

AMENDMENTS TO THE TAX CODE

in the light of the reasons for,
and consequences of, the 2018
revolution in Armenia



This research has been carried out by an independent researcher Artak Kyurumyan within the framework of the program of the Friedrich Ebert Foundation and the Political Discourse Journal. The goal of the research is to review the proposal to amend fundamental issues related to progressive and flat taxation of income in the tax system of Armenia and to consider the international practice and the available analytical materials, facts and other data to present comprehensive information about tax reforms. It can serve as a good base for evidence-based policy and decision-making in post-revolutionary Armenia.

Since September 2018, the Political Discourse Journal has conducted many researches and published articles related to the challenges and perspectives of the tax system. The Friedrich Ebert Foundation used its worldwide network to engage the best experts on tax system, progressive and flat tax methodology in the current discussions in Armenia.

This position paper includes materials accumulated over the last 6 months and the outlined proposals. It covers broad issues related to the current problems of the economic policy of Armenia and presents a comprehensive policy analysis. The research includes materials of the conference on “Taxation, Justice and Economic Development” held on 12 February 2019 in Yerevan, data published by the Ministry of Finance of the Republic of Armenia, the Statistical Committee of the Republic of Armenia, the Tax Revenue Committee of the Republic of Armenia, and others.

We are confident that this detailed work will help in developing an efficient and fair tax system that will foster economic development in Armenia.



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1. Introduction

The Government of the Republic of Armenia (GoA) initiated amendments to tax legislation with a goal to shift from progressive system to flat system of taxation of income. This document presents positions of a group of citizens who do not agree with the idea of the above-mentioned changes initiated by the Government of the Republic of Armenia and is a position paper in this sense.

Changes in income tax rates will result in AMD 27-37 billion loss for the state budget in the first year. The GoA could have used these funds to:

- improve the potential of defense of the Republic of Armenia;
- improve significantly the quality of general education to help pupils studying at schools in disastrous conditions to obtain thorough knowledge in different areas of studies, continue their education at universities, get high salaries in the future and live a prosperous life;
- improve the quality of health services, that will allow providing quality services to wider groups of the society, many of who are deprived of those services;
- solve various problems related to social protection, e.g., raise pensions,
- solve environmental and other problems Armenia faces.

Transition to flat taxation might not harm the progressivity of fiscal policy if it envisaged exemptions for employees with low salaries and the tax legislation was fully applied in case of those having high income. In such cases the tax system may be more progressive compared to models considered as progressive in traditional sense. However, the tax system with large loopholes cannot be considered as progressive. Taking into consideration the fact that among justifications of abandoning the progressive system of taxation the GoA has mentioned that those earning high income are able to avoid high tax rates, other methods to achieve progressivity might not be productive. The fiscal policy may become progressive if taxes collected as a result of implementation of flat rates and taxes levied on consumption are used to foster economic growth and finance expenditures targeting poverty reduction.

The GoA may not succeed in reducing the shadow economy by means of implementation of flat taxes because part of the society believes that in a couple of years, the Government may be forced to raise taxes with the view to address challenges faced by the country. The progressive taxation is a tool to protect the financial and economic system from external shocks. In case of such a shock revenues generated by means of progressive taxation may serve as a source to fund commitments associated with the national security and protection of socially vulnerable groups of population and . These means will serve as the first line of defense in case of shocks. By cancelling progressive taxation, the GoA makes this first layer weaker. There are number of cases when countries reinstituted progressive taxation after economic crises (in some cases upon recommendation of IMF).

2. Taxes and tax policy

Tax policy is the very important part of the economic policy and many researches were conducted by academic community, governments, international organizations, experts and other stakeholders. Usually taxes are classified into two main types: direct and indirect taxes.

Individuals or the organizations are responsible for paying direct taxes out of their income, profit or for property they own. The GoA collects the tax from a person or an organization that has income or profit. The person or organization receiving an income or profit cannot evade paying it. In several countries the employer charges the tax from the salary of the employee and transfers the amount of tax to the budget. Personal income tax (PIT) and the corporate profit tax (CPT) are direct taxes.

Indirect taxes are usually collected by a supplier of goods, services or those implementing works from buyers of goods, consumers of services and entities for who the work is done at the time when they pay for goods, services or works or agree to accept them. If there are goods or services that are exempt from value added tax¹ (VAT), the consumers can evade a VAT or reduce their VAT payments by consuming more VAT exempt goods and services. Usually the amount of the VAT is indicated in the payment document. The organization charging the indirect tax regularly transfers the amount to the government. In case of indirect taxes the consumer – not the supplier of goods or services or the entity that performs the activities – shall bear the burden of the tax. The VAT, the excise tax and the consumption tax are considered as indirect taxes².

More often, the indirect taxes have regressive nature, while the direct taxes can have progressive as well as regressive nature. The indirect taxes can have progressive nature if, e.g., food items of the first need that has big share in the structure of the costs of households with low income are exempt from VAT. Indirect taxes most often have regressive nature while direct taxes can be progressive as well as regressive. The indirect taxes can have progressive nature if, e.g., the food of first need that takes substantial amount from the budget of low income families is exempt from VAT. Similarly, the income tax can be regressive, if lower rate is applied to higher levels of income or if some income, e.g., capital gains is exempt from taxation.

In many countries the income tax and the VAT are the two main components of tax system. Based on experience of Latin American countries, Barreix and Roca (2007) recommend paying special attention to the opportunities provided by the income tax. In addition to ensuring revenues, the income tax has a special role in supporting social cohesion because the large part of the amounts being collected as a result of applying income tax is generated

from the contributions of tax payers having high income. According to Bird (2009), to have a viable comprehensive PIT system, the developing countries need to expand the tax base which in different countries may mean taxing interest earned on government bonds, taxing non-cash compensation to employees, taxing capital gains, exception of preferences and reducing the volume of unrecorded economy. All governments tend to create favorable tax environment and provide tax preferences. High income countries create favorable tax treatment of research and development (IMF 2015), while low-income countries offer tax preferences and low tax rates. Middle-income countries often create preferential tax zones.

Over the last decades, the PIT rates declined. In Latin America the average top rate on personal income declined from 51% in 1985 to 28% in 2003 (Lora u Cardenas 2006, referred to in Bird 2009). In most of the advanced countries of the Organization of Economic Cooperation and Development (OECD) the tax rates are progressive and high. According to a Report by Deloitte (2017), income tax rates in Japan are progressive (5-45%) and worldwide income including the income earned outside Japan serves as the base.

In XIX century, the flat income tax system was applied almost in all countries. In Hungary, the progressivity was incorporated into the tax system in 1909 during the reforms initiated by Sandor Wekerle, which entered into force only in 1922 (Ambrus 2012). Ambrus recorded that in 2012, the developed countries use progressive tax system. The International Monetary Fund (IMF) carried out a number of researches on progressive and flat taxation. When number of countries shifted to implementation of flat tax rate, the IMF experts (Keen, Kim and Varsano 2006) noticed that discussions about this radical reform concentrate on assertion and rhetoric instead of analysis and evidence. According to authors, the main question is not whether more countries will adopt a flat tax system, but whether those countries that adopted flat tax rates will move away from it.

Other IMF experts (Norregaard and Khan 2007) noted worldwide spread of the VAT and reductions in rates of direct taxes, duties and tax wedge on labor (which is the difference between the gross income and the income received in hand, after deduction of the taxes). At the same time they forecasted that the reduction of the CPT rates and adoption of the flat rates by more countries will continue. However, taking into consideration the need for the revenues, according to Norregaard and Khan, the main issue is about the “equilibrium” level of the rates. Norregaard and Khan also believed that the more countries adopt flat tax rates it will lose its positive impact on the new countries and economic decline at the time of research (2007) will lead to fiscal difficulties forcing some countries to move away from flat tax system.

IMF (IMF 2017) expressed an opinion that the wealthy people don't pay their fair share of taxes and records that the reduction of rates on high income individuals in 1980s contributed to the decline in progressivity. The IMF considers this trend as a significant factor contributing to income inequality in the US and other high income countries, which is a consequence of reduction of average income tax rate in OECD member countries from 62% in 1981 to 35% in 2015. In 1990s the tax reforms were accompanied by an increase

1. To address social issues the government may decide to exempt some goods consumed by socially vulnerable groups of population from VAT. In some European countries child garment is exempt from VAT.

2. Some economists classify the consumption tax as direct tax. However, it has the same feature as the VAT with an exception that it is paid at the very end of the value chain by the consumer, while VAT is charged at every stage.

in the exemption threshold that transferred the tax burden on middle class. IMF expressed an opinion that “excessive inequality can erode social cohesion, lead to political polarization and ultimately lower economic growth”.

While considering the rate reduction trend as a consequence of concerns about potential negative impact of progressivity on economic growth IMF publication (IMF 2017) suggests drastic increase of tax thresholds within the progressive system. At the same time it records that according to optimal tax theory the current marginal rates must be higher while we witness a declining trend. Developed economies with low level of progressivity may raise the top marginal tax rates without creating problems for economic growth.

A number of countries having introduced flat taxes faced decline in revenues and problems associated with fiscal balance. The economic crisis in 2008-2009 resulted in drastic decline of revenues in Latvia. In November 2009, the IMF recommended to Latvia to abolish the flat-rate system (Ambrus 2012). While Poland also received a similar recommendation, it refused to move to progressive taxation. Romania, which moved to flat taxation in 2005 asked for a EUR 20 billion assistance from the IMF and started discussions about radical tax reforms, the main component of which was restoration of progressivity of rates on income and corporate profit taxes (Tax Justice Network 2010).

Using OECD data for 1982-2009 Attinasi, Checherita-Westphal and Rieth (2011) concluded that, ceteris paribus, countries with more progressive income tax system have stronger automatic stabilizers³ which at the time of economic decline can serve as a first line of defense.

The next parts of this section below present issues related to progressive and flat taxation of income and profit, increase of collected revenues by reducing the rates (Laffer curve), other payments and structure of taxes collected in western countries.

2.1 Progressive and flat taxation of income and profit

Over the last 25 years several countries initiated a process of transition from progressive to flat taxation of income, including Estonia and Lithuania - in 1994, Latvia in 1995, Russia in 2001, Serbia in 2003, Slovakia and Ukraine in 2004, Romania and Georgia in 2005, the Czech Republic in 2007. In Estonia, Slovakia, Romania and Serbia, the CPT rate is equal to PIT rate.

Northern Macedonia which was called former Yugoslav Republic of Macedonia until 2019, introduced flat tax in 2007 and as a result it reduced the 15%, 18%, and 24% rates to flat 12% rate and the CPT from 15% to 12%. In 2008 the rates of the above mentioned taxes were further reduced to 10%.

Country (tax rate)	Flat	Progressive
Estonia (26%)	1994	
Lithuania (33%)	1994	
Latvia 25 (%)	1995	2018
Russia (13%)	2001	
Serbia (14%)	2003	
Slovakia (19%)	2004	2013
Ukraine (13%)	2004	
Georgia (12%)	2005	
Romania (16%)	2005	
Czech Republic (23 ⁴ %)	2007	2013
Montenegro (15%)	2007	2013
Macedonia (12%)	2007	2019
Albania (10%)	2007	

As a result of the studies of changes in tax and social welfare system in Czech Republic in 2007 Dalsgaard (2008) concluded that although they improve the fiscal policy in the short run they do not reduce the budget gap in the medium to long run they did not and may increase the pressure on fiscal policy. Dalsgaard also recorded that the transition to flat rates was accompanied by reduction of the taxes collected from taxpayers with the lowest and the highest income and reduction in tax base. There was no increase in tax revenues explained by Laffer curve. In 2013 the Czech Republic returned to progressive taxation.

