

Chapter 4

Challenges and Directions for the Future: A Dynamic Overview

Introduction

The main objective of the Poverty Reduction Strategy to reduce poverty will only be achieved by encouraging economic growth, ensuring macroeconomic balance, and adopting economic policies that optimize investments and mobilize resources. The previous chapters have shown that economic policies and government measures over the period 2003–2004 were unsuccessful in attracting the necessary domestic and foreign investments to achieve the PRS objectives. In addition, the national budget deviated from the PRS medium-term expenditure framework, although total revenues and expenditures exceeded PRS estimates and the deficit was maintained within safe limits.

Viability of the PRS

Over the two years, the PRS played a notable role in supporting and guiding planning for development challenges and poverty reduction. It also contributed to drafting and incorporating principles and procedures for the various programs, including plans to monitor and follow up on development using quantitative indicators. Creating a framework for monitoring programs is a challenge in its own right, and one that requires a comprehensive approach at the national, local, and sectoral levels. The PRS also contributed to expanding participation in the various phases of preparation, implementation, monitoring, and follow-up.

Although PRS achievements during the first two years have not been positive across all objectives, the government has made a good start in linking financial resources to development plans and establishing monitoring and evaluation mechanisms as instruments for revising plans and changing direction.

Moreover, despite the importance of the PRS objectives of reducing poverty, enhancing basic services, and improving governance, it may not be possible to achieve all of them in the first two years. Challenges are not limited to establishing the necessary constitutional, legislative, and financial foundations for change but extend to acquiring capable human resources. This last requirement is time-consuming and requires intensive and ongoing training programs at all levels and in all fields to enhance people's abilities to evaluate, monitor, draft plans and programs, and link them to the budget.

Over the past two years, a series of local and regional events have affected the forecasts and assumptions made by the PRS and adversely affected the Yemeni economy. These events also produced new information and additional challenges for the implementation of the PRS. The events are as follows:

- Repercussions of September 11 and the American occupation of Iraq created a negative image of the region and burdened its economies with additional liabilities, such as rising insurance premiums and transportation costs, and declining foreign investments and tourism.
- Previous acts of terrorism in Yemen made the country seem like a bad prospect for investment. Subsequent security measures have not yet succeeded in changing that impression.

- The parliamentary elections of April 2003 interrupted economic reforms and increased public expenditures to meet election-related expenses; this led to a rise in consumption at the expense of investment.
- Private sector response to incentives offered by the Investment Law was weak, oil exploration has been limited, and use of the Aden Free Zone has been limited because of inadequate services and red tape.
- Economic returns from Yemen's partial membership to some committees of the Gulf Cooperation Council have been limited; this situation is contrary to PRS expectations, especially those for economic integration and opening labor markets for Yemenis.

Other challenges have been caused by the decline in Yemen's oil production, which further impedes the national economy and government finance, given the limited tax base and inefficient tax administration and collection. Also, sensitivity of macroeconomic indicators to fiscal and monetary policies causes adverse effects on the investment climate, weakens the flow of national and foreign capital, and limits economic growth and new employment. Other major challenges are the rapid population growth and growing workforce, and the shortage of water resources, especially in the central highlands and desert plateau. To address these challenges, long-term strategies should be put in place, along with short and medium-term interventions and measures.

2005 Macroeconomic Framework

In light of the challenges and obstacles to growth, the government has explored alternative growth scenarios for the remaining period of the PRS. The objective is to conciliate the PRS macroeconomic framework with that of the Second Five-Year Plan (SFYP),¹ reflecting the new situation and integrating the PRS into the budget.

The revised macroeconomic framework indicates that PRS projections for 2005 were optimistic; the PRS estimated real GDP growth at 5.5% and non-oil GDP growth at 7%. Revision of the estimates brings real GDP to YR281,671 million at 2.9% real GDP growth and 4.1% non-oil GDP growth. These growth rates are based on reduced oil production to 381,000 barrels per day. They fall short of the PRS targets by 2.6 and 2.9 percentage points, respectively, thus reflecting negatively on poverty reduction efforts.

In light of the 2005 population estimate of 21.4 million, a slight decline in per capita GDP growth is expected (0.3%) resulting from the economic slowdown, compared with the PRS target of a 2.5% increase.

Inflation is expected to hit 15.5% in 2005 as a result of lifting the subsidy on oil derivatives. Total final consumption is estimated at YR1,762,075 million at 3.3% increase. Private consumption is expected to decline by 2.8% against a 9.8% surge in public consumption, resulting in total consumption reaching 70.8% of GDP. This figure is 15.5 percentage points below the PRS target that aimed at raising average

¹ Discrepancies between the frameworks are attributed to the time span between the formulation of the SFYP and the PRSP. A number of events created a different economic environment for the PRSP compared with the environment when the SFYP was drafted.

