ARMENIA AFTER A DECADE OF REFORM

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Abstract: *Despite geographical isolation, trade blockades, and occasional political upheaval, Armenia's economic performance during the last four years has been remarkable. This paper looks at the causes of such performance and takes stock of the economic reforms to date, focusing on the most recent period of economic stability, strong economic growth, and poverty reduction. The paper also discusses the remaining challenges to sustain high rates of economic growth and further reduce poverty, especially the policy actions needed to address remaining weaknesses in tax and customs administration and the banking system, improve the efficiency of social services, increase public investment, and combat corruption.*

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I. INTRODUCTION

The first decade of transition was difficult for Armenia. A severe earthquake, the break-up of the Soviet Union, and disputes with its neighbors led to drastic decline in output in the early 1990s. Declining living standards and rising poverty levels forced many of Armenia's most productive workers to migrate. During the last four years, Armenia's economic performance has been remarkable. Real economic growth has averaged 12 percent, inflation was kept at single-digit levels, and poverty and income inequities have been reduced. These outcomes are particularly impressive given the geographical location of the country, the closure of two critical borders, and occasional political turmoil.

Notwithstanding these achievements, per capita income is just about US$1,000, poverty is still high, and the structural reform agenda remains unfinished. The country's institutions are weak, and corruption remains a serious problem. Resolving these issues will be critical to sustaining growth in the medium term.

This paper focuses on three main themes: (i) Armenia's economic performance compared to similar transition countries, especially since 2001; (ii) the factors behind such performance; and (iii) the main obstacles the country needs to overcome to sustain high rates of economic growth in the future.

II. BACKGROUND

Before 1990, central planning and a disregard for economic incentives characterized Armenia's economy, as was the case in most Soviet block countries. The country received substantial financial support (transfers and subsidies on imported products) from Russia, and its industrial sector was quite important, accounting for about half of GDP. Armenia's human capital base was also in high demand in Russia. The most important industrial (and export) activities were electronics, heavy machinery, and chemicals.[1] These activities were the ones that suffered most from the disintegration of the Soviet Union after 1990.

Table 1.1. Armenia: Composition and Level of GDP, 1989–2004
(in percent)

	1989	1994	1999	2004
Agriculture	15	44	27	20
Industry	50	29	21	22
Construction	21	7	8	15
Transport	4	4	8	6
Trade/Services	11	17	36	37
Real GDP (Index 1991=100)	...	45	56	92
Income per capita (U.S. dollars)	...	173	566	1,135

Source: National Statistical Office and Ministry of Finance.

Between 1988 and 1994, the economy was severely affected by the 1988 earthquake, the collapse of the Soviet Union, and the Nagorno-Karakakh conflict.[2] Trade routes were

[1] Output was produced, mainly in large plants, and exchanged with other countries of the former Soviet Union, primarily Russia. See Avanesyan and Freinkman (2003).

[2] The 1988 earthquake is estimated to have left more than 25,000 people dead and many more homeless. The war with Azerbaijan was motivated by tensions about the Nagorno-Karabakh region. The war began in 1991 and a ceasefire was reached in 1994. Since then, Armenia's borders with Azerbaijan and Turkey have remained closed. This has constrained Armenia's trade prospects because of the higher costs of transportation to Europe (via Georgia) and lack of access to Turkey's internal market. Discussions between Armenia and Turkey have

disrupted, subsidies on energy and other inputs imported from the Soviet Union eliminated, Russian demand for Armenia's goods virtually disappeared, and transportation costs skyrocketed.[3] These factors led to an estimated 55 percent decline in Armenia's GDP (compared to a 50 percent average decline in the rest of the former Soviet Union) during this period.[4] By 1994, annual inflation escalated to 5,300 percent, the result of massive fiscal imbalances financed with money creation. The fiscal and the external current account deficits rose to 17 percent and 36 percent of GDP, respectively.

The shocks of the late 1980s and early 1990s led to massive unemployment and a large emigration to the countryside and to other countries. By 1997, an estimated 17 percent of the 1990 population of nearly 3.4 million people emigrated abroad (Ministry of Statistics, 1998).[5] Since the late 1990s, Armenia's diaspora has become an important source of remittances and transfers (officially estimated at an average of 8 percent of GDP per year during the period 2000–04), and has been a contributing factor to the recent surge in trade and investment.[6]

As in other countries of the former Soviet Union, powerful business interests have emerged in the transition to a market economy. These interests exert increasing influence in public decision making, leading to legally sanctioned tax privileges, nontransparent privatizations, and tax evasion. These developments are worrisome as they put at risk the country's prospects for lasting reform and sustained growth. In response to public pressure to deal with corruption in the public sector and the judiciary, the government approved a three-year anti-corruption strategy in November 2003.

III. ECONOMIC REFORMS

The cease-fire with Azerbaijan allowed the government to focus on its economic agenda, and a stabilization program was adopted in 1994 with support from the International Monetary Fund (IMF), the World Bank, and other donors. Since then, and despite a difficult political environment and policy slippages (especially during 1999-2001), Armenian policymakers have maintained a commitment to macroeconomic stability, market-oriented reforms, and the country's integration with the international community.[7]

A wide range of economic reforms have been undertaken during the last 10 years. Economic reforms in the early 1990s focused on land privatization, small-scale privatization of firms, and the liberalization of prices, trade, and the foreign exchange

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intensified during the last three years and there has been some improvement in diplomatic relations. Negotiations on the territorial conflict between Armenia and Azerbaijan are continuing. However, restoration of economic and transportation links remains a contentious issue.

[3] A railway blockade and the closure of the energy pipeline proved to be quite damaging for Armenia's industry. In addition, the route through Georgia was also unstable because of banditry and activities of separatists groups.

[4] See World Bank (2001).

[5] The population of Armenians living outside Armenia (most of them in Russia, the United States, France, and the Middle East) well exceeds that within Armenia.

