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INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

PROGRAM DOCUMENT

FOR

A PROPOSED LOAN

IN THE AMOUNT OF US$50 MILLION

TO

THE REPUBLIC OF ARMENIA

FOR THE

FOURTH DEVELOPMENT POLICY FINANCING

November 8, 2016

Global Practice for Macroeconomics and Fiscal Management
South Caucasus Country Unit
Europe and Central Asia Region

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ARMENIA GOVERNMENT FISCAL YEAR
January 1 – December 31

CURRENCY EQUIVALENTS
(Exchange Rate Effective as of November 8, 2016)

Currency Unit	Armenian Dram
US$1.00	AMD 479.48

ABBREVIATIONS AND ACRONYMS

ACF	Anti-Crisis Fund
ADB	Asian Development Bank
ADS	Armenia Development Strategy
AFD	French Development Agency
APSAS	Armenian Public Sector Accounting Standards
ARMEPS	Armenian Electronic Procurement System
CAD	Current Account Deficit
CBA	Central Bank of Armenia
CEQ	Commitment to Equity
CIT	Corporate Income Tax
COA	Chamber of Audit
COC	Chamber of Control
CPAR	Country Procurement Assessment Review
CPS	Country Partnership Strategy
CSO	Civil Society Organization
DB	Doing Business
DCFTA	Deep and Comprehensive Free Trade Agreement
DPF	Development Policy Financing
DPOs	Development Policy Operations
DSA	Debt Sustainability Analysis
EADB	Eurasian Development Bank
EBRD	European Bank for Reconstruction and Development
ECA	Europe and Central Asia
EEU	Eurasian Economic Union
EFF	Extended Fund Facility
EIA	Environmental Impact Assessment
EITI	Extractive Industries Transparency Initiative
ENA	Electric Networks of Armenia
ENP	European Neighborhood Policy
EU	European Union
FDI	Foreign Direct Investment
FSAP	Financial Sector Assessment Program
GDCA	General Department of Civil Aviation
GDP	Gross Domestic Product
GIZ	German Federal Enterprise for International Cooperation
GPA-WTO	Agreement on Government Procurement of the World Trade Organization
GRS	Grievance Redress Service
IBRD	International Bank for Reconstruction and Development
ICR	Implementation Completion Report
IDA	International Development Association
IDF	Institutional Development Fund
IFC	International Finance Corporation
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
IPSAS	International Public Sector Accounting Standards
ISSAI	International Standards of Supreme Audit Institutions
LPP	Law on Public Procurement
MENR	Ministry of Energy, Infrastructure and Natural Resources
MNP	Ministry of Nature Protection
MOF	Ministry of Finance
NCOs	Non-Commercial Organizations
OPCS	Operations Policy and Country Services
OSCE	Organization for Security and Cooperation in Europe
OSS	One-Stop-Shop
PEFA	Public Expenditure and Financial Accountability
PFM	Public Financial Management
PIs	Performance Indicators
PIT	Personal Income Tax
PLR	Performance and Learning Review
PRSCs	Poverty Reduction and Support Credits
PSC	Procurement Support Center

SCADA	Supervisory Control And Data Acquisition	USAID	United States Agency for International Development (USAID)
SEA	Strategic Environmental Assessment	VAT	Value Added Tax
SME	Small And Medium Enterprises	WSA	Water Supply Agency
UCO	Universal Credit Organization	WUA	Water User Association
UK	United Kingdom		

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REPUBLIC OF ARMENIA
FOURTH DEVELOPMENT POLICY FINANCING

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SUMMARY OF PROPOSED LOAN AND PROGRAM
REPUBLIC OF ARMENIA
FOURTH DEVELOPMENT POLICY FINANCING

Borrower	Republic of Armenia	
Implementation Agency	Chief of Government Staff	
Financing Data	IBRD loan of US$50 million with a fixed spread, 25 years maturity, and 14.5 years grace period. Commitment linked repayment schedule and level repayment of principal.	
Operation Type	Last in a programmatic series of Four Development Policy Financing Operations.	
Pillars of the Operation and Program Development Objective	The program supports the government in its efforts to: (1) Promote fiscal social and environmental sustainability. (2) Strengthen competitiveness.	
Result Indicators	Excise on tobacco and alcohol to GDP ratio Transparency on tax exemptions	Baseline: 0.72 percent (2015) Target: 0.88 percent of 2015 GDP (2017) Baseline: No published information on tax exemptions (2012) Target: Annual publication on tax exemptions (2017)
	Number of self-financing Water User Associations Accumulated net losses of ENA	Baseline: Zero (2015) Target: 5 (2017) Baseline: AMD 27 billion (April 2015) Target: Zero losses (April 2017)
	Number of households covered by the Family Benefit Program	Baseline: 96,309 (2012) Target: 105,000 (2017)
	New mining licenses issued in compliance with the amended Law on Waste Management and new provisions in the mining code	Baseline: Zero (2015) Target: 100 percent (2017)
	Number of tax inspections	Baseline: 1470 (2013) Target: 1200 (2017)
	Number of applications approved through the simple notification mechanism instead of licensing	Baseline: Zero (2012) Target: 35 (2017)
	Number of electronic IDs and certificates issued	Baseline: 26,000 (2012) Target: 900,000 (2017)
	Average value and standard deviation of performance appraisal scores of civil servants	Baseline: 95 percent and 3 (2015) Target: 90 percent and 5 (2017)
	Percent of non-energy imports processed through the 'single window approach'	Baseline: 20 percent (2012) Target: 45 percent (2017)
	Number of airline passengers	Baseline: 1.69 million (2012) Target: > 2.11 million (2017)
	Number of credit reports issued	Baseline: 1.2 million (2012) Target: 4.5 million (2017)
	Index on the strength of the insolvency framework in Doing Business	Baseline: 9 (2015) Target: 12 (2017)
	Number of consolidated audits carried out by the CBA	Baseline: Zero (2012) Target: At least 1 (2017)
Overall Risk Rating	Substantial.	
Operation ID	P160100	

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT
PROGRAM DOCUMENT FOR A
PROPOSED FOURTH DEVELOPMENT POLICY FINANCING TO ARMENIA

I. INTRODUCTION AND COUNTRY CONTEXT

1. **The fourth Development Policy Financing in Armenia will support the government's efforts to promote fiscal, social, and environmental sustainability and to strengthen competitiveness.** The original programmatic series of Development Policy Operations (DPOs) in Armenia comprised three operations. A fourth operation was subsequently added in 2015 to better align it with the government's reform program and the World Bank's Country Partnership Strategy (CPS) cycle, to provide the much needed response to a deteriorating macroeconomic context and to strengthen the impact of the supported reforms.[1] This programmatic series of four operations is anchored in the Armenia Development Strategy (ADS) for 2014–25 which was approved by the government in April 2014, and in the CPS for FY2014–17. Originally, the Program Development Objective (PDO) of this DPO series was to support job creation through growth enhancing reforms. However, given the country's increasing macroeconomic and fiscal vulnerability in the context of a worsening external environment, the PDO was amended (in the third operation under this programmatic series) to support the government's reform agenda under the following two pillars: (i) promoting fiscal, social, and environmental sustainability; and (ii) strengthening competitiveness. These reforms will ultimately bolster the prospects for the government's long-term objective of job creation. The first pillar includes measures to increase the fiscal space, improve the financial sustainability of key sectors, enhance the efficiency of social protection programs, and improve environmental safeguards in the mining industry, which accounts for over half of Armenia's exports. The second pillar includes actions designed to strengthen the business environment, improve trade facilitation and connectivity, and improve access to credit. This is the last operation in the programmatic series of four operations spanning 2013-16, in the amount of US$50 million.

2. **The current DPF series supports the government's efforts in addressing the key challenges faced by the country which include high external vulnerability and persistent unemployment.** Armenia is a small, lower middle-income, landlocked country with a GDP per capita of US$3,500 and a population of 3 million. External vulnerability in Armenia arises from its dependence on remittances, commodity exports, and large capital inflows necessary to finance the current-account deficit. During the 2008–09 global financial crisis, the Armenian economy contracted by 14.1 percent as external financing dried up and the booming construction sector collapsed. Fiscal stimulus, which was implemented in 2009 and resulted in the tripling of the country's external public debt, helped to stabilize the economy and the government turned its attention from crisis management to its longer-term reform agenda focused on sustainable growth. However, towards the end of 2014, the Armenian economy was hit hard by a deepening Russian recession which negatively impacted foreign direct investment (FDI), remittances, and exports, and put strong depreciation pressure on the Armenian dram. The geopolitical environment also changed. Whereas previous structural reforms had been anchored in a proposed Association Agreement with the European Union (EU), in September 2013, the country decided to join the Eurasian Economic Union (EEU). The high external vulnerability underscores the crucial importance of reinforcing macroeconomic stability through increased attention to fiscal sustainability and improved competitiveness. The country also has one of the highest unemployment rates (18.5 percent) in the Europe and Central Asia region largely stemming from low job creation and a mismatch of workers' skills and jobs. In addition, corruption remains an

[1] Such reforms include the Parliamentary approval of the Unified Tax Code and the amendments to the Mining Code.

endemic problem in the country although the government has established an anti-corruption council in 2015 to provide a more structured approach to tackling corruption.

3. **While some progress in poverty reduction was achieved during the post-crisis recovery, Armenia's poverty rate remains higher than it was in 2008, and its income distribution is less equal.** In 2014, 30 percent of Armenians were still living in poverty, compared to a post-independence low of 25.2 percent in 2008. In 2013, the poverty rate in Yerevan (25.5 percent) was substantially lower than in other urban centers (35.1 percent) and rural areas (29.9 percent). About 31.5 percent of female-headed households were below the poverty line, 2 percentage points higher than the rate for male-headed households. Inequality increased in the aftermath of the global financial crisis, and the Gini coefficient rose from 0.242 in 2008 to 0.277 in 2014 (based on national consumption expenditure). Armenia's performance in terms of promoting shared prosperity since the crisis is among the poorest in the region. During 2009-14, the average consumption of households in the bottom 40 percent of the distribution grew by 0.69 percent annually compared with 1.64 percent for the total population. The decline in remittances due to a weakening Russian economy presents serious cause for concern, as remittances are an important driver of poverty reduction in Armenia.

4. **Increase in tensions in the South Caucasus region in April 2016 as well as polarized debates linked to a security incident at a Yerevan police station in July 2016 have had implications for government policies.** There were renewed tensions in the South Caucasus region in April 2016, one of the worst escalations since 1994, but a ceasefire was brokered and the situation has remained calm up to the fall. In addition, armed members of an opposition group seized a police compound in Yerevan in mid-July demanding the release of their leader and the ouster of the government. Civilians joined rallies to support them, and these grew into street protests. The standoff ended with the surrender of the gunmen after two weeks and some casualties on both sides.

5. **To better manage the challenges facing the country, a new cabinet was appointed in early September 2016.** The new government presented to the Parliament its short-term priorities since parliamentary elections are scheduled for April 2017. Following the Constitutional referendum in December 2015, the country is moving from a semi-presidential to a parliamentary system. A new Electoral Code to facilitate the upcoming elections was approved by the Parliament and ratified by the President in May 2016.

6. **There are substantial risks to the proposed operation which will be managed through the Bank's close collaboration with the authorities, and strong monitoring.** Macroeconomic risks are high, as the Armenian economy could be affected by a further deterioration in global or regional economic conditions. Fiscal performance is likely to deteriorate significantly in 2016 because of lower revenue collections and higher execution of externally financed projects and significant fiscal consolidation will be needed in 2017 and thereafter. Declining commodity prices, increased financial market volatility, or a slower-than-expected recovery in Russia and the euro-zone could complicate an already difficult macro-financial outlook. The political and governance risk is substantial with upcoming Parliamentary elections in 2017. Institutional capacity risks are also substantial, and further measures will be required to strengthen the public administration. To manage these risks, the Bank and other development partners will continue to work in close collaboration with the government, provide technical and capacity-building assistance, and monitor the evolving macroeconomic and policy environment. The new government's reform program which was approved by the Parliament, is also designed to mitigate these risks by enhancing institutional capacity and strengthening the macroeconomic policy framework, while maintaining close engagement with development partners, including an ongoing Extended Fund Facility (EFF) arrangement with the IMF.

II. MACROECONOMIC POLICY FRAMEWORK

A. RECENT ECONOMIC DEVELOPMENTS

7. **In the first half of 2016, output expansion continued at 3 percent year-on-year, and was largely driven by strong external performance.** Increased exports, particularly to Russia and other traditional markets, supported growth in the first half of the year. Agricultural and alcoholic beverage exports to Russia increased significantly, partly helped by the sanctions against Russia and partly by other benefits accruing from the accession to the Eurasian Economic Union (EEU).[2] However, remittance inflows remained muted, adversely impacting aggregate demand and the contribution of consumption and investment to growth. The biggest decline was registered in construction which reduced by 7.2 percent in the first half of 2016 (year-on-year). In contrast, growth during the first half of 2016 was supported by mining and extractives and cultural, entertainment, recreational and transportation services. However, during July and August 2016, a slowdown in the economic activity index (an index to track the performance of the economy) was witnessed because of lower industrial output. The growth pattern in the current year is somewhat similar to that in 2015 which also benefited from higher exports of agri-products (largely to Russia) and copper (opening of a new copper mine) in addition to higher public consumption. More generally, economic growth over the past decade was mainly fueled by services, particularly, hotels and restaurants, financial services and entertainment and averaged 5.5 percent a year.

8. **Revenues continued to underperform in the first half of 2016 because of sluggish domestic demand, reduced imports and deflation.** Tax revenues were lower than budgeted because of decreased VAT collections from weak domestic demand and lower imports. At the same time, VAT refunds were higher because of strong export growth. The decline in VAT collections (8 percent in H1 2016, year-on-year, y-o-y) offset the increased revenues from personal and corporate income taxes (increase of 8 and 20 percent, respectively, y-o-y). In addition, the actual proceeds from the EEU common customs pool were less than expected because of the smaller than projected imports to the EEU markets (a decline of 17 percent in the first half of 2016, y-o-y). In response to lower revenue collections, the government rationalized spending and under-executed the budget resulting in a fiscal deficit of 1.7 percent of GDP, which was lower than budgeted but still 50 percent higher than the fiscal deficit in the first half of 2015. The fiscal deficit had widened significantly to 4.8 percent of GDP in 2015 from 2.1 percent in 2014, as a result of the fiscal stimulus which included increased spending on infrastructure investment, social protection, and public sector wages. With the increase in deficit, public debt reached 48.8 percent of GDP at end-2015.

9. **External performance remained strong in the first half of 2016, driven by increased exports and weak import demand.** The trend of improvements in external performance continued in the first half of 2016 with a current account deficit of 4 percent of GDP. Strong exports to traditional and non-traditional markets were sustained despite the difficult external environment. Higher exports were complemented with reduced imports because of a fall in gas prices and weak aggregate demand. The improved trade balance

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[2] Russia accounts for about 80 percent of remittances, 40 percent of FDI and 21 percent of Armenia's exports. In January 2015, Armenia formally became a member of the EEU. Armenia expects to benefit from higher customs revenues via the EEU revenue-sharing arrangement as well as greater access to Russia and other markets in the region. The customs union allows duty-free rates in merchandise between Armenia, Belarus, Kazakhstan, the Kyrgyz Republic, and Russia, but these do not apply to trade in services, investment, or public procurement. Armenia negotiated a number of concessions related to its EEU accession, but the influence of the process on its structural reform agenda is unclear. The country obtained a transition period of 5–7 years in which to achieve conformity with the EEU's common external tariffs, which will entail raising import taxes on over 800 types of goods. Armenia benefited from an estimated US$750 million to US$1 billion in natural gas price discounts in 2013 and 2015, and secured easier access to the Russian labor market and to bilateral concessional financing from Russia. EEU membership provides an important opportunity to boost exports, but improved competitiveness will be necessary to fully exploit its potential. Moreover, the deterioration of regional conditions has made it harder for Armenia to leverage its membership in the EEU to expand exports to Russia and Kazakhstan.

was the result of an import contraction of 4 percent in H1 2016, y-o-y, accompanied by an increase in exports of 17 percent, primarily of food products, precious/semi-precious stones and textiles. The main export destinations were Russia, EU and the middle-east, particularly Iraq and the United Arab Emirates. However, remittance inflows reduced by 10 percent to US$ 915 million during January to August 2016, year-on-year. FDI inflows during the first half of 2016 amounted to 1.9 percent of GDP, part-financing the current account deficit (CAD). The improvement in external performance continues from 2015 when the current account deficit narrowed sharply to 2.6 percent of GDP because of significant import contraction and increased copper and agri-exports.

10. **On the back of improved external accounts, the exchange rate of the dram against the US dollar has stabilized.** Armenia operates a managed floating exchange rate regime. In the first half of 2016, the real effective exchange rate depreciated by 3.6 percent bringing it close to its equilibrium value. Interventions in the foreign exchange market have been limited in recent months and the central bank has been a net buyer since March 2016, with a purchase of US$52 million, thereby, boosting international reserves. Foreign exchange reserves stood at US$ 1.7 billion at the end of August 2016 (5 months of imports).

11. **Inflation has been declining since mid-2015, with the dissipation of the pass-through effect of the dram's depreciation and lower food and fuel prices.** A continued decline in food prices, soft domestic demand, and low energy prices have brought down inflation, allowing the central bank to ease monetary policy. Inflation has remained below the 4 percent target of the CBA and as a result, since August 2015, the policy rate has been lowered seven times by a cumulative 3.75 percentage points, from 10.5 percent per annum to 6.75 percent in September 2016. Annual inflation (period average) in August 2016 stood at negative 1.6 percent. Reserve requirements for foreign exchange deposits were lowered from 20 to 18 percent while that on AMD deposits were maintained at 2 percent in September 2016. As a result, the effective reserve requirement is back to the pre-crisis level of 12 percent.

12. **The performance of the banking sector remains vulnerable but the banks are well-capitalized**. The nonperforming loan (NPL) ratio has steadily increased from 6.8 percent in December 2014 to 9.9 percent in July 2016. The banking system recorded losses each month from January 2015 to February 2016, finally recording a small profit in March 2016 which has been sustained till July. In January 2015 the CBA announced that the minimum capital requirement would increase from AMD 5 billion to AMD 30 billion, effective on January 1, 2017, to increase buffers, bolster the efficiency of the banking sector, and encourage the closure of weak banks or their merger with stronger banks. Sector-wide capital has steadily increased from a capital adequacy ratio of 16.2 percent in December 2015 to 17.8 percent in July 2016. As of September 15, 2016, 15 of Armenia's 19 banks had already met the new capital requirement and a contingency plan has been approved for those banks which will not meet the criteria by the deadline and it essentially envisages selling of liabilities. Meanwhile, the dollarization rates for bank deposits and loans declined to 63 and 60 percent, respectively. In the first half of 2016, credit growth has resumed with a 4 percent increase compared with December 2015 (credit contracted in 2015).

13. **According to the 2016 Doing Business survey results, Armenia was among the top performers in the ECA region last year and improved its ranking to 35 (out of 189 economies) from 38 the previous year.** This improvement is largely attributable to reforms it implemented in the following three areas: dealing with construction permits, trading across borders, and enforcing contracts. Armenia is among the 26 economies at the global level that implemented three or more reforms during the survey period. Improvements in dealing with construction permits advanced Armenia's score from DB 2015 to DB 2016. Reforms on trading across borders, supported by the current DPO series, led to reduced time and cost for documentation and border compliance, especially for trading with Russia after Armenia's accession to the EEU. The time for import border compliance was reduced from approximately 50 hours to 3 hours. Reforms aimed at enforcing contracts included a new law requiring that cases be assigned to judges randomly, and through a fully automated system, in courts throughout the country. Armenia retained its top

score on starting a business, for which it ranks fifth out of 189 economies. It takes only three days for an entrepreneur in Yerevan to start a business—the same time as in Denmark. This improvement was supported by the previous DPO series' policy action on creating a one-stop shop for business registration. Other areas where Armenia demonstrated sustained improvement is in registering property. It takes only seven days to register a property transfer compared to 48 days on average globally. The main areas where Armenia needs to improve include getting electricity (ranks 99), resolving insolvency (ranks 71) and dealing with construction permits (ranks 62), which although recently improved still requires significant streamlining.

Table 1: Macroeconomic Trends and Projections

	2011	2012	2013	2014	2015	2016	2017	2018
		Actuals			Prel.		Projections	
National income and prices								
Real GDP (percent change)	4.7	7.1	3.3	3.6	3.0	2.4	2.7	3.0
Gross domestic product (in millions of U.S. dollars)	10,142	10,619	11,121	11,610	10,529	10,671	10,846	11,335
Gross domestic product per capita (in U.S. dollars)	3,548	3,576	3,732	3,889	3,521	3,568	3,626	3,790
Consumer price index (percent change)	7.7	2.5	5.8	3.0	3.7	-1.4	1.6	3.5
Investment and saving								
Investment	27.0	22.8	20.7	20.8	21.0	21.3	21.8	22.1
Public	4.1	2.4	2.3	2.3	2.9	3.3	1.8	2.0
Private	22.9	20.3	18.5	18.6	18.0	18.0	20.0	20.1
National savings	16.6	12.8	13.4	13.2	18.3	18.4	17.8	19.5
Government operations								
Revenue and grants	22.1	20.9	22.2	22.0	21.5	20.8	21.8	22.0
Of which: tax revenue	16.7	17.0	21.0	21.1	20.1	19.5	20.2	20.5
Grants	1.5	0.4	0.2	0.3	0.6	0.6	0.6	0.4
Expenditures	25.0	22.4	23.8	24.0	26.4	26.7	24.6	24.2
Current expenditures	20.9	20.0	21.5	21.7	23.4	23.4	22.8	22.2
Of which: interest payments	0.9	0.9	1.0	1.3	1.5	2.0	2.2	2.0
Capital expenditures	4.1	2.4	2.3	2.3	2.9	3.3	1.8	2.0
Overall balance on a cash basis	-2.8	-1.4	-1.0	-2.1	-4.8	-5.9	-2.8	-2.2
Primary balance 1/	-1.9	-0.5	0.0	-0.8	-3.3	-3.9	-0.6	-0.2
External sector								
Exports of goods and services	27.0	27.5	28.4	28.6	29.8	31.7	33.1	33.9
Imports of goods and services	48.5	48.3	49.2	47.3	42.0	40.6	43.1	42.2
Net remittances 2/	17.4	18.0	19.4	17.4	13.5	12.3	12.3	12.1
Current account	-10.4	-10.0	-7.3	-7.6	-2.7	-2.9	-4.0	-2.6
Foreign direct investments, net	4.3	4.5	4.3	3.3	1.6	2.5	3.8	3.1
Change in gross international reserves (in millions of US dollars)	3	-70	454	-764	282	140	27	156
Gross international reserves (in months of next year's imports) 3	4.4	3.9	4.9	4.0	4.9	4.9	4.9	5.1

Sources: Armenian authorities and Bank and Fund staff calculations

1/ Excludes interest payments from expenditure.

