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**CHIEF ECONOMIC
ADVISOR**
TO THE PRESIDENT
REPUBLIC OF ARMENIA

Keynote Address

by

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at

The Third International Conference

of

Armenian International Policy Research Group

Washington D.C.

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Ladies and Gentlemen,

I am happy to be here again at this third conference of the Armenian International Policy Research Group. Clearly, AIPRG had another successful year in helping to advance research and technical analysis of Armenian public policy issues, including publication of its second compendium of policy papers--the Armenian Journal of Public Policy. I thus offer our heartfelt gratitude to AIPRG's Executive Board and associates. I also wish to thank the organizers and sponsors of this year's conference for their efforts and dedication in promoting this weekend's discussions on Income Distribution and Social Safety Nets. My special thanks goes to the World Bank for having hosted and funded the AIPRG annual conferences for now three consecutive years.

Before I proceed with the main theme of my statement today, I wish to let you know that we closed the year 2004 in Armenia with another double digit economic growth rate (around 10% of GDP), the fourth year in a row. Armenia was once again evaluated, in the Index of Economic Freedom, published by the Heritage Foundation and the Wall Street Journal, as the sole “mostly free” economy amongst the Commonwealth of Independent States, improving from 44th place in 2003 to 42nd place in 2004, just ahead of France and South Korea, and miles ahead of its immediate neighbors (ranging between 100 to 148). Armenia’s Index of Economic Freedom has dramatically improved in recent years: from 115th place in 1997 to 42nd place in 2004.

Nevertheless, there are still imbalances in the pattern of economic growth and distribution, adversely affecting the social dimensions of the economy, even though there has been a significant reduction in poverty, from 56% in 1998 to 29% in 2004. A recent World Bank analysis reports “poverty in Armenia has declined strongly since 1998, with particularly notable fall in extreme poverty”.

By the way, the above striking progress in economic liberalization, high economic growth rates and poverty reduction, during 1997 to 2004, corresponds closely with Robert Kocharyan’s terms of office as Prime Minister in 1997, and as President since 1998. As you will note from my statement today, the remaining economic imbalances are not due to policy design, but rather they are due to deviations from policy during the implementation phase.

This year, the focus of my statement is on the critical issue of adequate internal resource mobilization, particularly with respect to tax revenues, which is essential to fund the conventional state functions in an open, mostly private, market based economy, including the priority social sector expenditures.

You may recall my last year's statement attempted to identify the fundamental causes of the distortions in our society, our visions for the future of Armenia, the strategic directions of our reforms, and development of the foundations for liberal democracy and liberal economy. I also reviewed some of our achievements since independence fourteen years ago, and the challenges facing Armenia. My today's statement flows from the perspective set out in my last year's statement, which was printed in March 2004 issue of the Armenian Journal of Public Policy; it is also available electronically through the internet at the AIPRG website.

Clearly, the most challenging overall issue confronting the Armenian economy today is poverty reduction. Poverty (around 29%), unemployment (around 20%) and income inequality remain disturbingly high. The Government's Poverty Reduction Strategy addresses many essential measures required to deal with this challenge, and which is too broad and extensive for it to be included in the scope of my statement today. In a nutshell, our strategy is to reduce poverty through growth with equity. This requires investing in people and essential infrastructure, and promoting a free and competitive business environment so that investments are made and jobs created.

However, when we take a close look into the institutional constraints of poverty reduction and development of a skilled and large middle class, we find the crucial issue today is inadequate internal resource mobilization, particularly with respect to tax collection. This is the most pervasive and corrosive economic problem facing the Armenian economy today. It is pervasive because it adversely affects nearly all sectors of the economy. It is corrosive because it breeds corruption through collusion of public and private sector officials and leads to waste and misallocation of scarce public resources and thus undermines progress and development of the State of Armenia.

Although the tax regime in Armenia is one of the most favorable for business amongst transition economies (only 20%), the collection rate is amongst the lower. In fact, central government's tax revenues have declined steadily from 16.1% of GDP in 1999 to 14% of GDP in 2003. If social security payments are included, the revenues have declined from 19.9% of GDP to 17.2% of GDP during the same period. The above levels of tax revenue are grossly inadequate to fund the rapidly growing needs of the production infrastructure and public services, expansion and modernization of the social infrastructure to replenish and augment the required skilled manpower, provide targeted social safety nets for the vulnerable groups, and to meet the national security requirements of the Republic. Tax revenues should be at least around 20% of GDP and we should aim to reach this level by 2007. A strong fiscal system will strengthen Armenia not only to sustain good economic performance for improving quality of life for everyone, but also to deal effectively with national security challenges at home and abroad.

