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ENTREPRENEURSHIP IN THE SOUTH CAUCASUS

Special Editor: Jeronim Perović

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Entrepreneurship in Georgia

Philippe Rudaz

Abstract

Georgia has received a fair amount of publicity as a potential investment destination in recent years. The country won praise for its bold approach to reforms and economic policy. While it is true that Georgia made tremendous progress on issues like corruption, our examination of the structure of small and mid-sized enterprises (SMEs) revealed that they face many serious problems that are not yet addressed by the government. There are also a stunning number of self-employed persons, not observed by official statistics, many of whom could be described as “entrepreneur by default” as opposed to “entrepreneur by choice”. These measurement issues show that the notion of “entrepreneurship” should be considered carefully, especially in former Soviet economies like Georgia, and force observers to ask where entrepreneurship actually begins.

Introduction

Entrepreneurship is as much a social phenomenon as an economic one and as such, the shape entrepreneurship takes in Georgia opens the door to a wide range of complex issues that transition economies have to tackle. In 2010 *The Economist* concluded: “Today Georgia has reinvented itself as the star of the Caucasus. It is less corrupt than most former Soviet republics and one of the easiest places in the world to do business, according to the World Bank. Its liberalized economy has weathered Russian embargoes, and the state held together during the war with Russia. Its police do not take bribes and electricity is no longer a luxury. Most important, people are no longer surprised by such success. The biggest transformation is in their minds.” While one has to acknowledge that Georgian authorities took bold steps to fight corruption and gave economic policies a clear neo-liberal direction, it is nonetheless crucial to take a critical approach to the claims that Georgia has made about its success in facilitating entrepreneurial endeavors. The methodology used by the World Bank for its “ease of doing business indicators” (EDBI) is highly controversial and Georgia’s rise on the ranking took place against the background of important political concerns. To see beyond the facade, one has to look closer at the structure of the private sector.

From the regulatory, and in consequence statistical, perspective, Georgia’s economy consists of two different components: The “observed” economy is described by statistics and regulated by informed bureaucrats, while the “unobserved” economy functions beyond the bounds of any regulations (such as requirements to register, observe the labor code, pay taxes, or report performance statistics) and therefore falls outside of national statistical instruments. In terms of occupational statistics, the persons active in the unobserved part of Georgia’s economy are defined as “self-employed.” Little is known about the mode of activity of the self-employed except that they live mainly in rural areas and that

some may de facto run micro-enterprises. The workforce amounts to 1.9 million people, but only 20 percent is hired by the private sector and 12 percent by the public sector. With 16 percent of the workforce being unemployed, that leaves about half the total workforce as self-employed. Barely anything can be found about this portion of the Georgian economy in statistics. Yet self-employment amounts to about two-thirds of the total employment and, according to our estimates, generates about 18 percent of GDP.

These sharp employment differences within the population underline the sometimes overlooked side of entrepreneurship: “entrepreneurship for survival”. This form of entrepreneurship is a poverty-related and social policy issue. On one hand, it can be considered as massive unemployment, which harms the economic base of the country and is the reason Fitch Ratings estimated that Georgia has a middle level of income and a narrow economic base (EPRC, 2009:8). Indeed the staggering figure of 1.9 million self-employed individuals explains the narrow base of the Georgian economy and its low level of labor productivity. Moreover, more than 800,000 of the so called self-employed (81 percent) live in rural areas.

Thus, Georgia’s case illustrates very well the two-sided coin characteristic of “entrepreneurship”. In other words, on one side, the unemployment point of view is linked to social policy. The average monthly income for Georgia is US\$175 and about 41 percent of households were poor in 2009, if the minimum subsistence level is used as the poverty line (Gugushvili, 2011). On the other side, half of the economy relies on “entrepreneurs”, and that is an economic policy concern. Moreover this combined perspective on the GDP structure allows us to deduce that self-employment generates about 18 percent of the GDP. Interestingly, we find the two sided coin problem at the heart of the definition of a self-employed person given by Geostat: It can either be equated with “entrepreneurship” or survival.

Structure of the SME Population

It is crucial to acknowledge the difficulty in defining the economic reality of small and mid-sized enterprises, which boils down to the question of where does “entrepreneurship” begin. Georgian statistics, for example, do not distinguish between micro- and small enterprises even though the tax code does so and in contrast to the other South Caucasus countries. Moreover, what is considered a firm differs from institution to institution.

- The Ministry of Finance, which prepares the Georgian tax code, recognizes micro-business as those with an annual turnover below GEL 30,000 (approx. 18,000 USD) and small business as those with less than GEL 100,000 (approx. USD 60,000) annual turnover. From a tax perspective, micro-firms, which are not taxed, do not matter. Entrepreneurial activity begins with small firms, taxed up to 5 percent. There is no definition for medium firms.
- For GeoStat, the national statistics office, small firms are those that employ less than 20 persons with an annual turnover of less than GEL 500,000 (approx. USD 300,000). Medium enterprises are those with less than 100 persons generating a turnover of less than GEL 1,500,000 (approx. USD 900,000). Anything above that standard, in persons and turnover is considered a large enterprise.
- Commercial banks have their own standards: TBC for example does not differentiate between small and medium and considers SMEs as enterprises with an annual turnover of less than GEL 8 million and liabilities of USD 1.5 million.

Looking at the structure of enterprises, four disparities can be observed (see data p. 6 and p. 7).

1. The evidence of geographical disparity is given by the concentration of enterprises in Tbilisi. 45 percent of companies are registered in Tbilisi and they generate 73 percent of the country's turnover. There is a strong rural/urban dichotomy.
2. The disparity between the performance and employment levels of SMEs. SMEs contribute only 6 percent of the GDP, but amount to 43 percent of the private sector in terms of employment.
3. The disparity between the types of activity contributing to GDP. On the one hand, 22 percent of the GDP is generated by three activities in the enterprise sector: Industry, wholesale and retail trade (including repair of motor vehicles and personal household goods), and transport and communication. These activities constitute 70 percent of all the firms' activities. We can only guess that the self-employed layer, which by deduction, contributes approximately 18 percent of the GDP, includes farmers producing agricultural goods for subsistence living in rural areas

(81 percent of the self-employed live in rural areas) and people engaged in trade in cities.

Economic Policies for SMEs in Georgia

Economic policies targeted at SMEs can be viewed in two blocks: before and after 2006. The institutional and legal framework for SMEs started to be formed in the 1990s. The “Small Enterprise Support” Special Law of 1999 defined the key parameters for SME support. To implement these programs, the Center for Small Enterprise Development and Assistance and the Small Enterprise Coordination Council were created. Even though the development of the SME sector started steadily and efficiently, it was hindered in the early 2000s by high corruption, an unfavorable tax regime, and the budget deficit. In other words, economic policy took into account the specifics of SMEs, but the institutional environment was not business friendly. The exact opposite phenomenon took place after 2006. Georgia embarked then on radical reforms to change the economic environment and as a result developed several measures that made entrepreneurial activities easier to undertake. By the same token, the level of corruption went down as well. The new course of economic policy, heavily influenced by neoliberalism, eliminated government interference in the economic sphere and abolished the law on “Small and Medium Enterprise Support” in 2006. As a result, two laws now govern SME activities. The Law on the Georgian National Investment Agency, on which GeoStat bases its definition, and the Tax Code, which uses a different definition.

