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Assessment of tax performance and tax administration in Armenia

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LIST OF ABBREVIATIONS

AMD	Armenian Drams
CIS	Commonwealth of Independent States
FSU	Former Soviet Union
GDP	Gross Domestic Product
GNP	Gross National Product
IMF	International Monetary Fund
RoA	Republic of Armenia
VAT	Value Added Tax
USD	United States' Dollars
OECD	Organization for Economic Cooperation and Development
USAID	United States Agency of International Development

Abstract

This paper has the purpose to look at the dynamic of tax revenues, to describe the present tax situation in Armenia and to underline existing problems, especially in tax administration, that hamper achieving optimal tax performance. The methodology used is secondary data analysis and content analysis. Literature review assesses the importance of tax administration as well as sheds lights on some basic problems of tax administration in developing countries, as well as ways to improve the tax administration.

After comparing measurements of tax performance in Armenia with relevant data from other, formerly centrally-planned countries, it appeared that tax collection rate in Armenia is among the lower. However, it seems that Armenian tax rates in themselves, while not very high, are definitely not low to account for low tax revenues. The limited success in increasing tax revenues mainly reflects weaknesses in tax administration. Problems in tax administration range from such trivial ones as a lack of professionals to major ones such as the large size of the hidden economy, a high level of corruption.

The conclusion is that while tax policy and tax laws create the potential for raising tax revenues, the actual amount of taxes flowing into the government treasury, to a large extent, depends on the efficiency and effectiveness of the revenue administration. Weaknesses in revenue administration lead to inadequate tax collections in Armenia. Finally, recommendations are made on how to improve tax revenue collection in Armenia.

Introduction

"The art of taxation consists of plucking the goose so as to obtain the most feathers with the least hissing."

Jean-Baptiste Colbert

In a market economy taxes play an important role. It can be said that without an efficient tax system an effective market economy is not possible. The effective functioning of the whole economy depends on how correctly the tax system is built. Taxation is a major tool by which governments direct and influence how resources necessary for economic and social objectives are allocated. Taxation also plays the role of one of the most important economic regulators.

Furthermore, the importance of a tax policy is due to the fact that taxes are a major source of governmental funds, and every government must rely on taxes to finance its spending. Therefore, one of the most important objectives of taxation is to generate sufficient revenues.

Meeting this objective has become very important in countries in transition. Many socialist countries have experienced serious budgetary problems. Tax reform was needed to meet the revenue needs of government budgets in the transition period and to achieve macroeconomic stabilization.

Tax administration is a significant option for increasing tax revenues. Changes in tax administration permit more taxes to be collected form existing tax sources, even at unchanged tax rates. The potential for increased revenues from such actions is very large in virtually all countries in transition, although seldom realized.

The tax-GDP ratio is one of the most important indicators of tax policy. The overall tax ratio is in many ways the single most significant indicator of national fiscal development and revenue performance. The ratio of taxes to GDP in Armenia which still remains lower than in other formally planned countries.

Thus, the Armenian government's tax revenues have increased steadily in recent years on the back of robust economic growth that hit a record-high rate of 13.9% in 2003 and remained in double digits in 2004. However, tax revenue makes up less than 16% of the GDP, a very small proportion even by ex-Soviet standards.

While tax policy and tax laws create the potential for raising tax revenues, the actual amount of taxes flowing into the government treasury, to a large extent, depends on the efficiency and effectiveness of the revenue administration. Weaknesses in revenue administration lead to inadequate tax collections.

This paper has the purpose to look at the dynamic of tax revenues, to describe the present tax situation in Armenia and to underline existing problems, especially in tax administration, that hamper achieving optimal tax performance. The following research questions are addressed:

Research Question 1: What is the tax performance in Armenia presently?

Research Question 2: What was the dynamic of tax revenue during the past years?

Research Question 3:What are the reasons for limited success in increasing tax revenues?

In order to answer the research questions I have analyzed existing statistics. To measure tax performance I have chosen the indicator of ratio of tax revenues to GDP.

Methodology

The methodology used in the following master's essay on assessment of tax performance and tax administration in Armenia is secondary data analysis and content analysis.

Literature Review

Why do countries subject themselves to the unpleasant experience of imposing taxes? The answer is that taxation, so far, proved "the only practical means of raising revenue to finance government spending on the goods and services that most of us demand" (Tanzi and Zee 2001, p.1).

There are several canons a good tax system. Taxes need to be fair and non-distorting, they must generate adequate revenues, be simple and at the same time help stabilize the economy and promote economic growth (Alm and Wallace 2004).

According to Bird (2003), designing an appropriate and workable tax system is not an easy task in any country. Getting that reform accepted and then successfully implemented is much more difficult. Managing the whole process of tax reform is also far from simple, because of its inherently political nature. There is no simple, magic answer to the many complexities facing those who undertake this task. Each country and each major reform must take its own particular path.

However, setting up an efficient and fair tax system is challenging especially for developing countries, because they should raise essential revenue without excessive government borrowing. At the same time they should do so without discouraging economic activity and without deviating too much from tax systems in other countries (Tanzi and Zee 2001).

Guy Peters (1991) argues that making tax policy is not just passing laws about taxes. The laws must be put into effect and produce revenue. Therefore, administration and implementation play an important role in the success or failure of tax policy. The work of government in collecting tax revenues is a "costly and time consuming process," however it is essential for effective government (Peters 1991, p.270).

Three basic tasks of tax administration are to identify potential taxpayers, to assess tax on them and to collect the tax. In other words, the “three E’s” of tax administration are to “enumerate, estimate and enforce” (Bird 1992, p.99). All these tasks are especially difficult to accomplish in developing countries. However, tax administration is extremely important especially for developing countries. Richard Bird (1992) states that tax policy not only has an impact on the costs of administration, but also on the organization of the administration. Thus, the level of administrative capacity in the tax administration should be a key factor when designing a tax system.

According to Bird (1992), administrative aspect “should be placed at the center rather than the periphery of tax reform efforts” (p.189). Often, developing countries are so concerned with tax policy that they pay little attention to the aspect of tax administration. In other words, there may be too much preoccupation with “what to do” and little attention to “how to do it” (Bird 1992, p.189). This point has been made clear in Milka Casanegra’s famous statement that "tax administration is tax policy" (Bird 1992, p.189). This means that tax administration involvement in policy making should be guaranteed. Policies that depend for their success on administrative “fine-tuning” are doomed to failure in most developing countries (Bird 1992, p.14). Thus, the most rewarding approach to tax reform is to design a tax system that can be implemented by weak administration. Quoting Bird (1992, p.189), “miracles being always in short supply, any other course of action, is in the end, unlikely to prove successful.”

Surrey (1967) maintains that the administration of tax system generally receives little attention. When searching for additional revenue tax analysts search for additional taxes, for new sources of revenue. However, in many countries the successful administration of tax system would provide government with needed additional revenue. Moreover, multiplication of taxes often results in a weakening of the entire tax structure, thus endangering the entire revenue system. Furthermore, the adoption of new taxes may distort equity of the system, because "the rationale of tax structure is lost in a complex maze of one set of taxes imposed to adjust for defects in another set" (Surrey 1967, p.498). In addition, efforts to change the tax structure may invoke sharp political and social struggles, thus delaying the changes.

