ICR Review
Operations Evaluation Department

Report Number: ICRR11112

1. Project Data:		Date Posted:	10/29/2001	
PROJ ID:	P051171		Appraisal	Actual
Project Name:	Third Structural Adjustment Credit	Project Costs (US$M)	50	63.4
Country:	Armenia	Loan/Credit (US$M)	50	65
Sector(s):	Board: PS - Power (37%), Central government administration (20%), General industry and trade sector (17%), Irrigation and drainage (14%), General education sector (12%)	Cofinancing (US$M)	0	3.8
L/C Number:	C3153			
		Board Approval (FY)		99
Partners involved :	Government of Netherlands	Closing Date	06/30/2000	06/30/2001

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2. Project Objectives and Components

a. Objectives

The main objective was to consolidate macroeconomic stability and lay foundations for sustained private sector led growth over the medium term. The program included measures to (a) improve financial discipline in the private and public sector; (b) accelerate the growth and development of the private sector; (c) ensure the social sustainability of reforms and preserve the country's stock of highly-skilled human capital.

b. Components

Under (a) components were: (i) improve budget management systems (through adoption of a medium-term-expenditure-framework or MTEF); (ii) strengthen accounting and financial information systems; (iii) implement a financial rehabilitation program, carry out tariff and regulatory reforms, and maintain payment discipline in the energy sector; (iv) reform district heat system; (v) implement a financial rehabilitation plan, carry out tariff reforms, improve institutional capacity and maintain payment discipline in the irrigation sector.

Under (b) the components were: (i) maintain momentum of the banking sector reform; (ii) maintain momentum of the privatization program; (iii) liquidate state-owned enterprises that have failed three attempts at privatization and (iv) privatize power sector enterprises.

Under (c) the components were (i) initiate reform of the pension system; (ii) increase public spending shares on education and health and (iii) advance restructuring of the education and health systems.

c. Comments on Project Cost, Financing and Dates

The credit's original appraisal estimate was $50 million. To buffer against the Russian crisis' spillover effects, in early 1999, the original credit amount of $50 million was raised to $65 million, and distributed by $5 million allocations among each of the original three tranches. However, as the third tranche approached there were obstacles to fulfillment of conditions. In January, 2000, the third tranche was restructured into two--a third tranche of $20 million and a new fourth tranche of $5 million. The new fourth tranche had four conditions carried over from tranche three. In September, 2000, the Bank denied request for a waiver for this tranche but a waiver was eventually granted, and it was disbursed in December, 2000.

3. Achievement of Relevant Objectives:

1. Strengthening Public sector management and improving. financial discipline: (i) In December 1999, the MTEF was adopted. (ii) A financial rehabilitation plan (FRP) for the power sector was formulated and accounting and financial information systems were strengthened. Electricity tariffs were hiked, a time table was prepared for biannual electricity tariff reviews, the overall collection rate for billings improved to 90 %, budgetary arrears to the energy sector were cleared and a study was launched on heat strategy. International auditors were selected to conduct audits of major energy companies. And international consultants were hired to help the most important energy companies convert their accounts to international accounting standards -based (IAS) system and prepare a three-year maintenance program to ensure reliable electricity supply. A debt-restructuring plan was formulated and implemented for the energy companies. (iii) An irrigation sector financial rehabilitation plan was adopted focusing on tariff adjustments, cost recovery targets and improved collection methods.

2. *Accelerating private sector development*. Satisfactory progress was achieved in the reforms targeted by SAC 3 in the banking sector, in developing the legal framework for enterprise liquidation, and completing liquidations of enterprises targeted in conditions for tranche release. The public enterprise accounting system was strengthened with conversion to IAS of selected state-owned enterprises in irrigation, drinking water, power and air transportation sectors. The legal framework for privatization of energy sector companies was established, a privatization action plan for electricity companies was announced but not implemented.

3. *Social sustainability*: (i) social assistance reforms were adopted (legal framework for improving the Social Benefits System, approving a Law on the Social Benefit and implementing steps to ensure the sustainability of the pension system). (ii) in education, budgetary share allocated to education was increased and satisfactory progress was made in implementing the pilot school decentralization and rationalization program. (iii) Budgetary allocations to health were increased and a hospital rationalization plan was approved.

