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Evaluating Armenia's Fiscal Framework

Masud Al Taj, Nazim Belhocine, Vahram Janvelyan, and Ervin Prifti

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Evaluating Armenia's Fiscal Framework, Republic of Armenia
Prepared by Masud Al Taj, Nazim Belhocine, Vahram Janvelyan, and Ervin Prifti*

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ABSTRACT: This paper evaluates Armenia's fiscal framework, focusing on fiscal rule design and implementation. Despite the 2018 reforms strengthening the Armenia's fiscal rules, limitations persist: rules are somewhat procyclical and complex, ex-post enforcement is not legally binding, coverage is restricted to central government, and operational flexibility is limited. Armenia's fiscal rules have served the country well, but further improvements could be considered. Drawing on international best practices, the paper recommends upgrading fiscal rules to improve countercyclicality, simplify design, broaden coverage, and strengthen transparency and enforcement. Proposed reforms include consolidating expenditure rules, formalizing escape clauses, expanding coverage, and empowering independent oversight.

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SELECTED ISSUES PAPERS

Evaluating Armenia's Fiscal Framework

Republic of Armenia

Prepared by Masud Al Taj, Nazim Belhocine, Vahram Janvelyan, and Ervin Prifti[1]

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INTERNATIONAL MONETARY FUND

REPUBLIC OF ARMENIA

SELECTED ISSUES

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Middle East and Central Asia Department

Prepared By Masud Al Taj, Nazim Belhocine, Vahram Janvelyan, and Ervin Prifti, with assistance from Desislava Hineva, Branden Laumann and Xiaoqiao Shen.

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EVALUATING ARMENIA'S FISCAL FRAMEWORK[1]

A. Introduction

1. **Establishing a robust fiscal framework has become increasingly critical for governments worldwide as they navigate elevated debt levels and evolving spending demands.** A sound fiscal framework serves multiple interconnected objectives that collectively aim to promote macroeconomic stability, enhance resource allocation efficiency, and build public confidence in government financial management. At its core, such a framework seeks to achieve fiscal discipline by providing structured constraints on government spending and borrowing, ensuring that fiscal policies remain aligned with long-term fiscal sustainability. It also enhances fiscal transparency and accountability by clearly outlining the government intentions, targets, and performance, thereby fostering informed public debate and oversight of public finances (Wang et al., 2015).

2. **The strategic value of fiscal frameworks is to improve resource allocation and planning by extending the government's decision-making horizon beyond the traditional annual budget cycle.** Such a medium-term perspective enables policymakers to systematically consider the implications of current spending and tax policies on future fiscal stances, facilitating more informed prioritization of competing demands and better integration of policy objectives with available resources (Curristine et al., 2024). Furthermore, effective fiscal frameworks serve as crucial tools for economic stabilization during periods of economic volatility, while preserving the flexibility needed to respond appropriately to unforeseen circumstances and economic shocks.

3. **Fiscal rules play a pivotal role in operationalizing these broader framework objectives by establishing specific, measurable constraints on key fiscal aggregates.** These typically target variables such as debt, deficit, and expenditure levels. Fiscal rules serve as commitment devices that help governments signal their dedication to fiscal responsibility, thereby enhancing credibility with the public and financial markets. The design of fiscal rules must carefully balance several competing considerations: they must provide sufficient clarity to guide decision-making and enable monitoring, while maintaining adequate flexibility to accommodate economic cycles and emergency situations through well-defined escape clauses. The literature highlights that rules lacking appropriate flexibility or featuring poorly defined escape mechanisms can become procyclical and difficult to comply with, ultimately undermining their effectiveness and credibility (Davoodi et al., 2022; Ulloa-Suárez, 2024).

4. **The implementation of fiscal rules within broader fiscal frameworks has evolved significantly over time, particularly following recent global crises.** This evolution recognizes that effective fiscal management requires not just numerical constraints, but comprehensive institutional arrangements that integrate medium-term planning, robust forecasting capabilities, and strong coordination mechanisms across government entities (Caselli et al., 2022). The success of such frameworks ultimately depends on their ability to translate high-level fiscal objectives into practical,

[1] Prepared by M. Al Taj, N. Belhocine, V. Janvelyan, E. Prifti, with assistance from D. Hineva, B. Laumann and X. Shen.

day-to-day budgetary decision-making processes that promote both fiscal responsibility and effective public service delivery.

5. This Selected Issues Paper (SIP) evaluates the effectiveness of Armenia's fiscal framework, with a specific focus on the design and implementation of fiscal rules. A sound fiscal framework is essential for achieving macroeconomic stability, ensuring fiscal discipline, and enhancing policy credibility. International experience suggests that fiscal rules, when well-designed, can support these objectives and help correct policy biases by providing clarity, promoting countercyclical responses, and allowing for necessary flexibility and transparency.

6. The evaluation of Armenia's fiscal rules is of both theoretical and practical significance. A comprehensive assessment of how fiscal rules have served Armenia and whether they can be strengthened to improve both countercyclical effectiveness, operational flexibility, credibility, and transparency would provide valuable insights for the broader literature on optimal fiscal rule design in emerging markets. It is also timely to evaluate Armenia's fiscal framework from the perspective of fiscal rules as the recently approved 2026–28 Medium-Term Expenditure Framework (MTEF) envisages an ambitious fiscal consolidation path, while the fiscal rules in their current form have been largely non-binding due to recent levels of high economic growth. An evaluation of the fiscal rules with recommendations for improvement will help make them fit for purpose.

B. Armenia's Fiscal Framework Performance

Overview of Armenia's Fiscal Framework

7. Armenia's fiscal framework includes an MTEF, an annual budget and a number of fiscal rules. Three key pieces of legislation set the underlying legal framework: 1) the Budgetary System Law (BSL); 2) the Public Debt Law; and 3) the annual Budget Law.[2]

- ***The Medium-Term Expenditure Framework (MTEF).*** The MTEF provides indicative spending ceilings and projections for revenues and key macroeconomic indicators, including for GDP and inflation, over a three-year period. The MTEF is not a binding document and serves as a broad guideline for the preparation of the annual budget, although the latter has often deviated from it. The government approves the MTEF annually, by mid-year, and submits it to Parliament for information.

