

Reviewing Administrative and Fiscal Policies to
Enhance the Effectiveness of Combating Tax
Evasion: Legal Aspects

Astghine Batikyan

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Instructor: A. Mazmanyán

Law Department

American University of Armenia

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Introduction

Illegal business activity, showing excessive losses and expenses, decreasing the actual income and falsifying tax audit are the aspects of a phenomenon known as tax evasion. It is one of the most urgent problems in RA reality against which efficient steps need to be taken. When the roots of a matter lay in tax allowances based on the authority of person conducting the business, corruption, distrust of tax authority and weak administration and enforcement, the adoption of a poorly administrative solution by RA Government is inadmissible. A much detailed observation should be made taking into consideration peculiarities of the state, needs of the society and ability of the mechanism to eliminate the problem entirely, not only an aspect of it.

The objective of this paper is to provide an assessment of the efficiency of administrative policy of cash receipt machines in combating tax evasion and to show the need of creating favorable business environment for which a notion of flat tax is considered. Section 1 illustrates a case of tax evasion, gives a background on introduction of the policy of cash receipt machines and its weak enforcement and examines 2008-2011 Plan on Administrative Strategy of RA State Revenues (Taxes and Customs) and RA Law on Deployment of Cash Control Machines revealing their positive aspects in tax administration. In particular, giving VAT exemption to small enterprises, decreasing the number of tax verifications by adopting a selective principle, making mandatory the installation of cash control machines and the provision of cash receipts and imposing relatively high fines for violation of the Law.

Section 2 deals with the Law on Deployment of Cash Control Machines and proposed amendments and additions to it, concentrating on the flaws and rising unfavorable consequences.

Special attention is paid to high rates of fines imposed equally on large and small enterprises, lack of appropriate regulation concerning mandatory sending of tax reports to the State Revenue Committee and privileged attitude reflected in frequency of tax verifications in case of voluntary sending via net connection. Some other important issues are discussed, which are: imposing a fine on taxpayers for non-installation of appropriate cash control machine, when the latter is installed in the sphere of business where it is not required, the possibility of fining instead of sustaining business operation and making the provision of cash receipts mandatory for advocatory activity.

Section 3 considers the flat tax proposed as a solution to tax evasion, which had and continues to have unpredictable efficiency not only in tax matters, but also on overall economic growth. The notions of progressive and flat taxes are discussed referring to tax rates stipulated by RA Laws on Income Tax and Profit tax creating uncertainty and possible risks of tax evasion. Based on the criteria (equity, certainty, convenience and low administrative costs) suggested by economist Adam Smith the efficiency of flat tax in combating tax evasion is illustrated making parallels between Armenian and Estonian tax bases. Other aspects of economic growth in the case of adoption of flat tax are indicated, among which are: foreign investment, capital inflow instead of outflow, work incentive, rapid decrease in unemployment and middle class generation.

§ 1. 2008-2011 Plan on Administrative Strategy of RA State Revenues (Taxes and Customs) and Policy of Cash Receipt Machines: Positive Effects

Each year hundreds of companies, sole entrepreneurs and natural persons spent much time and money to find appropriate loopholes in tax legislation and in operational strategy of the tax administration body in order to pay as less as possible. It is an evolving problem, which has its roots in complicated legislative regulation and weak enforcement and supervision.

The whole scope of this destructing practice can be illustrated by examining real cases of tax evasion and discovering tax payers' intents hidden behind their actions. For instance, on April 15, 2009 Head of "Smbatyanshin" Ltd provided tax account with false data concerning the earning and spending of the company in the result of which 16,995,200 drams were not paid to the RA State Budget. The falsified tax account was presented with the sole purpose of artificially showing big losses and expenses and evading the payment of the real sum of money subject to profit taxation. Head of "Smbatyanshin" Ltd was convicted based on Article 205(2) of RA Criminal Code. The criminal case is now in the stage of preliminary investigation implemented by the General Investigation Department of RA Police.¹

Cash receipt policy was first introduced in 1999 as a mechanism of regulating and monitoring the lawful payment of mandatory taxes, as well as tax revenues gained by individuals and legal entities. Though implemented in the early stages of economic stabilization and subsequent development, it was not successful in combating tax evasion mainly based on the

¹ "Criminal case initiated on tax evasion", 16.06.2010//www.armtown.com/news/en/a1p/20100616/201006168/

absence of a binding law regulating that sphere. The fact of independence along with the development of interstate and international relationships gave rise to the spreading of various activities, which ought to be included in the field of taxation. Retail trade and the sphere of providing services became the scope of application of the RA Law on Deployment of Cash Receipt Machines entered into force on November 22, 2004.