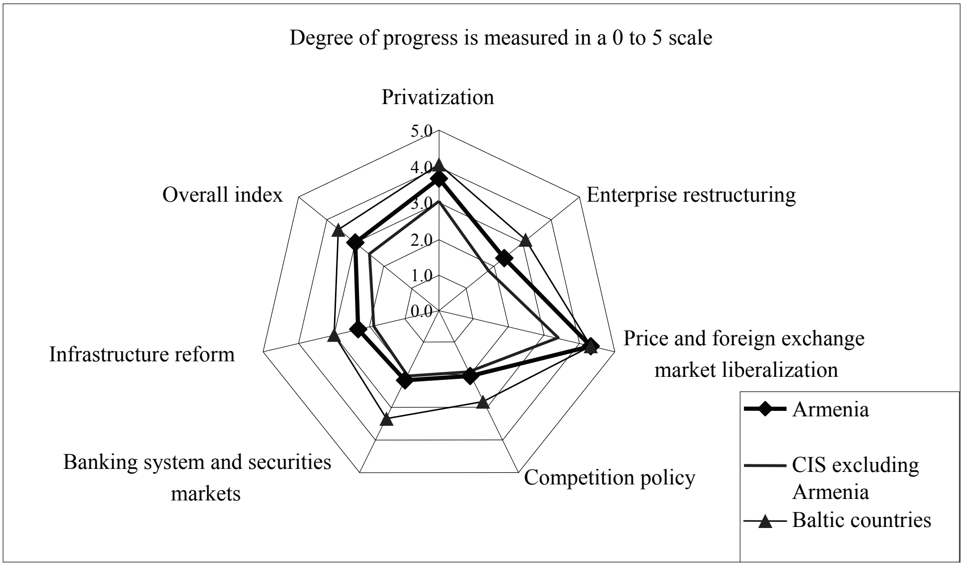
[6] Unofficial estimates suggest remittances and transfers range between 15 and 25 percent of GDP (USAID Armenia, 2004).

[7] Armenia has a turbulent political history and limited experience with democracy. The country was ruled with an iron hand for most of its history, leading to frequent abuse of power and lack of accountability. Disturbing political assassinations in 1999 involved the killing of the Prime Minister, the Speaker of Parliament, and five other parliamentarians.

regime. Reforms in the late 1990s and in the early part of this decade covered medium and large-scale privatization, the tax and the banking systems, the business environment, and the energy and water sectors.

By mid-2004, the European Bank for Reconstruction and Development (EBRD) transition indicators positioned Armenia ahead of other Commonwealth of Independent States (CIS) countries (although below Central European and Baltic States) on all dimensions of structural reforms (see Figure 1.1). The strength and sequencing of the reforms (initially price and exchange rate liberalization followed by a steady privatization program), while painful at the beginning, was essential to change relative prices and incentives and set the stage for a subsequent period of efficient market-driven capital formation. Nevertheless, this positive assessment of structural reforms is tempered by some delays and weak implementation in some areas. For instance, there have been delays in the resolution of banking problems in recent years, and the actual implementation of tax and customs administration reforms has been deficient (see below).[8]

Figure 1.1. EBRD Transition Indicators, 2004



The privatization process is almost complete. Land reform led to the creation of about 300,000 private and collective farms as well as the tradability of land.[9] The privatization process comprised an initial privatization of 3,963 small-scale enterprises from 1992 to 1996 and 1,513 medium and large enterprises from 1995 to 1999. A final privatization program comprising the last 900 state-owned enterprises began in 2000 and is expected to be completed by end-2005 (IMF, 1996, 1999, and 2001).

Goods' prices and the exchange rate were liberalized early in the transition. By 1995, most prices of goods and services had been liberalized (except for bread, utilities, urban

[8] This reflected choices made by the authorities (*e.g.*, prolonged period of intervention of commercial banks) as well as the influence of vested interests and capacity constraints (*e.g.*, discretion and inefficiency in tax and customs administration).

[9] Despite the overall positive impact of land privatization, there were weaknesses in implementation, especially because of lack of input markets. These and other problems have constrained agricultural productivity growth.

transport, and pharmaceutical products) and many subsidies were reduced or eliminated. Further price liberalization took place in 1995. A domestic currency (the dram) was introduced in 1993 within a liberal foreign exchange regime, with its value fluctuating without major interventions by the central bank since then.

By the mid-1990s, Armenia had put in place open trade and investment regimes. Trade policies included the removal of quantitative restrictions on imports and the adoption of a simple tariff regime with a single 10 percent tariff for most consumer goods and no tariff for the remaining goods, the elimination of export surrender requirements, the adoption of a liberal foreign direct investment regime, and full current account convertibility. The country joined the World Trade Organization (WTO) in 2003. Notwithstanding this impressive progress on trade liberalization, inefficiencies and corruption at customs have remained an impediment to trade, tax collection, and private sector development in general.

Table 1.2. Armenia: Index of Trade Restrictiveness [1)]

	1997	2004
Armenia	1	1
CIS (average)	3.7	2.6
Developing countries	5.1	4.0

Source: Trade Policy Information Database, IMF.

(1) Reflects both tariff and non-tariff barriers. The index ranges from 1 (most liberal) to 10.

A modern tax system with low rates was introduced in the 1990s. The tax system was revamped during the period 1992–1996 with the introduction of the Value Added Tax (VAT), personal income tax, a system of excise taxes, and a reformed profit tax. Further improvements in the tax system took place in 1997 when the imposition of the VAT on many imports moved to the point-of-entry (rather than the point-of-sale in the domestic market), the introduction of a new profit-tax law, and increases in excise taxes. At the same time, a system of presumptive taxes was introduced to capture activities whose profitability was deemed difficult to monitor. The system included a simplified tax for small retailers, and the activities covered by the system were excluded from the normal regime of VAT and profit taxes. In 1999, income taxes were reduced, a single profit tax rate with new depreciation allowances was introduced, and profit tax holidays for foreign investments were added.[10]

Tax and customs administration have improved gradually in the last decade. Capacity constraints in these agencies combined with lax management practices had led to discretionary treatment of taxpayers, nontransparent practices, and low collection rates. These problems, along with an inefficient judiciary, resulted in the accumulation of tax arrears by companies as well as of VAT refund arrears from the government.[11] Tax arrears (excluding penalties) peaked at 4.5 percent of GDP in mid-2003. On the tax refund side, arrears on VAT to exporters peaked at 0.5 percent of GDP at the end of 2002. The situation has improved slowly since mid-2003 after the strengthening of administrative procedures and the introduction of codes of conduct and an internal audit unit (Box 1.1).

