Armenia: Development Finance Assessment (DFA)

December, 2021

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CONTENTS

Acknowledgements ..... *ii*

EXECUTIVE SUMMARY ..... **II**

FINDING A NEW FINANCING PARADIGM IN ARMENIA **1**

1.1 MACROECONOMIC OUTLOOK 1

THE CHALLENGE OF FINANCING SUSTAINABLE DEVELOPMENT IN ARMENIA **8**

2.1 THE NATIONAL PLANNING SYSTEM 8
2.2 THE NATIONAL BUDGETING SYSTEM 10
2.3 PUBLIC EXPENDITURE DISCONNECTS WITH KEY PRIORITIES 10
2.4 ECONOMIC GOVERNANCE 12

PUBLIC FINANCE AND MAIN FINANCIAL FLOWS **14**

3.1 OVERVIEW OF PUBLIC FINANCE OPPORTUNITIES AND CHALLENGES 14
3.2 EFFICIENCY AND EFFECTIVENESS OF PUBLIC EXPENDITURE 15
3.3 MAIN PUBLIC FINANCE FLOWS 20
3.3.1 Tax Revenue *20*
3.3.2 Public Debt *30*
3.3.3 Official Development Assistance (ODA) *38*
3.3.4 Public Climate Finance *45*

PRIVATE FINANCE AND MAIN FINANCIAL FLOWS **52**

4.1 OPPORTUNITIES AND CHALLENGES FOR PRIVATE SECTOR DEVELOPMENT 52
4.2 MAIN PRIVATE FLOWS 56
4.2.1 Private Financial Sector *56*
4.2.2 Financial Inclusion and MSME Finance *64*
4.2.3 Public-Private Partnerships *71*
4.2.4 Foreign Direct Investment *78*
4.2.5 Diaspora Economy and Personal Remittances *84*
4.2.6 Private Philanthropy and CSO Financing *90*

KEY FINDINGS AND MAIN ACTION AREAS IDENTIFIED **98**

5.1 THE EMERGING PICTURE FROM THE FINANCING LANDSCAPE 98
5.2 USING THE DFA RECOMMENDATIONS TO IMPROVE ACCESS AND IMPACT OF DEVELOPMENT FINANCE 102
5.2.1 A strategic perspective to the reform areas suggested *102*
5.2.2 Removing binding constraints *106*
5.2.3 Analyzing the type of policy changes needed *109*

THE WAY FORWARD: A ROADMAP TO DEVELOP AN INTEGRATED NATIONAL FINANCING FRAMEWORK **112**

6.1 THE VALUE OF AN INTEGRATED NATIONAL FINANCING FRAMEWORK 112
6.2 DEVELOPING A FINANCING STRATEGY 113
6.3 BUILDING MONITORING AND REVIEW SYSTEMS 116
6.4 GOVERNANCE AND COORDINATION 118

ANNEXES **121**

7.1 AN IMPLEMENTATION PLAN BASED ON DFA RECOMMENDED MEASURES 121
7.2 IMPACT FINANCE INSTRUMENTS IN ARMENIA 129
7.3 OPPORTUNITIES FOR INCREASING FDI IN THE SHORT- AND LONG TERM 130
7.4 AN EXAMPLE OF POLICY GOALS AND MEASURES IN COUNTRIES WITH HIGH LEVELS OF MIGRANT WORK 131
7.5 EXAMPLE OF DIASPORA FUNDRAISING: THE 3X1 PROGRAM IN MEXICO 132
7.6 REFERENCES 133

List of Abbreviations

ADB	Asian Development Bank
ADS	Armenia Development Strategy 2014–2025
AEC	ASEAN Economic Community
AF	Adaptation Fund
AFD	Agence Française de Développement
AGBU	Armenian General Benevolent Union
AIIB	Asian Infrastructure Investment Bank
AIMS	Aid Management Information System
AMD	Armenian Dram
ANIF	Armenian National Interest Fund
Armstat	National Statistical Committee
ATS	Armenia Transformation Strategy for 2020-2050
BOT	Build Operate and Transfer Concessions
CBA	Central Bank of Armenia
CCBII	Climate Change Budget Integration Index
CIS	Commonwealth of Independent States
CIT	Corporate Income Tax
CO	Credit Organizaions
COFOG	Classification of the Functions of Government
CPEIR	Climate Finance Public Expenditure Reviews
CRI	Climate Relevance Index
CRRC	Caucasus Research Resource Center
CSO	Civil Society Organizations
CSR	Corporate Social Responsibility
DCM	Development Partners Cooperation Mechanism
DIB	Development Impact Bonds
DICA	Development and Investments Corporation of Armenia
DFA	Development Finance Assessment
EAEU	Eurasian Economic Union
EBRD	European Bank for Reconstruction and Development
ECA	Europe and Central Asia Region
EIAA	Export Insurance Agency of Armenia
FDI	Foreign Direct Investment
FEA	Fiji Electricity Authority
FEZ	Free Economic Zones
FI	Financial Institution
FM	Financial Market
FMIS	Financial Management Information System
FSSA	Financial System Stability Assessment (IMF)
GAF	German Armenian Fund
GAVI	Global Alliance for Vaccine & Immunization
GCM	Global Compact for Safe, Orderly, and Regular Migration
GCF	Green Climate Fund
GDP	Gross Domestic Product
GEF	Global Environment Facility
GFATM	Global Fund for Aids, Tuberculosis and Malaria
GSP	Generalized System of Preferences
GP	Government Program 2021-2026
HDI	Human Development Index
IBRD	International Bank for Reconstruction and Development (WB)
IDA	International Development Association (WB)
IFC	International Finance Corporation

IFI	International Financial Institutions
ILO	International Labor Organization
IMF	International Monetary Fund
INDCS	Intended Nationally Determined Contributions
INFFs	Integrated National Financing Frameworks
INGO	International Non-Government Organization
KfW	Kreditanstalt Für Wiederaufbau (German Development Bank)
LTFC	Long-Term Foreign-Currency
MoF	Ministry of Finance
MFIS	Micro-finance Institutions
MLSA	Ministry of Labor and Social Affairs
MSMEs	Micro, Small and Medium Size Enterprises
MTEF	Medium-Term Expenditure Framework
NDC	Nationally Determined Contributions
NDP	National Development Plan
NGO	Non-Government Organizations
NPL	Non-Performing Loan
ODA	Official Development Assistance
OECD/DAC	Organization for Economic Co-operation and Development/ Dev. Co-operation Directorate
OOFs	Other Official Flows
PEFA	Public Expenditure and Financial Accountability Assessment
PER	Public Expenditure Review
PIP	Public Investment Programs
PFM	Public Financial Management
PIMA	Public Investment Management Assessment
PIT	Personal Income Tax
PPP	Public Private Partnership
PSD	Private Sector Development
QoG	Quality of Governance
RA	Republic of Armenia
ROA	Return on Assets
ROE	Return on Equity
ROT	Rehabilitate Operate and Transfer Concessions
SDG	Sustainable Development Goals
SIB	Social Impact Bonds
SMEs	Small and Medium Size Enterprises
SNCO	State Non-Commercial Organizations
SPEC	State Commission for the Protection of Economic Competition
SRC	The RA State Revenue Committee
SOEs	State-Owned Enterprises
SOPs	Standard Operating Procedures
TADAT	Tax Administration Diagnostic Assessment Tool
TVET	Technical and Vocational Education
UMIC	Upper Middle-Income Country
UNCTAD	United Nations Conference on Trade and Development
UNDP	United Nations Development Program
UNEP	United Nations Environment Program
UNFCCC	United Nations Framework Convention on Climate Change
USAID	United States Agency for International Development
USD	United States Dollar
VAT	Value Added Tax
WB	The World Bank Group
WHO	World Health Organization
WTO	World Trade Organization

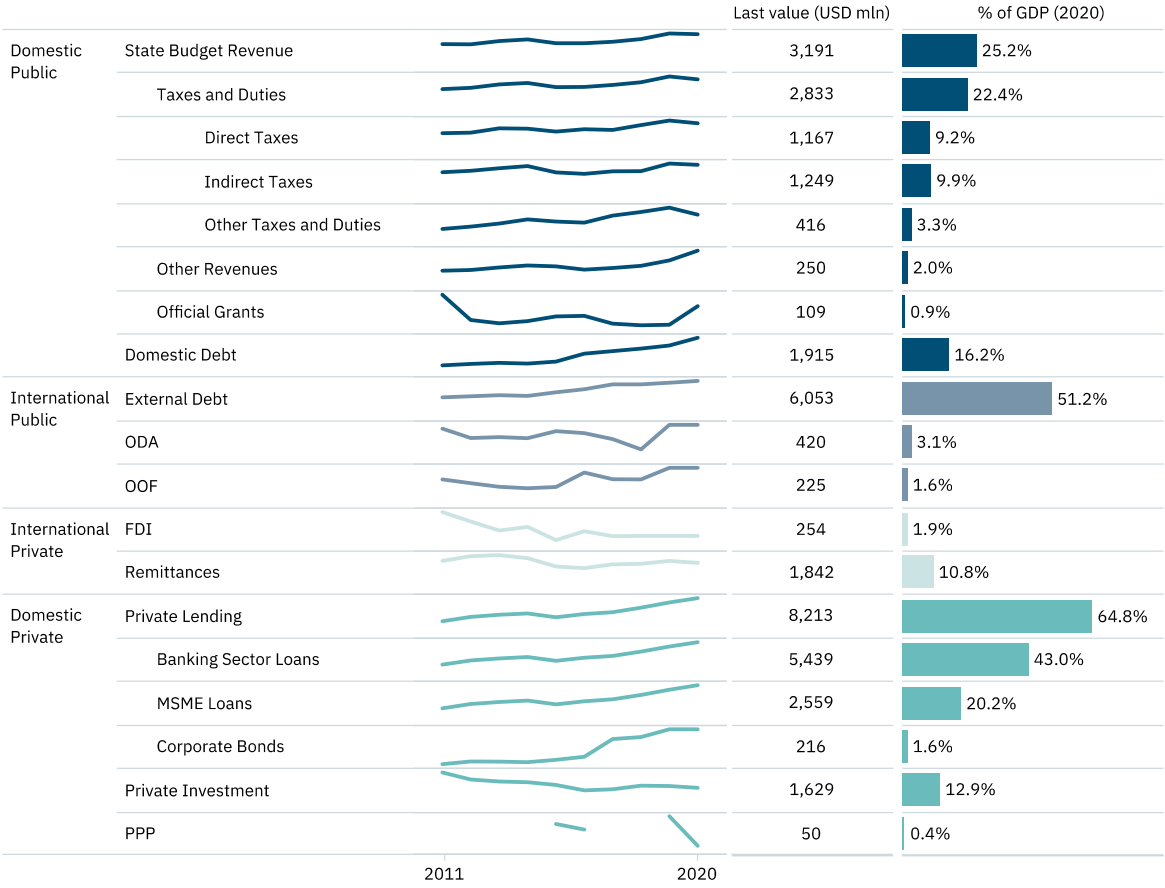
Executive Summary

The purpose of this DFA is to provide an understanding of the relevance and variety of resources that Armenia could mobilize to finance its development priorities. This is the first attempt to systematically map all the development finance flows and identify SDG financing opportunities and challenges. This assessment provides general guidance for the future mobilization of Armenia's domestic, external, public, and private resources. The UNDP Development Finance Assessment (DFA) is a tool to identify opportunities to mobilize additional finance sources and use existing financial resources more efficiently to achieve the Sustainable Development Goals (SDGs). The DFA offers support for governments and their partners in identifying and building consensus around priority solutions to address these vital challenges.

The Armenian Financing Landscape

Armenia's first DFA assessed the country's SDG financing architecture. It addresses critical knowledge gaps around the country's volume and trends of available development finance considering current SDG progress and the impact of the COVID-19 crisis. It provides the context analysis to implement priority SDG financing reforms. Finally, it aims to inform progress towards adopting an Integrated National Financing Framework (INFF), supporting cohesive, nationally owned sustainable development strategies, as per the Addis Ababa Action Agenda. The emerging picture of the financing flows analyzed in this assessment is summarized in the figure below.

The main finance flows analyzed by the DFA



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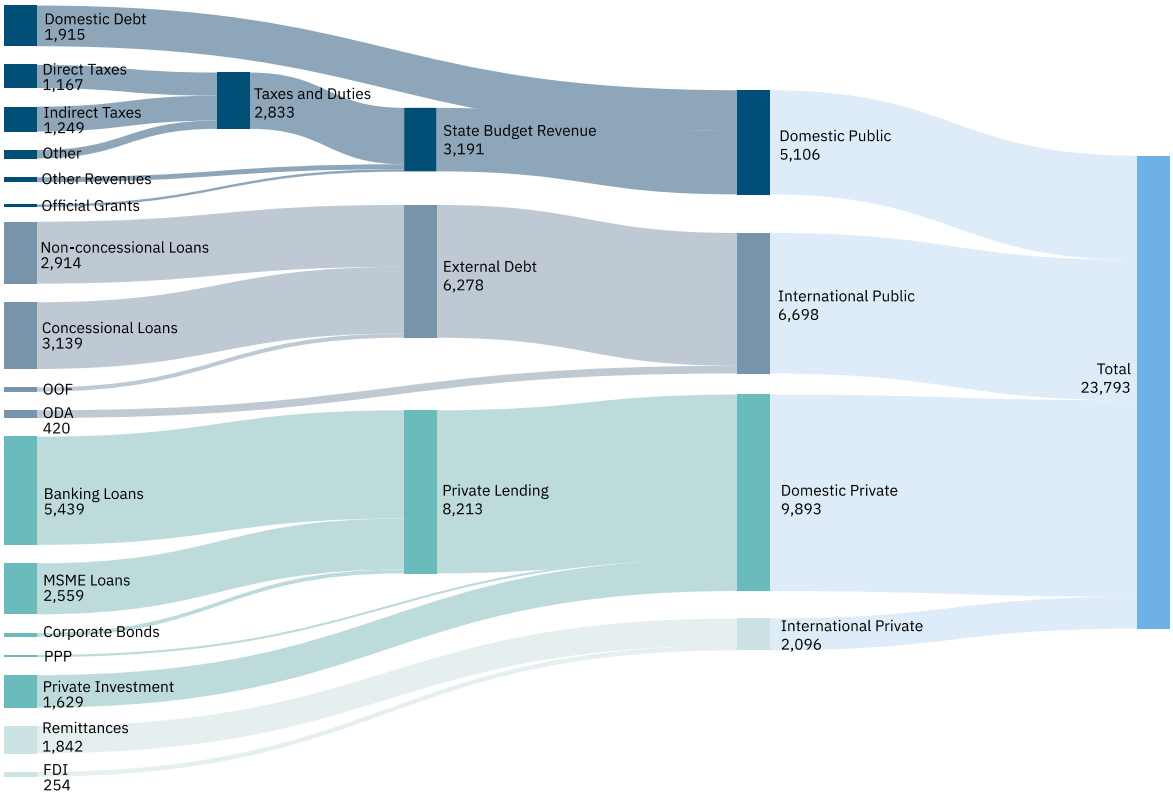
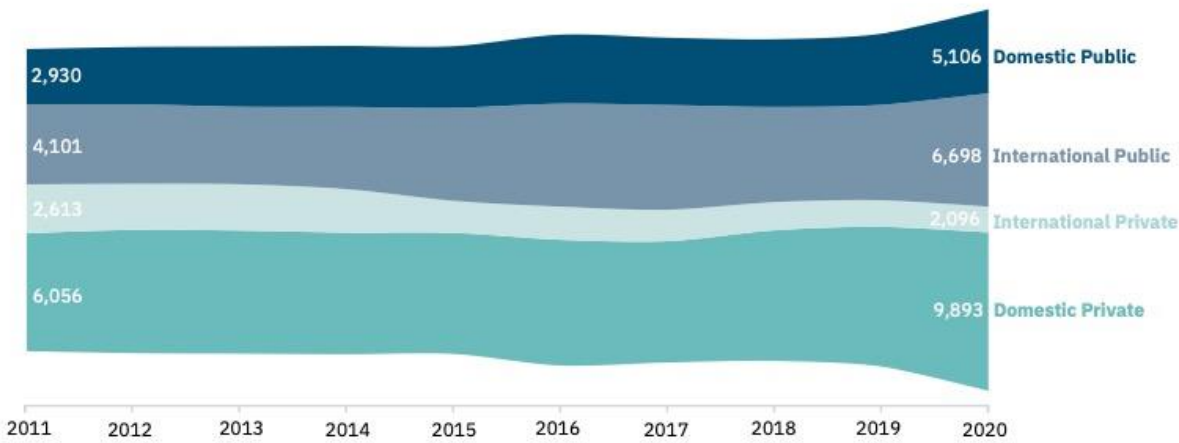
The structure of the financial flows measured by the DFA



The development financing mix measured in Armenia offers significant opportunities and challenges for the government. The total volume of the flows measured accounted for USD 23.793 bln in 2020. Almost one-half (49.61%) of the total comes from the public side. A significant part of it (28.15% of the total) is international public finance, and the vast majority is international external public debt. Almost one-third of the development finance resources used in the country comes from sovereign external public debt. The diagram shows the low amounts of private investment mobilized by the country. Total domestic and external investment (including FDI and PPPs) accounts for only 8% of the development finance measured.

General Trajectory of the development Financing Resources Measured

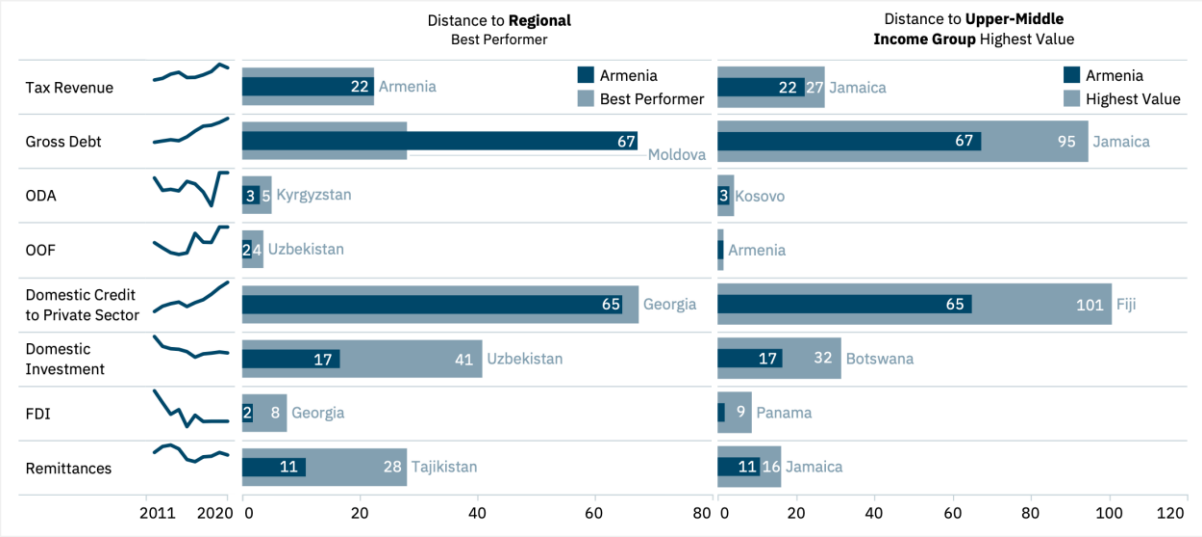


Already prior to COVID-19, Armenia's available development financing was increasing too slowly to meet the country's financing needs. The composition of the financing mix slightly changed, showing increased participation in public finance. This trajectory seems

counterintuitive in an economy in transition. The participation of the private sector in the financing mix decreased from 55.22% in 2011 to 50.39% in 2020. The highest growth was recorded for international public finance. Its participation in the total mix rose from 26.12% to 28.15%. This is explained by the increase of external debt from USD 3.725 bln to USD 6.278 in this period.

International comparisons show that Armenia's performance managing these flows is a little above average of different reference groups. The comparative analysis of the flows measured shows that Armenia measures almost identically to the average performance of Eastern Europe, the Caucasus & Central Asia region, and the upper-middle-income country groups. However, the distance measurements to the top-performing countries in each comparative group show that there is significant room for improvement, especially if compared to the same income country group. These comparisons from different countries and socio-economic situations are not linear, and the differences presented here are only for indicative purposes.

Comparing Armenia's results with top performers in both reference groups



The government will need to increase the availability and the quality of the information to manage these flows. he government has several "blind spots" where no official data sources are available for some flows (NGOs, PPPs, Inclusive Finance), or the ones available are incomplete or inconsistent to make quantitative assessments or international comparisons. In other cases (FDI, ODA, OOFs), evidence was taken from international sources, which does not fully coincide with the official data. It was impossible to estimate the current alignment of public flows with country priorities in almost all cases. The government must develop more robust monitoring and reviewing systems to support evidence-based management of these strategic resources. This is one of the main recommendations proposed in Chapter 6.

The challenge of financing sustainable development in Armenia

Armenia made significant progress in implementing public financial management reforms to improve fiscal discipline, efficient use of public money, and improved public services. However, as the public sector is not using long-term planning instruments to guide the long-term vision and reforms in the country, fragmented efforts arising from different processes proliferate making it challenging to visualize national strategic priorities and reducing their credibility.

The National Budgeting System is supported by robust macro framework instruments. However, significant public expenditure disconnects with key priorities also translate to the budgeting process. There are sufficient indications to suggest that the problem of not reflecting strategic priorities in the national budgeting process may be systemic. In this context, the lack of regular assessment of the impact and efficiency of budget programs is an additional element to

limit the development impact of public expenditure.

Economic governance and corruption were persisting issues in the public administration of Armenia for many years. The "velvet revolution" brought about many significant, positive changes. However, there is still a significant deficit in the implementation of the anti-corruption policies and more decisive action is needed to accelerate private sector development and international investment flows.

Main Findings and Action Areas Identified by the DFA

Public finance and main financial flows

The public finance sector in Armenia is comparatively small and well managed. The ongoing adverse effects of the dual crises of COVID-19 and hostilities in and around Nagorno-Karabakh in September-November 2020 posed significant challenges. However, is expected to return in 2022, and there are signs that the Armenian economy has already entered a recovery phase.

The main factors that generate public expenditure inefficiencies should be further analyzed. The improvement of public expenditure efficiency is needed to create room for reallocating resources to high priority areas, including ensuring an adequate social safety net. The PFM Strategy targets the primary sources of public expenditure efficiency; however, a new Public Expenditure Review is needed to analyze the factors that generate systemic (wage management) and sector (education, health, social) inefficiencies.

However, there are other areas where the issues are known and for which action is needed. The size and breadth of the SOE sector is a legacy of the former Armenian Soviet Socialist Republic. SOEs negatively impact macroeconomic performance and do not contribute enough to the economy because of low profitability, high leverage, and low liquidity. The public procurement transformations of the last decade, still require deeper reforms to provide transparency and generate more inclusive access, especially for SMEs.

There are significant opportunities to improve the management of the individual public finance flows analyzed. The DFA analyzed the following flows (i) government revenue, (ii) public debt, (iii) official development assistance, and (iv) public climate finance. A summary of the recommendations to improve the performance of these financing flows is provided in the Implementation Plan proposed in Annex 1 and condensed in the table below.

Address Strategic Planning and Budgeting Coherence	• Rationalize and simplify the use of planning instruments and align them with the new Armenia Transformation Strategy 2020-2050 (ATS). • Design an Integrated Financing Strategy (IFS) to mobilize the resources needed to provide feasibility for the ATS. Set financial targets and an action plan for the IFS for 2026 and 2030 • Mainstream the SDGs in the national budget process to resolve chronic planning and budget allocation disconnects and consolidate fiscal discipline • Complete the upgrade of the GFMIS and other PFM tools to consolidate program and performance-based budgeting • Strengthen PFM Strategy formulation and future PFM reforms by embedding SDG based policies
Improve Efficiency and Effectiveness of Public Expenditure	• Improve the evidence base to reduce public expenditure inefficiency (a PER to map public expenditure inefficiencies, a system to measure the alignment of tax expenditures with the SDGs) • A medium-term plan to eliminate known sources of public finance inefficiency (SOE losses, see public/private space) • Refine the public procurement system legal and regulatory reforms and provide more inclusive access to SMEs to ARMEPS

Policies to improve management of individual flows	• Introduce a strategic planning dimension to Government Revenue reforms (a medium-term fiscal and revenue strategy, reduce the informal economy, revenue administration) • A short-term plan to rationalize the use of Tax Expenditures (review the cost-benefit of the various tax privileges and exoneration regimes) • A long-term strategy to manage public debt (fiscal consolidation, SDG orientation to reduce costs, explore DNS or buybacks, prioritize debt use in essential areas) • An ODA management strategy (prioritizing domestic resource mobilization capacity development, aid multiplier effects. blended finance mechanisms). Expand ODA using new mechanisms (aid for trade and results-based aid) • Design and implement a Low Emissions Development Strategy (a Climate Change Financial Framework, accountability and transparency on CC expenditures, increased participation of CSOs)

Private finance and main financial flows

The country's recent development shows significant transformations in the private side of the economy. Despite the challenging geographic and geopolitical conditions, the country has made significant progress in improving its insertion in the global trade markets. Consequently, exports of Armenian goods and services have been expanding rapidly. However, despite Armenia's outstanding economic achievements, total investment remains relatively low compared to the region or other peer countries.

The opportunities for improving the management of the individual private finance flows analyzed are exciting. The DFA analyzed the following flows (i) private finance, (ii) financial inclusion and MSME finance (iii) public private partnerships (iv) foreign direct investment, (v) diaspora economy and personal remittances, (vi) private philanthropy and CSO financing. A summary of the recommendations to improve the performance of these financing flows is provided in the implementation plan proposed in Annex 1 and summarized in the table below.

Long term, policies to develop and promote new private investment areas	• Develop systems to measure the alignment of private investment with the SDGs and national priorities (banks, institutional investors) • Assess the opportunities for Armenia for attracting SDG oriented investments implementing results from SDG Investor map • A long-term strategy for FDI development in high potential areas that may take over a decade together and a short-term "FDI revolution" plan to change direction of this flow (modernize legal and regulatory, focused promotion)
Policies to Expand Individual Private Flows	• A policy to reduce credit risks and user costs and to improve alignment of banking institutions with the SDGs and national priorities • A medium-term plan to develop the national financial markets improving access, depth, and efficiency • A Financial Inclusion Strategy to support the implementation of the 2020-2024 SME Sector Development Strategy • Integrated policies to increase the development impact of seasonal work and remittances and open more opportunities for the diaspora

Public -private collaboration

This DFA also identified good opportunities for interventions to extend the development impact in the public-private collaboration space. There are significant opportunities to improve how public and private actors collaborate around the 2030 Agenda and how they act to promote economic gains and sustainable, inclusive private finance. The DFA identified opportunities to enhance the policy environment, strengthen incentives and deepen public-private collaboration to pursue this objective. The main areas identified relate to (i) the consolidation of the market

transition and the enabling environment for private sector development, initiate and extending the use of innovative finance mechanisms (blended finance, results-based financing, and impact investment), and the effective use of PPPs to address infrastructure development constraints. The recommendations for improvement in this field are provided in the implementation plan proposed in Annex 1 and summarized below.

Improve the enabling environment for Private Sector Development	• Address short term legal and regulatory reforms (insolvency, minority investors) • A medium-term plan to finance investments to remove infrastructure and other significant binding constraints • Improve results of ineffective policies (skills of the workforce, quality of TVET, anti-corruption) • Improve access and quality of domestic financing for the private sector
Policies to consolidate the market transition	• Develop a plan to sequence the privatization of SOEs, liberalization of markets, and plan the closure discontinuation of some SOEs. • Improve the remaining SOE governance with clear short-term targets (profitability, leverage, and liquidity) • Develop a PPP strategy to provide a more strategic, risk-balanced, and transparent use of PPPs to address critical infrastructure constraints.
Innovative Finance mechanisms	• Develop and implement a blended finance policy to leverage private commercial capital for strategic goals of the IFS • Develop appropriate "ecosystems" of policies to attract impact investments and innovative approaches for CSO investment • Develop PPPDs to co-finance and leverage resources for priority projects with the nonprofit sector • Develop and test innovative finance mechanisms to raise funds with the diaspora (like SDG diaspora bonds) for SDG investment areas

The gradual improvement of the enabling environment for business development and Armenia's international competitiveness is the main priority. Addressing some of the most problematic issues does not require significant investments as they are mainly related to legal and regulatory reforms. However, removing some of the binding constraints require investments for which the government needs to apply a strategic and integrated financing approach. There are also some areas where the government should strengthen public policies that are not producing the desired results. The country still has ample room for improving the domestic financing conditions for the private sector, which repeatedly appears as the most important constraining factor for private sector development.

Suggested Next Steps:

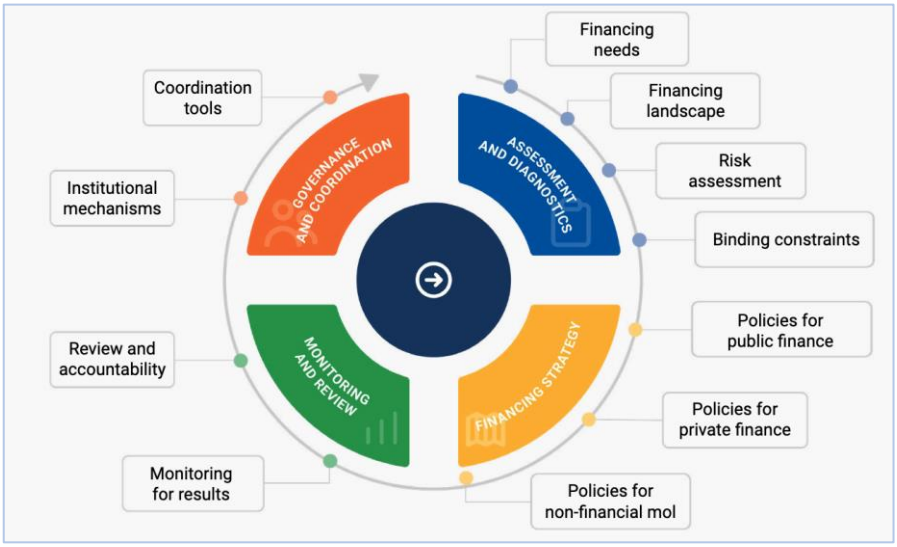
Although the current conjuncture is tight, the prospects for Armenia are very up-and-coming. Medium and long-term prospects are very positive, and – once achieving some negotiated solution is to formalize the resolution of the main international conflicts, the Armenian economy could expand significantly and produce some of the highest real growth rates in the region. The Government Program 2021-2026 (GP) estimates that this growth should be over 7% annually from 2022 onwards. Still, the country could even aspire at reaching double digits if the right policies are executed.

The findings of this DFA can be used to develop an Integrated National Financing Framework (INFF). This is a planning and delivery tool to help countries overcome existing impediments to financing sustainable development and the SDGs at the national level. It lays out the full range of financing sources – domestic public resources, aid and development cooperation, and domestic and international private finance – and allows countries to develop a strategy to increase

investment, manage risks and achieve sustainable development priorities as identified in a country's national sustainable development strategy.

The overarching idea is that the recommendations of this DFA would produce maximum results if implemented with a systemic approach that integrates the opportunities in the public and private spaces. The implementation of the recommendations of this DFA will have maximum impact if they are planned with a systemic view. Instead of adopting scattered, isolated interventions to address individual parts of the problem, a systemic approach would allow to take advantage of all the possible synergies and cross-cutting benefits of the policies implemented. This approach will produce the maximum results with the capacities and resources available in Armenia.

The Building Blocks of an Integrated National Financing Framework



Developing an integrated national financing framework should be a country-led process that requires an inclusive approach. Government policymakers must be in the driving seat during this process to determine the financing objectives of the strategy. This leadership is essential as the process will require considering different synergies and trade-offs or addressing the full range of financing sources and their contributions to the desired goals. It is essential to involve many stakeholders (government and non-governmental) from the outset to bring different perspectives and foster integrated thinking. INFF building is an iterative process to develop the four building blocks shown in the figure above. This DFA can be cosnidered as the completion of the Assessment and Diagnostics Phase. The DFA also provided a baseline and significant elements to start the other three's development. The roadmap proposed in Chapter 6 shows the recommended approaches to develop the other building blocks of an INFF in Armenia:

- **Financing Strategy**. The development of an Integrated Financing Strategy is the recommended next step to facilitate the establishment of an INFF in Armenia. The strategy should be designed to provide feasibility to the national development priorities in Armenia: the new Armenia Transformation Strategy 2020-2050 (ATS) and the Government Program 2021-2026. This DFA provides sufficient analysis to structure the design of the strategy. These are summarized in the Implementation Plan proposed in Annex 1.
- **Monitoring and Review Systems.** These systems will provide significant benefits to managing development finance in Armenia. The lack of quality evidence and information is a common binding constraint that affects most individual financing flows analyzed. These systems provide a "control panel" to monitor the implementation of the financing strategy. This DFA also provides sufficient contextual analysis to support the design of these systems, and a roadmap to develop them is provided in Chapter 6.
- **Governance and coordination**. The leadership required to build and manage an INFF will demand new roles for the government. The government will need to develop the capacity to conceptualize

this strategic approach and apply policies that reflect the importance of many interconnected reforms. This is a significant challenge in Armenia because implementing these frameworks transcends the mandate of a single government institution. The search for an institutional solution will require exploring managerial and institutional innovations since the coordination of highly cross-cutting policies is one of the areas where the governance system in Armenia has shown greater difficulty in providing coherent and effective responses. Initial approaches to analyze possible solutions are also provided in Chapter 6.

The ideal approach would be to allocate the principal responsibility for the INFF development to a high-level executive office. There will be a need to find robust mechanisms to ensure both 'vertical' alignment between the overarching, longer-term policies and 'horizontal' alignment between operational policies focused on different themes or financing types to avoid contradictions and ensure complementarity. This type of leadership could be provided only by the PMO or the Deputy PMO in Armenia. The INFF implementation plan should ensure sufficient technical support to develop the technical capacities needed to implement the actions required by the financing strategy.

To implement these new frameworks, some improvements to the current capacities of the government will be necessary. Implementing the INFF Financing Strategy could be an organic challenge for any government agency. The multiple coordination activities required by its programs do not correspond to the mandate of the Directorates of critical ministries like the MoF or the MoE. They will require informed decisions at the highest level of the Ministry and PMO. One solution could be to strengthen the technical capacity of the top executive offices of the government to establish the appropriate management and monitoring support systems to facilitate their tasks.

The DFA is a tool to set in motion or support an already ongoing process of institutional change towards improved country development financing. The proposed recommendations are expected to inform discussions across the Government of Armenia on these critical strategic matters and decide further action. The agenda demands systemic reforms and involves a broad range of areas, from public sector reforms to good governance and strengthening the management capacity of the central government and line ministries. The implementation of this roadmap could be complemented with the definition of a support program from the UNDP to develop and implement INFF under the leadership of a designated government agency.

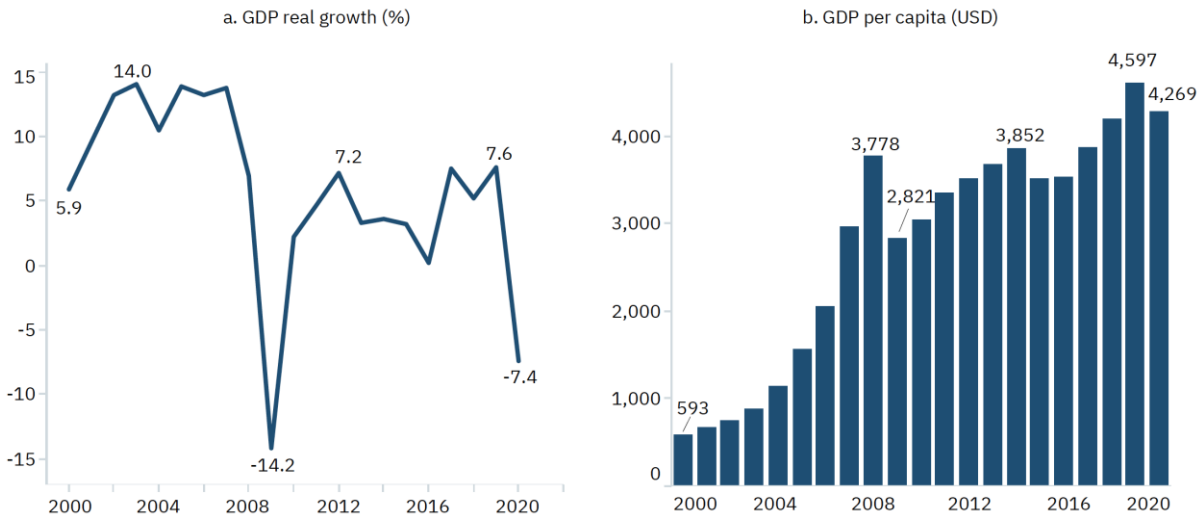
CHAPTER 1

Finding a new financing paradigm in Armenia

1.1 Macroeconomic Outlook

Armenia is a stable and growing economy that needs a further boost to take off. Armenia is an upper-middle-income country with a population of around 3 mln. After the collapse of the Soviet Union, the country's GDP shrank dramatically (from 6.4 bln USD to 2.9 bln USD in 1993). The development of GDP is presented in Figure 1. The country transitioned to one of the poorest countries in the region. Armenia entered this transition as the second poorest country in the Commonwealth of Independent States (CIS) in terms of GDP per capita. However, since its independence, the country has had a relatively stable growth and reached more than 12 bln USD GDP level in 2020, resulting in more than four-fold growth (1992-2020).

Figure 1 GDP growth rate and GDP per capita



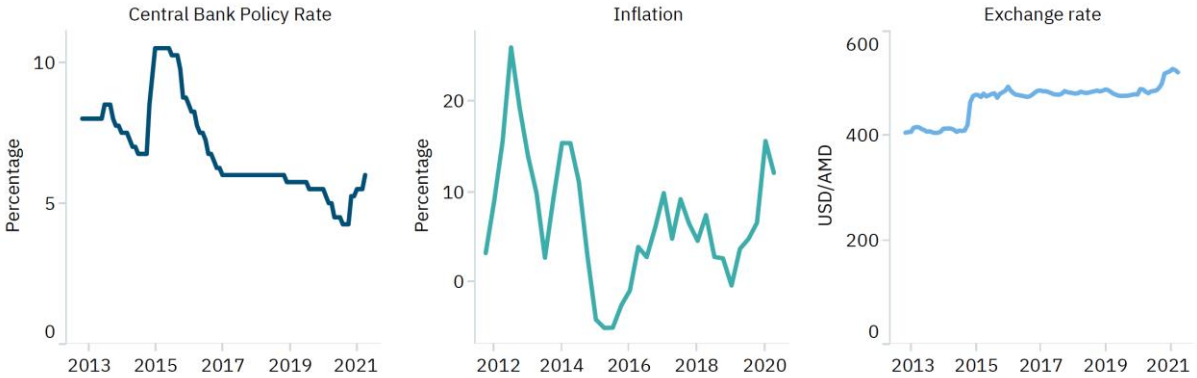
Source: Statistical Committee of the Republic of Armenia.

Over the last decade, Armenia's economy has been characterized by stable macroeconomic conditions and weaker economic growth when compared to the 2000s. During 2001-2008 the economic growth was mainly driven by the construction boom. The average economic growth in this period was 11.2% and decreased to 4.7% in 2011-2019. This was due to the "consumption" of resources to maintain the former model of the economy and the slowdown in world economic growth after the severe shock caused by the global financial and economic crisis. After the crisis, drivers of GDP growth changed, and export became the main contributor to the output growth. Private consumption strongly supported by the inflow of remittances was another key factor.

During the considered period, Armenia maintained a remarkable level of macroeconomic stability despite the country's exposure to several external shocks. Armenia endured a regional crisis in 2014-2015. In addition, the drop in commodity prices in international markets and shocks to the economy which led to a significant devaluation of the Armenian dram. All these events slowed economic growth. Like most countries, Armenia also had to endure a significant macroeconomic disruption due to the COVID-19 pandemic, resulting in economic activity restrictions in 2020. This negative impact was aggravated by the sudden large-scale military hostilities in the Nagorno-Karabakh conflict area between September and November 2020.

The country managed to keep inflation rates low during this whole process. Figure 2 shows that the policies applied by the Central Bank of Armenia (CBA) during this period ensured a low inflation environment under conditions of stable exchange rate behavior and price developments of international food products. The average 12-month inflation rate was 2.6% during 2011-2020. To address the negative impact of the pandemic in 2020, the Central Bank of Armenia (CBA) reduced the refinancing interest rate by a total of 1.25 percentage points, pursuing a stimulating monetary policy. However, since December 2020, inflation has significantly increased (reaching 6.2% in April 2021) due to the national currency devaluation and the inflationary developments in international food products, to which the Central Bank of Armenia immediately responded by raising the refinancing interest rate by 1.75 percentage points setting it at 6%.

Figure 2 Selected monetary policy indicators



Source: Central Bank of RA, Monetary and Financial Statistics, Real and External Sectors Statistics

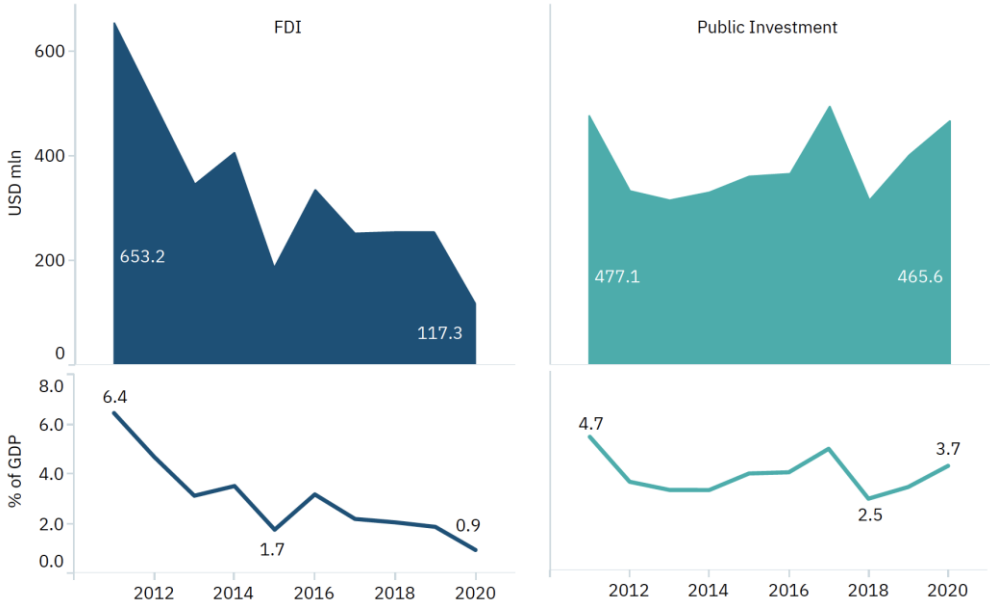
Financial intermediation has significantly increased in recent years. In 2011, the loans/GDP ratio was only 34%, while in 2020, it reached about 67%. This growth of loans was stimulated by the reduction of interest rates, the simplification of financial terms, and the increase of competition between the commercial banks of RA. However, after the hostilities in and around Nagorno-Karabakh in 2020, there was a significant slowdown in loan growth rates, mainly driven by increased uncertainty in the country and the more conservative behavior of banks.

Economic Development

During the last decade, the main driving force of economic growth was domestic consumption, with a marked decrease in national and foreign investment. The consumption boom was fed by the increase in financial intermediation and the significant increase in consumer loans, while the share of investments in GDP decreased. In 2020, private investments in GDP were 16.6%, compared to 30.6% in 2011. Data in Figure 3 shows that the percentage of foreign direct investments (FDI) decreased from 6.4% to 0.9% of GDP. The share of capital expenditures in the state budget was also low. Public investment to GDP ratio decreased by one percentage point compared to 2011, reaching 3.7%.[1] Subsequently, Armenia's economic growth model is still dominated by domestic demand, despite a positive impact of net export on GDP growth.

[1] Source: author's calculation, Statistical Committee of RA

Figure 3 **FDI and public investment**



Source: Statistics Committee of RA, Foreign accounts

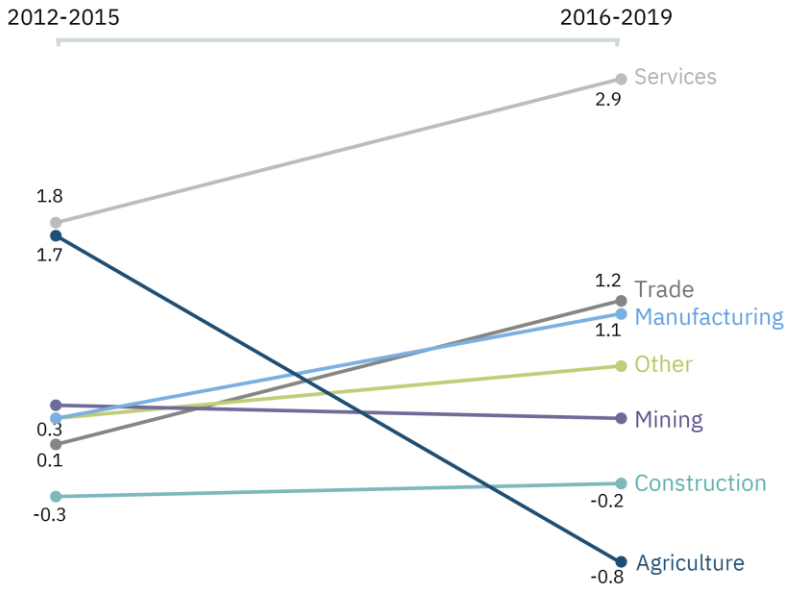
Figure 4 **Supply and demand share in GDP**

Source: Statistics Committee of RA

Significant changes in the structure of the economy occurred during the last decade. Data in Figure 4 shows that **r**eal GDP growth was mainly driven by services and manufacturing sectors, while the agriculture sector contracted. The main contributions to GDP growth are summarized in Figure 5. The role of the service sector increased to 40,1% of GDP in 2020. In 2016-2019 the average contribution of services was 2.9% compared to 1.8% in 2012-2015. The average contribution of the manufacturing sector increased from 0.3 to 1.1 percentage points during the same period. The main drivers of this growth were food and tobacco and other non-metallic mineral products. In 2019 contribution of the mining sector was also significant, about one percentage point, and in 2020, despite broad-based declines almost in all industries, mining has contributed positively to the growth. The most notable decline was in the agriculture sector. In

2016-2019 the average contribution of services was 1.7% compared to a negative average of 0.8% in 2012-2015.

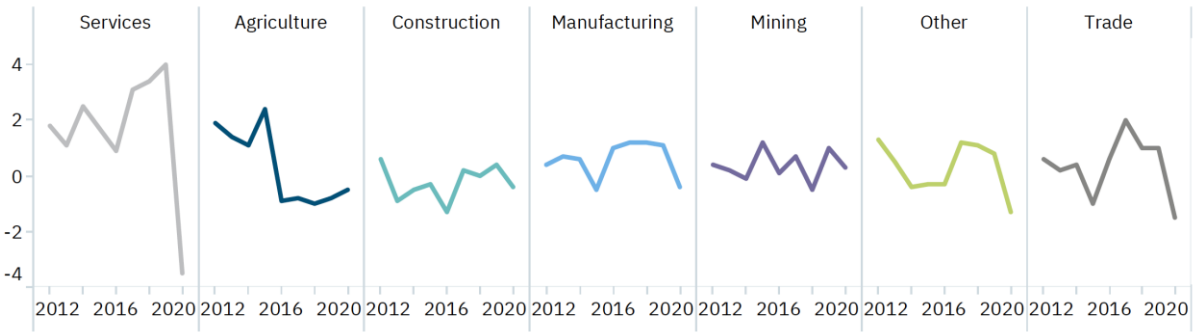
Figure 5 Average contribution to GDP growth (%)



Source: DFA Team calculations based on official government data

These growth rates declined due to the negative impact of the COVID-19 pandemic that started at the beginning of 2020. Movement restrictions were imposed by the RA government in March 2020. The marked decline in the economy is visible from April 2020 onwards. Data in Figure 6 shows the evolution of the same indicators described in Figure 6 and the relative impact of the 2020 crisis in each case. The economic recession hit the hardest on the service sector and also materialized in a decrease of the reduction in other sectors of the economy and a reduction in domestic demand and exports. In any case, the mitigation measures applied by the government seem to have managed to contain the potential negative impacts of this crisis.

Figure 6 Contribution to GDP growth (%)



Source: DFA Team calculations based on official government data

Government measures to compensate the impact of the COVID crisis generated significant pressure on public expenditure. The government response package included a variety of economic and social programs, lending mechanisms and additional measures to attract private investments. The investment made by all these measures is summarized in Table 1. The total estimated cost of the package is in the range of 2.7% of GDP, which shows the significance of these efforts, especially in a year where fiscal revenues were also challenged and contracting.

Table 1 COVID response and recovery measures in Armenia in 2020 (AMD bln)

	April 2020 (Intended)		December 2020 (Actual)	
	AMD bln	% of GDP	AMD bln	% of GDP
Total measures	150.0	2.4	165.0	2.7
Total expenditures	70.0	1.1	75.0	1.2
Economic programs	30.0	0.5	13.0	0.2
Social programs	30.0	0.5	26.0	0.4
Reservs	10.0	0.2		
Health programs			36.0	0.6
Total lending	80.0	1.3	32.0	0.5
Lending for economic support			19.0	0.3
Lending to Artsakh Republic			13.0	0.2
Measures to attract private investments	80.0	1.3		
Tax measures			58.0	0.9
Profit tax returns			58.0	0.9

Source: Ministry of Finance of RA, 2020 budget execution report and DFA team calculations

Social Development

Since independence, Armenia made remarkable progress in human development. Armenia's Human Development Index (HDI) value for 2019 is 0.776— which put the country in the high human development category— positioning it at 81 out of 189 countries. Since 1990, the country's HDI value increased from 0.654 to 0.776, an increase of 18.7%. Armenia's made significant progress in each of the HDI indicators from 1990 and 2019: (i) life expectancy at birth increased by 7.2 years, (ii) mean years of schooling increased by 1.2 years and (iii) expected years of schooling increased by 2.2 years. Armenia's GNI per capita increased by about 167.6 percent between 1990 and 2019.[2]

Until the outbreak of COVID-19, Armenia was making significant progress in reducing poverty. The total poverty rate was reduced from 54% in 2004 to 26.4% in 2019. These figures are also altered by the significant migration outflows that accelerated after the global crisis of 2008 and the high level of personal remittances, which in 2019 accounted for 11% of GDD. Poverty distribution also shows substantial regional disparities and a significant divide between rural and urban realities. Job creation mostly happens in urban areas, especially the capital Yerevan, and is very limited in rural areas, except for agriculture, which is often at subsistence levels. Children face higher poverty rates than the rest of the population, with every third child in Armenia living in poverty. Poverty directly affects children's lives, from good nutrition to early learning, success in school, opportunities for non- formal learning, and play[3].

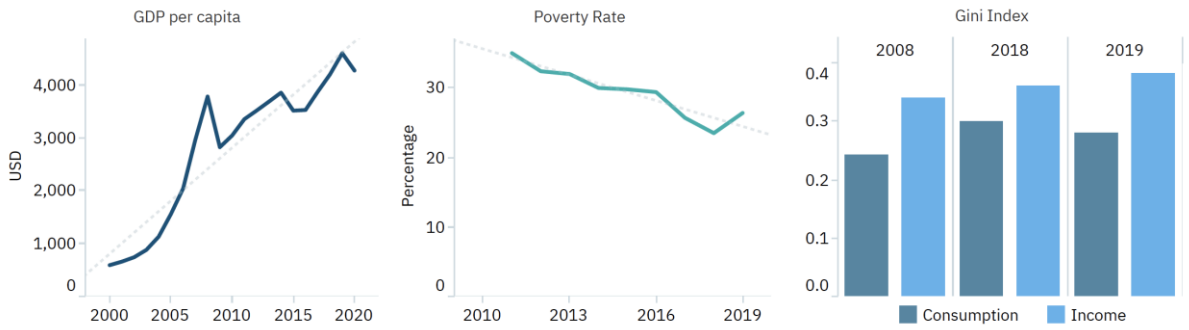
In the environment of relatively weak economic growth, the polarization of household income increased after the global economic crisis, despite the decline in the poverty rate. In 2008-2019, inequality for the entire population increased more than aggregate consumption in the total income index. Data in Figure 7 indicate that inequality indexes measured by the Gini coefficient explain that the polarization of the people in Armenia is more profound in terms of income distribution than that in terms of consumption distribution. In this regard, the level of disproportional regional development is high.

[2] UNDP (2020c)

[3] UNICEF (2020)

Public spending to remediate these situations has been insufficient. For example, in Armenia, public expenditure on education and health was about 2.3% of GDP in 2020, much lower than the average among ECA countries. Social protection expenditures around 6.9% of GDP in 2020 are also low compared to countries in the ECA region. The highest proportion of spending goes to pensions, and less than one-third goes to social assistance. Thus, labor market programs and social services need more attention.[4]

Figure 7 Social development indicators



Source: DFA Team calculations based on official data from the Statistics Committee of RA, Poverty

There are still significant opportunities for building a gender-inclusive and regionally balanced development model. Armenia ranks very low (114 of 156 countries) on the World Economic Forum's Global Gender Gap Index (2020). Measured by this, the country performs much better in education attainment (46) and economic participation and opportunity (96) but also remains at the lowest levels in political empowerment (132) and health and survival (150).

Even though gender inequality-related issues are improving, there are persisting issues limiting women's full economic potential in the economy. Women's employment is 11.1 percentage points lower than that of men and working women earn 28.4% less than men (adjusted gender pay gap).[5] Armenia is undergoing significant demographic changes. The population of Armenia is shrinking and ageing. In 1990, the country's population was 3.5 mln, which was reduced to around 3 mln in 2020 due to continuous migration. The rising share of older adults, the lack of qualified workforce and related issues put a lot of pressure on the government, which need to implement respective reforms in these areas.

Environmental Development

Armenia is exposed to substantial natural hazards and climate change risks. Climate change represents an increasingly important challenge to Armenia**.** This landlocked mountainous country with vulnerable ecosystems had to endure frequent landslides, floods, and other natural disasters that negatively affected infrastructure, agriculture, water resources, energy and forestry. Moreover, the country is exposed to a high risk of earthquakes, landslides and mudflows, and hydro-meteorological hazards. The intensified extreme weather conditions coupled with droughts (over recent decades) negatively impacts agriculture. The predicted decline of water, degradation of land, and deforestation will also negatively influence the agricultural sector and other sectors of the economy. Consequently, Armenia increasingly needs to adapt to these impacts and make itself more climate resilient.

Despite its relatively small emissions footprint, Armenia has been actively supportive of the global efforts to reduce emissions. Armenia's current emissions of greenhouse gases account for only 0.02% of global emissions. Energy (including fuel combustion from transport) has been the primary source of its GHG emissions since independence, but its share decreased from 88%

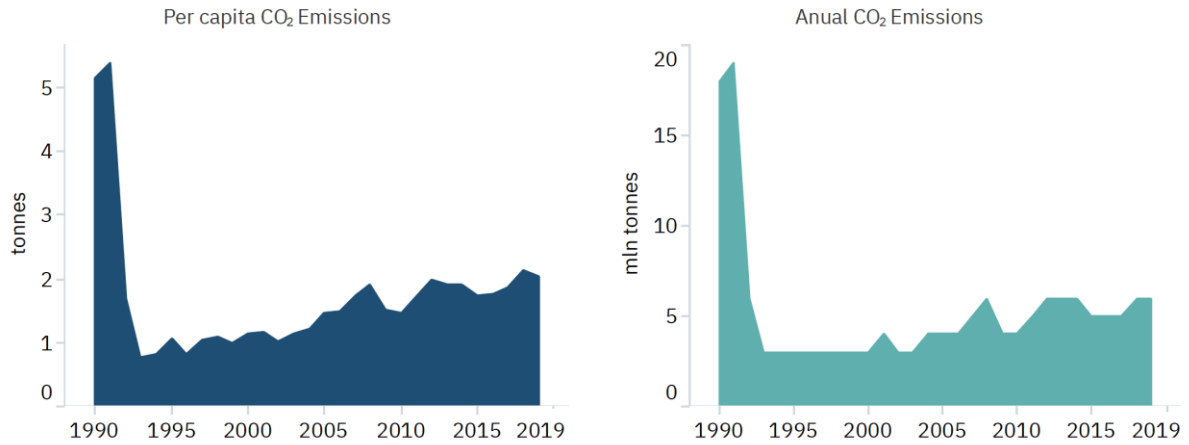
4 Source: SUSTAINABLE DEVELOPMENT GOALS REPUBLIC OF ARMENIA ,VOLUNTARY NATIONAL REVIEW REPORT, July 2020

5 UNWOMEN (2020)

in 1990 to 64% in 2016 (Figure 8). On the other hand, emissions from agriculture grew from 8% in 1990 to 22% in 2016. Industrial emissions increased from 2% in 1990 to 8% in 2016 and wasted emissions from 2% in 1990 to 6% in 2016.[6] Armenia ratified the UN Framework Convention on Climate Change in 1993, the Kyoto Protocol in 2002, the Doha Amendment to the Kyoto Protocol in 2017 and the Paris Agreement in 2015 in May 2019. Armenia also ratified the Kigali Amendment to the Montreal Protocol to phase down HFCs.

These intentions are reflected in the country´s international commitments to develop a green economy. The country´s Nationally Determined Contributions (NDC) for 2015-2050 pursues economy-wide mitigation measures to achieve per capita net emissions of 2.07 tCO2eq in 2050. Armenia is also proposing to double its share of renewables in energy generation by 2030. In 2021 Armenia updated its NDC and adopted a ten-year implementation period (2021-2030), maintaining its 2050 mitigation goal and proposed to reach a 40 % reduction below 1990 emissions levels by 2030.

Figure 8 CO2 emissions (tons)



Source: Our World in Data based on the Global Carbon Project, Gapminder & UN

To achieve its goals and meet the NDC commitments, Armenia adopted several policies. These include the development of renewable energy generation, specifically via expanding solar energy, and the promotion of energy efficiency measures in industrial and residential sectors. The Energy Sector Development Strategic Program intends *"to increase the share of solar energy generation in total to at least 15% or 1.8 bln kWh by 2030"*. Several legislative and regulatory reforms have been implemented in recent years, aimed at the development and comprehensive upscaling of renewable energy sources.

Armenia is taking the first steps towards improving financial/budgetary frameworks in climate change and providing a better connection between climate change policy and the budget. Armenia has well-developed PFM budgeting systems, which are well adapted to sectoral development policies, where institutional-level responsibilities for project results and financial management are mainly concentrated in specific sectoral agencies. Due to the cross-sectoral nature of climate change and adaptation issues, the state policy on climate change is primarily enacted through various programs implemented in different sectors. In recent years, measures have introduced climate change mitigation and adaptation as a component of national development policies. However, the cross-sector nature of climate-related policies poses significant challenges for the capacity of existing systems.

6 Source: Ministry of Environment

CHAPTER 2

The challenge of financing sustainable development in Armenia

Armenia embarked on ambitious reforms, transforming the economy, society, and the government. The critical policy measures so far have included liberalizing prices, trade tariffs, and the exchange rate, opening up the economy to private initiative and international trade, reducing the rates of direct taxes on businesses and households, reducing the role of the government in economic activity, and commencing civil service reform. In addition, the state's role is being restructured so that the government's control of factor markets and ownership of productive assets is gradually reduced. In contrast, its role in ensuring robust competition, prudent regulation, and delivery of higher quality of education and social services is enhanced.

The country made significant progress in implementing public financial management reforms to improve fiscal discipline, efficient use of public money, and improved public services. Armenia entered the COVID-19 crisis with relatively solid macro-economic fundamentals, characterized by fiscal soundness and a controlled path for government debt. In addition, a succession of tax reforms has streamlined tax policy and administration and reduced several tax rates without jeopardizing government revenues. As a result, budget processes and fiscal reporting coverage, quality, and transparency have improved. The RA fiscal rules define the link between the debt level and the fiscal policy, conditioning the government's fiscal response.

2.1 The National Planning System

In Armenia, the public sector is not using long-term planning instruments to guide the long-term vision and reforms in the country. The country does not use tools like long term planning instruments that could provide coherence to the planning made by different sectoral and cross-cutting areas. There were attempts to carry out this type of planning, for example, the Armenia Development Strategy (ADS) 2014–2025 was approved in 2014. Still, it was not fully utilized to guide national planning and budgeting. It is envisaged that the ADS will be replaced by the Armenia Transformation Strategy for 2020-2050 (ATS), which will also align national development goals with the SDGs. This could become a fundamental, long-term strategic tool of socio-economic development in Armenia. It was expected to be ready in 2020 but was delayed because of the Covid-19 pandemic and the hostilities in 2020 and has not been released yet.