The RA Law on Deployment of Cash Control Machines was not as much implemented by the sole entrepreneurs, companies and natural persons as would be efficient from the perspective of taxation. Until 2008, the substantial part of the retail trade and the sphere of providing services, were, in fact, not so much bound by the provisions of the Law. Most notably, the basic requirement, which is to put fiscal cash receipt machines, was very often not satisfied by the tax payers. Even when fiscal cash receipt machines were installed, the cash receipts were provided not to everyone. Besides, people were not encouraged to demand the mandatory cash receipts by the way of which taxpayers were free to act in their best interests.

The aforementioned situation started to stabilize by the confirmation of “2008-2011 Plan on Administrative Strategy of RA State Revenues (Taxes and Customs)” by the decision No. 941-N of the RA Government entered into force on 7 August, 2008. The plan has seven primary goals designed to strengthen the administrative capacity of the State Revenue Committee and guarantee development of small, medium-sized and large enterprises without any unnecessary obstacles, as well as improve the volunteer compliance with tax laws by way of timely payment of profit and income taxes. ²

² RA Government decision of 07.08.08 on confirmation of “2008-2011 Plan on Administrative Strategy of RA State Revenues (Tax and Customs)” [2008], No. 941-N// www.arlis.am

A number of efficient strategies regarding small and large enterprises are adopted in the 2008-2011 Plan, which are discussed further.

Firstly, one of the primary aims of cash receipt machines is to state the exact line (58.35 million drams) crossing of which makes VAT payment mandatory. Exemption from VAT payment is considered for those enterprises, which in the course of retail trade and provision of paid and unpaid services gain revenue, from which the turnover subject to profit and income taxes do not exceed 58.35 million drams for the previous tax year. In the present tax year, VAT is paid only for the portion of amount exceeding 58.35 million drams.

To my mind, the expressly mentioned exact sum of money makes a clear distinction between small enterprises subject to VAT and those exempted from it thus eliminating any chance of manipulation of the scope of Article 3 of the RA Law on VAT and provides an opportunity not to be exercised to the payment of additional taxes when low income is earned.

Secondly, with the intent of regulating the sphere of documentation and the provision of complete audit reflecting the real earnings and expenses, the number of tax inspections conducted in small enterprises is substantially decreased (20%-50%), while large enterprises are subject to verifications based on the selective principle. It means that tax authorities decide the object and the frequency of tax verifications relying on the overall examination of the enterprise and the probability of tax evasion risks.

The initial examination of the structure and the scope of operations of small and large enterprises, provides the State Tax Revenue Authority with the clear notion about the probability of falsifying data records and possible ways for its implementation. To my mind, basing on the discovered information, stricter attitude (frequent tax verifications, monitoring and supervision)

towards enterprises with more chances and devices for tax evasion would minimize the risks, thus reaching far more apparent results than conducting the same actions without determining against whom it should be directed. Besides, the audit and related documentation are more often sent to the State Revenue Committee by mail or electronically, excluding to the possible extent the relationship between taxpayers and tax authorities. In this case, no relationship would be equal to no corruption³ the latter of which is a very common practice in RA reality.

The RA Law on the Deployment of Cash Control Machines makes mandatory the installation of fiscal cash receipt machines and required detailed implementation of its operational rules. That innovation gave the tax authority an excellent opportunity to monitor and control the process of income formation, the effect of which was doubled by the connection of all fiscal machines with the central portal of the State Revenue Committee. Head of the Committee G. Xachatryan states that in the place of 400 cash receipts machines installed during 10 years, in the end of the previous year nearly 8000 fiscal machines were installed and for the first time the connection of all 8000 devices with the united computer net was enforced.⁴

In my view, with the introduction of this policy, the operations of small, medium-sized and large enterprises, sole entrepreneurs and natural persons are directly subjected to close scrutiny by the tax authority, which nearly eliminates tax evasion possibility. Each transaction conducted by the taxpayer in retail trade and in the sphere of providing services is visible for the State

³ See "RA Government: Anti-crisis measures in tax and customs sphere". Business 24. 15/06/2009 www.b24.am/economy/7979.html