[10] As in most countries, profit-tax holidays have proven to be an inefficient and costly way of providing incentives. The annual revenue loss in Armenia is estimated at 0.5 percent of GDP. Furthermore, the presence of accelerated depreciation allowances in Armenia also makes this exemption (set to expire in 2007) redundant.

[11] Armenia's judicial system is perceived as nontransparent and partial. The improvements in this area envisaged in the authorities' anti-corruption strategy require political commitment at the highest levels of government.

Box 1.1. Tax and Customs: Status and Pending Reforms

Weaknesses in tax and customs administration remain the main constraint to revenue collection. A large gap between actual and potential collection is evidence of Armenia's tax revenue potential. Reforms during the last two years focused on putting in place codes of conduct and internal audit units in the tax and customs agencies, disseminating tax laws and regulations, and enhancing the authority of the tax service to collect arrears. This, however, has not been accompanied by organizational improvements and the effective implementation of laws and regulations. In 2004, the large taxpayers unit collected about 23 percent of total revenues, while it could potentially collect up to 75 percent. Discretionary behavior, organizational deficiencies within the tax service, and creative accounting practices by companies all contribute to this disappointing performance. Looking ahead, it will be critical to revamp the internal organization of the tax service and implement risk-based systems for audit and administration of VAT refunds. A similar set of considerations apply to customs operations. In addition, bringing tax and customs under the control of the Ministry of Finance would improve coordination and ensure consistency between policies and administration.

While improving tax and customs administration is a priority, there is also room to improve the tax policy environment. Armenia's tax system is generally well-designed and characterized by low and uniform rates. The main tax policy reforms in the last three years focused on reducing VAT exemptions on imports and improving legislation to limit the erosion of the tax base. In the medium-term, there is room to streamline some overlapping taxes that lead to a fragmentation of the tax base. First, the simplified tax intended for small taxpayers, which has lower rates than in the regular tax regime (profit, income, and value-added taxes), provides incentives for the fragmentation of large businesses that take advantage of its lower rates and switch between regimes to minimize tax liabilities. Second, presumptive taxes on certain products were introduced in the mid-1990s due to the administrative difficulties in including them in the regular regime. There will soon be scope to begin covering these activities with the VAT. Third, a rather complex set of tax regulations has emerged in recent years, highlighting the importance of compiling a unified tax code. Fourth, the remaining VAT exemptions on imports of selected intermediate inputs and capital goods (equivalent to about 15 percent of total imports) could be removed, as they undermine the integrity of the tax system, distort price signals, and create an uneven playing field among importers. Lastly, it would be useful not to renew the profit-tax holiday for foreign investments beyond its expiration in 2007.

Expenditure management has improved during the last 10 years, but challenges remain. A key reform was the introduction of the single treasury account in 1997; however, the treasury system remained weak until 2001, as evidenced by a cumbersome system of controls and accumulation of expenditure arrears. The system substantially improved during the last three years. Commitment control procedures were introduced, all arrears have been paid, and no further arrears have accumulated. Recent decentralization policies in health, education, and water sectors have the potential to improve the quality of services, but these policies have not yet been accompanied by a sufficient increase in capacity, transparency, and accountability.[12] Lastly, while central government expenditures are relatively well-managed, local governments suffer from capacity constraints and lack of transparency.[13]

[12] In early 2003, about 5000 budgetary organizations (nearly 15 percent of the budget) were given a different legal status as part of a wide decentralization reform. Most of these entities are schools and hospitals and were not subject to sufficient auditing and reporting procedures, rendering their activities less transparent. The authorities have recently approved a regulatory framework for these entities and have begun implementing a reporting and monitoring system to compensate for the loss of budgetary control.

[13] Furthermore, budget coverage and budget presentation (budget and budget execution reports) could be more transparent and include extra-budgetary funds, all types of grants, and consolidated balances of state-owned noncommercial organizations and enterprises.

Table 1.3. Armenia: Chronology of Main Structural Reforms, 1991–2004[1)]

	1991-1994	1995-1997	1998-2000	2001-2004	Status as of end-2004
Liberalization of domestic prices					Completed, regulated prices retained for selected utilities and urban transport
Elimination of subsidies					Advanced, water and irrigation subsidies remain and are expected to be eliminated by 2007
Land reform and privatization of land					Completed
Trade and foreign exchange liberalization					Completed
Capital account liberalization					Completed
Small scale privatization					Advanced, to be completed by end-2005
Large scale privatization					Advanced, to be completed by end-2005
Tax policy reform					Advanced, a tax code and further rationalization of taxes are pending
Tax and customs administration					Incomplete, deficiencies remain in the structure of the respective agencies and implementation of existing procedures
Expenditure management					Advanced, new fiscal risks emerged in 2003 from the creation of government-owned noncommercial organizations
Banking system legislation					Advanced, further enhancements are needed regarding corporate governance and collateral and creditor rights
Banking supervision					Advanced, there is a need for a faster resolution of problem banks and a more efficient judicial system
Securities' markets and non-banks					Incomplete, insurance legislation needs alignment with best international practice
Competition policy and red tape					Advanced, some bureaucratic practices and enforcement problems remain
Infrastructure and telecommunications					Largely completed, although telecommunications is not cost–effective and competitive enough
Water and irrigation					Incomplete, further tariff increases and reforms (especially in irrigation) should be expedited during 2005–07
Energy sector reforms					Advanced, settlement of debts and other reforms should be completed in 2005

Sources: IMF staff reports, 1991–2004, EBRD transition reports, 1993–2004.

(1) Darker areas denote the periods when the most significant reforms took place. Blanks indicate little or no reforms during the period.

The efficiency of government services has been a major constraint on Armenia's development. A civil service reform was initiated in 2001 aimed at improving capacity, better linking salaries with skills, and reducing corruption. The reform process needs to be deepened to ensure an efficient provision of public services, the elimination of nepotism and political appointments in technical positions, and salary increases as envisaged in the Poverty Reduction Strategy Paper (PRSP) of the government.

