STIMULATING THE DEVELOPMENT OF THE SME SECTOR THROUGH EFFECTIVE TAXATION MECHANISMS

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Key words: SMEs, taxation, Armenia, reinvestment, policy reform, shadow economy, startup incentives, tax administration, international comparison

Introduction

Small and medium-sized enterprises (hereinafter referred to as SMEs) are considered one of the pillars of the economy around the world. They not only create the majority of jobs, but also contribute to economic diversification, the promotion of local production, and social stability. Numerous studies and reports by international organizations demonstrate that a developed and sustainable SME sector is one of the key factors for economic growth, especially in developing countries, where the density of large businesses is low.

In particular, the analyses of the World Bank, the Organization for Economic Cooperation and Development (OECD) and the International Monetary Fund (IMF) show that SMEs in developed countries account for 95–99% of the total number of enterprises, provide 60–70% of the labor market and make a significant contribution to the creation of GDP. At the same time, in developing countries indicators may differ from each other, depending on the forms of state support, tax policy and access to financial resources.

The attention paid to the SME sector is due to a number of factors:

• Activation of the potential of the economy at the macro and microeconomic levels,
• Reduction of unemployment through the creation of new jobs,
• Mobilization of local revenues due to increased tax revenues,
• The spread of innovation and technological updates.

However, for the development of SMEs, entrepreneurial aspiration or market freedom alone is not enough. An appropriate environment is needed, including tax, credit, administrative and legal components. In this regard, tax policy is a key tool that can both stimulate the development of SMEs and become a major obstacle for them.

The effectiveness of taxation is determined not only by rates, but also by the simplicity of processes, predictability, diversified mechanisms and a set of incentive tools. From this point of view, the correct structure of tax policy can become not only a source of stable revenue for the state budget, but also an incentive for the sustainable development of SMEs. However, the inflexible structure of tax systems, complex and intricate procedures, high fees and ineffective tax control mechanisms can have the opposite effect, reducing registered enterprises, stimulating the growth of the shadow economy. In Armenia, SMEs also make up the majority of economic entities (around 97%), but their participation in GDP, employment and exports is low compared to international averages. This disparate picture has many reasons, including the imperfection of state policy, limited financial flows, lack of management skills and shortcomings in the tax system.

Research methodology

This article uses a mixed research methodology that combines qualitative and quantitative approaches in order to comprehensively analyze the impact of SME taxation mechanisms on economic development. The qualitative part of the research includes a structural and legal-political analysis of the tax legislation in force in the Republic of Armenia, a study of international best practices, and an examination of practical examples from programs implemented within the framework of state and private initiatives. The quantitative analysis used comparable indicators from World Bank reports, data published by the State Revenue Committee and the Statistical Committee of the Republic of Armenia. A comparative analysis was also conducted during the research to assess the efficiency of tax administration in different countries, the involvement of the SME sector in GDP, budget, and employment structure.

Literature review

The role of SMEs in national economies has been widely studied within the framework of economic theories. Various approaches, from microeconomics to institutional economics, present the essential importance of SMEs in terms of economic development, employment, innovation, regional balance and ensuring low barriers to entry. Theories of the economic role of SMEs: In economic theoretical concepts, SMEs are considered as agents of "creative destruction" according to the theory of Joseph Schumpeter. According to Schumpeter, newly created small enterprises are carriers of innovation that stimulate industrial transformation, introduce new products and services and radically transform markets [Schumpeter, 1934]. A similar analysis is provided by David Birch, who notes in his famous study that most jobs in the United States are created not by large companies, but by SMEs. According to him, "small businesses are microamps of employment" that can respond to local demand more flexibly and quickly than large businesses [Birch, 1987]. These theories were later reinforced in the reports of the Organization for Economic Cooperation and Development (OECD), which recorded that SMEs account for about 99% of the total number of companies in member states and create more than 60% of jobs [OECD 2017]. Institutional and tax models in the context of SME development. One of the key factors in the development and sustainability of the SME sector is the approach of state intervention, especially the role of tax policy. According to institutional economics, the role of the state is to develop rules that reduce the costs of operating in the market and encourage the willingness to bear risks [North, 1990]. The impact of tax policy on the behavior of SMEs has been repeatedly studied using examples from different countries. The tax theory of Allingham and Sandmu analyzes how tax rates and the level of supervision affect the motives for tax avoidance. According to the model, high taxes, without

incentive mechanisms, can create a risk of growth of the shadow economy [Allingham & Sandmo 1972]. Moreover, no less important than the size of the tax burden are:
• Simplicity of tax procedures,
• Clarity of reporting,
• Transparency of control.

