

AMERICAN UNIVERSITY OF ARMENIA

**TAX EVASION IN ARMENIA:
MEASURES TO STRENGTHEN TAX COMPLIANCE**

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List of Abbreviations

AEPLAC-Armenian European Policy and Legal Advice Centre

CIS – Commonwealth of Independent States

EU – European Union

GDP – Gross Domestic Product

GoA – Government of Armenia

IMF – International Monetary Fund

LTI- Large Taxpayer Inspectorate

MoF- Ministry of Finance

MSR- Ministry of State Revenues

SME – Small and Medium Enterprises

STI-State Tax Inspectorate of the Republic of Armenia

STS - Government of Armenia affiliated State Tax Service

RoA – Republic of Armenia

RTI – Regional Tax Inspectorate

TAG- Taxpayer-as-gambler

VAT – Value Added Tax

WB – World Bank

Abstract

Flaws and drawbacks in tax administration are among the major challenges that hinder the robust development of Armenian economy and efficient functioning of public administration system. It is a problem that cannot be underestimated or ignored, as it is directly related to the tax payments which are the major source of government funds. Due to indigenous problems related to the wretched culture of tax compliance, inefficient tax administration and visible loopholes in tax legislation, a huge portion of economic activities successfully remains hidden and fosters the expansion of shadow economy. Tax evasion therefore is a major issue pending society's attention and urgent resolution.

The overcoming of these challenges requires complex approach and a program of actions. The list of activities includes establishment of strict rules and capacity to monitor and enforce the compliance. There is a need to support the preparation and the implementation of demand-oriented strategies which will definitely be the prerequisite of effective policy.

Another critical point is that the perception by the taxpayers is somewhat negative and all kinds of initiatives and reforms by the state authorities are often viewed as an attempt to harm the linear businessman rather than to support and facilitate the state-taxpayer interactions.

In this context, the policy internship project elucidates the important aspects of tax evasion, identifies the economic, social, psychological factors that has its say in the attitudes of taxpayers to tax compliance, evaluates the level of tax evasion in Armenia, analyzes possible factors that impede to overcome evasion and gives recommendations how to reduce this phenomenon, facilitate the procedure of tax payment, and motivate economic entities pay taxes voluntarily or enforce them by law.

Introduction

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

Jean-Baptiste Colbert

Tax administration in any country mirrors the nature of the country itself. It is the reflection of the values of those in power and is a central instrument by which governments attempt to achieve a more socially acceptable distribution of income than that which results solely from market forces (Brooks, 2001). The theory of four “R” more precisely illustrates the taxes as being one of the most weighty and powerful leverages of the government as being a major source of governmental funds taxes generate Revenues; secondly taxation assumes Redistribution by relocating wealth, and ensuring the allocation of resources based on economic, social, political objectives; then it has also Repricing function, as they are levied to address externalities; finally the last consequential effect is the Representation as the citizens demand accountability from the administration they pay.

Hence, taxation is one of the pivotal pillars in every country’s socio-economic life and the precise implementation of tax administration is striving towards the establishment of robust, stable and healthy economy. Without an efficient tax system an effective market economy is not conceivable as the successful functioning of the economy depends on the level of accuracy and precision of the tax system.

For the newly emerging democracies the transition to the market economy requires difficult set of economic reforms. Though there is not any widespread consensus on either the precise direction and content of these reforms or the speed and sequence with which they must be introduced, but there is a growing recognition of the necessity of stabilization of tax administration, which would be defended by law, and establishment of efficient system that will ensure the lawful and unbiased relations with taxpayers.

Over the past transition period Armenian economy has undergone a systemic transformation, and new systems of economic, social and political relationships have emerged in our society. Along with the establishment of new public and private institutions and development of markets Armenia faced major challenges with weak tax administration and large shadow economy, which impedes economic development of the country and violates the rules of social equity. Despite the fact that Armenian economy has performed strongly by most macroeconomic criteria particularly since 2000 (Davoodi, Grigorian 2007) politicians and economists acknowledge existence of large-scale hidden economic activities left outside the official statistics.

Among the forms of hidden activities are illegal and even criminal activities (smuggling, drug trade, human and drug trafficking, racket, money laundering etc.) but also generally legal economic activities, which however are not properly registered or profits or scope of transactions are not reported/underreported. Finally there is a whole group of economic activities carried out by households, which are legislatively just not considered as revenue generating, although economically they are (among examples are moms sitting with their children, or wife cooking a dinner, or husband repairing his house, since in all these activities have market value). While in the first group of activities the state intervention should be to suspend the activity and re-state public order, in the second group the government's role is to reveal the hidden activity and collect due taxes. The third group of activities is usually not taxed due to complexity of registration and accounting. It is the second group of activities which will be in the focus of this paper, namely the tax evasion. The above mentioned leads to the tax gap between estimated amount of tax revenues and their actual collection and further foster the enlargement of shadow economy in the country.

Thus, a general purpose of this study is to examine the triggering forces of tax evasion, to find out the reasons of vicious cycle of non-compliance, to question the relevance

of the ethical and sociological motivations, as well as the level of detection and sanctions. The emphasis is placed on the institutional aspect of tax compliance and possible remedies that can be suggested for reducing incompliance and tax gap.

The study should learn the impact of the tax evasion on Armenian economy, delineate the variety of factors affecting noncompliance and seek the possible strategies to reduce the tax gap, to search for methods to develop the tendency to comply rather to conceal the tax and come up with certain policy recommendations in order to bring economic entities under state control. This includes the investigation and comparison of the Armenian Tax Service with other states' tax services and finding out the level of correspondence with the European standards.

Literature Review

Taxation is the amalgamation of two processes: the tax administration and collection by the state and tax compliance by the taxpayer. The aspired target of proper tax collection could be achieved only by proper performance of both taxpayer and state itself (Jrbashyan, Harutyunyan 2007).

Tax compliance implies different types of taxpayers' behaviour stipulated by economic, sociological, psychological motivations, as well as direct interaction between the state and taxpayers. This is the reason that the economic literature on tax compliance entails a variety of factors influencing the taxpayers' behaviour as well as the performance of tax officials and no aspect of tax compliance has escaped at least preliminary scrutiny.

