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FISCAL POLICIES DIRECTED TO POVERTY REDUCTION IN ARMENIA

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## ABSTRACT

The 1990s can be viewed as a decade of triumph of democracy and democratic principles all over the world. The breakup of the Soviet Union caused drastic changes in political, economic, and social lives and structures of almost all former communist countries of the world. Some countries have succeeded in adopting, elaborating, and implementing reforms while others still have not. Armenia was not an exception and is among those countries that still bear harsh consequences of transition.

After fifteen years of reconstructions and reforms in various spheres of the country, it still faces higher rates of poverty, shadow economy, and unemployment. Some scholars argue that today's unfavorable socio-economic conditions are "due to" shocking therapy approach to reforms and state that the gradual approach was the best option for Armenia. Others state that whatever approach is chosen, the main reason is in existing higher rates of corruption and shadow economy in the country. However, what is worth noting is that country has steadily growing GDP rates. Hence, one can draw an assumption that if economy is growing steadily but poverty rates are still high in the country, then the gains from aggregate economic expansion are not equally distributed among all segments of the population. The most vulnerable groups are still denied from benefits of economic growth, which include those households that live in rural areas, earthquake zones, or borders. Seen in these terms, economic growth is an important and necessary but not sufficient factor for poverty reduction.

The purpose of this policy paper is to examine the current poverty situation in Armenia and what are the steps undertaken by the government for fighting poverty. More precisely, to find out whether poverty reduction keeps pace with economic growth in the country, and if not, what mechanisms can be performed to make growth more pro-poor. The first section discusses main theoretical approaches to the problem and addresses the experience of operationalizing pro-poor growth in Moldova and Romania. Second section refers to the poverty situation in Armenia and underlines the structure of public and governmental expenditures towards education, health care, and social assistance. The final section will summarize the paper from the perspective of assessments on to what extent economic growth in Armenia is pro-poor and what policies can be performed to make the latter more poor-directed.

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## LIST OF ABBREVIATIONS

AMD	Armenian Drams
CASE	Center for Social and Economic Research
CEE	Central and Eastern – European Countries
CIS	Commonwealth of Independent States
DAC	Development Assistance Committee
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
HIPC	Heavily – Indebted Poor Countries Initiative
IMF	International Monetary Fund
MDG	Millenium Development Goal
MFE	Ministry of Finance and Economy of the Republic of Armenia
MTEF	Medium – Term Expenditure Framework for Armenia
OECD	Organization of Economic Cooperation and Development
PRSP	Poverty Reduction Strategy Paper for Armenia
SME	Small and Medium Enterprises
UNDP	United Nations’ Development Program
VAT	Value – Added Tax

*“Of all the worldwide scourges which stunt human development, poverty is the most widespread. It denies individuals their most basic rights, and denies humanity the benefit of their talents.”*

*Kofi A. Annan, UN Secretary – General.*

## Introduction

The 1990s can be viewed as a decade of triumph of democracy and democratic principles all over the world. The breakup of the Soviet Union caused drastic changes in political, economic, and social lives and structures of almost all former communist countries of the world. Some countries have succeeded in adopting, elaborating, and implementing reforms while others still have not. Armenia was not an exception and is among those countries that still bear harsh consequences of transition.

After Armenia gained independence, the principles and values of democracy were declared as a priority for the country. As a result, the country’s economy also underwent basic changes. The government started to develop market economy in order to integrate into international markets. However, to what extent and in what ways such principles and values are enacted in Armenia are highly questionable, for the country still faces higher rates of unemployment, poverty, poorly constrained taxation administration and policies. Such undesirable outcomes may be described as being due to the unfavorable starting conditions of transition. Since the early days of its independence, in addition to the problems of reforming, Armenia had to face a war with Azerbaijan, which was a serious challenge for a newly independent state that had no such precedent and its institutions had not enough expertise and preparedness. The conflict of Nagorno-Karabakh, transportation blockade, and earthquake are factors that had devastating results for the performance of economically sound reforms. As a result, hundreds of thousands of refugees from Azerbaijan “flew” to Armenia and more than

half of the population was poor, of which, nearly half were extremely poor and were living under the poverty line<sup>1</sup>.

After fifteen years of reconstructions and reforms in various spheres of the country, it still faces higher rates of poverty, shadow economy, and unemployment. Some scholars argue that today's unfavorable socio-economic conditions are "due to" shocking therapy approach to reforms and state that the gradual approach was the best option for Armenia. Others state that whatever approach is chosen, the main reason is in existing higher rates of corruption and shadow economy in the country. However, what is worth noting is that country has steadily growing GDP rates<sup>2</sup>. Hence, one can draw an assumption that if economy is growing steadily but poverty rates are still high in the country, then the gains from aggregate economic expansion are not equally distributed among all segments of the population. The most vulnerable groups are still denied from benefits of economic growth, which include those households that live in rural areas, earthquake zones, or borders. Seen in these terms, economic growth is an important and necessary but not sufficient factor for poverty reduction. The point is that the transition to democracy posed serious challenges for Armenia and its path to democratic country and sound economic reforms was mixed and arcane.

Nonetheless, different countries in the world have made different ways for overcoming poverty. What is obvious is that poverty should be treated as not only a shortage of money but also as a specific area of attention, for it includes such aspects as health, education, environment, and human rights. Hence, such treatment will help poverty reduction policies be of larger scope with broad strategic framework of steady human development.

The main coping policies for the poor people in Armenia are transfers, allowances, and humanitarian aid. Among the cash transfers, pensions and child allowances have the largest share (Gelbard et al, 2005). In general, humanitarian aid and FDI have crucial positive impact

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<sup>1</sup> This will be discussed later in this paper in more details.

<sup>2</sup> In the period from 2001 to 2004, annual real GDP grew by an average 12 percent (Gelbard et al, 2005).

on poverty reduction and economic growth in the country. However, in reality it is obvious that foreign aid is important but not sufficient, since poverty in the country is still high.

Whatever strategies are implemented, poverty in the country should be alleviated and pro-poor expenditures from the budget should be prioritized. Economic growth is a necessary factor for poverty reduction, however, the question is what brings to economic growth and how to secure pro-poor economic growth. Hence, the main option is to perform flexible public policies to regulate labor markets, to increase workplaces, minimum wages, to secure equal opportunities, to increase public expenditures, to enhance investments in human capital, to implement macroeconomic management and price mechanisms in order to equalize income distribution.

Therefore, the purpose of this policy paper is to examine the current poverty situation in Armenia and what are the steps undertaken by the government for fighting poverty. More precisely, to find out whether poverty reduction keeps pace with economic growth in the country, and if not, what mechanisms can be performed to make growth more pro-poor. Thus, this paper poses the following research questions:

- What is the current poverty situation in Armenia?
- What is the present structure of governmental expenditures concerning social security, education, and health care?
- How pro-poor is growth in Armenia?
- What are the mechanisms for making public policies more pro-poor?

The answers to these questions will determine the extent to which the desired poverty reduction programs can be pursued in the current period.

## Methodology

The study is based on the secondary analyses of existing macroeconomic and financial data. The key direction in methodology is the operationalization of what pro-poor growth is and what policies are aimed at it. The reason is to find out whether aggregate economic expansion benefits the poor in Armenia equally and whether the existing structure of governmental expenditures and growth rates is enough to well target lower income quintiles and consider economic growth as being pro-poor.

## Literature Review

Poverty is a phenomenon that, to some extent, exists in all countries of the world. There are various theoretical approaches to poverty and its carcinogenic effects on overall human development. What is clear is that it should be eliminated and the policies directed to poverty eradication should be prioritized in all countries of the world. Unfortunately, most countries were referring to poverty as a social issue, whereas poverty should be treated as a specific area of attention as it encompasses such aspects of human development as education, health care, human rights, etc. Based on the assumption of poverty as a social issue, governments direct their resources to social welfare programs and enact poverty reduction policies confined to social sectors (UNDP Poverty Report, 1998). As a result, countries have economic growth accompanied with poverty growth, which is undesirable. For the sake of precision, the discussion of the paper will begin with some literature review in order to define what poverty and pro-poor growth are.

The most “favorable” factor for widespread high poverty all over the newly independent states was the collapse of the Soviet Union and the subsequent challenges that it posed to all former communist republics. Having no experience and historical precedents for such transition, the countries of former Soviet Union found themselves in very critical conditions,

namely, the necessity to change almost every aspect of previous system. The result of such a transition was sharp increase in poverty and unemployment rates, which in turn caused widespread illiteracy and migration.

Seen in these terms, one of the main concerns of the international community and international financial organizations was to develop programs directed to poverty reduction in the newly independent countries. The scope of such policies include FDI, foreign aid, HIPC Initiative,<sup>3</sup> advisory opinions and technical support by the specialists of IMF and the World Bank, etc. Indeed, this was not the solution to the problem of high rates of poverty, since the success in reducing the latter mostly depends on the particular country itself. More precisely, on such initial conditions of transition as inequality, macroeconomic stability, GDP per capita rates, unemployment rates, etc. The most empirical research suggests that growth is a crucial but not sufficient factor for the successful poverty reduction. Scholars state that growth should be in parallel with income distribution; otherwise, the growth will be beneficial to small segments of the population and will have no or little impact on poverty reduction. Other approaches to growth and poverty reduction correlation argue that for the former to keep pace with the latter, FDI and aid are necessary. Another factor securing economic growth and poverty reduction in the country, as the empirical data state, are flexible fiscal and taxation policies. Whatever the differences in approaches, the general concern is that growth with falling inequality is the most important tool for poverty reduction. The FDI, aid, fiscal and macroeconomic stabilization policies are factors that affect growth, hence increasing the possibilities to implement sound poverty reduction policies.

Nonetheless, recalling the empirical data that growth alone is not a sufficient precondition for poverty reduction poses the question of how to make growth pro-poor. Unless growth is directed to the poor, it will have no impact (or even a negative one) on decreasing inequality

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<sup>3</sup> IMF and the World Bank elaborated this Initiative aiming at reducing poverty through the alleviation of the burden of foreign debt on most developing countries.

and reducing poverty. Hence, pro-poor growth and policies are at the heart of poverty reduction strategies.

However, this will be discussed later in this section. The first concentration is to define what poverty is, by giving some basic poverty definitions what pro-poor growth is and how the latter is operationalized. The review will focus on the experience of the operationalization of pro-poor poverty reduction strategies in two post-communist countries; Moldova and Romania. The purpose of such approach is that these countries are former communist ones as is Armenia, which gives sufficient grounds for doing comparative analyses.<sup>4</sup>

So, Ravallion (2004) defines the meaning of poverty as a shortage in one's ability to consume certain pre-determined needs. The World Bank's 2000 World Development Report defines poverty as an unacceptable physiological and social deprivation in human well-being (quoted in Ames et al, 2001). It further defines physiological deprivation as the non-fulfillment of basic material and biological needs, which include inadequate nutrition, health, and education. Hence, a person can be considered poor if he/she is unable to afford the goods and services to meet his/her basic material needs. The concept of physiological deprivation is defined as the lack of monetary income and consumption levels. Social deprivation, on the other hand, means the deprivation of human rights that include risk, vulnerability, lack of autonomy, powerlessness, and lack of self-respect. Thus, as it was mentioned above, poverty reduction policies should be of larger scope, since they affect the overall human development. To support this point, it is worth referring to some basic poverty definitions that will give a larger scope of perceiving poverty as not only a social issue.

The 1998 UNDP Poverty Report brings six basic types of poverty, which are the following:

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<sup>4</sup> Later in this paper, the description of the selection of those poverty reduction categories that best fit and are comparable with Armenia will be analyzed.

- **Human Poverty** – The lack of essential human capabilities, such as being literate or adequately nourished.
- **Income Poverty** – The lack of minimally adequate income or expenditures.
- **Extreme Poverty** – Indigence or destitution usually specified as the inability to satisfy even minimum food needs.
- **Overall Poverty** – A less severe level of poverty, usually defined as the inability to satisfy essential nonfood as well as food needs. The definition of essential nonfood needs can vary significantly across countries.
- **Relative Poverty** – Poverty defined by standards that can change across countries or over time. An example is a poverty line set at one-half of mean per capita income – implying that the line can rise along with income. Often this term is used loosely to mean overall poverty.
- **Absolute Poverty** – Poverty defined by a fixed standard. An example is the international one-dollar-a-day poverty line – which is designed to compare the extent of poverty across different countries. Another example is a poverty line whose real value stays the same over time so as to determine changes in poverty in one country. Often this term is used loosely to denote extreme poverty (p. 16).

Thus, the main assumptions that can be drawn is that the content and extent of the above-mentioned definitions can vary across countries, for countries differ in terms of the efficacy of poverty reduction strategies' implementation. Different countries treat poverty in different ways, hence elaborate poverty operationalization strategies in different ways. That is why the enactment of the same policies<sup>5</sup> in different countries gives different results. Therefore, some scholars state that the policies for poverty reduction are the same, either fiscal or

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<sup>5</sup> Namely, structural adjustment policies of the IMF, World Bank, and other international organizations that generally are the same in nature.

macroeconomic stabilization or FDI encouragement: the difference is in prioritization of such policies, which depend on the overall country context.

To a large extent, countries differ in terms of economic institutions and policies. Some countries have a favorable investment environment whereas other countries have poor ones. Seen in these terms, poverty reduction in developing countries depends primarily on these countries' own approaches to improve their domestic policies and institutions. However, the vast majority of theoretical and empirical studies argue in favor of the inability of reducing poverty through solely reliance on rapid growth. Hence, the nature and pattern of growth in combination with the manners of gain distribution from economic expansion are equally important from the perspective of poverty reduction.

With the emergence of newly independent states, the aim of international efforts touches the primary purpose of significantly reducing poverty across the world. There is generally agreed consensus that economic growth is a vital tool for poverty reduction, however, it is not able to fight poverty alone. Thus, growth should be poor-oriented. So, what is pro-poor growth?

Ravallion (2004) talks about two pro-poor growth definitions that the recent literature and policy discussion papers addressed. Baulch and McCulloch argued that the growth is "pro-poor growth" if by the same rate of growing income, poverty falls more (quoted in Ravallion 2004). On the other hand, Ravallion and Chen defined "pro-poor growth" as being one that reduces poverty (quoted in Ravallion 2004, p. 2). The first definition focuses on the shifting character of the income distribution during the process of growth. Thus, according to the first definition, the growth is pro-poor, when the incomes of poor rise faster than nonpoor. However, even in this case, one cannot consider the growth to be pro-poor (Ravallion,

2004)<sup>6</sup>. This is so, because the incomes of poor may rise more than those of nonpoor, whereas the equality of access of poor to business environment, financial markets, or to basic services still be ignored or not performed in a pro-poor manner.

On the other hand, as Ravallion (2004) argues, the second definition mainly focuses on what happens to poverty. The scholar states that their finding for 47 countries was that changes in inequality at the country level have zero correlation with rates of economic growth. In growing economies, the tendency of falling inequality happens as often as increases, thus, growth tends to be distribution neutral. Therefore, economic growth is not typically “pro-poor” by the definition of Baulch and McCulloch.

Another definition of pro-poor growth is posed by Kakwani is that “Growth is pro-poor if its rate is higher for the poor than the non-poor; roughly speaking that inequality falls” (quoted in Ravallion 2004a, p. 1). In contrary to this definition, Ravallion (2004a) states, “By Kakwani’s definition, this is not pro-poor growth, rather it was growth that was biased against the poor..... In other words, pro-poor growth means growth that is deemed to benefit the poor” (p.1). Thus, the focus is on the distributional patterns of the gains from economic growth that can make the latter more pro-poor. Zepeda (2004), on the other hand, argues that the above-stated definition of Ravallion,

is too broad; it implies that most real world instances of growth are pro-poor, even if poverty decreases only slightly and income distribution worsens during a period of strong growth. A more appropriate definition has growth as pro-poor if in addition to reducing poverty, it also decreases inequality (p. 1).

To support Zepeda’s definition, Kakwani and Pernia give a relative definition of pro-poor growth stating that, “pro-poor growth compares changes in the incomes of the poor with respect to changes in the incomes of the non-poor” (quoted in World Bank, 2004). Thus, the assumption is that all this scholars argue in favor of poverty reduction policies through

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<sup>6</sup> “Similarly, a recession will be deemed pro-poor if poor people lose proportionately less than others, even though they are in fact worse off” (Ravallion 2004, p. 2).

redistribution. This may be redistribution of income, land, etc. Whatever the pattern of distribution, it should favor the poor. Only in this case the growth may be considered to be pro-poor. Now the turn is to discuss how poverty reduction, as well as, pro-poor policies is operationalized in parallel with those theoretical definitions.