Table 4.1: Macroeconomic Framework			
	2005 Estimates (YR millions)	% of GDP	PRS Target (% of GDP)
Final Consumption	1,762,075	70.8	86.9
Public consumption	367,854	14.8	17.9
Private consumption	1,394,221	56.0	68.9
Gross investment	673,864	27.1	26.0
GDP at market price	2,488,077	100.0	100
Net income of production factors from abroad	235,050	-9.4	-3.4
Net current transfer from abroad	285,210	11.5	13.6
National savings	490,952	19.7	23.3
Trade balance	-	-0.3	-8.1
Current balance	-	-0.6	-2.7

total consumption by 4.6 percentage points to reach 86.9% of GDP in 2005. This target assumed growing local and foreign private sector resources, along with government's ability to meet spontaneous consumption needs of society.

As a result of the declining total consumption growth rate, the ratio of national saving to GDP, estimated at 22.7% in 2005, is expected to approach the target of 24%. Gross investment is estimated to increase by 22.6% to reach YR673,864 million equivalent to 27.1% of GDP and exceeding the PRS target by 1.3 percentage points. Nevertheless, gross investment will not achieve the required GDP growth. The fisheries sector is expected to grow at 10%, but its contribution to GDP is small. Manufacturing is expected to grow at close to the current pace (4.5%, compared with 4.1% in 2004). Services will exhibit sluggish growth in restaurants and hotels (5.8%, compared with 6.6%) and in transport, storage, and telecom (3.6%, compared with 4.2%). This slow growth will undoubtedly affect job creation.

Estimates show a decline in the share of oil to 26.8% of GDP, compared with 31.4% in 2004. Trade balance (including oil company exports) will suffer a slight deficit equal to -0.3% of GDP compared with the -8.1% target, leading to a current account deficit of -0.6% compared with the -2.7% target.

2005 Budget

The budget estimates in the PRS are based on the macroeconomic framework, a decline in oil revenues, a rise in non-oil revenues, and rationalizing expenditures to increase at minimum limits to help control the deficit. The 2003 and 2004 budgets were not compatible with PRS directions and objectives. However, data available from the proposed 2005 budget suggest that the final 2005 budget will conform more closely to the PRS. Total current revenues and grants reached 28.4% of GDP against a target of 29.5%, based on an expected rise in oil and gas revenues by 2.1 percentage points compared with the target, due to high international prices and the government's efforts to maintain the current production level.

Direct and indirect tax revenues fell below the PRS target of 10.3% of GDP by 2.6 percentage points. This indicates continued inefficient collection, tax evasion, and smuggling, and calls for accelerating reforms of the tax and customs systems, particularly enforcement of the general sales tax (GST) scheduled for early July 2005.

Table 4.2: 2005 Fiscal Framework

Item	2005 PRS Target	2005 Proposed Budget	Deviation (Percentage Point)
Total current revenues and grants	29.5	28.4	-1.1
Total revenues	28.7	27.7	-1.0
Oil and gas	16.2	18.1	2.1
Non-oil revenues	12.5	-	-
Taxes	10.3	7.7	-2.6
Customs	3.1	2.1	-1.0
Nontax revenues	2.3	2.0	-0.3
Grants (cash)	0.8	0.7	-0.1
Total expenditures	33.2	33.6	-0.4
Current expenditures	25.4	23.4	-2.0
Civil salaries and wages	9.3	10.7	1.4
Goods and services	2.9	3.4	0.5
Maintenance and operations	0.4	0.5	0.1
Debt payments	2.6	2.9	0.3
Transfers and subsidies	3.6	6.0	2.4
Current transfers	3.5	2.7	-0.8
Subsidies	0.1	2.0	1.9
Development expenditures	7.8	7.9	0.1
Balance (including grants)	-3.7	-4.3	0.6
Net local financing	2.6	3.0	0.4
Net foreign financing	1.1	1.3	0.2

The 2005 budget reflected a rise in public spending by 24.9% above the PRS target. However, its ratio to GDP of 33.6% exceeds the PRS target by 0.4 percentage points. Current spending is expected to fall by 2 percentage points against the target despite the fact that wages and salaries exceed the target by 1.4 percentage points. This confirms the government's commitment to controlling current spending. The subsidy for oil derivatives is the largest liability. Despite the inclusion of gradual price reforms on local oil derivatives in the 2005 budget, the ratio of the subsidy to GDP is estimated at 2%, compared with the 0.1% PRS target. Defense-related expenditures are expected to decline to about 5.1% of GDP, compared with the 6% PRS target.

Capital and investment expenditures are estimated at over YR196 billion, which represents 23.4% of total public expenditures and about 7.9% of GDP, compared with the 7.8% target. The overall budget deficit, including grants, is estimated at 4.3% of GDP, which exceeds the PRS target by 0.6 percentage points and contributes toward increasing net local and foreign financing by 0.4% and 0.2%, respectively.