During international conference on “Taxation, Justice and Economic Development” held on 12 February, 2019 in Yerevan, the Minister of Finance of Northern Macedonia (Tevdovski 2019) expressed an opinion that transition from progressive to flat taxation did not have any impact on the level of shadow economy, which fluctuated around 30% of GDP, did not help to attract foreign direct investment, which actually declined, it did not help boosting economic growth because the GDP growth rate actually declined. PIT revenues of the state budget declined by 0.5% of GDP (from 2.7% to 2.2% of GDP) as a result of amendments to tax legislation and the revenues of the state budget declined from 33.4% of GDP to 29.5% of GDP (one of the lowest in Europe). In 2010 1% of the citizens with high income had 12.2% of income compared to 6.3% in 2006. Fiscal policy challenges forced the Government of Northern Macedonia to return to progressive taxation in 2019. The main rate remained at 10% but a new 18% rate was introduced to be applied to the taxpayers with the highest income, the tax base was expanded (and included also interest income), tax deductions were reduced and other changes were made. Capital income tax

3. Automatic stabilizers are the economic policies that allow offsetting fluctuations in economic activity without government intervention. The income tax and the corporate profit tax, as well as unemployment and social security benefits are the best known automatic stabilizers.

4. The Czech model included 15% PIT rate, but because it was calculated over gross income and social security payments by the employer the effective rate was 23%. In real life there are number of effective rates that emerge from tax credits, social security payments and merit based exemptions.

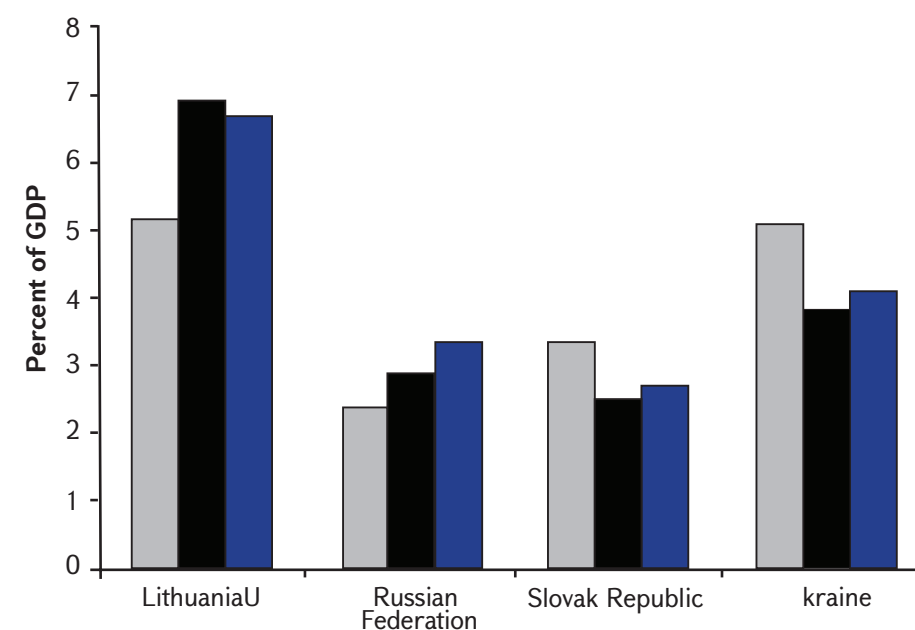
rate – dividends, capital gains and rental income – was raised from 10% to 15%.

One of the goals of changes in the tax system of Slovakia was the reduction of the tax burden. Slovakia was the most successful country with regard to closing loopholes during the process of reduction of rates. During the first year of implementation PIT revenues declined by 0.8% of GDP from 3.3% of GDP to 2.5% (Figure 1), and then they increased to 2.5% of GDP in 2005 mainly by including the self-employed (Gray, Lane and Varoudakis 2007).

Figure 1. PIT revenues

Source: Gray, Lane and Varoudakis 2007

According to the data of the representative of the Ministry of Finance of Slovakia



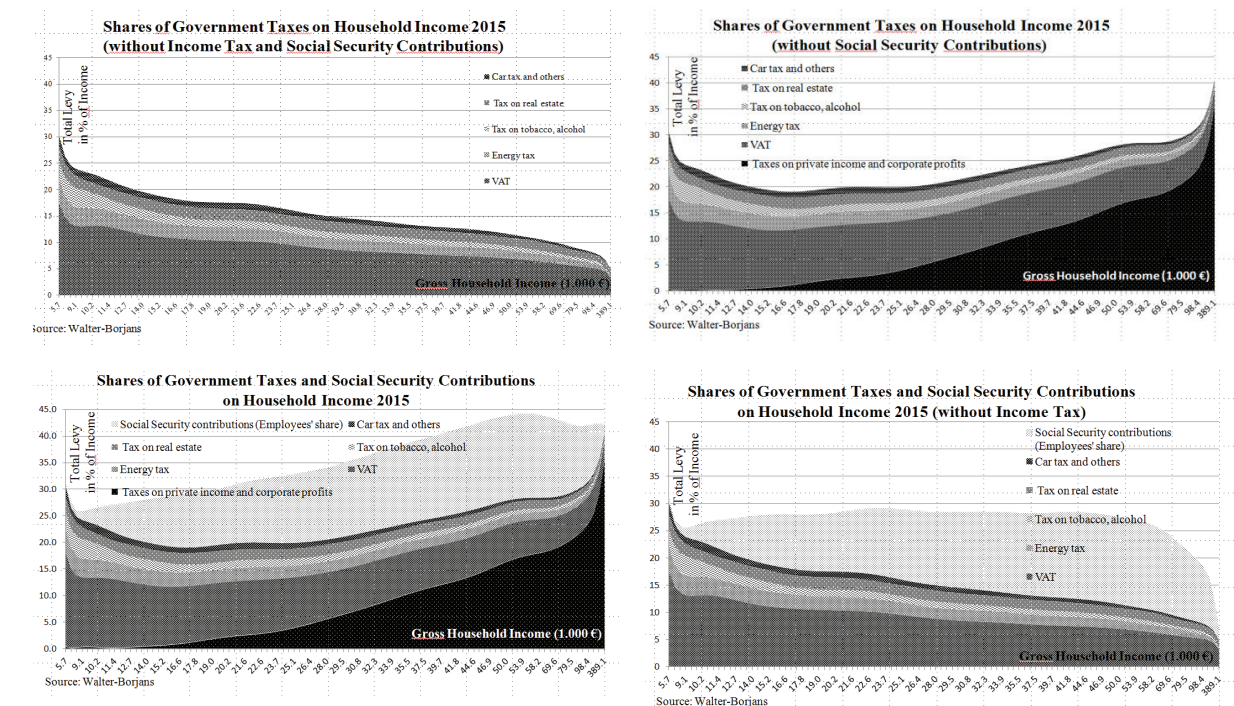
(Marciniciu 2019), in 2004 Slovakia shifted to 19%-19%-19% flat taxation when the same rate was applied for CPT, PIT and VAT. In 2000-2008, the GDP growth did not lead to an increase in the budget revenues and in 2007-2008 it stayed at the same level – 34.4-34.5%. 70% of PIT collections were channeled to local self-government bodies, 30% to regional budgets. The ratio of tax revenues to social contributions dropped from 1.9 in 1995 to 1.3 in 2017, which means that the social contributions are heavy burden for the employed. According to Marciniciu transition to flat rate did not touch upon the key issues associated with the composition of taxes, tax base, costly administration, tax evasions, reduced income of vulnerable groups such as single mothers; it did not result in the increase in foreign direct investment and tax revenues. At the same time it is not clear why the PIT, CPT and VAT rates should be equal.

When shifting to the flat income tax rates, Lithuania used the highest marginal PIT rate of 33% as a result of which the revenues went up (Keen, Kim & Varsano 2006). Authorities in Ukraine expected that PIT revenues would drop by 0.5% of GDP during the first year but

it would fully recover in 2005 (Gray, Lane and Varoudakis 2007). PIT revenues dropped significantly more than anticipated in the first year – by 1.3%, substantially increased to 4.1% of GDP in 2005 but remained below the pre-reform level.

According to the data of the former Minister of Finance of North Rhine-Westphalia region of Germany (Walter-Borjans 2019) the PIT and social security contributions substantially improve progressivity of taxes (Figure 2). Without PIT and social security payments the system is very regressive and families with lower income pay bigger share of their income as taxes. PIT substantially improves the overall picture and increases the share of taxes paid by high income taxpayers.

Figure 2. Impact of taxes on household income



Taxes as a share of household income flatten only when social security contributions are incorporated (without PIT). The share of taxes paid by high income taxpayers is relatively low. When both social security contributions and PIT are taken into consideration taxation has progressive nature and flattens only at the end, when including the taxes of the taxpayers with the highest income.

The German experience the importance of progressive tax system from the point of view of the social justice, as well as having the highest budget revenues.

2.2 The Laffer curve

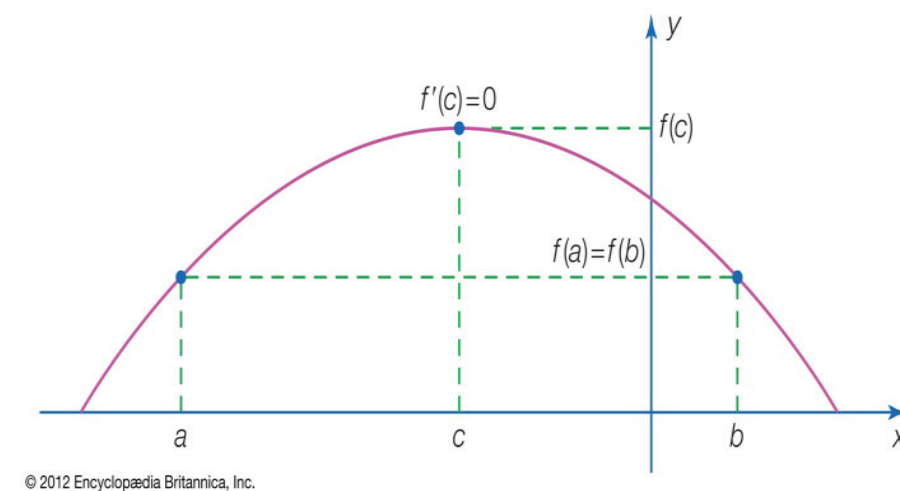
The idea of reducing tax rates to achieve optimal level of collected taxes and foster economic activity is based on conclusions that emerged from Laffer curve.

In early 1980s a group of economists developed the theory of supply-side economics; and according to supporters of supply-side economics reduction of taxes may boost economic growth. According to supply-side economists, high tax rates make people reduce supply of labor and capital and thereby reducing the tax base because economic activity is reduced. This viewpoint is presented with the help of Laffer curve. Efforts to boost economy by means of reduction of tax rates were key during Reagan and Thatcher administrations in 1980s. Many economists claim that the theory suggested by supply-side economists was not supported by real life experience because instead of increasing tax revenue collection rate reduction of tax rates resulted in reduction off tax revenue collection.

The problem of getting the maximum point on Laffer curve was solved in mathematics with the help of Rolle's theorem (Figure 3). According to Rolle's theorem, if the function $f(x)$ is continues on the interval $[a,b]$ (in Figure 4 it is presented as interval $[0,t]$), $f(a)=f(b)$ (on Laffer curve $f(0)=f(t)$), and is differentiable on the $(0,t)$ interval, there is such a point 'c' on the interval $(0,t)$ where $f'(c)=0$ (on Laffer curve $f'(t^*)=0$). Michel Roll proved the theorem in 1691.