According to Bird (1992, 99) the "three E's" of the tax administration are to "enumerate, estimate and enforce" implying that identifying taxpayer, assessing the tax levied on them, and ensuring the proper collection is the main principles of tax administration. The author further identifies three direct inputs determining tax compliance.

First, the environment such as external actors, forces and circumstances has the influence on the revenue administration and the need “to look outside the box” is one of the prerequisites for successful tax administration. Resources constitute the second main input for the tax compliance. These include tangible resources implying the annual budgetary allocations, IT systems, record storage facilities, while intangible resources supposed to be the perception of taxpayers and public about the fairness, transparency, integrity and enforcement capacity of the tax administration and honesty, morale and commitment of the tax authorities. And the last laudable factor is the history of the revenue administration. The author claims that at least the recent history of the tax system is essential (Bird 1992).

Brown and Mazur (2003) state that tax compliance consists of three separate elements: payment compliance, filing compliance and reporting compliance which are viewed as “three mutually exclusive and exhaustive measures.”(Jrbashyan et al. 194) The underestimation and underperformance of one of these duties leads to the distortion of tax system and generates tax evasion and tax fraud.

Cowell (1990) has referred tax evasion as a fraud that is committed against a very special economic agent: the government. The government is special in that it has, presumably, the power to set and to enforce some of the "rules of the game" by which economic relationships are supposed to abide. It sets the structure and the level of taxes. It also has ultimate control over the mechanism used to enforce the payment of taxes and over the structure of penalties for offenders. It combines the roles of rulemaker, victim, and umpire. Cowell describes tax evasion as a particular "economic crime that involves a breach of the laws designed to ensure that people act in the economic interests of the community and not just in their own economic interests" (1990, 6).

According to Slemrod (2000, 153) “evasion generates horizontal inequity” as people with equal abilities-to-pay end up paying different amounts of tax.

Taxpayer's stance is influenced by many factors, including disposition towards public institutions, the perceived fairness of the taxes, prevailing social norms, relevance of the ethical and sociological motivations, as well as the level of detection and sanctions (Franzoni 1998). However unlike other activities, the issue of tax evasion is inseparably bound up with the instrument of the fiscal control that the government attempts to use in carrying out its economic policy (Cowell 1990).

In most of the literature parallel to the presentation of the drawbacks and negative effects of tax evasion there is an aspiration to find the solutions for precluding the non-compliance and suggest methods which can instill the voluntary compliance to the tax laws and regulations. Here the major blame is on the state, the weak tax policy and inadequate methods in carrying out fiscal control.

Guy (1991) argues that making tax policy is not just passing laws concerning taxes. The laws must be put into motion and produce revenue. The level of administrative capacity in the tax administration should be a key factor when designing a tax system.

“Administrative aspect should be placed at the centre rather than the periphery of the tax reform efforts” (Bird 1992, 189). So, besides concentrating on “what to do” the state should contemplate on “how to do” and this is the very epitome of the successful tax system. 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” (Bird, 1992, 140).

Hence, the diverse literature speaks about the problem being one of the most essential issues for economy and the first segment of the chain reaction called economy and the straightforward approach towards the solution and reduction of the tax gap can become the most important remedy for the country's economy.

In most of the literature tax evasion and avoidance obviously have very strong similarities (Franzoni 1998) and the two terms have been coined as “avoision” in the cases, when the law is unclear (James et al. 2003).

Tax avoidance is the legal utilization of the tax regime to one's own advantage, in order to reduce the amount of tax that is payable by means that are within the law.

Whereas, **tax evasion** is the general term for efforts by individuals, companies and other entities to evade taxes by illegal means. Tax evasion usually entails taxpayers deliberately misrepresenting or concealing the true state of their affairs to the tax authorities to reduce their tax liability, and includes, in particular, dishonest tax reporting (such as declaring less income, maintaining double accounting and showing profits or gains less than actually earned; or overstating deductions).

Oliver Wendell Holmes wrote: "When the law draws a line, a case is on one side of it or the other, and if on the safe side is none the worse legally that a party has availed himself to the full of what the law permits. When an act is condemned as evasion, what is meant is that it is on the wrong side of the line..." (Bullen v. Wisconsin (1916), 240. U.S. 625 at p. 630). Thus, the distinguishing characteristic of evasion is illegality (Slemrod et al. 2000, 7). If the term "tax avoidance" describes lawful conduct, the purpose of which is to *avoid the creation of a tax liability* in the first place, an evaded tax remains a tax legally owed, an avoided tax is a tax liability that has never existed.

Evasion problem originates since the tax base is often not “observable”. Thus, an external observer cannot distinguish the actual magnitude of an individual’s tax base, and hence, is not able to know the tax liability. The inspection of each and every taxpayer and audit is too costly, and tax authority usually cannot afford it. This fact leads to the imperfect information and existing loopholes which are used by taxpayers to avoid full reporting of their income. It distorts the effective performance of the economy and impedes the aspiration

of the government towards the just distribution of economic resources. The presence of tax evasion reduces tax collection, creates misallocation in resource use, requires additional government resources, contributes to feeling of unfair treatment and disrespect for the law (Alm 1998).

The difference between the tax liability in any year and the amount of tax that is paid voluntarily and on time is called **the gross tax gap**.

The net tax gap is the gross tax gap less payments of that year's tax liability that come in later through either voluntary late payments or state enforcement activities.

The existence and further expansion of the tax gap highly contributes to the development of underground economy and leads to the corruption. 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. Thus, it becomes like a spiral of corruption generating even more corruption and the exit from Pandora's Box is unobservable. The organic continuation of the latter is the expansion of the underreporting and non-reporting which directly leads to the emergence of **shadow economy**. A simple definition of shadow economy is the part of the gross national product that, because of non-reporting and/or underreporting is not included in the official statistics.