The move toward neoliberalism shifted the focus toward the overall business environment thus resulting in economic reforms and a redesign of economic policy making. Support for SMEs is therefore not considered as an important element of the economic framework, which would deserve specific attention at the policy level, because the rationale is to support the economic environment in general, but not one group in particular. Thus the two considerations related to entrepreneurship—the poverty motive and the entrepreneurial motive—are difficult to reconcile in Georgia. The absence of a general non-taxed minimum amount of income, which is exceptional by international standards, does not address the poverty issue. Yet, the entrepreneurial motive is treated only partially by the tax code (Christie, 2008).

During the last 12 years the performance of SMEs has dropped, in terms of employment, turnover and share of overall production. The Russian embargo, the 2008 war and the global financial crisis all had an impact on this performance. However, one has to note that the neo-liberal policy eliminated all the SME laws, accompanying legislative acts and administrative mechanisms

for SME promotion and that probably had an impact too (Japaridze, 2011). The gap between the reality of the socio-economic fabric in Georgia and the economic policy of its government reflects the dilemma of economic reforms in transition. The imperative of reform demands non-interference with the economy and therefore does not favor any particular actors, but this policy prevents the development of SMEs.

Business Environment Measures: Tactic vs Strategy

The “policy vacuum” created by the retreat of the government gave rise to numerous measures and development projects sponsored by national and international agencies and NGOs. These measures significantly enhanced the business environment, but they are of a tactical nature and cannot replace strategic and comprehensive economic policies. Liberalization and the streamlining of bureaucratic procedures lightened the administrative burden of companies. Georgia successfully implemented and enforced anti-corruption laws. The Graft Index, reflecting the number of times firms were asked or expected to pay bribes to officials, is half the level found in Eastern and Central Asia. Georgia appears to provide better infrastructure (in terms of infrastructure service delays, water and electricity provision) than its counterparts (IFC, 2008). Public-Private Consultations (PPC) emerged and the quality of the dialogue improved. Business incubator projects and support units, financed by donor organizations, do exist. Access to capital is now easier, but the progress is mostly visible for big companies.

The Georgian government reviewed and simplified some procedures: Georgian State Procurement functions electronically, which adds transparency and makes the process more participatory. It reformed and digitized the cadastre system and implemented e-government/governance measures, whereby taxpayers may fill out their application online or communicate with authorities electronically. However, our interviews revealed that approximately 90 percent of land ownership in rural areas is still unregistered.

As a result of these reforms, Georgia’s rise in the ranking of the World Bank’s EDBI indicators is unprecedented. A USAID report (USAID, 2009) notes that the result of these fast, broad and deep reforms of the business climate in Georgia is that it is now considered an investment destination. According to the EDBI, Georgia is ahead of France, Germany, and the Netherlands when it comes to the “ease of doing business”. This points to a familiar story in emergent countries where administrative barriers for local business have been simplified, but where the overall basic institutional framework is

still fragile and the social (informal) barriers are still in place. Even though Georgia has undergone reforms of unprecedented breath and facilitates local business activities, its market institutions are still weak.

Thus there are still three areas of reform the country needs to address if it wants to attract international investment: Inadequate protection for property rights, low levels of judicial independence and rule of law, and a strict system of tax and customs penalties, which appears to distort business decision-making and artificially encourage imports over local production. These areas of weaknesses require more than minor technical fixes. They represent basic institutional pillars on which market economies rest and grow.

Thus it seems that Georgia demonstrates a perfect case of governance indicators’ abuse (Arndt and Oman, 2006). The ranking was used to propel the country from one with a reputation as a post-Soviet failed state to one known as a “frontier-market” and this marketing campaign allowed Georgia to attract foreign investments. Its first offering of sovereign debt was a success, securing a 7.5 percent fixed interest rate which was three times oversubscribed and a B+ rating from Standard & Poor’s. “Such events marked Georgia’s transformation from a failed state to a neoliberal vanguard state at the leading edge of capital market expansion into the periphery of the global economy” (Schueth, 2011).

Constraints to SMEs Growth

Georgia’s SME face a variety of constraints:

Institutional constraints: Many barriers to SME growth still remain. Access to finance is for SMEs in Georgia, as elsewhere, problematic. The interviews we conducted revealed, for example, that there is a law giving tax authorities the right to use the collateral of tax payers who owe money to fiscal authorities. Unsurprisingly, this provision has made banks reluctant to accept such collateral from SMEs. Similarly, the inefficiency of the bankruptcy law influences the banking sector’s willingness to lend. Also, the absence of a specific arbitrage court makes it harder for business to operate. SMEs do not tend to think judicial procedures will turn out in their favor and thus prefer not to use judicial channels to resolve whatever commercial conflict they might have.

The trust component of the Georgian economic sector (interpersonal or institutional) should not be forgotten. It is very hard to isolate that element to determine its influence on access to finance and relationships within the business sector. It is nevertheless an important one for SME financing, as it goes hand in hand with the use of the unquantifiable information that is needed to build long term relationship between banks and SMEs. As former Soviet economies suffer from general distrust, one

can expect that it is a factor hindering access to finance and economic cooperation.

Finally, the cultural base of what was Georgia's second economy under the Soviet regime, with its insistence on honor and trust and which encouraged risk taking behavior (Mars and Altman, 1983), influences the entrepreneurship dynamic of the Georgian economy. It is an example of the kind of entrepreneurial resources or barriers that the usual approaches used by international organizations fail to convey.

Systemic constraints: SMEs in Georgia perceive the existence of a "ceiling" to growth. There are many more business associations representing big companies than SMEs and big firms are better positioned to lobby their interests with government officials. As mentioned above, big companies are able to profit more from a simplified business environment, which makes SMEs feel that the playing field is biased in favor of large firms. The "ceiling" perception is accentuated by the ties between government and big businesses. The interviews we conducted revealed that some SMEs have the impression that they are allowed to grow only up to a certain point, beyond which further expansion becomes problematic. Despite the seemingly neoliberal orientation of the government, it recently has taken decisions that contradict liberal principles: It reinforced both the National Bank and the Tax Department with the ability to extract and gather financial information about businesses. This very intrusive move on the part of the government is expected to have repercussions on investments and was designed to bolster the government's position before the Fall 2012 parliamentary elections.

Social constraints: The lack of managerial staff, professional accountants and financial managers is also considered a limit to growth. Banks generally do not trust a firm's accountants and examine their books directly, thus helping SMEs with financial statements. The availability of managerial resources is particularly important if entrepreneurial activity is expected to be a regular eco-

nomically active. The notion of an enterprise, in its Western conception, supposes stable, repetitive activity. One-shot deals can be the expression of "entrepreneurial spirit", but do not necessarily create "enterprises". The availability of high-skilled labor is an important resource required for Georgia to evolve from "entrepreneurship" to enterprise.

Conclusion

In light of the labor and enterprise statistics presented here, the controversial uses of the EDBI described above, and the institutional problems Georgia faces, concluding that the country is an example of market liberalism seems a bit hasty. The famous EDBI kept the historical, institutional and social contexts (maybe even the economical) out of the picture. Georgia has indeed made huge progress since the Rose Revolution, but property rights are still not respected. The fact that half of the work force is self-employed does not mean that "entrepreneurship" suddenly emerged, for it might well mirror the necessity of survival. The over-optimistic advertising campaign Georgia pursued in recent years reflects the complexity of building market economies.

