

EUROPEAN
BUSINESS
ASSOCIATION



MAIN BUSINESS IMPEDIMENTS IN ARMENIA

Exploratory Study

European Business Association

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1. Introduction

Main objective of the study conducted by the European Business Association was to reveal major impediments of business activity in Armenia, to raise those issues at the public- private level and to conduct corresponding joint actions for overcoming those challenges.

It is a common knowledge that the SME sector is essential in stimulating economic growth, creating jobs and ensuring harmonious development of the country. Moreover, the SMEs that export within the region, Europe and beyond are the most dynamic contributors to the economy. The growth of SMEs has been hampered by a variety of barriers in Armenia. Fiscal constraints, particularly high rate of taxes and contributions, financial constraints and the institutional and business environment have been some of the major barriers they have had to surmount. These barriers have forced many firms to conduct some or all of their activities in the informal sector of the economy.

Currently, Armenia ranks 35th out of 189 countries in the World Bank's 2016 Doing Business index, which is a significant improvement compared to 43rd place out of 183 countries in 2009. The government increased transparency of public services by introducing e-based systems, including e-government and e-signature, and made significant progress on e-procurement. The Global Competitiveness Report 2014-2015 ranks Armenia well overall, it also identifies corruption as the biggest barrier to doing business, followed by tax regulation.

Besides the abovementioned deficiencies in Armenia's business environment, its economic development remains constrained by geo-political and security challenges, including the blockade by two neighbors. A volatile regional geo-political context and the unresolved Nagorno-Karabakh conflict are negatively impacting regional stability. After growing by 7.2 percent in 2012, Armenia's economic growth slowed to 3.3 percent in 2013 and 3.5 percent in 2014. In 2015, GDP growth slowed down to 2.3 percent in the context of the broader regional downturn to which Armenia is exposed via trade, remittances and investment flows.

Strengthening the competitiveness of the domestic private sector is pivotal to Armenia's ability to develop a more broad-based economy, reduce vulnerability to external factors, and achieve sustainable growth.

Current survey of hundred forty MSMEs highlights the issues faced by the enterprises in the Armenian business environment. MSMEs complain heavily about customs and trade regulations, law enforcement and financial risks. The results presented below show the problematic areas in the legal framework, tax and customs services and financial system, where the government together with the private sector and NGOs have to speed up the reforms. The study is especially useful for business support organizations as it brings into focus the most pressing issues that need to be addressed to nurture and grow MSME businesses in Armenia.

2. EBA Study Objectives and Methodology

This exploratory study examines the most pressing challenges faced by micro, small and medium sized businesses in Armenia. A survey approach was deployed in collecting data from business owners/Executive Managers. Representatives of European Business Community as well as local Armenian companies were interviewed. Discussion of key findings centers on the following issues: monopoly/fair competition; problems in dealing with tax and customs services; difficulties faced in legal and regulatory systems; issues in public procurement; challenges in securing financing, as well as accession to the Eurasian Union.

Majority of interviewees are small and medium organizations. However some micro companies have been also interviewed. The study conducted by the EBA is an ongoing process and this paper will be continuously updated to reflect upon the issues that are relevant for business environment improvement.

The study selected 140 companies for an in-depth survey, with quotas set on company size (10 % ‘micro’ companies with 1-9 employees were surveyed, 30% ‘small’ companies with 10-49 employees, and 60 % ‘medium’ companies with 50-250 employees). Industry sectors were well represented, the sample included 40% importer companies, 30% traders, 20% exporters and 20% producers.

As it was mentioned above, the main objective of the survey is to explore the impediments for business development in Armenia and define EBA's further strategic activities and steps. Based on the collected information and summarized results of the survey, corresponding initiatives will be proposed for the improvement of the legal framework, investment climate and tax and customs services in Armenia. EBA has already initiated joint discussions with the Government, State Revenue Committee and other public bodies on the mentioned improvements. It is agreed to create working groups consisting of the corresponding experts for each of the highlighted issues.

For the purpose of this research, a semi-structured questionnaire was administered to a sample of 140 selected businesses throughout Armenia. Respondents were mainly asked to identify those major challenges and difficulties that they constantly face in their business activity, and which impede the growth and development of their companies.

The survey was conducted during the spring-summer of 2016. The questionnaire for the survey has been developed by EBA and consisted of 5 sections: 1) Information about the company; 2) Main impediments related to production/services providing process; 3) Economic and commercial environment issues; 4) Legal environment issues; 5) Specific problems faced by the companies.