Ravallion (2004) identified two sets of factors serving as the main causes of the differentiations between poverty reduction rates at given rates of growth, namely, the initial level of inequality and how inequality changes over time. The main assumption that the scholar focuses on was the initial patterns of inequality of the country. Thus, “The higher the initial inequality in a country (even if it does not change over time), the less the gains from growth tend to be shared by the poor” (p. 14). In other words, if the initial share of poor from economic expansion is low it means that the share will be smaller in subsequent aggregate economic expansion. Therefore, the author concludes that “for high inequality countries, growth will be quite a blunt instrument against poverty unless that growth comes with falling inequality” (p. 17). Despite the generally accepted consensus that growth will have no positive impact on poverty unless equal distribution is secured, Ravallion (2004) argues that there is a feedback effect that high inequality not only hurts the poor but also impedes future economic growth. For supporting his argument, the scholar claims that in developing countries the main source that this feedback effect stems from is the failure of credit markets, meaning that

Some people are unable to exploit growth-promoting opportunities for investment. With declining marginal products of capital, the output loss from the market failure will be greater for the poor. So the higher the proportion of poor people there are in the economy the lower the rate of growth. Then poverty is self-perpetuating (Ravallion 2004, pp. 20-21).

For making growth more pro-poor involves the mixture of higher growth and pro-poor distribution of the gains from growth. The point is that what is good for growth should also be good for poor, hence decreasing inequality and fair distribution of economic gains from

growth will benefit the poor (Ravallion, 2004). In his reference to the latter point, brought by Ravallion, Lopez (2004) found that all pro-growth policies, whether they affect inequality or not, will become pro-poor in the long run. This point is supported by the assumption that if policies are positive for growth that will help eradicate all negative effects they may have on inequality. However, the scholar assumes that there may be some impermanent deviations of some policies from being pro-poor. Such policies that may have negative impact on inequality include trade openness, financial developments, and decreases in the size of government. By impermanent deviations, the scholar means “temporary” that will span several years” (Lopez 2004, p. 16). Thus, “policies in these areas present some conflict with respect to growth and inequality. To the extent that their positive impact on growth offsets the negative impact on inequality, these pro-growth policies would also be pro-poor” (Lopez 2004, p.4).

Further, Addison and Cornia (2001) also state the assumption that some policies have negative income on equality. According to scholars, the relationship between trade openness and inequality has the following tendency, “import liberalization raises the demand for skills and reduces the demand for unskilled labor as the cost of imported technology falls” (p. 23). They bring the argument by Wood who mentions that, “trade liberalization increases inequality in countries importing goods intensive in skilled-labor and improves it in countries exporting such goods” (quoted in Addison and Cornia 2001, p. 23). Thus, inequality is an issue that continues to rise and impedes economic growth not only in the newly independent transition countries but also in many developed economies. This is alarming that countries should be addressing this issue through more investment in human development and through sound economic reforms, since little progress can be achieved in promoting pro-poor growth when inequality is high and rising.

In this sense, Addison and Cornia (2001) raise the question of shifting from traditional considerations of causes of inequality and argue in favor of addressing to the new causes of inequality. As the scholars state, those new causes are “redesigning stabilization programs to avoid sharp anti-poor demand compression and to protect pro-poor spending; regulation of privatized enterprises to protect disadvantaged poor consumers; and more pro-poor education investment to offset the tendency of trade liberalization to increase income inequality” (p. 1).

Addison and Cornia (2001) argue that if economic growth and poverty reduction keep the current pace in future, then the DAC of halving poverty in 2015 will be possible around 2060. To support this point, the scholars bring the argument of Hanmer and Naschold, who estimate that

If the projected 4 percent growth is accompanied by low inequality (i.e. Gini coefficients of less than 43), then the DAC target can easily be met. In contrast, if the projected 4 percent growth is associated with high inequality, then by 2015 poverty rates will still be in the vicinity of 20 percent. In the high inequality scenario, the DAC poverty target will only be met if the growth rate of income per capita reaches a staggering 9 percent (quoted in Addison and Cornia 2001, p. 6).

Thus, “Unless reversed, current inequality trends will continue to reduce the poverty alleviation elasticity of growth and, as discussed in the subsequent section, may depress economic growth itself” (Addison and Cornia 2001, p. 6). The authors give some suggestions for successful operationalization of pro-poor growth. The first assumption refers to capital markets stating that when capital markets are imperfect and investments in industry are poorly constrained, productive opportunities tend to vary in accordance with the wealth distribution. This highly limits the ability of poor people to borrow, finance education, enter financial market, or open businesses. Hence, they cannot grasp their full productive potential. As noted by Aghion et al., “Redistributing wealth from the rich to the poor would enhance aggregate productivity and therefore growth” (quoted in Addison and Cornia 2001, p. 8). Therefore, unless the credit and insurance (capital) markets are expanded or the wealthy are

taxed to subsidize the public education of the poor, human capital accretion remains low (Addison and Cornia, 2001).

Another reason for new causes of rising inequality, the authors see in the problem of poorly constraint institutions of conflict management. The point here is that social tensions lead to conflicts that cause significant declines in output, the destruction of infrastructure and large human capital losses through death, displacement or forced migration. When social divergence is deep and the institutions of conflict management are weak, external shocks (such as trade losses) are exaggerated by the gain distribution conflicts. Conflicts may arise in particular when inequality between religious, ethnic and social groups is affected discernibly “because, for instance, of the concentration of public subsidies or privatized assets in the hands of few interest groups, thus altering a pre-existing and precarious political equilibrium” (Addison and Cornia 2001, p. 9). Rodrik addresses such conclusion by bringing an argument that countries with poorly constrained institutions of conflict management (e.g. social insurance) and high inequality are more sensible to growth collapses (quoted in Addison and Cornia, 2001).

Another factor that differentiates between the traditional and new causes of inequality and their impact on economic growth and poverty are income and assets inequality. The latter impedes adoption of sound macroeconomic policies directed to effective redistribution of land, taxation and human capital formation subsidization. The scholars bring the examples of Argentina and Peru where governments enacted the reduction of social tensions through populist fiscal expansion. As a result, inflation and the crowding out of private investment both undermined growth (Addison and Cornia, 2001). High inequality countries are more impelled to borrow rather than to tax, because in such countries the new elites have strong power to resist taxation (e.g. Russia), hence reducing the abilities of governments to perform sound pro-poor policies. Seen in these terms, in some countries distribution of public

spending and taxation is neither conducive to growth nor to poverty alleviation. The problem of taxation in these countries also concerns with low and even non-existent land taxes. The point is that large landowners benefit disproportionately from subsidization, namely, receiving public services (power or water) with much lower prices than is their economic cost. The solution is to establish effective tax institutions and introduce more progressive land taxes that will lead to lower income inequality through subsidization of human capital formation (Addison and Cornia, 2001).

The last argument provided by Addison and Cornia (2001) is that Globalization and the introduction of new technologies make education the core instrument for development. With the investment in education, real wages will rise and wage-inequality will fall. For income redistribution through such means, the labor markets also should be regulated and reformed to secure long-term social progress (Addison and Cornia, 2001).

Foster and Szekely (2001) conducted extensive empirical application involving household surveys from 20 countries over 25 years. The scholars found that when the lowest incomes receive greater emphasis (as they do with the general means) then the effect of growth on the poor is not quite as strong. Thus, the need for policies that take into account the distributional impact of growth emerges. However, what policy measures have been proven to be right for one country may not be necessarily right for another country, for countries vary in the degree of their social, political, and economic peculiarities. By focusing mainly on the variations in the sensitivity of poverty to growth across countries, Ravallion argued that the responsiveness of poverty to a particular rate of growth at large depends on the level of initial inequality of that country. The argument of Ravallion was that a 1 percent increase in income could reduce poverty in 4.3 percent (in very low inequality countries) or by 0.6 percent (in high inequality countries) (quoted in World Bank 2005, p. 17). On the other hand, Bourguignon found that in a high inequality country, a drop in inequality level would cause decline in poverty rates by

15 percentage points in 10 years, which will be 3 times longer to achieve if inequality remained unchanged (quoted in World Bank 2005, p. 17). The empirical evidence from the World Bank Report on Operationalizing Pro-Poor Growth (2005) argues that one of the key ingredients for making growth more pro-poor is the enhancement of access to girls' education. The efforts of increasing girls' education and rising female's participation in the labor markets, is an essential tool for the countries' goal of reducing poverty or making growth more pro-poor. Thus, spending on the regulations of the labor market, according to the Bank's investigations, is another crucial element of poverty reduction.

So far, the paper examined different stances of scholars and empirical literature to define the nature of poverty, its effects on overall human development, and different ways helping pave way out of that disastrous phenomenon. One of those "ways" is considered to be foreign aid. By the same token, Collier and Dollar claimed that AID could have a significant impact on poverty reduction by the support of strong policy environment (quoted in Gottschalk 2000, p. 2). The main concentration of the research is again the evidence that steady poverty reduction cannot be secured through growth only, rather aid is one of the most important ingredients in this particular case. Thus, the argument is that elaborating successful pro-poor growth through economic expansion only is "almost an unattainable task" (Gottschalk 2000, p. 3). In this case, the key role in income redistribution plays recurrent expenditure policy, however, additional financing will still be needed. The projections of the scholar indicate that for marked poverty reduction to occur larger external finance will be needed than in 1990s. The idea suggested by White and Anderson that better income distribution can have a better result in terms of poverty reduction alters the old view that there is a tradeoff between these two policy objectives, since the focus have been on income poverty (quoted in Gottschalk 2000, p. 20). However, the principal target should be poverty that has human development defined as its central direction. Such an approach means that the enhancement of public

policies to improve those social indicators as education provision is should be prioritized. By the same tokens, the key role in this process will play recurrent expenditure (Gottschalk, 2000). There is well-known expression scarcity of resources and unlimited society needs. However, this is not the main reason that too few resources are devoted to basic public services in developing countries. According to the data provided by the World Development Report on 1997, spending on public health in the world accounted for only 25 percent of what is set as a minimum requirement (quoted in Gottschalk 2000, p. 21). That is one of the reasons why poor countries “continue to face chronic problems over financing their recurrent expenditures, given their extremely weak ability to raise public revenues” (Gottschalk 2000, p. 21). The main measure that Gottschalk (2000) recommends for financing such “chronic” needs of poor countries is the raising of private savings, “which can then be taxed or borrowed or increase consumption-based tax revenues” (Gottschalk 2000, p. 22). However, the feasibility for such policy in poor or low-income countries is very low; hence, the main source is external financing. The famous measure for such financial needs is HIPC Initiative provided for heavily indebted countries. The debt servicing is public and the reduction of external debt enhances the abilities and financial resources of countries’ budgets to perform recurrent expenditures in social sectors. The alternative for such an approach is HIPC Initiative enhancement (Gottschalk, 2000). However, the latest Global Development Finance report argues that present aid flows to developing countries are below the levels required to meet the MDG (quoted in Gottschalk 2004, p. 12). The study conducted by Gottschalk (2004) shows that the external financing needs of poor (developing as well) countries exceed the amounts of capital currently “flowing from the North to the South” (p. 12). Given the concentration of private capital flows in very few developing countries, the projected financing gap would have to be filled with a significant increase in aid flows, particularly to the poorest countries of the world.

Contrary to the arguments in favor of the Aid's positive impacts on the implementation of poverty reduction strategies, Gemmell (2001) states that "Aid alters the precise specification of the budget constraint but foreign aid should be thought of like any other budget-financing element, together with any public expenditure implications associated with the aid inflow" (p. 17). The scholar argues that Aid is future cost itself, because it is borrowed by the recipient country (if it is not charity contribution). Therefore, the growth effects of aid-financed expenditures should be assessed in terms of cost-benefit analyses, which would generate any borrowing-financed increase in public expenditures (Gemmell, 2001).

Nonetheless, Aid "can assist the government and the society to provide public services, including critical ones needed by poor households to participate in the market economy" (Collier and Dollar 2000, p. 32). The achievement of this end can be possible if it is combined with good policy environment. Thus, good policy environment is the centerpiece of increasing poverty-efficiency of aid. The improvements in policy and institution environments decrease the cost of poverty reduction "so that for a given aid volume more people can be lifted out of poverty" (Collier and Dollar 2000, p. 1). Similarly, the conclusion can be drawn that the role of international assistance is very important in the policy objectives of poor and developing countries. Though recipient countries vary in the extent of receiving such allowances, the reason is to reduce poverty and inequality and pave the way of those countries to integrate into international community and markets. The point is that no country or investor will risk his/her financial resources in the country that lacks mixed economy<sup>7</sup> and clearly defined investment environment. In the opposite case, foreign investments may bring additional money for the country, which may serve as an important tool for that country's goal towards establishing a strong and prosperous society.

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<sup>7</sup> Countries that are not highly monopolized and have strong anti-monopoly regulatory mechanisms.

Therefore, “FDI is a key ingredient for successful economic growth in developing countries”<sup>8</sup> (Klein, Aaron, and Hadjimichael 2001, p. 1). Among the key alternative approaches directing more of the gains of growth to the poor are governmental programs aiming at improving social safety nets, redistribute assets and income. For funding these government-led programs, FDI is the key instrument. The scholars argue in favor of such advantages of FDI as improvements in environmental and labor standards, generate taxes that will support country’s poverty reduction objectives, and assist in improving the management of service delivery to the poor (e.g. water supply). The very essence of such an approach is that foreign investors worry about reputation in markets and will invest in places where high standards are seen as desirable. However, the authors state that FDI cannot deal with the socio-economic problems of the particular country directly, rather it will encourage rapid growth, which in turn, will tend to reduce poverty (Klein, Aaron, and Hadjimichael, 2001). Such tendency of rapid growth is now viable for those developing economies that are capable to importing and imitating technical and organizational innovations from the world’s leading economies. Hence, “Growth of this rapid type makes it possible for the first time in history to propel people from poverty to a reasonably comfortable life” (Klein, Aaron, and Hadjimichael 2001, p. 3). Arguably, FDI encourages rapid structural shifts in the economy with this helping the latter keep the pace with advanced economies, because it is the most effective means of importing best practice of developed countries. Thus, “FDI is not robbing poor countries” as is generally accepted to think (Klein, Aaron, and Hadjimichael 2001, p. 7). Similarly, rapid growth without importing best practice from abroad is impossible. The differentiations between foreign investment and other means of funding development is not the cost, but the incentive structure for foreign investors. Therefore, “foreign investment is equity investment” (Klein, Aaron, and Hadjimichael 2001, p. 7). This is so, since in most

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<sup>8</sup> However, FDI will only flow into those countries that have low productivity when wages and other costs are low enough to offset the productivity disadvantage (Klein, Aaron, and Hadjimichael, 2001.).

developing countries the ownership is concentrated in the hands of some segments of society because of the voucher privatization. Therefore, FDI is argued to lead to a less unequal ownership and to the point where distributional implications are more benign. By the same token, such a correlation of FDI and distributional patterns will also lead to decreasing corruption rates in the particular country, for, as Smarzynska and Wei argue, foreign investors tend to avoid investing in corrupt environments where the costs of doing business are very high (quoted in Klein, Aaron, and Hadjimichael 2001, p. 11).

Thus, among the possible advantages of FDI for the recipient country the scholars argue that foreign investment creates pre-conditions for generating tax revenues required to fund pro-poor programs through their own tax contributions, which stimulates growth and broadens the tax base. Moreover, foreign investors will themselves invest in promoting domestic capability (Klein, Aaron, and Hadjimichael, 2001). Hence, such assistance in upgrading domestic capabilities of the country may also bring to macroeconomic stability, which is another essential mechanism for making growth pro-poor.

