

SME Strategy Evaluation Report & Recommendations

Conducted by ADWISE Consulting in the Framework of EU SMEDA Project

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1. ACRONYMS & ABBREVIATIONS

AMD	Armenian Drams
ArmCCI	Chamber of Commerce and Industry of Republic of Armenia
BMO	Business Membership Organisation.
CBA	Central Bank of Armenia
CIS	Commonwealth of Independent States
CIT	corporate income tax (also referred to as profit tax)
CPI	Crisis Prevention Institute
EAEU	Eurasian Economic Union
EaP	Eastern Partnership
EaP	Eastern Partnership
EU	European Union
FDI	Foreign Direct Investment
FDI	Foreign direct investment
GDP	Gross Domestic Product
GII	Global Innovation Index
GRE	Government-Related Entity
GSP+	An advanced option of the Generalised Scheme of Preferences
HCI	Human Capital Index
ICT	Internet and Communications Technology
IFI	International Financial Institutions
IMF	International Monetary Fund
MEDI	Ministry of Economic Development and Investments of Republic of Armenia
NGO	Non-Government Organization
OECD	Organization of Economic Cooperation and Development
PPD	Public-Private Dialogue
REX	Registered Exporter System
RIA	Regulatory Impact Assessment
SDP	Sustainable Development Programme
SME	Small and Medium-sized Enterprises
SME DC	SME Development Council
TA	Technical Assistance

USD	United States Dollars
VAT	Value Added Tax
WB	The World Bank
WEF	World Economic Forum
WEO	World Economic Outlook
WITS	World Integrated Trade Solution
WTO	World Trade Organisation

2. ECONOMIC ANALYSIS

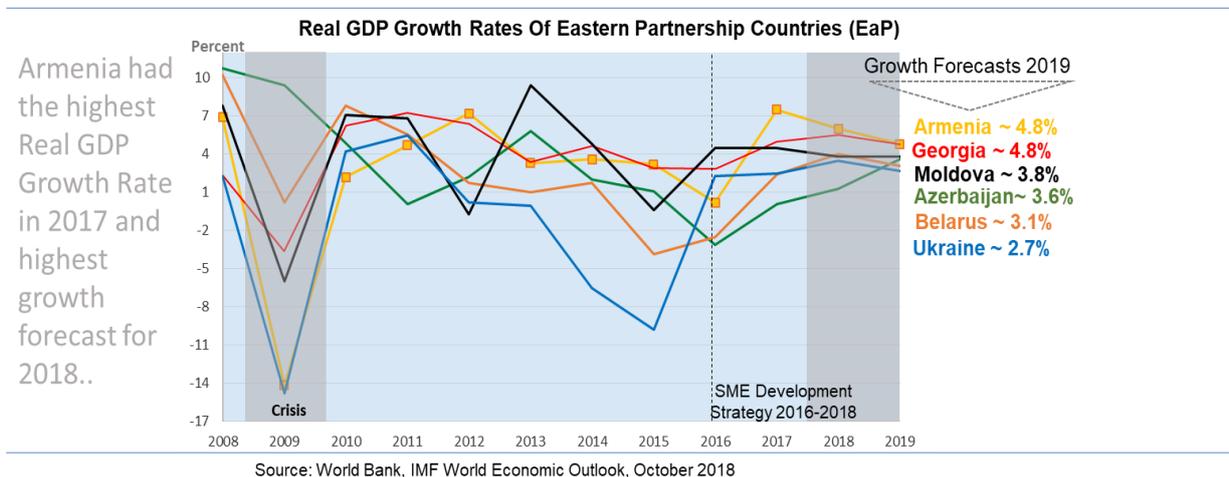


Uneven Growth Story

Armenia’s recent macro-economic development has been mixed. Ever since the sharp contraction of GDP of over 14% back in 2009 (Exhibit 1) in the aftermath of the Global Financial Crisis, Armenia’s GDP growth has been uneven. The GDP growth rate was in low single digits all but for two years: in 2012 (exceeding 7%) and in 2017 (reaching 7.5% (the highest in the last decade).

GDP growth in 2017 was driven by a significant expansion in trade (16%), industry (10%), and services (9%)¹. The high pace of growth continued in the first half of 2018 (GDP grew in Q1 by 9.6% YoY and Q2 by 7.2% YoY), and the Economic Activity Index² grew by about 9.3% YoY from the start of the year until end of July.

Exhibit 1

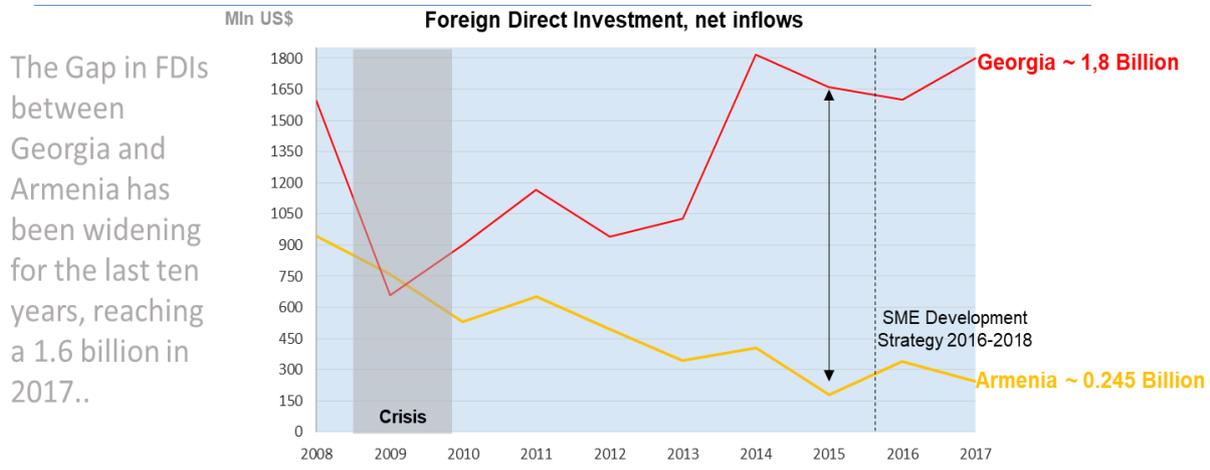


Over the past five years, lower potential growth in trade partner countries (CIS countries had negative growth rates in both 2015, 2016 and turned to positive growth of 2.1% only in 2017), sluggish FDI in recent years (Exhibit 2), the absence of strong growth drivers, and a still-weak business climate have constrained the economy’s capacity to grow

¹ Statistical Committee of the Republic of Armenia – www.armstat.am
² The output of products and services calculated on monthly basis with the average prices of last year, which gives the opportunity to measure the real output in the current year. It does not include net taxes and commissions and fees from financial intermediation, which are included in GDP calculation. Statistical Committee of the Republic of Armenia – www.armstat.am

rapidly and generate sufficient jobs to prevent emigration and reduce poverty. However, for 2018 the growth in Russia is projected at 1.7%, up from 1.5% in 2017, supported by higher oil prices and recovering domestic demand. Medium-term growth is expected to remain low at about 1.2%, with no expected structural reforms³.