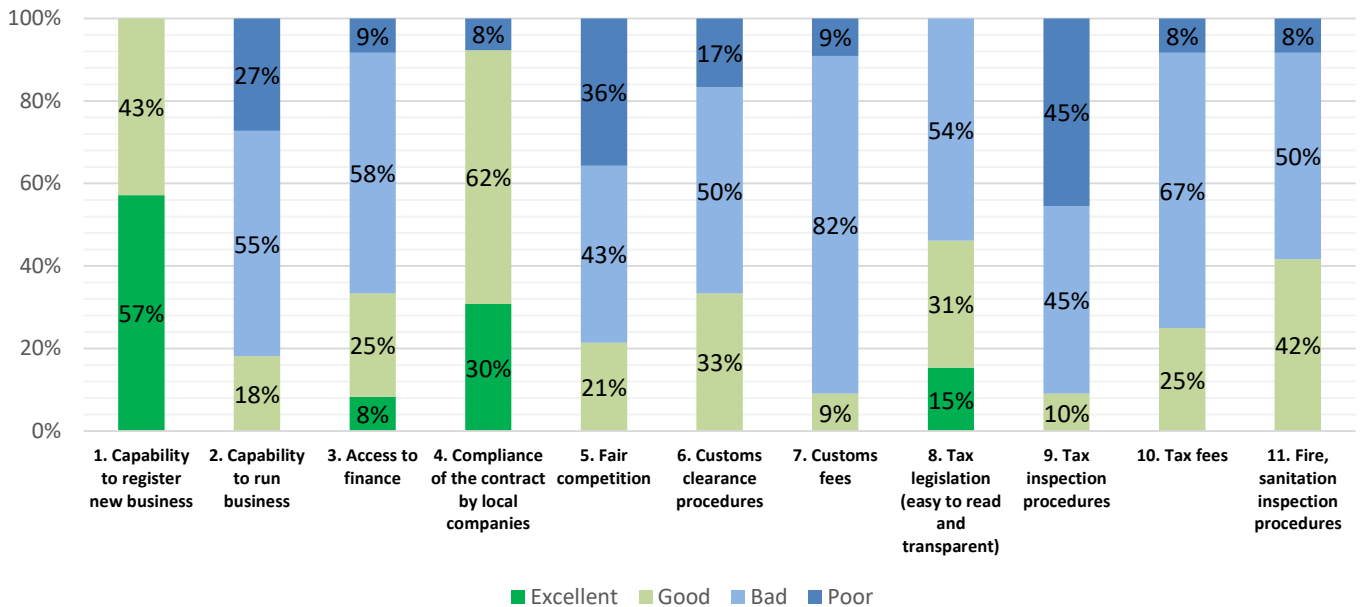
There is no special segmentation by sector, however majority of companies are local Small and Medium manufacturers, traders, exporters and importers. Respondents were mainly CEOs and founders of the selected SMEs.

3. Main Impediment for the MSME Development

The analysis of the survey data for the current study aims to explore the perceptions of business representatives toward investment climate and business environment, as well as identification of key problematic areas for their business development in Armenia, which are presented below in separate sections.

It appears that MSME representatives’ perceptions of the overall state of the business environment of the Armenian economy are quite critical especially in such areas as Capability to run business, Customs & Tax fees and procedures, Competitive environment and Access to finance. The Graph 1 below visually summarizes overall perceptions of the abovementioned group.