2/ Net transfers of individuals sent to and received from abroad through Armenian commercial banks.

3/ Gross international reserves in months of next year's imports of goods and services, including the SDR holdings.

B. MACROECONOMIC OUTLOOK AND DEBT SUSTAINABILITY

14. **Growth is likely to bottom-out in 2016 and pick up modestly over the medium-term but downside risks remain.** Growth is projected at 2.4 percent in 2016, largely supported by external demand but dragged down by a deceleration in industrial output. The index of economic activity declined from 4.8 in the first 6 months of 2016 to 2.4 during the first 8 months, largely explained by lower growth in extractives and mining and other manufacturing. The growth in services also decelerated because of weaker aggregate demand in light of the recent political uncertainty. Over the medium-term, the recovery of the global economy, including base metal prices, is expected to boost Armenia's growth, but only moderately

(Table 1). The lifting of sanctions against Iran creates a window of opportunity for Armenia as does the possibility to create a transit corridor for goods and services between Iran and Russia/Europe. However, downside risks remain, especially if the external environment deteriorates further and domestic tensions escalate in the run-up to the April 2017 elections. The performance of both Russia and the EU, Armenia's main trading partners, will impact growth going forward. Achieving higher rates of growth will require the government to address the structural weaknesses in the economy like the performance of the energy sector, competitiveness and the overall business environment. The structural reforms envisaged over the medium-term include increased commercialization of agriculture, reforms in utilities (water, irrigation and energy) to improve their quality, reliability and financial sustainability, and further improvements in the business environment, particularly the insolvency framework. The unified tax code is also likely to help.

15. **The fiscal deficit is likely to increase to 5.9 percent of GDP in 2016 because of lower revenue collections and higher externally financed capital expenditures, some of which were not included in the 2016 budget.** Tax revenues are likely to underperform during 2016 because of sluggish growth and weak imports. Compared with 2015, total tax collections are likely to be lower by 0.6 percent of GDP while expenditures will be higher because of larger capital outlays, including those for military equipment, by 0.4 percent of GDP. The increased capital spending is primarily because of the following projects: faster execution of the Asian Development Bank's (ADB) North-South Road Project, the M6 road project by ADB and the European Investment Bank (EIB) which was not included in the 2016 budget, an Organization of Petroleum Exporting Countries (OPEC) funded rural project which was also not a part of the 2016 budget and acquisition of military equipment (financed by Russia) in response to the April escalation in the South Caucasus region. All the externally financed projects have financing sources tied to the expenditures being undertaken, and the over-execution comes after several years of under-execution and efforts aimed at improving related capacity problems. In addition, neither the decline in revenues, nor the increased spending is the result of policy changes or reversals. However, it is clear that the government needs to exercise better control over externally financed projects and the IMF is discussing a structural benchmark indicator to ensure that externally financed projects are executed in accordance with the budget. As a result of lower revenues and higher spending in 2016, the fiscal deficit will increase significantly resulting in public debt in excess of 50 percent of GDP (Table 2), which would trigger the fiscal rule. The fiscal rule in Armenia states that if public debt exceeds 50 percent of GDP, the fiscal deficit for the next year would be reduced to 3 percent of the average nominal GDP of the previous three years. As a result, the government will need to reduce its deficit from 5.9 percent of GDP in 2016 to 2.8 percent of GDP in 2017.

16. **The lower deficit in 2017 will be achieved primarily through cuts in capital spending and increased revenues.** The 2017 budget of the government (which has been submitted to the Parliament and is publicly available) envisages a reduction in capital expenditures by 1.5 percent of GDP and a decline in current spending by 0.6 percent of GDP. An increase in revenues is likely to add 1 percent of GDP, helping the government reach its target deficit. The government has outlined the following measures in the budget that was submitted to the Parliament: (i) Increased revenues from higher excise on alcohol and tobacco, introduction of dividend taxation for non-resident persons, introduction of state duties on lotteries/online gaming, bringing into the tax net unregistered employees (from super markets, production companies and others by requiring the employers to register their employees and sign the contract before the employees come on board), expansion of electronic filing and e-declaration systems, improvement of VAT refund system and other improved tax administration measures (1 percent of GDP); (ii) Reduction in recurrent spending by 0.6 percent of GDP through a reduction in agriculture, water and irrigation subsidy (AMD 4.7 billion), lower health spending through improvements in the procurement process to buy drugs (AMD 1.6 billion), reduced bonus payments (AMD 2.2 billion), other reductions in public administration costs like the cost of vehicles, telecommunications and the like (AMD 1.8 billion), lower spending by local governments as there will be no election related expenditures in 2017 (AMD 1.3 billion) and other measures; and (iii) Lower capital expenditures, both self- and IFI-financed (1.5 percent of GDP). The Medium-Term Expenditure Framework which was approved by the government in July 2016 also adheres to the fiscal rule. Over the medium-term, the fiscal position is expected to improve as revenues recover and current spending

is restrained. Public investment bore the brunt of the post-crisis fiscal consolidation and is bearing the brunt this time around as well. Tax revenues are projected to recover in the medium-term as some revenue-enhancing policy provisions of the Unified Tax Code will help (notably, rationalizing the VAT threshold, introducing dividend taxation, and increasing the excise rates on hydrocarbons, alcohol and tobacco). Public debt is expected to reach 54.7 percent of GDP in 2016 and remain at an elevated level over the medium-term. Fiscal consolidation going forward will be crucial to provide the room to undertake countercyclical fiscal policy if need be and also keeping in mind the rising public debt level. In addition, there is need to increase capital spending without jeopardizing fiscal sustainability.

Table 2: Key Fiscal Indicators

	2011	2012	2013	2014	2015	2016	2017	2018
	Actuals				Prel.	Projections		
Overall Balance on a cash basis	-2.8	-1.4	-1.0	-2.1	-4.8	-5.9	-2.8	-2.2
Primary balance 1/	-1.9	-0.5	0.0	-0.8	-3.3	-3.9	-0.6	-0.2
Total Revenues and grants	22.1	20.9	22.2	22.0	21.5	20.8	21.8	22.0
Tax revenues	16.7	17.0	21.0	21.1	20.1	19.5	20.2	20.5
Taxes on goods and services	9.0	9.1	9.3	9.3	8.6	7.7	8.4	8.8
Direct Taxes	5.9	6.0	9.3	8.7	8.3	8.8	8.8	8.9
Taxes on international trade	0.9	1.0	1.0	1.0	1.2	1.0	1.0	1.0
Other taxes	0.9	0.9	1.4	2.1	2.0	2.0	2.0	1.8
Social insurance contributions	3.3	3.0	0.4	0.1	0.2	0.3	0.3	0.5
Non-tax revenues	0.6	0.5	0.6	0.6	0.7	0.5	0.8	0.5
Grants	1.5	0.4	0.2	0.3	0.6	0.6	0.6	0.4
Expenditures	25.0	22.4	23.8	24.0	26.4	26.7	24.6	24.2
Current expenditures	20.9	20.0	21.5	21.7	23.4	23.4	22.8	22.2
Wages and compensation	5.0	4.6	4.7	5.2	5.9	5.9	5.6	5.3
Goods and services	2.5	3.1	3.1	2.3	2.5	2.3	2.3	2.2
Interest payments	0.9	0.9	1.0	1.3	1.5	2.0	2.2	2.0
Current transfers	6.8	6.7	6.5	6.9	7.3	7.4	7.2	6.9
Pensions	4.9	4.6	4.4	4.5	4.9	4.9	4.6	4.5
Social assistance	1.8	2.1	2.1	2.4	2.4	2.6	2.6	2.4
Capital expenditures	4.1	2.4	2.3	2.3	2.9	3.3	1.8	2.0
General Government Deficit Financing	2.8	1.4	1.0	2.1	4.8	5.9	2.8	2.2
External (net)	1.1	1.3	1.9	0.5	4.1	3.1	1.7	0.6
Domestic (net)	1.7	0.2	-1.0	1.6	0.7	2.8	1.1	1.6
Functional classification								
General services	3.5	3.2	3.6	3.9	4.3	5.4	5.1	4.9
Defense	3.9	3.6	4.0	3.9	3.9	4.0	3.9	3.9
Public order and safety	1.9	1.8	2.0	2.2	2.4	2.4	1.9	1.8
Economic affairs	2.2	1.7	2.8	1.7	2.2	2.2	1.7	1.6
Health	1.7	1.5	1.4	1.6	1.7	1.7	1.6	1.6
Education	2.8	2.4	2.3	2.4	2.4	2.4	2.4	2.4
Cultural, sports, recreational, religious	0.5	0.5	0.4	0.4	0.6	0.5	0.5	0.4
Social protection	6.8	6.8	6.5	7.1	7.6	7.6	7.6	7.6

Sources: Armenian authorities and Bank and Fund staff calculations

1/ Excludes interest payments from expenditure.

17. **The Unified Tax Code, supported by this operation, helps address shortcomings in the tax system and increase the fiscal space for growth-enhancing capital investment and social spending.** The Unified Tax Code is a commendable step forward in tax policy reform, as it unifies and harmonizes what were previously two different sets of tax laws, bringing them together into a single Code. The new

Code will reduce the risk of rule duplication and, more importantly, of inconsistencies across different tax laws. Furthermore, by revisiting the level and structure of income taxes, reducing the number of exemptions and tax gaps, increasing excise taxes and strengthening coverage of high-wealth individuals and large companies, the Code will lead to higher revenue mobilization in the medium-term. The new Code strives to shift the tax burden towards consumption while also reducing tax expenditures by eliminating some VAT and income-tax exemptions and incentives. Preliminary estimates by the government suggest that, when implemented, the approved Code would result in additional revenues of 1.9 percent of 2015 GDP between 2018 and 2021. Improvements in tax administration could help increase revenues further.

18. **The current account is expected to remain in deficit in the medium-term, albeit, lower than the pre-2014 levels.** The deficit is projected at 2.9 percent of GDP in 2016, on the back of increased exports of agri-products, textiles and precious stones and continued sluggishness in import demand. The latter is the result of subdued remittances along with lower import prices for energy and food. In 2017, imports are likely to pick-up because of the investment in the new gold mine, thereby, widening the CAD to 4 percent of GDP. Exports from the gold mine are expected to narrow the CAD in 2018 and boost exports in the outer years. While a combination of FDI inflows and debt will continue to finance the current-account deficit, the Armenian economy will remain vulnerable to possible tightening of global credit conditions, particularly in the longer-term when the Eurobonds need to be rolled over. This may require the authorities to seek alternative sources of financing (Table 3). The authorities remain committed to exchange rate flexibility to build external buffers.

19. **The impact of Brexit is not likely to be significant on the Armenian economy.** Armenia's exports and imports to the United Kingdom (UK) are less than 1 percent of the total. Remittances from the UK into Armenia are negligible and financial linkages are weak. However, UK accounts for about 10 percent of FDI inflows which could be affected. In addition, lower growth in the EU could weaken export demand as the EU accounts for 27 percent of Armenia's exports. There are also ramifications for global growth and commodity prices which could affect Armenia adversely.

Table 3: Balance of Payment Financing Requirements and Sources

	2012	2013	2014	2015e	2016p	2017p	2018p
	Actuals				Projections		
	(In millions of USD)						
Financing requirements	**1088**	**1350**	**924**	**541**	**391**	**537**	**420**
Current account deficit	1058	813	883	279	312	430	292
Debt amortization	30	537	41	262	79	107	128
Financing sources	**897**	**1652**	**953**	**841**	**393**	**536**	**419**
FDI and portfolio investment (net)	482	466	346	139	237	378	318
Capital grants	108	84	70	65	78	88	88
Debt disbursements	255	914	257	898	396	283	313
Other capital	34	832	-371	30	-289	-256	-80
Change in reserves	70	-454	764	-282	-140	-27	-156
IMF credit (net)	-52	-190	-113	-9	-33	-52	-64
IMF EFF	0	0	0	0	44	22	0
EFSD	0	0	0	0	100	100	0
Errors and Omissions	191	-302	-33	-300	0	0	0

Source: Armenian authorities; and Bank and Fund staff estimates and projections.

20. **According to the IMF's debt sustainability analysis (DSA), Armenia's public debt remains sustainable, although risks are higher.** The public debt is projected to increase to about 57 percent of GDP in 2018-19, before it starts declining in response to fiscal consolidation. However, it is likely to remain

above 50 percent of GDP over the medium-term. Gross financing needs are likely to average at 7 percent of GDP per year over the medium-term and will peak in 2020 to 11 percent because of the repayment of Eurobonds. Short-term debt accounts for only 1 percent of the total debt. The high share of external debt (87 percent) is a source of vulnerability but the risk is partially mitigated by the fact that it is largely owed to official creditors and is at fixed interest rates. Alternative scenarios and stress tests indicate that an adverse growth shock would have the largest impact on debt dynamics and government financing needs (Table 4 and Figure 1).

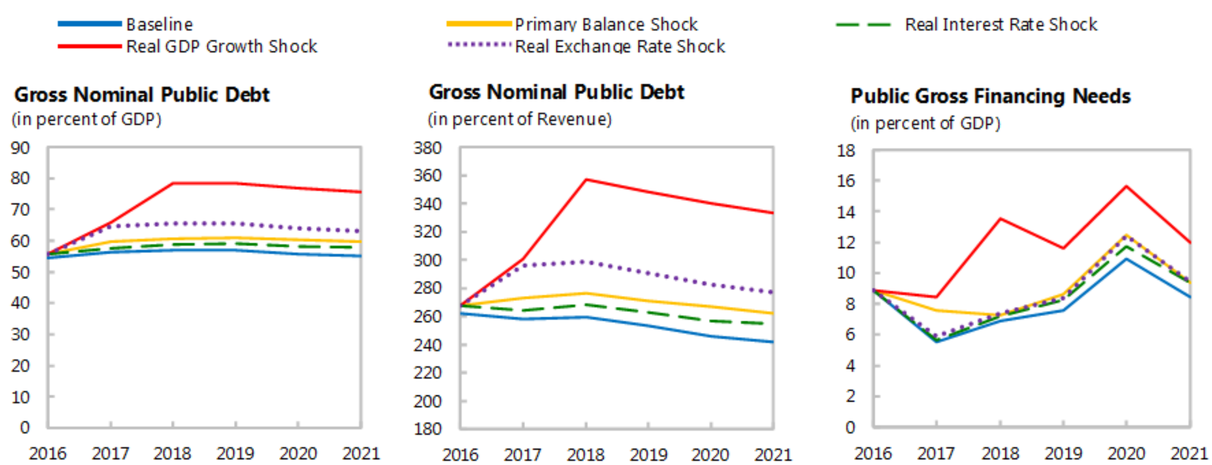
21. **The overall (public and private) external debt increased significantly from 71.3 percent of GDP in 2014 to 84.5 percent in 2015 largely because of the exchange rate depreciation.** It is likely to remain above 80 percent of GDP over the medium-term. External debt remains sensitive to shocks in growth, non-interest current account and real exchange rate depreciation. The large share of concessional debt in the country's external debt stock however provides cushion to interest rate shocks. The large holders of private external debt include a mining company, a food processing company and commercial banks. A significant share of the private sector debt is from IFC, EBRD and direct credits by other donors which minimizes risk.

Table 4: Debt Sustainability Analysis

	2011	2012	2013	2014	2015	2016p	2017p	2018p
	Actuals					Projections		
				(In percent of GDP)				
Total public sector debt	42.0	41.2	40.8	43.6	48.8	54.7	56.4	56.9
External public sector debt	36.5	35.3	34.8	37.6	42.4	46.5	47.7	46.0
Domestic public sector debt	5.5	5.9	6.0	6.0	6.4	8.2	8.7	10.9
Gross external debt	71.5	70.2	78.1	71.3	84.5	87.8	89.2	85.7

Source: IMF debt sustainability analysis.

Figure 1: Public Debt Sustainability Analysis Charts



*Source:*IMF Debt Sustainability Analysis.

22. **The overall macroeconomic policy framework is adequate for this operation.** Sustaining growth in a difficult external environment and with limited fiscal space is one of the key challenges facing the government of Armenia. To ensure that there is adequate fiscal space for critical capital investments and poverty-reducing social spending, increased tax revenue mobilization will be necessary over the medium-term. The implementation of the Tax Code is therefore a key priority. Maintaining fiscal and debt

sustainability will also be a critical priority going forward given the recent increases in the fiscal deficit. Dollarization, a structural feature of the financial system, poses a risk to financial stability. These risks are mitigated by the government's demonstrated commitment to sound macroeconomic management and a medium-term structural reform program rooted in strong donor support. The macro-fiscal framework is anchored by the IMF program, which remains on track.

C. IMF RELATIONS

23. **The IMF Extended Fund Facility (EFF) program was launched in Armenia in March 2014 and the fourth review is likely to be concluded in December 2016.** The EFF provides access to SDR 82.21 million over a period of 38 months. Its key objectives are to maintain stability, increase buffers against external shocks, and support growth through sound tax reforms, robust crisis preparedness and management frameworks, the introduction of a financial rehabilitation plan for the electricity sector, and structural reforms designed to enhance competition, competitiveness, and regional and global integration. The first, second and third reviews were concluded in December 2014, November 2015, and June 2016, respectively. The preparation of the DPO series has been closely coordinated with the IMF, particularly on the macroeconomic framework, debt sustainability, fiscal consolidation, tax policy, public sector management, and electricity tariff reforms. The adoption of the Unified Tax Code was a prior action for the IMF EFF as well.

III. THE GOVERNMENT'S PROGRAM

24. **The government's reform program is detailed in the ADS, its national development strategy for 2014–25, which primarily aims at increasing job creation.** The strategy, approved in April 2014, regards employment as the engine for improving living standards and reducing poverty, and it targets the creation of 350,000 new jobs in the non-agricultural sectors by 2025. The ADS is built on four pillars: creating jobs, developing human capital, strengthening social protection, and modernizing the public sector. Its priorities include:

(i) Investing in infrastructure and improving the maintenance of existing assets (e.g. the utility, irrigation, transportation, and energy networks).

(ii) Increasing the effectiveness of the social protection system through enhanced targeting of the Family Benefits program, other social assistance programs, and pensions.

(iii) Strategically reallocating public spending to enhance human capital formation and build workforce skills through improvements in healthcare, education, and the promotion of science and cultural activities.

(iv) Improving environmental sustainability, particularly in the mining sector.

(v) Strengthening and modernizing the public administration through e-governance, inspection reform, local governance initiatives, public financial management, civil service development, anti-corruption efforts, and justice, public order, and security sector reform.

(vi) Expanding employment in high-productivity, well-paying sectors by:

- Increasing productivity and encouraging employment growth, particularly in export-oriented activities;
- Enhancing external competitiveness by improving the business climate, ensuring fair competition, and promoting economic diversification;
- Expanding access to credit, especially among SMEs; and
- Reinforcing macroeconomic stability through improved revenue mobilization.

(vii) Providing direct support to high-potential sectors, including industry and export promotion, tourism, information technology, and modern agriculture.

25. **The reforms in the proposed DPF are well aligned with those in the ADS.** They include measures to maintain macroeconomic stability, increase competitiveness, improve infrastructure, enhance social protection and protect the environment. They fully support the government's emphasis on jobs, social protection and an improved public sector.

IV. THE PROPOSED OPERATION

A. LINKS TO THE GOVERNMENT'S PROGRAM AND OPERATION DESCRIPTION

26. **The proposed operation is fully aligned with the government's development strategy (ADS).** The DPO series supports reforms under Pillars 1, 3, and 4 of the ADS— creating jobs, strengthening social protection, and modernizing the public sector —which are underpinned by macroeconomic stability and fiscal sustainability. The proposed policy actions were identified based on the World Bank's policy dialogue with the authorities, existing analytical work, and ongoing technical assistance (Figure 2).