⁴ "Tax and Customs Authorities on the Way of Reforms". Official interview with Head of the State Revenue Authority Gagik Xachatryan. 31/08/2009 http://taxservice.am/index.php?menuID=0&tid=0&pid=speech_news&lng=9&url=&newsID=231

Revenue Committee, which enables the latter to discover almost any attempt of introducing low rates of profit and income. Besides the tax authority, the controlling role is also given to the citizens, who are encouraged to demand appropriate fiscal cash receipts (serving as lottery tickets). Such an incentive may seem efficient at first glance as it creates a situation of double control for taxpayers. However, it should be noticed that putting certain obligations on citizens encouraging them by a chance of winning, speaks about the state's inability to fight against underground economy.⁵

Furthermore, imposed fines of relatively big sum of money (300,000 AMD for the absence of fiscal cash control machine and 150,000 AMD for the breach of operational rules of machines) are additional incentives for voluntary payment of taxes. In the case of repeated violations, the sum of fines is doubled reaching 600,000 AMD and 300,000 AMD respectively and operation of a company or sole entrepreneur is suspended from 5 to 10 days.

The efficiency of cash receipt policy and “2008-2011 Plan on Administrative Strategy of RA State Revenues (Taxes and Customs)” is reflected in the rates of mandatorily paid and additionally fined tax revenues. In the first quarter of 2009, each month 800 cases of violation were discovered and fines with the overall amount of 37.850.000 AMD entered into the State Budget.⁶ The rates of profit tax and income tax increased in 1.7 per cent and 0.8 per cent respectively, in 2009 compared to 2008.⁷ Subsequently, the amount of collected taxes in 2008 increased in 40 billion drams resulting in more than 3 billion additional tax revenues⁸ and in 120

⁵ See E. ANTINYAN, Announcement. 27.04.2009 // www.dempros.am/arm/announcements/1.html

⁶ “Operation of 23 businesses is factually sustained for the violation of operational rules of cash receipts”.

Interview with Deputy Head of the State Revenue Authority Artashes Beybutyan. 29/01/2009

www.taxservice.am/index.php?menuID=0&tid=0&pid=customs_news_section&lng=9&url=&newsID=21

⁷ 2009 Annual Report on Tax and Customs // www.taxservice.am/uploads/pdf/annual_report.pdf

⁸ “Operation of 700 businesses is sustained for not providing cash receipts”. News Independent. 09/09/2009

billion drams or 24 per cent, totally having 615 billion drams entered in the State Budget in 2009.⁹

<http://ankakh.com/2009/09/15277/>

⁹ Official interview with Head of the State Revenue Committee Gagik Xachatryan, supra note 3.

§ 2. The Law on Deployment of Cash Control Machines and Proposed Amendments and Additions to It: Flaws

The substantial portion of economic development and the main source of the RA State Budget is the tax collected from people doing business in various aspects of social-economic life.¹⁰ Its legality and revenues gained from the conducted activities are thoroughly regulated and controlled by tax authorities. But not always the adopted law and the strategy based on its requirements are efficient in combating the most urgent problems, one of which is a tax evasion.

Article 11(1) of the RA Law on Deployment of Cash Control Machines states that in the case of the absence of cash control machines in places of transaction conducted in drams or plastic cards, the enterprise or sole entrepreneur is fined with the amount of 300.000 AMD. When the breach is repeated within one year, the fine is increased up to 600.000 AMD and the operation of the taxpayer is sustained until the cash control machine is installed. Part 2 of the same Article imposes a fine (150,000 AMD) for the violation of operational rules of fiscal machines, which in the case of two and more repeated breaches recorded within one year, is doubled reaching 300,000 AMD and the operation of the company or sole entrepreneur is sustained from 5 to 10 days.

As can be seen from the structure of the Article 11, there is no distinction among small, medium-sized and large enterprises and sole entrepreneurs. It means that irrespective of the gained revenues, in the case of a breach they are equally fined. To my mind, implementation of

¹⁰ See S. AVAGYAN, "Tax amendments will continue", Interview with Deputy Head of the State Revenue Committee A. Alaverdyan. Capital Business Newspaper. 28/08/2008//www.cdaily.am/home/paper/2008_08_28/news/10952/

this provision has an unfair effect, as the imposed fine for the large business is a minor issue, while for the small and sometimes for medium-sized business a huge amount of money. If the large business can afford paying such amount even in several times during a year, the small one can easily become insolvent and undergo bankruptcy. In order to eliminate this practice, it's recommended to apply the solution given in Article 185 of the Law on Value Added Tax of the Republic of Bulgaria¹¹, which states an amount of fine ranging from the low point to the high one, based on revenue earned within the current tax year. To my mind, such an approach will put a certainty in the Law and bring more favorable results for the State Revenue Committee, as small taxpayers will be able to continue their business and the large ones will be fined in accordance with their income.