According to Tunyan (2003) the first years of transition the shadow economy still had also some positive effects. In the first years after gaining independence Armenia has experienced sizable economic and social tribulations that were caused by various internal and external factors (economic blockade by neighboring countries, energy shortage, war and others) that resulted in the steep increase of poverty in the country. Many shadow activities, like small production workshops, unregistered street trade and other similar activities were widely practiced. While completely out of any official statistics, these activities provided

employment and income to thousands of families. The earnings from the shadow economy have been the only source of income for the significant part of our society. It is a measure of the flexibility of the market economy to respond to unreasonable regulation. Under these circumstances during the early 1990s the government adopted relatively “tolerant” policies and “closed eyes” on many shadow activities (Tunyan 2003).

However, with economic stabilization and development negative aspects of the shadow economy outweighed this positive social role. Besides the most obvious revenue losses and budget deficit, the shadow economy results in the failure of socially acceptable distribution of income. In this case economy finds itself in a vicious cycle as it should raise the taxes in order to reduce budget deficits, while this might cause an increase in the underground economy which in turn might require taxes to be raised even more. Moreover, those who participate in the underground economy continue to use public services, even though the tax losses they generate through their practices result in the increase in the tax burden of the majority of taxpayers who honestly pay their taxes. One of the most detrimental impacts of the tax evasion is that the phenomenon beget to the diminution of overall public revenues and automatically reduce the ability of the state to deliver public services such as national security, education, welfare, health etc. Moreover shadow economy diminish the productivity of the economy and overall efficiency of the system, as certain activities can be preferred since it can conceal some unreported activities. The economic entities trying to reduce the risks of being caught have to alter the production and sales methods.

At the macroeconomic level, the shadow economy biases the information flowing to policy makers, which can lead to the distorted policy decisions, and incorrect forecasts about the assessment of the possibilities of future revenue sources (Brooks 2001). Furthermore the underground economy jeopardizes the equilibrium and social consensus on which the most basic legal and political institutions of a democratic society are based. Taxation itself is about

the self-assessment and voluntary compliance since the taxpayer should provide the sufficient information about his/her income based on which the tax liability can be estimated. Unreported activities endanger the integrity of a taxation system based on self-assessment and lead to the erosion of community moral standards in general (Brooks 2001).

The Causes of Tax Evasion

In order to evaluate the way in which noncompliance affects the actual tax payment of individuals, the motivation, behavior and attitude of the taxpayer should be examined and studied. First of all compliance assumes the following:

- the true reporting of the tax base,
- correct subtraction of the tax liability
- timely filing of the return and
- timely payment of the amounts due (Franzoni 1998).

Though tax evasion can occur at all of the steps above, however, the bulk of the action involves only the first stage. Thus, the underreporting and nonreporting is the essential techniques using which taxpayers try to evade.

In this respect Allingham and Sandmo (1972) developed a 'portfolio' model of taxpayers' evasion revealing that the probability of tax evasion is positively related to the low audit rates and penalty. Furthermore, in the case of net return on evasion be positive, the only reason that taxpayers does not evade is the fear of uncertainty. Higher gross income will increase evasion if one believes that people become more willing to engage in risky activities as they get richer (Sandmo 2004). The taxpayer-as-gambler (TAG) model (Aaron 2003) which is otherwise called is perhaps the benchmark economic approach of modelling tax non-compliance.

At the heart of the analysis is a simple and familiar lottery: Is it worth the taxpayer's taking a chance on being caught and suffering a financial penalty? The basic principle of

economic theory of tax compliance assumes that “people would commit evasion when the expected utility of their criminal act exceeds its expected disutility” (Appendix A). Acting rationally, the taxpayer determines the benefit of non-compliance and the probability of being caught and sanctioned. Thus, tax compliance is positively related to factors such as ability to pay, the (perceived) probability of being prosecuted and the number of tax evaders known personally by the respondent. Oppressive tax enforcement, harassment of taxpayers and discontent with public service delivery seem to increase tax resistance and may explain the widespread tax evasion observed.

In the light of economic approach it is important to stress the implication of the transaction costs as a one of the major determinants of the performance of tax system. Being inevitable results of the interrelations between the state and the economic entities transaction costs are the costs related to tax administration. From the perspective of the tax authorities, transaction costs are those incurred by the tax official i.e. costs of the dissemination of the information, aiming to raise the awareness within public, cost of measurement, predetermined for the further processing of the documents, costs of protecting property rights, such as salaries paid to the tax officers and costs of opportunistic behaviour which implies the sum of unpaid taxes due to tax evasion (AEPLAC 2005).

Transaction costs for economic entities imply the costs of acquisition of information about the necessary documents, the costs of negotiation which are financial resources and time needed to establish “good” relations with representatives of the tax authority, costs of protection of property rights being expenses needed for hiring professional staff members during tax inspection process, and finally the costs of opportunistic behavior (AEPLAC 2005).

It is notable that apart from economic theory of tax compliance there are psychological and sociological theories which elucidate behavioural motivation of people in

respect with tax evasion. In the Challenges of Tax Administration and Compliance report basic theories are suggested aiming to give some economic, psychological and social implication to the phenomenon called “tax evasion”.

Economic model is criticized as being too one-dimensional by psychologists, and in the theory they advocate, the emphasis is put on the moral acceptability of tax evasion of the taxpayers, the attitudes and perceptions of the values. Exploring the factors that might have an affect on movement of taxpayers, psychologists point out that habit of compliance/non-compliance can turn to an inertial action rather than active decision-making. In addition, decision-making is viewed as a process, containing discrete actions whose only cumulative result is the decision of comply or not. The attitude towards the state and revenue authorities is also shaped by the perception of equity in determining compliance decisions (Brooks 2001, 19).