Various statistical studies have stated about the strong association between national per capita income and national poverty indicators. Such a study, consisting of 80 countries and covering over four decades, was conducted by Dollar and Kraay, who found that, on average, the income of the bottom one-fifth of the population rose one-for-one with the overall growth of the economy as defined by per capita GDP (quoted in Ames, Brown, Devarajan, and Izquierdo 2001, p. 3). The study found that the growth effect on incomes of the poor gave no difference in poor countries than in rich countries. Hence, a key objective of country's poverty reduction strategies should be the establishment of such conditions that will facilitate investments in private sector. Ames et al (2001) argue that the lack of macroeconomic stability will discourage domestic and foreign investors and resources will be diverted somewhere else. As Easterly and Kraay state, "macroeconomic stability is the cornerstone of

any successful effort to increase private sector development and economic growth stability” (quoted in Ames et al. 2001, p. 3). The poor have tendency to hold most of their financial assets in the form of cash rather than in interest-bearing assets. Consequently, the burden of inflation is typically borne disproportionately by those in lower income quintiles. Hence, price increases generally corrode real wages and assets of the poor more than those of the non-poor. The solution is sound fiscal policy that will have a direct impact on the poor, both through the government’s overall fiscal stance and through the distributional patterns of tax policy and public spending (Ames et al. 2001).

Overall, the data provided in the above section states that redistribution of income and assets, as well as, increasing investments in human development should be prioritized in any country, which lacks strong institutions and policy implementation mechanisms. To summarize the various theoretical approaches that were stated above, pro-poor growth is:

- Growth, that benefits poor more than the non-poor;
- Growth, that reduces poverty;
- Growth, through which, by the same rate of growing income poverty falls more;
- Growth, the rate of which is higher for poor than for non-poor;
- Growth, that not only decreases poverty but also inequality.

In a similar vein, there are also various empirical approaches concerning the measures that should be undertaken in order to make growth more pro-poor. Thus, it would be reasonable to summarize this part also for understanding what brings to pro-poor growth:

1. For making growth more pro-poor, the initial levels of inequality and further changes in it should be considered. The point is that if the initial share of poor from economic expansion is low, it means that the share will be smaller in subsequent aggregate economic expansion.

2. Another point is growth policies. If the latter are positive for growth, they will become positive for poor in the long run. Thus, the policies should be positive first for growth.
  - 2.1. Foreign aid is another mechanism that will assist economic growth and make it more pro-poor. More precisely, it will help governments implement recurrent expenditure policies directed to income redistribution.
  - 2.2. FDI encouragement is another crucial point in making growth more pro-poor. It will assist governments in managing service delivery and generating taxes, which will bring to rapid economic growth that will further benefit the poor.
  - 2.3. The expansion of credit markets is another tool towards the goal of making growth pro-poor. By enhancing the access of poor to micro credits will give an opportunity to increase their participation in business environment and will make great contribution in increasing employment in SME.
3. Income and assets redistribution is another tool that will make growth more pro-poor.
  - 3.1. The introduction of more progressive taxes (especially land taxes) and tax institutions will equalize income and assets inequality and make growth more pro-poor.
  - 3.2. Investments in education and labor market regulations will increase real wages and reduce wage inequality, which will bring to long-term social progress and direct the gains from growth to poor.

All the above were empirical and theoretical assumptions on the issue of operationalizing pro-poor growth from the perspectives of various stances of governments, international community and financial institutions. The following section will define how the above-mentioned criteria of operationalizing pro-poor growth are met in two former communist republics: Romania and Moldova. The reason behind such selection is that those countries have many similarities with Armenia. More precisely, the size of shadow economy, unemployment, corruption, inequality and tax burden are as high as in Armenia. Though in

some categories and subcategories the countries deviate from each other, which is natural because of the size of population, geographical location, etc., they are much alike in gross terms. Therefore, the main approaches to operationalizing pro-poor growth in Moldova and Romania will be taken and tested in Armenia.

## *Operationalizing pro-poor growth in Moldova and Romania*

### Romania

The late 1990s can be considered as the period when all economists and financial institutions were concerned about the issue of making growth more pro-poor through different policy objectives. Similarly, the question was to achieve more rapid poverty reduction in the world through growth and distributional implications. By the same token, the issue was that income and assets are distributed disproportionately among the societies, hence impeding the objective of rapid economic growth and steady poverty reduction. Among those countries are Moldova and Romania, which are still in the phase of transition to a more stable and prosperous country.

At the beginning of transition, Romania was lacking the political abilities to elaborate and perform reliable economic policy reform package. The result of domestic political developments was unsuccessful to liberalize the economy in a coherent manner and to ensure macroeconomic stability in the country. In a similar vein, a little was done on the privatization front, thus imposing further pressure on the macroeconomic environment.

Romania made its first efforts towards a more consistent economic program in 1994 with some combination of fiscal and monetary policies, liberalization of the foreign exchange market, opening to foreign investment and accelerated privatization. Only in 2000 Romania started to perform a more reasonable mix of basic fiscal, monetary, and wage control policies (CASE, 2004). The country faced large shifts in labor towards agriculture in the early years of transition.

However, such alterations cannot be justified in terms of allocative efficiency, rather in terms of the agricultural sector serving as an absorber, captivating people who have lost jobs in industry and were not able to find employment in the developing service sector due to rigidities of the labor market (CASE, 2004). The result was zero correlation between

economic growth and employment. The patterns of high employment in rural areas disguise large informal unemployment in agriculture. Another finding states that poverty is almost three times higher in rural areas than in urban ones.

Thus, the study suggests that the key transmission mechanism for reducing poverty in Romania is regulations in labor markets. The low skilled workforce in rural areas lack opportunities for non-agricultural employment and are the stagnant pool of poverty in Romania. This would corroborate the essential role played by labor market developments in terms of the projections of reducing poverty (CASE, 2004).

Further, job creation for the poor in Romania has been largely conditioned by the fast developments in the SME sector. The study illustrates that the share of SME sector employment in total employment of the country increased from 12.3% in 1992 to 29% in 1997 and 50.7% in 2002. In gross terms, the SME sector added 1.5 million jobs in ten years.

However, the growth of the SME sector could have been higher if various institutional barriers were absent. Those barriers include “corruption, excessive bureaucracy and the volatility of the legal system related to the legacy of communism and erratic transition process” (CASE 2004, p. 8)<sup>9</sup>. Corruption and shadow economy “dominate” among these problems. According to the Corruption Perceptions Index 2003, estimated by Transparency International, Romania is ranked 83-85 out of the 133 countries surveyed, far behind other CEE countries (quoted in CASE 2004, p. 8).

The high levels of informal employment are both the result of inflexible regulations and the unwillingness of employers and employees to legalize their employment relationship. The catalysts of such undesirable outcomes concerning shadow economy in Romania are high tax burden, rigid labor market regulations and awkward bureaucracy. The frequency of imposing controls in the country is at higher rates and is highly time-consuming. However, many

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<sup>9</sup> This situation is common for many countries with a communist past, although the intensity of some problems marks Romania out from other transition countries (CASE, 2004).

reforms were implemented in this regard, which result in decreasing the cost and duration of starting a business. In 2004, the above criteria were reformed and it was estimated that the average duration of registering a new company in Romania was 28 days, which is close to 25-day average in OECD countries (CASE, 2004).

Nevertheless, Stanculescu and Ilie have illustrated that in 1998 68% of households in Romania earned cash incomes in the informal sector (quoted in CASE 2004, pp. 29-30). Another comparative analysis conducted by Stanculescu showed that the share of Romanian shadow employment is high compared to other countries of the region. Thus, in spring 2001, of all employed aged 18-65, 12 percent did informal work without a work contract, 23% were self-employed and about 10% combined formal activity with additional informal work (quoted in CASE 2004, p. 30). The main policy option according to the estimations of CASE (2004) is the provision of high quality and uniformly accessible educational system for increasing employment and averting poverty. Thus, the contribution of public spending to poverty reduction can be performed through directly performing poverty reduction via redistribution.

Further, the consensus is that poverty reduction in the country is possible through securing labor-intensive growth that creates jobs for high poverty groups. The future increases in tax burden should be avoided, since it is already at very high level even by European standards. In the opposite case, increased tax burden may lead to employment reductions (CASE, 2004).

Achievements in the enhancement of the skills of labor force, will lead to poverty reductions via two characters: it has a positive impact on economic growth and will increase its pro-poor character. The equalization of the education opportunities of Romania's rural youth should be a main ingredient of government policy in this field, because it will increase migration of the labor force from rural to urban areas having strong poverty reduction

outcomes. The latter statement is treated as such, since “the larger the share of rural population, the more severe the poverty of the region/county” (quoted in CASE 2004, p. 66).

### Moldova

Nearly the same picture is in Moldova, namely, higher rates of corruption, unemployment, shadow economy, etc. Moldova’s implementation of reforms has slow pace, due to the Government’s hesitant attitude towards fundamental reforms. As a result, since the communist rule collapsed, short-term crisis management rather than strategic and long-term gradual reform policies took place in Moldova’s political and economic agenda (Torm, 2003).

From 1990 to 1999, Moldova’s GDP has fallen every year with the exception of 1997, when the agricultural sector benefited from favorable weather conditions. By 2002, the dependency on agricultural production caused a situation when 73 percent of rural population gross income derived from agricultural activities. In this regard, sales are the most important source of income for rural households, accounting for 20 percent of cash income for every quintile (See Table 1). By the same year, 63 percent of residents of small towns were poor, compared to 52 percent of rural residents and 29 percent of the people living in large cities (World Bank, 2004).

**Table 1: The typical rural farmer does not produce for the market**

Agricultural Sales of Rural Households, 2002			
<i>Expenditure Quintile</i>	<i>% of households with sales</i>	<i>Sales as share of total production</i>	<i>Sales as share of cash income</i>
Poorest	24%	12%	19%
Second	27%	8%	19%
Third	20%	5%	13%
Fourth	27%	7%	17%
Richest	32%	10%	20%
<i>All</i>	<i>26%</i>	<i>8%</i>	<i>17%</i>

Source: Jacoby (2004).

Thus, it can be assumed that the largest portion of the rural population was running subsistence-based agricultural activities. People were growing products not for sale in the market but for survival. Poverty in Moldova, like Armenia, also varied depending on the type of settlement and employment. In 2002, the poverty rate among employed was 50 percent compared to 46 percent among people whose heads were mainly pensioners. From settlement-type perspective, poverty rates are the highest in small towns (63%) followed by rural areas (52%), but lowest in large cities (29%). Thus, employment does not protect against poverty, since the large part of poor are employed (World Bank, 2004).

Furthermore, the government-provided unemployment benefits are so non-universal that job-seekers do not even worry to register, hence they are not recorded as being unemployed. In Moldova, as Ronnas states, only about one-fifth of the registered unemployed are entitled to unemployment benefits<sup>10</sup> (quoted in Torm 2003, p. 18). The picture is even worse when referring to the rates of the shadow economy.

In 1996, the total labor force in the trade, commerce and repair activities sector at large exceeded the manufacturing labor force, yet the share of wage labor in this sector presented only 21%, meaning that some 80% were working informally. Therefore, increased employment in the shadow sector also has its contribution to the declining levels in output in labor markets and increasing levels in poverty rates (Torm, 2003).

In 2004, Moldovan GDP per capita was still under US\$400, a sixth of the average for the Europe & Central Asia region and below the average for Sub-Saharan Africa<sup>11</sup> (World Bank, 2006). Both government transfers and private remittances from abroad have greater contribution to the rapid reduction of poverty rates over the period from 1999 to 2002, and such flows kept the pace over the period 2003-05 (World Bank, 2006). Unfortunately, data

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<sup>10</sup> In Armenia, according to the estimations of UNDP, only about 25% of all unemployed persons register and only 15% of these receive the less than US\$ 5 monthly unemployment benefit (quoted in Torm, 2003).

<sup>11</sup> Whereas in Armenia, it constituted for about US\$ 1,500.

analyses of the period from 2002 to 2004 illustrate that relatively small shares of public and private transfers reached to the poorest groups. Due to the increase in real wages and workers' remittances from abroad, the national poverty rate, as measured by the Ministry of Economy and Commerce (MEC), fell significantly. More precisely, over the period 1999-2003, the national poverty rate fell by more than half (World Bank 2006, p. 1).

Despite all the above-mentioned dissatisfactory economic trends, Moldova has strong transfer policies through many programs. The main types of government transfers include pension benefits. These include pensions to old age population, pensions for people of working age, for those suffering from disability, and social pensions. Nearly half of Moldovan households benefit from pension incomes and pensions are an important income source for poverty reduction policies.

Moreover, in Moldova, there are another 15 social assistance benefits with ranging eligibility criteria and processing procedures (World Bank, 2006). Among such benefits are child allowances and contributions for individuals with specific conditions, such as war veterans and victims of accidents. However, these benefits constitute on average only 2 to 3 percent of the household income. On the other hand, the share of private remittances in income have doubled over 1999-2004. A recent survey found that from 2003 to 2004, about 22 percent of households had a migrant family member who represented about 40 percent of the economically active population. In 2004, almost 56 percent of the people that benefit from private transfers are in rural areas and about 21 percent in small towns (World Bank, 2006).

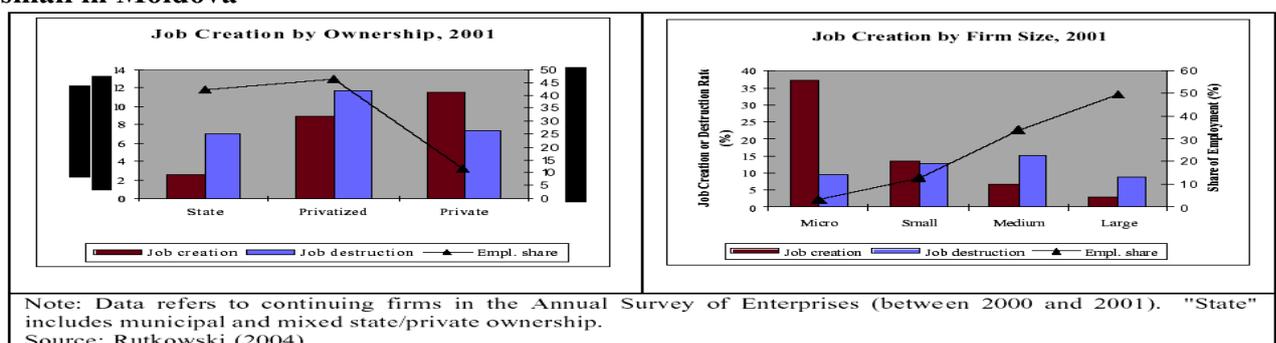
Policy measures directed to poverty eradication are implemented through the enhancement of the competitiveness of agricultural wholesale markets. The measure in this direction would be to eliminate regulations that constrain exports. Another issue is that social assistance benefits are allocated to categories of people that do not correspond to the poorest

groups. The major policy directions in this stance are the consolidation of social assistance programs to control total payments to each household. Concerning remittances, one of the best options can be the Government's enactment of flexible tax policy to guide remittances to poverty reduction investments, for example by increasing value-added taxes on consumer durables (World Bank, 2006).

Another report conducted by the World Bank (2004), states that the reduction of costs of doing business in Moldova or investments in basic infrastructure (roads, water, sanitation) is another pathway out of poverty. The present limited access of the poor to health care and education and consequent broadening of inequities in opportunities inescapably means future higher inequality rates and therefore lower poverty reduction. Thus, addressing non-income dimensions of human development is also an important policy option.

The next policy option is growth of SME sector and reduction of costs of doing business. The small enterprises are the only source of employment in Moldova, because they are much more dynamic in creating jobs than are larger ones. In Moldova, the privately owned small firms are the most productive. This suggests that the growth of SME sector is a potential pathway out of poverty for many Moldavians. However, the size of these job-creating portions is small in Moldova (as in Armenia). The small private firms account for only 11 percent of non-agricultural employment and only 17 percent of all workers are employed in small firms (World Bank, 2004).

**Figure 1: Only small private firms are net providers of jobs but the size of this sector is small in Moldova**



The main reason behind such outcomes is that the direct and formal costs of registering a business in Moldova are very high. The administrative burdens, corruption, and excessive bureaucracy highly increase the costs of doing business and highly impedes with the further developments in the SME sector. Thus, further improvements in this direction will have positive impacts on reducing the costs and enhancing the employment in the SME sector.