After the privatization of banks in the early 1990s, banking sector reforms proceeded at a gradual pace. Basic laws on the central bank, commercial banking, and insolvency were introduced in 1996. Banking regulations were aligned with the Basel Core Principles in 1997, and a chart of accounts and international accounting standards for banks were adopted in 1998. A weak legal framework and occasional political interference with the supervisory authorities weakened the effectiveness of banking supervision and led to cases of forbearance when prudential requirements were breached. Higher minimum capital requirements and connected lending in some banks contributed to the collapse of 10 commercial banks from 1999 to 2001. While these banking issues have now been resolved, a faster resolution process was possible, which would have resulted in an earlier return of confidence in the system. Another serious constraint to financial-system development has been difficulties in recovering collateral owing to distorted exit mechanisms and an inefficient and corrupt judiciary. Some legislation in the former area was adopted in 2003 but further amendments are needed to the Armenian Civil Code to strengthen creditor rights.

Energy sector reforms began in 1997 with the setting up of the basic regulatory framework, the establishment of the Energy Regulatory Commission, and increases in tariffs toward cost-recovery levels. While some improvements in performance were noted by 2000, the sector remained a drain on budgetary resources and a source of inter-enterprise arrears. The situation was aggravated during 2000-2001 owing to mismanagement and corruption in state-owned companies. A number of corrective actions have been undertaken since 2001, including improvements in technical and financial management, a reduction of staffing by almost one quarter, linking wages to performance, and enforcement of interruption of service to nonpaying customers (IMF, 2003a). In addition, the government privatized the electricity distribution company and two power plants in 2002 and 2003, respectively.

Energy sector reforms have generally been successful. The loss arising from technical deficiencies and theft fell from over 20 percent of generation during 1998-2002 to an estimated 2 percent in 2004. During the same period, collection rates rose to almost 100 percent, and the primary deficit of the energy sector (a measure of quasi-fiscal losses) turned into surplus (Table 1.4). While the most significant reforms in the energy sector have already been adopted, a few remaining state-owned enterprises still could be privatized, and years of erratic management have left a stock of (public) debt of US$34 million (one percent of GDP). To deal with remaining reforms and past debts, the government began implementing in 2004 a financial rehabilitation plan covering the energy, water, and transport sectors.[14]

Water and irrigation services have improved only gradually. Some reforms have been undertaken since the mid-1990s, including privatization and tariff increases, helping to improve efficiency and reduce reliance on government subsidies, loans, and arrears. More remains to be done, however, to reduce technical losses and theft and ensure these sectors' viability (Table 1.5). The pace of tariff increases should be stepped up as planned to reach cost-recovery by 2007. In addition, it is necessary to develop the country's water infrastructure and to improve efficiency and governance in the irrigation users' associations that manage the irrigation infrastructure.

[14] Measures already taken in the energy sector include phasing out management functions previously vested in the Ministry of Energy, restructuring the midstream sector (including settlement, dispatch, and transmission companies) and introducing an improved governance framework, and establishing direct contracting between power generators and the privatized distribution company. A restructuring of energy sector debt is also under way.

Table 1.4. Armenia: Key Indicators of the Energy Sector, 1998–2004
(in percent of GDP)

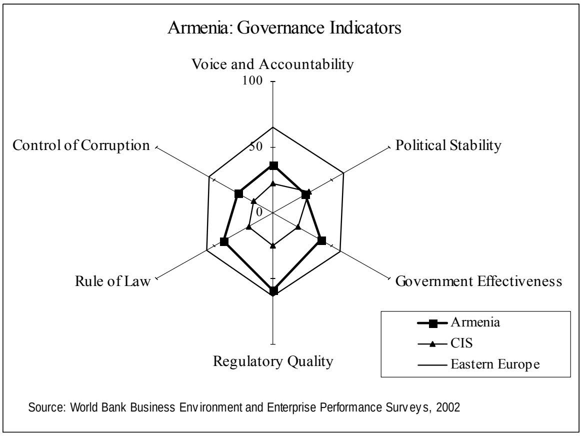
	1998-1999	2000-2001	2002	2003	2004
Technical and other losses[1)]	26.0	22.0	22.0	4.2	2.3
Collection rate[2)]	24	23	48	101	106
Overall financial balance[3)]	–3.3	–2.8	–1.7	–0.6	–0.4
Primary balance [3)4)]	–1.7	–1.9	–0.4	0.0	0.2

Source: Ministry of Energy and Ministry of Finance.

(1) Technical deficiencies in percent of generation (state-owned companies).
(2) In percent of billings.
(3) State-owned companies.
(4) Excluding interest and foreign-financed capital expenditures.

Box 1.2. Governance in Armenia

- Armenia's standing in the Transparency International rankings improved from the 80th percentile in 1999 to the 50th percentile in 2003. Similar progress can be noted in the World Bank's governance indicators and the EBRD business environment surveys. This reflects a number of reforms introduced during the last three years, including the simplification of licensing procedures, civil service reform, a new criminal code, privatization in the energy sector, and dissemination of laws and regulations. Notwithstanding these improvements, corruption indicators in Armenia are still higher than in other countries of Eastern Europe and the Baltic States. In a recent public opinion poll, Armenians cited the most concern with corruption in the judiciary, tax and customs operations, the defense and security forces, and the health sector.



- After a long preparation period, the authorities finalized an anti-corruption strategy at the end of 2003. The strategy contains a three-year action plan with measures to be implemented during 2004 to 2006, including:

  Harmonizing legislation to specify sanctions for corruption, protect witnesses, and improve access to information;

  Carrying out reforms on tax and customs administration and the judiciary, and

  Introducing financial audit standards in the public sector and strengthening Parliament's role in the audit process.

- The implementation of the strategy needs to gain momentum, and further efforts are required to fully involve civil society in the process and specify benchmarks for most activities. There is also a need to identify enforcement mechanisms, work on whistle blower protection regulations, and increase the transparency and accountability of local governments.

Since 2001, the government has focused on deregulating the environment for private sector activity and implementing measures to reduce transaction costs: the quality of regulation was improved, licensing procedures were simplified, a new criminal code was introduced, and laws and regulations were more widely disseminated. These changes led to an improvement in Armenia's business environment and put it ahead of most CIS countries in terms of a variety of governance indicators (Box 1.2). Corruption remains a serious problem, however, especially in tax and customs agencies, the health sector, and the judiciary.

