FISCAL CONSOLIDATION AND RECOVERY

(ARMENIA EXAMPLE)

Ministry of Finance
Republic of Armenia

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I. Economic Development (1991-1999)

Armenian economy suffered harsh fluctuations after proclamation of its independence.

Real GDP swang from a 42% drop in 1992 to 14% growth in 2007. There was time for a moderate inflation of 4% a year, as well as for hyperinflation.

Reforms were implemented, such as liberalization of prices, privatization of land and issuance of property rights on land, privatization of companies and liberalization in trade and investments.

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Economic Development (1991-1999)

After independence, due to loans borrowed at high interest rates and corporative debt for imported energy resources, the debt indicator grew from 0% to 49% of GDP in late 1999.

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Economic Development (2000-2008, pre-crisis period)

However, a well-thought fiscal policy allowed reducing budget deficit to 2.5% of GDP and less.

As a result, in 1999 – 2001, state debt dropped from 49 to 16% of GDP, with high indicators of economic growth, by 12% on average annually. By the end of this period the GDP per capita grew three times – up to $2,500. The percentage of the poor reduced from 50 to about 27.6 per cent in 2001-2008.

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II. Impact of the global financial and economic crisis

The global financial and economic crisis, felt in Armenia in 2009, had very bad consequences for Armenia.

This was conditioned by :

a) reduction of private transfers,

b) decreasing prices on raw materials in global markets, and, especially, prices on metals,

c) lower demand for export of Armenian goods and services due to lower global demand,

II. Impact of the global financial and economic crisis

d) lower investments in the country's economy, caused by lack of liquidity in the global economy, leading to temporary suspension of construction industry – the main driving force in economy in pre-crisis years.

Lower incomes of the population and changing consumption behavior, on the one hand, and lower external demand, on the other hand, led to reduced activity in a number of sectors.

II. Impact of the global financial and economic crisis

Due to crisis, export decreased by 33% and the amount of remittances by 35% in 2009.

As a result, the recession reached 14.1% in 2009, while it already reached 9.7% in the first 4 months of 2009.

In spite of the plans of the state budget for 2009, incoming tax revenues reduced by more than a quarter, which paused a real threat to the state programs of social and economic development and led to budget debts.

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2009 Anti-Crisis Measures

The Government recurred to a large-scale budget stimulation, which boosted budget expenditures by 13%, while deficit reached 7.6% of the GDP, which allowed to mitigate crisis impact for the poor and vulnerable groups of population.

The rapid economic growth in Armenia in 2001-2008, when the real GDP grew by 12% annually on average, allowed to raise the living standard and obtain a budget reserve, which was necessary to the Government to ensure a large-scale fiscal stimulation as a response measure to the crisis.

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2009 Anti-Crisis Measures

In this context, in order to mitigate the impact of the crisis on Armenian economy, the Government initiated active talks to attract privileged credit resources.

As a result, Armenia received over $1.6 billion which was used to mitigate external negative impact on Armenian economy. At the same time, it is worth to note that due to this, the public debt grew to 39.5% of the GDP in 2009.

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Principles of anti-crisis policies

Given the impact of the crisis on the country's economy, the Government's anti-crisis policies primarily focused on stimulation of economic activities, rather than enhancing financial institutions and additional insurance against possible risks.

The main principles of the anti-crisis policies were:

- ensuring macroeconomic stability through financial stability,
- expanding fiscal and monetary and lending policy,

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Principles of anti-crisis policies

- efficient foreign exchange policy,
- effective relations with society and businesses,
- large-scale infrastructural programs,
- improving business environment and offering temporary assistance to businesses,
- giving priority to social programs.

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Taxation measures

Taxation measures undertaken by the Government were mainly focused on tax legislation.

Fundamental to reforms in taxation was 2008-2011 Tax Administration Strategy Program, whose key idea was “taxpayer-friendly”.

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Taxation measures

Most important changes in tax legislation aiming to mitigate negative consequences of 2009 financial-economic crisis, on the one hand, aimed to ensure support to the local producers (especially small and medium businesses), and on the other hand, to ensure an adequate level of tax revenues to the public budget.