Graph 1: Perceptions of Business Environment



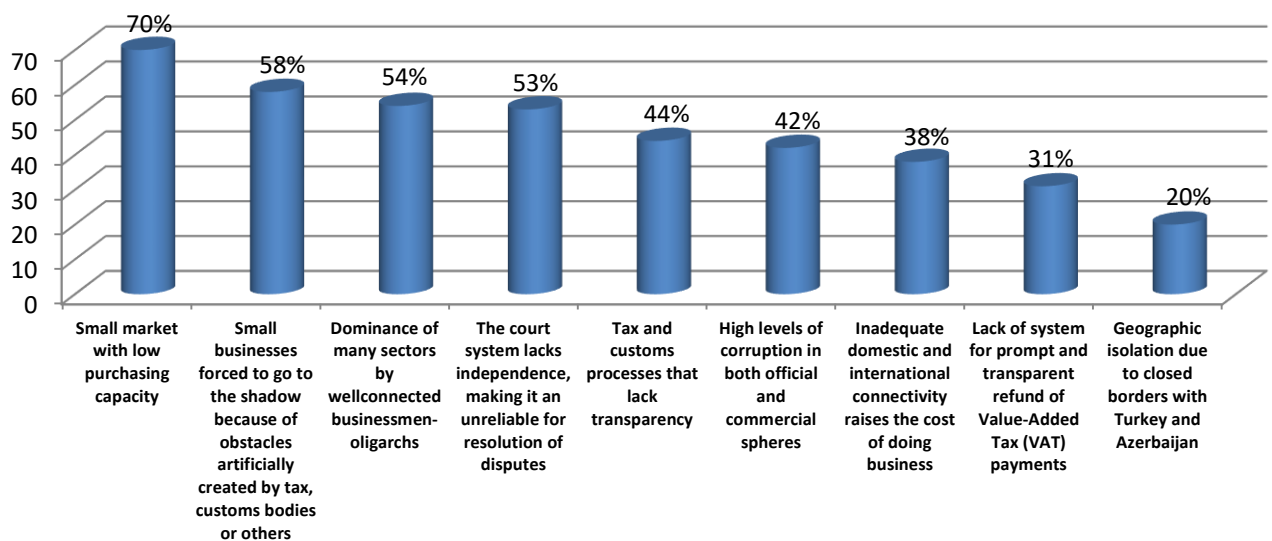
The most positive perceptions of the MSME representatives were regarding the capability to register a new business. Many of the respondents have stated that “starting a business”, which refers to registration of the company, is easily accessible and requires minutes. However, when answering about business operation and expansion, most of the respondents bring a range of challenges they experience in Armenia, such as lack of tax incentives, limited government support, strong monopoly, lack of equal rights and fair competition. Regional companies lack tax incentives, especially those that conduct production in Marzes, besides companies suggested decreasing customs fees for the imports of raw materials, complaining that sometimes it is cheaper to import readymade commodities than raw materials for subsequent production in Armenia. As a result local production loses its competitiveness.

In the frames of the current survey, the respondents were asked to indicate the severity of a number of barriers to business activity and growth. The barriers were eventually placed in seven groups covering: Perceptions of general barriers for export/import oriented companies; Difficulties in dealing with Customs services; Difficulties in dealing with Tax authorities; Difficulties in raising Finance;

Difficulties faced in Legal and Regulatory systems; Lack of trust toward judicial system; and Problems with Armenia joining the Eurasian Union.

Among the major general barriers faced by the export/ import oriented companies, the problem of small market with low purchasing capacity and shadow economy formed as a result of obstacles artificially created by tax, customs bodies were ranked among the top problems. The dominance of many sectors by well-connected businessmen/oligarchs and the problem of the court system lacking independence, which makes it unreliable for resolution of disputes are also perceived as very important with 54% and 53% of firms viewing those as major barriers to business expansion.

Graph 2: General Barrier Perceptions by Export/Import Oriented Companies



Respondents also claim that both domestic and international connectivity is inadequate due to the country’s landlocked location, geopolitical constraints, as well as deficiencies of its transport networks. It raises the cost of doing business in Armenia and impedes local SMEs from integrating into global markets.

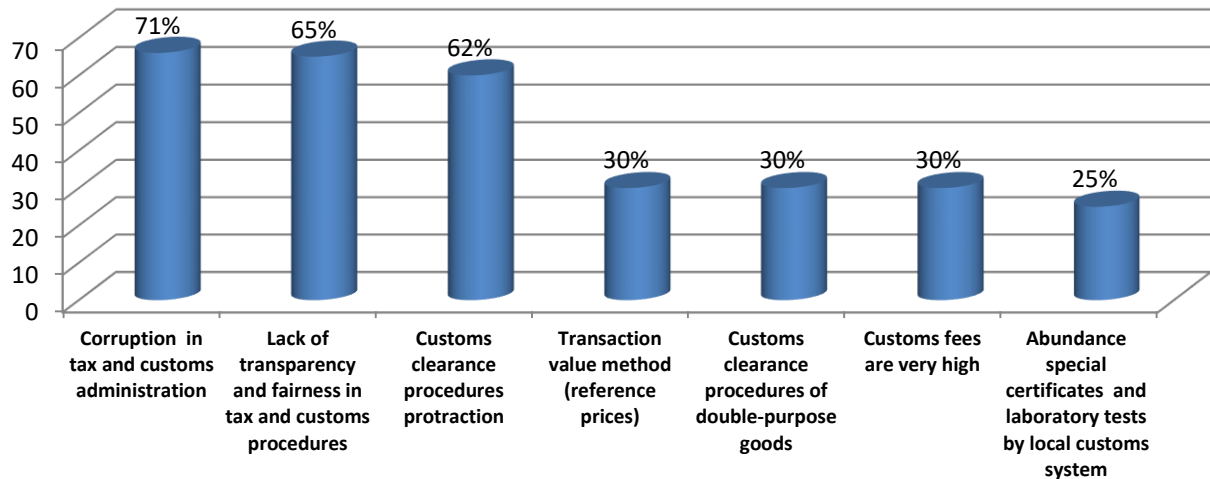
Armenia currently has incentives for exporters in terms of no export duty and VAT refund on goods and services exported, however, according to the respondents of the current survey, there is a need to ensure the prompt and transparent refund of VAT payments. There is a commitment on the side of the Government to reduce delays in VAT refunds.