Joint studies by the EU and the WTO (World Trade Organization) indicate that in countries where simplified taxation models are in place, the level of SME registration is significantly higher [European Commission, 2020]. Classification of different SME taxation models. From a tax perspective, the systems applied to SMEs can be divided into the following main models:
a. Flat-rate turnover tax. It is based on the company's turnover, without taking into account profits. It is easy to calculate and has a simplified reporting mechanism as is used in Georgia, Kyrgyzstan, and Armenia.
b. Standard corporate income tax with reduced rates. SMEs are granted preferential rates compared to large enterprises. For example, in Poland, the corporate income tax for SMEs is 9%.
c. Investment-based taxation model. Benefits are granted only if the company reinvests profits, not distributes them as dividends as in Estonia.
d. System of tax holidays and exemptions. Newly opened SMEs are granted tax exemption for a certain period. This mechanism is used mainly in developing countries to increase competitiveness.
These models are applied differently in different countries, depending on the government's strategy, economic structure and tax policy philosophy.

Criteria for the effectiveness of tax incentives. In international practice, the effectiveness of tax incentives is assessed by a number of criteria:
• Growth rate of businesses registered in the SME segment,
• Reduction of the shadow sector,
• Growth of SME investment in GDP,
• Employment expansion,
• Introduction of new technologies.

Recent OECD reports indicate that tax incentives are most effective in countries where they are accompanied by administrative simplification, electronic reporting and the spread of financial education [OECD, 2023].

The relationship between tax policy and economic growth. The interrelationship between tax policy and economic growth has been repeatedly established in economics. According to Barro, if tax revenues are reinvested in efficient infrastructure and human capital development, they can have a positive impact on economic growth [Barro, 1991]. This is especially important for SMEs, as this segment is sensitive to institutional instability.

According to a study by the European Bank for Reconstruction and Development, about 60% of SMEs surveyed in Armenia considered the tax burden to be one of the main obstacles to their activities EBRD, 2020].

Scientific novelty

The article uses a new approach to comparative analysis. In the context of SME tax policy, an analytical combination was carried out simultaneously using the examples of six countries, including both developed and countries at different stages of development. This multi-layered combination made it possible to identify specific structural patterns. The article presents clear practical recommendations based on international experience, data collection, and an analysis of the current legislation of the Republic of Armenia. The proposed changes can be used:

• in the process of developing tax policy reforms,
• during the assessment of the effectiveness of SME state support programs,
• during the review of the economic strategies of the Republic of Armenia.

According to the approach of the article, SME tax administration is considered not only as a source of income, but also as a development stimulus that affects the reduction of the shadow economy, the activity of registering new enterprises, investment confidence and employment growth. Such an approach can provide an opportunity to transform the point of view of executive and legislative policies based on analytical data.

Analysis

Different countries around the world have applied diverse approaches to the development and taxation of SMEs, based on their economic structure, administrative capabilities and political priorities. This section presents the experience of a number of countries: Germany, Poland, Estonia, Georgia, Great Britain and Singapore, which, with their structure and results, can serve as an example for improving the policy of the Republic of Armenia.

Germany. Germany is often called the leading country for small and medium-sized businesses, due to its deeply rooted Mittelstand system. Mittelstand represents a powerful network of medium-sized, often family-run companies that operate in both local and international markets. The main points are:

• Corporate tax: 15% at the federal level and an average of 14–17% at the municipal level, which results in an average burden of 30–33%. However, there are a number of benefits for small businesses.
• Innovative tax incentives: up to 25% tax refunds are provided for research and development (R&D) expenses.
• Indirect support: low-interest loans are provided to SMEs through the KfW development bank.

Thanks to the Mittelstand system, SMEs in Germany make up about 99.6% of companies, and their participation in GDP is 52%.