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Taxation Measures

1) <u>To support small and medium businesses:</u>

From 1 January 2009, the Government introduced the VAT-free threshold for the annual turnover in the amount of 58,350 Drams and introduced a system for those economic entities that are not VAT taxpayers.

As a result, a relatively soft taxation regime, simpler tax accounting and tax administration were established for small and medium enterprises.

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Taxation measures

2) To protect local producers and improve their investment activity and competitiveness :

- higher excise duties were introduced for imported excisable goods compared to excisable local products.
- a 3-year grace period for VAT payment was offered on import of groups of goods indicated in article 61 of the Law on Value-Added Tax for amounts exceeding 300 million Drams.

Taxation Measures

Similar condition applies to groups of goods that were not were not included in the above list and are meant for investment programs worth of 300 + million Drams approved by the Government.

- handmade carpets produced in Armenia and sold by by their manufacturers were exempted from profit (income) tax and VAT.
- sales of precious metals were exempted from VAT. VAT.

Taxation measures

- At the same time, the Government undertook an unprecedented step in terms of inspections having decided not to carry out inspections in 1 January 2009 – 1 January 2011 in entities whose turnover in 2008 did not exceed 70 million Drams.

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Taxation measures

3) In order to ensure an adequate level of tax revenues :

- a tax authority representative was introduced for the large taxpayers,
- “Excise Depo” regime was introduced for excise duty payers,
- To expand possibilities for accounting of real turnovers in retail and improve efficiency of tax administration, a gradually improving system of lotteries and prizes for special numbers on receipts (checks) produced by cash registers was introduced.

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Public Expenditure Measures

- **<u>In public expenditures,</u>** the main areas included large-scale infrastructural programs, temporary financial assistance to businesses, and giving priority to social programs.

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Public Expenditure Measures

Public expenditures expanded due to high current expenditures, which were conditioned by the fact that, in spite of recession, social expenditures and wage bill were paid to the extent stipulated in the law, which thus conditioned higher ratio in the GDP.

While in 2006-2008, the ratio of current expenditures in the GDP grew by less than 2%, in 2009 current expenditures in the GDP grew by more than 2.8%. This was conditioned by the Government Program aimed to support social expenditures.

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Public Expenditure Measures

At the same time, infrastructural programs were also supported with the help from international financial institutions.

Capital expenditures constituted 2.6% of the GDP in 2008; however, in 2009 capital expenditures reached 6.7% of the GDP, which was due to higher infrastructural expenditures in different sectors of economy (particularly in road management, melioration and energy, housing).

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Public Expenditure Measures

- We should note that stabilization measures were accompanied by conservation of those budget expenditure programs planned in 2009 budget, which did not correspond in essence and expected results to the objectives of the Government Anti-crisis Program.
- The share of conserved expenditures under such programs in the total planned 2009 public budget expenditures constituted 5 %.

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Public Expenditure Measures

- Besides, to render direct support to development of private sector, a Crisis Center was established to consider business projects from private sector and determine the form of assistance.
- The Crisis Center received over 300 business programs. The cost of selected projects amounted over $35 million.

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Public Expenditure Measures

- A Stabilization Fund was set up from the Russian credit resources to render support to the real sector (both to systemic entities and small and medium enterprises).
- To provide lending to small and medium enterprises, the Government also used resources offered by the international financial institutions.

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Country Credit Ratings

Unlike many countries in Eastern Europe, Armenia was not exposed to lower country credit ratings during the financial crisis, although in August 2009 Fitch decreased one position to BB- due to recession and higher public debt.

Nevertheless, the situation stabilized, and Moody 's left Armenia's rating untouched at the level Ba2 during the whole period of crisis, to confirm this rating later as well.

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III. Fiscal consolidation after 2009

As economic growth resumed, the necessity also increased to gradually scale down stimulation measures.

The Government initiated budget consolidation, although its firm focus on improvement of expenditures can come in contradiction with the need to accelerate economic growth.