3.1 Customs Issues

When discussing the issues faced at the Customs services, over two thirds of respondents mentioned corruption as top barrier with 71% of firms regarding this as a major impediment to business development. Lack of transparency and protraction of customs clearance procedures are ranked most highly with 65% and 62% of firms viewing this as a real problem. The problem with reference prices and double-purpose goods were mentioned by one third of all respondents, however the ranking is

much higher if we consider only importing companies, with almost 90% of the importers claiming that those issues are among the top barriers for their activity. The Graph 3 below presents all the Customs related problems mentioned by the interviewed MSMEs.

Graph 3: Analysis of MSMEs Facing Difficulties with Customs Services



As we can see from the Graph 3, corruption perceived as a significant obstacle to business development for MSMEs. The Armenian Government introduced a number of reforms during the last four years, including the simplification of licensing procedures, civil service reforms, a new criminal code, anti-corruption laws and regulations, and established an Anti-Corruption Council tasked with coordinating the government’s anti-corruption activities and improving policies aimed at the prevention of corruption. Nevertheless, corruption remains a problem in critical areas such as the judiciary, tax and customs operations, law enforcement.

As was mentioned above, among the main issues that companies, especially importers, complain is the reference price procedure applied by the customs clearance authorities. The clearance of products is very often done by clearance control price, which is higher than the sales price of the product. As a result, the customs duties are being charged based on reference prices while it should be based on the price mentioned in the invoice. The customs service representatives argue that some importers present underestimated value in their invoices that is why customs services are forced to use their own pricelists. Unfortunately, this brings to corrupt practices and discrimination, creating favorable conditions for the businesses affiliated to the government officials. There are lots of cases when companies affiliated to the government/monopolists were importing commodities fraudulently changing classification of goods to reduce/avoid the duties. The abovementioned issue also hinders cooperation with foreign and local partners when participating in tenders and signing agreements with negotiated fixed price, which later on can be changed based on the reference price lists. According to the respondents, this issue leads to unfair competition, difficulties in financial planning, contract relationship with foreign partners and higher customs payments that, as a result, slow down business development.

The issue with the double-purpose goods is as critical as the previous one. There are lots of cases when customs officers suddenly decide that the imported product can potentially have a double-purpose usage (for instance they decide that imported oil or equipment spare parts can be used for military purposes). They start investigation (importer should pay for it) and then provide a decision on approving or denying the double purpose usage. This process is not transparent, with no clear