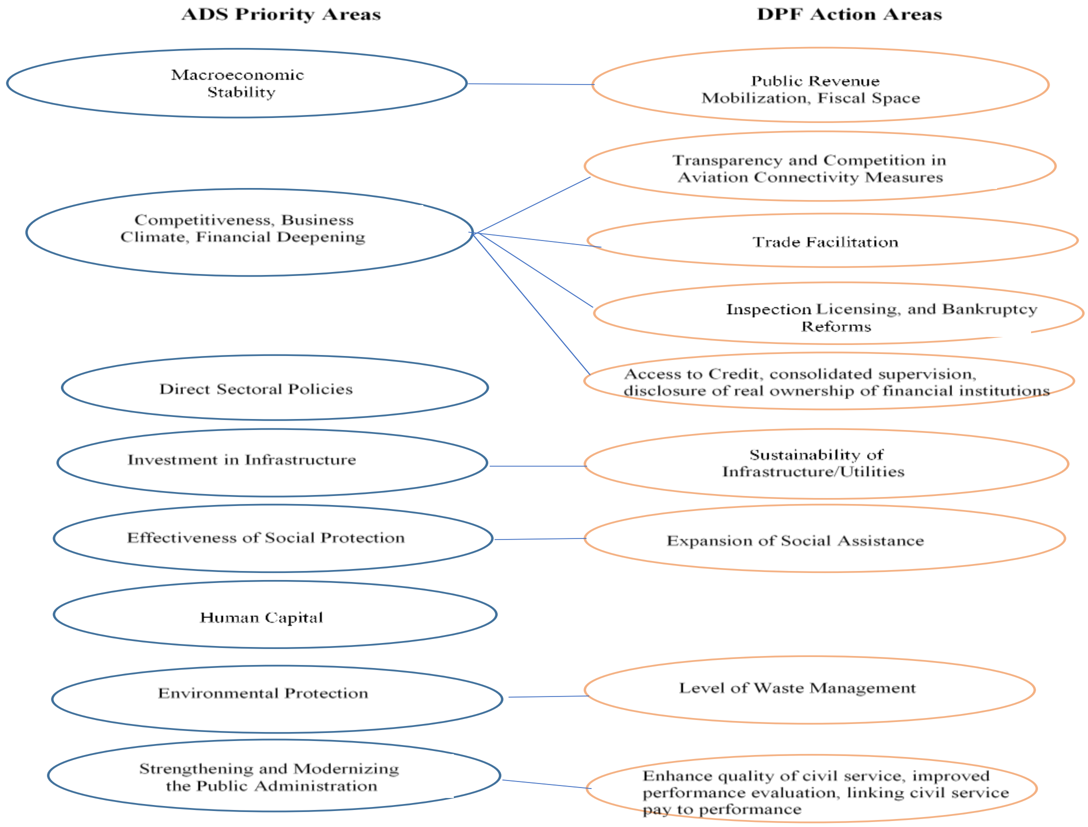
27. **The policy actions supported by this DPF target the government's key development challenges.** An improved tax code will help increase revenue mobilization and will contribute towards overall macro-fiscal sustainability. Policies supporting reforms in licensing, bankruptcy, consolidated supervision and disclosure of real ownership of financial institutions will improve the competitiveness of the economy and help create more and better jobs and also reduce poverty. In addition, linking the pay of civil servants to the strengthened performance appraisal system will help improve public administration.

28. **The DPF series is based on a longstanding partnership between the Bank and the Government of Armenia and builds on previous operations.** It furthers reforms supported by the previous DPO series (2009–12) through follow-up measures and complementary reforms. The previous series focused on mitigating the effects of the global financial crisis by strengthening the government's fiscal stance and reinforcing social safety nets. Reforms supported by the previous series included improvements in the business environment through a fortified financial sector, reduced costs of business registration, and improvements in information and communication technology. The operation helped the poor through reforms in the social protection system and improvements in education and health. It also supported improved public sector efficiency through reforms in the areas of tax, customs, public expenditure management and prevention of conflict of interest in public service. The current series builds on many of these areas which will help to maintain macroeconomic stability and create jobs.

29. **The proposed operation reflects the lessons learned from past engagements in Armenia through policy-based support.** Between 2009 and 2012, a programmatic DPO supported reforms to increase Armenia's resilience to vulnerabilities following the 2008–09 economic crisis, while strengthening competitiveness for post-crisis growth. Based on the Implementation Completion Report (ICR) for the previous DPO series, several key lessons can be identified. First, meaningful reform is typically longer term, and needs to be supported through consistent policy dialogue, outreach, and technical assistance. For example, the mining code was developed under the previous DPO series but the ongoing operation continues to support the sector. Second, outreach efforts can be effective in overcoming opposition to crucial reforms as was the case with the conflict of interest law. Third, a well-designed DPF can be used to garner additional donor resources, as was the case with the previous DPO series, which has led to complementary and coordinated funding and technical assistance from the Asian Development Bank, the European Commission, the Eurasian Development Bank, and the United States Agency for International Development. Fourth, the longer term nature of critical structural reforms suggests that result indicators need to be attributable, monitorable, and of the appropriate level of ambition. During the current DPF series,

legislative amendments were passed on environmental impact assessment, inspections, aviation, secured transactions, waste management, and social assistance. The Bank team also found appropriate formats for engaging with the Parliament on legal amendments (such as the secured transactions legislation and the Unified Tax Code) and participated in parliamentary hearings to consult on reform design and share international experience.

Figure 2: Link between ADS and DPF Measures



Source: World Bank

B. PRIOR ACTIONS, RESULTS, AND ANALYTICAL UNDERPINNINGS

30. **Some modifications have been agreed to in the policy and results matrix in response to specific sectoral developments and the political calendar.** Despite these modifications, the strength of the overall package has been maintained (Table 5:).

Table 5: Changes in the DPF-4 Policy and Results Matrix

Original	Revised	Reason
	DPF4 Prior Actions:	
Mining Code: The Borrower adopts the amendments to the Mining Code and develops regulations consistent with the Amendments to the Law on Waste Management as	The Borrower has enacted the amendments to the Mining Code consistent with the Law on Waste Management as applicable to the mining sector.	The amendments to the Mining Code required amendments to other related legislation as well like the Law on Waste Management and the Law on Natural Resource Consumption Fee. During the process, it also became clear that about 20 sub-regulations were needed rather than the earlier estimated 6. As a result, the legislative

Original	Revised	Reason
applicable to the mining sector.		amendments took much longer and more time will be needed to adopt the relevant mine waste management regulations, which also require public consultations. Therefore, this prior action has been amended accordingly and the timeline for the adoption of the regulations will be specified in the government's 'Letter of Development Policy' – July 2017.
Civil service: The government links pay awards to civil servants' performance using the strengthened performance appraisal system.	The Borrower has approved regulations to: (i) improve the mechanism for evaluating the performance of civil servants, and (ii) link bonus payments to performance in line with the Law on Civil Service.	The government wanted to add further improvements to the performance evaluation system to the existing prior action on linking bonus payments to performance. This was agreed to by the World Bank team.
Real ownership of financial institutions: Parliament approves legislative amendments to enforce disclosure of real ownership of financial institutions and groups. The government and Central Bank of Armenia (CBA) approve revised regulations to support these amendments.	The Borrower, through the CBA, has approved regulations to ensure disclosure of ultimate beneficial ownership of financial institutions and groups.	There is a minor gap in the legal framework in Armenia which currently does not require the identification and assessment of ultimate beneficial owners as part of the licensing process for universal credit organizations (UCOs). But this is a minor gap since (i) UCOs don't take deposits; (ii) UCOs are very small, and banks have little or no exposure to them; and (iii) CBA can require disclosure of UCOs' beneficial owners immediately after licensing. Since this policy action can be supported through a change in the regulations, the World Bank team agreed to do away with the requirement of Parliamentary approval.
Results:		
Tax revenues: Increase in tax to GDP ratio from 17 percent in 2012 to 20.8 percent in 2017.	Increase in the tobacco and alcohol excise collections from 0.72 percent of GDP in 2015 to 0.88 percent of 2015 GDP in 2017.	The Unified Tax Code has been approved by the Parliament in October 2016 and all provisions of the Code, barring the increase in excise collections for tobacco and alcohol, will come into effect from January 2018. Hence, the result indicator was changed to make it attributable to the policy actions supported by the DPF.
Irrigation: Reduction in irrigation subsidies by 5% in the 2017 budget compared with the 2015 budget.	Increase in the number of water user associations (WUAs) which are self-financing from 0 in 2015 to 5 in 2017.	One of the primary ways to improve the financial sustainability of WUAs is to restructure their debts from previous years, and ensure that they operate without accumulation of new debt. Another way of bringing efficiency into the system is to use data from the supervisory control and data acquisition (SCADA) compatible water measurement devices and require WUAs to calculate their revenues based on these actuals. This will improve their financial performance. An eventual reduction in subsidy will happen but will take a longer period of time – hence the result indicator has been changed accordingly.
Mining: Percent of mining companies with licenses in compliance with the new Law on Waste Management to increase from zero to >25%.	All new mining licenses to be in compliance with the amended Law on Waste Management and the new provisions of the Mining Code.	With the approval of the latest amendments to the Mining Code, it is expected that all new mining licenses that are issued to companies would be in compliance with the Law on Waste Management. For existing mining companies, a period of 5

Original	Revised	Reason
		years, from the adoption of the amendments to the mining code, will be provided within which they will have to adhere to the requirements of the new law.
Licenses: The number of activities requiring licenses to reduce from 95 in 2012 to 81 in 2017.	The number of applications approved through the simple notification mechanism to increase from zero in 2012 to 35 in 2017.	The prior action and the original result indicator were capturing the same data. Hence, this result indicator was changed. The new indicator envisages that at least 35 applications by businesses under these 17 low-risk activities will be approved through the simple notification mechanism.
Civil service: Share of external applicants in competitions for professional civil service positions to increase from 5 to 5.5 percent.	Reduction in the average value and standard deviation of performance appraisal scores of civil servants from 95 and 3 to 90 and 5, respectively.	The new indicator better captures the results from the prior actions. The earlier one was much more narrowly focused on one aspect of the civil service reforms and was therefore changed.
Credit Registry: Number of credit reports on individuals issued in line with the Law on Secured Transactions to increase from zero to 75,000.	Number of credit reports issued to increase from 1.2 million to 4.5 million.	This result indicator pertains to actions undertaken in DPF1 and the wording of the indicator changed in DPF3. Since the Law on Secured Transactions governs the pledge registry and not the credit registry/bureau, the original result indicator has been reinstated as it was in the DPF1 and DPF2 documents with an updated baseline and target value.
Consolidated supervision: Number of consolidated audits carried out by the CBA to increase to 50 percent.	CBA to carry out at least one consolidated audit during 2017.	It is unlikely that 50 percent of the financial groups would go through a consolidated audit in 2017 alone. Hence, the prior action was changed to achieve a more realistic indicator.

Pillar I: Promoting Fiscal, Social, and Environmental Sustainability

31. **The three policy actions supported by this operation under the first pillar focus on fiscal and environmental sustainability.** These policies aim to expand the fiscal space through increased revenue collections and reduced subsidies and also support better management of environmental resources.

Fiscal

Prior Action 1: The Borrower has enacted the Unified Tax Code including measures to enhance revenues, improve the efficiency, transparency and equity of the tax system and strengthen tax administration.

32. **At 20 percent of GDP, Armenia's tax collections are lower than in Georgia, Moldova, and Macedonia—regional comparators with similar per capita income levels.** This has constrained Armenia's ability to provide adequate social protection and invest in the human and physical capital necessary for growth and job creation. Moreover, the risks to the fiscal framework are on the downside, given high public debt levels, low rates of public investment, and modest medium-term growth projections. The 2014 public expenditure review on Armenia estimated the tax gap to be in the range of 4-6 percent of GDP. Consequently, strengthening tax revenues is a priority of DPF-4 and is being pursued through the enactment of the Unified Tax Code.

33. **The Unified Tax Code brings together all pieces of tax legislation in Armenia in a coherent manner and aims at expanding the tax base, rationalizing tax rates, and closing major loopholes in the existing tax legislation.** The new Code will address issues related to complex, unsystematic, and

occasionally contradictory tax regulations, which reduce collection efficiency, skew the distribution of the tax burden, and create uncertainty for businesses and households. The development of a Unified Tax Code encompassing both policy and administration is expected to improve transparency, facilitate supervision, and support effective enforcement over the medium-term. It includes measures which aid revenue enhancements and efficiency improvements. It is also a major step towards facilitating Armenia's medium-term fiscal consolidation program and improving the country's business environment. The current operation supports the adoption of the Unified Tax Code by the Parliament.

34. **The World Bank provided three main sets of comments on drafts of the Code shared by the government in end-March 2016 and agreement was reached on all three of them.** These included: (i) introduction of a personal income tax (PIT) exemption threshold; (ii) inclusion of large agricultural establishments (which are subject to value added tax–VAT) in the corporate income tax net; and (iii) reduction in the number of VAT exemptions. After several rounds of discussions, it was agreed that the government would not introduce a PIT exemption threshold because revenue losses arising from such a measure would put fiscal sustainability in jeopardy. However, large agricultural establishments would be included in the CIT net from January 1, 2025. The government agreed to the removal of VAT exemption on diesel fuel (which is estimated to generate additional revenues of 0.2 percent of 2015 GDP), and also reviewed the outstanding list of VAT exempt items. However, given the political resistance to the tax code in general and the VAT exemptions in particular, it agreed to eliminate only three VAT exemptions which are not very significant.[3]

35. **With strong opposition to certain provisions of the tax code, some articles were changed but the overall tax code is still a big improvement over the status quo.** The (additional) revenue impact of the approved tax code is 1.9 percent of 2015 GDP (with all the changes) compared with the earlier 2 percent of 2015 GDP. Given the larger benefits accruing from a Unified Tax Code which is significantly better than the status quo, the Bank and Fund teams support the amended Code, which was approved by the Parliament in early October 2016. The government, introduced the following changes to the tax code after the first reading: (i) The existing PIT rates and thresholds of 23 percent (for incomes up to AMD 120,000), 28 percent (for incomes between AMD 120,000 and AMD 1 million), and 33 percent (for incomes above AMD 1 million) were changed to 23 percent (for incomes up to AMD 150,000), 28 percent (for incomes between AMD 150,000 and AMD 2 million) and 36 percent (for incomes above AMD 2 million). The revenue loss on account of this change is estimated at AMD 1.5 billion (0.03 percent of 2015 GDP); (ii) The VAT threshold of AMD 40 million (starting from January 2019) has been raised to AMD 58.35 million resulting in revenue losses of AMD 3 billion (0.06 percent of 2015 GDP); (iii) For residents, withheld dividend taxes (at the rate of 5 percent) would be reimbursed if the dividend is reinvested in a company's statutory or equity capital. The estimated size of the annual reimbursement is AMD 0.5 billion (0.01 percent of 2015 GDP); (iv) The excise tax on tobacco would be reduced to 15 percent or a nominal amount (AMD 6,725 per thousand sticks in 2017 which will increase to AMD 11,070 by 2021), whichever is higher. The earlier draft of the tax code envisioned an excise rate of 25 percent in 2017 with a provision to increase it every year, leading up to 44 percent by 2021, with a similar nominal amount. The government estimates this measure to be revenue neutral; and (v) Accelerated depreciation on investments which will result in a revenue loss of AMD 8.8 billion (0.2 percent of 2015 GDP). The overall loss in revenues from the above measures is estimated at AMD 13.8 billion or 0.3 percent of 2015 GDP. In order to offset these losses, the government has proposed measures like an increase in the taxation on gaming (excluding casinos), removal of VAT exemption on tourism, and some tax administrative measures which will increase revenues by

[3] The 3 exemptions include (i) the supply of goods and services paid for by the funds provided for the preparation of loans or grants from international financial institutions; (ii) the proceeds from the sale of ownerless, inherited by the state, valuables and treasures; and (iii) the provision of goods and services by budgetary institutions to the extent that these revenues are accrued to the state and municipal budgets. If all the World Bank recommended VAT exemptions had been removed, the impact on revenues would have been 0.18 percent of 2015 GDP.

AMD 11.5 billion resulting in a net loss of AMD 2.3 billion (0.05 percent of 2015 GDP). Majority of the provisions of the Unified Tax Code will come into effect from January 1, 2018 with the exception of excise collections for tobacco and alcohol which will come into effect in January 2017.[4] The excise tax rate on alcohol and tobacco will be increased by 15 percent in 2017. As a result, the increase in excise collections will be monitored in the result indicator.

Result: The expected result of the policy actions related to the Unified Tax Code is to increase the tobacco and alcohol excise collections from 0.72 percent of GDP in 2015 to 0.88 percent of 2015 GDP in 2017.

Infrastructure

Prior Action 2: The Borrower has approved the 'Strategy to Improve Financial Sustainability of the Armenian Irrigation Sector' including measures to sustainably improve cost recovery and service delivery in the sector and reduce its reliance on public subsidies.

36. **Agriculture in Armenia is heavily dependent on irrigation.** More than 80 percent of the gross crop output is produced on irrigated lands. Returns are higher on irrigated lands. Water user associations (WUAs) play an important role in agricultural water management. Currently, there are 37 WUAs responsible for about 195,000 hectares (out of a total of 208,000 hectares of irrigable land in Armenia). On average, these WUAs in Armenia are big and they have 3000-4000 water users and irrigate about 4000 hectares or more in their command area. Since WUAs became operational, water supply has improved, the collection of water fees has increased, and there is an increasing conversion from low-value crops (e.g., wheat) to higher value crops (e.g., fruits and vegetables). However, water user associations are not yet financially sustainable and continue to depend on state subsidies. In addition, agricultural water management is still subject to other inefficiencies like the widespread use of high-lift pump irrigation systems built during Soviet times which are now uneconomical due to high energy costs.

37. **The irrigation sector is one of the largest recipients of budget subsides (0.12 percent of GDP in 2015) and has relied on the government to close its operational deficit.** In an environment of constrained fiscal space, this operation supports the government's efforts at making the sector operationally and financially viable and improving irrigation service delivery. This is being achieved through the adoption of a strategy which includes a medium-term action plan with specific measures to be achieved by specific dates. The action plan is focused on increasing the efficiency of irrigation service delivery which will ultimately reduce state subsidies to the sector. The strategy along with the action plan is publicly available. The Strategy envisages increase of irrigation water fees starting from 2019 by AMD 0.5 each year. This measure, along with other actions, proposed in the medium-term action plan, which is an annex to the strategy, can eventually bring down state subsidies by half. However, irrigation subsidies will not be eliminated because there will always be some water user associations which will not be able to recover costs fully (in certain remote geographical locations serving vulnerable communities). The action plan also incorporates measures that are targeted at improvements in the performance of Water User Associations (WUAs) and Water Supply Agencies (WSAs) through various measures, including changes in the methodology for calculating costs and tariffs, introduction of secondary sources of revenues (e.g., through electricity generation), improvements in the governing structures by putting in place an appropriate institutional framework, and the like. These efforts are likely to result in increased agricultural productivity per unit of water, more reliable and adequate water supply, more collection and recovery of irrigation service fees, trained personnel and adequate maintenance expenditures. The strategy also envisages a restructuring of accumulated arrears (about US$12 million), for which the World Bank will provide technical support. During the period of implementation of the Action Plan (2017-2021), the conversion

[4] The implementation of the tax code has been delayed (to January 2018) to give the government sufficient time to amend related laws and regulations, introduce new or amended reporting forms and amend the software for e-filing of tax returns.

from pumped to gravity irrigation will be implemented, both under the Bank financed Irrigation System Enhancement Project as well as under the Irrigation System Modernization Project financed by EDB, which will result in annual savings of more than 37 million KWh of electricity, equivalent to almost US$3.5 million. This will substantially reduce the level of subsidies and the tariff increase from 2019 will contribute to subsidy reduction even more. The Irrigation System Enhancement Project financed by the World Bank includes the following gender informed result indicators: (i) Female water users provided with improved irrigation and drainage services to increase from 0 in 2013 to 493 in 2017; (ii) Number of women staff in WUAs provided with training to increase from 0 in 2013 to 80 in 2017; and (iii) Presence of women in executive bodies (excluding water masters) of WUAs to increase from 4 percent in 2013 to 10 percent in 2017.

Result. The expected result of the policy actions related to the irrigation sector is to increase the number of water user associations which are self-financing from 0 in 2015 to 5 in 2017. These 5 WUAs largely provide gravity irrigation (and therefore consume less energy) and received AMD 165 million in subsidies in 2016.

Environment

Prior Action 3: The Borrower has enacted the amendments to the Mining Code consistent with the Law on Waste Management as applicable to the mining sector.

38. **The government has taken important steps to modernize the country's environmental legislation in line with international good practices and multilateral commitments, with a particular focus on the mining sector.** Armenia has a mature mining industry and modern standards of environmental management in natural resource industries have increased the compliance pressure on Armenian companies. In addition, a lot of the mines in Armenia date back to the pre-soviet times and pose an environmental hazard. As a result, the government's development strategy puts a strong emphasis on addressing environmental issues by reducing risks associated with the expansion of the mining industry. Recognizing the economic potential of the mining sector, the government is striving to improve the environmental footprint of the mining sector as a matter of public concern. Several policy changes were supported by previous operations in the series, including the Mining Code and the new Law on Environmental Impact Assessment (EIA). The Mining Code developed under the previous DPO series mandates the use of EIA for granting mining rights. This was followed by reforms of the EIA legislation aimed at aligning it with international practices and conventions to which Armenia is a signatory, such as the Aarhus Convention. This would strengthen the country's environmental governance, ensure better coordination between authorities, and provide public access to environmental information. To support the limited capacity within both the Ministry of Nature Protection (MNP) and the Ministry of Energy and Natural Resources (MENR), significant assistance has been provided through development policy operations, advisory services and grant funding for institutional capacity development.

39. **This operation supports amendments to the Mining Code and related legislation to make them coherent with the new Law on Waste Management.** The mining industry produces waste that can, if not well managed, result in loss of fertile land, disruption of natural drainage patterns, land erosion, and water pollution. The Armenian mining legislation has a gap concerning the management of mining waste. Armenia does not have a policy or financial instruments to address the long-term negative environmental impacts of mineral extraction, in particular mines, post-closure. With the approval of the amendments to the Waste Management Law (which defines mining waste as "waste" from prospecting/exploration, extraction and processing of mineral resources as waste rock, overburden, topsoil, and mine tailings), there was a need to amend the Mining Code to bring it in line with the recently upgraded law on Waste Management. The long-term goal of the proposed regulatory measures is to improve the framework for management of mine waste, promote best available technologies and reclamation/ rehabilitation, and decrease related environmental impact. It also aims to create the financial incentives for mine operators to mitigate environmental damages that have already been sustained and includes a reference to the regulation that will develop an inventory of legacy sites (from past mining operations) that does not currently exist in

the country. The amendments to the Mining Code address, among others, aspects such as financial guarantees including improvements of the surety instrument for mine closure, the roles and responsibilities for preparation and implementation of a mining emergency response plan, and a strengthened definition of the Environmental Protection Fund. The amendments to the mining code as well as the amendments to related provisions in the Law on Waste Management and the Law on Natural Resource Consumption Fee (to make them consistent with the mining code amendments) were adopted by the Parliament on October 18, 2016. These amendments are in line with the EU's Directive on Mine Waste Management and international standards and public consultations on the amendments were held in line with the national legislation. The regulations to implement the amendments to the Mining Code will be adopted by July 2017, as mentioned in the draft Letter of Development Policy.

Result. The expected outcome of these policy actions is that all new mining licenses will be issued in compliance with the amended Law on Waste Management and the new provisions in the Mining Code.