- ***The Annual Budget.*** The budget provides a detailed assessment of the macroeconomic and fiscal developments and outlook, and sets expenditure envelopes, revenue objectives and fiscal balance targets for the year. It is approved before year end by the parliament. The budget is a binding document and any major deviation from the targets that results in a higher-than-targeted deficit requires a supplementary budget or an endorsement by parliament for the

[2] These are further supported by specific government decrees.

government to make discretionary changes up to a certain limit.[3] Deriving powers from the BSL, the annual budget law (and the MTEF) can include also a general reserve fund of up to 5 percent of total expenditures, including for macro-fiscal (and other) risks. In case of lower-than-expected revenue mobilization during the year, the reserve fund serves as the first line of cuts in the expenditure envelope. The budget provides also some flexibility to increase, cut, or redistribute spending within defined limits without the need to seek separate parliamentary approval.[4]

- ***Fiscal rules:*** The fiscal rules set the parameters for the preparation and execution of the MTEF and the budget within the overall fiscal framework. The first rule was adopted in 1997 as a budget balance rule with a deficit ceiling of 10 percent of GDP. This ceiling was decreased to 5 percent of GDP in 2003 and then increased to 7.5 percent of GDP in 2009. A debt rule was added in 2008 with a debt limit of 60 percent of GDP. However, the most consequential changes took place in 2018 with the introduction of an expenditure rule for multiple debt thresholds and a capital expenditure sub-rule under the balanced budget rule. The objective was to improve countercyclicality and flexibility of the fiscal framework while preserving the credibility and sustainability of fiscal policy. As a result, current fiscal rules include a budget balance rule, an expenditure rule and a debt rule **(Box 1)**. The framework provides for an escape clause that can be triggered in "exceptional cases" of large-scale natural disasters, wars, and economic shocks based on the government's interpretation of the extent of its negative impact. Formally, the escape clause is considered activated once Parliament has approved the deviations from the rules with an amendment to the budget law as proposed by the government. However, the legislation doesn't require a formal declaration on activating the escape clauses

Box 1. Armenia: Fiscal Rules

Type of Rule	***Central Government Rules***
Balanced budget in T+1	• Budget deficit < 7.5 percent of GDP. • Capital expenditures should not be below the level of the budget deficit if the government debt exceeds 40 percent of GDP.
Expenditure ceiling in T+1	**Debt in T-1 < 60 percent of GDP, but >50 percent:** • Average current primary expenditure growth < average nominal GDP growth in previous 7 years. **Debt in T-1 > 60 percent of GDP:** • Average current primary expenditure growth < average nominal GDP growth in previous 7 years – 0.5 percentage points. • Current expenditures < tax revenues + state duties. • The expenditure rule was introduced in 2018 and applies for ex-ante planning purposes only. • The expenditure rule does not apply to capital expenditures.

[3] This practice was used during the Covid-19 pandemic, when parliament endorsed a right to the Government to increase the deficit up to a certain level on top of the approved deficit target without approving a supplementary budget.

[4] The government can (i) increase spending up to 10 percent of the approved budget expenditure for the year (in specific cases and when additional or more than projected revenues materialize as authorized by annual budget laws); (ii) cut spending up to 10 percent of the approved budget expenditures for the year, if there is a risk of revenue under-execution by up to 10 percent (as authorized by the budgetary system law) and (iii) redistribute allocations among programs and measures for up to 3 percent of the approved budget expenditures based on budgetary system law.

Box 1. Armenia: Fiscal Rules (Concluded)

Debt in T+1	**Upper threshold**: **60 percent of GDP.** • **Debt in T-1 > 60 %:** Submit an action plan to parliament to bring debt below 60 percent of GDP. • **Debt in T-1< 60 %:** Present an action plan in MTEF to lower debt to 50 percent of GDP in 5 years.

Compliance with Fiscal Rules

8. **Various reforms to strengthen the macro-fiscal framework have been introduced in recent years.** These have included strengthening macroeconomic projections, simplifying procedures and improving the quality, transparency and reporting of the fiscal framework and data, better alignment of the MTEF with the budget, and improving public investment management (PIM). More recently, the MOF has completed a thorough review of the MTEF and the annual budget process and the 2026-28 MTEF was recently approved in line with the new procedures. The objective of the review was to strategically focus the MTEF on medium-term macroeconomic projections, the fiscal deficit path, and overall expenditure ceilings. This limits procedural redundancy, allowing policymakers sufficient time to thoroughly evaluate and prioritize specific policy proposals during the annual budget preparation. Further, the budget framework now covers the annual budget for the year and indicative expenditure envelopes for the following two years. The overall changes to the process are expected to encourage line ministries to improve rolling baseline spending projections, new program and policy planning, and effective implementation of public investment projects. This will complement the fiscal rules in strengthening the credibility of the fiscal framework as better alignment of the MTEF and budget processes and substance will improve fiscal planning and policymaking (Box 2). Further, to strengthen the fiscal rules, the authorities (with IFI support) have submitted amendments in the budget systems law to the Parliament to restrict the government from taking on any new PPP liabilities and budgetary guarantees in case the sum of the central government debt, PPP liabilities and budgetary guarantees exceed 70 percent of GDP threshold. Further, it will also restrict taking on new PPP liabilities if the central government debt exceeds 60 percent of GDP.

9. **Fiscal policy implementation has occasionally deviated from the rules.** Breaches of the fiscal rules were experienced in both the preparation and implementation stages of the MTEF and the budget. These mostly occurred in 2020-21 when the escape clause was activated after the Armenian economy faced multiple shocks from the COVID-19 pandemic and the war with Azerbaijan. While the government did not publish a formal justification for triggering the escape clause, it submitted annually an amendment to the budget law to address the negative consequences of the shocks. Retrospectively, these breaches were considered as technical deviations rather than breaches since the escape clause was activated. Breaches have also occurred post and prior to the 2020-21 crisis period, as identified below:

- **The balanced budget rule (BBR).** The BBR was breached in 2009 following the global financial crisis. Since then, there have been no breaches to this rule. However, the balanced budget sub-rule on capital expenditures was breached in 2020-21, when the deficit exceeded capital expenditure (Table 1).

Box 2. Armenia: Recent Refinements in Fiscal Framework

Preparation Phase	Established Process	Reformed Process
MTEF preparation	• Detailed Line Ministries' submissions and approvals for budget programs, measures by economic classification, and cost savings by measures. • A preliminary draft budget for upcoming year is approved by government and submitted to Parliment as part of the MTEF. • No clear separation of submissions and discussions on baseline budget and policy changes • MTEF is approved by the Government by mid-July • MTEF requests are not published on the websites of state bodies.	• Simplified procedures, focusing mainly on expenditure ceilings, macroeconomic projections, fiscal policy objectives and targets. • Separate cycles of submissions and approvals of the MTEF and budget for the upcoming year. • Separate phases of submissions and discussions on baseline budget and policy changes. • MTEF is approved by the Government by early June. • MTEF requests will be published on the websites of state bodies to ensure civil society engagement. • MTEF ceilings serve as a basis for Annual Budgets.
Annual budget preparation	• Updated macro-fiscal and expenditure framework is provided only for the upcoming budget year. • No scenario analysis.	• Budget draft includes also updated macro-fiscal and indicative expenditure frameworks for the following 2 years. • Scenarios with 5 percent and 10 percent spending cuts are presented. • More time is dedicated for the preparation of detailed budget requests (February-July) for the upcoming 3 years and budget discussions (July-September).