Overall, the key mechanisms for fighting poverty and making growth more poor directed in Moldova and Romania can be summarized in the following way:

1. Labor market:

a. additional non-farming labor income;

b. growth of the SME sector;

i. corruption;

1. the frequency with which controls are imposed and the amount of red tape – measured in terms of time spent with officials and filling in forms and complaints about discretionary decisions;

ii. excessive bureaucracy;

c. Labor market institutions and shadow employment;

i. the minimum wage;

2. Public spending and its impact:

a. targeting lower income quintiles and the size of coverage;

b. education financing;

c. health financing.

### *Poverty, Unemployment and Inequality Trends in Armenia.*

The collapse of Soviet Union posed serious challenges for Armenia. In early years of 1990s, the still persisting Soviet ideology and remainders of planned economy highly impeded country's successful transition to market economy. Planned economy and a disregard to economic incentives were the main characteristics of the Armenian economy in that period (Gelbard et al., 2005). Main reasons behind this were the higher dependence on Soviet financial support and lack of experience for running independent market economy.

During Soviet era, the demand for Armenian human capital by Russia was very high and industry was the most important economic sector in the country, which constituted about half of GDP. The main causes of poverty and higher income inequality in the early 1990s are due to the rapid decline in output, the migration of workers to the countryside (into subsistence-based agricultural activities), and the demise of the system of social benefits (Gelbard et al., 2005). However, reasons for enormous increase in the poverty rates and in the number of poor in 1991-1998 were not primary consequences of economic factors.

More precisely, between 1988 and 1994, the country faced severe economic decline, because the 1988 earthquake and Nagorno-Karabakh war were added to the existing political disequilibrium caused by the demise of the Soviet Union. The 1988 devastating earthquake excluded a huge part of population, some 400.000 people, from property and basic means of existence. In addition, the immigration of some 360.000 refugees, which flowed from Azerbaijan into Armenia because of Karabakh conflict, further complicated the situation. As a result, the vast majority of these refugees were added to the number of people that were in desperate need for social protection (PRSP, 2003).

From 1990 to 1993, GDP shrunk more than two times making in 1993 only 46.9% of 1990 level; the largest decline in GDP among the CIS countries (PRSP, 2003). Because of Soviet collapse and the blockade, trade routes were destructed, subsidies on imports of

energy and other goods from Russia vanished, Russia's demand for Armenia-produced goods disappeared and transportation costs "skyrocketed." This brought to 55 percent GDP decline and 5,300 percent annual inflation in the early years of 1990s (Gelbard et al., 2005).

Due to ceasefire in Nagorno-Karabakh conflict, more attention was paid to economic recovery and government started to develop frameworks for sustaining aggregate economic expansion in the country. With the support of the IMF, World Bank and other donors, Armenia started reforms and improvements in all spheres of the economy. Namely, those economic reforms include land privatization, small and large-scale privatization of state-owned enterprises, trade and price liberalizations, reforms in tax (introduction of VAT, income tax, etc.) and banking system. As a result, the GDP started to grow steadily by 6 percent annually from 1996 to 2000, which brought down annual inflation from 5,273 percent in 1994 to 19 percent in 1996.

However, such positive trends of economic expansion, as stated above, made slight changes in terms of pro-poor growth. The country still faces negative consequences of poverty on overall development despite steadily growing GDP rates. The limited chances to find jobs in order to generate income, or engage in non-agricultural activities in rural areas, are among the main reasons for substantially higher poverty rates in rural areas of Armenia. In 1998, more than half of the population was poor, of which about half were extremely poor. Still one-quarter of the population is unemployed and about half of those employed are poor. Hence, the need for pro-poor growth emerges.

For assessing the situation in Armenia, let us use the framework developed by the World Bank. As mentioned above, recently pro-poor growth is in the focus of attention of the international community. Research shows that economic growth not always benefits poor more than non-poor. In other words, the higher rates of inequality in all sectors of economy will highly impede incentives of poor people to gain more from economic expansion.

World Bank has addressed the issue more systematically in terms of income redistribution and inequality reduction. Unless these criteria are met, growth will always benefit small segments of the population leaving severe unfavorable conditions of poor people unchanged. For us, Romania and Moldova are the most relevant ones, so we will assess Armenia's growth from poverty reduction purpose, using the findings of Romanian and Moldovan cases described above.

### Economic Growth and Poverty

The economic recovery in Armenia started from 1995 and its economic growth was remarkable. However, as mentioned above and as we will see in coming sections, these positive trends had little to do with strong poverty, unemployment and inequality reduction.

During 1995-1998, Armenia's real GDP growth was 5.8 percent per year. It is continuing to increase steadily, averaging at 6.68% from 1994 to 2002. Moreover, economic growth rose to an average of 11.6 percent per year during 2001-2004. As a result, estimates show that overall poverty has declined from 56% in 1998 to 32% in 2003. Of which, in Yerevan poverty is 22%, 38% in other urban areas, and 33% in rural areas (Gelbard et al., 2005). However, such patterns of economic growth made little contribution in terms of pro-poor growth.

By the same token, economic growth has the lowest impact on poverty and inequality reduction in rural areas, where the share of poor decreased only by 4.18 percent (against the republican average of 9.23 percent), while inequality remains markedly higher than in urban areas (PRSP, 2003). Such low rates of poverty reduction are a consequence of unfavorable structure of prices for sales of agricultural products: in 2001 it was 84.7% of the year 1997, while consumer price index was at the level of 102.9% from 1997 (PRSP, 2003). Often, the

produced agricultural products were mainly consumed by producers or sold at very low prices.

The outcomes for such higher poverty rates and unequal income distribution in rural sector are conditioned by the limited access of rural population to non-agricultural employment, low productivity of production, low market prices for agricultural goods, and higher seasonal deviations concerning locations of land. The latter is worth of special consideration, since government should introduce a system of insurance that will finance all the consequences of seasonal and settlement-type divergences in order to make some equalization in rural sector. Moreover, territorial differences of poverty levels in Armenia relate to the degree to which conditions for agriculture activities are favorable, to the number of border zones and earthquake zones. In 2001, the highest poverty levels were recorded in Gegharqunik, Aragatsotn and Tavush marzes, 62.2%, 60,3% and 59.7% respectively (republican average was 51.9%). The next is Shirak where poverty level was 57.8% (PRSP, 2003).

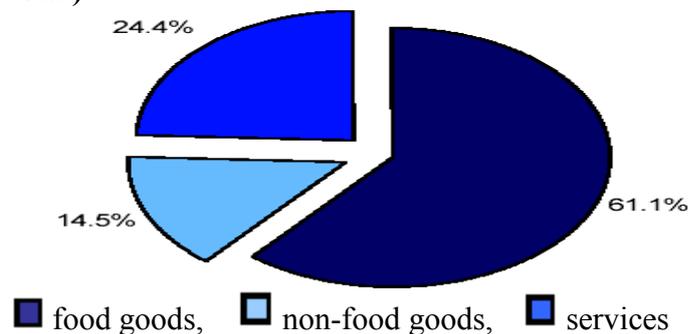
From 1999 to 2001, incomes of population, including income from work, increased at substantially higher rates than the average growth rates. However, poverty of poor and very poor people in this period did not. Growth of self-employment among poor and very poor is almost twice higher than among non-poor population (PRSP, 2003).

From 1999 to 2001, a 1 percent economic growth results in 0.468 percentage points of poverty reduction. In agricultural sector, a 1 percent GDP growth resulted in 0.35 percentage points of poverty reduction in rural areas, while 1 percent growth of GDP in non-agricultural sector led to 0.65 percentage points of poverty reduction among urban population, including 0.804 in Yerevan and 0.554 in other cities (PRSP, 2003).

Despite certain reductions of inequality in Armenia during 1999-2001, income inequality is still at a very high level constituting 0.535 in 2001 (0.593 in 1999), which is one of the highest indicators in the world. Moreover, recent estimations by IMF group shows that Armenia's estimated elasticity of poverty with regard to growth is  $-0.82$ . That is, a 1 percent increase in real per capita income will lead to a 0.82 decline in the rate of poverty. An econometric analysis of a panel data for 70 developing countries estimates the average growth elasticity of poverty at  $-1.08$  (Gelbard et al. 2005, p. 36).

According to the data provided by the Statistical Yearbook of Armenia (2005), it is obvious that the major part of the consumption were food products, stating that the overall incomes of families, to a larger extent, are sufficient mainly for securing basic food needs (See Figure 2).

**Figure 2: Structure of consumer expenditures of households in 2004 (in percents of total)**



#### Labor Market: Rural Poverty

There is no officially declared policy for the creation of additional non-farming labor income in rural sector. Since independence and following land privatization, the centralized workplaces in agricultural sector were destructed and wages from non-agricultural activities nearly vanished. The main source of income was money that came from agricultural production. Since barter-type trade dominated in this sector, the lack of cash money still poses serious difficulties for farmers to afford compulsory payments for water, electricity and used equipment. The above-stated is a very vulnerable issue, since without having additional

non-farm income, most of the rural population produces for self-survival purposes and most other material needs are financially non viable for people.

Nearly half of the population is employed in agriculture, of which, the vast majority is employed solely in farming activities. The latter fact highly impedes with the population's capability of affording basic health and educational needs, which caused widespread illiteracy in this sector. Therefore, unless creating additional non-farming workplaces for rural population, it would be impossible to overcome higher rates of poverty in this sector only through sporadic provision of fertilizers and seeds by the government.

In 2001, 48.7 percent of the rural population was poor, which included the extremely poor population at 11.3 percent, compared to the national average of 50.9 percent for the poor and 16 percent for the extremely poor. If the large number of agricultural employment added, the picture becomes even worse, because the workforce is extremely underemployed, and its productivity is substantially low.

In 2002, those working in the agricultural sector constituted 44.4 percent of the total number of the employed, and the share of agriculture in GDP was 23 percent, i.e. the productivity in agriculture was 1.9 times lower than the average and 3.1 times lower than the productivity in industry (PRSP, 2003). In a similar vein, the estimates of IMF show that in 2004, the total agricultural employment was 46.9 percent of total employment, which produced only 21 percent of GDP (Gelbard et al., 2005).

**Table 2: Average annual number of employed in the economy by the economy branches**

	1000 persons			Compared to the total, %		
	2002	2003	2004	2002	2003	2004
<b>Total</b>	<b>1106.4</b>	<b>1107.6</b>	<b>1081.7</b>	<b>100</b>	<b>100</b>	<b>100</b>
<b>Industry</b>	143.1	138.8	132.0	12.9	12.5	12.2
<b>Agriculture</b>	500.8	509.0	507.1	45.3	46.0	46.9
<b>Construction</b>	36.1	37.2	33.3	3.3	3.4	3.1
<b>Transport and Communication</b>	40.2	41.8	46.5	3.6	3.8	4.3
<b>Trade</b>	99.6	105.0	103.8	9.0	9.5	9.6

*Source: Statistical Yearbook of Armenia (2005).*

From the above table it is obvious that the largest portion of the population is employed in agriculture, which is a devastating result for Armenia, since the production in this sector is very low and most part of those employed perform subsistence-based agricultural activities. Though the share of construction in total employment is the lowest among those sectors, in GDP it has increased from 6.7 percent in 1994 up to 15.5 percent in 2004 (MFE, 2005). Moreover, it is also clear that industry sector, in combination with SME, have relatively low share of employment, while having much higher productivity rates than agricultural sector.

The main reason for such an outcome is the high level of subsistence-based farming among the rural population. Generally, the produce is consumed by the family and only the remainder, about 40 percent of the total production, is marketed, where a certain share of it is bartered for other products. From this perspective, the level of poverty is mainly the result of low productivity, unfavorable weather conditions in uplands, very limited irrigated land, distance from agricultural markets, small production volumes, and limited opportunities for non-farm type of employment (PRSP, 2003).

**Table 3: Rural poverty and location of rural settlements**

Indicators	I level: up to 1300 m above sea level	II level: from 1301 to 1700 m above sea level	III level: 1701 m above sea level and higher	Total rural areas
Share of population, %	39.0	26.0	35.0	100.0
Poor, %	42.35	54.93	57.99	50.76
<i>including extremely poor, %</i>	<i>16.37</i>	<i>24.86</i>	<i>28.28</i>	<i>22.55</i>

Source: PRSP (2003).

However, some positive shifts were made to agricultural development in recent years. Over the last years, planned governmental support has been provided to economic entities, through the performance of certain works for supplying seeds (potato, grain), young plants, mineral fertilizers, and plant protection chemicals. As a result, in 2004, the agricultural planted area increased by 10.6 thousand hectares as compared with the previous year and the gross agricultural product amounted to 504.1 billion drams, which is by 14.5 percent more than the previous year level (MFE, 2005).

To conclude, rural population is in the most critical and vulnerable condition of all the groups, because: a) rural poverty still persists, especially in remote areas; b) farming employment continues to be very large in combination with very low productivity potential; c) governmental expenditures, subsidization and other provisions, in this sector are inefficient, since they are mainly comprised of the sporadic provision of fertilizers and seeds, which changes very little in terms of poverty alleviation, income inequality elimination and literacy enhancement; d) still there is no official policy on the creation of additional non-farming labor income in the agricultural sector.

## Trends of the SME Sector Growth and Factors Impeding It

Based on the specific peculiarities of the agricultural and SME sectors, certain emphasis is placed on the policy-makers to direct more efforts to improve them in terms of: a) formation of legislative bases in the agrarian sector, b) creation of favorable conditions for the activities of small and medium economic entities in the sectors and for investments, c) development of flexible credit markets, including the enhancement of the access to it, to further support the growing trends of those sectors (MFE, 2005).

By the same token, further developments in SME sector can make substantial changes in incomes of households and in the rates of unemployment. As opposed to Moldova and Romania, the SME sector is not well supported in Armenia. The reasons for this are excessive bureaucracy, higher tax burden, and costs of starting a business (as is in case of Moldova and Romania). Small and medium enterprises are among the main sources of employment enhancement. The point is that in countries with large share of employment in SME sector, as in case of Romania, economic growth leads to higher employment rate (PRSP, 2003). Moreover, expansion of SME sector has positive impact on the reduction of inequality in general terms. Hence, ensuring favorable conditions for SME sector operation is also important from the perspective of promoting equal business opportunities.

Despite all positive impacts that the development of SME sector may have on total employment and equality rates, its growth in Armenia is limited. According to PRSP (2003) assessments, in 2001 the number of registered commercial organizations increased by 4.7 percent, in 2002 it increased by 4.1 percent in combination with economic growth rates of 9.6 and 12.9 percent respectively. Thus, the growth patterns of SME sector are far behind economic growth rates.

As of 2003, there were 48,069 registered commercial organizations in Armenia, or 15.9 enterprises per 1,000 people, which is far behind the average rates of developed countries. For example, in Germany this rate was 37 enterprises per 1,000 people and in USA it was 74 (PRSP, 2003). In 2004, the share of SME sector in GDP amounted to 40 percent. During that year, around 8,500 new SME entities were registered, creating some 21,000 new jobs (MFE, 2005).

Considering the higher productivity and employing potential of this sector, it should be among the first priorities of public policies concerning poverty and unemployment reduction. Though the production of SME sector in 1999 constituted 40 percent of industrial output, which is 5.2 times higher, the employment in this sector was only 7.7 percent of total employment (PRSP, 2003).

Repeating the above-mentioned arguments, the administrative barriers highly impede future developments in the SME sector. According to World Bank constructed indices (2006a), the ease of doing business in Armenia, in gross terms, is better than in Moldova and Romania; though in some aspects it is worse than in those two countries. The study was based on the comparison of 170 countries in terms of investment protection, tax payments, credit accessibility, etc (See Tale 4).

**Table 4: Ease of doing business by ranks in 170 countries**

<b>Economy</b>	<b>Ease of Doing Business</b>	<b>Dealing With Licenses</b>	<b>Employing Workers</b>	<b>Getting Credit</b>	<b>Protecting Investors</b>	<b>Paying Taxes</b>
<b>Armenia</b>	34	36	41	65	83	148
<b>Romania</b>	49	116	101	48	33	131
<b>Moldova</b>	103	119	128	101	99	119

From the above table it is obvious that generally Armenia is successful in terms of ease of doing business, getting licenses, and employing workers. However, the country lacks flexible system in credit and insurance markets and in imposing regulatory framework for tax compliance. Especially, the use of credits is awfully insufficient. As of 1 January 2002, the total credits provided to the agricultural sector amounted to only 7 billion drams or 2.25 percent of the agricultural GDP in 2001. In 2001, the same indicator for industry was 13.2 percent of the GDP, and 8.1 percent for the entire economy.

