



Center for Strategic & International Studies
Washington, DC

Armenia and Georgia: Preparing for the Millennium Challenge

Russia and Eurasia Program
Caucasus Initiative

Hills Program on Governance

On July 28, 2004, the CSIS Russia and Eurasia Program and Hills Program on Governance hosted a half-day workshop on economic growth and foreign assistance in Armenia and Georgia, “Armenia and Georgia: Preparing for the Millennium Challenge.” The selection of Georgia and Armenia as two of sixteen countries eligible to apply for Millennium Challenge Account (MCA) assistance comes at a time when their economies have been growing at an impressive rate: 14 percent for Armenia in 2003, 8 percent for Georgia. These figures are in stark contrast to the slower economic growth of the 1990s as well as the political difficulties both countries faced in 2003-04.

The workshop was structured around three basic questions: How can U.S. assistance, and the Millennium Challenge Corporation (MCC) in particular, best promote sustainable economic growth in Armenia and Georgia? How sustainable is Armenia’s current economic growth? Is Georgia on the verge of a radical economic transition? Participants included representatives from the U.S. government (including the State Department, USAID, and the MCC), the IMF and the World Bank, think tanks, and the embassies of Armenia and Georgia. This report summarizes the proceedings.

Introduction: US Foreign Assistance in Armenia and Georgia

Daniel Rosenblum, Office for US Assistance to Europe and Eurasia, US Department of State
Stephen Groff, Millennium Challenge Corporation

The workshop began with an overview of current U.S. assistance to the region and the role of the Millennium Challenge Account.

For twelve years, the U.S. State Department has provided assistance to Armenia and Georgia with the aim of promoting transitions to democracy and market-based economies. In addition to the funds allocated through the Freedom Support Act, other sources of assistance include military, agriculture, and exchange programs. For this fiscal year, U.S. aid totals approximately \$90 million for Armenia and \$100 million for Georgia.

U.S. assistance to Armenia and Georgia is distinctive. As a result of congressional earmarks and specific directives, aid programs for both countries enjoy large per capita budgets. This provides an opportunity to conduct work in various sectors of society at a deeper level than might otherwise be expected. In Armenia, for example, the Department of Agriculture established the Marketing Assistance Program (MAP), which works with individual producers to

help market their products more successfully. The U.S. is working closely with these businesses, enjoying a hands-on approach it does not possess elsewhere. In Georgia, there has been an enormous border security effort over the last seven years, involving the training, outfitting, and equipping of border guards. The tangible results of this assistance have been tremendous.

Regarding Georgia, the U.S. scaled back assistance last summer by \$20 million because the government was not implementing promised reforms. After five years of discussions, as well as minor budgetary and programmatic changes, the United States made a decision to cut programs, sending a signal of dissatisfaction to the Georgian government. Recent political changes in Georgia have given the United States an opportunity to engage the government in a more productive fashion.

The MCC provides a new, refined approach for providing assistance. By basing development assistance on a set of objective criteria, the MCC aspires to promote a system of aid that is merit-based and provides countries with a strong incentive to implement reforms.

The MCA process for awarding money differs from that of most other aid assistance programs. Each government submits proposals on how to spend MCA funds. These proposals outline primary constraints to economic growth, methods to address those constraints in a way that takes into consideration both economic growth and poverty reduction, and effective ways to measure the impact of the proposed programs. The proposal process is a consultative one that includes the perspectives of civil society and the private economic sector. The MCC needs to see a commitment to continued policy reform. Backsliding on the sixteen indicators that establish initial eligibility can lead to the suspension or cancellation of the program. The MCC will also monitor governments' fiscal accountability.

The MCC focuses on making large investments in a few select countries. The MCC does not anticipate entering into compacts with all sixteen eligible countries. It will base its allocation on the quality of the proposed programs. By mid-summer 2004, the MCC had not yet received any proposals but anticipated entering into compacts by the end of the year.

Roundtable 1: Armenia

*David Grigorian, IMF and Armenian International Policy Research Group (AIPRG)**

*Garbis Iradian, IMF and AIPRG**

Richard Giragosian, Abt Associates and AIPRG

* The views expressed are those of the author and do not reflect the views of the IMF or IMF policy.