It is necessary to raise tax revenues as a key feature of budget consolidation.

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III. Fiscal consolidation after 2009

- Public debt will somewhat decrease in the future, in order to enable an anticyclic budget policy in case of serious economic shocks.
- Tempos of budget consolidation will influence the public debt situation.

III. Fiscal consolidation after 2009

Starting from 2010, the Government initiated policy aiming to reduce public budget deficit : thus, if in 2010 it constituted 5% of the GDP, in 2013 it was 1.7%. However, the public debt kept growing: while it was 39.8% of the GDP in 2010, in 2013 it increased to 44.1%.

In this context, some additional measures of budget consolidation are required to reduce public debt and make budget reserves for eventual external shocks in the future.

III. Fisсal consolidation after 2009

- One of the key priorities is further consolidation through such measures that do not jeopardize economic growth.
- Improved performance in all public finance sectors (tax politics, tax administration and public expenditures) plays key role in the ongoing budget consolidation in order to ensure efficiency of expenditures and higher revenues.

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III. Fisсal consolidation after 2009 : public revenue measures

Due to the fact that the ratio of tax revenues and GDP in Armenia is lower than in other countries with similar income per capita, the main priority in budget consolidation must be given to increasing tax revenues (by 0.3-0.4% GDP per year, on average).

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III. Fiscal consolidation after 2009 : public revenue measures

Meanwhile, the following measures will be necessary in the long run:

- to change the structure of the country's economy, so that more sectors with higher tax capacity prevail,
- to identify taxes with unused potential which can generate additional tax revenues, and to reconsider tax policy accordingly, in order to enhance principles of horizontal and vertical equity in taxation and determine the best tax burden.

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III. Fiscal consolidation after 2009 : public expenditure measures

In terms of public expenditures, the following measures will be necessary in the long run :

- To improve performance of public expenditures, reduce non-targeted expenditures, gradually introduce program budgeting in budget process and ensure subsequent complex application of this method
- To ensure an adequate level of remuneration in public sector

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III. Fiscal consolidation after 2009 : public expenditure measures

- To allocate adequate resources for healthcare and education which determine the quality of human capital in the country.
- To increase expenditures for physical infrastructure, which can enable growth required to ensure sustainability of fiscal policy.

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III. Fiscal consolidation after 2009

- In view of the above, it should be noted that after 2009, the Government policy led to a visible gradual growth in both revenues and expenditures of the public budget.
- Already in 2010, the ratio of revenues to the GDP (22.6%) exceeded the level of 2008 (22.0%), and in 2013 it constituted 25.1%.
- In the context of policy aimed to reduce budget deficit in 2010-2013, the ratio of expenditures to the GDP (26.4% on average) exceeded the level of 2008 (22.7%), and in 2013 it constituted 26.8%.

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Mid-Term Budgeting

The ongoing fiscal policy must be countercyclical, i.e. it should stimulate the economy in the period of recession and vice versa.

However, the trends in development of the global economy, as well as the limited number of fiscal instruments compared to 2008, makes us undertake policies focused on ensuring debt sustainability in the middle run, which will limit the impact of fiscal expansion.

In this connection, in order to ensure debt sustainability, the budget deficit level will fluctuate at 2% of the GDP, public debt to the GDP ratio will go down gradually, and tax revenues to the GDP ratio will grow by 0.3-0.4% points per year on average.

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Table 1. Economic Development