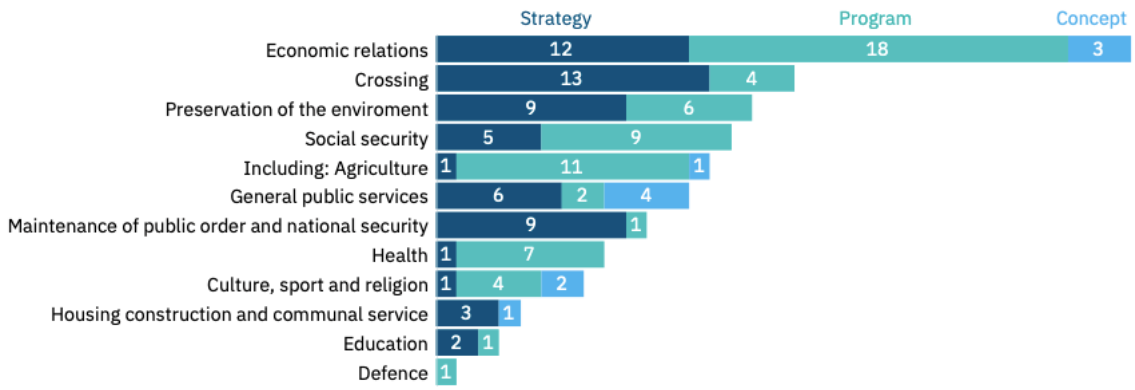
To compensate for the absence of long-term planning, fragmented efforts arising from different processes proliferate. A UNDP's ongoing mapping study reviewed 168 approved strategic documents and concluded that the government uses 125 strategic planning documents. From these, 105 are medium-level strategy documents, and there are also 20 budgeting programming strategies. A deeper analysis showed how this proliferation generated an impressive array of planning tools (programs, concepts, and strategies), each proposing their own

goals, objectives, measures, and outcomes as described in Figures 9 and 10. The illustrations show the distribution of strategic documents according to a sector or cross-cutting priorities.[7]

Figure 9 Distribution of strategic documents[8]

Strategic Documents	Goals	Objectives	Measures	Outcomes
53 programs	98	253	984	279
10 concepts	26	58	86	25
61 strategies	169	568	1638	563
124 total	**293**	**879**	**2708**	**867**

Figure 10 Distribution of planning documents by sector



Source: Harutyunyan, K. (2021),

The vision proposed in these documents is not incompatible, but it is not necessarily coherent, nor does it reflect a strategic prioritization. The strategic coincidences of these plans are rather fortuitous and generally pose complementary, but not necessarily compatible, visions of the future. Political factors that negatively affect its implementation can also be detected, such as when a line ministry attributes national planning powers that exceed what should be their institutional mandate and its ability to budget or execute the actions proposed in those strategies. The ongoing UNDP mapping is measuring several potential issues that might be happening:

- Logical coherence and scope when integrating all existing strategic documents
- Approximation of policy scopes of strategic documents developed with different approaches and principles and the presentation of those scopes in the same format and comparability
- There is a need to simplify compliance of budgeting programs with the implemented policies, and to review the links between separate strategic documents and the budget
- Identify various policy overlaps

[7] UNDP (2021), "Making Finance Work for Transformative Change in Armenia: Unlocking Finance for Armenia 2030" Project

[8] This distribution does not include the Government Program

- Identify sectors that do not have clearly defined strategic targets
- Identify gaps and opportunities for improvement in current budget programs in terms of policy links, create a basis for harmonization of policies and budget programs

The proliferation of strategies makes it challenging to visualize national strategic priorities and reduces their credibility. The proliferation of instruments reveals lack of coordination and hinders the work of monitoring and transversal execution of government actions. Furthermore, this is a significant obstacle to ensuring its correct financing, especially when promoting private investment. An external investor would have difficulties in making investment decisions to be fully informed about any potential contradictions from the many strategies. This complexity lowers the added value of the strategic orientation that these individual instruments could add and their credibility with the market. The IMF PIMA assessment conducted in 2018 pointed out the inconsistency of planning documents with investment decisions as a priority area for reforms[9]

2.2 The National Budgeting System

The Law on the Budgetary System of Armenia regulates the process for establishing the annual budget; according to it, the draft state budget is composed of the Budget Message of the government and the draft Law on the State Budget. In addition, the draft state budget includes an explanatory note aiming to justify the revenues, expenditures, deficits, and other financial data related to the draft budget. The annual budget process starts with the approval of the prime minister decree on the Start of the Budgetary Process of the Republic of Armenia. The decree establishes the budget calendar and the two phases of the budget process

- ***The first phase*** defines the steps to be taken to draft the Medium-Term Expenditure Framework (MTEF), and the second the elaboration of the draft annual budget. The budget calendar is comprehensive and covers the entire process, from drafting the macroeconomic forecast to submitting the draft state budget to the National Assembly.
- ***The second phase*** begins with preparing the expenditure ceilings for drafting the budget proposals available to line ministries following the government's approval of the MTEF. Consequently, line ministries prepare and submit their budget requests, and then discuss and negotiate budget plans with the Ministry of Finance (MoF) and the government.

The government developed robust macro framework instruments to support the budget process. The government approves a three-year MTEF annually by July 10 and submits the approved document to the National Assembly. The MTEF document is well developed at both the macro and budget policy levels and meets the requirements set out in the Law on the Budgetary System. However, this submission is purely formal, and there are no deliberations on the MTEF at the parliamentary level. Moreover, the Law does not require the MTEF to be based on general government fiscal aggregates[10]. A Medium-Term Budgetary Framework is used and covers three years. This is based on central government data only, and according to the baseline assessment, the reliability of medium-term forecasts needs to be improved[10].

2.3 Public expenditure disconnects with key priorities

In the absence of a comprehensive long-term strategic plan, Armenia's main strategic planning instruments are the 5-year Government Programs (GPs). These programs differ in their type from other strategic documents. These are more political documents, and their structure does not entirely correspond to generally accepted planning practices and requirements. On August 26, 2021, the Parliament approved the new GP 2021-2026, which focuses on internal and external security, fighting corruption, socio-economic aspects, economic

[9] IMF (2018)

[10] Baseline Measurement Report key indicators : The Principles of Public Administration, Armenia, March 2019

development, and territorial administration and infrastructure projects. However, the mapping analysis mentioned above applied to the GP identified the following situations:

- 23.1% of the GP goals are not reflected in any of the strategies being utilized,
- No outcomes or KPIs are defined for 27 of the 44 subdivisions of the program.
- At least 8 of the significant goals proposed in the strategies are not reflected in the GP goals[11]

These inconsistencies also translate to the budgeting process. Even though the recent year's state budget has been drafted and approved according to Program Budgeting formats, full compliance of the strategic planning system to the program budgeting system is incomplete. The strategic planning system mostly does not allow matching outputs with strategic objectives and any roadmap to achieve those objectives. Many budget programs do not refer to the adopted strategies or link outcomes to the targets of objectives identified by those strategies. Moreover, outcomes are presented in an imprecise manner and sometimes are not quantified. An initial review of the 2021 Annual Budget Law shows that there are a few (apparently priority) national objectives that are not at all reflected in the annual budget, for example:

- ***Manufacturing***. Ensure continuous increase in the international competitiveness of Armenia's manufacturing industry. Create three industrial zones and develop existing ones, ensuring infrastructure and environmental excellence. Extend industrialization and production chains as much as possible, promoting the production of more complex and high-value products.
- ***Sustainable Development and Green Economy***. Ensuring preparedness of the economy for the new, low-carbon energy reality; Creation of pre-requisites to keep natural resources in the economic cycle for much more extended periods
- ***Transport*** Create a unified route network that will allow all communities to enjoy transport services; the quality of passenger transportation will improve together with oversight levels

There are sufficient indications to suggest that the problem of not reflecting strategic priorities in the national budgeting process may be systemic. This lack of coherence could be presumptive as annual budgets can be modified to include the missing elements. However, a basic fact-check shows that many government goals and measures defined by the GP are absent in the budget. For example, only 340 out of a total of 579 measures proposed by the GP are, to a certain extent, reflected in the 2021 Annual Budget Law. This means that 41% of the strategic measures proposed by the GP were not budgeted. In addition, strategic planning is complicated by the lack of a hierarchy of national and sectoral strategic plans and synchronization of planning horizons. A decree was passed in 2017 to streamline strategic plans into three levels (comprehensive, medium-level budget program), but further regulations and guidelines required to make it fully effective are lacking.

In this context, regular assessment of the impact and efficiency of budget programs becomes essential. In the absence of a comprehensive framework of defined indicators, with targets for outputs and outcomes, the system does not provide clear information on the achievement of the intended results or a complete picture of the progress of implementation[12]. Budget programs regular assessment processes have not been introduced yet, which restricts the possibility of evaluating the impact and results of budget programs. The 2019-2023 Public Finance Management System Reform Strategy (PFM Strategy) foresees full implementation in 2023. The strategy targets the improvement of financial discipline, i.e. evaluation of quantitative and qualitative output indicators of the programs financed from the state budget, by establishing accountability mechanisms based on an input-output logical system.

[11] These include areas like the policies for complete feeding in the field of food security of the population and Increase in the level of food independence, Conduction of constitutional reforms, Strengthening the rule of law by the use of a transitional justice toolkits, Reduction in property rights violations with alleged violations presented to the European Convention on Human Rights (ECHR) and the Development of construction, promotion of new technologies, establishment of a favourable work environment and promotion of investments amongst others.

[12] Moreover, these indicators are not disaggregated, so it's difficult to track allocation in term of age, gender, poverty/poor etc.

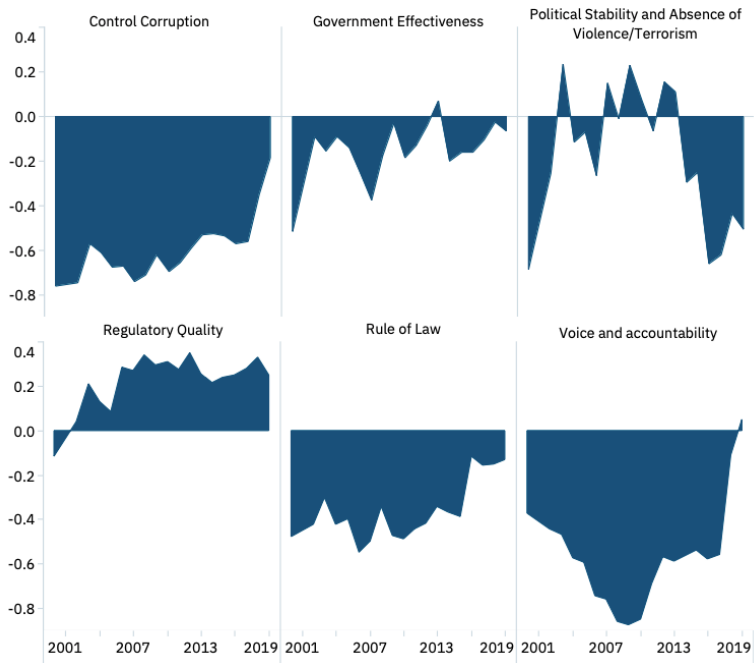
2.4 Economic governance

Corruption was a persisting issue in the public administration of Armenia for many years. Some improvements of business climate and marginal decrease of the perceived level of petty corruption have been achieved due to simplifying regulations and introducing e-governance tools. The most significant achievement since 2015 was the alignment of laws and institutions with international standards (the adoption of the new laws on the Commission for the Prevention of Corruption and whistleblowing, on Public Service and Civil Service, and regulations enhancing corruption prevention tools, such as asset declarations)[13]. Other positive developments included procurement reforms and the introduction of e-governance.

While human and financial constraints were contributory factors, a deficit of political will has been the endemic underlying cause of governmental inaction However, these efforts had only limited impact, and corruption remained a problem in key areas of public administration, such as the judiciary, tax and customs, health, education, military, and law enforcement.

The "velvet revolution" brought about many other significant, positive changes. The Civil Contract Government resulting from the massive social protests in 2018 made significant progress of anti-corruption efforts. The authorities have set out an anti-corruption strategy for 2019-2022 that aims to address conflicts of interest in policymaking bodies, ensure judicial and prosecutorial independence and integrity, and guide efforts to detect, investigate and prosecute corruption cases. In 2021, the law on a single autonomous and central anti-corruption entity with enhanced detection and investigative powers was approved. International rankings and corruption trends show marginal change. In 2018, Armenia ranked 60 among 180 countries on Transparency International's Corruption Perception Index and in 2020 jumped up to the 49th position. The scores for the World Bank's Quality of Governance (QoG) indicators throughout the post "velvet revolution" period show improvements. This is especially notorious in corruption control and voice and accountability indicators, as shown in Figure 11 below.

Figure 11 Governance indicators



Source: DFA Team calculations based on The Worldwide Governance Indicators.

International assessments show that there is still room for improvement. According to the

[13] OECD (2018)

2019/20 Caucasus Barometer poll from the Caucasus Research Resource Center (CRRC),[14] the court system was thoroughly distrusted by 25% of the population as opposed to 3% who fully trusted it. Another challenge is the workload of courts that adversely affects the quality of judicial decisions. Nevertheless, the government in October 2019 approved a Legal and Judicial Strategy and Action Plan for 2019–2024, which aims to achieve independence and impartiality of the judiciary, ensure the professionalism of judges and judicial servants, and improve the public accountability the judiciary. The Venice Commission found that the Judicial Reform Package "generally deserves praise" and that "most proposals contained in the Package are in line with European standards and contribute to combatting corruption without, at the same time, encroaching on the independence of the judiciary."[15].

One way to facilitate this coherence could be to mainstream the SDGs in different processes of the budget cycle. Integrating the SDGs in the budget cycle generates an immediate improvement of the system by starting a strategic budgeting process. Linking SDGs to the strategic budgeting activities will strengthen the SDG policy, planning, budgeting, execution, monitoring and audit process. In addition, this approach can help the government identify and implement strategic budget reforms across various contexts. This exercise is compatible and reinforcing of current PFM reforms driven by the 2019-2023 Public Financial Management Strategy (PFM Strategy). The application of SDG aligned processes is fully compatible with the objectives of the PFM reforms (Box1). Many development partners (IMF, OECD, WB) and UN agencies provide methodologies for embedding various types of SDGs in the budget cycle.

Box 1

Application of SDG aligned processes with Objectives of PFM[16]

As PFM system traditionally aims to improve ***operational efficiency*** (value for money), ***allocative efficiency*** (spending in line with budget priorities) and ***fiscal sustainability*** (maintaining public finances at a credible and serviceable position over the long term), linking the SDGs to strategic budgeting requires improving PFM outcomes. In this context, UNDP's primary mandate is to secure the successful attainment of the 2030 Agenda through pursuing macro-economic development and sector SDG financing in collaboration with other development partners.

PFM Objectives	Application of SDG aligned systems and processes
Fiscal Discipline	• SDG-aligned macro-fiscal rules • SDG-informed fiscal space / fiscal gap analysis • Risk management for macro-fiscal parameters
Strategic Allocative Function	• Budget prioritisation using SDG framework and accelerators • Sector-specific SDG-aligned fiscal rules • Bridging policies with budget decisions, incl. using SDG costing, gap assessment, SDG financing framework • SDG-informed MTEF/budget circulars and budget negotiations processes • SDG-informed vertical fiscal transfers (conditional transfers) • Sustainable Development Financing
Effectiveness and Efficiency	• Aligning MTEF and budget performance framework with SDG indicators/targets

[14] CRRC (2020)
[15] Council of Europe (2019b)
[16] Reproduced from UNDP (2020)

CHAPTER 3

Public finance and main financial flows

3.1 Overview of public finance opportunities and challenges

The public finance sector in Armenia is comparatively small and well managed. The weight of the public sector in the economy fluctuates around 26% of gross domestic product. Armenia endured several global, regional, and domestic crises. At times, the macroeconomic situation was challenging, like in 2016, but subsequently improved with economic growth reaching 7.6% in 2019. Also, the government's budget deficit, which was 4.8% of gross domestic product (GDP) in 2017, was reduced to 1.0% in 2019 and thus provided a fiscal consolidation needed to lower the government debt-to-gross domestic product ratio (53.6% by end-2019).

Armenia had to address significant budget deficits, but, overall, the fiscal situation is regarded to be well managed. This is reflected by the assessments made by the IMF and the rating agencies that qualify Armenia's external debt. The most recent IMF Article IV Consultations from June 2019 highlighted the government's corrective action plan to bring down the central government debt to below 50% of GDP by 2023. This plan implies the control of the fiscal deficit at around 2% of GDP supported by solid revenue mobilization and spending constraints while protecting the social spending envelope to promote sustainable and inclusive growth. The assessment concludes that revenue mobilization and spending restraint efforts *strike a realistic balance between reducing debt and preserving capital and social spending.*[17]

The country made significant progress in implementing Public Financial Management (PFM) reforms to improve fiscal discipline. The government's revenue performance measured by the tax-to-GDP ratio is well above the average of upper-middle-income countries[18] and underwent substantial improvement during the past decade, was 17.07% in 2010 and increased to 22.4% in 2020. However, considering expenditure levels, revenue mobilization is insufficient, and the deficit has been financed by increasing public debt. This allowed Armenia to enter the COVID-19 crisis with relatively solid macro-economic fundamentals, characterized by fiscal soundness and a controlled path for government debt.

The ongoing adverse effects of the dual crises of COVID-19 and hostilities in and around Nagorno-Karabakh in September-November 2020 posed significant challenges. An increase in state budget expenditures in 2020 was due to the need for additional anti-crisis measures and hostilities. The share of public budget expenditures in GDP in 2020 increased by 5.8 percentage points to 30.6%, in which the share of current spending increased by 5.1 percentage points to 27.0%, and the share of transactions with non-financial assets increased by 0.7 percentage

[17] IMF (2019)

[18] WorldBank database, Middle income Tax to DGP ratio for 2018 – 11.98%

points to reach 3.7%. (0.9% of which are additional military expenditures). GDP declined by 7.4% in 2020, and in nominal terms, budget revenues decreased. The fiscal deficit in 2020 reached 5% of GDP due to weak revenue performance and higher government spending.

However, is expected to return in 2022, and there are signs that the Armenian economy has already entered a recovery phase. The sound fundaments of the Armenian economy and public finance management give hope for a quick recovery. In 2020, the total state budget revenues amounted to 25.2% of GDP against 23.8% of the previous year, and taxes and duties - 22.4% of GDP - against 22.3% of the last year. At the same time, the improvement in taxes and duties /GDP ratio was mainly conditioned by the growth of taxes generated by the domestic economy. In contrast, the tax revenues generated from imports decreased. As a result, GDP already started to growth in the first half of 2021[19].

The development of a fiscal risk management framework in Armenia is incipient. It is developing based on the roadmap approved by order of the MoF in 2019. The efforts were put to implement a monitoring mechanism for SOEs and recipients of budget loans financial performance which resulted in the publication of the analysis in the MTEF 2022-2024. According to the roadmap, by the end of 2021, the MoF should play a role in proposing mitigation strategies for SOEs and debtors based on monitoring results. Moreover, the MoF Fiscal risk unit should play a vetting role when assessing budget loans proposals. However, capacity constraints deferred the implementation of the objectives. In parallel, SOE reporting requirements have been strengthened by adopting a law that imposes the mandatory audit and publication of financial reports of SOEs exceeding specific criteria.

3.2 Efficiency and effectiveness of public expenditure

The PFM Strategy targets the primary sources of public expenditure efficiency. Historically, the Public Expenditure and Financial Accountability (PEFA) Assessments have been the benchmarks for evaluating PFMS in Armenia. It was first implemented in 2008, and the second PEFA assessment was carried out in 2013. Still, PEFA 2013 is the latest available report and is much outdated. However, the information served as a basis for developing the PFM reform strategy first in 2016-2020. The current baseline for the PFM reform Strategy for 2019-2023 was developed using SIGMA and IMF assessments from 2019[20].

The main driver for this reform is the PFM strategy approved by the government decree in 2019. The objectives of the strategy related to public spending include: (i) compliance of budget programs with policies implemented with existing strategic documents, (ii) Introduction of a regular process of evaluating the efficiency and effectiveness of budget programs, (iii) application of a unified mechanism for estimating different types of expenditures of all state bodies in the state budget of the Republic of Armenia, (iv) Improvement of SNCO financial-economic activates accountability and monitoring, (v) introduction of financial management and control and (vi) increase the efficiency of the financial-budgetary oversight function

The main factors that generate public expenditure inefficiencies should be further analyzed. The latest Public Expenditure Review was conducted in Armenia by the World Bank in 2014 and is of limited use as many significant reforms and interventions were implemented by the government during this period. Nevertheless, with the support of the WB and the IMF, the government plans to conduct an expenditure review in 2021 to reduce the current expenditure and implement quality revenue measures over the medium term starting in 2022.

The improvement of public expenditure efficiency is needed to create room for reallocating

[19] MoF *official statistics*

[20] "Baseline Assessment Report on the Public Sector of Armenia" SIGMA, March 2019"Assessment of Public Investment Management in the Republic of Armenia" by the International Monetary Fund (IMF), January 2019

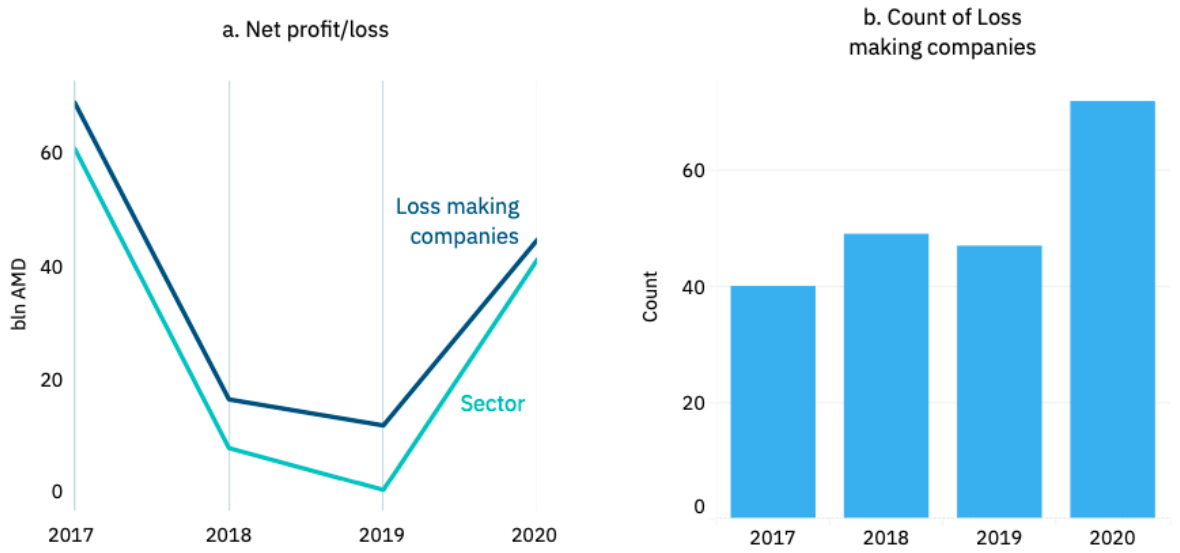
resources to high priority areas, including ensuring an adequate social safety net. The bulk of social protection spending is directed to pensions and family benefits. In 2020 64% of social protection expenditure were pensions and 11% family benefits while social services and active labor market programs are underfunded. After the transition to the cumulative pension system in 2014 significant amount of budget spending in this area is related to the government's contribution to the pension fund (22% in 2020). Therefore, there is considerable interest in analyzing the efficiency and effectiveness of the approaches and methods currently used.

State-Owned Enterprises (SOE)

The size and breadth of the SOE sector is a legacy of the former Armenian Soviet Socialist Republic, where public capital played a predominant role in the economy at all levels of government. Many SOEs were privatized during 1994- 2004 at different rates and efficiency. The highest rates were observed during 1996 and 1997, mainly explained by the availability of privatization certificates. At the end of 2020, there were more than 210 SOEs; however, there are not publicly available covering long period datasets about the SOE sector.

Public consolidated accounts are not being prepared In Armenia. To address the issue of loss-making SOEs, it is necessary to present non-consolidated information from the SOE database. In recent years the MoF slightly improved its reporting on SOEs in the framework of fiscal risk reporting. In addition, the State property management committee is publishing a combined report on SOE performance. The database developed by the ministry of finance is covering the period 2017-2020 was used as a primary source of information for this analysis.

Figure 12 Non-consolidated loss of SOEs 2017-2020, bln AMD



Source: DFA Team calculations based on official government data

The SOE sector overall was loss-making during 2017-2020 with close to zero results only in 2019. The current dynamics of the SOE profits and losses are presented in the Figure 12. A significant amount of SOEs financial performance is close to zero, and it can be assumed that they are receiving government grants that are equal to their expenses. The elevated losses of 2017 were registered due to high loss-making water system companies that went through reorganization during the following period. Degraded performance of 2020 primarily relates to exchange rate differences. Many companies -mainly in the energy sector- hold foreign currency nominated debt, and Armenian dram devaluated at the end of 2020. The total number of SOEs fluctuates around 210 and in 2020 loss-making SOEs were 72, approximately 34% of the total.

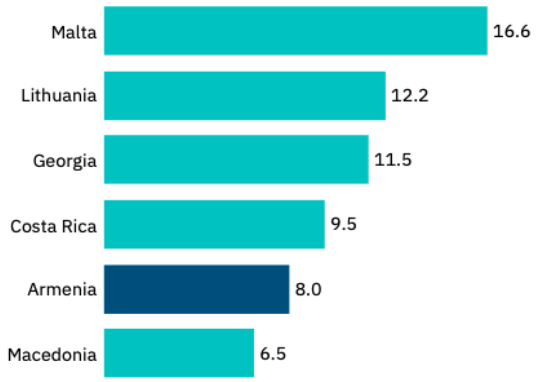
The majority of SOEs are small and medium-size municipal services; however, most of the economic activity is performed by the SOEs owned by the central government. Municipal

SOEs account for 129 (or 61%) of the total of 210 enterprises. However, central government owned SOEs generated AMD 194 bln, approximately 74 % of the total SOE revenues of AMD 262 bln generated by SOEs in 2020. These enterprises also roughly hold 89% of total SOE assets and 92% of their liabilities (AMD 700 bln and AMD 481.5 bln, respectively). The largest central government owned SOEs are in the electricity generation sector and the water supply, sewage, waste management, health, post, television & radio sectors. The three SOEs with the highest average revenues in the sample period are the Yerevan Thermal Power plant (82.6 bln AMD), the Armenian Nuclear Power Plant (26.8 bln), and the High voltage electric networks (11.3 bln).[21]

SOEs are also a significant source of employment in Armenia. In the sample period of 2017-2020, all SOEs employed around 35,400 people. This is equivalent to 17% of public sector employment and 5.5 % of total employment[22]. Moreover, the large scale SOEs owned by the central government employed 15,500 out of 35.4 thousand total SOE employees, equivalent to 44% of the people employed in the sample period. Municipalities own 129 SOEs, mainly in the health sector. Total employment of municipal SOEs was almost 20,000 by the end-2020 equivalent to 56% of the country's total employment provided by SOEs.

The Armenian SOE sector is highly leveraged. The combined assets of SOEs represent 13% of GDP in 2020, mainly consisting of long-term assets that are about 76% % of total assets. Unconsolidated SOE debt totaled roughly 8%of GDP in 2020, AMD 481.5 bln of central government-owned SOEs and AMD 42 bl by municipal-owned SOEs, respectively. Figure 13 shows comparative situations, using IMF data; in Georgia, according to the IMF, liabilities of public corporations amounted to 16.8% of GDP and 17% in Malta.

Figure 13 Non-Financial SOE liabilities to GDP



Source: DFA Team calculations based on different soucesk[23].

SOEs hold about 80% of the liabilities in the Energy sector, with health and other companies having about 10% each. The water sector used to concentrate most liabilities and accumulated losses. However, as of 2020, most of the companies were liquidated, and the assets were transferred under a PPP (lease) agreement to Veolia Djur cjsc (2017). Long-term debt totals about 5.7% of GDP, and a significant part (96% or AMD 354 bln) is held by SOEs from the energy sector, followed by AMD 7.4 bln AMD 5.4 bln in health and transportation, respectively. Out of that debt, AMD 322 bln is in the form of budget loans and on-lending, which means that the state debt-funded all large-scale investment projects of SOEs. "Yerevan TPP", "High-Voltage Electric Networks", and "Armenian Nuclear Power Plant" CJSCs are among the largest receivers of credit means provided to that sector under sub-loan agreements in frames of targeted loan programs being implemented with the support of international organizations and foreign states. The fact

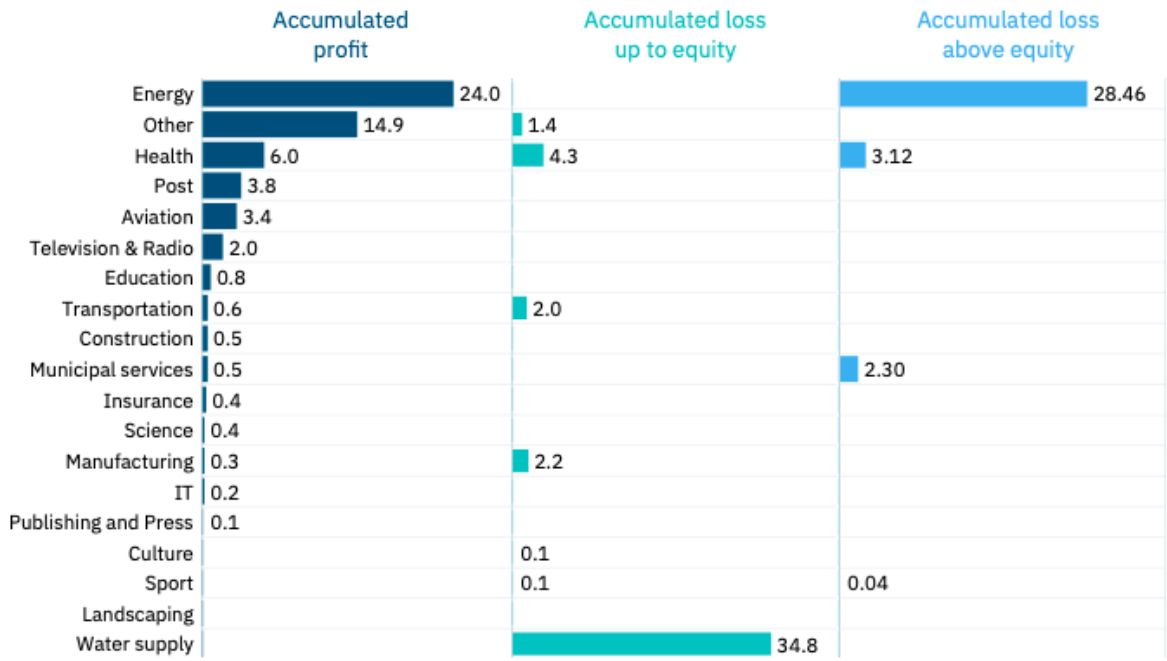
[21] More details are provided in the Annex

[22] Authorities' data and own calculations based on Armstat.am data

[23] Georgia, Costa Rica data for 2020 World Bank, Lithuania 2017 FTE by the IMF, Malta& Macedonia 2016 FTE

that most of these liabilities are denominated in foreign currency and the fluctuation of the exchange rate by the end of 2020 have resulted in the re-evaluation of the liabilities and losses due to the exchange rate differences, which have manifested by a drastic decline in profitability.

Figure 14 2020 Accumulated profits/losses by industry, bln AMD



Source: DFA Team calculations based on official government data

The SOE sector balance sheets point to significant structural weaknesses, which may require policy measures in the short term. For example, while about 92% of SOEs are solvent as of end-2020 with positive equity of about AMD 265.5 bln, 16 of these enterprises have accumulated losses of above AMD 100 mln (total AMD 77.4 bln), thus wiping out the value of their equity. This suggests that operational and financial restructuring, which may include fresh capital injections, are needed to restore solvency in these companies. Alternatively, some of these firms may have to be placed into bankruptcy proceedings.

The SOE sector's financial performance compares poorly relative to the overall economy. Profitability, leverage, and liquidity indicators point to the weak performance of the SOE sector relative to the private sector. Profitability indicators (ROE and ROA) suggest that the government received negative returns on equity invested and that SOEs generate little value from the assets at their disposal. SOEs are also more leveraged than the private sector, and their liquidity is lower than the private sector. These indicators point to the need for continued government support of many large SOEs in the short run. Some issues require policy attention:

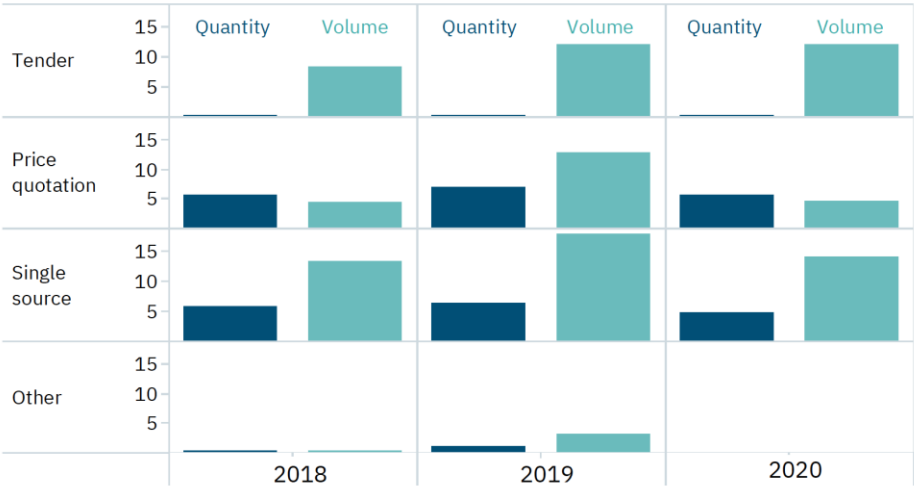
- The SOE sector was loss-making on average in 2017-2020. While the industry was relatively profitable in 2019, foreign exchange losses affected it significantly in 2020, and only 59% of companies were profitable in 2020, while in 2019, the same indicator was 74%.
- About 28% of SOEs have quick liquidity ratios below one, signaling difficulties in meeting short-term obligations that might require explicit and implicit budgetary support.
- During 2017-2020, the SOE sector Return on Equity (ROE) averaged -0.3 %, implying that government investment in the sector yielded negative returns. As a result of 2020, 148 companies' ROE was below 1%, with only 50 companies' exceeding 6%.
- An average Return on Assets (ROA) of -3.6 % for the period 2017-2020 suggests that the SOE sector does not extract value from the assets at its disposal. Moreover, during 2020 only 54 companies' ROA exceeded 3%.

It can be said that SOEs negatively impact macroeconomic performance and do not contribute enough to the economy because of low profitability, high leverage, and low liquidity. The SOE sector is not contributing enough to the economy; data from Figure 17 shows the accumulated profits and losses of SOEs by industry. Moreover, the SOEs do not contribute substantially to infrastructure development, except for Energy, Health and Defense sectors. During the period observed, assets of the Energy sector increased by 23% or AMD 88 bln, for health by 55% or AMD38 bln. No public corporation is listed on the Armenian Stock Exchange, and only 8 companies out of 210 have shareholders other than government or municipalities.

Public Procurement Systems

The public procurement system has undergone significant transformations in the last decade. The Ministry of Finance oversees the country's public procurement policy and its operational aspects, including the e-procurement system (ARMEPS). Since April 2017, procurement has been fully decentralized, public entities have undertaken their procurement. There are currently about 1,000 procuring entities, including state entities, local governments and SNCOs

Figure 15 Procurement procedures, types, and volumes 2018-2020



Source: DFA Team calculations based on official government data from the Annual Procurement Report (MoF)

Public procurement is highly decentralized, but the processes still need refinement. In 2020, public procurement was being carried out by 200 contracting authorities, including state entities, local governments and SOEs. The current dynamics of public procurement are shown in Figure 15 They show that single source procurement still accounted for 44% of the total procedures during this period and for 47% in terms of value. In addition, the average number of bidders per tender during this period was still low, as there was an average number of 2.59 bidders per tender during the analyzed period.

The public procurement legislation is undergoing frequent changes to adjust to the requirements of the new constitution and improve the economy, efficiency, and transparency of the system. Public procurement is currently regulated by the Public Procurement Law (PPL) adopted on 16 December 2016, Government Decree No. 526-N of 4 May 2017 and several other pieces of secondary legislation. Although many of its provisions reflect obligations under the Treaty on the Eurasian Economic Union, the PPL broadly corresponds to international practice, with the organization of the review system being one crucial exception. In 2011, Armenia became the first of the former Soviet Union countries to become party to the World Trade Organization's

General Procurement Agreement,[24] which regulates government procurement of goods and services by public authorities based on openness, transparency, and non-discrimination.

According to some sources, deeper reforms are needed. The Sigma Baseline Assessment of 2017 indicates that the improvements achieved are somewhat superficial and highlights the following shortcomings of the public procurement system and environment in Armenia[25]:

- The objectives of economy, efficiency and transparency in public procurement are put into question by the weakness of the local supply market, indications of lack of procurement skills in many contracting authorities, and concerns about the integrity of the procurement processes.
- Attaining value for money in public procurement is made difficult by the almost exclusive use of the acquisition price as the only award criterion, subject to the tender meeting minimum technical requirements.
- There are no specific provisions in the PPL regarding contract management.
- No formal ex-post evaluation requirements are set out in the PPL. There is no evidence of any systematic, specific review of the performance of contracts concluded by the contracting authorities.
- Guidelines and standard documents focus mainly on the tendering and award phase of the public procurement process, with scant attention to aspects like needs assessment and market consultations and only limited engagement to post-award contract management.
- Contracting agencies lack the skill and experience to use the system properly

The government has many opportunities to explore how to generate more development results from the public procurement system. The government needs to balance the procurement improvement process to ensure that it is not too loose with the rampant temptation of corruption or too tight when zealous procurement officers block or delay execution unnecessarily. Too often, it is challenging to generate accountability, a value system and work ethics that do not focus on client service and outcomes and, more generally, the public interest and authoritarian tendencies. Once that job is done, there are many other ways of using public procurement to generate more development impact, such as providing inclusive access to MSMEs and developing opportunities for these firms to benefit from this high-value source. There are also opportunities to design policies that discourage adverse effects on climates change (e.g. favoring low-carbon-footprint suppliers and developing green public procurement systems.

3.3 Main Public Finance Flows

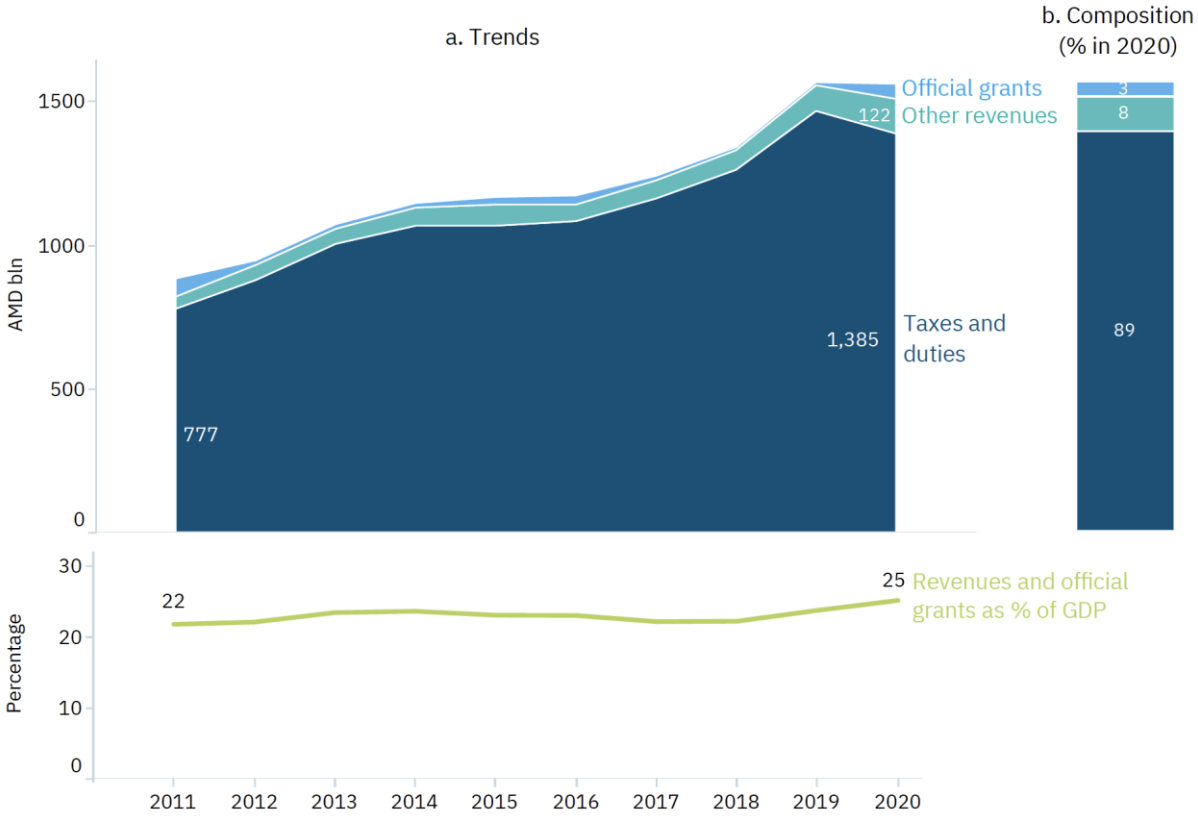
3.3.1 Tax Revenue

Over the last two decades, Armenia succeeded in mobilizing resources to support its national development efforts and ensured good levels of macroeconomic stability. In addition to attaining sustained high growth rates over the last few years, domestic revenue mobilization has also steadily increased. The deficit has been manageable and sufficiently financed by loans, and inflation has been controlled. Total state budget revenues comprise three primary sources: (i) tax revenues (incorporating taxes and duties), (ii) other non-tax revenues, and (iii) official grants. Over the last decade, total budget revenues increased in nominal terms. Figure 16 shows that the total revenue to GDP ratio fluctuated within the range of 22-25%. The economic slowdown of 2020 reversed this steady growth trend, leading to a decrease in budget revenues in nominal terms. However, as Figure 17 shows Armenia's domestic resource mobilization is one of the highest in the region.

[24] The revised General Procurement Agreement of the World Trade Organization was approved by the President's Decree N NH-217-N, dated 23 February 2015.

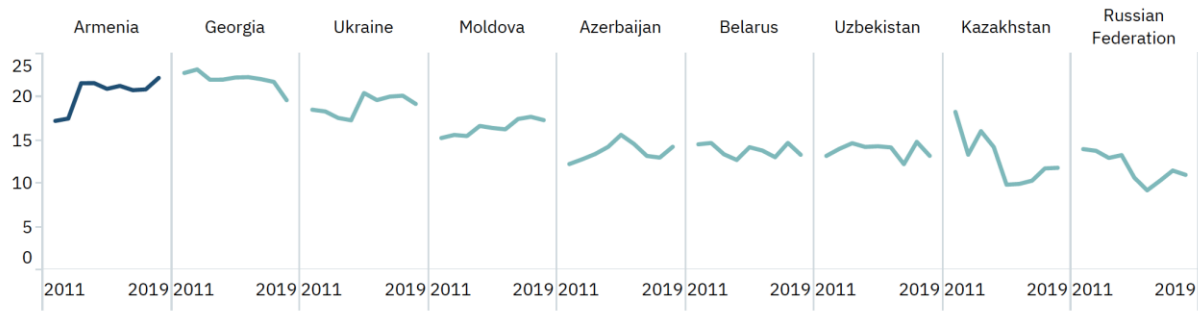
[25] Sigma Baseline Assessment

Figure 16 **Composition and trends of state budget revenues**



Source: DFA Team calculations based on official data from the State Budget Execution Reports

Figure 17 **Tax revenue regional comparison (% of GDP)**



Source: DFA Team calculations based on World Bank Indicators

Taxes and Duties

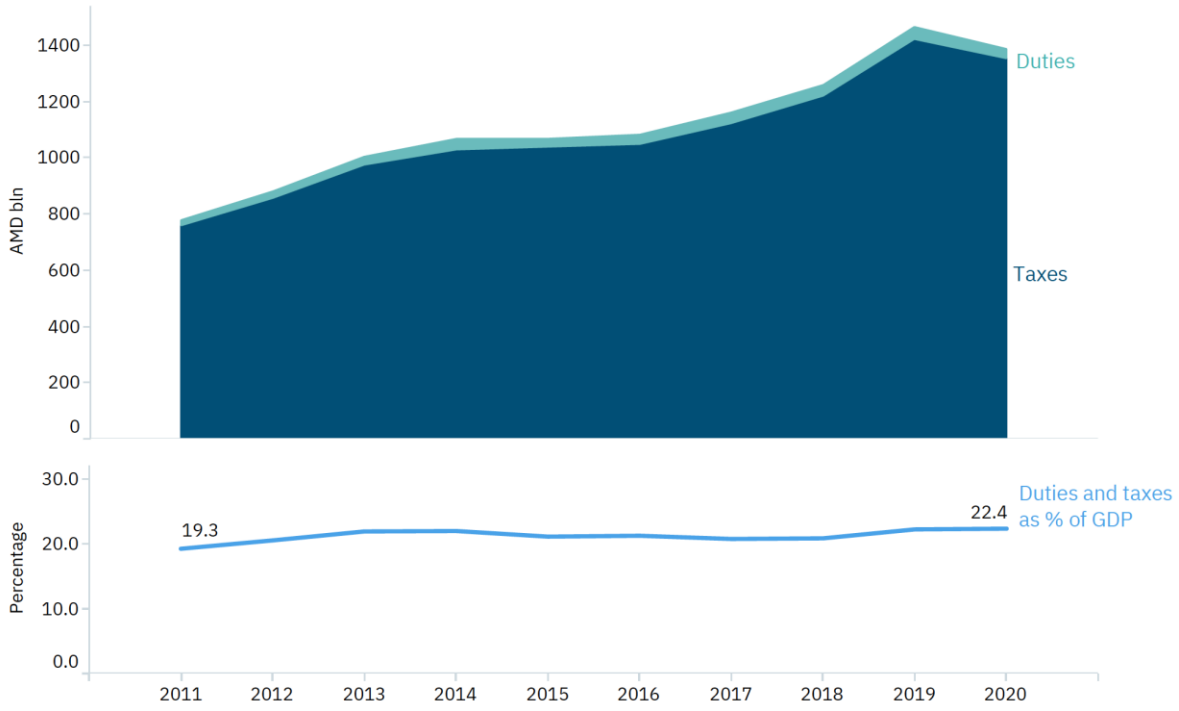
Taxes and duties constitute the largest group of total budget revenues, accounting for 88.8% of total revenues and 22.4% of GDP in 2020. Other, non-tax revenues constituted 7.8% of total revenues (1.98% of GDP), and official grants accounted for 3.4% (0.86% of GDP). After 2016, the share of official grants in the composition of the total revenues has gradually decreased, mainly due to reducing foreign assistance in grants. However, in 2020, official grant revenues grew sharply due to the unprecedented budget support received during the pandemics. Another prominent figure in 2020 is a sharp growth recorded in other (non-tax) revenues, due to receipts of the funds donated by "Hayastan" All Armenian Fund to the state for funding infrastructure, social and healthcare expenses conditioned by the hostilities in Nagorno-Karabakh [26].

Taxes and state duties are the primary sources of budget revenues. Budget revenues in Armenia are highly concentrated in tax revenue. Figure 18 shows that during 2011-2020, tax

26 Annual Report on the RA State Budget Execution for 2020.

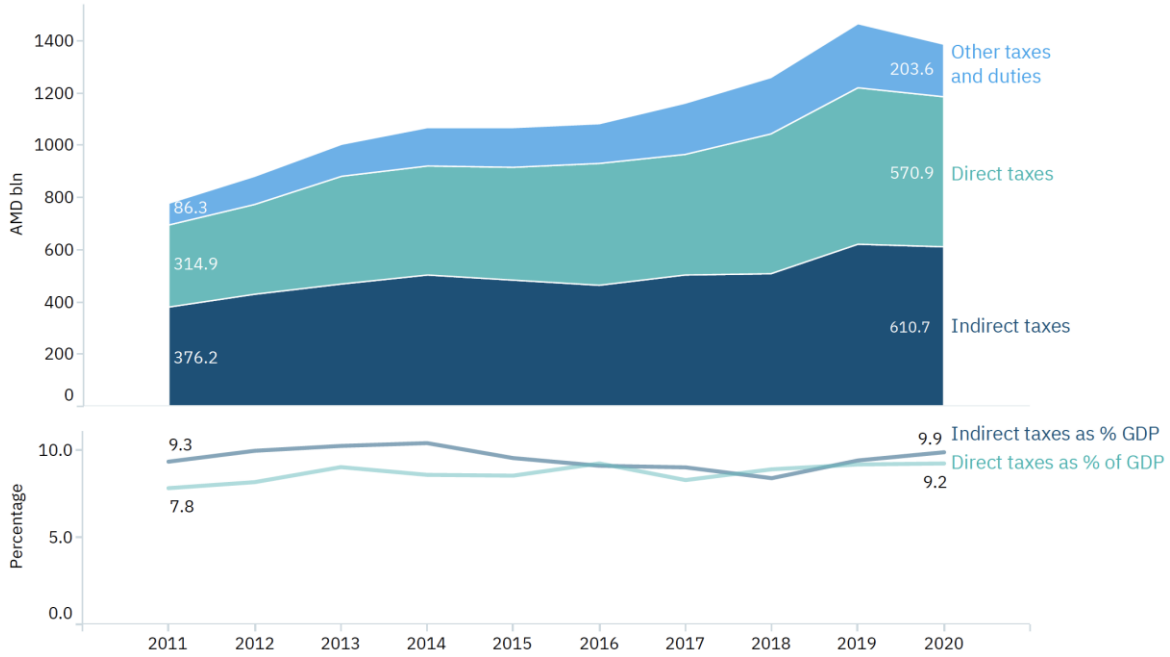
revenue trends were generally aligned with GDP. During that period, tax revenue to GDP ratios fluctuated between 20.6-22.4%, attaining the historically high level of 22.4% over the last two years. This growth of tax revenues slowed down only during the 2015-2016 regional crisis and in 2020, conditioned by the deep economic slowdown generated by the pandemic and the hostilities. In 2020, tax revenues reduced in nominal terms by 5.4% from the previous year[27]:

Figure 18 Composition and trends of taxes and duties



Source: DFA Team calculations based on official data from the State Budget Execution Reports,

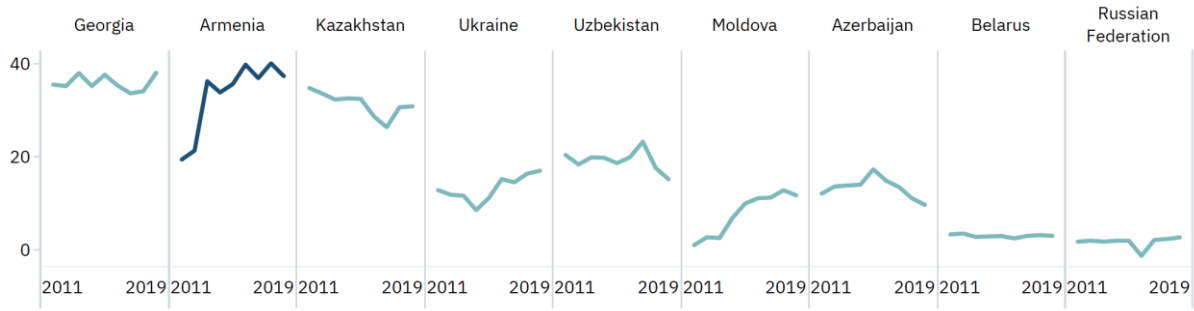
Figure 19 Composition and trends of direct, indirect, import, and export taxes



Source: DFA Team calculations based on official data from State Revenue Committee Annual Reports.

[27] Ibid

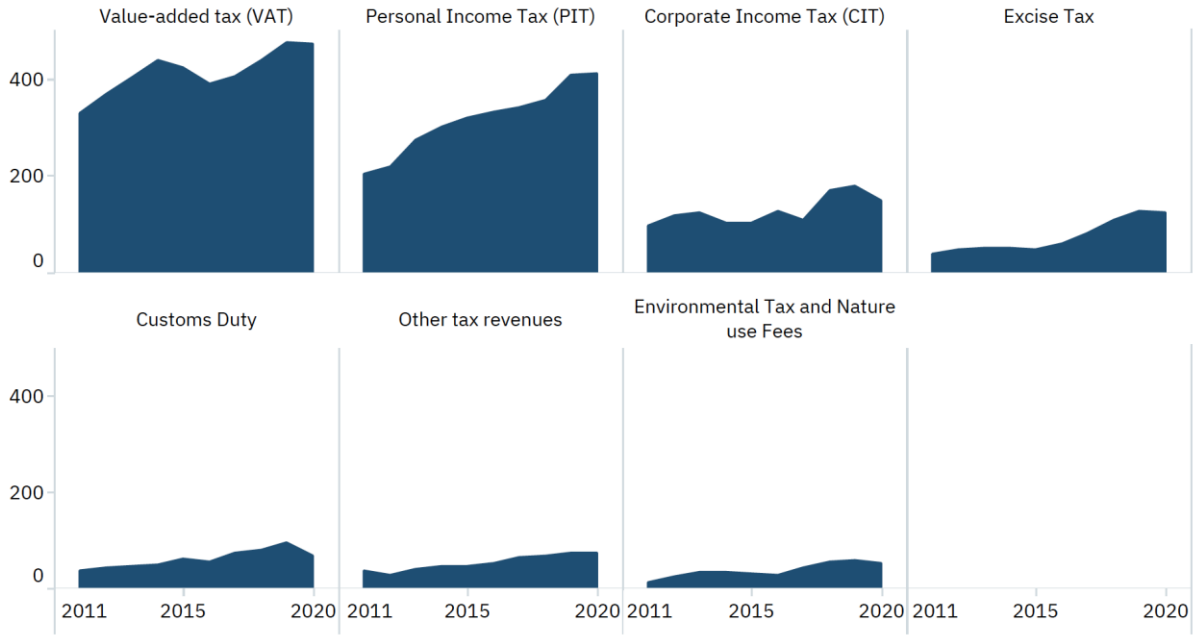
Figure 20 ***Taxes on income, profits, and capital gains (% of revenue) regional comparison***



Source: DFA Team calculations based on World Bank Indicators

Over the last decade, the revenue mix showed a relatively balanced distribution between direct and indirect taxes. The dynamics of the composition of direct and indirect taxes during 2011-2020 are shown in Figure 19. Indirect taxes represented on average 45% of tax revenues in this period whereas, direct taxes accounted for 41% and other taxes and duties constituted the remaining 14% of tax revenues. However, these dynamics are about to change. The government's goal is to gradually decrease the share of direct taxes in the mix by increasing indirect taxes[28]. The rationale is that this will increase the economy's competitiveness, raising profitability and thus incentivizing investments in the export sector. This process already started in 2020 and is analyzed in more detail later in this section. This rationale seems to align with the evidence shown in Figure 20, indicating that Georgia and Armenia are the countries with the highest levels of direct taxation in the region.

Figure 21 Trends of budget revenues by main taxes



Source: DFA Team calculations based on official data from the State Budget Execution Reports

Tax revenues and trends by main taxes

Tax revenue in Armenia is concentrated in four main taxes that generate over 80% of revenues. Figure 21 shows the trends of revenues over the last decade by main taxes. The majority of revenues from taxes and duties are formed from four main taxes. Using 2020 data the Value Added Tax (VAT) accounted for 34% of revenue, Personal Income Tax (PIT) for 29.7%,

[28] Republic of Armenia (2019)

Corporate Income Tax (CIT) for 10.7% and the Excise Tax for 8.9%[29]. Before the COVID-19 crisis and the tax reforms in 2020, PIT and the Excise Tax showed stable growth trends over the last decade. However, the 2015-2016 regional crisis-affected VAT and CIT revenues that showed a marked downward trend.

Over the last decade, the evolution of the main taxes and their policies experienced significant changes. The dynamics shown in Figure 24 describe the relative development of the main taxes during the last decade, particularly[30]:

(i) Value-added tax (VAT) is the primary source of state budget revenues. The main source in VAT proceeds is from imports, making up 60.2% of VAT revenues in 2020. The remaining is formed from domestic turnover. Since becoming an EAEU member in 2015, the VAT applicable to the goods imported from EAEU member states comprised 22.8% of the total VAT revenues in 2020.

(ii) Personal Income Tax (PIT). This is the second source of taxes in Armenia. Over the last decade, PIT revenues fluctuated within the range of 5.9-6.7% of GDP. Trends of the proceeds from the PIT were mainly attributable to the growth of the number of jobs and the average salary (e.g., 2018-2019). The increase of the PIT since 2013 was attributable to the introduction of a single PIT replacing the previous regime of PIT and Compulsory Social Insurance Contributions[31].

(iii) Corporate Income Tax (CIT). During this period, proceeds from this tax fluctuated in the range of 2.0-2.8% of GDP, attaining a historically high level of 2.8% during 2018-2019, before falling to 2.4% in 2020. In 2020, CIT revenues sharply declined 17.9% due to the economic slowdown, the reduction of the CIT rate[32], and the introduction of tax privileges for advance payments of CIT as a measure to neutralize the consequences of the coronavirus pandemic

(iv) Excise Tax. These revenues increased from 1% of GDP in 2011 to 2% in 2020. The primary sources are the locally produced excisable goods, comprising 50.4% of the proceeds in 2020. Exceptional meager proceeds from this source in 2020 were mainly caused by the reduction of the excisable goods produced during the economic slowdown. The economic recession reduced local production volumes and goods imported from third countries that are also subject to Excise Taxation. The changes to the tax base and the increase of the tax rates for locally produced and imported goods introduced on January 1, 2020, harmed the revenues generated by these taxes[33].

(v) Customs Duty. Since Armenia joined the EAEU in 2015, continuous activities have been carried out to conform the RA customs and tax legislation to the common customs legislation. A predominant part of the customs duties is now aligned with the EAEU framework (99.4% in 2020). The significant growth of Customs duties, particularly in 2019, was mainly due to the increase of vehicle imports. In 2020, the reduction in customs duties was 28.3%, attributable to a decrease in import volumes by around 33%.

(vi) Environmental Tax and Nature use Fees. The Environmental Tax and nature use fees comprised around 3.8% of the proceeds for the state budget in 2020. The environment tax is targeted at companies engaged in producing or importing goods that generate environmental damage[34]. Payments made by these companies are allocated into the local budgets of the communities in whose territory these activities may cause harmful impacts. Nature use fees are

[29]. MoF (2020)

[30] 2020 figures provided are from MoF (2020)

[31] MoF (2013).

[32] From January 1, 2020, the Profit tax rate has reduced from 20% to 18%. The taxation rate for dividends received from the Armenian sources by non-resident organizations also reduced, being set at 5% instead of the 10%.

[33] Currently only the quantity (the volume) of imported goods is considered as a tax base, while previously the tax base would incorporate also the value of the excisable goods.

[34] Main objects of this taxation are the emission of harmful substances into the atmosphere, the leakage of harmful substances and(or) compounds into the water resources, the disposal and(or) storage of waste from entrails use, production, and(or) consumption in specially designated places, the import of goods causing environmental damage to the territory of Armenia.

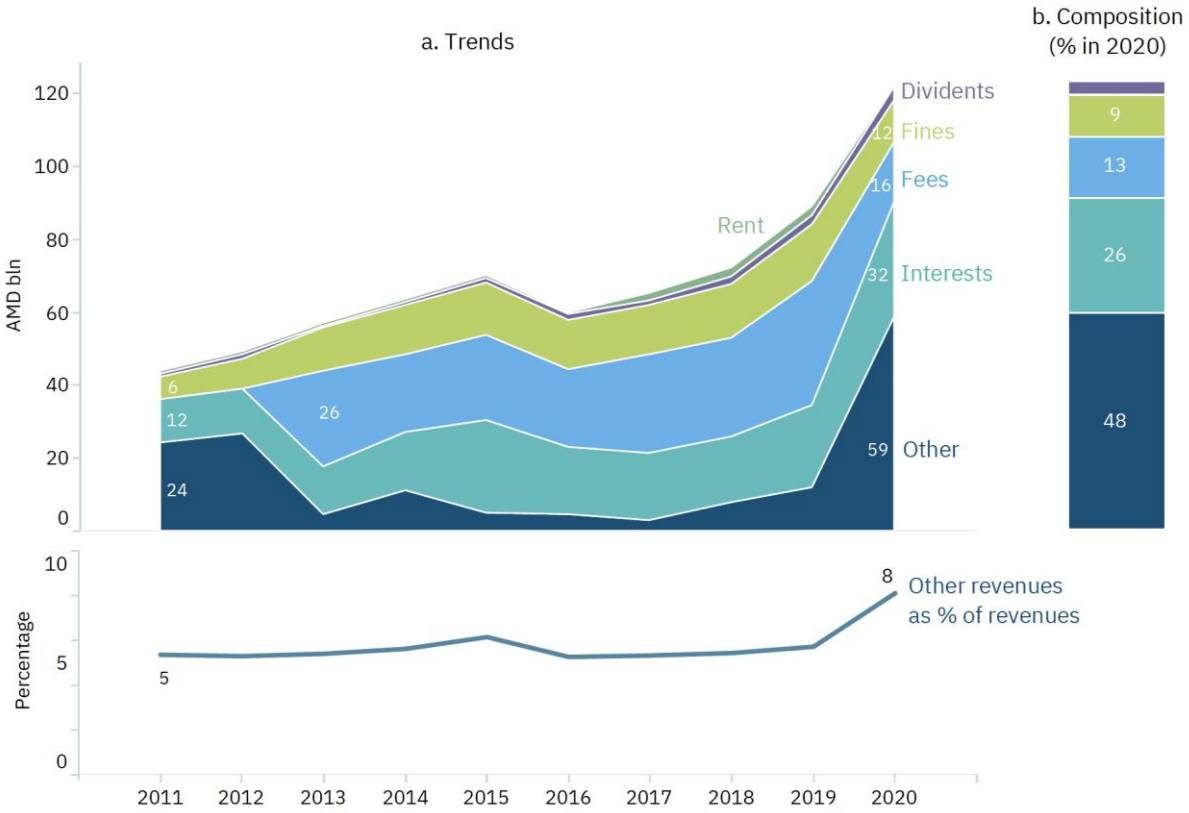
paid to the state budget for the use of state-owned natural resources[35]. The Royalties payable for the sale of extracted metallic minerals and the products produced from their processing in 2020 amounted to 82.4% of the proceeds from the Environmental Tax and nature use fees.