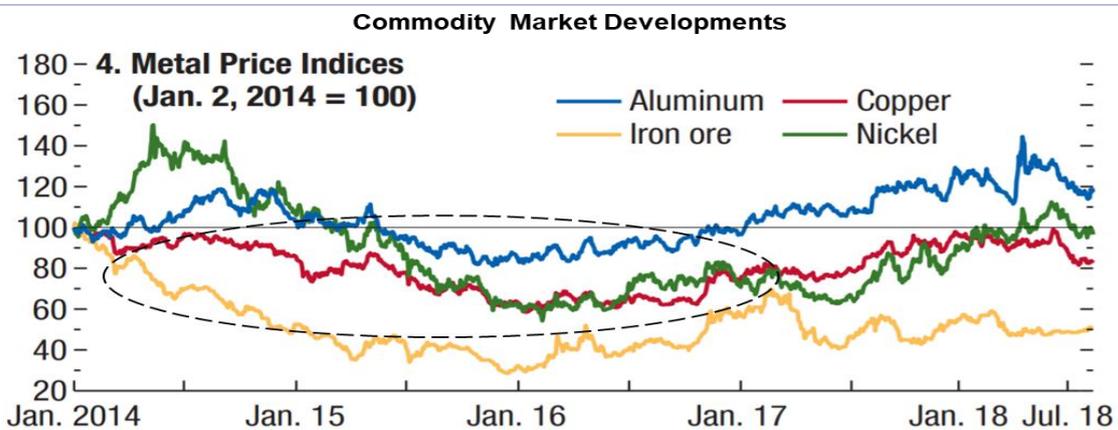
Exhibit 2



Source: World Bank

The low to moderate growth rates in Armenia indicated above were influenced by several factors. According to the exogenous growth theory the slow growth rates were mainly influenced by the economic slowdown in Russia, which is the main trade partner of Armenia, as well as the source of sizable remittance flow. In addition, the same period coincided with the decline in many commodity prices (copper prices in fact declined by 35-40% from 2014 to 2017) (Exhibit 3), which also negatively affected the growth rate, as copper remains the key export commodity⁴ for the country.

Exhibit 3



Source: IMF WEO, November 2018

³ IMF WEO 2017, 2018

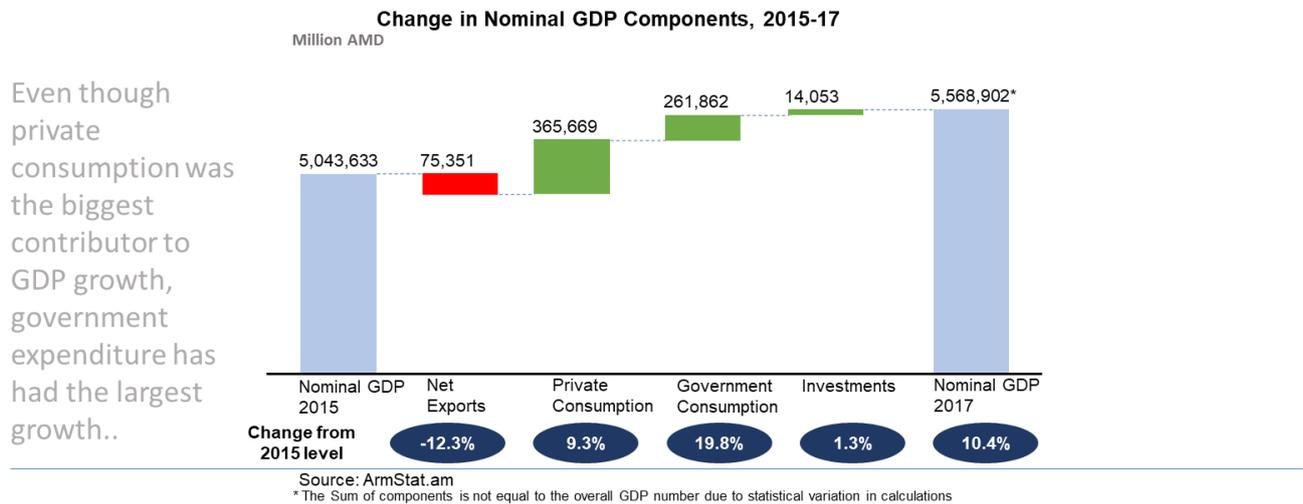
⁴ WITS Database, Copper ores and concentrates are the largest export category, along with trade value, in 2010-2016 period

On the other hand, according to the endogenous growth model theory the economic experts argue that the growth both in Armenia and in other EaP countries is mostly constrained by internal factors such as lack of policy interventions, social and economic reforms. If the “right” institutions⁵ are developed, then growth will follow.

In late 2016 (during the period of SME strategy 2016-2018) the Armenian government has been changed and has been implementing a series of reforms up to March of 2018. Partially driven by implemented reforms in 2017 Armenia had the highest growth rate among the EaP economies (Exhibit 1).

Although the private consumption continued to be the biggest contributor to economic growth, closely matching the growth rate of overall GDP (Exhibit 4) in this period, the government expenditure had the largest growth of 19.8% in this period, double that of the rate of the GDP (Exhibit 4).

Exhibit 4



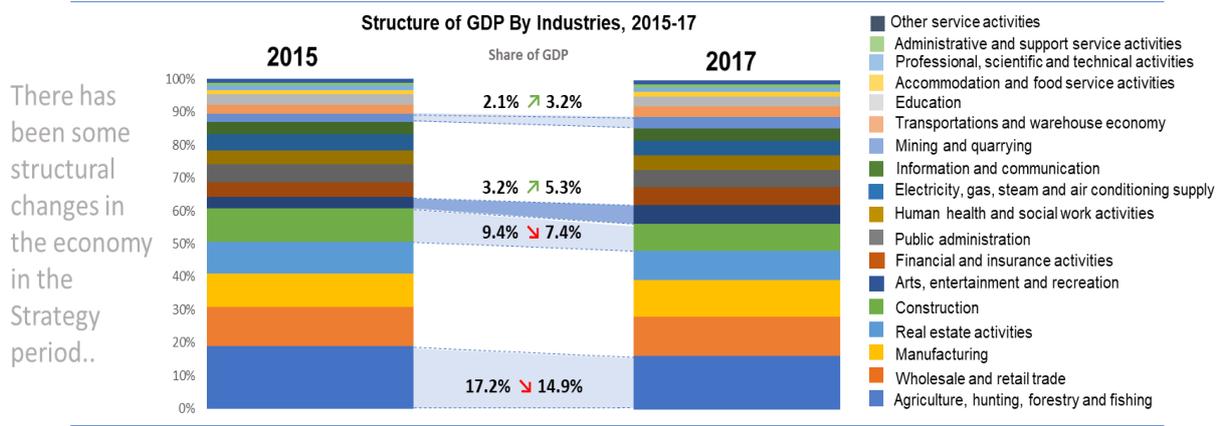
Even though private consumption was the biggest contributor to GDP growth, government expenditure has had the largest growth..

The “Velvet Revolution”, which took place in April – May, 2018, has created positive expectations. In fact, Armenia was one of the few countries that did not experience economic shocks during this period and the growth rate of Economic Activity Index in the first 8 months of 2018 has been promising so far, at close to 9%⁶.

⁵ Institutions determine the incentives of and constrains on economic actors and shape economic outcome – Institutions as a Fundamental Cause of Long-Run Growth, Handbook of Economic Growth, D. Acemoglu, Simon Johnson, James Robinson, 2005
⁶ Statistical Committee of the Republic of Armenia – www.armstat.am

Over the period of 2016-2018 there were important changes in the structure of GDP. More specifically, the weight of the agriculture sector, which still continues to be the largest component in GDP, has declined sharply from 17.2% at the end of 2015 to 14.9% of GDP at the end of 2017 (Exhibit 5). The same situation is evident in the construction sector, which once was the largest industry in terms of economic output during the high growth rate period of 2000s, but has slowed considerably, and continues to decline in the overall structure (Exhibit 5). On the other hand, new emerging industries such as Arts, entertainment and recreation (gambling, betting, etc.) has increased by 80%, making up a notable 5.3% share of GDP.