How can market institutions emerge from the old, rotten socio-economic tissue? Foreign investment becomes a crucial element for countries with very limited resources like Georgia to get out of the "virtual economy" (Gaddy and Ickes, 1999), the ugly cross-breed of the two systems, as Yeltsin put it. Multinational companies with their international capital, know-how and best practices can transfer knowledge to Georgia that would indeed help Georgia develop from the top-down. But do entrepreneurs come from the observed or unobserved part of the economy? Is the self-employed segment of the Georgian economy a stumbling block or a building block for economic development? How does one go from a social transformation to "entrepreneurship"? These questions refer to the possible option of a bottom-up rescue out of the economic purgatory that some transition countries are in.

About the Author

Philippe Rudaz is a PhD student in Economics at the University of Fribourg, Switzerland. His dissertation focuses on the links between financial development and economic development in emerging economies. He worked for the past 4 years as a consultant for financial institutions in Russia and South-Eastern Europe.

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DATA

Structure of the Georgian Private Enterprises Sector, 2010

Table 1: Firm Population

Number of registered enterprises (thousands)	321.20
Number of active enterprises	42.530
<i>% of registered firm</i>	<i>13.2%</i>
Small firm, as % of total registered	88%
Medium firm, as % of total registered	8%
Large firm, as % of total registered	4%

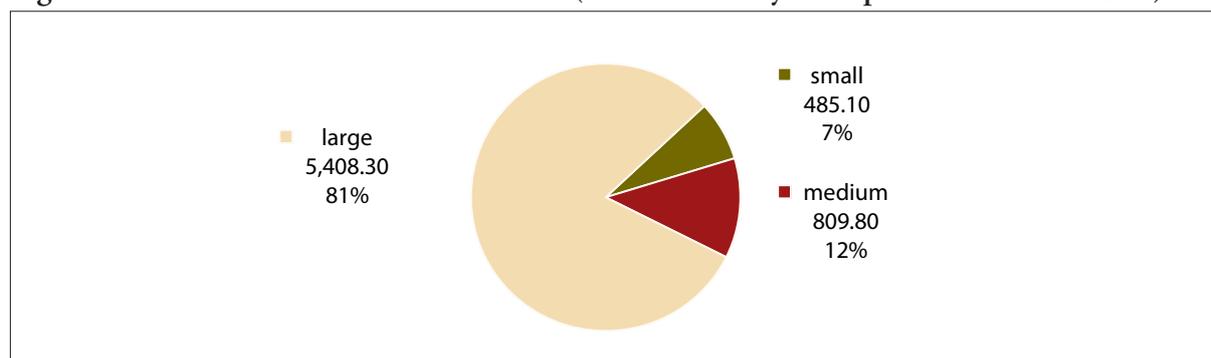
Compiled by Philippe Rudaz; source of data: Geostat

Table 2: Firm Performance

Firm contribution to GDP, mln. GEL	6,703.20
As % of GDP	32%
Contribution of SMEs to GDP generated by private sector	19%

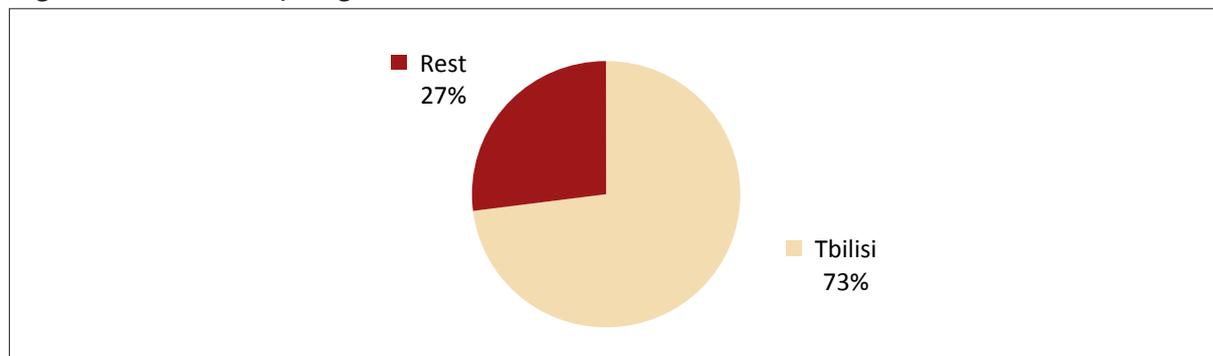
Compiled by Philippe Rudaz; source of data: Geostat

Figure 1: Performance of the Private Sector (Value Added By Enterprise Size in Mln. GEL)



Compiled by Philippe Rudaz; source of data: Geostat

Figure 2: Turnover by Region



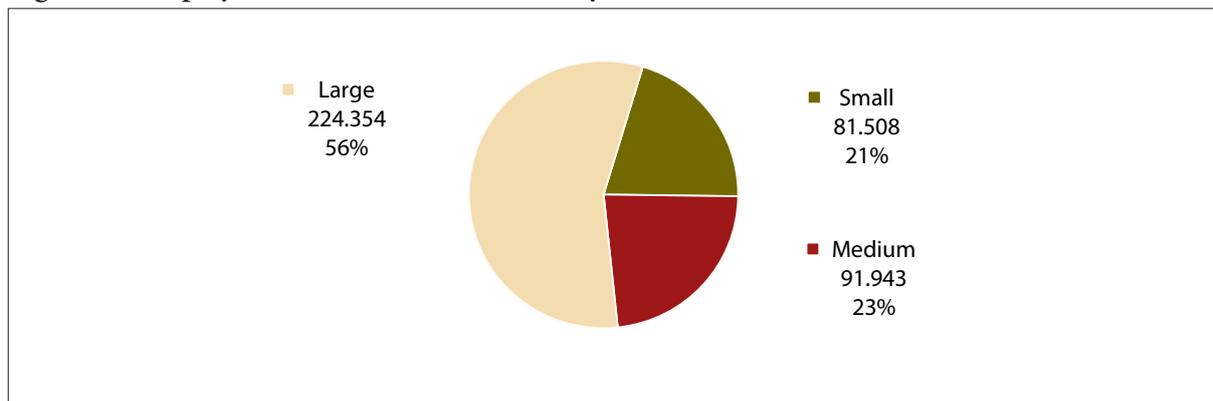
Compiled by Philippe Rudaz; source of data: Geostat

Table 3: Employment in the Private Sector By Size of Firm

Small (thousands)	81.508
Medium	91.943
Large	224.354
<i>Employment generated by SMEs as % of total employment of private sector</i>	<i>43%</i>

Compiled by Philippe Rudaz; source of data: Geostat

Figure 3: Employment in the Private Sector By Size of Firm (Thousands)