Agricultural insurance systems for protecting investors against natural disasters and unfavorable weather conditions are practically non-existent. The payments to alleviate such destructions are carried out by the state budget, which provides only partial compensation for damages. However, this system also is ineffective and not flexible enough to protect investors in agricultural sector (PRSP, 2003).

Nevertheless, Armenia took serious steps in improving the situation. As a result, the average time needed for registration of companies reduced from 27.3 days in 2000 to 21.1 days in 2001. The average cost of registering a business reduced from the equivalent of US \$ 109 in 2000 to the equivalent of US \$ 92 in 2001. Major reforms in the spheres of license obtaining and inspection frequencies also were made. The time needed for obtaining official license for operations reduced from 23.5 days in 2000 to 18.5 days in 2001. The average number of annual inspections of companies reduced from 6.6 in 2000 to 6.4 in 2001 (PRSP, 2003).

Currently, in Armenia, the number of payments per year is 50 and the average time spent in this regard is 1,120 hours. The annual number of payments is 89 and the time spent on registration is 198 hours. On the other hand, the number of annual payments in Moldova is 44 and time duration per year is 250 hours (World Bank, 2006a).

In conclusion, it is noteworthy that Armenia is considered successful in decreasing the rate of complexity for starting a business. However, many shortcomings still persist and need further improvements in order to make the growth trends of the SME sector steadier. Currently, the situation in SME sector can be addressed as: a) having low rates of employment despite its higher productivity and employment potential; b) being officially prioritized by the government, but current expenditure and improvement levels are not sufficient to secure higher rates of employment and investment in the sector; c) still having high administrative barriers, including corruption and excessive bureaucracy still persist at higher rates.

#### Labor Market Institutions and Shadow Employment

The economic crisis during first years of transition largely distracts most public jobs. People were forced to find jobs out of capital city; either in agricultural sector or in other countries. Seen in these terms, agricultural sector served as an absorber of most active population. The reason behind this was mainly the fact that in rural sector the capability to produce food and survive was more possible than in capital city.

According to PRSP (2003) estimates, in 1991-1992, some 645,000 jobs were cut in non-agricultural sector of the economy, while in agriculture, the number of jobs increased almost twice and, subsequently, productivity fell more than twice, enabling a vast majority of population survive the existing economic crisis. Despite poverty reduction trends, new job creation has not been fully compensated after economic shocks in early 1990s (Gelbard et al., 2005). As a consequence of diverging employment and incomes, household income structure reflected only 29% of revenues generated on formal employment in 2001 (2.5 times decline from the beginning of transition), and only 38% in sum with self-employment incomes (PRSP, 2003).

Overall, the IMF specialists argue that although official employment data shows a decline in total employment, the change fails to confine with the expansion of informal sector, estimated at 45 percent of GDP in 2001 (Shiells and Sattar in Gelbard et al. 2005, p. 16). According to the official data, unemployment fell from 11.2 percent in 1990 to 10 percent in 2004. However, the more detailed analysis estimates that the true figure rests between 15 and 25 percent (Gelbard et al., 2005).

Inefficient labor markets and limited number of workplaces are among the most vulnerable factors that create such higher rates of impoverishment in the population, deepen inequality and accelerate decline of the employment income. Hence, increase of employment by the creation of new workplaces is the most socially favorable and economically efficient tool for poverty reduction.

Though labor market regulations can serve as an optional tool for improving primary income distribution, minimum wage policies are not always desirable from this perspective. The low potential of minimum wage policies in reducing poverty is behind the fact that it will benefit skilled labor force more than unskilled ones. Thus, the policy will have no impact on those who are seeking for jobs or who have not sufficient skills for the positions in various public organizations. From this perspective, minimum wage policy is not always pro-poor, because it will increase incomes and equalize income inequality among already employed population and will change nothing for other groups of the society (CASE, 2004).

In Armenia, however, minimum wage policies may change something in poverty reduction patterns in terms of reducing poverty among employed. This is of special consideration, since poverty among employed is also very high. The estimates by Tumasyan et al (2002) show that 45.7 percent of employed population is poor and 17.3 percent is very poor. The primary cause of such undesirable outcome is low wages and inefficient employment.

Currently, the nature of minimum wage policy and its definition has a symbolic character in Armenia (see Table 5). The point is that defining minimum wage at AMD 5,000 level will have no impact on state-owned, private and public organizations in the process of defining salaries and wages for their employees. The reason is the very low amount set as minimum level of salary in the economy. In Armenia, increases in minimum wages may change something in terms of decreasing the number of employed poor, however, it is not enough to address the policy as pro-poor.

**Table 5: Fixed Minimal Size of Wages**

Drams per month				
Years	January	April	July	October
2000	5,000	5,000	5,000	5,000
2001	5,000	5,000	5,000	5,000
2002	5,000	5,000	5,000	5,000
2003	5,000	5,000	5,000	5,000
2004	13,000	13,000	13,000	13,000

*Source: Statistical Yearbook of Armenia (2005).*

From the above table it is obvious that despite double-digit economic (11.6 %) growth from 2001 to 2003, minimum wage level did not increase. Though it increased by more than 150 percent from 2003 to 2004, it still means nothing, because it is less than the defined minimum consumer basket (AMD 19,000). This means that no one will ever work for the amount less than the defined minimum wage. Moreover, hardly anyone will work even for the monthly amount equal to minimum consumer basket. Hence, minimum wage level in Armenia is a threshold that serves only as a unit of measure for different fines envisioned by administrative law.

By the same token, salaries in Armenia are mainly business-oriented. In the private sector, they are mainly based on the type of the particular organization, its revenue obtaining capacity, other specific features, etc. In all private enterprises, even the lowest position

employees receive more than the minimum wage level. Hence, defined minimum wage levels are emblematical and increases in minimum wages may not contribute in making growth more pro-poor.

**Table 6: Average Monthly Nominal Wages Per Worker**

Years	Drams	In % of Previous Year
2000	22,706	112.6
2001	24,483	107.8
2002	27,324	111.6
2003	34,783	127.3
2004	43,445	124.9

*Source: Statistical Yearbook of Armenia (2005).*

In case of average wages, the picture is somewhat different. It is worth noting, that in all years (see Table 6) average salaries were more than the minimum consumer basket. In 2004, it was 3 times more than the minimum basket, which seems to be a positive shift in increasing affordability and purchasing capacity of employees. However, the per capita extreme poverty line in 2004 was about AMD 8,000 (see Table 8). Such implication means that for a 4-person family the average salary of 43,445 will only be enough to pool family out of extreme poverty. Hence, for making growth more pro-poor through labor market institutions, the additional workplaces should be created in parallel with increasing wages.

In summary, labor market institutions are very important in alleviating poverty and making growth more pro-poor, however, a) unemployment rates are still very high; b) shadow employment is extremely large; c) higher rates of poverty among employed still persists; d) minimum wages are very low and bear a symbolic character; e) governmental policies for increasing minimum wages will benefit only skilled labor force and will change nothing in making growth more pro-poor.

## Taxation Policies and Tax Burden

Tax burden, in gross terms, is not very high in Armenia compared to other OECD high-income countries. In Austria and Belgium, which are high-income countries, the total tax rate constitutes 56.1 and 70.1 percent of total profit respectively, whereas In Armenia, total tax rate is 42.5 percent. In Romania and Moldova, these numbers are 48.9 and 48.8 percent respectively. Thus, compared to other high-income developed countries, the total tax burden is not very high in Armenia, however, the taxation efficiency is a real issue for the country as compared to the above-stated ones.

From taxation perspective, in Armenia, tax evasion turns out to be cheaper than compliance. This conclusion is supported by the higher rates of shadow economy, which is 45 percent of GDP (Gelbard et al., 2005). The higher rates of corruption and excessive bureaucracy are the main inducing conditions for such outcomes. The lack of sound regulatory framework for tax compliance made tax revenues relatively stable compared to growing incomes in recent years.

Currently, despite double digit income growth in recent four years, which was estimated to be 9 percent per year, the tax revenues in this regard were relatively stable at about 14 ½ percent. The tax-to-GDP ratio was relatively flat at 14 percent in 2003 and 2004, despite steady income growth in these years. As of 2001-2004, nominal GDP grew by 66 percent while tax revenues grew by 60 percent. The result was that expenditure side remained highly constrained (Davoodi and Grigorian, 2006).

Moreover, in 2004, large taxpayers unit collected about 23 percent of total revenues, whereas that sector could potentially collect up to 75 percent (Gelbard et al., 2005). In a similar vein, the land-tax-produced revenues equal to 0.2 percent of GDP in 2003. The tax on agricultural land is 15 percent of “cadastral net income,” which means, the potential value of output that particular land can produce. It may seem high unless considering that agriculture

is exempted from corporate, income, and value-added taxes. Hence, agriculture is taxed lightly (Brown, 2003).

The issue behind this is that decreasing tax burden on employers will highly motivate growth in SME sector, which will create workplaces in the labor market. However, such outcome may be achieved only through better taxation, corruption reduction, and introduction of more progressive tax rates. What is noteworthy is that though agriculture is taxed lightly, which is desirable in a given rates of rural poverty and low productivity, it should make contributions to tax revenues as average agricultural incomes rise (Brown, 2003).

To sum up, despite low burden of taxes, the revenue generating capacity of the latter are performed inefficiently. The situation in Armenia is: a) the burden of taxes is low compared to high-income countries; b) tax administration is performing inefficiently; c) governmental policies in this direction are insufficient.

#### Targeting Lower Income Quintiles: Poverty by Different Groups

Social security system is among the key features in combating poverty and should be defined in a manner that will highly secure people in need to suffice their basic needs. It should be one of the most prioritized systems and expenditure categories for any developing country's government. Though social transfer system in Armenia is defined relatively well, the total targeting remains inefficient and the size of coverage is very low.

Children are the most vulnerable group among the poor. The exposure of children to extreme poverty is the highest, 23.75 percent, and is much higher than the poverty risk. Currently, there are 55 thousand female-headed households in Armenia, where the number of children is more than 63.7 thousand. More precisely, 23.8 thousand of these children (37.4%) have single mothers, 11.1 thousand (17.4%) have divorced parents, and 28.8 thousand (45.2%) children have lost their male heads of households. Total allocations for maintenance

of orphanages in 2003-2015 are projected at the level of AMD 366 million, maintaining the level of 2002 in 2002 prices (PRSP, 2003).

The early years of transition were characterized by a sharp decline in pension benefits. Pensions in Armenia are very low, even the lowest in the CIS countries. Despite respective growth of the GDP and average salary rates by 18.8 and 18.7 percent, the average pension rate grew only by 3.4 percent and the average retirement pensions by 2.9 percent during the period from 1999 to 2001. This caused higher impoverishment in addition to the existing rates. Generally, the number of pensioners is relatively high in Armenia constituting about 15 percent of the population. The ratio of the value of pensions to average wages fell from 33 percent in 1996 to 19 percent in 2001, and rose slightly to 21 percent in 2003. Not considering other sources of income, all the pensioners in the country should be considered as extremely poor, since average pension rate does not guarantee even the affordability of minimum food basket of AMD 19, 000 (PRSP, 2003). Thus, for pensioners that have no other source of income except monthly pensions, the existing pension level (AMD 3,000) is below the extreme poverty line (Gelbard et al., 2005).

Households that have pensioner members are more vulnerable, because other sources of incomes, such as transfers or wages, are so miserable that may not cover basic needs of all household members. From the table below it is obvious that the share of households with pensioners among members (19.2 percent) in total extremely poor population is much higher than the share of lonely pensioners (5.1 percent).

**Table 7: Poverty among pensioners in 2001, in percent, by members of household**

	Households with pensioners among members	Households consisting of pensioners	Lonely pensioners	Average in Armenia
Non-poor	43.2	64.1	69.2	49.1
Poor	37.6	29.7	25.8	34.9
Very poor	19.2	5.8	5.1	16.0

*Source: PRSP (2003).*

## Existing Social Security Programs and the Size of Their Coverage

It is very crucial for Armenia to develop a well-targeted social security system, because the main coping mechanisms for poverty in the country are child allowances, governmental transfers, and pensions. Thus, further developments in the social security system and increases in its capability and efficiency in poverty reduction are among the basic tasks of the country.

Family benefits are among the key poverty reduction strategies and may have substantial positive impact on incomes of poor. The average size of the benefit increased by 26.3% in 2004, and by 25.5% in 2005, as compared with the respective previous year, while keeping the number of beneficiary families unchanged (PRSP, 2003). According to the 2002 Integrated Household Survey, social transfers (mainly pensions and family benefits) constituted the largest source of income of poor families, i.e. 57.8% for the poorest 10% of families; 45.5% for the next 10%; and 52.9% for the third decile. As a result, their contribution to poverty and inequality reduction was large, but not enough for making substantial positive shifts in country's goal towards alleviating poverty.

Nonetheless, about 45% of the reduction in the share of very poor households from 22.9% down to 16% was preconditioned by the increase of the volume of social transfers. From income inequality perspective, according to 2001 data, one percent growth of family benefits at the national level reduced the income inequality (Gini coefficient of income concentration) by 0.67 percentage points, of which 0.4 percentage points in rural areas, 0.25 percentage points in Yerevan and 1.14 percentage points in other cities (PRSP, 2003).

External remittances are also noteworthy in this particular case. They are certainly not a part of official governmental policy, their contribution in cutting poverty was substantial. The 2003 household survey revealed that private transfers, mainly assistance from relatives abroad, accounted for 16.1 percent of household income, compared to employment earnings

of 26.1 percent. Official benefits and state pensions accounted for 9.9 percent of household income (Gelbard et al., 2005).

Over 2006-2008, allocations for financing family poverty benefits will amount to 24,660.2 million drams, 26,587.7 million drams, and 27,166.1 million drams, respectively. This will represent an increase in expenditure, as compared with the respective previous year, by 23.1 percent in 2006, 13.5 percent in 2007, and 2.2 percent in 2008 (MFE, 2005).

In the same period, allocations to the program Monthly Benefits to Persons Taking Care of Children Under Two Years of Age are forecasted to be 256.5 million drams annually. The program Pregnancy and Delivery Benefit will be allocated 1,094.2 million drams, 1,355.4 million drams, and 1,679.0 million drams, respectively (MFE, 2005). The birth rates over the last years and the average annual increase in wages are also worth considering in future allocations. Hence, allocations to the program One-Off Benefit for Childbirth over the MTEF 2006-2008 period will amount to 1,265.5 million drams, 1,326.2 million drams, and 1,389.9 million drams, respectively (MFE, 2005).

Expenditure in social security programs will total 4,542.3 million drams in 2006; 4,525.3 million drams in 2007; and 4,551.6 million drams in 2008. Among the basic programs forecasted to be performed over the period from 2006 to 2008 are those related with services to the old, families, women and children, and to the disabled (MFE, 2005).

Expenditures in the program **Social Pensions** over 2006-2008 will increase by 267.4 million drams, 357.2 million drams, and 349.0 million drams, respectively, reflecting the increase in the base pension (MFE, 2005).

**Table 8: Family Benefits, 2004-2008 (Million Drams)**

<b>Indicator</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>
Average number of family members (person)	3.6	3.6	3.6	3.6	3.6
Number of beneficiary families (thousand families)	139	139	132.4	125.1	119.1
Family benefit expenditure as a share of GDP (percent)	1	1	1.2	1.2	1.2
Average monthly benefit (drams)	9500	12115	15521.3	17612.4	19007.9
Extreme poverty line, per capita, as to the PRSP (drams)	7827	8002	8207	8416.7	8626.3
Average monthly benefit, per capita (drams)	2638.9	3365.3	4311.5	4892.3	5280.0
<i>Ratio to the extreme poverty line (percent)</i>	33.7	42.1	52.5	58.1	61.2

*Source: 2006-2008 Medium-Term Public Expenditure Framework for Armenia.*

The above table states that the governmental expenditures in this direction will still be insufficient as of 2008. In that year, the average benefit for 4-person household will be equal to current minimum consumption basket of AMD 19,000. Hence, in coming years, poor people will still be capable of affording only basic food needs, because more than half of the consumer basket is food goods. Moreover, the average per capita family benefit will constitute only 61.2 percent of per capita extreme poverty line. Such patterns may mean that public expenditures in this direction, in gross terms, will only help make extremely poor people become poor.