Figure 3. Graphical representation of Rolle's theorem

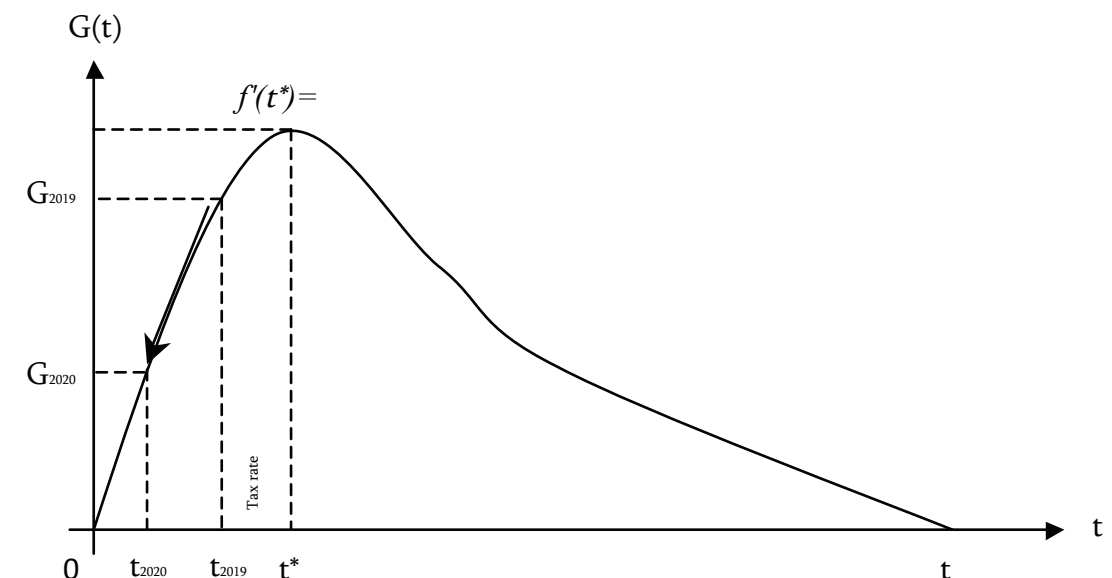
Source: <https://www.britannica.com/science/Rolles-theorem>



The Laffer curve is based on the viewpoint that as the tax rate (t) increases the tax revenue collected increases up to some $G(t)$ level after which revenues start declining (Figure 4), because taxpayers are not motivated anymore to offer more capital and labor because in their opinion they don't get sufficient compensation after paying taxes. Laffer curve can be used to explain the behavior of all taxes; however it is easier to visualize it

in case of direct taxes, because in case of indirect taxes the rate may exceed 100% of the price of the good. In case of direct taxes the rate can be up to 80% or 90% of the income or profit while 100% will mean that all the income or profit is collected as tax. The reduction of tax rates may have positive impact on budget revenues collected if the rate is on the right of point t^* .

Figure 4. Laffer curve



If the tax rate is lower than t^* or is located on the left of t^* on horizontal axis at t_{2019} then reduction of tax rate to level t_{2020} will reduce budget revenues from G_{2019} in 2019 to G_{2020} in 2020. Of course this is a theoretical judgment. However, the judgments of the Ministry of Finance of the Republic of Armenia (MoF) about improvement of competitiveness, attracting investments and other issues are more than theoretical.

2.3 Other payments

The Law of the Republic of Armenia "On Mandatory Social Security Payments" was recognized void in 2016⁵. The employers and the employees stopped making social security payments. In many western countries, in addition to taxes paid from income, the employers and employees make social security contributions. In Germany, the social security contributions amount approximately 21.4% of the gross salary of the employees.

5. HO-179 adopted on 26 December 1997. Recognised void simultaneously after the Law "On Income Taxation" entered into force and the Law on "Personal Income Tax" (HO-183, adopted on 27 December 1997) was recognized void.

Table 1. Social security contributions in Germany⁶ (as percent of gross salary)

Component of social security contribution ⁷	Employee	Employer	Total
Pension insurance	9.3%	9.3%	18.6%
Health insurance ⁸	7.3%	7.3%	14.6%
Unemployment insurance ⁹	1.25%	1.25%	2.5%
Nursing care insurance ¹⁰	1.525% ¹¹	1.525%	3.05%
Accident insurance	-	1.16% ¹²	1.16%
TOTAL	19.375%	20.535%	39.91%

Contributions for all components are consolidated in a common fund. The employee may chose the health insurance provider. In 2019 employees earning gross salary of up to EUR 60,750 are mandatorily insured by one of the public health insurance operators (Gesetzliche Krankenversicherung, GKV). Employees with income exceeding the EUR 60,750 threshold may choose from public and private insurance companies (Privat Krankenversicherung, PKV). Taxpayers are entitled to child benefits for children up to 18 (up to 25¹³ if the child studies): (1) EUR 204 per month for the first two children, (2) EUR 210 per month for the third child, and (3) EUR 234 per month for each next child.

2.4 Tax structure of western countries

Direct taxes prevail in revenues of OECD member states. In 2017 income and profit taxes constituted 59% of taxes in Denmark, 48% in the USA, 42% in Switzerland, 38% in Norway, 36% in Belgium and Sweden, 32% in Germany, 31% in Italy and Japan, 29% in Portugal, 28% in Austria and Spain, 27% in the Netherlands, 23% in France, 22% in Czech Republic, 21% in Poland, Slovakia and Greece, and 19% in Hungary. The average figure for OECD countries is 33%.

In 2017 indirect taxes constituted 40% of taxes collected in Portugal (including 25% VAT), 42% (24%) in Hungary, 33% (22%) in Czech Republic, 31% (22%) in Norway, 36% (21%) in Poland, 33% (21%) in Slovakia, 40% (21%) in Greece, 28% (21%) in Sweden, 32% (20%) in Denmark, 27%

6. Source <https://www.gtai.de/GTAI/Navigation/EN/Invest/Investment-guide/Employees-and-social-security/the-german-social-security-system.html?view=renderPdf>

7. Plus some minor payments

8. Plus the additional amount that any health insurance company can charge from the employee and employer. For 2019 the Federal Ministry of Health set the average amount of additional payment at 0.9% that is equally shared by the employee and the employer. German National Association of Statutory Health Insurance Funds (GKV-Spitzenverband) provides online information about public health insurance companies and their rates.

9. Unemployment contributions are collected by health insurance company and transferred to Bundesagentur für Arbeit.

10. Nursing care insurance

11. Nursing care insurance contributions are transferred via health insurance companies. Employees of age 23 or higher who don't have a child, pay additional 0.25%. There is a special regulation in Saxony.

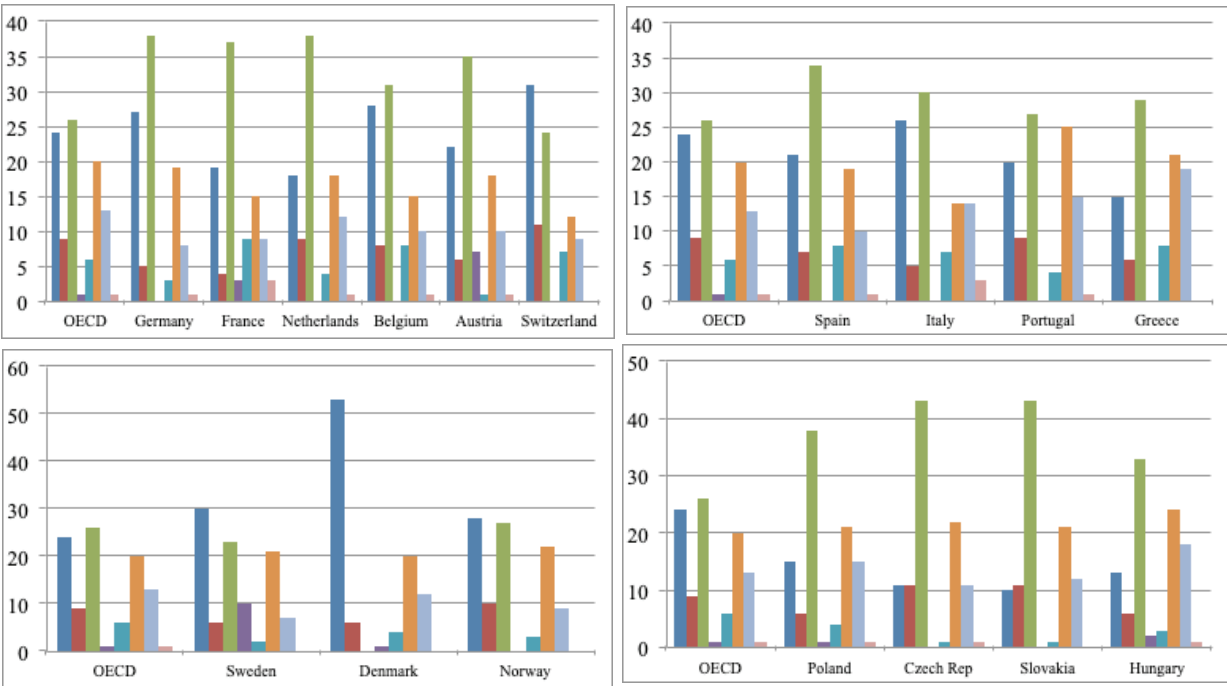
12. The average contribution for accident approved by for 2017 by German Social Accident Insurance (DGUV).

13. Kindergeld Source: <https://www.kindergeld.org/>.

(19%) in Germany, 29% (19%) in Spain, 30% (18%) in the Netherlands, 28% (18%) in Austria, 24% (15%) in France, 25% (15%) in Belgium, 28% (14%) in Italy, 21% (12%) in Switzerland, 20% (13%) in Japan, 17% (0%) in the USA. The average figure for OECD countries is 33% (20%).

Figure 5. The structure of tax revenues in number of OECD countries (as % of total taxes)

Source: OECD



Income tax	Property tax
Profit tax	VAT
Social security contribution	Taxes on goods and services
Payroll taxes	Other taxes

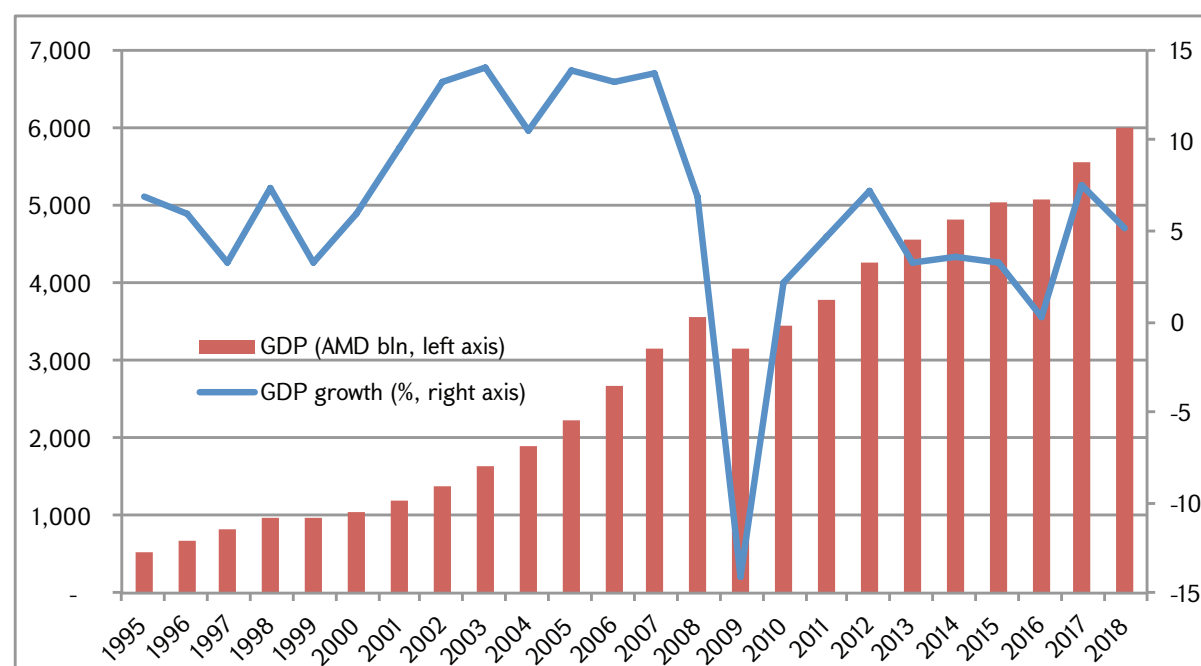
Social security contributions make up a big share in revenues of OECD governments (on average 26%) including 43% in Czech Republic and Slovakia, 38% in Germany, Poland and the Netherlands, 37% in France, 35% in Austria, 34% in Spain, 33% in Hungary, 31% in Belgium, 30% in Italy, 29% in Greece, 27% in Norway and Portugal, 24% in Switzerland, 23% in Sweden, and 0% in Denmark.