Table 1.5. Armenia: Indicators of the Water and Irrigation Sector, 1998–2004
(in percent of GDP)

	1999	2000-2001	2002	2003	2004
Technical losses[1)]	43	51	55	58	59
Collection rate[2)]	35	34	48	76	66
Overall financial balance	-2.0	–1.6	–1.0	–0.8	–0.4
Primary balance[3)]	-1.5	–1.2	–0.9	–0.6	–0.3

Source: Ministry of Finance

(1) In percent of output. The recent increase is explained by improved metering.
(2) In percent of billings.
(3) Excluding interest and foreign-financed capital expenditures.

IV. MACROECONOMIC STABILIZATION

Prudent management of fiscal and monetary policy coupled with economic reforms set the foundation for sustained macroeconomic stability and high rates of economic growth. As a result, economic indicators displayed a marked improvement, especially since 2001. The reduction in the fiscal and quasi-fiscal deficits played a key role in lowering inflation to single digit levels and in stabilizing the value of the dram.[15] Another key factor was the presence of a largely independent central bank. Monetary policy followed strict targets on the net domestic assets of the central bank and minimal accumulation of bank credit to the government. This led to a rapid deceleration of growth in both reserve money and broad money. After inflation fell to single-digit levels in 1999, real money demand began to increase, and a virtuous circle of re-monetization and low inflation was inaugurated. A flexible exchange rate gave authorities the necessary control over the money supply in an environment of free capital mobility. Real and nominal interest rates fell in response to macroeconomic stability, and international reserves rose.

The magnitude of Armenia's fiscal adjustment is noteworthy. The general government deficit fell from 17 percent of GDP in 1994 to six percent in 2000 and to an estimated 1.6 percent in 2004 (Table 1.6). During the same period, the financial balances of the energy, water, and irrigation sectors fell drastically, contributing to overall fiscal consolidation and macroeconomic stability.[16] This process was accompanied by a debt management strategy that prioritized the use of concessional financing and grants and led to a reduction in debt ratios.

[15] An additional factor was the formal prohibition of central bank net-lending to the government since 1998.

[16] For an alternative approach in estimating the extent of fiscal and quasi-fiscal adjustment in Armenia, see Avanesyan and Freinkman (2003).

Figure 1.2. Armenia: Monetary Growth and Inflation, September 1995–December 2004 (12-month percentage change)

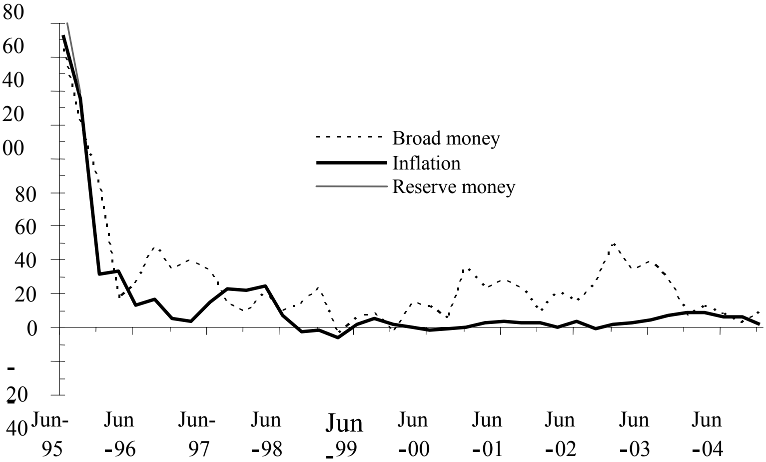


Figure 1.3. Armenia: Fiscal and External Current Account Deficits

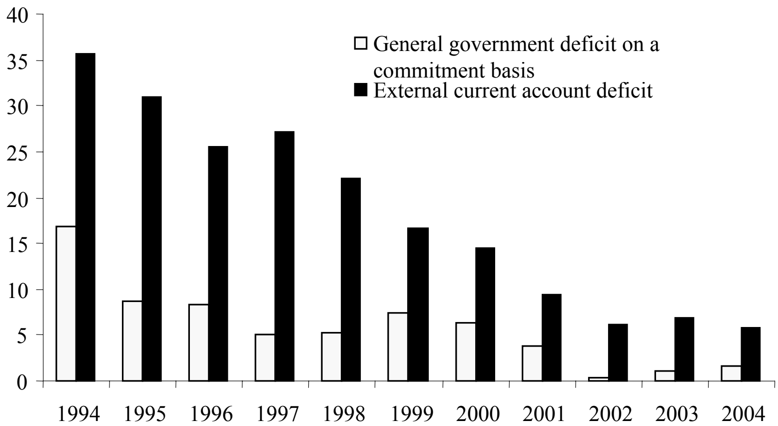


Table 1.6. Armenia: Fiscal and Quasi-fiscal Adjustment and External Debt (in percent of GDP)

	1998-1999	2000-2001	2002	2003	2004 (est.)
Fiscal and quasi-fiscal balances	–11.7	–9.3	–3.0	–2.5	–2.6
General government	–6.4	–5.0	–0.3	–1.1	–1.6
Quasi-fiscal[1)]	–5.3	–4.3	–2.7	–1.4	–0.8
Net present value of debt/exports[2)]	151	135	131	87	75

Source: Armenian authorities.

(1) Comprising the energy, water, irrigation sectors and the chemical company Nairit.

(2) About 98 percent of Armenia's public debt is external, making this concept the most representative. The ratio is expressed in percent of the three-year moving average of exports of goods and services.

Table 1.7. Armenia: Tax-to-GDP Ratios
(in percent of GDP)

	1995-1997	1998-2000	2001-2002	2003	2004 (est.)
Tax revenue, general government	13.9	18.6	17.8	17.2	17.4
of which: VAT	3.8	6.5	6.8	6.6	6.3
Profit tax	3.0	1.8	1.3	1.1	1.7
Payroll	2.3	3.1	2.9	2.8	2.8
Excises	1.5	2.3	2.6	2.4	2.2
Tax revenue-to-estimated tax base (1)	15.1	20.2	19.8	20.0	20.3

Source: Armenian authorities.

(1)The tax base is estimated as GDP minus 90 percent of the value-added in construction which is largely tax-exempt due to international agreements with donors.