(vi). Turnover Tax. This tax comprised around 1.92% of total taxes and duties in 2020. This is even if revenues in 2020 were 8.3% lower than those of 2019, partly due to the introduction of the Micro-entrepreneurship tax regime, which generated exemptions from VAT, CIT, and Turnover tax. This reduction was also affected by the economic activity slowdown, and the resulting decrease of sales turnover caused by the coronavirus pandemic and the martial law declared in 2020. In addition, the proceeds from this tax have also been conditioned by the recent changes in the VAT taxation threshold[36].

Other, Non-Tax Revenues

This additional source of revenues experienced moderate increases over the last decade. Proceeds from this source in 2020 amounted to 8.1% of the state budget revenues (122.2 bln AMD). Over the previous years, these proceeds increased from 1.1% of GDP in 2011 to 2% of GDP in 2020. However, it should be noted that 2020 was a peculiar year as the sharp growth (37.7%) of these revenues was due to donations of around 52.7 bln AMD, made by "Hayastan" All Armenian Fund to Armenia for funding infrastructure, social, and healthcare expenses.

Figure 22 Composition and trends of other revenues of the state budget



Source: DFA Team calculations based on official data from the State Budget Execution Reports

Interests, fees, and fines mainly define the composition of other non-tax revenues. Data in Figure 22 shows that in 2020, a large portion of these revenues (29.1%) were generated by the

[35] The objects of nature use fees are the use of surface water, extraction of fresh groundwater and thermal water, extraction of mineral groundwater (including the production of carbon dioxide), salt extraction, extraction of solid non-metallic minerals (except salt), use of life resources (flora and fauna objects, including wood and forest material) and the objects of royalty.

[36] Economic entities with annual turnover not exceeding the VAT threshold (since January 1, 2020, it has been 115 mln AMD per year) can be incorporated in the Turnover tax system.

combined proceeds from interest payments, dividends, and rent payments. The most prominent part thereof (26%) constituted the interest payments received from temporarily allocating free resources of the budget and deposits and those obtained for the loans issued by the government. Another primary source (13%) is the revenues from the supply of goods and services and the receipts from sanctions (10%) imposed by the executive, judicial bodies for violations. On the other hand, dividends on investments in the capital of legal entities constituted only 3% of these revenues. Finally, the revenues received from the rent of state property made up only 0.3%.

Tax privileges and tax expenses

Tax expenses in Armenia are significant. In 2020 the total volume of tax expenses was estimated at 457 bln AMD, representing around 28.5% of tax revenues or 6.45% of GDP[37]. The most significant part of these tax expenses (78.2%) is related to VAT privileges. Tax expenses generated by the CIT amounted to 17.8% of the total, and those concerning the PIT to 4% of the total. The total amount of tax expenses arising from the introduction of presumptive tax regimes (Turnover tax and Micro-entrepreneurship) in 2020 was estimated to be 71.2 bln AMD or about 15% of tax expenses. In general, the tax privileges as prescribed by the RA tax legislation can be categorized into three main groups:

(i) Tax privileges with a social or regional focus. The main goal of these tax privileges is to exempt the provision of some services and supply of goods for healthcare, educational and scientific purposes from the VAT and to acquire the above goods and services at relatively lower prices. There are also geographically based tax exemptions -partial compensation of gas, electricity and irrigation water in borderlines settlements, and complete land and real estate tax compensation.

(ii) Sectoral Tax Privileges. Applied to sectors considered as a development priority that have traditionally shaped the profile of the national economy (jewelry, tourism, carpet making). In this regard, the government assists economic entities engaged in these sectors with various instruments, and their combined effect has not been formally assessed.

(iii) Improving and promoting an enabling business and investment environment. Their aim is to create a favorable tax environment and enhance the competitiveness of the economy. These privileges have been drafted on an "ad hoc" basis without paying due attention to overall policy goals. It is impossible to judge whether the established privileges serve their intended purpose.

This is an area that would deserve significant attention and more systematic policy approaches. The government does not have a centralized database for tax privileges, and approximately 80% of the privileges are discretionally granted[38]. Moreover, there is no systematic monitoring and assessment mechanism to compare the performance of the companies benefiting from the privileges and the policy goals in practice. Similarly, no assessments are made to measure the impact of VAT exempt transactions and privileges. The same could be said about the *Free Economic Zones (FEZs)* system analyzed later in this report. The PFM Strategy and the analysis of development partners all addressed the need to revise and reduce tax privileges[39].

Revenue Mobilization Policies

The main government policy orientations and reform agendas for the state revenue are expressed using several planning instruments. The programmatic documents establishing these policy decisions are the RA Government program[40] and the PFM Strategy. Each year, the main medium-term directions and targets of the state fiscal policy are defined by the Medium-

[37] MoF (2020a).
[38] WB (2019)
[39] IMF (2019).
[40] Republic of Armenia (2019)

Term Expenditure Framework (MTEF) approved by the RA Government. These documents define the government policy goals, the main issues in the sector, and the steps aiming at the regulation thereof. In addition, the Government Program and PFM Strategy specify several issues and challenges that form the current agenda of the state policy and reforms:

- **The size of the informal economy** in Armenia is rather significant. According to the PFM Strategy, as of 2019, the informal economy constitutes approximately 22% of the GDP.
- ***Tax privileges prescribed under the tax legislation*** are far too many, and they often fail to serve their primary purpose. For example, in the case of the VAT privileges, the high-income groups of the society are the ones who mainly benefit, as they consume the goods and services exempted from the VAT to a much greater extent[41].
- ***The tax burdens formed under various taxation systems*** vary significantly. For example, the tax burden formed under the general taxation system is significantly higher than the tax burden of presumptive tax systems like Turnover tax. As a result, economic entities seek to perform the Turnover tax system activities and carry out aggressive tax planning.
- ***In some sectors, no transaction documentation is carried out***. Practically no documentation for agricultural product sales transactions is carried out under the current legislation.
- ***Income received by natural persons is not entirely taxed***. There are many cases of under-declaration or non-declaration of income.

The principles and the main directions of the fiscal policy in the medium term are defined by the Medium-Term Expenditure Framework (MTEF). Among other information, the MTEF establishes the goals, directions, projected trends, and program indicators of the state revenue policy and administration for the upcoming three years. The MTEF also presents the assumptions and risk analysis underlying the macroeconomic and fiscal forecasts. The MTEF is approved by the government each year by the end of July, after which it is submitted to the RA National Assembly. During the recent two years, along with MTEF documents, the government prepared and submitted the preliminary version of the state budget for the upcoming year to the National Assembly (NA), which is further discussed and adopted by the NA before the end of the year.

Tax System Reforms

After the 2018 revolution, the government adopted a revenue policy to reduce the informal economy and form a competitive business environment. This policy aims to enhance the investment attractiveness of the economy and increase economic activity. It is expected that this will create preconditions for long-term economic growth and ensure fiscal sustainability[42]. In this context, among other activities, the government has set the following goals[43]:

- ***(i) Reduce the weight of direct taxes at the expense of indirect taxes,*** which is expected to enhance economic competition and increase profitability and the incentives for making investments in the export sector of the economy.
- ***(ii) Promote micro-entrepreneurship,*** creating a privileged tax system to stimulate formalization and growth of this economic activity
- ***(iii) Ensure horizontal tax fairness,*** establishing similar taxation rules and regulations for taxpayers functioning under identical economic conditions.
- ***(iv) Revise and reduce existing tax privileges,*** ensuring they serve their intended purpose.

The new orientation proposed by the revenue policy may face significant challenges. Some of the primary directives and policy directions are of crucial importance. For example, those included in the new unified Tax Code in 2018 and amendments to it in 2019-2020 resulted in

[41] Republic of Armenia (2020)
[42] Republic of Armenia (2019)
[43] MoF (2019)).

essential revisions of the previously existing tax system. The main policy changes proposed include several areas: (i) Transition from a progressive to a flat PIT system, (ii) Reduction of the CIT Rate, (iii) changes in the taxation threshold for the value-added tax (VAT) and (iv) a new system of taxation for micro-entrepreneurship, (v) the revision of the Excise Tax base and rates and (vi) the revision of the immovable property taxation system

Tax Revenue Administration

Significant efforts are in motion to improve state revenue administration. The government has been implementing significant activities with the focus on improving tax and customs administration. These activities were aimed at the improvement of the quality of the services provided to taxpayers, mainly (i) the introduction of the electronic service system, which has simplified the taxpayer-tax authority relationships, (ii) reduction of tax discipline risk, including introduction of risk management-based systems, (iii) improvement of the processes and organizational structures for revenue administration

As a result of the reforms and the adoption of the new Tax Code, over the recent years, the administration of state revenues has been significantly improved[44]. The outcomes of tax and customs reforms implemented in recent years have been reflected in the international ratings concerning the RA. In the last "Doing business" report, Armenia ranked 47 among 190 countries improving its position by 8 points[45]. Some of the advantages of the tax administration system in the RA are the seamless registration process, a range of information and support to enhance voluntary compliance, strong withholding at source and advance payment arrangements, extensive use of e-filing facilities, universal electronic payment of taxes, automated risk-based audit planning, effective revenue accounting system that benefits from single taxpayer account and periodic internal audit.

Notwithstanding the many achievements, there is still room for improvement, especially in tax administration. The latest Tax Administration Diagnostic Assessment Tool (TADAT) performed in 2017 revealed the need to address several issues: a large number of inactive but registered taxpayers, inadequate governance structures to approve risk-mitigating strategies and evaluate their effectiveness, inadequate management of tax arrears, a lack of effective monitoring at an aggregate level of the number and amount of payments due that are made on time, limited automated cross-checking of information from third party sources vs. taxpayer declarations, a small percentage of VAT refunds paid within 30 days, no evaluation of the impact of audits on taxpayer compliance level, no current strategic plan that underpins SRC's activities.[46]

The Way Forward: Policies to Improve Government Revenue

It seems convenient to organize the process of a systematic review of the cost-benefit of the various tax promotion and exoneration regimes and rationalize their use. To address the abovementioned issues in the tax policy sphere, a systematic review of the strategies and the tools implemented would be convenient. This also applies to other areas analyzed later in this report. For example, there is no clear correlation between some of the measures adopted to incentivize foreign direct investment and the practical results obtained. The DFA suggests the review of targeted individual tax exemptions and the regime of *Free Economic Zones (FEZs)*.

It would also be imperative to ensure that the activities that the RA programmed to address until 2023 defined under the PFM strategy and other documents are continued by the incoming government, namely:[47]:

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[44] IMF (2020)
[45] WB (2020)
[46] TADAT (2017).
[47] IMF (2020a)

- Revision and reduction of the scope of the current tax privileges (especially in respect to VAT).
- Revise the tax weight for the Turnover tax and make it adequate to the tax burden of the general taxation system
- Regulate the issues associated with the documentation of agricultural product sales transactions.
- Increase the Excise Tax rates.
- Increase.
- Introduce an income declaration system to operate based on economic motivations, in the scope of which natural persons will submit a combined declaration on their gross income (among other things, taxed by a tax agent during the year) once per year to enjoy their right of making some deductions from the tax base and receiving a refund for the so-called taxes "paid in excess" during the year.
- Enlarge the geography of agreements excluding double taxation and, to safeguard tax bases established within the country, introduce transfer pricing regulations and information exchange systems for taxation purposes.

The government has an opportunity to consolidate the improvement of the tax revenue administration to achieve the ambitious tax revenue goals set for 2025. The government has already tackled part of the issues identified by TADAT during the previous administration (for example, the issues related to the VAT refund and the development strategy of the revenue administration). The other issues raised have been included in the current tax administration reform agenda. These are defined by the Government Program, the PFM Strategy, and the Strategic Plan for the Development and Administration Improvement of the RA State Revenue Committee (SRC strategy). The government target is to improve the *tax to GDP* ratio to 24.42 % by 2025[48]. The SRC strategy specifies five main directions for the reforms in revenue administration with more than 100 activities. The stated reform directions are:

- Increasing the quality of services provided to taxpayers through streamlining the management systems.
- Enhancing the effectiveness of the tax and customs control with novel solutions in line with best international practices – revenue increase and shadow reduction.
- Upgrading infrastructures and constructing new modern infrastructures, to automate tax and customs procedures.
- Establishing an atmosphere for a healthy dialogue with the public and improving interrelations between the actors of the tax and customs administration will promote the enhancement of public trust towards the SRC activities and the improvement of the tax discipline.
- Improvement of the SRC human resources management system.

The government may also want to further review the proposed transition from the progressive PIT rates to the flat ones as they may lead to revenue loss and compromise of equity. Many analysts, including the IMF, are advising against applying the flat PIT as it may exacerbate the unequal distribution of the population income. This is especially relevant considering the large share of the poor population in Armenia, and that income inequality is increasingly growing. A recent FMI assessment calculated that the revenue loss of setting a 20% flat PIT rate will amount to around 53 bln AMD and estimated that the tax base should be increased by 41.5% to compensate the revenue loss generated. The government intends to offset the losses from the PIT at the expense of increasing the indirect taxes, particularly the Excise Tax and the Environmental Tax and fees that are aligned with other IMF recommendations[49].

48 MoF (2019a)

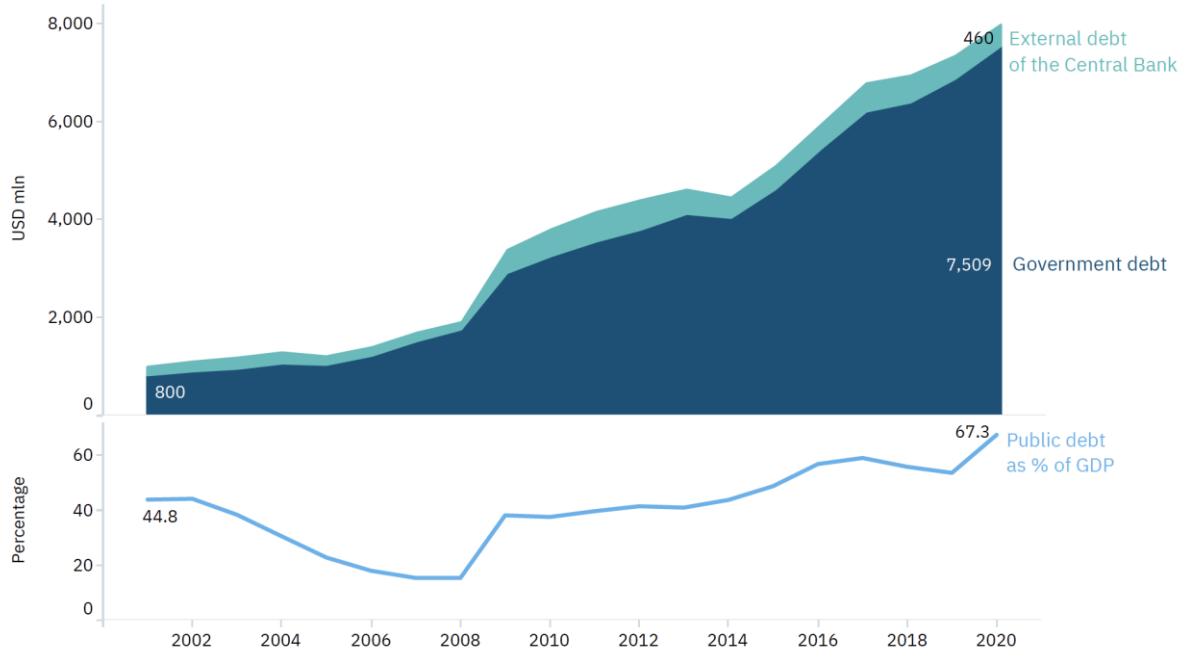
49 Sources IMF (2019) and IMF (2020b)

3.3.2 Public Debt

Over the last decade, public debt has accelerated in nominal terms and as a percent of GDP. Public debt constituted 15.4% of GDP (USD 1.7 bln) in 2008; this value doubled to 39.6% of GDP (USD 3.5 bln) in 2011 and almost doubled again to reach 67.3% of GDP in 2020 totaling USD 7.96 bln. Government debt is the primary source (about 94%) of public debt. The government debt increase was mainly driven by the low economic growth recorded during various years of the period under analysis. After the global crisis of 2008, the country was affected by two economic crises in 2014-2015 and 2020. To ensure macroeconomic stability during these periods, the government, as a rule, had enlarged the State budget deficit. In addition, the government had to finance the critical infrastructure investment needs through foreign project loans, which also contributed to the deterioration of the public debt indicators for these years.

The positive trend observed before the 2020 crisis has reversed again, generating some reasons for concern. Debt to GDP ratios improved and dropped from 58.9% in 2017 to 53.5% in 2019 (Figure 23). This was mainly the result of favorable macroeconomic developments, improvement of tax administration, and the underperformance of the State budget capital expenditures[50]. Several factors caused the sharp increase of the public debt seen in 2020: (i) the reduction of the tax revenues because of the unprecedented 7.6% economic decline resulting from the Covid-19 pandemic and the hostilities in Nagorno-Karabakh, (ii) the increase of the budget deficit caused by the growth in expenses to finance anti-crisis measures and (iii) the depreciation of the AMD against the USD.

Figure 23 Trends of the Public debt



Source: DFA Team calculations based on official data from the RA MoF and the RA SC

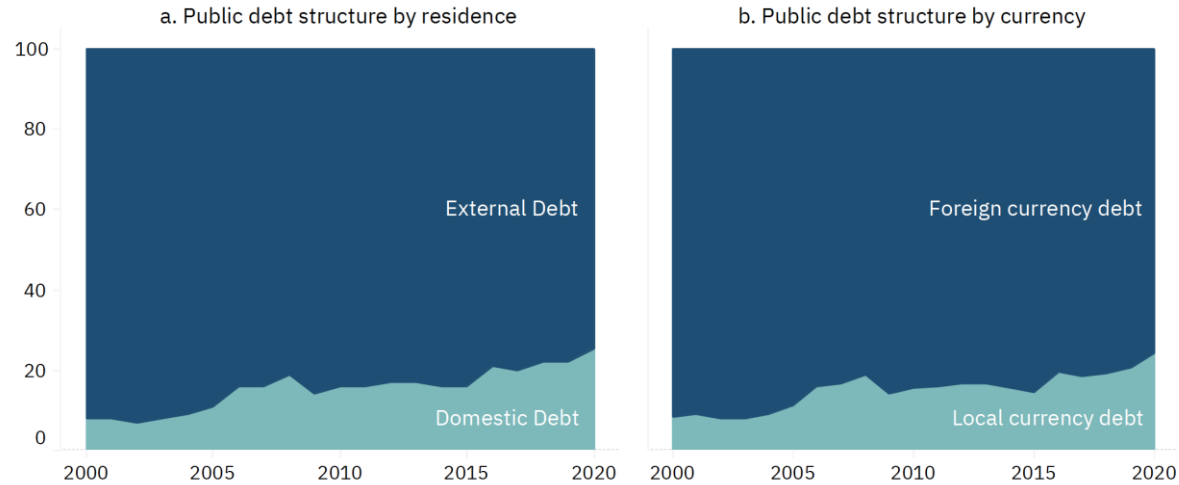
As a result of this unusual situation, government debt surpassed the threshold set in fiscal rules. The public budget deficit rose to 5.4% of the GDP in 2020, increasing by 4.4 percentage points from the previous year. In addition, the government debt to GDP ratio reached 63.5%, rising by 13.6 percentage points of the prior year and going far beyond the 60% threshold set in fiscal rules. Public debt figures include the central government debt and the Central Bank. The debt generated by SOE is not accounted for in this structure. However, this debt could also be a reason for concern. According to the IMF Fiscal Transparency Evaluation Report of 2016, state

[50] IMF (2019a)

organizations generate contingent liabilities to the extent of 40.9% of GDP, which is not recorded in the composition of the public debt of the RA[51].

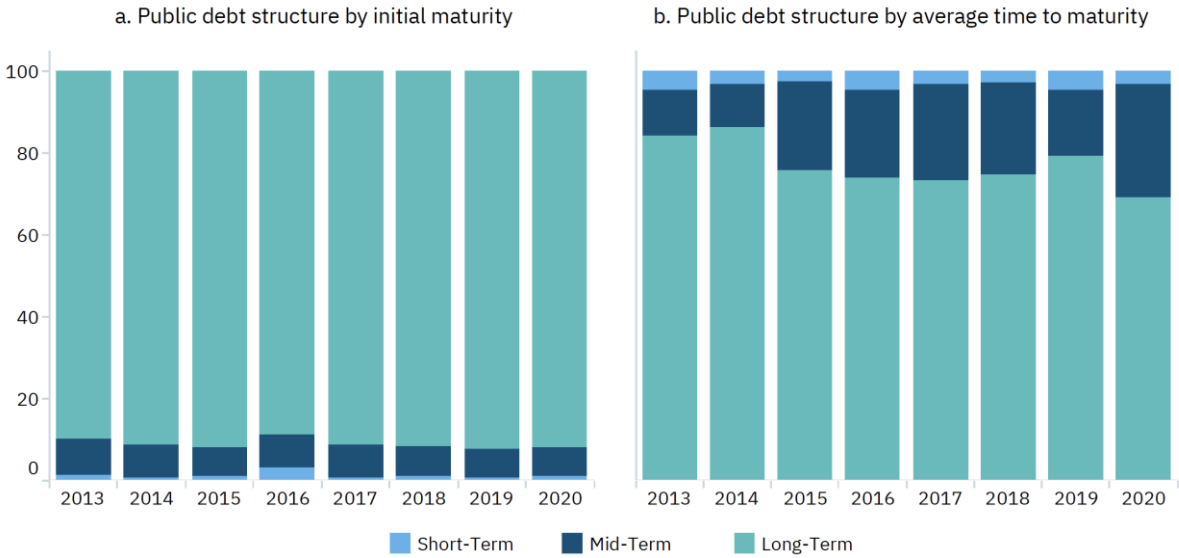
An additional reason for concern is that most government debt is external and denominated in foreign currency. The dynamics in Figure 24 illustrate that despite that over the last 20 years, the domestic debt market has been gradually enlarged, the weights of domestic debt and the debt denominated in AMD are still low, making up, respectively, 25.5% and 24.4% in 2020. According to the IMF such debt structure was deemed to be highly risky[52]. In this context, the Government Medium-Term Debt Management Strategic Program for 2021-2023 intends to enhance the role of domestic sources in financing the budget deficit, assuming an increase in the share of the domestic debt and the debt denominated in AMD in the government debt.[53]

Figure 24 The Public debt structure by residence and currency



Source: DFA Team calculations based on official data from the RA MoF and the RA SC

Figure 25 The Government debt structure by initial maturity and by average time to maturity



Source: DFA Team calculations based on official data from the RA MoF and the RA SC

On the positive side, government debt is mainly comprised of fixed interest rates debt

51 IMF (2019b) Note: 40.9% concerns all public corporations and 15% for non-financial corporations only. Although the debt of SOEs is not accounted and considered as part of the public debt (both from GFS statistics and legislative), part of the SOEs debt is (budget sub-loans) provided to SOEs from external budget loans that are already included in the government external debt.

52 The report states that to achieve a moderate risk debt portfolio in Armenia, the weight of the domestic debt should be higher than 55%, and the weight of foreign currency debt - higher than 40%, whereas, in order to be assessed as being at low risk, the weight of the domestic debt should be higher than 85%, and the foreign currency debt - higher than 80%. Source IMF (2013).

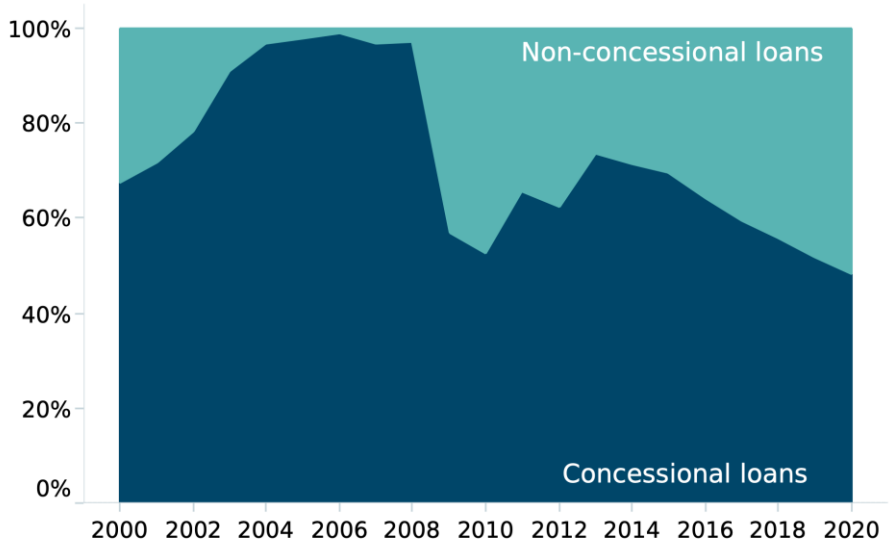
53 MoF (2011)

instruments. In 2013-2020, the share of debt at a fixed interest rate averaged 86.6%, with a generally declining trend over the years. In 2020 the percentage of the debt at a fixed interest rate in the government debt was about 80%. Therefore, the interest rate risk from the whole debt portfolio is relatively mild. These dynamics are presented in Figure 25.

In addition, long-term debt prevails in the structure of the government debt both in terms of initial maturity and average time to maturity. In terms of initial maturity, the long-term debt (with five years and more maturity) averaged 91.1% of the government debt in 2013-2020, comprising 91.9% in 2020. In terms of average time to maturity, the Long-term debt averaged 77.1% of the government debt in 2013-2020, reaching about 70% in 2020. Figure 29 shows that these indicators did not change much in the period under observation.

External loans and credits predominate in the structure of the government debt, with a share of more than 60% in 2020. Figure 26 shows that since 2014, the share of non-concessional loans has been growing, As Armenia is classified as a middle-income country, has limited access to concessional loans provided by the international organizations. In recent years the WB and the ADB have reviewed and increased the interest rates for the previously provided concessional loans[54]. At the end of 2020 the share of commercial loans increased by 3.6 percentage points compared to 2019 and comprised 51.7% of total external loans.[55]

Figure 26 Share of concessional in total external loans and credits of the government



Source: Source: DFA Team calculations based on official data from the MoF, 2020 Annual report on Public Debt,

Loans and credits from international organizations (multilateral) comprised 76.9% of the total amount of foreign loans and credits in 2020, with the IDA (21.3%), ADB (16.6%), and IBRD (17.0%) as the main sources of financing. The loans from foreign states constitute 22.6% of total external loans and credits in 2020, with Russia (7.7%), Germany (6%) and Japan (4.9%) having the major share. External loans from commercial banks constituted only 0.4% of the total external loans and credits in 2020.

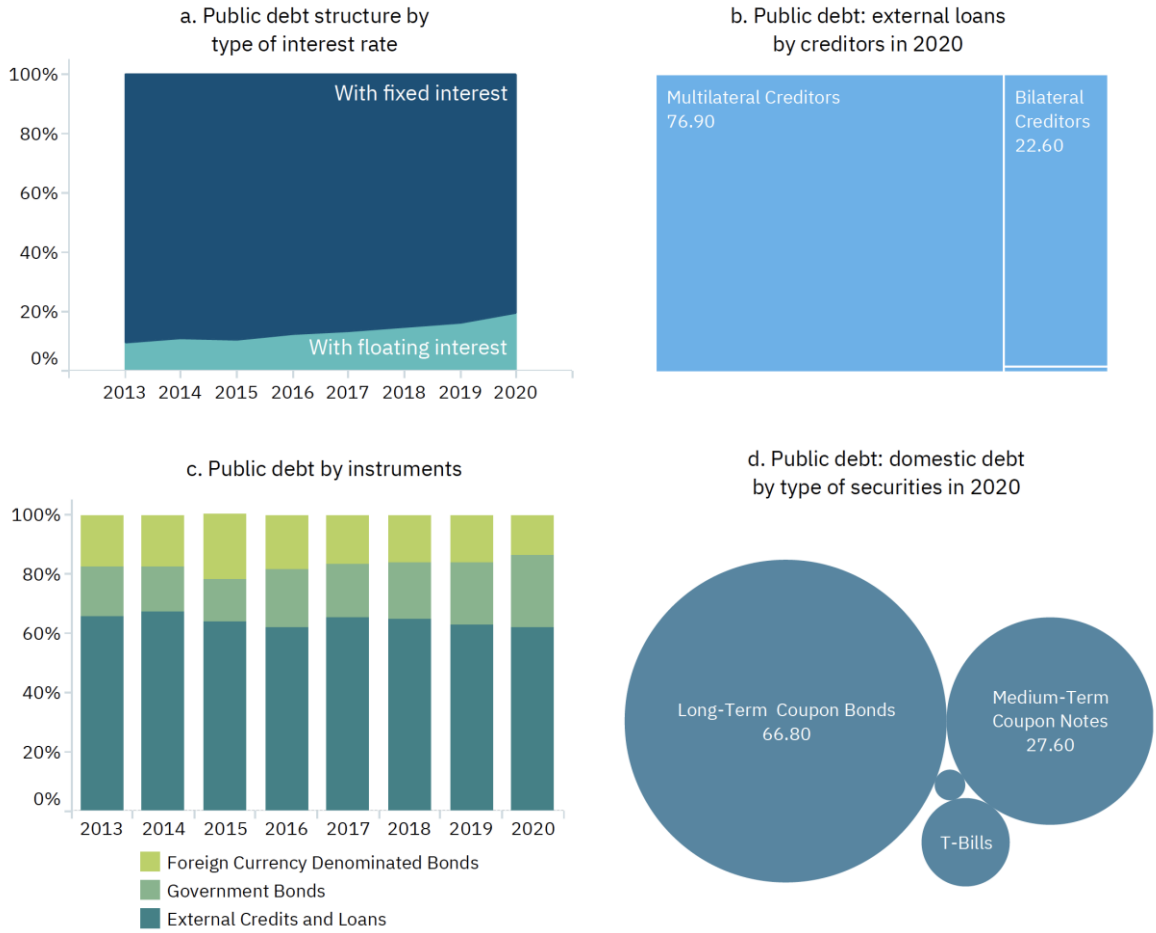
Government Treasury Securities recently became a significant source of debt instruments, with a share of 24% of the government debt in 2020. Figure 27 shows that long-term coupon bonds have the largest share of the government Treasury Securities (66.8% in 2020). This includes bonds with placement maturity of 10, 15, 20, and 30 years.

- ***Long Term Bonds*** with a maturity of 30 years were placed for the first time in 2017.

[54] MoF (2021)
[55] MoF (2020b)

- ***Medium Term Bonds*** with a maturity of 3 and 5 years, accounted for 27.6% of securities in 2020.
- ***Short-term bond*** portfolio incorporates only bonds with a 1-year maturity, and they constitute 5% of the government treasury securities.
- ***Treasury Bill***s Short-term T-bills with are issued with a maturity of 91 days (3 months), 182 days (6 months), and 273 days (9 months) through reopening of outstanding Treasury bills with 1-year maturity[56]. Saving coupon bonds constitute only 0.6% of treasury securities.

Figure 27 The structure of the government debt by instruments and the type of interest rate



Source: DFA Team calculations based on official data from the RA MoF and the RA SC, the CBA

The share of foreign currency sovereign bonds in public debt was about 13% in 2020. Three issuances of Eurobonds are circulating in international markets. The first series was issued in 2015 with a volume of USD 500 mln and the most recent one was issued in 2021 for USD 750 mln with a maturity of 10 years. While the bond yields of the first and second issuances were 6.25% and 7.5%, respectively, the bonds of the third and fourth issuances offered a significantly lower yield (4. 2% and 3. 9%,), reflecting a reduction in Armenia's sovereign risk premium.

Although external sources of financing have historically prevailed over domestic sources, the share of domestic sources in 2020 sharply increased. As a result, during 2000-2020, the State budget deficit to GDP ratio was 2.7% on average, of which 0.5 percentage point was financed from domestic sources and 2.2 percentage points from external sources.

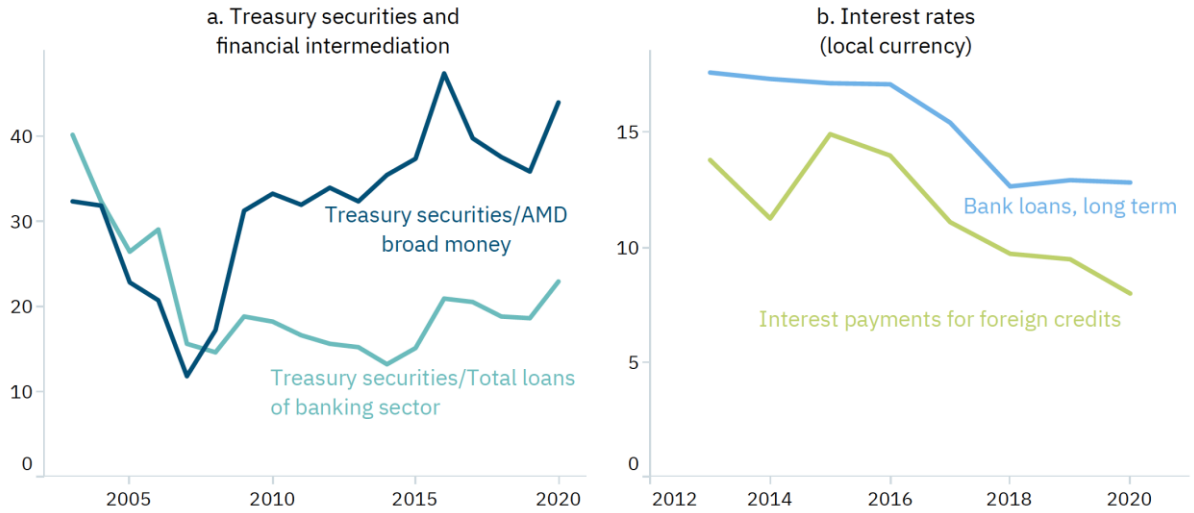
Given such a structure of deficit financing, the Treasury security market depth in the economy was stable during 2000-2008, though in 2009-2020, it showed enlargement trends. During that period, the treasury security to GDP ratio increased from 2.4% to an unprecedented

[56] MoF (2018):

15.5% in 2020. Moreover, the treasury security market was particularly enlarged during 2016 and 2020 when the government carried out voluminous issuances of Treasury securities in the scope of its counter-cyclical fiscal policy.

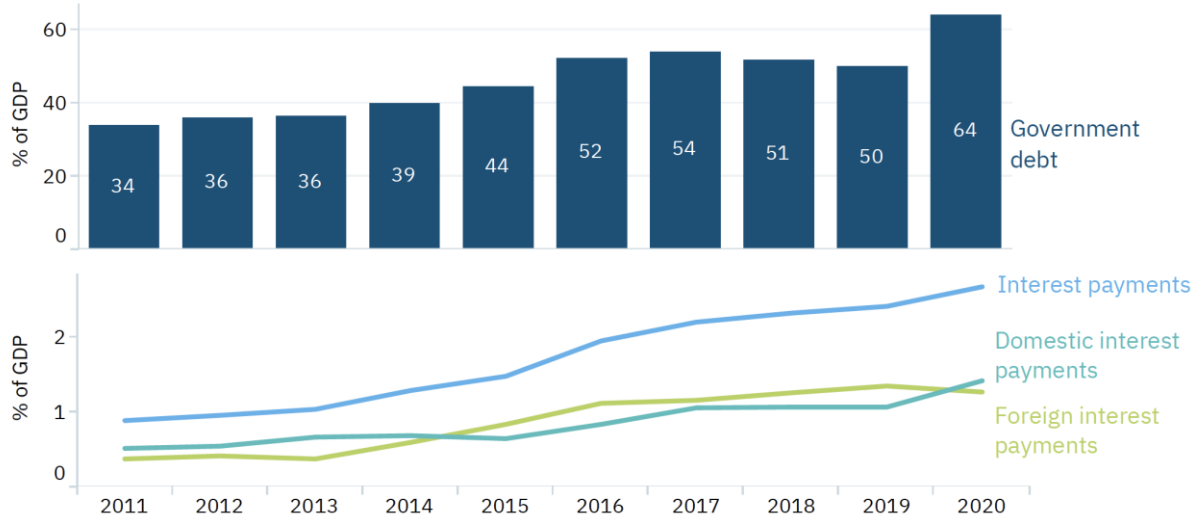
The enlargement of domestic debt was aligned with the deepening of the financial market, hence, not being accompanied by any negative impact on financial markets. The dynamics in Figure 34 show that in the period analyzed, the share of treasury bonds in the broad money, and the bank loan volume had not changed significantly. Figure 28 also shows that in the period of domestic debt enlargement, the interest rates of both treasury bonds and the loans denominated in local currency had shown a falling trend.

Figure 28 Treasury bonds and financial market (%)



Source: DFA Team calculations based on official data from the RA MoF and the RA SC

Figure 29 Government debt service



Source: DFA Team calculations based on official data from the RA State Budget Execution Reports

Over the last decade, the government debt service expenses increased almost five times, amounting to 164.8 bln drams in 2020 (2.7% of GDP) compared to 35.5 bln drams (0.9% of GDP) in 2011. Since 2015 expenses for external debt service exceeded the costs for the domestic debt service. However, as shown in Figure 29, in 2020 the pattern changed, and costs for domestic debt service increased, comprising more than 52% of debt service expenditures (1.41% of GDP in 2020). Although the volume of the government debt in 2020 increased by approximately 19.7% vis-a-vis 2019, the debt service expenditures increased only for the domestic debt. On

the contrary, external debt service expenses decreased due to the reduction of service expenses for foreign currency government bonds. This is a result of the change in the structure of the debt, reduction of the average weighted nominal interest rate of the government debt and its main components, and the changes in the USD/AMD exchange rate used for currency conversions[57].

Irrespective of the growth of expenses for the debt service, between 2018 and 2020, the government debt's average weighted nominal interest rate reduced from 5.0% in 2018 to 4.3% in 2020. These trends were manifested for both external and domestic obligations. While over the last decade, the average weighted nominal interest rate for Treasury securities dropped year by year, amounting to 10.4% in 2020. In the case of the external debt, the dynamic of interest rate reduction was seen only beginning from 2018. This is due to the contraction of the share of loans with a floating interest rate and the reduction of LIBOR interest rate affecting expenses of loans with floating interest rates. The decrease in the yield of foreign currency treasury bonds largely contributed to reducing external debt interest rates.

Debt Management Policy

The RA fiscal rules define the link between the debt level and the fiscal policy, conditioning the government's fiscal response. The current fiscal rules were introduced in 2017, whereas fiscal policy rules, in general, were defined back in 2008. The old rules used debt ceiling and brake principles. Hence, at the end of a fiscal year, debt should not have exceeded 60% of the GDP of the previous year, and if that happened, any transaction giving rise to the debt shall be deemed null and void. The rule also defined that if the debt exceeded 50% of the GDP of the previous year, the state budget deficit of the following year should not have exceeded 3% of the average of the GDP volumes for the last 3 years. The new fiscal rules provide a more flexible link between the debt burden and medium-term and long-term sustainability. It contains built-in stabilizers for economic cycles, standards for executing fiscal consolidation and defines the priorities for undertaking capital expenditures.

The MTEF for 2021-2023 and the Draft State Budget for 2021 was elaborated based on "exceptional case" (escape clause) regulations introduced in the fiscal rules. This enables to have in 2020 and to project for 2021 a higher level of the budget deficit and expenditures than those defined by the regulations[58]. As a result, the budget deficit was more significant than the capital expenditures, and the growth of the current primary expenses exceeded the average growth rate of the nominal GDP for the previous seven years. The Armenian government envisages that from 2022 the fiscal policy will return to its regular regime, entirely based on the fiscal rules, aiming to gradually decrease the debt to GDP ratio to a 60% target level by the end of 2026[59]. The practice of applying "exceptional case" (escape clause) regulations were registered in many countries around the world during the coronavirus crisis [60].

Armenia managed to implement significant support measures regarding several social, healthcare, fiscal and monetary policies despite the unexpected shocks, which contributed to the stimulation of the economy. Along with this, the government was able to maintain the continuity of the implemented targeted programs. Foreign observers and the IMF also appreciated how the Armenian government ensured the transparency and accountability of the expenses in connection with COVID-19[61].

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[57] MoF (2020c).

[58] During 2020, the RA NA had twice revised the RA Law on State Budget for 2020, that is unprecedented through the last decade.

[59] IMF (2020a)

[60] These occurred at both national and sub-national levels (particularly, in the Central African Economic and Monetary Community, Eastern Caribbean Currency Union and the European Union). The exceptional case regulations of fiscal rules were activated in Austria, Brazil, Costa Rica, Croatia, Grenada, Honduras, etc. Some countries, namely Columbia, Ghana, Poland and Russian, made amendments to the rules For more on this see IMF (2021b)

[61] IMF (2020a)

Over the last decade, debt analysis has mainly shown that the debt has been sustainable, though its structure and the recorded trend of sharp growth are problematic. Government debt sustainability analyses were conducted and published by the MoF and the IMF since 2011. The 2011 debt analyses recorded no severe risks to debt sustainability, though it was necessary to run a more conservative policy. Despite the conclusions made in the assessments on the necessity of running a prudent fiscal policy, in subsequent years, especially during 2015-2016, an enlargement fiscal policy was pursued in practice and the debt burden continuously increased, increasing by approximately 21.5 percentage points in 2017. The debt sustainability analysis conducted in 2019 and 2020 concluded that the government debt was within the low-risk range, though the debt structure was highly vulnerable. The study concluded that the debt structure was highly vulnerable, but overall, the government debt was still in the low-risk range.

International credit rating agencies recently placed Armenia's debt in the speculative market range. On March 2021, Fitch Ratings rated Armenia's Long-Term Foreign-Currency (LTFC) Issuer Default Rating 'B+' with a Stable Outlook. On May 2021, Moody´s assigned Armenia's proposed senior unsecured, US dollar-denominated notes rating of "Ba3", the lowest of the investment-grade category. Moody´s looks at Armenia's debt burden as "moderately high" and "vulnerable to sharp currency depreciation." These assessments will generate more pressure on the compensation offered in future bond emissions. However optimistic the assessments still sound; they indicate a higher level of concern that deteriorating economic conditions and country-specific developments could hinder the issuer's ability to meet its obligations. Therefore, investors will expect a higher yield for purchasing these bonds as compensation.

Debt management and accountability

According to the Law, public debt management shall be carried out under the principles of transparency, accountability, predictability, and publicity. Since 2008, the Law "On Public Debt" regulates the relationships connected with the public debt. The public debt management shall be carried out by the authorized body (the MoF of Armenia) and the Central Bank of Armenia in terms of its debt. There is a State Debt Management Department in the structure of the MoF of Armenia, which manages public debt, the cash flow of the state budget, and the organization of the activities of the Treasury Direct System. In this structure, the Treasury Depository Activity Organization Division is responsible for organizing the retail sale of state bonds, servicing investors, and monitoring the investors' composition and structure. This structure is in line with international good practice, based on the organizational structure acceptable in the bank system.

Debt management continuously improved over the last decade and is aligned with the medium-term strategies of government debt management. Government medium-term management strategies for debt have been published since 2010 as part of the MTEF. They have been gradually improved, incorporating quantitative tools for strategy development and risk assessment, debt management benchmarks, and statistical information for the actual and projected periods. Since 2015, debt management strategic programs defined benchmark performance indicators. From 2016, debt management strategies are selected through a medium-term debt management analytical tool developed by the IMF and WB. The benchmark indicators defined under the debt management program for 2020-2022 and their performance as of December 2020, are presented in Table 5 below.

Over the last decade, the volume of published information about public debt has increased, and the content of the debt strategies has been enriched. Public debt reports being published on an annual basis by the MoF since 2000 have a crucial role in presenting the information on the public debt. The Public debt report for 2019 incorporated information about the volume and trends of the debt, the debt service, primary and secondary markets of treasury securities (also the retail market), foreign currency bonds, the government external loans, the Central Bank external debt, cash flow management, and risk analysis. In the meantime, the information on

public debt is available to the public via monthly statistical bulletins published on the MoF website and continuous updates of news regarding treasury securities.

The Way Forward: Policies to Improve Public Debt

The top recommendation is to place the focus on ensuring short-term sustainability of public finances and fiscal consolidation. The delicate fiscal situation that the country is navigating through generates significant concern. Fiscal consolidation could happen if the tax reforms implemented by the government show substantial positive results in a period of less than five years, but giving greater weight to the first two years, where most of the fiscal measures should produce market confidence. The current scenario is very sensitive to economic growth, which should pick up at an even faster pace than the historical trends. From the point of view of public debt management, a true consolidation would require that the tax reform initiated in 2020 reverses the current trend and produces a positive yield in the range of 2-3% of GDP.

International best practices recommend the introduction of long- and medium-term approaches to public debt management. A long-term public debt strategy will be a useful instrument to make the best possible use of this flow. This type of tool could be very useful since it would provide a guide to obtain the required funding at the lowest possible cost in the medium and long term, consistent with a prudent degree of risk. This would allow the MoF, as the manager of public debt, to fulfil its responsibility to ensure that financing restrictions do not lead to abrupt adjustments in fiscal policy or interest costs. The strategy could address the following opportunities:

- A plan to reduce costs and obtain more favorable conditions by aligning future debt instruments with SDG targets and attract international impact investors
- Analyze the possibility of using SDG-targeted instruments to re-profile existing debt with lower cost and more extended term conditions.
- Explore better uses of public debt and sovereign guarantees to facilitate the development of blended finance mechanisms where public debt is a catalytic element of the financing mix.
- Explore opportunities for debt for nature swaps or buybacks and other innovative mechanisms to leverage further resources required by the national development strategy
- Strategically allocate public debt for infrastructure investments only in those areas where PPPs are not possible.
- Further develop risk management capacities and procedures to address real and contingent liabilities demands required for extending public and SOE investments and PPPs
- Introduce a procedure for establishing financial conditions and requirements for state-owned enterprises in the provision of state guarantees

It may be also opportune to approach the issue of public debt with a different lens and manage this financial flow in the most strategic possible way in the short-term. Despite the promising perspectives for the Armenian economy, major uncertainties also loom in the future, deriving from the unresolved conflict and the persistent effects of the COVID crisis and the complex geopolitical situation. This would call for a prudent and conservative management as current debt levels are higher than desirable. The tax reforms analyzed in the previous section add additional risks as one of the possible outcomes of the reform could be a generalized weakening of the tax revenue base. A recommended short-term management approach for public debt would be to treat this as a very scarce resource before this condition might be dictated by the markets.

The much-needed expansion of PPPs will require a deeper and more systematic management of the policy implications of contingent liabilities, both explicit and implicit. There are multiple possible contingencies, such as vulnerabilities in the financial system, pension systems, APPs, etc. However, in Armenia many of these risks are even more present due to the

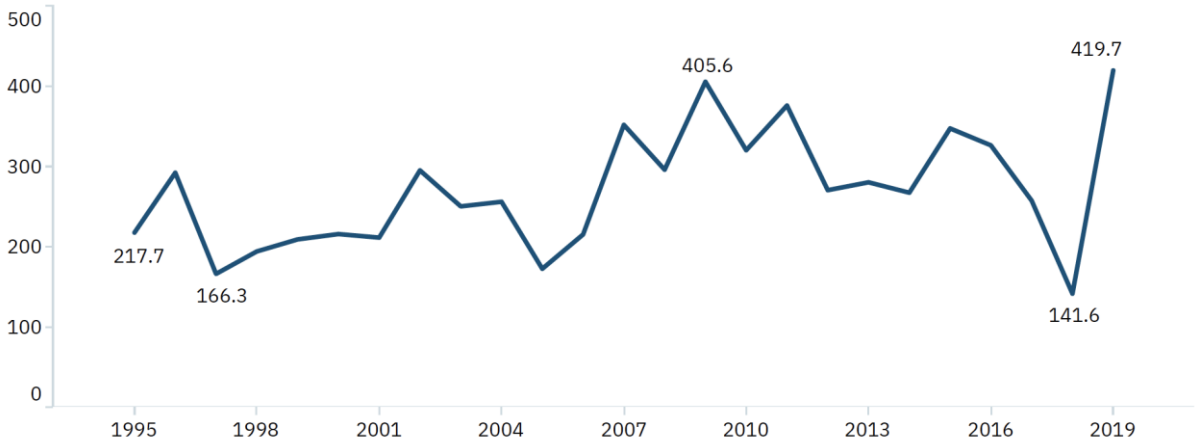
size of the public sector and its direct participation in various sectors such as electricity, banking, pensions and insurance. The most visible contingencies are the leasing contracts for public works that public entities have signed with trusts (see Section 4.2.3 PPPs) and others that have already materialized in the financial sector with the intervention of a commercial bank owned by the State. The modernization of these capacities is mandatory to ensure that the expansion of these new financing mechanisms is done ensuring prudent management and quality of public finances.

If this path is chosen, it might be necessary to strengthen the capacities of the Ministry of Finance. The MoF has the technical capacity to quantify the cost / risk of the different options for public debt management strategies and has adequate computer systems that make it possible to keep a record of the public debt and produce daily reports on the government's indebtedness. It also prepares reports that quantify the market risks to which the debt portfolio is exposed, including some explicit contingent liabilities. However, the good management of alternative sources of financing, such as PPPs, will require modernizing and reinforcing the MoF's management capacities and strengthening its role in controlling the management of direct and contingent risks that this type of instruments may introduce.

3.3.3 Official Development Assistance (ODA)

The information available to analyze ODA is minimal. Although an SDG-aligned Development Assistance Database is under development with support from UNDP and the EU, there is currently no official management information system on official development assistance. As such, the government does not have a consistent information base to support this flow's proper analysis or management. This assessment was made using information produced by the OECD. Therefore, the assessment may not capture a significant part of the funds received in Armenia. This is, the case of the ODA funds from official sources through private channels and recipients which, might not be covered.

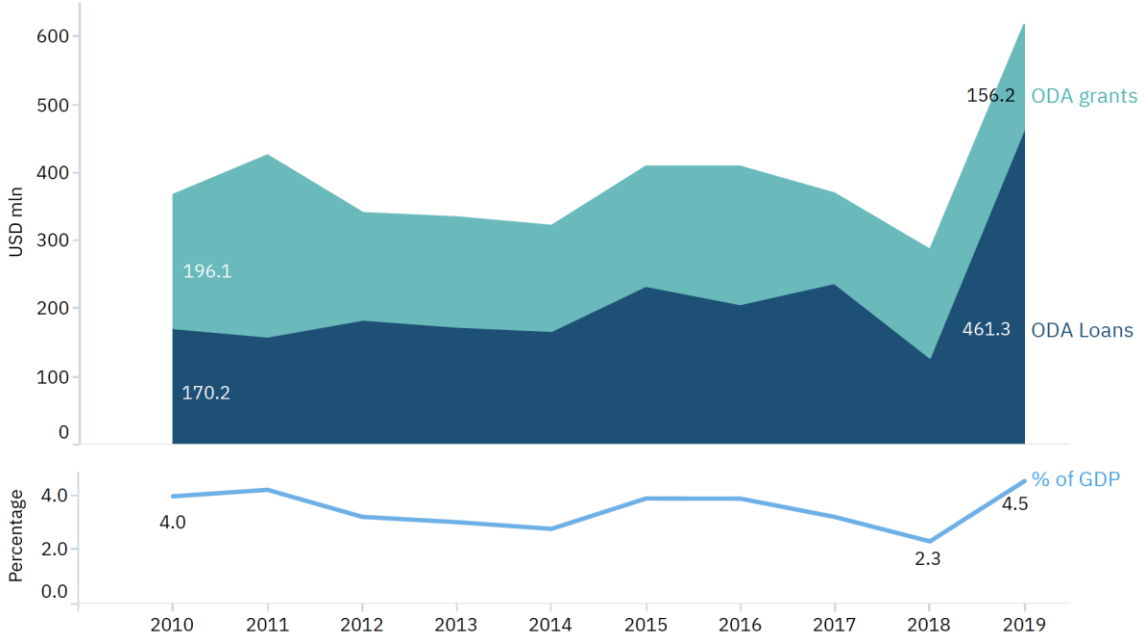
Figure 30 Net ODA to Armenia (current prices, USD mln



Source: DFA Team calculations based on official data from the OECD.

The international community's support to Armenia has always been an essential source for development finance. Official development assistance has been one of the primary sources of development finance since Armenia's independence. The average volume of net ODA flows was about USD 300 mln per year in constant prices (2018). In 2019 net official development assistance totaled USD 417.27 mln or USD 141 per capita. From 2015 through 2019, the average net ODA per capita was USD 101, comparable to other upper-middle-income economies.

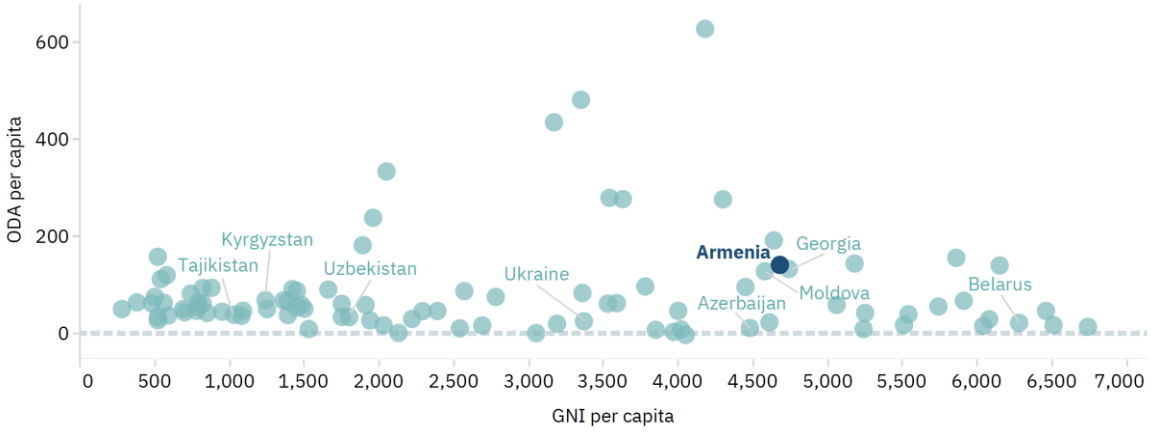
Figure 31 ODA Grants and Loans (current prices, USD mln)



Source: DFA Team calculations based on official data from the OECD.

Armenia receives concessional financing and is eligible for both grants and loans. The current dynamics of ODA presented in Figure 31 show that, on average, this flow has been fluctuating around 3.5% of GDP. Except for 2019, the trend of total ODA was showing a marked reduction from 4% of GDP in 2010 to 2.3% of GDP in 2018. Similarly, excepting 2019, there was also a moderate reduction of the grant component in the total composition of ODA. During the period 2010-2019, grants averaged 46% of total gross ODA. The significant increase shown in 2019 was caused by the large disbursement programmed under the IMF stand-by agreement.

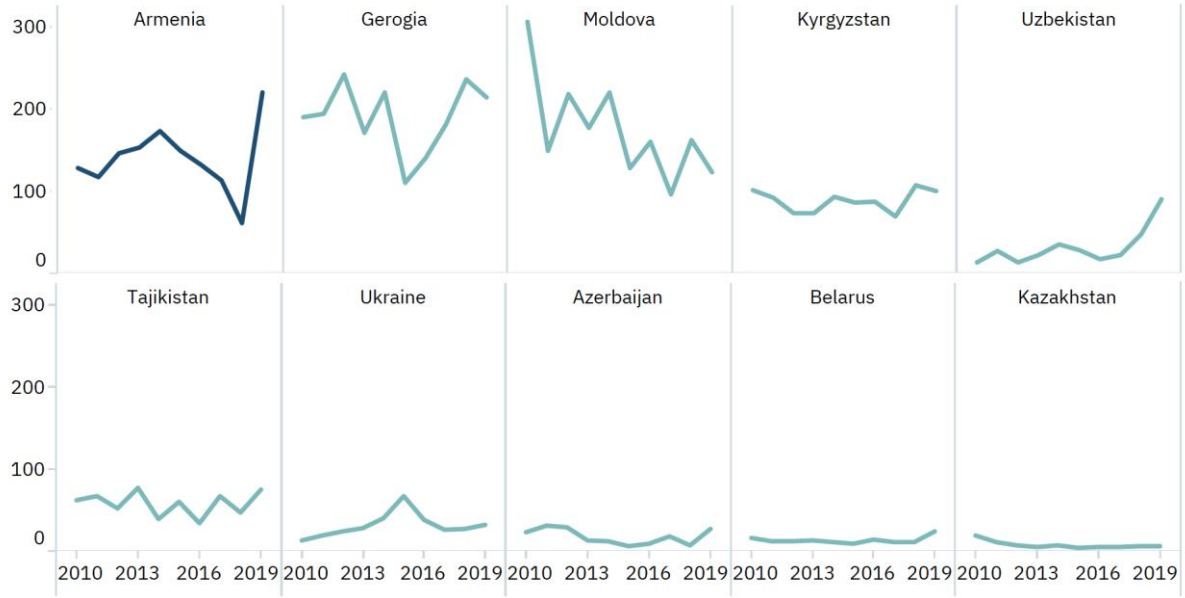
Figure 32 Relationship between net ODA and GNI in 2019 (per capita, USD)



Source: DFA Team calculations based on official data from the OECD.

In comparative terms, it could be said that the country is well funded from this source. In comparing the level of ODA per capita for the countries in the region (figure 33), Armenia is in third place with the 10-year average of USD139 after Georgia and Moldova with USD189.6 and USD174.9, respectively. However, this comparison is not a fair one; Russia is primarily a donor country and not a recipient, Kazakhstan and Azerbaijan are also emerging donor countries, and ODA access to countries such as Tajikistan, Uzbekistan and Belarus were considerably reduced during the last decade due to political and governance issues.

Figure 33 ODA per capita trend comparison in the region (current prices, USD)



Source: DFA Team calculations based on official data from the OECD and WB

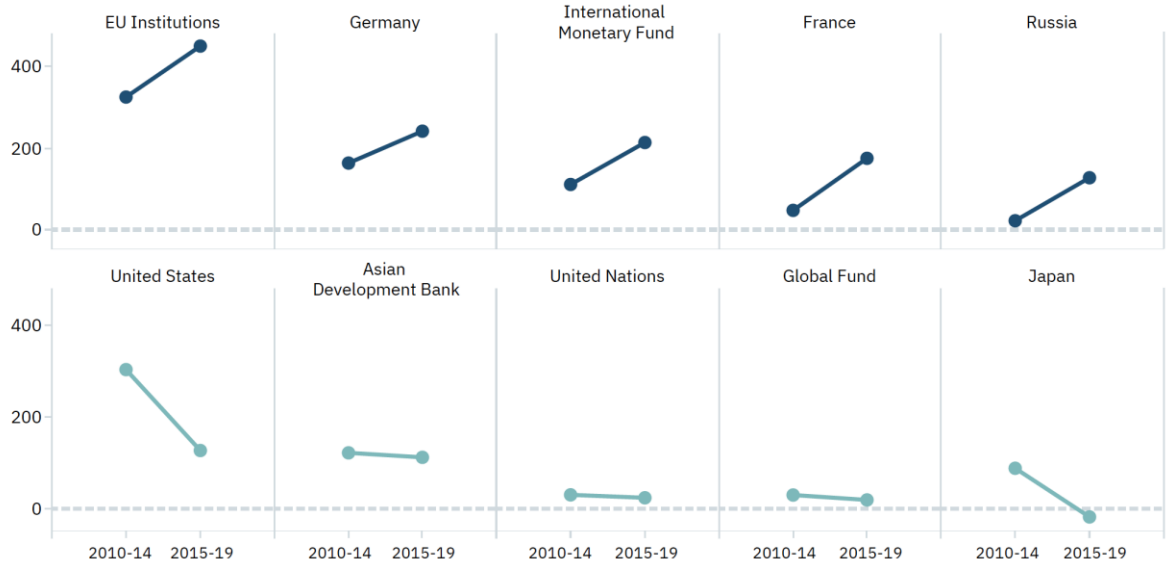
A significant part of the ODA received by Armenia is concentrated to a few development partners. Figure 34 summarizes the activity by primary donors of ODA to Armenia: the IMF, the EU institutions, and the ADB. The IMF has been assisting the country with financial support over the decades since independence. These other development partners have been supporting the country with significant resources in the following areas:

- **European Union**. The EU approved programs in various sectors: infrastructure (energy (€361.7mln), transport (€326 mln)), agriculture (€70 mln), SME support (€105 mln), education, innovation and IT, good governance (justice, public administration), etc. For the implementation of investment projects in Armenia, blending of EU grants with loans EU are being used with grant component amounting to €154.9 mln (18%).
- **Asian Development Bank.** Approved 36 loans totaling USD 1.55 bln since 2005. This included 23 sovereign loans amounting to USD 1.19 bln, 13 private sector loans, and one equity financing facility amounting to USD 356.9 mln. In addition, they also provided technical assistance grants totaling USD26.6 mln. As a middle-income country, Armenia has access only to their market-based ordinary capital resources. The approved main programs include USD 500 mln for the North-South Road Corridor Investment Program and USD 400 mln for the Sustainable Urban Development Investment Program financing facilities.[62]
- **DAC Bilaterals.** The United States and Germany are the major bilateral donors to Armenia. The US cooperation invested USD 431 mln during 2010-2019 with a preference on implementing programs in tourism, rural development, energy, and other areas. Germany's cooperation invested USD 401 mln over the same period and focused on sustainable development, environmental and climate protection, democracy, municipal development, and the rule of law promotion. Other sources include Austria, France, Japan, Sweden, Switzerland and the UK.
- **Russian Federation.** Russia contributed with USD 148mln during 2010-2019. Among the non-DAC countries, the RF is the leading donor as all the other countries contributed to only USD 1 mln during the same period. Areas financed included sustainable school feeding, health, rural tourism and development, and others. Based on the country policy approved in 2014, this will likely expand as priority is given to the CIS countries and members of economic unions and the RF[63].

