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Staff Country Reports

Republic of Armenia: Report on the Observance of Standards and Codes—Fiscal Transparency Module

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REPUBLIC OF ARMENIA

**Report on the Observance of Standards and Codes (ROSC)
Fiscal Transparency Module**

Prepared by the Fiscal Affairs Department

Approved by John Odling-Smee and Ke-young Chu

February 15, 2002

Executive Summary

This report provides an assessment of fiscal transparency practices in the Republic of Armenia against the requirements of the IMF *Code of Good Practices on Fiscal Transparency*. The report is based on the authorities' response to the IMF fiscal transparency questionnaire, and on additional information provided to the mission.

The Republic of Armenia has made substantial progress in recent years to improve a number of aspects of fiscal transparency. It has achieved significant results, especially regarding the legal framework and reporting. This progress will be furthered when the draft laws currently under consideration by the authorities,¹ especially the treasury law, the law on state debt, and the disclosure requirements on high-ranking officials' property and income, are effectively implemented.

However, substantial weaknesses remain in some areas. In particular, a sustained top-level commitment will be necessary to further clarify what remains of the involvement of the government in the economy and to enhance reporting capacity in that regard. Audit functions, and especially the internal audit function, need to be strengthened to provide adequate controls. Additional information needs to be provided with the budget presentation, in order to provide a clear understanding of contingent liabilities and fiscal risks. Procurement and employment systems need clearer rules, and planned reforms in this area must be completed.

More generally, the achievement of a higher standard of fiscal transparency will require an increased focus on the implementation phase of new legal frameworks and planned reforms. In particular, the proposal to create new public agencies to increase the autonomy of some government functions (as regulator or as service provider) should be very carefully thought through to avoid endangering reporting and accountability.

¹ The description and assessment included in this report are based on the situation that existed in the Republic of Armenia at the time of the mission in February–March 2001. Since then, the treasury law and the financial disclosure law for the civil service have both been enacted and implemented.

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ABBREVIATIONS AND ACRONYMS

CBA	Central Bank of Armenia
GDDS	General Data Dissemination System
GFS	Government Financial Statistics
MFE	Ministry of Finance and Economy
MSR	Ministry of State Revenue
MTA	Ministry of Territorial Administration
MTBF	Medium-Term Expenditure Framework
NSS	National Statistic Service
PIU	Project Implementation Unit
SFSI	State Fund for Social Insurance
SNA	System of National Accounts
SPA	Special Privatization Account
TGL	Treasury General Ledger
TSA	Treasury Single Account

I. INTRODUCTION²

1. This report provides an assessment of fiscal transparency practices in the Republic of Armenia against the requirements of the IMF *Code of Good Practices on Fiscal Transparency*. The authorities have completed the fiscal transparency questionnaire prepared by the IMF staff. The assessment has two parts: the first part is a description of practice, prepared by the IMF staff on the basis of the questionnaire response and additional information provided by the authorities; and the second part is an IMF staff commentary on fiscal transparency in the Republic of Armenia.³

II. DESCRIPTION OF PRACTICE

A. Clarity of Roles and Responsibilities

2. **General government is defined in a way that is consistent with international standards but clarification of some aspects is required.** General government comprises central government, local government, and the State Fund for Social Insurance (the pension fund (SFSI)). The involvement of general government in commercial activities has been substantially reduced through privatization, although it remains substantial. A program to set up public agencies with a substantial degree of autonomy to perform functions that may be considered either as: (i) regulatory, or as (ii) service providers (schools, cultural centers) is being worked out and is planned to be implemented in the coming months. However, the exact definition of such activities, the new financial and supervisory relations, and the overall impact on the functioning of government, are not yet defined.

3. **Quasi-fiscal activities are extensive and are only partially reported in budget documents.** Most publicly owned, or at least partially publicly owned, companies are concentrated in a few key industrial sectors. Companies in the energy sector, state-owned irrigation and drinking water companies, centralized district heating, as well as the Nairit rubber plant are referred to as “the quasi-fiscal sectors”⁴ in the Republic of Armenia, and most existing quasi-fiscal activities are undertaken by these enterprises. Their activities are subject to price regulations and most of them show substantial operating losses that are only partially covered through recurrent subsidies.⁵ Additional financing has been provided

² An IMF team consisting of Mr. Fournel (FAD) and Mr. Ramachandran (IMF Treasury Resident advisor in Armenia) prepared this review.