Surrey (1967) argues that many countries, dissatisfied with their revenue system, opting for fundamental changes in tax structure are, in fact, "putting the cart before the horse" (p.499). Therefore, it is reasonable to strengthen the tax administration first and only then to face the issue of tax reform.

According to Jit B. S. Gill (2003), there are various reasons why revenue administration reform may be needed in a country. First, while tax policy and tax laws create the potential for raising tax revenues, the actual amount of taxes flowing into the government treasury depends on the efficiency and effectiveness of the revenue administration. Weaknesses in revenue administration lead to inadequate tax collections. Alternative methods of financing the resulting budget deficit through borrowing or monetary expansion would likely cause an unsustainable increase in public debt or inflation, respectively. Second, the quality of revenue administration influences the investment climate and private sector development. Firms are not only concerned about the formal tax system, but also about how the system works. The same is true for multi-national companies that are a major source of foreign direct investment. A revenue administration that is arbitrary or predatory discourages investment. Furthermore, weaknesses in the tax administration put law-abiding firms at a competitive disadvantage, as their competitors in the informal sector are allowed to get away with tax evasion. This reduces incentives for businesses to join the formal private sector. Third, tax and customs administrations are at the top of public-sector organizations with a high incidence of corruption. The cost of this corruption is high, both for the government and taxpayers. The government suffers major revenue leakages, while honest taxpayers suffer as corruption in revenue administration leads to “harassment, inflated assessments, high litigation costs and leniency towards non-compliant competitors” (Gill 2003, p.2). Finally, Gill (2003) maintains that reform of the revenue administration may be needed to enable it to monitor taxable activity and counter tax evasion.

However, creating an efficient tax administration is far from simple, particularly for developing countries for several reasons, according to Vito Tanzi and Howell Zee (2001). First of all, most workers in these countries are working in agriculture or in small, informal enterprises. Thus, they are seldom paid fixed salary and many are paid in cash. That makes the base for an income tax difficult to calculate. As a result, income tax plays a diminished role in raising revenue. Second, developing countries have to deal with a lack of well-educated and well-trained staff, and a lack of systematized computer systems or even efficient telephone and mail services.

Third, because of the informal structure of the economy and because of financial limitations, statistical and tax offices have difficulty in generating reliable statistics. The lack of data prevents policymakers from assessing the potential impact of major changes to the tax system. As a result, marginal changes are often preferred over major structural changes and this perpetuates inefficient tax structures.

Fourth, income tends to be unevenly distributed within developing countries. The economic and political power of rich taxpayers often allows them to prevent fiscal reforms that would increase their tax burdens. This partially explains why many developing countries have not fully exploited personal income and property taxes and why their tax systems rarely achieve satisfactory progressivity.

Finally, in developing countries, tax policy is often “the art of the possible rather than the pursuit of the optimal” (Tanzi and Zee 2001, p. 2). It is therefore not surprising that optimal taxation literature have had relatively little impact on the design of tax systems in these countries.

Common perception is that there is a widespread tax evasion in most developing countries. Studies of tax evasion in developing countries show that often half or more of potential income tax is uncollected. Matters are not much better with respect to most other taxes (Bird 1992). Moreover, the tax structure in those countries is often designed in such a way as to ensure a huge gap between the potential and the actual base system. The result is that in most developing countries there is a great discrepancy between “what the tax system appears to be on the surface and how it actually works in practice” (Bird 1992, p.190).

Tax administration in any country reflects the nature of the country itself. Thus, if the country is “a sea of corruption”, as some countries are, the tax administration will not be “an island of incorruptibles” (Bird 1992, p.191). In some developing countries, the honesty of taxpayers and tax officials is suspect. In such circumstances, the problem of tax administration in many countries is simply ignored, in a hope it will go away on its own. Moreover, some tax reform proposals in developing countries would make tax administration even more difficult.

One of the reasons for the lack of attention to tax administration in developing countries is that it is difficult “to go beyond platitudes on this subject” (Bird 1992, p.193). A more basic reason, as Bird (1992) puts it, “has less to do with platitudes than with attitudes” (p.193). Quoting Witt (1987): “Efficient and inefficient tax systems are not the result of some kind of happy coincidence but of social and political power constellations” (p.140). In other words, if there is little improvement in tax administration in developing countries after thirty years of criticism, the problems are likely to persist for the next thirty years. Thus, good income tax administration requires a favorable political environment. Governments must have the desire and the ability to enforce taxes. No improvement in tax administration can be expected in the absence of political support for the revenue authorities (Bird 1992).

There are various indicators that point to the existence of weaknesses in the tax administration. According to Gill (2003), one of those indicators is total tax revenue ratio to Gross Domestic Product (GDP). Comparing the tax to GDP ratio of countries with similar economic and tax structures gives a sense of the relative effectiveness of the revenue administration. Thus, if the tax revenue growth rate lags behind GDP growth rate, then the government's ability to tax income is inadequate.

Musgrave (1967) asserts that the tax structure must be adjusted so as to increase its revenue response to rising Gross National Product (GNP). It means there should be "increased responsiveness to growth in real output," and therefore "adequate taxation of those sectors of economy which will undergo most rapid growth" (Musgrave 1967, p.50).

According to Gill (2003), three direct inputs determine revenue administration performance. First, the environment in which it operates. Several external actors, forces and circumstances influence the revenue administration. Therefore, in order to understand the reasons for poor performance of the revenue administration, we must first look "outside the box" and analyze the impact of important environmental factors on its performance.

Resources constitute the second main input for the revenue administration. Tangible resources consist of managers and staff; annual budgetary allocations; IT systems; and infrastructure - buildings, vehicles, office equipment, communication systems, weigh-bridges, records storage facilities and so on. Intangible resources include the legal authority granted to the revenue administration for administration of the tax laws; the perception of taxpayers and the public about the fairness, transparency, integrity and enforcement capacity of the revenue administration; and the honesty, morale and commitment of revenue administration employees. Three general issues need to be considered with reference to the resources of the revenue administration. First is the aggregate level of resources. Lack of adequate resources may impose serious constraints on the revenue administration in managing voluntary compliance and countering tax evasion. It may also limit its ability to upgrade its operations to improve performance. Second is the quality of available resources. Skill deficiencies, outdated IT systems or run down infrastructure may be the cause of low performance in many critical areas. Third is the degree of flexibility available to revenue administration management in the use of resources. Inability to change the resource mix in response to emerging priorities and difficulties in re-tooling, retraining and reconfiguring resources may be the source of many chronic deficiencies.

The history of the revenue administration is the third direct input. History has a major impact on current performance. It also often restricts the degrees of freedom available for future action. As such, a good understanding of at least the recent history of the revenue administration is essential (Gill 2003).

In some countries, a first step in the reform of the tax administration was to simplify taxes. More generally, reforms of the tax administration typically include elements such as wider registration of taxpayers, the simplification for procedures of taxing the informal sector, the establishment of large taxpayer-units, and staff trainings and computerization (Abed 1998).

Solutions to the problems of tax administration can be divided into three groups: those that would change the environment, those that would change the administration, and those that would change the law (Bird 1992).

Bird (1992) speaks about modern tax compliance being motivated more by fear being caught and less by civic conscience. However, it is extremely difficult, if not impossible, to administer a tax "if every hand is raised against it" because one cannot arrest the entire population (Bird 1992, p.193).