The RA Law on Deployment of Cash Control Machines includes no regulation concerning the cash calculation report prepared on daily basis. Section VI of the Operational Rules of Cash Control Machines¹² only refers to the report typed when one seller shifts the other. The report contains detailed information about the entire process of income generation, but is prepared for the sole purpose of using it as an initial document for the later audit. It is sent to the archive and kept for 3 years, without any notice given to the State Revenue Committee. In these circumstances the tax authority receives no data regarding the income earned during the day and, in my view, the taxpayer get an excellent opportunity to show either no income at all, or reduced amount with the intent of gaining excessive profits by way of tax evasion.

¹¹ RB Law on Value Added Tax // <http://www.skmbg.com/zdds.html>

¹² RA Government decision of 26.08.04 on confirmation of "Operational Rules of Cash Control Machines " [2004], No. 1325-N // www.arlis.am

This problem is addressed in the proposed additions to the Law on Deployment of Cash Control Machines. First, a provision is added making mandatory the sending of a tax report on cash calculation directly by the taxpayer at the end of each day to the State Revenue Committee, while an electronic sending only has a voluntary character. Second, if the taxpayer does not fulfill the aforementioned obligation, fine of 150,000 AMD is imposed for the first breach and 300,000 AMD for the second one, with an exception when the net connection is insufficient or is absent. To my mind, stipulation of such an exception can't serve its aim of discovering real turnover conducted by cash control machines, as taxpayers can easily avoid sending appropriate tax reports justifying it with the provided exemption. Third, enterprises and sole entrepreneurs that make the sending via net connection receive favorable treatment illustrated in conducting tax verification only when business activity is considered a risky one. Not only voluntary nature, differentiated approach and high rates of fines provide extra loopholes, but also create a situation where the aim¹³ of the Draft Law can't be achieved. In my opinion, the issue can be more efficiently regulated when the sending process is conducted not by the taxpayer directly or electronically, but automatically from the fiscal cash control machine. Besides, the retail turnover and the quantity of provided services, as well as received income from those activities, will be more accurately recorded and supervised if several records are prepared instead of one.

The Act No. 289/2008 Coll. on the Use of Electronic Cash Registers adopted by the National Council of the Slovak Republic on 18 June, 2008 pays a special attention to this matter stating three types of records (day-end closing report, interim closing report and summary closing report) designed to perform interconnected work in order to guarantee an exhaustive data

¹³ The aim of the Draft Law is the need of providing information to the tax authority on cash calculation conducted by cash control machines and increasing the efficiency of tax administration on full audit of tax revenues.
www.parliament.am/drafts.php?sel=showdraft&DraftID=4459&Reading=0

gathering.¹⁴ All daily transactions conducted in the spheres of retail trade and provision of services are included in day-end closing report. The interim closing report records data regarding specified time interval from the fiscal memory of the electronic cash register. The function of the summary closing report is to provide a daily summary of all financial transactions conducted starting from the first moment of the business operation. To my mind, these reports may triple the operational efficiency of cash control machines, as full information will be provided and not a single report will be prepared the data in which can be easily falsified by the taxpayer.

The Draft Law raises some other important issues, among which are: imposing a fine on taxpayers for non-installation of appropriate cash control machine, when the latter is installed in the sphere of business where it is not required, the possibility of fining instead of sustaining business operation and making the provision of cash receipts mandatory for advocacy activity.

The taxpayer is obliged to install a device capable of providing accurate reports, which creates additional expenses for taxpayers.¹⁵ In the case of their absence, company or sole entrepreneur is initially warned, then fined with the amount of 300,000 AMD, and 600,000 AMD when the violation is repeated. In addition to fines, the operation of the business is sustained until required electronic device is installed. The high rates of fines will most probably create the same inequalities discussed in §1.