Fiscal adjustment was primarily achieved through expenditure compression, however, with little contribution from the revenue side. While tax revenues grew rapidly in both nominal and real terms during the last five years, the tax revenue-to-GDP ratio did not improve (Table 1.7). This is explained by four main factors, namely strong growth in activities that are tax-exempt because of international agreements (*e.g.*, grant-financed construction), a reduction in income and effective profit taxes since 1999, profit-tax exemptions for foreign investment, and lingering weaknesses in tax and customs administration.

The road to macroeconomic stabilization was not without obstacles. A stabilization program supported by a stand-by arrangement during 1995-96 helped reduce the fiscal deficit by almost nine percent of GDP and brought inflation down from 5,273 percent in 1994 to 19 percent in 1996. However, the Russian financial crisis of 1998 and the political assassinations in 1999 led to a period of political uncertainty and a slowdown in the reform effort and in economic activity.[17] Exports, transfers, and remittances fell, the fiscal deficit rose again, and domestic and external payment arrears grew rapidly.

Between 2001 and 2004, a new three-year economic program supported by the Poverty Reduction and Growth Facility led to fiscal consolidation and a deepening of structural reforms. The program aimed at reducing the fiscal and quasi-fiscal deficits, repaying domestic and foreign arrears, lowering debt ratios, and running a cautious monetary policy in a flexible exchange rate environment. The structural reform agenda was geared to support stabilization efforts, reduce vulnerabilities, and sustain medium-term growth prospects. It focused on improving the business environment, strengthening the banking system, tax and customs administration, and expenditure management, as well as increasing efficiency in the energy and water sectors.

The program went off-track initially, but, after a year, the authorities garnished enough political support for the envisaged reforms and reform momentum was restored. This led to rapid fiscal and quasi-fiscal consolidation, the repayment of the stock of domestic and external arrears, and increased attention to the composition of government expenditures in light of a decline in social spending during the period 1999–2001.

The new economic program has been consistent with Armenia's PRSP.[18] The government has progressively integrated the policies and programs envisaged in the PRSP into the

[17] Gunmen killed the Prime Minister, the Speaker of Parliament, and five other parliamentarians.

[18] An interim PRSP was prepared in March 2001, and the full PRSP was finalized in September 2003 (IMF Country Report No. 03/362).

economic program and the budget process. The authorities have changed expenditure priorities in the budget, implemented reforms in the areas of health and education, and proceeded to develop monitoring indicators.[19] They have also refocused their efforts with respect to social policies and the rural economy.

V. ECONOMIC PERFORMANCE

Macroeconomic stabilization and the aforementioned reforms contributed to an improved business environment and higher levels of investment, foreign financing, and donor assistance. The availability of foreign resources (loans, transfers) helped to supplement low domestic savings and facilitated the observed higher levels of consumption and investment (Table 1.8).

Table 1.8. Armenia: Investment and Official Employment

	1996–1998	1999–2001	2002	2003	2004
	Averages				Estimated
Investment (percent of GDP)	19.4	18.9	21.7	24.7	22.5
GDP growth (in percent)	5.5	6.2	13.2	13.9	
Official employment (thousands)	1,382	1,280	1,106	1,112	1,201

Source: Armenian authorities.

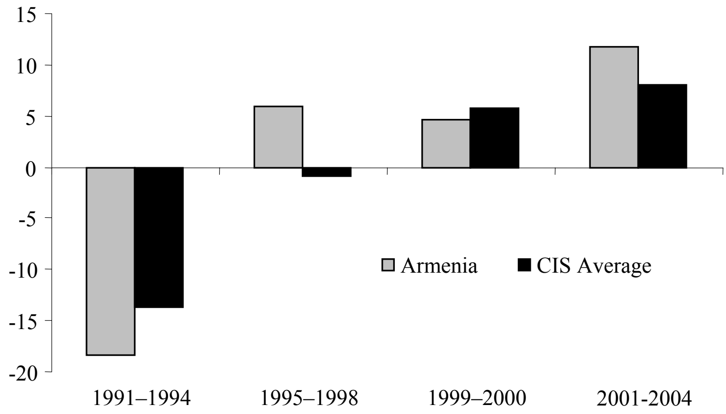
Growth was ignited by higher investment and a rapid increase in total factor productivity. Total investment grew from 18 percent of GDP in 1997 to nearly 25 percent in 2003. As a result, annual, real GDP grew by an average 12 percent during 2001-2004 (Figure 1.4). While official employment data show a decline in total employment, the change fails to capture the expansion of the informal sector, estimated at 45 perc. of GDP in 2001 (Shiells and Sattar, 2004). Unemployment has declined slightly in recent years, though it remains high. It is estimated currently to be between 15 percent and 25 percent.

The structure of the economy suffered a radical transformation since the early 1990s. The composition of output shifted from heavy industry to agricultural production in the mid-1990s, and to light manufacturing in the second half of the 1990s. Most activities that thrived during the Soviet period (chemicals and heavy machinery) contrast sharply with the new ones (food processing, non-metallic minerals, jewelry, and textiles) that have emerged. Since the late 1990s, import substitution has intensified in light industries and an export boom has started in the precious stones sector, followed by booms in the export of agricultural products, processed foods, and textiles. The observed progressive broadening of the structure of production (and exports) is consistent with recent empirical research on diversification and growth where at low income levels the two are positively correlated over time.[20] As a result, exports of goods and services increased from an average of 21 percent of GDP during 1998-2000 to 29 percent during 2002-2004 (Figure 1.5). Similarly, the current account deficit fell drastically during the same period.

[19] In early 2005, the authorities prepared a draft Annual Progress Report of PRSP implementation. The draft outlines the policies adopted during the last year, including the additional allocations for poverty-reducing expenditures and the improvement in poverty indicators.