Exhibit 5

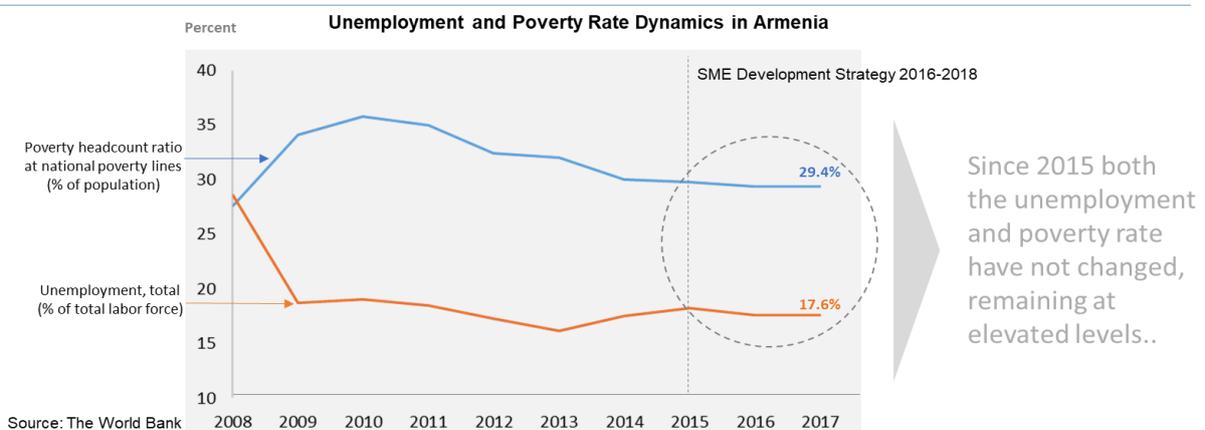


There has been some structural changes in the economy in the Strategy period..

Source: ArmStat.am

As highlighted in Armenia’s Sustainable Development Programme (SDP) as part of 2014-2025 Development Strategy, one of its three main objectives is the reduction of poverty⁷. Unfortunately, poverty continues to be one of the major problems in Armenian society, with double digit rates for many years (Exhibit 6). Furthermore, the unemployment rate has also stayed at very high levels. During the period of 2016-2018⁸ both indicators have been somewhat flat (see Exhibit 6).

Exhibit 6



Source: The World Bank

Since 2015 both the unemployment and poverty rate have not changed, remaining at elevated levels..

⁷ Stated in Development Strategy 2014-2025 - Reduction in poverty to the extent that poverty is not be a problem of economic development

⁸ Data was available only as of the end of 2017

Debt and Fiscal Policy

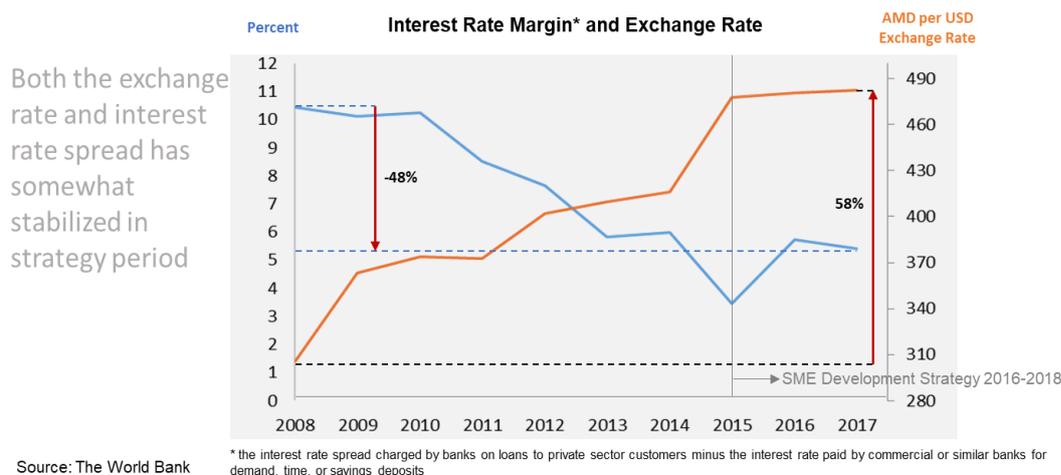
After registering of 4.8% and 5.5 % of GDP deficit in 2015 and 2016 respectively, the former Government began fiscal consolidation in the 2017 budget, with a deficit target below 3%. As both during 2017 (before the Velvet Revolution) as well as 2018 the collection of taxes overperformed the budgeted indicators due to higher than expected GDP growth indicators, if the expenditure side of the budget is closely monitored, the budget deficit can come to lower indicators.

The government debt reached 52% of GDP at end 2016, of which 80 percent consisted of external debt, only part of which was on concessional terms. As the public debt threshold of 50% of GDP is established in Armenia's budgetary legislation⁹ the previous Government has delayed some foreign financed capital expenditures to meet this above-mentioned threshold requirement. The Ministry of Finance of the former government introduced amendments to the public debt law to make the relevant rules more flexible and countercyclical by prioritizing capital expenditures and introducing an expenditure rule, which contains current spending, while leaving the current debt threshold unchanged.

Monetary & Exchange Rate Policy

Monetary policy tightened in late 2014 and into early 2015, with the CBA raising the refinancing rate to 10.5 percent by August 2015. Policy loosened thereafter, with the rate declining over the subsequent one and half years by 450 basis points, to reach 6 percent in February of 2017; since then, it has remained unchanged. This has affected the long-term trend of declining interest rate spread, that Armenian commercial banks were earning. In fact, over the last nine years this spread has declined 48% (Exhibit 7), making net interest margin of the banks historically low.

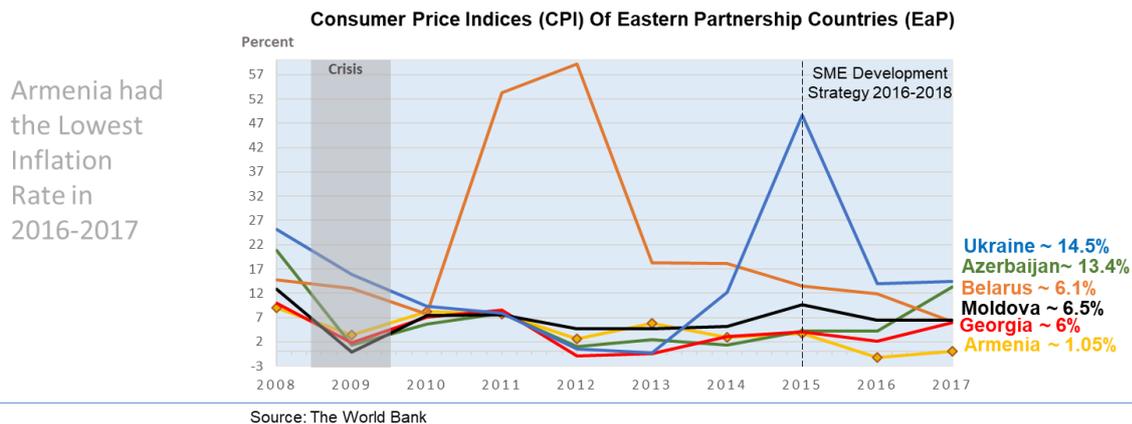
Exhibit 7



⁹ Armenia's Law on Public Debt includes a strict debt ceiling of 60 percent of the previous year's GDP, and a "debt brake" of 50 percent of the previous year's GDP which triggers a requirement that the budget deficit be below 3 percent of the average GDP of the past three years. The rule has a hard ceiling; if debt exceeds the ceiling of 60 percent of GDP, no further debt can be issued.

The CBA continues to adhere to a managed flexible exchange rate policy and intervenes only to prevent large fluctuations. Economic growth strengthened in early 2017, resulting in a slight rise in the still low inflation rate. Both the inflation (Exhibit 8) and the exchange rate (Exhibit 7) and have been largely stable, with the former being within the target range of the Central Bank, which pursues inflation-centered monetary policy.

Exhibit 8



Monetary policy is likely to remain focused on bringing inflation back to its medium-term target. Lastly, the Central Bank will also monitor the impact of recent policy actions and assess the need for further easing going forward.