3. General characteristics of Armenian Economy

Since 1995 Armenian economy grew 10.5 times, reaching AMD 5,569 billion in 2017¹⁴ from AMD 522 billion (Figure 6) or AMD 1,869 thousands or USD 3,872 per capita. Over the same period, Estonian economy grew 8.5 times (per capita GDP was EUR 23,275 in 2017), Latvian economy grew 6.7 times (EUR 20,128), Hungarian economy - 6.6 times (EUR 19,739), Lithuanian and Irish economies - 5.4 times (EUR 22,672 and EUR 43,701 respectively), Polish economy - 5.8 time (EUR 20,107). The impressive growth of the Armenian economy was not smooth, experienced ups and downs and was characterized by unequal distribution of newly created wealth.

Figure 6. Gross domestic product of Armenia

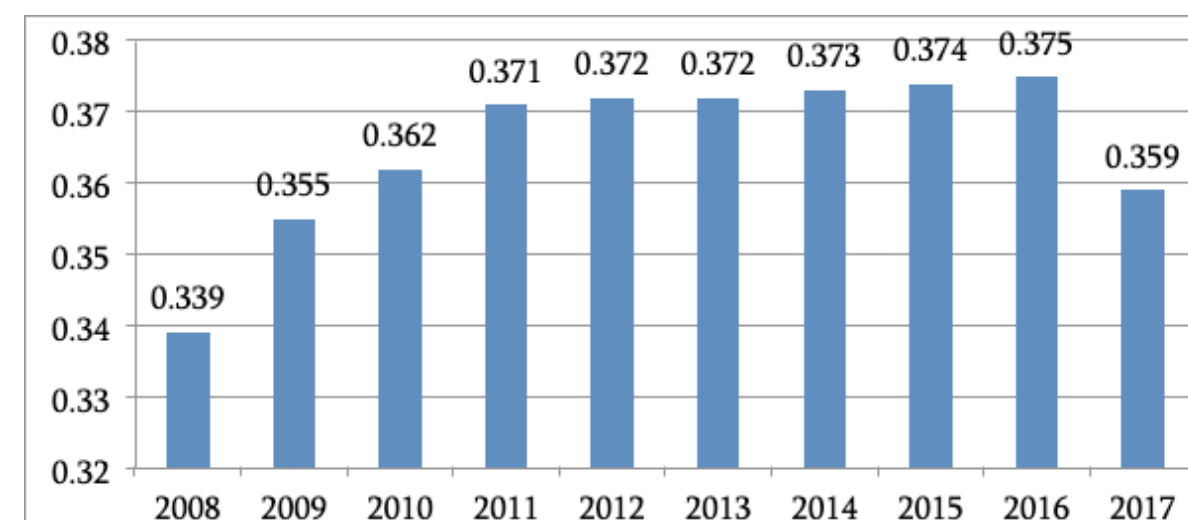
Source: Statistical committee of the Republic of Armenia



Concentration of income described by Gini index¹⁵ reached 0.359 in 2017 compared to 0.339 in 2008 (Figure 7).

Figure 7. Changes in Gini index over 2008-2017

Source: Statistical Committee of the Republic of Armenia



Since 2008, investments in Armenian economy have been declining. In 2017 private investments declined to 17% of GDP compared to 36% in 2008 while public investments declined from 5% of GDP to 2%. Foreign direct investment was USD 230 million (2% of GDP) compared to USD 930 million (approximately 8% of GDP) in 2008. Next parts present the key indicators of the Armenian tax system and the proposed changes.

3.1 Description of Armenian Tax System

The following main taxes, duties and social security contributions existed or exist in Armenia:

Direct taxes	Indirect taxes	Duties and contributions
<ul style="list-style-type: none"> • CPT • PIT 	<ul style="list-style-type: none"> • VAT • Excise tax 	<ul style="list-style-type: none"> • Customs duties • Social contributions

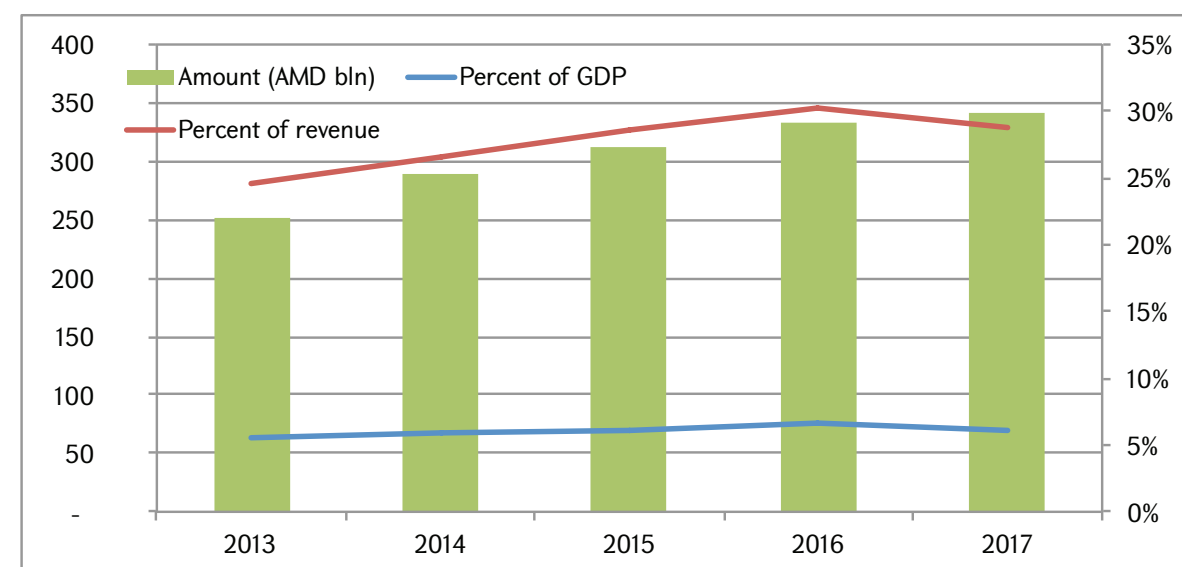
After adopting the Law of the Republic of Armenia “On personal income tax” (HO-246, adopted on 22 December, 2010) and entering into force on 1 January, 2013, PIT became one of the most important sources of budget revenues. Proceeds from PIT increased from AMD 251 billion in 2013 to AMD 342 billion in 2017 or from 24.6% of revenue to 28.8% of revenue (Figure 8).

14. Data for 2018 is preliminary.

15. In case of equal distribution of income Gini index is equal to 0 while in case of absolute inequality it is equal to 1.

Figure 8. Absolute and relative values of personal income tax

Source: Statistical Committee of the Republic of Armenia



PIT is the second biggest source of revenue (Figures 9 and 10). While the share of PIT in total taxes and as a percent of GDP increases, the share of VAT declines from 8.8% to 7.3% of GDP from 2013 to 2017 or 39.3% to 34.3% of taxes.

Figure 9. Revenues collected (AMD bln)

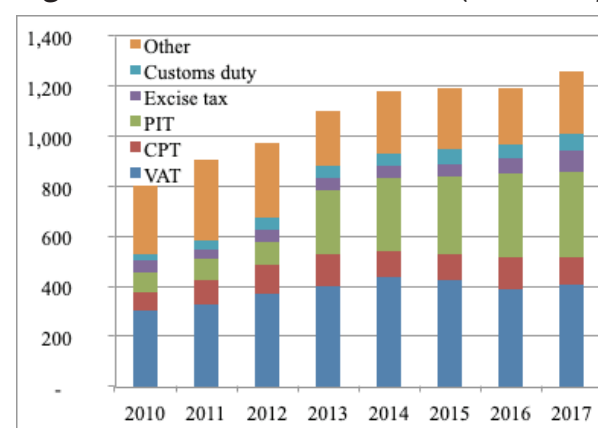
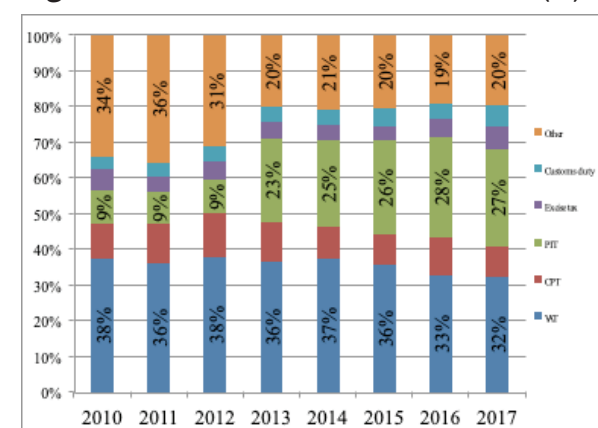


Figure 10. Share of different taxes (%)



Source: Statistical Committee of the Republic of Armenia

VAT collections constituted 32% of all revenues, CPT – 9%, excise tax – 7%, customs duties – 6%, and other revenues – 20%. Only the excise tax and customs duties have clear growth tendency. Other revenues including the property tax, land tax, fixed payments, payments for use of natural resources and environmental protection, the simple tax, turnover tax and other taxes and duties as well as other revenues and official grants constituted 19-20% of revenues (Figures 9 and 10).

Other taxes and duties, out of which CPT, excise tax and customs duties are the most important ones although they don't have clear growth tendency (Figure 11), despite the

fact that the share of excise tax and customs duties have grown to some extent. Over the recent years the payments for use of natural resources and environment protection have a tendency to grow reaching from 1.3%¹⁶ to 3.6% in 2010 to 2017 (Figure 12), however, one must take into consideration that it is quite possible that in the coming years Armenia will have to bear expenditures related to utilization of natural resources (tailing dams, other expenditures).

Figure 11. VAT and the PIT as share of GDP and taxes

Source: Statistical Committee of the Republic of Armenia

Note: Taxes include taxes and duties

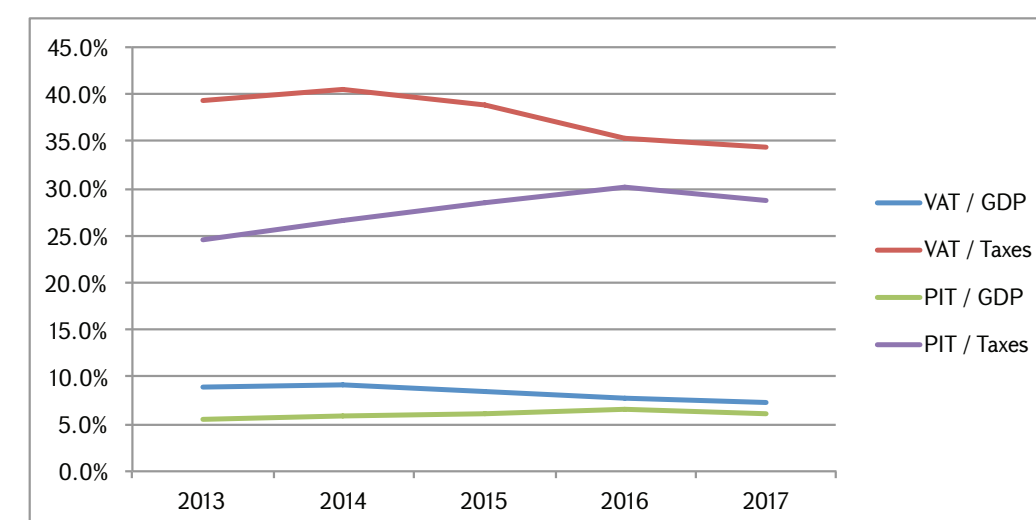
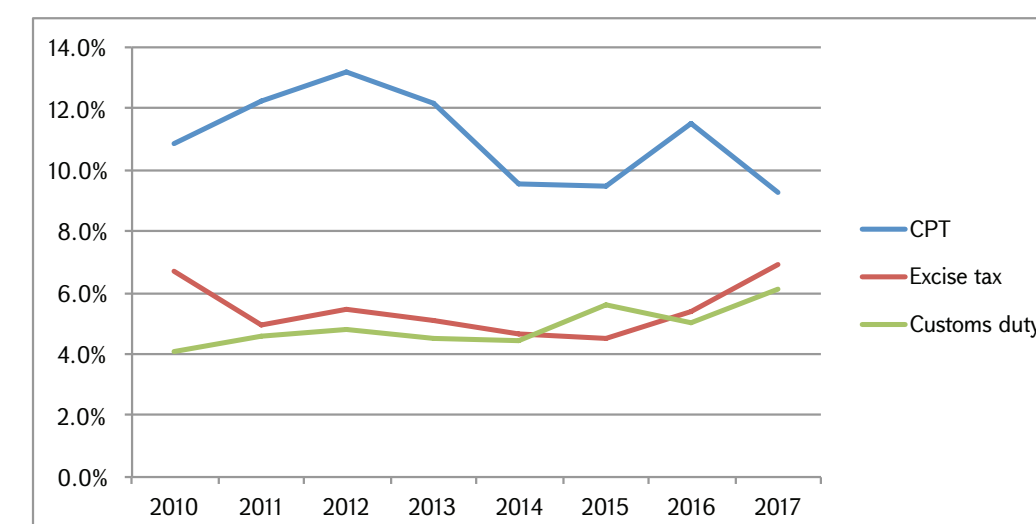


Figure 12. The share of CPT, excise tax and customs duties as percent of taxes

Source: Statistical Committee of the Republic of Armenia



16. From the point of view of this research payments for use of natural resources and environment protection is included as part of taxes and customs duties. Statistical Committee of the Republic of Armenia included those payments among taxes and duties.