Poland. Poland has implemented a number of reforms aimed at strengthening the SME sector in the last decade. As a member of the EU, the country benefits from various financial programs: EFSI, COSME, etc. The main provisions are:
• Corporate tax for SMEs: 9%, which applies to companies with an annual revenue of up to 2 million euros.
• There is no sales tax, instead a flat VAT system operates.
• Digitalized tax control: reports are submitted in a unified electronic format, which reduces administrative costs.
These approaches have contributed to a 12% increase in the number of SME registrations in 2018–2021 alone [PARP, 2022].

Estonia. Estonia is considered one of the leaders in digital governance. Its tax model is philosophically different from traditional approaches, thanks to its "dividend-based taxation" model. The main provisions are:
• No corporate tax is paid if profits are reinvested.
• Corporate tax: 20%, only upon distribution of dividends.
• Average reporting time: 15 minutes, fully electronic.
• Business registration: within one day, without a visit.
The Estonian model is often seen as a best practice in small countries in the context of SME promotion [OECD, 2021].

Georgia. Georgia is a regional example of implementing a simplified tax system. It has adopted a "pay when you make a profit" approach, as in Estonia. Key provisions include:
• Microbusiness status: businesses with an annual turnover of up to 30,000 GEL are fully exempt from taxes.
• SME tax: 1% of turnover, up to 500,000 GEL.
• No profit tax until dividend distribution.
• Electronic reporting, automated control.
The Georgian model has contributed to the reduction of the shadow sector and a significant increase in the number of business registrations. According to GIZ, the number of SME registrations increased by 28% in 2017–2022 [GIZ, 2022].

United Kingdom. The UK government has applied a progressive approach to tax incentives for SMEs. There are incentive mechanisms aimed at both start-ups and businesses in the growth phase. Key provisions include:
• Enterprise Investment Scheme: investors are given a return of up to 30% of investment.
• SME R&D tax credits: up to 130% of costs offset against corporate tax.
• Startup zones with a package of tax incentives for the first 3–5 years.

As a result of these approaches, SMEs in the UK account for 99.9% of enterprises and provide 61% of private sector employment [UK Department for Business, Energy & Industrial Strategy, 2021].

Singapore. Singapore is one of the most business-friendly countries in the world, according to the World Bank's Doing Business ranking. Its SME policy is based on clearly targeted tax incentives. The main provisions are:
• Corporate income tax: 17%, but for SMEs, a 75% discount on the first SGD 100,000.
• Tax holiday: up to three years on the first SGD 200,000 of profits.
• Microcredit government guarantee systems aimed at newly established SMEs.
In addition to tax factors, Singapore provides digital business registration services, a strategic environment, and a competitive financial system [IRA of Singapore, 2022].

The example of these countries shows that the basis of successful SME policy should be tax flexibility and simplicity combined with institutional transparency, technological tools, and targeted incentives. In addition, the approaches of the countries under consideration are based on policies tailored to the stages of development of the countries, from initial stimulation to stimulation of growth stages.

Armenia. In Armenia, the regulation of small and medium-sized enterprises is carried out through a number of legal acts and tax legislation. Although the state has declared the need to promote SME development in different years, the current tax system and administrative environment still do not provide sufficient predictability, simplicity, and an incentive environment for business. According to the 2011 Government of RA Resolution No. 538-N, SMEs are classified:
• Microenterprise: up to 10 employees, annual revenue: up to 24 million AMD,
• Small enterprise: up to 50 employees, annual revenue: up to 500 million AMD,
Medium enterprise: up to 250 employees, annual revenue: up to 1.5 billion AMD [Government of the Republic of Armenia Resolution No. 538-N, 2011]
These criteria do not fully comply with international standards (e.g., EU definitions), but are somewhat acceptable for comparison purposes. The tax field in Armenia [Tax Code of the RA, 2016] is structured mainly in the following areas:
A. Profit tax. According to the Tax Code of the Republic of Armenia, the general profit tax rate is 18%. It is applied to all legal entities operating in the general taxation field. The burden of corporate income tax on SMEs is considered significant, especially in the case of micro and small enterprises, which lack adequate accounting capabilities and face administrative difficulties.
B. Turnover tax: The majority of SMEs operate under the turnover tax regime, which is intended for companies with an annual turnover of up to 115 million drams. Rates vary depending on the sector, from 1% to 20%. This system has formed a certain segment of

business that registers exclusively for turnover tax, but when it crosses the threshold, it is forced to leave the tax "comfort zone".

