

AMERICAN UNIVERSITY OF ARMENIA

A STUDY OF THE SIMPLIFIED TAX SYSTEM  
IN THE REPUBLIC OF ARMENIA

A MASTER'S ESSAY SUBMITTED TO  
THE FACULTY OF THE GRADUATE SCHOOL OF  
POLITICAL SCIENCE AND INTERNATIONAL AFFAIRS  
FOR PARTIAL FULLFILLMENT OF THE DEGREE OF  
MASTER OF ARTS

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NOVERMBER 2005

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November 2005

## **Acknowledgments**

*I would like to express my deep gratitude to all people who have supported me on working on this paper and have contributed to the drafting, interviewing and writing of my Master Essay. Without their genuine assistance, it would be impossible for me to finish this research.*

*My special thanks to my faculty advisor Dr. Jimmy McHugh. I really appreciate his invaluable support, advises, directions, consultations during the study. A great specialist, professional and person, his role was indispensable for my researching process.*

*I am very grateful to Gohar Minsyan, an economist in the IMF Office of Armenia. She has greatly assisted me by providing necessary materials, helping to analyze the findings of the research and by her professional advises.*

*I also want to thank my friend and classmate Anna Matghashyan. Her assistance during interviewing process was really very precious.*

*My thanks also to the School of Political Science and International Affairs, and especially to the dean, Dr. Lucig Danielian, for her encouragement, sincerity and readiness to understand and help me as much as She could.*

*I also want to express my gratitude to all the respondents of my survey, for their beneficial cooperation during the survey.*

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## List of Abbreviations

AEPLAC	Armenian-European Policy and Legal Advice Center
AMD	Armenian Dram
AUA	American University of Armenia
AZM	Azerbaijani Manat
CIS	Commonwealth of Independent States
EU	European Union
GDP	Gross Domestic Products
IMF	International Monetary Fund
OECD	Organization for Economic Cooperation and Development
RoA	Republic of Armenia
SFSI	State Fund of Social Insurance
SME	Small and Medium Entrepreneurship
STS	State Tax Service
USA	United States of America
USD	American Dollar
VAT	Value Added Tax

## **Abstract**

This Master Essay assesses the overall situation of simplified tax system in Armenia. The study is based on the original data, which has been collected through the survey of small businesses operating currently in Yerevan city. It elucidates the important aspects of simplified tax system, such as the major problems for simplified taxpayers, the specific issues of tax administration, the correspondence of facts with the purposes for which this tax has been introduced, the difference of taxpayers operating in different regimes. Study makes appropriate conclusions and recommendations for the system.

The first part of the essay is the literature review. It reviews the general meaning and implications of tax system, as well as the main characteristics of simplified tax. In addition, the practice of CIS countries is also presented. This part also discusses the overall situation of simplified tax in Armenia, its main problems and strengths. The assessment of tax administration situation in the country is also presented discussed here.

In subsequent parts of the essay, the methodology and basic findings are presented. Paper discusses the overall situation of simplified tax based on the findings of the survey. Appropriate tables and figures present the numeric data of the study.

In the next part of the study, the analysis of the situation is introduced. The analysis is based on the findings of the research. It assesses various aspects of simplified tax regime, as well as tax administration. In addition, analyze reveals some very specific, essential and intriguing issues about the sphere.

At the end of the essay, overall situation is presented. In conclusions, main findings and their implications for Armenian simplified tax system, as well its possible consequences for the small business sector of Armenia are discussed. Some proper recommendations and policy proposals are also made.

## **Introduction**

Taxation is one of the most important pillars in every country's socio-economic life. It is known that post-communist countries, particularly Armenia, have significant difficulties in legislating, implementing, administering and improving their tax systems. That is why it is imperative to examine the current state of taxation system in our country. Therefore, my research explores a specific issue in our taxation system: simplified tax.

Armenia introduced the simplified tax in 2000. In consequent years (especially in 2003 and 2005), "The Law about Simplified Tax" has been changed considerably. The last change on this law came into force just in July of 2005. Thus, we have a system which real operation is to be examined yet. Therefore, my original research assesses how the relatively newly introduced system of simplified taxation works in Armenia. It is worth noting, that other countries of the former Soviet Union have also introduced such kind of tax for their small businesses; consequently it was rather useful to compare the current situation in Armenia with their passed way.

Thus, the development of original dataset provided us with needed information to focus on simplified tax payers. The simplified tax is turn-over based small tax-payers tax. Such taxes are typically applied to enterprises that can not keep good accounting records, typically because they are one-person firms. Sometimes, these taxes are used to reduce contact with the tax service, possibly because of governance issues. Therefore, my objective was to assess the extent to which these taxpayers keep proper records. Another issue was whether those taxpayers receive proper invoices from their suppliers. Some governance issues: like how often those firms are inspected, whether they are compelled or offered to pay bribes, whether the administration of simplified tax has been changed tangibly after January 2005, are also evaluated in my research. An important aspect of the system is the availability of an accountant. It is known, that one of the main reasons of introducing this type of tax was that

many small businesses are not able to hire additional qualified personnel for accounting. Consequently, it was rather useful to examine what is the situation of this aspect among Yerevan's small businesses.

As owners of many small enterprises pay simplified tax, it was appropriate also to assess whether they have problems with such issues as the tax rate; accounting; tax form and filing; payment reports; frequency of payment and payment records; frequency of changes in rules and rates; as well as extra-legal requirements for advance payment of taxes. Their thoughts about these issues were collected and analyzed along with other aspects of the problem.

Thus, the general purpose of my research is to collect original database by conducting survey among small businesses in Yerevan; then using the information and results of the survey to analyze, examine and comprehensively assess the operation of simplified tax system in Armenia. The survey will elucidate important aspects of simplified taxation. It will help us to analyze how the system really operates in Armenia, what are its main problems, shortcomings and strengths, as well as to make some appropriate policy recommendations and/or predictions. This, in turn, will be useful to make proper conclusions for overall tax policy.

In the paper, firstly I will present the notion of tax, simplified tax and how the system of simplified tax operates in other countries: Belarus, Russia, Azerbaijan, Kazakhstan etc. Then the brief outline of the situation of small business in Armenia will be provided. Afterward, I will discuss the overall situation of the system in Armenia: what the purpose of simplified tax was in Armenia, appropriate legislation, problems and other related issues. The assessment of the situation by other researchers will also be briefly presented. After this general review, the findings of our survey/research will be introduced. I will analyze each point of our findings: answering my research questions. Our general and specific explanations, observations and explanations about each of the points, as well as about existing practices, respondents'

comments, overall atmosphere in which Armenia small business operates will be presented, analyzed and discussed. After the assessment of the broad situation of simplified tax system in Armenia, appropriate recommendations and policy options will be proposed.

Thus, the specific research questions of my study are the following:

- Whether the introduction of simplified tax was justified?
- Whether the frequent alterations in the methods of paying and filing of simplified tax are very problematic?
- Is the simplified tax an appropriate method of taxing in the context of invoice-transactions?
- What is the situation of governance issues in the field of taxation?
- To what extent do the simplified tax payers keep proper records?
- What are the major problems for small businesses that pay simplified tax?
- Whether firms, which are not simplified tax-payers, would prefer to shift into simplified tax system?

## **Literature Review**

A principal determinant of a country's economic success is the quality of the country's institutions and policies. Because institutions are the vehicles that carry policies, the existence of good institutions is a necessary, if not sufficient, condition for the implementation of good policies. This is true for many areas of economic policy, but it is especially true in taxation, where the distinction between policy and administration may become artificial.(Rastogi, 1997).

Thus, being involuntary payments, taxes are intended to support collective provision of certain goods and services, not a price for services rendered. According to Clague, Cristopher (1997,35), "...the existing tax systems are also widely used to advance wide ranging and often conflicting economic policy objectives, such as revenue enhancement, industrial and regional development, savings, investment, employment, and export promotion." In recognition of these factors, many countries have been reforming and many more have begun to critically evaluate their tax systems.

Bird and Oldman (1967) state, that "A tax system is no better than its actual application, no matter how sophisticated and advanced the law itself may look. One must recognize that social customs, administrative skills, business organization and practices all provide the setting in which the tax law operates." In addition, the law, to be effective, must be adjusted to its environment; and it should be recognized that complex and sophisticated schemes, while most effective and equitable under ideal conditions, would be rather ineffective and inequitable in the actual setting.

Thus, the main purpose of taxation is the following. Its aim is to raise resources to finance government expenditure. We may see the problem of tax design as one of finding ways of raising these resources, which is politically and administratively feasible, and which promotes equity and efficiency as far as possible. There must clearly be some trade-offs among revenue, administration, political acceptability, equity and efficiency. The problem of tax reform is to find an improvement, with respect to these criteria, of an existing system. (Helpman E. and Krugman P.).