³ While the fiscal situation of Nagorno-Karabakh is partially reflected in the budget through lending operations involving Nagorno-Karabakh, the report only addresses fiscal transparency practices relating to the Republic of Armenia.

⁴ For a detailed presentation of the “quasi-fiscal sectors” in the Republic of Armenia, see “Republic of Armenia: Recent Economic Development and Selected Issues,” IMF Country Report No. 01/78, May 2001.

⁵ In the irrigation sector, subsidies still amount to around half of the overall production cost.

through budget loans, and/or through debt bailouts and below-market rate government credit.⁶ Quasi-fiscal activities may also be found in the transportation sector as transfers designed to compensate for reduced tariffs benefiting targeted social groups that have been underbudgeted in 2001.

4. **Public enterprise reporting is limited.** Reporting requirements on public enterprises have been strengthened and include, in particular, quarterly reporting on financial flows, on debt and arrears, and extracts from their balance sheet. However, while the requirements are intended to cover most public enterprises, implementation has been gradual and only the largest public enterprises are providing the required reporting. Moreover, most of these enterprises are not publishing fully audited financial statements.⁷ The valuation of their assets and, more generally, the quality of their balance sheets is uncertain. While cross-arrears between energy suppliers and other entities of the “quasi-fiscal sector” exist, information on these liabilities is partial. In addition, institutional arrangements for monitoring these enterprises, designating board members, and collecting dividends are not yet fully set up.

5. **The central bank does not carry out quasi-fiscal activities and deficit financing has been severely limited.** The independence of the central bank from the government, as set by the “Law on the Central Bank of Armenia,”⁸ is effective. The National Assembly appoints the chairman and deputy chairman of the Central Bank of Armenia (CBA), while the President of the Republic of Armenia appoints other members of the CBA board. The CBA announces its policies to the public and publishes reports on a monthly, quarterly, semiannual, and annual basis. According to the law on the CBA, the budget deficit can be financed by direct credits from the CBA, but the annual amount of credits should not exceed 15 percent of the previous year budget revenues, and the interest rate should not be less than the average market interest rate. The development of a market for government securities in 1997 started reducing the role of CBA direct credit in budget financing.⁹ In 1999, an agreement was reached between the CBA and the Ministry of Finance and Economy (MFE) that no new net credit will be provided directly by the CBA to the government.¹⁰ Annual

⁶ In the energy sector.

⁷ 100 percent publicly owned companies are closed joint stock companies and, therefore, not subject to the same requirements as private companies with a shared capital.

⁸ June 1996.

⁹ In 1995–96, when financial markets were underdeveloped, CBA direct credits were the main sources of budget deficit domestic financing, which complicated the implementation of monetary policy. The development of the government securities market began in 1997 and started playing a significant role in budget deficit financing from 1998, although the CBA remained an important source of intraquarter deficit financing.

¹⁰ During a quarter, the CBA can, however, acquire treasury bills in the secondary market. But the stock of CBA net credit will not be allowed to exceed the end quarter target by more than 10 percent of the cumulative monthly revenues within the quarter at any point during the quarter. At the end of each quarter, the stock of the net claims to the government must have returned to its previous end-quarter level.

(continued...)

budget laws enforced this agreement and for 2001, the amount of CBA net credit to the government was the amount due at end-December 2000, i.e., dram 8.3 billion. The CBA ceased to provide guarantees to the public sector in 1998. Representatives of the central bank and government can participate in the decision-making process of each other only with a consultative role. To improve the institutional coordination of the CBA and the government, a draft regulation on coordination was prepared by the CBA in close cooperation with the MFE.

6. **Government equity holdings in the private sector are not reported.** As a result of the extensive privatization program, government equity holding is now marginal outside the “quasi-fiscal sector,” and government regulation of the nonbank private sector is implemented within a clear framework. However, some government participation in private companies remains, both in the industrial sector (in particular in mostly private companies that are subcontractors of the publicly owned energy sector) and in the banking sector: the state shareholding in the banks’ equity capital was 4.0 percent at end-2000 (against 2.4 percent at end-1999).¹¹ For partially publicly owned enterprises, equity holding reporting is under development but will only address companies with a 51 percent or more state participation.