Cash control machines are installed in places of retail trade and where various services are provided to the public. Not only absence of these devices in required spheres, but also their existence in business spheres not covered by the Law on of Cash Control Machines cause mandatory payment of fines (300,000 AMD). In my view, such approach is not justified, as the

¹⁴ SR Act No. 289/2008 Coll. on the Use of Electronic Cash Registers
www.finance.gov.sk/en/Default.aspx?CatID=405

¹⁵ "Does the State Revenue Committee Participate in Terror?" Armenian Version. 29/06/2010
www.armversion.com/index.php/hy/2010-05-09-09-09-04/2010-06-10-11-24-50/1161-----lr

matter can be resolved by taking out these machines from registration¹⁶ and not accepting the cash receipts as valid documents approving gained profit. It should be noticed that the proposed addition will certainly create unnecessary burdens for the productive operation of the business.

In each instance of violation of the Article 11(2), the taxpayers receive the possibility of creating an alternative outcome, i.e. merely choosing the fine (2 percent of revenue for each day of suspension received by an average daily turnover of the previous month, but not less than 60,000 AMD) instead of sustaining the operation of the business. If the purpose of this recommendation is to lighten the burden imposed on taxpayers, then it is worth mentioning that in this case the rationale behind it does not justify the chosen means for its implementation. Its implementation will bring such additional revenues for the State Budget that the need for combating underground economy will cease to exist.¹⁷ In my opinion, large taxpayer will again be in prevailed position in comparison with small one, as the latter can't afford such excessive payments out of its budget. Besides, large enterprises will most probably abuse the favorable choice given to them in the result of which there will be no recorded case, when their business operations have been in fact sustained. It should be noticed that the drafters of the RA Law on Deployment of Cash Control Machines by stating this provision, had an aim of preventing further violations, which would not serve its purposes if adopted.

Probably the most unjustified proposal is the elimination of an exception stated in the Article 4(2) of the RA Law on Deployment of Cash Control Machines, which finds the advocatory activity not being the sphere requiring mandatory installation of cash control

¹⁶ The provision was not initially included in the Draft Law, but later was considered in the Law on Deployment of Cash Control Machines: Draft on Proposed Amendments and Additions discussed in RA Parliament in 14.11.2010// www.parliament.am/drafts.php?sel=showdraft&DraftID=4459&Reading=0

¹⁷ H. GEVORGYAN, "Top of the iceberg" The Armenian Times. 07/08/2008 // www.armtimes.com/17661

machines. In the case of its adoption, people will be deprived of their right to be represented and protected before the court by a professional advocate, as the essence of latter's activity will be distorted¹⁸ by the obligation to handle a cash receipt for the provided service. The advocacy is an institution considered as a fundamental element in creation of the legal state, not as a means of filling the State Budget.¹⁹ Furthermore, lawyer's duty of professional secrecy in relation to clients and subsequently provided documentations and information having an effect of guaranteeing proper administration of justice without unreasonable interferences²⁰ is breached when the tax authority demands sufficient evidence proving the amount of gained revenue.

The provisions of the existing law and proposed amendments and additions to it must be stated in a manner that does not create adventurous conditions for one group of people at the expense of the other. The burden of economic development must be allocated equally among small, medium-sized and large enterprises: viewing the large enterprise as a target is inadmissible. The taxpayer is encouraged to break the large business into several small ones in order to gain advantages prescribed by law.²¹

The policy of cash receipt machines is an administrative instrument designed to manage cash flows and make business turnover fully visible for the State Revenue Committee. Such problem as tax evasion can't be merely resolved by administrative means, sufficient business environment should be created a way of which is discussed further.

¹⁸ See H. SHOGHIKYAN, "Advocates are dissatisfied with the plan of installing cash control machines in their offices", Interview with lawyer A. Zohrabyan. Liberty. 14/10/2010
www.azatutyun.am/content/article/2190485.html

¹⁹ G. GYOZALYAN, "The incompatibility of cash receipts with advocatory activity" 04/11/2010
www.lex.am/articles.php?n=23

²⁰ See judgment of 16.12.92 in case 13710/88, *Niemietz v. Germany*, [1992] ECHR, par. 37; judgment of 20.06.00 in case 33274/96, *Foxley v. The United Kingdom*, [2000] ECHR, par. 50; judgment of 16.10.07 in case 74336/01, *Wieser and Bicos Beteiligungen GMBH v. Austria*, [2007] ECHR, par. 65, as well as judgment of 02.11.10 in case 41723/06, *Gillberg V. Sweden*, [2010] ECHR, par. 123

²¹ D. MALXASYAN, " Interview with Deputy of the National Assembly Samvel Baghdasaryan". Seven days. 22/05/2009 www.7or.am/hy/news/2009-05-22/2482/