The “social factors” as the basis of taxpayers’ decision is viewed as the significant aspect of individual behaviour. Here the emphasis is on the “stigma” effect assuming that tax evasion has strong spill-over effects. Social stigma is likely “to give rise to a multiplicity of possible equilibria” that is when most people evade, the stigma effect is small and evasion is not in fact discouraged thus generating the “non-compliance epidemics”, while when few evade, the stigma effect will be great and evasion will be discouraged either (Franzoni 1998). Sociological theories tend to perceive the cause of variation in human behaviour in the structure of social systems. The taxpayers’ actions are examined in the light of social forces and ethics that finally shape behaviouristic patterns and prototypes that are as firm and inflexible to changes. Given their basic assumptions about human behaviour, sociologists tend to look to attitudes towards government, views relating to the enforcement of tax laws, fairness of the system, etc (Brooks 2001). As James mentioned in the report “Individuals are not simply independent selfish utility maximizers, but that they also interact with other

human beings in ways which depend on different attitudes, beliefs, norms and rules” (James et al. 2003). Researchers argue that non-payment is not only related to inability to pay, but also to whether citizens perceive the domestic government to act in their interest. In particular, three dimensions of trust may affect citizens' compliance: (1) trust in the local government to use revenues to provide expected services; (2) trust in the authorities to establish fair procedures for revenue collection and distribution of services; and (3) trust in other citizens to pay their share.

Thus, the conclusion can be drawn that the human behaviour can not be shaped by a single aspiration of evading, but it is the interconnection of different attitudes, approaches and perceptions that ultimately shape the taxpayers behaviour. And while defining and launching policies towards the prevention of tax evasion the abovementioned factors should be considered as the indispensable. Considering all aspects of mentioned theories it can be stressed that in general everyone will violate the rules if they have the opportunity. Consequently, searching for systems processes and means towards minimizing opportunities for cheating becomes a cornerstone of tax administration.

The Brief History of the State Tax Service of RA

The State Tax Service under the Government of the RA has started its activity since 1991. During this period the Service has functioned under different names and statuses. The previous names included State Tax Inspectorate of the Republic of Armenia (RA STI), RA Ministry of State Revenues (RA MSR), RA Government affiliated State Tax Service (RA STS) (Aharon Paradigma & AEPLAC 2007). History of this agency includes several cases of merger with the Customs authorities and then separation. This was once under the Ministry of State Revenues and since August 20, 2008 according to the Presidential decree under the State Committee of State Revenues (RA Presidential Decree 2008).

STS is organized into two main entities: headquarters and Inspectorates. According to the RA STS Administrative Capacities Assessment report (2007) at present there are 2400 employees who are employed in the central office (headquarters) located in Yerevan and special/regional inspectorates placed in the whole territory of RA.

Overall STS has passed three main stages of reforms adoption serving to the step by step establishment of the Tax Service.

With the devolution of Soviet Union and the adoption and integration to the market economy values in 1992 the first stage was launched assuming the establishment of an agency where the specific taxes such as VAT tax, and excise tax were intensively applied. Along with these taxes road use and renovation fee, land tax and other non mandatory payments were collected. Until 1996 the efficiency of tax service was planned to rise using the special tools, as

- Imposition of fixed payments in difficult-to-control sectors;
- Introduction of special registers for the purpose of tax administration;
- Applying “cash-desk”¹ method, “intermediate” method and finally internationally recognized “accrual” method to determining profit from sale;
- Initiating dialogue with other countries and signing RA tax international treaties (Bulgaria, Syria, etc)

(Aharon Paradigma & AEPLAC 2007).

During further years and up to the late 90’s the tax policy was affected by a number of events such as adoption of the RA Constitution in 1995, the RA Civil Code in 1998, structural reforms of economy, development of the budgetary legislation, development of legislation on territorial division and administration, RA international cooperation progress, etc.

Since 1997 the package reforms have been applied to the STS which formed the ground for the second stage of improvement. It was the first Armenian tax policy plan away

¹ A place in a restaurant, bar, or shop etc, typically containing a cash register, which enables to check the actual turnover generated from sale

from the soviet influence and its legislative impact. The package assumed the following steps to be fulfilled:

- Completely new two laws on direct taxes with modern structure and composition;
- Ad valorem excise tax rate, a system of minimum threshold and excise stamps;
- New VAT law based on the EU Directive 6 of 1993, switch to the principle of the VAT taxation at the place of consumption (including with CIS countries);
- Legislation specific for a new level of tax administration;
- Principle of using cash registers by the RA Government
(Aharon Paradigma & AEPLAC 2007).

The third stage of reforms was initiated in 2000, the major features being exercise of simplified tax, publication of taxpayers with tax arrears and tax losses, adoption of the Customs Code meeting international standards, cooperation with international organizations (IMF, WB) preparation of two large-scale projects for the development of tax self-assessment system, approval of the Tax System 2007-2009 Triennial Plan by the Government in 2007.

However it will be erroneous to underestimate the steps of the present Government towards the promotion of tax administration system. The present innovations can be supposed as a beginning of the fourth stage of upgrading.

Since taking office in April 2008 President Sargsyan instigated an ambitious program to cardinaly transform the tax and custom services of RA. The core of the renovation is the alteration from the rigid, deep-rooted “traditions” of the tax compliance or more precisely non-compliance towards more transparent flexible and well-organized tax administration process.

The first step was the 08/20/2008 presidential decree on the amalgamation of the two adjunct bodies of GoA namely State Tax Service and State Customs Committee into State Revenue Committee (RA Presidential Decree 2008). According to PM T. Sargsyan 80% of the overall home trade takes place at the fairs and markets just because they provide refuge from taxes. For the proper functioning of the mechanism market owners should be responsible for ensuring the mandatory use of cash registers, and as fiscal agents they will

have to enforce this rule on the territories under their control. Cash registries 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 (Official Webpage of GoA). This is the only way to compliance and loyal atmosphere as the mechanism of checks and balances inevitably leads to the spiral of responsibility and trustworthiness. Nationwide adherence to bureaucratic standards is the key to combating tax evasion and shadow economy. There is no alternative to exposing the real volume of trade turnover and complying with full tax-payer liabilities. This is the reason the government has adopted a strong, even a revolutionary tax policy.

The establishment of a Prime Minister-headed supreme council on introduction of new revenue management practices has the purpose to coordinate the reforms in tax and customs administrations, watch over these processes and keep in touch with the public-at-large and business organizations. In order to ensure smooth progress in the reform process the feedback of the society and all positive and negative implications identified during the implementation stage could be sent via email or phone call to hotline.