Development spending mainly targets sectors related to poverty reduction with the aim of enhancing living standards and providing basic services, especially in rural areas. The total expenditure ratios (current and investment) on education and health are below the target by 0.5 and 2.5 percentage points, respectively, despite estimated capital and investment expenditures that exceed PRS targets by 15.9% for health and 12.2% for education. It is noteworthy that investment spending on education in the 2005 budget has been reduced to YR34.5 billion, compared with YR37.8 billion in 2004. Current spending levels for education and health are essential to improve services in these sectors and reach all regions, especially rural areas.

The social safety net includes a number of funds; the most important are the Social Welfare Fund, the Social Fund for Development, the Agriculture and Fisheries Production and Promotion Fund, and the Civil Service Fund. Total spending from the four funds in the 2005 budget approaches YR44.3 billion, compared with the YR46 billion target. Distribution of these resources varies significantly. The estimated spending of the Social Fund for Development aligns with the target, while estimated spending of the Civil Service Fund and the Agriculture and Fisheries Production and Promotion Fund exceeds targets by 73.8% and 380.4%, respectively. The big increase in Civil Service Fund spending is attributed to the delay in its operation to early 2004, while the increase in Agriculture and Fisheries Production and Promotion Fund spending is caused by the lifting of the subsidy on diesel in 2005. The fund acts as an agent to mitigate the negative effects of reforms by expanding current and investment spending in the agriculture and fisheries sectors.

Table 4.3: Budget Spending Priorities

Item	2005 Targets	2005 Budget
Total expenditure (YR million)	644,669	836,379
Defense (% of GDP)	6.0	5.1
Health (% of GDP)*	2.2	1.7
Investment expenditure in health (M/YR)	12,847	14,886
Education (% of GDP)*	9.6	7.1
Investment expenditure in education (M/YR)	30,759	34,506
Social Welfare Fund (% of GDP)	1.4	0.6
(YR billion)	28,238	14,306
Social Fund for Development (YR billion)	13,502	13,041
Civil Service Fund (YR billion)	1,300	2,260
Agriculture and Fisheries Production and Promotion Fund (YR billion)	3,000	14,431
Economic growth	17,660	36,332
Human resources development	43,606	39,297
Enhancing infrastructure	41,915	184,227

* Spending on health and education includes activities of the Social Fund for Development and the Public Works Project.

Planning for the Future

The PRS has been unable to achieve its objectives in 2003 and 2004 because of regional and international developments, local factors related to the investment climate and private sector growth, and deviation of the budget from the PRS fiscal framework. A significant change in macroeconomic performance is not expected in 2005. Reforms and restructuring are prerequisites for economic growth.

According to the program presented to Parliament in June 2003, the government is moving along three tracks. The *first track* focuses on general economic policies, enhancing the investment climate with a program that adopts measures outlined in the policy matrix. The program calls for initiating necessary measures to enhance the private sector's role, accelerating economic growth, providing more job opportunities, and directing more programs and projects toward rural areas.

To accelerate delayed reforms, the government took serious measures, despite strong opposition to lifting the subsidy on oil derivatives and enforcing the GST beginning in July 2005. Structural reforms will be implemented to ensure the integrity of the overall reform program. The government will also put in place clear and specific policies, with the full commitment of all branches of government, regarding challenges such as dependence on oil and the decline in its production, dates and effects of World Trade Organization (WTO) accession, limited employment opportunities and high unemployment, and water shortages in a number of basins.

Integrating women into economic activities is a powerful way to reduce poverty. The strategy will adopt policies to empower women, especially in terms of economic growth and in developing the promising sectors. Yemen will pursue local, regional,

and international efforts; in particular, efforts to enhance democracy and human rights, to get the economy out of recession, to find means for economic integration with neighboring countries, to develop and encourage non-oil exports, and to find new markets for local products.

The *second track* is concerned with upgrading the planning process. In the past, there has been duplication of activities related to preparing the SFYP (2001–2005) and the PRSP (2003–2005), and to following up and monitoring their implementation. As both the Third Five-Year Plan (TFYP) and the second PRSP will be drafted in 2005, the government has approved a program to merge the two documents into one to cover the period 2006–2010. This will consolidate preparation, follow up, and monitoring activities and will provide longer time to assess the impact of policies on poverty reduction. The new document will also reflect revisions in the current PRSP and adopt measures to overcome obstacles that have been identified.