Financial sector

Both international experts and Armenian government officials agree that the banking sector is one of the well-developed sectors in Armenia from an institutional perspective and is being regulated effectively by Central Bank of Armenia. There has not been a major banking and/or financial issue in the Armenian economy for the past decade, when many eastern European countries have had such issues post global financial crisis. Banks began 2017 in a stronger capital position following a six-fold increase in the minimum capital requirement at the beginning of the year. Following several mergers and acquisitions, the number of foreign and domestic banks operating in Armenia fell to 17 in 2017 from 21 (end of 2015). There continues to be a fierce competition within the banking sector, among commercial banks operating in the economy. The banking sector remains well capitalized and liquid.

Putting it all together

- Growth rebounded in 2017, and IMF forecasts 6% and 4.8% for 2018 and 2019¹⁰ (Exhibit 1).
- Inflation has been well managed by CBA, having the lowest inflation rate in both 2016 and 2017 (Exhibit 8). Additionally, banks are over liquid and market interest rates both in AMD and USD are down by over 2% over the last 2 years.

¹⁰ October of 2018 by IMF

- Even though FDIs have been depressed in the economy, declining for the last 10 years (Exhibit 2), but some positive expectations are already built in 2018.

All of those factors indicate an economic outlook that remains largely positive. Moreover, the strong economic performance in 2017 combined with the change of government (The new government is in place from May 2018 since the “Velvet Revolution” and has sent strong signals related to anti-corruption and the importance of upholding the rule of law within the economy) suggest a window of opportunity to tackle and accelerate the challenging reforms to make the growth inclusive and sustainable in the medium- to long-term.

There are risks to this outlook: the decline in remittances due to the continuing economic slowdown in Russia, further decline in copper prices (importance of copper prices is mentioned above) and slowdown in growth in key trading partners such as Bulgaria, Georgia, Iraq, Germany and Switzerland.

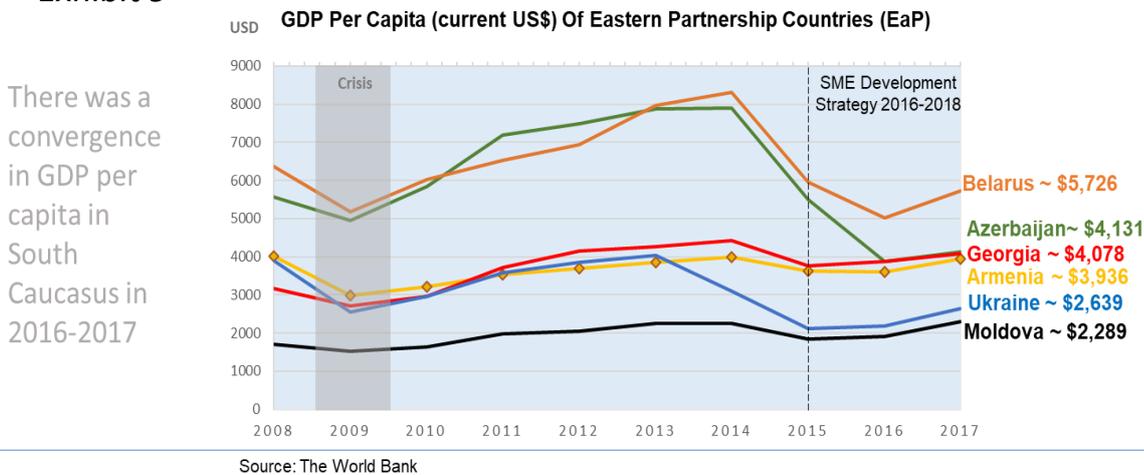
3. BUSINESS ENVIRONMENT ANALYSIS



Even though Armenia has jumped from being a lower-middle to becoming an upper-middle income¹¹ country in 2017, the GDP per capita still remains low, and ranks only 3rd in the EaP countries (Exhibit 9).

Both the former and the current governments have engaged in a continuous effort to implement business environment reforms, simplify the legislative and regulatory framework and enhance its business support infrastructure.

Exhibit 9



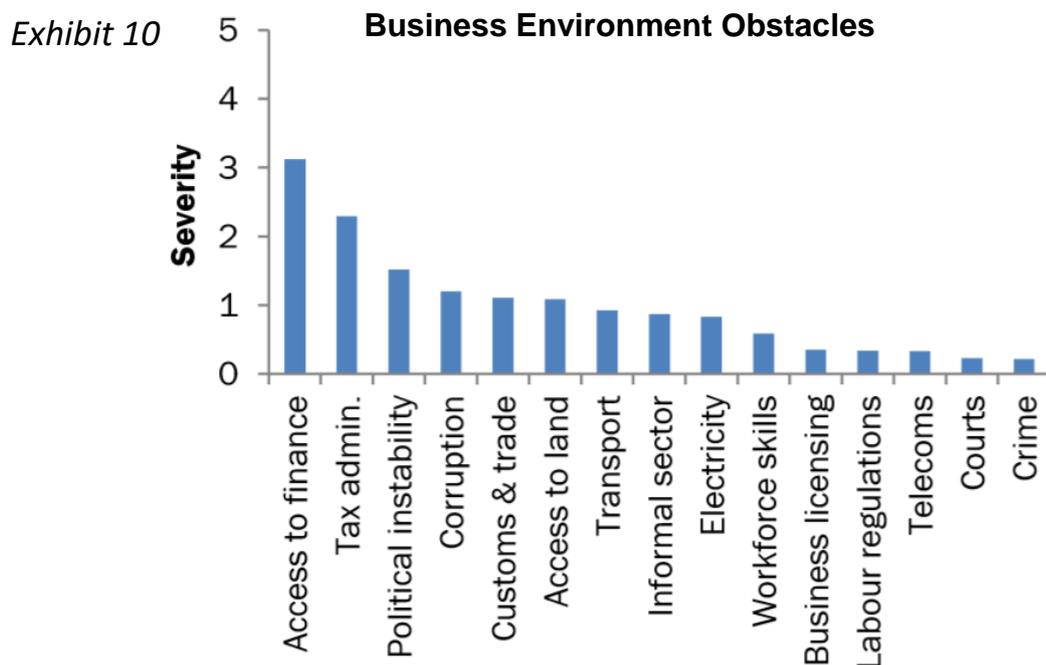
The “2014-2025 Armenian Development Strategy” emphasizes export-led growth based on agriculture, IT, tourism and industrial processing. Economic competitiveness and private sector development reforms (in particular to reduce administrative barriers and streamline tax administration) are among the key priorities.

Following several years of negotiations with the European Union (EU) on an Association Agreement (AA), including a Deep and Comprehensive Free Trade Area (DCFTA), Armenia decided to join the Eurasian Economic Union (EAEU) in 2013. In 2017, the authorities sought to leverage EAEU membership to promote export diversification, improve standards, enhance domestic competition and invest in infrastructure, while pursuing greater trade integration beyond the EAEU. In November 2017 Armenia signed

¹¹ GNI/Capita (current US\$) has to be in the range of 3,896 - 12,055 according to the updated country income classifications for the World Bank, 2018-2019

the Comprehensive and Enhanced Partnership Agreement (CEPA) with EU.¹² To give an indication of the financial support received from EU during the period 2014-2017, it is worth mentioning that EU has allocated EUR 118.5 million¹³ of financial support to Armenia under bilateral cooperation programmes. This funding was directed to three main development priorities in Armenia, as indicated in the Single Support Framework 2014-2017: private sector development; public administration reform and justice reform.

According to the EBRD's latest Business Environment and Enterprise Performance Survey (BEEP) survey for Armenia (Exhibit 10), the top five biggest obstacles for business environment are access to finance, tax administration, political instability, corruption and customs and trade.



Source: ebrd-beeps.com, Estimated for a hypothetical "average" firm. Higher values correspond to a weaker business environment.