Surrey (1967) argues that tax administration does not function in vacuum. Effectiveness of tax administration is affected by the attitude of the nation towards the tax system. Voluntary tax compliance differs from country to country and the full understanding of the nature, extent and causes of these differences have not been achieved yet. But while tax administration is affected by national attitudes, it is also true that national attitudes are affected by tax administration. Stable and honest tax administration can increase public respect and voluntary compliance. As long as tax officials are inefficient and corrupt, compliance from the taxpayer cannot be expected (Surrey 1967).

Vito Tanzi (2000) understands a country's tax culture as a certain tax consciousness. He argues that in most transformation economies, taxpayers lack this consciousness because of the long-time prevailing planned economy. Central planners tried to avoid direct taxes and relied on indirect means of taxation, which were not made noticeable to the taxpayers. That, in part, explains why the introduction of direct tax systems was met by hostility. Thus, voluntary tax compliance does not have a long history in many developing countries. Therefore, encouraging it is a major challenge.

According to Gill (2003), various activities can be undertaken to make potential taxpayers aware of the general concept of taxation and why they should pay their taxes. Bird (1992) states that governments wishing to encourage compliance must convince taxpayers that the funds taken from them are put in good use. The perceived fairness of the tax system also is an important factor in shaping attitudes. Furthermore, governments should make compliance easier for taxpayers who want to comply voluntarily. This consists of publishing pamphlets and creating web pages giving out information on tax laws, rules and procedures and changes, organizing seminars and workshops for taxpayers and so on (Gill 2003).

Another approach to improving tax administration is to solve the organizational and procedural problems. Often tax administration in developing countries is characterizes by "poor training, poor salaries and poor equipment" (Bird 1992, p.196). Surrey (1967) maintains that the result of inadequate salaries is incompetent staff, dishonesty, bribery and corruption. High salaries could be justified on the ground that the resulting increase in efficiency will produce increased tax revenue. High salaries will attract qualified and able individuals. Training programs should be conducted to give personnel an understanding of the operation of the system as a whole. In order to address the issue of dishonesty and corruption, an effective system of discipline and investigation is necessary for.

One of the best ways of dealing with administrative problem is to reduce the amount of discretion tax officials have. It is obvious that room for negotiation between official and taxpayer bribery paves the way for bribery. Therefore, the more tax is based on some "measurable, observable and verifiable base" the less scope there is for maneuvers (Bird 1992, p.198).

Finally, Bird (1992) states that legal structure must be modified to match with the administrative realities of developing countries. According to Gill (2003), changes should be directed at removing loopholes in legislation; strengthening taxpayer registration requirements; strengthening enforcement powers of revenue authorities; simplifying legal provisions, and so on.

At the same time it is important to consider the costs to the government of collecting taxes and the costs to taxpayers of paying taxes. In this regard, according to Alm and Wallace (2004), reducing administrative and compliance costs requires doing such things as keeping taxes simple, because complicated taxes require skilled and expensive people to administer; collecting taxes from a few "points", because the more agents from which a tax is collected, the more people must be watched and monitored; levying only a few taxes; exempting low-income households and firms; keeping tax structures in place without frequent change; using presumptive taxes; imposing taxes on a broad base and at a low rate.

Thus, revenue administration reform is a serious undertaking, involving considerable costs and a multi-year year effort. Without support of the top political executive, Parliament, in case legal amendments are needed, and managers and staff success is doubtful. While computerization is necessary to improve efficiency and effectiveness in the revenue administration it is not sufficient. It is necessary to address a broad range of institutional weaknesses in order to achieve lasting performance improvements. Moreover, changes aimed at strengthening the tax administration's enforcement powers, are likely to meet with opposition from vested interests. These should, therefore, be accompanied by proactive efforts to explain their rationale and purpose to taxpayers, representative associations and legislators (Gill 2003).

The Basic Findings

After comparing measurements of tax performance in Armenia with relevant data from other, formerly centrally-planned countries, it appeared that tax collection rate in Armenia is amongst the lower. While the tax-to-GDP ratio improved by 0.1 percentage points in 2004 relative to 2003, tax collection record still remains poor.

As in past years, the Armenian government's tax revenues have increased steadily on the back of robust economic growth that hit a record-high rate of 13.9% in 2003 and remained in double digits in 2004. However, tax revenue makes up less than 16% of the GDP, a very small proportion even by ex-Soviet standards.

The study showed tha low level of taxation is not a cause for insuffiecint tax revenues. Armenian tax rates in themselves, while not very high, are definitely not low. The limited success in increasing tax revenues mainly reflects weaknesses in tax administration. Problems in tax administration range from such trivial ones as a lack of equipment to major ones such as the large size of the hidden economy, a high level of corruption and weak enforcement powers.

Analysis

PART ONE: The Types of Taxes and Structure of Tax Revenues in Armenia

Armenia has been implementing an independent tax policy since 1992, when new principles were set forth. In fact, the whole sphere of taxation was renewed, with new laws pertaining to VAT, revenue tax, and income tax adopted. Currently, Republic of Armenia (RoA) has eight main taxes - value added tax (VAT), profit tax, income tax, property tax, land tax, the so-called simplified tax, presumptive tax and excise. Most taxes are paid exclusively to the federal budget. Local budgets receive revenue only from the tax on property in municipalities and several duties and local payments, in addition to federal budget subsidies. Table 2 illustrates the structure of tax revenues.

Table 1: Armenia: Structure of General Government Tax Revenues (Percent of total tax revenues)

	1997	2000	2003	2004
Tax revenue	100.0	100.0	100.0	100.0
Value-added tax	29.2	35.0	38.6	37.0
Excises	13.9	13.7	14.0	12.6
Enterprise profits tax	11.9	10.7	6.3	8.2
Personal income tax	10.9	7.8	6.0	6.5
Land tax	2.0	0.8	0.7	0.9
Customs duties	7.9	4.6	3.8	3.7
Payroll taxes	19.3	16.5	16.0	17.0
Other taxes	3.7	7.4	8.4	7.2
Presumptive income tax	0.5	2.1	2.9	3.8
Simplified Tax	0.0	0.1	1.8	2.3
Property tax	0.8	1.4	1.4	1.5
Memorandum Items				
Direct taxes	22.8	18.4	12.3	14.6
Indirect taxes	77.2	81.6	87.7	85.4

Source: Ministry of Finance and Economy

- *Personal Income Tax*

One of the main concerns of taxation is to distribute the tax burden as fairly as possible among population. The essential role of personal income tax is that it treats people equitably, in accordance with their ability to pay. Thus, the personal income tax is the only significant component of the tax system "which has at least the potential of being completely fair" (Bird 1992, p.85). Therefore, the personal income tax is widely used in most all countries around the world, and is often a major source of revenues for the government.

At the same time, there are strong arguments against the income tax, according to Alm and Wallace (2004). Thus, because it is income elastic, revenues may decline during economic downturns. Moreover, the tax is often used to give special preferences to certain groups, thus disrupting the equity and efficiency advantages of the tax. Furthermore, the tax requires a high level of administration, which imposes costs on the tax agency. Quoting Bird (1992, p.88), "the key to a good income tax is a good income tax administration."

Richard Goode (1967) maintains that in order for the personal income tax to be successfully implemented in a developing country, six conditions must be met. First of all, there must be a predominantly monetary economy. Second requirement is a high standard of literacy among taxpayers. Third, accounting records must be honestly and reliably maintained. Fourth condition is a large degree of voluntary compliance in the long run. The absence of wealthy groups with political power is another important condition for satisfactory income taxation. Finally, honest and efficient administration is required. In other words, in order for the income tax to be successfully implemented in any developing country, the government must have the ability and the desire to enforce it.