Stephan Haggard (1997, 122) notes, "For the newly emerging democracies of the developing countries and formerly socialist countries, the transition to the market involves a difficult set of economic reforms." Though there is not any widespread consensus on either the precise content of these reform measures or the speed and sequence with which they

must be introduced, there is growing recognition of the necessity of stabilization and some structural adjustment and restructuring of property rights.

Therefore, the broad goal of tax reform is to secure an efficient tax system based on taxes that are politically feasible and administratively practicable, and produce sufficient revenue with a minimum of economic distortion. (Boyes, W and Melvin Michael 1991).

Specific regimes of small business taxation exist in most countries. The main reason behind this is that there are significant differences in compliance costs aligned with the complex procedures of business taxation depending on the size of an enterprise, where economies of scale discriminate small business. Specific regimes of taxation can reduce the compliance costs of small business and therefore improve the economic environment for its development. This is the more so as small business is an important sector of the economy. Small enterprises are more flexible in comparison with large ones. They easier accommodate to market changes. The development of small business allows to increase the occupational level and to reduce the government expenditure for unemployment benefits in such a way.(Valevich, Yuri and Stephan, Bach 2004).

There are two basic approaches to taxation of small business. The first approach is to use reduced rates in relation to the tax base that is determined according to the general rules. This measure is sometimes complemented by various investment allowances or tax holidays. The second and more common approach implies the usage of specific regimes of taxation. One option is to use the different simplified ways of determining the tax base on the basis of actual outcomes of enterprises' performance (e.g. cash-flow or gross turnover taxation). Another option is presumptive taxation, which means an indirect estimation of the potential income of a taxpayer and introduction of a lump-sum tax that replaces one or several taxes. Usually, this alternative is used as a kind of last resort when taxpayers do not comply with

the tax rules, i.e. refuse bookkeeping obligations or do not declare their tax base, or if high degree of tax evasion is assumed.(Valevich, Yuri and Stephan, Bach 2004).

For example, in Armenia, simplified tax is the tax substituting VAT and (or) Profit Tax (Income Tax). For legal persons simplified tax substitutes VAT and (or) Profit Tax. For individual entrepreneurs simplified tax substitutes VAT and (or) Income Tax.

Legal persons and individual entrepreneurs shall be considered to be simplified taxpayers if during previous reporting year total amount of turnover of sale of goods supplied and services rendered by taxpayers (exclusive VAT) have not exceeded AMD 50 million. This restriction shall not apply to the sphere of trade and public catering activities carried out in shops and counters.(“Business, Economy and Tax Customs of Armenia”, Webpage: <http://www.armeniaemb.org/BusinessEconomy/TaxCustoms/Taxes/SimplifiedTax.htm>).

On the other hand, In Belarus, the specific regime of small business taxation includes the simplified system of taxation and presumptive taxation. However, neither of the approaches led to improvement of the economic environment for small business development. Insignificant quantity of small enterprises, minor share of employed at these enterprises in comparison with most successful transition economies, and dissatisfactory dynamics of output indicate the relative non-profitability of small business in the Belarusian economy. Of course, the situation of small business depends not only on taxes. However, the influence of taxation is of crucial importance. (Valevich, Yuri and Stephan, Bach 2004).

### **How Simplified Tax Operates in Other Countries**

In this part of the paper, I will present the general and specific features of simplified tax system in CIS countries, such as in Belarus, Tajikistan, Kazakhstan, Kyrgyzstan, Russian federation, Azerbaijan etc. Initially, I will introduce a common characteristic of the system,

used in almost all countries, and then some distinctive aspects of particular country will be discussed.

In all countries, organizations and proprietors can apply for using simplified taxation. In Belarus, only those organizations or businesspersons can use it, which have special license form their taxing agencies. In Tajikistan, sole proprietors are not eligible for simplified tax; and only those firms can use it, which are not VAT payers.

Another common aspect is that taxpayers shift to simplified tax system at their desire. Nevertheless, in Belarus, taxpayers are not allowed to go to the general taxing system and re-shift back to simplified tax during a year. In Russia, after shifting to general tax system, taxpayers will not be permitted to alter their system during a year.

In all cases, taxpayers should meet special conditions for being eligible for simplified tax. In Russia and Belarus, the main requirement is the number of employees. In Belarus, there should be 15 employees, and in Russia: no more than one hundred. In Belarus, addition prerequisite is the lack of any credits at the moment of receiving the license from tax agency. In Kazakhstan, additional provision for proprietors is that their annual income must not exceed 1,5 mln tenges. Another interesting requirement is that the wages of businessmen's employees should be at least twice as high as the minimum salary rate of the country. In Kyrgyzstan, the use of cash registers is mandatory for simplified taxpayers. In Russia, one's share in other organizations' basic capital should not exceed 25%<sup>1</sup>; in addition, the sum of amortization of one's own property must not surpass 100 mln rubles.

Special conditions exist that do not allow applying for simplified tax. In Belarus, the representatives of small businesses that are parts of a joint activity agreement cannot be eligible for simplified tax. Likewise, in Kyrgyzstan, those representatives of small business who are able to conduct their activity by the license, or are soil-owners and pay taxes for

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<sup>1</sup> The exception is done only for some non-governmental organizations of disabled persons.

soil, are not permitted to use simplified tax. In Russia, those small proprietors who are taxed by general tax regime are not allowed to shift to simplified tax either.

It is quite noteworthy to mention that branch restrictions exist for businesses desiring to apply for simplified tax. In Belarus, the following kinds of businesses are not eligible for simplified tax. The representatives of small business who produce goods, which are taxed by excise duties, or produce or distribute precious stones and metals. In addition, banks, insurance and investing organizations, as well as the organizers of casinos and other entertainment events are not qualified for simplified tax either. The situation is rather similar in Russia. The firms, which have representative offices or branches, or produce goods taxable by excise tax, cannot be simplified taxpayers. Non-state pension foundations, pawnshops, casinos, non-state notaries, the producers of useful minerals also are not allowed to pay simplified tax.

In all countries, the simplified tax regime replaces other forms of taxes. In Belarus, simplified tax replaces VAT, income tax, property and natural taxes; in Kazakhstan: social and income taxes. In Kyrgyzstan, it may replace income, trade, road taxes and the payments to the foundation of emergency states; in Russia: VAT, income and trade taxes, for juridical persons it also replaces joint social and property taxes; in Tajikistan: VAT, income, property, road and mineral usage taxes.

Taxing base may vary for different countries. For Belarusian simplified taxpayers the base is the income of jobs and services, for Kyrgyz businessmen it is the overall income. In Tajikistan, the base is the same: overall income, which is calculated through cash registers and profits from the provided services and implemented jobs.

The rates of simplified tax are different in the countries of CIS. For Belarus, the rate is 10% of the whole income. In Kazakhstan, it is 4%-9%, 13% for juridical persons and 3%-7% for sole proprietors (the rate depends on the actual size of income). In Kazakhstan, the rate is

5% for agricultural production and catering; 6% for trade and transportation services and 10% for other activities. In Tajikistan the fixed simplified tax rate is 5%. (Alaverdyan A. and Mesropyan A., 2005).

In Azerbaijan, the simplified tax has the following characteristics. Persons not registered for VAT purposes and whose volume of taxable operations for the previous three months period does not exceed 22,500 conventional financial unit (123,750,000 AZM) are entitled to be taxpayers under simplified regime. Such taxpayers must submit tax returns or written notification about relinquishment to exercise this right to the tax authority at which they are registered no later than April 20 and apply selected method until the end of the year.

Persons performing passenger and cargo transportation activity (with exception of international passenger and cargo transportation) on the territory of Azerbaijan Republic with automobile transport means (including taxis) which are owned and used by them are payers of simplified tax. Following persons are not entitled to be taxpayers on simplified system: persons producing excise goods; crediting and insurance entities, investment funds, professional security market participants, pawn-shops; non-governmental pension funds; persons obtaining income from the lease of property or royalty; as well as persons possessing fixed assets whose residual value as of the beginning of the year exceeds 1,000,000 times of conventional financial unit (5,500,000,000 AZM) (except for persons who perform passenger and cargo transportation activity with automobile transport means owned and used by them or through other persons on contract).

The simplified tax is calculated based on the amount of funds (gross volume of cash flow) obtained from provision of goods, implementation of works, rendering of services by taxpayers and non-sale profits at the following rates: for Baku: four percent; for other regions and cities, Nakhichevan Autonomous Republic: two percent. For taxpayers involved in activities in other cities and regions of the Azerbaijan Republic, including Nakhichevan

Autonomous Republic with exception of Baku, the established tax rate is applied only when taxpayers are engaged in activities in these territories using their own production facilities, property and labor. (Ministry of Taxes of Azerbaijan, 1999).

### **Small Business, Tax System and Simplified Tax in Armenia**

Small and medium entrepreneurship (SME) faces mainly similar obstacles in countries in transition, their essence, methods and ways of solutions depend on such kind of specific factors as the economic development tendency and rate, the stage of market economy development, national mentality, existence of correspondent legislative framework, the efficiency of financial, tax, customs structures' functioning etc. (Reference Book, 2005).