To combat those issues, one of the initiatives of the government was the establishment of a new government-related entity – the Centre for Strategic Initiatives (CSI) – in January 2017, to foster reforms as well as public-private partnership (PPP), align developmental goals between investors and line ministries. After the change of the government in 2018 this entity has been resolved, citing inefficiencies in the overall governmental structure. Several other GREs are also being considered¹⁴ for a closure or optimization by the new government.

Pursuing structural reforms remains essential for fostering sustainable and inclusive growth in the Armenian economy. Moreover, strengthening domestic competition and regulatory reforms are pivotal to promoting private sector development and diversifying the economy. In this context, the authorities' growth promoting initiatives announced

¹² European Neighborhood Instrument (ENI) 2017-2020

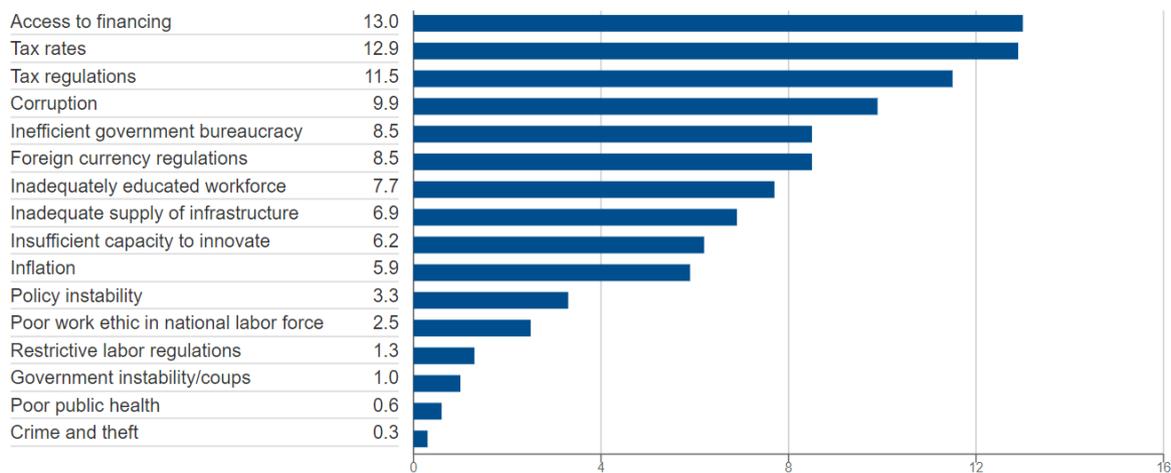
¹³ Report on EU-Armenia relations in the framework of the revised ENP, Brussels, 4 June 2018

¹⁴ Based on ADWISE's one-on-one interviews with government officials and executives at government related enterprises

after the “Velvet Revolution” highlighted in our analysis of Macroeconomic Developments section are very important.

With the highest growth rate in 2017 among EaP countries and GDP real growth rate forecasts of 3.5 - 4%¹⁵ for the next 2 to 3 years, combined by a stable outlook for growth rates in major trading partners (Russia (1.4-1.5%), EU (2.2-1.8%) and China (6.4-6%)) and a pickup in private sector activity, there are positive signs¹⁶ in terms of the forecast short term growth. Moreover, the reform momentum under the current government appointed in May of 2018, combined with the level of EU financial assistance indicated above, should also affect growth positively in the medium term.

Exhibit 11 Main Obstacles for Doing Business, 2017-2018



Source: World Economic Forum Competitiveness report 2017- 2018

In the World Economic Forum’s Competitiveness Report 2017-2018 executives were asked to rank the top three issues that effect their decision making in doing business. In the last two years the number one issue was the same, access to financing. Corruption was ranked as number 4 issue in 2017 (Exhibit 11) as opposed to being the number 2 issue a year earlier. There are some differences versus the BEEPs survey highlighted above as the political stability is not a priority issue in WEF survey compared to BEEPs, but the top 3 issues the access to finance and Tax administration and corruptions still remain top priority ones.

Other initiatives to improve the business environment include a simplification of tax code, strengthening of rule of law and ongoing reforms to make the economy more competitive, which will also positively effect the targeted industries such as Hospitality and Tourism, ICT and Food Processing. In addition, there is ongoing work focusing on the Sustainable Development Strategy (Inclusive growth strategy¹⁷), SME Strategy¹⁸, Innovation

¹⁵ IMF DataMapper

¹⁶ Announcements made by Prime and his cabinet on multiple formal and informal (Facebook livestreams) occasions.

¹⁷ The document is in process of being development at the time of writing of this report therefore the name is subject to change, but is a revision of Armenia Development Strategy 2014-2025 is being conducted by Government of Armenia.

¹⁸ Ideally should be based on assessment report of 2016-2018 SME strategy.

Strategy, etc. all of which should help create a sound framework for economic development in the country.

Doing Business Fluctuations

Being a small land-locked country with a strong dependence on imports and remittances, the SME sector development in Armenia is crucial for strengthening economic competitiveness. The previous and current governments have prioritised reforms targeting improvements in the business environment, the most important of which are highlighted below:

- One of the key priorities of the current government is combatting corruption and monopolies, which sends a strongly positive signal to the business community and in the medium- to long-run can result in material improvements to the business environment.
- A new law on Public Procurement was adopted in 2016 which aligns public procurement principles and procedures with the revised WTO Agreement on Government Procurement requirements;
- Access to the electronic procurement system was extended to all municipalities in 2016 and in 2017 all foundations and funds operating with public money were given access to the system that now covers all forms of procurement;
- The State Committee for Tourism was established in 2016 under the Ministry of Economic Development and Investments to exploit Armenia's growth potential in the tourism sector by elaborating and implementing a more proactive tourism policy; Digital channels are being utilized, including a web page¹⁹ that has been created in coordination with Armenian Tourism Development Foundation to promote tourism via internet/social networks.
- Business Armenia (the rebranded Development Foundation of Armenia) was established by the Government of the Republic of Armenia in 2015, with the mission of promoting the country's economic growth. The aim of the Foundation is to enhance Armenia's rating and competitiveness, attract investments and promote export. Business Armenia promotes cooperation between public authorities and entrepreneurs (PPP), implements joint projects, supports foreign investments and provides post investment services.

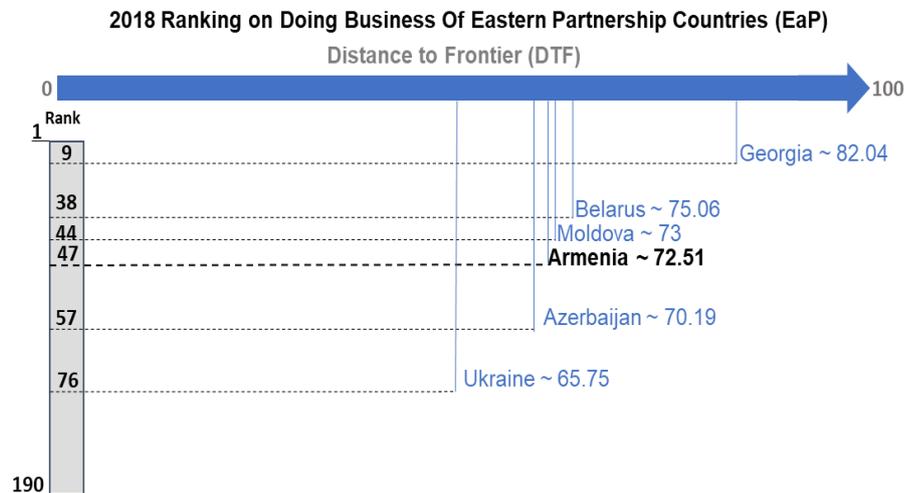
According to the 2017 Doing Business report, Armenia strengthened access to credit by adopting a new law on registration of secured rights towards movable property, that establishes a modern and centralized collateral registry, improving regulatory framework for credit reporting, making it easier to enforce contracts, expanded the alternative dispute resolution framework, improved its credit information system by adopting a new law on personal data protection and made enforcing contracts easier by introducing a consolidated chapter regulating voluntary mediation and establishing financial incentives for the parties to attempt mediation.