Compiled by Philippe Rudaz; source of data: Geostat

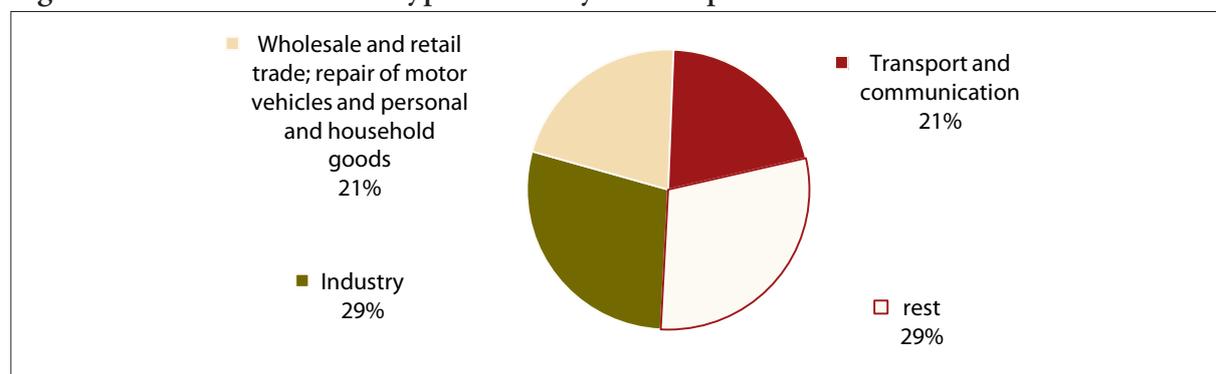
Value Added By Type of Economic Activity

Table 1: Value Added of the Enterprise Sector, Mln GEL

Agriculture, hunting and forestry and fishing	39.2
Industry	1,914.5
Construction	618.1
Wholesale and retail trade; repair of motor vehicles and personal and household goods	1,421.8
Hotel and restaurants	149.9
Transport and communication	1,393.3
Real estate, renting and business activities	517.9
Education	88.9
Health and social work	351.9
Community, social and personal service activity	207.7
Total	6,703.2

Compiled by Philippe Rudaz; source of data: Geostat

Figure 1: Distribution of the Type of Activity of Enterprises



Compiled by Philippe Rudaz; source of data: Geostat

Table 2: GDP Structure 2010, Mln. GEL

Business sector	6,703.0	32%
Remittances	1,244.0	6%
Foreign aid 2009*	1,852.9	9%
FDI	1,629.0	7%
Government expenses	5,480.3	26%
Self employed	3834.18	18%
Total	20,743.4	100%

Compiled by Philippe Rudaz; source of data: Geostat, except for: * OECD aid flow database, <http://www.aidflows.org>; GEL/USD rate used 2

Entrepreneurship in Armenia

By Hrant Mikaelian, Yerevan

Abstract

The Armenian economy is mostly private and is characterized by a strong big business sector. But despite common perceptions, the share of small and medium-sized enterprises in the economy is growing. Key obstacles for Armenia's small businesses are corruption, lack of protection for investments and property, and the complexity of the tax administration.

Background

In the Soviet Union, the entire economy was state owned. However, before it seceded from the USSR, Armenia started to create a private economy. On November 30, 1990 the Council of Ministers of the Republic of Armenia adopted a decision "On the privatization of both industrial and non-industrial objects" which marked the beginning of the large-scale privatization of state property. The privatization of land and its distribution among the peasants began in March 1991.

Privatization proceeded quickly and if at the end of 1990 only 11.7% of the GDP of the country was carried out by private enterprise, in a year, this proportion had increased to 32.7%, and by 1998 comprised 74.5% of the entire economy¹. Privatization was practically complete by 2004, when the share of the private sector reached 84% of the economy. It has not grown since then², while the number of state companies is only 0.7% of all registered firms³.

By 1998, industry, transport and public services still were not fully privatized, while such micro-business as retail traders and small farms were totally private. For comparison, in many other former Soviet republics, the share of the public sector in the economy was much higher. In Georgia, the main privatization took place in 2005–2008 and in Russia many large enterprises are still owned by the state.

However, since privatization in Armenia was not planned properly and was carried out by the transfer of vouchers for public property to the population, the result has been that the state received almost nothing

from privatization;⁴ at the beginning of the privatization process, state property holdings were estimated at 20–40 billion dollars.⁵ Another consequence of privatization was the growing polarization in society: by the early 1990s, the majority of the population being in extreme poverty⁶ preferred to sell their vouchers, which were quickly concentrated in the hands of a small group of individuals. First, they privatized all objects associated with the food industry and trade. At the same time, many heavy industrial plants were closed and for the first time in Armenia, large-scale industry was concentrated.

In 1990, industry and construction, two spheres of the economy which were dominated by large enterprises, made up 54.6% of GDP. By 2000, this number fell to 38.4% of GDP and to only 35.4% of GDP in 2010.⁷ Accordingly, the major enterprises lost their share in Armenia's economy. By contrast, the agricultural sectors, as well as retail and service sectors have been developing. And if in the area of trade Armenia has several large retail chains, small and medium businesses dominate much of the services sector and most of the agricultural sector.

Large Enterprises in Armenia

A new phenomenon for the Armenian economy has been the emergence of influential owners in the late 1990s; they have mastered the former state-owned enterprises or occupied dominant positions in foreign trade. In public discourse, they are called "oligarchs"

1 Peculiarities and Stages of Economic Reforms In Armenia 1991–1998, National Statistical Service of Armenia, p. 4. armstat.am/file/article/tntbar_91-98eng_1.pdf

2 Small and Medium Entrepreneurship Development National Center of Armenia, SME in figures smednc.am/?laid=1&com=module&module=menu&id=189

3 Firms with private domestic ownership make up 89.9% of all firms, firms with private foreign ownership: 7.7%; with state ownership: 0.7%. See WB, IFC Enterprise Surveys Website, Rev. 7, 2011. Running a Business in Armenia www.enterprise-surveys.org/~media/FPDKM/EnterpriseSurveys/Documents/Country%20Notes/Armenia-09.pdf

4 Foreign direct investment to the Armenian economy during 1992–1996 totaled only \$54.4 mln.

5 See Oleg Gasparjan. Armenian experience in mass privatization (Rus.), Central Asia and Caucasus #2, 1999 ca-c.org/journal/cac-02-1999/st_09_gasparjan.shtml

6 In 1992, GDP per capita in Armenia was only \$87.8, making Armenia one of the poorest societies in the world. See Peculiarities and Stages of Economic Reforms In Armenia 1991–1998, National Statistical Service of Armenia, p. 3. armstat.am/file/article/tntbar_91-98eng_1.pdf

7 Statistical Yearbook of Armenia, 2011 p. 581 armstat.am/file/doc/99466733.pdf

and often demonized,⁸ often with the use of leftist or “green” rhetoric⁹.

Initially in the privatization process, the largest and most profitable trading enterprises were taken by the combatants who returned from the Karabakh war and filled many high level government positions. Later the most successful merchants joined this class and gradually forced the former soldiers out of their government positions and partly out of the economy.

The new class of influential owners that rose in the late 1990s–early 2000s became a kind of a corporation and its representatives jointly entered high-level state positions, where they were well represented.¹⁰ They achieved the greatest representation in the parliament elected in 2007; according to the opposition they gained 76 seats out of 131.¹¹

Soviet Armenia was an industrialized republic that manufactured high-tech products. However, much of the production belonged to the military industry, and the enterprises of Armenia produced an estimated 40% of the total output of the USSR military electronics¹². Since the industry did not adapt to the needs of the peacetime economy, it simply stopped working.