[62] ADB (2020)

[63] Russian Federation (2021)

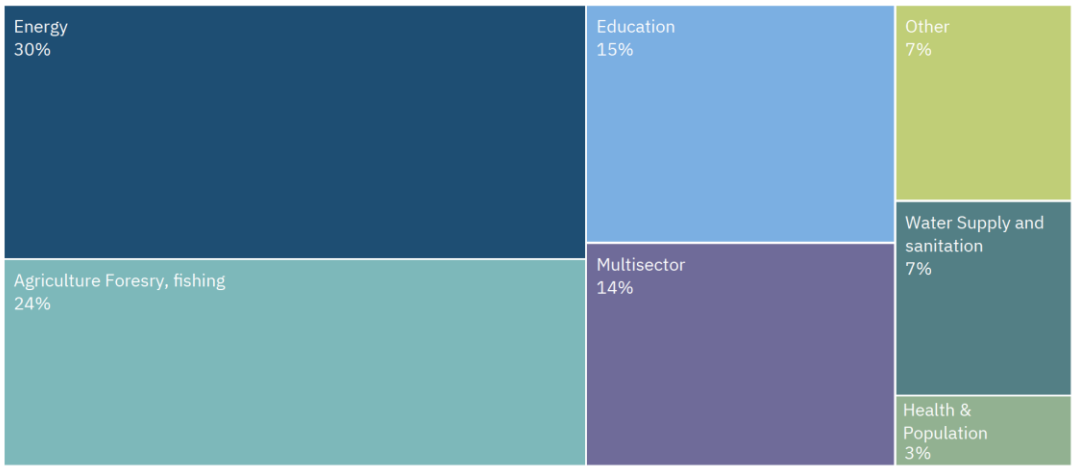
Figure 34 **Total Net ODA by major donors comparison over time (2010-2014 and 2015-2019)**



Source: DFA Team calculations based on official data from the OECD.

Although there are no means to track the SDG-specific allocation for ODA, general sectoral information shows a balanced use of these resources. The information on sectoral allocation of ODA is available only for bilateral ODAs and is summarized in Figure 35. The energy sector has attracted 30% percent of total ODA. The relative priorities of donors seem to have shifted slightly over the period 2013-19. ODA to the energy sector has decreased while ODA to education and multisector projects has increased significantly.

Figure 35 **Bilateral ODA by Purpose, 2013-2019**



Source: DFA Team calculations based on official data from the OECD.

Over the past 20 years, Armenia received significant assistance from various environmental and climate change-related initiatives. The projects financed are aimed at needs assessments, policy development, reducing greenhouse gas emissions, adaptation capacity building in sectors vulnerable to climate change, disaster risk reduction, technology transfer, education, and awareness-raising in target areas. A list of the specific funding received is shown in Table 2. Mainly, these funds were used

- **Global Environment Facility (GEF).** The GEF has provided over USD 40 mln in grants to Armenia to implement national environmental programs throughout its activities, about half of which were channeled to support climate change-related issues. Under the Small Grants Program, the GEF additionally provided approximately USD 1.5 mln in grants for financing climate change mitigation projects implemented through NGOs/community-based organizations.

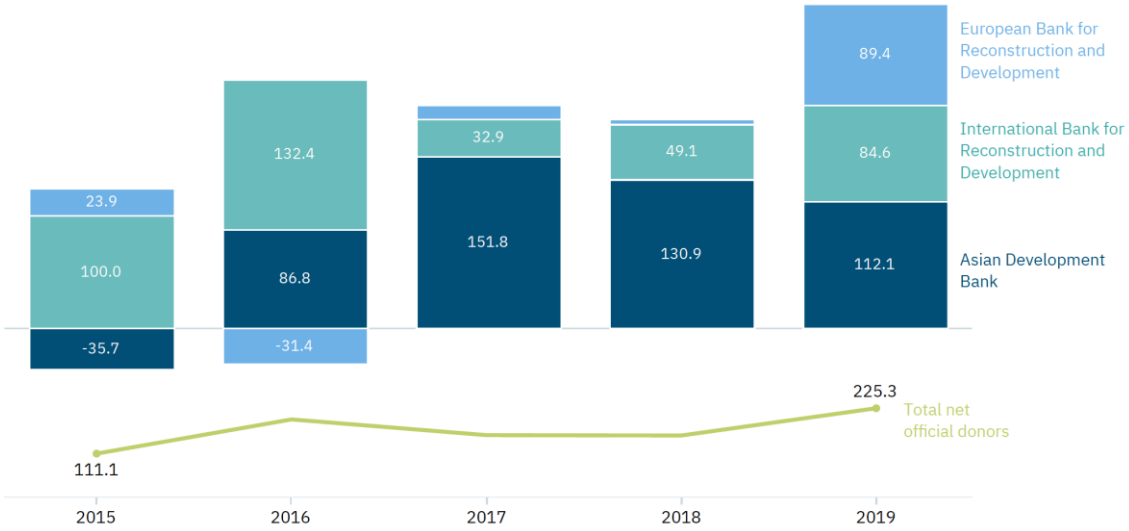
- **Green Climate Fund (GCF).** Armenia is the first country in Eurasia and the tenth to receive a grant from the GCF. The country has received more than USD 30 mln in funding from GCF. These funds support the country to implement projects in investment risk mitigation of energy efficiency retrofits, the development of a National Adaptation Plan (UNDP), and preparedness support (EPIU). In addition, another two regional programs funded by the GCF and implemented by the EBRD are underway, which provide financing for green cities and sustainable energy[64].
- **Climate Investment Funds.** These funds have approved an investment of USD 40 mln for Armenia in grants and soft loans. These funds are expected to attract significant private sector investments and leverage additional capital from multilateral development banks. They are targeted at the implementation of renewable technology pilot projects on geothermal and photovoltaic stations in Armenia.

Table 2 Climate funds' investments in Armenia

Donor	Approved project (USD mln)
Global Environment Facility (GEF)	41.5
Climate Investment Funds	40
Green Climate Fund (GCF)	30
Adaptation Fund	4

Source: Armenia Climate Public Expenditure and Institutional Review, UNDP (2020b)

Figure 36 Other official flows (OOF) and export credits - disbursements



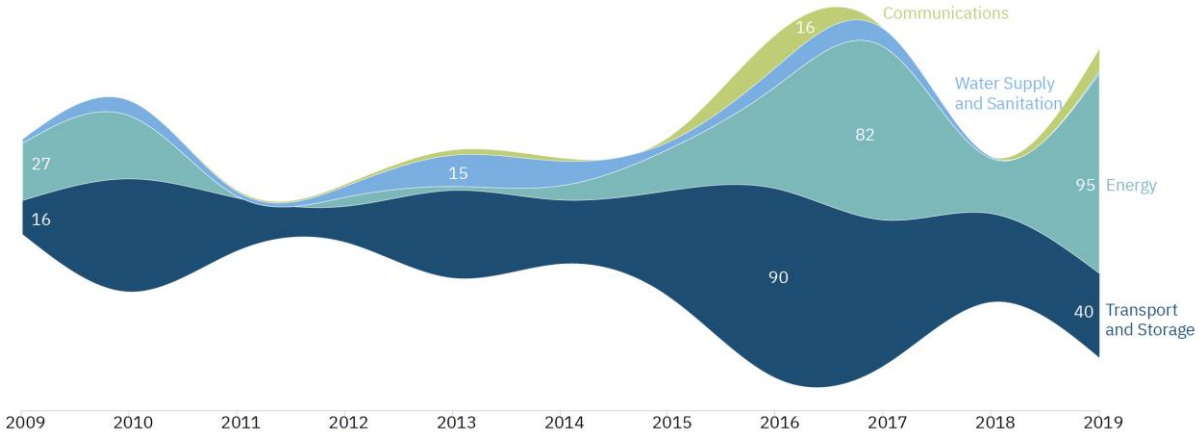
Source: DFA Team calculations based on official data from the OECD.

Other official flows

Other official flows provided at close to market terms or with a commercial motive substantially increased since 2016. The leading providers of OOF in Armenia are the development finance institutions Figure 36 shows that over recent years, the most significant disbursements were conducted from the ADB and the IBRD. The latest main projects are in energy, irrigation, roads, local development, and trade promotion.

[64] According to the 2016 "Agreement on the Privileges and Immunities of the GCF" signed between GCF and the RA Government, the national authorized body of the GCF in Armenia is the MoEn, represented by the Minister of Environment, which has the authority to approve funding projects in Armenia. The MoEn EPIU is the only accredited national body in the region with "direct access" for up to USD 10 mln in funding for implementation of GCF projects

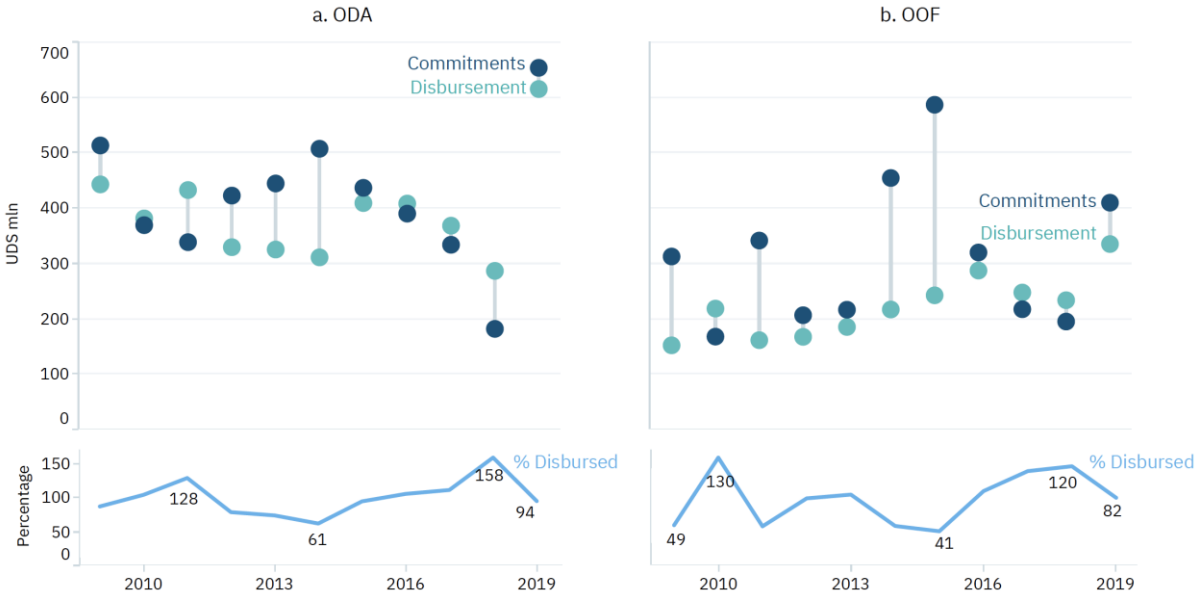
Figure 37 **Other official flows disbursement by sector (USD mln current prices)**



Source: DFA Team calculations based on official data from the OECD.

The government's performance managing ODA flows has been fluctuating over the past decade. Figure 37 shows that the actual disbursements compared to commitments of ODA have been unstable during the period observed. Overall, average disbursement amounted to 93%. This difference is much considerable in the case of other official flows where under-disbursement is about 29% during the ten years studied. The reasons for this underperformance are not analyzed in any available assessments, and these figures might indicate that there could be low levels of absorptive capacity from the government side. These issues shall be additionally studied as they are very significant to inform a potential expansion of the use of ODA financing.

Figure 38 **ODA and OOF commitments and disbursements (USD mln)**



Source: DFA Team calculations based on official data from the OECD.

The country does not apply general policy orientations or use dedicated institutional solutions to manage this finance flow. Aid is most effective when it supports a country-owned approach to development and is aligned with a country-wide development policy corresponding to the extent to which priorities are established. However, the government does not guide the management of this flow using a specific development cooperation policy or strategy. Some management functions will be covered by the National Council of Sustainable Development, coordinated under the authority of the Prime Minister. The Council includes representatives from ministries and other state agencies and NGOs. In addition, there are other dispersed coordination

efforts, for example, those made by the Ministry of Finance under the PFM Strategy. The mission of the National Council of Sustainable Development would be compatible with this purpose.

There are currently no management information systems to provide evidence to support the overall management of ODA. Their government does not dispose of an adequate information system to manage this flow. The external financing like grants and loans provided to the public sector are included in the budget documents. The data used for this section mainly comes from the OECD-DAC database. The government system must be comprehensive, helpful, and widely adopted by all stakeholders. The data and information obtained must comply with the following quality criteria: (i) *Complete*: all relevant data and information must be available in the system (all projects, all donors, all proposals, all expenditures, etc.), (ii) *Accurate*: data/information must be validated and official, (iii) *Reliable*: to satisfy all stakeholders (government and DPs) and (iv) *Timely*: it must be available when it is needed to support decision making needs and calendars

The way forward:

Develop a robust and comprehensive ODA management system for the country. In this context, the government might also consider introducing an ODA Policy and Institutional Framework and clear management procedures. This tool works better if developed jointly with development partners and defines key government agencies' fundamental roles and coordination mechanisms. Joint policy agreements based on transparency, sustainable availability of resources, strategic alignment, and result-oriented approaches would contribute to more effective management of these resources. In addition, the Policy Framework could allow reaching greater efficiency and effectiveness by:

- Facilitating greater transparency and accountability and enhancing scrutiny
- Aiming at innovative solutions to address development challenges by encouraging private sector participation and resource sharing
- Consolidation of efforts from different potential donors – institutional and private
- More effective prioritization
- Accelerate the introduction of results-oriented management approaches

An additional recommendation would be to consider a re-definition of the strategic prioritization and allocation of ODA for maximum outcome. It would also be helpful to consider analyzing and prioritizing the most strategic possible allocation of this scarce resource. Instead of the usual allocation priorities to supplement financing for the main SDG priority areas- in some cases, the government could consider using ODA to develop the capacities that could, in turn, generate more additional funding for these SDGs (or improve the development results obtained by the existing resources). For example:

- **Multiplier Effects**. ODA resources can generate maximum benefits if allocated to further improve the government's capacity in areas that will have multiplier effects on the impact of all the development resources available. For example, strengthening the quality of the planning and budget process, extending public spending efficiency, developing effective PFM systems, improving PPP risk management tools, preventing, and controlling corruption, and increasing internal accountability for performance and results-based management.
- **Domestic Resource Mobilization**. There are opportunities to use ODA to continue improving the fairness, transparency, efficiency, and effectiveness of the tax system, improving domestic tax mobilization, and continuing efforts to empower and integrate the informal sector into the formal economy and to develop a better environment to encourage private sector development
- **Blended Finance Mechanisms**. ODA can be used to extend the use of this capital structuring approach that combines the catalytic and strategic use of public or development financing (whether concessional or not) to leverage additional private commercial funding that would not otherwise be used to finance development objectives. This practice increases the total capital available for sustainable development and is preferred by the leading DPs in Armenia.

- **Aid for Trade**. ODA can be targeted at trade-related programs and projects to mobilize resources to overcome specific trade-related constraints[65]. Trade policy and regulation, trade development, and other trade-related needs are classified as trade-related assistance This is not an easy to manage area as it captures a broad range of trade-related activities. However, experiences in most countries show that this is a very positive way to increase ODA volume and bring additional resources that otherwise would not be available.

An additional effort could be made to strengthen the quality and availability of data and information and the monitoring and evaluation process. For example, one of the potential values of implementing periodical evaluation of ODA management conducted by the government is to bring ODA constraints to the attention of policymakers, such as policy shortcomings or rigidities inadequate coordination structures, or inefficiencies of other supporting practices. For this purpose, the availability of quality data and information is essential

Ensure that the planned Development Assistance Database is finalized and provides a robust Management Information System (MIS). The Armenian Donor Assistance Management System (ADAMS) is being developed as a project supported by the EU and the UNDP The project's initial aim is to allow transparent, open, and results-based public reporting on development funds and their allocation in Armenia. In addition, it is expected to provide all development partners and stakeholders with a unified source of data on development projects enabling aid tracking and effective management of development efforts. The system is still in its initial phase of design, several prototypes were designed and discussed with the Deputy Prime Minister's office which is the main stakeholder of this development.

The development of the ADAMS could allow to introduce of more advanced management features gradually. Once the ADAMS is in place and achieves the basic minimum quality requirements, it can be further improved to support other essential government management functions, like for example i) accurate information on commitments and disbursements from all the main programs; ii) program markers to identify how ODA is supporting SDGs or national priority programs and their significant components; iii) develop specific 'markers' to track ODA impacts on specific cross-sector areas, such as climate change, gender equality or private sector development; iv) include in the ADAMS all interventions financed by development partners that are executed by international and national NGOs or any other civil society organizations.

3.3.4 Public Climate Finance

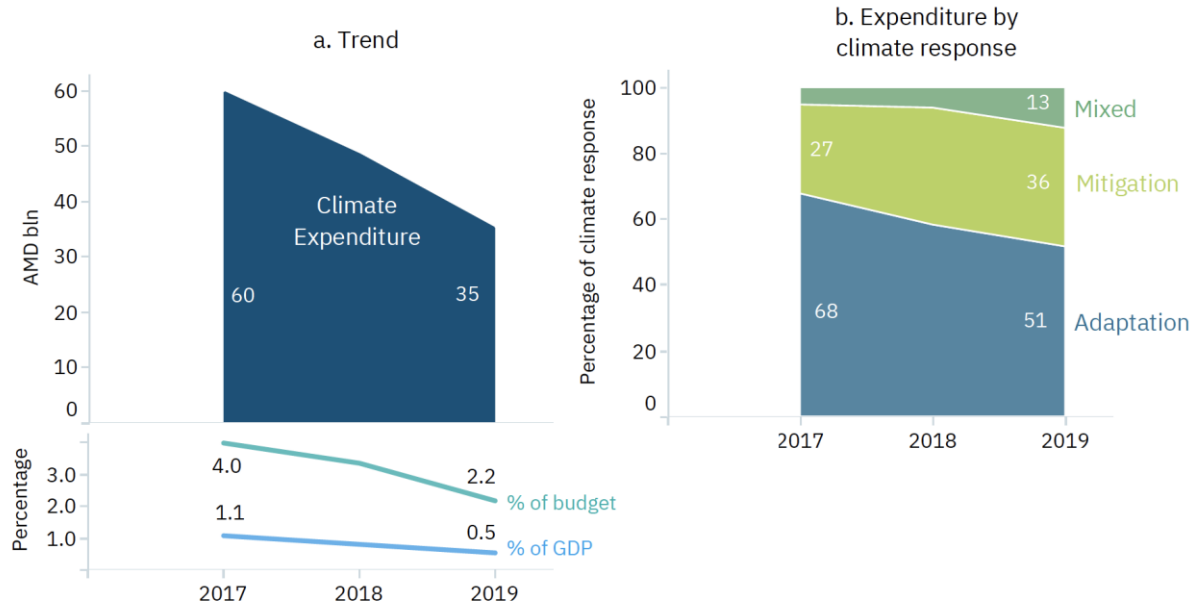
The information on the size and trends of the budget expenditures related to climate change is primarily based on the Climate Public Expenditure and Institutional Review (CPEIR) results in Armenia. The review was conducted by UNDP in 2020 and is the first comprehensive review on Climate Change (CC) related to public expenditures in Armenia. It covers the CC financial flows for 2017-2019 and focuses basically on climate expenditures made in the framework of the State Budget. The CPEIR climate expenditure estimates were made based on the estimated weights of the climate expenditure in budget programs' expenses, which were defined based on the purpose of programs and the expected climate benefits.[66]

According to the CPEIR, the CC-related public expenditures in Armenia are not significant. The assessment measured that in 2019 they amounted to AMD 35.3 bln, equivalent to 2.2% of the total budget expenditures and 0.5% of GDP. Moreover, Figure 39 shows that during 2017-2019, the climate expenditures showed a steady declining trend, both in absolute and relative terms, basically due to the decline in climate expenditures financed by external sources.

[65] Aid for trade is part of the Official Development Assistance (ODA) and a practice strongly promoted by the WTO. This aid usually covers six types of areas: i) trade policy and regulation; ii) trade development; iii) trade-related infrastructure; iv) building productive capacity; v) trade-related adjustment, and vi) other trade-related needs.
[66] UNDP (2020b).

Adaptation related investments predominate in climate change expenditures. In 2019, mitigation-related spending accounted for about 35% of the climate-related total expenses, while adaptation-related expenditures accounted for about 51%. Amid the overall decline of climate-related expenditures in 2017-2019, mitigation and adaptation-related expenditures have decreased. However, the mixed-impact expenditures, which has both mitigation and adaptation purposes or equally contribute to both the mitigation and the adaptation, have somewhat increased, basically due to the increase in forest protection-related expenditures.

Figure 39 Size, structure and trends of climate-related public expenditures



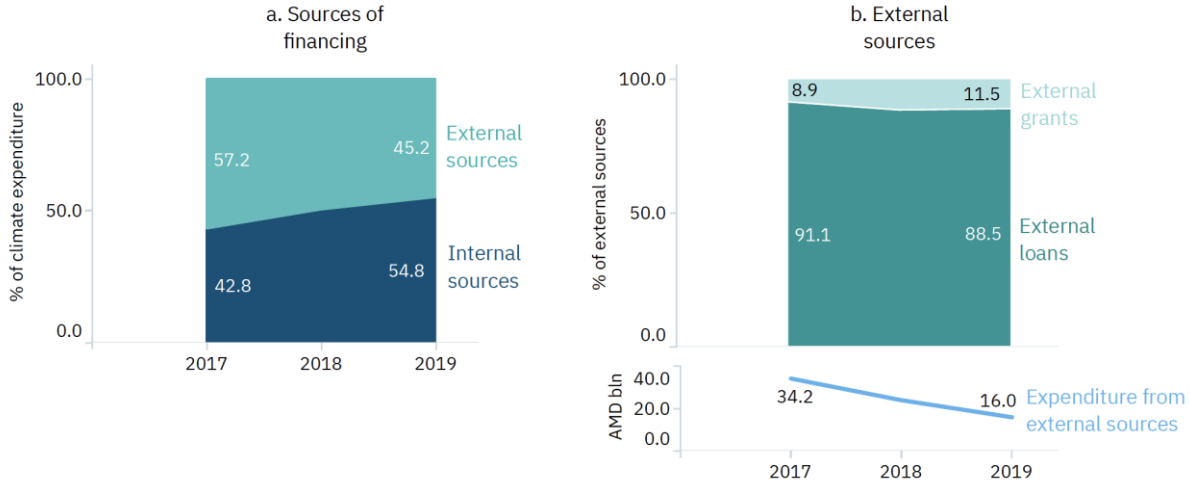
Source: CPEIR Armenia, 2020

Internal and external sources are equally important in financing climate-related expenditures in Armenia. In 2019, 54.8% of the total climate-related budgeting expenditures were financed from internal sources. Though in 2017-2019, the climate-related costs funded through internal sources have decreased in absolute terms (decreasing from AMD 25.6 bln in 2017 to AMD 19.4 bln in 2019), the share of those expenditures in total climate-related spending increased from 42.8% in 2017 to 54.8% in 2019 (Figure 40). This is explained by the fact that during the mentioned period, amid the overall decline in climate-related expenditures, the ones financed from internal sources decreased less in absolute terms than the climate-related expenditures funded through external sources. Available data shows the following choices for the CC investments financed with internal and external resources:

- ***Internal Sources*** Investments in pipelines (e.g. metro) and other transport (12.3%) and in biodiversity and nature protection (12.2%) comprised the largest share of climate expenditures financed from internal sources in 2019. Other relatively large climate expenditures were road transport, rescue services, and street lighting.
- ***External Sources.*** Investments in some areas (forestry, pipelines (e.g. metro) and other transport, biodiversity and nature protection). In general, climate expenditures financed from internal sources showed an upward trend, which differs from the general downward trend for climate expenditures funded through internal sources.
- **Most climate-related expenditures financed from external sources are funded by earmarked loans**. According to the CPEIR, 88.5% of CC-related expenses were financed using external earmarked loans. Official grants are also considered external financing sources of climate-related expenditures, with ten times less share. These expenditures showed a steady declining trend. This was basically due to the low financial performance of budget programs or measures

funded through external sources. For example, in 2019 alone, about 17% of the total climate change budget measures were not implemented (zero performance). In contrast, another 20% of those measures were not included in the initial budget (introduced during the year).

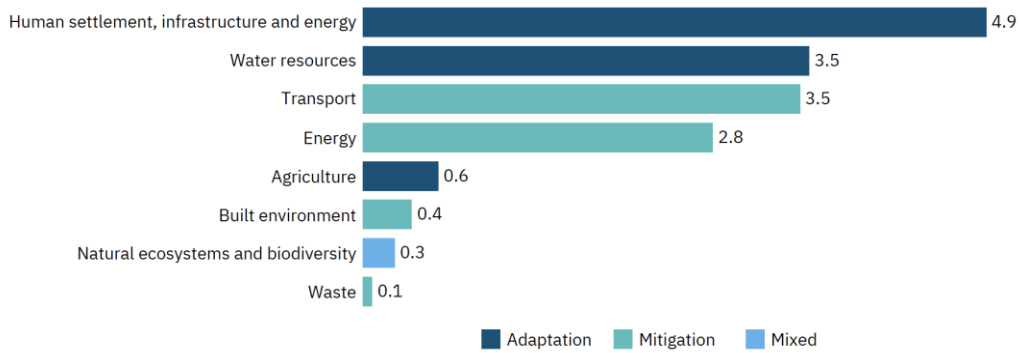
Figure 40 Financing sources of climate-related public expenditures



Source: CPEIR Armenia, 2020

Climate-related expenditures financed through external assistance were mainly applied to irrigation, energy, and road transportation, which covered about 87% of climate-related expenses funded through external aid. Other similar areas are waste collection, street lighting, biodiversity and environmental protection. The largest international partner organizations financing the climate-related expenditures are the WB, the ADB the EBRD and the French AfD, which covered about 78% of climate-related budget expenditures financed through external assistance 2019 (Figure 41).

Figure 41 Climate Expenditures from External sources by Climate Change Policy Areas (AMD bln



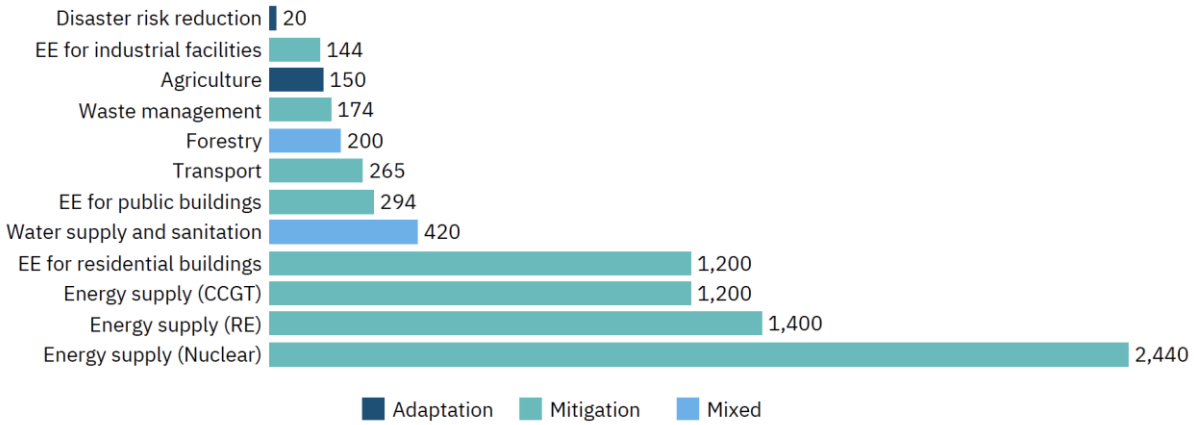
Source: DFA Team calculations based on data from CPEIR Armenia, 2020

Climate-Related Financing Needs

The country has made ambitious commitments in this field. The goals of the Republic of Armenia policy related to the climate-related issues until 2030 are defined by the Nationally Determined Contributions (NDC) for 2021-2030 under the Paris Agreement[67] There is also a National Climate Change Adaptation Plan defining the list of measures for 2021-2025,[68] which to some extent regulate the issues mentioned above. The government also plans to elaborate a Low Emissions Development Strategy.

[67] This is explicit under the RA Government Decree N 610-L dated 22.04.2021
[68] Republic of Armenia (2021)

Figure 42 Gross investment needs for climate actions by sector in 2020-2030 (USD mln)



Source: OECD, (2021). Note: RE = renewable energy; CCGT = combined-cycle gas turbine; EE = energy efficiency.

Armenia should make additional investments equivalent to 4-6% of GDP per year to meet the pledged targets during the upcoming seven years According to an OECD assessment, to meet the targets set by the NDC, Armenia will need to make additional investments of at least USD 5.7 bln (AMD 2.7 trillion) in the form of fixed assets, or USD 8.3 bln (AMD 4 trillion) if the investments in the field of nuclear energy are implemented according to the planned program (Figure 42). This was calculated over ten years (2020-2030) and comprised about 45.0% and 65.6% of 2020 GDP. This means that during the upcoming seven years, Armenia will need to make investments equivalent to 4-6% of the GDP each year for that purpose. These figures correspond to public and private investments.[69]

Those estimates place a significant priority on mitigation-related investments. These assessments establish that the central part of the gross investment needs (86%) in 2020-2030 falls to mitigation-related actions of USD 4.9 bln, while adaptation-related and mixed-impact measures cover 3% and 11% of the investment needs[70]. The central part of the CC-related investment needs) falls to the energy sector: nuclear (USD 2.44 bln), renewable ($1.4 bln) and energy generated from combined cycle gas turbine stations (USD 1.20 bln). The next major area of investment needs is the energy-saving sector of residential and administrative buildings, which covers more than 18% of the investment needs of the CC-related sector (USD 1.44 bln).

Other Climate Change-Related Financial Instruments

Green debt instruments or mechanisms were not used yet in Armenia. Green bonds or other green instruments have not been used so far for financing CC-related expenditures. However, the government seems interested in developing and investing in such innovative instruments in the CC-related field. In particular, the NDC states that: *"Armenia seeks to develop an innovative "climate debt" financial exchange mechanism aimed at attracting additional financing for climate change response, which proposes the application of innovation not only in the technical context of the "climate debt", but also by the prioritization and evaluation of obligations assumed by the countries in bilateral and multilateral levels".*[71]

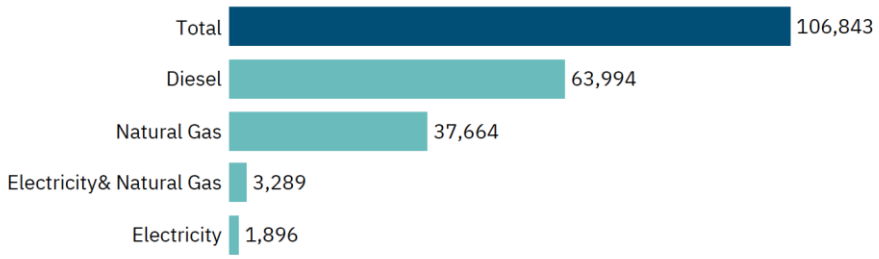
Armenia is not considered a heavy user of fuel subsidies. Armenia is one of the few countries in the region where the fuel market is liberalized, and the fuel prices are typically taxed rather than subsidized. Not having its sources of fossil fuels, Armenia greatly relies on imported fuel, especially natural gas imported from the Russian Federation. Petroleum products - diesel fuel,

[69] OECD, (2021)
[70] This is without considering investments in the nuclear energy field. The study involved mixed impact measures for forestry, water and sanitation measures. Agricultural, as well as the disaster risk management were considered as adaptation-related measures. Energy, Transport and Waste Management were classified as mitigation-related measures.
[71] Republic of Armenia (2021)

petrol, liquefied oil gas is also fully imported. The primary fuel consumed in the country is natural gas, which covers 84.2% of fossil fuel consumption and almost 83% of greenhouse gas emissions from fossil fuel combustion (2016).[72]

The use of fuel subsidies has been declining over time. The dynamics of the central fuel subsidies used by the government over the last decade are shown in Figure 43 below. Before adopting the Tax Code in 2018, diesel imported to Armenia was exempt from VAT, and compressed natural gas was exempt from the Excise Tax. After the adoption of the Tax Code, those tax rules do not operate anymore. According to the OECD, the size of the tax and the direct budgetary expenditures formed because of the fossil fuel subsidies mentioned above in 2019 amounted to AMD 2.34 bln. To support the population that faced social problems during the COVID crisis, the government has fully or partially reimbursed the natural gas, electricity, and water costs of the population, spending more than AMD 4 bln in 2020.[73]

Figure 43 Fossil fuel subsidies in Armenia 2011-2019, AMD mln



Source: DFA Team calculations based on official data from (OECD 2020a).

Armenia has neither a carbon tax nor a carbon market. The NDC adopted in 2015 envisaged establishing an internal (local) climate civil-based investment fund if the necessary financial resources were available. This investment fund would be replenished regularly from the means of ecosystem services, including the utilization of climate resources ("Carbon taxing"). Nevertheless, there was no clarity on the timing and mechanisms for the establishment of this investment fund. Therefore, there is no reference to carbon taxes in the revised NDC (2021).

However, the country has made significant progress with the introduction of environmental taxing. Nature use fees and environmental taxes are critical sources of financing for environmental (including climate) expenditures in Armenia. They are targeted taxes, the proceeds of which are directed to the solution of ecological problems. The nature use fee is a fee paid to the state budget for using state-owned natural resources. These instruments previously analyzed in Section 3.2.1 Tax Revenue represented 3.8% of the proceeds for the state budget in 2020. This tool is also used to stimulate private investments in CC related areas.

Integration of Climate Finance into Public Financial Management/ Budgetary Systems

Armenia is taking the first steps towards clarifying the financial/budgetary frameworks in the CC area and improving the link between the CC policy and the budget. The CPEIR and the estimated Climate Change Budget Integration Index (CCBII) show that the integration of CC related public finances into the existing PFM/budgetary systems is very low. Armenia has a well-developed system (e.g. introduction of Program Budgeting, Performance Reporting, etc.), which provide good platforms for integrating climate finances. Those studies differentiate several issues related to climate public finance. Addressing those issues is essential in terms of climate change and improving public finances related to transversal policies in general and their integration into the existing PFM systems.

[72], UNDP, (2021)
[73] MoF (2020)

The public policy framework for climate change mitigation and adaptation is not clear and comprehensive. The CC-related policy and strategic issues are mainly reflected in the sectoral strategies and programs, where the CC-related problems are not sufficiently addressed. This refers to the absence or lack of quality of climate-related goals, measures, and outcome indicators. These deficiencies of the strategic planning system of the CC sector spread over all budgeting areas leading to respective issues and inefficiencies.

There is no methodology for identification, coding, and accounting of CC-related budget expenditures. One of the essential issues with CC integration into the PFM systems is the lack of methods and mechanisms for identifying CC-related budget measures, results and expenses, and coding (tagging) and weighting for climate expenditures. These are the critical tools without which it will be practically impossible to identify, track and report these expenditures and result at different stages of the budgeting process.

Lack of clarity in the scope of CC-related budgetary programs and measures and their performance indicators is a significant barrier to the presentation of CC policy and results in the budgetary process. As a result of the introduction of program budgeting, the PFM systems in Armenia provide favorable conditions for presenting the budget performance information and making performance-based or performance-informed budget decisions. Nevertheless, budgetary programs and measures are currently designed around the sectoral development goals. The performance indicators describing them mainly reflect the sectoral development targets, usually not addressing cross-cutting policy issues.

There are no respective coordination mechanisms for CC-related expenditure budgeting in the framework of the budgeting process. The RA Ministry of Environment is responsible for developing and implementing state policy in the field of CC mitigation and adaptation. However, the Ministry coordinates only the budgetary programs implemented under its responsibility. In practice, the CC-related budget expenditures are dispersed in the sectoral programs implemented by different line ministries, which creates a need for coordinating the CC-related expenditure processes within the budgeting process. Moreover, the budget information submitted to the National Assembly does not specify the relation of budgeting expenditures with CC policy. Consequently, there are no separate targeted discussions on CC-related policy expenditures in the National Assembly of the RA.

The programs implemented in the ODA framework provided to the Republic of Armenia generally have a high level of integration into the national PFM systems. However, though the coordination mechanisms with donors and the representation of external loans and official grants in budgetary documents and the treasury system are high, not all budget execution processes are carried out following the national procedures. This refers to the procurement, accounting and auditing processes. At the same time, there is no complete information on external assistance provided in the form of technical assistance (consultancy services) in the budgetary documents. The MoF receives such information from the state bodies and publishes it on its website. However, there are concerns in the Ministry that information provided to the MoF is incomplete.

The Way Forward: Policies to Improve Public Climate Finance

The development of a comprehensive Climate Change Financial Framework is an important step forward to make an adequate management of this flow and could be used as a model to manage all cross-cutting priorities. There are many limitations that the government needs to address in this field that are standard solutions for all cross-cutting policies. The UNDP is currently supporting the RA Government in developing a climate budget expenditure identification methodology and the introduction of SDG budgeting and tagging, including in terms of cross-cutting policies.

The government can also significantly improve accountability and transparency on CC

related expenditures. The level of accountability for CC-related spending is low. As such, no official comprehensive reports on CC-related budget expenditures are published. Currently, no separate reports are prepared for CC-related public expenditure within the framework of the budgeting process, and CC-related expenses are not differentiated from other sectoral program expenditures in the budgeting reports. The CPEIR implemented in 2020 is the first and only study on CC-related public spending in Armenia.

The level of participation of civil society organizations (CSOs) in CC-related expenditure budgeting can be significantly improved. CSO participation in monitoring and reporting processes is low. Although the CSOs are actively involved in developing environmental programs and policies (including CC-related) in various formats, they are not directly involved in monitoring and reporting processes of budgetary programs. CSOs are invited to participate in the discussions on budget applications/programs of the state bodies. However, no separate talks are carried out on cross-cutting (including CC-related) expenditures. The conversations are happening around budget programs and measures designed around the sectoral development goals. Efforts are made to increase CSO involvement in CC-related sectoral issues under the coordination of the Ministry of Environment. It includes the implementation of training and capacity building for the CSOs on CC-related project management and finances.

Significant efforts should be made to improve the quality of information systems to strengthen evidence-based management of this financial flow. Complete and integrated information on CC-related budgetary programs, measures and expenditures that could be used to inform evidence-based decision-making is currently unavailable. The main areas where these efforts should focus include:

- ***Budget Information Systems.*** A methodology for identifying and classifying climate expenditures and their integration into the budgeting processes is needed. The government is still taking the first steps towards establishing those processes, and it is too early to talk about the implementation of the system and its results.
- ***International Aid.*** As discussed above, the government has initiated the integration of all ODA information, programs and activities in one unified MIS. It is anticipated that it will be possible to identify and correlate the information available in the system with the relevant information available in the budgetary information systems.

Government leadership is essential to ensure the technical coherence of these efforts. The ADAMS must also make it possible to initially identify the objectives of external assistance projects and their relevance to climate change. Moreover, it is also vital that the taxonomy, mechanisms, and methodology used to determine the climate expenditures in the above systems are identical and comparable.

Depending on fiscal space availability, the country could experiment with green debt instruments or mechanisms to increase access to external debt at reasonable costs. The analysis of the public debt in Section 3.2.2 shows that under the current fiscal situation, the government will have to face increased pressures from external markets investors on the compensation offered in future traditional bond emissions. As green bonds or other green mechanisms have not been used so far for financing CC-related expenditures, they could provide an opportunity to raise sovereign debt at reasonable costs soon. Therefore, the government might be interested in exploring these innovative instruments in the CC-related field to relieve the pressure from traditional investment sources.

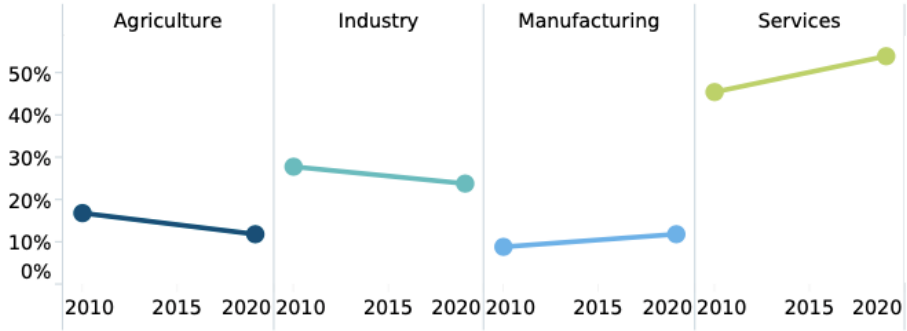
CHAPTER 4

Private finance and main financial flows

4.1 Opportunities and Challenges for Private Sector Development

The country's recent development shows significant transformations in the private side of the economy. In the last decade, the service and manufacturing sectors significantly increased their participation in the economy. Data in Figure 44 shows that the service sector rose from 46% of GDP in 2010 to 54% in 2020 and manufacturing from 9% to 12% of GDP. As this expansion happened, the participation of agriculture and industry in the economy decreased by 6% and 4%, respectively. The gradual development of inbound tourism, lack of technological advancements in the agricultural sector, and development of manufacturing in some subsectors (e.g., food processing) are some of the reasons to explain these structural changes.

Figure 44 Structure of output as % of GDP (2010-2019)



Source: World Bank indicators

Despite the challenging geographic and geopolitical conditions, the country has made significant progress in improving its insertion in the global trade markets. Armenia is a landlocked country that borders with Azerbaijan, Georgia, Iran, and Turkey, although borders with Azerbaijan and Turkey are closed. The absence of trade channels with these two significant countries complicates Armenia's integration into regional trade networks. The only borders that Armenia has open are Georgia and Iran. While international sanctions limit trade and transit opportunities with Iran, Georgia is the country through which Armenia transits goods (both import and export) to its leading trade partner Russia and the rest of the world. The following achievements summarize these efforts:

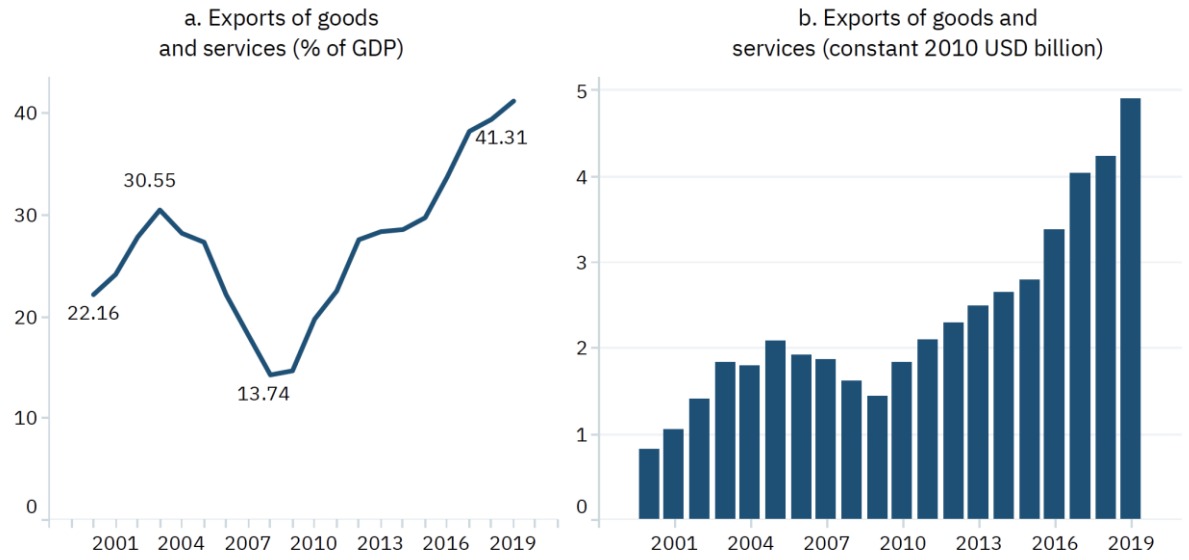
- **World Trade Organization.** Armenia has been a member of the WTO since 2003.
- **Eurasian Economic Zone.** Joined in 2013. This union guarantees the free movement of goods, services, capital, and persons. Armenia is the only country in this zone (Russia, Belarus,

Kazakhstan, and Kyrgyzstan) with no borders with any member countries.

- **European Union.** Signed a Comprehensive and Enhanced Partnership Agreement with the EU in 2017, which entered into force in 2021. EU and Armenia have cooperated in the framework of the European Neighbourhood Policy since 2004 and its regional dimension -the Eastern Partnership - since 2009, which initiates reforms and encourages cooperation in governance, connectivity, economic development, and environmental protection[74].
- **Generalized Scheme of Preferences (GSP)**. Armenia is a beneficiary of the GSP+ scheme[75]and, since 2018, has benefited from the REX system[76.]
- **Electronic Customs.** Electronic filing for customs declarations was introduced in 2017, allowing importers and exporters to file declarations and supporting documents remotely[77]. Amongst other benefits, the system reduces time needed for customs clearance procedures.
- **Bilateral Trade Agreements.** Armenia successfully negotiated 43 bilateral investment treaties (BITs), 38 of which are in force.

Consequently, exports of Armenian goods and services have been expanding rapidly. Data in Figure 45 shows that exports increased six-fold in nominal terms during the last two decades, rising from USD 820 million in 2000 to USD 4.9 bln in 2019. Measured as a percentage of GDP, the relative weight of exports in the economy doubled in these two decades, growing from 22% in 2000 to 41% in 2019.

Figure 45 Development of exports



Source: World Bank indicators

Despite Armenia's outstanding economic achievements, total investment remains relatively low when compared to the region or other peer countries, which could be compromising potential growth in the long term. This reality makes the attraction of both domestic and foreign investment particularly relevant for the country. In this sense, it is central to analyze the main factors that may be constraining the income of a greater flow of investment and the policy decisions that are needed to address them.

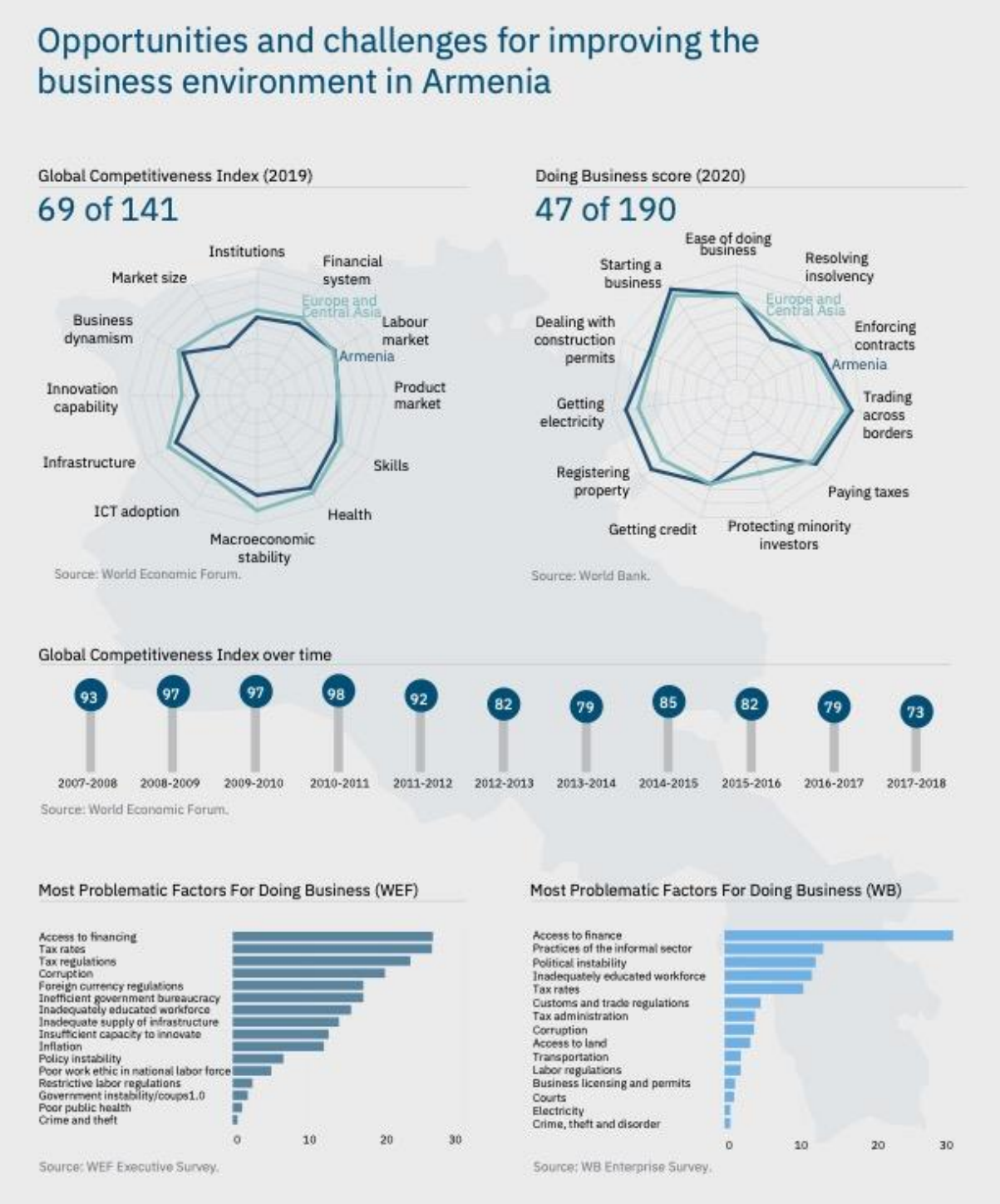
[74] The EaP includes Armenia, Azerbaijan, Belarus, Georgia, Moldova and Ukraine

[75] The GSP+ is an advanced option of the GSP, which grants economically vulnerable countries (including Armenia) particularly large exemptions from import duties for import to the EU, on the condition the respective countries adhere to key international agreements on human rights, environment, and good governance

[76] The Registered Exporter System allows exporters to benefit from GSP+ benefits without acquiring certificates of origin for each shipment, by registering in the REX system once (which is generally quicker, and unlike the certificates of origin implies no costs).

[77] Government of Armenia No. 546-N dated 30. 03. 2017

Figure 46 The enabling environment for private investment in Armenia



Source: DFA Team calculations based on official data from World Bank and WEF

International measurements coincide to show a gradual improvement of the enabling environment for business development and of the international competitiveness of Armenia. International assessments of the conditions for private sector development provide an imperfect measure of a complex and multidimensional concept, but they allow for the construction of a general idea of the main intervening factors and facilitate comparison between countries. The summary presented in Figure 46 shows the main results from the Doing Business 2020 report

from the World Bank and the Global Competitiveness Index 2019-2020[78]. It also shows the most problematic factors for doing business in the country that emerged in the enterprise surveys carried out by the same institutions. In many of the indicators measured, the country has been improving gradually in recent years and has positioned itself as one of the best in the region.

Some of the most problematic issues identified would not require significant investments. From the assessments shown in Figure 59, several of the areas where Armenia underperforms, or is below the region, require major reforms (labor market policies, internal labor mobility, complexity of trade tariffs, incidence of corruption) that might take some time to produce results. There are, however, other areas that could significantly improve the business environment that are mostly related to the quality of the legal and regulatory system that require more political will than costs, like for example:

- ***Protecting Minority Investors.*** Armenia scores zero in three important areas: (i) protecting shareholders' rights and role in major corporate decisions, (ii) governance safeguards protecting shareholders from undue board control and entrenchment and (iii) corporate transparency on ownership stakes, compensation, audits, and financial prospects. Armenia strengthened minority investor protections by requiring an independent review and immediate disclosure to the public of related party transactions, increasing shareholders' rights and role in major corporate decisions, and clarifying ownership and control structures.
- ***Resolving Insolvency***. The reasons for the low performance (95 of 194) relate to the need for further improving the insolvency framework, high costs required to recover debt, and the low level of recovery rates for creditors. The country amended the bankruptcy law to clarify procedures for appointing insolvency administrators, reduce the processing time for bankruptcy proceedings and regulate asset sales by auction. However, for all these variables Armenia is still performing low and below the region.

Removing some of the binding constraints will require significant investments for which the government may benefit from developing a strategic and integrated financing approach. There are some areas that demand significant investments, for example those that relate to the quality and reliability of the energy supply, road connectivity and the quality of the road infrastructure and airport connectivity and efficiency of air transportation services. Most likely, the government will not have the financial capacity to address all of them in the short-term. Even if that was possible, it might be counter-productive to attempt to crowd in markets where significant private investment could be leveraged. Making the most of these opportunities will require clear strategic definitions from the government and an integrated financing strategy to make them happen. A good example is what the GP 2021-2026 is proposing for energy:

- ***A clear strategic definition***. The country recognizes that gas reserves may end by 2045, that alternative generation solutions are needed. One way to address this is to set a very bold goal of transforming the country to become a regional energy hub in the region.
- ***The private – public space.*** To achieve this goal, the plan is proposing investments in wind and solar power generation plants, mega distribution corridors that link Armenia with Iran and Russia. The plan is not specifically targeting these investments as concessions and PPPs, but this is an area where significant private investment can be mobilized.
- ***A strategic use of public investments.*** There are other key areas, that for economic or national security reasons the government may want to keep as public investment. For example, the extension of current and construction of new nuclear power plants. If public investment is used strategically in other areas (for example, not used for alternative energy plants), there could be sufficient fiscal space to make this happen.

There are also some areas where the government needs to strengthen the efforts on getting

[78] Comparative figures with Eastern Europe, the Caucasus & Central Asia region countries (Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyzstan, Moldova, Russian Federation, Tajikistan, Turkmenistan, Ukraine and, Uzbekistan)

more development impact of current expenditure. Many of the areas that are also hindering private sector development relate to public policies that are not producing the desired results, for example: (i) the lack of skills of the workforce and the quality of the TVET programs and skillsets of graduates, (ii) R&D expenditures and innovation policies, (iii) tax administration and (iv) anti-corruption policies.

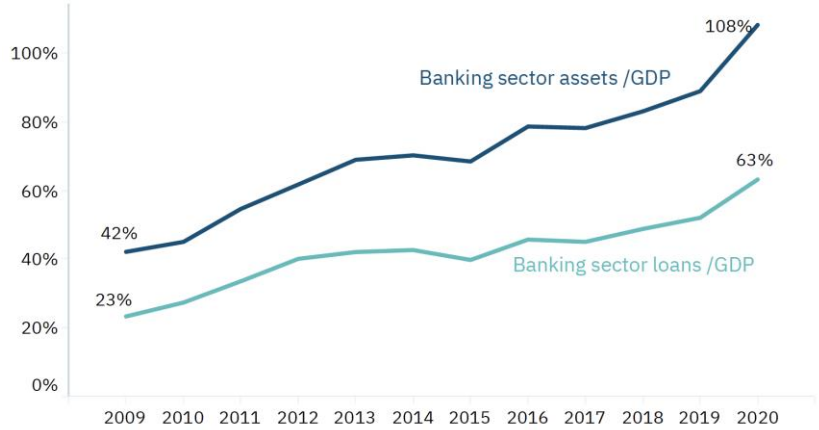
The country still has ample room for improving the domestic financing conditions for the private sector. The improvement of internal financing conditions is a pending challenge that is permanently mentioned as the main obstacle for doing business. Several conditions persist in the private financing market that have harmful effects on the entire economy. There are opportunities for reducing risks to encourage financial inclusion and reduce banks interest rates, bureaucracy, and the price of banking services. Similarly, the capital market is limited despite initiatives for its development. Significant improvements in this sector combined with a continuation of the insurance and pension reforms can lead to a deepening of the capital market.

4.2 Main Private Flows

4.2.1 Private Financial Sector

Like many other aspects of the Armenian economy, financing to the private sector showed significant advances during the last decade. Private credit was one of the critical sources of finance contributing to developing the country's private sector. Armenia's private financial indicators have had a stable growth for the last ten years. Data in Figure 47 shows that the banking sector assets-to-GDP rose from 42% of GDP in 2009 to 108% in 2020: A similar trend happened to loans-to-GDP ratios that expanded from 23% to 63% in the same period.

Figure 47 Private Finance Indicators

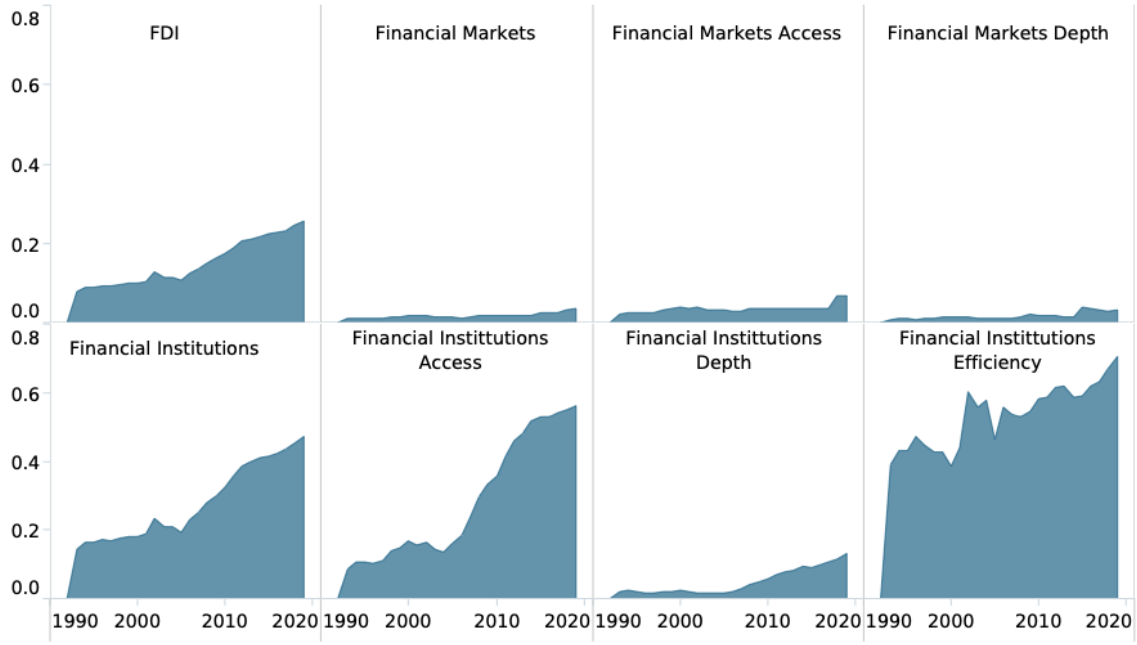


Source: DFA Team calculations based on official data from the Central Bank of Armenia

However, significant improvements are still needed as access to credit is regarded as one of the primary binding constraints for private sector development. According to the latest WEF Executive survey, access to credit is the most critical problematic factor for private businesses in the country. Measurements by the Doing Business reports from 2020 show that the total score for the getting credit dimension (70.0) is near the regional average (72.2) but is much lower than comparative economies like Georgia, which ranks 85.0 and for countries like Bulgaria, Moldova, and Ukraine. The main area for improvement is related to the role and capacities of the credit registry functions, where the country scores zero. The general legal framework can also be improved to increase overall performance.