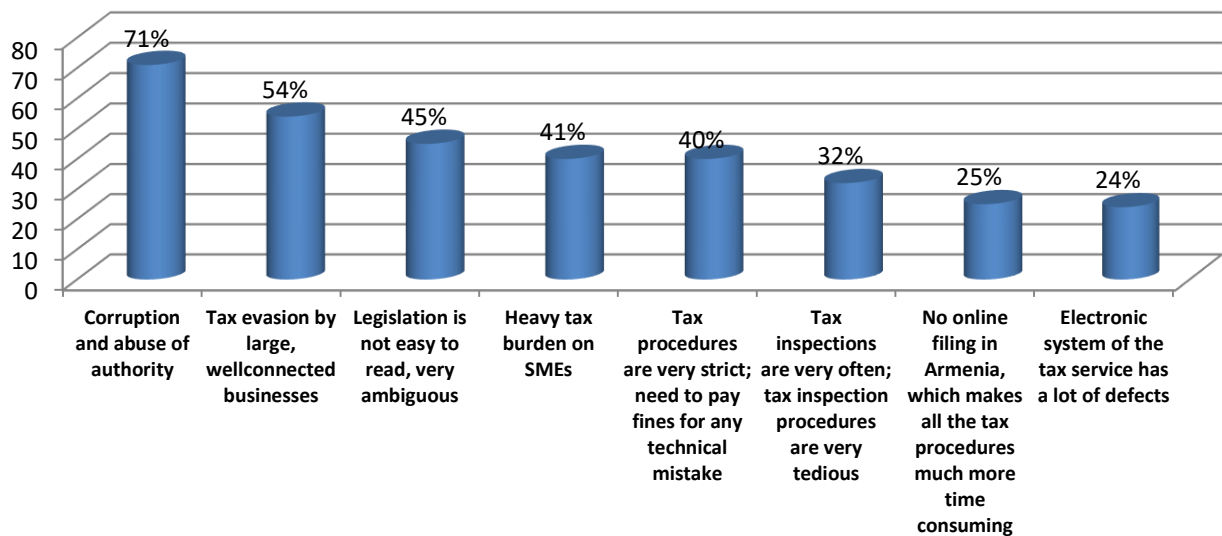
procedure/criteria for approving or denying its double purpose usage. It creates an artificial obstacle for businesses and takes additional financial and time resources.

There are cases when Customs authorities delay the clearance without any written clarification, while requesting bribes for the settlement of the issue. As a result products may perish, and company should also pay additional money for the storage of products in the warehouse. Companies' turnover slows down and they experience losses. The most frequent solution to this situation is dealing with the corrupt officials. However, despite persistent problems with those corrupt officials, both local and foreign businesses assert that a sound knowledge of tax and customs law and regulations enables business owners to deflect a majority of unlawful bribe requests.

3.2 Tax Issues

Discussion of the tax issues revealed the following main barriers to the development of the MSMEs in Armenia. Corruption and abuse of authority were again ranked at the top of all difficulties experienced by the respondent firms. Tax evasion by large/well-connected businesses was ranked as a serious barrier by 54% of respondents. Over 40 percent of the company representatives believe that tax legislation is ambiguous, taxes are too heavy for the MSMEs and procedures are overly strict with lots of fines for minor technical/filing mistakes.

Graph 4: Analysis of MSMEs Facing Difficulties with Tax Authorities



The main complain about the tax services is corruption, required prepayments to meet the plan and fulfill the budget. Tax legislation is being amended too frequently. Businesses are not dealing with constant updates and all new changes. The new Tax Code is being developed without necessary participation and representation of business interests. As a result, many businessmen claim that the increase of income tax as well as the dividends taxation will lead to the expansion of the shadow economy. Besides, foreign investors will be discriminated by paying 10% tax for dividends instead of 5% tax charged from locals.

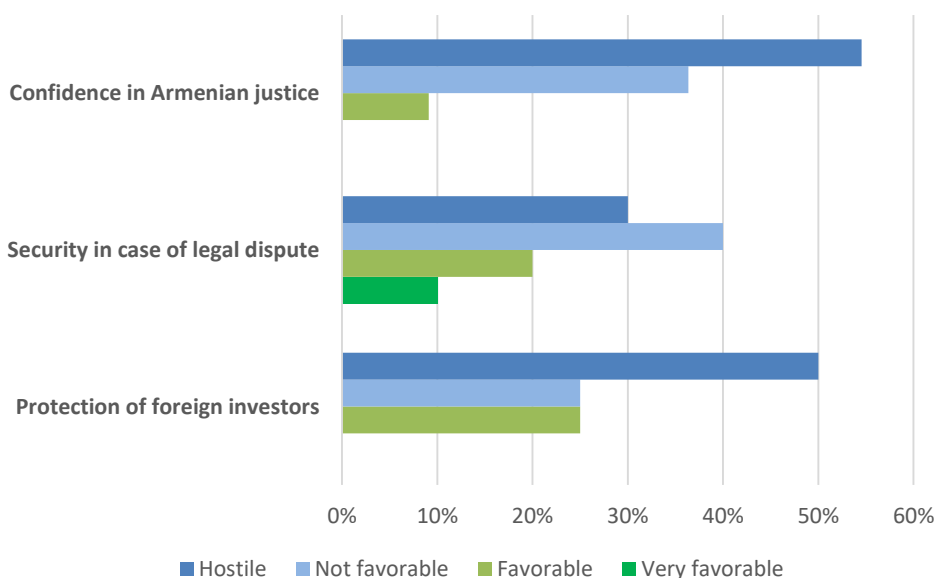
The new tax legislation is very complicated and creates additional workload for businesses. Examples include the depreciation period extension, which makes businesses pay more profit tax. The tax inspection procedures are very frequent. The system is extremely corrupt, tax inspectors are open for bribe, and in case if they do not get it, they complicate the inspection procedure creating additional problems for businesses.