What are the major enterprises in Armenia today? According to the 2011 ranking of the largest taxpayers, most of the top ten companies are natural monopolies. In addition, among the largest companies are distribution networks, telecommunication companies, and companies involved in the sales or import of essential goods. Another important feature of the largest companies is that most of them partially or totally represent foreign capital.¹³

First place in the list belongs to the Zangezur copper-molybdenum plant, representing the mining industry. It

provides 3.5% of all taxes¹⁴ and has a significant share in the country’s exports. In second place is “ArmRosGazprom”, which provides gas supply and distribution across the country’s pipeline network. In third place is the telecommunication company “K-Telecom”, fourth is “Alex Grig” primarily engaged in importing, fifth: “Armenia Telecom Company”, representing the telecommunications sector, sixth is “City Petrol Group”, seventh: “Electric networks of Armenia”, eighth: “Flash”, which sells gasoline, ninth is the “International Airport of Armenia”, and in tenth place is the construction company “HAEK”.

The industrial sector today consists of the mining industry, electricity production, and light industry (mostly food production). Big business is well represented in the mining and energy sector, while the food industry is diversified. As of 2010, large businesses made up 57% of GDP in Armenia¹⁵.

Small and Medium Enterprises in Armenia

Prime Minister Tigran Sargsyan and President Serzh Sargsyan have repeatedly made statements about the need to support small and medium enterprises in Armenia.¹⁶ There is a wide spread perception that big business poses a danger to Armenia through the ongoing concentration and monopolization of the economy. In fact, data do not confirm the thesis that the economy is increasingly being monopolized. During all recent years, small and medium enterprises have increased their presence in the economy.

By contrast, in Georgia, there is an ongoing consolidation among businesses and the share of SMEs is declining: In 2000, small and medium enterprises made 33% of GDP¹⁷, in 2003: 29.4%¹⁸, and by 2010 this figure had dropped to 15%. Small and medium enterprises in 2011 amounted to 16.5% in the total turnover of business in Georgia, showing a permanent decline during the last decade, with the exception of the crisis year 2009¹⁹.

8 For ex. see Hakob Badalyan. How Oligarchy Wastes Armenia. Mar. 23, 2012. Lragir.am/lragir.am/engsrc/comments25555.html

9 “However, observers believe for the city authorities, which defend the interests of private property to the detriment of municipal green space, as many say, it has become a matter of principle, and they are unlikely to give up.” Naira Hayrumyan. Experts: Armenian oligarchy’s fate at stake in Mashtots Park. Apr. 2, 2012. ArmeniaNow.com armenianow.com/society/environment/37004/yerevan_mashtots_park_pavilions_dismantling

10 Alexander Iskandaryan. Armenia between autocracy and polyarchy (Rus.), Pro Et Contra, #3–4, 2011. Carnegie Endowment for International Peace Moscow Centre carnegieendowment.org/files/ProetContra_52_19-28.pdf

11 Arshaluys Mghdesyan. General Elections in Armenia: Oligarchs will be replaced by their representatives? (Rus.) Nov. 30, 2011 Regnum.ru regnum.ru/news/1472984.html

12 See Military Industry of Armenia. (Rus.) Military Caucasus mil.kavkaz.net/?q=node/94

13 See the full list here: express.am/taxes/taxes7.pdf (Arm.)

14 For more detailed information on Armenian state budget and tax income, see Socio-Economic Situation of RA, January–December 2011, p. 104 (Arm.) National Statistical Service of Armenia, armstat.am/file/article/sv_12_11a_211.pdf

15 SME share totals 43% of Armenia’s GDP. Sep. 14, 2011. Pan-Armenian.net panarmenian.net/eng/news/78037/

16 See for example: Serzh Sargsyan at the 13th Republican Convention. Mar. 10, 2012 A1Plus.am a1plus.am/en/official/2012/03/10/president; PM Answers Questions of Interest to Political Analysts, Journalists. Jun. 6, 2012 gov.am/en/interviews/1/item/3200/

17 Vladimir Khikhadze. Small business loses its share in Economy. (Geo) Mar. 12, 2012 Banks and Finances bfm.ge/banks/3642..html

18 Small and Medium-Sized Enterprises in the Caucasian Countries in Transition. Experience in Armenia, Azerbaijan and Georgia. p. 9 UNITED NATIONS. New York and Geneva, 2006 erenece.org/country/unece_cau.pdf

19 Production Value By Enterprise Size. National Statistics Office of Georgia geostat.ge/cms/site_images/_files/english/business/by%20

In Armenia, the methodology for determining the size of the business differs from that in Georgia: if in Georgia enterprise size is determined by its turnover, in Armenia it is determined by the number of people employed. In all spheres the micro-enterprises are considered those that employ up to 5 people. Small enterprises in industry are considered those that employ up to 50 people, in education and energy: up to 25 people, and in transport, trade, services, etc.: up to 25 people. Medium industry enterprises in Armenia are those that employ up to 100 people, education and energy: up to 50 people and services: up to 30 people. All others are considered large.²⁰

Tables 1 and 2 on p. 14 present data on small and medium enterprises in Armenia.

As we can see, each year more than 10,000 new small and medium enterprises are registered as opposed to 200 to 400 new large companies. Most companies are now registered as SMEs and the statistics for the first six months of 2012 show that there are 6,047 newly registered individual entrepreneurs, 1,479 limited liability companies and 54 joint-stock companies (both open and closed).²¹

Thus, we see that the small and medium businesses are gradually increasing their share in the economy and Armenia is ahead of many countries in the region, including Azerbaijan (15%), Bulgaria (33.3%), Moldova (28.9%) and even Greece (27%)²², but is behind more developed countries, where SMEs make up nearly 50% of GDP.²³

It is worth mentioning that compared with the domestic market, the presence of SMEs in international trade is significantly lower: SMEs share of exports is 18%, while its share of imports in recent years fluctuated around 35–38%, and in the crisis year fell to 26.2%. However, Armenia is not unique in this regard. In the Netherlands,

where the SME's share in GDP is 50%, SMEs provide only 27% of overall imports and 19% of exports.²⁴

Another reason for the low level of SMEs in international trade is the high cost of cargo transportation, especially taking into account Armenia's landlocked position and the transport blockade.²⁵ The export of one container costs in average of \$1,815 (\$1,595 for Georgia, \$1,153 for Greece), and the import of one container costs about \$2,195 (\$1,715 for Georgia, \$1,265 for Greece).²⁶ The decline in the share of SMEs in imports in 2009 was due to a rise in the price of transportation costs by 44% in 2009, which imposed too heavy a burden for the small and medium-sized importers.

Armenian Businessmen's Reaction to the Crisis

Before the crisis, Armenia's economy has been growing rapidly due to favorable external conditions: inflow of foreign currency, the growth of foreign markets and domestic demand. After the recession the recovery in Armenia has been slow. GDP fell 14.1% in 2009, while it grew only 2.2% in 2010 and 4.7% in 2011,²⁷ the Armenian economy is still far from making a full recovery whereas the economy of Georgia has recovered and exceeded pre-crisis levels.²⁸

In 2009, exports decreased by 30%. Private transfers, which financed household consumption and the construction sector, fell by the same amount. In this situation, most companies were able to survive but faced reduced turnover.