Whatever the projections are, currently, the coverage of total transfers is very low and does not secure even the minimum needs of the recipients. Moreover, for most poor families, social transfers is the main source of future survival. The latter criterion is of special priority, because the current size of coverage of the social transfers is ridiculous compared to the minimum consumer basket of AMD 19, 000 (See Table 9). The picture is even worse, if recalling the consumption patterns of the population. In Figure 2, it is clearly stated that in 2004, 61.1 percent of total consumption constituted food goods. Hence, AMD 3,000 monthly pension or AMD 13,000 minimal wage, in comparison with AMD 19,000 consumer basket, are very low to secure even food needs.

**Table 9: Size of monthly wages and social transfers of the population**

<b>In AMD</b>	<b>2000</b>	<b>2001</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>
<b>Minimal Pension</b>	2,900	3,000	3,000	3,000	3,000
<b>Minimal Wage Size</b>	5,000	5,000	5,000	5,000	13,000
<b>Unemployment Benefits (Average)</b>	3,164	3,307	3,260	3,217	3,332
<b>Allowances for children under 2 years old</b>	10,490	9,226	7,721	7,610	7,171
<b>Disabled Children</b>	3,431	3,431	3,600	3,600	3,601
<b>Orphans</b>	3,678	3,712	4,170	6,941	9,851
<b>Maternity Allowances</b>	—	—	4,050	4,340	4,520
<b>Minimal Size of Monthly Grant</b>	4,000	4,000	5,000	5,000	5,000

The efficiency of targeting is also in a very dissatisfactory situation. The outcomes of such patterns of income, indeed, will be carcinogenic. According to the 2001 Integrated Survey, 40 percent of the poor population received 55.3 percent of total family benefits (65.6 percent in 1999). Moreover, 10 percent of the extremely poor population received only 6.5 percent of total benefit funds (PRSP, 2003).

In sum, if such patterns of targeting and coverage continue, it will bring to awful outcomes in future. Currently, the picture in Armenia is the following: a) targeting of lower income quintiles is highly inefficient; b) the size of coverage is very low when compared to minimum consumer basket; c) the same trends will continue until 2008, because the average per capita monthly income will constitute only 61.2 percent of per capita extreme poverty line defined for that period; d) governmental allocations in this direction are still inefficient (in 2008, average monthly benefit will be equal to current minimum consumer basket of AMD 19,000).

## Financing Essential Infrastructures

The inequality in access to basic educational and health care services is very high in the country. The preconditions for such outcomes are behind the large corruption rates and excessive out-of-pocket expenses for receiving services. While the quantitative indices of education and health care sectors are comparable with OECD countries, Armenia is substantially behind of those countries in terms of relative volumes of financing.

Thus, the financing in terms of absolute amounts per capita in Armenia is 5.45 times lower than the average indicator in East-European and CIS countries, 55.1 times lower than the average of OECD countries, and 2.5 times lower than the average in developing countries (PRSP, 2003). Such patterns of substantial under-financing could not survive in the present volumes if funded only from budgetary resources. The volume of officially recorded co-financing by population of only higher education constituted 0.73% of GDP in 2001 and was twice more than that of state financing rates (PRSP, 2003). Maintaining such levels of state financing for education and health care contradicts the objectives of addressing the issues related to UN declared human development concepts, which were adopted by Armenia.

Further transition of financing burden towards population will exacerbate the essential problem of human poverty. Results of several surveys conducted in Armenia showed that 31% of households are not able or can hardly survive expenses needed for education. In the same rates, 7% of poor children do not attend public schools and 70% of ill people do not have access to health care services (PRSP, 2003). Thus, the insufficient redistribution patterns directed to the equalization of access of the poor to education and health services, as well as, lack of financial capabilities of the government state that more resources and efforts should be invested in these areas to overcome human poverty.

The maintenance of developments in the educational sector can serve as a key tool in poverty reduction strategies. Increases in the quality and accessibility of educational sector

can be treated as a successful investment, since the future gains from it are very high. In general, increasing the quality and access of education sector are good preconditions for securing future stable economic growth and substantial poverty and inequality reductions.

The data provided by PRSP (2003) analysis state that poverty rates in Armenia vary depending on levels of education. As the data state, there is a strong negative correlation between educational levels and exposure to poverty. The risk of people that have higher education being exposed to poverty is much lower than for those with secondary and elementary education (See Table 10). The reason is that it is much easier to find jobs for people with higher education than for people with elementary or secondary education. Thus, the main consideration should be to increase the participation of poor in education in order to further decrease the rates of unemployment and poverty.

**Table 10: Poverty by education in 1999 and 2001, in percents\***

	Higher		Secondary vocational		Secondary		Elementary	
	1999	2001	1999	2001	1999	2001	1999	2001
Non-poor	56.7	65.5	47.1	50.9	42.7	46.1	42.9	41.8
Poor	29.4	25.2	32.9	34.2	32.3	37.6	32.3	43.0
<i>Poverty Risk</i>	-8.4	-27.7	+2.49	-2.0	+0.62	+7.73	+0.62	+23.2
Very poor	13.9	9.3	20.0	14.9	25.0	16.3	24.8	15.2
<i>Poverty Risk</i>	-39.3	-41.8	-12.6	-6.8	+9.1	+1.8	+8.2	-5

\* 18 years old and above.

Source: PRSP (2003).

The MTEF projections for the period of 2006-2008 show that the government of Armenia is taking serious steps in addressing the issue of human poverty. Over recent years, certain positive tendency have been observed with reference to public spending in education. Budgetary allocations for the educational sector, as a percentage share of GDP, increased from 1.96 percent in 2003 to 2.33 percent in 2004 and 2.74 percent in 2005 (the average in the OECD countries is 4.7 percent of GDP; see Table 11).

**Table 11: Public Expenditure over 2003-2005 in General and Vocational Education Programs as Percent of GDP, and in Comparison with OECD Countries**

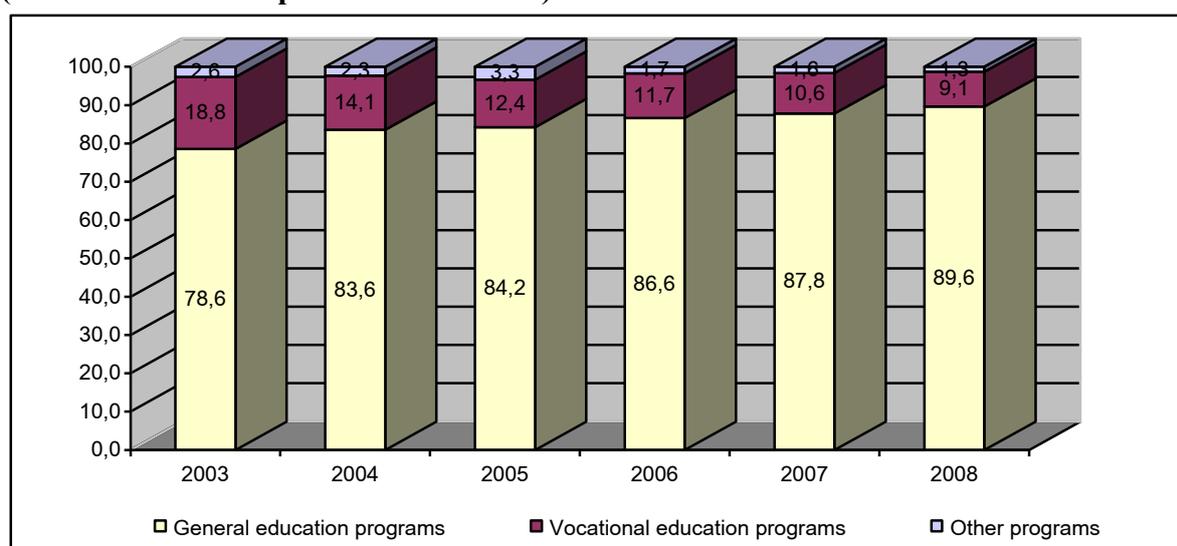
Indicator	2003	2004	2005	OECD Average
<b>Total education</b>	<b>1.96</b>	<b>2.33</b>	<b>2.74</b>	<b>4.7</b>
Including				
General education programs	1.54	1.95	2.31	3.3
Vocational education programs	0.37	0.33	0.34	0.9

*Note: General education programs include elementary, basic, and secondary general education and special general education. Vocational education programs include initial vocational (technical) education, secondary vocational, higher, and post-graduate vocational and additional education programs.*

*Source: 2006-2008 Medium-Term Public Expenditure Framework for Armenia.*

However, the structure of budgetary allocations by different levels of education is equivalent to the OECD indicators. In 2004, about 83.6 percent of the education budget was directed to the general education and 14.1 percent to financing vocational education programs (see Figure 3). In 2005, these indicators constituted to 84.22 percent and 12.44 percent respectively (against the respective averages in the OECD countries at 72 percent and 20 percent) (MFE, 2005).

**Figure 3: Public Expenditure in Education over 2003-2008, by Levels of Education (Percent of Total Expenditure in Sector)**



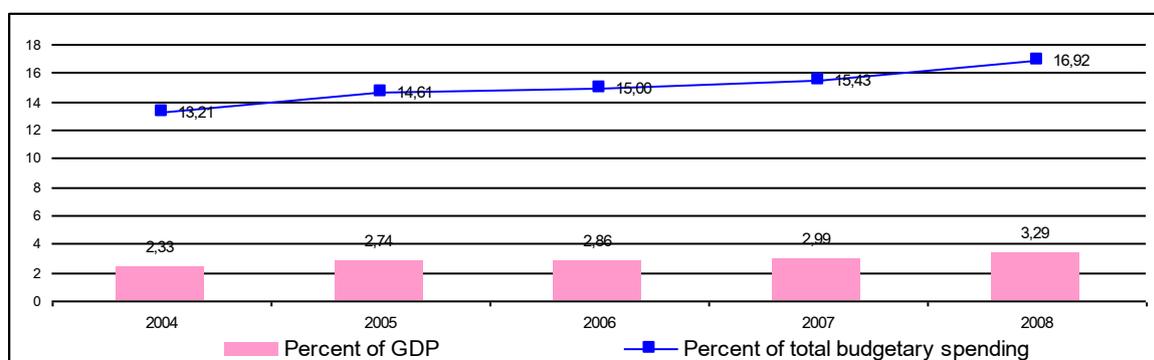
*Note: General education programs include elementary, basic, and secondary general education, special general education. Vocational education programs include initial vocational (technical) education, secondary vocational, higher, and post-graduate vocational and additional education programs.*

*Source: 2006-2008 Medium-Term Public Expenditure Framework for Armenia.*

The above figure illustrates that the allocations to the improvements of general education highly exceed those in vocational and other sectors. This is natural, since general education is the core prerequisite for obtaining necessary amount of knowledge for further education in vocational and high-education sectors. In other words, without profound general education it would be impossible to obtain further vocational and higher education. That is the first reason for prioritizing general education sector in total expenditure volume.

Another reason is behind the huge number of beneficiaries of general education sub-sector. Services in this sub-sector are almost equally accessible for all groups of the population. Hence, the improvements in this sector are of first priority, because of their high potential to ensure profound knowledge for future higher education and assure sufficient wisdom and skills for making future generation more professionally competitive in domestic and international labor markets.

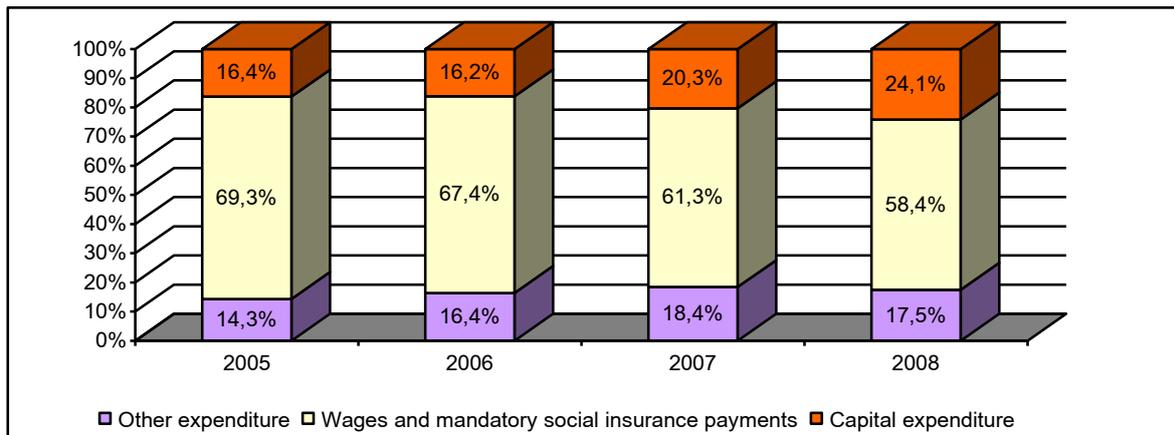
**Figure 4: Target Indicators of Budget Expenditure in Education**



*Source: 2006-2008 Medium-Term Public Expenditure Framework for Armenia.*

The MTEF 2006-2008 provides for expenditure in education amounting to 65,975.9 million drams in 2006 and forecasts the latter to be 75,293.9 million drams in 2007 and 90,447.9 million drams in 2008. This will represent an increase in expenditure, as compared with the respective previous year, by 14.4 percent in 2006, 14.1 percent in 2007, and 20.1 percent in 2008 (see Figure 4). Education expenditure will comprise 2.86 percent of GDP in 2006, 2.99 percent in 2007, and 3.29 percent in 2008 (MFE, 2005).

**Figure 5: Public Expenditure in Education over 2005-2008, by Economic Classification (Percent of Total Expenditure in Sector)**



*Source: 2006-2008 Medium-Term Public Expenditure Framework for Armenia.*

Among the key priorities of MTEF projections for education sector are increasing teacher wages and improvement of their retraining practices (see Figure 5). The objective for such actions is the enhancement of the quality of education. Such allocations for general education over the period from 2006-2008, will enable to keep the average monthly teacher wages at the per capita GDP level. The ratio of annual teacher wages to the per capita GDP in Armenia was 0.49 in 2003, 0.7 in 2004, and 1.0 in 2005, depending on the educational level and the length of service, against the OECD indicators of 0.97-1.45, respectively (MFE, 2005).

Wage increases will contribute to the process of staffing general education schools with qualified teaching personnel, which will increase the quality of education in such vulnerable areas as are border and rural zones. The average monthly teacher wages will increase from 50.5 thousand drams in 2005 to 58.8 thousand drams in 2006, 64.2 thousand drams in 2007, and 70.1 thousand drams in 2008 (MFE, 2005).

The low share of capital expenditures is not a plausible situation, because destructed heating and building conditions may highly impede the normal educational process. Capital and other expenditures are also necessary but not prioritized in total expenditure commitments, because they can be somehow solved by merging schools and heating them

with non-gas or non-oil systems. However, it will be impossible to assure profound knowledge and increase literacy among poor without qualified general education system.

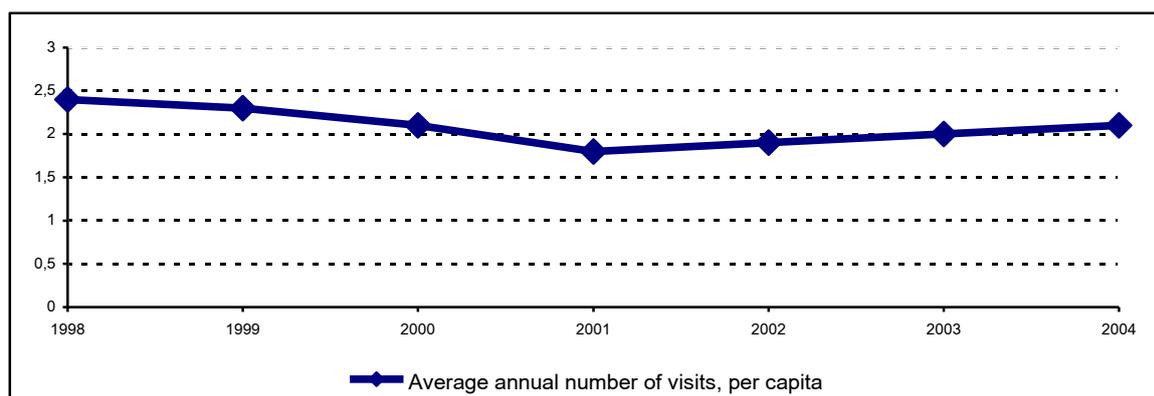
To sum up, improvements in educational sector can be considered as the most successful in total reform process. In educational sector, most sub-sectors nearly meet the OECD higher-income countries' criteria. However, problems are still remaining, especially with regard to: a) access inequality in higher education sub-sector; b) inefficient framework for ensuring compulsory education; c) low capital expenditures for heating and building conditions for schools; d) non-sufficient gross levels of governmental expenditures.