The roundtable on Armenia examined Armenia's economic performance and growth prospects, poverty and income distribution, and relations between government and the private sector.

Economic Performance and Growth Prospects

The achievements of the Armenian economy in the last decade have been remarkable, considering the circumstances. In the last five years, GDP grew at more than 8 percent on average, despite the Russian crisis of 1998, political turmoil in 1999, and the continuing blockade by Turkey and Azerbaijan. The economy has reacted well to liberalization, privatization, and improvements in institutional capacity undertaken by the government since independence. The Armenian economy has enjoyed low single-digit inflation since 1998 (even though in 2003, it climbed to 8 percent, mostly on account of increased prices for imported cereals). Fiscal position has tightened significantly since independence, with deficits of under 3

percent of GDP for the past two years. As far as balance of payments are concerned, Armenian exports have grown in excess of 20 percent over the last four to five years, and the gap in the country's trade account is narrowing. Debt ratios went down dramatically owing to the growth of exports and GDP, as well as the debt-for-equity swap with Russia.

Despite this strong record of stabilization, serious vulnerabilities remain that could derail the course of reform and reverse some of the achievements. The *sources of growth* and its current narrow base remain a major issue. A large part of Armenia's double-digit growth over the last few years has come from foreign-financed expenditures, namely construction and infrastructure-related expenditures financed by the US-based Lincy Foundation. (The direct impact of these expenditures is estimated to be at least 4 percentage points per year, with indirect impact potentially sizable). The other main source of growth, responsible for over half of Armenian exports, is diamond polishing and jewelry. Since unpolished diamonds are being imported from Russia and elsewhere, Armenia remains vulnerable not only to price but also quantity fluctuations in this sector.

The *sustainability of growth* is another key policy challenge. While the economy generates sizable savings, these are not channeled back to economic activity through the banking system. This suggests that the funds are either transferred abroad or continue fueling the already sizable underground economy.

The issues of *poverty and income distribution* (for details, see next section) are the most daunting short-term challenge for the government. Owing to the highly concentrated ownership structure of key economic assets, the strong growth registered since 1998 has not trickled down and the pattern of income distribution has not changed in any significant way. One indicator that suggests problems ahead is the extremely poor revenue performance of the government. For the past 2 years, the tax revenue hovered around 15 percent of GDP (even declining slightly in 2003), one of the lowest records for the former Soviet republics. This allows no leeway for the government to increase social spending to alleviate poverty, leaving the economy ill positioned to benefit from future growth.

On the positive side, serious potential still remains that could be converted into major sources of growth in the future. The first is the vast human as well as financial capital of the Armenian diaspora. The traditional diaspora, coupled with the well-educated citizens that have left Armenia since independence, provide a sizable source of ready-to-be-tapped human capital. On the financial side, seeing what \$65 million per year of Lincy funding alone has done to the Armenian economy, one can only wonder what \$100-250 million of consolidated, well orchestrated, and properly utilized diaspora funding would accomplish. So far, the relationship with diaspora capital has remained focused on only a number of wealthy individuals.

Second, better governance and institutional capacity will improve prospects for sustained economic growth. Recent studies have demonstrated that the quality of institutions affects growth prospects more than trade, resource availability, or geographic location. This offers a strong message to Armenia, as well as other resource-poor states, that much more can be gained from improved institutional capacity and governance.

Finally, prospects for closer regional integration with Georgia hold promise. The Georgian market is at least twice that of Armenia, and Georgia has access to the sea that Armenia could fruitfully utilize. Such cooperation has always looked attractive for Armenia,

given the Turkish blockade, and recent events in Georgia opened an opportunity for capitalizing on it.

