



HIGH-LEVEL SUMMARY TECHNICAL ASSISTANCE REPORT

REPUBLIC OF ARMENIA

Review of Tax Expenditures

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Summary Technical Assistance Report Fiscal Affairs Department

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The *Summary Technical Assistance Report* series provides high-level summaries of the assistance provided to IMF capacity development recipients, describing the high-level objectives, findings, and recommendations.

ABSTRACT: Supporting the authorities' objective to consolidate revenue, this technical assistance report assesses tax expenditures in Armenia. The report covers major tax expenditures related to the value-added tax, excise taxes, the profit tax, and the personal income tax. With total estimated tax expenditures in excess of 5.5 percent of GDP in 2021, streamlining preferential regimes, exemptions and incentives has strong potential for boosting revenue while improving the equity and efficiency of the tax system.

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Background

Armenia is keen to increase its tax revenue from under 23 percent of gross domestic product (GDP) in 2022 to 25 percent by 2026 to support sustainable and inclusive growth. One important element of achieving this objective is rationalizing tax expenditures (TEs), as it is currently planned by the authorities¹, including through streamlining preferential tax regimes, exemptions, and tax incentives. Estimated revenue foregone from TEs is at least 5.5 percent of GDP in 2021, of which 4.4 percentage points for the value-added tax (VAT) alone.

The Fiscal affairs Department of the IMF reviewed TEs in Armenia within the VAT, the business income tax, the personal income tax, and excise taxes, and assisted the authorities in (i) updating existing TE estimates where needed; (ii) identifying tax policy options to consolidate revenue while contributing to a less inequitable and more efficient tax system.

Summary of Findings

Following international best practices, during the last decade Armenia has achieved considerable progress in estimating and reporting TEs, laying strong foundations for informing tax reforms. TE estimates in the VAT, the profit tax, and the personal income tax have been regularly published as part of the budget documentation.

VAT and excises

VAT in Armenia is a critical source of revenue, raising about 35 percent of tax revenue in 2021 and covering a relatively broad base. However, as tax administration has been improving in recent years, the VAT registration threshold of AMD 115 million (\$ 300,000) has become high relative to comparators, requiring a reconsideration. The current threshold gives rise to an estimated TE of about 1 percent of GDP and contributes to distortions. The TEs in the VAT also feature regressive elements that overwhelmingly benefit wealthy households such as reduced rates and exemptions for education (1.6 percent of GDP), health (0.5 percent of GDP), and agricultural equipment (0.3 percent of GDP).

Armenia does not report excise TEs. The mission estimated those TEs at 0.12 percent of GDP, stemming mainly from the application of varying rates across similar goods.

Profit tax

The business income tax consists of three overlapping tax systems, the micro-entrepreneur, turnover, and standard profit tax regimes. Companies fall within one of these systems primarily based on annual turnover, although companies of any size can elect to be taxed under the profit tax. The micro-entrepreneur regime exempts companies from any profit tax, in effect a major TE.

Other TEs on business income include the exemption for public caterers (restaurants) that are allowed to remain under the turnover tax; the tax exemption for companies operating in free economic zones; and the recently enacted tax exemption for sale of securities held for more than two years.

¹ <https://www.imf.org/en/Publications/CR/Issues/2022/12/14/Republic-of-Armenia-Request-for-a-Stand-By-Arrangement-Press-Release-Staff-Report-and-526890>.

There are also significant tax expenditures which are, appropriately, already set to expire. These include the exemption for agricultural production; a five percent reduced rate for special projects outside Armenia; and the exemption for information technology startups.

Personal income tax

The interest tax credit for mortgage contracts (an estimated TE of 0.3 percent of GDP) is among Armenia's highest TEs and has been, correctly, slated for gradual elimination for the Yerevan region. Another significant income tax expenditure is the tax credit for reinvested dividends, which de facto provides tax-free treatment of dividend distributions.

There are multiple income tax exemptions on the personal income tax that, like excise TEs, are not accounted for. Up to 43 measures providing deductions, exemptions, and reduced rates are not monitored.

Lastly, capital gains realized by individuals are not taxed in Armenia, another significant TE.

Summary of Recommendations

Considerations could be made to lower the VAT registration threshold. While the precise optimal threshold largely depends on parameters such as the administrative costs of including new registrants in the VAT network, a threshold close to AMD 23 million (\$ 60,000) is estimated to boost revenue by about 0.8 percent of GDP.

The revenue potential of removing VAT exemptions that mostly benefit high-income households is estimated at over 2 percent of GDP.

The next step in broadening the coverage of TE reporting is to include TEs related to excise taxes. In addition, excise TEs could be streamlined by applying the same rate per unit of harm across similar goods. Changes to the taxation of fuels and vehicles can also improve the excise regime. The revenue potential from these measures is estimated at about 0.1 percent of GDP.

The micro-entrepreneur regime could be repealed to subject those enterprises to the turnover tax. The income tax exemptions granted to public caterers, free economic zones and securities could likewise be repealed.

Regarding the personal income tax, overly generous tax credits to individuals could be reined in. While it is acknowledged that the mortgage interest tax credit on existing contracts cannot legally be easily reversed, for new contracts to be issued during the phase-out period (2023-2025), the cap on the credit can be lowered.

Finally, capital gains realized by individuals for securities and real estate transactions can be taxed at a flat rate of 10 percent (same as for other capital income types), with an exemption provided for a specific amount on primary residences.