Small business is classified in accordance with number of employees, based on the Law of the Republic of Armenia "On Small & Medium Entrepreneurship State Support." As Table 1 shows, the number of employees for small business is different for various spheres of activities.

**Table 1: Classification of Small Enterprises in Armenia**

Classification/Sphere	Micro [number of employees/man]	Small [number of employees/man]
Industry and other sections of production	5	50
Construction and power engineering sphere	5	25
Science and education sphere	5	25
Transport, trade and services sphere	5	15

Source: Reference Book "Small & Medium Entrepreneurship Sphere in Armenia 2003-2004", 2005

Share of SME sector in GDP has been 38.6% or 730866.4 mln AMD in 2004 and 36.5% or 592517.7 AMD in 2003. This means that the share of SMEs in generating GDP increased by 2.1 percentage points or 138 348.6 mln AMD in comparison with 2003. The analysis of

above-mentioned figures shows that there is a stable tendency of GDP growth in Armenia for the past few years. The GDP growth is mainly constrained with the growth of the basic spheres of economy. By the same time, it is important to fix that SMEs have considerable input in the following spheres of economy: industry, trade and service. (Reference Book, 2005, 7-9).

In 2004, the number of small enterprises has risen in Armenia. As Table 2 shows, the growth of sole proprietors was 5,7%. Moreover, we can see rather significant increase in the number of registered small businesses for the same year.

**Table 2: Number of Registered Economic Units for 2003, 2004**

Economic Units	End of 2003 [quantity]	End of 2004 [quantity]	2004 in comparison with 2003 [%]	Registered during 2003	Registered during 2004	2004 in comparison with 2003 [%]
Sole proprietors	63502	67116	105.7	5814	6293	108.2
Commercial legal entities total	49984	51480	103.0	2685	2796	104.1
TOTAL	113486	118596	104.5	8499	9089	106.9

Source: Reference Book “Small & Medium Entrepreneurship Sphere in Armenia 2003-2004”, 2005

Armenian SMEs are operating more actively in the spheres of trade and industry, where the share of SMEs is accordingly 99.4 and 91.6 percent. The role of SMEs was also considerable in the spheres of communication (89.3%), services (87.5%) and transport (77.5%). What about the regional distributions of SMEs in Armenia, there are considerable differences of business activity in Yerevan city and RA other marzes, which brings to the huge disproportions in social-economic conditions particularly in far regions and border areas.

It should also be stressed that the distribution of employment in small enterprises and large companies is quite worrying. For instance, in 2004 small and medium firms employed only 32.9% of working people. Likewise, the situation in the Armenian foreign trade is also

not in favor of SMEs: their share is only 28.2% in the total foreign trade turnover. (Reference Book, 2005, 21-23).

Trying to compare the state of Armenian SMEs with that of developed countries yields rather interesting and unfavorable results for us. In developed countries, SMEs constitute 97-99% of the economic units. In the USA, the share of SMEs in the total number of enterprises is 99.7%, in GDP-52% and in the total number of employees-53%. According to OECD in France and Spain the share of SMEs in the total number of enterprises is 99.8% and in Japan this figure amounts for 99.7% (Small Business in Japan, 2002). In these countries SMEs also have significant role in increasing employment rate. For instance, in France they employ 7.9 mln people, which is 65% of economically active population. The same figures for Switzerland, Germany and Spain are accordingly 69.1%, 70% and 80% of the job places. Therefore, the comparative outlook between the same indicators for Armenia and above-mentioned countries makes obvious the underdevelopment of Armenian economic system and particularly SME sphere.

As with all tax systems, the Armenian tax system has three main functions: i) generating revenues for public services, ii) setting economic and social policy, iii) facilitating the oversight of economic activity and prevention of violations. In view of its imbalanced tax burden and poor administration, the Armenian tax system cannot perform these functions effectively.

In Armenia, the legal framework for the tax system comprises seven main laws, one on taxation in general and individual laws on each kind of tax, plus regulations, instructions, tax and customs administrative rulings and international treaties. There are eight kinds of taxes which private corporations operating in Armenia may be subject to under the Armenian tax system: a. Profit Tax ("corporate income tax"), b. Income Tax ("personal income tax"), c. Value-Added Tax (hereafter VAT), d. Custom Duties and Excise, e. Property Tax, f. Land

Tax, g. Simplified Tax, h. Presumptive Tax (Fixed Tax). In addition to income tax, employers and employees pay social security on salaries.

Armenia has signed bilateral double taxation agreements with 28 European and Asian countries, of which the Armenian National Assembly has ratified 18. The most significant of these 18 are with the Islamic Republic of Iran, Greece, France, China, the Netherlands and the Baltic States although not all these are currently in force or under implementation; one important exception is the United States, with which Armenia does not have a tax or social security treaty.

In 2002 the Armenian State's annual revenues from taxes totaled USD 345 million or 14.6 % of GDP, of which 47.8% was VAT, and 8.7% Profit Tax. Note that all USD conversion from AMD have been calculated at the exchange rate \$1=AMD 575. 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%). 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. Several foreign companies however, have expressed the concern that international target setting has the opposite impact on tax revenues because the tax authorities resort to harassing foreign investors in order to meet these targets, which in turn harms the investment climate, inhibiting investment and growth and shrinking the tax base. (Reform of Armenian Tax System, 2003).

During 1998-2001, Armenia recorded the highest proportion of tax revenues accounted for by VAT amongst the post-Soviet transition economies, whereas Profit and Income Tax revenues had very low proportions in comparison to the other countries. These low levels of income and profit tax revenues, despite the strong growth in national income, can be largely attributed to poor tax administration and high tax evasion. These facts indicate a major

imbalance in Armenia's revenue base and collections and suggest a need for a reassessment of the focus and implementation of the tax system. This imbalance is very harmful and inequitable because VAT is a highly regressive tax that has a greater incidence on the poorer members of society, exacerbating poverty in Armenia. (Reform of Armenian Tax System, 2003).

The simplified tax system in Armenia commences in July 2000, when the law on Simplified Tax was adopted. It is worth noting, that the law ‘On Small and Medium Entrepreneurship State Support’ was adopted a couple of months later: in concord with the simplified tax law. This innovation was connected with the general tax administration reforms efforts. Despite continuous attempts to reforms tax administration, it was rather complex and complicated for micro and small enterprises. In particular, the introduction of new accounting standards in 1999 further aggravated the situation. That is why the underlying logic of simplified tax was the simplification of the accounting. Therefore, according to the RoA Government Decision #471, simplified taxpayers acquired some essential privileges with regard to accounting procedures. Thus, they may not keep proper accounting records, receipts, other record keeping. Moreover, taxpayers may not present financial statements to taxing agencies.

Another important aspect was the combination of different tax regimes for a single subject. Until 2003, the mixture of several regimes was allowed; nonetheless, since 2003 only the combination of statutory and simplified taxes was permitted.

According to law, adopted in 2000, only juridical persons and sole proprietors were allowed to pay simplified tax. However, in 2002 only trading organizations can become simplified taxpayers; in addition notaries were also eligible for that tax. In addition, since 2003 trading organizations and sole proprietors can apply for shifting into simplified tax

regime only from the beginning of the next year: if they have already applied for it till January 25.

Like in other CIS countries, Armenian simplified tax system has also its specific requirements. The maximum amount of sales circulation is 50 mln AMD per year. This amount is calculated summing up the incomes received from all types of activities. According to the changes in law, this came into force since January 2005, simplified taxpayers are shifted into regular tax regime as soon as their income exceeds 50 mln AMD in any period of a year<sup>2</sup>. Other important aspect is connected with the use of cash registers. The law does not provide strict requirements for cash register: even the gross violations of the cash registers usage norms do not suppose the change of tax regime<sup>3</sup>. (Alaverdyan A. and Mesropyan A., 2005).

Other prerequisite for simplified tax is the following. A proprietor's tax debt should not exceed 100 thousand AMD at the moment of applying for simplified tax. Additional noteworthy aspect of simplified tax regime in Armenia is that the businessmen, who import goods which are taxed by zero rate of simplified tax, are allowed to pay only 20% of VAT, and avoid any further restrictions.

Strict branch restrictions also exist for various spheres of enterprises. According to the initial draft of law, excise-goods producers, persons directly connected with financial market (banks, auditing organizations), consulting and audit firms were not allowed to pay simplified tax. Later this restriction was applied to pawnshops, producers of agricultural products, as well as to mineral production, production and distribution of energy, capital construction spheres. (Alaverdyan A. and Mesropyan A., 2005).

The taxing object is the circulation income: received by sales or provided services. In addition, renting incomes and royalties are also calculated for simplified taxation. However,

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<sup>2</sup> Until this change in law, simplified taxpayers shifted into regular regime from the beginning of the next year.

<sup>3</sup> In the initial version of law, a simplified taxpayer would have to shift into regular tax regime at such cases.

there still exist several kinds of other incomes, which are not taxable for those, who pay only simplified tax.