Therefore, Armenia has also been able to avoid large-scale layoffs: in 2009 employment dropped by about 4%, but most of them were at non-permanent jobs. As for full-time jobs, in some cases, salaries were cut, but layoffs mostly were avoided.²⁹

size%20of%20enterprises/production%20value.xls

20 Small and Medium Entrepreneurship Sector in Armenia 2007–2009, p.5. Small and Medium Entrepreneurship Development National Center of Armenia. smednc.am/download.php?f=1252&fc=REFERENCE%202007-2009%20english.pdf

21 According to Socio-Economic Situation of RA, January–February... January–July, 2012. National Statistical Service of Armenia.

22 Dr. Antal Szabó. Development of entrepreneurship and SME sector in the BSECRegion. ERENET Profile. ISSUE Vol. VI No. 4, p. 15. Oct.2011, UN. erenet.org/publications/profile24.pdf. It should be noted that the methodology used for counting SMEs in GDP for Albania and Romania differs from others. While Albania shows 70% SME share in GDP, there are only 21.8% employed in SME (See Erenet issue Vol. VII No 2. May, 2012. erenet.org/publications/profile26.pdf)

23 For more details, see: Meghana Ayyagari, Thorsten Beck, and Asli Demirgüç-Kunt. Small and Medium Enterprises across the Globe: A New Database, p. 22. Aug. 2003. World Bank www-wds.worldbank.org/external/default/WDSContentServer/1W3P/IB/2003/09/30/000094946_0309160409277/additional/106506322_20041117160012.pdf

24 Moritz Roth. SMEs in the Netherlands. Making a difference, April 13, 2011 p.5. Deutsche Bank Research. dbresearch.com/PROD/DBR_INTERNET_EN-PROD/PROD0000000000271742/SMEs+in+the+Netherlands%3A+Making+a+difference.PDF

25 Even before gaining independence, Armenia faced blockade from Azerbaijan and since gaining independence also from the Turkish side. Thus, 84% of officially recognized borders of Armenia, or 1050 km., are blocked.

26 Country Profile: Armenia, p. 12. Doing Business. World Bank, International Finance Corporation [doingbusiness.org/~media/fpdkm/doing%20business/documents/profiles/country/ARM.pdf](http://doingbusiness.org/~/media/fpdkm/doing%20business/documents/profiles/country/ARM.pdf)

27 See Gross Domestic Product at market prices, Time Series. Armenian National Statistical Service armstat.am/en/?nid=126&id=01001

28 In 2009, decline consisted 3.8%, while in 2010 GDP grew by 6.3% and in 2011 by 7.0%. See Gross Domestic Product of Georgia in 2011. National Statistics Office of Georgia geostat.ge/cms/site_images/_files/english/nad/GDP_2011__press-release__Eng1.pdf

29 According to Socio-Economic Situation of RA, January–December, 2011, p. 88 (Arm.) National Statistical Service of Armenia armstat.am/file/article/sv_12_10a_141.pdf

However, despite the significant decline in foreign trade, local businesses partially reoriented to meet domestic demand, which decreased less than foreign trade. During the crisis in 2009 about 90% of production by enterprises was sold in Armenia, and only 10% exported.³⁰

Each sector performed differently. The first shock hit industry and construction, while agriculture, trade and services showed smaller declines. The most dramatic reduction came in construction, which is heavily dependent on foreign transfers made by diaspora Armenians. As the crisis in Armenia's construction began later than in the U.S., at some point, real estate purchased by American-Armenians in Yerevan, had comparable prices as in California. As a result, many American-Armenians have sold their property in Armenia and bought real estate in the U.S., which they could not afford earlier. Prices in the real estate market fell, with a negative impact on the construction sector and the Armenian currency exchange rate.

The weakening of large enterprises has led to the fact that small and medium enterprises in 2009 amounted to 30.6% of total industrial production (comparing to 22.3% in 2008), a similar situation took place in the transport sector, where the share of SMEs increased by 7.2% and reached 28%.

On the other hand, in construction, the most affected sector during the crisis, the share of SMEs dropped since many small construction firms went out of business because of the increased competition while those that remained saw their income decline. Another consequence of the crisis was the closure of many small companies, which previously had operated in the shadows. The crisis has forced the government to seek new sources of revenue for the treasury and has required these firms to pay taxes. These companies were located mostly in the poorer regions of Armenia.

Business Environment in Armenia

According to the Index of Economic Freedom prepared by the Heritage Foundation, the Armenian economy is "moderately free" and close to being ranked "mostly free," taking 39th place in the world, ahead of several advanced economies. On most of the technical indicators, Armenia shows good or very good results: for example, a high score in business freedom, labor freedom, monetary freedom, trade freedom, fiscal freedom, etc. However, estimates in the rule of law section, such as the protection of property rights and freedom from corruption, are very low.

According to another report, the World Bank Ease of Doing Business Index 2011/2012, Armenia held the 55th position and with five reforms implemented in 2011 is one of the leaders in carrying out reform.³¹ Since Armenia is suffering from a lack of investment, the government is trying to fix the business environment in order to attract potential investors. As one of the five reforms in 2011, Armenia made starting business easier by establishing a one-stop shop that merged the procedures for name reservation, business registration and obtaining a tax identification number and by allowing for online company registration.³² Thus, the business environment in Armenia is gradually improving.

Despite the majority of good results, Armenia showed one of the worst results in tax administration, taking 153th place in the world. The main tax rates are not very high. Thus, the income tax in Armenia ranges from 10 to 20%, while in Austria it spans from 36.5% to 50%.³³ In this case, there is a public inquiry to increase the upper limit of taxes for large enterprises and use a progressive tax.³⁴ But despite the comparatively low tax rate and some improvements in the administration of its payment, it is still a problem: the businessman in Armenia has to make 34 payments and spend 500 hours on paying taxes each year.³⁵ This complexity increases the risk of corruption in the tax area and poses a problem for small and micro enterprises.

According to many SME representatives, large business is in a privileged position in the tax sphere and that is how they explain why a large proportion of SMEs operate in the shadows. Partially, in the shade are big businesses that seek ways to split up their businesses to get tax benefits. For this reason the tax collection rate remains low and amounts to 17% of GDP, excluding social security contributions. However, in late 2011, the Government of

30 See WB, IFC Enterprise Surveys Website, Rev. 7, 2011. Running a Business in Armenia, p. 4 enterprisesurveys.org/~media/FPDKM/EnterpriseSurveys/Documents/Country%20Notes/Armenia-09.pdf

31 See Doing Business Report 2011–2012, p. 6. WB, IFC. doingbusiness.org/~media/FPDKM/Doing%20Business/Documents/Annual-Reports/English/DB12-FullReport.pdf

32 Country Profile: Armenia, p. 20. Doing Business. World Bank, International Finance Corporation doingbusiness.org/~media/fpdkm/doing%20business/documents/profiles/country/ARM.pdf

33 See Georgia: Selected Issues, p. 39. Apr. 2011, International Monetary Fund www.imf.org/external/pubs/ft/scr/2011/cr1193.pdf

34 According to Caucasus Institute Parties Pre-election Promises, this promise was one of the most common and was made by practically all parties, including members of ruling coalition. See: Nina Iskandaryan, Hrant Mikaelian, Tatev Sargsyan. Parties Pre-Election Promises. c-i.am/wp-content/uploads/2012/05/brief-prefinal.pdf (Rus)

35 Country Profile: Armenia, p. 70. Doing Business. World Bank, International Finance Corporation doingbusiness.org/~media/fpdkm/doing%20business/documents/profiles/country/ARM.pdf

Armenia developed a package of reforms aimed at equalizing the conditions for SMEs and large companies.³⁶

Among other results, it is worth mentioning insufficient level of protecting investors, in which Armenia takes the 97th place in the world. Thus, the three major problems affecting Armenia's ratings are corruption, lack of protection for investments and property, and the complexity of the tax administration.