7. **The allocation of responsibilities between different levels of government is not yet fully stabilized.** Local government in the Republic of Armenia is composed of 930 local communities (villages, towns, or districts). The regional level (Marz)¹² is a territorial administration for the central government but has no autonomy. The legal framework is specified mainly through the Law on the Budgetary System, the Law on Financial Equalization, the Law on Local Self-Governance, and the Law on territorial Administration.¹³ Two taxes collected by the Ministry of State Revenue (MSR), the property tax and the land tax, have been fully allocated to local governments since 2000.¹⁴ Central government transfers amount to around 18 percent of approved local government budgets on average, but low realization of own revenues and related expenditures raises the overall percentage of central government transfers in actual local government expenditures. Transfers are allocated on the basis of a formula, taking into account the size of the local community, its population, and its deviation from average tax revenue collection. Local governments perform functions related, in particular, to transportation, education, social welfare, agriculture, and environment. Adjustments to these functions, and an improved

¹¹ This increase results from the restructuring of a state-owned enterprise that previously carried the equity holding. The equity holding was passed directly to the central government.

¹² There are 10 Marz excluding Yerevan.

¹³ Respectively adopted in June 1997, November 1998, and June 1996.

¹⁴ Both taxes were split on a 95/5 percent basis in favor of local governments prior to January 2000. For the property tax, local authorities share the responsibility for collection.

definition of responsibilities between Marz and local governments are under consideration,¹⁵ as the limited size of most communities currently limits their capacity to carry out their functions in an effective manner.

8. **Reporting on local government fiscal activities is not yet comprehensive.** Specific provisions allow local governments to borrow from the Treasury,¹⁶ but such loans have remained limited so far. Local branches¹⁷ of the central treasury perform the treasury function for local government. Monthly reports on the cash implementation of the local government budgets are made through the treasury network. In addition, local governments report on a monthly basis to the Marz and to the Ministry of Territorial Administration (MTA) on the implementation of their budget. However, owing to arrears buildup, this cash reporting does not yet provide a comprehensive picture of the fiscal position of local government. Reporting on local government budgets as approved is not complete, and there is no reconciliation between data collected through the treasury and through the MTA.

9. **The roles of the executive, legislative, and judicial branches are clearly defined in the Constitution of the Republic of Armenia.**¹⁸ The constitution empowers the National Assembly to adopt the state budget, supervise its implementation, and examine the final report on the budget. Relations between the three branches are in general clearly stated. Article 75 of the constitution defines the broad principles under which the National Assembly may amend the draft budget.

10. **A clear but limited legal and administrative framework defines fiscal management.** The Law on the Budgetary System currently provides the main legal framework for fiscal management. The law covers both central and local government, and provides the definitions and framework for preparing, implementing, and reporting on the budget both at the central and local level. In particular, central government and community budgets are prepared under a unified presentation and according to similar processes. However, the law does not address performance issues and does not provide sufficient guidance on treasury operations. A draft law on the treasury is now being considered and should be implemented in the next few months. It will provide additional regulation of the responsibilities of chief accounting officers, the management of funds, the organization and processes related to the Treasury Single Account (TSA), and the Treasury General Ledger (TGL).

¹⁵ A revision of the Law on Territorial Administration, which would delegate more responsibility to local government, is under consideration.

¹⁶ No regulation prohibits local government from borrowing from the banking system, although such borrowing is currently not taking place.

¹⁷ There are 44 Local Treasury Branches.

¹⁸ Constitution of July 5, 1995.

11. **Mechanisms for the coordination and management of extrabudgetary activities are defined, but additional clarification is needed.** Extrabudgetary activities, which had been pervasive in the past, have been substantially reduced and are now limited to a few specific areas. The coordination and management of these extrabudgetary activities is defined on a case-by-case basis rather than under a general framework, but is broadly consistent with a comprehensive coverage. Extrabudgetary funds include the pension fund and the fund of the MSR, which collects 10 percent of revenue in excess of tax officers' initial performance targets. Expenditure financed by the MSR fund includes, in particular, bonuses to MSR employees, which can amount to a substantial share of their overall compensation. The SFSI is not integrated into the budget but is presented separately with the budget documentation. Expenditure financed by the MSR fund, together with the revenues accruing to the fund, are not appropriated in the initial budget but are included in the reporting on budget execution. In addition, some extrabudgetary accounts also exist,¹⁹ especially for external assistance management and for privatization.