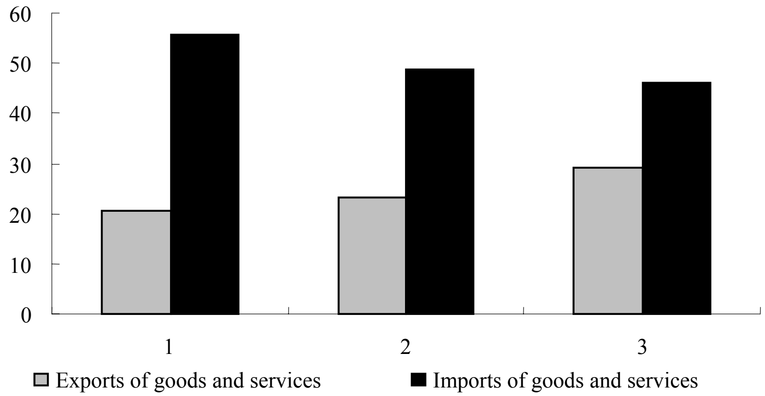
[20] Imbs and Wacziarg (2003).

Figure 1.4. Annual Average Real GDP Growth in Armenia and other CIS[1)] Countries (annual average, in percent)



1) Azerbaijan, Belarus, Georgia, Moldova, Kazakhstan, Kyrgyz Republic, Russia, Tajikistan, Turkmenistan, Ukraine, and Uzbekistan

Figure 1.5. Armenia: Trade Ratios (in percent of GDP)



High economic growth and improvements in social policies since 2002 contributed to a reduction in poverty rates and income inequality. Extreme poverty fell even faster than overall poverty; however, most of the improvement took place in the capital Yerevan, leaving rural poverty nearly unchanged at about 48 percent. Improvements in social policies since 2002, especially a well-targeted family benefits program, have helped the most disadvantaged groups in society.

Table 1.9. Poverty and Inequality in Armenia
(percent of total population, unless otherwise noted)

	1996	1999	2001	2003
Overall poverty rate	56.7	56.3	47.0	32.0
Rural poverty	49.0	47.7	46.0	33.9
Extreme poverty	27.7	26.1	16.2	5.5
Gini coefficient (income)[1)]	0.6	0.59	0.54	0.44
Gini coefficient (consumption)[1)]	0.4	0.37	0.38	0.33

Source: Based on Household Surveys, 1996, 1999, 2001, 2003.

All figures except for 1996 ones reflect a new methodology applied by the World Bank.

[(1)] Ranges from 0 (perfect equality) to 1 (total inequality).

As noted above, the central bank's monetary policy was focused on price stability and was complemented by a prudent fiscal policy and exchange-rate flexibility. The exchange rate appreciated appropriately during and after the Russian financial crisis with minimal central bank intervention. The real exchange rate then depreciated by nearly 25 percent between 2000 and 2003 (mainly because of a concomitant real effective appreciation of the Russian ruble). Since productivity growth in tradable sectors accelerated during 2001-04, competitiveness remains high despite an estimated 15 percent real effective appreciation of the dram in 2004 (Gelbard et.al., 2005).

Despite a drastic reduction in interest rates in recent years, real interest rates and spreads remain high. As expected, lower inflation brought about higher levels of monetization after 1996, but both financial intermediation and monetization stagnated between 2000 and 2003. This reflects lower confidence in the banking system after the collapse of 10 banks during 1999-2001 and the relatively slow pace of banking sector reforms. The situation has improved since mid-2003. There has been a recovery in confidence in the banking system following the resolution of eight banks that had been intervened by the central bank. During 2004, bank deposits and credit to the private sector grew by 32 percent and 38 percent, respectively.

Figure 1.6. Armenia: Nominal Effective and Real Effective Exchange Rates
(Index, 1995=100)

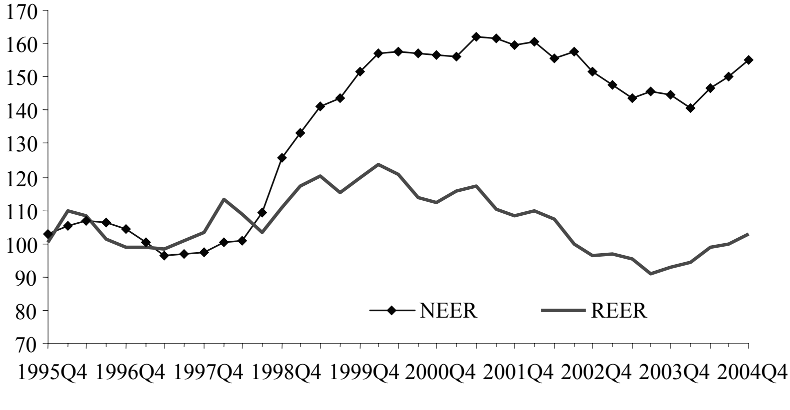
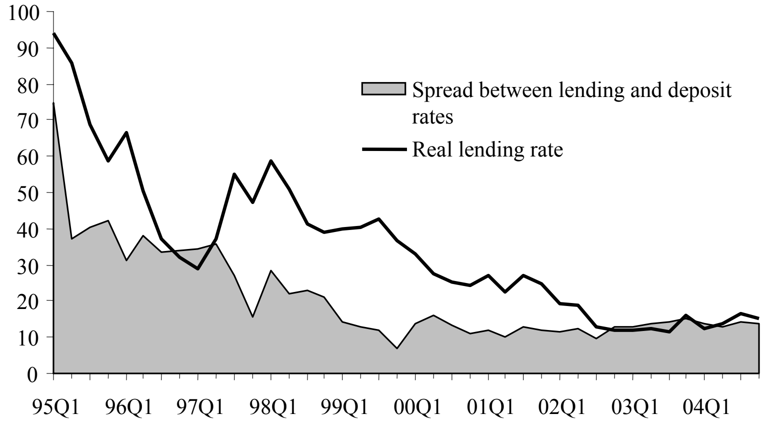


Figure 1.7. Armenia: Interest Rate Spread and Real Lending Rate (in percent)



VI. REMAINING CHALLENGES

While many low-income countries have been able to achieve macroeconomic stabilization and jumpstart economic growth in the last two decades, most have had difficulties sustaining high rates of growth for longer than five years. Recent research on this issue suggests that the presence and proper functioning of economic institutions are likely to play a key role in the long-run growth process by lowering transactions costs and increasing the rate of return on investment.[21]

Armenia has made substantial progress in setting up the basic economic institutions of a market economy, but some of these institutions are not yet functioning properly and the reform agenda in certain areas awaits completion. There are inefficiencies and broad exercise of discretion in tax and customs operations, the levels of tax collection and of financial intermediation are still low, and corruption and vested interests are a problem. Furthermore, social and public investments are still insufficient, and the extent of Armenia's trade integration with the world economy is small. The reforms outlined below could address current deficiencies and cementing an institutional set up that ensures the rule of law and effectively counters corruption.