This objective, i.e. a strong and reliable revenue system, should be realized through sweeping reforms in tax and customs administration so as to achieve a fair and objective collection system. In response to President Kocharian's wishes and directives, several technical reports for this purpose have been prepared recently on the basis of the international experience, which now must be carefully reviewed and integrated into a coordinated administrative reform program by the Government. In addition, bold and decisive action by the justice authorities would be required to bring alleged violators of law and public trust to account, through due process of law, swiftly. The purpose here is not to raise tax rates, nor to introduce new additional taxes; it is rather to substantially improve compliance with the existing tax measures.

I will now attempt to illustrate briefly the pervasive and corrosive consequences of tax evasion in Armenia, which I mentioned earlier.

Closed and opaque business governance, so as to evade taxes, is preventing development of the capital markets. Yet, a well functioning capital market is essential for Armenia to mobilize internal and Diaspora savings to investment in order to help sustain high levels of growth and employment. Investors in capital markets require open, transparent governance and accurate accounting so as to enable them to evaluate benefits and risks, whilst the current opaque business governance in Armenia does not allow this. Tax evasion also hampers development of the debt market in the commercial banking sector since businesses tend to finance their expansion, modernization and working capital needs primarily through internal cash generation that comes from tax evasion, rather than borrowings from commercial banks. Consequently, commercial banks' lending volume remains small and does not play a significant role in funding investment and growth; lending by the commercial banks are currently around only 8% of GDP.

Tax evasion through collusion of the public and private sector officials also distorts the markets and the business environment and thus stifles competition because those enterprises that are not well connected to the rent seeking bureaucracy cannot compete very long and exit from the market. As a result, prices tend to rise and products become less affordable at home and less competitive in external markets. It also affects the foreign investors, who are not as skilled in evading local taxes, or may risk prosecution by their home governments if they engage in corrupt practices. Thus, many local and foreign investors are frustrated by the unequal business environment. All these tend to discourage investment and ultimately, of course, will lead to decline of the enterprise sector. Gross investments are currently around 23.5% of GDP (19.5% private, And 4% public), whereas Armenia must sustain gross investments, with high productivity, at a level of at least 30% of GDP in order to maintain the double digit growth rates in the medium term and thus keep the momentum of job creation and poverty reduction accordingly.

Moreover, because tax revenues are grossly inadequate, budgetary allocations for public health, education and social safety nets during this difficult period of economic transition are also grossly inadequate, causing social problems, and in time it will seriously affect both quality and quantity of the skilled manpower and will undermine the economic growth and quality of life in Armenia. It has already created an unjust environment where those who benefit most from the facilities of the new economic order are contributing relatively least to it. Under these difficult revenue conditions, the Government has been courageous in increasing the share of budgetary allocations for the social sectors significantly since 2002 (from 30% to 40% of the budget). However, continuation of this policy would require commensurate increases of tax revenue in the future. Low tax collections often lead to low salaries for public servants, which in turn causes corruption, initially under pressures of the necessities of life, and subsequently, once implicated in the practices of corruption, under the temptations of greed.

The collusion of public and private sector officials that emerge from tax evasion, and develop into a clandestine joint ownership of enterprises and oligarchies, lead to gradual erosion of democracy in Armenia, as these opaque “partnerships” break the laws, upset the checks and balances, and corrode the political institutions that are to serve as foundations of liberal democracy by infesting the parliament, the judiciary, the executive branch and even the mass media. This carries the risks of relapse to the corrupt oriental autocracy of the past rulers of Armenia: the Shahs and Shahenshahs, the Khans and Sultans, the Czars and Soviets, from which we have been trying to extricate ever since our independence fourteen years ago.

Armenia today is on a cross-roads: either to continue decisively along the path we chose at the time of our independence towards a liberal democracy with a free and competitive market economy, or to stray towards an oriental oligarchy with extractive economy. We have achieved a great deal since our independence fourteen years ago: open and stable economy with only low single digit inflation rates, double digit economic growth rates, robust trade and investment, extrication from our centuries old despotic political culture, the beginnings of liberal democracy, and plenty of freedom, all together unprecedented in our long and stormy history, and for which we must be grateful indeed. On the other hand, as I pointed out earlier, there are disturbing danger signs of relapse to our old habits of oriental corruption and arbitrary concentration and abuse of economic and bureaucratic power. Clearly, there is a fierce competition between two mutually exclusive segments of our economy; namely, between those who struggle for a fair, transparent, policy driven economic management and production; and those who go for public-private sector collusion and opaque transaction driven economic extraction. The choices are clear.

In his end of the year messages to government and business officials, and the population at large, on December 27th, and again after the Armenian Christmas on January 8th and 11th, President Kocharyan has pointed out his policy of strict fiscal discipline and his strong determination for the fight against corruption and tax evasion. It is now up to the Government, the Prime Minister and his team, to implement the policy. I hope when we meet again next year, I will be in a position to review significant progress on this important set of issues affecting nearly all sectors of the economy.

Thank you for your attention.