However STS continues to be under pressure to improve its collection performance. While the tax-to-GDP ratio² has steadily grown during the past few years, it remains at the lower end of the scale among CIS countries (See Table 1). The cross-country comparison indicates that Armenia is far behind most of CIS countries. Government of RA planned to increase the tax-to-GDP ratio annually by 0.4% which implies that only after 8 years Armenia will achieve the 20% threshold.

² Tax//GDP ratio is a universally accepted indicator to assess performance of tax administration.

Table 1 Cross-Country Comparison of tax-to-GDP ratio of CIS countries

Country	2004	2005	2006	2007
Armenia	14.4	14.5	16.1	16.8
Georgia	18.4	19.8	21.8	25.7
Belarus	26.1	28.5	30.8	32.2
Azerbaijan	15.4	15.2	18.8	22.4
Estonia	25.5	26.8	27.0	27.5
Kazakhstan	22.3	26.3	26.8	26.3
Kyrgyz Republic	18.3	20.0	21.5	21.6
Tajikistan	15.2	16.6	16.5	16.5

Source: IMF AND MoF

Includes social contributions

The estimates of the National Statistical Service show the level of underground economy and informal activity which are untaxed in Armenia (see Table 2).

Table 2 Distribution of underground economy by sectors in Armenia

Armenian sectors of economy	Percentage
Economic entities (%) not fully disclosing the amount of profit for tax purposes	26.15*
Industry	28.7**
Construction	46.1
Transport and Communications	21.1
Trade	75.5
Agriculture	21.0
Other sectors	27.1

* Source: World Bank

** Source: National Statistical Service

The table reveals that over 75% of the trade is in the shadow market and does escape from taxes. The solution of the GoA to reduce the percentage is the installation of cash registries which will disclose the actual amount of retail trade. In case of wholesale trade the trail of invoices should be properly produced and monitored to make sure all transactions are captured and taxed.

Research Questions

In this paper the following research questions were addressed:

1. Which are the major causes for tax evasion in Armenia?
2. How hidden economic activities and tax evasion affect Armenian economy?
3. Does the legal and institutional environment in Armenia support the proper functioning of the tax service?
4. What are the strategies to bring the illegal or hidden activities under the regular tax regime?

Methodology

The methodology applied for the policy internship project is based on the primary analysis, namely data analysis, study of RA criminal code, legal acts, regulations and secondary analysis of relevant documents, international literature related to tax evasion and effective tax administration.

For the assessment of tax evasion in Armenia I used the data from the nation-wide survey conducted by AEPLAC during my internship among 1029 economic entities on the issues of audit conducted by all kind of inspectorates in Armenia. From the list of the businesses the entities were clustered proportionately according to their field of activities. Then from each cluster 854 and 175 economic entities from Yerevan and Marzes respectively were proportionately selected by using simple random sampling.

The EU has been developing its “Draft Fiscal Blueprints” that provide guidelines for would-be member-states’ tax administration. Based on the latter, the report prepared by Aharon Paradigma and AEPLAC on the “Assessment of the Administrative Capacities of the Republic of Armenia State Tax Service” made it possible to assess the level of tax compliance in Armenia on the standards adopted by EU.

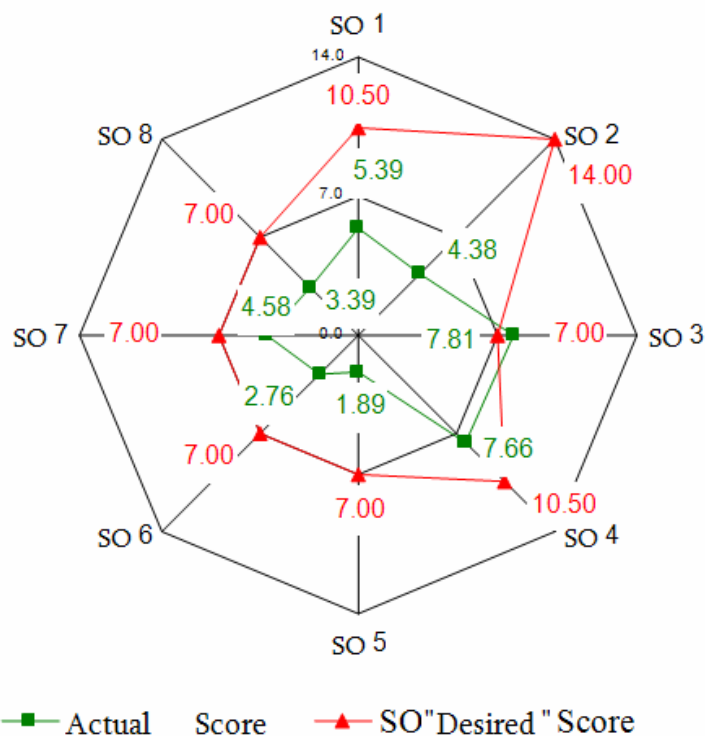
Findings and Analysis

As it was already mentioned, the main purpose of the research was to assess how tax evasion influences Armenian economy. For that reason tax evasion should be estimated. The identification and objective assessment of STS is the only way towards the improvement of the service efficiency, instigation of the demand-driven strategies and increase the general level of tax compliance.

The level of evasion and fraud was estimated against eight strategic objectives /SOs/ adopted by the EU (Aharon Paradigma & AEPLAC 2007). Each of SOs has its key indicators /KIs/ through which the assessment became possible (Figure 1). Within the diamond-shaped figure the red lines indicate the benchmarks of EU and lines with green colour -- the actual score in Armenia. The figure shows how much the actual score deviates from the desired European benchmarks.

Figure 1

Picture 9.01 SO deviation from the achieved SO "desired" scores



The first and foremost strategic objective which assumes the accumulation of other strategic objectives in itself is the existence of tax fraud and avoidance prevention strategy which encompass all the aspects starting from the proper legislative grounds and ending with environment to promote a culture of taxpayer compliance. This kind of prevention strategy is totally absent in Armenia as the elements to initiate comprehensive policy is semi-developed. Thus, the qualitative and quantitative estimation of non-compliance is missing as the practice of circulation of internal reports analyzing the nature of tax evasion is not applied. It is impossible to estimate the tendency and hence instigate the demand-driven policy of prevention. As a central element of prevention, however, the dissemination of adequate information concerning the fraud prosecution, publication of detailed explanation of the evasion cases, possible appraisal in case of voluntary compliance can be assumed. In general tax authorities need an efficient public outreach and taxpayer education strategy to support long-term compliance goals. The educated society facilitates the communication between government and the public and makes public intolerant to the phenomenon. The negative public attitude to evaders becomes an additional tool to reduce evasion.