Pillar II: Strengthening Competitiveness

40. **The five prior actions supported by the second pillar will help address structural challenges to competitiveness.** The policy actions will help strengthen the business environment and improve access to credit.

Business Environment

Prior Action 4: The Borrower has approved regulations to facilitate the implementation of the Law on Business Notifications thus replacing licenses for 17 low-risk activities with a simple notification mechanism.

41. **The amendments to the Law on Trade and Services (June 2015) and the Law on Business Notifications (November, 2015), introduced the principle of notification to replace licensing for certain types of economic activities.** Reforms and streamlining of the licensing regime are primarily centered on the risk-based identification framework which identifies low-risk activities which are subsequently removed from licensing requirements to reduce the time for starting and the cost of doing business. Armenia currently issues licenses for 95 activities. A risk-based identification exercise in Armenia ascertained 17 low risk activities which are being replaced with a simple notification mechanism.[5] According to expert estimates, all licensed activities in Armenia comprise 25 percent of GDP while the 17 identified activities comprise 3-4 percent of GDP. A business which needs to operate in any of the 17 identified activities would now need to fill in an application form, pay the stamp duty and submit the electronically available application for government approval. If the business does not hear back from the government within 5 days, it can start its operations. To operationalize this simple notification process, the Prime Minister's Decree # 258-A approved on April 4, 2016 identified 66 pieces of sub-legislation to be approved by different line ministries and agencies to facilitate the actual implementation of the business notification practice. Also, a regulation on registration of notifications was approved by the government which sets generic requirements applicable for registration of all 17 activities. This operation supported the approval of regulations required to make the simple notification mechanism operational and will be particularly beneficial for small and medium enterprises (SMEs). All the 66 sub-legislations have been approved.

[5] Some of these activities include wine making, production of beer, alcohol and soft beverages, organization of retail trade points, and production of fertilizers and chemical products for plants.

Results. The expected outcome of these policy actions is that at least 35 applications will be approved through the simple notification mechanism by the end of 2017.

Civil Service

Prior Action 5: The Borrower has approved regulations to: (i) improve the mechanism for evaluating the performance of civil servants, and (ii) link bonus payments to performance in line with the Law on Civil Service.

42. **This DPF series has supported the modernization of the civil service with the primary objective of refocusing staffing on skills and performance, rather than years of experience within the government.** Effective reforms were implemented to depoliticize the civil service in 2002 but at that time, priority was given to stability and centralization. Currently, low public sector salaries and cumbersome bureaucratic procedures undermine the capacity of the civil service and reduce its attractiveness for highly qualified applicants. In June 2014, the Parliament passed amendments to the Law on Civil Service to increase the flexibility of recruitment, encourage the promotion of professional staff, and establish a modern performance evaluation system. In September 2014, the Civil Service Council adopted a comprehensive and mandatory job description catalogue specifying administrative and professional requirements and competencies for the about fifty occupations in the civil service.

43. **This operation supports the adoption of regulations to further strengthen the performance evaluation system and to link bonus payments with performance.** The mechanism for calculation of performance bonuses was introduced in January 2016. This mechanism introduced the bonus co-efficient which is calculated based on the salary rate and the performance of the civil servant, as determined by the performance evaluation system. The new formula establishes a linear relationship between the performance scores and the calculated bonuses. Therefore, the real challenge is to ensure that the performance scores are meaningful and more robust. The current performance appraisal system produces inflated scores because it is based on informal communication between supervisors and staff on the completion of deliverables rather than formal submission of completed deliverables. This generates very high scores with small standard deviation and consequently high bonus payments which may or may not reflect actual performance. The changes in the performance appraisal process for supervisors creates incentives for them to ensure that assessment of their staff members better reflects actual performance and is based on formal submission of deliverables. The government has adopted regulations aimed at reducing the inflation of performance scores through built-in disciplining mechanisms for supervisors. These regulations will also make the distribution of performance appraisal scores more meaningful in terms of a lower average value and increased standard deviation. In addition, they will make it harder for managers to discriminate among staff based on different parameters. A better performing civil service will lead to more robust policy formulation, access to improved public services and lower bureaucratic obstacles for investors.

Result. The expected outcome of these policy actions is to reduce the average value and standard deviation of performance appraisal scores of civil servants from 95 and 3 to 90 and 5, respectively.

Access to Credit

Prior Action 6: The Borrower has enacted the amendments to the Law on Bankruptcy thereby: (i) improving the rules for appointment, qualification, and remuneration of insolvency practitioners; (ii) improving the rehabilitation provisions in line with international best practices; and (iii) revising the moratorium provisions to enable rehabilitation of insolvent companies.

44. **Insolvency cases in Armenia almost always result in liquidation while reorganization rarely happens.** Armenia's insolvency framework improved significantly with the passage of the new bankruptcy law in December 2006. The main deficiency in the insolvency practice currently is the lack of reorganization cases. The insolvency regime remains a collection tool for banks and the country does not enjoy the benefits

of reorganization like jobs and higher economic activity. The main legal shortcomings include the following (i) post-commencement financing during insolvency reorganization is not available; (ii) insolvency practitioners (IPs) lack incentives to support reorganization; (iii) debtors face disincentives to file and cannot file cases in early stages of financial distress; (iv) deficiencies in the procedures for development and approval of reorganization plans hinder their effectiveness; (v) tax rules negatively impact both the possibilities of reorganization and recovery for creditors; (vi) current provisions to reverse fraudulent transactions are inadequate and allow debtors to successfully hide assets; and (vii) moratorium provisions do not allow a debtor to retain secured assets that are necessary for reorganization against a secured creditor's will. The shortcomings in the institutional framework include the following (i) courts are no longer specialized and cases are heard by non-specialist judges who face case overload; (ii) insolvency practitioners lack adequate training and accountability, and new insolvency practitioners are not licensed; (iii) there is no framework for pre-insolvency out-of-court workouts; and (iv) alternative dispute resolution is under-utilized in addressing debt resolution and insolvency. The current operation aims to rectify most of these shortcomings.

45. **The Ministry of Justice drafted amendments to the Law on Bankruptcy which were approved by the Parliament.** The draft was reviewed by the World Bank and the Council of Europe's experts. Essentially, concerns were raised by the CBA (on weakened creditor rights) and by the State Revenue Committee (on barring them from imposing fines and penalties once the bankruptcy procedures were underway) which were addressed. The new law takes a much more balanced view of creditor and debtor rights. It aims to improve the rules for appointment, qualification, and remuneration of insolvency practitioners, strengthen the rehabilitation provisions and revise the provisions on moratorium to enable rehabilitation of insolvent companies. The amendments to the law were approved by the Parliament in June 2016.

Result. The expected outcome of these policy actions is to increase the index on the strength of the insolvency framework in Doing Business from 9 in 2015 to 12 in 2017. The index on the strength of the insolvency framework captures commencement of proceedings, management of debtors' assets, reorganization proceedings and creditor participation.

Prior Action 7: The Borrower, through the CBA, has approved a package of regulations on consolidated supervision in line with the Laws on Financial Supervision.

46. **The CBA initiated and the Parliament approved a package of legislative amendments to facilitate the consolidated supervision of financial institutions.** This package, supported by DPF3, included amendments to the Law on Banks and Banking Activity, the Law on the Central Bank of Armenia, the Law on Insurance and Insurance Activity, the Law on the Securities Market, the Law on Investment Funds, and the Law on Credit Organizations. The authorities remain committed to continued strengthening of the financial regulatory framework in line with the 2012 Financial Sector Assessment Program (FSAP) recommendations and international standards.

47. **The current operation supports the approval of regulations by the CBA to facilitate the operationalization of consolidated supervision.** Consolidated supervision is an important step towards a more comprehensive supervisory legal framework. CBA is the financial supervisor in Armenia, as it supervises on a solo basis all the different types of financial institutions operating in the country. As such, introducing consolidated supervision would reinforce CBA's supervisory powers, allowing it to directly

perform supervision at the groups' level and to better control the effects of intra-group transactions.[6,7] Potential supervisory gaps at the individual level can be addressed in practice via consolidated supervision powers and vice versa. The CBA prepared a matrix, in consultation with the World Bank, comparing individual regulations with types of financial institutions so as to ensure consistency between individual and consolidated supervision and also to identify gaps at the individual level, some of which could be addressed at the consolidated level. Based on this matrix, the CBA drafted and its Board approved the required regulations. Consolidated supervision will follow the standards of inspections of financial institutions and will consolidate the balance sheets of all members of the group and consider intragroup transactions and their risk. The consolidated audit reports will be shared with the inspected financial group only, and will be used by CBA's supervisory department to assess compliance and, if needed, determine remedial actions required by the financial group. They will not be published.

Prior Action 8: The Borrower, through the CBA, has approved regulations to ensure disclosure of ultimate beneficial ownership of financial institutions and groups.

48. **Full disclosure of ultimate beneficial owners of financial institutions and groups would help the CBA in developing a clear understanding of the risk profile of financial institutions (in terms of related party and connected lending) and its impact on the stability of the financial sector.** It will also help deter the use of financial institutions for illicit activities such as money laundering, tax evasion and terrorist finance. There are currently eight financial groups active in Armenia containing banks, insurance companies, credit organizations, investment firms, and management companies. These groups are not registered as groups and the exact size of these groups is not clear since the CBA does not yet conduct consolidated supervision. Instead, it supervises the different financial institutions on a solo basis. There are also no laws or regulations that require public disclosure of the ownership structure of financial groups. This operation supported the CBA in adopting regulations which will help in the full disclosure of ultimate beneficial ownership of financial groups.

Results. The expected outcome of these policy actions pertaining to financial groups is that at least one consolidated audit will be undertaken by the end of 2017.

49. **The preparation of the DPF program has been informed by analytical work carried out by the Bank, the government, and other donors.** Details for DPF-4 are presented in Table 6.

Table 6: DPF Prior Actions and Analytical Underpinnings

Prior Actions	Analytical Underpinnings	Progress
	Pillar I	
Prior Action 1: The Borrower, has enacted the Unified Tax Code including measures to enhance revenues, improve the efficiency, transparency and equity of the tax system and strengthen tax administration.	Public Expenditure Review (2012) recommended the revamp of the excise regime, phasing out of tax expenditures, and various improvements in tax administration. Public Expenditure Review (2014) reiterated some of the messages of the 2012 PER. In particular, it recommended the removal of exemptions on corporate and income taxes on	**Completed.**

[6]For the sake of simplicity, it was considered preferable to use the term "consolidated supervision", even though, being fully precise, the term to be used according to international standards should be "additional" or "complementary" supervision, as this new kind of supervision includes institutions from different financial sectors. For the same reason, the term "financial group" is used instead of "financial conglomerate".

[7] In fact, the new legal framework also enables CBA to perform supervision on a sub-consolidated basis, whether based on activity or geographical criteria.

Prior Actions	Analytical Underpinnings	Progress
	agriculture, removal of tax exemptions, and avoidance of open-ended tax relief measures. Armenia Country Economic Memorandum (2015) recommended the consolidation of tax policies and tax administration principles across all government agencies to increase transparency and consistency of the tax system.	
Prior Action 2: The Borrower has approved the 'Strategy to Improve Financial Sustainability of the Armenian Irrigation Sector' including measures to sustainably improve cost recovery and service delivery in the sector and reduce its reliance on public subsidies.	Towards Integrated Water Resources Management in Armenia (2015) recommended improvements in the skills and the institutional capacity of water resource management institutions, enhancements in the monitoring of water quantity and quality, among others. Strategy to Improve Financial Sustainability of Armenia Irrigation Sector (2015) proposed medium term (2016-2021) measures for improving the management and financial accounting systems, in particular, a differentiated approach for increase of tariffs and membership fees.	**Completed**.
Prior Action 3: The Borrower has enacted the amendments to the Mining Code consistent with the Law on Waste Management as applicable to the mining sector.	The Armenia Country Environment Analysis (2011) and the Armenia Country Environmental Note (2014) recommended the adoption of a new Environmental Impact Assessment (EIA) law in line with good international practice; operationalization of a one-stop shop for mining rights in line with environmental and social guidelines, and amendments to the Law on Waste to include regulation of all mining waste. The Strategic Mineral Sector Sustainability Assessment (2016) recommended the need for a national mining policy to maximize the sector's contribution to sustainable development as well as strengthening sector governance, thereby, building upon the foundations of the Extractive Industries Transparency Initiative (EITI). Two thematic papers on Improving Environmental and Social Sustainability of the Mining in Armenia (October 2013, June 2014) recommended the need to strengthen the regulatory framework and enhance strategic planning of the mineral sector through development of a strategic environmental assessment (SEA) to also facilitate dialogue and information sharing. The work on Environmental Governance in Mining sector (June 2016) relevant to implementation of amendments of the Mining Code recommends the need to develop specific regulations that strengthen the environmental permitting process and promotes a risk-based inventory procedure for management of mining	**Completed.**

Prior Actions	Analytical Underpinnings	Progress
	waste supported by a new financial assurance mechanism.	
	Pillar II	
Prior Action 4: The Borrower has approved regulations to facilitate the implementation of the Law on Business Notifications thus replacing licenses for 17 low-risk activities with a simple notification mechanism.	Country Economic Memorandum (2013) and the Regulatory Guillotine Project (2015) recommended improvements in and simplification of the licensing regime so as to improve the business environment.	**Completed.**
Prior Action 5: The Borrower has approved regulations to: (i) improve the mechanism for evaluating the performance of civil servants, and (ii) link bonus payments to performance in line with the Law on Civil Service.	Public Expenditure Review (2012 and 2014) recommended changes in civil service legislation designed to enhance flexibility of recruitment and promotion of professional staff and instruments for staff motivation to supplement Civil Servants' performance pay.	**Completed**.
Prior Action 6: The Borrower has enacted the amendments to the Law on Bankruptcy thereby: (i) improving the rules for appointment, qualification, and remuneration of insolvency practitioners; (ii) improving the rehabilitation provisions in line with international best practices; and (iii) revising the moratorium provisions to enable rehabilitation of insolvent companies.	The report on "Resolving Insolvency in Armenia" (2014) recommended improvements in the legal and institutional framework for insolvency in Armenia. It included measures aimed at providing incentives to lenders to provide financing to debtors in reorganization, eliminating disincentives to undertake reorganization by insolvency practitioners, reducing restrictions that deter debtors from filing for reorganization, and enhancements to the insolvency practitioner profession, among others. Country Economic Memorandum (2013) recommended enhanced credit reporting and improved legal framework for bankruptcy and debt work-out.	**Completed.**
Prior Action 7: The Borrower, through the CBA, has approved a package of regulations on consolidated supervision in line with the Laws on Financial Supervision. **Prior Action 8:** The Borrower, through the CBA, has approved regulations to ensure disclosure of ultimate beneficial ownership of financial institutions and groups.	The Country Economic Memorandum (2013) recommended increased access to ownership information and an improved regulatory environment for financial institutions. Financial Sector Assessment Program (2012) and the Basel Core principles for effective banking supervision – assessment of observance (2012) recommended introduction of consolidated supervision and disclosure of beneficial ownership of financial groups. Technical Note on Identification and Disclosure of Ultimate Beneficial Owners (2016) recommended the legal amendments and changes in the supervisory framework which are needed to operationalize consolidated supervision and disclosure of real ownership of financial groups in Armenia.	**Completed**. **Completed.**

C. LINKS TO THE CPS, OTHER BANK OPERATIONS AND THE WBG STRATEGY

50. **The DPF series is fully aligned with the Country Partnership Strategy for 2014-17.** The CPS focuses on (i) Supporting competitiveness and job creation; and (ii) Improving the efficiency and targeting of social services. The current DPO series supports both pillars of the CPS. The CPS for 2014-17 is fully

consistent with the government's development strategy (ADS). Discussions with various stakeholders, including the government, on the preparation of both the CPS and the DPO series were held in parallel. As the main policy-based lending instrument of the Bank, the DPF is aligned with and directed at providing support for the implementation of the government's Armenia Development Strategy. The overall share of the DPF is about 30 percent of the portfolio with a broad cross-sectoral content and leveraging of budget support operations from other partners, such as the Asian Development Bank (ADB), the Eurasian Development Bank's Anti-Crisis Fund (EDB-ACF), the French Development Agency (AFD) or the EU. The Performance and Learning Review (PLR) summarized the progress in the implementation of the CPS. It revealed that in spite of significant changes in the macroeconomic environment, the WBG-supported program is making progress towards the achievement of some important CPS outcomes. It also stated that the strategic areas of focus in the CPS remain valid for the World Bank's engagement in the country although some adjustments are required to address the challenges arising from the regional and national context.

51. **The DPF series also supports the Bank's twin goals of reducing poverty and boosting shared prosperity.** Enhanced revenue collections through the adoption of the Unified Tax Code will help the government in safeguarding social spending to help the poor. In addition, previous operations in this DPO series have helped strengthen the family benefits program and enhanced health coverage to those in the program. Improved operational efficiency of the irrigation sector will help the poor who are dependent on agriculture for their livelihood. In the medium- to long-term, the alignment of the Mining Code with the Law on Waste Management is expected to reduce the environmental impacts from mining and preserve the asset endowment for households in rural areas which often depend on income from agricultural activity. Policy reforms supported by the second pillar of this DPO series will help strengthen competitiveness which will, in turn, help create more and better jobs. This will contribute to a sustained reduction in poverty and also help boost shared prosperity.

52. **The complementary efforts of programmatic support under the DPF, analytical and advisory services, and investment lending will support reforms and institutional change, and enhance the fiscal space for investment**. The DPF-supported reforms in the areas of tax policy and administration, access to finance, public administration, and competitiveness create a better policy environment for the implementation of investment projects under the CPS. In particular, reforms targeting improved fiscal space are critical for ensuring adequate investment and social spending by the government. An Institutional Development Fund (IDF) grant has helped support the capacity of Armenian institutions and key stakeholders to improve environmental governance, inclusion, and transparency in the use of the country's mineral resources. A number of grant-funded activities in the financial sector are being implemented as a follow up on the results of the 2012 FSAP, including in the areas of capital markets development and pension reform, access to finance and secured transactions, consumer protection and financial capability, enterprise accounting, and audit reform.

53. **The International Finance Corporation's (IFC) investment activities and advisory services support the strengthening of the business environment.** The IFC intends to continue its focus on the financial sector, as this is the most effective way for IFC to reach a large number of smaller businesses in the economy. To support its client banks, IFC continues to provide short and medium-term finance and supports recapitalization with equity or quasi-equity. SME finance and microfinance have been key priorities. In the medium term, priorities such as energy efficiency and housing finance are likely to take precedence. The IFC will also explore opportunities to reach key sectors, such as agriculture and mining, either directly or through financial intermediaries. The IFC collaborates closely with IDA/IBRD in these areas, many of which are included in the DPO series.

D. CONSULTATIONS, COLLABORATION WITH DEVELOPMENT PARTNERS

54. **Throughout the current DPO series the government engaged with different stakeholders to build consensus around important policy reforms and to make them inclusive.** The Unified Tax Code was open for public consultations from October 2015 to April 2016, one of the longest and most inclusive consultation processes seen in recent policy reform in Armenia, on the understanding that this is a very important piece of legislation with strategic implications. In the irrigation sector, the government has actively consulted with water user associations and the water supply companies. The revisions to the Law on bankruptcy also went through a wide consultation process jointly organized with the Council of Europe and involving the central bank, banking association, the chamber of advocates, insolvency practitioners, the state revenue committee and other stakeholders. The Strategic Mineral Sector Sustainability Assessment, which largely informed the DPF-4 prior action on amending the mining legislation, was also discussed with a large number of stakeholders from different public and civil society organizations. On the amendments to the mining code more specifically, a stakeholder workshop was held in June 2016 in Yerevan to discuss the regulatory principles and public consultations with CSOs were held in September. All the other prior actions have also gone through similar consultations with relevant stakeholders and many of the inputs from stakeholders have been incorporated in the legislative and policy changes supported by this operation. The World Bank team collaborated with OPCS to involve Armenia in the global consultation process on DPF Retrospective and held a session in Yerevan in June, 2015 to collect and incorporate feedback from different stakeholders.[8] In addition, the World Bank organized a meeting with CSO representatives in July 2016 and presented the reforms supported by the current programmatic series to receive feedback on implementation results. The team also liaised with the Center for Responsible Mining at the American University of Armenia, which conducted public consultations on recent amendments to the Mining Code addressing mine waste management concerns. The summary of discussion along with a list of recommendations was submitted to both the Parliamentary Committee and respective ministries of the government in September, 2016. The participants in the mining code consultations included Center for Responsible Mining, Ecoright, Civil voice, Ecolur, Yerevan State University, and American University of Armenia. The key concerns expressed by them related to definitions used in the Mining Code, mechanisms for assessment and compensation of damages to biodiversity and to human health, and the recommendations to add the mine waste management plan to the operational plan and expand the definition of Best Available Techniques.

55. **The Bank is actively collaborating with the ADB, the EBRD and the AFD on their respective programs.** These IFIs have a large and growing portfolio in Armenia. In addition to large-scale infrastructure projects, the ADB portfolio also includes budget support operations. The current cycle of policy-based operations of the Bank and the ADB provides an opportunity for coordination and cross-support. The EBRD's portfolio in Armenia is largely geared to supporting the private sector development agenda. DPF measures addressing improvements in the business environment ensures complementarities with the EBRD program and better outcomes. The AFD is active in the irrigation sector in Armenia and is also providing budget support to the government based on the policy reform matrix supported by the current operation. Donor coordination meetings are organized at least every quarter and more frequently if needed. The economic thematic group is co-led by the World Bank, the IMF and the EU and the sectoral meetings are led by donors which are more active in that particular sector. There is active and candid donor coordination that gives upstream information on all major projects under consideration as well as updates on implementation.