The rates for Armenian simplified tax regimes are the following. For enterprises, trading through kiosks, stores simplified tax rate is 4%. For other types of activity simplified tax is calculated by this way: 7% for the circulation of up to 30 mln AMD, and 12% for incomes exceeding 30 mln AMD<sup>4</sup>. (Alaverdyan A. and Mesropyan A., 2005).

### **The Assessment of Regular and Simplified Tax Administration by other Researches**

A few scientific researches has been implemented for assessing the overall situation of regular and simplified tax regimes, as well as tax administration in Armenia. One of such significant studies is the joint white paper “Reform of The Armenian Tax System” of the American and European Union Chambers of Commerce in Armenia<sup>5</sup>. The general conclusion that was drawn is that while Armenia’s rates are higher than in Russia and many other countries, the overwhelming problem with the Armenian tax system, as applied by both the tax authorities and private sector, is unpredictability and difficulty of compliance. This stems from both the application of the laws and the laws themselves.

While the Armenian tax laws are on a par with most of those of the CIS, they fall short in precision and consistency when compared with advanced legal systems; and in respondents' estimation, they are significantly less practical than the tax laws in the Baltic States, Russia or in Eastern European countries. Moreover, in the view of almost respondents, the tax administration and the implementation of the tax system in Armenia on the part of the tax

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<sup>4</sup> Until 2005 the rate system has been quite complex, which has created redundant complications. Subsequent changes in the law simplified the existing regime of rates.

<sup>5</sup> The study has been published in august 2003. It is based on a survey of 34 members of the American and European Union Chambers of Commerce in Armenia concerning the Armenian Tax System. The survey was mainly conducted by personal interviews with the chief financial directors of large and smaller-sized companies operating in a wide range of sectors, and evenly split between large and small taxpayers.

authorities is inefficient, inequitable and unprofessional, with widespread corruption and harassment of foreign investors and corporations that try to abide by the laws.

According to the study, 67% of respondents found the Armenian tax system to be illogical at least in part, and only a third found it to be reasonably logical. In comparing Armenia's tax system to those of other transition economies, in particular CIS countries and to a lesser extent Turkey and the Balkan states such as Romania, Bulgaria and FYROM, respondents stated that tax administration and procedures in Armenia were more cumbersome and difficult to comply with than in most other jurisdictions. A particularly negative aspect of the Armenian tax system in comparison to other transition economies is the frequent change in applicable laws, with new laws often being adopted in December when most foreign investors are absent for application on January 1st. This effectively precludes them from public participation in the law-making process and makes it difficult for companies to prepare for legal compliance. Moreover, old laws are not always amended to harmonize with new legislation following such changes, resulting in conflicts between laws and legal uncertainty that ultimately increases companies' compliance issues.

Furthermore, preparing the required income and expenses documentation was considered much more difficult in Armenia than elsewhere. VAT refunds were mentioned by numerous participants who stressed that 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, which simply wrote off these costs.

Of the 34 participating companies in the survey, 54.5% had been audited by the Tax Authorities every year since they came to Armenia, 9.2% once every two years and 33.3% once every three years or had never been audited. 3% had been audited twice in one year. 82% of respondents had experienced at least one tax dispute with the tax authorities,

including fines, penalties or legal proceedings. Of these 28 cases, 10 were challenged in court, and in all cases the taxpayers won. While this phenomenon may not be statistically significant, it suggests that the laws are very unclear and too complicated for the tax authorities to apply effectively. It could however also indicate that the authorities are abusing their prosecutorial powers to harass companies into giving bribes or over-paying their taxes so that the authorities meet their tax collection targets.

Another very important research is “Fifth Annual Regulatory and Administrative Costs Survey: Armenia”, published in November 2004<sup>6</sup>. The Government of the Republic of Armenia, in partnership with the World Bank, on an annual basis, is carrying out the “Regulatory and Administrative Costs Survey” to assess the impact of state requirements, procedures and institutional arrangements on private Armenian firms. The Government conducts this survey to assess the private business development climate and impact of administrative and regulatory changes undertaken during past one-year period.

When asked about the general satisfaction with the quality of regulations, administrative requirements and bureaucratic behavior of state agencies, exactly 60.7% of Armenian businesses has indicated it as a problematic constraint, with an average rating being equal to 2.93 (somewhat dissatisfied). It is almost the same result as received during the previous surveys: according to the findings of the similar survey conducted in year 2003, 60.3% of companies were dissatisfied with the overall quality of business regulations, in 2002 – 50.0%, in 2001 – 55.5% and in 2000– 71.5%. The survey results show that the small sized companies are somehow more dissatisfied (42.86% of small companies) with Government regulations than medium (34.23%) and large-sized (34.69%) enterprises do. Also, the companies operating in different sectors of the economy have almost the same level of

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<sup>6</sup> The sampling of this research was a nation-wide representative sample of 300 private enterprises. Respondents were top managers of Armenian private enterprises and the method was face to face interviews with them.

dissatisfaction with Government regulations –service-providing companies being a little bit more constrained with the overall quality of business regulations.

Focusing on a proportion of dissatisfied companies, the following constraints stand out: (a) taxes and tax administration/regulation (with 84.3% of respondents judging as a serious problem - moderate or major obstacle), (b) policy instability/uncertainty (75.0%), (c) corruption (71.3%), (d) financing (71.3%), and (e) infrastructure (68.0%), as top five constraints affecting the operations and growth of private Armenian businesses. Additionally the survey participants were asked to evaluate different regulatory areas related to business start-up and operations in Armenia, i.e. business registration, licensing, obtaining construction and use permits, certification, tax and customs regulations, inspections, etc. The survey results show some increase of the costs associated with business start-up process in Armenia during the last year. In particular, the time spent on company registration has somehow increased from 14.5 days in 2003 to 18.6 in 2004 and from 6.8 person-days in 2003 to 8.3 person-days in 2004.

The same pattern is observed for business operations in Armenia. Among areas related to business operations taxes and tax administration/regulation is considered as somehow more problematic area. The majority (84.3%) of surveyed Armenian companies evaluate this area of state regulations as a serious constraint, which is almost the same as received during the last year study (83.6% in 2003). Within the tax and tax administration, the most problematic ones are “extra-legal requirement for advance payment of taxes”, “frequency of changes in rules and rates” and “availability of information regarding the laws and regulations”. Nearly the half of the companies, which have to deal with the customs office (64.4% for import operations and 45.8% for export operations), has expressed dissatisfaction with the operations of this structure. It should be mentioned that, as a survey results revealed, all aspects of dealings with customs authorities are evaluated better for export than import

among the companies, which actually undertake import/export operations. While comparing the evaluation of different aspects of dealings with customs authorities with the similar ones of last year a substantial improvement of the evaluation could be noticed (from around “moderate obstacle” last year to “no obstacle” this year). Additionally, the average cost of inspections has somehow decreased compared to the previous year: 679,915.3 AMD (1,174.7 SD) in 2004 vs. 727,364.3 AMD (1,280.6 USD) in 2003. Tax Inspectorate and State Pension Fund conduct the highest proportion (46.3% vs. 41.6% last year) of inspections. The next group of inspecting agencies having relatively high weight in total number of inspections is Fire Department, Sanitary Inspection, Electricity Agency<sup>7</sup>, Water Agency<sup>8</sup> and Environmental Inspection.

A very important survey is the AEPLAC’s “Analysis of Current Transaction Costs Related to the Tax Collection Procedure in the Republic of Armenia”. The main objective of the study was to identify and determine the transaction costs derived during the tax collection procedure in Armenia and provide their quantitative estimation<sup>9</sup>. Essential finding was that the need to establish “good” relations with tax authorities is primarily caused by the “expensiveness” of contacts with the latter, drawbacks of the tax legislation and the “unfriendly” attitude of tax officers. The survey findings also suggest that the amount of tax collections is not directly correlated with the frequency of tax inspections, which proves the overall inefficiency of such inspections. Dissatisfaction with the tax system is also brought about by the frequency of inspections. Generally, the tax inspections are “costly” for the state when they do not ensure an adequate level of tax collections. The expensiveness of legal proceedings (in terms of finances and time) seriously impedes the activities of the entities’ as regards to the protection of their rights. The disputes on tax issues are primarily

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<sup>7</sup> Currently privatized, former state Electricity Distribution Company responsible for controlling proper application of electricity safety rules at consumer sites

<sup>8</sup> State Water Agency and its subordinated structures.

<sup>9</sup> The sampling was this survey was 328 enterprises: out of 1300 asked for interview.

caused by the drawbacks of the tax legislation, collection of advanced payments by tax authorities and the “unfriendly” attitude of tax officers. One of the reasons for paying extra salaries to a skilled accountant is the “expensiveness” of contacts with tax authorities, while those for the opportunistic behaviour are the shortcomings of tax legislation. According to our estimates, in 2003 the economy lost nearly 1 million dollars in investments due to the collection of advanced payments. The majority of companies that have paid advance payments have not had law suits against the tax authorities because they have always agreed with tax inspection reports, i.e. the opportunistic behaviour of the tax authority provides some “guarantees” for the economic entity. Thus, 32% of surveyed companies had to make advance payments upon the request of the tax authority (12.5%, 5.2% and 5.9% of companies have made advance payments for simplified tax, VAT and profit tax, respectively). Note that the most “suffered” companies are those representing the sectors of trade (54%), industry (58%) and construction (45%).