Risk-based audit system for monitoring tax evasion and fraud is another strategic objective adopted by EU that can facilitate the actions and rationalize the costs of the STS. Not having the database of the potential evaders and not possessing the capacity to identify the taxpayers which are likely to evade, means that the risk assessment for selection of taxpayers for audit is not performed and the detection is possible only the evasion has been done. In this case the audit and monitoring is much more costly than prevention. In addition STS cannot audit each and every enterprise for discovering the level of compliance. National audit program paper stipulates that RTIs transfers the cases of 35 ‘more-difficult-to-control’ taxpayers to the operative-intelligence department for audit on a monthly basis (Harrison et al. 2007). It means that the risk-based audit system, however, is partly applied and the RTIs,

managing thousands large, small entities and individual entrepreneurs, should indubitably apply risk-based audit system.

The next factor that can assure the effective functioning of STS is the internal linkage within tax inspectorates and with other state agencies which allows disseminating intelligence about tax evasion. The actual picture shows that the absence of efficient internal communication first of all leads to ineffective operation of the intelligent bodies and inspectorates. In addition constant relationship with other state agencies would reveal the loopholes performed by the certain economic entity and would facilitate the identification of possible evaders.

The introduction of rules and guidelines for fraud investigators to eliminate or significantly reduce the risk of bribery, corruption in state apparatus is problematic for the country like Armenia. If the close circle of corruption has the place to be cut it is the prohibition of actions by laws. But if lots of businesses are under the patronage of senior officials in the government, who guarantee the tax-free and punishment-free business, it will be hard for the government to enforce application of laws without any discrimination. In other words it is an issue of building a trust between taxpayers and state, taxpayers and tax administration.

The assessment indicates that the only strategic objective that was accomplished and even goes beyond the established European standards was the existence of fiscal and enforcement laws to cope with evasion and fraud. However, the existence of two articles /205,206/ in the Criminal Code of RA does create the room for various interpretations, different explanations and ambiguities based on which the evaders escape obligations and remain unpunished. Thus, Article 205 of RA Criminal Code states: “Evasion from taxes, duties or other mandatory payments by means of entering obviously false data into ledgers or tax report forms, in large amount, is punished with a fine in the amount of 500 to 1000

minimal salaries or with deprivation of the right to hold certain posts or practice certain activities for up to 5 years, or arrest for the term of 2 to 3 months, or with imprisonment for the term of up to 2 years.” According to article 206 ‘failure to submit a property and income declaration by a citizen, when mandatory, as well as, entering obviously distorted data on incomes and expenses into the declaration, which caused large loss of taxes, is punished with a fine in the amount of 100 to 500 minimal salaries, or with arrest for the term of up to 2 months’. The articles do not contain a comprehensive list of evasion acts, relying on which the evasion will be viewed as lawful action. In addition, RA legislation does not specify the concept of tax fraud, but “tax evasion” concept is used, which can be by means of entering obviously false data into ledgers or other taxation documentation; i.e. through fraud or failure to submit reports. Moreover, Article 206, unlike Article 205, determines incomparably lenient penalty for tax evasion by a citizen.

The evidence of the non-efficient legislation to enforce tax evasion is the statistical data that in 2007 the administrative penalties did not exceed 5000 cases, with only 350 cases taken to the court. This is in the situation when according to different estimates 30-45% of the economy is left outside of the official statistics.³ It makes obvious that impunity and the absence of uniform and equal application of the laws and regulations to all businesses eventually lead to the tax gap.

The laws and regulations on tax system are in place, however, there is a need for greater certainty and consistency in interpretations of the laws by the STS as they are not properly implemented and enforced. In this point the EU has properly assessed the existence of the fiscal and enforcing laws but it should not be mixed with the actual functioning of the

³ According to the estimates of Central Bank of Armenia 30-33% of the official economy, which are not included in the official accounts of GDP.

According to the Poverty Reduction Strategy Paper 45-50% of the official economy is hidden activities. PRPS estimates that the shadow economy is almost equally divided into non-registered activities, which are prevalent in services sector and incomplete declaration of incomes and volumes of activities by officially registered businesses.

laws. Another stunning point is that from 140,717 registered taxpayers less than 100 taxpayers account for half of the collected revenue. In the nine months (January-September) of 2007, the top 1000 taxpayers contributed to 77 percent of total tax revenues (Harrison et al. 2007). However it is obvious that the 100 owners of the “flourishing businesses” are either the state officials who are engaged in executive branch, law-making or very closely linked to them thus having the power to impact and decide the size of taxable amount that due to political connotations is paid.

At the same time SMEs are under the microscope of tax officials and they do not promote SMEs development, just the opposite the required volume and periodicity of tax reports is excessive and creates obvious obstacles for all the small businesses. In the meantime the larger enterprises possess all the aptitude to avoid. Therefore, viewing SMEs as a priority the 2008-2011 strategy is based on the ‘soft’ tax administration towards small and medium enterprises (Tax Administration Strategy Paper 2008-2011).

The survey conducted by AEPLAC seeks to disclose the existing problems during the audit process in Armenia, appeal procedure, the level of awareness of the rights and obligations the economic entities possess. The distribution of respondents based on the field of activities is shown in the Table 3.

Table 3 Distribution of Respondents by Economic Sectors

Sector	Number of respondents	%
1. Industry	149	14.5
2. Construction	47	4.6
3. Mining Industry	1	0.1
4. Trade	477	46.4
5. Agriculture	31	3.0
6. Financial	18	1.7
7. Transport services	53	5.2
8. Communication services	22	2.1
9. Hotels and Restaurants	45	4.4
10. Health services	29	2.8
11. Other	157	15.3
Total	1029	100.0

This distribution is in line with the estimates of shadow economy by sectors. As shown above, 477 selected entities are from trade sector and 149 from industry. Thus, it can be inferred, that those in the sectors of trade and industry are the actual targets of the auditors. When it comes to geographic distribution of economic entities in Armenia, there are considerable differences of business activities in Yerevan city and RA marzes, which brings to huge disproportions in social-economic conditions particularly in remote regions and border areas. In RA marzes from initially selected 450 economic entities it was possible to interview only 175 because of the unavailability of most of taxpayers (Table 4).