12. **Arrangements regarding the Special Privatization Account (SPA) need further clarification.**²⁰ The SPA is managed by the CBA. Revenues are not budgeted at the time they are accruing to this account, and are not included in the government position toward the banking sector. They are invested abroad with other international reserves of the CBA, and yield the same interest, although they are not part of the CBA reserves. The use of these proceeds is made according to guidelines,²¹ which are, however, not formalized. While information on privatization proceeds and the use of the funds is largely provided with the budget documentation (parliament's approval is required for spending from the SPA), little information is provided on the account itself.

13. **Legislative basis for taxation, regulation, and administrative procedures exist, but implementation suffers from delays and insufficient preparation.** Tax laws and other legislation are regularly published, and the documentation is available to the public through official publications (e.g., monthly tax bulletins). A tax code consolidating all laws and regulations is under development. A specific unit in charge of tax education has also been set up. However, the training of public servants in charge of law enforcement, and the education of the public are insufficient, and there are delays in the implementation of subsidiary

¹⁹ The main extrabudgetary accounts beside the SPA relate to publications (National Statistics Service), external assistance, and schools (for the publication and sales of training material within the framework of a donor-financed program).

²⁰ Privatization operations are handled according to the Law on the Privatization of State Property adopted in September 1997.

²¹ The rule, as specified in the PRGF-supported program, is that at most 50 percent of the account's assets at the beginning of the year may be used to finance capital expenditure and at least 25 percent should be set aside to pay off nonconcessional external debt, with the remainder being carried forward to the next fiscal year. However, these figures remain indicative rather than normative and, exceptionally, the government has temporarily borrowed from this account to finance priorities (in particular, salaries and pension arrears).

regulations.²² This has negative implications for transparency, as it causes uncertainty about the applicable provisions during the months immediately following the enactment of a new law.

14. Public servants are not subject to a code of behavior. No code of ethical standard has yet been created that is applicable to public servants in general. However, specific laws provide a framework for the rights and obligations of civil servants related to tax and to inspection.²³ Further developments in this area are expected, as two laws are currently under consideration by parliament relating respectively to: (i) the civil service (including rights and obligations of civil servants, their responsibilities and their liability to sanctions); and (ii) the disclosure of property and income by high-ranking state officials.

B. Public Availability of Information

15. The budget documentation provides a broad but not yet complete coverage of fiscal activity. The budget documentation²⁴ covers the central government and the SFSI, and provides detailed estimates for the budget year. Additional information on current year budget implementation, on the previous year's outturn, and on two years ahead is provided on a more aggregated basis. Information on the financial situation of the energy and water sectors (including three-year forecasts) began being provided with the 2001 state budget.

16. Information on debt is presented for central government on a gross basis. Some detailed information on central government debt is provided with the budget documentation, including separate information on domestic and external debt. Information on arrears²⁵ has also started to be disclosed in the budget documentation in 2001. Detailed information on financial assets is, however, not available.

17. Information related to tax expenditure and contingent liabilities remains very limited. A contingency reserve²⁶ is appropriated in the budget and identified in the budget

²² In the tax area, these delays may be compounded by insufficient coordination between the MFE and the MSR, respectively in charge of tax policy and tax and customs implementation.

²³ This is, in particular, the case for the law on "organizing and carrying out inspection in the organizations functioning in the territory of the Republic of Armenia," adopted in May 2000, which spells out the rights and obligations of the person carrying out an inspection, the rights and obligations of the person being inspected, and specifies a right for compensation in case of unlawful behavior from the inspection officer. Tax legislation also includes provisions imposing duties on tax officials and mechanisms allowing taxpayers to enforce their rights.

²⁴ Budget documents include the draft budget and a fiscal statement comprising the budget speech, macroeconomic assumptions, explanations of the fiscal policy stance, and supplementary fiscal data.

²⁵ The amount at end-2000 for central government is around 4.3 percent of GDP.

²⁶ According to the Law on the Budgetary System, the contingency reserve cannot exceed 5 percent of the total budget appropriations of the fiscal year.

(continued...)

documentation. The budget documentation does not, however, provide other information on contingent liabilities and no information on tax expenditure is available.

18. **The IMF General Data Dissemination System (GDDS) is largely being observed.** An assessment of data dissemination practices through a data module of the ROSC has been finalized.²⁷ Practices generally meet the requirements of the GDDS and exceed them in terms of periodicity and timeliness. Comprehensive data on central government and on general government operations are compiled and disseminated on a monthly and quarterly basis, respectively. Comprehensive information on central government debt is provided on a quarterly basis.