C. Value-added tax: VAT is applied to all organizations with an annual turnover of more than 115 million drams. The rate is 20%. Many SMEs, seeking to avoid VAT calculation and reporting, artificially reduce their income or operate without documentation, which stimulates the shadow economy.

While there has been some progress in recent years towards the introduction of electronic tax platforms, a wide range of businesses continue to face the following challenges:

- Complexity and frequent changes in tax forms,
- The uncertain and subjective nature of audits,
- The high cost of accounting services for small businesses.

According to the 2021 Business Environment Survey (BEEPS V), about 63% of SMEs surveyed cite tax administration as a major obstacle to doing business [BEEPS, 2021].

The current system has key shortcomings that hinder the full development of SMEs:

- Abrupt change in thresholds: the transition from turnover tax to VAT occurs immediately after the border, without soft transitional mechanisms.
- Disincentives to reinvest profits: tax is not diversified depending on investment goals.
- Lack of tax predictability: frequent changes in policies complicate long-term planning.

In order to formulate the right tax policy for the SME sector, we have also conducted a comparative analysis of different countries. This also allows us to assess Armenia's position in the global context and identify possible ways to improve the policy.

Table 1. Main characteristics of tax policies in the SME sector by country[1].

Indicator / Country	Germany	Poland	Estonia	Georgia	Great Britain	Singapore	Armenia
SME share in GDP	52%	51%	64%	48%	50%	44%	~27%
Share of jobs	~70%	67%	~63%	~60%	~61%	~72%	~42%
Profit tax for SMEs	15–30%	9%	20% (only divident)	only from divident	19%	17% (discount 75%)	18%
Turnover tax	n/a	n/a	n/a	1%	n/a	n/a	1–20%
Tax holidays	Limited	yes	n/a	yes	yes	yes	limited
Average reporting time (hours/year)	~40 hours	~30 hours	~15 hours	~20 hours	~30 hours	~20 hours	~55 hours

[1] Composed by the auther by using the following sources: OECD (2023). *Tax Policy Reforms 2023*, World Bank (2020). *Doing Business Report: Armenia Profile*, IRAS (2022). *Corporate Tax Rates and Rebates in Singapore*, UK Gov (2021). *Business Population Estimates for the UK and Regions*, PARP (2022). *Report on the SME Sector in Poland*, GIZ & Ministry of Finance of Georgia, *SME Policy Index Georgia*, 2022, Republic of Armenia' Tax code (2016)

As a result of the comparative analysis, we can note that in advanced countries a flexible approach to taxation for SMEs is being considered. For example:

• In Poland, 9% corporate income tax has lead to the growth of new SME registrations.

• In Estonia and Georgia, there is no corporate income tax if profits are not distributed. This approach encourages reinvestment and company growth.

• In Singapore, tax rebates at the first income levels support newly established SMEs, reducing risk.

• In Armenia, a flat 18% corporate income tax reduces the ability to stimulate new investments.

International experience also shows that not only the number of taxes is important, but also the simplicity of their collection. According to the World Bank Doing Business report, in Estonia, one tax return is submitted on average in 15 minutes, in Georgia - up to 20 minutes, and in Armenia - on average in 1-2 hours, which is a significant burden for micro-enterprises [World Bank. 2020].

Increasing the level of digitalization directly contributes to both the reduction of the shadow economy and the growth of business registration. In countries where tax incen-tives are accompanied by simple procedures, the following results have been recorded:

• In Germany, the innovative activity of SMEs increased by 20% with the use of R&D incentives [BMWK. 2022].

• In the UK, the number of startup registrations increased by 9% annually thanks to the use of tax credits [UK Government 2021].

• In Armenia, tax incentives often do not operate in an automated manner, and the procedures for their application are complex. Moreover, there is no separate business platform to ensure the visibility of favorable tax regimes.

The current turnover tax system in Armenia is relatively simplified, but it has serious structural problems, which we can call the so-called turnover tax “trap”. When a company crosses the threshold of 115 million drams, the tax burden increases sharply and many companies are artificially divided into different entities in order not to exceed the threshold. In contrast, in Poland and Germany, there is no such closed regime, and SMEs can plan their growth in the long term without a drastic change in the tax regime.