The personal income tax is of more importance in tax revenues in developed than in developing countries. More generally, taxes on consumption (e.g., value added taxes and excise taxes) are of more importance in developing than in developed countries, while taxes on income (Alm and Wallace 2004). Thus, the personal income tax has yielded relatively little revenue in most of developing countries. Moreover, in developing countries the number of individuals subject to this tax, especially at the highest marginal rate, is small. Furthermore, income tax progressivity is severely weakened by exemptions and deductions that benefit those with high incomes (Tanzi and Zee 2001).

Income tax provides a smaller portion of tax revenue in Armenia than in many other CIS countries. This is largely because the system for collecting taxes from individuals is not as efficient as it should be and due to a number of national characteristics (Interfax 2005).

Analysts said that Armenia has the highest relative level of cash transfers in individual incomes. ArmenPress reports that in 2003, the amount of cash sent home by Armenians working abroad reached 544 million USD, as much as Armenia's budget was. This money essentially bypasses the tax authorities. Moreover, according to the majority of experts, Armenia unfortunately remains a country with the high level of corruption and "shadow" economy. As much as 40 percent of overall economic activity, and in some areas, such as retail, as high as 80 percent, took place without being recorded or taxed by local authorities (Bureau of Democracy, Human Rights, and Labor 2005).

The Armenian income tax system appears to use the comprehensive income tax base upon which to apply taxes. The tax base of the income tax is gross income. The gross income is the total of all the income, irrespective of the source, received by a taxpayer in the course of a tax year. Gross income includes: salaries and wages, interest, dividends, winnings prizes, donations, inheritance, insurance compensation and income from business activity, etc.

Residents are liable for income tax on their worldwide income. Non-residents re taxable on the income derived of Armenian sources. Income tax is assessed at the following rates: 10% on monthly taxable income up to 80,000 AMD; 8,000 AMD plus 20% of the amount exceeding 80,000 AMD for incomes above 80,000 AMD a month. On interest from deposits and lease of property a 10 percent final withholding tax is applied.Tax on Armenian-source income is normally withheld at the source. Income from an overseas source is assessed on an annual basis.

Table 2: Armenia: Tax revenue performance, 1997–2004
(million drams)

	1997	1998	1999	2000	2001	2002	2003	2004
Total taxes	108.7	136.6	165.4	159.1	168.5	198.6	227.4	266.7
VAT	39.3	59.8	68.3	66.6	78.3	95.0	107.8	117.9
Profit tax	16.1	12.3	21.5	20.3	15.7	17.4	17.6	32.0
Income tax	14.7	15.2	18.8	14.8	11.0	12.5	16.8	20.4
Other taxes	38.6	49.3	56.8	57.4	63.5	73.7	85.3	96.4
Data for figure -- nominal tax performance								
Total taxes	68	86	104	100	106	125	143	168
VAT	59	90	102	100	118	143	162	177
Profit tax	79	60	106	100	77	86	87	158
Income tax	100	103	127	100	75	84	114	138
Other taxes	67	86	99	100	111	128	149	168
Total taxes	75	85	102	100	102	117	128	142
VAT	64	89	101	100	113	134	145	150
Profit tax	86	60	104	100	74	81	78	133
Income tax	109	102	126	100	72	79	102	117
Other taxes	73	85	98	100	106	121	133	142
Memorandum Items								
GDP deflator	92	101	101	100	104	106	111	118

In 2004, income tax was 20,4 million drams, which made 6,5 percent of the total tax revenues. Compared with 2000, the nominal income tax increased by 38 percent. However, the real income tax growth from 2000 to 2004 was only 17 percent (Table 2).

- *Value-Added Tax*

The rapid rise of the value-added tax (VAT) was the most important development in taxation in the twentieth century, and it still continues. Forty five years ago, the tax was barely known outside theoretical discussions. Today, it is a key component of the tax system in over 120 countries, raising about one-fourth of the world's tax revenue (Ebrill et al. 2001).

The popularity VAT is due to its well-known characteristic that, in its ideal form, it is the least distorting type of broad-based consumption tax. At the same time, has a built-in self-enforcing mechanism (Tait 1995). Furthermore, its record of generating large amounts of revenues quickly, and in comparatively painless fashion, has given it a reputation of a money machine.

While VAT has been adopted in most developing countries, it is often incomplete in one aspect or another. For example, many important sectors, such as services and the wholesale and retail sector frequently are left out of the VAT net. These kinds of limitations reduce the benefits from introducing the VAT in the first place. Many developing countries have adopted two or more VAT rates. Multiple rates are politically attractive; however the cost of a multiple-rate system should be carefully studied (Tanzi and Zee 2001).

A survey of the IMF advice with VAT policy and administration in 37 countries showed that many issues in the design of the tax are not disputable. Moreover, there were several areas in which IMF advice was consistent across countries, but was not always put into practice. Thus, zero rating which is recommended only for exports, in practice, is used more widely. Furthermore, exemptions are more common than advised. Finally, some countries use multiple tax rates rather than the single rate that the IMF generally prefers.

The VAT is often thought to be an intrinsically complicated tax and thus ill suited to developing countries. However, what is more important is that in many developing countries, a simple VAT is clearly much simpler to administer than the taxes that such a VAT replaces (Ebrill et al. 2001).

VAT is the biggest revenue item, contributing more than a third of budget revenue. VAT accounted for 37% of tax revenue in 2004 (Table 2). Value added tax (VAT) is an indirect tax, which shall be paid to the state budget for imported goods, at all stages of their production and turnover, as well as provision of services on the territory of the Republic of Armenia. VAT is paid quarterly except when taxpayers declare monthly payments. VAT is paid to the state budget by the 20th of the month following the tax period.

The tax base of VAT is the total revenue of all transactions for all goods and services (including imports but excluding exports). The rate of VAT is 20 per cent of taxable turnover of goods and services. A rate of zero is applied to certain goods and services and certain goods and services are exempt from VAT. VAT may be replaced by fixed payments (presumptive tax/simplified tax) under certain circumstances.

- *Excise Tax*

According to Tanzi and Zee (2001) the most important shortcoming of the excise systems found in many developing countries is their broad coverage of products. It is done often for revenue reasons. However, the economic rationale for imposing excises is very different from that for imposing a general consumption tax. While the latter is imposed for maximizing revenue with minimum distortion, the former should narrowly target a few goods, consumption of which causes negative externalities. Generally, the goods deemed to be excisable (tobacco, alcohol, petroleum products, and motor vehicles, for example) are few and usually inelastic in demand. A good excise system is one that generates revenue from a narrow base and with relatively low administrative costs.

The share of excise in total tax collection increased the most in 1996 when political stabilization fuelled a sharp increase in the trade of tobacco, alcohol products, rugs, and jewelry. The share of excise in tax revenue increased from 4.3% to 15.1% that year. Excise in Armenia provides 10-15% of state budget revenue (Table 1). Table 3 illlustartes the excise tax collected during the last five years. Excise is charged on: beer, wine, wine materials, alcohol and alcoholic beverages, tobacco substitutes, tobacco products, gasoline, crude oil and petroleum products, diesel fuel, petroleum gases and other gaseous hydrocarbons, with the exception of natural gas. In addition to these rates, excise on some goods is set under special legislation depending on current market trends. This applies to products such as gasoline and tobacco products.

