RUEA

BUSINESS TAXATION IN ARMENIA

POLICY PAPER

February 2022

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Introduction

Armenia's economic performance is likely handicapped by an excessive, and badly distributed, tax burden under which it operates. In 2019, the country's tax revenues-to-GDP ratio rose to 22.2%, a peak level from 2015, the heaviest tax burden in the EU Eastern Partnership region and far greater than the median ratio of 17.3% observed across peer countries. Armenia's tax burden increased against a backdrop of generally stagnating or declining tax burdens elsewhere in the region, adding additional pressure on Armenian taxpayers. Furthermore, throughout the 2015-2019 period, the share of taxes on income and profits in total tax revenues remained elevated, representing on average 41.2% of total tax revenues – once again, the highest in the region.

Tax policy in Armenia is undermined by a narrow base of taxation. This critique is not new, having been highlighted in previous assessments of Armenian taxation. Yet little progress has been made over the years, meaning still too many exemptions and an extra burden on paying taxpayers. In 2019, tax expenditures amounted to 6.7% of GDP and 30.3% of tax revenues, well above reported world averages of 3.6% and 23.2%, respectively, resulting in unfair competition amongst economic agents while also promoting a weak tax culture in the country. An excessive use of exemptions not only makes for more complex tax administration, but also inhibits more efficient tax policy by thwarting options such as a broad-based low-rate policy.

The main tax rates paid by businesses and workers in Armenia are broadly in line with those on display in the EU Partnership region. The corporate income (or profit) tax follows an 18% flat-rate structure, a rate that is equivalent to the median headline rate practised across the region, the same pattern occurring in value-added tax (VAT) with Armenia's 20% VAT rate. As regards personal income taxation, the tax now operates under a flat-rate framework as well, although at 22% the headline rate sat above the 18% median rate observed amongst regional peers in 2021. The personal income flat-tax rate is expected to decrease to 20% by 2023. Preferential taxation for micro, small, and medium-sized enterprises (MSMEs) has gained importance, and so have excise taxes which have grown the most since 2015. Yet overall, VAT remains the largest contributor to total tax revenues, despite its relative decay in recent years.

VAT is the weak spot in Armenia's framework of business taxation. Not only is VAT responsible for the bulk of foregone (tax) revenues, impeding a policy shifting-out of direct taxes on income and profits onto to indirect and consumption taxes, but it is also the tax, amongst the main ones, that has exhibited the lowest growth in recent years. From 39.8% of total tax revenues in 2015, VAT revenues declined to 34.0% of total in 2020. Productivity indicators for VAT, measuring actual vs. potential tax receipts, score low in Armenia compared with peers on all commonly used measurements. Armenia is therefore stuck with an inefficient VAT framework, one which does poorly for an optimal tax policy in as much as not contributing to a better tax culture.

Armenia's fiscal position is challenging. The country is currently under pressure to reduce its public deficit. Moreover, the Government also aims at reducing the burden of public debt, which sat at 63.5% of GDP in 2020, to a level of 50% of GDP over the medium-term. Fiscal policy is thus tight and will likely disavow a significant easing of tax revenues. Yet tax policy could be made more competitive and inducive of economic growth by re-aligning the relative burden of existing taxes and making improvements not only in general business taxation but also in preferential taxation for micro, small, and medium-sized enterprises (MSMEs). Greater simplification of tax policy, and better communication, would also strengthen tax administration.

Policy Proposals

Rebalance tax policy by lowering the relative weight of direct taxes on income and profits in total tax revenues. Armenia is fiscally constrained, yet at the same time the country also exhibits a heavy tax burden. Policymakers are thus confronted with a twofold challenge: achieving the most growth-enhancing tax policy, aiming at increasing GDP growth and a not so heavy tax burden, while not sacrificing tax revenues over the medium-term. Tax-shifting, out of direct taxes and into indirect taxes, might prove a coherent strategy to achieve these objectives. Already there are tentative signs that this is occurring. Moreover, policymakers should make consistent use of data measuring the medium-term responsiveness of tax revenues to changes in GDP, and vice-versa to eliminate and/or reform uninspiring taxes.

Publish a detailed annual tax expenditure statement. Tax expenditures in Armenia are above reported world averages both as a percentage of GDP and total tax revenues. They are mostly concentrated in VAT, and to a minor extent also in the profit tax. Forgone tax revenues represent an opportunity cost to the government and may also lead to the dis-levelling of the playing field amongst taxpayers. Furthermore, in the case of foregone VAT revenues, they are a significant obstacle against the kind of tax shifting Armenia would likely warrant. Tax expenditures must exhibit clearly defined policy objectives, they should be time-limited, and subject to regular assessments, thus assisting the cost-benefit calculus of taxation.

Make reinvested profits tax-free. Armenia's profit tax follows a standard base of taxable profit equal to gross income minus deductions. Yet apart from reigning-in on the myriad of deductions allowed under the tax code, which degenerate into elision and evasion, there should also be a greater focus on bestowing the profit tax with internationally competitive features. These range from changing the nature of the profit tax itself, moving into a cash-flow approach such as Georgia's, or otherwise evolving within the existing framework by not levying the profit tax on reinvested earnings. This would reinforce a somewhat similar feature already in place under the personal income tax, whereby withheld taxes on dividend payments are refunded to taxpayers whenever proceeds are reinvested back into the dividend-paying businesses.