§ 3. Progressive Tax vs. Flat Tax: Comparative View

The collapse of the Soviet Union and subsequent independence of the states opened a new window for their establishment and development. One of the most urgent issues was to adopt a tax system capable of providing practical solutions to the main problems and guaranteeing the harmonized growth of the economy. The transition from centrally-planned to market-based economies was significant, in the result of which some states followed progressive taxation principle, while the others accepted flat tax approach, while being dramatically unprepared to face difficulties.²²

The Republic of Armenia has a tax system formed on the notion of progressive taxation: a taxing mechanism, where a natural person, sole entrepreneur or company is taxed based on the amount of revenue gained by its business activity. The income earned by the taxpayer undergoes taxation of different rates, is subject to various exemptions and priorities depending on the nature and scope of the financial transaction, as well as the person or company conducting it.²³

In particular, the RA Law on Profit Tax states two groups of taxpayers: residents and non-residents, whose taxable profit depends upon the place of their operation, profit earned by an RA resident from the source settled out of the state territory, and profit gained by non-resident taxpayer from the source located within the boundaries of the Republic of Armenia. In both cases the taxable amount, which is the positive difference between the GDP and the diminutions

²² J. MARTINEZ-VAZQUEZ and R. McNAB, *Tax systems in transition economies*, Atlanta, Andrew Young School of Policy Studies, 1997, p.20

²³ See M. K. LIGHT and T. F. RUTHEFOLD, *Taxation and economic efficiency in Armenia*. World Bank, 2004, p.5-6

prescribed by the current law, is levied at the rate of 20 per cent. In addition to the mentioned rate, the tax agent collects mandatory payments at the amount of 5 per cent for insurance, reinsurance and transportation, and 10 per cent for the revenues gained from tenancy, royalties, stocks, passive incomes and other transactions conducted in Armenia.

The RA Law on Income Tax also recognizes the distinction made between resident and non-resident taxpayers, with a difference that income tax is levied from natural persons while profit tax is paid by legal entities. Similarly, taxable amount is considered income gained in and out of the state boundaries for the residents, and income earned from the operation of the business having its establishment in RA. The taxable income below 80,000 AMD is collected at 10 per cent, and at 20 per cent for the exceeding amount plus 8,000 AMD when the income is more than 80,000 AMD.²⁴ Article 18 parts 3, 4 and 5 stipulate the transactions (selling and tenancy of the apartment and royalties; percentages; buying of goods by the tax agent) in the result of which gained revenues are taxed at the rate of 10 per cent, not taking in account the diminutions prescribed by law in first two cases.

As can be seen from the structure of the Laws on Profit Tax and on Income Tax, the legislator states a number of circumstances, the presence of which makes the taxation rate unequal for the natural persons and legal entities. This design is often hard to understand, which, to my mind, creates the risk of not being complied with and inevitably gives the opportunity for taxpayers to show (at least in first glance) that the transaction falls within the ambit of those being taxed at low rate. The complexity of the provisions included in the Laws, directly contribute to the increase of the number and frequency of tax evasion cases. The latter greatly

²⁴ Legislative proposal to the Law on Income Tax was put on the agenda of the RA Parliament in 08.06.2010, which stipulates to increase rates of taxable income from 80.000 AMD to 120.000 AMD (from 10% to 24.4%, below 120.000) and from 8000 AMD to 29.280 AMD (from 20% to 26%, above 120.000)
<http://www.parliament.am/drafts.php?sel=showdraft&DraftID=20987>

distorts legislative framework of the RA tax scheme and weakens administrative capacity of the State Revenue Committee.

Flat tax was first applied by Jersey and Hong Kong in 1940 and 1960 respectively, followed by Guernsey (1960) and Jamaica (1986). Though adopted in earlier stages, the concept gained large acceptance, when Robert Hall and Alvin Rabushka introduced it as a policy measure for the reimbursement of tax systems in 1981.²⁵ It became very popular among post-Soviet countries, remarkably the Baltic bloc (Estonia, Latvia, Lithuania), which switched their tax systems to flat tax. As of 2008, the number of states using flat tax regime reached to twenty four²⁶ (Russia, Slovakia, Ukraine, Iraq, Romania, Georgia, Iceland, Mongolia, Kyrgyzstan, Macedonia, Montenegro, Mauritius, Kazakhstan, Albania, Czech Republic, Bulgaria) and most probably would continue to grow. Flat tax has been so successful, that states lower their tax rates to keep pace with other nations.²⁷