¹⁹ <https://www.armenia.travel/en>

According to Doing Business Report, Armenia has made progress in the rankings, where it ranked 38 in 2017 (compared to 43 in 2016). Armenia has a quite a favourable regulatory framework for SMEs and ranks highly amongst its regional peer group according to that report. However, in 2018, the ranking of Armenia changed, jumping to 47th which is the fourth highest ranking among the EaP countries (Exhibit 12).

Exhibit 12

Armenia has the fourth highest score in 2018, down from second in 2017



Source: The World Bank: Doing Business 2018

Georgia (82.04) remains ahead of Armenia (72.51) but it is Ukraine (65.75) that trails the group. However, the business climate has steadily been improving over the past five years, according to this WB indicator. For example, of the various topics that Doing Business covers, Armenia is most advanced in respect to property registration and starting a business (13th and 15th positions, respectively), but lags behind with resolving insolvency, where it is ranked 97th out of 190 countries covered.

Taking into account the fact that Georgia's²⁰ case is considered a success story in Doing Business reports over the last ten years, and given the fluctuations in ranking for Armenia, the following analysis benchmarks Armenia against Georgia's to gauge the components that have changed. In the analysis over 40 components were assessed for the period 2015-2017 from 10 pillars of the ranking and the Consultant compared the ones that have changed over the last three years.

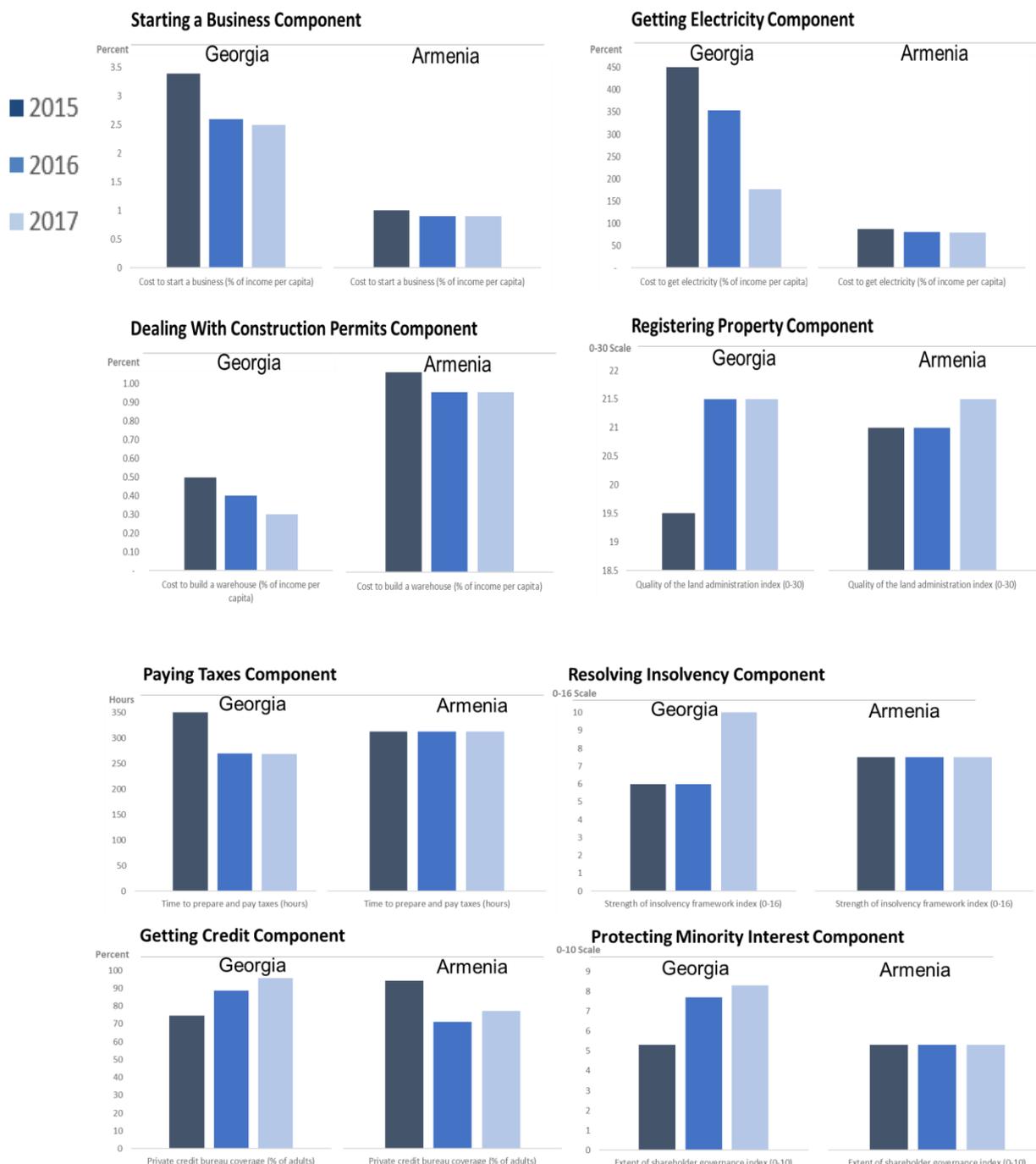
The analysis provides a clear picture of the possible areas of improvement going forward for the Armenian authorities, in order to replicate a case such as Georgia:

- constructions permits are three times more expensive (0.9% vs Georgia's 0.3%),
- duration (time required to prepare and pay) of paying taxes is 20% higher (300 hours vs Georgia's 250 hours),
- resolving insolvency is 20% more difficult (8 vs Georgia's 10),
- Armenia's eligible adults for getting credit are covered by 15% less vs Georgia's close to 95% coverage

²⁰ Due to similar geography, similar economic structure, development indicators etc (<https://www.indexmundi.com>)

- protection level for minority shareholders is 38% lower (shareholder governance index is 5) that of Georgia’s index score of 8.

Exhibit 13



Source: Doing Business, ADWISE analysis

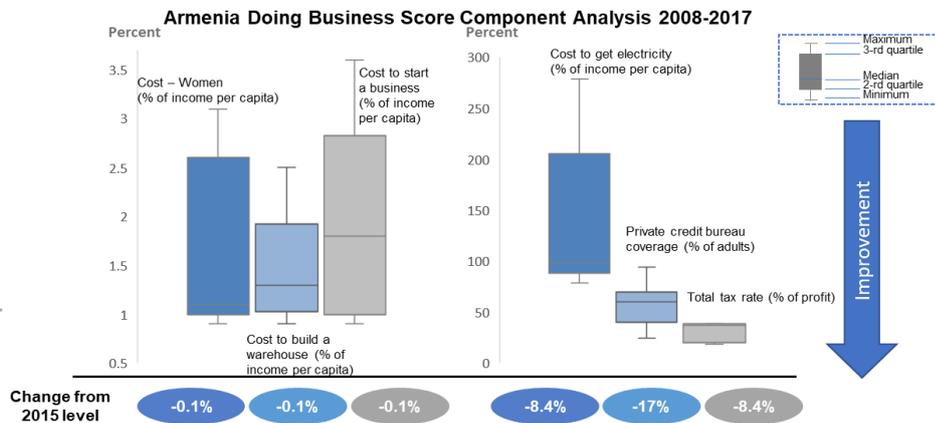
As can be seen from Exhibits 13, there has been a consistent trend of improvements over the last three years for Georgia’s components in the pillars (10 in total) of starting a business, dealing with construction permits, getting electricity, paying taxes, resolving insolvency, getting credit, resolving insolvency and protecting minority interest, whereas the same indicators for Armenia have not changed. Given the specific methodology for calculation (Distance to Frontier is very close for comparable countries) of the overall ranking done by the World Bank, a small change in any single pillar can result in the large change in the overall ranking, as can be seen in Exhibit 9, therefore this combined with no improvement in pillars has contributed to the decline for Armenia’s ranking on Doing Business in 2018.