Corruption

The topic of corruption deserves detailed attention. The fact is that the assessment of corruption embedded in the Index of Economic Freedom is a reflection of Armenia's Transparency International Corruption Perception Index. Armenia ranks low in this index, earning 2.6 points out of a possible 10, which shows a deterioration since 2005. Is the corruption environment worsening in Armenia?

According to the Transparency International Global Corruption Barometer 2009, 22% of respondents in Armenia reported that one of their household members paid a bribe in the past 12 months. According to the results of Global Corruption Barometer 2010/2011, this number improved to 19.4%. Certainly, this is not the only measure to estimate bribery and corruption, but it makes it possible to compare with different countries. As we see in Table 3 on p. 15, among the many countries there is no direct correlation between the perception of corruption and how often people give bribes.

Thus, we see the contrast between the dynamics of perceived corruption and its actual physically measured indicator as a proportion of those who gave a bribe in the past year in the population.

Other studies show similar results. For example, according to the EBRD 2005 Transition Report, Armenia showed one of the best results in the EBRD region in terms of freedom from corruption and was only slightly lower than those of Georgia and a number of Central European countries (but better than most of the Balkan and Eastern European states), showing improvements from 2002.³⁷

Later surveys conducted by the CRRC (Caucasus Barometer) likewise tell the same story.³⁸ The willingness of the Armenian businessmen to pay bribes is significantly lower than the average for the countries of

Eastern Europe and Central Asia, and slightly higher than those in Western Europe. Also, the level of losses due to theft, robbery, vandalism, and arson is very low.³⁹

Private Initiative

It seems that the problem of post-crisis recovery is also subjective. According to the EBRD 2011 Transition Report, successful business startups comprised less than 4% of the total population, which is the worst result of all transit countries and only a quarter the rate of major EU member states.⁴⁰

Thus, Armenia is facing a shortage of private initiative, which is probably the main factor hindering the development of SMEs. This problem is common within most successor states of the former Soviet Union⁴¹, but in Armenia it seems to be more acute.

A survey conducted by CRRC in November 2011 shows that 57% of people find it necessary to increase the share of government in the economy, and only 18% insist on continuation of the economic liberalization.⁴² Such paternalistic attitudes among the population have a negative impact on willingness to open a business and reduce the level of private initiative. Another obstacle to entrepreneurship is the high level of distrust in the government and the perceived level of corruption, which causes people to rate their chances of success very low. This circumstance is an important motivator for emigration, the rate of which is high in Armenia and was about 8–15% per year during 2008–2011.⁴³ Therefore, many who plan to emigrate in near future postpone the decision to start a business in order to realize it in another country.

Women are able to give new impulse to the development of entrepreneurship in Armenia. In recent years, women in Armenia began to show more initiative than before. According to the World Development Indicators & Global Development Finance database, in 2005 only 11.5% of firms had female participation in ownership while in 2009 they made up already 31.8% of all firms.⁴⁴

36 Sara Khojoyan. Armenia Prepares for Major Tax Reform. Nov. 11, 2011. Institute for war and peace reporting iwpr.net/report-news/armenia-prepares-major-tax-reform

37 Transition Report 2005. Business in Transition, p. 13. EBRD. ebrd.com/downloads/research/transition/TR05.pdf

38 According to CRRC polls, 9% of respondents reported one of household members paying bribe during last 12 months in 2008. By November, 2011 this number had decreased to 6%.

39 See WB, IFC Enterprise Surveys Website, Rev. 7, 2011. p. 5. Running a Business in Armenia enterprisesurveys.org/~media/FPDKM/EnterpriseSurveys/Documents/Country%20Notes/Armenia-09.pdf

40 Transition Report 2011. Crisis and Transition. P. 78. EBRD ebrd.com/downloads/research/transition/tr11.pdf

41 Compare CIS and other regions results in table "If someone wants to start a business in this country, can they trust the government to allow their business to make a lot money?" Latin Americans See Barriers to Entrepreneurship. Oct. 22, 2010. Gallup. gallup.com/poll/143966/Latin-Americans-Barriers-Entrepreneurship.aspx

42 See Caucasus Barometer 2011

43 According to State Migration Service of Ministry of Territorial Administration of Armenia, 43,800 people emigrated only in 2011. For detailed statistics visit smsmta.am.

44 World Development Indicators & Global Development Finance database in Excel format can be downloaded here: databank.worldbank.org/databank/download/WDlandGDF_excel.zip.

In conclusion, the perceived high level of corruption and other barriers to business is becoming a significant factor hindering the development of SMEs in Armenia. Despite the desire among large companies to achieve a

greater presence in the markets, small and medium businesses are gradually increasing their share in Armenia's economy and now have reached the level of Central and Eastern Europe, i.e., 43% of GDP.

About the Author

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DATA

SMEs in Armenia: Participation in the Economy and Business Environment

Table 1: SME Participation in the Economy of Armenia

	SME, share in GDP*	Share of SME employees in total number of employed people	Total number of registered SMEs during the year	Share of obligatory social security payments paid by SMEs as a % of the total of the obligatory social security payments	Share of taxes paid by SMEs as a % of the total amount of taxes paid in Armenia
2002	34.4	28.2			
2003	36.5	31.0	8,295		
2004	38.6	32.9	8,889	33.0	28.3
2005	39.8	34.0	9,445	33.9	27.9
2006	40.3	35.1	10,082	35.0	27.7
2007	41.0	40.7	12,535	45.7	25.2
2008	41.7	42.1	20,952	50.9	28.0
2009	42.5	42.2	14,023	48.7	26.8
2010	43.0				

* Non-financial GDP, except agriculture

Sources: Reference Book. *Small and Medium Entrepreneurship Sphere in Armenia 2003–2004*, p. 8. Yerevan, 2005; Reference Book. *Small and Medium Entrepreneurship Sphere in Armenia 2005–2006*, p. 45. Yerevan, 2007 (in Armenian); Reference Book. *Small and Medium Entrepreneurship Sector in Armenia 2006–2008*, p. 14. Yerevan, 2009; Reference Book. *Small and Medium Entrepreneurship Sector in Armenia 2006–2008*, p. 9. Yerevan, 2010; SME share totals 43% of Armenia's GDP panarmenian.net/eng/news/78037/