In coming years, economic growth and capital formation should be broad-based and generate employment. Such growth cannot rely almost entirely on foreign financing, a factor that highlights the importance of fiscal management and financial intermediation. The tax and customs systems must function adequately, and the state should become an efficient provider of social services and public investment. This would generate additional tax revenues to ensure fiscal sustainability and help finance growth-enhancing public expenditures. As envisaged in the PRSP, it is necessary to mitigate rural and regional imbalances, and the government must devote more resources to these areas as well as to strengthening the public infrastructure.

[21] Acemoglu et.al (2001, 2004) provide theoretical and empirical evidence that the quality of economic institutions is a key determinant of growth performance. A comprehensive analysis of the role of institutions on economic performance and growth is also provided in IMF (2003b).

Remaining areas for reform include:

Tax policy. Armenia has relatively good tax legislation with moderate tax rates, though some aspects of the tax system need to be revisited, most notably the simplified tax. First, the authorities should review the simplified tax and presumptive taxes with a view to expanding the tax base. Second, they should focus on compiling a unified tax code—this is important given the number of amendments and supplementary provisions for different taxes made over the last six years. Third, it is important to allow the current profit-tax exemptions for large foreign investments to end as projected in 2007.

Tax and customs administration. While progress has been made in the last few years, the discretionary activities of collection agencies remain a key obstacle to a better business environment. Collections are based on targets and businesses complain about bribes demanded by officials and discrimination among taxpayers. There is a need to make wide use of risk-based methods for audit, VAT refunds, arrears collection, and imports' clearance. An additional distortion arises from insufficient communication between the agencies and their lack of integration with the Ministry of Finance. The authorities should proceed to reorganize these agencies and unify them under the Ministry of Finance.

Public sector efficiency and expenditure management. The government needs to ensure the efficient provision of health, education, water, and sanitation services and finance improvements in the basic infrastructure. This requires additional capacity building, transparency, and accountability. The recent tendency to prioritize current expenditures in the medium-term expenditure framework and the budget is misguided and appropriate weight should be given (as envisaged in the PRSP) to improving the public infrastructure, especially in rural areas and cities aside from Yerevan. In this regard, a public investment program should be prepared. Lastly, a public expenditure review should look closely at non-priority expenditures and budget classification.

Financial intermediation. The key factors limiting the development of the banking system in Armenia are weak corporate governance and poor enforcement of financial contracts. Bank ownership should be made more clear, capacity in banks should be enhanced to develop new financial products, borrowers' financial conditions should be made transparent, and the judiciary should be more efficient to facilitate creditor rights and collateral recovery. These actions will all serve to lower real interest rates and spreads, discourage adverse selection, and increase financial intermediation.

Trade integration. The loss of markets in the former Soviet Union combined with the trade blockade severely disrupted Armenia's trade opportunities. Despite the recent export boom, exports remain relatively low and concentrated on a few categories. The structure of trade has also shifted toward goods with low transport costs. Looking ahead, the main challenges are to improve customs administration, normalize trade relations with Turkey, and reach a peaceful solution to the conflict with Azerbaijan. Improvements in customs administration alone will help trade and economic activity.

Armenia is now at a crucial phase of its development. The completion of the reform agenda and the implementation of the policies envisaged in the PRSP will likely allow Armenia to be one of the few low-income countries that will achieve the Millennium Development Goals within the next ten years. On the other hand, failure to tackle the above-mentioned issues could expose the country to a vicious circle of low tax collection, low and unproductive social and infrastructural investment, insufficient employment creation, and persistent poverty and inequality. Since vested interests oppose many of the remaining reforms, overcoming these challenges will require a renewed dose of leadership and political resolve at the highest levels of government. As a reinforcing factor, improved prospects for integration with the European Union could also help to strengthen institutions and the role of reformers in the country.

VII. CONCLUDING COMMENTS

Despite geographical isolation, trade blockades, and occasional political upheaval, Armenia's economic performance during the last three years has been remarkable. Growth has averaged nearly twelve percent and poverty has fallen. This performance reflects the consolidation of macroeconomic stability, structural reforms undertaken since the mid-1990s, and support from the Armenian Diaspora. These factors led to substantially higher domestic and foreign investment, improvements in competitiveness, and a market-driven process of import substitution.

The sustainability of growth and further poverty reduction is not yet assured, however. Examples abound of countries that managed to achieve higher rates of economic growth in the short term but could not maintain the momentum for more than a few years. The presence and proper functioning of economic institutions will likely condition Armenia's long-term growth, and I highlighted earlier those institutions that still need to meet that test, namely tax and customs operations, the financial sector, and the judicial system.

During the next few years, economic growth, exports, and capital formation should become more broad-based and generate employment. Since such growth cannot be exclusively financed with foreign resources, Armenia's fiscal framework and the banking system will have to play a more prominent in consolidating savings and channeling them into their best possible use.

The tax and customs systems should function adequately, and the state should become a more efficient provider of social services and public investment. At the same time, rural and regional imbalances will have to be mitigated. This will require devoting more resources to capital expenditures in rural areas and urban centers outside the capital Yerevan. In addition, financial intermediation should increase to channel domestic savings to capital formation and foster the development of small and medium-sized enterprises. While Armenia's financial sector could benefit from further enhancements in supervision and in the legal framework, the key factor in its future development will be the presence of a strong and independent supervisory authority.

While Armenia has already put in place the basic legal and institutional arrangements present in modern tax and banking systems, the observed weaknesses in these areas is related to deficient implementation. This also involves the judicial system. In essence, improved transparency in the public sector and reduced corruption will be essential to encourage efficient investments, foster growth, and contribute to a more equitable distribution of income. Political will, more than technical assistance, will be required to address these shortcomings. Lastly, Armenia's economic potential lies in an export-led development growth process, and further integration with its neighbors and main trading partners should be a priority. Such potential will be realized when artificial barriers to regional integration (such as discretionary customs administration and border closures) are removed.

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