Looking at the changes in pillars over the last 9 years, and as highlighted in Exhibit 14, components such as cost to get electricity, private bureau coverage rate and total tax rate as percentage of profits, cost for women to start a business and cost to build a warehouse in Doing Business have had large improvements. However, the changes since 2015 the level of improvement have not continued. There can be a few explanations of this trend – firstly, as the country ranking improves, incremental changes becomes even more difficult to make, and secondly, lack of enough interventions from government related entities.

To conclude, to consistently improve in rankings of Doing Business, like is the case of Georgia, Armenia needs to refocus on components highlighted in gap analysis that are underperforming those of Georgia.

Exhibit 14

There has been a wide range of changes in some key SME related components..



Source: The World Bank: Doing Business 2018

Looking Ahead

Although Armenia has made progress in developing its business environment, the issues highlighted in this section that hinder the development of a predictable and simplified business environment, need to be tackled to further increase the competitiveness of Armenian SMEs, both for fostering and growing the existing SMEs and the start-ups.

Among those issues that limit the economic competitiveness access to finance²¹, tax administration, corruption and public administration effectiveness²², human capital development²³ etc.

The benchmark analysis with Georgia has revealed some of the gaps present in the relative underperformance of Armenia's Doing Business ranking, which incorporates 10 different pillars and overall 40 components. The positive trend of improving ranking for Armenia was not maintained in 2018, and going forward targeted interventions need to be addressed as the higher the country is ranked the more difficult it is to keep improving in the rankings as the competition is very fierce (rankings are very sensitive to small changes in each pillar).

Armenia's commitment to good governance and economic reforms under CEPA (Comprehensive and Enhanced Partnership Agreement (CEPA), signed in November 2017) represents a solid basis for shaping the country's reform agenda and further enhance cooperation with the European Union, guided by the recently signed Partnership Priorities. The real impact of the new, enhanced partnership between the EU and Armenia will depend on the commitment and determination of the Armenian stakeholders to pursue political, economic and social reforms and to consolidate the common values that constitute the foundations of the EU-Armenia relationship.

A horizontal development agenda in line with the overall priorities of the government's long term sustainable development strategy needs to be enforced to make Armenia's value proposition for doing business and to compete with other economies, which are equally determined to attract FDI²⁴ and generate growth opportunities.

The risk is that Armenia's dependence on remittances will leave the economy vulnerable to external shocks, while a shrinking labour force associated with emigration makes it difficult to generate broad-based prosperity. Armenia's economic development remains constrained by geo-political and security challenges, including the blockade by two neighbours. A volatile regional geo-political context and the unresolved Nagorno-Karabakh conflict negatively impacting regional stability. However, the success of Georgia, a neighbouring country which was benchmarked in this section, highlights that positive and consistent developments could potentially also occur in Armenia.

²¹ This pillar is analyzed in Access to Finance part of the Report under Assessment of SME Strategy 2016-2018

²² This pillar is analyzed in Legal and Regulatory part of the Report under Assessment of SME Strategy 2016-2018

²³ This pillar is analyzed in Competitiveness, Innovation and Human Capital part of the Report under Assessment of SME Strategy 2016-2018

²⁴ Georgian National Investment Agency, case can be used as benchmark, as it has consistently attracted FDIs for many years (FDI data is presented in Macro Analysis part) –<https://www.investingorgia.org>

4. SME SECTOR IN ARMENIA

SMEs play an important role in facilitating the country's economic growth, creating new jobs, improving living standards, building a middle class within society and ensuring social and political stability inside the country.

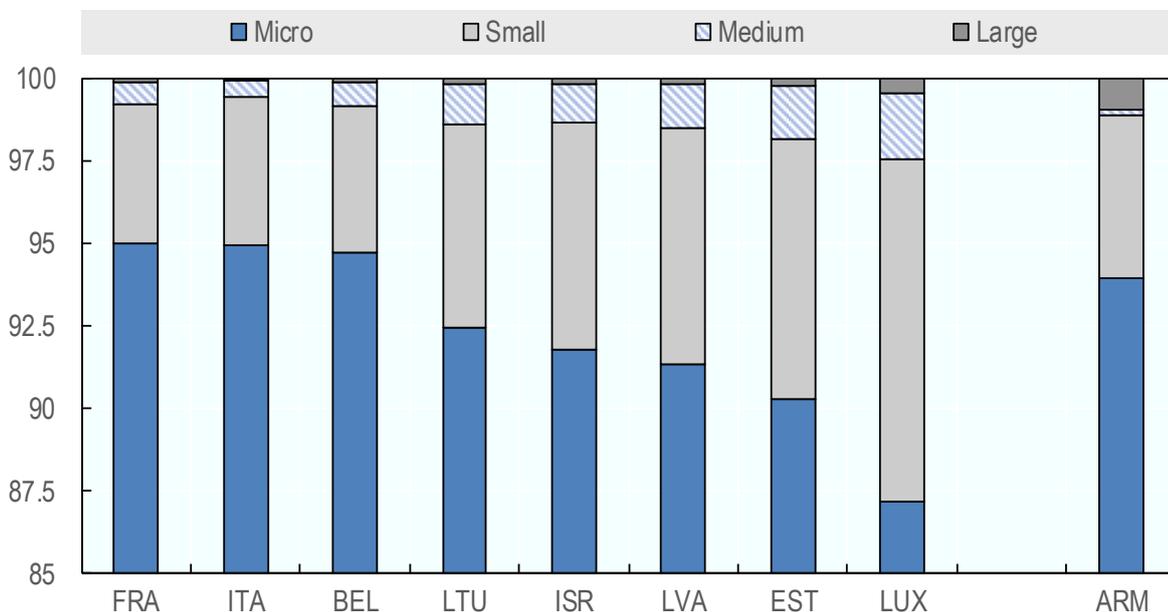
According to Law of Armenia on State Support to Small and Medium Entrepreneurship SMEs are classified according to the criteria's highlighted below in Exhibit 15.

	Employment	Annual Turnover	Balance Sheet
Micro	< 10 Employees	< AMD 100 million	< AMD 100 million
Small	< 50 Employees	< AMD 500 million	< AMD 500 million
Medium	< 250 Employees	< AMD 1 500 million	< AMD 1 000 million

Exhibit 15: Definition of micro, small and medium enterprises in Armenia

Comparing the breakdown of Armenia's enterprises to some benchmarked countries, large and small, developed and emerging one can see that the share of micro and small companies in the Armenian economy is close to that of Belarus, Italy and France, with one distinction – large organization have a larger share in the overall businesses in Armenia compared to the countries highlighted above, which have more medium size firms instead.