Box 4.1: Unifying the Planning Processes

Yemen's Strategic Vision 2025 is based on achieving average real growth of 9% over the next two decades, to lift the country to medium human development status. The Second Five-Year Plan (SFYP) reflects medium-term programs, with specific goals such as achieving average GDP growth of 5.6% and 8% for non-oil. The PRSP reviewed the goals of the SFYP, which were considered to be optimistic. The PRSP targeted a GDP growth of 4.7% and 6.3% for non-oil. The report on Millennium Development Goals (MDGs) estimated that achieving the first goal of halving poverty by 2015 requires real growth of 8% per annum; thus, the importance of coordinating medium- and long-term goals with the MDGs, and specifying the same reference point at the macro and sectoral levels becomes self evident.

The PRS emphasized that the available local resources and the level of foreign assistance to Yemen may not be enough to achieve the required development or reduce poverty in a manner that enables individuals to obtain basic and natural rights, let alone to achieve the Millennium Development Goals (MDGs) by 2015. Hence, the Millennium Project sees that the various international organizations including the World Bank and the International Monetary Fund (IMF), did not link poverty reduction planning to specific goals and time schedules. It is imperative to make this link by using the MDGs as the framework for socioeconomic development plans and PRSPs.

Yemen has been selected as one of eight countries for the Millennium Project. Technical assistance to those countries will be directed to set up frameworks that enhance the relationship between the PRSPs and the MDGs. All resources and ODA will be provided to LDCs with the aim of achieving the MDGs.

Box 4.2: Planning According to MDGs

The planning process is based on three phases. The first phase involves a needs assessment that compares the current situation with the MDGs and determines the investments required to achieve these goals by 2015. The second phase involves the development of long-term policies (10 years) to achieve the MDGs. Policies are the result of consultation and are based on the needs assessment conducted in phase 1. The third phase involves drafting the Third Five-Year Plan for development and poverty reduction (2006–2010) based on achieving the MDGs by 2015. A five-year plan integrated with a long-term plan that extends to 2015 is not a new mechanism for reducing poverty. The government is merely reviewing current approaches and adopting measures that will move the country toward achieving the MDGs. All governance issues and development objectives should be integrated in the PRS.

Merging the five-year plan with the PRSP in one document linked to the MDGs constitutes a leap in planning, setting priorities, and specifying programs. This approach will also help in mobilizing the required financial resources locally and from foreign assistance to achieve the PRS objectives. Additional foreign assistance should be used to reduce development gaps, support administrative reforms, build capacities, and provide systems to upgrade human and administrative capacities at the central and local levels, especially after the adoption of administrative and fiscal decentralization. The third five-year plan for development and poverty reduction will adopt an

integrated fiscal framework for 2006–2010, to be prepared by the Ministry of Finance in accordance with the macroeconomic framework and the plan's objectives.

The *third track* aims to expand the participation of the private sector, support civil society organizations, and enhance internal consultations, especially with local authorities. The TFYP for development and poverty reduction is based on encouraging private investment (including local and Yemeni expatriate investment) to offset the limited amount of foreign investment. It is necessary to expand current investments and initiate new ones by setting up shareholding companies, activating the role of the banking sector, focusing on economic growth poles, and supporting small and medium businesses. The TFYP also aims to use the abilities of civil society organizations to express people's needs and opinions, and to respond to those needs. These organizations can be helpful in raising awareness, including in local communities, and encouraging people to support government efforts and initiate their own efforts to combat poverty.

Existing PRS mechanisms will be used to support coordination among the thematic working groups and to improve monitoring and coordination of the PRS subunits in line ministries, government agencies, and governorates. New groups may be established and current subunits modified to ensure their effectiveness in the remaining period of the current PRS and in drafting the new one. The government will use the mechanisms to ensure the correct timing of decisions in 2005 and effective participation in budget committees. Various sectors of the Ministry of Finance and the Ministry of Planning and International Cooperation will participate in all activities, including conducting studies and drafting reports, especially the PRS Annual Progress Report.

Next year's training will build on previous efforts, in particular those conducted in the governorates for planning according to the PRS. The training will focus on linking plans to budgets and on monitoring roles. Special training will be organized for those involved in budget preparation, highlighting the identification and evaluation of indicators. With donor support, special workshops will be conducted on budgeting for poverty reduction and the inclusion of women, and will coordinate with the priority sectors of health, education, agriculture and irrigation, and social affairs to integrate poverty reduction and gender considerations in the national budget.

The government is drafting a national strategy to support decentralization, which will provide the framework for government policies and activities, and for donor support. The government plans to expand the current decentralization programs across the eight districts of Taiz and Hadhramout and to include other districts in Amran, Hodeida, Ta'ez, Abyan, and Al Jawf; bringing the total number to 28 pilot districts in 2005. The government aims to expand the experience across all districts.

Finally, to achieve success with the next plan, all efforts should be directed and consolidated toward implementation; including a unified vision and direction at high levels and the coordination of tools and instruments at the implementation stage. The government should expand participation and consultation with all concerned parties to ensure political support for the plan.