### Health Care

One of the core objectives of PRSP was the elimination of the negative trends observed in the path of development in the health sector. However, currently the consumption of health care services by population is substantially contracted. Analyses show that certain groups of population cannot afford the expenses of health care system, that widely differs depending on the type of service.

Results of the 1998/99 integrated household survey show that in 1999, the consumption of health services by the 20 percent richest population is 3 times higher than the consumption by the 20 percent of the poorest groups (PRSP, 2003). In 1998, the per capita budget allocation towards population's health care needs was 3.6 thousand drams; in 2000, this figure decreased to 2.5 thousand drams and in 2003, it increased up to 5.9 thousand drams. These allocations show a wisely increasing trend, comprising of the AMD 7.8 thousand per capita budget allocations to health care in 2004, and around 10.0 thousand drams in 2005 (MFE, 2005).

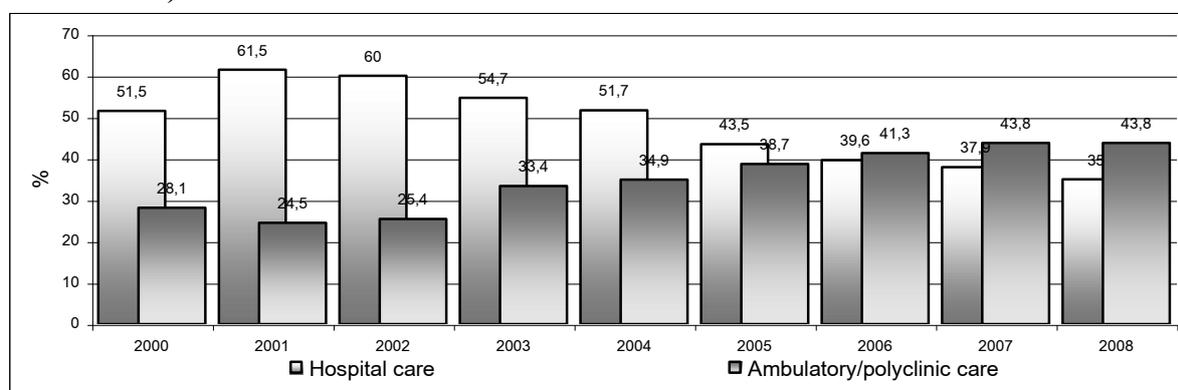
**Figure 6: Average Annual Number of Ambulatory-Polyclinic Visits (Per Capita)**



Source: 2006-2008 Medium-Term Public Expenditure Framework for Armenia.

In 1998, 56.6 percent of the total expenditure in health care was channeled to hospital care and 19.0 percent to primary health care. This ratio changed to 51.7 percent and 34.9 percent in 2004, and to 43.5 percent and 38.7 percent in 2005, respectively (see Figure 7). The reasons for increasing investments in health care imply that primary health care is appeared to be the most important and the least accessible one for the poor population. In 2006, the allocation to primary (ambulatory-polyclinic) care will amount to 15,434.1 million drams, including 2,020.0 million drams for the centralized procurement of medicines; this will be a 24.0 percent increase over the 2005 adopted budget and will comprise 41.3 percent of the total spending in health care (MFE, 2005).

**Figure 7: Financing of Ambulatory and Hospital Care (Percent of Total Expenditure in Health Care)**

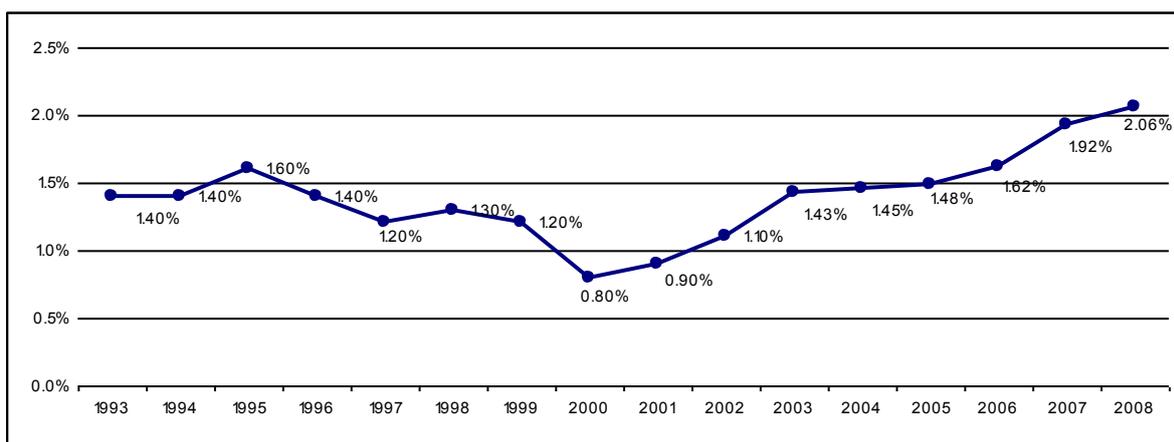


Source: 2006-2008 Medium-Term Public Expenditure Framework for Armenia.

Based on the public policy and the basic priorities in the sector, 41.3 percent of the total health care expenditure will be channeled to ambulatory/polyclinic care sector in 2006, 43.8 percent in 2007, and 43.9 percent in 2008 (see Figure 7).

Over 2006-2008, the medium-term expenditure framework specifies for an increasing share of public expenditure provided for the health care system as a percentage of GDP, as presented in the figure below. What is obvious, is that the 2006 expenditure level equals the expenditure level in 1995. More precisely, the public expenditures in total health care system constituted 1.6 percent of GDP in 1995 and it comprises 1.62 percent of GDP in 2006 (see Figure 8). Thus, the relative growth rate of this sector is very low, since for ten years it was possible to increase the expenditure only by 0.02 percent (MFE, 2005).

**Figure 8: Level of Public Expenditure in Health Care (Percent of GDP)**



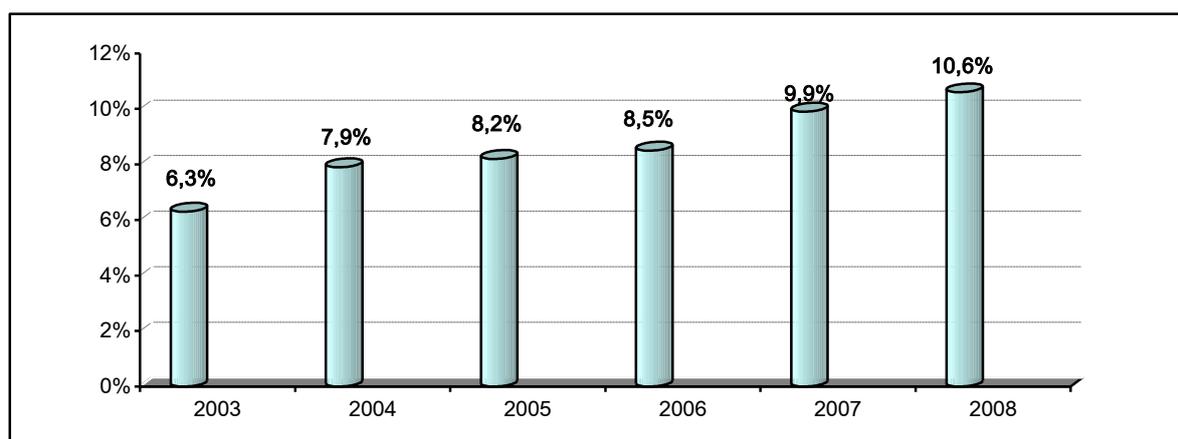
*Source: 2006-2008 Medium-Term Public Expenditure Framework for Armenia.*

Moreover, from 1994 to 2000, the expenditure of this sector as a percent of GDP was declining nearly in the same rate as growing. In 2000, the expenditure was the lowest: 0.80 percent of GDP (see Figure 8). In 2000, this percent is 1.62, which is 0.82 percent increase, which is nearly the same amount of decrease (0.60 %) starting from 1994. Hence, for twelve years it was only possible to increase the share of health care expenditure in GDP up to 1995 level (1.60 percent). Let us not forget that the GDP growth after 2000 was a double-digit number. Because of the low levels of governmental subsidization of this

sector, the corruption and out-of-pocket expenses are very high and the consumption of this service by poor people is very low.

Nevertheless, the share of public expenditure provided for the health care system according to the MTEF 2006-2008 will increase as a proportion of the total public expenditure, as presented in the figure below.

**Figure 9: Share of Health Care Expenditure within Total Public Expenditure (Percent)**

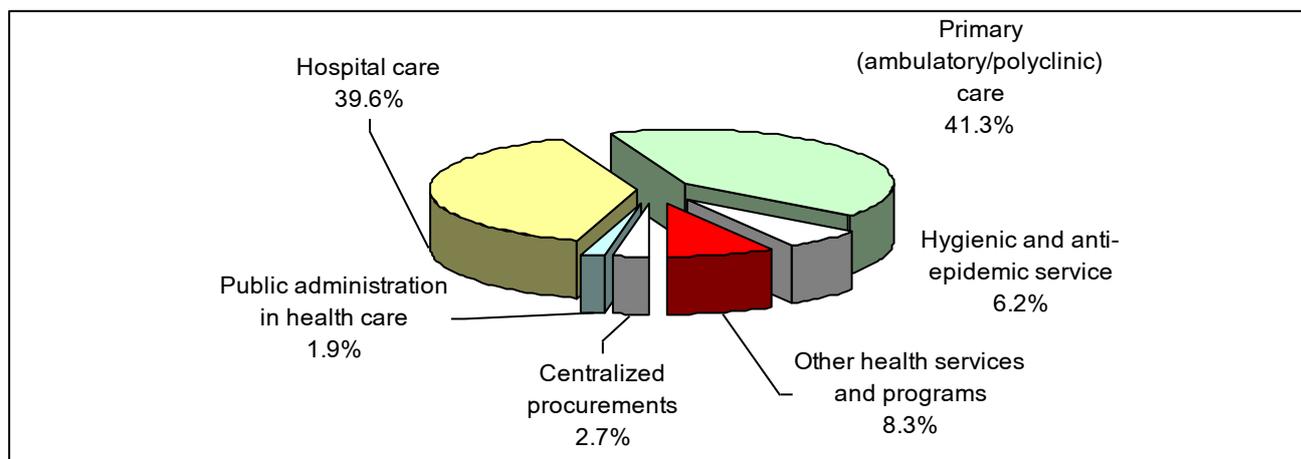


*Source: 2006-2008 Medium-Term Public Expenditure Framework for Armenia.*

Another priority in improving health care system efficiency in Armenia is the introduction and expansion of the system of family doctors. As compared with the 2005 level, public expenditure in health care will increase by 5,151.7 million drams in 2006. About 12.4 percent of the total increase, or around 637.0 million drams, will be directed to the sanitary-hygienic security of the population. As compared with the 2005 level, public expenditure in this program will increase by around 37.6 percent, comprising 6.2 percent of the total health care expenditure in 2006 (see Figure 10), 6.0 percent in 2007, and 5.1 percent in 2008.

Expenditure in hospital care will increase by around 791.2 million drams in 2006, as compared with the 2005 level, comprising 15.4 percent of the total increase and 39.6 percent of the total health care expenditure in 2006 (see Figure 10), 37.9 percent in 2007, and 35.0 percent in 2008 (MFE, 2005).

**Figure 10: Structure of Health Care Expenditure over 2006, by Subgroups (Percent)**

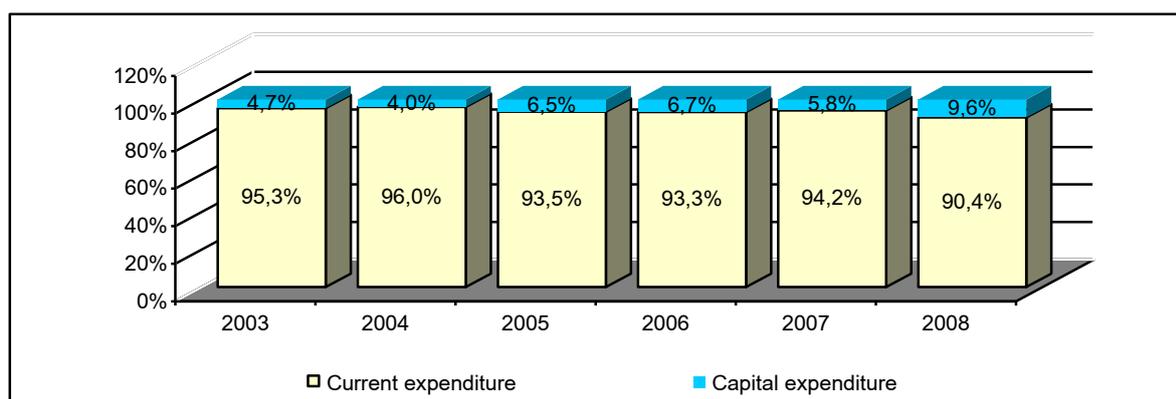


*Source: 2006-2008 Medium-Term Public Expenditure Framework for Armenia.*

The monthly wages of the medical staff is also forecasted to increase from the previous year's 33,500 drams to 37,500 drams, and those of the paramedical staff is to increase from the previous year's 24,550 drams to 29,300 drams (MFE, 2005). Moreover, the MTEF 2006-2008 provision for total health care expenditure is to amount to 37,339.8 million drams in 2006, including 34,850.1 (93.3%) million drams for current expenditure and 2,489.7 million drams (6.7%) for capital expenditure (see Figure 11).

In 2007, total expenditure will constitute 48,398.9 million drams, including 45,569.8 million drams (94.2%) for current expenditure and 2,829.1 million drams (5.8%) for capital expenditure. As of 2008, these numbers will be 56,434.2 million drams in total, including 50,996.3 million drams (90.4%) for current expenditure and 5,437.9 million drams (9.6%) for capital expenditure (see Figure 11). The increase in expenditure, as compared with the respective previous year, is 16.1 percent or 5,177.8 million drams in 2006; 29.6 percent or 11,059.1 million drams in 2007; and 16.6 percent or 8,035.3 million drams in 2008 (MFE, 2005).

**Figure 11: Public Expenditure in Health Care, by Economic Classification (Percent)**



*Source: 2006-2008 Medium-Term Public Expenditure Framework for Armenia.*

The health care sector ties with the educational sector the low capital expenditures. One can imply that the basic structures of both sectors are so destructed that in the short run main priorities will be given to the improvements of quality and accessibility of both sectors for the poor. However, in case of health care sector, the difference is in higher rates of privatization of hospitals and higher rates of creation of other private medical centers. The latter fact highly reduces the share of capital governmental expenditures in the health care sector.

From Figure 7 and Figure 10 it is obvious that expenditures are highly prioritized in ambulatory/polyclinic sub-sector. The reason is behind the higher availability and territorial accessibility of primary (ambulatory-polyclinic) care. Hence, the share of primary health care expenditure will be increased in the total budget spending, at the expense of the share of hospital care expenditure and increasing the amount of total expenditure (MFE, 2005).

In sum, despite increasing patterns of governmental expenditures in health care sector, enormous problems of various types persist in the sector. Thus, a) total growth rates of expenditures in the health care sector are very low; b) the orientation of governmental subsidization and prioritization are rightly increasing the accessibility and quality of primary

health care sub-sector; c) higher corruption and out-of-pocket expenditure levels in hospital care sub-sector still highly limits the consumption capability of this service by poor.

### *Findings*

Despite the fact that Armenian government is investing strenuous efforts in improving the poverty situation in the country, both policy measures and the overall investment volumes are very low to consider the country as having pro-poor growth. The lack of financial resources, due to the inefficient taxation administration, highly limits the capability of government to reach its objectives.