The notion of flat tax is illustrated in the adoption of tax systems, which levy personal income and corporate taxes as well as VAT (not in any jurisdiction) at a single low marginal rate generally below 20 per cent. The low rate applies irrespective of the type and sphere of activity, as well as the amount of revenue earned. Only income earned in the state territory is taxed, no world-wide taxation. Flat tax is generally accompanied by the elimination of exceptions, exemptions, special preferences, additional allowances and deductions. A special attention is paid to families, giving generous allowances based on their size.²⁸ The rationale behind the

²⁵ M. A. PIGEON, "A closer look at the flat taxes". Depository Services Program. 23/08/2001
<http://dsp-psd.pwgsc.gc.ca/Collection-R/LoPBdP/BP/prb0110-e.htm>

²⁶ D. J. MITCHELL, "The Global Flat Tax Revolution: Lessons for Policy Makers", (2008) *Freedom and Prosperity Foundation* 7/1. 3.

²⁷ D. J. MITCHELL, "A Brief Guide to the Flat Tax", (2005) *The Heritage Foundation* 1866. 6.

²⁸ S. HADLER, C. MOLOI and S. WALLACE, *Flat Rate Taxes: A Policy Note*, Atlanta, Andrew Young School of Policy Studies, 2007, p.10.

concept of flat tax is to exclude the differentiated approach towards taxpayers gaining high and low revenues by the way of increasing or decreasing tax rates, respectively. Furthermore, it seeks to establish very simple tax strategy, which is easy to understand and administer. Taxpayers are given an incentive not to waste money on searching loopholes for tax evasion and avoidance, but to reinvest the earned income in business.²⁹ Tax authority effectively collects the required taxable income and the state budget is filled not by the sum of money received from imposed fines, but by voluntary payments. State becomes an attractive place for foreign direct investment in the result of which a rapid growth of economy is recorded.

A famous economist Adam Smith proposes a number of criteria³⁰, the fulfillment of which indicates the fact of economic growth. Comparative approach is taken to show prospective differences between Armenian and Estonian tax systems based on the suggested canons. According to Smith, imposed taxes and tax base of each country, as a whole, should guarantee the following:

- ❖ *Equity*. Tax scheme should be designed in a way that taxpayers be able to pay imposed taxes voluntarily. Tax legislation of Armenia states taxes of relatively high rate (20 per cent)³¹ depending upon the gained revenue, while Estonia tax all personal and business income at the single rate of 19 per cent, which is expected to reach 18 per cent in 2011. In my view, a single rate eliminates differentiated approach towards small, medium-sized and large enterprises, in the result of which tax authorities gradually deserve taxpayers' trust. In addition, main part of existing exemptions in progressive tax systems are not so

²⁹ See M. LAAR, "The Estonian Economic Miracle". The Heritage Foundation. 07/08/2007
www.heritage.org/research/reports/2007/08/the-estonian-economic-miracle

³⁰ R. JACQUELINE "Are Flat Taxes the Best System?" International Debate Education Association. 13/10/2002
www.idebate.org/debatabase/topic_details.php?topicID=169

³¹ Income tax rate will reach 24.4%-26% due to adoption of legislative proposal. Supra note 24.

efficient for low income families, but have contributing effect on middle and high income families which do not necessarily need such support³².

- ❖ *Certainty*. Reasonably clear tax rates must be expressly mentioned in corresponding laws and regulations, so as each taxpayer exactly knows when and how much to pay. Both Laws on Profit Tax and Income Tax state the taxable amount, but at the same time mention a number of exceptions and allowances discussed earlier, which create uncertainty and give taxpayer an incentive of gaining advantages from provisions.³³ Estonian Taxation Act is simpler, as there are no additional allowances and deductions, thus is understandable even for people having no legal knowledge.
- ❖ *Convenience*. Taxpayers should be encouraged to voluntary compliance by means of imposing such rates that are easy to pay and corresponds to the scope of taxpayer's business activity. If progressive tax base very often does not take into account the convenience and availability of imposed taxes and fines as the State Budget must be filled, then flat tax system stipulates taxes at a low marginal rate, which is easy to pay both for small and large enterprises. Consequently, flat tax gives work incentives and gives an opportunity for later growth, which can't be said in case of over-taxation as much less revenue is received.³⁴ In my view, the latter will certainly create new workplaces, in the result of which the problem of unemployment will be gradually resolved and middle class will be generated.