Poverty and Income Distribution in Armenia

The incidence of poverty and inequality declined significantly in recent years. Preliminary estimates for 2003 show that overall poverty has declined from 55 percent in 1999 to 43 percent in 2003. Income inequality, as measured by the Gini-coefficient (where zero indicates perfect equality and one, perfect inequality), decreased from 0.59 in 1999 to a preliminary estimate of 0.44 in 2003. These positive developments are partly due to the strong economic growth registered in recent years and the improvements in targeted social policy. However, the small reduction in poverty in rural and urban areas other than the capital city of Yerevan raises questions regarding the quality and sources of growth. Growth contributes the most to poverty reduction when it expands employment, productivity, and the wages of the poor. The unemployment rate remained high in Armenia.

Using the World Bank's definition of poverty (the percentage of the population living under \$1/day), the poverty rate in Armenia was 43%, a decided improvement from previous years (1999: approx. 55%; 2001: 47%). Prior to the breakup of the Soviet Union, the poverty rate in Armenia was only about 14%. By comparison, the poverty level for Middle Eastern countries and North Africa is approximately 19%; for Latin America, 20%; sub-Saharan Africa, 50%.

The most important factor contributing to poverty in Armenia was the collapse of output from 1989 to 1994, caused by the transition from a centrally planned economy to a transitional economy. Also, the Nagorno-Karabakh conflict and the closing of the borders with Azerbaijan and Turkey increased poverty. Output from 1990-1993 dropped by almost 60%. This scale of collapse, similar to that in Georgia, was significantly higher than in other post-Soviet areas.

Another contributing factor to the increase in poverty has been the deterioration in income distribution. Income inequality went from 0.27 in 1989 to about 0.60 in 1998, and then declined to 0.44 in 2003. If you compare two countries with the same per capita income and output, poverty will be higher in the country with a less equal income distribution. Even if GDP does not change, poverty can be reduced if income distribution improves.

Another factor that explains the increase in poverty in Armenia is an adjustment in expenditures from 1994 to 1998. Government expenditure as a share of GDP dropped from 40% in the early 1990s to 23% by 1998. Less government expenditures in the social sector on health, education, and other social services increases poverty. If the goal of the government is to reduce poverty, more money for social sectors is needed.

Sustainable economic growth is the main key to reducing poverty. Armenia needs to grow by at least 6% on a per capita basis every year to reach the goal of 20% poverty reduction by 2015. If income distribution improves further at this growth rate, then poverty will be reduced even faster. For example, if income distribution improves by half a percentage point every year, then Armenia will need only 5% per capita growth rate for the next 10 or 12 years in order to reach the poverty reduction goal.

Relationship between state and business

State authority and legitimacy are much stronger in Armenia than Georgia, but the institutions in Armenia need to be bolstered and balanced. One promising indicator for this is that both Armenia's ruling government coalition and the parliamentary opposition are composed of several different parties. This degree of genuine political pluralism, neglected in some analyses, is promising.

Still, the challenge to improve good governance and combat widespread and systemic corruption remains. This is especially so due to a competition of elites in power politics and the emergence of a new elite—the oligarchs. This is not a unique trend. It is prevalent throughout the former Soviet Union and affects many economies in transition. It is rooted at times in widespread corruption and at times in imbalanced or imprudent privatization programs. In the 2003 parliamentary elections, there was a significant and worrisome entry into politics by the oligarchs. Their rise presents difficult challenges because of their proximity to power.

In Armenia, the term oligarch is admittedly too general, incorporating a number of entities and movements that can play a positive economic and political role. The power of Armenian oligarchs stems from their control, as cartels, over different commodities and inputs. The existence of oligarchs in Armenian society and politics is not the main issue, but rather how the Armenian government deals with them. The challenge facing Armenia as it drafts a plan for the MCA is how to both contain and constrain the influence and power of oligarchs.

In recent months, an interesting trend can be observed. Oligarchs, having entered the political realm, have embarked on an early course of legitimization. Several oligarchs are trying to go straight and want to work with the government to improve tax and revenue collection. The model for many of them is “Joe Kennedy,” i.e., a transformation from robber baron into political dynasty in which the sources of dynastic wealth get obscured in later years. Unlike the competition in Russia, which is characterized more by a power struggle with government to renationalize industry and energy, in Armenia the power struggle involves more an outright competition between elites. The important thing for Armenia is to find a mechanism that incorporates economic cartels as stakeholders in establishing good governance and deepening economic reform.