Table 4. Respondents Distribution by RA Regions

1.Yerevan	854	4.Ararat	18	7.Tavoush	3	10.Gegarkunik	2
2. Aragatsotn	11	5.Lori	31	8.Vayots Dzor	4	11.Kotayk	26
3.Armavir	11	6.Shirak	59	9.Syunik	10		

The respondents were suggested to answer some pre-designed questions. The questionnaire consisted of 18 questions from which nine were related to the audit procedures, two questions sought to find out the level of awareness about the rights and obligations of both auditors and respondents and finally three last questions sought to depict the system of appeal process and try to discover the obvious grounds and covert implications of the process.

A very interesting point is that to the question of the major obstacle for the doing business in Armenia from the list of answers including the lack of professionals, audits, taxes, competition, procedures of license, registrations, certification the most common answer /22.6%/ was taxes. It comes to prove that tax administration remains fragile as there is a weak community culture towards paying tax and lack of confidence by the business sector in the tax system and its administration.

If we try to analyze from the perspective of business sector it is logical that they view taxes as major hindrance for business, as STS does not provide any incentives to encourage

the voluntary compliance. Good compliance is now in fact discouraged, because compliant taxpayers are continually “squeezed” for more payments while tax evaders continue operating outside the law and remain largely undetected by the STS. In addition, there is very little if any consultation with the business community by government officials on proposed reforms in tax policy, legislative or procedural changes. No regular forums exist in which business representatives can discuss issues with senior MoF or STS officials.

One of the most important issues of tax administration is the visits of tax inspectors. The questionnaire had a question on this issue: What is the frequency of audit?/During last 12 month how many times you interact with inspectors/ the duration of each inspection and the number of inspectors during each audit. Answering this question 63.8% of respondents mentioned that they are visited by a tax inspector (?) for the purpose of inspection/audit once a year. At the same time only 39.4% noted that particularly tax inspection duration is less than 3 days, while 19.3% and 41.4% have selected “from 3-5” and “more than 5 days” respectively. 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. The only reasonable explanation for abnormally frequent visits is corruption or ‘extra-legal requirements’.

To the question on what are the reasons of not appealing the audit results 60.4% of the respondents answered they view appeal process as a source of prosperity for the auditors, waste of time for the business and source of corruption risks. Here the majority of economic entities blame the top-down corrupted tax administration system and inability to appeal the decision of the tax official. As the main reasons for not initiating appeal process 43% of the respondents mentioned that they were sure that it would be time-consuming and doubted that it could lead to positive results. Next common answer /15.6%/ is that respondents are afraid of the harmful consequences for the business. Overall appeal process is fully unaccepted as

an option among the economic entities as the lack of trust to the appeal bodies, low of possibility to win the appeal case and receive back the taxes collected in excess or as a result of penalty imposed after an audit, the failure of the state authorities to protect the linear businessman, lack of affiliation with elite leads to the inappropriate and ineffective procedures during the appeal process. This reflects the number of 88.2%, who never appealed the audit results which actually mirrors the atmosphere of fear and tolerance in Armenia.

This happens in the event that the legal base for appeal is exists and the process is defined by the law (Law on Audit, article 11), according to which taxpayers can appeal directly to inspectorate to which they are directly subordinate, or they can go to directly Appeals Commission at STS. Besides, if resolution of the case is not reached at the Appeals level, the economic agent has the right to seek litigation in court.

The logical continuation of the problem is the question “what do you do if you do not agree with the audit results”. To this question the most common answer is that they offer a bribe to the auditor /38.1%/, turn for help to relatives from “powerful elite” /34.1%/. Tax inspectors will hardly dare to extort bribe from companies, which have direct or indirect relations with high-level government officials but will feel free to do so from businesses without powerful “patron”.

Results of the survey show that as the proper functioning system is not in place, the businessmen prefer to evade from taxes using a set of illegal means (bribing tax inspectors, using patronage of senior government officials to ensure tax-free regime of operation, etc.). This picture further indicates that the bribery is an inevitable result of the malfunctioning system of tax administration and tax evasion becomes possible because the rule of law does not apply universally and consistently throughout the country.

Conclusion and Recommendations

One of the objectives of tax administration is to achieve high levels of voluntary compliance within taxpaying community, since this is the best way to maximize revenue collections (reflected in high rates of the tax-to-GDP ratio) and minimize collection costs. It becomes apparent that there is a need to improve the tax vehicle, make it more demand-driven and thus alleviate the work of businesses. An initial precondition for any kind of reform is the simplification of the tax system to ensure that it can be applied effectively in the generally “low-compliance” context of Armenia.

No single strategy for improving tax compliance and reducing evasion is appropriate for all countries and under all circumstances. Even the experience of EU countries that apparently led to improved compliance cannot be simply replicated in Armenia. Being multi-faceted and pervasive, tax evasion cannot be eliminated through policy measures in one single direction, where success can guarantee the accomplishment in all other sectors of public administration. Therefore combating tax evasion requires elaboration of a strategy specifically for our country which in this context means a comprehensive plan that assigns clear priorities to the tasks that must be performed, tailored to the available resources. Recommendations suggested below are clustered into groups to ensure the parallel progress in each of the directions. We view these recommendations as a complex program, in which all the elements are interdependent and reinforcing each other; only undertaking the all-encompassing strategy will create possibility to achieve desirable effect.

- Providing adequate taxpayers assistance and information is the starting point for compliance under a system of self-assessment. Few taxpayers use the law itself as a primary source of information, so tax office advice plays a crucial role in bridging the knowledge gap. In self-assessment environment taxpayers expect that the tax administration will provide summarized, understandable advice upon which they can

rely. In this case the particular relationship will tie the state and taxpayers and will significantly minimize the non-compliance. Targeted measures can include explanatory leaflets, practice notes explaining interpretive views on complex legislative provisions, press releases, special events such as open days, seminars, workshops and regular meetings and workshops with business associations and professional organizations.

