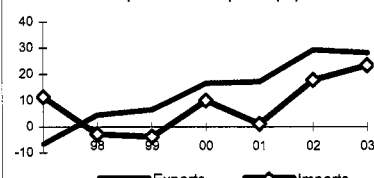
	1983	1993	2002	2003
(% of GDP)				
Agriculture	..	51.4	26.0	23.5
Industry	..	26.9	35.1	39.2
Manufacturing	..	22.9	20.9	21.9
Services	..	21.7	39.0	37.3
Private consumption	..	86.5	85.1	82.5
General government consumption	..	17.2	10.0	10.3
Imports of goods and services	..	60.8	46.6	49.8

	1983-93	1993-03	2002	2003
(average annual growth)				
Agriculture	..	3.4	3.8	4.3
Industry	..	6.6	20.5	23.2
Manufacturing	..	4.3	13.9	15.4
Services	..	8.7	21.8	15.3
Private consumption	..	5.2	52.0	-17.1
General government consumption	..	0.4	2.2	14.0
Gross domestic investment	..	9.7	21.3	35.5
Imports of goods and services	..	1.9	17.9	23.5

Growth of investment and GDP (%)



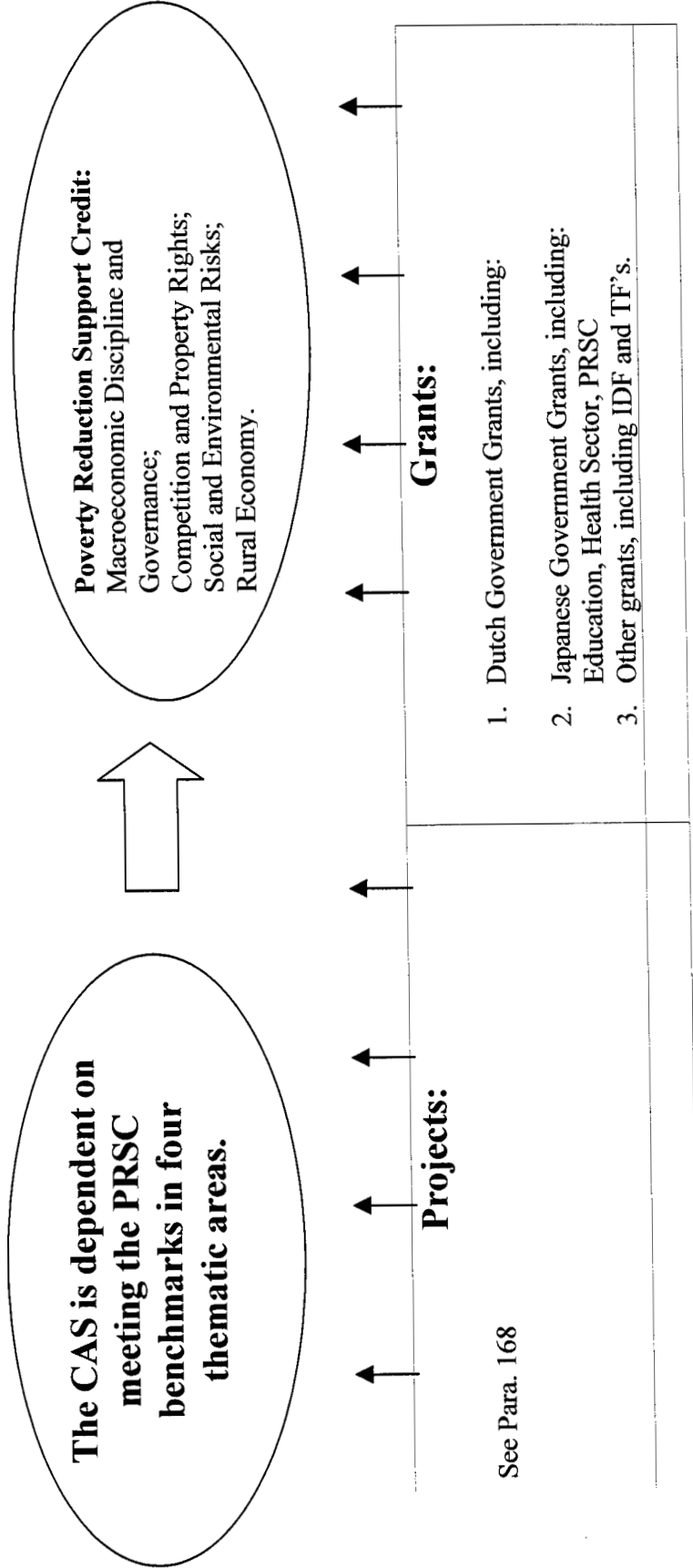
Growth of exports and imports (%)



Note: 2003 data are preliminary estimates.

* The diamonds show four key indicators in the country (in bold) compared with its income-group average. If data are missing, the diamond will be incomplete.

LINKAGES WITH CAS
Linkage of PRSC program with the CAS



Poverty Reduction Support Credit & Supporting ESW				
PRSC1				PRSC2
FY01	FY02	FY03	FY04	Forthcoming
<ul style="list-style-type: none"> • CEM Growth Study • Institution and Governance Review Workshop 	<ul style="list-style-type: none"> • Children's Initiative IDF • Cultural Heritage IDF • CG meeting • Child Welfare Note • Poverty Update • Public Expenditure Review • Trade Facilitation Workshop • Water Resources Plan 	<ul style="list-style-type: none"> • Client Survey • Financial Sector TA • FSAP Follow-up • Poverty Update • Procurement Assessment • Strengthen Statistical System IDF • Urban Heat Strategy 	<ul style="list-style-type: none"> • Country Financial Accountability Assessment • Fiscal Study • Poverty Assessment 	<ul style="list-style-type: none"> • CEM on Pro-Poor Growth • Programmatic Poverty Assessment • Programmatic Public Expenditure Review • For others, please see para. 164, "Analytical and Advisory Activities".