C. Open Budget Preparation, Execution, and Reporting

19. **The annual budget presentation is relatively comprehensive and focuses on macroeconomic constraints and financial compliance rather than performance.** The annual budget is clearly documented. The breakdown of the budget is documented by organizational, functional, and economic categories. Economic and functional categories established in the budget are compatible with the GFS. The budget presentation spells out the fiscal strategy of the government, and details the government program for the use of the proceeds from privatization. Appropriations to local government budgets are identified in accordance with the relevant laws and the budget also prescribes reporting requirements for transaction pertaining to the extrabudgetary funds. Additional information is provided on a more ad hoc basis. For instance, the budget identifies significant energy-consuming public entities in order to flag possible arrears in energy payments.

20. **The overall budget balance of the next fiscal year is the main indicator used to define the fiscal policy stance.** Projections for GDP growth, inflation, and the current account are the main indicators used to define the macroeconomic environment. The budget also contains forecasts for the following three years of the main macroeconomic parameters. The budget statement brings out the main goals of socio-economic development and the fiscal policy of the government, but the analytical tools of the fiscal position of the government remain limited to the overall budget balance. A general but relatively unconstraining fiscal rule is stated in the Law on the Budgetary System,²⁸ but new fiscal rules are provided for in the draft Law on State Debt.

21. **Medium-term budget planning is being initiated.** A rudimentary Medium-Term Expenditure Framework (MTEF) was established during the budget cycle for the financial year 2000. This MTEF is being further refined to establish formal rolling medium-term estimates for a three-year period. The economic parameters underlying the MTEF are developed by the MFE in consultation with the MSR and the CBA. The budget document

²⁷ See <http://dsbb.imf.org/gddswb/country/arm/arms2.htm#fiscalsector>.

²⁸ The Law on the Budgetary System currently includes a fiscal rule-limiting deficit to 10 percent of GDP.

also indicates the objectives of major programs of the government. However, these objectives are not yet comprehensive and are not consistently integrated with the MTEF. Furthermore, while the format for collecting data for the MTEF requires the budgetary units to provide information separately on the costs of ongoing and new policies, they are not systematically distinguished. There is no analysis of long-term fiscal sustainability or of long-term liabilities such as pensions.

22. An analysis of the sensitivity of the estimates to changes in economic variables is not published, and the main fiscal risks are not stated. Some attempts have recently been made to analyze the sensitivity of the budget estimates to changes in economic variables, but there no systematic assessment is yet conducted. Contingent liabilities emerging during the financial year, such as guarantees that are called,²⁹ are provided for in the annual budget largely in the form of a global appropriation included in the Reserve Fund. However, there is no comprehensive statement of contingent liabilities, and the Reserve Fund is already partially preempted (by liabilities that are already certain) at the time of the budget preparation and presentation.

23. Control of recurrent expenditures within the authority of the budget is improving. Over the past few years, control over recurrent expenditure has been weak and resulted in a large buildup of arrears. More recently, problems arose in the health sector, when hospitals asked for reimbursement under the free medical help program, and appropriations proved insufficient to meet state obligations. In addition, quarterly warrants have been implemented with delays in the past year creating difficulties in budget implementation and control. However, substantial improvements have been made. Recurrent and capital expenditures are still recorded on a cash basis. But budgetary units, both central and local government, are now required to submit monthly reports on payment arrears, and central government budgetary units meet this requirement. Moreover, the MFE is also setting up procedures for a commitment control system, and for the monthly monitoring and reporting of receivables and payables, which should allow for controls at earlier stages of the expenditure process.

24. Accounting reports are effectively and regularly reconciled with budget appropriations and with the bank accounts. The reconciliation has improved considerably with the establishment of the TSA (see Box 1 below). The TSA includes all extrabudgetary funds and local government funds except the SFSI and Project Implementation Units' (PIUs) bank balances relating, inter alia, to World Bank-financed projects. The current agreement between the government and the World Bank does not permit the amalgamation of the PIU bank balances into the TSA. However, the government is presently discussing with the World Bank the possibility of bringing their PIU accounts into the TSA. Government revenues and expenditures are reconciled on a daily basis with the CBA. The MFE also