3.2 Proposed amendments to the tax system

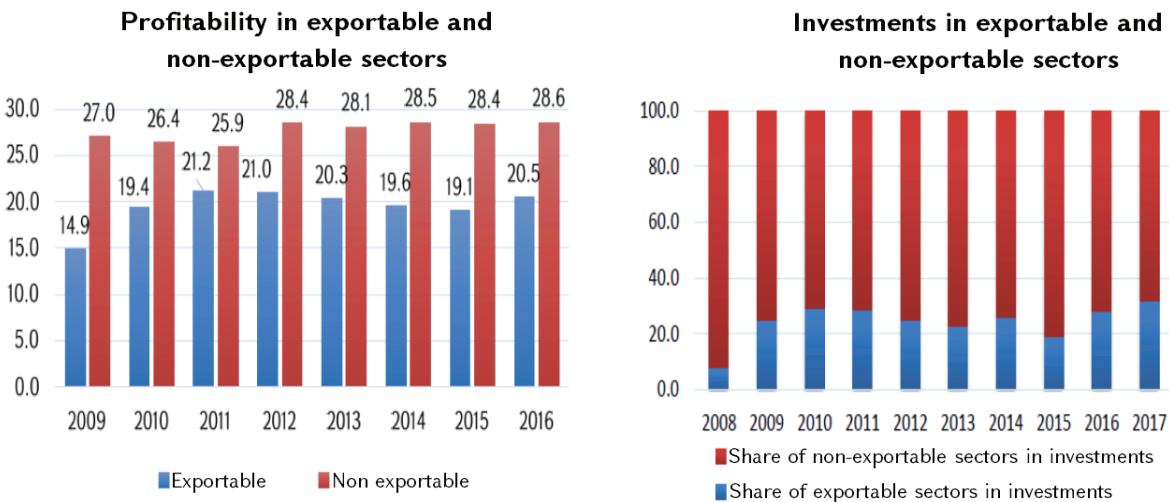
The Ministry of Finance of the Republic of Armenia recommends promoting changes in tax system in the following main directions: (1) reduction of rates of PIT and application of fixed rate, setting the same rate for PIT, profits and dividends, (2) reduction of CPT rate, (3) expansion of items subject to excise taxes, elimination of percentage rates and increasing the rates of excise taxes, (4) increase of the burden of the property tax.

Self employed About 2060 taxpayers Up to AMD 9 mln turnover		Micro-entrepreneurship system Up to AMD 24 million
Family business About 2740 taxpayers Up to AMD 18 mln turnover		
Patenting system About 8200 taxpayer No threshold		
Turnover tax system About 62550 taxpayers Up to AMD 58.35 mln turnover		Turnover tax system Up to AMD 115 mln turnover
General system of taxation About 11000 taxpayers VAT rate - 20% CPT rate - 20%		General system of taxation VAT rate - 20% CPT rate - 18%

According to MoF¹⁷ the export sector of the economy was characterized by low profitability, while investments mainly flew to non-exportable sectors and profits mostly concentrated in non-exportable sector.

Figure 13. Profitability and shares of investments in exportable and non-exportable sectors (%)

Source: Statistical Committee of the Republic of Armenia



According to Statistical Committee of the Republic of Armenia, other services (49.7%), mining (37%), hospitality and organization of public nutrition (28%), administrative and supporting activities (27.6%) and construction (23.8%) are the most profitable industries. Profitability of product is below 20% in other sectors, while for health and social services to public, the profitability of output is negative (-8.1%). Only assets in other services have high asset profitability (40.6%). Profitability of other assets is below 17%, while supply of electricity, gas, steam and fresh air (-0.7%), supply of water, sewage services, waste management and processing (-2.1%) and health and social services to population (-3.9%) have negative asset profitability.

MoF did not present analysis of profitability levels and differences of profitability between exportable and non-exportable sectors. Over the period presented by the – 2009-2016 – the Armenian economy was characterized by low competition, presence of monopolies, etc., which could result in high profitability in certain industries or of certain products or services. Some “non-exportable” services (e.g., barbers, organizations of funerals and other services) may have very high profitability¹⁸. Notably, high profitability was recorded in industries (repair of computers, mobile telephones, house appliances, furniture repair) that provide small-scale workshops¹⁹ related to services and require professional skills. At the same time exporting companies don’t have the privileges that enjoy the companies with monopoly power in the domestic power and must compete in external markets with

17. “Main directions: of changes of tax system of the Republic of Armenia” prepared by the Ministry of Finance of the Republic of Armenia.

18. In cooperation with the Statistical Committee of Armenia Modex consulting company calculated the profitability of different big and medium size companies operating in different sectors or Armenian economy. Source <http://b4b.am/archives/news/%D5%B8%D6%80%D6%84%D5%A1%D5%9E%D5%B6-%D5%A7-%D5%B7%D5%A1%D5%B0%D5%B8%D6%82%D5%A9%D5%A1%D5%A2%D5%A5%D6%80%D5%B8%D6%82%D5%A9%D5%B5%D5%A1%D5%B6-%D5%B4%D5%A1%D5%AF%D5%A1%D6%80%D5%A4%D5%A1%D5%AF%D5%A8>

19. The statistical committee of Armenia provides info about big and medium size companies providing these services.

companies operating in those markets and must accept the rules, business practices and prices established in those markets while in the past some local companies used to establish their “own” rules and prices for the market.

The goals of changes of the tax system are:

- 1) Improving the investment attractiveness of national economy.
- 2) Improving economic activity:
 - a. creation of sustainable basis for export,
 - b. creation of sustainable basis for economic growth,
- 3) Strengthening fiscal sustainability.

3.3 Impact of proposed amendments on income

Proposals related to changes in the Tax Code will have different impact on incomes of employees with different salaries. While the income of employees with the lowest income will increase by at most AMD 1500 per month over 2020-2023, the incomes of employees having the income from AMD 150 thousands to AMD 2 million will increase by several dozens of thousands of drams and the salary of person e.g., earning AMD 9 million per month will increase by about one million drams per month. MoF “observations show that the monthly income of 65% of about 610 thousands employees do not exceed 150 thousand drams, while only in the case of 0.3% of employees more than 2 million drams income per month is reported”. In case of these amendments the increase of monthly income of those employees earning 150 thousand drams is presented in Table 2 for each next year (where the additional income is the increase compared to 2019).

Table 2. Impact of amendments in tax legislation on employees with monthly income of 150 thousand drams

Source: Own calculations

Year	2019	2020	2021	2022	2023
Tax rate	23%	23%	22%	21%	20%
After tax income	115,500	115,500	117,000	118,500	120,000
Additional income	0	0	1,500	3,000	4,500

Employees earning 2 million drams per month will grossly benefit as a result of these amendments (Table 3): The monthly income of an employee earning 2 million drams will increase by 92,500 drams per month in 2020 (or about \$190 if we use the exchange rate as of the beginning of 2019), AMD 112,500 (\$230) in 2021, AMD 132,500 (\$270) in 2022, and AMD152,500 (\$310) in 2023.

Table 3. Impact of amendments in tax legislation on employees with monthly income of 2 million drams

Source: Own calculations

Year	2019	2020	2021	2022	2023
Tax rate	23%, 28%	23%	22%	21%	20%
After tax income	1,447,500	1,540,000	1,560,000	1,580,000	1,600,000
Additional income	0	92,500	112,500	132,500	152,500

Employees earning 9 million drams per month will substantially benefit as the result of these amendments (Table 4). The monthly income of an employee earning 9 million drams will increase by 1,002,500 drams per month in 2020 (\$2000), AMD 1,092,500 (\$2250) in 2021, AMD 1,182,500 (\$2400) in 2022, and AMD1,272,500 (\$2600) in 2023.

Table 3. Impact of changes in tax legislation on employees with monthly income of 9 million drams

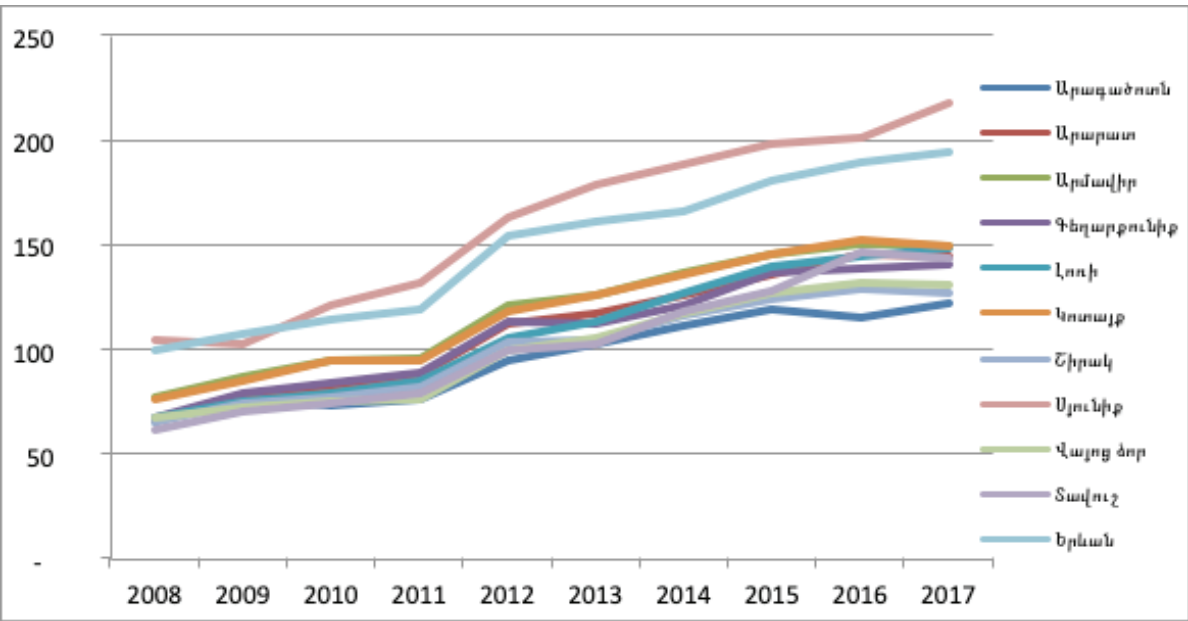
Source: Own calculations

Year	2019	2020	2021	2022	2023
Tax rate	23%, 28%, 36%	23%	22%	21%	20%
After tax income	5,927,500	6,930,000	7,020,000	7,110,000	7,200,000
Additional income	0	1,002,500	1,092,500	1,182,500	1,272,500

3.4 Regional consequences of proposed amendments

Changes in PIT rates will have impact on regional development aggravating disproportionalities of income of population living in Yerevan and Marzes. According to data of the Statistical Committee of the Republic of Armenia in 2017 (this was the most up to date data as of March 2019) only average monthly salaries in Syunik Marz have been above AMD 150 thousands since 2012 and equaled to AMD 218 thousands in 2017. The monthly average salary in Syunik Marz exceeded even those in Yerevan, where it was equal to AMD 194.2 thousands. Over the recent years salaries in 3 Marzes changed in line with economic developments in Armenia and came close to AMD 150 thousands including in Kotayk – AMD 149.9 thousands, Armavir – AMD 149.4 thousands, Lori – AMD 148.9 thousands. Salaries in other Marzes were below AMD 145 thousands and were equal to AMD 122 thousands in Aragatsotn Marz, AMD 144.5 thousands in Ararat Marz, AMD 140.6 thousands in Gegharkunik Marz, AMD 127.4 thousands in Shirak Marz, AMD 132 thousands in Vayots Dzor Marz and AMD 143 thousands in Tavush Marz. Taking into consideration that some part of rural population is not hired employee at all it will not benefit from proposed changes.