As to the average figure for transaction costs per employee, the Table 3 below shows that the larger the company is (the more employees it has), the lower are the transaction costs per employee. For instance, in an entity with one employee this indicator is 51 times more than in companies with more than 101 employees.

**Table 3: Average transaction costs per employee**

<b>Number of employees</b>	<b>Transaction costs per employee (AMD)</b>
1	209,738
1-5	67,628
6-10	45,485
11-50	22,979
51-100	10,430
more than 101	4,107
not mentioned	-

Source: AEPLAC “Final Report of Tax Administration”.

As Table 4 indicates, the difference of enterprises evaluating the level of difficulty of relations with the State Tax Service is not that conspicuous. Though it is apparent, that micro businesses regard it much simpler than small and medium ones. The fact can be partially explained by the simplified tax system generally used by those kinds of enterprises.

**Table 4: Simplicity of the relations with tax authorities measured by the number of employees**

Number of employees	Simplicity of the relations with the State Tax Service			
	very simple	simple	difficult	very difficult
1	-	61.1%	27.8%	11.1%
1-5	3.1%	61.2%	28.6%	7.1%
6-10	4.2%	58.3%	29.2%	8.3%
11-50	4.3%	55.1%	30.4%	10.1%
51-100	-	64.5%	12.9%	22.6%
more than 101	-	66.7%	25.0%	8.3%
Not mentioned	-	72.7%	18.2%	9.1%
Total	2.8%	60.3%	26.8%	10.1%

Source: AEPLAC “Final Report of Tax Administration”.

When measuring the relations with the governmental authorities by their “expensiveness”, the answers are not in favour of the State Tax Service. For instance, 71.4% of companies think that the contact with this body is the most expensive one compared to the others. In the breakdown by the number of employees, the “leaders” are the companies with 1-5 employees, which account for 34.6%, those having 11-50 employees - 25.3% and the companies with 6-10 employees - 18.4%. Of the surveyed companies, 6.2% consider the tax legislation perfect, 59.2% see some shortcomings, while 28.1% think it has significant flaws.

The Concept Paper prepared under the scope of this activity describes various methods used to evaluate the tax administration. Based on these methods the main indicators reflecting the efficiency of tax administration in 2002-2003 in Armenia have been calculated. These figures are essential for understanding the overall tax administration system in Armenia and can be seen in Table 10 (Appendix A).

## Methodology

The methodology, used for my master essay study, is the survey and analyze of secondary data. We have conducted a survey of one hundred twenty small businesses operating currently in Yerevan city. We have used non-probabilistic sampling methods for our survey: mainly purposive or judgmental sampling, as well as quota sampling partially and reliance on available subjects, whenever needed. We have included various types of small businesses from almost all suburbs of Yerevan city in our survey. The reasons of using non-probabilistic methods of sampling were the following. First, no comprehensive database exists in Armenia, which would identify the names of simplified taxpayers<sup>10</sup>. Second, relying on available databases would be senseless, since they do not indicate whether the particular business pays simplified, presumptive or regular tax. Thus, the probability that the majority of our respondents would be regular taxpayers would be very high; at this case, the survey would lose its main logic of assessing simplified taxpayers. Third, as the results of other business-related researches indicate<sup>11</sup> the cooperation of businesses is extremely low; consequently, the refusal rates are dramatically high<sup>12</sup>. At such cases, it is very problematic to have a representative sampling. It is noteworthy, that more than 500 small businesses were asked for interviews, from which only 120 gave their agreement<sup>13</sup>. Thus, the refusal rate was more than 75%. The method used was face-to-face interviews with the persons who actually make decisions in the enterprises (owners, directors, managers etc.) We have also used other existing data for the secondary analysis.

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<sup>10</sup> State Tax Agency possesses more or less comprehensive databases, which are not provided for the purposes of student master researches.

<sup>11</sup> For example, "Fifth Annual Regulatory and Administrative Costs Survey" of AEPLAC, conducted in 2004 in Armenia.

<sup>12</sup> Actually, during our survey we experienced that kind of problems: very low cooperation and extraordinary high refusal rates: approximately 80%.

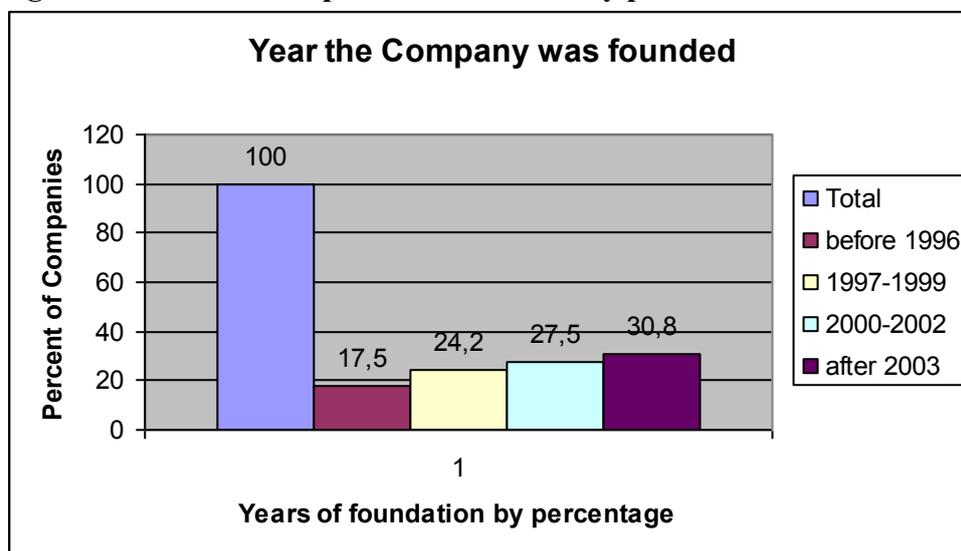
<sup>13</sup> The number of simplified taxpayers in Armenia is approximately 20,000; thus our sample size constitutes nearly 0,45%-0,50% of that number which is quite normal and admissible for such cases.

## Findings

As it was already mentioned, the main purpose of our research was to assess how simplified tax system operates in Armenia generally. In this part of the essay, I will present the findings of our survey. The findings are based on the data received from the survey questionnaire. First, I will introduce the general information about the respondents, such as the types of businesses participated in the survey, the years of their foundation etc, then the data for each question relevant for my study will be discussed.

One hundred twenty small businesses have participated in the survey. The geographical are includes Yerevan. Businesses operating in almost all districts of Yerevan city were included<sup>14</sup>. Main area of activity for the respondents was retailing service. The majority of the businesses are engaged in that type of activity. There were also several hairdressing saloons, catering booths, stores, reconstruction company etc. As Figure 1 shows, the majority of companies were founded after 2003.

**Figure 1: Years of Companies Foundation by percent**



<sup>14</sup> However, the majority of respondents were from Center and Arabkir districts that are the most populous and business developed districts of the city. Small number of participants represented Kanaker-Zeytun, Nor Nork, Avan, Erebuni, Mashtoc, Malatia-Sebastia, Ajapnyak & Nor-Aresh districts.

Another considerable portion is companies established in 2002-2003. It is worth mentioning, that according to Reference Book for SMEs in Armenia, after 2003, the country has witnessed rather significant increase in the number of small businesses. Therefore, this part of our findings generally corresponds with the official statistical numbers for the country.

Other interesting part is the number of employees in the surveyed organizations. For all taxpayers the average number of employees is 3.3. For simplified taxpayers this number is 3.1, for not simplified taxpayers: 4.1<sup>15</sup>. According to Armenian law, the average respondent of the survey are micro businesses<sup>16</sup>. It should be mentioned, however, that 75.8% (91 enterprises) of the respondents are simplified taxpayers and only 23.3% (28 enterprises) are not. More elaborate job structure is presented in the Table 5.

**Table 5: Number of Enterprises by the Number of Employees**

Number of Employees	Total Number of Firms (119)	Total Number of firms [%]
Up to 2	47	39,5
3-5	56	47,1
6-8	14	11,8
More than 8	2	1,7

Thus, almost all businesses are micro or small enterprises. As one of the main purposes of the study was the evaluation of small business situation, the study population exactly fits the purpose of the study.

A very interesting point is the size of an average salary in the companies. For all taxpayers the average wage is 28.158 AMD per month<sup>17</sup>. For simplified taxpayers that

<sup>15</sup> There is point in stressing the fact, that the standard deviation for the average number of employees of regular taxpayers is quite high: 2.9. This implies that regular taxpayers generally have more diverse structure of business and employees.