- **The debt rule.** Deviations from the debt rule occurred in 2020-21 following the sharp 7.2 percent contraction of real GDP in 2020, which was accompanied by a 9.0 percent depreciation of the exchange rate. The central government debt-to-GDP ratio spiked to 63.5 percent in 2020 and 60.2 percent in 2021. Following the debt rule requirements, the government prepared debt reduction plan for 2022-26, although these lacked the depth and detailed measures to bring debt below the fiscal rule thresholds.

- **The Expenditure rule.** There have been multiple ex-ante and ex-post breaches of the expenditure rule since its inception. These were recorded in 2020-21 when the escape clause was in place, as well as in 2022-23. However, the authorities consider ex-post breaches as technical deviations from the expenditure rule because a legal limitation binds its application for ex-ante planning purposes only. Separately, the authorities have managed to adhere to a sub-expenditure rule that requires the overall current expenditures to not exceed tax revenues and state duties when the debt exceeds 60 percent of GDP. (Table 2-3).

Table 1. Armenia: Adherence to the Capital Expenditure Rule

	2018	2019	2020	2021	2022	2023	2024
Debt in t-2 (*in percent of GDP*)	51.9	53.7	51.2	50.1	63.5	60.2	46.7
Budget Deficit Projection	-2.7	-2.2	-2.3	-5.3	-3.0	-3.1	-4.6
Capital Expenditures Projection	3.0	3.3	4.1	3.4	4.5	6.0	6.8
Budget Deficit Actual	-1.8	-1.0	-5.4	-4.6	-2.5	-2.0	-3.7
Capital expenditures Actual	2.5	2.9	3.7	3.1	4.6	5.2	5.5

Deviation from rule/Escape clause - COVID, Martial Law

Sources: Annual budget laws and annual budget execution reports.

Table 2. Armenia: Adherence to the Primary Current Expenditure Rule

	2018	2019	2020	2021	2022	2023	2024
Debt in t-2 (*in percent of GDP)*	51.9	53.7	51.2	50.1	63.5	60.2	46.7
Nominal GDP growth (average of 7 years)	6.1	6.1	5.9	6.4	4.1	5.1	8.0
Primary current expenditures growth	-0.7	5.4	10.4	6.3	4.1	5.1	13.0
Primary current expenditures growth	-1.0	5.9	14.8	12.8	6.5	6.7	10.5

Deviation from Rule/Escape Clause - COVID, Martial Law

Ex post breach

Sources: Annual budget laws and annual budget execution reports and staff calculations.

Table 3. Armenia: Adherence to the Current Expenditure Rule Condition on Tax Revenues

	2018	2019	2020	2021	2022	2023	2024
Debt in t-2 *(in percent of GDP)*	51.9	53.7	51.2	50.1	63.5	60.2	46.7
Current Expenditure Projection	22.4	21.1	22.1	25.6	23.4	21.9	23.9
Tax Revenue Projection	21.3	20.7	22.6	22.5	23.4	23.7	24.9
Current Expenditure Actual	21.6	22.0	27.0	25.6	22.3	21.9	23.7
Tax Revenue Actual	20.9	22.4	22.4	22.7	22.7	23.4	23.5

No breach of the rule observed.

Sources: Annual budget laws and annual budget execution reports and staff calculations.

Assessment of Armenia's Fiscal Rules

Countercyclicality

10. The 2018 reforms of the fiscal rules were envisaged to strengthen countercyclicality of fiscal policy, but gains have been limited. Prior to the introduction of the expenditure rule and new debt threshold levels, fiscal policy was consistently procyclical in good times during 2010-17. Post-reforms, fiscal policy was countercyclical during the crises period of 2020-21 when the escape clause was triggered due to double-shock from COVID-19 and war with Azerbaijan, but remained procyclical ex-ante as well as ex-post as growth rebounded and reached peak levels during 2022-24 **(See Figures 1, 2 and 4a)**. During this period, the expenditure rule was breached twice, and the expenditure outturn consistently exceeded the authorities' projections, driven by over-execution of current expenditures and under-execution of capital spending. During 2018-2024, the actual share of current expenditures in total expenditures was on average 1.8 percentage points of GDP higher than envisaged in the annual budgets. This average further increased recently to 2.8 percentage points of GDP in 2023-24. The somewhat procyclical fiscal stance and high current expenditure bias in the post-reform period underscore the following limitations of the existing fiscal framework[5]:

- ***The fiscal rules are inherently procyclical.*** The fiscal rules are backward-looking and enable additional spending during periods of high economic growth and could severely constrain spending during extended periods of low growth. A procyclical fiscal stance in good times and countercyclical stance in downturns driven by higher expenditures reflect a bias towards spending across economic cycles. Further, the expenditure rule becomes binding only when the debt exceeds 50 percent of GDP and does not warrant countercyclical fiscal policy below the threshold.

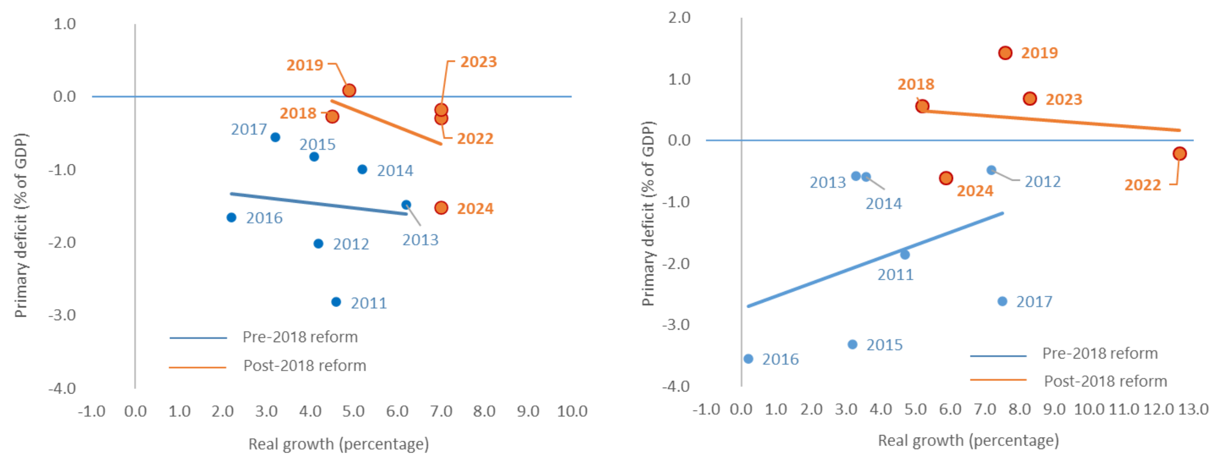
- ***The fiscal rules may incentivize unrealistic planning.*** The expenditure rule applies to primary current expenditures, which incentivizes higher projections for interest payments to comply with fiscal rules ex-ante. Higher projected interest payments allow space for discretionary spending within the overall current expenditure ceiling but could result in a breach of expenditure rule ex-post. Likewise, capital expenditure is excluded from the expenditure rule, which helps remove constraints on much-needed public investment that could yield long-term benefits. However, it encourages unrealistic planning for higher capital spending and lower current expenditure to comply with the fiscal rules ex-ante, but deviate from the expenditure rule ex-post, while still meeting the overall fiscal deficit target.