Allow for the full expensing of all fixed capital assets. Investment is fixed assets is usually depreciated over time according to the lifespan of the asset. Depreciations represent a cost in a company's profit and loss statement, thus by introducing full dispensing businesses are allowed to depreciate 100% of the asset's value upon purchase rather than doing it over time. This policy measure has been adopted amongst OECD member countries such as Estonia, Latvia, or Chile. It increases the present-value recovery rate of capital expenditures, by lowering today's tax liability and increasing the long-term return on investment earned on capital assets. In practical terms, full expensing acts as an incentive to front-loading capital formation, spurring growth.

Consider a lower threshold for mandatory VAT registration. Armenia exhibits low readings in VAT productivity measurements, which is to say that the country only captures a fraction of its potential revenues. Yet the inefficiency of Armenia's VAT is associated not only with existing exemptions, but also with a very high minimum threshold for mandatory registration. The current minimum registration threshold is 4.5 times greater than the median threshold in the Eastern Partnership region, and 7.5 times greater than Georgia's (the lowest within the region). A lower threshold, and greater VAT revenues as a percentage of total tax revenues, would likely yield favourable outcomes such as increasing the incentives to deduct input VAT, promoting professional standards at SMEs, and granting an opportunity for tax-shifting as discussed above.

Reform key aspects of VAT administration. No other tax incarnates better the inherent complexity of Armenia's tax code than VAT, and unsurprisingly VAT revenues have ceased being a predictable proxy of the general state of the economy yielding no clear relationship between the two. Tax administrators should thus make two key changes in VAT. First, VAT reverse-charge rules – whereby tax liabilities are remitted by buyers (not sellers) of goods or services – should be established between resident taxpayers in sectors that are prone to evasion. And second, VAT filings and refunds should become entirely automatic and executed through digital means. This process of automatization likely requires infrastructural investments from the Government to avoid the kind of server failures reported by interviewees making use of digital platforms.

Address the design inconsistencies of the turnover tax. The design of the turnover tax is well defined in making the tax's upper threshold coincidental with the (bottom) threshold for VAT registration, thus allowing the turnover tax to replace both for the profit tax and VAT. Yet two inconsistencies emerge, one potentially related with VAT, and one effective already, that should be addressed decisively. In the first case, any change in the VAT registration threshold (as discussed above) would need to be accompanied by an equal adjustment in the threshold of the turnover tax. And second, eligible businesses under the turnover tax threshold, yet unable to use the tax to replace both the profit tax and VAT (e.g., individual entrepreneurs and notaries), should not be restricted in making full use of this preferential regime as is currently the case.

Replace the multi-rate structure of the turnover tax for one single rate. The whole purpose in having a preferential, presumptive-based, regime for MSMEs is to simplify tax administration, reducing the opportunity cost of business formalisation. Therefore, adopting different rates according to the type of business activity runs against the intended purpose of the regime. Calculating a single turnover tax rate across all eligible sectors can be pursued through two avenues, either by making the effective tax rate at the threshold level more onerous to eligible businesses than the standard corporate income tax rate (to reduce arbitrage opportunities between the two), or by aiming to equalise after-tax profit margins across economic sectors (to minimize tax inequality across different sectors). Perfect optimality is elusive, yet the advantage of simplicity in having one single rate applicable to all small businesses is enticing.

Develop an expenditure-based approach to tax benefits incentivising research and development (R&D). Armenia has long incentivised its technology sector by providing tax benefits to businesses operating in the information and technology (IT) field, and recently also became one of the few countries in the world where software can be licensed. Yet existing incentives suffer from a design paradox: by limiting eligibility to a government-vouched subset of businesses, moreover with less than 30 employees, they introduce inequality in the awarding of benefits while also stifling business growth. Transforming existing benefits for IT start-ups into expenditure-based R&D tax incentives, available not only to IT start-ups but rather to all businesses in Armenia, small and large, tech or non-tech, would be more equitable and likely more efficient as well in generating transformative investment and intellectual assets.

Promote trust by building taxpayer capacity. The Armenian tax code urgently requires clarification and simplification to act against the weak tax culture observed in the country. Recent surveys suggest that the first step towards a more trustful relationship between the Government and taxpayers ought to consist in cleaning-up tax laws, removing legal ambiguity. Policy uncertainty usually does not bode well for economic growth. The second step towards a more trustful business environment would be arresting the frequent changes in tax laws. The Government should also place additional efforts in reaching out to taxpayers unaware of the training services provided by authorities or others. A better tax culture would likely emerge.

Bullet Line Summary

- Rebalance tax policy by lowering the relative weight of direct taxes on income and profits in total tax revenues.
- Publish a detailed annual tax expenditure statement.
- Make reinvested profits tax-free.
- Allow for the full expensing of all fixed capital assets.
- Consider a lower threshold for mandatory VAT registration.
- Reform key aspects of VAT administration.
- Address the design inconsistencies of the turnover tax.
- Replace the multi-rate structure of the turnover tax for one single rate.
- Develop an expenditure-based approach to tax benefits incentivising research and development (R&D).
- Promote trust by building taxpayer capacity.