<sup>16</sup> If an enterprise has up to five employees, regardless its sphere of activity, it is considered a micro business.

<sup>17</sup> Standard deviation for this number is quite high: 9,540 AMD.

number is 27.681<sup>18</sup>, and for regular ones:29,643. A more comprehensive picture of average salaries in Yerevan's small businesses can be seen in Table 6. Thus, the overwhelming majority of them get up to 30.000 AMD per month. The number is rather low even for Armenian standards. The fact may indicate to considerable under-reporting of wage rates.

**Table 6: Salary Ranges for Enterprises**

Salary Ranges	Total Number of Firms (120)	Total Number of firms [%]
Up to 20,000	26	21,7
20,000-30,000	69	57,5
30,000-40,000	17	14,2
40,000-50,000	4	3,3
More than 50,000	4	3,3

One of the most important issues of tax administration is the visits of tax agency inspectors. The study revealed conspicuous facts. Almost all (119 from 120) enterprises have been visited by a tax inspector during last 12 months. In majority of cases (101 out of 118) tax inspectors have asked questions about number of employees and wages. As Table 7 indicates, the general purpose of tax agency visits is audits and inspections. Checking of cash registers and tax collection are the following aims of those inspections.

**Table 7: The Purposes of Visits by Tax Inspectors**

	Purposes of Visits(all respondents: 119)	Purposes of Visits (all respondents, %)	Purposes of Visits (only simplified taxpayers: 91)	Purposes of Visits (only simplified taxpayers, %)
Inspection/audits	79	66,4	57	62,6
Cash registers	15	12,6	15	16,5
Tax collection	19	16,0	15	16,5
Employees	3	2,5	2	2,2
No purpose/extra-legal requirements	3	2,5	2	2,2

<sup>18</sup> Standard deviation for simplified taxpayers employees' average wage is 10,342 AMD. This is a very larger number, which can purport a serious under-presentation of real data.

It is worth stressing, that the inspectors of State Fund of Social Insurance have visited the majority (105 out of 120) of organizations. In case of simplified taxpayers, the purposes of those visits were inspections/audits and the verification of number of employees.

Another noteworthy finding is the question about bribes. The respondents have been asked whether they had been offered to pay bribe by tax or social fund inspectors. Only a few (eight out of 120) businessmen has confessed the fact of such offer from tax inspectors<sup>19</sup>, though 15 respondents have refused to answer this question<sup>20</sup>.

The results of the survey, concerning the opinions of small enterprises about various aspects of simplified tax, are rather significant and interesting. They were asked to evaluate the following aspects of simplified tax regime: the tax rate, tax accounting, tax forms/filing, payment methods, frequency of reporting frequency of payments, inspections, audits frequency of changes in rules and rates, extra-legal requirements for advance payment of taxes and other problems. Table 8 presents the distribution of responses by percentage.

**Table 8: Opinion of Taxpayers about the Simplified Tax by percents**

Specific Tax Problems	No problem[%]	Minor problem[%]	Moderate problem[%]	Major problem[%]
Opinion about the tax rate	30,8	31,7	27,5	10,0
Accounting /reporting	41,7	40,8	11,7	5,8
Payment methods	45,8	36,7	15,0	2,5
Frequency of reporting	30,0	47,5	12,5	10,0
Frequency of payments	18,3	41,7	25,8	14,2
Inspections, audits	10,0	21,7	28,3	40,0
Frequency of changes in regulations	35,3	31,9	14,3	18,5
Extra-legal prepayment demands	10,8	18,3	27,5	43,3

<sup>19</sup> Correspondingly, only six respondents have admitted that they have been offered to pay bribe by SFSI inspector.

<sup>20</sup> Twelve respondents have refused to answer the question concerning bribe-offer by SFSI inspectors.

According to these numbers, the most conspicuous problems for simplified taxpayers are audits/inspections and extra-legal prepayment demands. Frequency of payments and tax rates are relatively light problems<sup>21</sup>.

Our findings have also revealed some key characteristics of Armenian small and micro businesses, or simplified taxpayers. This data is crucial in analysing how simplified tax system works in Armenia. Thus, the overwhelming majority (81 out of 91) of simplified taxpayers pay 6000 AMD per month as social payment for each employee<sup>22</sup>. One of the amusing results is the fact that half of simplified taxpayers (45 from 91) employ an accountant. Another interesting point is that more than half (52 from 91) of respondents get accurate receipts from their suppliers<sup>23</sup>. Only 69 (out of 91) businesses use cash registers. The usage of cash registers is essential for simplified tax regime, as it is the only way of calculating the incomes of enterprises. Few companies (13 from 91) have multiple branches. Majority (55 out of 91) have been established as simplified taxpayers, e.g. they are under this tax regime since their foundation. Only a few respondents agree for the possibility of abolishing the simplified tax system (5 from 91). Table 9 presents the key characteristics of simplified taxpayers and all respondents in percentages. As we can see, the differences are not that remarkable. Simplified taxpayers use cash registers more frequently. This is logical, as cash registers are the main means for measuring their income. Other noticeable difference is that much more companies were established as simplified taxpayers since their foundation. This is again logical, as the new-created small enterprises shift to this regime from the commencing of their activities. And surely more non-simplified-taxpayers agree with the notion of the possible abolishment of simplified tax system.

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<sup>21</sup> Figure 2 in the Appendix B presents the opinions of taxpayers about simplified tax by the numbers of respondents.

<sup>22</sup> It is known that by law simplified taxpayers are allowed to pay presumptive 6000AMD as social payment for each of their employee. Therefore, Armenian taxpayers fully use this option.

<sup>23</sup> It is noteworthy, that 15 respondents have refused to answer this question.

**Table 9: Key Characteristics of Simplified Taxpayers and All Respondents in Percents**

	Simplified Taxpayers [%]			All Respondents [%]		
	Yes	No	No Answer	Yes	No	No Answer
Pay AMD 6000 as social payment for each employee	89	11	0	85	15	0
Have accountant	49	51	0	50	50	0
Get accurate receipts from suppliers	57	16	26	52	14	33
Use cash registers	76	24	0	66	34	0
Have multiple branches	14	86	0	18	81	2
Were established as simplified taxpayers	60	40	0	45	55	0
Would like the simplified tax to be abolished	5	63	32	10	50	39

Almost all of the businesses (118) have not been simplified tax payers in the past. During the survey, there were also quite interesting comments regarding the problems of simplified tax regime. Most of the respondents have named frequent inspections and corruption as the main problems with simplified tax regime. Among other comments were the remarks about bureaucratic complexities, unnecessary documentation, not clear mechanisms etc.

## Analysis

After having presented the findings of our data, I will try to analyse them. In particular, I will discuss what those numbers mean for Armenian simplified tax system, to interpret them based on numbers as well as our quite valuable observations during the interviewing period of the study.

The interesting point is that the average number of employees for simplified taxpayers is 3.1, and for regular ones: 4.1. Factually, the difference between enterprises functioning in

different regimes is not that significant<sup>24</sup>. Moreover, during interviews many respondents admitted the fact of serious under reporting of the number of their employees. Consequently, these official numbers are even less than the real ones. There is point in noting, that the main target of simplified tax regime were sole proprietors, businesses that cannot afford several employees and thus need help. In reality, the picture is slightly different. In a word, from the point of view of employee numbers the difference is very insignificant. This means, that either there is very serious underreporting of the real employee numbers by Armenian enterprises, or one of the logics behind simplified tax regime (e.g. to assist enterprises with very few employees) does not justify itself properly.

Another closely related theme is that of average wages. First, for nearly 80% of companies the average reported salary does not exceed 30,000 AMD per month for each employee. Second, average wages for businesses acting in regular and simplified regimes differ very slightly<sup>25</sup>. Moreover, the standard deviation of simplified tax regime for this indicator is so great (more than 10,000 AMD) that practically no serious difference exist between various regimes at all<sup>26</sup>. This indicator again purports about the lack of any serious difference between small enterprises functioning in different tax regimes: especially in terms of wages. It also worth stressing the fact, that the minimum salary is approximately 14,000 AMD in Armenia, and that, for instance, the minimum rate for a public servant is 20,000 AMD<sup>27</sup>. In comparison with these numbers, the vividly low salaries of small business sector seem rather unlikely. In sum, there is serious underreporting of real wages in Armenian enterprises. The likelihood, that one of the purposes of such behaviour is to decrease the overall circulation of an enterprise for remaining eligible for simplified tax, is very high and

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<sup>24</sup> Especially taking into notice the fact, that in our survey the majority of non-simplified taxpayers were in presumptive tax regime.

<sup>25</sup> The difference is only 2000 AMD. For all taxpayers the average wage per month was a little more than 28,000 AMD.

<sup>26</sup> During interviews, most of the respondents have confessed that they seriously under-present the real number of wages for avoiding additional social and tax payments.

<sup>27</sup> From the January 2006, this rate will reach up to 30,000 AMD per month.

plausible. The difference of salaries, and consequently the overall economic situation of small businesses operating in various regimes are unimportant.