- ***Enforcement of fiscal rules is not legally binding.*** Since the expenditure rule legally applies for ex-ante planning purposes only, there is limited incentive for its monitoring ex-post.

[5] The current budget planning framework includes also other characteristics, which complicate implementation of countercyclical policy (for instance, mechanism of annual allocations for large equalization subsidies to municipalities), but they are not in the scope of these analyses.

Figure 1. Armenia: Fiscal Policy (Non-Crisis Period)

a. Ex-Ante Fiscal Policy (Non-Crisis Period) | **b. Ex-Post Fiscal Policy (Non-Crisis Period)**



Source: IMF Staff calculations.

Source: IMF Staff calculations.

Flexibility

11. Armenia's fiscal rules provide sufficient flexibility to maintain an agile fiscal framework, but there are key limitations:

- ***The escape clause***. Good escape clauses should have clearly defined conditions in which they can be activated; communicated without ambiguity; have specific, measurable trigger criteria; and be temporary in nature with a clear plan and inbuilt correction mechanism for returning to the rules. Armenia's escape clause served the country well by providing the authorities the necessary flexibility to undertake countercyclical policy during severe economic downturn. However, it lacks clarity and specificity about potential trigger events —how it is activated—; procedural details, transparency and communication to the public; monitoring indicators; guidelines on the path back to the application of fiscal rules; and independent ex-ante and ex-post scrutiny. These shortcomings leave considerable room for interpretation and make its application ambiguous and discretionary.

- ***The reserve fund.*** In practice, the reserve fund rules are not binding since it could be used for discretionary spending by redistributing funds from other allocations (e.g., capital expenditures to current expenses) even in case of lower revenue mobilization, which could result in deviation from planned spending, lead to over-execution of current spending as well as ex-post breaches of the expenditure rule. Thus, in practice the reserve fund is used more like tool for discretionary spending, rather than risk management.

Complexity

12. The complexity of Armenia's fiscal rules reduces their effectiveness and ease of communication. Simple fiscal rules help improve transparency and communication, reduce administrative burdens, and enhance compliance and enforcement. Simplicity comes down to ease of understanding, implementation, monitoring, and communication and is especially important in contexts where institutional capacity is limited or public transparency is a priority. As shown in **Box 1**, Armenian fiscal rules are quite complex and made of several "if-then" statements reflecting various rules for deficit and expenditures depending on the debt thresholds. Further, the expenditure rule is not a typical expenditure rule that would predetermine limits even for safe levels of debt and has different rules for current and current primary expenditures relative to the deficit, revenues and moving average nominal GDP growth, while capital expenditure is exempted from the expenditure rule. These complexities create incentives for inconsistent projections, and reclassifications of expenditures.

Coverage

13. The coverage of fiscal rules in Armenia is limited to central government. A broad fiscal coverage beyond the central government allows for a more accurate assessment of the overall public sector's financial health and improves effectiveness of fiscal rules. By encompassing all levels of government and public entities, it promotes enhanced accountability and encourages prudent fiscal management across the board. It also mitigates risks associated with sub-national entities and public enterprises, providing early warnings of potential fiscal distress. Armenia's fiscal rules are limited to central government and do not cover subnational governments, SOEs, PPPs and contingent liabilities. However, there are separate and more lax rules issued through government decrees on capping the stock and flow of guarantees. This arrangement creates preferences for off-balance sheet transactions and increases complexity in monitoring and compliance of applicable rules.

Monitoring and Enforcement

14. Independent monitoring, compliance, and enforcement of fiscal rules have been lacking. Independent fiscal institutions monitor fiscal policy, assess the realism of budget forecasts, and promote informed public debate. Their independent assessments reduce information asymmetries, discourage manipulation, and raise the political cost of violating rules. Further, oversight bodies play a crucial role in assessing the justification for triggering escape clauses of fiscal rules and monitoring the implementation of correction mechanisms. They strengthen both the credibility and flexibility of fiscal rules, contributing to better compliance and more sustainable fiscal outcomes. In Armenia, the MOF's macroeconomic department prepares the medium-term macro-fiscal framework which is required to be ex-ante in compliance with the fiscal rules. The government approves and publishes the framework as part of the MTEF without independent scrutiny. Although the ex-post compliance with the fiscal rules, including expenditure rules, is not legally binding, the MOF conducts and publishes an assessment of the ex-post deviation in the MTEF. While the independent Parliamentary Budget Office (PBO)[6], occasionally conducts assessment of compliance with fiscal rules for internal purposes only, it lacks the mandate and adequate resources to assess

[6] The PBO is responsible for contributing to the effective implementation of the oversight powers vested in the National Assembly and to provide professional support and information to members of National Assembly, standing committees, and factions.

fiscal forecasts or ensure ex-ante compliance with fiscal rules. Similarly, the Audit Chamber focuses on ex-post financial audits but is not mandated to systematically review fiscal rule implementation.

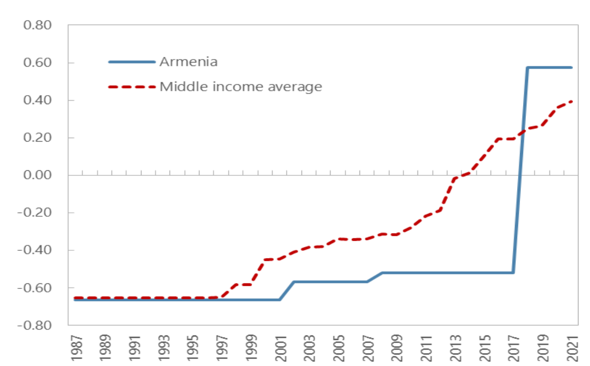
Transparency and Reporting

15. The authorities have made progress enhancing the transparency and reporting of fiscal framework, including the fiscal rules. Fiscal transparency significantly enhances the effectiveness of fiscal rules by increasing the visibility and political cost of non-compliance. When fiscal data and government actions are transparent, it becomes harder for governments to use creative accounting or hide slippages (Milesi-Ferretti, 2004). In Armenia, the MTEF and the annual budget are prepared, approved and published in a timely manner and cover detailed macroeconomic and fiscal projections, scenario analysis, priorities and objectives of the fiscal policy, an assessment of compliance with the fiscal rules in the medium-term, and an assessment of macro and specific (SOEs, PPP, other) fiscal risks. Annual execution reports on the state budget include sub-sections on fiscal rules, which discuss MOF's assessment of ex-post compliance during the reporting year. The general government financial statistics are published in line with the international standards. The 2019 IMF Fiscal Transparency Evaluation found that Armenia met good or advanced practices on 16 out of 36 principles of the IMF's Fiscal Transparency Code and basic practice on 14 others (IMF, 2018, 2019). However, major gaps remain, including limited institutional coverage.