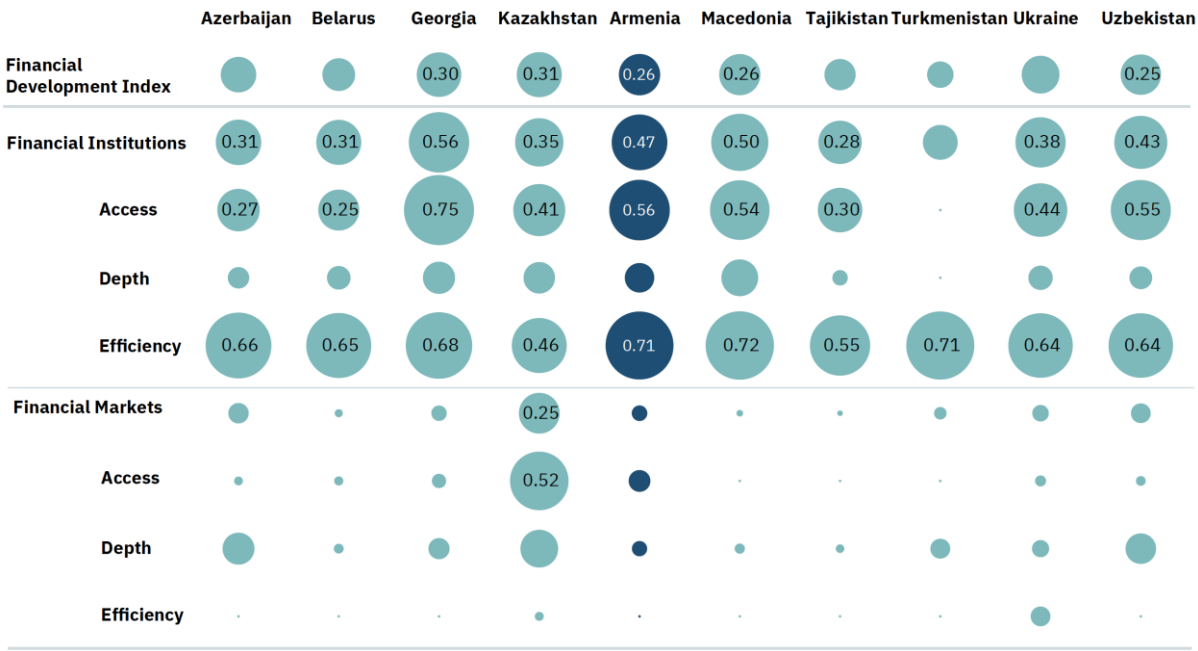
According to the IMF Financial Development Index, the Armenian financial system shows some clear strengths and weaknesses. The IMF developed this comprehensive Index to overcome the shortcomings of single indicators as proxies for financial development. The Index

Figure 48 **Financial Development Index (FDI)**



Source: DFA Team calculations based on official data from the International Monetary Found

Figure 49 **Armenia's Financial Development Index position 2020**



Source: DFA Team calculations based on official data from the International Monetary Found

captures key dimensions (depth, access, and efficiency) of the financial institutions (FI) and financial markets (FM).[79] The overall ranking of the country is relatively low (0.23). In relative terms, Armenia qualifies in place 95 of 187 countries measured. The top-performing countries (Switzerland, USA) achieve over 0.90, almost quadrupling hose of Armenia. The main reason for this low score is related to specific characteristics of the FI and FM markets:

- **Financial Institutions.** The main strengths are access (number of branches and ATMs per

[79] Financial institutions include banks, insurance companies, mutual funds, pension funds, and other types of nonbank financial institutions. Financial markets include mainly stock and bond markets.

100,000 adults) and efficiency (interest margins, lending deposits spread, costs to total assets, and return on equity). Data from Figure 48 shows these aspects have been improving fast. The main weakness is regarding depth (the combination of private sector credit, pension fund assets, mutual fund assets, and Insurance premiums as a % of GDP)

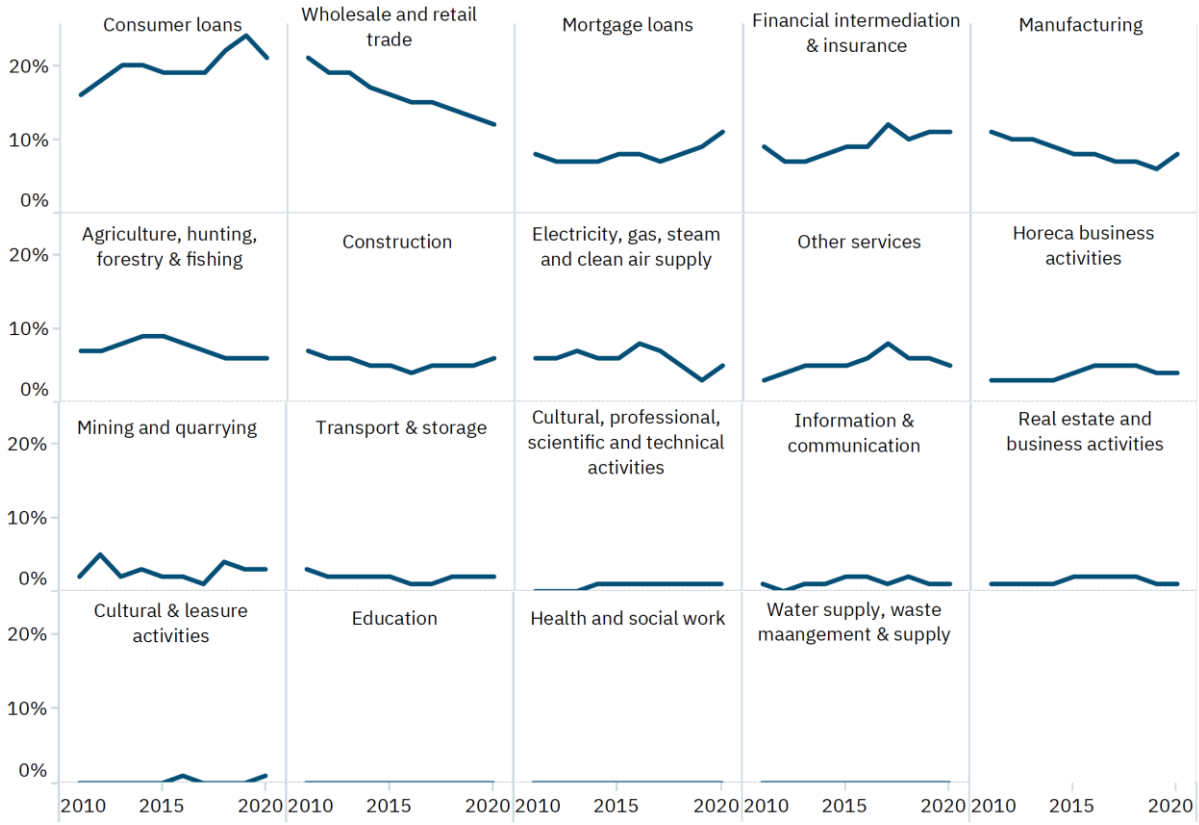
- **Financial markets**. The country qualifies very low in all measured dimensions of access (market capitalization outside the top 10 largest companies, total number of debt issuers) and depth (stock market capitalization, stocks traded, government debt securities, debt securities of financial and non-financial corporations to GDP).

However, if compared to regional peers, the county is performing relatively well. For example, the data in Figure 49 compares Armenia's relative position compared to a selected number of regional peers. Its performance in the Index (0.26) is in the same level of Georgia (0.30), Kazakhstan (0.31), Macedonia (0.26), and Uzbekistan (0.25) and much better than countries like Azerbaijan, Belarus, Tajikistan, Turkmenistan, and Ukraine.

The Financial Industry

The banking sector is the dominant player in the Armenian financial market. The banking sector accounts for around 90% of the total assets of the financial system. As of December 2020, the financial industry consisted of 17 commercial banks, 44 universal credit organizations, 8 insurance companies, 4 insurance brokers, several pawnshops, exchange bureaus, and money transfer companies.[80] There are no national development banks in the country. The financial leasing activities are treated as financial intermediation and thus can be realized only by banks and universal credit organizations.

Figure 50 Dynamics of the loan portfolio sectoral distribution



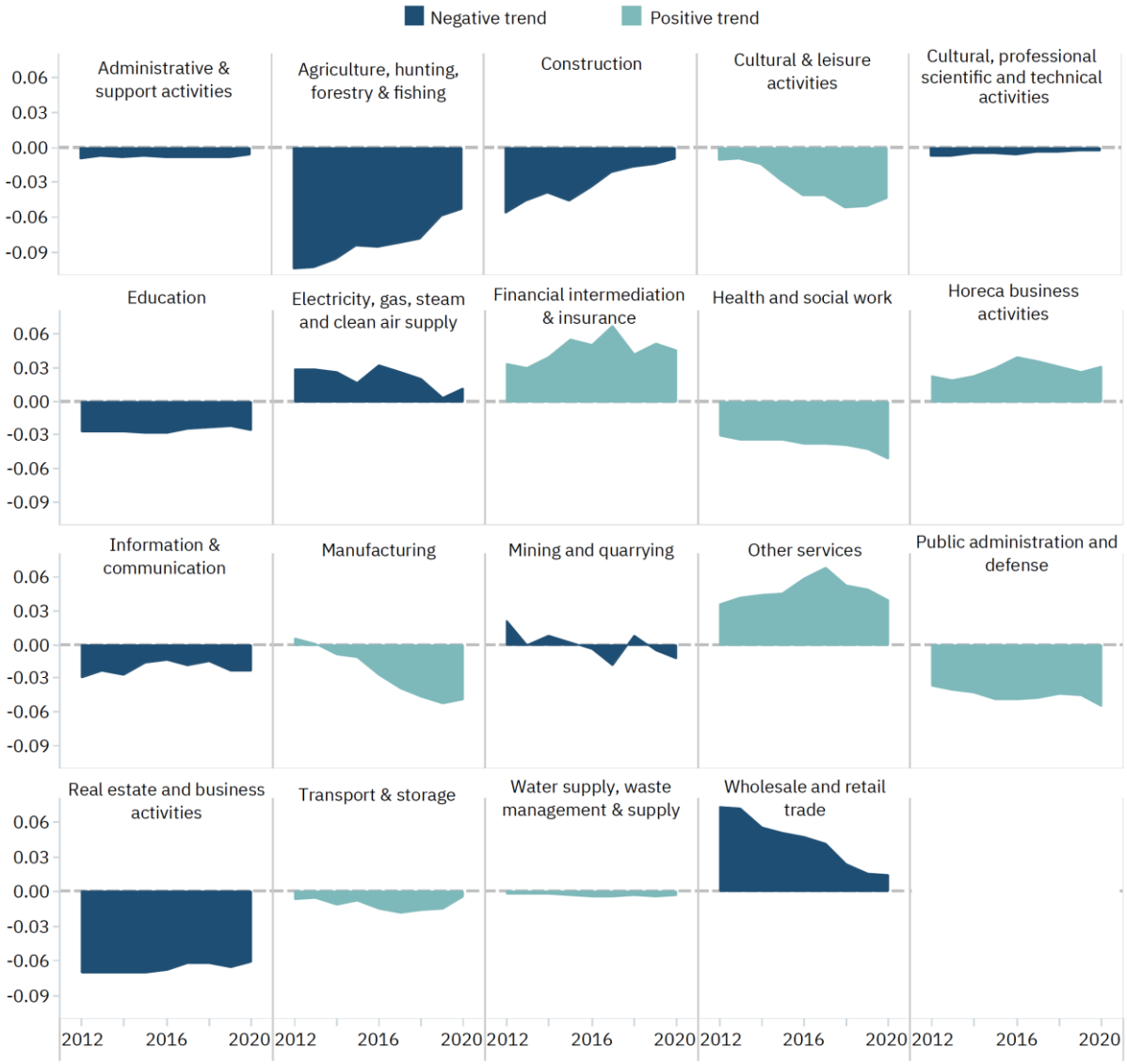
Source: DFA Team calculations based on official data from the Central Bank of Armenia

The sectoral distribution of the financial sector loan portfolio experienced some notable

[80] Central Bank of Armenia website

changes over the last ten years. The banking system operations have been historically concentrated in a few sectors of the economy, such as trade, manufacturing, consumer lending, and mortgages. Figure 50 shows the dynamics of the sectoral distribution of the financial sector loan portfolio over the last ten years. The most notable change regards consumer loans, which quadrupled in nominal terms during this period and increased participation from 16% of the total in 2011 to 21% in 2020. Another significant change is the reduction of the share of loans to the wholesale and retail trade sector, which decreased its participation from 21% in 2011 to 12% in 2020. Another remarkable aspect is the almost negligible participation of sectors like Education, Health, Water and Sanitation.

Figure 51 Comparison of the sector concentration in GDP



Source: DFA Team calculations based on official Statistics of Central Bank of Armenia, and the State Statistical Service

The distribution of domestic credits shows some disconnects with the economic relevance of some sectors. Figure 51 shows the difference between the sector concentration of the total loan portfolio (as % of GDP) minus the sector participation in the GDP during the last decade. For the majority of the sectors, this difference is almost zero, meaning that the share in the loan portfolio mirrors the percentage of that specific industry in the GDP. There are many cases where this difference is negative, meaning that the levels of financing are below the sector economic relevance. There are some notable behaviors:

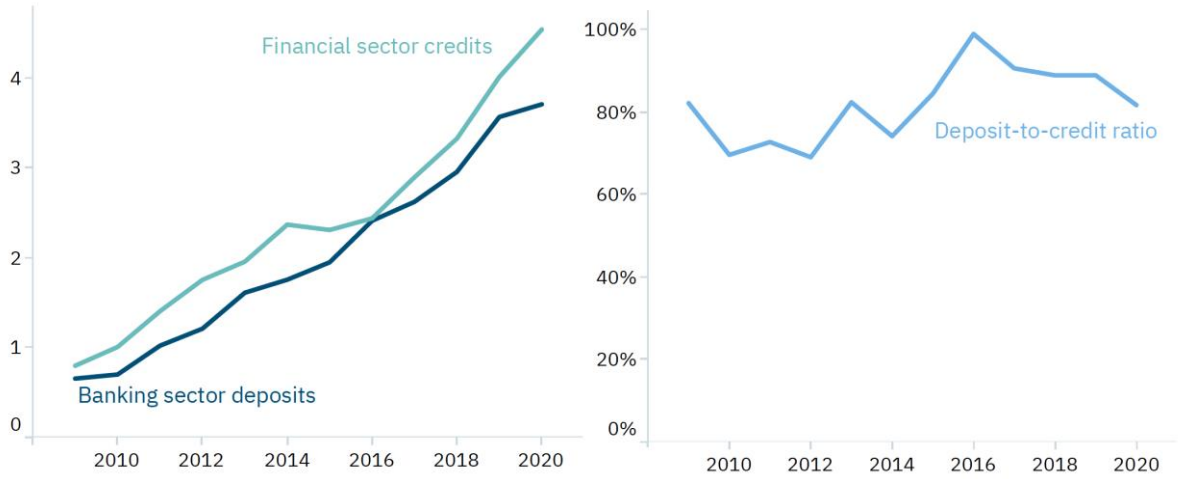
- **Historical gaps that are improving**. This is the case in agriculture, where the negative gap

averaged 8% of GDP during this period. This difference narrowed in recent years to reach 6% in 2020. A similar situation happened in the construction sector, with an average gap of 3% that was recently reduced to 1%

- **Gaps are worsening**. In the case of manufacturing, a negative gap started to show in 2013 and has been growing since to reach a negative difference of 5% in 2020. Reversing situations are also happening in culture and leisure, health and wholesale and retail trade.

The deposit and credit base of the financial sector has been growing stably over the last ten years, and a relatively stable deposit-to-loan ratio is being maintained. Figure 52 shows the deposit-to-credit ratio fluctuated around an average of 82% during the whole period. The sound development of the deposit base was reinforced by the financial sector's stability and the introduction (in 2005) of the Deposit Guarantee Fund, which guarantees the remuneration of bank deposits of physical persons. However, as deposits do not fully cover the funding needs of the banking sector, there is a significant supply of IFI funding in the market. There is no evidence to show the actual incidence of IFIs as the funding received by these institutions is not disclosed in the statements of the financial institutions.

Figure 52 Deposit-to-credit relationship dynamics (USD Millions)



Source: DFA Team calculations based on official data from the Central Bank of Armenia

The profitability of the banking sector has been gradually decreasing during the studied period. This is mainly linked to the country's economic downturns since 2009 and the new regulations that increased minimum absolute capital requirements in 2017. In addition, higher equities, higher competition, and thus decreasing margins, higher NPLs, and NPL reserves partially encouraged higher risk-taking behavior. Therefore, Interest rates have been quite volatile during the studied period. Still, despite the economic, geopolitical, and political turbulences, all banks were profitable in 2020 with a total net profit of AMD 60.4 bln, which is by AMD 14 bln lower (19%) of what was recorded in 2019.

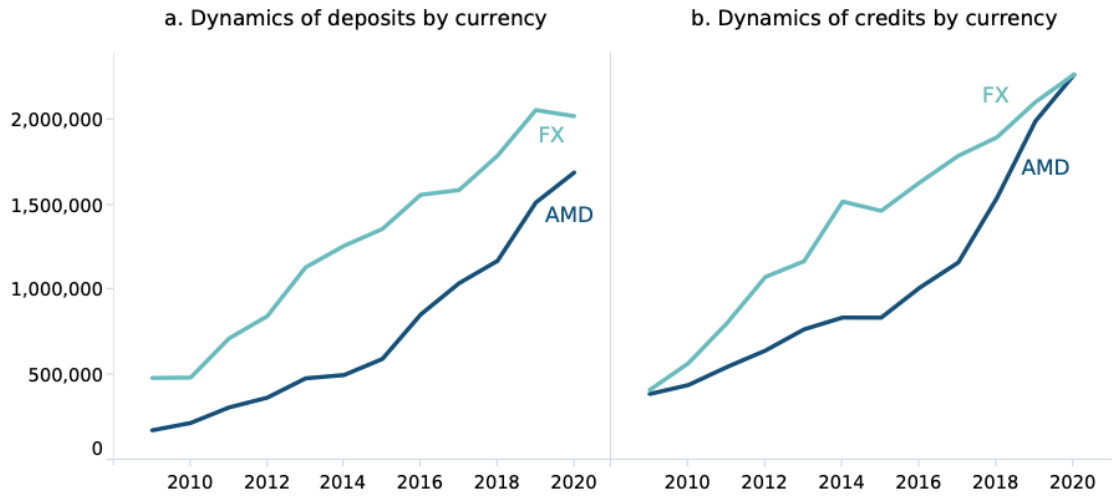
The COVID pandemic severely affected profitability but did not challenge the overall stability of the banking system. The Returns on Equity (RoE) of the banking sector decreased from 9.46% in 2019 to 6.99% in 2020 and the Returns on Assets (RoA) from 1.4% in 2019 to 0.98% in 2020. The shrink in profits and profitability levels are mainly driven by a deterioration of the loan portfolio quality during 2020.[81]However, the situation remains manageable, and no significant threats that could collapse the system happened during this period.

Dollarization is one of the defining features of the Armenian economy and the internal debt

[81] Published IFRS Financial Statements, financial-economic bulletin issued by ARKA News Agency, "Financial rating of Armenian banks" report issued by ArmInfo information agency

market. Figure 53 shows that the foreign currency operations' weight for deposits and loans in foreign currency is traditionally higher than in local currency. This is partially due to the import-orientation of the economy and the increased significance of personal remittances in GDP. To mitigate the inherent risks of dollarization, the CBA progressively introduced higher and provisioning requirements for foreign currency assets and other measures analyzed below.

Figure 53 Dynamics of deposits and credits by currency

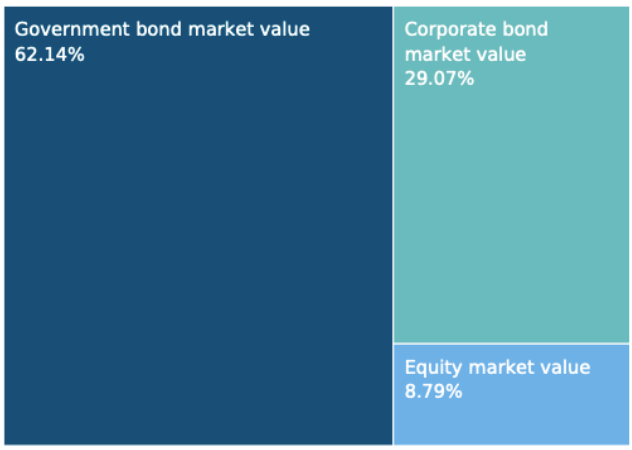


Source: DFA Team calculations based on official data from the Central Bank of Armenia

Capital Markets

Despite recent improvements, the capital market remains significantly underdeveloped. The Armenian capital market is thin and has a small volume, a narrow range of instruments, and low secondary market liquidity. Traditionally, the majority share of the capital market consists of government bonds, and only a tiny portion consists of corporate bonds and equity security capitalization, as depicted in Figure 54. The depth of the capital market is hindered by the dollarization of the economy and its limited size. The same lack of capital market will make it difficult for both pensions and life insurance to develop.

Figure 54 Capital market value distribution, 2020



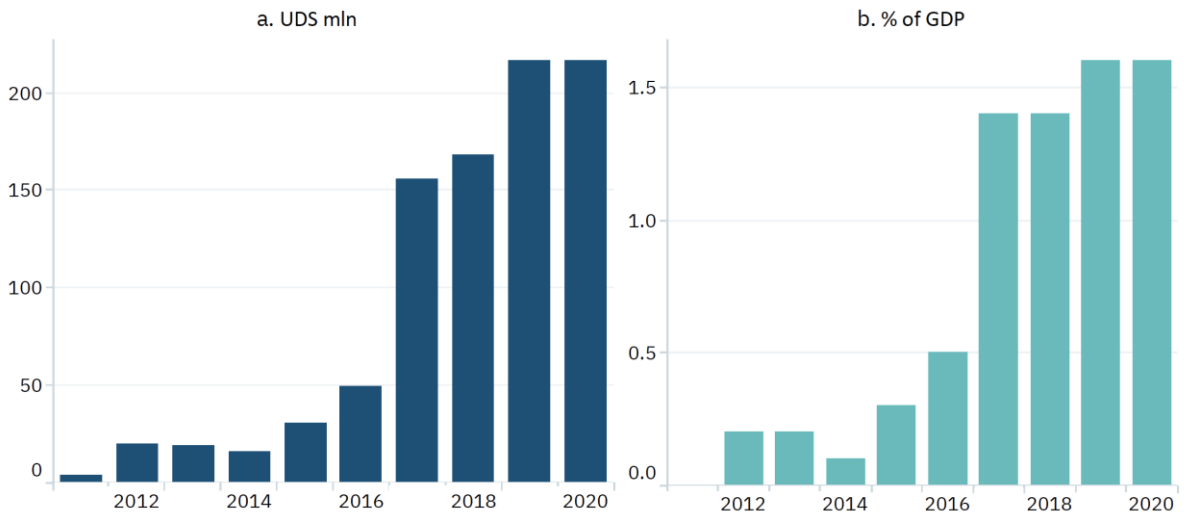
Source: DFA Team calculations based on official data from Armenia Securities Exchange, Annual Report 2020

A significant step forward to accelerate the capital market development was the pension reform introduced in 2014. This reform introduced a multi-pillar pension system. Two private investment companies were licensed as mandatory pension fund managers, each responsible for

managing three compulsory pension funds[82]. Since then, significant public savings started to accumulate in these pension funds: as of December 2020, their combined Net Asset Value as of 370 bln AMD, approximately 5% of GDP[83]. It is projected that by 2037 the funds will reach the level of 6.5 in AMD, equivalent to 25% of GDP. However, the investment opportunities for these savings in the private sector are minimal. The corporate stock and bond markets remain small, and there is not much choice in terms of investments.

The corporate bonds market is still small despite the favorable regulatory framework and several reforms in this field. The largest issuer of the corporate bond market is the financial sector who prefers to attract funds via bonds versus deposits due to more favorable tax and reservation policies. As a result, the secondary market of corporate bonds is characterized by low liquidity. The dynamics of the corporate bond market are presented in the Figure 55 below.

Figure 55 Dynamics of the corporate bond market



Source: DFA Team calculations based on official data from the Ministry of finance of Armenia

Sovereign Eurobonds had a positive impact attracting investors from international markets. The government started issuing sovereign Eurobonds in 2013. Their excellent reception led to similar issuances by one of the Armenian commercial banks. Pilot placements of new debt instruments, e.g., asset-backed securities and covered bonds, occurred in previous years in the market, but this was not scaled up due to several obstacles. The main reasons quoted in several reports are the lack of scale and thus cost inefficiency, the overabundance of IFI funding which is often channeled via government refinancing institutions and others. Rigorous analytical information is needed. A joint IMF-WB financial sector assessment was carried out in 2013, and since then, no other comprehensive studies have been implemented to measure these obstacles.

Armenia Stock Exchange trades in ordinary and preferred shares, corporate bonds, government bonds, REPO contracts, and foreign exchange (USD and EUR). The equity market is almost non-existent: issues of equity securities are sporadic; the secondary market of equity securities is not active either. In 2020, there were only 38 trades in the equity market (compared to 993 transactions in the government bond market and 2,432 exchanges in the corporate bond market).

The authorities developed a well-founded regulatory and supervisory system which has been improving over the years. The Central Bank of Armenia (CBA) is the centralizing regulator responsible for banking and non-banking supervision, financial stability, protection of consumer rights, and market conduct of the financial system. The financial sector was tested due to the

[82] Amundi-Acba Asset Management and C-Quadrat Ampega Asset Management

[83] Statistics of Central Bank of Armenia

global financial crisis and the Russian crisis of 2014 and is considered resilient. An IMF assessment from 2019 states that "*The CBA has made significant progress in its approach to banking supervision with the adoption of the RBS framework and addressing gaps in the regulatory framework identified in the 2012 Basel Core Principles (BCP) assessment*"[84].

The Central Bank of Armenia has been actively introducing reforms to improve banking and non-banking supervision and financial stability, crisis management, and resolution. Since formally adopting the additional mandate over financial stability by Law in 2017, the CBA Board approves macroprudential policies based on the Financial Stability and Special Regulation Committee (FSSRC). In addition, the Law allows the CBA to select and use different macroprudential instruments, including Basel III buffers. The most recent IMF Financial System Stability Assessment (FSSA) in 2018, states that the measures taken by the CBA (since the previous Assessment in 2012) had a considerable impact on strengthening the financial system.

The CBA has also been active in introducing measures to mitigate the risks of dollarization. These include introducing higher and provisioning requirements for foreign currency assets and more stringent liquidity requirements to reduce foreign exchange funding liquidity risk. However, the IMF FSSA report still underlines the existing vulnerabilities of the financial system due to the highly dollarized economy and the insufficient levels of liquidity cushions in foreign currency.

There are still opportunities for improvement in this field. The IMF report recommends introducing capital conservation buffers and the surcharge for important domestic banks and measures to address credit risk from unhedged foreign exchange exposures, such as introducing stressed debt service to income ratio limit. In addition, it is advised to gradually raise the requirement for banks to maintain reserves in foreign currency for liabilities denominated in foreign currency and the liquidity coverage ratio and net stable funding ratio in AMD and USD. It was also recommended to prepare to implement the countercyclical capital buffer if the current trend in credit growth persists.

Another significant step forward was the introduction of an improved and upgraded risk-based supervision framework. The Risk-Based Supervision Framework (RBS) was adopted in 2017 to introduce a more forward-looking risk assessment and allocate supervision resources more effectively. The changes are considered positive. However, the IMF still recommended further reforms that are pending, that include[85]:

- Refine the risk-based supervision framework for a more granular assessment of banks' capital needs, enforce significant exposure limits, and amend the definition of nonperforming and restructured loans in line with international best practices
- Address the narrowness of functions of the Deposit Guarantee Funds by developing and implementing financial safety net and crisis management arrangements in line with best international practices.

The Armenian financial sector has a sound and large-coverage credit bureau. The ACRA Credit Bureau is the first private credit bureau in Armenia and was founded in 2004. ACRA provides information on the credit history of individuals and legal entities and cooperates with banks, microfinance organizations, utility companies, grantors, and insurance companies operating in Armenia. The WB Ease of Doing report scores very high the performance of the credit bureau due to its coverage of 82.5% of adults, transparency, and data quality.

Reforms to improve the Capital Market are ongoing and may benefit from higher prioritization. In mid-2020, the Armenian government approved a Capital Market Development Program, which presents a comprehensive overview of the existing challenges and opportunities of the capital market and a detailed action plan targeted at the development of capital markets

[84] IMF (2019)
[85] Ibid

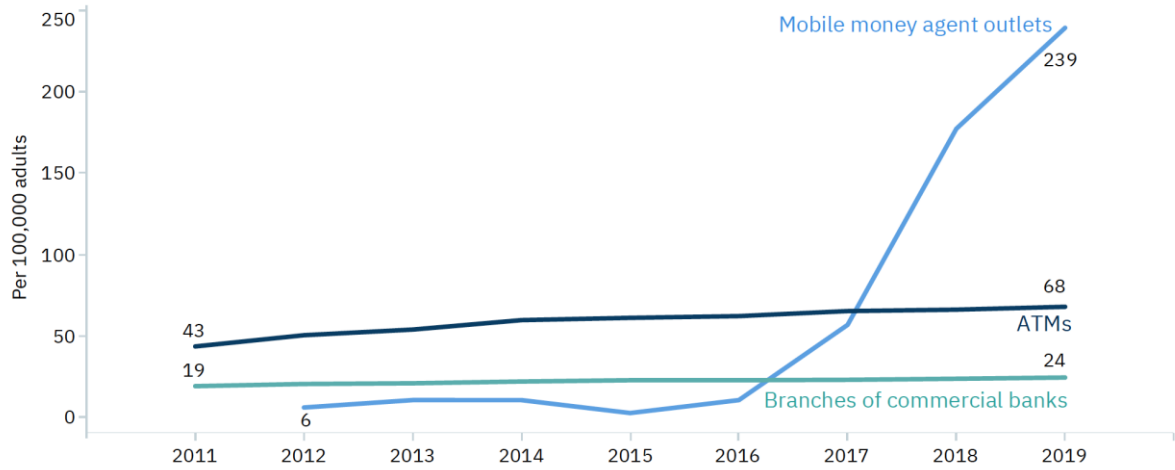
of the country. The program actions are targeted at the improvement of a broad list of areas.[86]

The reforms projected by this program significantly impact the development of other critical financial flows analyzed in this DFA. For example, the development of infrastructure and PPP financing, the introduction of specialized thematic bonds (green, SDG) at the national and municipal level, and the widening of the stock exchange investor base to facilitate the introduction of new financial instruments oriented to the expansion of the private sectors, such as private equity funds or blended funds. For all these reasons, the reforms projected by this program should be considered of high priority.

4.2.2 Financial Inclusion and MSME Finance

The analysis in this section complements the assessment presented in the previous one and mainly focuses on the quality of access to finance, understanding by financial inclusion as the proportion of the population and firms that use financial services. Financial inclusion is essential for reducing inequality and poverty and a key driver for inclusive economic growth. Inclusion depends on supply-side factors regarding the availability of financial services to the population and firms and demand-side aspects of the usage of financial services by the community.

Figure 56 Financial inclusion indicators per 100,000 adults



Source: DFA Team calculations based on official data from the IMF, Financial Access survey data.

Supply-side indicators show that the coverage of access facilities significantly improved in the last decade[87], increasing from 6.73 per 100,000 adults in 2010 to 21.78 in 2015. This significant increase is mainly due to the emergence of more access both from banks and from non-traditional financial institutions, such as Credit Organizations. It also shows that the number of traditional cash access facilities, such as bank branches and ATMs, increased slightly. For example, the number of bank branches and ATMs per 100,000 adults increased only from 1.04 and 3.35 in 2010 to 1.17 and 4.74 in 2015. However, this analysis can be misleading, as the data for MFIs and Cooperatives is only available from 2014 onwards.

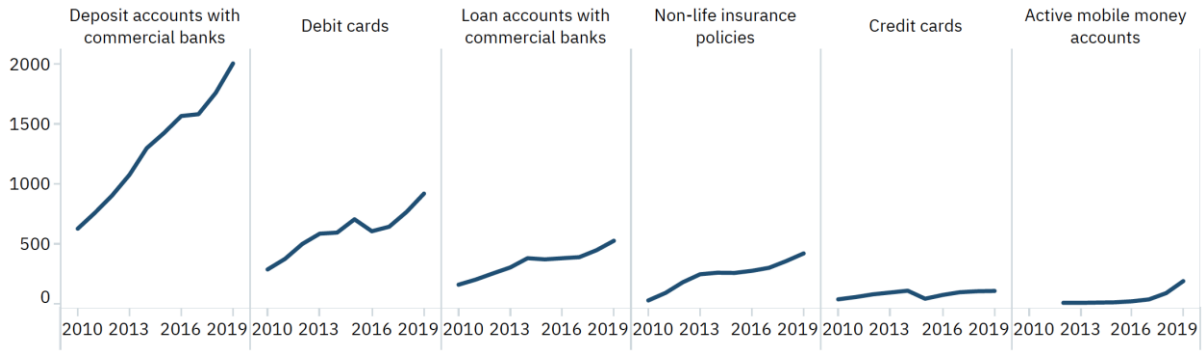
In addition to physical access points, mobile financial services have emerged as significant financial facilities. Until 2015, the number of mobile money financial services access points remained below 200. Since then, access to mobile money services has experienced a fast expansion, surpassing the 6.000 outlets in 2020. All-access indicators significantly improved

[86] These include: the government bond market, Repo market, issuances in the context of public-private partnership and investment funds where government has shares, issuances of municipal bonds, issuances by public companies, issuances by private sector, issuances by financial sector, market of derivative financial instruments, investor base stock exchange infrastructure, depositary infrastructure, legal and regulatory framework

[87] Cash-in and and cash-out access facilities include, bank branches, bank and mobile money agents, credit unions, co- operatives, ATMs and microfinance branches

during the last decade. Figure 57 shows that deposit accounts with commercial banks and the number of debit cards increased significantly, and that moderate but relevant growth also happened in the number of loan accounts and non-life insurance policies.

Figure 57 Financial inclusion indicators



Source: DFA Team calculations based on official data from the IMF, Financial Access survey data.

Dated demand-side information shows that there could be significant room for improvement to address financial inclusion disconnects and access gaps. Unfortunately, the lack of comprehensive demand-side surveys limits the capacity to diagnose these reasons and to propose adequate policy responses. According to Global Findex Survey measured in 2017 found significant gender, geographical, age, and income financial inclusion disparities:

- ***Gender*:** The difference between men and women who have a bank account (15%), saved at a financial institution (9%), own a debit card (10%), a credit card (9%), or have an active mobile money account (8%) indicate there are gender inclusion gaps. These gaps are significant in all the measured dimensions.
- ***Income*.** Inclusion gaps are also present in all the measured dimensions for people of the 40% lower income. Their difference with the average is 14% for a bank account, 12% for debit card ownership, 2% for a credit card, 3% for access to credit, and 2% for mobile money
- ***Age***: Older people are also excluded in some categories. Savings in a financial institution are 4% lower than the average, 2% for mobile money, and 1% for credit cards. There are some categories for which their access is higher than average or equal: bank accounts and ownership of debit cards.
- ***Geographic*:** there are also indications that financial exclusion happens for people in rural areas. Their performance in all measured categories is slightly lower than average. The main exception is that their access to mobile money was 1% above average. This could be linked to 8% of all respondents receiving payments for agricultural products through a mobile phone.

There is limited demand-side information to understand the reasons for these disconnects and access gaps. The Global Findex Survey measured in 2017 that those without a bank account claimed that the main reasons for not opening one were: because financial services are too expensive (25%), they lack trust in financial institutions (20%), financial institutions are too far away (14%), or they lack the necessary documentation (8%). Adequate evidence and targeted policy responses are needed to address these issues.

Compared with other peer countries, Armenia's performance is still lagging. Despite the accelerated improvement of all the financial inclusion indicators shown above, the comparative data shown in Figure 58 indicate that there is still significant room for improvement. Compared to countries like Georgia and Ukraine, Armenia's progress seems much more limited and comparable only to countries like Moldova.

Figure 58 Selected financial inclusion indicators

Source: DFA Team calculations based on official data from the IMF, Financial Access survey data.

Financial Inclusion of MSMEs

The MSMEs market is vast, and the services provided by commercial banks dominate their access to finance. The banking system is the prominent participant in the financial market and accounts for 83.5% of the system's total assets. The latest published data from the CBA shows that as of December 2019, the financial market included 17 banks (total assets AMD 5.828 trln), 43 credit organizations (AMD 711.5 bln), 13 investment companies (AMD 63.5 bln), 108 pawnshops (AMD 9.9 bln) and a variety of other institutions (insurance, currency exchange, money transfer, payment clearing, and others).[88] While some consolidation occurred in recent years, further consolidation could help more effective and efficient economic credit allocation.

Most commercial banks are universal, target all types and sizes of companies and private individuals and are not well suited to the demands of MSMEs. While banking sector loans increased from 23% of GDP in 2009 to 63% in 2020, this growth has been driven mainly by lending to households, and the share of business lending to total bank lending declined sharply in the same period. Banks often lack appropriate products, processes, and procedures designed explicitly for MSMEs. In addition, loans provided by banks tend to rely on collateral requirements, which significantly generates significant access-to-credit problems for SMEs. The poor quality of financial reporting substantiates these requirements by many corporates, but they are also

[88] CBA website (https://www.cba.am/en/SitePages/fscintroduction.aspx)

related to the lack of hands-on, customer-focused banking management practices.

The microfinance market is relatively recent in Armenia. Microfinance started in the early 90s with the entrance of well-known international institutions, such as FINCA International, Oxfam, Umcor, World Vision, Eclof, Save the Children, and others. Until 2002 the microfinance lending sector was largely unregulated. The Law on Credit Organizations enacted in 2002 led to compulsory licensing and regulating and supervising microfinance activities. According to the Law, there are three credit organizations: universal credit organizations, refinancing credit organizations, and credit unions. The information provided in Table 3 shows the main capital requirements, exposure, and adequacy ratios mandated for their operations.

Table 3 **Universal Credit Organizations, Credit Unions and Refinancing Credit Organizations**

	Refinancing Credit Organization	Universal Credit Organization	Credit Union
Capital requirement	4,000 mln	150 mln	50 mln
Maximum exposure to single largest borrower	30%	20%	25%
Capital adequacy ratio	10%	10%	6%

Source: Reproduced from ADB (2018)

Microfinance is mainly provided through credit organizations Previous to the COVID-19 crisis, the number of Credit Organizations (COs) and the volume of their operations were growing fast. By the end of 2019, there were 46 COs: 33 universal COs, 11 refinancing COs, and 2 credit unions. Credit organizations assets increased from AMD 21 bln in 2006 to AMD 711.5 bln in 2019. As a result, their assets-to-GDP ratio reached 8.70% in 2019 from 0.78% in 2006. Before COVID, the number of COs proliferated, increasing from 35 by December 2017 to 46 in December 2019 in a range of specialized activities (refinancing, leasing, factoring, and export financing).

Lack of adequate, official MSME finance information and statistics is a significant barrier to a practical analysis and effective management of this critical financing flow. Accurate supply-side statistics and information and periodical demand-side surveys are essential for a coordinated policy response to real market needs. There are currently two primary sources that provide partial and not comparable information regarding MSME finance:

- ***Government Statistics***. The Central Bank of Armenia does not publish segregated information regarding MSME finance and does not measure the state of the art of MSME financial access, depth, and efficiency indicators. The National Statistical Committee (Armstat) produces an SME Entrepreneurship Statistical Bulletin, which covers a broad range of areas but provides no information about the financial practices of these firms or demand-side perceptions of the perceived main barriers for these firms to access financial resources.
- ***News Agencies***. The scarce quantitative information available is produced and reported by private media, like the Financial Economic Bulletin issued by ARKA News Agency or the Financial Rating of Armenian Banks issued by ArmInfo[89]. Both agencies provide different estimations of the size of MSME financing in the market. For example, Arminfo reported that the SME loan portfolio in December 2020 was AMD 650 bln (27% of the total loan portfolio to businesses), while ARKA estimated the same figure to be AMD 903 bln (37% of the entire loan portfolio to businesses). Both estimates are mainly based on the self-declared figures by the banks, which in their turn have various definitions of SMEs and loans to SMEs.

[89] ARKA is an Armenian news agency that has been operating since 1996 and delivers its news, analyses and market data to government agencies, commercial and international financial organizations, banks, consulting companies and embassies on a regular basis. Some of ARKA clients are the Central Bank of Armenia, the International Monetary Fund, the International Finance Corporation, the European Bank for Reconstruction and Development. ArmInfo" is an independent news agency founded in 1991. It cooperates with international media (Reuters, BBC, Euromoney, RBC), and provides breaking news from Armenia and the region to China, Iran, and media markets in the Middle East.

Comparative data with other peer countries show that Armenia's performance in this field is relatively positive, but significant improvements are needed in some areas. For example, a recent comparative study by the EU Eastern Partnership Countries Initiative shows that Armenia's performance in several dimensions is near or above average (Table 4) [90]. This is the case of the Responsive Government and Access to Finance. The legal and regulatory framework is the main reason for the relative underperformance of several of the dimensions shown here, which include the development of the stock market, venture capital, and other innovative finance systems. In addition, non-bank financing performance is significantly lowered by the lack of adequate systems to develop leasing operations, also studied later in this section.

Table 4 Access to finance regional pillar comparison

	Georgia	Armenia	Belarus	Moldova	Ukraine	Azerbaijan	Average
Access to finance for SMEs	4,0	3,8	3,6	3,6	3,3	3,1	3,6
Bank financing	3,4	2,9	3,1	2,8	1,8	2,2	2,7
Financial literacy	4,7	3,8	3,3	2,7	3,1	3,3	3,5
Legal and regulatory framework	4,4	4,2	3,7	4,1	3,9	3,4	3,9
Non-bank financing	3,0	3,7	4,4	3,8	4,0	2,5	3,6
Venture capital	2,9	3,4	2,3	1,5	1,7	1,8	2,3

Source: DFA Team calculations based on official data from the SME Policy Index 2020.

Positive steps were taken to improve the financial literacy of SME entrepreneurs, but these were scattered isolated initiatives. The Central Bank of Armenia has a mandate of raising the financial literacy of MSMEs in Armenia. Steps were taken to support SME financing through various government programs, but their effectiveness was unknown. The most remarkable initiatives implemented included:

(i) ***German-Armenian Fund (GAF).*** The GAF was established in 2001 by the CBA to implement and manage loan programs concluded between the CBA and KfW Bank. In addition, GAF also implements loan programs with other IFIs and donor institutions (e.g., EIB, ADB, etc.). Within the framework of each program, GAF is refinancing eligible loans disbursed by partner financial institutions, which comply with the criteria set for that specific program. GAF implements refinancing in local currency; thus, the foreign exchange risk is born by the CBA. At the same time, as the loans to the real sector enterprises are disbursed by the commercial financial institutions according to their lending procedures, credit risk remains with the latter. Long maturities of provided resources are also contributing to the high interest in GAF programs. Depending on the program, the loans may have a tenor of up to 12 years and a grace period of two years.

The majority of GAF programs are designed for financing SMEs. There are no loan size or company size limitations imposed by the programs but judging by the average sizes of the disbursed loans, and a considerable share is extended to the SME sector. Green finance is another critical area where GAF is pioneering credit lines and technical assistance. All GAF lending lines are accompanied by technical assistance programs to build capacities and raise awareness, mainly among financial institutions and different economic segments.

(ii) Green Finance has had a considerable uptake in the country during recent years and is extended in two main directions: energy efficiency and renewable energy. Renewable energy investments (mainly solar photovoltaic systems) have had significant uptake due to a favorable legislative and regulatory framework and affordable financing. The development of green finance is primarily driven by special programs initiated by IFIs and donor institutions. The facilities are

[90] Compared data from the EU Eastern Partnership (EaP) that includes, Armenia, Azerbaijan, Belarus, Georgia, the Republic of Moldova and Ukraine. This partnership is based on shared values, mutual interests, and commitments, bringing EaP countries closer to the European Union through economic integration and by developing stronger ties among the partner countries themselves. For more, see OECD (2020)

usually accompanied by technical assistance as well as financial incentive/grant components.

Private financial institutions do not usually issue green loans financed by internal funding (e.g., customer deposits). This is due to low awareness and capacities in green finance and the absence of incentive mechanisms. However, it is noteworthy that Ameriabank became one of the first banks in the region to place green bonds in EUR in the amount equivalent to USD 50 mln[91]. This is an important milestone for the financial sector of the country and the region.

(iii) Agricultural Financing. The government heavily subsidizes agricultural sector lending. Full subsidization of interests is in place for all sub-sectors of agriculture. The government does not provide debt or other types of funding to the FIs. Instead, they give loans to the agricultural sector from different funding sources and receive total interest income from those loans (interest rates are limited to 14%). Thus, the interest expenses of the farmers are entirely (at the moment) subsidized by the government. An overwhelming part of the lending to the agricultural sector is done via subsidization programs. There are currently nine active programs, and their main features are: (i) All program interests are subsidized. The farmer receives interest-free loans, (ii) both private individuals and legal entities are eligible for the programs and (iii) programs cover all sub-sectors of agriculture.

By 'agricultural loans,' many financial institutions mean loans targeted at financing primary agricultural production (cultivation of crops and husbandry of livestock) rather than processing agricultural produce. The loans for processing agricultural produce are instead referred to as "business loans" by most FIs. However, the separation is not always very straightforward, mainly when the same farmer has engaged in both activities. In addition, as most of the primary producers are subsistence farmers both in terms of size (on average around 1.4 hectares per household) and applied technologies, the "agricultural loans" are usually extended to these smaller farmer segments (micro and very small).

(iv) SME Equity Finance. Private equity is still underdeveloped in Armenia. There are only a few private equity funds with relatively small portfolios. This may be due to several reasons: scarce investment opportunities, lack financial transparency of SMEs, or limited exit opportunities. The full implementation of the pension reform will lead to the accumulation of funds and could allow for the development of this market. However, attractive, innovative finance initiatives are being tested in this area. There are a few venture capital funds (Granatus Ventures, HIVE Ventures, SmartGate VC), angel investment networks (*Business Angel Network of Armenia, Angel Investor Club of Armenia) a*nd private equity funds (*EU-Armenia SME Fund, Entrepreneur+ State Anti-Crisis Investments Fund, Riviera Capital CJSC.* [92] These initiatives could be scaled to match demand.

The way forward: addressing opportunities and barriers

The government is showing commitment to developing the MSME sector and improving the quality and coherence of the current policy system. The government plan establishes that SMEs should reach 55% of GDP over the next five years. Improving access to financing is the top measured proposed to address this ambitious target. In 2020 the government approved its 2020-2024 SME sector development strategy. The strategy provides a framework of policies aimed at SME sector development, the objectives and targets, expected outcomes, main focus areas, and priority actions. The following directions are prioritized in the strategy:(i) enhancement of access to finance of SMEs, (ii) capacity building and development of entrepreneurial culture among SMEs, (iii) ensuring access to markets for SMEs, ensuring favorable institutional and legal framework for SME sector development

The implementation of the following actions foreseen in the new SME Strategy is essential

[91] Ameriaa bank website

[92] See Box 4 in Annex 7.2 for more detailed information on these innovative finance instruments

for improving access to finance for SMEs. The following actions planned under the access to finance component are essential:

- Enable the legal and regulatory environment that would allow application of collaterals alternative to immovable property
- Facilitate access to finance for those SMEs that do not have collateral vie government programs (guarantees and similar)
- Develop alternative financial instruments and infrastructure, including business angels, venture funds, and similar
- Enhancement of financial literacy, financial transparency, and ethical business conduct
- Reforms in bankruptcy legislation

This new policy framework needs to be supported by additional institutional coordination to provide coherence. The strategy implementation will require significant policy innovations, strengthened roles and improved coordination. The current system and institutional infrastructure of government support to the SMEs is fragmented, inefficient, and small-scale. Several agencies have the mandate of providing support as well as facilitating access to finance to SMEs:

- ***Export Insurance Agency of Armenia CJSC (EIAA***). The EIAA was established in 2013. Its main objectives are to promote Armenian exports, provide affordable finance for SMEs, and develop the private market for commercial credit insurance. EIAA falls under the regulatory requirements of the CBA. EIAA's insurance contracts can be written in AMD, USD, EUR, or RUB currencies. The EIAA provides export insurance services and charge its clients premiums based on credit period (days), country risk classification, and foreign buyer creditworthiness.
- ***The Development and Investments Corporation of Armenia (DICA***) is a Universal Credit Organization closed joint-stock company established in 2009 by the CBA. DICA provides loans and leases to businesses and farmers in Armenia. The formerly SME Development National Center (SME-DNC) of Armenia Foundation (currently Enterprise Armenia) owns 50.9% of DICA shares. The Ministry of Finance owns the remaining 49.1%.
- ***Enterprise Armenia*** (former SME DNC) The Government of Armenia created the "Enterprise Armenia" (formerly, "SME Development National Center" Fund), which was established in 2002. The institution's mission is to support the country's SMEs with technical assistance and financial assistance. In addition, it has several cooperation agreements with different development partners. The institution used to offer a range of financing services, including loans with preferential rates and guarantee programs to MSMEs and start-ups with the primary purpose of facilitating access to finance of start-ups

The legal framework is an explicit binding constraint for developing a modern and effective system to finance MSMEs. Several efforts are needed to update and strengthen the legal framework that is hindering the sector's development. This affects the role of traditional MSME financing institutions and, more importantly, restricts additional private investments to develop innovative and agile finance systems that could accelerate the development of this sector. Legal framework reforms should attempt to address at least the following issues:

- **Microfinance Legislation.** The Law de facto regulates microfinance activities on Credit Organizations. Still, as it does not contain specific definitions of microfinance, it generates operational challenges for the different critical aspects of this highly specialized financial market segment. Linked to this, there are several longstanding pending reforms, like, for example, the need to introduce insolvency prevention measures (information tools and early-warning system) and complete reforms to the insolvency framework to strengthen creditor rights and promote corporate recovery.
- **Factoring**. Factoring platforms create a market for accounts receivable that expands access and improves efficiency. This could be an intelligent way to solve access to credit for various MSMEs

as the financing received is not based on the analysis of the borrower's credit data or its assets but the payment capacity of its client (a much more solvent actor than the MSME) and the performance history of business with the customer selling the payment documents. Factoring helps companies obtain better credit conditions than other sources, which is facilitated as companies develop a successful track record of compliance. In Armenia, factoring is limited as it is regulated by provisions in the Civil Code rather than through a specific law.

- **Leasing.** Similarly, leasing takes away the pressure on MSME collaterals for capital expenditure investments. This can be a helpful alternative for various MSMEs that may allow them to operate immediately and prove their business model without making risky, heavy initial CAPEX investments. However, leasing activities are underdeveloped in Armenia, as they are also regulated by provisions in the Civil Code rather than through a specific law.
- **Fintech.** These companies can address the obstacles that traditionally hamper access to credit for MSMEs: lack of credit history and quality accounting data (and informality); low financial or commercial capacity of clients; difficult access to markets (e-commerce, supply chain, market data, and prices) and lack of traditional collaterals. However, they can also harm, and specific "legislative sandboxes" are needed to foster their development and protect the rights of final users, especially those with low financial literacy.
- **Crowdfunding.** This mechanism is used for debt or equity investment, or pre-purchase offers for new product launches. Virtual platforms could accelerate this market and even promote diaspora financing support. Crowdfunding sites use P2P systems where financial sponsors provide funds and receive a repayment with predetermined installments and interest rates. Crowdfunded investments are paid with capital shares of the company with transparently defined terms. This can be a valuable source of start-up capital and long-term funding. Specific legislation is needed to establish a legal framework to encourage their development

Additional efforts are needed to systematically monitor and review the effectiveness of the current system. Insufficient information is available to assess the market orientation towards MSMEs of COs, their effective contribution to providing access, or the services' efficiency. Similarly, little is known about the performance and cost-effectiveness of the programs, incentives, and subsidies listed above. Positive steps have been taken to improve financial literacy, but no recent assessments were made to assess the impact on the population of the financial literacy programs. Efforts to monitor and review these instruments are well justified as significant investment is also made by the government in all these areas.

4.2.3 Public-Private Partnerships

Despite the lack of a specialized legislative framework, PPPs have already been used in Armenia on several occasions. PPPs are a method for a government to procure and implement public infrastructure projects using the resources and expertise of the private sector. Reports suggest that fifteen years after the collapse of the Soviet Union, Armenia was one of the leaders in the CIS in terms of the percentage of PPP projects to national income[93]. Despite the lack of PPP legislation in Armenia, several projects with PPP elements have been implemented in various sectors of the economy, such as the railway, airport, water, waste, energy, postal services sectors. In most cases, PPPs have been critical in the rehabilitation and maintenance of infrastructure. Most of the projects are concessions based on existing assets that ran specific investment programs under the BOT (ROT) model.

However, the legal and institutional blind spot generated several problems and allowed for low transparency decision-making practices. The government has initiated PPP projects, and concession agreements were granted to private companies. The selection process has been done via specific Government Decrees (regulating the selection process of the private partner, the

[93] PPP in Armenia, Leonid Polischuk, commissioned by the UNDP, 2008; Armenia: Public-Private Partnership Assessment and Opportunities, Adrian Torres, commissioned by the Asian Development Bank, 2014.

concession agreements terms) varying for each PPP project. Some project agreements have been concluded due to direct negotiations (as opposed to a competitive tender). In many cases where a tender was held, there was only one bidder. Responsibilities were split between multiple existing agencies, ministries and even municipalities. The lack of coordination and delineation of duties presented significant challenges[94]. In the absence of a dedicated unit to manage PPPs, historical projects were implemented on an ad hoc basis.

PPP Policy and Institutional Setup

The government started to organize the PPP legal framework very recently. Since independence, PPP practice implementation in Armenia has advanced further than the applicable legal system and the institutional framework. The government recently started a process of continuous development and improvement of the legal framework that includes the following main milestones:

- ***PPP Policy,*** adopted in 2017. The Policy Statement, among others, outlined the scope of its application and provided for a definition of partnerships that it will apply to. It also described the essential characteristics of PPPs, PPP contract types, stages of PPP project implementation, appraisal of projects, institutional arrangements, and contract monitoring, oversight reporting, and evaluation.
- ***The Law on Public-Private Partnership (PPP Law),*** adopted in 2019 by the National Assembly, came into force on January 1st, 2020. The PPP Law provides that the private partner selection procedures shall be governed by the Law of the Republic of Armenia on Procurement (Procurement Law). However, no amendments to the procurement legislation have been adopted. In addition, no secondary legislation has been adopted either.
- ***Amendments to the PPP Law,*** approved in 2021 introduced several changes, amongst them: (i) PPP award procedures were separated from the procurement law framework and embedded in the PPP law; (ii) introduced the possibility to accept PPP projects through unsolicited proposals (a private initiator with relevant experience shall have the right to submit to the public entities proposals aiming at the implementation of specific PPP projects).

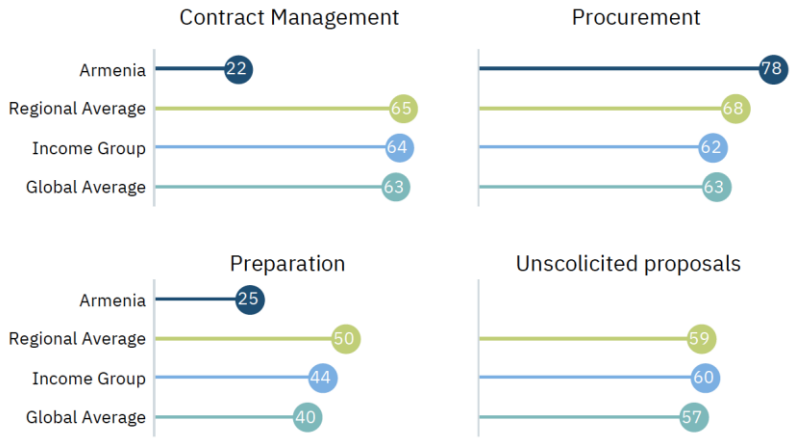
The new law provides a conventional two-stage procedure for selecting the private partner: pre-qualification stage and stage of submitting proposals by pre-qualified bidders. The selection at the pre-qualification stage shall be made based on the bidder's experience, technical capacity and experience and financial and economic capacity. The selection can be organized either through an open or closed tender (invitation to participate in the selection is directly submitted to a limited number of potential participants).

However, the law still requires the adoption of significant secondary legislation to complete its application. There is still room for improving this legal framework. The law sets a deadline of January 2022 for the government to develop and adopt such legislation. It should define sectors where PPP might be used, procedures and rules for implementation of PPP projects, the appointment of the PPP unit. Without considering these latest additions (unsolicited proposals and procurement), the benchmarking infrastructure development study conducted by the World Bank gives the scores to the PPP framework in Armenia shown in Figure 59.[95] In the absence of secondary legislation, the framework is incomplete and concerns low scores for the project preparation and contract management pillars. Most of the issues in the scope of the assessment are to be regulated by secondary legislation.

[94] Several ministries and government entities, as well as some municipalities were involved in PPPs (e.g. the Ministry of Transport, Communication and Information Technologies/MEDI/Ministry of Energy Infrastructures and Natural Resources/MoH/Water Committee/Yerevan Municipality, etc.).

[95] Benchmarking Infrastructure Development - World Bank Group

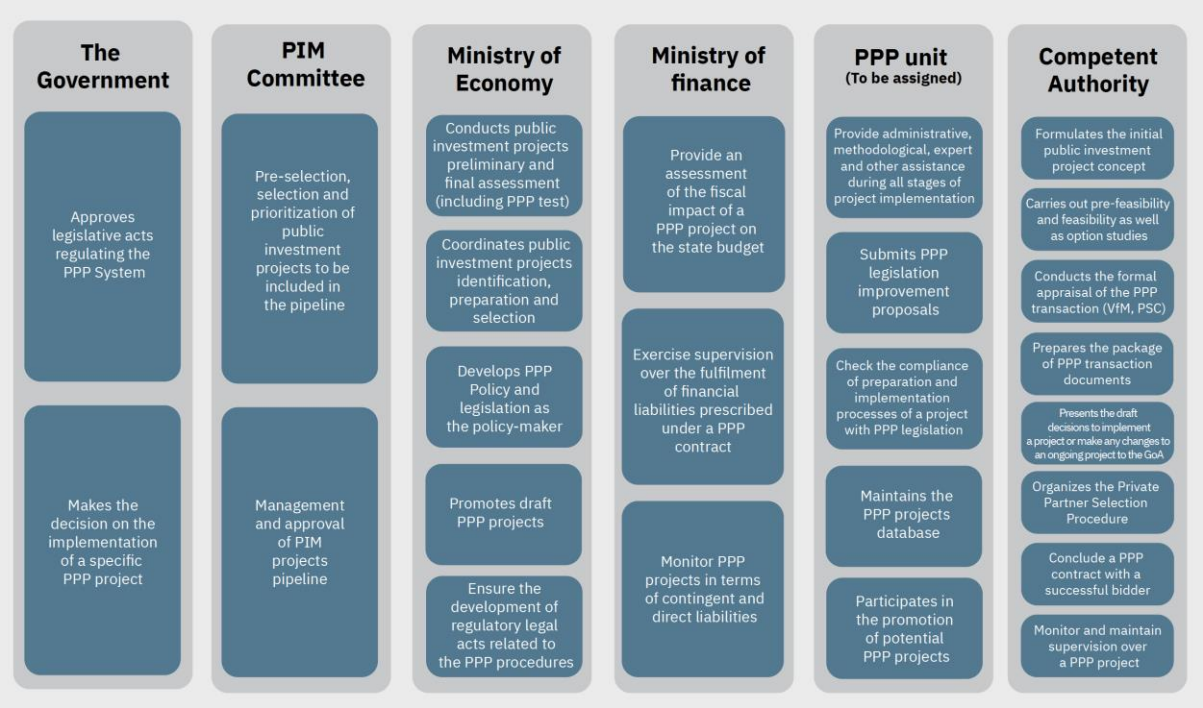
Figure 59 **Benchmarking Infrastructure Development 2020 scores**



Source: DFA Team calculations based on official data from the World Bank

The institutional set up under the new PPP legislation was also modified with the creation of a new PPP Unit. This Unit is responsible for assisting other public bodies in the preparation and implementation of PPP projects and for the oversight on the compliance with the regulations. A government decree will appoint the Unit.

Figure 60 **Current institutional set-up under the PPP legislation**[96]



Source: DFA Team based on official data

The PPP policy-making body is the Ministry of Economy, and sectoral authorities are responsible for developing and implementing PPP projects. The cabinet shall decide on the implementation of a PPP project. Based on the RA law on PPP and the PM decree on Public Investment Management, the institutional set-up should work is the one shown in Figure 60. According to the recent amendments to the PPP law, a PPP project shall be evaluated and selected to be implemented according to the identification, development, evaluation, and prioritization of the public investment programs. This procedure was approved in May 2021 as a

[96] Based on the RA law on PPP and PM decree on Public Investment management

first step in the reform for the improvement of Public Investment management.

Historical Trends and Main PPP Projects

There is limited data available on PPP investments over the years, and there are no comprehensive statistics on the number of current PPP deals. This is primarily because of the absence of PPP criteria until 2019 and the lack of institutional arrangements to manage PPP agreements. The information provided in Table 9 shows the ongoing projects in Armenia. Still, unfortunately, there is no reliable data to provide a historical account of the evolution of PPPs in the last decade. Four projects (Airport, Railway, Yerevan Water and Sanitation, Vorotan Hydropower) reached the operation stage, and the other two (Yerevan Thermal power plant and Masrik Solar power plant), construction is advancing. International private partners were attracted to participate in the delivery of the services.

Table 5 On-going PPP projects in Armenia

Project name	Sector	Financial closure year	Investment (USD mln)
Armenia Railway Concession	Railways	2008	$575
Yerevan gas-fired combined-cycle cogeneration power plant	Electricity	2019	$321
Zvartnots International Airport	Airports	2001	$294
Vorotan Hydropower Plant (450MW)	Electricity	2015	$250
Veolia Water and wastewater services affermage contract	Water and sewerage	2016	$200
Masrik-1 solar power plant	Electricity	2021	$50
Total			**$1691**

Source: DFA Team calculations based on official data from the PPP knowledge lab, and MTEF 2022-2024

In some cases, the concessions are partially subsidized by the government. Many projects are user funded where the private partner is reimbursed based on user tariffs regulated by the Public Services Regulatory Commission. For example, in the case of the railway concession, the private investor made all the necessary investments, and the public entity subsidizes losses for the passenger transport services. The concession agreement includes subsidizing the losses for non-profitable passenger transportation routes, which happens every year. However, according to the contract, the maximum amounts subject to payment are limited to the amount of the annual concession fee payable by the concessionaire. These two numbers have been roughly netted each year. Most of the projects in the list above went through renegotiations; the Yerevan waste management project was early terminated. The majority of capital-intensive projects have been financed by IFIs, due to insufficient availability of local bank financing.