Table 3: Armenia: Excise tax, 1999–2004
(million drams)

1999	2000	2001	2002	2003	2004
21,677	25,403	31,015	35,333	39,104	40,656

The rates vary depending on the good in question. Taxes are applied to the quantity of the goods subject to the excise tax. For example, a tax of 70 drams is applied to one litre of beer, 1,500 drams is applied to one kilogram of tobacco substitutes, 11,500 to one ton of diesel fuel. These amounts are indexed to the rate of growth of consumption prices. Excise on goods imported to Armenia must be paid within 10 days of import. Taxpayers in this case do not present tax authorities calculations on the taxes.

- *Profit Tax*

The profit tax is a direct tax to be paid by tax payers into the state budget in the amount and according to the procedure established by the law of Law of the Republic of Armenia on Profit. Taxable profit is the positive difference between the gross income and deductions. The tax period is the calendar year. The tax base is gross income, which is the total amount of income received by the tax payer in the reporting year, including revenue from the sales of goods, services, assets, interest, dividends, capital gains and patents.

The profit tax is 20% but fixed payments can be set for some taxpayers that replace this tax. Taxpayers calculate the profit tax at the end of each year and submit balance sheets to the tax inspectorate by April 15th. The tax must be paid by April 25 (inclusive). Taxpayers in Armenia are required to pay estimated profit tax during the year based on 1/16th the actual tax for the previous year and payment must be made by the 25th of the month. New companies are not required to make the advance payments until April 25th of the following year but must notify the tax inspectorate in advance.

In the early 1990s profit tax was essentially the main source of tax revenue, but starting in 1998 its share declined significantly. Problems in economic development are affecting profit tax collection.

Table 4: Armenia: Profit Tax, 1999–2004
(million drams)

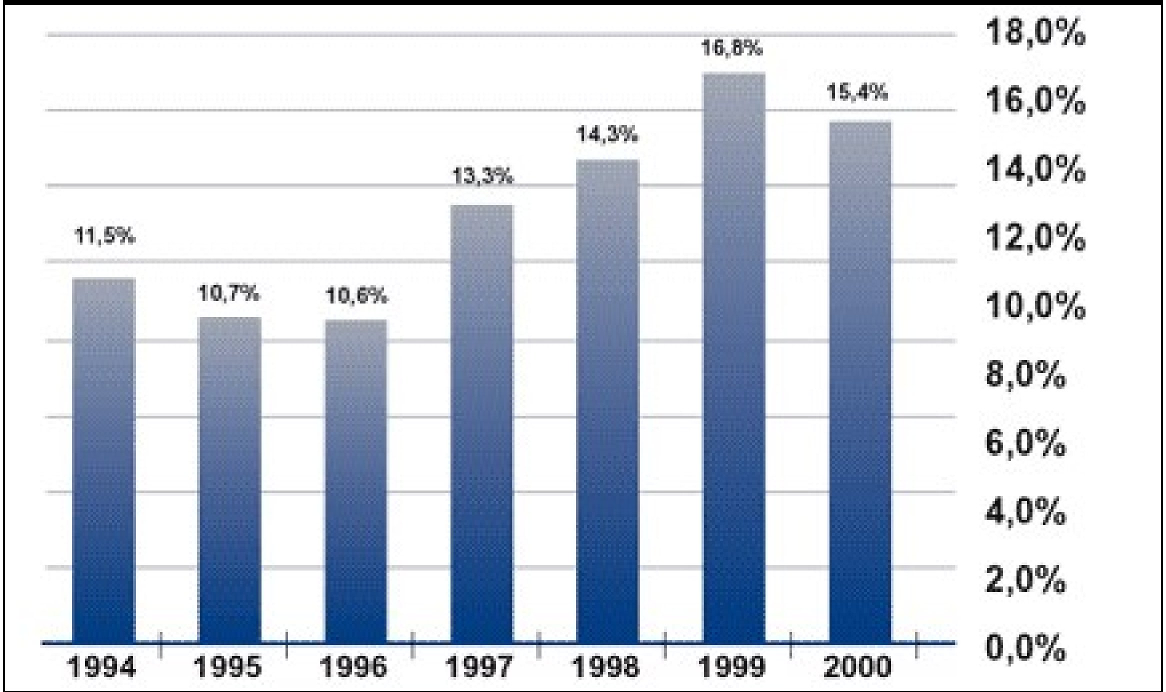
1999	2000	2001	2002	2003	2004
21,499	20,379	16,317	17,429	17,627	32,010

Profit tax in 2004 accounted for less than 8,2 % of tax revenue, which is even less than excise (Table 1). Table 4 illustrates the change in collection of profit tax during the last five years.

PART TWO: Dynamic of Tax Revenue Performance during the Past Years in Armenia

The optimal tax policy is the one that maximizes economic growth and minimizes tax evasion. Therefore, the ability of the system to produce large amounts of revenue is essential. Since no ideal or optimal level of taxation can be calculated, statistically based approach to assessing whether the overall tax level in a developing country is appropriate consists of comparing the tax level in a specific country to the average tax burden of a representative group of both developing and industrial countries, taking into account some of these countries' similarities and dissimilarities. This comparison indicates only whether the country's tax level, relative to other countries and taking into account various characteristics, is above or below the average. This statistical approach has no theoretical basis and does not indicate the "optimal" tax level for any country.

Figure 1: Dynamics of Tax Revenues and Nominal GDP Ratio from 1994-2000 in Armenia



According to Tanzi and Zee (2000), data show that the tax level in major industrialized countries (members of the Organization for Economic Cooperation and Development or OECD) is about double the tax level in a representative sample of developing countries (38 percent of GDP compared with 18 percent).

Figure 1 illustrates dynamics of tax revenues and nominal GDP ratio from 1994-2000 in Armenia. As it can be observed from the figure, there was the relative reduction of tax revenues, which reached its lowest point in 1996. Since 1997 due to tough tax administration, the tax collection process for the state budget revenues started to improve. It may be useful to compare measurements of tax performance in Armenia with relevant data from other, formerly centrally-planned countries. Table 6 illustrates tax revenues for former Soviet Union (FSU) countries in percent of GDP for years 2000-2003. Although the tax regime in Armenia is one of the most favorable for business amongst transition economies, the collection rate is amongst the lower. In 2002 the Armenian State’s annual revenues from taxes totaled USD 345 million or 14.6 % of GDP. According to IMF, in comparison to the other countries of the former Soviet Union, Armenia’s proportion of tax revenues to GDP was the second lowest after Georgia (14.5%), and was significantly below the average across the CIS (24.8%).

Table 5: FSU Countries: General Government Tax Revenue, 2000-2003 (In percent of GDP)

	2000	2001	2002	2003
Armenia *(social security included)*	18.5	17.7	17.9	17.2
Azerbaijan	14.5	14.6	15.1	15.7
Belarus	37.7	37.1	35.4	36.9
Georgia	14.2	14.3	14.4	14.1
Kazakhstan	20.0	22.3	21.0	24.1
Kyrgyz Republic	15.1	15.8	17.6	17.8
Moldova	25.0	24.4	25.8	26.6
Russia	35.3	35.3	35.1	34.5
Tajikistan	12.9	14.1	15.0	14.9
Turkmenistan	23.0	22.2	17.7	18.7
Ukraine	28.0	27.9	30.4	30.8
Uzbekistan	26.2	23.4	22.9	23.1

The International Monetary Fund (IMF) subsequently assessed that the level of tax revenues in Armenia was too low, and has set higher collection targets for the Government for 2003. However, central government's tax revenues have declined from 14.6 % of GDP in 2002 to 14% of GDP in 2003 (Table 6). If social security payments are included, the revenues have declined from 19.9% of GDP to 17.2% of GDP during the same period (Table 5).