56. **The European Union is developing the next phase of assistance to Armenia, while the Eurasian Development Bank started its operations in Armenia recently and is gradually expanding its portfolio.** In 2013, the EU was expanding its program in Armenia to support the implementation of the

[8] The summary feedback is available at https://consultations.worldbank.org/Data/hub/files/consultation-template/2015-development-policy-financing-retrospective/en/meetings/feedback_summary_dpf_retrospective_consultation_armenia.pdf

Eastern Neighborhood Partnership (ENP) Action Plan and a Deep and Comprehensive Free Trade Area (DCFTA). All seven rounds of DCFTA negotiations were successfully concluded in preparation of an Association Agreement between the EU and Armenia. After Armenia's 2013 decision to instead join the Eurasian Economic Union, the EU undertook a review of their program, and in 2016 is actively working with Government counterparts and other partners to develop the next phase of their assistance. In addition to a growing number investment projects in infrastructure, the Eurasian Development Bank is also providing budget support by way of its Anti-Crisis Fund (EDB-ACF) facility. Under this DPF series, the Bank team collaborated closely with both the EU and EDB teams in critical reform areas, seeking complementarity and avoiding duplication.

V. OTHER DESIGN AND APPRAISAL ISSUES

A. POVERTY AND SOCIAL IMPACT

57. **The reforms supported by the current operation will have an overall positive distributional impact.** Direct distributional impacts are likely as a result of the reform of the Tax Code; the efforts to move towards cost recovery in irrigation water sector; changes to the mining code; and promotion and performance evaluation policies in the public sector. In addition, new framework aimed at replacing licenses with a simple notification mechanism, a new law on bankruptcy, and better regulation of the financial sector allows for lower transaction costs and higher transparency and can lift the growth potential of the economy which then translates into more employment and higher wages in the medium-term.

58. **The proposed changes to the tax code are likely to raise revenues with neutral to slightly positive distributional impacts.** More broadly, the proposed changes to the excises are expected to yield higher revenues. To the extent that some of these revenues can be used to support the less well off, the positive distributional impacts of the proposed measures could be larger than the ones described here. Under the new tax code, the Personal Income Tax (PIT) will have 3 tax rates (23, 28 and 36 percent for incomes below 150,000 AMD, between 150,000 AMD and 2,000,000 AMD, and above 2,000,000 AMD respectively) and no minimum income exemption threshold, compared to currently 24.4, 26.0 and 36.0 percent for incomes below 120,000 AMD, between 120,000 AMD and 2,000,000 AMD, and above 2,000,000 AMD. In addition, dividends will be subject to income taxation. These changes will have two main effects. First, they will enhance the overall progressivity of the PIT by reducing the tax rate paid by low income earners and increasing the tax rate paid by high income earners, as well as increasing their tax base. Second, they will reduce the tax burden on low income earners by lowering the tax rate applicable to this group (from 24.4 to 23.0 percent), and this will translate into higher disposable incomes at the bottom of the distribution and thus lower poverty. Simulations using the Commitment to Equity (CEQ) methodology suggests that the changes to PIT will lead to an increase in disposable income among the bottom 40 of the distribution of 0.7 percent and a reduction in poverty of 1.6 percentage points (World Bank, 2016). In contrast, the proposed broadening of the tax base for condensed gas and increases in excises on petrol, alcohol and tobacco are likely to have a negative, albeit relatively small impact on consumable income for both the poor and the non-poor. This is due to the fact that the consumption of these goods is relative unresponsive to changes in their price and, as a result, increases in prices (such as those resulting from an increase in the tax levied on these goods) are likely to translate into an overall increase in spending, other things being equal. The overall distributional impact of these changes will depend on the amount spent on these goods by different groups, relative to their total income or consumption. Results from the CEQ simulation suggest that the proposed broadening of the tax base and increases in excises will translate into a 1.0 percent decline of consumable income among the bottom 40 of the distribution, compared to 1.3 percent decline for the rest of the population, and no significant change in the poverty rate. Having said this, it is important to note that the impacts described here focus exclusively on changes in monetary welfare, measured in terms of consumption/income, and do not take into account the beneficial health effects that

could be associated with a decline in the consumption of alcohol or tobacco. Nor does it account for the potential savings in public health costs associated with morbidity and mortality links to alcohol and tobacco.

59. **From a distributional perspective there is strong justification for promoting financial sustainability of the irrigation sector through improved cost recovery.** Currently, subsidies to Water User Associations (WUAs) enable them to bridge the gap between cost of water provision and delivery of irrigation water at a relatively low tariff to farmers. The subsidies are aimed at helping WUAs close the gap between revenues (from use of water by farmers) and expenditures. Although farmers' payment rates are high, revenues do not fully cover WUAs' expenditures because of several reasons including the high cost of supplying water in several systems and the below-cost recovery tariffs paid by most farmers. The DPF supports reforms to reduce state subsidies to WUAs and public Water Supply Agencies (WSAs) through a decrease in operational and maintenance costs. An analysis of administrative data on WUAs, conducted as part of a poverty and social impact assessment of the irrigation sector reforms, found the following. First, from a distributional perspective there is strong justification for promoting financial sustainability of the sector. In many WUA systems, providing irrigation water costs more than AMD 11 per cubic meter such that below cost-recovery tariff mainly benefits farmers with larger plots –countrywide, nearly 63 percent of subsidized irrigation water benefits the 15 percent of farmers who cultivate plots of 1 hectare or more (85 percent of farmers own plots of less than 1 hectare in size). Second, rising electricity prices are affecting WUAs financial health. In 2013, share of energy in total WUA expenditures was 34 percent, up from 24 percent in 2010. Third, WUAs appear to be underinvesting in repairs and maintenance: only about 15 percent of total WUA expenditures go toward maintenance and repair. Results from a qualitative study of irrigation water users conducted in 2015 suggests that farmers are dissatisfied with water losses in the system – a reflection of WUA's low investment in maintenance.

60. **In the medium- to long-term, the alignment of the Mining Code with the Law on Waste Management is expected to reduce the environmental impacts from mining and preserve the asset endowment for households in rural areas which often depend on income from agricultural activity.** Around 75 percent of individuals in poor households in rural areas work in agriculture and their most important asset – aside from labor – is the quality of the soil. The amendments to the Waste Management Law will help to protect fertile land in Armenia. Actions related to better regulation of waste in the mining sector need to be accompanied by a strong public awareness effort, including consultations with and incorporating feedback from relevant sections of the society and civil society organizations. Given a tradition of strong civic engagement in Armenia in the area of environmental protection, and specifically in relation to mining, feedback from society and non-government experts is important to build trust and support for these regulatory changes.

61. **Reforms in the recruitment and promotion of civil servants could have a positive gender impact.** The DPF series has supported the modernization of the civil service shifting recruitment and promotion to a competence-based system (instead of tenure-based). This shift is expected to benefit women as they tend to have less tenure than men even though they are equally or better qualified. According to the data from LFS 2014, the public sector (state and municipalities) employs around 22 percent of working individuals between 15 and 64 years, with a higher share among female (28 percent) than among male (18 percent). Women and men working in the public sector have different tenure characteristics. For instance, 70 percent of men versus 52 percent of women have been employed in their current job or activity for 5 years or more. However, 87 percent of women employed in the public sector have specialized secondary, tertiary or graduate education, while this proportion is 71 percent among men. These differential characteristics suggest that the reform of the human resource system in the public sector has the potential to positively impact career prospects and paths, particularly for women. Complementary measures to progress towards gender parity in promotion and management grades in the civil service could help in ensuring gains to women. In principle, talented women constrained by fewer years of tenure would now have the chance to be promoted and advance their careers, however experiences in other countries show that even in a competence-based performance system, complementary measures to progress towards gender

parity in promotion and management grades in the civil service are recommended for ensuring gains to women. In Ireland for example, the Initiative of the National Women's Strategy 2007-2016 recommends establishing a specific leadership training course to foster the advancement of women into senior management roles in the public sector. In the UK, it is been pointed out that the government's introduction of the Talent Action Plan reform will be beneficial for women only if several recommendations to strengthen the diversity agenda are taken, for example, create greater transparency and accountability for delivering diversity plans and engaging in coaching and mentoring women to successfully apply to senior positions (Table 7).

Table 7: Summary of Poverty, Social, and Gender Impacts

	Prior Actions	**Expected Distributional, Social, and Gender Impacts of Reform**
1.	The Borrower, has enacted the Unified Tax Code including measures to enhance revenues, improve the efficiency, transparency and equity of the tax system and strengthen tax administration.	Proposed PIT structure with no exemption threshold will be slightly progressive. Changes to excises have limited distributional impact with a marginal increase in poverty.
2.	The Borrower has approved the 'Strategy to Improve Financial Sustainability of the Armenian Irrigation Sector' including measures to sustainably improve cost recovery and service delivery in the sector and reduce its reliance on public subsidies.	Has the potential to have a positive distributional impact.
3.	The Borrower has enacted the amendments to the Mining Code consistent with the Law on Waste Management as applicable to the mining sector.	Distributionally neutral.
4.	The Borrower has approved regulations to facilitate the implementation of the Law on Business Notifications thus replacing licenses for 17 low-risk activities with a simple notification mechanism.	Distributionally neutral.
5.	The Borrower has approved regulations to: (i) improve the mechanism for evaluating the performance of civil servants, and (ii) link bonus payments to performance in line with the Law on Civil Service.	Positive impact on gender, distributionally neutral.
6.	The Borrower has enacted the amendments to the Law on Bankruptcy thereby: (i) improving the rules for appointment, qualification, and remuneration of insolvency practitioners; (ii) improving the rehabilitation provisions in line with international best practices; and (iii) revising the moratorium provisions to enable rehabilitation of insolvent companies.	Distributionally neutral.
7.	The Borrower, through the CBA, has approved a package of regulations on consolidated supervision in line with the Laws on Financial Supervision.	Distributionally neutral.
8.	The Borrower, through the CBA, has approved regulations to ensure disclosure of ultimate beneficial ownership of financial institutions and groups.	Distributionally neutral.

B. ENVIRONMENTAL ASPECTS

62. **Policies supported by the current operation are expected to have a positive impact on Armenia's environment, water resources, habitat, and other natural resources.** The mining industry produces waste that can, if not well managed, result in loss of fertile land, disruption of natural drainage patterns, land erosion, and water pollution. The reforms supported by DPF-4 address shortcomings identified in the environmental sustainability of the mining sector. This includes enhancing the regulation on mining waste to include waste management planning, use of best available technologies, and strengthening the environmental permitting process. The government is committed to strengthen the

enforcement and implementation capacity of the government agencies responsible for mitigating environmental impacts of the mining sector, especially concerning environmental liability provisions. This requires adopting procedures and financial surety mechanisms that would increase the accountability and transparency in the use of funds from the Environmental Protection Fund and reduce the risk of future liabilities to the state regarding rehabilitation of mines after closure. The Parliament approved the amendments to the Mining Code in October 2016 and the development and subsequent approval of the secondary legislation on management of mining waste and closure of mines (likely by July 2017) will ensure effective implementation of the amended Mining Code. The Bank has provided technical assistance on environmental management of mining waste which outlines good mining practices. It proposes the basis for the following regulatory procedures: (i) a new financial assurance mechanism based on international best practice; (ii) revision of the existing mine permitting process by bringing existing waste management requirements in line with international best practice; (iii) a risk based inventory of tailings site, based on perceived risks to the environment and/or human health; and (iv) capitalizing a fund for rehabilitation/remediation of mine legacy prioritized for rehabilitation/ remediation. By adopting and implementing the amendments to the Mining Code, the government supports a significant step to improve mining waste management and in the medium-term it will strengthen the sustainability profile of the Armenian mining sector. Table 6 lists the analytical underpinnings which have informed the environmental impact assessment of the current operation.

63. **Reform measures related to irrigation and the law on bankruptcy will have a positive impact on the environment while the remaining policy actions will be neutral.** Measures aimed at improving the operational efficiency of the irrigation sector (which would help reduce subsidies) would have a positive effect by way of incentivizing more effective use of water resources, energy efficiency and other environmentally sustainable irrigation practices. All these measures are likely to have climate change co-benefits as they will result in lesser water and electricity consumption. The adoption of the amendments to the Law on Bankruptcy is expected to help businesses maintain their economic viability while also meeting environmental corporate goals. Insolvent companies would need to comply with environmental obligations and bear financial responsibility for environmental liabilities and any pollution residue. Tax reforms, on the other hand, could result in distributional effects that can cause change in behavior that may affect the environment. Mitigation would come from protecting consumption of low income households from indirect tax increases (Table 8).

Table 8: Summary of Environmental Impact

DPF-4 Prior Actions	**Expected Environmental Impacts**
Prior Action 1: The Borrower, has enacted the Unified Tax Code including measures to enhance revenues, improve the efficiency, transparency and equity of the tax system and strengthen tax administration.	Neutral impact.
Prior Action 2: The Borrower has approved the 'Strategy to Improve Financial Sustainability of the Armenian Irrigation Sector' including measures to sustainably improve cost recovery and service delivery in the sector and reduce its reliance on public subsidies.	Positive impact if the improvements and cost cutting measures target innovative irrigation practices that enhance water efficiency and help farmers adapt to techniques which reduce environmental burden such as water abstraction, pollutants, and high energy use, while still reaping economic benefits.
Prior Action 3: The Borrower has enacted the amendments to the Mining Code consistent with the Law on Waste Management as applicable to the mining sector.	Positive impact of the amended Mining Code which outlines the improved requirements for mining waste management. Implementation of specific regulations that address mine waste management and mine waste reprocessing, use of best available techniques, strengthening of environmental permitting process, and the financial guarantee mechanisms for mine

DPF-4 Prior Actions	Expected Environmental Impacts
	waste management and rehabilitation is expected to have positive impact.
Prior Action 4: The Borrower has approved regulations to facilitate the implementation of the Law on Business Notifications thus replacing licenses for 17 low-risk activities with a simple notification mechanism.	Neutral impact.
Prior Action 5: The Borrower has approved regulations to: (i) improve the mechanism for evaluating the performance of civil servants, and (ii) link bonus payments to performance in line with the Law on Civil Service.	Neutral impact.
Prior Action 6: The Borrower has enacted the amendments to the Law on Bankruptcy thereby: (i) improving the rules for appointment, qualification, and remuneration of insolvency practitioners; (ii) improving the rehabilitation provisions in line with international best practices; and (iii) revising the moratorium provisions to enable rehabilitation of insolvent companies.	Positive impact through the incorporation of environmental liabilities as stipulated in the relevant law in the restructuring plans for the rehabilitation of insolvent companies.
Prior Action 7: The Borrower, through the CBA, has approved a package of regulations on consolidated supervision in line with the Laws on Financial Supervision.	Neutral impact.
Prior Action 8: The Borrower, through the CBA, has approved regulations to ensure disclosure of ultimate beneficial ownership of financial institutions and groups.	Neutral impact.

C. PFM, DISBURSEMENT, AND AUDITING ASPECTS

64. **The overall public financial management system is acceptable for this operation and efforts to implement further reforms continue.** The government's PEFA self-assessment was conducted in 2013 (published in 2014) with support from the EU, the World Bank, and GIZ. As per the PEFA report, the PFM system performance has remained strong (scores of at least B) for 16 out of the 28 performance indicators (PIs) including for budget credibility, policy based budgeting, budget execution and cash management, accounts reconciliation, information on resources received by service delivery units, and timeliness of in-year budget reports. However, some critical PFM system elements including oversight of aggregate fiscal risk, effectiveness in collection of tax payments, effectiveness of payroll controls, effectiveness in internal controls and internal audit, annual financial reporting, external audit and parliament scrutiny of its reports still remain weak.

65. **The government, with technical support from the EU, updated the 2011–2020 Strategy for Reforming the PFM System and the accompanying Action Plan which addresses shortcomings in the PFM system.** Government budgets are published on the Ministry of Finance's website and are also made available in printed form. The treasury has a robust system in place and all Bank-financed project accounts were transferred into the treasury in December 2010 and have been satisfactorily maintained. A Law on Internal Audit has been adopted, and a modern internal audit system with internal audit standards and detailed manuals is being rolled out. The government has developed the Armenian Public Sector Accounting Standards (APSAS) based on International Public Sector Accounting Standards (IPSAS), a chart of accounts, and a draft law on public sector accounting with the World Bank's support. The law has already been adopted by Parliament. The APSAS has been successfully piloted, and is now being rolled out by the government. A full transition to APSAS by ministries, public entities and agencies, is planned by 2018. A comprehensive fiduciary control framework for non-commercial organizations (NCOs) has been designed to help manage the fiscal risk posed by NCOs as well as improve the quality of service delivery

by these state organizations. The Chamber of Control (Armenian supreme audit institution, COC) has been made independent from Parliament and a law enhancing its mandate was enacted as a result of amendments in the constitution in 2005. In the recent 2015 constitutional change, the COC has been renamed to Chamber of Audit (COA). The Bank assists the COA in strengthening its capacity to conduct financial and compliance audits in line with International Standards of Supreme Audit Institutions (ISSAI).

66. **The legal and regulatory framework for Armenia's public procurement, enacted in 2011, is conducive to competitive, economic, efficient, and transparent procurement.** Armenia is one of 47 members of the Agreement on Government Procurement of the World Trade Organization (GPA-WTO) since September, 2011. In January 2015, Armenia formally became a member of the EEU. To meet both the GPA-WTO and the EEUT (Eurasian Economic Union Treaty) requirements the Government has drafted the new Law on Public Procurement (LPP). The draft Law identifies certain principles which include value for money ("economic, efficient, and effective procurement process"), equal right and non-discrimination, competition, transparency and openness, and proportionality in the procurement process. These principles reflect good international practice and are in line with the policies and objectives set forth in the WTO General Procurement Agreement ("GPA"), EU Directives, and in fact the World Bank's current Procurement Guidelines and New Procurement Framework. Currently, the Government is finalizing the draft on the basis of the observations provided by the different investment partners, including the World Bank. In parallel the secondary legislation is being developed. The draft Law establishes a Procurement Complaint Review Board, a government entity (i.e. the Procurement support Center, PSC) that reports to National Assembly and that is in charge of reviewing procurement complaints. The draft Law adequately regulates important aspects of the activity, functions, and mandate of the Procurement Complaint Review Board. Transparency and service delivery improvements were enabled through various electronic government systems, including the e-procurement platform known as ARMEPS (Armenian electronic procurement system). ARMEPS was introduced under World Bank financing and will constitute a total solution for the implementation of public procurement. Starting from 2015, the use of the ARMEPS became mandatory for all methods of procurement stipulated by the current LPP. At present, three more modules have been installed and tested: (a) contract management, (b) planning, and (c) reporting. The Government is expected to launch the full application of new functions of the updated system by end of 2016. As for Bank financed procurement, progress has been made towards the use of country systems, including authorization to use the e-procurement platform for local procurements and agreement on the publication of bidding documents by Project Implementation Units (PIUs) in the Armenia Procurement Portal. Recently by the joint initiative of the World Bank, the MOF (department of the internal control and public procurement) and the PSC the appropriate training has been conducted for the PIUs staff. After fixing of some inconsistencies between ARMEPS and the Bank's regulations, revealed in the course of the training, PIUs will be able to use the e-procurement system. There are no major issues as far as procurement implementation is concerned in Armenia. Although the Country Procurement Assessment Review (CPAR) updated in 2009 concluded that the public procurement environment in Armenia is in the medium- to high-risk category, this assessment will very likely need to be upgraded based upon the above.

67. **The CBA's foreign exchange management is transparent and subject to adequate operational controls, and the CBA maintains safeguards in its financial reporting practices, the external audit mechanism, and the internal audit function.** This was reconfirmed in the latest central bank safeguards assessment by the IMF in 2014. The CBA adopted the International Accounting Standards (now International Financial Reporting Standards, IFRS) in 1996 and has been audited by internationally recognized auditing firms. Independent auditors have issued unmodified opinions on recent CBA financial statements including for FY 2015 (issued by Price Waterhouse Coopers). The CBA's foreign exchange environment, the current performance of the PFM system, and the government's commitment to reform, taken together, support the operation.

68. **Borrower and credit amount:** The Borrower will be the Republic of Armenia. Upon effectiveness of the Loan Agreement, the proposed IBRD loan of US$50 million will be made to the Republic of Armenia,

represented by the Ministry of Finance (MoF). The effectiveness provision will be a legal opinion by Armenia that it has followed its laws and procedures for the ratification of the legal agreement. The proposed IBRD loan will have a maturity of 25 years including a 14.5 year grace period.

69. **Disbursement:** The Bank will disburse the loan in US dollars in the MoF's US dollar deposit account in the Central Bank of Armenia, which forms part of the country's foreign exchange reserve. The Borrower shall ensure that upon deposit of the proceeds of the loan into the said account, an equivalent amount will be credited in the Borrower's budget management system, in a manner acceptable to the Bank, that is: the MoF's budget account will be credited with the Armenian dram equivalent at the official exchange rate within 30 days of disbursement. The MoF will be responsible for the operation's administration, for preparing the withdrawal application, and for maintaining the deposit account at the CBA, as required. The MoF, with the assistance of the CBA, will maintain records of all transactions under the DPF-4 in accordance with sound accounting practices.

70. **Reporting, auditing and closing date:** Considering the Bank's knowledge of the public finance management systems and the ongoing improvements of these systems, the positive assessment of the CBA made by the IMF, previous unmodified audit opinions on deposit account under Poverty Reduction and Support Credits (PRSCs), and unmodified opinions issued by the CBA's auditor on the recent years financial statements, no additional fiduciary arrangements, including audit, will be required for the deposit account. The closing date of the proposed loan will be November 30, 2017. The fiduciary risk for the program is rated as moderate.

71. **Confirmation and eligible expenditure:** The Borrower will provide to IBRD a confirmation that the amount of the DPF-4 has been credited to the account that is available to finance budget expenditures within 30 days from the date of receipt of the amount (the format of the confirmation letter should be acceptable to IBRD). The administration of the loan will be the responsibility of the MoF. If the Bank at any time determines that any amount withdrawn under the Bank loan has been used for excluded expenditures, as stated in the legal agreement, the Bank will require the Borrower to refund the amount to the Bank. The amount so refunded shall be credited to the loan account and canceled.

D. MONITORING, EVALUATION, AND ACCOUNTABILITY

72. **The government has designated the Chief of Government Staff as the main counterpart for the DPF program**. In practice, the chief of staff and the Deputy Prime Minister together serve as the focal points for the DPF because the Deputy Prime Minister is also responsible for donor coordination, policy coordination and overall project implementation. The focal points rely on assigned officials in the different government ministries and agencies to help implement the policy reforms supported by the DPF.