The energy legislation provides opportunities for a gradual liberalization of the electricity market in Armenia. The deregulation of the electricity market requires the transition to a new model, which will improve the efficiency of the wholesale and retail electricity markets. At the same time, the promotion of interstate commerce will enable to have new elements of competition in the domestic market. This process has already commenced, and activities aimed at the development of bylaws are currently underway. Currently, the legislation prescribes licenses for electricity generation at wind power plants with a capacity exceeding 30 MW and solar power plants with a capacity exceeding 5 MW are issued under the PPP framework.

As for PPP agreements, the policy is to conclude such contracts exclusively for utility-scale generation units on a competitive basis. Their access to the electricity market cannot be granted without additional guarantees from the state[97]. Three of the PPP projects listed above are energy-producing companies. Their structuring differs from the rest since they concluded the Power Purchase Agreement with Electric Networks of Armenia, a private company. However, to

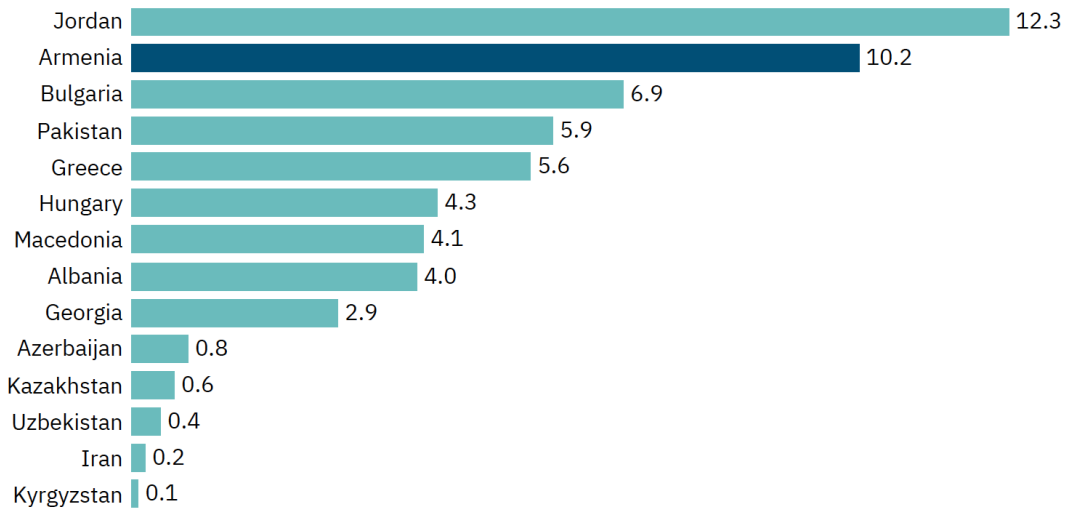
[97] http://mtad.am/u_files/file/energy/Energy%20Strategy_%20Jan%2014%202021_English.pdf

make the deal possible, the agreement with the government ensures coverage for the demand, foreign exchange, political and force majeure risks.

The PPP law sets a ceiling on the annual flow of direct and total stock of contingent liabilities stemming from PPP contracts. The limit shall be established by the government decree. Currently, there is a limit on contingent liabilities for PPP agreements concluded after the Law entered into force at 3% of GDP. For the direct liabilities annual ceiling, it is expected to be approved until January 2022. The Ministry of Finance is responsible for assessing and monitoring PPP contracts regarding contingent and direct liabilities. The ceiling at 3% of GDP amounting to 206 bln AMD[98] means that the government is limited in taking significant contingent liabilities through implementing large-scale projects in the coming years.

Historical PPP projects concluded before the PPP law entered into force bear a significant amount of potential liabilities. According to the IMF's Fiscal Transparency Evaluation[99], the size of the investment commitments under PPP projects (not including PPAs) was 10.2% of GDP in 2016, which ranks Armenia highly compared to regional peers. This current capital stock of PPPs poses significant fiscal risks to the government, and there is pressure for new PPPs to be planned.

Figure 61 PPP capital stock in different countries, 2014 (Percent of GDP)



Source: DFA Team calculations based on official data from the IMF FTE Armenia (Data for Armenia 2016)

The Ministry of Finance is working to improve further the fiscal risk management of PPPs, which was already an emerging problem before the arrival of the 2020 crisis. The MTEF 2022-2024 included a section dedicated to the fiscal risks from PPPs. The analysis comprises the contracts of three companies operating under PPP and the three major Power Purchase Agreements. The assessment categorized these risks to medium or low before the onset of the 2020 crisis. However, the degree of risk significantly increased for all PPP contracts since then, as the crisis impacted the companies' cash flows one way or another. This, in turn, increases the risks of renegotiation (due to the force majeure and economic equilibrium clauses in those contracts) or early termination (or early repurchase in PPAs) of contracts. Furthermore, in the case of projects still under construction ("Armpower" CJSC and "FRV Masrik" CJSC), the economic crisis has caused significant delays, which also increased the risk of causing considerable cost overruns.

Public Investment Management

A recent Public Investment Management Assessment (PIMA) shows that Armenia's

[98] MoF projected GDP for the 2021 at 6,880.2 bln dram

[99] IMF Country Report No. 19/134, May 2019

institutions score at the same level as the average of emerging market economies. Armenia performs better than other emerging market economies in fiscal rules, budget comprehensiveness and availability of funding. However, a notable feature is the underperformance of key institutions that span across the project cycle. The lowest scores were in the field of project appraisal, budgeting for investment, and project selection[100]. This assessment triggered reforms to enable the development of public investment projects pipeline. Announcing a pipeline of PPP projects to be marketed to private investors shall become a good start for providing the most competitive selection process based on effective market sounding.

Armenia's public capital stock is on a declining path. The public capital stock declined from 160 % of GDP in 2000 to 62 % of GDP in 2017[100]. Moreover, public investment has remained low at approximately half of that invested by regional peers since 2012. This can be explained—to some extent—by faster growth of recurrent spending at the expense of capital expenditure. As a result, Armenia ranks the mid-range of comparator countries in terms of the public capital stock. However, the same assessment also notes significant gaps in the efficiency of public investments in the energy and roads sectors (physical outputs and quality). In addition, procedural shortcomings were reported in several specific PIM areas, including:[101]

- ***At the planning stage*** with national and sectoral strategies not guiding public investment decisions.
- ***At the allocation stage***, as the MoF has no power to reprioritize projects that overspend (which undermines the reliability of the MTEF), budget allocations for capital projects are not credible because appropriations are not binding, there is no centralized project pipeline for significant projects, and projects are selected based on the availability of financing rather than project viability.
- ***At the implementation stage***, the e-procurement system is not integrated with the government financial management information system (GFMIS), and project implementation plans can be modified significantly throughout a year (thus limiting the government's ability to control project implementation);
- ***Cross-cutting Issues*** as the MoF covers only domestically financed projects and has limited resources for scrutinizing and controlling major, externally funded projects.

Other assessments address the shortcoming of established rules and procedures for budgeting and managing capital investment projects[102]. According to the observations, foreign development partners primarily finance public investments according to funding agreements, and the line ministry conducts the initial discussions with them to fund specific investment projects. During the implementation of investment projects, information available about the relevant project was concentrated within line ministries. The assessment voices that because of this budgeting approach, there might be a risk that targeted availability of funding will prevail over the government's investment priorities while selecting investment projects.

The government has initiated a PIM improvement process, aiming to allocate public investment funds and effectively increase public investment efficiency. The Ministry of Economy has launched a pilot process for identifying and preparing public investment projects with the support of the World Bank and the participation of the line ministries. On-site workshops and online meetings were held during the first half of 2020, and now the MoE has about 20 draft project concept notes that are going through pre-assessment. Furthermore, the prime minister's decree establishing the procedures for identifying, developing, evaluating and prioritizing public

100 IMF (2019) Public Investment Management Assessment

101 Ibid

102 Baseline Measurement Report: The Principles of Public Administration Armenia, March 2019

investment projects was approved in 2021[103]. The MoE is engaging the World Bank, Asian Development Bank and Agence Française de Développement (AFD) to make this reform fully operational by providing technical assistance. A pipeline of projects will be publicly available to external and internal potential investors. Also, it is planned to create a publicly available database of PPP projects to ensure transparency and accountability of information on PPP projects.

The Way Forward: Policies to Improve PPP Usage

The government will have to make strategic financing decisions about the use of PPPs. There is no doubt that PPPs will be necessary to finance the infrastructure needs that Armenia will require in the medium and long term. However, the level of public Indebtedness suggests that the state's capacity to finance public works with debt will be very limited. Therefore, private investment will be required for its financing. On the other side, there is a ceiling on the level of risk the government may take by entering PPP agreements, and current exposure is already considerable.

It is essential that the decision-making on what type, location and scale of PPPs will be based on strategic planning that responds to national development priorities. Currently, in Armenia, the public investment plan is under development and is not published yet. According to the reform, the prime minister will establish the Investment committee to prioritize projects, align them with more urgent needs, and support the high-level decision-making process.

PPPs can improve the provision of public infrastructure, but national and international experience shows that their performance is not guaranteed. The main attraction of PPPs consists of generating financing flows from the private sector towards infrastructure works of public interest, thus allowing their funding and the use of the private sector's knowledge, technology, and experience in the different stages of the projects. However, to achieve the maximization of the benefits of PPPs, the government must be able to manage several factors, among which are: (i) considering limited fiscal space selection of the projects that match strategic priorities, (ii) the selection of the most efficient bidder in the bidding of the projects, (iii) conclude agreements with efficient risk distribution (iv) establish efficient management and monitoring mechanisms.[104]

The institutional framework could be further strengthened to stimulate the use of PPPs by providing greater certainty for all the parties. Some adjustments are necessary to ensure that the government has the required capacity in critical areas of managing PPPs. Sufficient resources should be invested to strengthen the capacity and develop the highly specialized expertise of the PPP unit in areas like appraisal methodologies, fiscal risk management and reporting related to PPPs. This will support government decisions, allowing timely and adequate decisions on the level of risk, the form and structure of state support and risk management arrangements for each PPP project. The capacity of the implementing bodies should also have sufficient technical background to ensure that good practices are applied in all phases of the project (study, tender, project management).

There is still a need to continue improving transparency and accountability for these operations. The clarity on the ongoing PPPs is low because the existing contracts were concluded without any regulation. The Law on PPPs sets one of its objectives "improving the information database on public infrastructures and public services covered by PPP projects". It envisages a PPP database to be publicly available.

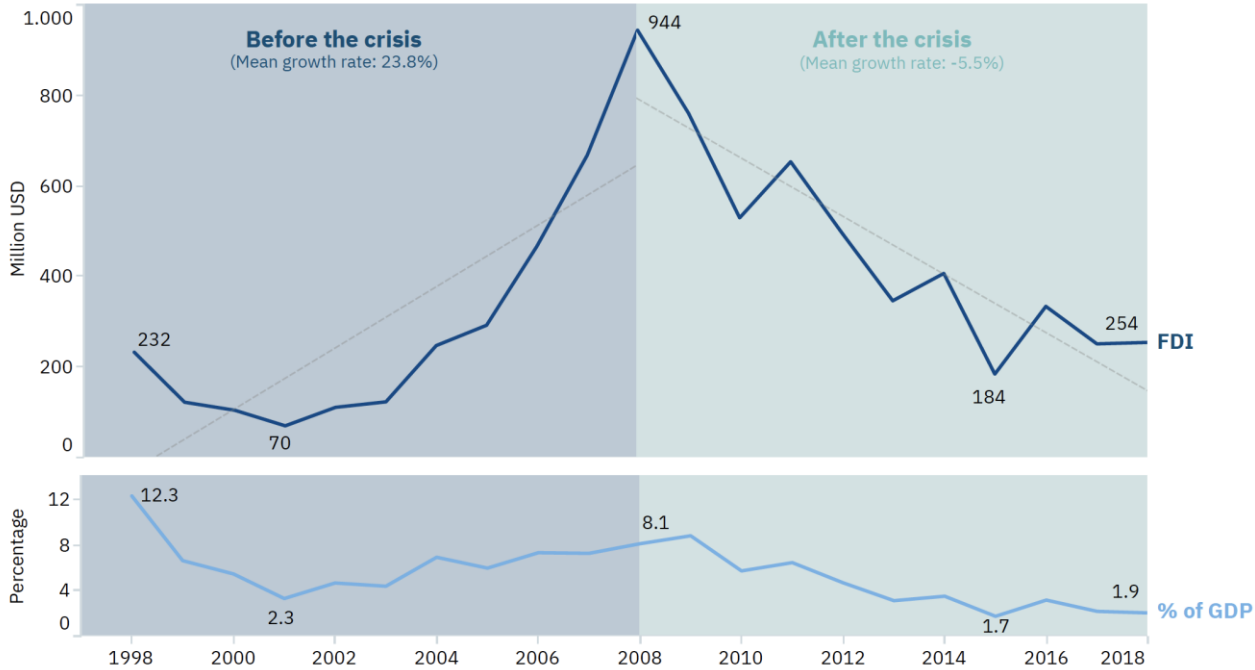
[103] PM Decree "On approval of procedure for identification, development, evaluation and prioritization of public investment projects in the Republic of Armenia, methodology for evaluation and project concept note of public investment projects" May 2021

[104] Stratta, N (2017)

4.2.4 Foreign Direct Investment

For almost twenty years after its independence, Armenia attracted a steady foreign direct investment outperforming many neighboring countries. Long-term trends summarized in Figure 62 show that during 1991-2008 FDI was experiencing an accumulated annual growth rate of 23.8%. This growth was even faster right before the 2008 global crisis. From 1998 to 2008, the average FDI growth rate was 52.7%, quite a remarkable performance, especially for a landlocked country with political barriers to trade with neighbors. These constraints were compensated by the country's bold decision to implement a significant number of pro-market reforms and for offering an attractive efficiency profile characterized by a well-educated workforce, strong skills, and competitive salary levels.

Figure 62 FDI Evolution (mln USD and as a % of GDP)



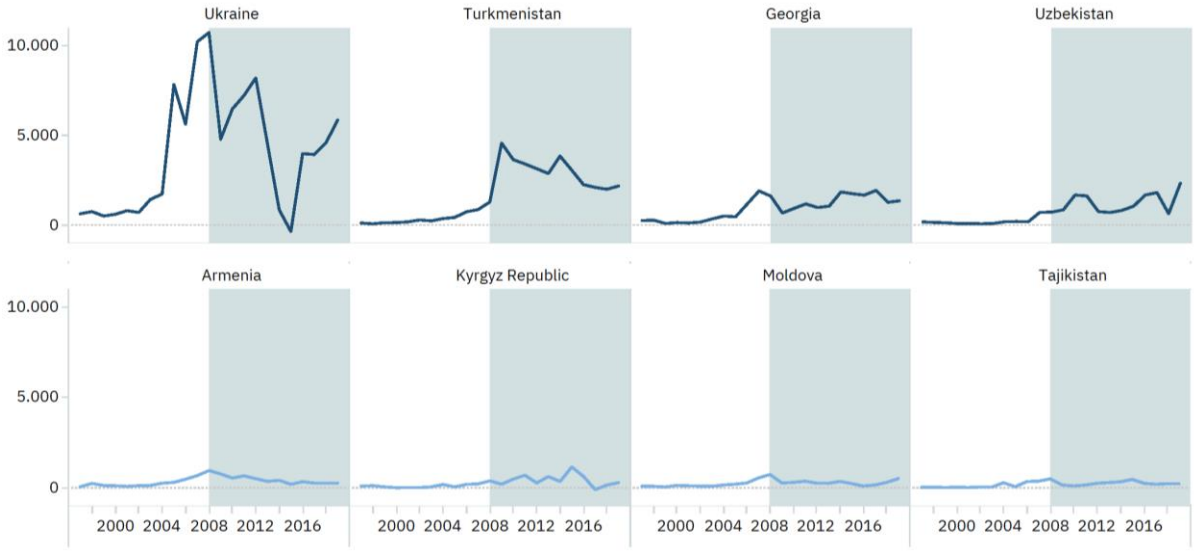
Source: DFA Team calculations based on official data from the World Bank Open Data.

However, since the global crisis of 2008, Armenia reached a turning point of never fully recovered. Figure 80 also shows that FDI inflows have been on a declining trend since 2008, and annual investment dropped from USD 944 in 2008 to a mere USD 254 in 2008, showing a negative trend of 5.5% during that decade. If measured as a percentage of GDP, FDI participation dropped from 8.1% in 2008 to 1.9% in 2019. This remarkably negative trend was generated way before the arrival of the COVID crisis. It was probably aggravated hostilities in and around Nagorno Karabakh between September and November 2020.

This is not what happened to other peer countries in the region. Figure 81 shows that several countries in the region managed to bounce back from the 2008 crisis. The most remarkable case was Ukraine, which was on a fast track to recovery until the armed conflict with the Russian Federation over Crimea in 2014. In addition, many countries like Turkmenistan, Georgia, and Uzbekistan managed to recover their FDI volumes before the crisis fully, and some of them even increased the 2008s values. However, only the Kyrgyz Republic, Moldova, and Tajikistan experienced a similar market response like the one of Armenia, where FDI inflows never fully recovered from the crisis

What happened during the post-2008 crisis unveiled that significant issues were at play that the country must address. In the case of Armenia, several factors may have concurred with this situation, but inescapably the business climate factors reviewed in 4.2 are a significant part of this explanation.

Figure 63 **Armenia's comparative reaction in the region**



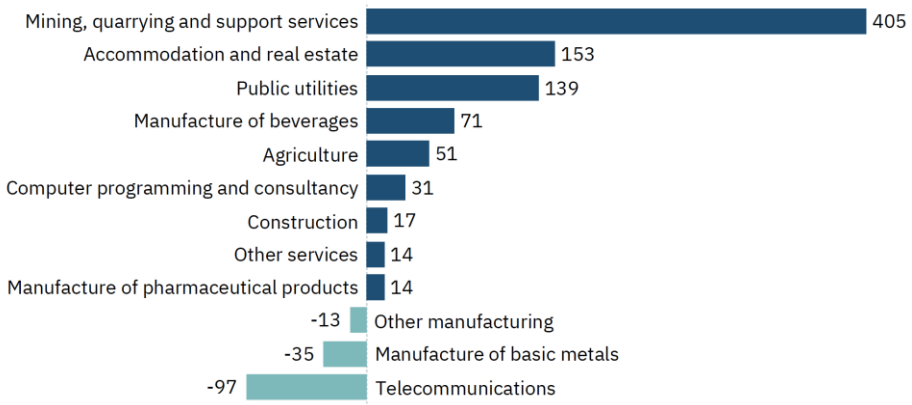
Source: DFA Team calculations based on official data from the World Bank Open Data.

Figure 64 **Armenia's competitive FDI position in the region in 2019**

Source: DFA Team calculations based on official data from the United Nations Conference on Trade and Development.

Current competitive benchmarks show that the country has significant room for improvement in the competitive FDI market. The data in Figure 64 shows different ways of comparing Armenia's competitive position in the region. Armenia is attracting the lowest volume of nominal investment and is one of the lowest-performing countries in the region by its share of GDP. There is room for improvement; if measured per capita, Armenia's FDI is much lower than many comparative countries, like Georgia, Turkmenistan, Kazakhstan, or Belarus.

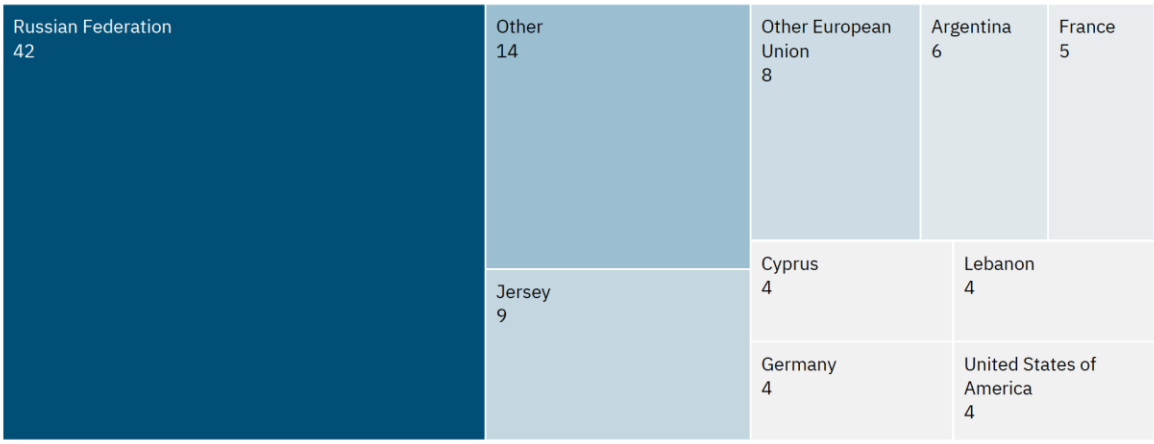
Figure 65 **Cumulative FDI inflows to Armenia by type of activity, 2014–2017 (USD mln)**



Source: DFA Team calculations based on official data from UNCTAD (2019).

This expansion will have to be based on a substantial diversification of the investment base. Accumulated figures from 2000-2017 shown in Figure 65 indicate that the vast majority of FDI (78%) inflows were concentrated in three categories: mining and quarrying, accommodation and real estate, and public utilities. Some areas, which show promising perspectives, like agriculture, computer programming and consultancy, services, and manufacturing, were minor components (12%) of the investment mix. The country can aim to significantly expand FDI in areas like computer programming and consultancy, manufacture, and agriculture.

Figure 66 Armenia's FDI stock by country of origin, 2017 (Percentage)



Source: DFA Team calculations based on official data from UNCTAD (2019).

The origin of FDI inflows has increasingly diversified but is still heavily dependent on the diaspora. The distribution of FDI inflows by country of origin summarized in Figure 66 shows that except for Jersey, all these origin countries coincide with the main population centers of the Armenian diaspora. This group of investors represents an opportunity for further investor targeting. However, the dependence of diaspora investors could also signal the need to broaden the outreach and find beyond those already familiar with the country.

- ***The Russian Federation*** is the largest source, accounting for over 40% of the total inflows, but this participation reduced from almost 60% in 2008. Traditionally concentrated in energy, mining, transport, banking, and trade. Recently oriented to gas and telecommunications.
- ***EU countries*** account for around 20% of total FDI, and this participation remained stable since 2008. The largest share of EU investment comes from France (beverages, water supply and sewerage management) and Germany (mining and basic metals manufacture).
- ***Other notable investor countries*** include Jersey, the country of origin of Lydian International Argentina (airports and wine), the United States (IT and electricity) and Lebanon (telecommunications, food, garbage collection and disposal).

Policy and Legal Framework

After its independence in 1991, Armenia adopted forward-looking, pro-market reforms that generated great initial responses from foreign investors. Armenia's initial reforms to improve its investment climate put the country at the lead in the region. Some of these reforms are generic but had a profound impact on the investment climate. For example, the country's constitution protects all forms of property. The privatization of land started in the early 90s, and currently, approximately 70% of the land is private. Although a non-resident private individual cannot own agricultural land, local companies with foreign investments can acquire and own land. Non-agricultural land can be rented for up to 99 years, while agricultural land can be rented for 25 years. The country does not have any restrictions on the transfer of capital or exchange rate.

The Law on Foreign Investments **adopted in 1994 set out the core principles and provisions governing FDI.** The law defines the conditions under which FDI is permitted and allows FDI to happen

in a comprehensive range of economic activities, limiting only investments to activities prohibited by the legislation of Armenia or that contradict national security requirements. The law also establishes a national treatment regime for all foreign investors (on par with local investors), protects against nationalization, guarantees compensation for damages caused by the State, and freedom to repatriate profits. Moreover, it grants foreign investors protection from unfavorable regulatory changes, including five years after their investment.

Over the last decades, the country consolidated an open regime attractive for FDI through various additional reforms. In addition to the Law on Foreign Investments, the passing of the Law on Privatization of 1997 was also an important landmark towards promoting private investments in priority sectors. Further legislative and regulatory reforms include the Law of Free Economic Zones and the Law on e-government. *The Law on Free Economic Zones (FEZs*) was adopted in 2011 to attract foreign investment into the FEZs through various incentives. The law defines the procedure of becoming a FEZ organizer and an operator, the role of the government, and the benefits granted to the operators, which include:

- ***VAT Exemptions***. FEZ organizers and operators are exempted from VAT when delivering services and supplying goods in FEZ territory
- **Profit and Income Tax.** Legal entities are exempted from profit tax and individual entrepreneurs from income tax when being a resident and performing activities in FEZ
- **Property Tax.** Public and industrial buildings and structures that belong to or are used by FEZ residents in FEZ territory are exempt from property taxes.
- **Free Circulation.** Goods released through the "Import to Free Economic Zone" regime as well as other goods produced in the territory of the FEZ can be exported to foreign countries through "export for free circulation" or "re-exportation" regimes without applying customs charges and non-tariff regulation measures

The Law on Licensing was approved in 2001 and last revised in 2017, establishing the type of activities for which licensing is mandatory and import/export of specific categories of goods per EAEU regulations. Currently, this list mainly includes activities directly involving safety or other high areas of risk[105] . For several activities in agriculture and trade, licensing was replaced by self-declarations by the business. This helps to avoid wasting time. In addition, it is possible to make the self-declaration electronically.

The Law on Protection of Economic Competition was approved in 2000 and revised in 2021 to meet the requirements of the new constitution, international standards, and the specific needs of EAEU and the CEPA. The State Commission for the Protection of Economic Competition (SCPEC) is the regulator in abuse of dominance/monopoly, anti-competitive agreements, concentrations (mergers & acquisitions), unfair competition, and since 2021 also state aid. All private concentrations are subject to ex-ante control by the SCPEC. In addition, the commission can prohibit uncompetitive transactions or impose specific remedies. The reforms from 2021 introduced more regulations and significantly broadened SCPEC's investigative powers.

E-Governance. The system is quite advanced and has proven to be an essential competitive element in other countries. The functionality on the e-gov.am platform offers several e-services, including filing tax reports and social security contributions, pensions, participating in public procurement tenders, cadaster, register, filing for submitting intellectual property related applications, visas, performing payments for all state duties, state and municipal service fees, fines and public auctions. The system can be further expanded to provide access to SMEs to government procurement, accelerate the digitization of trade and cover digital education.

Efforts were also made to align the national regulatory framework with good practices and international standards. Armenia is a party to the ICSID Convention and the Convention on the

[105] Licensing is mandatory for specigic activities related to explosives and weapons, pharmaceuticals and medical care, FX trade, financial institutions, energy sector, education, communications, nuclear energy, hazardous waste, gambling, public transport and construction

Recognition and Enforcement of Foreign Arbitral Awards. Although all disputes that arise with a foreign investor must be settled in Armenian courts, Armenia's law on arbitration -based on UNCITRAL model- introduced mediation. Armenia is a party to several bilateral investment protection treaties, providing international arbitration. In 2019 Armenia was included in the OECD FDI Regulatory Restrictiveness Index[106] which assesses the level of the country's restrictions within the framework of the country's FDI regulations and was ranked among the top 10 freest economies across 70 countries, including all OECD and G20 countries.

The country experimented with different institutional setups and promotion initiatives that did not produce the desired results. Since the global crisis in 2008, FDI results have been negative. Armenia has been one of the poorest performing countries in the region despite the legal and regulatory reforms implemented. Not even the new law of FEZs could change the clear downturn trend. Probably, other factors may be originating this problem, such as the country's proactiveness and budgets invested in promotion activities. The government has been streamlining government-wide institutional reforms to address this issue. Currently, the Ministry of Economy is the focal point of investor relationship coordination. Two government agencies were established to attract investors:

- ***Armenian National Interest Fund (ANIF).*** A state-owned foreign direct investment enterprise created with the primary objective of attracting investors and co-invest (equity) in private companies in strategic industries. As analyzed in the previous section, ANIF is investing USD 100m in the Entrepreneur+ State Anti-Crisis Investments Fund
- ***Enterprise Armenia*** is the new national investment promotion authority. It replaces the abolished Business Armenia.[107] The mission of the new IPA is to promote and facilitate foreign and domestic investments, attract new foreign direct investments, support and provide financing to SME

The way forward: addressing opportunities and barriers

Although Armenia's initial FDI regime was very advanced for its time, it now needs further modernization and significant updates. Since adopting the law on foreign investments, no by-laws have been passed. However, some concerns remain regarding the clarity of key provisions and the alignment of the law with modern practice. For instance, fundamental concepts of investment legislation require refining and additional clarity, including the definitions of investment and investor, the conditions for the transfer of funds, and currency convertibility. A comprehensive list of recommendations was provided by the latest UNCTAD IPR report summarized in Box 2.

To generate large inflows of FDI, the government should develop a long-term strategy to set goals for the next two decades and ensure consistent interventions. The country has significant opportunities in this field. The government can generate the conditions for attracting FDI and significantly improve its relative position in the region. A key element for this is the definition of an ambitious, long-term, comprehensive strategy to address the main obstacles that require consistent reforms in various areas over a long period. The strategy should also plan critical and coherent interventions that may need over a decade to consolidate. The following areas should be at the core of this strategy:

- ***Labor costs and productivity.*** Labor costs are regionally favorable, especially for skilled workers. However, the country does not rank well when pay and productivity are combined. There are also disconnects between the skill supply and market demand. Improvements are needed to the curricula and the quality of TVET institutions

[106] https://www.oecd.org/investment/fdiindex.htm

[107] This is not the first reorganization. Business Armenia itself was formed by the merger, in 2014, of the Industrial Development Fund, the National Competitiveness Framework and the National Tourism Agency under the original name of the Development Foundation of Armenia

Box 2

An agenda to modernize the legal and regulatory framework for FDI in Armenia

The United Nations Conference on Trade and Development (UNCTAD) serves as the focal point within the United Nations Secretariat for all matters related to foreign direct investment (FDI). Its work is carried out through intergovernmental deliberations, research and analysis, technical assistance activities, seminars, workshops, and conferences. The latest Investment Policy Review report from 2019 recommended that the Government of Armenia adopts a new draft Law on Foreign Investments with the following revisions:[108]:

- ***Clarify key FDI-related provisions*** in such areas as entry restrictions, standards of treatment, expropriation, transfer of funds, dispute settlement and access to incentives.
- ***Reflect on the mandate of investment promotion authorities***. The key mandates and roles of investment promotion institutions should be included in the revised Law.
- ***Revise and harmonize the definition of investment and investors***. All laws and regulations on investment should contain coherent definitions on what constitutes "foreign investor" and "foreign investment".
- ***Limit potentially excessive investor guarantees***. This includes removing the reference to Fair and Equitable Treatment (FET), Most-Favored Nation (MFN), full protection and security and minimum standards, but also reconsidering the need for an open-ended stability clause, as well as the entitlement to compensation in case of improper performance by the public administration.
- ***Include refinements to the guarantees*** in case of indirect expropriation. Increased predictability could be achieved by clarifying what indirect expropriation entails without unduly compromising the ability of the State to regulate.
- ***Introduce a provision indicating that foreign investors shall not be accorded privileges beyond those afforded to Armenian investors in similar circumstances***. There is no reason foreign investors should be offered tax and other concessions not available to Armenian investors. This would only encourage local investors to register companies abroad and invest in Armenia as foreign investors (so-called "round-tripping investment").
- ***Reduce the country's exposure to Investor-State Dispute Settlement (ISDS)***. Given the recent surge of ICSID arbitration cases, Armenia should strengthen dispute prevention policies, including promoting consultation, investor-State dialogue, and prioritizing ADR and domestic solutions.

- ***Infrastructure.*** Developing an advanced road and transport infrastructure demands coordinated government actions over several administrations and prioritizing the recommendations to develop PPPs suggested in section 4.3.5. Armenia could aim to position itself as a hub in large-scale ongoing regional logistic projects. providing high value-added services for which the high-tech profile of the country is an advantage[109]
- ***Policy and Legal Framework.*** The reforms that are needed should be executed in the short term. However, competition on FDI attraction in the region is tough and demands proactive and effective efforts from the government, as trade and competition dynamics vary considerably.
- ***Tax Incentives.*** It is necessary to review the current system of incentives and assess the cost-effectiveness of the instruments used. It seems that many of them, for example, the Law on Free Economic Zones, may not have accomplished the expected results, generating unnecessary tax expenditures. This fiscal space is essential as tax incentives could be used for attracting other investments (green-tech and other innovative areas) that the country consider of high priority.

[108] Reproduced from UNCTAD (2019)

[109] These large international transport projects are aimed to transforming the South Caucasus into a hub on the China-Europe trade route. The most notable projects are the Baku-Tbilisi-Kars railway and the construction of a new Baku International Sea Trade Port (Alat), which aims to become the biggest multi-purpose port in the Caspian Sea. Armenia is also promoting the development of the Persian Gulf – Black Sea multimodal transport corridor, connecting the Islamic Republic of Iran with Europe via Armenia and Georgia, in the One-Belt-One-Road initiative (OBOR). For more on this see UNCTAD (2019)

- ***Seeding New Areas.*** Armenia can pretend to expand as a hub for the export of services to the whole region. Several new alternatives are condensed in Box 5[110]. The long-term development of these markets may require the same type of bold actions as the one already made by the government to create the Entrepreneur+ fund managed by ANIF. For example, by attracting some big-name universities to establish in the country

Armenia can aspire to improve FDI significantly in the short-term by implementing focused and targeted promotion and incentive measures. Significant results can be achieved in the short term with the right strategy and a well-targeted use of the available resources. Despite all the known constraints, the country can still aspire to improve FDI flow in the short term significantly. Many of the identified opportunities in Box 5. However are not likely to happen by implementing generic promotion and incentive measures. To use the available resources wisely, directed to the following areas:

- ***Tap existing market potential.*** There is significant room for improving the utilization of the many favorable trade opportunities opened by the country's multilateral and bilateral trade agreements in vigor. This is especially valid for Armenia's most attractive immediate trading destinations: The Russian Federation, the EAEU, and the European Union.
- ***Focus on the diaspora.*** The diaspora is Armenia's critical competitive edge. The size and economic power of Armenia's diaspora are only comparable to Israel. Therefore, Diaspora-originated FDI should continue to be pursued as a significant resource by short-term FDI promotion. The diaspora could also be a resource to fill advanced management skills gaps.
- ***Markets of low transport impact.*** Distance, costs and time to reach markets may not be a barrier to investment in several promising sectors. The country's connectivity to the Russian Federation and the Islamic Republic of Iran is sufficiently good to justify a significant expansion in some sectors. Moreover, Armenia is closer to the European market than many competing host countries for investment in specific sectors like agribusiness and textiles and garments[111]. A well-targeted promotion could make investments prosper even without addressing the significant barriers.
- ***Exporting services.*** Armenia can continue to seek investments to expand global markets for its services exports, especially high value-added tech services such as ICT, systems engineering, and contracted R&D. There are also significant, innovative internal impact and blended funding mechanisms (analyzed in the previous section) that support these foreign investments locally.

The prospects are promising. The government still has a long way to go, but the country has already reached significant milestones and can realistically aspire to consolidate its position as one of the most attractive countries for FDI in the region.

4.2.5 Diaspora Economy and Personal Remittances

Through the centuries, the migration of the Armenians was spread across the world, establishing communities in several countries. The modern Armenian diaspora was generated by the genocide of Armenians during World War I and the events that followed the collapse of the Soviet Union. Official statistics show that just from 1992 to 1994, a total of 760 to 780 thousand Armenians left the country. However, other estimates calculate this mass migration to be in the range of 980 to 990 thousand[112]. The Higher Commissioner for Diaspora Affairs estimates that over 7 mln Armenians live in more than 100 countries worldwide.[113] ` The Armenian diaspora has established communities in the Middle East, the CIS, and Western Europe (mainly France and

[110] This content is available in the Annex 7.3

[111] Another UNCTAD report shows that Armenian garment producers are only seven days away door-to-door from European customers compared with Asian competitors. From Bangladesh (the world's largest garment exporter), it requires 27 days to ship a twenty-foot container to Rotterdam (UNCTAD, 2013)

[112] Makaryan (2013)

[113] [113] http://diaspora.gov.am/en/diasporas

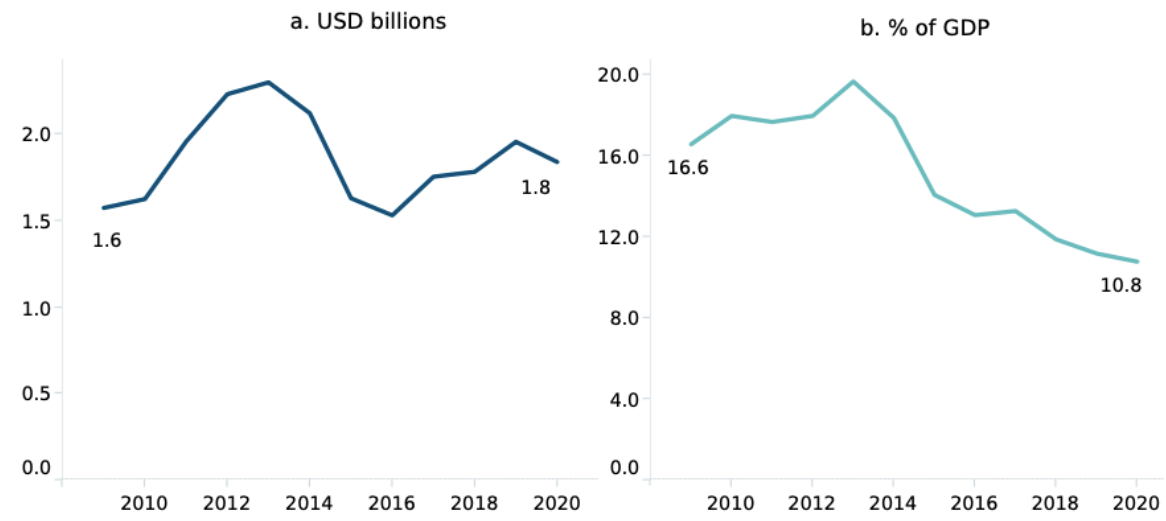
Greece). However, the bulk of the Diaspora Armenians reside in Russia and the United States[114].

The Armenian diaspora is an asset for the country of substantial potential strategic importance that could be further utilized. Global diaspora resources represent a significant source of strategic priority for Armenia. The economic success of the Armenian diaspora abroad could be a possible competitive edge that the government could aim to use more systematically. The diaspora can be a vehicle to access talent and business connections in every field in the most attractive market economies in the world. The UNCTAD FDI assessment pointed out that "*probably only Israel matches Armenia in the ability of a small country to find such talent, wealth and business connections among its diaspora.*"

Lack of quality data and systematic analytics is a binding constraint to adequate management of this flow. Knowledge produced in this field is mainly confined to academic circles or by one-time inputs driven by donor support[115]. Some empirical data is published by the surveys carried out by the National Statistical Service (NSS). However, the lack of unified technical criteria to guide data production and research conspires against its valuable to guide systematic government policies and interventions[116]. Therefore, the evidence presented in this section is a compilation of different approximations and estimates made by academic scholars and a few available studies carried out with the support of various development partners.

Steady inflows of personal remittances and diaspora donations helped the country navigate through the most critical periods of the transition process. Personal remittances have been an essential component of the Armenian economy during the last two decades. Data from Figure 67 shows that personal remittance inflows ranged from 10 to 20% of GDP during this period. This situation is no different from other countries in the region; Figure 68 shows that this is the case for many other countries that also belonged to the former USSR, mainly smaller and less developed market economies.

Figure 67 Inflows-of personal remittances (USD bln and as a % of GDP)



Source: DFA Team calculations based on official data from the Central Bank of Armenia Statistics

Regional comparisons show that Armenia is more dependent on remittances than other former USSR countries. Data in Figure 86 shows this flow's comparative relevance, measured as a percentage of GDP. Armenia is only surpassed by Moldova, Tajikistan, and the Kyrgyz

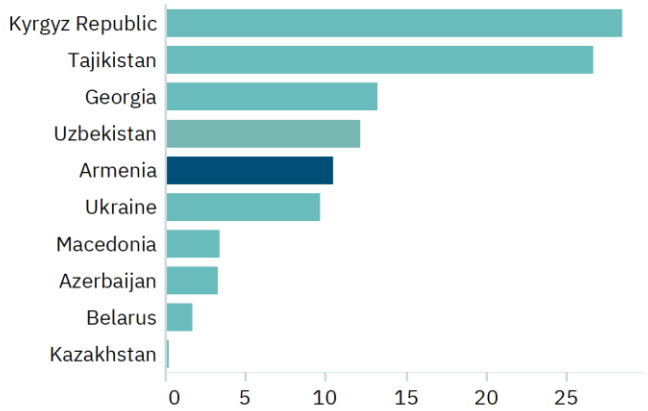
[114] Ibid

[115] Sources used include Data from the ILCS carried out by the National Statistical Service (NSS), and several individual academic or research studies carried out supported by the IOM, ILO, UNDP, the WB, and the EC.

[116] For example, the number of migrants registered by the ILCS refers only to migrants still belonging to local households and who left the country or returned since 2013. This leads to significant underestimations of the number of international migrants reported in this survey, which scholars try to compensate with benchmark-based estimates

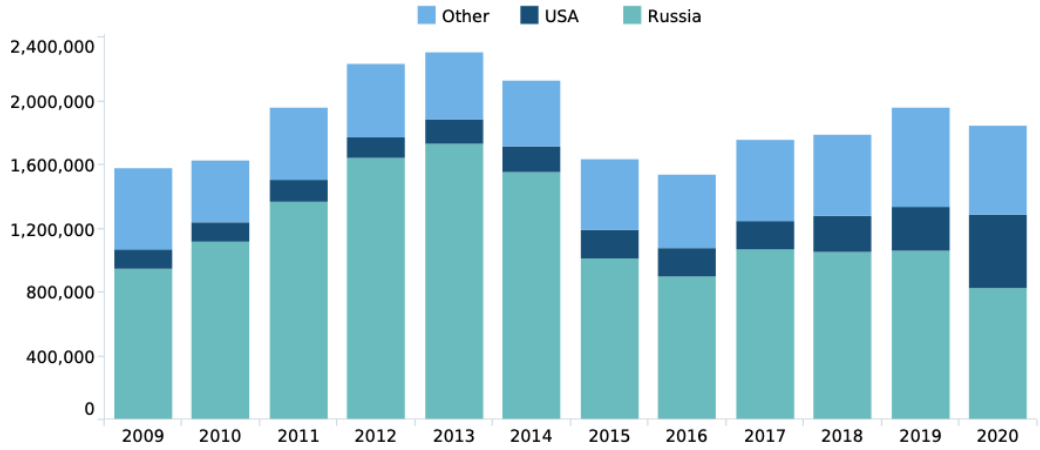
Republic in its dependency on this flow. This situation shows that many of the market reforms in the country did not yet succeed in generating favorable and equitable economic conditions for all the population. Almost 8% of the total population in the country engages in temporary, seasonal work abroad every year. This measurement is an underestimate and implies that approximately 250,000 workers migrate every year.

Figure 68 Regional comparison of personal remittance inflows as a % of GDP



Source: DFA Team calculations based on official data from the World Bank, World Development Indicators

Figure 69 Remittances by main source countries



Source: DFA Team calculations based on official data from the Central Bank of Armenia Statistics

An important element to inform policy decision-making is the distinction between permanent migrants and temporary, seasonal workers. This initial differentiation is vital as socio-demographic characteristics, motivations for migration, and welfare impact on origin households are different in each case. Government interventions may be very different; for example, the educational and income levels or age profiles are significantly different among these two groups.

Temporary, Seasonal Migrant Work

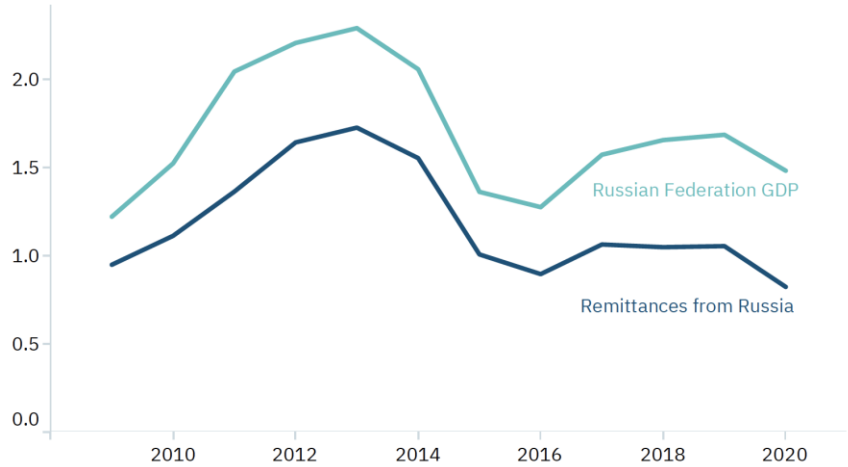
Limited available analysis coincide in constructing a general profile of the temporary, seasonal workers. Most temporary migrants are males (94%), mostly married men who travel alone, leaving their spouses to take care of the children or other dependents. They are generally in the 25-54 age group, with a more prominent 40-60 age group presence. Most of them come from rural settings and are in a precarious position in the labor market before leaving. These migrants primarily seek non-qualified jobs, the majority (80%) work in the construction sector.

Most of them are usually low- or semi-skilled workers with secondary education. They typically engage in high-risk and often informal contracts, with no social or other benefits

The Russian Federation is the country of choice, for Armenian seasonal migrant workers. Over 95% of temporary, seasonal migrants move to the Russian Federation as their preferred destination. The visa-free regime with Russia, large migrant networks, cheap transportation costs, and Armenians' knowledge of the Russian language are all facilitating factors for migration to that country. There is also substantial demand for seasonal labor during the post-winter season, especially in the construction sector, the preferred occupation for temporary migrants from Armenia.

Indeed, the vast majority of remittance inflows can be correlated to the economic situation in the Russian Federation. Remittances arrive from many countries, but the overwhelming majority originated in the Russian Federation, which accounted for 64% of the total remittances received from 2009 to 2020. The USA is the next largest country of origin and accounted for 10% of this flow during the same period. The high dependency on remittance inflows with the economic situation in Russia is expressed in the significant correlation shown in Figure 70. This is related to this steady flow of seasonal migrant workers analyzed.

Figure 70 Russia GDP and remittances from Russia



Source: DFA Team calculations based on official data from the World Bank, Central Bank of Armenia

The estimates for the average amounts of remittances received per household tend to be relatively low. Available estimates for income figures are unreliable. Most survey respondents choose not to answer these questions (around ¾ of them), and those who do may not declare their actual income, fearing tax repercussions. The main socioeconomic impacts of this seasonal work are summarized in Box 3. The evidence tends to show that this flow produces low additional incomes to the families, is insufficient to generate any savings and is mostly used to finance basic consumption and partially used on education and health.

Remittances do not have a significant effect on investment or business ownership. The OECD assessment based on IPPMD survey data concludes that business ownership by households with remittance income is very low (2% of total). It also shows that these households are less likely to own a business than those that do not receive remittances. Potential reasons for this could be the low level of financial literacy and inclusion of the population receiving remittances, and the underdeveloped financial instruments available for them, especially in rural areas. For instance, the study shows that 96% of urban communities have a bank compared to only 2% of rural communities. In addition, participation in financial training programs is meager among migrant households: less than 1% of surveyed households benefited from a financial training program.

Box 3

The impact of remittances from temporary, seasonal workers[117]

Despite the limited data available, the following are confirmed effects from the remittances received from seasonal migrants:

- ***Low Volume per Household***. Depending on the source, the average monthly remittances per household is the range of 18,000 AMD (USD 36) to 23,000 AMD (USD46)
- ***Remittances are used to pay basic household needs***. In urban settings, 40% of remittances are spent in food and clothes, to pay debts (8%) and other uses like paying utilities and heating
- ***A small portion goes for education and health investment***. Only 1 in 10 households invest remittances in education and health.
- ***Remittances are not boosting business ownership***. Busines ownership of remittance-receiving households (2%) is lower than those who don't receive remittances
- ***Remittances have a positive effect on real estate ownership***. Real estate ownership of remittance-receiving households (24%) is higher than those who don't receive remittances

Seasonal migrant workers are primarily informal and must accept harsh and coercive working conditions. The exploitation of seasonal construction workers from Central Asia in Russia is a long-standing issue. It applies to all seasonal migrants, who are vulnerable to labor exploitation and coercive labor practices. Much of this abuse and exploitation are from private actors: employers, employment recruitment agencies, and other intermediaries. Russian law obligates the government to protect all people from abuse, including by private actors. However, the Russian authorities failed to protect migrant workers by not providing sufficient legal protections, or by neglecting to enforce existing protections. The government has also failed to take adequate action against police or other officials who threaten or abuse migrant workers. The ILO and the EBRD advocated for policies to address this situation at the regional level.[118]

Moreover, most Armenian seasonal workers lack any social or health protection. Data from the available surveys show that most Armenian seasonal workers did not have health insurance when residing abroad; only 13.7% had temporary health insurance, and 8.2% had permanent health insurance[119] This is a significant issue in regular times and a massive problem in the post COVID era, where the health of migrants could be at severe risk.

The Way Forward: Policies to Improve Impact of Seasonal, Migrant Work

Armenia would significantly benefit by developing more ambitious, integrated policies to harness sustainable development results from seasonal migrant work and remittances. Experience from DFA analysis in countries where remittances represent a significant component of the national GDP (Bangladesh, Philippines, Nepal, and Fiji) pointed out the potential synergies that a virtuous circle of policies could create by addressing the following interactions with a strategic, holistic approach. Some examples of the main policy goals and interventions are summarized in Annex3. These policies could focus on:

- **Formalize seasonal work.** Develop bilateral agreements to formalize and promote the use of temporary, seasonal labor and protect workers' rights and their integrity. These reforms should reward the formalization of labor migration and the possibility of accumulating social security benefits from migrant workers in their home countries
- **Increase Income of Migrants**. Policies to incentivize the provision of more skilled workers to

[117] Data from the Integrated Living Conditions Survey (National Statistical Service), the 2011/12 migration survey on the relationship between skills, migration and development, (European Training Foundation) and the comprehensive survey of the migration of Armenia Population 2017, conducted by Russian-Armenian (Slavonic) University, IOM (2019), OECD (2017), ILO (2019) and EBRD (2009)

[118] ILO and EBRD (2009) Preventing forced labour exploitation and promoting good labour practices in the Russian construction industry

[119] IO M(2014)

improve the economic benefits of labor migration. This can be done by targeting technical, vocational, and language education to the needs of destination markets. Simple systems of loans for legal migrants could increase the number of people benefitting labor opportunities abroad.

- **Increased Impact of Remittances**. Policies and measures designed to increase the financial inclusion and literacy of the families of migrant workers. Additional measures could be coordinated with community level programs financed by INGOs. The policies could focus on the increased access to credits for housing, farms and productive MSME investment by families from rural settings and poor economic backgrounds.
- **Reinsertion to the Local Labor Market.** Policies to provide labor opportunities and stimulate reinsertion of those who return may have a high impact on poverty reduction. A system of TVET mutual skills recognition with destination countries could also ensure improved reinsertion in the national labor markets. In addition, the country can develop opportunities to improve the employability of those who come back, working with the private sector.

This policy design could benefit from the experience and knowledge accumulated by the Global Compact for Safe, Orderly, and Regular Migration (GCM). The GCM is the first intergovernmental agreement to holistically cover all dimensions of international migration and includes the protection of migrant labor rights, their access to public services regardless of their migration status. The policy goals described above, and the measures summarized in Annex 3 are examples of the arrangements that can be implemented using this framework. A good example to show the benefits of these practices are the successful programs developed by Australia and New Zealand to hire seasonal agricultural workers from the Pacific island's region.

To implement and monitor these integrated strategies, it might be necessary to strengthen the institutional setup and government capacities. The newly created office of the Higher Commissioner for Diaspora Affairs could act as the reference government institution t implement such integrated policies. It should receive the mandate from the government to provide the necessary leadership to coordinate several policies that involve different government interventions at the national and sub-national levels. The office should receive adequate resouces and develop technical capacities to implement and monotir these policies.

In the absence of an integrated strategy, one of the most critical goals in the short term could be to negotiate bilateral agreements to formalize seasonal migrant work. In the post COVID era, there is an additional reason to pursue the formalization of these practices and to protect the rights of migrant workers abroad. The best way to do that is to define bilateral agreements to formalize seasonal work. The opportunity seems fitting, as the shortage of migrant work hardly hit the construction industry in Russia during the COVID pandemic. Russia and Tajikistan reached an agreement of this kind in early 2020. The Tajik Government is responsible for marshaling workers for positions requested by Russian employers, selecting candidates with the necessary qualifications, providing training (including language), and facilitating workers' return. The agreement also establishes that Russian employers must actively participate in organized recruitment of migrants, provide safe work conditions and ensure regular payment of wages."

To expand the opportunities to mobilize the permanent diaspora the government may need to develop a long-term strategy based on a social capital development approach. The Armenian diaspora should be accounted for as part of the country's social capital. Policy design should consider the various dimensions that guide the design of specific actions (bonding, bridging, and linking). These policies should aim to generate new bonds of the diaspora with the country. They should try to bridge the negative memory that many diaspora members, or their parents or grandparents, left the country in the first place because of poor governance. The image of those problems still looms large as a counterweight to any warm feelings of patriotism.

There are several policy instruments that Armenia could explore in such a strategy. The UNDP has abundant experience supporting the implementation of innovative financing instruments in

remittance dependent countries. Some of the following could be explored further in Armenia:

- **SDG Diaspora Bonds.** Diaspora bonds and remittance-backed bonds can finance railways, roads, power plants, and educational institutions. Lessons learned from these instruments suggest that diaspora bonds would have a greater chance of success if the proceeds were to finance projects which interest the diaspora, such as housing, schooling, hospitals, and community infrastructure projects that could benefit them and their families, or their region in their homeland.
- **Innovative mechanisms to stimulate diaspora donations and foreign fundraising.** Measures to mobilize resources from the significant number of pro-Armenian organizations abroad[120] for local non-for-profit work. Diaspora activities could be interested in co-financing a broad range of initiatives regarding: (i) targeted economic and emergency assistance, (ii) education, health, and extensive communication infrastructure, (iii) capacity-building and cultural development, and (iv) establishing joint ventures and restarting industrial enterprises. This capacity could be enhanced with incentives and innovative promotional programs developed by the government. There are good experiences, like for example, the case of the 3 x 1 in Mexico that could serve as reference to this policy design[121].
- **Link national with international talent and sources of cutting-edge know-how.** The country could develop instruments to stimulate the engagement of national universities or researchers with peers abroad. For example, the Greek Diaspora Fellowship Program enables Greek universities to host Greek-born scholars residing abroad in collaborative research, curriculum co-development, and graduate and undergraduate research mentoring. Other alternatives to promote temporary return and skills exchange to transfer diaspora skills "back home." This can be done by demand-led mentoring, internships, consultancies, and job placements. Competency networks can also be organized by sector, and locality can also be developed to connect specific diaspora profiles with real, local needs. All these programs are greatly facilitated by the extensive usage of post-pandemic digital platforms.
- **Innovative initiatives for cultural development designed to strengthen social capital.** In this category, many government-targeted interventions are intended to foster contributions to soft power and diplomacy, promote national cultures and languages, and develop transnational networking. The basic concept is that diasporas can project their nation of origin's image overseas while at the same time contributing to the diversity of their communities of residence. Furthermore, the focus is on reinforcing the emotional connections of the diaspora with the mother country and contributing to building trust. An example is the case of the Copenhagen Goodwill Ambassadors. This global leadership network aims to promote Denmark internationally to attract foreign investors, companies, conferences, talents, and tourists.

4.2.6 Private Philanthropy and CSO Financing

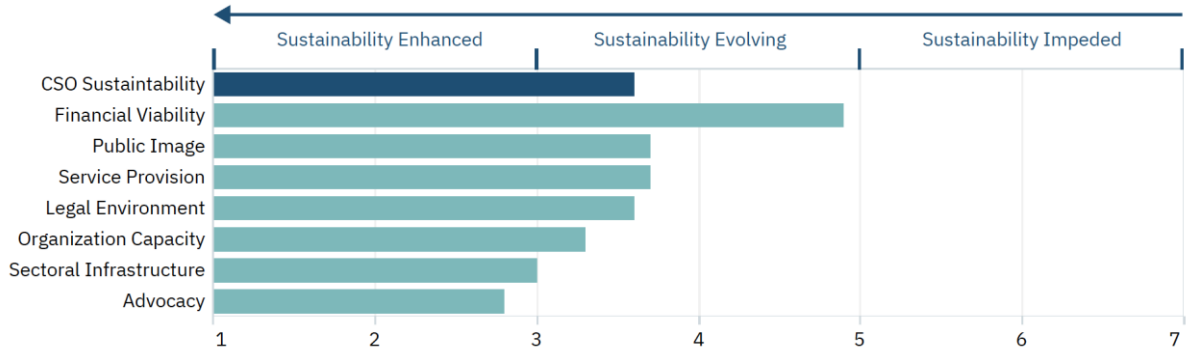
Civil Society Organizations (CSOs) became active in Armenia in the early 90s, mainly engaged in relief and humanitarian activities in response to the 1988 earthquake, the 90s military hostilities in Nagorno-Karabakh, and the highly harsh economic situation. Back then, the Armenian government could not cope with the calamities of the post-earthquake and post-conflict situation in the country and had to accept the activities of CSOs. Initially, the CSO sector cooperated mainly with the government, distributing humanitarian aid via inexperienced local government bodies. Partially due to this reason, the perception about humanitarian assistance and the CSO activities was largely negative – refugees, victims of the earthquake and other vulnerable groups were claiming that they had received only a tiny portion of assistance[122].

[120] These include the AGBU, Lincy Foundation, Fund for Armenian Relief, Armenian Relief Society, Hayastan All-Armenian Fund, Aznavour pour l'Armenie, the Union of Armenians of Russia, Union of Armenian Physicians of France, Canadian Armenian Council of Commerce and by many individual benefactors

[121] See Box 6 in Annex 7.4 for more on this program

[122] USAID (2001)

Figure 71 Overall CSO Sustainability in Armenia



Source: DFA Team calculations based on official data from USAID (2020).

Since the independence, diaspora philanthropy played a lead role. Armenian diaspora made large contributions in humanitarian aid, development projects, and business projects. But the relationship with the country has been asymmetrical and problematic. The diaspora roughly doubles the size of Armenia[123]. There is also a historical cultural divide between a diaspora situated in advanced market economies and a post-Soviet, authoritarian government, with a disturbing lack of democratic credentials or free and fair elections. These issues have never been fully addressed and still generate a significant divergence of interests. The major frustration within the diaspora is driven by a common perception that the government maintains a policy that is very welcoming to their aid, assistance, and philanthropy, but which is strictly exclusionary of any diaspora engagement in internal domestic politics. Two diaspora institutions stand out:

(i) Hayastan All-Armenian Fund. This is one of the major organizations consolidating diaspora funding and implementing development projects. The institution was established in 1992 to implement projects ensuring the proportional and sustainable development of Armenia and Nagorno-Karabakh. The Fund implemented 1,300 major projects in infrastructure, healthcare, social welfare, arts and sports. The institution's vision is *"to build a global Armenian network to continuously support Armenia, Armenians and the world with innovative ideas and projects by creating real development opportunities"*. During the recent hostilities, the Fund collected more than USD 170 mln in donations from abroad.

(ii) The Armenian General Benevolent Union (AGBU) is the world's largest non-profit organization devoted to upholding the Armenian heritage through educational, cultural, and humanitarian programs. AGBU also implements projects targeted at sustainable socio-economic development. The organization is headquartered in New York and has a history of 115 years. It currently operates an annual budget of over USD 46 mln, has a presence in 31 countries and 74 cities.

Alongside these activities, the arrival of international NGOs accelerated the development of an endogenous non-governmental sector. Among the first international NGOs operating in the country were the Armenian Technology Group, CARE International, Catholic Relief Services, Oxfam Great Britain Armenia, Save the Children, and United Methodist Committee on Relief. The diaspora played an essential role in the country's rehabilitation process and provided funding through local and international NGOs. This was when local NGOs started to develop and spread across the country (including different regions of Armenia). Regional NGOs were implementing projects in education, healthcare, culture, community development etc.

The number of CSOs in the country has grown exponentially during the last three decades. The number of CSOs has been growing fast in recent history. In 1997 the number of registered NGOs was over 500, and by 2001 this number reached 2585. In 2010 the country reported this

[123] Current estimates hold that while the population of the RA is below 3 mln, the global Armenian diaspora is over 7 mln.

number to be 5745 (45 international and 5,000 national) but with only 977 operating ones.[124] According to some assessments, more than 5,000 CSOs were registered in 2018, including 4.222 NGOs and 1.120 Foundations, and 244 legal entity unions[125]. The total number of CSOs in 2018 was significantly reduced from the previous year. In 2017, the government decided to dissolve those public organizations that did not submit reports for the last four years.