²⁹ The Law on the Budgetary System states an ex-ante limit to the guarantees that are provided: liabilities resulting from these guarantees must not exceed 10 percent of the tax revenues collected in the previous fiscal year.

provides daily data to the government and the legislature on the cash execution of the budget, and monthly budget execution data are posted on a treasury web page.³⁰

Box 1. Implementing a Transparent and Efficient Payment and Accounting System

The treasury system uses the electronic communication network (CBANET) of the CBA for communicating with the local treasury branches, the Central Tax Inspectorate, and the CBA. The TGL is compliant with the GFS, and treasury accounts are maintained in a double-entry system. The payment and accounting functions in the treasury system are carried out through customized software installed in the central treasury and 44 local treasury branches.

The TSA held in the CBA includes: (i) state budget resources; (ii) extrabudgetary resources of the state budgetary institutions; (iii) local government budget resources; and (iv) all other deposits related to state and local governments not classified elsewhere.

The Treasury on the basis of payment orders received from the budgetary institutions and local governments authorizes payments from the TSA. Payments from the state budget unified subaccount are restricted to the available budget allocations. Payments from the other subaccounts (community budget unified subaccount and budgetary institutions extrabudgetary resources unified subaccount) are restricted to the extent of balances available in those subaccounts.

- Direct payments to suppliers of budgetary institutions are made through electronic transfer of funds initiated by the budgetary institutions and processed through the central treasury and the CBA.
- Cash payments to budgetary institutions and their suppliers are made by the commercial bank branches servicing the local treasury branches, on the basis of checks issued by the local treasury branches. All cash payments are made by the servicing commercial banks from their own currency chest and *reimbursed by the CBA from the TSA within two days. The commercial banks servicing the local treasury branches for payments are selected on the basis of tenders. They charge the government a fee for the service rendered. The detailed accounts of expenditures for budgetary institutions are maintained in the books of the local treasury branches.*
- Government revenues may be deposited in branches of any commercial bank. These revenue deposits are swept daily into the TSA at the CBA.

25. **A broad statement of accounting policies is included only in the Law on the Budgetary System.** Under the current cash accounting regime, no measure has yet been proposed to include statements of accounting policies in the annual budget and final accounts. However, Article 10(d) of the 2001 Budget Law (which eliminates any additional period after the end of the year to record transactions) could be construed as stating a cash basis of accounting. The government proposes to implement a full accounting of payables and receivables before the year 2002. Budget arrears are already reflected in monthly, quarterly, and annual reporting.

³⁰ <http://www.mfe.gov.am>

26. **Internal control procedures are not adequate.** Internal controls are weak. Internal control is carried out sporadically and in an ad hoc manner. There is no systematic and sustained process of testing internal controls and processes. Insufficiently defined mandates, poor coordination, and overlapping competence and activities of existing control agencies further weaken the credibility of the process. Internal audit functions at the government-wide level are, for example, performed by three different internal audit entities: at the President's office, at the Prime Minister's office, and in the MFE. The internal audit of institutions financed through the budget will, however, be systematized with the implementation of the proposed draft Treasury Law in 2001.

27. **The procurement and the employment systems are in transition.** Contracting and procurement rules are defined in the Procurement Law, which came into effect in August 2000. Subsidiary regulations have been adopted, and the Public Procurement Agency has been established. However, the necessary regulatory framework is not yet fully implemented and the Agency is not yet functioning effectively. Former processes, which were poorly regulated, are still in place. Similarly, employment and pay regulations are not well defined. This leaves substantial room for ministries to implement ad hoc measures within their overall wage allocation. However, the government is working, with international and bilateral assistance, toward a comprehensive civil service reform.

28. **Fiscal and final accounts reports meet a high standard of frequency and timeliness.** The government is required to publish monthly information on the execution of budget expenditures by economic and functional classification. The Law on the Budgetary System also requires the government to publish information on the execution of the quarterly budget within 40 days following the end of each quarter of the financial year. These legal requirements are met, and some practices reflect an even higher standard: information on the quarterly budget execution is published within one month. Moreover, the MFE presents daily, monthly, quarterly, and annual budget execution data to a number of agencies, including the government, the legislature, and the CBA. The coverage of these data is comprehensive, as it includes the cash operations of extrabudgetary funds and local governments. Further steps are being taken to improve the content of accounting reports. These include the requirement for a comprehensive monthly reporting of receivables, payables, and movements of financial assets/liabilities. Ministries will also be required to submit detailed annual reports of activities undertaken during the financial year along with the annual accounts.