Loan conditions were fulfilled except concerning privatization of four electricity distribution companies. However, the loan did not address reforms that were critical for private sector led growth and for this reason the relevance of the loan is considered modest (on a scale of 1 to 4, with 4 the highest, the loan's relevance would be considered only a 2).

The SAC 3 objectives were almost identical to SAC 2 although when SAC 3 was appraised (1998), the key constraints to economic growth had been identified in Bank's analytical work (starting in 1993) and during implementation of four previous loans (the Rehab loan of FY95, the SAC of FY96, the enterprise development project of FY97 and SAC 2 of FY98). These constraints included onerous government regulations, arbitrary administrative action, administrative harassment and red tape, difficulties in entry for new businesses, weak contract enforcement, and an ineffective regulatory, trade, tax and customs regime were stifling private sector growth. These issues were subsequently addressed less than a year later when the SAC 4 was identified and appraised. It is unclear why these issues were not included in SAC 3 design.

Without properly functioning regulatory public sector institutions and working legal systems, the emphasis on IAS in SAC 3 can also be considered to be of modest relevance.

With respect to social sustainability, the loan conditionality in SAC 3 emphasized budgetary allocations for health and education, but actual spending in health fell far short of budgeted, raising questions about whether actual social spending consistently fell short of budgeted in the past and, if it did, whether conditionality was sufficiently realistic. Perhaps the Bank could have asked for expenditure tracking surveys because despite increased health and education spending and high growth rates, poverty rates have remained persistently high.

4. Significant Outcomes/Impacts:

Macroeconomic stability was achieved despite several adverse factors. The MTEF is an important step for improving the budgetary framework. Measures in the power and irrigation sectors accomplished groundwork to deepen these reforms and have had a positive impact on macroeconomic and debt sustainability of the country. Budget expenditures allocated to health and education sectors were increased and other measures were implemented to restructure these sectors. Social assistance system was strengthened. For example, a new means-tested poverty benefit was introduced. Pension system was reformed. Reforms initiated in the education sector led to an increasing number of schools that would receive funding on per capita basis, rather than per class as had been the norm. In fact, in the areas of social protection and education, Armenia is one of the leaders among FSU countries. Although electricity distribution companies were not privatized, both the Bank and borrower proceeded cautiously, taking care that each step was as credible and transparent as possible.

5. Significant Shortcomings (including non-compliance with safeguard policies):

The loan was of somewhat modest relevance for private sector led growth. Electricity distribution companies were also not sold. Actual health spending was only 62 percent of the budgeted. The ICR does not state if planned budget for education was fully executed and what percent of assets, infrastructure and non-infrastructure have been privatized; or whether enterprises that are still in the public domain rely on budget support or bank credit or neither.

6. Ratings:	ICR	OED Review	Reason for Disagreement /Comments
Outcome:	Satisfactory	Moderately Satisfactory	See para 3.

Institutional Dev .:	Substantial	Modest	Government capacity to allow a detailed assessment of the medium-term economic and fiscal framework appears weak. Institutional development in the power sector is hindered by proper privatization of key sector enterprises. Private sector development is hampered by the failure to privatize some large SOEs and other serious constraints not addressed in this operation. Financial intermediation remains low and little progress has been made so far in ensuring a public sector that supports the development of the private sector.
Sustainability :	Likely	Likely	
Bank Performance :	Satisfactory	Satisfactory	
Borrower Perf .:	Satisfactory	Satisfactory	
Quality of ICR :		Satisfactory	

NOTE: ICR rating values flagged with ' * ' don't comply with OP/BP 13.55, but are listed for completeness.

7. Lessons of Broad Applicability:

1. Adjustment programs must address the many interrelated constraints to private sector development including an environment conducive to private enterprise and the entry of new firms . 2. Capacity must be built in the government to support a market economy. 3. Continuity and dedication of task managers can contribute to effective relations with the Government and receptiveness to Bank advice . In this operation. the same task manager and country director continued from appraisal in 1998 to closing in 2001 and the Government response to the operation as documented in the ICR has been positive.

8. Assessment Recommended? ● Yes ○ No

Why? SAC3 is one of five lending operations which should be audited as a cluster to evaluate key aspects of the Bank's stabilization, adjustment and technical assistance program to Armenia, and derive lessons for future operations. A cluster audit will also provide an evaluation of the reform program over a continuos period 1995-2001 which can serve as the main building block of a country assistance evaluation .

9. Comments on Quality of ICR:

The ICR is of good quality.