Policy and Legal Framework

In line with the increase in the number of NGOs, the government started regulating the sector. The regulatory framework for NGOs is covered in the Constitution as well as several other legislative acts. The Civil Code provides the basis for non-commercial organizations and allows for establishing public associations and foundations. In 1996 the government adopted the Law on Non-Governmental Organizations, which encouraged the sector to gradually shift from emergency response activities to activities related to development, human rights, and others. There are two types of non-profit organizations under Armenian law: foundations (non-membership organizations) and public associations (membership organizations). Public associations, include NGOs, religious organizations, political parties, and trade unions.

All non-governmental organizations must be registered in the State Registry Agency. The Law on State Registration of Legal Entities requires that all organizations apply for registration. This information includes the organization's charter and a protocol of the founding assembly or the decision on the organization's founding with details on the founders. In addition, these organizations are subject to reporting requirements. This is on top of regular tax and statistical reporting requirements, which universally apply to for-profit and non-profit organizations.

The legal and regulatory framework is mainly focused on the initial control of the registration process and tax evasion. The Law on Public Organizations requires that NGOs present comprehensive annual reports. These reports must be published on the official website of the Tax Service and shall be, before publication, reviewed by the controller of the NGO. Reporting can contain the following information:

- ***Activities.*** Changes to the number of members, the number of general meetings, names, and brief descriptions of each project implemented.
- ***Financials.*** Annual income, use of proceeds and assets (including real estate), revenues from business activities, if any, and how it was utilized.
- ***Use of Public Funds***. Report of public funding must include the name, location, status and general information (objectives, main results) of the project implemented. The total inflows from public sources (specified by each source) and public funding use and expenditure.
- ***Large-scale Public Projects.*** If the public funding exceeds 10 mln AMD, a special report is needed and subjected to mandatory independent audit. This special report and the audit report must be published alongside the annual report

Foundations are also obliged to report on their annual activities. The Law "On Foundations," establishes that foundations must publish annual reports, which shall contain information about the performed projects, sources of funding, the total volume of funds used during the year, information about the number of staff, information on the use of foundation funds by the founders, and governance. Furthermore, if the foundation's assets in the given year exceed 10 mln AMD, then the report shall be subjected to an independent audit.

Although the required reporting information is quite detailed, its usefulness for policy decision making is very limited. The main use of the information requested is for tax monitoring and controlling purposes, but this reporting produce a wealth information that could be useful for

[124] Council of Europe (2019)

[125] CSO Sustainability Index for Central and Eastern Europe and Eurasia, September 2018

other policy purposes. However, several flaws of the information requested make it unusable. For example, the information on the expenditure side (segregated by programs) does not oblige to use sectoral classification systems, and there are no requirements to demonstrate alignment of program goals, targets and outputs with national priorities or the SDGs. This information is not consolidated either centrally or by line ministries.

The law also regulates the fiscal aspects of domestic philanthropy. The Law on Public Organizations was passed in 2002 and was amended in 2003 and 2008. This Law defines what a charitable organization is and what charity projects are, the relationships between benefactors and beneficiaries, and tax privileges and titles expected from the government by benefactors. It also establishes the tax deductions for donations (taxable income of commercial organizations for donations up to 0.25% of the gross annual income) and VAT refunds

The legislation provides for detailed procedures for recognizing specific projects as charitable. The initiation of a project qualification as charitable may take place if the project implementer: (i) expects the incentives defined by the Law; (ii) envisages benefits on taxes, duties, mandatory payments prescribed by law, (iii) expects to receive logistical support or financial assistance from the government or relevant community. The Deputy Prime Minister is the authorized body that coordinates this field. This office qualifies the projects aimed at achieving the charitable status set forth by the law. A consultative committee for the coordination of charitable projects was established, which submits proposals to the authorized body on the implementation of the functions of the authorized body defined by this law.

Private Philanthropy in Armenia

Financial sustainability is a challenge faced by CSOs, which are primarily dependent on donor funding[126]. This is the weakest score ranked by the CSO Sustainability Index. Since 2017 the ban on conducting entrepreneurial activities by CSOs was removed from legislation which was a positive step in creating opportunities for CSOs to finance their activities. Although entrepreneurial activities are now legally possible, current legislation was still assessed to be "*insufficient to provide a favorable tax environment for NGOs who engage in entrepreneurship and legal frameworks are complex"*[127] As local funding sources are limited it is very difficult for NGOs to achieve long-term planning and they mainly function from one project to another.

The Armenian legislation provides different opportunities for CSOs for attracting funding from multiple various sources. Philanthropy and charity are regulated by the Constitution of the Republic of Armenia, the Civil Code, the Law on Charity, other legal acts, and international treaties. The Law on Public Organizations defines a comprehensive range of financing sources that are accepted: *"investments and fees by the organization's members, funds received from entrepreneurial activity, funds generated from other organizations established by the organization or with the participation of the organization, receipts from the state budget, donations, including grants, collected donations and other means not prohibited by law*".[128]

The COVID-19 crisis negatively affected the access to finance to CSOs. The possibilities to generate income through the provision of services, products, and renting assets significantly decreased during 2020. The lockdown and state of emergency limited access to fundraising tools such as events, charitable dinners, and festivals. Available estimates show that 20% of social enterprises completely ceased operations, 50% ceased for 5 months, and CSOs and individuals faced significant difficulties when trying to establish new social enterprises. There was an overall 70&% decline in social enterprise income in 2020 compared to the previous year[129].

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[126] USAID (2020)

[127] Council of Europe (2019)

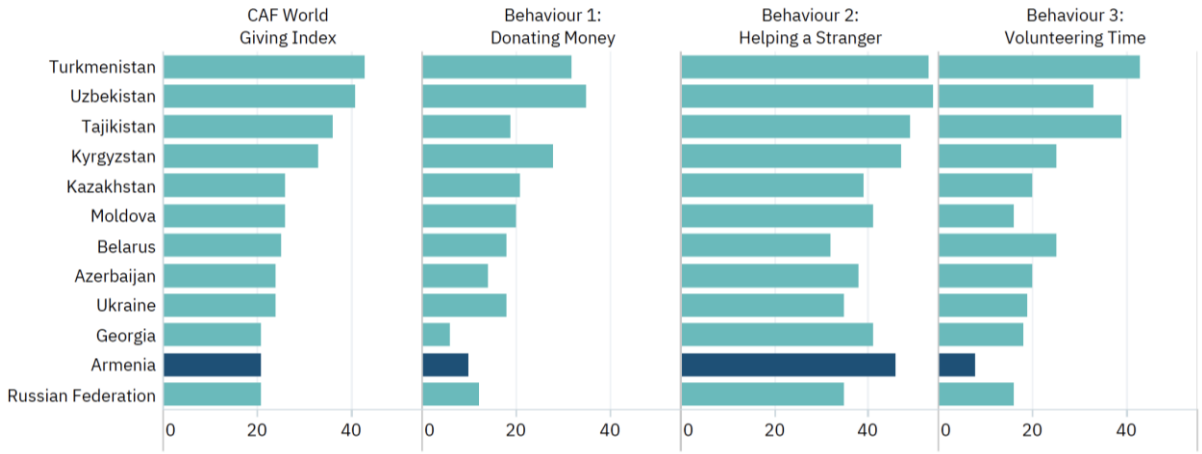
[128] RA Law on Public Organizations

[129] Measured by "Social Entrepreneurship in Armenia" research by the USAID-funded Innovation for Change (I4C) Armenia project,

COVID-19 and the hostilities in and around Nagorno Karabakh encouraged unusual increases in diaspora philanthropy. COVID fundraising gained momentum as many CSOs adapted their programs to support vulnerable social groups deprived of scarce income sources because of the lockdown. The pandemic brought new grant funding provided by USAID, Open Society Foundations, Black See Trust, and others. Many CSOs expanded their services to protect vulnerable people and increase awareness on the health protection measures. The All-Armenian Fund collected over USD 170 mln through its Pan-Armenian fundraising campaign. Donations were solicited to provide humanitarian aid for displaced people and repair damaged infrastructure because of military actions. In addition, the Insurance Foundation for Servicemen collected more than USD 16 mln through local philanthropy[130]..

Crowdfunding platforms and innovative finance tools for CSO fundraising are becoming popular but they are still insufficient. CSOs have increasingly made use of business funding and crowdfunding in recent years. The use of crowdfunding significantly increased during 2020. For example, the successful fundraising campaigns of the All-Armenian Foundation and the Insurance Foundation for Servicemen utilized online tools. Some membership-based organizations collect membership fees, although this income is insufficient to ensure sustainability. The World Giving Index states that 15% of surveyed Armenians reported giving donations and 9% volunteered.[131]

Figure 72 Charity Aid Foundation World Giving Index Score by country[132]



Source: DFA Team calculations based on CAF World Giving Index (2019).

Corporate Social Responsibility (CSR) is a relatively new concept in Armenia and a potential source of finance. Collaboration between CSOs and the private sector is still not very strong. Some companies (mostly foreign) have CSR strategies, dedicated staff and periodically engage in activities to support certain causes through CSOs. However, these collaborations are limited to one-time, ad hoc project based giving. Multi-national companies and large local businesses with a large customer base tend to favor CSR. Some use their own charity trusts as a marketing vehicle to promote their products. This could be a source of financing opportunities for CSOs in the short term. Especially if they lead this process of innovation by offering projects that are impact oriented and conceived to be compatible with more innovative corporate practices.

However, many CSOs appear to lack the technical capacities needed to apply many of these advanced fundraising strategies. According to the study Philanthropy in Armenia conducted by

130 CSO Meter (2020) and USAID (2020)

131 CAF World Giving Index 2017 and 2018

132 USAID (2020 (2009-2018 aggregate scores in percentages)

NGO Centre and European Centre for Non-profit Law[133] the most active fundraising channels in Armenia are social media; however, websites and crowdfunding platforms are also very busy. The same report confirms that despite good practices and initiatives in fundraising and philanthropy, the CSOs of Armenia do not yet have solid institutional capacities to raise funding. Only 29% of respondents among CSOs confirmed to have well-established internal fundraising procedures.

CSO Partnerships with the Government

In recent years several policies have been adopted to enhance CSO-government partnerships at the local and central government levels. Over the last years, the government has passed decrees, regulations, memorandums, and agreements related to cooperation with CSOs, and formed institutional bodies and units ranging from community to national levels. Formally, CSOs have access to government decision-making processes through Public Councils established adjacent to the ministries and actively participate in government financed programs. However, the perception from the CSO community is that this relationship still needs significant improvement[134]. This sentiment has been persisting for a long time. A mapping study of the Armenian CSO engagement in policymaking conducted in 2014, indicated that even if the CSOs demonstrated the ability to engage in policy dialogue, these interactions often lack impact.[135]

Funding statistics are not available to make an appropriate assessment of the magnitude and opportunities in the public-private space. Anecdotic evidence from the 2021 CSO Sustainability Index indicates that foreign donors for Armenian CSOs in 2020 included the European Union, USAID, OSF, the Black Sea Trust for Regional Cooperation. According to their scale, contributions were catalogued as[136]:

- ***Smaller grant contributions*** were made by the Swedish, Dutch, and German governments, the US, Lithuanian, and Japanese embassies, the UNDP, Robert Bosch Stiftung, the European Endowment for Democracy, and the Prague Civil Society Centre.
- ***Large-scale projects*** included the USAID-funded Engaged Citizenry for Responsible Governance (2014– 2021), the EU-funded EU4Youth: Better Skills for Better Future (2018-2020), and the USAID-funded DATA program (2020-2022). These funds mainly benefited large CSOs, which already had experience working with international donors, while small and recently established CSOs had limited access to the same resources.

The relationship between CSOs and the government responds to a reality of very heterogeneous situations. The history of the relationship between the government and civil society in Armenia shows some milestones of considerable conflict and rigidity. In the history of this relationship there are also positive cases that show promising opportunities for working together. In contrast to a confrontational and conflictive relationship approach that is still present on both sides, there are other cases of collaboration where CSOs have contributed ideas, proposals, and good solutions, and that have generated spaces for collaboration with the government that have promising aspects.

Unfortunately, only anecdotal evidence is available to analyze the quality of the relationship between the government and civil society. Systematic monitoring data and evaluations is missing and could provide the government with quality information to inform public policy decision making. The lack of the information about these practices from both sides significantly contributes to generating distrust between the parties.

The European Union has been advocating for the development of a more enabling environment for CSO participation in Armenia. This is part of Armenia's participation in the

[133] European Centre for Not-For-Profit Law (2020)
[134])Ibid
[135] Margaryan, T. et al (2014)
[136] USAID (2020)

Eastern Partnership (EaP). Considering the many limitations observed and the recommendations made by a recent visit of the Conference of INGOs to Armenia, a new Roadmap for Engagement with Civil Society was adopted in 2019. This roadmap defines targets, priorities, and actions for cooperation between NGOs and the EU. The document focuses on creating enabling environment for CSOs in different areas and specifically in the participation of civil society in policymaking[137].

Moderate improvements were achieved for government-grant financing to CSOs. The number of grants provided by central and local governments to CSOs accounted for AMD 604 mln in 2020 (about USD 1.3 mln). This is an improvement compared to the AMD 110 mln (about USD 220,000) in the previous year. However, there are allegations that these grants were allocated using non-transparent, non-competitive processes, where only CSOs that are perceived "favorably" by the government could access public funding[138]. A report from the Council of Europe of 2019 echoes on this situation, insists that there are no clear selection procedures and criteria for grant competitions. It also points out Armenia's remiss implementation of the Open Government Partnership initiative and advocates for greater transparency and accountability.

There are no sources to report on the usage of Public-Private Partnerships for Development (PPPDs) with CSOs on Results-Based Financing (RBF) systems. Anecdotical evidence indicates that national and local governments are using RBF, but despite the good results reported, this use is not generalized. Two examples show the potential of these relationships::

- **The Ministry of Labor and Social Affairs (MLSA).** A pioneer in cooperation with NGOs, the MLSA introduced innovative approaches and cooperated with the National Assembly Public Network and the Network for the Protection of Disabled People's Interests and Rights, and other networks. Initial cooperation focused on public relations, awareness campaigns; seminars for journalists; public discussions on large-scale reforms, and communication efforts. More recently, the ministry started to foresee the CSO sector as an independent provider of social goods and services that could be contracted (outsourced) or partner as a co-financer of their delivery. MLSA delegates services to NGOs with partial financing from the state budget.
- **Health Care.** RBF practices have been used by the Ministry of Health in primary health care (PHC) facilities. The experience is considered positive as it contributed to increased utilization of PHC services and improved service performance. The system is financed by the State Health Agency (SHA) of the Ministry of Health (MOH) and includes two modalities: open enrolment (OE) and pay for performance (P4P). The OE allows for free choice of providers and pays each PHC provider in line with the number of people registered with that provider. In the P4P component, PHC providers receive bonus payments based on their performance defined by 27 indicators. However, CSOs are not considered providers of these services.

During the pandemic, the government took steps to improve the partnerships with CSOs. In 2021 the government introduced a methodological guideline to set the principles to increase public participation in the budgeting process. A consultative process is proposed to enhance citizen participation informing the public on budgeting processes, involving them in developing budget programs (receiving proposals, public discussions), and providing feedback on budget-related decisions. The guideline describes the approaches to be applied during the participatory budgeting process.[139] Another positive move was the acceptance of the amendments proposed by the Armavir Development Centre to the Law on Local Self Governance adopted in 2020. These amendments require that local municipalities (over 20,000) post local legal acts on community websites for public discussion and copy them on the e-draft platform

The way forward: harnessing the development impact of CSO Financing

The generation of quality, aggregated data, and information on this flow should be the

[137] Council of Europe (2019)
[138] Ibid
[139] MoF (2022)

starting point for any improvement to the management of this finance flow. The government can collate valuable information to know what CSOs are doing, the amounts invested, the destination of these investments, their alignment with national priorities, and duplications with public financing. To develop such a system, the government could:

- Modify the current annual reporting system, simplify procedures (online and with formats defined by the government), and use it to generate useful information
- Use the same platform and format as the one designed for ODA management and generate identical information on aligning with national priorities and the SDGs.
- Gradually generate benchmark information to compare the cost of achieving results with traditional public financing and with projects conducted in cooperation with CSOs. T

This added transparency should generate trust and stimulate private investment for projects generating development impact.

The government should consider introducing new approaches and financial instruments to stimulate co-investments with the nonprofit sector. The government should explore the "Social PPP" approach expanding results-based financing modalities. The focus of this partnership approach should be to leverage additional private, non-for-profit resources**.** This could be reinforced through the extension of results-based aid and the adoption of blended finance mechanisms. These practices could allow the government to attract additional public and private aid funds that otherwise would not be available. There is a growing interest in results-based aid by most of the development partners in Armenia. This is explicit in the country strategies of many DPs, for example, USAID, the WB, the EC, and the agencies from UN System.

The government should consider the construction of more advanced "ecosystems" of policies to stimulate the development of impact investments. Impact philanthropy is results-oriented and more effective than traditional donations. This approach requires a new relationship between donors, the government, and the private non-profit sector that can have many applications in Armenia. The use of new instruments in the results-based aid toolbox includes Social Impact Bonds (SIBs) or Development Impact Bonds (DIBs). This new way of orienting investments combines multiple public and private agents, both for-profit and non-profit, domestic, and external. To create such "ecosystem" the government must consider changes in the demand and supply side:

- **Demand:** create conditions so that the government and other agents can be buyers of results and so that the service providers (large, medium, or small) can participate in this "market".
- **Supply:** improve conditions to ensure the supply of financing, such as developing channels for risk investment, stimulating access to domestic and external sources of capital (which can be governments, foundations, pension funds or funds), insurance, commercial companies but "with a social purpose" and a wide range of others including crowdfunding) and to stimulate intermediaries that make impact investments feasible.

Another important aspect will be to stimulate efficient, strategic, and broader dialogue mechanisms and more productive ways of working in partnership with CSOs. The government should stimulate effective dialogue with multiple stakeholders. Dialogue with civil society should increase mutual trust and knowledge of the national development goals with potential development partners, national and international investors, philanthropists, and other actors. This should make their participation more likely. Some of the main stakeholders, who could provide the broader forms of funding that the country could mobilize, will probably not do so unless they have confidence in the goals set, find the role assigned to them attractive, and have confidence in the process. The government will need to take the lead and establish a meaningful dialogue with these actors at the political and technical levels and bring them on board in resource mobilization. Dialogue with civil society can contribute in a similar way to improving policy monitoring performance and mutual accountability at the national level.

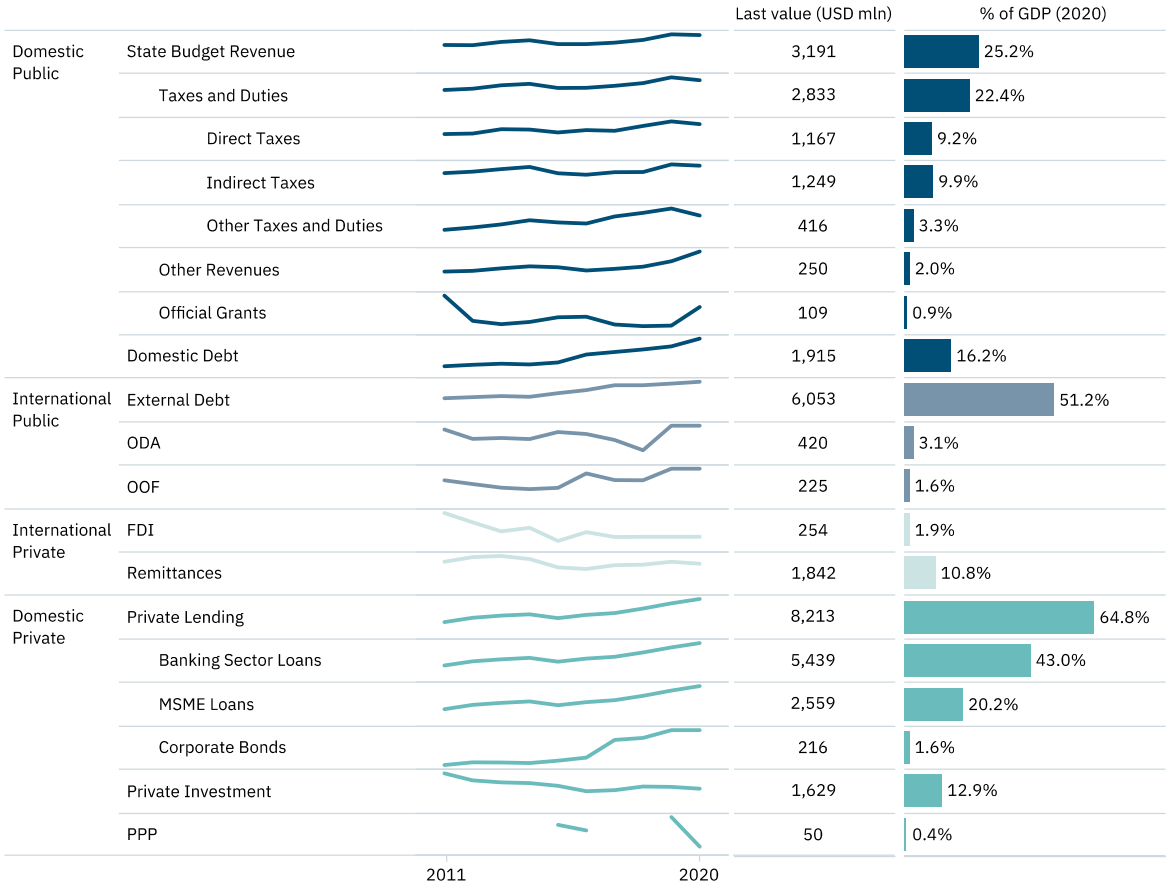
CHAPTER 5

Key Findings and Main Action Areas Identified

5.1 The emerging picture from the Financing Landscape

The purpose of this DFA is to provide an understanding of the relevance and variety of resources that Armenia could mobilize to finance its development priorities. This is the first attempt to systematically map all the development finance flows and identify SDG financing opportunities and challenges. This assessment provides general guidance for the future mobilization of Armenia's domestic, external, public, and private resources. The emerging picture of the different financing flows analyzed in this assessment is summarized in Figure 73.

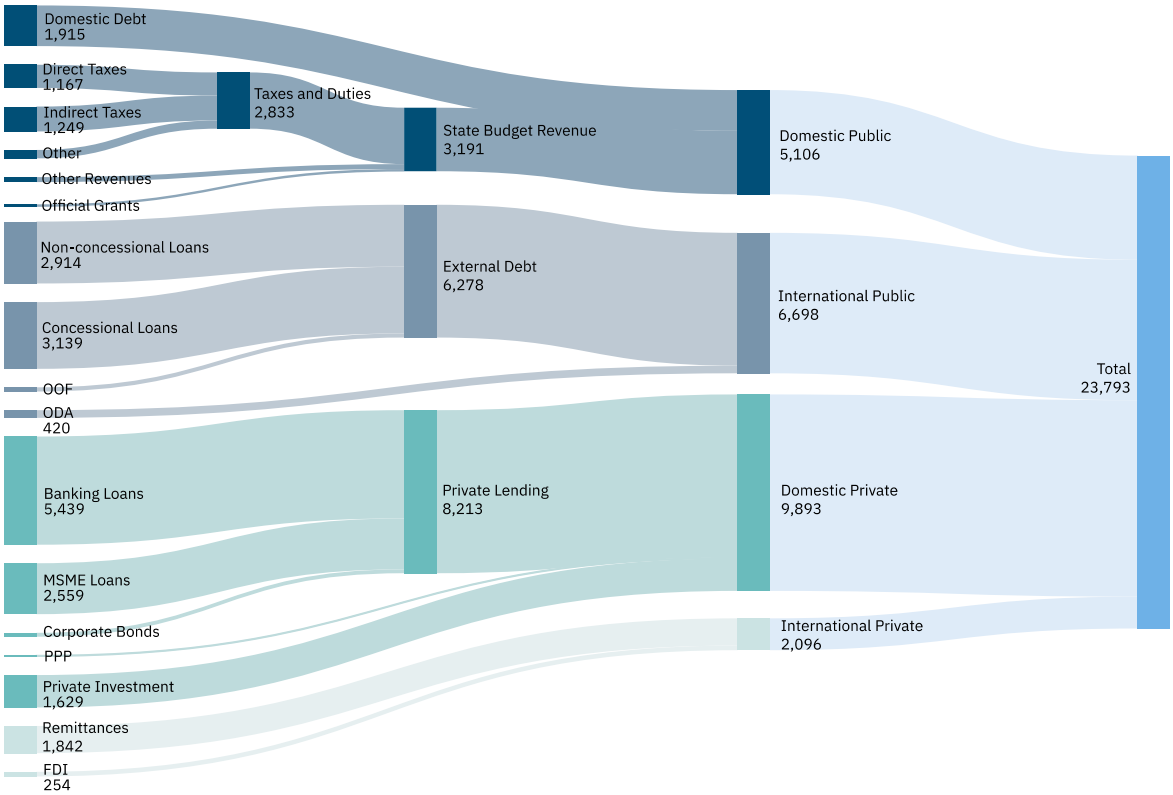
Figure 73 The main finance flows analyzed by the DFA



Source: DFA Team

This first effort is exhaustive but should be refined in the future. The information in Figure 74 shows the evolution of the main flows for which data is available. The list shows a diversity of situations and paths of the different financing flows analyzed in the report, for which this assessment provides an initial background and a general baseline. The purpose of this exercise is to generate a discussion on the need for the government to intervene strategically to modify the speed of growth of these flows and their alignment with national priorities.

Figure 74 The structure of the financial flows measured by the DFA

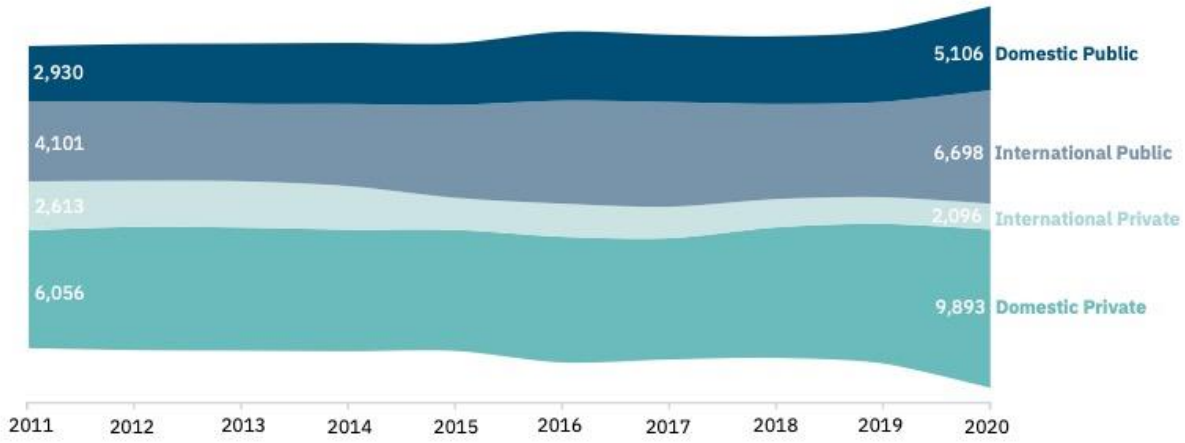


Source: DFA Team

The general scenario for financing long-term development in Armenia offers significant opportunities and some challenges for the government. It is expected that all countries will face an increasingly complex landscape to manage development financing. This complexity is depicted in Figure 92 that dissects the general structure of the development finance flows available in Armenia as measured by this DFA. The assessed values are not entirely independent as they may be seen in the diagram, as some overlapping exists. By presenting them as independent sources is easier to visualize their relative weight and potential and the opportunities for the government for mobilizing additional resources. The total volume of the flows measured accounted for USD 23.793 bln in 2020. This structure shows some characteristics worth highlighting:

- ***Public Finance***. Almost one-half (49.61%) of the total development finance measured comes from the public side. A significant part of it (28.15% of the total) is international public finance, and the vast majority is international external public debt. Almost one-third of the development finance resources used in the country come from sovereign external public debt.
- ***Private Finance***. Private lending to the private sector is the primary financing flow in Armenia, measuring USD 8.213 bln. This flow accounts for 34.5% of the total development finance measured. The diagram shows the low amounts of private investment mobilized by the country. Total domestic and external investment (including FDI and PPPs) accounts for only 8% of the development finance measured.

Figure 75 General Trajectory of the development Financing Resources Measured



Source: DFA Team

The general composition of the development finance mix in the last decade shows moderate changes with increased participation in public finance. In nominal terms, the volume of development finance increased from USD 15.700 bln in 2011 to USD 23.793 in 2020, which represents a 51.54% growth over this period. The composition of the financing mix slightly changed, showing increased participation in public finance. Public flows represented 44.78% of the total in 2011 (USD 7.031 bln) and are now responsible for 49.61 % (USD 11.805 bln). This trajectory seems counterintuitive in an economy in transition. The participation of the private sector in the financing mix decreased from 55.22% to 50.39%(Figure 75). This can be explained by the following remarkable situations that happened during this period:

- ***Domestic Public Finance***. Domestic resource mobilization rose from USD 2,930 in 2011 to USD 5.106 bln in 2020 and increased its participation in the total finance mix from 18.66% to 21.46%. This growth shows the positive results of the government efforts to increase state budget revenues.
- ***International Public Finance***. This flow increased in nominal terms from USD 4.101 to USD 6.698 bln in the period, and its participation in the total mix rose from 26.12% of the total to 28.15%. This is explained by the increase of external debt from USD 3.725 bln to USD 6.278
- ***Domestic Private Finance*** This flow increased in nominal terms from USD 6.056 to USD 9.893 bln in the period, and its participation in the total mix rose from 38.57% of the total to 41.58%. However, this positive increase is still insufficient compared to other peers.
- ***International Private Finance***. This flow remained almost constant in nominal terms during the whole decade and reduced its participation in the total financing mix from 16.64% in 2011 to 8.81% in 2020. This is an area where significant improvements could be achieved

International comparisons show that Armenia's performance managing these flows is a little above average of different reference groups. Figure 76 shows the comparative performance of the flows measured regarding regional peers and same income country groups. Armenia measures almost identically to the regional average in all areas except for the low performance in mobilizing investments from a geographical perspective[140]. Armenia outperforms its regional peers in tax revenue and domestic credit to the private sector; it also has one of the highest debt to GDP levels. A similar situation happens when comparing Armenia to upper-middle-income

[140] Comparison with Eastern Europe, the Caucasus & Central Asia region comprising Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyzstan, Moldova, Russian Federation, Tajikistan, Turkmenistan, Ukraine and Uzbekistan.

countries[141]. The country performs better than the group's average tax revenue and domestic credit to the private sector and is slightly more dependent on remittances than the rest. The deficits in mobilizing private and public investment are also eloquent in this comparison.

Figure 76 Comparing Armenia's results with regional and upper-middle-income averages

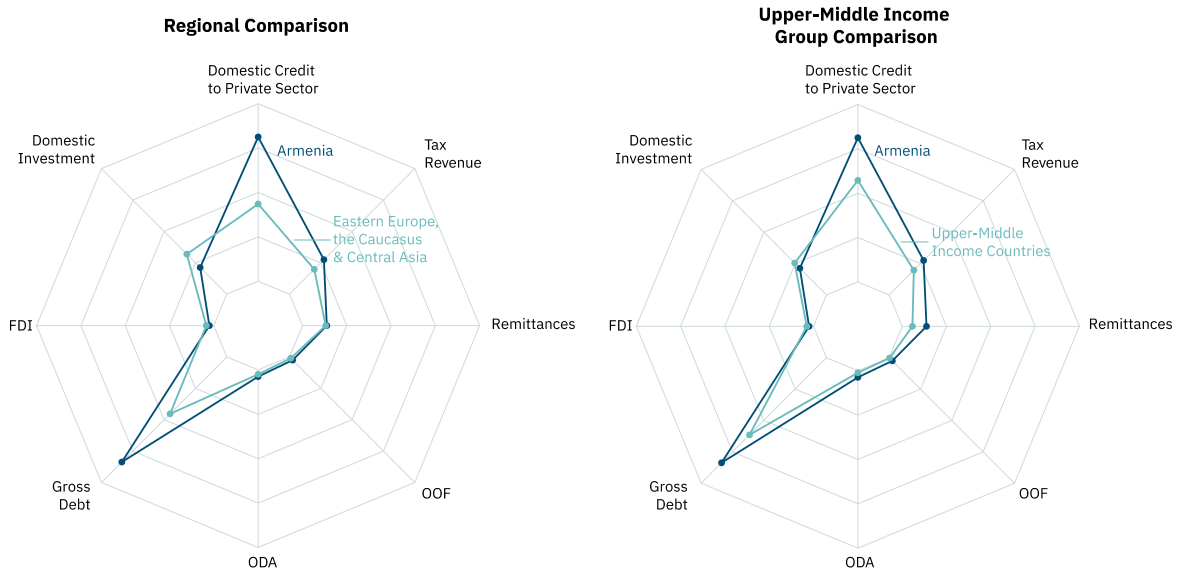
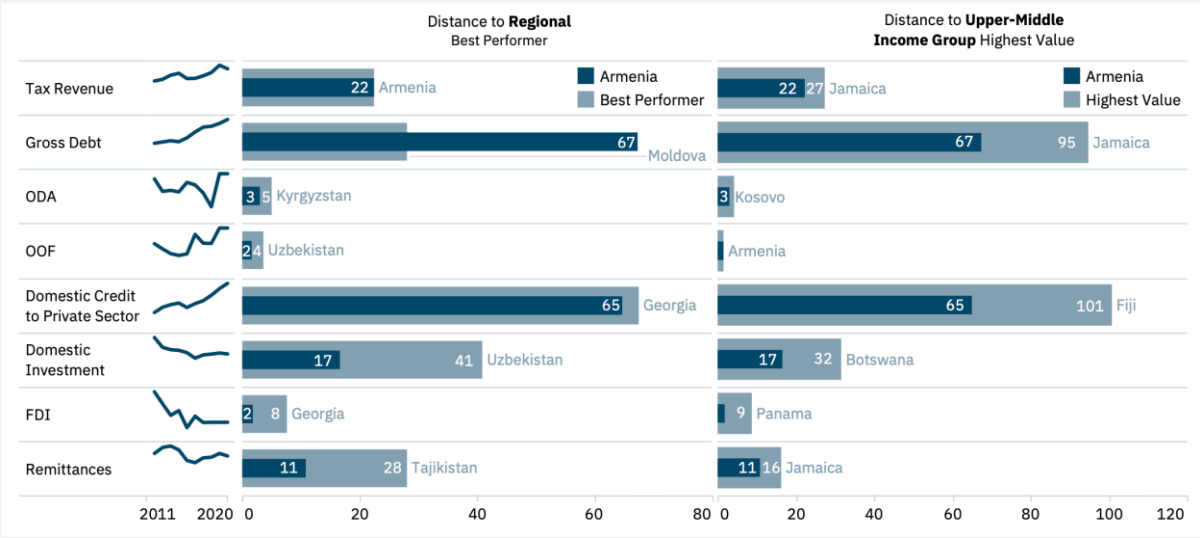


Figure 77 Comparing Armenia's results with best performances in both reference groups[142]



Source: DFA Team calculations based on DFA and WB data

A closer look at the top-performing countries in each of the comparative groups selected provides some indicative references for their future development. The distance from the best performers in the region may illustrate opportunities for improvement in several categories. For example, Uzbekistan invests 25% of GDP more than Armenia, and Georgia provides 14% domestic credit to the private sector and receives 6% more foreign direct investment. Moldova achieves comparable development results with only 22% of public debt. Those distances are even more compelling compared to the other countries in the upper-middle-income group. For

[141] The WB divides economies into four income groupings using GNI per capita. According to the World Bank's analytical classifications 's fiscal year 2022 (July 2021-June 2022), low-income economies are defined as those with a GNI per capita of $1,045 or less; lower middle-income economies are those with a GNI per capita from $1,046 to $4,095 in 2020; upper-middle income economies are those with a GNI per capita from $4,096 to $12,695 in 2020; and high-income economies are those with a GNI per capita greater than $12,696 in 2020. With a GNI per capita of $4,220 in 2020, Armenia is at the bottom of the list of upper middle-income category that includes other 53 countries.

[142] Data from 2019. Regional debt comparison excluded Russia, Azerbaijan and Kazakhstan for their unusual low levels.

example, Fiji duplicates Armenia regarding access to domestic private sector financing (101% of GDP), and Panama mobilizes almost five times more FDI than Armenia. These comparisons from different countries and socio-economic situations are not linear. The values presented here are only for indicative purposes and show that specific flows have a different weight in their financing for development packages in other economies.

It was not possible to estimate the current alignment of public flows with country priorities. The purpose of DFAs is not just to focus on measuring historical trends and the potential for expansion of each financial flow. The assessment should analyze their alignment with national development priorities and sustainable development's economic, social, and environmental dimensions. The situations analyzed in Chapter 2 show that the government has not yet developed the capacity to allocate and align public expenditure with national priorities or the SDGs. This is a critical issue that should be prioritized the financing strategy proposed.

This challenge is much higher for private flows. As they are not under direct government control, the possibilities of aligning private finance with national priorities are more limited. In this case, the government should generate incentives to influence their growth to align broadly with national priorities. Some private flows could produce positive economic impacts in Armenia. However, if only the market forces are left to predominate, they can also undermine the environmental or social priorities of the country. An example of this could be the mining industry's negative environmental impact and the difficulties for attracting the right kind of investors in a strategic sector for Armenia's future development. Unfortunately, the government does not collect enough evidence to analyze this alignment for most private flows.

The government will need to increase the availability and the quality of the information to manage these flows. This DFA measures the availability and quality of evidence and information as a strategic resource to support coherent, evidence-based management. In many cases, there was not enough information to substantiate a quantitative analysis. For example, no official sources are available for some flows (NGOs, PPPs, Inclusive Finance) or are incomplete or inconsistent to make rigorous quantitative assessments and international comparisons. In other cases (FDI, ODA, OOFs), evidence was taken from international sources which may or may not coincide with official, unpublished data. To support evidence-based management of these strategic resources, the government will need to develop the capacity to monitor and review them. This is one of the building blocks of an INFF analyzed later.

5.2 Using the DFA recommendations to improve access and impact of development finance

The list of possible improvements that emerged from this DFA is extensive, and the government will have to select or prioritize their implementation. A summary of all the suggestions from this DFA can be found in Annex 7.1. This list shows all the interventions proposed following the chronological analysis of the assessment. Two approaches are proposed to condense the analysis of these findings maintaining acceptable levels of clarity and depth:

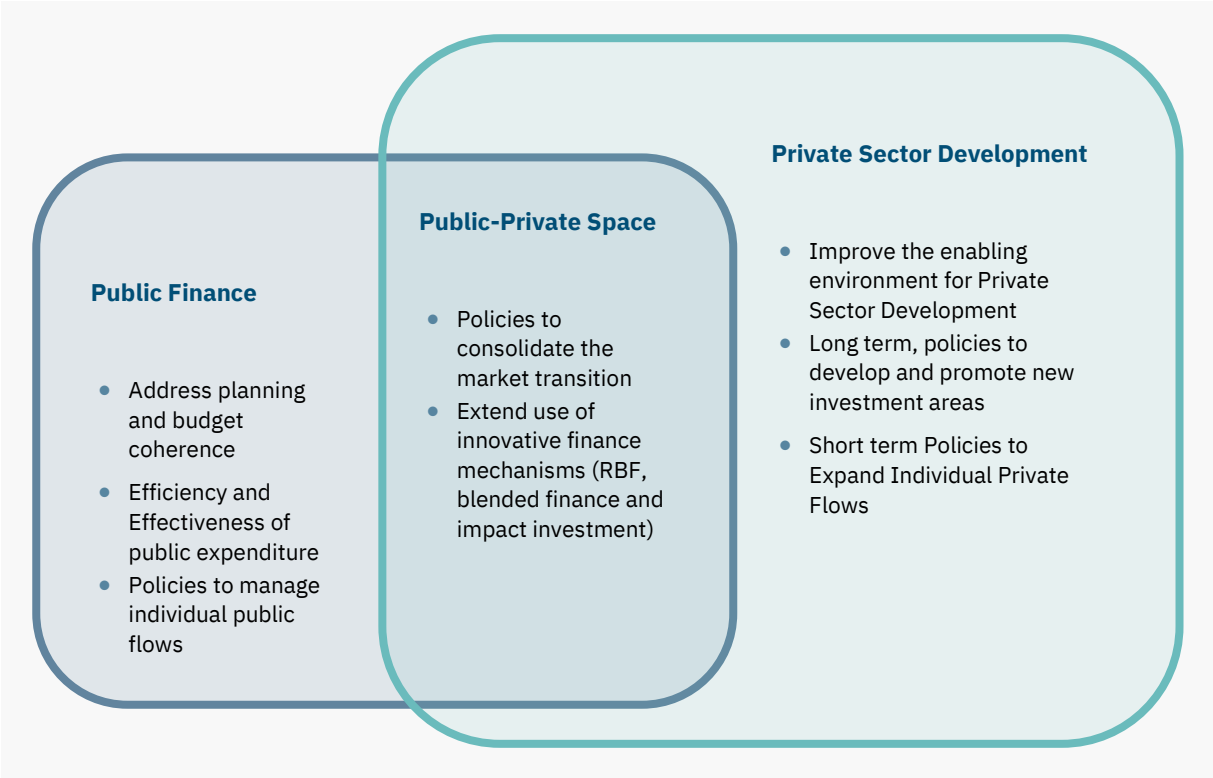
- A strategic perspective to the reform areas suggested
- Removing binding constraints

5.2.1 A strategic perspective to the reform areas suggested

At the most strategic level, the DFA provides concrete ideas to design a new architecture to finance the SDGs in Armenia. The most important contribution of a DFA is to provide clarity of the integrated approaches to managing the sources of public and private finance needed to achieve sustainable development. An essential element that emerges in this assessment is the opportunity to accelerate the growth of the private sector and extend its role in the economy. These opportunities are extensively analyzed in Chapter 4. On the other hand, the analysis of public finance

in Chapter 3 of the DFA does not foresee many options to increase the primary sources of public finance significantly discourages a generalized expansion of public sector expenditure. Instead, the assessment recommends focusing on getting more development results from the resources that are already invested and planning more strategically the interventions in the public/private space where public funds can be used in a catalytic way to leverage more private resources (for and non for profit).

Figure 78 A strategic perspective for the expansion of development finance in Armenia



The overarching idea is that the recommendations of this DFA would produce maximum results if implemented with a systemic approach that integrates the opportunities in the public and private spaces. The implementation of the recommendations of this DFA will have maximum impact if they are planned with a systemic view as the one illustrated in Figure 78. Instead of adopting scattered, isolated interventions to address individual parts of the problem, a systemic approach would allow to take advantage of all the possible synergies and cross-cutting benefits of the policies implemented. This systemic approach will produce the maximum possible results with the capacities and resources available in Armenia.

For this reason, the main recommendation from this DFA is that the government should develop an Integrated National Financing Strategy. This is a critical element for budling an Integrated National Financing Framework in Armenia and is further elaborated in Section 7. This key tool will allow the government to articulate private and public flows from domestic and external sources and combine financing policies to increase their overall impact. This should be the main instrument to ensure the long-term feasibility of the country's long-term national goals. A potentially helpful starting point for the strategy design are the primary outcomes of the DFA summarized in Figure 78 that are analyzed below.

Public Finance

Most of the improvements needed in public finance will require medium- and long-term reforms. The list of main aspects that emerged from the assessment points out to provide coherence to the national planning process and improve the allocative efficiency of public resources. The country made significant progress in fiscal management and has a clear path established by the PFM Strategy. However, there is still considerable room to improve the strategic focus of the budget process, moving away from line-item budgeting to program-based

budgets to results-based finance. A key input is to rationalize the large variety of planning instruments used (strategies, concepts, and programs) and provide coherence and alignment with national development goals and budgets.

Figure 79 A summary of the main measures recommended in the Public Finance Space

Address Strategic Planning and Budgeting Coherence	• Rationalize and simplify the use of planning instruments and align them with the new Armenia Transformation Strategy 2020-2050 (ATS). • Design an Integrated Financing Strategy (IFS) to mobilize the resources needed to provide feasibility for the ATS. Set financial targets and an action plan for the IFS for 2026 and 2030 • Mainstream the SDGs in the national budget process to resolve chronic planning and budget allocation disconnects and consolidate fiscal discipline • Complete the upgrade of the GFMIS and other PFM tools to consolidate program and performance-based budgeting • Strengthen PFM Strategy formulation and future PFM reforms by embedding SDG based policies
Improve Efficiency and Effectiveness of Public Expenditure	• Improve the evidence base to reduce public expenditure inefficiency (a PER to map public expenditure inefficiencies, a system to measure the alignment of tax expenditures with the SDGs) • A medium-term plan to eliminate known sources of public finance inefficiency (SOE losses, see public/private space) • Refine the public procurement system legal and regulatory reforms and provide more inclusive access to SMEs to ARMEPS
Policies to manage individual flows	• Introduce a strategic planning dimension to Government Revenue reforms (a medium-term fiscal and revenue strategy, reduce the informal economy, revenue administration) • A short-term plan to rationalize the use of Tax Expenditures (review the cost-benefit of the various tax privileges and exoneration regimes) • A long-term strategy to manage public debt (fiscal consolidation, SDG orientation to reduce costs, explore DNS or buybacks, prioritize debt use in essential areas) • An ODA management strategy (prioritizing domestic resource mobilization capacity development, aid multiplier effects. blended finance mechanisms). Expand ODA using new mechanisms (aid for trade and results-based aid) • Design and implement a Low Emissions Development Strategy (a Climate Change Financial Framework, accountability and transparency on CC expenditures, increased participation of CSOs)

Significant reforms are also needed to improve the efficiency and effectiveness of public expenditure. The latest available Public Expenditure Review is dated (2003); however, later reports indicate that many proposed reforms still require attention. For example, there is still significant room for improvement on expenditure rationalization in some areas to balance unattended needs in others. In addition, accumulated expenditure restructuring in some sectors may not have yet reached the desired levels. The pandemic also unveiled the fragility and real quality of public expenditure in critical areas such as health and education. Therefore, the time seems right to conduct another PER to provide a baseline and elements to design long-term reforms beyond PFM. This will allow the government to address the other essential issues to obtain more development outcomes with current spending levels.

An additional aspect that emerged from the assessment of public finance is that there are many opportunities to improve the management of specific finance flows. Although the overall management of public resources tends to be above the average of regional peers, there are still many opportunities to improve the management of individual flows. For example, the need to review and rationalize tax expenditures, the convenience of using more strategically ODA

and public debt, and the opportunity for developing a robust climate finance framework, an experience that could also allow for managing other complex, cross-cutting sectors.

Public-Private Collaboration

One of the most motivating aspects emerging from this DFA are the actions in the public-private collaboration space. Although Armenia is one of the countries that advanced the most in the economic transition process, there is still ample space for private sector expansion. The DFA claims that SOEs negatively impact macroeconomic performance and do not contribute enough to the economy because of low profitability, high leverage, and low liquidity. Therefore, it is proposed to devote further efforts to privatize SOEs, liberalize markets or even close some. This should be a gradual and well-planned process designed to minimize potential social costs, as SOEs are also large employers. However, this move will generate fiscal relief for the government and open more spaces for the private sector to operate. There are also ample opportunities for improving the strategic management and use of PPPs to address critical infrastructure gaps that constrain private sector development.

Figure 80 A summary of the measures recommended for the Public-Private Space

Improve the enabling environment for Private Sector Development	• Address short term legal and regulatory reforms (insolvency, minority investors) • A medium-term plan to finance investments to remove infrastructure and other significant binding constraints • Improve results of ineffective policies (skills of the workforce, quality of TVET, anti-corruption) • Improve access and quality of domestic financing for the private sector
Policies to consolidate the market transition	• Develop a plan to sequence the privatization of SOEs, liberalization of markets, and plan the closure discontinuation of some SOEs. • Improve the remaining SOE governance with clear short-term targets (profitability, leverage, and liquidity) • Develop a PPP strategy to provide a more strategic, risk-balanced, and transparent use of PPPs to address critical infrastructure constraints.
Innovative Finance mechanisms	• Develop and implement a blended finance policy to leverage private commercial capital for strategic goals of the IFS • Develop appropriate "ecosystems" of policies to attract impact investments and innovative approaches for CSO investment • Develop PPPDs to co-finance and leverage resources for priority projects with the nonprofit sector • Develop and test innovative finance mechanisms to raise funds with the diaspora (like SDG diaspora bonds) for SDG investment areas

The assessment found that most of the opportunities in the public-private space will require innovative practices that could generate significant impact by making better use of blended finance mechanisms to attract commercial capital to finance development areas. There are opportunities to develop partnerships with national and international NGOs and explore results-based programs that can improve the quality of public services and leverage significant additional philanthropic resources. These policies may be seen as innovations in Armenia.

In most cases, successful pilot experiences could be taken as models to scale up to more ambitious policies. The leadership of key government institutions will be the critical variable needed to support these interventions in the innovative finance space. They may demand changes to the existing regulatory frameworks and established procedures. There are also opportunities to support introducing these policies with ODA, as some of the areas suggested (like, for example, Blended Finance) are aligned with development partner priorities.

Private Investment and Finance

Improving the enabling environment for private sector development demands sustained short-, medium- and long-term interventions. The private sector expansion will be one of the best contributions to sustainable development in Armenia**.** Some of the most problematic issues identified would not require significant investments and can be achieved quickly. These are mainly related to reforms in the legal and regulatory system (for example, protecting minority investors and resolving insolvency).

Some of the binding constraints will require significant investments for which the government will benefit from the strategic and integrated financing approach in the public-private space addressed above. Other improvements will demand a longer-term approach to obtain better results of current expenditure (for example, workforce skills, the quality of the TVET programs and skillsets of graduates R&D expenditures and innovation policies, and anti-corruption policies).

Many of the actions required on the private side will demand changes in the policies implemented until now, some of them radical. Compared to regional peers, the country has not performed as well as it could on this front, despite the many competitive advantages that it has built since independence. Even if the geographic and geopolitical conditions are challenging, Armenia can aspire to improve its insertion in the global trade markets and develop endogenous private markets. The government has ambitious plans to expand the private sector during the next five years, and export manufacturing is a primary target. Still, there are also great opportunities for attracting FDI, developing SMEs, and increasing domestic private investment. However, most of these policies require significant changes and sometimes a radical departure from previous policies and incentives that failed to deliver the desired results

Figure 81 A summary of the main measures recommended for the Private Space

Long term, policies to develop and promote new investment areas	• Develop systems to measure the alignment of private investment with the SDGs and national priorities (banks, institutional investors) • Assess the opportunities for Armenia for attracting SDG oriented investments implementing results from SDG Investor map • A long-term strategy for FDI development in high potential areas that may take over a decade together and a short-term "FDI revolution" plan to change direction of this flow (modernize legal and regulatory, focused promotion)
Policies to Expand Individual Private Flows	• A policy to reduce credit risks and user costs and to improve alignment of banking institutions with the SDGs and national priorities • A medium-term plan to develop the national financial markets improving access, depth, and efficiency • A Financial Inclusion Strategy to support the implementation of the 2020-2024 SME Sector Development Strategy • Integrated policies to increase the development impact of seasonal work and remittances and open more opportunities for the diaspora

5.2.2 Removing binding constraints

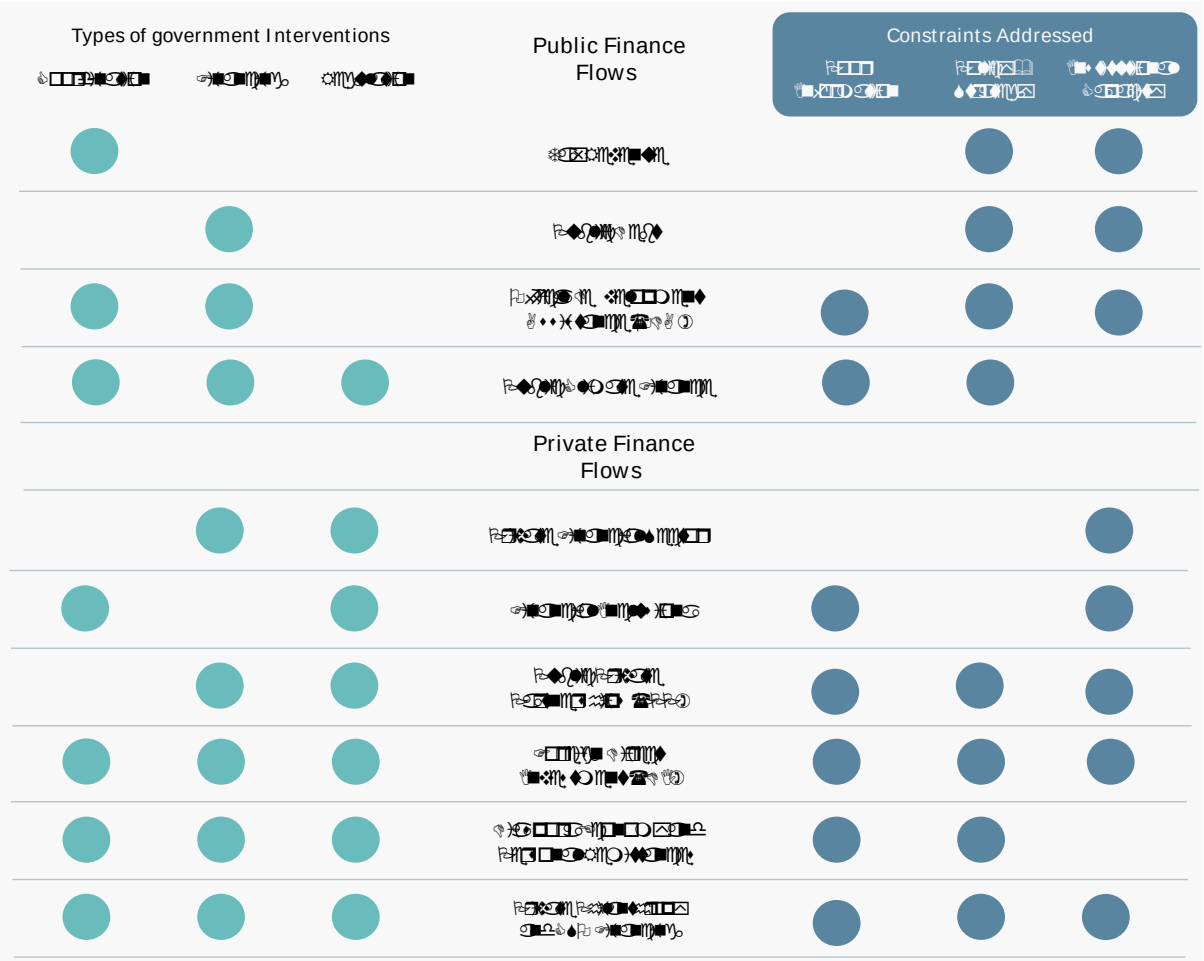
The analysis of the individual finance flows identified several issues that are blocking their full development or their alignment with national development priorities. Across the complete study, the DFA found several constraints that repeatedly block individual flows' development. There are also some essential repetitions in the type of government interventions embedded in the recommendations for their development. These elements are summarized in Figure 82 to facilitate visualization. These outcomes were grouped into two main categories:

- ***Limitations of the Country Systems***. The sound management of these flows is often hindered

by the lack of adequate policies or strategies. Sometimes there are weaknesses in the institutional capacity of the government agencies that should implement them. One of the most persistent factors is inadequate or absent evidence and the lack of quality information to make informed government policy decisions or guide and stimulate private investment.

- ***Government Interventions Needed***. In most cases, the recommended actions address problems regarding the legal and regulatory systems that govern individual financing flows. Inappropriate financing or incentives are also recurrent elements in which good policies are underfunded and incapable of producing the desired results. One of the most critical constraints is the quality of government coordination, especially for cross-cutting policies

Figure 82 A categorization of the main types of interventions and constraints



The analysis of the constraints that limit the development of the financing flows highlights the importance of some of the building blocks of an Integrated National Financing Framework. The most typical constraints identified relate to three main factors: (i) the insufficient quality of the data and information to inform evidence base policy decision making, (ii) the quality of the policies that govern individual flows and (iii) the institutional capacity limitations to implement these policies. These bottlenecks highlight the importance of the Monitoring and Review and Governance and Coordination building blocks of the INFF (analyzed in the next chapter). A methodological review of the approaches needed to adapt the policies that govern these flows is offered in the next section. The analysis shows the convenience of adopting the strategic financing approach component of an INFF.

Similarly, the interventions needed to address these binding constraints show the convenience of adopting a strategic and integrated approach to financing. The analysis of the main recommendations to improve the management of each flow shows some recurrent issues

that would benefit from a more strategic approach: (i) the need to visualize the upgrades or changes to the legislative and regulatory frameworks, (ii) the need to invest more resources to provide adequate management and (iii) the need to strengthen coordination, primarily to manage the cross-cutting policies. These situations highlight the convenience of adopting the financing strategy component of an INFF as most of the financing flows affect each other, and their management impacts on the performance of the overall solution.

The DFA identified and prioritized a few critical bottlenecks that constrain the country's ability to accelerate sustainable development. Even in the absence of the long-term integrated financing strategy proposed above, systematic removal of these obstacles may generate significant improvements in the individual performance of the major finance flows. Accordingly, the government may consider the feasibility of the investments needed to address or remove them. By creating better conditions, expect an expansion of development finance to pay the investment back. The most critical constraints include:

(i) Global Connectivity and infrastructure bottlenecks. Although it has been demonstrated that significant export business expansion can be achieved with the existing conditions, this is a long-term issue that must be addressed. The government could develop a plan to identify, sequence, and cost the actions to remove the most critical bottlenecks. This plan should then be analyzed for feasibility to find the best possible ways to mobilize the necessary resources (public and private) to get it financed. As described in the next section, significant synergies can be achieved by developing these solutions with an integrated approach. A positive side of these recommendations is that the implementation of a considerable part of this plan can be initiated during one government administration.

A good example of this approach could be to apply it to the energy targets proposed by the Government Program 2021-2026. The program makes a bold proposal regarding energy and transforms a known negative element into a regional competitiveness factor. This plan could be operationalized in this recommended way. This plan could also be complemented and transformed into an operable program. This plan should be developed and extended to other areas like roads and infrastructure connectivity essential for private sector development.

Table 6 Main elements of the Energy proposal in the GP 2021-2026

Area	Targets for 2026
Energy Sector	• Become an Energy Hub in the Region • Armenia-Iran and Armenia-Russia 400KW of electricity transmission lines • Solar generation capacity up to 1,000 mW, to reach 15% of total generation by 2030 • Wind stations with a capacity of about 300 feet [500 m] • Plan a second HEK power plant • investments to extend the second nuclear power plant for another 10 years • Plans for the construction of a new nuclear power plant • North-South Electricity Corridor • Gradually liberalize the electricity market

(ii) Developing the domestic financing market. The analysis in Sections 4.4.1 and 4.4.2 show significant limitations of the domestic financing system, oligopolist banking structures that must be addressed, lack of financial inclusion and literacy of large segments of society, poor market specialization for MSMEs of the banking system, and underdeveloped alternative solutions. To top all this, the small size of the capital market impedes significant areas for private sector development and better management of public domestic debt instruments. Same as above, with adequate planning, funding, and committed leadership from the government, significant results could be obtained during one administration.

The DFA provides sufficient elements to develop a plan with an integrated financing

approach to address this binding constraint. The factors addressed in these sections of the DFA will allow a discussion of a potential program. This plan can also help to address the few targets set by the government in the GP 2021-2026 regarding some of these areas, for example:

- Increase the size of the SME market to grow to reach 55% of GDP by 2026
- Support agro-processors within the scope of subsidized credit and leasing programs,
- Reviewing the tax regulations in the capital market
- Raise the level of predictability of tax regulations applicable for revenues from securities and corporate profits

(iii) The quality and inclusiveness of the human capital development profile. Although Armenia has achieved a reasonably good human development performance compared to regional peers, the analysis in Section 4.2 shows that this binding constraint is also a significant problem area. Several problems pointed out in the international assessments persist over time as important factors for reducing Armenia's investment attractiveness and competitiveness. They mainly relate to the disconnects of the skills and productivity of the labor force with private-sector market demands, the insufficient capacity to innovate, and the low labor market relevance of the whole education system. There are also well-diagnosed asymmetries in human development that affect women and people living in rural settings.

In this case, the country should significantly focus on getting better development results for the current public expenditures made in these areas. This is one of the areas where society pays the highest costs of public expenditure inefficiency. UN agencies lead some initiatives to improve the quality of education expenditures. This is an area that the WB has targeted as a significant pathway for reinvigorating inclusive growth and resilience. The WB recent Systematic Country Diagnostic (SCD) proposes clear policy directions to start operative action, like for example[143]:

- Ensure the education and workforce development systems provide skills relevant to the market (through teacher training, promotion of STEM and higher education, expansion of tertiary in rural areas, better VET regulation, workforce development, and apprenticeships)
- Support matching of workers to jobs (through strengthening the State Employment Agency, activation of social assistance beneficiaries)
- Facilitate women's labor market participation (through ECE, gender mainstreaming in general and higher education)

Contrary to the cases mentioned above, meaningful results of these efforts will be achieved over more extended periods of persistent and efficient public investments. However, there are several opportunities for obtaining high impacts in the short term that the government should prioritize to gain confidence and consensus to ensure the future continuity of these efforts. Some of these actions can be developed by implementing innovative finance mechanisms, like, for example, the gradual introduction of Results-Based Financing systems for government expenditure and of Results-Based Aid programs. These systems include a range of instruments; some are highly complex, like the Social Impact Bonds and Development Impact Bonds that could also be explored in Armenia.