The Estonian and Georgian models prove that if profits are reinvested, tax exemption becomes an incentive tool. This approach is absent in Armenia. According to a survey conducted in 2020, about 58% of SMEs reinvest profits, but are taxed regardless of that purpose [Ministry of Economy RA. 2020].

Conclusion

Small and medium-sized enterprises are one of the pillars of the economy. SMEs not only contribute to the development of local production, but also ensure social inclusion, territorial balance and innovative mobility. International experience, theoretical models and practical cases show that the existence of a targeted, calculated and incentive tax policy is crucial for the sustainable development of SMEs.

In Armenia, despite some reforms, the tax system continues to operate primarily as a revenue-generating model without a clear development philosophy. The turnover tax and profit tax regimes, the threshold application of VAT, the complex structure of the administration, and the disincentive to reinvestment combine to create an environment of "growth pressure" for SMEs.

The analysis conducted shows that tax policy in the Republic of Armenia, although somewhat reformed, remains a key obstacle to the development of SMEs. In our opinion, the following reforms are necessary:

1. Making tax thresholds reasonable and phasing them out. The turnover tax threshold in Armenia (115 million drams) is a growth "fear zone" for SMEs. Companies that approach the threshold often split into different private enterprises or simply limit their turnover, avoiding the VAT field. We propose:

• Develop a model for a gradual change in the threshold, where payments during the transition period are calculated in a combined manner (e.g. turnover tax + partial VAT).

• Develop a structural mechanism that would allow companies with a turnover of up to 150–180 million drams to use mixed regimes without accounting complications.

2. Exemption from taxation of reinvested profits. Companies that do not distribute profits and reinvest in developing production or technologies are taxed in the same way as those that distribute dividends. In this regard, we propose:

• Introduce an element of the "Estonian model" - payment of profit tax only upon distribution of dividends.

• At least apply a tax deduction for reinvestments when capital expenditures are directed to clearly established production lines, equipment, acquisition of raw materials or creation of jobs.

3. Digitalization and simplification of tax administration. Tax reporting for micro-enterprises remains a complex process. The prices in the consulting services market are high, and state support is limited. We believe it is necessary.

• Develop a digital single window system where SMEs can submit reports in a simplified form, also automatically attaching bank movements.

• Create a platform for "tax advisor" businesses, where SMEs receive tax and financial advice with state support.

• Provide mobile solutions, including solutions built into commercial banks' mobile applications, for filing turnover tax and income tax.

4. Tax holiday for newly established SMEs. The first 1–2 years of businesses are the most risky and capital-poor. However, it is at this stage that universal tax obligations apply. In this regard, we propose:

• Provide tax holidays during the first calendar year, if the organization maintains legal jobs and does not distribute dividends.

• The holiday can be in the form of a turnover tax discount or in another form.

Tax policy is not just a tool for raising financial resources: it is a strategic guide for economic development. These proposals can become the basis for structural reforms that will not only reduce the financial pressure on SMEs, but also promote their active participation in the national economy.

The development of the SME sector cannot take place without a calculated and stimulating tax environment that is at the same time simple, predictable and development-oriented. For Armenia, this turnaround is possible, but requires a systematic approach and strategic determination.

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Stimulating the development of the SME sector through effective taxation mechanisms

Key words: SMEs, taxation, Armenia, reinvestment, policy reform, shadow economy, startup incentives, tax administration

Small and medium-sized enterprises (SMEs) play a crucial role in the economic development of both developed and developing countries. This article examines how properly designed and targeted tax policies can stimulate the sustainable growth of SMEs. The study includes a comparative analysis of SME taxation models in Germany, Poland, Estonia, Georgia, the United Kingdom, and Singapore, highlighting best practices such as reinvestment-based tax exemptions, simplified administrative procedures, and startup tax holidays. The paper also presents a comprehensive assessment of Armenia's current legal and tax environment for SMEs, identifying major challenges such as rigid tax thresholds, lack of reinvestment incentives, and complex reporting systems. Based on international experience and case studies from Armenia, the article proposes structural reforms to the SME tax system, including progressive thresholds, sector-based differentiation, and digital simplification. These reforms aim to foster formalization, improve competitiveness, and increase the SME sector's contribution to Armenia's GDP and employment.