73. **The proposed operation is aligned with the goals specified in the government's strategic policy documents, with a detailed matrix of expected outcomes and monitoring indicators.** The government monitors the implementation progress in line with procedures stipulated by the Prime-Minister's Decree No. 803-N approved on September 24, 2009. The Decree sets standards and requirements for preparation, discussion, and monitoring of the government's action plans and strategic development programs, and defines a procedure for organizing discussions, addressing received comments, and settling disputes.

74. **The government has sufficient institutional capacity for program monitoring**. As the experience of the last few years shows, the above described framework of policy preparation, discussion, and monitoring has been institutionalized in Armenia. Amendments made in 2011 introduced new requirements pertaining to prioritization of policies and program actions and streamlining deadlines for different submissions. Armenia subscribed to the IMF's General Data Dissemination System in 2002 and is a compliant country. The overall data quality, availability, and timeliness of released statistics are in line with international standards (www.armstat.am).

75. **Grievance Redress**. Communities and individuals who believe that they are adversely affected by specific country policies supported as prior actions or tranche release conditions under a World Bank Development Policy Operation may submit complaints to the responsible country authorities, appropriate local/national grievance redress mechanisms, or the World Bank's Grievance Redress Service (GRS). The GRS ensures that complaints received are promptly reviewed in order to address pertinent concerns. Affected communities and individuals may submit their complaint to the World Bank's independent Inspection Panel which determines whether harm occurred, or could occur, as a result of non-compliance with its policies and procedures. Complaints may be submitted at any time after concerns have been brought directly to the World Bank's attention, and Bank Management has been given an opportunity to respond. For information on how to submit complaints to the World Bank's corporate GRS, please visit http://www.worldbank.org/GRS. For information on how to submit complaints to the World Bank Inspection Panel, please visit www.inspectionpanel.org.

VI. SUMMARY OF RISKS AND MITIGATION

76. **The overall risk rating of this operation is substantial, and it reflects macroeconomic, implementation capacity, and political and governance risks.**

77. **Macroeconomic risks are high.** Growth will remain subdued in the medium-term with a sluggish recovery tied to the bottoming out of the recession in Russia and gradual improvement in external conditions. At the same time, Armenia's macroeconomic framework remains vulnerable given that the reforms needed to ensure new and resilient sources of growth and job creation have been interrupted by global shocks, first in 2008 and then in 2014, with the government needing to re-orient policy priorities towards mitigation and recovery. Another risk is posed by the winding down of the transitory factors that drove growth in 2015. Slow credit and falling metal prices also suggest that near-term risks are on the downside. Risks to the fiscal framework stem from low tax revenues and limited potential for further spending cuts, which took the brunt of the last fiscal adjustment. In particular, the trend of low public investment and increasing public debt has highlighted the need to create fiscal space for growth and equity-enhancing capital and social spending. Tighter global financial conditions and the possibility of a disorderly external adjustment remains a risk, in spite of adequate reserves, given the high levels of external debt, high dollarization, and dependence on remittance inflows, largely from Russia. Further depreciation of the dram could potentially increase the vulnerability of the highly dollarized financial sector through direct and indirect balance sheet effects. Support from international partners, both in terms of policy-based budget lending and technical assistance, has led to renewed attention to reforms focused on growth-enhancing competitiveness and trade facilitation, as evidenced by Armenia's recent improvement in the Doing Business ranking. In the longer run, fiscal risks should be mitigated through the enactment of the Unified Tax Code, which aims to strengthen tax revenues and improve transparency, administration, and supervision. The IMF program anchors the government's resolve to maintain a flexible exchange rate within the inflation target and to seek enhanced reserves management. To mitigate risks to the financial system, the CBA has introduced measures to strengthen contingency planning, safety nets, and risk assessments. The authorities have already begun closer monitoring of the banks and intensifying their asset quality review of the most affected banks.

78. **Risks from the institutional capacity to implement and sustain reforms is substantial.** The government's implementation capacity is low, particularly at the mid-levels of the civil service, which could weaken the impact of reforms. While stakeholder risks are moderate overall, the capacity to implement and sustain the reforms is weak. These risks are somewhat mitigated through the following measures. The government has set up a steering committee for the DPF program chaired by the Deputy Prime Minister to ensure high-level engagement. The Bank and IFC advisory services are supporting reform efforts by providing technical assistance in key areas, such as tax policy and administration, social protection, customs, aviation, competition framework, pension and capital markets reform, business environment,

irrigation, and road sector policy. Furthermore, several Bank investment projects or donor-supported programs are expected to continue to provide institution-building in key policy areas covered by the DPF.

79. **The political and governance risk is substantial.** The country is moving from a semi-presidential to a parliamentary system and elections are scheduled for April 2017. Political risks are managed through continuous dialog with the authorities, and an emphasis on the strategic medium-term economic context of this operation, which helped counteract efforts to dramatically delay or undermine the reform. The World Bank team has also provided extensive technical assistance in various sectors to help the authorities complete the reforms being supported by DPF4. Pressures from interest groups could also derail program implementation. Corruption also remains endemic in Armenia with the country ranked 95 out of 168 countries in Transparency International's corruption perception index in 2015. The government has long condemned corruption but has largely failed to investigate or prosecute senior officials suspected of wrongdoing. To mitigate this risk, the government established the anti-corruption council in 2015 with the objective of boosting the confidence of the citizens in public administration by promoting an environment of zero tolerance towards corruption. The council focuses its activities in four areas: healthcare, education, revenue collection and the police and is jointly financed by the United States Agency for International Development (USAID) and the government. Since the launch of this council about 10 public sector officials (in healthcare and police) have been dismissed on charges of corruption. The new Prime-Minister plans to review and enhance the anti-corruption council by appointing new members. In addition, the World Bank provided technical assistance which supported the implementation of Armenia's anti-corruption strategy through specific interventions for improving the regulation of public service ethics and training new anti-corruption focal points in public service.

80. **Other risks are substantial.** Geopolitical tensions remain and continue to represent a risk to the success of the operation. The government is engaged with the Minsk Group of countries under the Organization for Security and Cooperation in Europe (OSCE) in their efforts to assist the parties in finding a peaceful solution to regional tensions. It should also be noted that Armenia's geo-political situation has implications for trade and growth; over 70 percent of its borders are currently closed due to various tensions with neighbors, leaving access only through Iran and Georgia (Table 9).

81. **To manage risks, the World Bank team is holding frequent consultations with the government on the evolving policy environment.** The team has also intensified its macroeconomic monitoring and discussions with the Ministry of Finance and the IMF. The strong relationship with the government ensures frank and clear policy discussions at the highest levels.

Table 9: Systematic Operation Risk Rating (SORT)

Risk Categories	Rating (H, S, M or L)
1. Political and governance	S
2. Macroeconomic	H
3. Sector strategies and policies	M
4. Technical design of project or program	L
5. Institutional capacity for implementation and Sustainability	S
6. Fiduciary	M
7. Environment and social	M
8. Stakeholders	M
9. Other (security/conflict)	S
Overall	S

Annex 1. Policy and Results Matrix

Policy Areas	Prior Actions				Result Indicators (Baseline 2012, Target 2017, unless otherwise stated. *Current status, where available, is mentioned*)
	DPF-1 Prior Actions	**DPF-2 Prior Actions**	**DPF-3 Prior Actions**	**DPF-4 Prior Actions**	
Pillar 1. Promoting Fiscal, Social, and Environmental Sustainability					
1. Fiscal	The Government through Government Protocol Decree No. 29, Item 33 dated July 25, 2013, has adopted "Guidelines on Strategic Principles for Review of Tax and Customs Legislation," including the review of tax exemptions and excise rates with the aim of identifying areas for improving revenue collection, and approved a medium-term strategy on amendments to the tax and customs legislation.	The Borrower has: (i) improved tax mobilization through submitting to Parliament a draft *"Law on Amendments to the Law on Value Added Tax,"* which discontinues the exemption from VAT of financial brokerage services as evidenced by the Prime Minister's transmittal letter dated September 19, 2014, No. 01/23.18/15551-14, and (ii) approved the package for the draft 2015 State Budget, in Government Session of September 25, 2014, including a "Report on Tax Expenditures" in its Explanatory Note, which explains and provides revenue impact estimates of major tax expenditures, transmitted to Parliament on October 2, 2014.	1. The Borrower has approved a draft Unified Tax Code; as evidenced by the *Government's Protocol Decree* No. 45 dated October 8, 2015 (duly published in the Borrower's website www.e-gov.am on said date).	1. The Borrower, has enacted the Unified Tax Code including measures to enhance revenues, improve the efficiency, transparency and equity of the tax system and strengthen tax administration.	Excise on tobacco and alcohol to GDP: Baseline: 0.72 percent (2015) Target: 0.88 percent of 2015 GDP Transparency on tax exemptions: Baseline: No published information on tax exemptions Target: Annual publication on tax exemptions *Current: Achieved. (Annex on tax exemptions included in 2017 Budget – published online)*
2. Infrastructure		The Borrower has: (i) adopted an Action Plan on Drinking Water Sector Reforms, including the decision to create a new, nation-wide lease contract through the approval of Government Decree No. N883-N dated August 14, 2014, and (ii) has started the Action Plan's implementation by issuing the tender for the transactions advisory for a new lease contract, as evidenced by the announcement published on: www.scws.am, www.procurement.am, and in the Government's official newsletter dated September 11, 2014.	2. The Borrower has increased the electricity tariff for end-users to improve financial sustainability of the electricity sector, as evidenced by the Public Services Regulatory Commission's Decision No. 174-N dated June 17, 2015 (duly published in the Official Gazette on July 15, 2015).	2. The Borrower has approved the 'Strategy to Improve Financial Sustainability of the Armenian Irrigation Sector' including measures to sustainably improve cost recovery and service delivery in the sector and reduce its reliance on public subsidies.	Number of self-financing Water User Associations: Baseline: Zero (2015) Target: 5 Accumulated net losses of ENA: Baseline: AMD 27 billion (April 2015) Target: Zero losses (April 2017) *Current: Achieved. (Zero losses)*

Policy Areas	Prior Actions				Result Indicators
	DPF-1 Prior Actions	DPF-2 Prior Actions	DPF-3 Prior Actions	DPF-4 Prior Actions	(Baseline 2012, Target 2017, unless otherwise stated. *Current status, where available, is mentioned*)
3. Social assistance	The Government through Government Decree No. 1859-N, dated December 29, 2011, has improved the targeting accuracy and coverage of the Family Benefits Program through improvements in the targeting formula.	The Borrower has extended the coverage of the health benefits (waiver of co-payments) to the same group of households covered by the Family Benefits Program through the Law on 2014 State Budget.	3. The Borrower has: (a) enacted the Law on Social Services aimed at providing integrated Social Services, as evidenced by the Borrower's Law No. 231, dated Dec 17, 2014 (duly published in the Official Gazette on December 30, 2014); and (b) issued regulations to said amended Law on Social Services, as evidenced by the *Government's Decrees* No. 984-N dated August 31, 2015, No. 1044-N and No.1061-N, both dated September 10, 2015 (duly published in the Official Gazette on September 9, 2015, September 23 and September 30, 2015, respectively) and No. 582 –N dated June 4, 2015 (duly published in the Official Gazette on June 17, 2015).		Number of households covered by the Family Benefit Program: Baseline: 96,309 Target: 105,000 *Current: 103,000*
4. Environment	The Government has developed and adopted a new draft Law on Environmental Impact Assessment in line with good international practices and submitted it to Parliament for approval on August 2, 2013.	The Borrower has strengthened its management of natural resources through: (i) Parliament approval of the Law on Environmental Impact Assessment on June 21, 2014 and necessary amendments to the same Law on September 11, 2014; (ii) the approval of the "one-stop-shop (OSS)" for mining rights in line with environmental and social guidelines, as evidenced by Government Protocol Decree No. 29.6/209727-14(37) of September 4, 2014.	4. The Borrower has: (a) amended the Law on Waste Management aimed at improving the management of mining waste to reduce negative environmental impacts, as evidenced by the Borrower's Law No.105 dated June 22, 2015 (duly published in the Official Gazette on July 22, 2015); and (b) issued regulations to said amended Law on Waste Management; as evidenced by the *Government's Decrees* No. 1038-N, 1043-N, 1042-N, 1045-N, all dated September 10, 2015 (all duly published in the Official Gazette on September 23,2015); and the Minister of Environment's Orders Nos. 243-N and 244-N, both dated August 20, 2015 (both duly published in the Official Gazette on September 15, 2015).	3. The Borrower has enacted the amendments to the Mining Code consistent with the Law on Waste Management as applicable to the mining sector.	New mining licenses issued in compliance with the amended Law on Waste Management and the new provisions in the Mining Code: Baseline: Zero (2015) Target: 100 percent
Pillar 2. Strengthening Competitiveness					

Policy Areas	Prior Actions				Result Indicators
	DPF-1 Prior Actions	DPF-2 Prior Actions	DPF-3 Prior Actions	DPF-4 Prior Actions	(Baseline 2012, Target 2017, unless otherwise stated. *Current status, where available, is mentioned*)
5. Business environment	The Government has merged two inspection agencies (Labor Inspectorate and Anti-Epidemiology Inspectorate) aiming to reduce the burden of inspections on businesses pursuant to Government Decree No. 857 dated July 25, 2013.	The Borrower has: (a) adopted a new reform strategy for optimization of its inspection agencies system through Protocol Decree No. 40-59 of September 25, 2014, and (b) submitted to Parliament a draft "Law on Inspection Bodies" establishing greater independence, oversight, and transparency of inspections as evidenced by the Prime Minister's transmittal letter 01/23.18/16012-14 dated September 26, 2014.	5. The Borrower has: (a) enacted the Law on Inspection Bodies aimed at streamlining inspection requirements, as evidenced by the Borrower's Law No. 254-N dated December 17, 2014 (duly published in the Official Gazette on December 30, 2015); and (b) issued regulations to said Law on Inspection Bodies to, inter-alia: (i) facilitate the introduction of an electronic information system for inspections, (ii) establish a market surveillance (MS) inspection body with its charter, organizational structure and working and HR procedures, and (iii) authorize the collection of supervision-related information by said MS inspection body, in accordance with the "Inspections Reform Strategy" and the Law on Inspection Bodies"; as evidenced by the *Government's Decrees* Nos. 677-N and 678-N, both dated June 18, 2015 (both duly published in the Official Gazette on June 29, 2015); 1063-N dated September 10, 2015 (duly published in the Official Gazette on September 23, 2015) and Minister of Economy's Orders No.856-A dated June 29, 2015.		Number of tax inspections: Baseline: 1470 (2013) Target: 1200 *Current: 1414*
			6. The Borrower has approved: (a) an amendment to the Law on Trade and Services; and (b) the Law on Business Notification, both aimed at introducing the principle of notification to streamline licensing for businesses, as evidenced by the Borrower's Law No. 35-N and Law No. 36-N, both dated on May 7, 2015 and duly published in the Borrower's Parliament webpage.	4. The Borrower has approved regulations to facilitate the implementation of the Law on Business Notifications thus replacing licenses for 17 low-risk activities with a simple notification mechanism.	Number of applications approved through the simple notification mechanism instead of licensing: Baseline: Zero Target: 35 *Current: 15*

Policy Areas	Prior Actions				Result Indicators
	DPF-1 Prior Actions	**DPF-2 Prior Actions**	**DPF-3 Prior Actions**	**DPF-4 Prior Actions**	(Baseline 2012, Target 2017, unless otherwise stated. *Current status, where available, is mentioned*)
		The Borrower has: (i) adopted through Protocol Decree No. 14 dated April 10, 2014 a Strategy and an Action Plan for creating e-government applications (including further requirements for e-signatures, electronic administrative registries, information access, and interoperability requirements for databases, etc.), and (ii) initiated the Strategy's implementation with the submission to Parliament of a draft "Law on Personal Data Protection" and a draft "Law on Amendments to the Law on e-Signature and e-Documentation" as evidenced by the Prime Minister's transmittal letter dated September 5, 2014, No. 01/23.18/14668-14 and its respective attachments.	7. The Borrower has adopted the Interoperability Program aimed at ensuring the inter-operability and secure data exchange between public e-government databases; as evidenced by the *Government's Decree* No. 1093-N dated August 31, 2015 (duly published in the Official Gazette on September 30, 2015).		Number of electronic IDs and certificates issued: Baseline: 26,000 Target: 900,000 *Current: 739,421*
6. Civil Service	In the Government session of July 25, 2013, the Government has adopted a draft Law on Amendments to the Civil Service Law designed to enhance the flexibility of recruitment and promotion of professional staff, and discontinue the mandatory periodical attestations, and submitted it to Parliament for approval on August 2, 2013.	The Borrower through the Civil Service Council Decree No. 833-A dated September 23, 2014, has strengthened its performance evaluation system, by adopting a comprehensive and mandatory job description catalogue specifying administrative and professional requirements and competencies for about fifty occupations in the Civil Service.		5. The Borrower has approved regulations to: (i) improve the mechanism for evaluating the performance of civil servants, and (ii) link bonus payments to performance in line with the Law on Civil Service.	Average value and standard deviation of performance appraisal scores of civil servants: Baseline: 95 percent and 3 (2015) Target: 90 percent and 5
7. Trade facilitation and connectivity		The Borrower has implemented measures to strengthen its management of cross border transactions, including through: (i) amendments approved by Parliament on May 20, 2014 to Article 128 of the Customs Code to allow *electronic declaration* as a valid mode of customs clearance to expedite processing; (ii) implementation of the "single window approach" for goods that require phyto-sanitary control	8. The Borrower has: (i) streamlined customs clearance procedures for e-trade at post services to improve trade facilitation, as evidenced by the *Government's Decree* No. 1461-N dated December 18, 2014 (duly published in the Official Gazette on December 20, 2014), and (ii) issued regulations to operationalize the functions of the Authorized Economic Operators (AEO) to facilitate self-		Percent of non-energy imports processed through the 'single window approach': Baseline: 20 percent Target: 45 percent *Current: 35 percent*

Policy Areas	Prior Actions				Result Indicators
	DPF-1 Prior Actions	DPF-2 Prior Actions	DPF-3 Prior Actions	DPF-4 Prior Actions	(Baseline 2012, Target 2017, unless otherwise stated. *Current status, where available, is mentioned*)
		through the initiation of the process for contracting special software and business process engineering that would facilitate customs clearance through Government Order No. 02/23.18/13691-14, dated August 29, 2014.	assessment and self-declaration; as evidenced by the *Government's Decree* No. 590-N dated May 21, 2015 (duly published in the Official Gazette on June 17, 2015), and the Borrower's Minister of Finance Orders No. 392-A and 389-A dated June 15, 2015, and Orders No. 583-N and 584-N dated August 26, 2015 (both duly published in the Official Gazette on September 15, 2015).		
	The Government: (a) through Government Protocol Decree No. 22 dated June 6, 2013 has adopted a new policy on aviation; (b) has published in the General Department of Civil Aviation (GDCA) website air services agreements and respective amendments aiming to raise transparency in the aviation sector; and (c) has completed and published a study on policy options for the liberalization of the air transport sector.	The Borrower has created a new institutional structure for its oversight of the aviation sector, which separates the responsibility for policy making and implementation, now to be handled by the Ministry of Economy, from certification and technical regulation, to be handled by the GDCA; a multi-stakeholder council will be in charge of licensing decisions and instructing the GDCA on approvals of applications for air services to increase transparency and accountability as evidenced by Government Decrees No. 856-N and 859-N introducing changes to the Charters of the Ministry of Economy and of the GDCA, respectively, passed on August 14, 2014; and Government Decree No. 1022-N dated September 25, 2014.	9 The Borrower has: (a) amended the Aviation Law aimed at strengthening the institutional framework, as evidenced by the Borrower's Law No. 101-N dated June 19, 2015 (duly published in the Official Gazette on July 22, 2015); and (b) issued regulations to the amended Aviation Law on: (i) the procedures for air operating license and air operating certification; and (ii) the criteria for establishing the Aviation Council, as evidenced by the *Government's Decrees* Nos. 962-N, 963-N, 964-N, 965-N, and 966-N, all dated August 6, 2015 (all duly published in the Official Gazette on September 2, 2015).		Number of airline passengers: Baseline: 1.69 million Target: > 2.11 million *Current: 1.6 million (January-September 2016)*
8. Access to Credit	The Central Bank has implemented a series of measures to enhance the operation of the credit registry and reporting systems, including: (i) issuance of specific requirements regarding consumer credits notified to all banks and credit organizations in Armenia; (ii) amendments to the Charter of Financial	The Borrower has adopted a series of legislative changes to create a modern regulatory framework for secure transactions, allowing the use of moveable assets as collateral for better access to credit, aiming to benefit small and medium sized companies; and submitted said legislative draft changes to Parliament in September 2014, which include: (a) Law on	10. The Borrower has: (a) enacted the Law on Secured Transactions aimed at registering secured rights movable property, as evidenced by the Borrower's Law No. 263-N, dated December 17, 2014 (duly published in the Official Gazette on December 30, 2014); and (b) issued regulations to said Law on Secured Transactions, concerning , inter-alia: (i) the	6. The Borrower has enacted the amendments to the Law on Bankruptcy thereby: (i) improving the rules for appointment, qualification, and remuneration of insolvency practitioners; (ii) improving the rehabilitation provisions in line with international best practices; and (iii) revising the	Number of credit reports issued: Baseline: 1.2 million Target: 4.5 million *Current: 4.3 million*

Policy Areas	Prior Actions				Result Indicators
	DPF-1 Prior Actions	DPF-2 Prior Actions	DPF-3 Prior Actions	DPF-4 Prior Actions	(Baseline 2012, Target 2017, unless otherwise stated. *Current status, where available, is mentioned*)
	System Stability and Development Consumer Protection Unit clarifying the role of said unit in relation to credit report matters; (iii) the limitation of the CBA's credit register functions starting in January 1, 2014; (iv) clarifying and consolidating the responsibility for credit reporting systems oversight by: (a) amending the charters of Supervision, Legal, and Financial Stability Departments; (b) defining the role of the Consumer Rights Protection Unit; and (c) establishing the responsibility for unified oversight and enforcement for all financial institutions in the "Licensing and Supervision Committee"; as evidenced by CBA's Chairman Decision Nos. 1/599A dated July 16, 2013 and 1/710L dated August 08, 2013; and CBA Circular dated July 4, 2013.	Registration of Rights in Movable Assets; (b) Law on Amendments to Civil Code; (c) Law on Amendments to Criminal Code; (d) Law on Amendments to the Law on Registration of Legal Entities; (e) Law on Amendments to the Law on Judicial Enforcement; (f) Law on Amendments to the Law on State Property Rights; (g) Law on Amendments on Banks and Banking; (h) Law on Amendments on Insurance; (i) Law on Amendments on Limited Companies; (j) Law on Amendments on Mining Code; (k) Law on Amendments on Law on trademarks; (l) Law on Amendments on Law on Aviation; (m) Law on Amendments on Tax Law; (n) Law on Amendments on State Duty; as evidenced by Prime Minister's transmittal letter No. 01/23.18/14616-14 of September 5, 2014 and attachments.	execution of the action plan to establish a credit registry, (ii) the recognition of the MoJ as the authority responsible for the credit registry, and (iii) the creation of the agency for registry maintenance, as evidenced by *Government's Decrees* Nos. 511-N dated May 14, 2015 (duly published in the Official Gazette on May 27, 2015), and 633-N dated June 10, 2015 (duly published in the Official Gazette on June 24, 2015).	moratorium provisions to enable rehabilitation of insolvent companies.	Index on the strength of the insolvency framework in Doing Business: Baseline: 9 (2015) Target: 12
	In the Government session of August 22, 2013, the Government has adopted a draft Law on Amendments to the Law on Funded Pensions and submitted it to Parliament for approval on August 28, 2013; and the Central Bank, during its Governing Board meeting held on September 9, 2013, has issued clarifications to some of the provisions of Article 44 of said Law to enhance pension fund asset management.		11. The Borrower has approved amendments to the Law on the Central Bank of Armenia, the Law on Banks and Banking Activity, the Law on Insurance and Insurance Activity, the Law on Securities Market, the Law on Investment Funds, and the Law on Credit Organizations; aimed at consolidating supervision of financial institutions and financial groups, as evidenced by their publication in the Borrower's Parliament web page.	7. The Borrower, through the CBA, has approved a package of regulations on consolidated supervision in line with the Laws on Financial Supervision. 8. The Borrower, through the CBA, has approved regulations to ensure disclosure of ultimate beneficial ownership of financial institutions and groups.	Number of consolidated audits carried out by the CBA: Baseline: Zero (2012) Target: At least 1

Annex 2. Letter of Development Policy

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PRIME MINISTER OF THE REPUBLIC OF ARMENIA

Letter of Development Policies
Republic of Armenia

Yerevan, November 3, 2016

Mr. Jim Yong Kim
President, the World Bank
Washington, USA

Dear Mr. Kim:

Allow me to express assurances of my consideration on behalf of the Republic of Armenia.