An amazing result is the fact, that tax inspectors have visited all enterprises during last twelve months. Overwhelming majority of respondents has noted that as a rule, their companies are inspected once in a month. Comparing the purposes of visits for simplified and non-simplified taxpayers does not yield any tangible results, as the purposes are almost the same. Thus, the main aim of such visits is inspections/audits. Among other purposes are the checking of cash registers and tax collection. An intriguing fact is that the purpose has been tax collection only in the 16% of cases. The tax administration policy of every country tries to minimize the expenditures associated with frequent inspections by encouraging self-reporting initiatives and procedures of taxpayers. In Armenia, this logic is totally absent. Moreover, one of the main purposes of simplified tax was the simplification of tax paying documentation and procedures and the promotion of small business self-administration. Our data vividly demonstrates the opposite activities. Simplified tax provides a miserable amount of income for state budget<sup>28</sup>, and from the point of view of tax administration, huge expenses associated with abnormally frequent visits if tax inspectors are senseless. Therefore, the only reasonable explanation for such a practice is corruption or extra-legal requirements<sup>29</sup>. Summing it up, instead of simplifying the job of simplified taxpayers, state tax service more complicates it by unnecessary inspections and audits. The state spends considerable means for collecting or auditing enterprises that provide only a minuscule part of the state income. Thus, as Table 11 indicates, simplified tax regime is heavily biased against compliance checking, rather than revenue collection. One of the underlying logics of simplified tax

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<sup>28</sup> The incomes received from this regime constitute nearly 2% of the total tax income of the country (Appendix 1, Table 11).

<sup>29</sup> Corruption and extra-legal requirements were the most serious problems for Armenian simplified taxpayers. Moreover, in the private conversations most of the respondents stress the fact, that the aims of such numerous visits are indeed money extortions and extra legal requirements.

regime, the simplification of documentation and assistance of small enterprises, is grossly violated<sup>30</sup>.

Closely related to above-mentioned problem is the question of bribe offers. Only eight respondents have admitted the fact that they have been offered to pay bribe by a tax inspector during last year<sup>31</sup>. This data obviously contradicts other findings of the study, such as the comments, the opinions about various aspects of the simplified tax regime<sup>32</sup>, as well as our observations and the private confessions of respondents. Such situation may further indicate about the existence of illegal practices in the sphere<sup>33</sup>. In addition, there is quite widespread avoidance of articulation of any such kind of issues for “reporting” purposes.

Several important aspects of simplified tax regime: the tax rate, tax accounting, tax forms/filing, payment methods, frequency of reporting frequency of payments, inspections, audits frequency of changes in rules and rates, extra-legal requirements for advance payment of taxes and other problems, have been analysed based on the opinions of respondents. As one can notice, most of the questions concern the characteristics or essence of simplified tax regime itself. Yet other questions are about general tax administration or practices. The most intriguing fact is that more than 70% of the enterprises consider the extra-legal prepayment demands as moderate or major problem for themselves. Almost the same number regards inspections and audits as major problem. This finding is corresponding with the findings of other researches about the inspections and illegal practices being the major problems for Armenian tax administration.

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<sup>30</sup> The general picture of the situation will become more comprehensive if we add the fact, that the inspectors of SFSI visit the overwhelming majority of enterprises by the same regularity.

<sup>31</sup> It was already mentioned that most of them admit the fact of bribe-offer in private conversations, but categorically refuse to have that information registered in the questionnaires.

<sup>32</sup> The vast majority of respondents name corruption and extra-legal requirements as a serious problem for them.

<sup>33</sup> One of the respondents explained us that only businesses without powerful “roof” or supporting official will be asked to pay bribe; and that tax inspectors will hardly dare to make such an offer to enterprises, which have direct or indirect relations with high officials and other powerful persons in the country.

However, it is noteworthy that the procedures or rules of simplified tax itself generally are not much problematic for Armenian simplified taxpayers. Payments methods, frequency of reporting, accounting, in a word all technical and documentation part of simplified tax, is not a serious problem for enterprises. Usually they are quite satisfied with the simplified tax regime, its rules, regulations and even tax rates. An apparent contradiction at this case is that small businesses are delighted with simplified tax, what make it greatly problematic are illegal practices of tax inspectors and general tax administration in the country<sup>34</sup>. In sum, small business in the country normally accepts and is satisfied with the simplified tax system. The major problems in this area are not the regulations, rules or procedures of the system itself, but the numerous inspections, extra-legal demands and corruptive practices and character of tax agency and tax administration methods.

The analysis of the key characteristics of Armenian simplified taxpayers reveals some astonishing facts. First of all, it must be noted; that the general purpose of introducing simplified tax was the assistance of small companies in the following sense. As most micro businesses are difficult to afford an accountant, and thus to carry out quite complex accounting and reporting procedures, simplified tax is to release them from that necessity. Moreover, because of the above-mentioned circumstances they do not need to get accurate receipts from their suppliers, as well as they are allowed to pay just 6000AMD per month as social payment for each employee. Nevertheless, our data shows a different picture.

Nearly 90% of simplified taxpayers use the opportunity of paying fixed social payment, which undoubtedly negatively affects the social insurance situation of their employees<sup>35</sup>. At this sense, simplified tax does not contribute to the development of social security system in Armenia.

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<sup>34</sup> It was already mentioned that many businesspersons consider corruption, senseless complications, and extortions as major problems. Some of them complained that simplified tax is “not simplified at all”, and that it should have more precise procedures or rules.

<sup>35</sup> If not a simplified taxpayer, they would have to pay social payments in accordance with the salary size of an employee which would often exceed 6000 AMD.

A stunning point is that the half of the simplified taxpayers employs an accountant<sup>36</sup>. It is possible to extrapolate that taxpayers hide the fact of existence of an accountant to avoid paying payments for an extra employee and to be more appropriate for simplified tax. In addition, one of the basic logics of simplified tax regime does not function properly, as simplified taxpayers often use the services of accountants and at this sense do not differ that much from regular taxpayers. Therefore, either the accounting or reporting procedures of simplified tax are seriously complicated and difficult to conduct for a single businessperson, or the issue is not that pertinent for general characteristics, capacities or atmosphere of Armenian small business. Alternatively, there may be many relatively affluent companies in the sphere of simplified tax, for which the employing of an accountant cannot be a problem per se. At both cases, the argument of an accountant for introducing simplified tax regime is not appropriate.

Closely related to the above-mentioned issue is the question of getting appropriate receipts for suppliers. Here again it must be noticed, that simplified tax aimed at freeing micro and small enterprises from the need to conduct complicated reporting procedures of receipts. The data of our study shows utterly different picture. Only 16% do not get accurate receipts, the majority gets them or do not answer (26%). An amazing fact is that simplified taxpayers receive accurate receipts more than the whole respondents do. Rather high percentage of respondents, who have not answered the question, can be explained by their unwillingness to be looked like regular taxpayers. In fact, there is no serious difference between regular and simplified taxpayers in regards to getting receipts. As at the case of accountant, here again we do not discover any tangible difference between businesses operating in separate regimes. Because simplified taxpayers seem so alike others, the question of receipts for justifying simplified tax is also inappropriate.

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<sup>36</sup> Moreover, many respondents admit they have a person carrying out the responsibilities of an accountant, or have a part-time accountant; and these “latent” accountants are not reported in official documents of an enterprise.

A serious problem is the use of cash registers. Although the majority of simplified taxpayers use them, almost quarter of respondents do not operate them<sup>37</sup>. Cash registers are indispensable means for measuring the overall income circulation of businesses; and it is not clear how tax inspectors can calculate the income without them. Possible corruptive relations of taxpayers and tax inspectors can explain the situation. There may be serious misunderstanding of respondents about the business conducting mechanisms, which is not very palpable. In addition, there are some spheres where the use of cash register is not mandatory. Nonetheless, it is evident that serious flows for the operation of simplified tax exist.

Another interesting issue is that only 14% of respondents own multiple branches for their companies. The problem is rather sensitive, as it is argued that some prosperous, middle-size enterprises split their businesses into several parts for being able to pay simplified tax for their overall business. In addition, companies having multiple branches will hardly match the picture of hardly surviving micro-enterprise. Nevertheless, the number of such companies is relatively small for allowing us to make any such conclusions with firm confidence.

It should be noted that the majority of companies (60%) have been established as simplified taxpayers<sup>38</sup>. This fact may further evidence about the strong attractiveness of simplified tax regime for Armenian small business<sup>39</sup>. Most of new established enterprises begin their activities directly in the simplified tax system. It is possible to conclude, that probably simplified tax serves as an additional incentive for businesspersons to start new

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<sup>37</sup> There is considerable difference for this number between all respondents and simplified taxpayers. The later use them more then the former, which is quite a normal situation.

<sup>38</sup> For all respondents this number is 40%.