Table 6: Armenia: Total revenue in percent of GDP, 2002–2005

	2002	2003	2004	2005 Est.
Total revenue and grants	18.8	17.8	15.6	15.8
Of which: tax revenue	14.6	14.0	14.1	14.7
grants	3.5	3.2	0.6	0.6

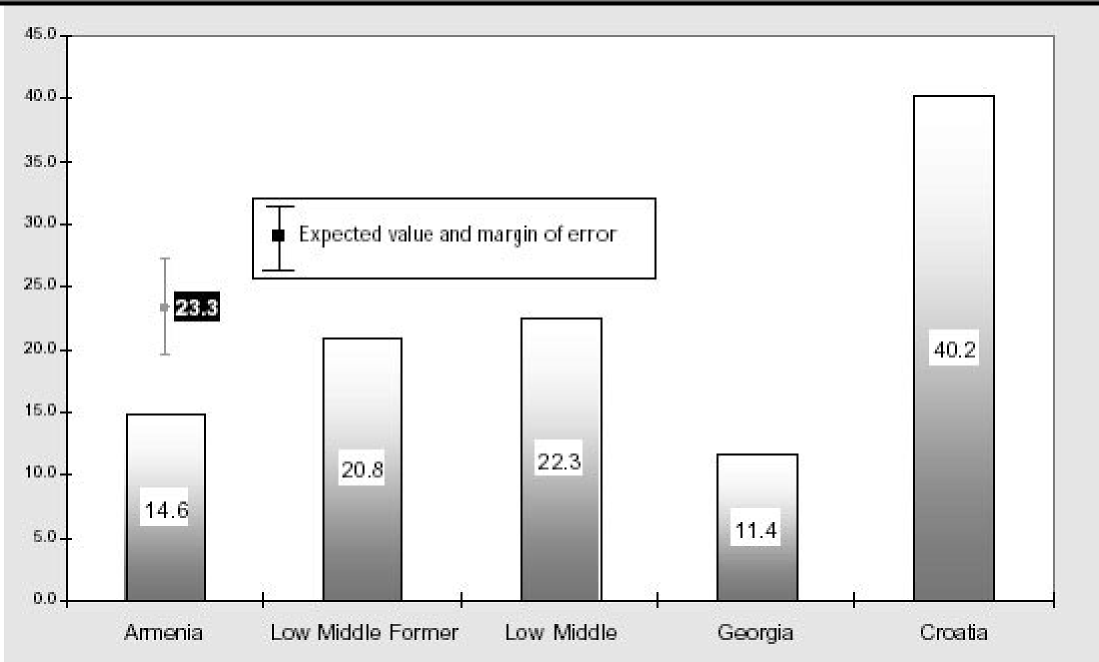
Sources: Ministry of Finance; and Fund staff estimates.

Not counting grants, revenues stood at 14.6% of GDP in 2003 compared with 22% of GDP for lower middle -income countries in general and 21% of GDP for lower middle - income former Soviet economies (Figure 2).

According to IMF Country Report No. 05/178, while the tax-to-GDP ratio improved by 0.1 percentage points in 2004 relative to 2003, tax collection record still remains poor. As in past years, the revenue target was met in nominal terms, but lagged in percent of GDP terms, suggesting low tax buoyancy (IMF 2004).

According to USAID economic performance assessment report (2005), government revenues are too low in Armenia so that the level of the government's financial involvement in the economy appears insufficient in terms of providing needed investment in infrastructure and the health and quality of the labor force. Low revenues limit the ability of the government to invest in key areas, such as health, education, and infrastructure if the budget deficit is to remain prudent. Armenia cannot expect to be able to rely on donor funding forever, and without an adequate domestic revenues base, the budget deficit may be vulnerable to a slowing of Armenia's high growth rates.

Figure 2: Government Revenue, % GDP (Comparisons to other countries, 2003)



The average value of the five countries with the highest government revenue relative to GDP is 38.3. The average value of the five countries with the lowest government revenue relative to GDP is 6.9.

At his keynote address, at the Third International Conference of Armenian International Policy Research Group at Washington D.C. on January 15, 2005, Vahram Nersissiantz, Chief Economic Advisor to the President of Armenia stated that tax revenues should be at least around 20% of GDP and that Armenia should aim to reach this level by 2007. Quoting Mr. Nersissiantz, "a strong and reliable revenue system, should be realized through sweeping reforms in tax and customs administration so as to achieve a fair and objective collection system." Vahram Nersissiantz also stated that several technical reports for that purpose have been prepared recently on the basis of the international experience, which must be carefully reviewed and integrated into a coordinated administrative reform program. The purpose is neither to raise tax rates, nor to introduce new additional taxes; it is rather to substantially improve compliance with the existing tax measures.

PART THREE: Causes for Insufficient Tax Collection

- *Level of Taxation*

More than forty years ago a well-known English economist Nicholas Kaldor wrote an article provocatively entitled "Will the Underdeveloped Countries Learn to Tax?" In his article Kaldor was arguing that the level of taxation in most developing countries was too low. Increased taxation was needed to yield savings needed to finance the investment. Therefore, developing countries need to tax more. Most who have studied this question, assumed, that "tax increase is just what the doctor ordered" (Bird et al. 2004, p.3). However, this argument has been questioned by Stanley Please, who stated that increases in tax revenues have been matched by increases in expenditures. As a result, there is no corresponding increase in public-sector saving. Moreover, there is a "supply side" concern of disincentive effect of taxes on private savings, dating back to Peter Bauer. A contemporary of Kaldor, Bauer is considered a modern father of supply-side taxation in developing countries. Bauer was arguing that in order to encourage development governments need to tax less. According to Bird (1992), it is the "voice of Bauer, not that of Kaldor" that echoes in developing countries today, and were Kaldor to write his article now, it would need another title, since the underdeveloped countries "learned to tax with vengeance" (p. 203).

The question however is could the low level of taxation be a cause for insufficient tax revenue in Armenia. Tables 7 and 8 illustrate VAT rates for CIS countries, including Armenia and VAT Rates applied in the member states of the European Community. Thus, average VAT rate for CIS countries is 18.5 %, average VAT rate for the member states of the

European Community is 19.6%, compared to Armenia's 20%. Table 9 illustrates the income tax rates, both individual and corporate, of some of the former socialist countries. It seems that Armenian tax rates in themselves, while not very high, are definitely not low enough to give a powerful incentive for encouraging investment.

Table 7: VAT rates for CIS countries, %, 2005

Situation at 1st July 2005

Armenia	20
Azerbaijan	18
Belarus	18
Georgia	18
Kazakhstan	15
Kyrgyz Republic	20
Moldova	20
Russia	18(10)
Tajikistan	20
Turkmenistan	15
Ukraine	20
Uzbekistan	20(10)

Moreover, decreasing tax rates may actually result in decrease of shadow economy, because businesses will be more motivated to move from informal sector of economy to formal. Decrease of shadow economy, in its turn, will result in the rise of budget revenues. Thus, for example, Russian government intends to cut VAT from 18% to 13% by 2007 to accelerate economic growth. According to RIA-Novosti, Prime Minister Mikhail Fradkov, who supports the idea of reducing the VAT rate, said, "...half of the revenues that would be lost as a result of VAT cuts could be refunded through more rigorous [tax] collection" and the other half could be compensated for by taking advantage of the positive investment climate that the proposed measure is expected to achieve (RIA-Novosti 2005).