In this letter we would like to present the expected trends of economic developments and ongoing reforms in the Republic of Armenia.

The Government program:

The Government vision of the country's long-term development is reflected in the 2014-2025 Long-term Development Strategy Program adopted per Government Decree 442-N of 27.03.2014. The Strategy identifies four key priorities based on which medium-term, sectoral and other program documents are built. These priorities are:

1) **Employment growth**: for the first years of the Development Strategy of Armenia, employment growth is recognized as a key priority with focus on efforts towards creation of high quality and well-paid jobs. The government actions should aim at providing opportunities for fair incomes for everyone commensurate to one's working skills and efforts.

2) Development of human capital: within the context of this priority objective, activities will be carried out towards broadening the scope, quality and accessibility of primary services (including health care, education, science, culture and key infrastructures) along with placing a special focus on ensuring harmonization of nature-individual relations.

3) Enhancement of the social protection system: the system improvements are now underway: creating bases for long-term financial sustainability, ensuring comprehensive social guarantees, reducing significantly social risks, and the poverty component are the fundamental actions within the context of this priority objective.

4) Institutional modernization of public administration and governance: actions will be taken towards implementing the adopted fundamental policies and ensuring the consistency of reforms aimed at improving the efficiency of the State, broadening the State resources and their targeted use, enhancing the quality and accessibility of public services, reducing corruption, increasing the transparency of decision-making and broadening the civil society involvement.

Along with setting employment growth as a key objective, we will focus on creation of jobs in the non-agricultural sector which will be accompanied primarily by increased efficiency. In the long-term horizon it is also planned to make changes to the employment structure. These changes will rely on the industry and construction sectors which will account for the main share in the employment growth.

The above mentioned ongoing reforms have been implemented with the invaluable support of both the Armenian government and donors. The assistance provided by the World Bank has a crucial role for the economic recovery and further sustainable growth. The proposed new Development Policy Operation will support the strengthening of necessary conditions of the sustainable growth fundamentals which is a prerequisite for achieving sustainable macroeconomic situation.

In addition, the new government program envisions implementation of rapid and radical reforms, having in mind the current economic situation in Armenia and the existing challenges. Analysis of the economic situation shows that development cannot be achieved by using standard instruments and methods. Therefore, the government undertakes to conduct an in-depth diagnosis of the governance system and the economic situation within the shortest possible timeframe and then, relying on international experience, propose a plan of short-term actions, as well as **long-term strategic reform programs** identifying the conditions for development of the Armenian economy. For the purpose of elaborating long-term strategic programs, it is planned to establish a **Center for Strategic Initiative** at the Government where leading specialists and experts of the country will be involved in efforts towards addressing the above issue.

In order to implement short-term measures within the shortest possible timeframe, it is planned to adopt a new economic policy aiming to address the below issues apace with a number of strategic objectives pursued by the government:

- Developing democratic institutions,
- Increasing trust in the election system,
- Fostering export-oriented production in priority areas,
- Providing government support to emerging clusters in the private sector, including those ensuring rapid economic growth (IT, agro industry, tourism, etc.),
- Attracting private and large international investments in Armenia,
- Triggering public-private partnerships,
- Diversifying the electricity generation structure through clean and renewable energy sources, as well as developing energy efficient technologies,
- Improving environmental protection,
- Ensuring qualitative growth in the health care and education sectors,
- Increasing the targeting of social assistance.

Having in mind the specifics of the Armenian economy, **encouraging of exports** in the medium and long terms should become the main driving force for development of the national economy.

The State will have its contribution in ensuring economic growth via creating an attractive and trustworthy environment which will be realized through supporting the economy in all possible ways, and through labor market, IT, energy and transport sectoral policies, as well as legal policy and economic diplomacy.

Macroeconomic Situation

Despite the abundance of external challenges, in particular, the recession in the Russian economy, fallen copper prices, as well as low level of economy lending, economic growth in 2015 was 3.0 percent. In January-June, 2016 economic growth was 2.8 percent compared to the previous year, and the economic activity indicator for January-August vs. the same period in the previous year was 2.4 percent. High growths recorded in the mining industry, gambling and agriculture were the main contributors to the economic activity growth. Following income-related shocks in 2014-2015, the ultimate household consumer spending stabilized in the second quarter of 2016, thus recording a fragile increase of 0.2 percent. The overall consumer spending moderately grew, although government expenditures related to main consumption had the key role in this increase. Low, but recovering demand and certain increase in external demand accompanied the economic growth during the first six months: domestic consumption picked up while investments dropped whereas improvement was observed in net exports which, in turn, was primarily due to increased export of goods and services, as opposed to the previous year when the positive change in net exports was due to decreased imports.

In this environment, economic growth based on the results of the current year (2.2 percent) will be above the planned level envisaged in the 2016 budget program but it will still remain low (around 2.4 percent). Factors affecting the modest economic growth are: considerably lower demand in partner countries and the effect of shocks associated with low disposable income indicator expressed in real terms due to reduced remittance flows.

Low domestic demand resulted in a decrease of the current account deficit in 2015 to 2.7% of GDP against 7.6% in the previous year reflecting the sharp drop in imports. In the first half of 2016 the country's current account deficit continued improving, mainly triggered by increased net exports which, in turn, is taking place due to expansion of exports and reduction of imports (in nominal terms). Growth of exports for the first 8 months of 2016 had a 2-digit value, primarily due to export of precious and semi-precious metals, finished foodstuff and textile products which were the main drivers of increase in exports.

In order to ensure macroeconomic stability and counter external shocks, the government has implemented anti-cyclic fiscal policy. Results show that the macroeconomic policy implemented during the year was reasonable from the perspective of ensuring macroeconomic stability and mitigation of shocks affecting incomes. The fiscal policy approach was stimulating and, at the same time, reasonably balanced, thus ensuring a stimulating effect on the overall demand. In addition, moderate investment in economic recovery aimed to prevent potential risks undermining macroeconomic and debt sustainability. Besides, an objective was set to invest moderately in recovery of the economy without undermining macroeconomic and debt sustainability along with achieving a general stimulating effect on overall demand through the macroeconomic policy.

The *Export-Oriented Industrial Policy Strategy of the Republic of Armenia* implemented by the government has largely contributed to economic recovery. The government expects that improvement of the current account deficit thanks to faster export growth (compared to imports) will continue in the medium term. But the existing challenges in global development, geopolitical threats and related potential external risks should not be ignored. Under the mentioned conditions, the lower than expected level of demand in partner countries, particularly Russia, as well as price instability in international markets can adversely affect the Armenian economy by reducing the export growth rates.

In June, 2016 the 12-month deflation was 1.1 percent which is below the 1.5 percent permissible band within the 4 percent target. It is anticipated that at the end of 2016 the 12-month inflation will return to its positive band. In the medium term horizon it is projected that inflation will return to its target level. It should be noted that risks from external and domestic economy persist, and if these are materialized, the CBA will possibly respond through appropriate monetary policy terms in order to meet the inflation target.

Macroeconomic and Fiscal Framework

It is projected in the draft 2017 State budget that the Armenian economy will grow by 3.2 percent in 2017. However, the government will strive to accelerate growth rates to reach 4 percent in the medium term driven mainly by growth in industry and services, coupled by global economic developments, including recovery of economic growth rates in Russia starting 2017, as well as expected recovery of metal prices.

Due to anti-cyclic fiscal policy and changes in the economic growth structure, the public debt to GDP ratio is close to 50 percent. In order to counter exogenous shocks for macroeconomic stability purposes, the government has implemented an anti-cyclic fiscal policy, at the same time the change in the economic growth structure has adversely affected the tax to GDP ratio and thus, following the above mentioned policy measures, the level of public debt grew. The government is committed to maintain sustainable macroeconomic environment which will allow to counter external shocks. In this regard, fiscal consolidation will be conducted in the medium term under the conditions of high and growing public debt for the purpose of ensuring debt sustainability. Results of debt sustainability analysis show that the public debt remains sustainable whereas risks are growing. We have envisioned adjustments through comprehensive tax reforms which will be targeted in the medium term at reducing the debt level and ensuring sustainability. In 2016 the fiscal deficit target was above the one projected in the medium-term program (5.9 percent of GDP) due to under-collection of taxes and moderate growth of expenditures. Nonetheless, taking into account the debt sustainability framework, in 2017 we expect a 2.8 percent deficit/GDP ratio.

Management of Social Risks and Development of Human Capital

The priority of the social risks mitigation policy for the coming years is to ensure the planned key social transfers and investments but we will manage the allocations cautiously, having in mind the budgetary tension. At the same time, taking into account the potential growth of social vulnerability, as well as the poverty level in 2014 (30 percent) we plan to maximally increase the number of needy beneficiaries firstly through enhancing the targeting of social transfers and improving the overall efficiency of our programs.

On December 17, 2014 the Law on Social Assistance establishing the legal basis for the integrated social services system was passed by the RA National Assembly which became effective on January 1, 2015. During 2015, key legal acts ensuring the enforcement of the mentioned law were drafted and adopted.

Activities aimed to enhance information infrastructure of the pension security sector are in progress. In particular, today the necessary information available in the population registry is applied automatically. Steps have been taken towards automating the procedures of sharing bank account information with banks and paying pensions through bank accounts.

Activities of implementing the employment tenure assessment module based on personified income tax and social contribution recordkeeping information system are in progress.

In 2014 the implementation of the funded pension system was launched. With the enactment of the new RA Law on Funded Pensions on July 1, 2014, the issue of harmonizing specific provisions with the law recognized as inconsistent with the RA Constitution and invalidated per the Constitutional Court Decision No. CDO-1142 of April 2, 2014 was finally resolved. According to the Law, the funded component (Pillar 2) should be fully launched from July 1, 2017. This timing was extended for one year under the legislative change made in 2016.

Today the number of participants enrolled in the system exceeds 150 thousand and more than half of these individuals are employed in the private sector (including those who can refuse paying social contributions).

The Government is improving the family benefit's targeting. It is a priority that the increase of public funding for the benefit system, as well as the efficient use of such funds are integrated into social assistance area and become key factors for reducing poverty which, in turn, will be a major step towards increasing the livelihood of the poor and reducing poverty and inequality in the country. From August, 2016 the family benefit level was increased by AMD 1000 (associated with the electricity tariff). The draft RA Law on 2017 State Budget envisions an approx. 3 percent upward adjustment of appropriation for paying family benefits (due to the increase of the benefit amount by AMD 1000 in 2016). From January 1, 2016 maternity benefits and child care benefits for unemployed women are granted and processed through the newly created information system which ensures the data accuracy (individuals' data are identified based on the population registry data). The activities of developing sub-systems for on-line submission of applications for the one-off child birth benefit are completed. This will allow beneficiaries to receive the one-off child birth benefit without having to visit their regional centers (the draft legal act ensuring the enforcement of these sub-systems has been submitted to the Government). During 2014-2016 AMD 20.2 billion was allocated for social packages provided to employees of government agencies, as well as specialists of the education and culture areas, employees of social protection organizations. These packages are aimed at meeting the health care, education and other needs of the above employees and their families.

Improving the Business Environment

Creating an enabling environment for high business activity and sustainable investment flows is regarded by the Government as a crucial factor for economic progress in the country. To this end, the Government has a comprehensive policy agenda, which to some extent, is also covered in the DPF package.

The Law HO-120-N on Activity Notification and the package of related legislation was developed by the National Legislative Regulation Center during the first quarter of 2015 and passed by the National Assembly on November 13, 2015. Under the mentioned law, several types of activities were removed from the list of those subject to licensing and included in the notification regime. As a result of adoption of the mentioned package, a simple electronic notification to the authorized body is required for engaging in around 15 types of economic activities. Two other licenses are ultimately removed from the licensing framework.

The Law HO-120-N on Activity Notification and the package of related legislation adopted on November 13, 2015 fully regulate the types of activities included in the new notification regime. They do not create any additional risks associated with the regulation of such activities because the respective requirements are binding also for notified activities: this change simply involves removal of the initial market entry permission mechanisms, and a control mechanism is put in place after launching business.

At the same time, under Prime Minster Decree 258-N on Approving the List of Measures Ensuring Enforcement of Several Laws of the Republic of Armenia of April 4, 2016, the lists of measures ensuring the enforcement of the Law HO-120-N on Activity Notification and the package of related legislation adopted on November 13, 2015 were approved, and the respective RA public administration bodies have presented the supporting sub-legislative acts to the Government for approval according to the timetable set in the above decree.

According to the World Bank *Doing Business* ranking report, out of ten indices, Armenia has made progress in three ones. In particular:

- For the Trade across Borders index, the country's position has improved by 29 points, moving from 58 to 29. The progress is explained by shorter time-period spent on exporting and importing, which is 5 hours both for export and importing instead of 16 and 18 days, as well as a reduction in the number of necessary documentation for exporting and importing which is now 4 for both instead of 5 and 8.
- For the Dealing with Construction Permits index, the country's position has improved by 10 points, moving from 72 to 62. The number of processes is reduced by 1 and the costs are now lower by AMD 175.000.
- For Enforcing Contracts index, Armenia's position has improved by 8 points, moving from 36 to 28. The progress is due to the changes to the RA Judicial Code according to which judges are assigned to cases randomly, through a fully automated system. As a result, the quality of contract enforcement has improved.

Among 189 countries covered by the report in the ranked areas, Armenia has leading positions for Staring a Business (5th position), Registering Property (14th position), Enforcing Contracts (28th position) indices. While progress is observed for Getting Electricity (99th position), Resolving Insolvency 71th position) and Dealing with Construction Permits (62th position) rankings, still efforts should be exerted towards reforming these areas and ensuring tangible progress.

The government is committed to undertaking and implementing targeted actions towards improving the country's position in international rankings. For example, an action plan for improving Armenia's position in Global Competitiveness index was adopted in 2014 which is revised annually based on progress results. The latter is a series of multi-disciplinary actions covering expansion of the exportable sector of the economy and development of quality infrastructure, budget system reforms, infrastructure development, and enhancement of efficiency in the health care and education sectors, broadening of opportunities for agricultural development.

Reforms Implemented as part of Prior Actions under DPF-4

1. Tax and Customs Reforms. Adoption of the Tax Code

The below main activities have been implemented in the tax reform area:

1) Efforts have continued towards enhancing the e-filing system, specifically, new reporting forms have been developed, as well as some of the existing forms have been revised based on legislative changes. In addition, all legal regulations necessary for e-filing of environmental and natural resources use reports are put in place,

2) From January 1, 2016 full transition is made to the e-system for issuance of settlement documents,

3) From July 1, 2016 the system for issuing adjusting tax invoices is operational, software-related

issues of electronic issuance, as well as cancellation of tax invoices have been resolved,

4) Through revisions to the tax legislation, the respective legal bases have been established for implementing a new treasury single account system from January 1, 2018 for recording taxpayers' tax liabilities to the state budget. The implementation of such a system implies exclusion of overpayments and automated repayment of liabilities from funds accrued on the single account,

5) For the purpose of contributing to efficient and effective use of operating funds of businesses treated as VAT payers, a gradual transition has been made to the accrual basis of VAT offsetting (from January 1, 2016 for entities with up to AMD 500 million taxable turnover).

Within the framework of EEU membership, measures have been implemented by the customs authorities in the following areas:

1) The timing for storing goods in temporary storage warehouses before filing the customs declaration is set to be 2 months with a possibility for extending this timing to 4 or 6 months,

2) After filing the customs declaration, the accuracy of its completion should be checked within 4 hours, after which the customs declaration should be registered by the customs authorities,

3) A possibility is provided for releasing goods by customs authorities within a working day (and for some customs procedures – within 4 hours) upon performing all customs procedures, registering the customs declaration and effecting customs payments,

4) As a result of introducing the institution of authorized economic operators, a number of specific simplifications have been defined for entities involved in foreign economic activities which meet the criteria established in the customs legislation, such as:

- Temporary storage of goods in the facilities of authorized economic operators, open grounds and other sites,
- Release of goods prior to filing of customs declaration,
- Implementation of customs operations related to release of goods in the facilities of authorized economic operators, open grounds and other sites,
- Other special simplified procedures laid down in the legislation of the Customs Union,

5) It has been established that in case of any disagreements during the exercise of control by customs authorities as part of customs procedures performed during the demonstration of goods by the applicant, when a security for paying customs duties and taxes is presented, goods can be released, provided the unpaid portion of customs fees is paid upon changing their FEA CC code or customs value,

6) New *Processing for Domestic Consumption* and *Special* customs procedures have been established which accordingly envision organization of inland production of goods intended for domestic consumption by using foreign raw materials, and application of privileges for import and (or) export of certain categories of goods,

7) Opportunities have been provided for applying a simplified declaration procedure for border-crossing of individuals and vehicles. During the import of personal effects by individuals, the customs value of goods imported by such individuals is determined based on their declared value, without including their transportation and insurance costs,

8) The time-frames of customs procedures of economic nature (processing within the customs territory, processing outside the customs territory) have been extended.

9) As a result of legislative changes which came into effect in 2016, legal violations involving smuggling of goods and waste, disposal, hiding or illegal transfer of property of not large value which is under lien or subject to seizure have been decriminalized. The definition of 'smuggling' has been revised, and its specific forms are now described in the RA Criminal Code.

The draft Tax Code was approved at the government session on March 31, 2016 and duly presented to the RA National Assembly for consideration. On October 4, 2016 the RA National Assembly fully adopted the Tax Code at its third reading. Some of its provisions which pertain to sub-excise goods will become effective on January 1, 2017 while the Code itself will enter into force from January 1, 2018.

Changes envisioned in the Tax Code have been discussed with the World Bank team in the course of its review both within the government and the National Assembly, and mutually acceptable solutions were reached.

It is anticipated that the adoption of the Tax Code will serve as an important factor for ensuring additional tax revenues, creating an enabling environment for attracting investments, as well as establishing a sustainable and predictable tax environment. It consolidates the entire Armenian tax legislation for the purpose of broadening the tax base, optimize tax rates and eliminate the main gaps in the existing tax legislation. In particular, the Tax Code envisions limiting the scope of VAT exemptions, including eradication of VAT exemption for import of diesel fuel and its further disposal, from 2025 eradication of the profit tax exemption for agriculture, increase of the excise tax rates for tobacco products, alcoholic beverages, condensed natural gas and engine oils along with preserving the combination of progressive rates, gradual increase of the rates of environmental tax and natural resources use fee, creation of legal framework for calculation of immovable property tax based on its market value instead of its cadastral value.

On the other hand, important changes are made within the framework of the Tax Code towards improving the business climate and increasing investment activity of businesses. In Particular, it is established that taxpayers may receive back VAT debit balances on a semi-annual basis; a new alternative system for making profit tax advance payments is introduced. These two changes aim to increase taxpayers' operating funds and improve the efficiency of their spending.

Significant improvements are made under the Tax Code in the tax administration area. In particular, a single account system is being implemented which, on the one hand, will allow to avoid further accumulation of tax overpayments, and, on the other hand, will considerably reduce taxpayer – tax authority contacts. A horizontal monitoring system is being introduced for the purpose of strengthening partnership relations between taxpayers and the tax authorities, improving the quality of taxpayer services and broadening their scope. In order to better manage tax avoidance risks and to ensure level conditions for business, a system of transfer pricing rules is being implemented. For the purpose of improving the business conditions for bona fide taxpayers, responsibility measures are loosened in all cases when tax infringements are committed non-deliberately, without causing any losses to the state budget.