Figure 14. Gross monthly salaries in Marzes over 2008-2017 (AMD thousands)
Source: Statistical Committee of the Republic of Armenia



The GoA did not present information about which part of the additional income of AMD 27-37 billion that it plans to leave to citizens will be distributed to Marz population. One may assume that managers of financial organizations, mobile operators, mining and IT companies earn salaries that exceed AMD 2 million. The head offices of most of those companies (if not all) are located in Yerevan. Thus, one may assume that managers of those companies live in Yerevan. Hired employees living in Yerevan will be the main beneficiaries of flattening of PIT rate. Most probably the proposed amendment will deepen the differences in the level of living standards between capital city and Marzes and will not support proportional development of regions.

3.5 Progressivity of proposed amendments

On 1 January 2016, the 17 Sustainable Development Goals (SDGs) of the 2030 Agenda for Sustainable Development – adopted in September 2015 at a historical UN Summit – officially came into force (UN 2016). The assumption is that countries will mobilize efforts to end all forms of poverty, fight inequalities and tackle climate change. Some SDGs refer to poverty reduction and equity. Specifically within the framework of goal №8 (Promote Sustained, Inclusive and Sustainable Economic Growth, Full and Productive Employment and Decent Work for All) the least developed²⁰ countries must sustain at least 7% GDP growth, within the framework of goal №10 (Reduce Inequality within and Among

Countries) it is assumed that by 2030 countries must achieve income growth of the bottom 40% of the population at a rate higher than the national average (Goal 10.1), must adopt policies, especially fiscal, wage and social protection policies and progressively achieve greater equality (Goal 10.4), and within the framework of goal №12 (Ensure Sustainable Consumption and Production Patterns) must promote public procurement practices that are sustainable, in accordance with national policies and priorities (Goal 12.7).

If one assumes that in 2019 the minimal consumption basked is worth AMD 62,500 a family of 4 with 2 children and with two parents earning salary of AMD 150,000 in hypothetical situation will pay as taxes approximately equaling to AMD 107,580 or about 35.84% of monthly income. At the same time the family will be about AMD 19,000 short of money to cover its costs within the limits of the consumption basket.

	AMD
Salaries of two parents (150,000 x 2 =)	300,000
PIT paid by two parents (300,000 x 23% =)	69,000
After tax income	231,000
Consumption of a family of four (62,500 x 4 =)	250,000
Amount necessary to fully pay for the consumption	(19,000)
VAT paid against goods consumed at AMD 231,000 (231,000 x 16.67% =)	38,508
	Percent
PIT and VAT as percent of total family income (35.84

At the same time, if 2 working members of the family earn AMD 2 million each and spend the minimum consumption basket, the family will pay AMD 1,146,675 or 28.67% of its income. The regressivity of PIT rates is obvious.

	AMD
Salaries of two parents (2,000,000 x 2 =)	4,000,000
PIT paid by two parents (4,000,000 x 23% =)	1,105,000
After tax income	2,895,000
Consumption of a family of four (62,500 x 4 =)	250,000
Savings ²¹	2,645,000
VAT paid against goods consumed at AMD 250,000 (250,000 x 16.67% =) ²²	41,675
	Percent
PIT and VAT as percent of total family income (28.67

21. Even if the savings are deposited the income will be taxed at the time when the term of the deposit expires.
22. VAT paid by the family will be bigger because it will be used to pay against the entire consumption basket while the first family income was AMD 19000 short to cover the entire costs of consumption basket.

20. Starting from 2018 Armenia is classified as a high middle income country.

In order for the second family to pay the same share of taxes from its incomes as the share of taxes paid by the first family, the second family must consume 7.88 times more. Taking into consideration that it is unlikely that a family of 4 will spend AMD 1.9 million on consumption it is highly probable that as a result of amendments in PIT rates high income families will spend the additional income abroad, on luxury items and for other purposes which will not support Armenian economy and will negatively affect external trade balance. Taking into consideration amendments to be proposed with regard to property tax, less money will flow to real estate market (that issue will be addressed later).

	AMD
Salaries of two parents (2,000,000 x 2 =)	4,000,000
PIT paid by two parents (4,000,000 x 23% =)	1,105,000
After tax income	2,895,000
Consumption of a family of four (7.88 times of minimum consumption basket)	1,971,206
Savings	923,794
VAT paid against goods consumed at AMD 1,971,206 (1,971,206 x 16.67% =)	328,600
	Percent
PIT and VAT as percent of total family income (35.84

3.6 Amendments considered in the area of property tax

The Head of the International Monetary Fund (IMF) Armenia Mission Hossein Samiei welcomed the Armenian authorities' commitment to overhaul property taxation within 2019-20 to increase fairness.

Armenian authorities must establish high property tax rate for fashionable real estate, cars and other property. However, it is less probable that the property tax will become a reliable and stable source of funding of the state budget and will compensate the losses resulting from reduction of PIT rates, because:

- 1) Article 28¹ (Inflows and Outflows of Administrative Budget) of the Law of the Republic of Armenia "On budgetary system of the Republic of Armenia" (HO-137, adopted on 24 June 1997) the property tax on real estate and means of transportation are the tax income of local self-governing bodies,
- 2) The tax base of the property tax is limited and establishing higher tax rates will compress the formation of new property and restrain the increase of budgets of local self-governing bodies.

The policy of taxing property instead of income is dangerous for the state budget because it can reduce the tax base (the income of the citizens of the Republic of Armenia

may increase but their property in Armenia may not), as instead of taxation of the income at the source, its taxation makes it in dependent from the desire of the citizen to have property in Armenia. The revenues of the budget will depend on prices of real estate in the market and may play the role opposite to automatic stabilizers, as the revenues may decline at the time when they are most needed²³. This mechanism can make the Armenian economy more vulnerable to external shocks.

It is quite possible that the additional income the Armenian citizens will receive as a result of reduction of PIT rates will be invested in real estate of foreign countries. In that case the additional income will not have any positive role for the Armenian economy while the capital outflow may worsen the economic situation in the period of economic problems.

3.7 Assessments by International institutions

International financial institutions addressed the issue of Armenian tax system and its progressivity many times.

Davoodi and Grigorian (2007) recorded that over time, Armenian tax system has less reliance on direct taxes that tend to increase with income and react to economic developments and rely more on indirect taxes. The share of indirect taxes increased in total taxes and from 64% in mid 1990s it reached 80% in early 2000s. According to the authors, basing the tax policy on indirect regressive taxes adds up inequality because the propensity of consumption of low income households is higher. At the same time, if the tax system is not sufficiently progressive, the increase of gross income may not result in substantial improvement of collected taxes especially if the large part of the additional income is accumulated by the taxpayers having high income. Publications related to the region also indicate the need to improve progressivity of the tax system (Kunzel, de Imus, Gemayel, Herrala, Kireyev and Talishli 2018).

In 2008 Gracia, Floerkemeier and Darius concluded that automatic stabilizers in Armenia were weak because on the expenditure side the unemployment benefits and other countercyclical policies were weak while on the revenue side, any progressivity of the tax system was eliminated because of the weaknesses in tax administration that weakens the link between the economic activity and the tax collection.

The 2010 the IMF publication (El-Ganainy and Weber 2010) recommended Armenian authorities to strengthen the impact of automatic stabilizers by enhancing revenue collection, increasing the progressivity of the tax system and improving tax administration. The authors concluded that one of the explanations of weakness of automatic stabilizers was insufficient progressivity of tax system which due to non-proportionality of the tax

23. At times of economic decline prices of real estate usually decline which might result in reduction of tax base. At the same time, in case of economic decline expenditures related to unemployment and social protection benefits increase.

system²⁴ and wide spread exemptions and tax preferences. Taking into consideration the fact that automatic stabilizers provide quick and self-correcting fiscal response, among other things the authors suggested increasing the progressivity of the tax system. In June 2017 publication of IMF experts (Dabla-Norris, End, Rahim, Zohrab and Grooke 2017) indicated that low level of public expenditures and weak progressivity of the tax system weakens the impact of automatic stabilizers in Armenia.

Based on 2014 public expenditure review, the World Bank (World Bank 2014) concluded that from point of view of justice it was preferable to make changes that would result in an increase of direct taxes either by increasing tax rates or by engaging more employees in formal economy.

International partners regularly highlight the issue of tax credits. In its 2014 publication, the World Bank (World Bank 2014b) indicated that the tax overpayments constituting 5% of GDP were a serious problem for effectiveness of business environment because working capital of companies was used to “lend” money to state budget. In 2016, the World Bank informed (World Bank 2016) that throughout 2010-2014 actual tax collection was supported by tax credits paid by active taxpayers. Tax credits are the state budget liabilities that are the consequence of prepayment, VAT subject to return and other amounts received by the state budget. At the end of 2014 tax credits were equal to AMD 258.7 billion or twice the amount of tax arrears. The amount of overdue tax arrears in 2015 was equal to AMD 120 billion, however large part of it was due by bankrupt or non-performing companies.

Table 5. Tax arrears and credits in 2012-2015 (end-of the year, AMD billion)

Source: World Bank 2016

	2012	2013	2014	2015
Tax arrears	100.1	102.7	114.0	120.5
Tax credits	234.7	254.7	258.7	262.7
Net tax arrears	(134.6)	(152.0)	(155.3)	(142.2)
GDP (nominal)	4,267.0	4,556.0	4,828.0	5,043.6
Net tax arrears, % of GDP	(3.2)	(3.3)	(3.2)	(2.8)

This means that the private sector implicitly subsidizes the state budget by about 3% of GDP.

In 2017 report the World Bank (World Bank 2017) indicated the limited ability to raise public revenue compared to the size of the economy. The Bank also mentioned that Armenia’s CPT was relatively efficient. Touching upon the poverty issues, the report mentioned indicated that the Family Benefit Program covered only 27.5% of families in

need²⁵. In 2015, the program reached around 13% of the population although there is further scope to improve targeting because only 61% of resources went to poor.

Some international financial institutions were very optimistic and considered some events taking place in Armenia as a “window of opportunity”. 100 years after October Socialist Revolution and 5 months before velvet, non-violent populous revolution in Armenia the World Bank published a report about a window of opportunity to tackle challenging reforms (World Bank 2018b) where it noted that the ruling Republican Party of Armenia (RPA) won a commanding victory in April 2017 parliamentary elections, hinting that the 58 mandates out of 105 enabled to form a stable majority government, encourage export promotion and foreign direct investment. The report referred to GIZ 2011 publication that discovered that two thirds of Diaspora Armenians who had invested in Armenia found the business environment unfavorable due to inefficient public administration, tax policy and corruption.

In its first publication after velvet, non-violent revolution in Armenia in April-May 2018 the World Bank mentioned (World Bank 2018) that “Although the new government has signaled its commitment to lower the deficit while strengthening redistributive policies and fighting tax evasion, the details are yet to be articulated.” Based on the above it is not clear (1) how the flat rate applied in case of PIT will support the the strengthening the redistributive policies, and (2) how the GoA is planning to fight against “tax evasion” when it declares that the progressive PIT system does not serve the redistributive purpose because high income taxpayers evade paying taxes and plans to amend the legislation with that justification.