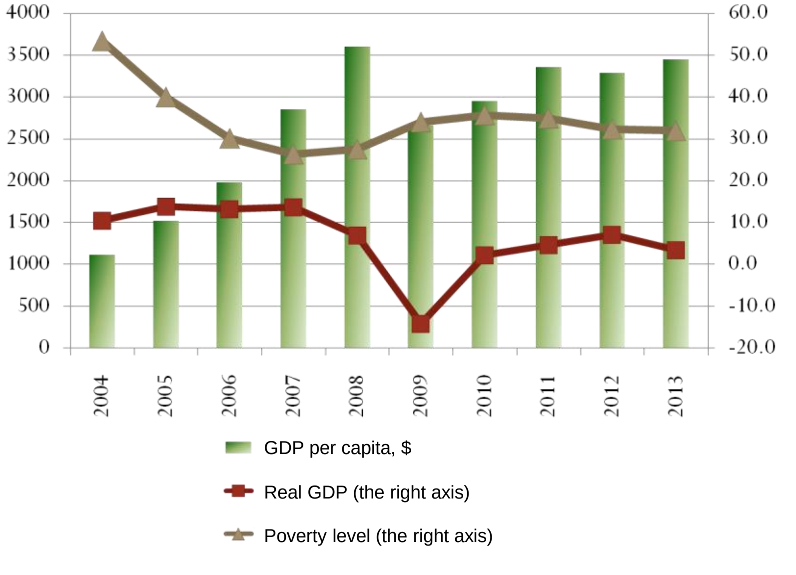

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Table 2. Real GDP and CPI

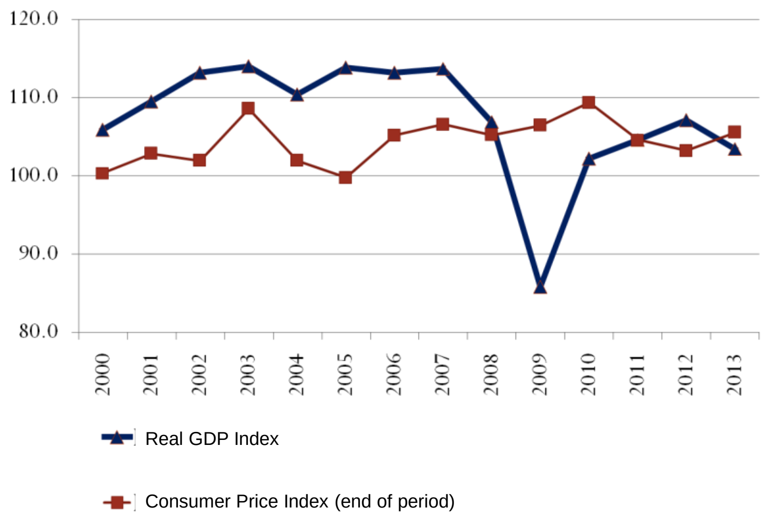

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Table 3. Real and Potential GDP

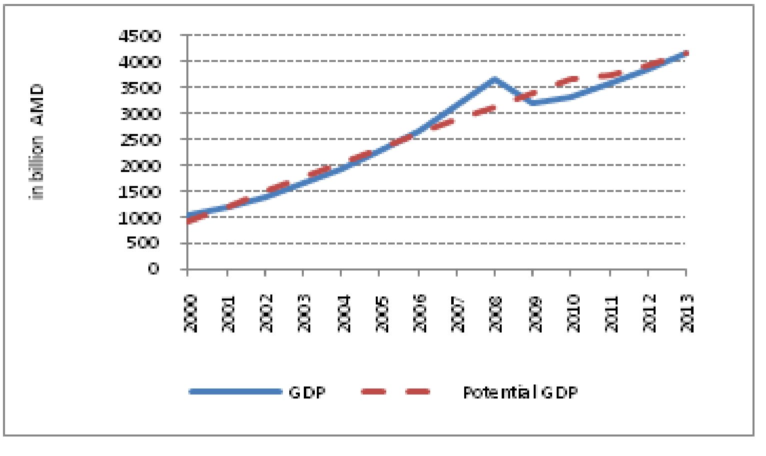

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Table 4. Budget indicators as % of GDP (2008-2013)