International Comparison

16. Since Armenia first introduced fiscal rules, their strength initially remained below peers' average but caught up with the 2018 reforms. Figure 2 shows the progress over time of the fiscal rule strength index in Armenia and the average strength for the upper middle-income group of countries.[7] While its strength remained below peers between 1997-2017, following the 2018 reforms, the de jure quality of Armenia's fiscal framework exceeds the peer group average. Even so, the increase in the country's fiscal rule strength only placed Armenia in the middle of peer group in terms

Figure 2. Armenia: Fiscal Rule Strength Index

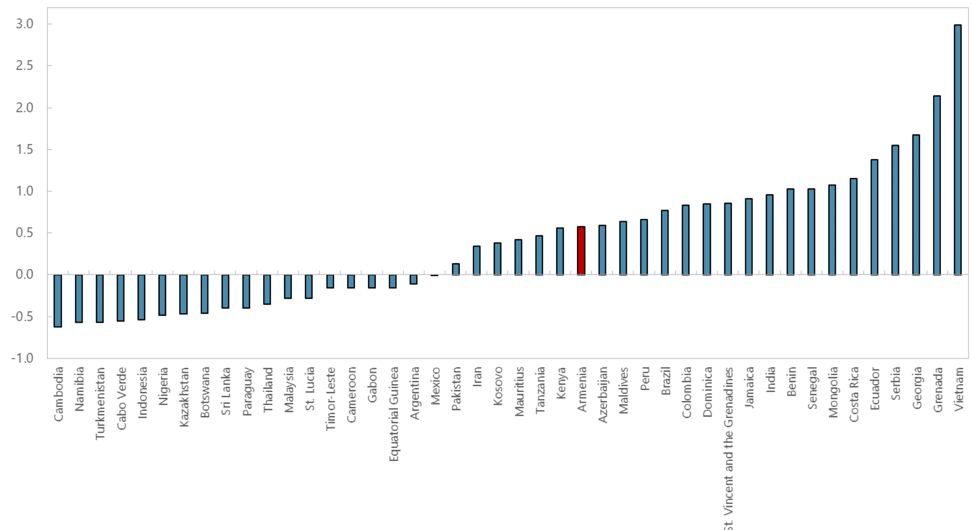


Source: IMF staff calculations on data from Davoodi et al. (2022).

[7] The Fiscal Rule Strength Index was developed by Davoodi et al. (2022) as a composite indicator designed to assess the institutional quality of fiscal rules based on their de jure features along four dimensions: 1) legal basis (whether the rule is enshrined in statutory law, a fiscal responsibility law, or the constitution); 2) monitoring mechanism (the presence and independence of institutions responsible for monitoring compliance); 3) enforcement and correction mechanisms (whether formal procedures exist to correct deviations from the rule); and 4) flexibility and resilience (the inclusion of well-defined escape clauses and the use of cyclically adjusted targets to accommodate economic shocks). Each rule is scored on these dimensions using standardized indicators ranging from 0 to 1 and the final index is standardized across the sample with score ranging from -0.7 to 3.6, with higher values indicating stronger fiscal rule frameworks.

of institutional quality of the rule, with Armenia ranking 19th out of 45 countries in its income group and 58th out of a total of 106 countries for which the index was available in 2021 (Figure 3).

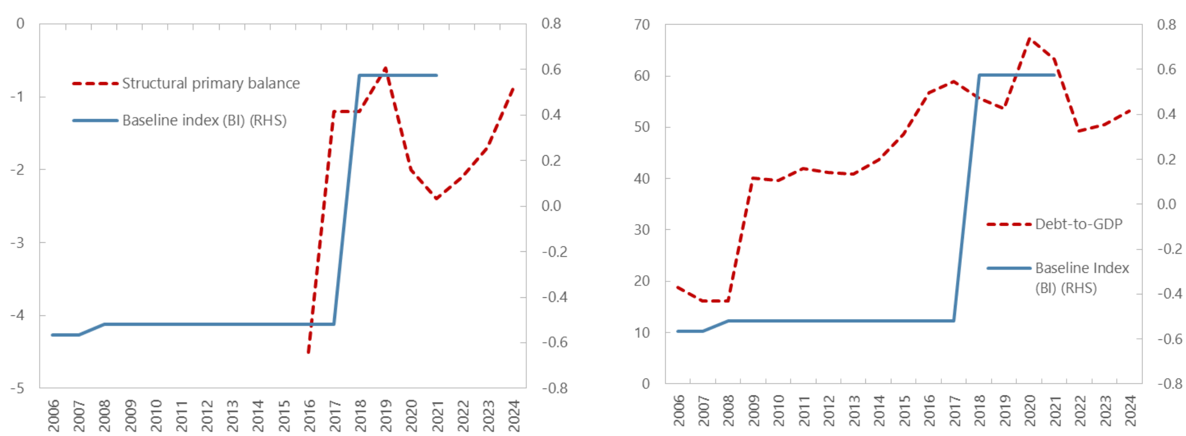
Figure 3. Armenia: Fiscal Rule Strength Index in 2021



Source: IMF staff calculations on data from Davoodi et al. (2022).

Figure 4. Armenia: Baseline Index, 2005 Onward

a. Countercyclicality of Rule **b. Sustainability of Rule**



Sources: IMF staff calculations on data from Davoodi et al. (2022) and WEO.

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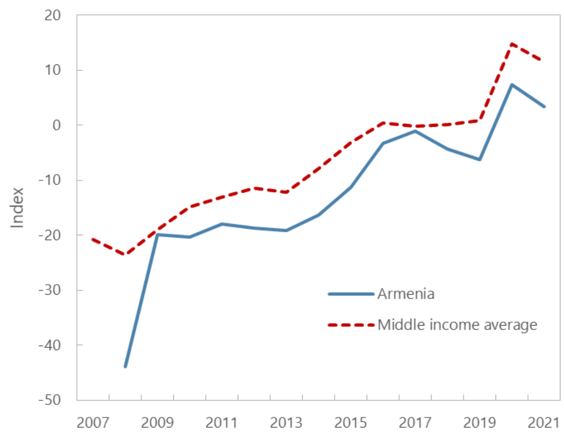
17. In Armenia deviations from the debt rule limit have been in line with the overall trend in its peer group, but smaller deviations were experienced for the balanced budget rule. Figure 5 (right panel) shows the absolute deviations between actual debt and the debt limit for Armenia and its peer group, with negative values indicating that countries are below the limit. Most countries edged closer to the debt limit, breaching it during the pandemic and regaining back fiscal space afterwards. However, in terms of balanced budget rule, the country seems to have smaller deviations relative to its peers as shown in Figure 5 (left panel).