MoF explained the transition to PIT flat rate and reduction of the rate in the coming years by the expression “to reduce the tax burden resulting from direct taxes and transfer it to indirect taxes to some extent” in the Program of the GoA. In summer 2018 the World Bank mentioned (World Bank 2018) that “indirect taxes accounted for the bulk of the increase in tax collection”. Instead of diversifying its revenues the GoA prefers changes that from the point of view of the state budget will increase the role of indirect taxes, will make the revenues of the state budget less diversified, collections from indirect taxes – VAT and excise tax – will become bigger and will comprise a bigger share of the state budget revenues, reducing diversification of the state budget revenues and increasing the associated risks.

The IMF expressed an opinion²⁶ that reforms suggested by the GoA will lead to the loss of revenue in the short run while the increase in revenue resulting from improved tax administration will materialize only over time. According to IMF, from the point of view of

25. The number of families receiving benefits was 121,000 in 2008, became 91,000 in 2011 and consistently grew to 107,000 in 2016.

26. The IMF will provide USD 250 million within the Stand-By Arrangement <https://banks.am/am/news/newsfeed/16934>, the economic growth in Armenia in 2019 will be 4.5%. The IMF projection http://arka.am/am/news/economy/HH_um_tntesakann_ajy/ expressed during press-conference of the IMF Armenia Mission Hossein Samiei on 26 February 2019.

24. For instance, both the bottom and top personal income tax rates of 10 and 20 percent, respectively apply at relatively moderate to low income levels suggesting that the tax system imposes a heavy tax burden on low income households with little revenue for the system.

mitigating implications of losses it is extremely important to implement overall package of tax reforms paying attention to the impact of the proposed amendments on equity²⁷. The IMF welcomed the decision to consider changes to the property tax considered for 2019-2020 to improve equity and called on for further efforts to improve tax administration and fight against deeply rooted tradition of tax evasion. According to the IMF though the flattening the PIT rate *may have* positive effect in the medium run, in the short run it is necessary to find alternative sources to cover revenue loss.

3.8 Participativeness in discussions of amendments

Within the framework of its mandate in the area of public revenue policy the MoF carried out overall tax analysis²⁸ and regularly discussed the formulated proposals in the offices of the Deputy Prime Minister and the Prime Minister with participation of the representatives of the staff of the MoF, the Ministry of Economic Development and Investments, the Central Bank, the State Revenue Committee and of the Prime Minister's office. MoF mentioned that representatives of taxpayers, civil society and professional organizations participated in discussions and some changes proposed in specific areas were discussed in MoF with industry representatives²⁹. As a result of the behavior of the MoF the process was not participatory, making some of the other organizations that were not invited to the events organized by MoF to organize their own events to which the representatives of MoF were invited.

4. Analysis

Among the principles of amendments to the tax system MoF mentioned:

- Neutrality from point of view of the impact on 2019 state budget;
- Reduction of tax burden in respect of direct taxes, increase of the tax burden on consumption and property;
- Simplification of the tax system;
- Equity of the tax system;
- Comprehensive and balanced promotion of reforms.

According to the first sentence of paragraph 5 of Article 47 of the draft posted on the www.e-draft.am website “The second part of Article 3, Articles 21, 22, 23, 24 and the first part of Article 27 of this law shall enter into force on 1 September 2019”. The above-mentioned first part of Article 27 regulates PIT rates. In that sense the argument on neutrality of the proposed amendments to 2019 budget is not convincing.

The claim about increasing the tax burden by means of property tax is also not convincing because provisions related to these amendments were included neither in the draft posted on www.e-draft.am on 15-30 November 2018, nor the posted on 23 January to 7 February 2019 which underwent substantial amendments though compared to November draft but did not address the issues related to property tax.

The draft amendments to the Tax Code envisage simplifications for self-employed, family businesses and entities working under licensing system. The draft was complicating the tax regulations for accountants, consultants and entrepreneurs providing legal service³⁰ whose turnover does not exceed the threshold set for turnover tax purposes.

Amendments to the Tax Code increase the gap between the welfare of high income and low income members of the society and in that sense the claims about the fairness of the system are not well reasoned. During discussions couple of very negative trends emerged. In particular, the supporters of amending the progressive rate system blamed their opponents in matters that have nothing to do with opponents. More specifically, the supporters of transition from progressive to flat tax system and changes of PIT rates claim that in this case high quality experts will emigrate. It is at least strange, that the experts that lived and worked in pre-revolutionary Armenia with progressive PIT rates and did not think about emigrating, will do so in post revolutionary Armenia if PIT rates are not changed from progressive to flat.

This leaves the impression of blackmailing. If Armenian citizens relocate abroad to work, there is little probability that this will be because of the PIT rates, because in most

27. In the Armenian text the English word “equity” was translated as “equality” which does not correctly express the essence of one of the concerns expressed by critics of proposed changes.

28. MoF answers to citizen Hrag Papazian.

29. It is not clear how MoF selected organizations.

30. The Prime Minister announced in the National Assembly that the GoA dropped this initiative because of technical problems in implementation.

countries where Armenian citizens have mainly moved to since independence³¹ – with the exception of Russia - have more progressive systems and higher rates. Table 6 presents PIT rates effective in the USA³².

Table 6. PIT rates in the USA depending on income level in 2018-2019 fiscal year

PIT rate	Individual	Married couple
10%	Up to \$9,525	Up to \$19,050
12%	\$9,526 - \$38,700	\$19,051 - \$77,400
22%	\$38,701 - \$82,500	\$77,401 - \$165,000
24%	\$82,501 - \$157,500	\$165,001 - \$315,000
32%	\$157,501 - \$200,000	\$315,001 - \$400,000
35%	\$200,001 - \$500,000	\$400,001 - \$600,000
37%	Exceeding \$500,000	Exceeding \$600,000

Table 7. PIT rates in Canada depending on income level in 2019 fiscal year³³

Canadian dollar	Marginal tax rates for 2019			
	Other income	Capital income	Dividends in Canada	
			Eligible	Non eligible
Up to \$47,630	15.0%	7.50%	-0.03%	6.87%
\$47,630 - \$95,259	20.5%	10.25%	7.56%	13.19%
\$95,259 - \$147,667	26.0%	13.00%	15.15%	19.52%
\$147,667 - \$210,371	29.0%	14.50%	19.29%	22.97%
Exceeding \$210,371	33.0%	16.50%	24.81%	27.57%

Table 8. PIT rates in 2018 fiscal year

Germany ³⁴		France ³⁵	
Rate	Bracket (EUR)	Rate	Bracket (EUR)
0	Up to €9,000	0	Up to €9,964
14%	€9,001 - €54,949	14%	€9,964 - €27,519
42%	€54,950 - €260,532	30%	€27,519 - €73,779
45%	Exceeding €260,533	41%	€73,779 - €156,224
		45%	Exceeding €156,224

31. The USA, Canada, EU member states (mainly Germany, France, Belgium and the Netherlands) and Russia.

32. Presents the main indicators. May be reductions and other regulations. <https://www.forbes.com/sites/robertberger/2017/12/17/the-new-2018-federal-income-tax-brackets-rates/#8f6124e292a3>

33. Presents the main indicators. May be reductions and other regulations. <https://www.taxtips.ca/taxrates/canada.htm>

34. Presents the main indicators. May be reductions and other regulations. <https://home.kpmg/xx/en/home/insights/2011/12/germany-income-tax.html#2>

35. Presents the main indicators. May be reductions and other regulations. There are other brackets for married couples. <https://www.french-property.com/guides/france/finance-taxation/taxation/calculation-tax-liability/rates>

Table 9. PIT rates

Belgium ³⁶ (2018)		The Netherlands ³⁷ (2017)	
Rate	Bracket (EUR)	Rate	Bracket (EUR)
25%	Up to €11,070	8.9%	Up to €19,982
30%	€11,070 - €12,720	13.15%	€19,982 - €33,791
40%	€12,720 - €21,190	40.8%	€33,791 - €67,072
45%	€21,190 - €38,830	52%	Exceeding €67,072
50%	Exceeding €38,830		

Russian Federation has a 13% flat tax rate. There are several publications that claim that the Government of the Russian Federation considers raising the PIT rate to 15%.

The supporters of changes of PIT rate and transition from progressive to flat system claim that the supporters of progressive system are against high salaries^{38 39}. This is a

[french-property.com/guides/france/finance-taxation/taxation/calculation-tax-liability/rates](https://www.french-property.com/guides/france/finance-taxation/taxation/calculation-tax-liability/rates)

36. Presents the main indicators. May be reductions and other regulations. There are other brackets for married couples. https://europa.eu/youreurope/citizens/work/taxes/income-taxes-abroad/belgium/index_en.htm

37. Presents the main indicators. May be reductions and other regulations. There are other brackets for married couples. https://europa.eu/youreurope/citizens/work/taxes/income-taxes-abroad/netherlands/index_en.htm

38. A piece from the speech of the Prime Minister Nikol Pashinyan on 27 March 2019: “Who is the person that earns high salary: that is the one who went and studied at the university from morning until night, plodded, did not sleep at night, had the status of a starving student abroad or in Armenia, became a high quality professional and now he earns a salary of 1-2 million drams. We should not go after that person and say how can you earn such a high salary? We should point out at him ... When we say hero of our times, he is the hero of our times. This person went to study, did not hang around in the street and got education.” (available on page <https://www.shantnews.am/news/view/325480.html>):

39. In response to the question from a member of National Assembly during the discussion on execution of the program of the GoA, Prime Minister Nikol Pashinyan said: “Thank you. You are raising a very important issue. In reality it is a broader issue than to be answered in 3 minutes. I will try to answer some of them. Firstly, regarding the property tax. Yes, we intend to implement reforms in the area of property tax simultaneously from 1 January of 2020, and because I want to show the link of this issue with our intention related to the process of flattening of personal income tax, because there is such a criticism, that we actually reduce the personal income tax for high salaries and that is considered as socially incorrect policy. I don’t agree with this of course. I will try to justify it now why. And secondly, however I want to say, that we change the property tax system in a way, that socially fair taxation will be introduced via property tax. Because in the Republic of Armenia there is an impression that say that the number of people getting high salary is very small. There is an impression that we all go after those people getting high salary and want to present them as a social pole, as if they are the rich, and so on, and so forth. I want to announce in a responsible way that nobody in the Republic of Armenia has become rich and especially extremely rich with a salary. On the contrary, when speaking about the vision of our country, yes, in the program of our Government it is written that we will encourage the policy of high salary. Today there are people that say wow, what a bad policy you are promoting. Let’s do so, that the citizen earning a salary of 80000 drams can do well with his/her salary of 80000 drams. We say that is a fake position, because we don’t want to fight for the person to earn 80000 drams in the Republic of Armenia and we do so that he/she lives a little bit better. We speak about the strategic vision of Armenia. In the Republic of Armenia, sorry for rude word, there should be no cheap labor, in the Republic of Armenia there should be high quality labor that earns high salary. And yes, we reduce the tax for those earning high salary to communicate this message. On the other hand we say that we want to become a high tech country. But we impose so high tax on high salaries in the sector of technologies that nobody would want to invest in Armenia. I want to state clearly, noway we can agree with those who maintain that 80000 dams of salary. We should push our people to education. We should push our people to develop their professional skills. In the Republic of Armenia there should not be a person who thinks he/she can work with 80000 dram

manipulation of viewpoints expressed by the supporters of progressive rates of PIT. The supporters of progressivity of PIT system cannot be against high salaries from the very beginning because in case of high salaries the progressive system will allow collecting additional funds in the budget and use those funds to finance important expenditures of education, healthcare, social sectors and of socially vulnerable groups of population.