Discussion

Discussion in part centered on the impact of emigration from Armenia. From 1990 to 1996, Armenia lost up to one-third of its population. Over the last few years, however, the population seems to have stabilized. As a result of the improvement in the economy and regional stability, equal numbers of Armenians are leaving and returning to the country. This has not compensated for the previous loss, however. The point was also raised that those who have left the country fuel the current economic growth. Recent estimates by the Central Bank put diaspora contributions at about \$500-700 million in 2003, although other estimates suggest something more like \$150 million. (To comprehend the potential significance of transfers, \$500 million of transfers would amount to nearly 25% of Armenia's GDP).

Another issue raised was whether the poverty indicators incorporated the informal economy. If the latter were taken into consideration, poverty would undoubtedly be lower. To counter this, the point was raised that the poverty threshold can be misleading, even if adjusted for the informal economy, if access to education and health care are ignored. If one factors this in, the poverty rate may not look much lower than the numbers cited here.

Over 51% of the Armenia parliament are so-called oligarchs (or, more accurately, businessmen), tied to businessmen, or act on their behalf. An important element to getting them to play by the rules is to introduce anti-trust legislation and enforcement that can break cartels as impediments to economic development (and, indirectly, democratization). The days of the oligarchs are numbered. Civil-military relations in Armenia are sound and there is much more stability in Armenian politics, even given the confrontation between the government and the opposition.

Roundtable II: Georgia

Louise Shelley, Transnational Crime and Corruption Center

Mamuka Tsereteli, America-Georgia Business Council

The Fight Against Corruption

Georgia's Rose Revolution has brought to power many young, energetic leaders and has produced a hope that long-awaited reforms will at last be implemented. Many of these new leaders, however, lack experience in administering and dealing with bureaucracies. For all its accomplishments, Georgia still does not have a clear and easy path towards transparent, non-corrupt government. Developments in Georgia over the last nine months suggest there is an ongoing need to not only assist reform processes but also to continuing addressing the problem of corruption.

The following are some priorities and pitfalls.

Privatization. In earlier aid efforts, a tremendous amount of money was spent on the privatization process. If any aid is to go towards privatization, it should be done with more scrutiny and care than in the past. Any privatization-related assistance should promote fairness and transparency, especially given the political clout that devolves to oligarchs and external actors that acquire control of the economy.

Education. One contribution to the success of Georgia's Rose Revolution was an educated, engaged population. The corruption that exists from the elementary-school level up through higher education affects the future of this population. Money should be spent on education and university reforms. Assistance in the educational sector has in the past been misappropriated; oversight of educational assistance funding is needed.

Corporate governance. Corporate governance merits greater attention. A business school, established with U.S. government funds, has sought to build a sense of integrity among aspiring businesspeople. Russian influence in Georgia increases the importance of this area, as Russian investment is not especially prone to transparency or good corporate governance.

Civil society. There needs to be more oversight by civil society and trained financial specialists on economic performance and revenues. Currently, no department in Georgia focuses on providing such accountability.

Infrastructure and investment. Infrastructure is an area that has been plagued by enormous corruption. The Georgian economy could develop a tourism industry with lots of small businesses. To achieve this, however, requires better infrastructure: a functioning transportation system, including efficient railroads, airplanes that arrive at normal hours, and competition on routes that will drive down prices. In the past, money for the reconstruction of roads has been embezzled, and road quality is very poor. One accomplishment has been the establishment an oversight board for the railroads. Telecommunications is a significant problem. There needs to be more competition and oversight in this sector and more efforts to clean up the corruption.

Borders and customs. After ousting Aslan Abashidze, the Georgian central government has tried to root out corruption in Ajara, the central entry point from Turkey into Georgia. If the roads are passable and customs officials do not extract huge bribes from drivers, Georgia may hope to become a transport link between the markets of Europe, Turkey, and other parts of the world. Further attention needs to be paid to Georgia's regions, particularly the crucial border regions and conflict zones.