29. **Defense expenditures are included in the budget.** However, they are presented on an aggregated basis and not broken down by object of expenditure.

D. Assurances of Integrity

30. **The quality of fiscal data is improving.** The efficiency of the payment and accounting system, together with the broadening coverage and increasing frequency of the

fiscal reporting, and the regular reconciliation procedures with bank statements³¹ have resulted in a substantial improvement in the quality of fiscal data.

31. The Control Chamber of the National Assembly of the Republic of Armenia carries out external audit.³² The Chamber is fully independent from the Executive and exercises its duties in close relation with the National Assembly. The chairman of the Chamber is named for six years by the President of the National Assembly and may be dismissed by the National Assembly. The Control Chamber prepares its own work program, which is approved by the National Assembly and, according to the Law on Auditing, the audit themes put forward by the Chamber must take into account requests from the various Standing Committees of the National Assembly but also from deputies. Eventually, a short list of audit themes is proposed by the Control Chamber, to which the National Assembly may ask for modification or addition.

32. Strengthening of audit capacity is required at all levels. The Control Chamber performs an annual audit on the implementation of the state budget by the end of May of the following year, and another annual audit on the half-year implementation of the current budget by September. The National Assembly is, however, not bound to discuss this half-year audit. Other audits include, inter alia, investigations on the use of foreign loans and the execution of the privatization program, but the number of value-for-money audits remains limited. The external audit function is weakened by its limited resource capacity (25 staff only). More generally, and while the external audit has a latitude to disseminate its findings, no effective coordination mechanism exists to ensure that remedial actions are considered.

33. Macroeconomic assumptions are disclosed but not subject to external scrutiny. The macroeconomic framework underpinning the annual budget is coordinated between the CBA and the MFE, and presented together with the budget statement and the accompanying documents to the budget, but macroeconomic assumptions and models are not subject to specific external review.

34. The National Statistics Service has technical independence and benefits from a high level of autonomy. The technical independence of the National Statistic Service (NSS) is guaranteed by the Law on State Statistics,³³ which was elaborated in accordance with European Union and United Nations standards. The law defines the objectives of the NSS, and specifies its technical independence from central and local government. The Head of the Service and the 7-member State Council on Statistics are appointed for six years by the President of the Republic. The National Assembly approves a three-year work program of the

³¹ As mentioned above in paragraph 22, 24, 28 and Box 1.

³² Law on the Control Chamber of the Republic of Armenia, adopted in May 1996.

³³ Adopted in April 2000. See also the ROSC data module for more details on the NSS.

NSS and a report on its implementation must be submitted to the Assembly.

III. IMF STAFF COMMENTARY

35. **The Republic of Armenia has made substantial progress over the last few years in improving many aspects of fiscal transparency and in many cases has achieved significant results.** Two main areas, in particular, have witnessed substantial improvement:

- legal provisions have been strengthened and provide a clear framework for the regulation of economic activities, the independence of the central bank, and the technical independence of the national statistics service; and
- the internal reporting and accounting system has been substantially upgraded and provides a strong base to build upon. The implementation of the TSA, the modernization of the payment system, and the integrated accounting and reporting through the treasury network provide a regular flow of information on the fiscal position of the government.

36. **Further improvements may be achieved over the next few months if various pieces of draft legislation currently under consideration are enacted and fully implemented.** This would, in particular, provide a general framework for the conduct of public servants, submit high-ranking officials to property and income disclosure requirements, improve the clarity of relations between central and local government, and formalize and further enhance the framework for treasury operations and for debt management and reporting.

37. **Careful preparation is required before the projected creation of agencies along a user/provider split is carried out.** This reform should be carefully prepared, gradually implemented, and accompanied by the necessary regulatory framework. In the absence of such a cautious approach, there is a substantial risk that transparency and accountability of government's activities could be weakened, the achievements of the TSA could be undone, and reporting capacity could be impaired.

38. **In the current state, there remain significant shortcomings compared to the requirements of the *Code of Good Practices on Fiscal Transparency*.** In many cases, the improvement does not require new legislation but rather full enforcement of existing legislation, and improved presentation or disclosure of already existing information. In other cases, further reforms are needed to provide an adequate framework for the government's activities.