The IMF position is highly questionable. On the one hand the Head of the IMF Armenia Mission Hossein Samiei called for additional efforts to improve tax administration and fight against deeply rooted tradition of tax evasion, on the other hand he does not object the argument of the Armenian authorities that the progressive PIT system does not serve its redistribution purpose because the persons having high incomes evade paying taxes. *This is the same, if the authorities say that it is necessary to change the traffic rules because citizens driving expensive cars don't follow traffic rules.*

The World Bank (World Bank 2015b) estimates the value of direct tax and duties evasion by business elite equaling to 1.4-2.6% of GDP. It is not clear why a high level official of an international organization does not call the Armenian authorities to fight against the deeply rooted tradition by business elites to evade taxes and improve tax administration instead of changing tax rates. According to the IMF publication although governments around the world use tax policy to foster investments, the evidence indicates that the efficiency of that policy in attracting additional⁴⁰ investment is questionable (Tanzi and Zee 2001). The IMF publication also notes that the foreign investors that are the objective of the tax “incentives” take their investment decisions based on several factors such as natural resources, political stability, transparency of regulation, availability of infrastructure and skilled labor, etc, among which tax “incentives” are not the most important factors. In case of foreign investors tax factor may not be efficient at all because their real beneficiary may end up being not the investor by the foreign government, which may collect profit tax

from the foreign investor in its home country based on the difference of rates applied in Armenia and in the home country. Armenian Tax code also has such a provision (Article 20. Exclusion of double taxation) pursuant to which the income or profit earned by Armenian resident organizations or individuals outside Armenia may be taxed in Armenia. The amount of the tax may be reduced by the amount the organization or the individual paid in foreign country according to its legislation. The amount is reduced according to the rules and rates approved by the Tax Code. If the deductible amount of CPT and PIT exceeds the obligation of CPT and PIT then the amount is deducted from the respective tax obligations in future years.

In addition, it is worth mentioning that in case of Armenia the IMF failed and did not perform its duty of assisting countries in making better and more efficient use of tax incentives requested by the G20's Development Working Group to the staff of the IMF, as well as to the staff of the OECD, UN and the World Bank (IMF 2015). In the XXI century countries improve their competitiveness by improving productivity achieved by producing new types of products, delivering services or performing works, using new technologies and new methods of organization of works during production of the above mentioned products, delivery of services or performance of work. Reduction of tax rates and artificial depreciation of the national currency are old methods used in the XX century that were not always effective (Porter 1998).

MoF justified the amendments to the Tax Code by the fact that there was a statement “reduce the tax burden resulting from direct taxes and transfer it to indirect taxes to some extent” engraved in the Program of the GoA (website of publication draft legal acts 2019). Such an approach may be reasonable in OECD member countries where direct taxes (CPT and PIT) and indirect taxes (VAT and other taxes applied to goods and services) are approximately equal (each of them making about 33% of the total revenues), while part of social expenditures, such as pensions, health and unemployment insurance and other services are funded by means of social contributions. Indirect taxes in Armenia – VAT and excise tax – make 41.3% (49% in 2010) of the consolidated budget revenues and 42% of the state budget revenues, while CPT paid by companies and PIT paid by employees make 38.1% (21% in 2010) of the consolidated budget revenues. This means that in recent years Armenia has succeeded to reduce big reliance on the VAT and the excise tax. Amendments proposed by the GoA will increase the share of the VAT and the excise tax in consolidated and state budget, will reduce revenue diversification and will increase reliance on indirect taxes making it more risky because any substantial decline in consumption will negatively affect the budget revenues. This means that Armenian citizens may have some income but not use it for consumption in Armenia.

The state budget has already accumulated big liabilities obligations towards businesses, large part of which – according to the World Bank publications – are for indirect taxes. Over the last 20 years indirect taxes were always one of the main sources of the state budget revenues and in order to collect the planned taxes, the tax authorities sometimes forced

salary. In the Republic of Armenia there should not be a person who can think, as an employer, that he/she can hire in the Republic of Armenia an employee with a salary of 80000 drams, pay so much salary and think that he is paying a salary”, and for the future “First, I don't share the idea at all, when they say ... There is an impression that they are making the persons earning high salary the enemy of this country. Who is the person earning high salary? That is the person who went and studied at the university from morning until night, plodded, did not sleep at night, lived in the status of a starving student abroad or in Armenia, became a high quality professional and now he earns a salary of 1-2 million drams. We should not go after that person and say how can you earn such a high salary? We should show to him ... When we say hero of our times, he is the hero of our times. This person went to study, he did not sit in the street and got education. Now we say to that person, hey, why do you get 2 million dram salary? Come here. We will impose 30 percent tax and take half of your salary. No, we say everyone in our country should be like that. In our country no one should squat in the street and speak about criminal and the “truth”, they must go to the university, school and get education. This is the new Armenia. Nobody should have other hopes. Otherwise these changes will make no sense. We did not make a revolution in the country to create a society of black work laborers. No, here we will have a high technology education, a society with citizens' having high education, high professional skills. And that is our policy. And there is no need for fake social slogans, that we are doing a job, ah lets fight, for the person earning a salary of 80000 drams to pay 300 drams less tax. Keep those 300 drams to yourself. We should do our best not to have a person who earns 80000 drams in this country. In our country salaries should rise twice, three times, four times, five times. And for that we should reduce the tax on high salaries. We should encourage high salaries.”

40. Additional investment compared to the level the country would have attracted if it would have not tried to make the tax policy more “promotional”.

businesses to make advance payments to the budget. Now the GoA adopted a policy to “reduce the tax burden resulting from direct taxes and transfer it to indirect taxes to some extent” which means that instead of reducing reliance on some taxes like VAT and excise tax the GoA increased the reliance of budget revenues on those two taxes. With this policy the GoA increases the risk associated with the collection budget revenues and creates a problem because reduction of consumption will result in larger reduction of revenues than it would have been if the revenues were more diversified.

MoF published the draft amendments on www.e-draft.am website twice. Electronic communication is welcomed and it allows the stakeholders to communicate their comments to state authorities. However, electronic platforms may not substitute face to face discussions while some of the MoF answers posted on www.e-draft.am website were formal and in many cases repetitive. Taking into account the fact that MoF refrained from discussing some articles of the draft law with its opponents face to face, one may claim that drafting and discussions of the law were not participatory.

Amendments to the Tax Code will have little impact on income of employees earning AMD 150 thousands per month. By 2023, the employees earning AMD 2 million per month will have additional income of AMD 1830000 compared to 2019. That means that the increase of income of employees earning AMD 2 million per month will be more than the annual income of employees earning AMD 150 thousands per month. By 2023 the annual income of employees earning AMD 9 million per month will increase by USD 31,355 compared to 2019.

The government that came to the power after the velvet, non-violent revolution regularly mentions about the need to make economic revolution. The head of the new Government and some of its members ignore or in some cases express antagonistic and disrespectful attitude towards the concept of “social justice” manipulating with the opinion of people who have a viewpoint different from the government and presenting them as “supporters of poverty”. One should remember that the velvet, non-violent revolution took place in 2018 in Armenia while in 2017 the Armenian economy registered the highest economic growth after financial-economic crisis. This means that the reason of the revolution was not the insufficient economic growth but the acute perception by a large group of population that the results of the growth were not reallocated fairly and several other issues linked to social justice. Transition to flat PIT rate will deepen already existing problems associated with reallocation of economic gains generated in Armenia.

Instead of diversifying its revenues the GoA plans to make amendments that will increase the role of indirect taxes from the point of view of the budget, while in summer 2018, the World Bank indicated that “indirect taxes accounted for the bulk of the increase in tax collection”, they will make the budget revenues less diversified, the collection of indirect taxes – VAT and excise tax – will increase and will comprise bigger share of the budget revenues, reducing diversification of the state budget revenues and increasing the associated risks.

The knowledgeable, skillful and innovative labor force is the driving force of the modern economy. The above characteristics are associated with western education. However, in order the new generation is able to get good education in western universities they must firstly get high quality general education in Armenia. As a result of the policies promoted by Armenian authorities over the last 20 years the quality of general education declines, which deprives the Armenian labor force of the opportunity to become high quality experts and earn high income in the future. Under these circumstances, over the last 10 months, instead of showing some developments with regard to actions that will improve the quality of general education and assessing the volume of financial needs and identifying the sources necessary for those actions, the GoA initiated a policy of improving the welfare of already well doing citizens. That policy will not improve the lives of less fortunate citizens and will not give them knowledge and skills, necessary to earn higher incomes.

The supporters of the flat PIT claim that the investors who want to invest in Armenia complain that calculations of progressive tax are complicated. Calculations for 3 salary levels within the framework of the current progressive tax system are presented below.

Salary	Calculation of tax	After tax income
AMD 149 000	$149000 \times 23\% = 34270$	$149000 - 34270 = 114730$
AMD 1 950 000	$34500 + (1950000 - 1500000) \times 28\% = 538500$	$1950000 - 538500 = 1411500$
AMD 9 950 000	$552500 + (9950000 - 2000000) \times 36\% = 3414500$	$9950000 - 3414500 = 6535500$

These claims are not trustworthy if we take into account that Armenian authorities claim that they want to bring investors and companies working in the sector of information technologies to Armenia. If the above calculations are difficult for investors willing to invest in Armenia then how they are going to develop business plans and investment programs, how they are going to make cash flow calculations of their investment programs. In addition, one should take into account that in the XXI century the above-mentioned calculations are carried out with the help of professional accounting software and usually do not require manual calculations from businessmen.

5. Conclusions

The above mentioned analysis leads to the following conclusions:

- 1) The GoA is stepping back from progressivity of PIT. It will be useful to remember that “progressive”⁴¹ in Armenian means “advanced”. Armenian authorities refuse more progressive tax system that is functioning in several OECD countries.
- 2) The argument of Armenian authorities that the progressive tax system is not performing its redistribution role because the people having high income avoid paying taxes is not acceptable. If those having high income avoid paying taxes, instead of changing the tax legislation the authorities must strengthen tax administration.
- 3) The idea of Armenian authorities to reduce the tax burden from the direct taxes and transfer it onto the indirect taxes is not acceptable because it reduces diversification of revenues of the state budget and increases the risks associated with VAT and excise tax.
- 4) Using the data of OECD member countries for 1982-2009 Attinasi, Checherita-Westphal and Rieth (2011) concluded that ceteris paribus, countries with more progressive tax system had stronger automatic stabilizers which serve as the first means of protection in the period of economic decline.
- 5) The proposed amendments to tax legislation are beneficial for those who earn highest income. People with relatively low income – those earning AMD 150 thousands per month – will have very little increase of their income.
- 6) Transition to flat tax rates will deepen the existing problems associated with redistribution of wealth generated in Armenia.
- 7) Transition to flat tax rates and reduction of rates will not increase income of those having low income, will not allow their children to get good quality education in Armenian school and high education in western universities and the absolute majority of them will not have the chance to become high income earner.
- 8) Efforts to reduce the volume of the shadow economy by introducing flat taxes may not be effective if the employers do not trust the GoA. Businessmen already had bad experience in their relations with the Government which tried to increase the taxes collected from accountants, consultant and lawyers by means of changing tax regulation. Several members of the above-mentioned group registered in the tax authorities after 2013 when turnover tax and the possibility to submit simplified tax reports were introduced. As a result of a negative reaction by a large public, the GoA refrained from making this amendment with justification that in real life this transition was not possible because tax authorities did not have the necessary software support.

However, for employers or employees having high income and who – according to the authorities - operate in “shadow”, this is an indication that it is not excluded that when the GoA concludes that the “shadow” payments by the majority of those employers is already registered in “observed” economy will raise the tax rates or will reintroduce progressivity. In that sense the effort to cut the “shadow” part of salaries by means of introducing flat rates may not lead to desirable results.

- 9) The arguments of officials considering the PIT simplification for investors attractive leave an impression that (1) the potential investors don’t have knowledge of elementary mathematics to make simple calculations and (2) there is no accounting software.

41. The word “progressive” is used to describe ideas or systems that are new and modern and that encourage a change and development. <https://dictionary.cambridge.org/dictionary/english/progressive>

6. Recommendations

We recommend the following:

- 1) Not to amend the progressivity of PIT and the rates and to channel the AMD 27-37 billion revenue which the GoA wants to give up to education, significantly improving the quality of general and high education, providing the opportunity to representatives from low income families to enter and study at leading foreign universities.
- 2) Not to refuse the progressivity of PIT because, ceteris paribus, a more progressive PIT system is the first automatic stabilizer in case of economic decline.
- 3) With the view to improve the progressivity of PIT, introduce a new threshold at 50% rate.
- 4) Introduce non-taxable threshold.
- 5) In the medium term, to prepare and implement comprehensive income declaration system which must be accompanied by substantial modernization of tax authorities and raising their analytical and efforts to develop policies to change the social culture related to taxes.
- 6) Make the process of preparation and discussion of amendments to the tax legislation participatory.

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