Table 8: VAT Rates Applied in the Member States of the European Community, %, 2005 *Situation at 1st July 2005*	
Belgium	21
Czech Republic	19
Denmark	25
Germany	16
Estonia	18
Greece	19
Spain	16
France	19.6
Ireland	21
Italy	20
Cyprus	18
Latvia	15
Lithuania	15
Luxembourg	18
Hungary	25
Malta	18
Netherlands	19
Austria	20
Poland	22
Portugal	21
Slovenia	20
Slovakia	19
Finland	22
Sweden	25
United Kingdom	17.5

Table 9: Income tax rates of former socialist countries (2005)

Country	**Income Tax**	
	Corporate	**Individual**
Bulgaria	15%	10%-24%
Czech Republic	26%	15%-32%
Estonia	24%	24%
Latvia	15%	25%
Lithuania	15%	10%-35%
Poland	19%	19%-40%
Russia	24%	13%
Slovakia	19%	19%
Armenia	15%	15%-20%

In 1994, Estonia became the first country in Europe to introduce a so-called "flat tax", replacing three tax rates on personal income, and another on corporate profits, with one uniform rate of 26%. Latvia and Lithuania followed its example (The Economist 2005). In 2001, Russia too moved to a flat tax on personal income.

Table 10: Flat tax rates on personal income

How simple can it be?
Flat tax rates on personal income, %

Country	Rate	Year introduced
Estonia	26	1994
Lithuania	33	1994
Latvia	25	1995
Russia	13	2001
Serbia	14	2003
Ukraine	13	2004
Slovakia	19	2004
Georgia	12	2005
Romania	16	2005

In all, eight countries have now followed Estonia (see Table 10). On January 1, 2001, a 13 percent flat tax on personal income took effect in Russia. It replaced a three-tiered system with a 30 % top rate. The old system was complicated, and because of the high rates evasion was widespread. It also produced little revenue. The new flat tax has achieved greater compliance due to its simplicity and low rate. Russia's 13 percent flat tax exceeded all expectations and it is producing far more revenue than the former system.

- *Tax System*

In 2003 the American and European Union Chambers of Commerce in Armenia conducted a study based on a survey of 34 members concerning the Armenian Tax System. The study aimed to be an accurate representation of the views expressed by the foreign investors who took part in the survey. The general conclusion was that while Armenia's rates are higher than in Russia and many other countries, the problem with the Armenian tax system was unpredictability and difficulty of compliance. Moreover, while the Armenian tax laws are on a par with most of those of the CIS, they lack precision and consistency when compared with advanced legal systems and less practical than the tax laws in the Baltic States, Russia or in

Eastern European countries. Furthermore, in the view of respondents, the tax administration and the implementation of the tax system in Armenia is inefficient, inequitable and unprofessional, with widespread corruption.

Thus, the study showed that the respondents were mainly dissatisfied with the following aspects of the Armenian tax system. First of all, there are frequent changes in laws that create confusion since companies are generally unprepared for them. Moreover, there is no process in place for updating old laws following the adoption of new ones. Second, Armenian laws are copied from foreign legal systems (France, United Kingdom, Russia) and are adopted without being adjusted to take into account Armenian realities. Finally, there was dissatisfaction with corrupt activities of the tax authorities which result in laws not being applied in practice (American and European Union Chambers of Commerce in Armenia 2003).

In comparing Armenia's tax system to those of other transition economies, in particular CIS countries respondents stated that tax administration and procedures in Armenia were more cumbersome and difficult to comply with than in most other jurisdictions for the following reasons. First of all, Armenian tax authorities are "excessively draconian and intrusive in their practices, unwilling to accept the work of independent auditors, and are insistent upon personal inspection of companies' accounts" (American and European Union Chambers of Commerce in Armenia 2003, p. 5). Second, corrupt activities of the tax authorities are aimed at making it as difficult as possible for companies to comply with the tax rules, rather than to assist and encourage them to follow the laws and pay reasonable tax. Furthermore, preparing the required income and expenses documentation was considered much more difficult in Armenia than elsewhere. Thus, in other transition economies such as Kazakhstan, the refunding of VAT was simple and quick, whereas in Armenia the procedural difficulties in obtaining refunds were not worth the effort for many companies.

A particularly negative aspect of the Armenian tax system in comparison to other transition economies is the frequent change in laws. Moreover, old laws are not always amended to harmonize with new legislation following such changes, which results in conflicts between laws and legal uncertainty that increases companies' compliance issues.

Table 11: Armenia: Dissatisfaction with Tax Administration (percentage of firms reporting major or moderate obstacles)

	2002	2003	2004
Extra-legal requirements for advance payments of taxes	66.8	57.7	58.6
Frequency of changes in rules and rates	57.2	51.7	53.7
Availability of information, updates on tax requirements	37.6	44.4	42.3
Inspections, audits	31.2	37.0	37.3
Frequency of payments	27.6	26.4	30.3
Frequency of reporting	29.2	30.4	30.0
Tax accounting	20.4	27.7	26.0
Tax forms / filing	18.4	30.3	25.3
Payment methods	19.2	20.7	23.0

Source: World Bank, Annual Regulatory and Administrative Cost Surveys, 2004, 2003

Table 11 illustrates the results of World Bank, Annual Regulatory and Administrative Cost Surveys, in 2002, 2003 and 2004 in Armenia. Thus although, dissatisfaction with two indicators - extra-legal requirements for advance payments of taxes and frequency of changes in rules and rates, declined in 2004 compared with 2002, dissatisfaction for the remaining seven indicators grew in 2004 compared with 2002.

- *Weak Tax Administration*

According to the recent Article IV Review by the IMF, Armenia's comparatively low tax to GDP ratio has been the result growth in tax-exempt sectors such as grant-financed construction, re-export of processed diamonds, and agriculture. However, a major cause for insufficient tax collection is weak tax administration. Improved tax collection would allow the government to increase necessary spending without running large budget deficits.

Weak tax administration is one of the biggest problems in Armenia, and it has drawn frequent comments from the International Monetary Fund. Problems in tax administration range from such trivial ones as a lack of equipment to major ones such as the large size of the hidden economy, a high level of corruption and weak enforcement powers. There is also a lack of professionals, as well as a lack of systematized computer systems. These problems, together with weak enforcement and low wages for the tax inspectors create an environment conducive to corruption, which leads to a decrease in the overall efficiency of the tax administration. According to the majority of experts, Armenia unfortunately remains a country with the high level of corruption and "shadow" economy. At present Armenia is experiencing significant shortfalls in direct tax revenues due to non-compliance. Clearly, a low level of tax to GDP ratio suggests that some parts of the economic activities that are recorded in the official GDP are not taxed at least fully, which results in the tax revenue to GDP ratio being at this low level compared to other transition countries.