Among the specific problems was mentioned the VAT tax, which is being charged on the border during the import, but normally should be charged when the product is sold. This issue creates problems for the companies from the point of limitation of their cash reserves. However, the main argument that authorities articulate is that after border crossing it's difficult to control and collect VATs. The study also showed that the quarter of the surveyed micro, small and medium business entities were unhappy about the lack of the online filing system and inaccuracies in existing online services.

3.3 Legal and Regulatory Issues

The judicial system is not independent in Armenia according to the majority of respondents. Foreign and local investors don't consider judicial system reliable and it is very difficult to deal with the local courts without contacts and affiliation to the corresponding authorities. The general picture is not so positive with the perceptions of the legal environment by the surveyed MSMEs. Companies don't trust Armenian Judicial system and they don't feel protected.

Graph 5: Perception of the Legal Environments

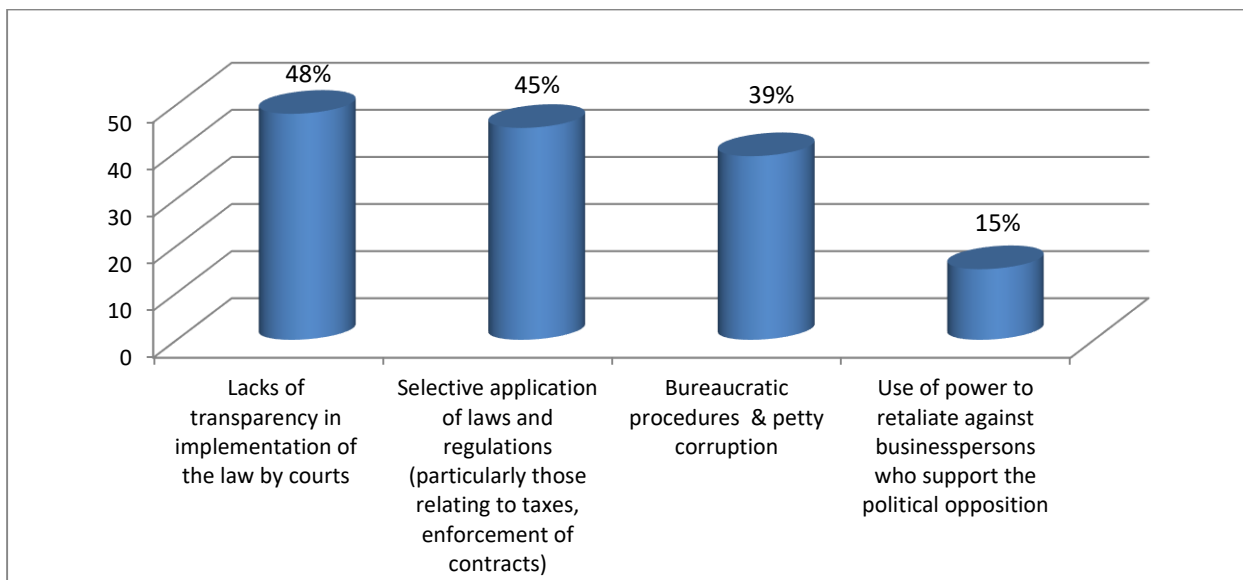


Armenia ranked 95th out of 168 countries in Transparency International's 2015 Corruption Perceptions Index. Its percentile rank on most of the World Bank's Worldwide Governance Indicators worsened between 2009 and 2011. Only a third of firms that participated in the 2011 European Bank

for Reconstruction and Development (EBRD)—World Bank Business Environment and Enterprise Performance Survey considered the courts to be fair and impartial in Armenia.

Graph 6 below presents the most problematic barriers to business expansion encountered by Armenian MSMEs in the Legal and Regulatory spheres, ranked by the incidence of very high barriers. Of these, lack of transparency and selective application of laws mentioned by almost half of the surveyed enterprises.