³² W. SCHEKLE "Interview with Mart Laar on flat taxes". Development and Transition. 05/12/2006
www.developmentandtransition.net/index.cfm?module=ActiveWeb&page=WebPage&DocumentID=611

³³ See J. OWENS, *Fundamental Tax Reform: an International Perspective*, Paris, OECD Centre for Tax Policy and Administration, 2005, p.36.

³⁴ S. FORBES, *Flat tax Revolution: Using a Postcard to Abolish the IRS*. Washington DC, Regnery Publishing, Inc., 2005, p.11-12

Flat tax regime, as mentioned earlier, attracts foreign direct investment, the growth of which in Armenia will give an additional source of income for filling the State Budget, the Government will not be forced to borrow huge amount of money in form of loans from other states and international organizations, a favorable business environment will be created both for resident and non-residents³⁵ in the result of which capital outflow will not take place, Armenia would become from importing to exporting country and gain status of a competitive player in economic sphere.

- ❖ *Low administrative costs.* Tax base should have a structure, where tax authorities are not obliged to perform excessive operational supervision and monitoring. RA State Revenue Authority is overloaded with cases of non-compliance, tax evasion and tax avoidance, as the high tax rates as well as fines of enormous amount incite taxpayers to reach for rooms in tax legislation. In order to cope with these phenomena, tax authority spends huge amount of money and hires a number of specialists, which in its turn split the State Budget. Estonian Tax and Customs Board carries out the same responsibilities as any other tax administration, but with a difference that it is not forced to waste money on unnecessary observations due to lack of tax violations. To my mind, such a positive result is gained by a right tax mechanism (flat tax), where taxpayers are encouraged to work instead of searching ways of tax evasion and tax avoidance.

The proof of flat tax efficiency is the rapid development recorded from the first year of its implementation. Economy experienced growth of six per cent each year, reaching 11 per cent in 2005 and 12 per cent in 2006. The economic growth continued up to nine per cent in last four

³⁵ Even Armenians living outside the boundaries of RA are either unwilling to make investment, or demand the same privileged attitude received by monopolies, due to the high rates of taxes and non-competitive business environment. Interview with Chairman of "DEMPROS" NGO and Deputy Chairman of ADLP Edvard Antinyan

years. If Estonian per capita GDP was 34.8 in 1996, it increased up to 65 in 2007.³⁶ Foreign direct investment in Estonia reached from 10.2 per cent in 2003 to 12 per cent of GDP in 2004³⁷ and continues to grow. The rapid economic growth makes Estonia the Baltic Tiger, which continues to develop faster, standing in the first rows among post-Soviet countries.³⁸

The global flat tax revolution attracts many Western countries among which are Holland, Germany, Spain, Denmark, Great Britain, Greece, as well as US seriously considering the idea of changing their tax systems and switching to flat tax regime.³⁹ It once again indicates that flat tax is a wise choice and serves as a guarantee for stable economic growth.

³⁶ M. LAAR, supra note 29.

³⁷ S. HADLER, C. MOLOI and S. WALLACE, supra note 28, p.12.

³⁸ D. J. MITCHELL, "Baltic Beacon". Wall Street Journal Europe. 20/06/2007
www.cato.org/pub_display.php?pub_id=8378

³⁹ J. ARNOLD, "The ups and downs of flat taxes". BBC News. 15/04/2005
<http://news.bbc.co.uk/2/hi/business/4444717.stm>

Conclusion

Thoroughly designed tax legislation in conjunction with proper administration and enforcement are the guarantees of economic growth and competitiveness. Each measure adopted against tax evasion should be initially researched in order to avoid problems connected both to its regulation and people's willingness to be bound by it. The successful implementation of a certain practice in other states, does not necessarily mean its appropriateness for Armenia.

The policy of cash receipt machines is a good strategy, but does not prove to be the best due to its gaps and inadequacies, as well as lack of accurate control by the State Revenue Committee. Flat tax can be a wiser solution, as it concentrates not to exact spheres of social life, but reform the entire tax base. Most notably, flat tax system is a way of attracting foreign direct investment, minimizing cash outflow, creating workplaces and competitive conditions for business operations. Low tax rates and elimination of various exemptions may be a more favorable approach for small, medium-sized and large enterprises, which are given a work incentive instead of corruption and tax evasion, thus guaranteeing voluntary tax compliance and stable economic growth.

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