Figure 5. Armenia: Rule Compliance—Middle-Income Average

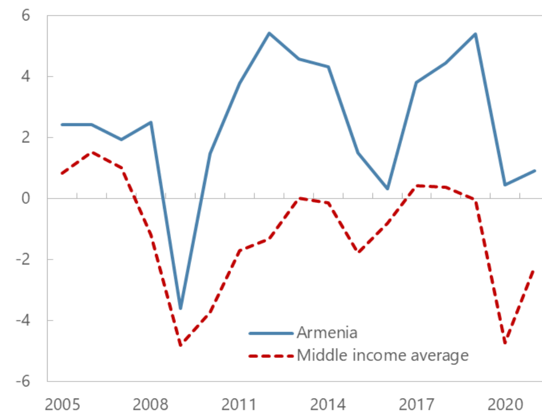
a. Debt Rule Compliance



Sources: IMF staff calculations on data from Davoodi et al. (2022) and WEO.

Note: The blue line refers to the absolute deviations of actual debt from the debt limit for Armenia, while the red dashed line is the average for the whole group of middle-income countries.

b. Budget Balance Rule Compliance



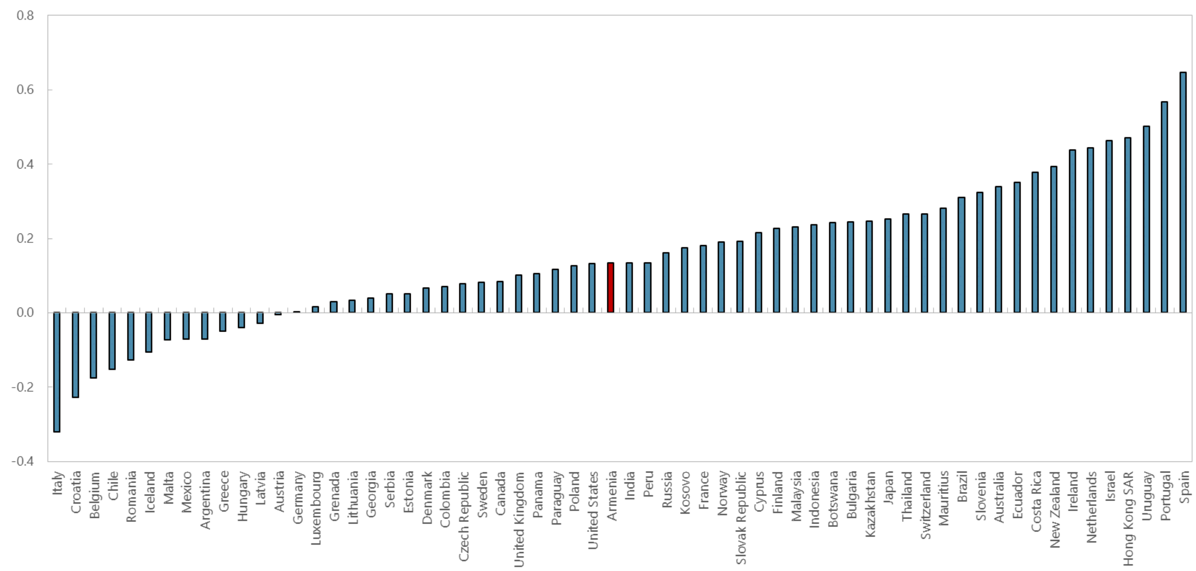
Sources: IMF staff calculations on data from Davoodi et al. (2022) and WEO.

Note: The blue line refers to the absolute deviations of actual debt from the debt limit for Armenia, while the red dashed line is the average for the whole group of middle-income countries.

18. Compared to peers, Armenia's fiscal rule shows limited countercyclical features and has considerable room for improvement. Figure 6 ranks countries based on the magnitude of the total effect on growth of a change in the structural primary balance.[8] Armenia ranks 31st out of 62 countries for which estimates are available. Armenia's coefficient of countercyclicality is 0.13, i.e., during boom (recession) phases the structural primary deficit has moved in the same direction (procyclical) by 0.13 percent for every one percent change in GDP on average. Armenia performs slightly better than the average country in the sample with a coefficient of countercyclicality of 0.15. Figures 4a and 4b show that despite the shortcomings, the strengthening of the rule in 2018 is associated with lower structural primary balances and more stable debt.

[8] For each country we regress the structural primary balance in year t on growth in the same year while controlling for the fiscal rule strength index and their mutual interaction (Jalles et al., 2023). The ensuing coefficient is an indicator of the strength of fiscal stabilization. The presence of a fiscal rule in each of these countries contributes only in part to the way fiscal policy is conducted, amidst other important domestic institutional factors as well as the global business cycle.

Figure 6. Armenia: Economy by Countercyclicality Strength



Sources: IMF staff calculations on data from Davoodi et al. (2022) and WEO.

C. Policy Options for Armenia

Improving Countercyclicality and Escape Clauses

19. The countercyclical features of Armenia's fiscal rules leave considerable room for improvement. The expenditure rule defined in relation to historical averages of nominal GDP growth could be upgraded with more countercyclical features including by: (i) regular adjustment for the past forecast errors to limit the impacts of shocks that make the rules too lax in the upturn or constraining in the downturn; and (ii) adding a forward-looking feature based on conservative, independent and credible forecasts of potential output (as, e.g., in Chile – see **Box 3**). The expenditure rule should apply to total expenditures including capital expenditures and interest payments to avoid incentives for forecast biases that result in procyclicality and ex-post breaches of the rule. Further, stricter regulations and formal procedures on the discretionary use of the reserve fund and flexibility to increase current spending could help limit the high-spending bias, reduce procyclical spending and avoid ex-post breaches. As Armenia has maintained economic stability in recent years and made progress on PFM reforms, it could consider redesigning the balanced budget rule as a more dynamic tool with countercyclical deficit targets or structural balance targets across economic cycles as part of reforms to strengthening countercyclicality of fiscal rules (as, e.g., in Serbia or Croatia – see **Box 3**).

