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PROGRAM INFORMATION DOCUMENT (PID)
CONCEPT STAGE

June 20, 2016
Report No.: AB7859

Operation Name	Armenia Fourth Development Policy Financing
Region	Europe and Central Asia
Country	Armenia
Sector	Other Mining and Extractive Industries (12%); Irrigation and drainage (13%); General finance sector (25%); General industry and trade sector (25%); General public administration sector (25%)
Operation ID	P160100
Lending Instrument	Development Policy Lending
Borrower(s)	Republic of Armenia
Implementing Agency	Prime-Minister's office Government Building 1, Republic Square, Yerevan, Armenia, 0015 Tel: (374-10) 595-277 Fax: (374-10) 151-446 David.Harutyunyan@goa.am
Date PID Prepared	June 20, 2016
Estimated Date of Appraisal	October 10, 2016
Estimated Date of Board Approval	November 29, 2016
Corporate Review Decision	Following the corporate review, the decision was taken to proceed with the preparation of the operation.

I. Key development issues and rationale for Bank involvement

1. Armenia was hit hard by the global financial crisis and the economy contracted by 14 percent in 2009. Between 2010 and 2015 the economy rebounded at an average rate of 4 percent a year, largely supported by domestic consumption fueled by remittances and mineral exports. The poverty rate has risen in the wake of the crisis and is estimated at 30 percent. The key challenges faced by the country include high external vulnerability and persistent unemployment. External vulnerability in Armenia arises from its dependence on remittances, commodity exports, and large capital inflows necessary to finance the high current-account deficit. As the economy was recovering from the 2008-09 financial crisis, it was hit hard again by the deepening Russian recession, which negatively impacted foreign direct investment (FDI), remittances, and exports, and put strong depreciation pressure on the Armenian dram. The geopolitical environment also changed. Whereas previous structural reforms had been anchored in a proposed Association Agreement with the European Union (EU), in September 2013 the country decided to join the Eurasian Economic Union (EEU). The shift in the government's policy orientation and the worsening external environment both underscore the crucial importance of reinforcing macroeconomic stability through increased attention to fiscal sustainability and improved competitiveness. The country also has one of the highest unemployment rates (18.5 percent) in the Europe and central Asia region largely stemming from low job creation and a mismatch of workers and jobs.

2. The objectives of this operation are consistent with the development strategy of the government and the CPS which focuses on areas in which the World Bank has a comparative advantage. These include convening power, rigorous analytical work, and the ability to leverage assistance from development partners. The policy actions supported by this DPF targets the government's most urgent development challenges and builds on previous development policy operations. The previous series of DPOs concentrated on structural reforms to build competitiveness for sustained growth.

3. The DPO series builds on a long-standing partnership between the Bank and the Government of Armenia. Specifically, it builds on the previous DPO series (2009-12) by supporting follow-up and complementary reforms. The previous DPO series supported a widened fiscal stance to mitigate impacts of the global crisis, measures to strengthen social safety nets and more affordable social services (health, education), and better financial sector supervision to address vulnerabilities to the crisis. It also aimed at strengthening competition, the business environment, corporate governance, and public-private partnerships to lay the foundations for post-crisis growth. It addressed public financial management, public sector efficiency, and critical infrastructure needs and the regulatory environment to enhance the effectiveness of the public sector, and promoted the sustainable use of natural resources.

II. Proposed Objective(s)

4. The program development objectives are to (i) Promote fiscal, social and environmental sustainability; and (ii) Strengthen competitiveness.

5. The first pillar includes measures to increase the fiscal space, improve the financial sustainability of key sectors, enhance the efficiency of social protection programs, and improve environmental safeguards in the mining industry, which accounts for over half of Armenia's exports. All these measures will help achieve greater fiscal, social and environmental sustainability. The second pillar includes actions designed to strengthen the business environment, improve trade facilitation and connectivity and the civil service, and improve access to credit. These measures will help create jobs and lead to a sustainable reduction in poverty.

6. The proposed operation is fully aligned with the government's development strategy – Armenia Development Strategy (ADS). The DPO series supports reforms under Pillars 1, 3, and 4 of the ADS—creating jobs, strengthening social protection, and modernizing the public sector —which are underpinned by macroeconomic stability and fiscal sustainability. The proposed policy actions were identified based on the World Bank's policy dialogue with the authorities, existing analytical work, and ongoing technical assistance. The policy actions supported by this DPF target the government's key development challenges. An improved tax code will help increase revenue mobilization and will contribute towards overall macro-fiscal sustainability. Policies supporting reforms in licensing, bankruptcy, consolidated supervision and disclosure of real ownership of financial institutions will improve the competitiveness of the economy and help create more and better jobs and also reduce poverty. In addition, linking the pay of civil servants to the strengthened performance appraisal system will help improve public administration.

III. Preliminary Description

7. The program is designed around 2 pillars. The prior actions under the first pillar include adoption of the Unified Tax Code, improvements in the operational efficiency of the irrigation sector and amendments to the mining code to make it compliant with the Law on Waste Management. The prior actions under the second pillar include replacement of licenses for low-risk activities with a simple notification mechanism, improvements in the performance evaluation mechanism for civil servants and linking bonus payments to performance, amendments to Law on Bankruptcy, and approval of regulations for consolidated supervision and disclosure of real beneficial ownership of financial institutions and groups.

IV. Poverty and Social Impacts and Environment Aspects

Poverty and Social Impacts

8. The DPO program supports reforms that affect the poor and the bottom 40 percent of the welfare distribution through additional revenue mobilization, improvements in irrigation and measures which will enhance job creation. The ex-ante assessment of these impacts suggests that on the revenue side, the distributional impact depends on the tax incidence and the implementation of mitigation policies to compensate the poor for a higher tax burden. A new framework aimed at replacing licenses with a simple notification mechanism, a new law on bankruptcy, and better regulation of the financial sector allows for lower transaction costs and higher transparency and can lift the growth potential of the economy which then translates into more employment and higher wages in the medium-term.

9. The distributional impact of the tax reforms described in the draft Unified Tax Code is expected to be neutral. The proposed Tax Code envisions three tax brackets with 23, 28 and 33 percent for PIT and no minimum threshold. In comparison to the current tax structure, the proposed reform of the Tax Code would enhance progressivity as disposable income for relatively poor households will increase more than for the relatively rich households. The base and rate for some excises will be adjusted to generate additional revenues. From an equity perspective this will not have major implications for poverty and equity but rather offers an opportunity to support behavioral change towards healthier behavior. From a distributional perspective there is strong justification for promoting financial sustainability of the irrigation sector as the subsidies largely finance the relatively richer farmers. The alignment of the Mining Code with the Law on Waste Management is expected to preserve the asset endowment for households in rural areas which often depend on income from agricultural activity. Finally, reforms in the recruitment and promotion of civil servants is expected to have a positive gender impact.

Environment Aspects

10. The reforms supported by the current operation address shortcomings identified in the environmental sustainability of the mining sector. This includes enhancing the regulation of mining waste to include waste management planning, use of best available technologies, and strengthening the environmental permitting process. In the future, the government intends to further strengthen the enforcement and implementation capacity of the government agencies mitigating environmental impacts of the mining sector, especially concerning environmental liability provisions. This would require adopting procedures and financial surety mechanisms that would increase the accountability and transparency of the use of funds from the Environmental Fund and reduce the risk of future liabilities to the state regarding rehabilitation of mines after closure. Reform measures related to irrigation and the law

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

V. Tentative financing

Source:	($m.)
International Bank for Reconstruction and Development	50.00
Total	50.00

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