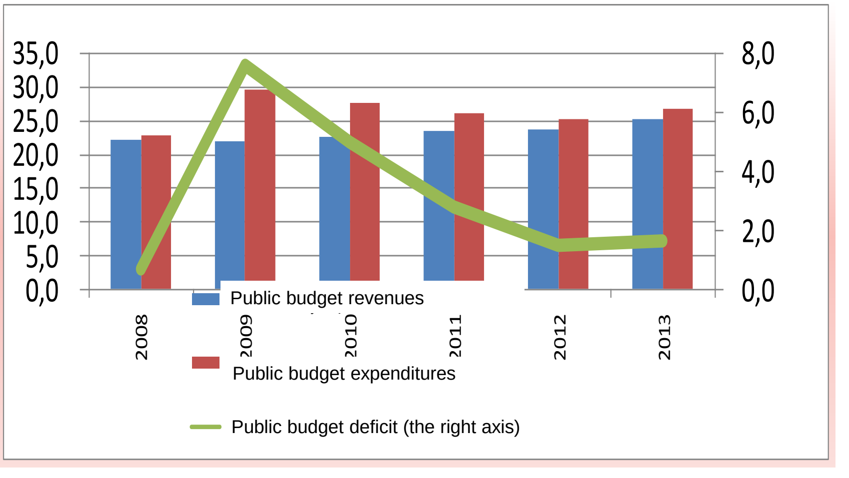

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Table 5. Fluctuation of State Debt

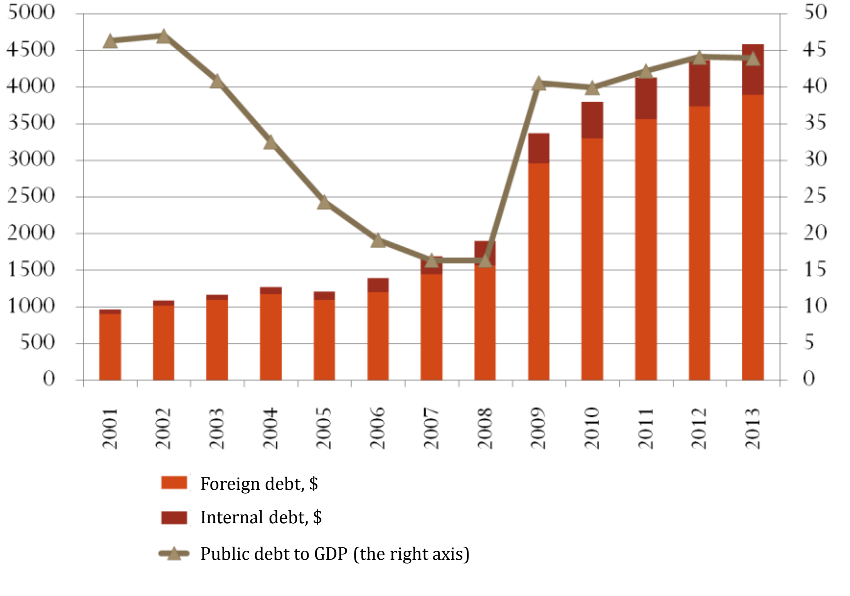

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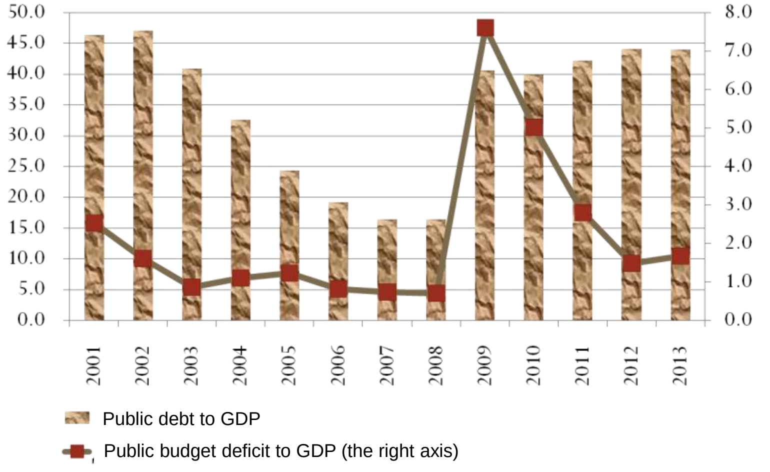
Table 6. State Budget Deficit and State Debt to GDP



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