20. The escape clauses in Armenia's fiscal rules could be strengthened through improvements in clarity, transparency, and correction mechanism. Armenia's escape clauses could be reinforced by including clearly defined and measurable conditions and triggers for activation such as a specific threshold for GDP contraction or certain size of the fiscal impact of

Box 3. Armenia: Examples of Countercyclicality

Serbia's Fiscal Rules: Built-in Countercyclicality

Serbia has adopted a fiscal framework that includes two key rules: a Budget Balance Rule (BBR) and a Debt Rule (DR), alongside an independent Fiscal Council. The BBR is defined by the following formula:

$$d(t)=d(t-1) - 0.3\,[d(t-1)-d^*] - 0.4[g(t) - g^*]$$

where d(t) is the general government fiscal deficit as a share of GDP with higher positive values implying loose fiscal policy, d* is the medium-term deficit target, set at 1% of GDP, g(t) is the real GDP growth rate, g* is the medium-term potential GDP growth rate, set at 4%. This formulation embeds two correction mechanisms: one toward a sustainable fiscal deficit target, and one reacting to deviations of actual economic growth from its medium-term trend. The fiscal rule comprises a debt rule that caps general government debt at 45% of GDP and a Fiscal Council, which is mandated to assess compliance with these rules and promote transparency and accountability in fiscal policy. In 2015, the Budget System Law had a provision that restricts spending to keep the share of general government wages up to 7 percent of GDP and share of pensions up to 11 percent of GDP. The BBR is explicitly countercyclical in nature, as it adjusts the permissible deficit based on the economic cycle. The Debt Rule, while not inherently countercyclical, serves as a long-term fiscal anchor.

Croatia's Fiscal Rule: Multilayered Approach to Sustainability

Croatia's fiscal framework includes three main numerical rules: an expenditure rule, a budget balance rule, and a debt rule, all reinforced by the institutional oversight of the Fiscal Policy Commission and compliance with the EU's supranational rules, including the Stability and Growth Pact (SGP), (European Commission, 2020).

Croatia's expenditure rule initially required nominal spending cuts until a zero primary balance was reached. From 2014, it became growth-sensitive, capping real expenditure growth at potential GDP growth unless funded by defined discretionary revenues. This embeds countercyclicality: limiting spending in booms and relaxing constraints in downturns if sustainably financed. The budget balance rule complements this by targeting the structural fiscal position. Once a zero primary balance is achieved, it requires a cyclically adjusted balance at zero or surplus, with a minimum annual structural adjustment of 0.5% of GDP until medium-term goals (deficit <3%, debt <60%) are met.

The debt rule, in place since 2009, prohibits increases in the debt-to-GDP ratio unless debt remains below 60%, mirroring EU benchmarks and serving as a sustainability anchor. EU accession in 2013 added oversight via the Excessive Deficit Procedure (EDP), prompting consolidation. Croatia exited the EDP by 2017 after structural improvements and credible debt reduction. The 2019 Fiscal Responsibility Act strengthened oversight by enhancing the Fiscal Policy Commission's autonomy and embedding numerical rules across government budgets.

Chile's Fiscal Rule

Chile provides one of the most prominent examples of a countercyclical fiscal framework in practice, anchored in a structural balance rule first introduced in 2001. Under this rule, government expenditures are set ex ante based on structural revenues—i.e., the revenues that would be expected if the economy were operating at full potential and if copper (and formerly molybdenum) prices were at their estimated long-term levels. The values for trend GDP and long-run commodity prices are provided by independent expert panels, limiting the scope for political manipulation.

Chile's structural balance rule does qualify as a countercyclical expenditure rule, even though it's framed around the structural budget balance. The rule links government spending to structural revenues, not actual revenues. Structural revenues adjust for: output gaps (difference between actual and potential GDP) and commodity price deviations (e.g., copper). So, when the economy is in a downturn: actual revenues fall, but structural revenues remain relatively stable (or fall less). This allows the government to maintain or increase spending, even if actual revenues are declining. Moreover, the rule is forward looking, as spending plans are not based on current or past revenues, but on an estimate of what revenues would be under normal conditions. A Fiscal Council, established in 2013, now oversees the estimation of key inputs (potential output and long-run copper prices) and provides non-binding advice on methodological aspects of the rule. This institutional setup has enhanced the credibility, transparency, and countercyclical nature of fiscal policy in a commodity-dependent economy.

natural disasters or wars. Such conditions could be codified in the Budget System Law and publicly communicated through budget documentation, to eliminate ambiguity and ensure public understanding of when and why the clause is triggered. While Armenia's escape clauses are temporary in nature and includes a corrective mechanism in the form of clear requirements of a plan to return to rules within 5 years of invoking the escape clause, the details to be covered in the plan could be clarified and an independent fiscal institution such as the PBO could be mandated with its compliance evaluation (Gotjes, 2022). The examples of Peru and Jamaica present clear and effective escape clauses (**Box 4**).

Box 4. Armenia: Best Practices of Escape Clauses and Correction Mechanisms

Peru

Peru's fiscal rule features a well-defined escape clause with an inbuilt correction mechanism. The escape clause is trigger though a process requiring coordination between the Executive and Legislative branches. It begins with a report from the Ministry of Economy and Finance (MEF) submitted to Congress, justifying the suspension of the fiscal rule. The law stipulates that upon activation the application of the fiscal rules may be suspended for up to three years under two conditions:

When real GDP is declining: The ceiling on the deficit can be raised to 2.5 percent of GDP, accompanied by a minimum annual reduction of 0.5 percent of GDP until the deficit ceiling of 1 percent is restored.

In emergencies declared by Congress: At the request of the Executive, specific ceilings for deficit and expenditure rules must be specified, with the same minimum annual reduction of 0.5 percent of GDP applying.

Jamaica

Jamaica's escape clause is a model of clarity and sound design, aligning with Valencia et al. (2024)'s principles for effective fiscal rule flexibility. It can only be triggered under specific conditions: natural disasters, public health or other emergencies, or a quarterly GDP contraction of at least 2and the projected fiscal impact must exceed 1.5% of GDP.

Activation is through a formal report to Parliament, backed by Ministry of Finance documentation, approval by both houses of Parliament, and independent verification by the constitutionally autonomous auditor general. Legal provisions ensure transparency and public communication. Rated well above the regional average across six clarity dimensions—including trigger specificity, institutional roles, and verification—, the Jamaican escape clause safeguards fiscal credibility while allowing flexibility during major shocks.

Simplifying the Design of Fiscal Rules

21. Armenia's fiscal rules could benefit from simplification. Armenia's fiscal rules could be simplified by consolidating separate rules for current expenditures, current primary expenditures and capital expenditures into an "all inclusive" or a more streamlined expenditure rule. Such a rule could be specified to apply even for safe levels of debt, with more restrictive provisions for higher debt thresholds. These desiderata underscore some tradeoffs involved, in particular, between simplicity and countercyclicality. Costa Rica offers good country practices of simple expenditure rules, where total expenditure cannot grow faster, on average, than revenue. Another example of simple expenditure rule is Peru, where the Responsibility Law caps nominal annual growth of non-financial expenditure at 4% (IMF, 2023b).

Enhancing Transparency and Broadening Coverage

22. Although fiscal transparency has made notable progress in Armenia, communication could be improved. Armenia has sound reporting and transparency practices, but some improvements could make fiscal rules more effective. These include adequately reporting compliance with fiscal rules, mandated by law, in a timely, transparent, independent, and simplified manner; enhancing the standardization and providing concrete revenue mobilization and expenditure rationalization measures in the debt reduction plans that are mandated after the escape clause is triggered; and consolidating all fiscal rules in a single primary legislation instead of multiple laws and decrees. A good example is New Zealand that promotes fiscal transparency through an open budget process that encourages public participation and scrutiny. Its fiscal responsibility act mandates clear long-term fiscal strategies and regular performance reporting, while the treasury ensures credible analyses and projections. By prioritizing public access to financial information, New Zealand fosters trust and accountability in its fiscal management (Căpraru et al., 2024).