2. Ensuring Financial Sustainability of Irrigation System

Studies have been conducted by the World Bank in this area. The main study which is entitled 'Strategy for Improving Financial Sustainability of Irrigation Sector' defines the key areas for using economic levers for irrigation water, modernization of the irrigation system, reduction of water losses. It is anticipated to improve the performance of WUCs and water intake companies with the aim of making a gradual transition from water user companies (WUCs) to water user associations (WUAs) in terms of irrigation process management. Today, irrigation water is supplied to water users by 37 WUCs through two water intake companies.

This transition will allow to empower WUCs with certain authority of land use consultancy, agricultural planning, and farmer support.

The course of reforms in the irrigation system should gradually lead to a public-private partnership.

On August 25, 2016 Government Protocol Decree No. 33-18 on Approving the Strategy for Improving Financial Sustainability of Irrigation Sector and Its Action Plan was adopted. Its components include construction of new water reservoirs, modernization of existing infrastructures, deepening of institutional reforms, strengthening of participatory governance, as well as institution of a new level of transparent relations with water users.

A draft government protocol decree on approving the program for restructuring payables of irrigation system companies has been developed by the State Water Economy Committee at the RA Ministry of Agriculture. Based on feedback from the RA Ministry of Finance, the draft decree has been revised and submitted to the RA Ministry of Justice for expert conclusion. Upon the receipt of the mentioned conclusion, the draft will be presented to the Government.

3. Amending the Mining Code

On June 22, 2015 the Law HO-105-N on Making Modifications and Additions to the RA Law on Waste was passed. In consistency with the mentioned legislation, during 2016 draft RA Laws on Amending the Mining Code, Amending the Law on Environmental and Nature Resources Use Fees, Supplementing the Law on Waste were developed. The mentioned drafts regulate issues pertaining to management of mine waste and mine waste handling facilities. More specifically, they establish the principles for safe operation of mine waste handling facilities, the rights and responsibilities of operators in the sector, assessment of impact threats and risks to human health and the environment, processes of closure and reclamation of the respective facilities, submission of mine waste management and mine waste treatment plans, creation of financial guarantees according to mine waste management and mine waste treatment plans.

The need for developing these draft laws derives from the necessity for harmonizing the Armenian legislation with Directive 2006/21/EC of 15 March, 2006 and Directive 2008/98/EC of 19 November 2008 of the European Parliament and of the Council.

As a result of revisions, the concept of 'man-made mine' has been removed from the Code, and production heaps originated from prospecting, mining or treatment of minerals are treated as mine waste (also including tailings). In the code, the concept of mining now also covers treatment of mine waste, but there is no need for issuing an additional permit for mine waste treatment because it is a constituent component of the mineral mining permit. The mining agreement sets forth provisions on the procedure and terms for presenting financial guarantee.

Management and treatment of mine waste must be performed without causing any harm to human health, and such technologies should be applied that will minimize the negative impact of the environment, as well as the landscape, or special sites, such as monuments of history, culture, ethnography, nature.

In the course of mine operation and after mine closure, operators must undertake at their own expense measures anticipated under the mine waste management plan – and in cases identified in the Code, the mine waste treatment plan in order to prevent or minimize any harm to the environment or human health.

The RA Law on Amending the Mining Code has been passed by the RA National Assembly on October 18, 2016; the Government undertakes to develop and adopt by July 31, 2017 the respective secondary legislation on management of mining waste and closure of mines that will ensure effective implementation of the amended Mining Code.

At the same time, taking into account the high level of interest of non-governmental and private sector stakeholder organizations in the above revisions, it is planned to conduct public hearings through authorized government bodies this November during which detailed clarifications will be presented on the effected changes and the concerns raised by stakeholders.

4. Business Notification Process and Reducing of Number of Licenses

The Law HO-120-N on Activity Notification and the package of related legislation was developed by the National Legislative Regulation Center during the first quarter of 2015 and passed by the National Assembly on November 13, 2015. Under the mentioned law, several types of activities were removed from the list of those subject to licensing and included in the simple notification regime. As a result of adoption of the mentioned package, a simple electronic notification to the authorized body is required for engaging in around 15 types of economic activities. Two other licenses are ultimately removed from the licensing framework.

The Law HO-120-N on Activity Notification and the package of related legislation adopted on November 13, 2015 fully regulate the types of activities included in the new notification regime and do not create additional risks associated with the regulation of such activities because the respective requirements are binding also for notified activities: this change simply involves removal of the initial market entry permission mechanisms and the control mechanism after launching business is put in place.

5. Civil Service Reforms

The role of civil service policy attains special importance in post-crisis development stage of the economy when quality human capital needs to be recruited in the system for the sustainable development of the economy.

For staff motivation purposes the government continuously enhances performance-based supplement payment procedure for civil servants. Measures towards increasing performance-based supplement payments aim to strengthen the public sector capacity to recruit and retain adequately skilled and proficient employees.

The draft decree on making appropriate amendments to Government Decree No. 1510-N on *Approving the Procedure for Preparation of Work Programs in State Power Bodies of the Republic of Armenia, Inputting of Work Programs in the Electronic Documentation Flow System, Their Validation, Performance Appraisal through the System and Performance-based Awards* of October 20, 2011 was discussed and adopted at the Government session on September 22, 2015.

The need for adopting the draft decree was also driven by the increased level of objectivity of the performance appraisal system, as well as the need for creating a competitive environment for improving performance efficiency through a reformed appraisal system for employees.

Presently the draft RA Law on Civil Service is in its development stage, according to which the below listed will be improved in the civil service:

- Process of selection and hiring of civil servants based on the principles of equal access, transparency and merits,

- Process of promotion of civil servants according to the merit and capacity-based principle,
- System of classification of civil service positions,
- Issues pertaining to lawfulness of civil servants, their rules of ethics, conflict of interest and its exclusion,
- Mobility system in the civil service system.

On September 22, 2016 the Government approved the draft decree on Making Appropriate Amendments to Decree No. 1510-N on *Approving the Procedure for Preparation of Work Programs in State Power Bodies of the Republic of Armenia, Inputting of Work Programs in the Electronic Documentation Flow System, Their Validation, Performance Appraisal through the System and Performance-based Awards* of October 20, 2011. Presently, the development of draft Law on Civil Service is underway. These measures, inter alia, are aimed at streamlining and enhancing the systems of selecting and recruiting, promotion, mobility of civil servants.

6. Access to credit: Adoption of Revisions to the Bankruptcy Law

During the period from October 1, 2015 to September, 2016, after the adoption of the RA Law on Registration of Secure Rights to Movable Property on December 17, 2014 by the RA National Assembly, 1529 secure rights to movable property were registered by the Movable Property Secure Rights Registration Agency of the RA Ministry of Justice, changes were made to 143 registrations and 587 ones were terminated.

On June 17, 2016 the National Assembly passed the RA Law on Amending the RA Law on Bankruptcy. The below regulations are covered in the mentioned law:

• The timeframe of financial rehabilitation program is extended from 36 months to 72 months.

• For unhealthy but still not liquidated organizations, a pre-bankruptcy process is introduced for the purpose of ensuring the rights of unhealthy organizations which will contribute to their rehabilitation.

• No moratorium will be applied to debt incurred after the approval of the motion on bankruptcy by the court. By this amendment the RA Law on Bankruptcy has been aligned to the legislation of several countries. The purpose of moratorium is to protect the debtor from debt collections before the implementation plan is approved.

• Bankruptcy cases will be reviewed by specialized judges.

• Cases related to a particular bankruptcy case will be reviewed as part of the concerned bankruptcy case.

• Civil restrictions on individuals after bankruptcy have been repealed.

• Compensation of bankruptcy administrators includes encouragement payments from financial rehabilitation claims at the rate of 5 percent.

• Code of conduct for administrators, and the bases for suspending and terminating their powers are established. Moreover, for the purpose of ensuring the efficiency of the bankruptcy process, annual trainings are defined for administrators.

7-8 Financial Sector Reform.

With a view to improve the financial sector framework in line with international standards, to increase its transparency and strengthen its sustainability, on September 27, 2016 the Central Bank approved the package of regulations on consolidated supervision and disclosure of ultimate beneficiaries of financial groups. The package includes:

• Regulation 20/01 'Regulation for Recognition of Financial Groups and Termination of Qualification As a Financial Group, Making Changes in Composition of Financial Groups, Designation of Responsible Persons of Financial Groups, Types of Financial Groups', CBA Board Resolution 157-N of 27.09.2016,

• Regulation 20/02 'Limits of Economic Prudentials of Financial Groups, Composition of Elements Included in Their Calculation and Frequency of Calculation' CBA Board Resolution 158-N of 27.09.2016,

• Regulation 20/03 'Reports Filed by Financial Groups with the Central Bank of the Republic of Armenia and Their Frequency', CBA Board Resolution 159-N of 27.09.2016,

• Regulation 20/04 'Minimum Conditions for Internal Control of Financial Groups', CBA Board Resolution 190-N of 27.09.2016,

• Procedure for Maintaining Registry of Financial Groups, CBA Board Resolution 161-N of 27.09.2016,

• CBA Board Resolution 162-N on Amending CBA Resolution 166-N of June 2, 2009.

With a view to improve the financial system regulatory framework in Armenia, as well as ensure bases In order to exercise its powers in the area of consolidated supervision as prescribed in the Law on the Central Bank of Armenia, in 2016 the CBA Board has approved the package of regulations on consolidated supervision and disclosure of beneficial owners of financial groups.

8. As agreed between the CBA and the World Bank, Benchmark 8 of DPF-4 has been reformulated as 'disclosure of beneficial owners of financial groups' along with the adoption of the respective regulatory framework by the CBA. The package of regulations approved by the CBA Board on 27.09.2016 sets forth provisions on disclosure of beneficial owners of financial groups.

In addition to the above mentioned reforms under DPF-4, we would like to present a brief account of progress in important reforms highlighted in previous years. In particular:

1. Aviation sector reform

After the promulgation of the open sky policy, outreach activities were carried out to inform partner countries and all stakeholders of changes taking place and new opportunities in the aviation sector in the Republic of Armenia. Negotiations were conducted with aviation authorities in 26 partner states for revising air communications agreements. Preliminary negotiations are underway for joining the EU common aviation zone which will allow liberalizing air communications with EU member states. We were successful in liberalizing the air communications sector with several states, including granting of 5th sky right and elimination of restrictions on commercial activities of air companies along with consistently applying the reciprocity principle in all cases.

From 2016 *Aviakompania Armenia*, the local airline started its regular flights, and today it is expected that the frequency of its flights and number of routes will grow.

Through participation in a number of international conferences and working discussions, ongoing efforts are taken towards attracting new air companies in the Armenian aviation market, as well as increasing the weekly frequencies of flights by air companies servicing the Armenian market. As a result of negotiations with more than 30 airline companies, some companies have accessed the Armenian market while others are interested in servicing incoming flights and are now in the process of conducting market surveys.

The comparative dynamics of passenger operations is as follows: compared to January-September, 2015, during the same period of 2016 the number of passengers grew by 5.7 percent, and the increase in the number of passengers only in September, 2016 compared to the same month of 2015 was 26.8 percent.

2. Business Audit Reforms

As a key guarantee for strengthening the trust of the business community in the State, these reforms are within the logic of building new economic and legal relations for further improving the investment and business environment. The Government has taken steps in this direction by adopting the inspection reform concept paper in 2009. Appropriate legislative changes were made for the purpose of implementing the provisions set forth in the concept paper. Use of risk-based inspection methodologies and availability of checklists has become a mandatory requirement for inspection bodies.

With a view to ensure the logical continuity of reforms, reduce administration corruption, eliminate duplication of inspection functions, as well as achieve more efficient use of resources, the Government has launched the inspection system streamlining program.

The foundation of third generation reforms in the sector was laid in 2014 through adoption of the RA Law on Inspection Bodies and the Inspection System Optimization Concept Paper and Brief Action Plan (both covered by DPO-2). The implementation of the third-generation reforms consistent with the new law and strategy envisions a modern and effective inspection system, regulation of the legal status of inspection bodies, their establishment (through or without amalgamation, dependent on specific cases), management, principles and specifics of organizing their operations, as well as creation of a single data sharing information system. In order to implement the mentioned changes in consistency with the requirements of the new legislation and concept paper, creation of a single inspection body is envisioned under DPO-3 benchmarks which will become the 'evidence of reform implementation' and will allow to apply practical solutions in other inspectorates. One of the DPO-3 prior actions is the reorganization of the Market Supervision Inspectorate of the RA Ministry of Economy in light of the more important role of the mentioned inspectorate in private sector, domestic and external trade, application of technologies, etc. Presently activities are underway towards creation of the Market Supervision Inspection Body, and the respective legislative package was approved at the meeting of the Inspection Reform Coordination Council at the Prime Minister Office on September 2, 2016. At the same time, preparatory work is conducted for the establishment of two other inspection bodies (State Health Inspectorate and two inspectorates of the RA Ministry of Finance) which are covered by DPF-4. Adoption of the respective government decree on creation of a single data sharing information system is envisioned under DPO-3 actions, and it has been already approved as per Government Decree 678-N of June 18, 2015.

3. Infrastructure: Portable Water Supply

Over the recent years investments were channeled to modernization of water supply and water removal systems. At present the 2[nd] generation reforms are underway in the water supply and water removal sector. Within the scope of PPP development, a single operator for the water supply and sanitation systems has been selected through a tender, and it is planned to sign a concession agreement with the above organization aimed to ensure reliable and safe water supply and removal. The government, represented by the lessor, i.e., the State Water Economy Committee of the Ministry of Agriculture, will undertake effective and operant measures towards ensuring all key provisions of the concession agreement aimed to enhance water supply and removal services.

The Government undertakes efforts through the use of various tools and principles, including through public-private partnership cooperation, with the investment policies supported by loan proceeds, to increase the level of cost recovery of companies and the quality of provided services.

A number of actions and projects have been implemented to achieve sustainability in the portable water supply and sanitation sector, which are continuous by nature. These actions and projects aim to improve record-keeping systems along with ensuring the reliability, sustainability and safety of water supply and sanitation, improving the quality of provided services, and the proficiency of staff involved in the service delivery. Projects for improving water supply and removal which have been implemented with the support of public funds, investments and loan proceeds, aim to address these issues.

Project Monitoring and Evaluation

The key counterpart for implementation of the DPF series is the Staff of the RA Government. Pursuant to the Prime Minister's Decree No. 901-A of September 17, 2014 the Chief of Staff of the Government of the Republic of Armenia-Minister Davit Harutyunyan was appointed as the coordinator of the Development Policy Operation Project signed between the Government of the Republic of Armenia and the World Bank.

Key monitoring and evaluation indicators of reform results planned under DPFs are regularly collected and analyzed by the Financial and Economic Department of the Office of RA Government.

Կ. Կարապետյան **KAREN KARAPETYAN**

Annex 3. Fund Relations

IMF Executive Board Completes Third Review of Armenia's Extended Arrangement

Press Release No. 16/284
June 15, 2016

The Executive Board of the International Monetary Fund (IMF) completed today the third review of Armenia's performance under a three-year arrangement under the Extended Fund Facility (EFF). The completion enables the release of SDR 15.65 million (about US$22.01 million), bringing total disbursements under the arrangement to SDR 50.87 million (about US$71.53 million). The extended arrangement for SDR 82.21 million (about US$115.60 million) was approved on March 7, 2014 (see Press Release No. 14/88).

In completing the review, the Executive Board also approved the authorities' request for waiver of non-observance of the end of December 2015 fiscal deficit performance criterion (PC), modification of the end-June 2016 fiscal deficit and budgetary domestic lending PCs, as well as shift from a net domestic assets (NDA) PC to monetary policy consultation clause (as of end-June 2016).

Following the Executive Board's discussion on Armenia, Mr. Mitsuhiro Furusawa, Deputy Managing Director and Acting Chair, said:

"Despite difficult external conditions, program performance has been broadly satisfactory, with most targets met. The weak global and regional conditions have, through lower commodity prices and remittances, contributed to declining domestic demand. Moreover, bank credit growth and inflation have been negative. Nevertheless, real GDP growth has held up moderately, primarily due to export-related supply-side factors in mining and agriculture. Monetary conditions have stabilized and pressures in the FX market have diminished.

"The authorities remain committed to fiscal consolidation and debt sustainability, along with a greater focus on revenue gains to protect and increase capital and social spending. The new tax code (recently submitted to the national assembly) provides a major opportunity to broaden the tax base by reducing exemptions and addressing gaps and thereby supporting both consolidation and increases in growth-enhancing spending.

"The central bank's actions have helped ensure orderly market conditions and financial stability. Going forward, exchange rate policy will continue to limit intervention and sustain buffers. Further normalization of the monetary conditions will help bring inflation closer to the target and support a resumption of bank lending, while the use of macro- and micro-prudential regulations and further strengthening of the crisis preparedness framework will help maintain orderly financial markets conditions.

"Pursuing further structural reforms to enhance competition, competitiveness, and regional and global integration remains critical to reduce vulnerabilities and support medium-term growth. Ensuring that the state budget does not absorb losses or liabilities or make payments on behalf of utilities or other companies will be needed to safeguard the prudent use of the limited budgetary resources.

"The outlook remains challenging, but the risks to the program are manageable. Steadfast implementation of the agreed set of measures going forward will keep the program on track, rebuild buffers and policy space, and accelerate achieving key reform agenda objectives."

Armenia: Selected Economic and Financial Indicators, 2013–17

	2013	2014	2015		2016		2017
	Act.	Act.	CR No. 15/320 1/	Prel.	CR No. 15/320 1/	Proj.	Proj.
National income and prices:							
Real GDP (percent change)	3.3	3.5	2.5	3.0	2.2	2.2	2.5
Gross domestic product (in billions of drams)	4,556	4,843	5,122	5,047	5,443	5,297	5,646
Gross domestic product (in millions of U.S. dollars)	11,121	11,644	10,607	10,561	10,672	10,735	11,112
CPI (period average; percent change)	5.8	3.0	4.3	3.7	3.4	-0.4	4.0
CPI (end of period; percent change)	5.6	4.6	3.4	-0.1	4.0	1.0	4.0
GDP deflator (percent change) 2/	3.4	2.7	3.2	1.2	4.0	2.7	4.0
Investment and saving (in percent of GDP)							
Investment	22.3	21.1	18.9	19.5	19.5	19.6	20.0
National savings	14.7	13.8	14.0	16.9	13.7	16.6	16.6
Money and credit (end of period)							
Reserve money (percent change)	29.9	-0.1	4.9	3.9	4.8	5.8	6.7
Broad money (percent change)	15.2	8.9	6.8	10.7	6.3	5.5	6.7
Central government operations (in percent of GDP)							
Revenue and grants	22.2	22.0	21.5	21.5	21.2	21.5	21.6
Of which: tax revenue	21.0	21.0	20.1	20.0	20.0	20.0	20.5
Expenditure	23.8	23.9	25.4	26.3	24.7	25.6	24.4
Overall balance on a cash basis	-1.0	-2.1	-3.9	-4.8	-3.5	-4.1	-2.8
Public and publicly-guaranteed debt (in percent of GDP)	40.8	43.5	48.2	48.7	50.6	52.4	54.0
Share of foreign currency debt (in percent)	85.2	86.2	88.5	86.9	87.7	87.0	86.2
External sector							
Exports of goods and services (in millions of U.S. dollars)	3,156	3,319	3,226	3,140	3,215	3,059	3,137
Imports of goods and services (in millions of U.S. dollars)	-5,365	-5,468	-4,634	-4,357	-4,693	-4,041	-4,202
Exports of goods and services (percent change)	8.2	5.2	-2.8	-5.4	-0.3	-2.6	2.5
Imports of goods and services (percent change)	4.6	1.9	-15.3	-20.3	1.3	-7.3	4.0
Current account balance (in percent of GDP)	-7.6	-7.3	-4.9	-2.6	-5.8	-3.0	-3.4
Debt service ratio (in % of exp. of goods and serv.)	27.9	8.6	5.8	12.5	6.6	8.0	9.2
Gross international reserves (in millions of U.S.	2,253	1,489	1,712	1,771	1,779	1,858	1,959

Annex 4: ENVIRONMENT AND POVERTY/SOCIAL ANALYSIS

Prior Actions	Significant positive or negative environment effects (yes/no/to be determined)	Significant poverty, social or distributional effects positive or negative (yes/no/to be determined)
Pillar I:		
Prior Action 1: The Borrower, has enacted the Unified Tax Code including measures to enhance revenues, improve the efficiency, transparency and equity of the tax system and strengthen tax administration.	No.	Yes – slightly positive distributional impact but marginal increase in poverty.
Prior Action 2: The Borrower has approved the 'Strategy to Improve Financial Sustainability of the Armenian Irrigation Sector' including measures to sustainably improve cost recovery and service delivery in the sector and reduce its reliance on public subsidies.	Yes – positive.	Yes – potentially positive.
Prior Action 3: The Borrower has enacted the amendments to the Mining Code consistent with the Law on Waste Management as applicable to the mining sector.	Yes - positive	No.
Pillar II		
Prior Action 4: The Borrower has approved regulations to facilitate the implementation of the Law on Business Notifications thus replacing licenses for 17 low-risk activities with a simple notification mechanism.	No.	No.
Prior Action 5: The Borrower has approved regulations to: (i) improve the mechanism for evaluating the performance of civil servants, and (ii) link bonus payments to performance in line with the Law on Civil Service.	No.	No.
Prior Action 6: The Borrower has enacted the amendments to the Law on Bankruptcy thereby: (i) improving the rules for appointment, qualification, and remuneration of insolvency practitioners; (ii) improving the rehabilitation provisions in line with international best practices; and (iii) revising the moratorium provisions to enable rehabilitation of insolvent companies.	Yes – positive.	No.
Prior Action 7: The Borrower, through the CBA, has approved a package of regulations on consolidated supervision in line with the Laws on Financial Supervision.	No.	No.
Prior Action 8: The Borrower, through the CBA, has approved regulations to ensure disclosure of ultimate beneficial ownership of financial institutions and groups.	No.	No.