5.2.3 Analyzing the type of policy changes needed

The government must consider that the type of policy intervention needed to manage the different financing flows is significantly different in each case. The DFA analysis pays significant attention to the quality of the policies that govern each financing flow. The assessment also covers the institutional and implementation aspects of these policies. This provides an overall picture of the recommendations made in this report. The efforts needed to manage these flows vary depending on each case. The recommendations were grouped into three broad

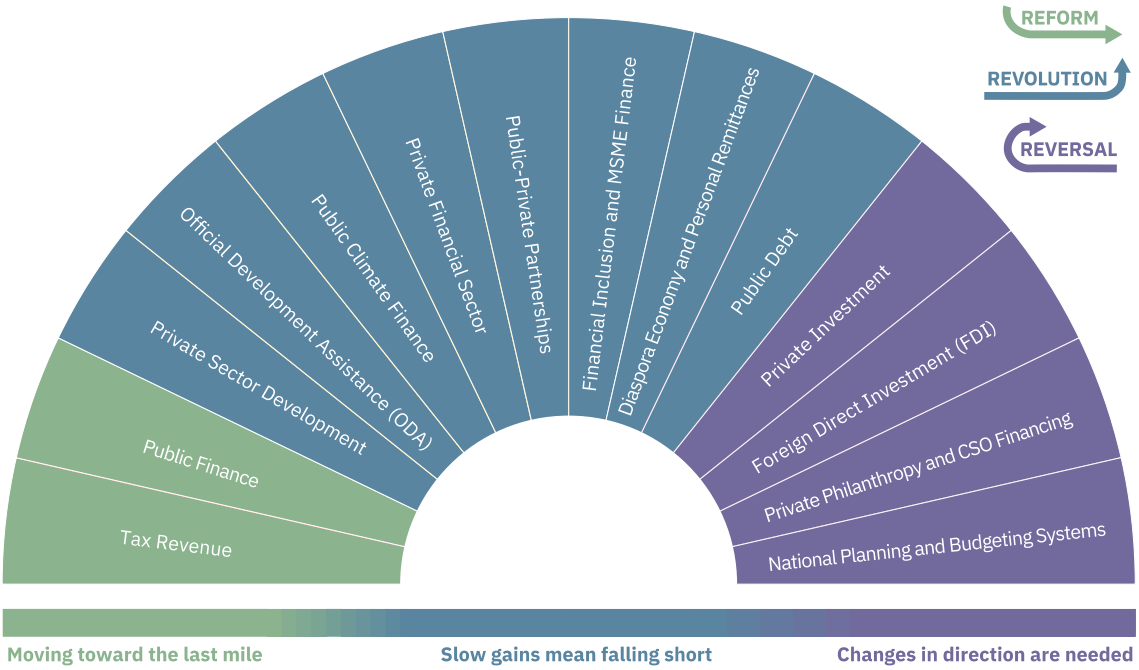
[143] Reproduced from WB (2017) "FUTURE ARMENIA: CONNECT, COMPETE, PROSPER " a Systematic Country Diagnostic

categories summarized in Figure 82 to facilitate visualization.

i) Moving Towards the Last Mile. In some cases, the government policies are going in the right direction, and the speed of development of the flows is adequate. Hence, what is recommended is to keep the direction and the pace of the reforms and achieve the “last mile" needed to reach adequate levels of maturity and perform according to the exigencies of the new economic model. This status applies, for example, to public revenue and tax expenditure. These reforms still have some way to go, but the role of the government is to maintain current momentum, as their planned growth would fully develop them within the next decade. This category also includes the overall strategic direction of public finance management and the implementation of broad reforms in critical areas (public administration and Public Finance Management).

ii) At Risk of Falling Short. The assessment also revealed that a broad range of flows are progressing in the right direction, but at current speeds, their improvement would be too slow and not conducive to reaching the required levels of development within the next decade. This would be a problem, as many of these flows are usually the backbone of more developed economies' public/private finance mix. Therefore "a revolution" is needed to accelerate development and improve the alignment of these flows with national priorities. This category includes (i) ODA and public climate finance, (ii) PPPs, (iii) private finance and financial inclusion, (iv) diaspora economy and personal remittances, and (v) public debt. Overall reforms to improve private sector development also fall into this category.

Figure 83 The type of approach needed to improve the management of the areas analyzed



iii) A Change of Direction is Needed. The last category includes the areas where a radical change of direction is needed, as the current course will not meet the country's demands. Finance flows that fall in this category are i) domestic private investment, ii) foreign direct investment, iii) private philanthropy, and CSO financing. In some cases, the government may need to start from scratch and find good practices and other countries' experiences to design new strategies. Many of these are at the top of Armenia's prioritization list but do not get the (quality and quantity) implementation and investment needed. However, this condition does not mean that these flows cannot reach their full potential soon. On the contrary, it will be possible to develop and implement reforms that could lead to significant results in less than a decade with resolute

government leadership. The national planning and budgeting system also falls in this category.

The Government Program 2021-2026 provides good examples of policy decisions that would benefit from the abovementioned analysis. Some of the GP's targets imply significant changes in the direction or in the speed of development of some of the flows analyzed in the DFA. The analysis of the projections of the individual flows shown in Figure 86 below illustrates in practical terms the three management situations analysed above:

- ***Last Mile***. What is proposed for tax revenue for 2026 almost coincides with the historical projection of the "business as usual" case. This is a typical case where the government has to push forward current reforms to achieve the needed last mile results.
- ***Revolution.*** In the case of public debt, the government needs a management revolution to change the current trajectory for this flow. The historical projection would take public debt close to 85% by 2026, and the government is proposing to decrease it to 60%. A policy change is not needed to achieve that, but a significant change of management is required.
- ***Change of Direction***. For private investment and FDI, the government's is proposing to completely revert the historical trends and achieve values close to 2012. In this case, the government recognizes that the policies applied did not produce the desired results, and radical changes of the policy and institutional setup are needed to make this happen.

Figure 84 Projections of key targets proposed by the Government Program 2021-2026

CHAPTER 6

The way forward: a roadmap to develop an Integrated National Financing Framework

6.1 The value of an Integrated National Financing Framework

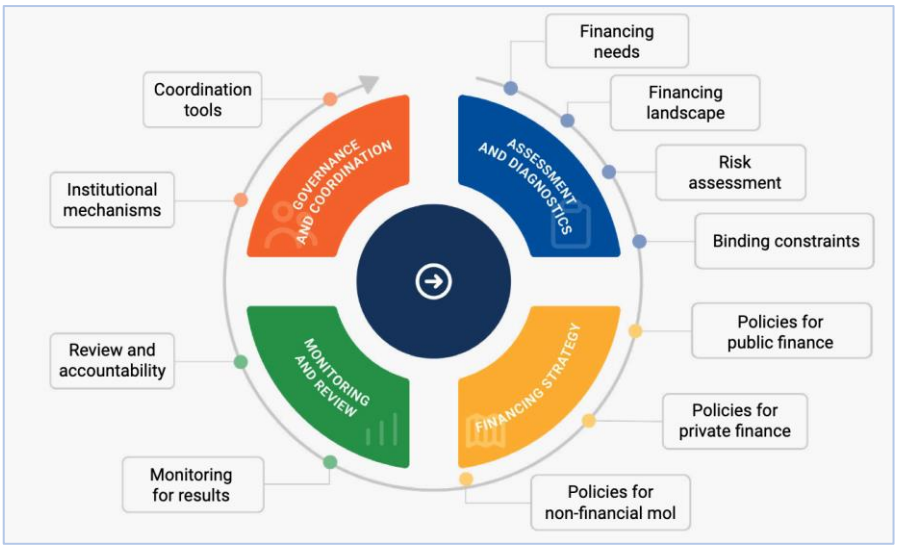
Although the current conjuncture is tight, the prospects for Armenia are very up-and-coming. Medium and long-term prospects are very positive, and – once achieving some negotiated solution is to formalize the resolution of the main international conflicts, the Armenian economy could expand significantly and produce some of the highest real growth rates in the region. The Government Program 2021-2026 (GP) estimates that this growth should be over 7% annually from 2022 onwards. Still, the country could even aspire at reaching double digits if the right policies are executed.

The DFA reveals the benefits of adopting an integrated approach for development finance. For various reasons explained in the previous section, this evaluation shows the convenience of adopting a comprehensive and integrated approach to improve development finance. Considering the cross-cutting nature of the multiple financing opportunities and challenges, this DFA recommends packaging them into a strategic approach for financing a comprehensive mid-term recovery**.** The identified actions and reforms recommended for improving the size and alignment of individual flows should not be implemented in a disjointed way or left to the spontaneous initiative of individual agents in isolation.

The main findings of this DFA can be used to develop an Integrated National Financing Framework (INFF). This is a planning and delivery tool to help countries overcome existing impediments to financing sustainable development and the SDGs at the national level. It lays out the full range of financing sources – domestic public resources, aid and development cooperation, and domestic and international private finance – and allows countries to develop a strategy to increase investment, manage risks and achieve sustainable development priorities as identified in a country's national sustainable development strategy. This DFA provides a baseline and recommendation for actions for the four budling blocs of an INFF shown in Figure 83.

The novelty of this approach lies in its integrated nature. INFFs aim to foster practices to mobilize private and public flows from domestic and external sources and combine financing policies to increase their overall impact. Their aim is not to replace the many existing methodologies and tools that the country already uses. Instead, they provide a rational framework to align specific instruments with the broader financing strategy, avoid fragmented decision-making, better align efforts, and identify gaps and opportunities for resource mobilization. Moreover, INFFs can promote coherence by centralizing the otherwise sectoral debate around financing approaches into one overarching policy framework and incentivizing greater collaboration.

Figure 85 The Building Blocks of an Integrated National Financing Framework



Source: UNDESA 2021

Developing an integrated financing framework should be a country-led process that requires an inclusive approach. Government policymakers must be in the driving seat during this process to determine the financing objectives of the strategy. This leadership is essential as the process will require considering different synergies and trade-offs or addressing the full range of financing sources and their contributions to the desired goals. It is essential to involve many stakeholders (government and non-governmental) from the outset to bring different perspectives and foster integrated thinking. Once the government has agreed to develop an integrated national financing framework, there are still several options to organize this work.

The following sections provide the initial guidance to define the process of developing an Integrated National Financing Framework in Armenia. INFF building is an iterative process to develop the four building blocks shown in Figure 84. This DFA can be taken as the completion of the Assessment and Diagnostics Phase. The DFA also provided a baseline and significant elements to start the other three's development. The following roadmap shows the recommended approaches to develop the other building blocks of an INFF in Armenia

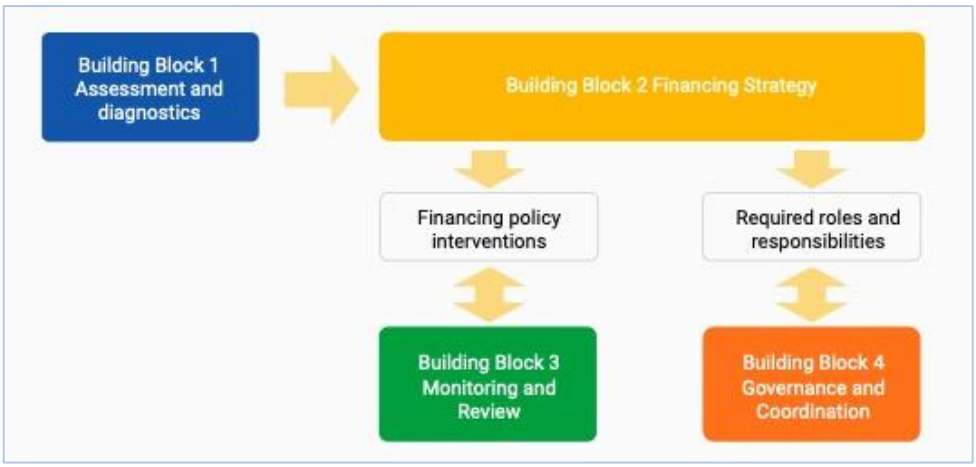
6.2 Developing a Financing Strategy

The development of a financing strategy is the recommended next step to facilitate the establishment of an Integrated National Financing Framework (INFF) in Armenia. These strategies are innovative methodological approaches designed by the UN to provide governments with the means to mobilize the unprecedented levels of domestic and external, public, and private funds required to achieve the SDGs. This new methodology approach foresees an iterative path described in Figure 85, where the assessment provided by this DFA is the first step. The following steps will guide to develop this Strategy:

Focus and objectives of the Strategy

The Integrated Financing Strategy should be designed to provide feasibility to the national development priorities in Armenia. This strategy should be designed to provide feasibility to the new Armenia Transformation Strategy 2020-2050 (ATS) goals and targets. This financing strategy must give the overall orientation of the actions needed to increase these resources on a timely basis The strategy Action Plan should be designed to support the financing of the Government Program 2021-2026.The design of the Integrated Financing Strategy should aim to help the government of Armenia to:

Figure 86 A Methodological Approach to Design and Implement an INFF



Source: UNDESA 2021 (b)

- Raise financing for sustainable development and better align existing financing policies with medium and long-term national sustainable development priorities.
- Prioritize policies to take advantage of opportunities in the near term and identify financing policy areas for the medium- and long-term.
- Ensure that financing policies, instruments, and regulatory frameworks from across different areas are coherent, sustainable, and risk-informed.
- Identify opportunities to access technical assistance and capacity-building support from development partners and highlight peer-to-peer exchanges and learning areas.

Setting Targets for the Strategy

The scope of the financing strategy will concentrate on providing feasibility to the government ambitions for medium- and long-term planning. The UN developed this financing instrument to provide feasibility to the SDGs at the country level. The scope and ambition of the strategy are directly related to the ambitions of the national development plans as they should address the financing needs of these plans and fill any foreseen gaps. If the national authorities decide to develop this comprehensive strategy (time-bound, action items); this should be linked to the high-level development policy document goals and targets, such as Armenia Transformation Strategy 2020-2050 (ATS) and the Government Program 2021-2026

A practical way to start this iterative process would be to focus the initial scope of the strategy on the financing needs of the Government Program 2021-2026. Without a finalized definition of the ATS, the Financing Strategy could be designed to provide feasibility to the actions planned in the GS 2021-2026. Additional technical work will be necessary to assess the financing needs of the GS and propose financing targets for public and private resource mobilization. This assessment should provide the following elements:

- The costing of the GP to define the future need for public finance, and to project the fiscal space needed for public investment and recurrent budget.
- Defining the areas where private investment should take the lead and estimate the size of the private resource mobilization efforts.

However, the main elements of the strategy can be drawn even in the absence of a definitive financing needs assessment. he DFA already provides orientations to guide the resource mobilization efforts. Some general estimates of the Government Program 2021-2026 may suffice to set the initial targets of the strategy. The examples in Table 7 correspond to definitions made by the GP that could be costed. They would benefit from a more precise definition of the indicators and actions. However, they already show the type of analysis required to guide the

initial definition of the strategy. The Action Plan of the GP will surely provide the necessary elements to guide this process. The definitive targets of the financing strategy can be refined later as more technical elements emerge during implementation.

Table 7 Examples of quantitative targets proposed by the Government Program 2021-2026

Area	Targets for 2026	Baseline and measures
1. Manufacturing	• Projected its growth to at least 15% of GDP • Economic Complexity Index increased to 0.1 • Classify as high economic complexity in 2030	• Manufacturing is 12.4% of GDP • Economic Complexity Index -0.39
2. High Technology	• Expand the sector to 6-7% of GDP (USD500b) and provide 35,000 jobs	• 4% of GDP and 19,000 jobs
3. Private Investment	• Expand it to at least 25%	• Estimated to be 12.9%
4. Foreign Direct investment	• Expand it to 6% of GDP	• WB baseline 1.9%
5. SMEs	• Expand the sector to reach 55% of GDP	-
6. Tax Revenue	• Increase 2.6 percentage points to reach 25%	• Taxes and Duties: 22.4% • Tax revenue only:21.9%
7. Public Debt	• Reduce debt to reach 60% of GDP	• Central government 67.3%

Alternatively, the scope of the financing strategy could also be designed to focus on the financing needs of the SDGs at the national or sector level. An alternative path would be to extend current efforts to mainstream the SDGs in the national budget and cost the SDGs. The UNDP provides technical assistance to define this, especially from a public financing perspective. As this could be a very ambitious effort, the government may experiment with this instrument by tying it to existing sub-strategies and linking the financing strategy to sustainable development goals or plans. For example, this iterative process could be started by focusing on a selected SDG (gender, environment) or sectors (health, education).

Identifying policy options and intervention pillars of the Strategy

This DFA identified several policy options that could be used to support the formulation of a comprehensive strategy. This assessment provides with abundant material to structure a financing strategy building on the implementation plan of the DFA recommendations provided in Annex 1. The main pillars of the financing strategy were already drafted in section 5.2. The strategy could be organized around the following three strategic goals. Their expected financing outcomes are summarized in Table 8 below.

- ***Public Finance***. Increase efficiency and effectiveness of public finance, eliminating unnecessary expenditures and implementing reforms to increase the development results from the resources that are already being invested. Improve management of selected finance flows and their alignment with national priorities.
- **Public/Private Space**. Provide adequate policies to develop the public/private collaboration space focusing on the development of innovative finance instruments to accelerate key areas (like infrastructure) or new practices (like blended finance or results-based finance)
- ***Private finance***. Accelerate the growth of the private sector and extend its role in the economy by opening more markets for domestic private activities. Significantly extend private investment and align them with national priorities by improving the management of selected finance flows.

The process to develop the Strategy

The process to develop a financing strategy in Armenia should be participative and integrate the diagnosed country situation. The strategy design process should be government-led and participative. Following UN good practices, the design of the strategy in Armenia could be structured following the indicative process below.

- ***Inception Phase.*** During this phase, consultations with the government counterparts will be organized to discuss the main options for this strategy and explore government priorities. The outcome of this phase is an outline of the strategy. This outline will include critical elements such as objectives, proposed approach, main thematic elements, and an action plan, including a list of the main stakeholders who should participate.
- ***Financing Dialogues***. A participative process to carry out thematic discussions with key stakeholders. The most important part of this process will focus on the strategic and thematic discussions with different national government levels. In addition, technical dialogues should be carried out with representatives of the private sector, CSOs, and development partners to discuss the main elements of the strategy, eliminate barriers, and find common ground. The outcome of this phase is a first draft of the strategy that the government will have to analyze
- ***Prioritization and Formulation***. The government will decide on the final prioritization of the strategy after analyzing several elements, like (i) policy coherence checks, (ii) trade-offs and externalities, (iii) preconditions (institutional, procedural, capacity), (iv) resource requirements, and (v) short, medium. and long-term impact expected of the actions suggested. The final strategy may need formal approval by the government or the parliament.

Table 8 A summary of the main policy options identified by the DFA

Financing Area	Type of Intervention	Main Purpose	Financing Outcome
Public Investment and Finance	**Medium/Long Term Reforms**	Increase Budget Efficiency	More public resources for the SDGs
		Reduce tax Expenditures	
		Reduce SOE Losses	
		Increase Tax Revenue	
		Reduce Corruption	
		Improve Sector Effectiveness	More SDGs per $ spent
Public -Private Collaboration	**Innovative Finance Instruments**	Results Based Financing	
		Blended Finance	More SDGs per $ spent Leverage additional private resources for the SDGs
		Impact Investment	
	New uses of Private Philanthropy	Private Public Partnerships for Development (PPPDs)	
	Integrated Financing Policies	Migrant work/remittances	
		Infrastructure	
Private Investment and Finance	**Private Sector Development Policies**	Legal and regulatory Improvement	Increased private investment and private finance oriented by the SDGs
		SDG Targeted FDI	
		Incentives and Tools	
	New Markets Created by the SDGs	Increase investment in several new areas	
	Climate Investment	Adaptation to effects of CC	Reduce long-term costs of climate related effects

The final document will contain the major objectives, action pillars, and deliverables (short and long term) of the strategy together with further proposals to (i) carry out additional assessment and diagnostics, (ii) set the baseline and program the development of the monitoring and review system for the strategy and (iii) establish the governance and coordination procedures and the support that the government will require to implement them.

6.3 Building Monitoring and Review Systems

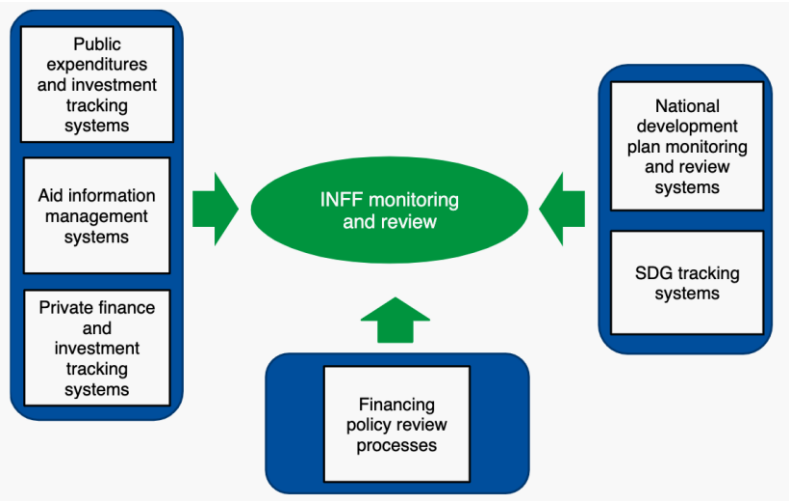
The INFF monitoring and review system development will provide significant benefits to managing development finance in Armenia. As discussed in the previous chapter, the lack of quality evidence and information is a common binding constraint that affects most of the individual financing flows analyzed. Moreover, these systems can provide a "control panel" to monitor the results of the implementation of the financing strategy.

- ***Build the necessary evidence base*** to improve efficiency and effectiveness of financing policies and reforms, encourage broad-based participation in policy processes by all relevant

stakeholders, and enhance buy-in and understanding of the value of the INFF

- ***Streamline monitoring efforts by reducing gaps.*** As analyzed in the previous section, the strategy will focus on financing gaps for private finance and investment. This unit will perform the economic forecasting of projected reforms and their costing consequences and the strategic backcasting and the reverse engineering of particular targets. It will also help address redundancies and overlaps (for example, between public finance and donor systems or private philanthropy).
- ***Alignment with national priorities.*** This system can be designed to measure and address misalignments of financing flows with national priorities. For example, they could be designed to measure the alignment of private bank credits, institutional investors, or even public debt with national priorities and/or the SDGs
- ***Performance of the Financing Strategy.*** These systems should regularly review and report on the value-added of the financing strategy, including whether it is succeeding in enhancing mobilization and increasing coherence and alignment of financing with national development priorities
- ***Support dynamic policy-making*** by facilitating learning on what works and what does not work and enabling timely course adjustments in response to changes in conditions, such as financing and risk landscapes. This is very important in the relatively unstable Armenian context
- ***Improve transparency and accountability*** and strengthen the government's capacity to generate partnerships, dialogue, and trust among stakeholders. The DFA shows that this is a relevant factor for managing several flows like remittances and diaspora philanthropy

Figure 87 A categorization of the main types of interventions and constraints



Source: UNDESA 2021 (b)

This DFA provides sufficient contextual analysis to support the design of these systems. The components of an integrated monitoring system are summarized in Figure 87. It should make compatible and integrate (i) quantitative information from the PFM system and of the public finance flows analyzed (including specific strategy targets as tax expenditures) (ii) private finance and investment tracking, eliminating "blind spots"(like CSO, PPP and private Climate financing) and adding the capacity to measure their alignment to national priorities, (iii) the newly designed ODA information system and the one that is suggested for Foundations and NGOs using the same platform. This information could be enhanced by policy reviews and systematic monitoring and reporting on the progress to achieve national development goals or the SDGs.

Finding an adequate institutional solution to locate these systems will need additional analysis and discussion. These systems should integrate and adapt considerable amounts of data scattered in different government units (like the ones by Armstat and the CBA) and integrate current and projected MIS (like GFMIS and ADAMS). However, these systems' most significant

value added is their capacity to process data to produce information and analyze information to produce usable knowledge. Same as with INFF governance, these tasks exceed the mandate of one specific ministry. This would suggest that the best institutional location for these systems should be in the same place selected for the INFF management unit discussed below.

6.4 Governance and coordination

The leadership required to build and manage an INFF will demand new roles for the government, as they will introduce a variety of challenges to current practices. The INFF concept emphasizes the need for a long-term vision for finance and a better understanding of the interconnected nature of the factors that affect development finance that the government will need to address with a holistic and coherent approach. This job will take the Armenian government outside of its comfort zone as it requires a degree of strategic planning and coordinated implementation that are not usual in the country. This need can be better illustrated with the following examples:

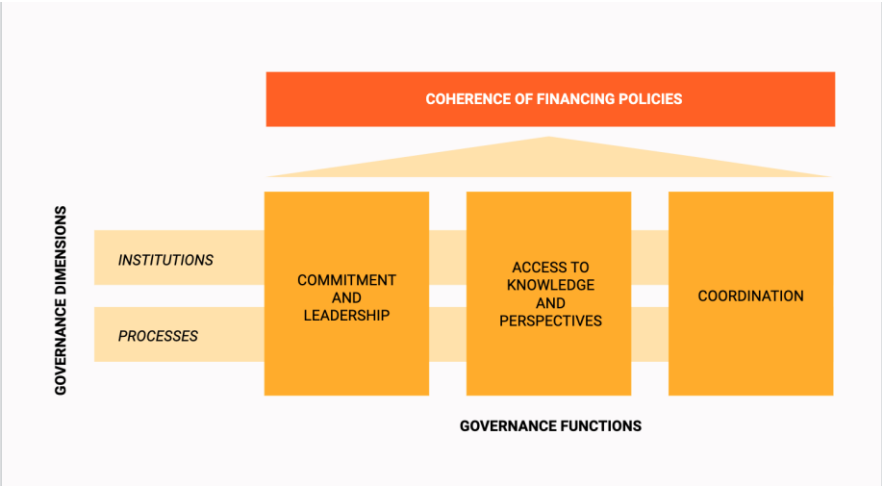
- The Financing Strategy in Armenia will indicate that the long-term expansion of private sector investment requires specific improvements to infrastructure (roads, energy, ports), that these investments will demand a targeted use of public funds and a strategic and successful expansion of PPPs, which in turn may require a significant and successful increase in FDI, the expansion of the national capital market and more efficient use of available ODA.
- Increasing the development impact of remittances may require combined policies to formalise seasonal migrant work, to provide workers with higher skills to increase their income, to extend the financial literacy and inclusion to their families so they can make better use of the resources received, to use innovative finance mechanisms to collateralize remittances to buy properties or start-up businesses and to integrate government actions with efforts by NGOs and Foundations

The government will need to develop the capacity to conceptualize this strategic approach and apply policies that reflect the importance of these interconnected reforms. The greatest challenge to achieve the deep transformations and ambitious goals that this plan to build an INFF proposes is to generate a consensus at the highest level of the government about: (i) the strategic need for an INFF, and (ii) to identify an efficient institutional solution to implement the roadmap to build it. Moreover, it is most likely that the implementation agenda, like the one shown in the example above, will transcend the duration of a single administration

UN good practices recommend considering the different dimensions requested to provide adequate INFF governance. As illustrated in Figure 88, three key functions are needed:

- ***Commitment and leadership from the top*** both at the political and technical level. This is needed to provide the overall vision and direction around which increased coherence can be pursued, and ensures ownership, broad-based buy-in and participation, sustained momentum over time (including across political cycles), and adequate resourcing of INFF-related efforts and activities.
- ***Access to knowledge and perspectives*** ensures that policy makers have the information they need to make decisions on the suitability of different financing policy options and their impact on sustainable development; that finance providers (public, private, national, international) can be held to account; and that the broad set of needs, priorities and interests that affect the success of INFFs are recognized and addressed.
- ***Coordination among different stakeholders*** both within and beyond government. This is needed to maximize synergies, reduce duplication, enable the management of tradeoffs, and minimize contradictions or inconsistencies in the formulation and implementation of financing policies in different areas. Coordination among stakeholders is also critical to facilitate a coherent approach to financing that reduces risk across economic, social, and environmental systems and ensures that financing priorities and policies in one area do not create risk in another.

Figure 88 Dimensions and Functions of INFF Governance



Source: UNDESA 2021 (c)

This is a significant challenge in Armenia because implementing these frameworks transcends the mandate of a single government institution. It will be necessary to ensure the coherence of the various policies that together will form the INFF and align a wide range of policy areas, each with different models of investing, partnering, or influencing the way private and non-state actors use their resources. The following steps will guide to develop of the governance and coordination mechanisms in Armenia:

Confirming government ownership

Achieving a genuine sense of ownership is a key element to attain the high-level leadership needed to guide the implementation of these frameworks Government ownership of the INFF development agenda is essential to provide direction and facilitate institutional coherence for aligning policy around a shared vision. The strategic challenges that the INFF should address are not always evident in plain sight, and the construction of a shared vision will demand some effort. A fundamental issue is that this shared vision should emerge naturally from the government and not be imposed by any development partner's agenda. This sense of ownership is essential for effective government implementation of the cross-sector financing strategy described in the previous section.

The starting point is to build this ownership is through the leadership of the DFA Oversight Committee. The institutions that provided the leadership and governance role during the DFA process are the ideal starting point to lead the INFF building process. The DFA Oversight Committee could transform itself into the INFF Oversight Committee. The INFF Coordination Committee needs to provide the following critical capacities:

- Having delegated authority and responsibility from the highest levels of government to lead the INFF process, along with leadership at a senior technical level to shape public and private finance policy and ensure national ownership of all financing plans.
- Having the convening power to bring together actors from across government, the legislature, the private sector, civil society, development partners, and other stakeholders to create ownership by all actors.
- Be able to establish the tools, including a monitoring framework and secretariat capacity, to manage the financing framework.

The discussion of the results of this DFA can be used to generate additional support from different stakeholders. The outcomes of the DFA -and especially the financing opportunities and challenges that emerge from it- should be discussed with a broad audience, including public and private decision-makers, civil society, and international development cooperation partners. The

thematic financing dialogues that this assessment offers for discussion (public finance, private investment, and public/private innovations) can generate significant interest and, eventually, additional support for implementing the DFA recommendations (Annex 1) and this roadmap.

Defining an institutional solution

The search for an institutional solution will require exploring managerial and institutional innovations since the coordination of highly cross-cutting policies is one of the areas where the governance system in Armenia has shown greater difficulty in providing coherent and effective responses. The leadership required to build an INFF will demand support from several ministries and the offices of the Prime Minister or the Deputy Prime Minister. The constitution of the INFF Oversight Committee will require confirmed leadership from the two key ministries:

- ***The Ministry of Finance.*** Many of the common interventions proposed in these plans directly correspond to areas of responsibility of the MoF or its subordinate agencies. This is, for example, the reforms regarding PFM, Public Expenditure Efficiency, Public Revenue, and External Debt management, the expansion of the Strategic Phase of the budget process The MoF is already the leading partner in the context of PFM and SDG budgeting.
- ***The Ministry of Economy.*** The MoE is the leading partner for Private Sector Development and the policies for developing the business environment. It is also the focal point for critical areas of the financing strategy, such as Public Investment Management and the Public-Private Partnership policymaking, SME development, and Foreign Direct Investment policies.

The ideal approach would be to allocate the principal responsibility for the INFF development to a high-level executive office. There will be a need to find robust mechanisms to ensure both 'vertical' alignment between the overarching, longer-term policies and 'horizontal' alignment between operational policies focused on different themes or financing types to avoid contradictions and ensure complementarity. In Armenia, this type of leadership could be provided only by the PMO or the Deputy PMO. The INFF implementation plan should ensure sufficient technical support to develop the technical capacities needed to implement the actions required by the financing strategy.

An alternative way to facilitate the start-up would be to grant responsibility for this task to the Ministry of Finance. The main reason for this is that the purpose of any "INFF Financing strategy" coincides with the MoF principal objective, which is the maintenance of macroeconomic stability. However, as the strategy will propose reforms that other Ministries and government agencies should execute, these responsibilities could be coordinated through the Cabinet or under an ad-hoc monitoring system led by the PMO.

To do this, some improvements to the current capacities of the MoF will be necessary. Implementing the INFF Financing Strategy could be an organic challenge for any MoF, even for those actions that are entirely under the Ministry's direct area of responsibility. The multiple coordination activities required by its programs do not correspond to the mandate of any of the MoF Directorates, and this will require informed decisions at the highest level of the Ministry. One solution could be to strengthen the technical capacity of the top executive offices of the MoF to establish the appropriate management and monitoring support systems to facilitate their tasks.

The DFA is a tool to set in motion or support an already ongoing process of institutional change towards improved country development financing. The proposed recommendations are expected to inform discussions across the Government of Armenia on these critical strategic matters and decide further action. The agenda proposed demands systemic reforms and involves a broad range of areas, from public sector reforms to good governance and strengthening the management capacity of the central government and line ministries. The implementation of this roadmap could be complemented with the definition of a support program from the UNDP to develop and implement INFF under the leadership of a designated government agency.

CHAPTER 7

Annexes

7.1 An Implementation Plan based on DFA Recommended Measures

IMPROVED USE OF PUBLIC INVESTMENT AND FINANCE	
Desired Outcome	**Recommended Actions**

1. Improve Strategic Planning and Budgeting Coherence	**Improvements to the Long-Term National Development Planning Process**
	• Complete the formulation of a nationally owned Armenia Transformation Strategy 2020-2050 (ATS)
	• Rationalize and simplify the use of fragmented planning instruments and align them with the ATS
	• Eliminate policy overlaps and provide coherence between sector plans
	• Eliminate planning "blind spots" for priority sectors that do not have clearly defined strategic targets
	• Set an operational plan for the ATS for 2030 and quantitative targets
	Mainstreaming the National Priorities (and the SDGs) in the National Budget Process
	• Develop a tighter strengthening of the methodology for the 5-year Government Programs (GP) Action Plans (AP) to eliminate endemic planning and budget allocation inconsistencies
	• Develop a taxonomy to align GP targets with the SDGs
	• Aligning MTEF and budget performance framework with SDG indicators/targets
	• Identify gaps and opportunities for improvement in current budget programs in terms of policy links, create a basis for harmonization of policies and budget programs
	Strengthen PFM Strategy formulation and future PFM reforms by embedding SDG based policies
	• Promote ways for improving fiscal discipline by introducing
	  ○ SDG-aligned macro-fiscal rules, SDG-informed fiscal space / fiscal gap analysis and
	  ○ Risk management for macro-fiscal parameters
	• Explore ways for improving budget allocative efficiency by applying
	  ○ Budget prioritization using SDG framework and accelerators
	  ○ Sector-specific SDG-aligned fiscal rules
	  ○ SDG-informed MTEF/budget circulars and budget negotiations processes
	• Complete the upgrade of the GFMIS and other PFM tools to consolidate program and performance-based budgeting

2. Provide Financial Feasibility to the National Priorities	**Development of an Integrated National Financings Strategy (INFS)** • Define the Operational Targets of the ATS for 2030 • Define costing estimates of ATS Operational Targets • Define areas where private investment should lead and estimate the size of the private resource mobilization efforts • Define intervention pillars of the Strategy (public finance, private finance, public-private collaboration) • Prioritize the main reform areas (policy coherence, trade-offs, externalities, institutional and capacity limitations, and other criteria) • Adopt a participatory process in the INFS formulation to generate consensus amongst key stakeholders
3. Improve Efficiency and Effectiveness of Public Finance	**Improve the evidence base to reduce public expenditure inefficiency** • Conduct Public Expenditure Reviews to analyze the factors that generate systemic inefficiencies (wage management) and sector (education, health, social)

IMPROVED USE OF PUBLIC INVESTMENT AND FINANCE	
Desired Outcome	**Recommended Actions**
	• Develop institutional capacity to conduct regular assessment of the impact and efficiency of budget programs • Review cost-effectiveness of tax expenditures instruments (tax incentives, tax holidays, Free Economic Zones) • A system to measure the alignment of tax expenditures with the SDGs and with national priorities

	A medium-term plan to eliminate known sources of public finance inefficiency
	• Medium term actions to eliminate SOE losses
	  ○ Sequence the privatization of commercially feasible SOEs
	  ○ Liberalize key markets to increase competition to existing SOEs
	  ○ Program the closure of unsustainable SOEs
	  ○ Short-term actions to improve SOE governance with clear targets for increasing profitability, reducing leverage
	• Effective measures to improve economic governance and significantly reduce the incidence of corruption
	  ○ A more proactive action plan to eliminate know issues in key areas (the judiciary, tax and customs, health, education, military, and law enforcement
	  ○ Strengthen the institutional capacity to accelerate the implementation of the measures planned in the existing anti-corruption strategy for 2019-2022
	  ○ Open a participatory process to develop and implement a new anti-corruption strategy for 2023-2026
	  ○ Seek sufficient development partner TA support to accelerate implementation of some measures
	• Effective actions to improve the quality and transparency of the public procurement system
	  ○ Strengthen procurement skills in contracting authorities, and the integrity of the procurement processes
	  ○ Improve value for money by adding technical criterion to the acquisition price as the only award criterion
	  ○ Improve the e- procurement system to provide more inclusive access to MSMEs and suppliers from all regions.

4. Improve domestic resource mobilization and government revenues	**Introduce a long-term strategic planning dimension to Government Revenue reforms**
	• Development of a medium-term fiscal and revenue strategy to match public finance needs of the GP and the ATS targets for 2030
	• Program gradual improvements to the tax reforms
	  ○ Revise the tax weight for the Turnover tax and make it adequate to the tax burden of the general taxation system
	  ○ Simulate the transition from the progressive PIT rates to the flat ones to avoid revenue loss and compromise of equity
	  ○ Program further increases to the Excise Tax rates, license payments for gambling and the financial sector
	• Develop and implement a program to gradually reduce the size of the informal economy (e-invoicing, incentives, and targeted taxes)
	• A long-term plan to continue the introduction of environmentally oriented taxation systems
	• Actions to generate public trust on the SRC activities and the improvement of the tax discipline
	  ○ Improve transparency by publishing tax evasion and tax elusion data and the proposed targets to improve them
	  ○ Introduce a healthy dialogue with the public and improving interrelations between the actors of the tax and customs administration

	A short-term plan to rationalize the use of Tax Expenditures • Organize a systematic review of the cost-benefit of the various tax promotion and exoneration regimes and rationalize their use Revision and

IMPROVED USE OF PUBLIC INVESTMENT AND FINANCE	
Desired Outcome	**Recommended Actions**
	reduction of the scope of the current tax privileges (especially in respect to VAT) • Develop a comprehensive strategy for improving the enabling business and investment environment that goes beyond isolated tax incentive measures • Review the use of transfer pricing, import/export invoice adulteration and other illicit practices facilitated by the FEZ system to allow a more comprehensive review of the cost-benefits of this system • Estimate the tax impacts generated by the GP proposals for reducing specific taxes and introducing new incentives
	Accelerate the improvement of the processes and organizational structures for revenue administration • Improvement of the SRC human resources management system • Increasing the quality of services provided to taxpayers through streamlining the management systems. • Enhancing the effectiveness of the tax and customs control with novel solutions in line with best international practices. • Upgrading infrastructures and constructing new modern infrastructures, because of which the tax and customs procedures to automate tax and customs procedures.
5. Introduce a Strategic approach to manage Public Debt	**Develop and implement a long-term Public Debt Strategy** • A medium-term plan to ensure fiscal consolidation and meet the GP target of reducing debt to 60% of GDP by 2026. • Introduce SDG-targeted bond instruments (Green Bonds, SDG bonds, Gender Bonds) to re-profile existing short-term debt with lower cost and more extended term conditions. • Establish the alignment of future sovereign debt instruments with the SDGs to attract international impact investors and improve rating classification of Armenian debt • Explore better uses of public debt and sovereign guarantees to facilitate the development of blended finance mechanisms where public debt is a catalytic element of the financing mix • Explore opportunities for debt for nature swaps or buybacks and other innovative mechanisms to leverage further resources required by the ATS and the GP • Strategically allocate public debt for infrastructure investments only in those areas where PPPs are not possible. • Further develop risk management capacities and procedures to address real and contingent liabilities demands required for extending public and SOE investments and PPPs • Introduce procedures for establishing financial conditions and requirements for SOEs in the provision of state guarantees • Modernize and strengthen the capacities of the Ministry of Finance to develop and implement this strategy • Develop specific measures to stimulate the development of the securities market and the secondary market for public debt in local currency to accelerate the development of the national capital markets
6. A more strategic use of Official Development Assistance (ODA)	**Develop and implement an ODA management strategy** • Complete the development of a robust and comprehensive ODA management information system to allow a coherent and strategic use • Strengthen the quality of the ODA monitoring and evaluation systems • A strategic prioritization and allocation of ODA to key areas: ○ To improve existing public expenditure efficiency and effectiveness, reduce risks and extend RBF systems

IMPROVED USE OF PUBLIC INVESTMENT AND FINANCE	
Desired Outcome	**Recommended Actions**
7. Public Climate Finance	○ To improve capacity in areas that accelerate domestic resource mobilization ○ To ensure better management financial flows ○ To incentivize blended finance mechanisms • Increase access to ODA by the introduction of new mechanisms, like Aid for Trade and Results-Based Aid **Design and implement a Low Emissions Development Strategy** • Develop a comprehensive Climate Change Financial Framework. This framework could be used as a model to manage all other cross- cutting priorities • Significantly improve accountability and transparency on CC related expenditures • Generate conditions to stimulate the effective participation of civil society organizations (CSOs) in CC-related expenditure budgeting • Improve the quality of information systems (budget and aid financing) to strengthen evidence-based management of this financial flow • Depending on fiscal space availability, experiment with the introduction of green debt instruments or mechanisms to increase access to external debt at reasonable costs

EXTEND THE PUBLIC – PRIVATE COLLABORATION SPACE	
Desired Outcomes	**Recommended Actions**
8. Consolidate the enabling environment for Private Sector Development (PSD)	**A medium-term plan to consolidate Private Sector Development** • Focus short term actions to address legal and regulatory reforms (Protecting Minority Investors or Resolving Insolvency) • A medium-term financing solution to address binding constraints will require significant investments (infrastructure, energy, connectivity) • Develop a plan to provide a more strategic, risk-balanced, and transparent use of PPPs to address critical infrastructure constraints • Set clear targets and responsibilities for a results based improvement of the performance of key policies: ○ The lack of skills of the workforce and the quality of the TVET programs and skillsets of graduates, ○ R&D expenditures and innovation policies, ○ Tax administration and ○ Anti-corruption policies • Some of the most problematic issues identified would not require significant investments as they demand
	• Removing some of the which the government may benefit from.
	• There are also some areas where the government needs to strengthen the efforts on getting more development impact of current expenditure, like for example the skills of the workforce and the quality of the TVET and anti-corruption measures. • This strategy should define the strategic allocation of public resources and maximize the use of the public-private space
9. Initiate and extend use of	**Develop and implement a blended finance policy**

EXTEND THE PUBLIC – PRIVATE COLLABORATION SPACE	
Desired Outcomes	**Recommended Actions**
innovative finance mechanisms	• Explore legal or regulatory limitations to introduce blended financing mechanisms (funds, loans, etc.) • Identify areas where blended financing could leverage additional private resources for the SDGs (SME development, green growth) • Analyze opportunities to de-risk private institutional investors (pension funds, insurance) to finance SDGs in blended finance mechanisms • Gather support of key DPs (ADB, EC, EBRD, IFC) to develop the policy, co-invest in prototype projects and provide non-reimbursable TA for new blended finance mechanisms
	Develop a policy ecosystem to favor impact investment • Extend the usage of Public-Private Partnerships for Development (PPPDs) with CSOs using Results-Based Financing (RBF) approaches • Focus this application in areas where experience exists (Labor and Social, Health Care) and extend it to key human development priority areas (education, social protection) • Engage DP support to introduce performance-based aid systems (cash on delivery, performance-based loans and debt buy downs) • Explore use of Social Impact Bonds (or Development Impact Bonds using ODA) • Develop and test innovative finance mechanisms to raise funds with the diaspora (like SDG diaspora bonds) for SDG investment areas • Capacity development of government institutions using innovative finance mechanisms
10. Public-Private Partnerships (PPPs) are effectively used to address infrastructure development constraints	**Design and implement an integrated PPP strategy** • Complete the Public Investment Management (PIM) system improvement • Define strategic financing objectives to use PPPs and address national development priorities (GP and ATS) • Complete further improvements to the institutional framework to stimulate the use of PPPs by providing greater certainty for all the parties • Continue improving transparency and accountability for PPP operations • Technical capacity development to improve further the fiscal risk management of PPPs

INCREASE PRIVATE INVESTMENT AND FINANCE	
Desired Outcomes	**Recommended Actions**
11. Systematically improve the domestic financing conditions for the private sector	**Develop strategic approach to improve private finance** • Develop systems to monitor alignment of bank credits with the SDGs and national development priorities • Articulate access to concessional finance to address the disconnects between the sectoral distribution of the bank loan portfolio with national development priorities • Generate gradual interventions to further expand the financial markets to achieve similar levels of development as the ones achieved by the country's financial institutions • Review the legislative and institutional framework (for example for credit unions and other NBFIs) to achieve further improvements • Improve the credit rights protection and other conditions reduce the costs of private banking institutions and increase access to the banking system

INCREASE PRIVATE INVESTMENT AND FINANCE	
Desired Outcomes	**Recommended Actions**

12. Extend financial Inclusion and improve MSME finance	**Introduce a medium-term strategic approach to improve financial inclusion**
	• Develop and substantially support the implementation of a Financial Inclusion Strategy aligned with the CBA new Strategy and lead by the CBA to ensure the implementation of the 2020-2024 SME Sector Development Strategy
	• Significant improvements to the legal framework to develop a modern and effective system to finance MSMEs:
	  ○ Improve the microfinance legislation
	  ○ Extend use of factoring, leasing and crowdfunding
	  ○ Develop a sandbox approach to balance positive and negative impacts of fintech
	• This new policy framework needs to be supported by additional institutional reforms to provide coherence and coordination
	• Develop systems to analyze and address disconnects between supply and demand for current and future priority sub-sectors of MSME activity (gender, geographical and sectoral)
	• Strengthen capacity gaps and avoid sustainability threats of key NBFIs such as MFIs and credit unions

13. Revert current trends and significantly increase Foreign Direct Investment (FDI)	**A new strategy to significantly improve FDI over the next two decades**
	• Develop an agenda to modernize the legal and regulatory framework for FDI
	  ○ Clarify key FDI-related provisions
	  ○ Reflect on the mandate of investment promotion authorities
	  ○ Revise and harmonize the definition of investment and investors
	  ○ Limit potentially excessive investor guarantees
	  ○ Include refinements to the guarantees
	  ○ Provisions to avoid that foreign investor be accorded privileges beyond those afforded to Armenian investors in similar circumstance
	  ○ Reduce the country's exposure to Investor-State Dispute Settlement (ISD)
	  ○ Strengthen the capacity of the selected institutional setup to promote FDI (ANIF, Enterprise Armenia) and provide with adequate and predictable resources until 2026
	• A medium-term plan with targeted actions to tap existing market potential and meet GP 2026 targets
	  ○ Promotion actions focusing the effort on attracting investments for selected markets (for the bln-dollar club and the emerging bln-dollar club, exports non obstructed by current transportation, exporting services).
	  ○ Actions to expand the investor base and making better use of the existing trade agreements
	  ○ Promotion actions to attract new SDG-oriented FDI using the SDG investor map
	• A long-term strategy to orient consistent interventions to address key issues as
	  ○ Infrastructure and other capital-intensive investments
	  ○ Address labor costs and productivity issues
	  ○ The refinement of the policy and legal framework,
	  ○ The review and adjustments of current ineffective tax incentives
	  ○ Seeding new FDI areas that may take a decade to flourish
	  ○ Efforts are needed to modernize and align the national regulatory framework with good practices and international standards

INCREASE PRIVATE INVESTMENT AND FINANCE	
Desired Outcomes	**Recommended Actions**
14. Increase the development impact of the diaspora economy and of seasonal migrant work	**A new policy approach to harnessing sustainable poverty reduction results from seasonal migrant work in the short term** • Develop bilateral agreements to formalize seasonal migrant work (especially in Russia) and ensure the protection of men and women, • Provide training improve the skills of seasonal migrants to increase their income • Measures to boost financial inclusion of the families that receive remittances • Explore use of blended finance mechanisms to collateralize remittances for SME startups, housing, or farm property acquisition • Measures to support the work reinsertion once they come back (skills recognition, private sector incentives) • Apply UN Global Compact for Safe, Orderly, and Regular Migration (GCM) accumulated knowledge in this policy design

	A long-term strategy for fully mobilizing the permanent diaspora
	• Test innovative measures based on a social capital development
	  ○ Explore emission of SDG Diaspora Bonds and other innovative mechanisms to stimulate donations and foreign fundraising
	  ○ Strategically develop linkages between national and international talent to access to cutting-edge know-how
	  ○ Start innovative initiatives for cultural development designed to strengthen social capital.
	  ○ Support the institutional setup in Armenia seems adequate to implement and monitor such an ambitious and integrated strategy, but resources must be made available

	Provide a robust institutional setup for evidence-based decision making • Extend the mandate of the newly created office of the Higher Commissioner for Diaspora Affairs to act as the reference government institution. • It should receive the mandate from the government to provide the necessary leadership to coordinate several policies that involve different government interventions at the national and sub-national levels. • Provide quality data and systematic analytics to ensure the adequate management of this flow
15. Improved conditions for Private Philanthropy and CSO Financing	**Provide an adequate policy framework** • Modify the financial information requirements for CSO reporting to facilitate understanding of their alignment with the SDGs and national priorities • Facilitate online reporting of CSOs using the same ODA MIS and use compatible taxonomies to link this information to the actions in the national development plans and the national budget programs • Develop measures to stimulate private sector support to CSOs and a legal framework to facilitate innovative fundraising (crowdfunding, CSR,) • Generate conditions for a productive social dialogue process and a way of working with the institutions concerned. • Extend the use of partnerships and leverage co-investments with public resources in PPPDs (see outcome 9) • Support the construction of appropriate "ecosystems" of policies to attract and encourage the development of impact investments and innovative approaches for CSO investment (see outcome 9) • Generate adequate statistics and reports on CSO investments

7.2 Impact finance instruments in Armenia

Box 4

The shape of things to come: Venture Capital, Angel Investors and Private Equity Funds in Armenia

Access to institutional equity finance is essential in Armenia. Whilst bank finance is readily available, very few SMEs can secure financing terms at attractive rates. The USD- bank debt available to SMEs has interest rates of 7% - 9% and tenure of between one and three years. For local currency-denominated debt, the respective rates are much higher. In addition, the business is required to post significant amounts of collateral – from fixed assets to personal guarantees by business owners. A new wave of innovative finance mechanisms is emerging to fill this gap.

Venture Capital & Business Angels:

- *Granatus Ventures*. This venture capital was established in 2013 and is designed to invest in start-ups in high-tech industries. It was established by three private partners and attracted investments from the Government of Armenia and private investors from Armenia, Russia, the United States and other countries.
- *HIVE Ventures* was founded in 2014 to catalyze the global Armenian tech ecosystem by investing in start-ups led by Armenian entrepreneurs worldwide. They provide venture capital, offer mentorship and a Silicon Valley network of leading founders. This is an initiative of diaspora Armenians (Hirair and Anna Hovnanian Foundation)
- SmartGateVC is a Silicon Valley pre-seed venture fund backed by US and European investors and operates as a venture capital firm. The company focuses on deep tech, artificial intelligence, security, the internet of things, computational biotech, quantum computing, and blockchain.
- *Business Angel Network of Armenia (BANA)* is a for-profit network of investors, entrepreneurs and executives from Armenia and abroad interested in making investments in start-up companies. In addition to capital, the members bring their expertise, experience, and network to influence the start-ups they invest in. They were established to bring together investors from Armenia and the Armenian diaspora abroad.
- *Angel Investor Club of Armenia (AICA)* is a non-profit organization that promotes investment in Armenia's high-tech and other high-potential industries. It brings together a very diverse group of CEOs, Entrepreneurs and Business Professionals from Armenia, Russia, Germany, Austria, Denmark, and the US

Private Equity Funds:

- *EU-Armenia SME Fund*. It is a private equity blended fund managed by Amber Capital, a London-based investment firm supported by a dedicated team in Armenia. It was created by the EU and EBRD initiative using EC Access to Finance (A2F) equity instruments. The Fund had its first close in January 2020 at USD 31m and is currently seeking to raise to USD 75m. The Fund's investor base consists of international finance institutions, family offices and other institutional investors. The Fund is invested in manufacturing, high-tech agriculture, IT, textiles, pharma & healthcare and tourism but is sector agnostic and can finance different industries/
- *Entrepreneur+ State Anti-Crisis Investments Fund* was created by ANIF, the Armenian National Interest Fund, a state-owned foreign direct investment enterprise. The Armenian government will allocate up to USD 100 mln, which is also open to private investors. The objective of the Fund is to invest in the private sector of Armenia and thus have a positive impact on the strategically important industries. The target sectors are agriculture, manufacturing, healthcare, tourism, high tech & defence. Capital participation is in the range of 25.1% to 49.9%, and investment ticket per project is USD 0.5 – 4 mln
- *Riviera Capital CJSC* is another investment advisor specializing in private equity investments in Armenia. The target equity stakes are 20%-100%, and average investment sizes are USD 500K-2M. Currently, there are five companies in the portfolio of the company. Investments are made through equity, preferred equity, mezzanine debt and convertible debt. Deal origination is generated by active on the ground involvement with business and government networks.

7.3 Opportunities for increasing FDI in the short- and long term

Box 5

High growth expansion opportunities for FDI in Armenia[144]

The UNCTAD IPR also analyzed the investment areas with potential of achieving high growth. For all these areas the report analyses tangible opportunities for Armenia to promote. They are presented in three main categories:

The Billion Dollar Club

Industries that are already close or that could reach USD 1 bln annual exports in less than a decade.

- ***Tourism***. This industry is close to achieving the USD 1 bln exports, despite Armenia's low profile and poor air links with Europe. Expansion could be boosted by providing small tax incentives, focusing and targeting international promotion, improving air links (especially with European low-cost airlines) and by raising the standard of local facilities aimed at high-end tourism segments.
- ***High Technology***. The high-tech sector is already booming and attracted a notable foreign investor presence. Local start-ups are flourishing, supported by government initiatives and international venture capital. A comprehensive strategy for positioning Armenia as a leading world center in AI, data science and deep tech is needed to insert the country in global value chains
- ***Textile and Garments***. The industry is undergoing a revival from a collapse that happened about a decade ago. Positioning the industry in higher value-added products and in global value chains seems possible, as the country has several competitive advantages. Targeted investment promotion, direct support to the design segment and diaspora linkages are amongst the recommended actions.

The Emerging Billion Dollar Club

Industries which could reach $1/2 bln of annual exports in 10 years and attempt for $1 bln in less than 20 years.

- ***Wine.*** Armenia is one of the world's oldest wine producers with privileged access to huge consumer markets (Russian Federation) and shares same competitive advantages of successful neighbors (Moldova and Georgia). Investment is needed to replace outdated production techniques and focus on high potentially grape selection like the Areni Noir. Reforms to the tax system and targeted promotion strategies to attract intelligent diaspora capital (Argentina) are amongst the most important measures
- ***Agribusiness.*** The traditional fruit and vegetable sector (tomatoes, cucumber, bell peppers and mushrooms and apricots), could expand with large-scale investment on intensive cultivation of fruit and construction of modern greenhouses. Potential addressable markets are huge (Russian Federation, UAE, EC). Targeted incentives to attract intelligent capital (Israel, Argentina) are also needed.
- ***Pharmaceuticals.*** Opportunities for growth could relate to the expansion of current modalities with contract research organizations (CROs) to sell high value-added activities (for example, R&D on new formulations of drug compounds) or services (data management) to the industry. Other paths to explore include outsourcing to contract manufacturing organizations (CMOs). The government might need to provide seed funding in the form of first-class facilities., or invest in a comprehensive upgrade of one of the free zones

Nascent Industries

There are also several possibilities for Armenia to aspire to become a hub for the export of services to the region.

- ***Business Process Outsourcing (BPO).*** Opportunities range from lower value added like call centers (in Russian, English and Armenian) to telesales, web design and maintenance, social media support services, to egal services, accounting, software solutions and data management.
- ***Regional Financial Services*** Several possibilities are open: the country could aspire to create a regional capital markets hub or to become the preferred intermediary country for investment in the region, especially in the Russian Federation or to develop an offshore financial services industry.
- ***Logistics and Food Safety.*** The country could aim to participating in large scale regional logistic projects providing high value-added services for which the high-tech profile of Armenia is an advantage.
- ***Aircraft Repair and Maintenance*** The commercial aviation maintenance, repair and overhaul (MRO) market in the region is worth exploring. Many smaller airlines outsource their maintenance, and other small countries like Estonia and Lithuania are successfully participating-
- ***Education Services***. The explosion of distance education worldwide could allow Armenia to aspire to participate in some categories. The country is currently a net importer of contents, but this trend could be reversed, perhaps by attracting some big-name universities to establish in the country

[144] Reproduced from UNCTAD (2019)

7.4 An example of policy goals and measures in countries with high levels of migrant work[145]

Policy Target Group	Policy Goal	Type of Measures
Temporary Migrants	Protection and empowerment of men and women seasonal migrant workers	• Development of multilateral, regional and especially bilateral cooperation agreements to formalise labour migration
		• Sex-disaggregated data on migration is collected and analysed regularly to inform evidence-based policy
		• Improved consular services to provide assistance; facilitate access to justice through implementing the complaints mechanism
		• Provide free COVID vaccination and affordable international health insurance schemes for migrant workers abroad at accessible costs
		• Inspection of Private Recruitment Agencies to ensure delivery of pre-departure training, regulating costs of migration and brokerage fees
		• Monitoring of PRAs assistance to migrant workers in establishing bank accounts, accessing financial services in destination countries
		• Provide information on safe migration and rights at work in major migrant-sending communities and transit hubs
	Improve the capacity of migrants to increase their income	• Provide quality online information to assist men and women migrant workers with migration (travel, migration, housing, work opportunities)
		• Provide free, certified, and recognised vocational training programs for key skills146 to significantly increase income abroad
		• Develop a "work and skills passport" with certified working history and skills acquired in Armenia or abroad
		• Provide low-cost cell phone roaming services to access fintech and mobile banking tools to reduce costs of remittances
		• Provision of low cost, revolving credit and loan funds to prefinance travel and initial living costs
Families receiving remittances in Armenia	Promote the use of remittances to boost financial inclusion	• Provide financial literacy training and counselling services to migrant workers and their families on productive uses of remittances
		• Link migrant worker families and financial institutions to obtain loans with low-interest rates that cater to the needs of migrant workers
		• Establishment of village development funds or village savings groups.
		• Focus existing community development programmes in high-migrant communities and promote the effective use of resources
		• Promote the bankarisation of remittance recipients hand in hand with poverty reduction policy tools, such as conditional cash transfers.
		• Promote small-scale migrant savings for low-income families and their capacity to purchase health insurance or other vital services
		• Support entrepreneur training for migrant workers family members.
	Improve the development impact of remittances	• Develop economic incentives to collateralise remittances for investments in productive sectors of the economy
		• Subsidise access to credit or equity finance for new small productive or commercial MSMEs
		• Establish migrant welfare funds to stimulate contributions to the Armenian social security from workers abroad
Returning Migrants	Support measures for those who come back	• Develop programs to recognise and certify migrant workers skills acquired abroad
		• Link returned migrant workers to Employment Agencies' and employers' organisations, and special placement services for skilled men and women

[145] Summarised from the DFA experiences in several countries (Bangladesh, Cambodia, Philippines, Nepal and Fiji) . For more on this see Stratta N. (2017)

[146] For example: construction foreman, bricklayer, waterproofing, electrician, sanitary, carpenter, blacksmith, and others

7.5 Example of Diaspora Fundraising: the 3x1 program in Mexico

Box 6

The Tres por Uno (3x1) Program in Mexico

It is a national program of the federal government, managed by the Secretariat of Social Development (SEDESOL), that supports the initiatives of the diaspora. The system was designed to carry out projects of social infrastructure or community services and productive community, family or individual projects that contribute to the development of their communities of origin. This is done through the contribution of the federal, state, and municipal governments and the Clubs or Organizations of Migrants based abroad.

- ***How the 3x1 works.*** For every 1 USD mobilized abroad, an additional 2 are provided, 1 by the national government and 1 by the municipal government.
- **Social Infrastructure *Projects*** include water, sanitation, electrification, classrooms, clinics, and other educational and health and sports infrastructure. Streets, sidewalks, parks, and other works that improve urbanization works for environmental sanitation and conservation of natural resources
- ***Community Services Projects*** include the financing of educational scholarships 3x1, culture and recreation, Community social development
- ***Productive Loans***. Productive projects (agricultural, livestock, services, manufacturing.) in Mexican territory. They are presented to SEDESOL by a family of migrants or a migrant; in both cases, they belong to a migrant club located abroad. SEDESOL resources must be fully recovered within a maximum period of 5 years
- ***Who can Apply*** to Mexican migrants over 18 years of age, living abroad, organized in a Migrant Organization, with a valid, formal constitution.
- ***Open channels.*** Applications for proposals can be presented locally, at the Mexican Embassies and Consulates abroad or online.

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