Graph 6: Difficulties Faced in Legal and Regulatory Spheres



3.4 Rule of law

The laws and regulations are applied selectively. Thus, large companies that are affiliated to the government do not pay taxes or pay it partially; they import commodities under different customs classification and therefore pay less customs duties. Besides, they pass customs clearance procedures under the privileged conditions while other companies should suffer from unfair treatment. The smaller enterprises cannot afford unfair competition and run out of business. Equal rights should be provided to all market players. Monopolists create inequality for other companies and those unfavorable conditions stress the local and foreign SMEs.

3.5 Public Procurement Issues

Bureaucratic procedures are present in all public institutions and accompanied by petty corruption. Public tenders application procedures are not transparent. Announcements are being made sometimes only several days in advance, while getting prepared and applying for the tender takes

longer time. Besides, terms of references or technical specifications are not clear and sometimes are being adjusted to match the preselected winners.

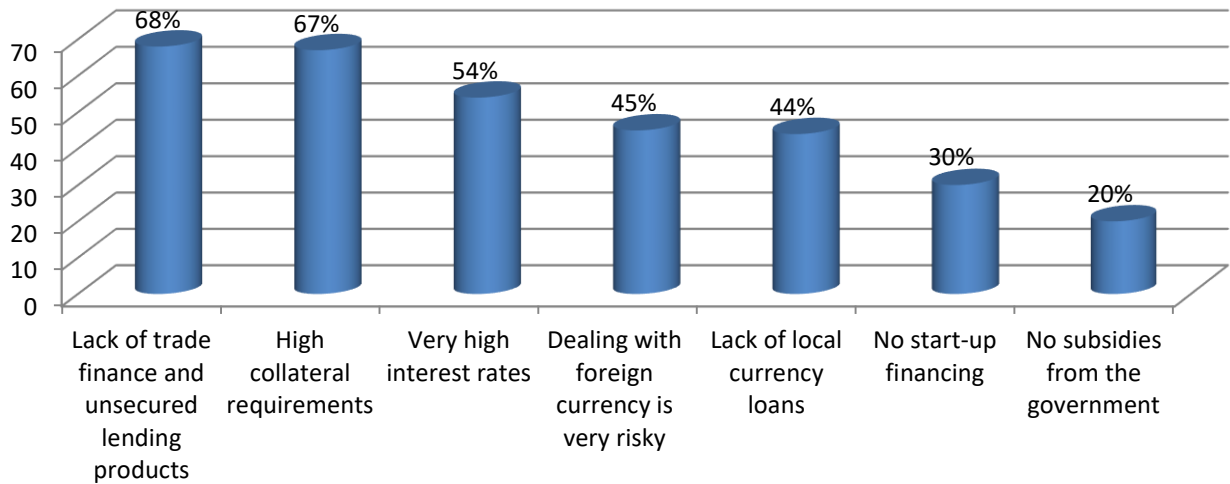
3.6 Access to Finance

As cliché as this might sound, access to finance is still a major impediment to the growth of MSMEs in Armenia. Access to Finance issue includes high interest rate, lack of loans in local currency and unsecured loan products such as purchase order finance, factoring, unsecured credit lines, etc.

About 68% of micro, small and medium entrepreneurs said they were in need of trade finance and unsecured financial products to develop their businesses.

High cost of credit and loans and high collateral requirements are ranked among the most serious barriers, with 54% and 67% of firms respectively viewing these as significant barriers to their business expansion. Graph 7 presents the most problematic barriers Armenian MSMEs encounter in financial area.