<sup>39</sup> It was interesting that none of our respondents had been simplified taxpayer in the past. Thus, we do not have any case when a company has shifted from the simplified tax regime to regular one by its will. The fact further confirms the attractiveness of this regime for Armenian small enterprises.

small-scale businesses. At this sense, simplified tax is really useful for triggering Armenian small enterprise system.

At last, the issue of possible abolishing of simplified tax is rather actual for today's Armenia. However, only 5 % of simplified taxpayers and 10% of all taxpayers agree with this scenario. The interesting point is that non-taxpayers do not favour simplified tax regime much. This question, in its turn, directly confirms the conclusion that simplified taxpayers are enough satisfied with this tax regime and would hardly agree with its abolishment.

## **Conclusions and Recommendations**

The simplified tax has been introduced in 2000. The tax was very attractive for Armenian businesses. Since its introduction in 2000, the number of simplified taxpayers had raised ten times by the end of the 2004<sup>40</sup>. Nevertheless, the average contribution of a single taxpayer to state budget has been steadily decreasing. For 2001, that number was 38,900 AMD, for 2003: 26400AMD per month, and for 2003-2004: only 19000 AMD. (Alaverdyan A. and Mesropyan A., 2005, 14). Thus, it is evident that the issue of simplified tax is quite controversial and actual for Armenia.

Several studies have assessed the overall situation of tax regimes, small & medium enterprises and tax administration in Armenia. However, there was no specific research, which would evaluate the operation of simplified tax system in Armenia per se. Therefore, the general purpose of our study was to assess how simplified tax system works in Armenia, what its main problems, shortcomings, strengths or flaws are. For that aim, we have tried to acquire an original database through a survey of micro and small businesses operating

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<sup>40</sup> In 2004, the number of simplified taxpayers was nearly 20,000, while VAT payers were nearly 27,000.

currently in Yerevan. Thus, our conclusions are based on the findings derived from our original database.

An important aspect must be mentioned. The cooperation of Armenian small enterprises is extremely low; the refusal rate was above 75%. We witnessed widespread avoidance from answering questions properly. Usually, businesspersons present their official data, and only in private conversations admit the fact of serious underreporting or skewing of real numbers. Thus, huge amount of clandestine, unregistered business activity exist in Armenian small and medium sector business. We are able to conclude that “business culture”, which is an important precondition for a successful tax administration, is still at quite a low level in Armenia’s business reality.

The survey helped us to answer our research questions, as well as to draw very relevant conclusions about simplified tax system in Armenia. Accordingly, the general conclusions are the following.

- Actually, the simplified taxpayers do not differ much from regular ones in the sense of their number of employees and average wages. Considerable evidence suggests, that there is serious underreporting of these numbers for possibly two reasons: to pay less social and tax payments and to stay eligible for simplified tax by reducing the size of overall circulation. From this point of view simplified tax does not justify its initial purposes, as micro and small businesses operating in different tax regimes does not differ tangibly.

- Tax service representatives visit and inspect all small enterprises at least several times a year. State spends considerable amount of finances and efforts for the inspection of sector, which provides very small part of state revenues. Considerable evidence suggests about the corruptive purposes of such activities. Because of these regular, numerous inspections simplified tax regime and tax administration generally

are deprived from their main logic: to encourage the self-reporting and voluntary contributions of taxpayers and to ease the job of simplified taxpayers, who cannot afford enough time, means and efforts for frequent and complex reporting procedures. Thus, simplified tax regime is heavily biased against compliance checking, rather than revenue collection (as shown in Appendix 1, Table 11).

- In their comments and private conversations, Armenian taxpayers admit the fact of serious level of corruption in the sphere; however, the vast majority of them categorically refuse to admit the fact of being offered to pay bribe.

- Procedures or rules of simplified tax itself are not much problematic for Armenian simplified taxpayers. Payments methods, frequency of reporting, accounting, in a word no technical and documentation part of simplified tax system is a serious problem for enterprises. They are quite satisfied with the simplified tax regime, its rules, regulations and even tax rates. As a contrast, the major problems for them are extra-legal prepayment demands; inspections & audits; corruptive practices. Thus, simplified taxpayers are satisfied with simplified tax system per se, and are very discontented with the administration of that system by State Tax Agency.

- It was assumed that simplified tax would assist those enterprises that cannot afford to hire an accountant and to conduct rather complicated accounting procedures of receipts form suppliers. Nonetheless, most of simplified taxpayers employ an accountant and get accurate receipts from their suppliers. At this case also they do not differ much from regular taxpayers. From this point of view, this system again does not meet its initial purposes.

- Simplified taxpayers actively use the opportunities of law. The overwhelming majority of them pay fixed 6000AMD as social payment of each of their employee.

Many of them do not have cash registers (without which it is extremely difficult to calculate their overall circulation). Some of them own multiple branches (a micro business would hardly be able to have branches). Above-mentioned clearly illustrates the flaws of the system, which allows small enterprises to circumvent as it is beneficial for them.

- Simplified tax system is very attractive for Armenian small businesses. For instance, the majority of simplified taxpayers have been in the regime since their foundation. Moreover, only a very tiny part of simplified taxpayers agrees to abolish the system.

Summing it up, we can contend the following. Simplified tax system in Armenia is favorable for small businesses; they are satisfied with its regulations, but unhappy with its administration. The system is useful for the country; it somehow promotes the small entrepreneurship in Armenia; nevertheless, it has serious flaws that may reduce its revenues and be a factor for rising corruptive practices. For tax agency and administration, it is beneficial, as it makes easier the procedures; but it is also detrimental, as it allows enterprises to seriously circumvent and avoid of paying some revenues, as well as somehow “encourages” tax inspectors to aggravate their corruptive practices.

After having analyzed the situation, we are able to make some appropriate recommendations or policy options.

- It should be noted, that for the long-term perspectives simplified tax must be used only for quite restricted number of small businesses. In addition, presumptive tax should be abolished ultimately.

- Simplified tax will be appropriate for retailing sector. Cash registers will serve as a means for measuring the overall circulation of an enterprise. For other small businesses (such as shoemakers, small recording services etc.) the system can be

successfully replaced by presumptive tax, especially when many kinds of activities just do not use cash registers at all. Thus, Armenia needs a new law on cash registers, which could regulate all those kinds of problems.

- When submitting the requested information (tax reports, letters, etc.), it is recommended to exclude the possibility of personal contacts between the representatives of economic entities and tax authorities, i.e. the information should be mailed or e-mailed.

- It is recommended to stop the practice of advance payment clearance to reduce the entities' costs incurred due to advance payments collected on some taxes; all advanced payments should be refunded in monetary terms (within a certain period of time) .

- The changes in the tax control system, particularly the onsite regime for tax control, the application of the random selection mechanism for selection of companies to be subjected to inspection, as well as possible changes in the tax information system, shall lead to structural reorganization of the tax system.

- It is necessary to ensure that law-abiding companies only have to pay their true tax liabilities and are not subjected to pre-set tax targets and/or harassment from the tax authorities; 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.

- It is also necessary to increase fines for companies involved in illegal practices and the consistent enforcement of penalties for tax officials that instigate illegal activities. In addition, the Tax Agency should publish a quarterly report of the most common errors that taxpayers make including guidance on how to avoid such mistakes as well as statistics on the numbers of fines, audits, bases and amounts collected each quarter through these activities.

- It is recommended to specify and maximally simplify the hearing procedures for tax-related disputes. In this context, the specialization of judges on tax issues is considered very important. This would increase the entities' incentive to defend their interests in the court and “do not follow the rules of the game” set by tax officers.

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## Appendix A: Table 10: Indicators of Tax Administration efficiency in Armenia

Indicators	2002	2003	Percentage growth as to the previous year
GDP (mln AMD) <sup>41</sup>	1,362,471.7	1,624,642.7	19.2
Number of employees (people)	1,779	1,774	-0.3
Total costs of tax authority (thousand AMD) <sup>42</sup>	1 773 835	3,816,636	115.2
including salaries (thousand AMD)	961 905	2,396,090	149.1
Average costs per employee/salary (thousand AMD)	541	1,351	149.8
Overall average costs per employee (thousand AMD)	997	2,151	115,8
Amount of collected taxes (bln AMD)	105,8	117,7	11.2
Administrative costs/ tax revenues (cost of collection ratio, %)	1.7	3.24	93.4
% change in tax revenues/% change in administrative costs	-	0,10	-
Tax buoyancy (% change in tax revenues/% change in GDP)	-	0.58	-
Net tax revenues (thousand AMD)	104,026,166	113,883,364	9.5
Tax revenues per employee (thousand AMD)	59,472	66,347	11.6

Source: AEPLAC “Final Report of Tax Administration”.

<sup>41</sup> We consider here the value of nominal GDP to ensure the compatibility with the amount of tax collections.

<sup>42</sup> Expenditures directed to the tax system include both budgetary and off-budget financing.

**Table 11: 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				

**Appendix B: Figure 2: Opinion of Taxpayers about the Simplified Tax by Numbers**