Emerging Business Climate

An encouraging act occurred during the donor summit for Georgia held in Brussels earlier this year. For the first time, the government of Georgia communicated a vision for the country's economic development. Its stated objective was to transform Georgia from a recipient of foreign assistance into a country where sustainable growth is driven by the private sector. Such a formulation demonstrates that Georgians recognize the need to focus on the utilization of internal resources and the growth of internal capacity for development, and that external assistance should be employed with these objectives in mind. During the summit, the Georgian leadership focused on private sector development including the development of property rights, privatization, and tax reform. To date, tax legislation has been streamlined and taxes reduced.

Regulatory and tax reforms are important for encouraging legal business transactions in Georgia. Traditionally, the cost of doing business illegally has been much lower than the cost of doing business legally. Whether anticipated reforms will lead to the legalization of Georgia's very strong informal sector remains to be seen. The trend, however, is positive.

How privatization proceeds is also important, especially in the light of Georgia's past experience. The privatization of Tbilisi's energy distribution company Telasi to the U.S. company AES promised to be successful. The project never had any donor subsidies, however. AES ran into difficulties, and the company was sold to the Russian company UES. Donor support in the initial stages would have greatly helped the company to establish successful operations.

The privatization process needs to be transparent and competitive. It should maintain a focus on the long-term interests of Georgia, particularly as it affects transportation and port facilities critical for the country's economic security. If the process is transparent and competitive, not only Russian companies, but also European and American ones, will be interested in privatization.

Recent economic growth in Georgia has been strong. In 2003 it was 8.3%. In the first six months of 2004, it was close to 9%. Pipeline construction contributed 3.5% of this growth, while construction, communication, and financial sectors contributed the rest. The government has successfully rescheduled its foreign debts freeing up funds for social spending. For the first time

in the history of Georgia, the government submitted a proposal to increase spending—by almost \$110 million.

Still, major difficulties lie ahead. First, the Georgian population has very limited business opportunities. Many Georgians still see a bleak future ahead; this has resulted in the emigration of approximately one million people since 1989. Unless economic opportunities develop, people will continue to leave and not return. The brain drain of young and talented people relates to a problem of education. Fewer opportunities in the educational system create a greater incentive to leave the country.

Energy should be a priority. In twelve years of independence, the state and the donor community failed to create a functioning energy system in Georgia. Unless infrastructure is drastically improved, the system will remain on the verge of collapse.

An orientation towards private sector development is the correct one, but there are several elements that need to be in place for this to be successful. The first is a respect for property rights. This is the most critical issue in Georgia. The second is a reduction of decision-making influence by government agencies, entities, and officials in private business. The third is the reduction of regulations and barriers that help government officials seek rents and prevent or deter individuals from entering private business. A fourth challenge concerns police reform—15-20,000 individuals working for the Ministry of the Interior and other law enforcement agencies will be fired in the next few months. This force lacks training to find new job opportunities. The Interior Ministry has traditionally been one of the most corrupt ministries in the government. While reform is a good thing, the potential for former police employees to turn to criminal activity exists. One of the top priorities of the donor community and the Georgian government should be to organize training for these people and create opportunities for them to enter the private sector.

Discussion

It was noted that some, but certainly not all, officials still think they should and can operate in the same manner and mindset as before the Rose Revolution. Dismantling this legacy requires time and proper economic restructuring.

The course of privatization in Georgia was discussed in greater detail. Many efficient enterprises are to be sold, while several inefficient companies are not. It was noted that the government might be better off selling companies that are not operating efficiently and retain control over assets—such as ports—that are important components of its infrastructure, economy, and security. An enterprise fund, possibly supported by the MCC, could help achieve better levels of transparency and accountability in the privatization process.

Although Georgia faces considerable economic challenges, changes of this magnitude do not occur overnight. Georgians are working to resolve their problems and have demonstrated a commitment to professionalism and a respect for doing what is right. Georgia is aware of its European obligations; the Ministry of Justice, for example, is working to develop and institute a criminal procedure code that adheres to European requirements.

Summarized by Anastasia Handy