The Armenian government's tax revenues have increased steadily in recent years on the back of robust economic growth that hit a record-high rate of 13.9% in 2003 and remained in double digits in 2004. Many of the big businesses are owned by government-connected individuals and are believed to be highly lucrative. Economists regard them as the prime beneficiaries of Armenia's economic growth. However they are described as the largest tax evaders. According to IMF (2004) government-connected businessmen and oligarchs avoid paying their taxes. Thus, in 2004 IMF suggested that profit taxes paid by large companies could easily be tripled. The most serious form of tax fraud is the underreporting of corporate revenues. Many large and lucrative businesses falsely claim to operate at a loss to avoid paying taxes on profits.

According to Eurasia Daily Monitor (2005), employers also evade taxes by underreporting the salaries and number of their employees. The Armenian Ministry of Labor estimates that more than 400,000 workers are affected by the practice. Therefore, the tax authorities launched large-scale business inspections in early January to uncover hidden employment. The head of the Taxation Service, Felix Tsolakian, said in a newspaper interview published on January 20, 2005 that his agency has already identified 10,000 hidden jobs. Tax evasion is likely to remain a serious problem for Armenia as long as there is no solution to its genesis: corruption.

Bagrat Tunyan (2005) maintains that although the international experience suggests that the main reason for the existence of the shadow economy are high rates of taxes imposed by the government, however, in Armenia these have not been the only major factor contributing to the existence of shadow economy. Thus, he argues that widespread corruption and ineffective systems of accountability in the public sector have had largely contributed to the expansion of hidden economic activities in Armenia during the past decade. Corruption in the public sector has been one of the major factors that contributed to the growth of the shadow sector of the economy in Armenia. More corruption provides both incentives for the businesses to go underground. By paying the tax inspectors or other government agencies the regular “tax-bribes” the businesses consider themselves protected for the coming periods and get incentives to hide even more in order to justify the payments made. One of the few studies on shadow sector of the transition economies also suggests that one of the main reasons for the companies to go underground is to avoid the burden of administrative regulations and taxation

For economic entities the bribes paid to the tax officials have been preferable to the real taxes because of several reasons. First, the bribe paid to the tax officials are usually lower that the real tax amounts that should be paid to the tax authorities. Second, non-payment of taxes saves some time for the businesses, because it limits the required paperwork and visits to various state agencies. The tax regulations and bureaucracy in the Armenian state apparatus are so much complicated that some economic agents prefer going underground not only for evading taxes, but mostly for avoiding to enter the official state registry so that to save their time and energy.

Unfair and unequal tax administration is another major reason for the existence of shadow economy. Many business entities are hiding their activities in order of being able to compete with those who enjoy the protection of various tax and state officials. The unfair tax administration, unequal treatment and discretionary use of tax code are also main problems for the investors.

Forth, usually regular payments of bribes to tax inspectors establishes special personal relationships between them, and over some period of time and with the expansion of a particular business the underreported amount increases even more.

The major reason for existence of the shadow sector in the economy in Armenia is the relatively easy and not risky possibility of tax avoidance. Today it is too easy to hide and too easy to avoid any punishment, and many economic entities prefer to get as much benefit from working underground, as possible, since they know that if caught there are easy and quick ways of solving their problems.

The other major factor that has contributed to the existence of the shadow sector in Armenia is the widespread politicization of many businesses. Today, many public officials have stakes in or effectively own various businesses, and by using their role and position in the public sector they create favorable conditions for those economic entities (Tunyan 2005).

Conclusion and Recommendations

Tax administration in Armenia still suffers from severe deficiencies. The operations of the large taxpayers unit need to be revamped to improve collection from all large taxpayers and prevent discretionary treatment of taxpayers. A major change in direction is required to improve efficiency and transparency in these agencies. Improved tax collection would allow the Armenian government to increase necessary spending without running large budget deficits. The following recommendations are made on how to improve tax revenue collection in Armenia:

To make the existing taxes more transparent and stable: The tax system should facilitate compliance and tax administration. This is best supported by adopting relatively simple taxes, with low rates, broad bases and few exemptions. Therefore, there is a need to simplify the tax system and to eliminate a number of taxes with small yields.

To enforce the rule of law: The climate characterized by the absence of legality and due acceptance of and respect for the law has introduced considerable uncertainty in investment climate, thus discouraging investment that is essential for the Armenian economy. Not only must the tax system be transparent and free from ad hoc decisions, but it must also remain stable for the foreseeable future. This will simplify and improve tax compliance and tax administration, and will also facilitate investment.

To create, cultivate, monitor and enforce tax compliance: Tax compliance depends upon the perceived ability of the tax administration to detect and penalize tax violators. Thus, it is necessary to complement a credible system of penalties that are both severe enough and credible enough to discourage non-compliance. Taxpayers must believe that if they fail to comply with tax regulations, there is a high risk that they will be caught and interest charges and penalties will more than offset any potential benefit of evasion.

But it is also important to facilitate voluntary compliance. Here people's perception about the fairness of the system is very important. Studies have found that there is a relatively close association between the sense that taxes are fairly imposed, the sense of the legitimacy of the government and the extent of tax evasion. How people feel about taxes reflects how they feel about expenditure. When people feel that government is wasting their money and not acting in their best interest taxes are likely to be even more unpopular than usual.

For these reasons the tax authorities need to strengthen enforcement efforts, applying sanctions fairly and with sufficient publicity. But voluntary compliance cannot succeed where taxpayers find it hard to calculate their obligations correctly, as is the case when laws change frequently, are not clearly explained and, in all too many cases, are not administered properly.

Finally, a change in the philosophy of the entire system itself is required, with corrupt activities being punished and inspectors undertaking tax collection in a professional manner. One of the main directions for the government's fight against shadow economy should be the anti-corruption activities. The shadow economy and anticorruption are interrelated; on one hand the existence of the shadow economy promotes the corruption in tax authorities, on the other hand because of corruption, there is an increase in shadow activities. So, the government and the society should combine their efforts in carrying out effective anti-corruption program that would also result in the decrease of the size of the shadow economy. Further modernization of tax and customs administrations, by strengthening and improving the professional tax and customs services and developing ethical standards of tax and customs officers with some strict mechanisms of control, can have significant impact on the size of the shadow economy.

To scale down the paperwork: The tax administration could be easily and significantly improved if the paperwork/bureaucracy were scaled down to require simple reporting of business information relevant to taxation only. For example, invoices could be made more user-friendly so that the stamp of the purchaser is not required, and receipts could be substituted for invoices.

To put emphasis on forcing the country's wealthiest businessmen to pay up rather than focusing on compliance checking. In other words, in order to achieve a sizable increase in the state revenues tax service should be willing and capable to scale down tax evasion of big businesses.

To establish a more professional tax authority, smaller in size and comprised of well-paid, trained personnel conversant with and abiding by tax laws and procedures.

To reduce the number of taxes and tax rates by focusing on a static or fixed, flat tax base, which are transparent and easy to administer. Actually, in January 2005, the differentiated tax rate structure in the simplified tax will be replaced with one tax rate on turnover and with no deductions for expenses. Action will be taken to remove large taxpayers from the simplified tax regime and move them to the regular regime (VAT and profit tax). At the same time there is a need to simplify business activities considered to be taxable objects for presumptive tax.

And last but not least, presently the biggest collector of VAT in Armenia is the customs and not the State Tax Service. It is recommended to revise the system of VAT collection in order to ensure that the State Tax Service, as the main tax collecting body, is the largest VAT tax collector in Armenia.

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