Graph 7: Difficulties in Raising Finance



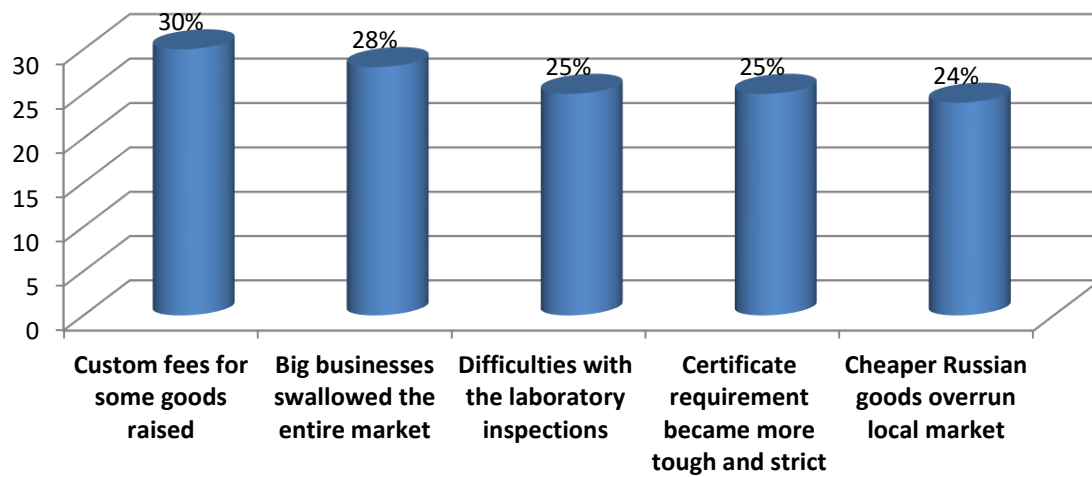
There are lots of banks and credit organizations operating in Armenia. The access itself is there, however the interest rates are often too high and there is a lack of funds in local currency. Besides, companies need more financial products without collateral requirements. There is limited access to finance for start-up businesses and governmental subsidies.

3.7 Eurasian Union

In January 2015 Armenia joined the Eurasian Economic Union (EEU), which aims to increase trade and investment with Russia, Kazakhstan, Belarus and Kyrgyzstan. The surveyed MSMEs were expressing their opinions regarding the issues, which they started to face after accession of Armenia to the Eurasian Union. Companies have been asked what has changed for them after Armenia joined the Eurasian Union and the main problematic areas are summarized in the graph below.

Apparently, it became cheaper to import from Russia than from Europe, China and other countries now (if there is a factory/franchising, representative office). For some European companies membership to EEU had negative impact. The market is being flooded with cheap and low quality products from EEU member countries, which hits the competition. There is an increase in the level of bureaucracy and documents requirements for clearance in Russia. Some respondents claim that they have started to experience difficulties with the laboratory inspections and certificate requirements became stricter. Thus, restaurants specializing on European cuisine now face problems importing food from France, because of all additional certificate requirements among which veterinary certificates, ISO 22000, HACCP Certificates. After EEU membership customs fees are added to a range of agricultural products.

Graph 8: Problems with Armenia Joining the Eurasian Union



4. Conclusion

This study is only an exploratory piece of research. Although the findings are based on a limited number of medium, small and micro enterprises, the analyses suggest that the SME sector faces pressing issues related to corruption, rule of law, unfair competition and shortage of financial resources.

Due to the small sample size of this exploratory study it cannot be considered as a representative for the entire MSME sector, however this study has revealed important issues that need to be further investigated and addressed. This document highlights the problematic areas of the enterprise development in Armenia and aims to provide a strategic framework for further activities initiated by the EBA to boost the development of the SME sector of the economy and to expand and diversity exports.

Top business, economic and policy threats for business growth outlined in this document call for cooperation between the government, private and NGO sectors in implementing necessary strategies, enhancement of the SME sector through improvements in the regulatory framework and business environment, and government support of SMEs particularly with export potential.

In this context, the EBA has already started to pursue the following strategic orientations in the coming period:

- As a result of preliminary discussions, 14 business associations in Armenia have signed Memorandum of Understanding that lays the foundation for cooperative efforts for resolving the main issues mentioned in the current paper.
- These issues discussed in this document have been presented to the Prime Minister during the Public-Private Dialog organized by EBA in July 2016, as a result of which the commitment of the government was received to cooperate with business associations in the direction of creation of better business and investment climate in Armenia.
- EBA was included in the SME development council under the Government where it can voice the major issues and present official proposals on corresponding changes/improvements.
- EBA started to develop the paper outlining corresponding joint actions to be taken in the coming year.
- For the tax and customs issues, EBA has initiated the cooperation with the State Revenue Committee of Armenia and agreed to work on the legislative amendments as well as on the improvement of tax inspections and customs procedures.
- EBA is in the process of creating the expert working groups to work on the most important issues and present proposals on necessary legislative amendments.
- Being a part of European Business Organization World Wide Network EBA in Armenia will also use international experience adapted to Armenia to work on the mentioned in this report issues for business environment improvement.



This report was prepared by the European Business Association in Armenia to explore main impediments for the foreign and local businesses operating in Armenia.
The main objective is to reveal problems and construct the further activities of EBA and its partners to create better business environment and investment climate in Armenia.

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