23. A broad public sector coverage of fiscal rules will help Armenia further strengthen economic stability and support sustainable fiscal policies. The Armenian authorities could consider expanding the coverage of their fiscal rules beyond the central government to include non-financial SOEs, PPPs and contingent liabilities to avoid separate rules and limits for each. Similarly, the flexibility for discretionary spending by the government and the usage of the reserve fund should also be covered within the fiscal rules and have clearly defined enforceable rules. The authorities are undertaking a comprehensive revision of the 2008 Debt Law to enhance the legal and institutional framework governing debt management. The draft legislation expands the coverage of public debt to include state-owned and municipal entities, but excludes public guarantees. By expanding the legal definition and coverage of public debt and reforms related to restricting PPPs when debt is high (see ¶8) would help address a key limitation of the current fiscal rules, which apply narrowly to central government debt. These are steps in the right direction for expanding the coverage of public debt and fiscal rules. One example of a broader coverage of fiscal rules is Ecuador, where the debt rule limits non-financial public sector debt to 40 percent of GDP, and Article 125 of the Código Orgánico de Planificación y Finanzas Públicas limits decentralized entities' debt to 200 percent and debt service to 25 percent of their annual revenue. Similarly, Panama and Peru limit their non-financial public debt to 40 and 30 percent of GDP respectively.

Strengthening the Oversight and Enforcement of Fiscal Rules

24. Reforms could be envisaged to strengthen enforcement and oversight of fiscal rules in Armenia. An accountability mechanism (e.g., legal requirement to publish the reasons and corrective measures for ex-post breach of the rule) could be introduced for the expenditure rule (e.g., as part of the MTEF or the budget) to strengthen ex-post implementation commitment. Further, IMF TA on fiscal rules recommended putting in place an independent mechanism for ex-ante as well as ex-post scrutiny of fiscal projections and compliance with fiscal rules (IMF, 2019). These roles could be vested in an independent fiscal council created for the purpose of assessing compliance with fiscal rules, or in the Parliamentary Budget Office (PBO) for ex-ante and the Audit Chamber for ex-post evaluation. In Aruba, for example, the Board of Financial Supervision (CAft) oversees compliance with fiscal rules **(IMF, 2025)**. The PBO, while formally independent since 2016, currently lacks the mandate and resources to assess fiscal forecasts or ensure ex ante compliance with fiscal rules. Similarly, the Audit Chamber focuses on ex-post financial audits but is not systematically mandated to review fiscal rule implementation. Empowering and resourcing independent fiscal oversight institutions would help strengthen Armenia from a more procedural framework to one that genuinely constrains fiscal behavior and supports long-term sustainability. Canada, Croatia, Serbia, and Sweden provide examples of good country practices on independent fiscal oversight **(See Box 5)**.

Box 5. Armenia: Canada, Sweden and Aruba's Independent Fiscal Institutions

In response to persistent underestimation of budget deficits and surpluses, Canada enacted its Federal Accountability Act (FAA) in 2006, creating the Parliamentary Budget Office (PBOf) to provide independent fiscal analysis. Operational since 2008, the PBO is mandated to assess national finances and economic trends, with two divisions focused on economic analysis and budget costing.

Initially, the PBO faced political resistance and resource limitations due to its critical reports. Reform proposals called for greater independence, legal transparency, and sufficient funding. These were largely realized through Bill C-44 in 2017, which made the PBO an independent Officer of Parliament. Key reforms included fixed-term appointments with removal only for cause, direct reporting to Parliament, an expanded mandate, and improved access to government data. The PBO was also empowered to cost election platforms during the 120-day pre-election period and required to publicly table reports to both house and senate speakers.

Established in 2007, the Swedish Fiscal Policy Council (FPC) strengthens fiscal governance in order to help prevent crises like those of the 1990s. Composed of six academic economists and two former politicians, the FPC operates as a government agency with a small staff and external consultants. Its broad mandate includes evaluating fiscal policy, economic trends, budget clarity, and forecast quality.

Despite a modest budget, the FPC is respected for its rigorous analysis. Its critiques have occasionally caused friction with the Ministry of Finance, but its independent voice has grown more important, especially following recent fiscal framework reforms. Although it lacks legal authority for ex-ante forecasting or costings, the FPC plays a key role in promoting transparency and accountability—serving as a model for fiscal councils globally.

D. Conclusion

25. Armenia's fiscal framework served the country well, but further improvements could be considered. Such improvement would serve to further improve its efficacy, align it with international best practices, and facilitate the fiscal consolidation envisaged in the 2026-28 MTEF. The following policies would help achieve these objectives:

- ***Improve the countercyclicality features of fiscal rules.*** Upgrading the expenditure rule to incorporate adjustments for past forecast errors and forward-looking elements based on credible estimates of potential output would improve countercyclicality. Redesigning the balanced budget rule to include countercyclical or structural deficit targets would further enhance the framework's responsiveness across economic cycles. Additionally, stricter procedures governing the use of reserve funds and current spending flexibility would help mitigate overspending.

- ***Simplify and strengthen the design of fiscal rules.*** Armenia's fiscal rules are complex, undermining the fiscal framework's transparency and accountability. A simplified set of rules would improve clarity and facilitate monitoring. Further, while some flexibility mechanisms already exist, they are not systematically defined or operationalized. Establishing transparent, well-defined escape clauses that are linked to well-specified economic or emergency conditions would enhance the framework's responsiveness to shocks while preserving fiscal discipline (Lledo et al., 2018).

- ***Improve transparency of fiscal rules.*** Transparency of fiscal rules can strengthen their effectiveness through clearer and legally mandated reporting of compliance with fiscal rules, standardized and detailed debt reduction plans required as part of the escape clause, and consolidation of fiscal rules in a unified primary legislation.

- ***Broaden the coverage of fiscal rules.*** Broadening the operational scope of fiscal rules to include off-budget entities, extra-budgetary funds, and contingent liabilities would improve comprehensiveness and hence coverage of fiscal risks. These enhancements would support Armenia's fiscal consolidation objectives and strengthen the resilience of public finances.

- ***Enhance oversight and enforcement of fiscal rules.*** Weak ex-post enforcement and limited institutional oversight constrain the credibility of Armenia's fiscal rules. Statutory codification of rules and ex-post enforcement mechanisms would strengthen accountability and compliance. Establishing an independent fiscal council or enhancing the mandate of existing oversight bodies such as the PBO and audit chamber could improve transparency, support rule-based fiscal policy, and foster public accountability.

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