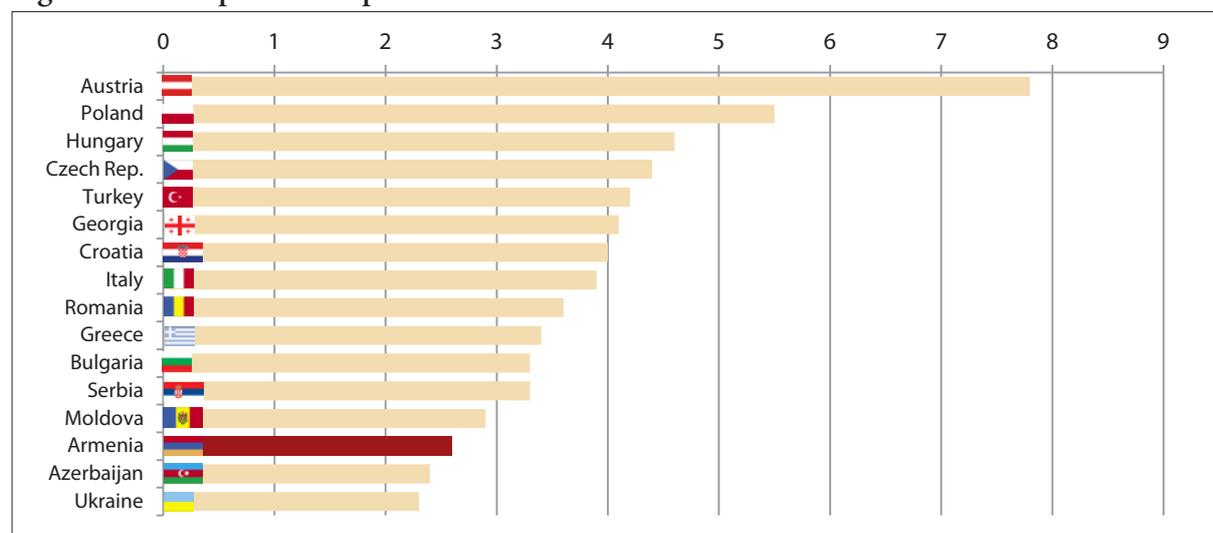
Table 2: International Activities of SME

	The share of foreign investments made in SMEs as a % of overall FDI	Shares of SMEs in export	Shares of SMEs in import
2003		14.3	31.6
2004	9.1	15.7	34.8
2005	10.4	16.4	36.3
2006	9.5	16.9	36.8
2007	8.8	17.4	37.3
2008	8.2	17.9	37.8
2009	8.0	17.7	26.2
2010		18.0	

Table 3: Corruption in Armenia Compared to Central and Eastern European Countries

	CPI-2011	In past 3 years, the level of corruption in country has		GCB-2010/2011, % of who reported one of household members paying bribe during the last 12 months		GCB-2010/2011, % who reported not paying bribe
		Decreased (%)	Increased (%)	to speed things up	to avoid problems with authorities or to receive entitled service	
Armenia	2.6	15	50	7.4%	12.0%	74.5%
Azerbaijan	2.4	28	52	12.4%	26.9%	33.7%
Georgia	4.1	78	9	0.2%	1.2%	58.4%
Ukraine	2.3	7	30	11.9%	13.1%	57.8%
Moldova	2.9	12	53	13.8%	14.2%	65.1%
Hungary	4.6	4	76	5.7%	16.8%	69.6%
Poland	5.5	26	49	3.1%	3.8%	92.3%
Czech Rep.	4.4	14	44	4.9%	6.0%	88.1%
Romania	3.6	2	87	7.1%	10.5%	76.7%
Bulgaria	3.3	28	30	1.6%	5.0%	82.4%
Turkey	4.2	26	57	3.1%	4.2%	69.9%
Serbia	3.3	14	49	6.0%	8.6%	60.2%
Croatia	4.0	10	57	2.2%	2.5%	53.5%
Greece	3.4	5	75	6.1%	9.5%	81.9%
Italy	3.9	5	65	1.5%	4.3%	86.2%
Austria	7.8	9	46	1.8%	1.5%	95.5%

Sources: Transparency International, Corruption Perceptions Index 2011 (CPI); Transparency International, Global Corruption Barometer (GCB) 2010–2011

Figure 1: Corruption Perceptions Index 2011

Higher index – less corruption

Source: Transparency International, Corruption Perceptions Index 2011

CHRONICLE

From 23 November to 10 December 2012

23 November 2012	An advisory commission in Mexico City recommends the removal of a public statue of the late Azerbaijani President Heydar Aliiev
26 November 2012	EU foreign policy chief Catherine Ashton visits Georgia and meets with Georgian President Mikheil Saakashvili and Georgian Prime Minister Bidzina Ivanishvili to discuss EU–Georgia relations before a visit to Central Asia
26 November 2012	The Georgian Ministry of Defence says that Defence Minister Irakli Alasania is on an official visit in Afghanistan to meet with Georgian troops serving under the NATO-led ISAF mission
28 November 2012	The new Georgian Interior Minister Irakli Garibashvili says that the crime situation in the country is not deteriorating following the change of government in November 2012
29 November 2012	Turkmen President Gurbanguly Berdimukhammedov visits Armenia and holds talks with Armenian President Serzh Sarkisian on trade and energy issues
30 November 2012	The Georgian prosecutor's office says that the former chief of police in the Georgian town of Borjomi is arrested for the alleged abuse of a detainee
4 December 2012	Four Azerbaijani citizens are sentenced for terrorism and high treason in Azerbaijan's capital of Baku after they are found guilty of preparing attacks on the eve of the Eurovision Song Contest in Baku and of having links with members of Iran's Revolutionary Guards Corps
4 December 2012	NATO Secretary General Anders Fogh Rasmussen says that Georgia has passed an important test with the parliamentary elections of November 2012, but speaks of the necessity of a "smooth cohabitation" between Georgian President Mikheil Saakashvili and the new government
6 December 2012	The Georgian Ministry of Defence says that its internal investigations unit has found evidence of corrupt schemes in arms procurements made at the time when Bacho Akhalaia served as Defence Minister
6 December 2012	Georgian President Mikheil Saakashvili meets with Polish President Bronisław Komorowski in Warsaw to discuss the deepening of bilateral relations between the two countries as well as recent internal developments in Georgia
7 December 2012	The Georgian Parliament passes a draft law on amnesty in its first reading that envisages different forms of amnesty for Georgian prisoners
7 December 2012	Former Georgian Prime Minister Vano Merabishvili is summoned to answer questions regarding the alleged use of a fake passport by the investigative unit of the Interior Ministry
8 December 2012	The Georgian Interior Ministry says that a former officer of the Interior Ministry's Department for Constitutional Security who is wanted in Georgia on charges of allegedly beating up police officers was arrested in Kiev on 7 December 2012
9 December 2012	Russian Foreign Minister Sergey Lavrov says that contacts are planned with the Georgian Prime Minister's Special Representative for Relations with Russia in the "nearest future" to clarify the "context" in which Tbilisi is willing to normalize its relations with Moscow
10 December 2012	The Azerbaijan Foreign Ministry says that an agreement with Russia to use the Qabala early-warning radar station expired on 9 December 2012 after Moscow had shown no interest in renewing the deal
10 December 2012	The Azerbaijani police disperses an unsanctioned gathering of opposition activists trying to mark Human Rights Day in a central Baku square

Compiled by Lili Di Pippo

For the full chronicle since 2009 see www.laender-analysen.de/cad

ABOUT THE CAUCASUS ANALYTICAL DIGEST

Editors: Lili Di Puppo, Iris Kempe, Matthias Neumann, Robert Orttung, Nana Papiashvili, Jeronim Perović, Heiko Pleines

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