Higher corruption and excessive bureaucracy highly impede the motivations of enhancing the SME sector and increasing the employability of the latter. The potential of this sector to increase incomes and to reduce unemployment is very high. SME sector has higher productivity rates and can make substantial changes in living standards of most poor people. However, governmental subsidization and protection of this sector is very low.

On the other hand, the overemployed rural sector has very low potential for increasing the productivity, because it is still mainly based on subsistence-based agricultural activities. The absence of an official policy of creating non-farm workplaces in the rural sector further limits the possibility of earning incomes for the rural population. This is a very serious issue, since the rural population is highly sensitive to shocks and highly impoverished, especially, those living in border and earthquake zones. The picture is even worse, when adding to these complexities the absence of the insurance system for protecting rural households and landowners from damages caused by environmental factors.

The incomes of the poor population and the targeting structure of the social transfers is another crucial issue that lacks effectiveness. The average monthly incomes and transfers are so meager that highly limit the possibility of the recipients to protect themselves against impoverishment. The largest part of the minimum consumer basket and the major share of the people's consumption patterns are comprised of food products. Hence, the low size of coverage of the social transfers limits the ability of poor people to secure even basic needs.

This issue becomes more prone if recalling the fact of the highest exposure of children to poverty. Monthly allowances in this sphere also are very low.

Another crucial issue is educational and healthcare aspects of human poverty in Armenia. The poverty rates highly vary in terms of educational levels. The more educated is the person, the lower is the risk of the latter to be exposed to poverty. Thus, the lack of access of poor to education infrastructure will further deepen the problem of poverty and will further increase the rates of unemployment and widespread illiteracy in rural areas. Health care service also is highly limited in accessibility terms. The higher rates of corruption, low rates of subsidization and higher rates of out-of-pocket expenses, make the usage of health care service a “luxury” good for many poor.

Overall, the inefficient framework and targeting features of the government further hardens the situation. It may also seem that government cannot keep pace with rapidly growing GDP rates and the result is increasing inequality in the country. Whatever the approaches, currently the growth in Armenia cannot be called pro-poor and the gross assessments of the poverty reduction strategies in the country are as following:

<b>Situation in Armenia: Assessment</b>	
<b>Labor Market:</b>	
Additional non-farming labor income	No official policy. When rural poverty is very high and agricultural sector is the highest employer, the creation of additional non-farming labor income for rural poor is an essential strategy for making growth more pro-poor. The latter Armenia lacks.
Doing business	Successful but still needs improvements, particularly, in spheres of increasing tax compliance, increasing access of poor to credit markets, and protecting investors.
Minimum wage	Low; a barrier that does not have any substantial impact on defining payment size for workers, since payments for private employees (e.g. construction or shops) are defined depending on the performance type/size or are mainly based on the revenue obtaining capacity of the particular organization.
<b>Public Spending:</b>	
Targeting of lower income quintiles	Inefficient
Coverage	Low

### ***Conclusion: How Pro-Poor is Growth in Armenia?***

Despite the favoring objectives, most studies are very broad and it is difficult to provide comprehensible directions for future accomplishments. To varying degrees, all the countries in the former Soviet Union are fighting against the abrupt impoverishment of huge segments of the population. The latter was performed in a context of high job destructions, increasing shadow economy rates, and enormously limited budgetary revenues. The reason for such results in most former communist countries was the lack of experience and coherent framework required for formulating effective policies targeted to lower income quintiles.

Nevertheless, confronted with dramatic deterioration in living standards of large parts of the population, Armenia is making strenuous efforts to overcome the problem as a matter of priority. Thus, the impulsive rise of poverty after the collapse of the Soviet Union has stemmed not only from economic distortions but also from a combination of such factors as declining real wages and increasing inequality, massive refugee flow and higher unemployment, Nagorno-Karabakh conflict, transportation blockade and the breakdown of infrastructure.

The consequence of such transformation crisis was higher income inequality and poverty rates. From income distribution perspective, the transition benefited only top quintiles of the population whereas the major part was impoverished. The salaries and living standards become miserable among those social groups that were not previously affected by poverty, such as public sector workers. Another negative consequence is the inability of government to target lower income quintiles, because monitoring between the poor and the non-poor that avoid reporting their incomes and do not claim the benefits that they are entitled in is very vague.

In general terms, economic growth may become pro-poor in the long run, however, it cannot be considered as such in present terms. According to Baulch and McCulloch (2004), pro-poor growth means that by the same rate of growing income, poverty falls more. Moreover, unless gains from economic growth are directed to poor and benefit the poor, the growth cannot be considered as being pro-poor. The speed and extent of poverty reduction depends on the quality of growth, the initial level of income inequality, further shifting in the patterns of income and assets distribution, human development, fair taxation policies, and macroeconomic stabilization.

Armenia's estimated elasticity of poverty with respect to growth is  $-0.82$ . That is, a 1 percent increase in real per capita income has led to a 0.82 decline in the incidence of poverty. An econometric analysis of a panel data for 70 developing countries estimates the average growth elasticity of poverty at  $-1.08$  (Gelbard et al. 2005, p. 36). Thus, in gross terms, growth in Armenia is not pro-poor. The picture is even worse in case of agricultural sector. In agricultural sector, 1% growth of GDP resulted in 0.35 percentage points poverty reduction in rural areas, while 1% growth of GDP in non-agricultural sector led to 0.65 percentage points of poverty reduction among urban population, including 0.804 in Yerevan and 0.554 in other cities. Currently, 70% of population is self-employed (PRSP, 2003). Self-employment, in its turn, is more characteristic to rural sector. However, current trends in poverty show that in rural sector, the changing pattern of the rates of poverty, to a large extent, depends on seasonal and location features. The more the particular region is far from the capital city and the more unfavorable is land and weather conditions, the higher is the poverty rates. From this particular perspective, little attention is paid to those agricultural livelihoods and poverty rates are the highest in those zones. Moreover, there is a certain relation between income distribution in terms of different groups of population and regional distribution of income. The relative centralization of business in a capital city implies greater

possibility for concentration of income in hands of a small group of people as the chances for more people to be involved in business activity are decreasing. Thus, geographical distribution of income also should be a subject for study. There are several economic indicators showing substantial differentiation of business activity in the regions of Armenia. In a number of regions, unemployment rate is significantly swerving from the average, especially in the earthquake and border zones. Moreover, if we consider that public subsidies in rural sector are distributed without considering specific peculiarities of the particular region, then the landowner that is close to capital city will get the same amount (or nearly the same) than the farmer that is some 300 km far from Yerevan. The point is that the latter case poses serious deviations from equality perspective, because transportation costs and fertility rates are different.

By the same token, land taxes in Armenia are not calculated on the basis of the parcel's market value or location. In a similar vein, the nature of land taxes is highly regressive and contradicts to principles of establishing equal income and assets distribution in the country (Brown, 2003). Subsidization of irrigation and other services also state that large landowners will benefit more than small farmers will. Hence, the above-mentioned statements argue that in this sector growth is far from being pro-poor.

Inequality in health care and education sectors is also a vulnerable issue. As the only reserve of the poor is human capital, participation of the poor in income distribution is possible through investment in human capital and through increase in the value of human capital as a creative factor. Access to education and health care services are largely unfair. However, in educational system, recent reforms largely changed the situation and now those who perform better while studying may be freed from tuition fee. Nonetheless, higher rates of corruption in educational system may pose serious challenges in implementing those criteria fairly and precisely. In border areas, the educational enrollment is very low because of the

inability of households afford minimum needs for their children concerning educational expenses.

Results of the 1998/99 integrated household survey show that consumption of health services in 1999 by the 20% richest population is 3 times higher than the consumption by the 20% poorest groups provided that in case of hospital services the discrepancy is even larger (3.2 times), while polyclinic and out-patient services have been far more equally (1.8 times) distributed and affordable by the poor population (PRSP, 2003). The data states that due to the lack of strong redistribution policies, poorer households are incapable of securing their basic health care needs. Again the issue can be addressed from the perspective of corruption. The large amounts of out-of-pocket expenses in this service are not financially viable for the poorest quantile of the population. If we add low rates of public investments in this area and steadily growing GDP rates, it may be concluded that poor are not among the beneficiaries of economic expansion.

Lack of investments in rural non-farm developments is another issue facing Armenia today. There is no defined official policy for creating additional non-farm income. Credits for developing small businesses in rural areas are not equally available to all. The higher interest rates highly impede the motivations of rural population take credits. Moreover, lack of workplaces for non-farm hired employment in rural areas also states that aggregate expansion is not targeted strategically to poor. This is described by the fact that due to high level of business concentration, economic growth has limited potential of usage of available resources by poorer economic agents, which are not involved in current business activities.

Social assistance programs are flexibly developed in Armenia. The main problem is the low size of coverage that in comparison with present minimum monthly consumer basket of AMD 19,000 is undesirable. Social programs are the most direct fiscal tool for poverty reduction, and the government should increase allocations on social spending either through

re-allocation from other programs or by increase of total expenditures through improvement of taxation administration.

All in all, for implementing the above-mentioned investments, country needs revenues. The first assumption to be drawn is that aggregate economic expansion means that tax base will also increase, however taxes are still very high. The reason for that is the shadow economy, which constitutes 45% of GDP. This means that the poorly constrained tax institutions and low rates of tax collection should be improved. From this perspective also growth is not pro-poor, since income taxes, payroll taxes and property taxes are regressive in their nature. The property tax also is not calculated based on its market value and the poorest person will pay the same tax as his/her next-door rich neighbor.

The key to solving the problem of poverty lies in guaranteeing stable economic growth and creating new jobs for unskilled labor force. Under such circumstances, the main obstacles facing Armenia today are to eradicate extreme poverty and create favorable conditions for impoverished people to escape poverty. The issue is to define a system that will effectively translate the existing priorities into policies. Thus, the comparative analyses on the existing empirical data and proposed policy priorities in Armenia will clarify, to some extent, the scope and nature of future pro-poor policy options.

***Recommendations: What are the Mechanisms to Make Growth More Pro-Poor?***

1. For making growth more pro-poor, the initial levels of inequality and further changes in it should be considered. The point is that if the initial share of poor from economic expansion is low, it means that the share will be smaller in subsequent aggregate economic expansion. This option is not the best one in its nature, since the data showed that the initial levels of inequality in Armenia were very high and the considerations of changing characteristics of those trends will not raise sufficient grounds for making growth more pro-poor.
2. Another point is growth policies. If the latter are positive for growth, they will become positive for poor in the long run. Thus, the policies should be positive first for growth. The policies in Armenia are positive for growth since the GDP is steadily growing. However, it turned out that the positive policies for economic growth does not make substantial changes in poverty and unemployment rates. Hence, unless policies are directed to poor and are benefiting the poor more than the non-poor, future growth will reduce poverty in very low rates. It will also affect negatively the subsequent growth rates, because if not implemented now than in future the expenditures for poverty reduction will slow down the rapid growth rates. The point is that expenses (social security, environment, allowances, etc.) that do not add per capita GDP rates will not bring increases in economic expansion rates. Hence, the growth policies should be strongly evaluated from pro-poor perspective, then measured, by making cost-benefit analyses, and performed.
- 2.1. Foreign aid is another mechanism that will assist economic growth and make it more pro-poor. More precisely, it will help governments implement recurrent expenditure policies directed to income redistribution. Foreign aid is not a good option for making growth pro-poor. The issue is that foreign aid is future cost. It will also

impede policy direction for reducing external debt burden. Though it may change something in implementation of poverty reduction policies, the reliance on it is not the best option for Armenia.

2.2. FDI encouragement is another crucial point in making growth more pro-poor. It will assist governments in managing service delivery and generating taxes, which will bring to rapid economic growth that will further benefit the poor. To encourage FDI, better governance and stable macroeconomic environment are essential. The policy options for reaching such goal are decreasing costs of doing business, corruption, and increasing effective control. However, FDI will flow to those countries that have low productivity, low wages and low costs of running a business. The latter statement somehow contradicts the argument that for encouraging FDI, a country should have stable economy. If a country has stable economy, high wages and high productivity, the FDI encouragement as a priority is nonsense. Nevertheless, as Klein, Aaron and Hadlimichael (2001) state, the risk with FDI encouragement is lower than with debt or voucher privatization. Moreover, since Armenia lacks the above criteria of stable economy and highly productive enterprises, the FDI encouragement is among the best policy options for future developments. Indeed, FDI will not reduce poverty directly, rather it will secure growth and generate revenues, which will make it possible to enact policies for faster poverty reduction. For a developing country like Armenia, the importation of innovative technologies and best practice from abroad is essential. The FDI can be encouraged, besides stable economic and macroeconomic environment, through increasing further allowing of the entrance of some goods duty-free and giving VAT refunds to foreign investors. The VAT refunds to foreign investors are desirable to the extent that the costs in this regard are not transformed to domestic producers and increase the burden of taxes on the latter.

3. Income and assets redistribution is another tool that will make growth more pro-poor.

3.1. The introduction of more progressive taxes (especially land taxes) and tax institutions will equalize income and assets inequality and make growth more pro-poor. Further increases in the tax rate will highly impede the prospects of increasing income of the unskilled poor labor force. The major reform, besides decreasing the level of shadow economy, is to shift from financing social expenditures through income and payroll taxes. It would be better to progressively tax agriculture and property. This will increase revenues without increasing tax rates, which, in turn, will increase the ability of government to finance its expenditures without harming employers and employees. Indeed one may ask whether such an option is not a contradictory one, in a manner that rural poverty is the highest and taxing the poor will further deepen the problem. The answer is that most large landowners can be taxed through VAT, income taxes, and corporate taxes, since agricultural sector is totally exempted from such taxes. Such an exemption is progressive from the perspective of poor farmers, however, it is very unfair from the perspective of large landowners. Moreover, the picture is even worse if we consider the uneven distribution of farmlands. Nevertheless, all the above can be improved through better tax collection and increased tax compliance. Making tax evasion much higher through effective legislation framework then compliance will would boost future benefits and increase spending capabilities of government in social protection sector more financially viable for the country.

3.2. Investments in education and labor market regulations will increase real wages and reduce wage inequality, which will bring to long-term social progress and direct the gains from growth to poor. Though increasing wages contradicts the policy option of income equalization from the perspective that skilled labor force will benefit more

than unskilled ones, it will be possible to balance through further investments in increasing workplaces for unskilled and increasing the quality of education in rural areas. This will increase the number of skilled labor force in future and will equalize income diversities among different segments of population. However, minimum wage policies can reduce the rate of employed poor in Armenia. Thus, the point is that policy-makers should be concerned that despite increasing salaries the incomes of unemployed also should be increased in order to have better poverty targeting outcomes.

- 3.3. Improving access of the poor to education and health care through the reduction of out of pocket costs for poor is another crucial poverty reduction strategy. The optional tool can be the introduction or expansion of targeted subsidies to reduce the formal costs of health care and education. Another mechanism can be increasing subsidization of structures securing training and increasing qualification of teachers. Targeted subsidization for the poor also is needed to reduce costs associated with the completion of compulsory education.
- 3.4. The relatively low poverty impact of social assistance programs is due to their low coverage, poor targeting performance and benefit levels that do not adequately match needs. Thus, the suggested directions is to continue efforts to improve targeting and define benefit levels in line with needs. This will increase the purchasing capacity of poor and will serve as an effective tool for decreasing inequality and making growth more pro-poor.
- 3.5. Growth in SME sector will decrease agricultural employment and increase productivity. Further improvements in decreasing the costs of doing business will increase SME sector employment. Increasing access of the poor to micro credits can serve as an essential tool in this regard. Also, the reductions in not only the costs of

doing business but also in time durations and bureaucratic burden of registering and running a business is a catalyst feature for further enhancement and development of SME sector. In Moldova and Romania, especially in the latter, the SME sector is one of the main creators of workplaces. So, why this cannot serve as such in Armenia as well. The anti-monopoly policies are the best ones in encouraging the access of small businesses in the market. This will not only increase workplaces but also increase competition, decrease prices and increase purchasing capabilities of the poor. This will make monthly allowances, to a smaller extent, sufficient to cover basic biological needs of the poor households. In the long run, such tendency of growing SME sector and competition may make it possible for poor segments to cover they material needs by monthly allowances as well.

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