Identification of risk of non-compliance i.e. taxpayer practices and patterns of activity that place the revenue collection at risk is one of the fundamental steps towards the improvement of tax administration. It will allow tax administration to focus its limited resources on the most significant threats to the tax system, while leaving compliant taxpayers free to conduct their business without unnecessary intervention by tax officials. The adoption of risk-based audit system should consider building profiles identifying risk characteristics among groups of taxpayers. This should be done by checking and analyzing information collected in returns and using cross-matching system by using information from third parties, such as banks or government agencies. It will more efficient and less costly auditing taxpayers, which according to reviews are in the risk area. This allows identifying which taxpayers were delinquent the day after every deadline. This is the first step towards risk-based management principle which reduces the transaction costs.

- Division of the taxpayers by sectors /large, medium size, and micro/ will allow to treat each segment separately. Acknowledging that each segment has its own particular risk characteristics the compliance program for each should vary as well. It is worth mentioning that STS has a special division that deals with large taxpayers, namely Large Taxpayers' Inspectorate/LTI/. The overriding feature for the small enterprises is their large number, but low revenue potential. Due to the latter many small companies tend to operate outside the tax system: for those that are registered, attention to filing and payment obligations is often poor.

In case of large enterprises the compliance issues tend to be more complex and consequences of non-compliance are more damaging and harmful. Finally, businesses in the medium-size segment display different compliance characteristics depending on their size and complexity. Those with higher turnovers tend to have more sophisticated structures and business operations, while others can be engaged in simpler transactions. Non-compliance in case of medium-size businesses includes underreporting of income, non-payment of arrears, usage of false records etc. Thus, the divergence between clusters assumes different approaches to each segment acknowledging that each segment has its own particular risk characteristics.

- Improving the audit process is an essential part on the way to reforming the system. However, audit cannot effectively operate in isolation; it must be supported by an effective taxpayer education program, fair and trustworthy appeals process, and enforcement. Additionally, it needs to be complemented by other enforcement programs directed at the fundamental obligations of registration, filing, payment and record keeping.
- An effective appeal process is critical to the integrity of the tax system. The appeal process is a major problem in Armenia as the taxpayers do not believe in transparent and fair procedures of appeal process preferring bribery-giving.

Taxpayers' attitude towards tax authorities and taxation in general is the most important factor for successful implementation of reforms. Attitudes affect intentions and intentions affect behaviour. Attitudes are formed in a social context by such factors as the perceived level of evasion, the perceived fairness of the tax structure, its complexity and stability, how it is administered, the legitimacy of the government. Government policies affecting any of these factors may thus influence taxpayer attitudes and hence observed level of tax compliance.

All the abovementioned is achievable, however, when there is enough political will, strong commitment and support by higher echelons of the government to overcome the impediments to an effective tax system and try to introduce mechanisms and methods for voluntary compliance. Without this support all kind of changes and innovative initiatives will be useless.

Foreign estimations, appreciative reports have become the milestones for the overall course of our economy which in some circumstances empowers the officials to validate the mainstream economic policy of Armenia. However the external encouraging feedback can be the supportive factor as still, the government bears the main responsibility and the indigenous efforts are needed that should persistently ensure compliance to laws and enforce proper tax compliance.

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Appendix A

An Economic Model of Tax Compliance

If the taxpayer decides to pay, the tax burden is:

$$C^P = t \times R + TC^P$$

Where` C^P – costs of paying taxes for the firm,
 t – tax rate,
 R – taxable income,
 TC^P – transaction cost of filing and auditing if the taxpayer decides to comply.

If the taxpayer decides not to comply, the tax burden is

$$C^e = p_d \times (\text{penalty} + t \times R) + TC^e$$

Where` C^e – expected cost of the taxpayer not paying taxes (expected cost of tax evasion),
 p_d – probability of violation detection,
 t – tax rate,
 R – taxable income,
 TC^e – transaction cost of filing and auditing in case of detecting tax evasion.

In order to promote full compliance, C^e must always be larger than C^P , or

$$p_d \times (\text{penalty} + t \times R) + TC^e > t \times R + TC^P$$

The only way to preserve this inequality is to have p_d equal to 1. In that case each taxpayer will have an incentive to pay taxes (or forced to pay) for any positive penalty as long as the transaction costs of detected evasion are not less than the transaction costs of paying taxes on voluntary bases. The problem is that in reality the probability of detecting tax evasion never equals 1. That is why the most acceptable option implies the situation when p_d is less than 1: In this case, to guarantee that each taxpayer pays taxes, the following inequality must take place.

$$\text{penalty} > \frac{(1 - p_d) \times t \times R - (TC^e - TC^P)}{p_d}$$

If $TC^e = TC^P$, it means that transaction costs of tax evasion will not be higher than transaction costs in case of full compliance. In this case the inequality will be as follows.

$$\text{penalty} > \frac{(1 - p_d) \times t \times R}{p_d}, \text{ or}$$

$$\text{penalty} > \left(\frac{1}{p_d} - 1 \right) t \times R.$$

The formulas show that the higher the tax rate (t) and taxable income (R) are, the larger penalty is needed to push taxpayers to pay taxes, under the constant probability of detection (p_d). If the penalty is not a flat value of money but rather a function of the tax due, the above-mentioned relationship is:

$$K (t \times R) > \left(\frac{1}{p_d} - 1 \right) t \times R.$$

Where k – constant is greater than 1 i.e. the larger the tax due is, the larger is the constant, which is used to determine the penalty.

Experience shows that the detection of tax evasion leads to inspection an procedure that is more detailed than the original filing. In other words, detecting tax evasion implies an additional penalty that taxpayers would be reluctant to pay. In this case, $TC^e > TC^p$, and the penalty should satisfy the condition of inequality provided above.

It should be noted that though the main goal of tax authority is reduction of transaction costs in both cases, in order to control tax evasion the government should always guarantee the direction of mentioned inequality.