39. In the short-run, it should be possible to further the reforms that are already being implemented and expand disclosure and reporting practice, and priority should be given to the following areas:

- **the Procurement Law should be effectively implemented.** Even if it is only a temporary problem, the absence of effective functioning of the Public Procurement Agency creates a severe legal loophole in a sensitive activity;
- **reporting on commitments and information on arrears should be fully integrated within the reporting system.** Development of commitment recording and controls will substantially improve the information on budget implementation and strengthen the capacity to monitor budget operations; and
- **arrangements regarding state privatization should be formalized.** Rules guiding the use of privatization proceeds, and possible exceptions to these rules, should be clearly stated. In addition, the current information on the central government's position toward the banking sector should be supplemented by a consolidated report, including the activities of the SPA.

40. **For long-term improvement in transparency, it will be crucial to address the problems related to the management of public enterprises.** While requiring a sustained effort over the medium term, further rationalization of central government intervention in the economy, with a view to having a clear understanding of potential fiscal risks, and clearly reporting (and preferably eliminating) quasi-fiscal activities, should be undertaken forcefully and could be developed along two main venues:

- **equity holdings need to be reported in a detailed and comprehensive way and fully disclosed.** This constitutes a first step toward enhanced transparency in the publicly or partially publicly owned sector, as unclear and complicated shareholding interests may further contribute to uncertainty regarding the final cost of public enterprise restructuring. It should also provide a basis for analyzing the justification for maintaining a small state participation in other sectors that are being privatized; and
- **further clarification regarding public enterprises is necessary.** Adequate pricing of activities performed by these enterprises, and where necessary, subsidies fully appropriated in the budget constitute a first necessary step to limit the scope of quasi-fiscal activities carried out by the public sector. In addition, the improved financial reporting that is currently being implemented needs to be developed further in three directions: (i) a deepening of the information available through better reporting on interenterprise arrears, financial situation of subsidiaries, and a move toward standard financial statement practices; (ii) the implementation of clear rules and guidelines for the monitoring and management of the state-owned enterprises, including prohibition of barter and offsetting; and (iii) the consolidation of the information from the various sectors to provide a comprehensive view of the central government's exposure.

41. Improving information and management tools, both for the government and for the National Assembly, should be the focus in the budget and civil service area.

- **Budget implementation should be made more transparent** by avoiding delays in the publication of quarterly warrants, as required by the Law on Budgetary Systems, and by systematically comparing actual figures with initial quarterly allocations. The quarterly reporting to the National Assembly and the half-year report of the Chamber of Control on the implementation of the budget provide adequate timing for such discussion and presentation of the budget implementation. This would supplement the information that will be provided by the treasury website that is being established, and the current reporting of treasury transactions to the National Assembly.
 - **Budget presentation and budget documentation could be substantially improved.** While efforts have already been made, budget documentation should provide specific information on contingent liabilities (amount of the contingency reserve devoted to contingent liabilities, main risks, detailed use of the Reserve Fund during past and current fiscal years), tax expenditure (presentation of tax expenditure and their estimated costs), and fiscal risks (in particular, the assessment of the sensitivity of the main fiscal variables to changes in key macroeconomic parameters).
42. **The public service reform should be finalized and implemented.** The public service reform, besides contributing to the clarification of rights and duties of civil servants, should also aim at providing adequate guidance on the wage and employment policy followed by the various ministries and agencies.
43. **Additional reforms aimed at further building up institutional capacity will also be necessary**, within a medium-term framework, to meet a reasonable standard of fiscal transparency.
- **The audit function needs to be substantially strengthened.** The external audit function performed by the Control Chamber has a substantial degree of independence from the Executive. Its capacity and credibility must, however, be considerably enhanced if it is to fully perform its role, and it must be given the latitude to perform audits that go beyond the compulsory requirements, and to extend its activities to the public sector at large. In parallel, internal audit bodies should be rationalized and given a clear mandate to avoid interference between themselves and with the external audit.
 - **Relations between central and local government should be further clarified**, with financial resources and the size of local government entities matching the missions that are ascribed or delegated to them. Fiscal reporting should also be improved with a full reporting on local government arrears, to avoid the buildup of liabilities at the local government level, and a systematic consolidation and reporting of budgets approved by local governments.
 - **Enhanced coordination between the preparation of laws and subsidiary regulations**, improved information for taxpayers, and training for tax and custom officers are needed to provide for the smooth implementation of new tax legislation.