Exhibit 16 Share of Enterprises by Size in OECD Economies

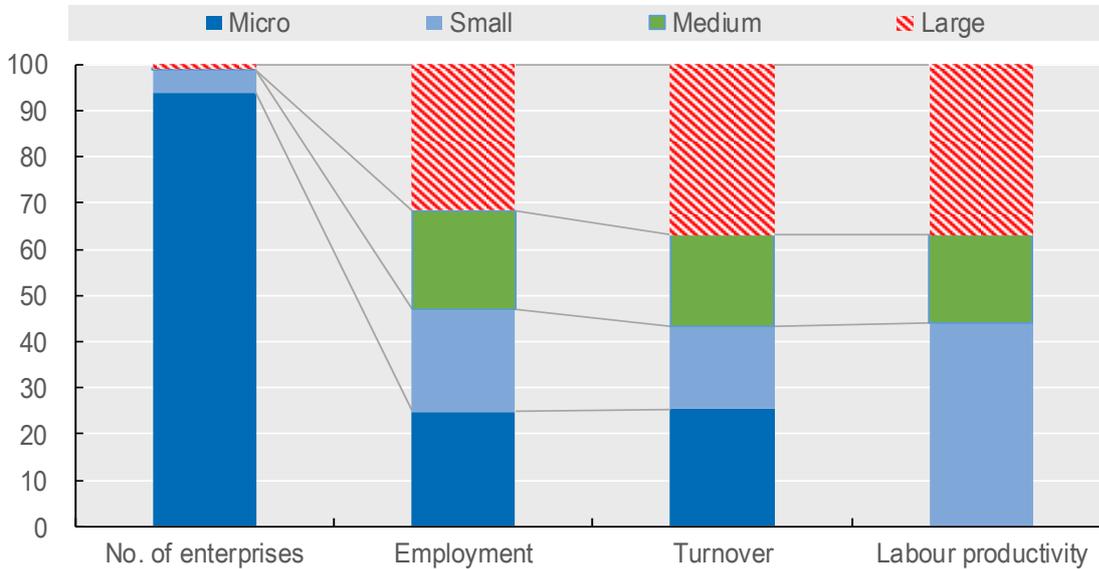


Source: OECD Compendium of SME Indicators of Armenia 2018 – Not Published as of writing

Even though Armenia's micro enterprises account for the majority of businesses in the country (Exhibit 16), their contribution to employment, turnover and labour productivity is quite low (Exhibit 17).

More than 35% of the turnover is made by the large enterprises with over 30% of the overall employment provided from them as well.

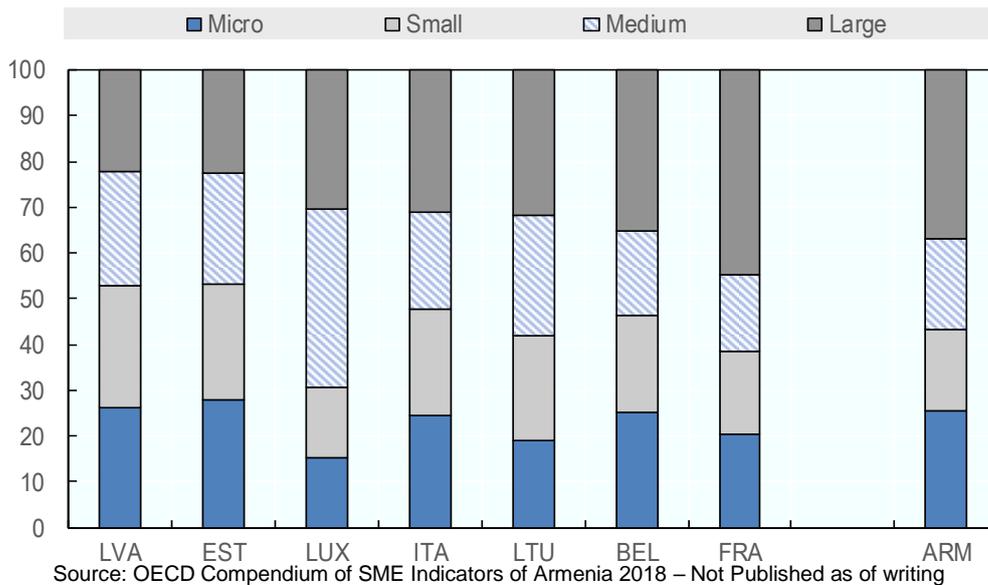
Exhibit 17 Number of Enterprises, Employment, Turnover & Production by size



Source: OECD Compendium of SME Indicators of Armenia 2018 – Not Published as of writing

Taking into account the fact that with its high share of large enterprises Armenia stands at the higher end of selected OECD economies (Exhibit 18), one can say that the statistics highlighted above should have been expected. How does this affect the competitive environment²⁵ is an important question going forward?

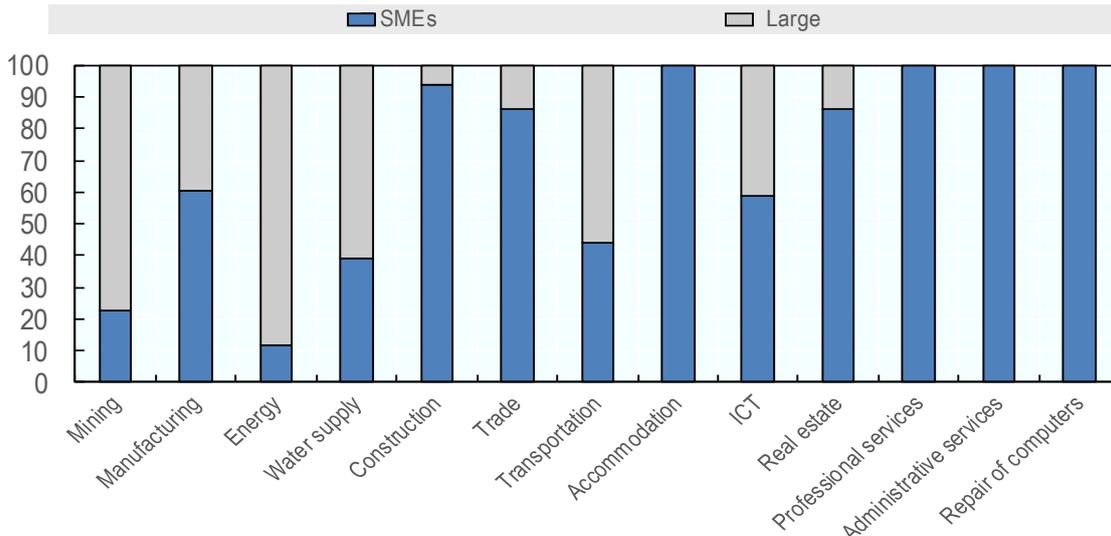
Exhibit 18 Turnover by size, Armenia vs Selected OECD countries



Source: OECD Compendium of SME Indicators of Armenia 2018 – Not Published as of writing

²⁵ Analysis is done in Business Environment section of the report

Exhibit 19 Share of employment by sector and size

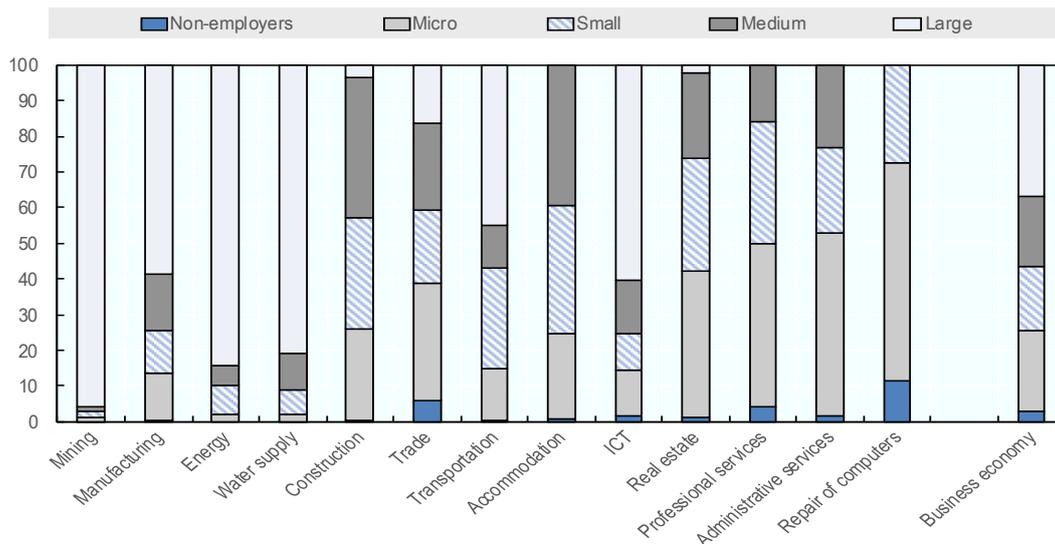


Source: OECD Compendium of SME Indicators of Armenia 2018 – Not Published as of writing

On the other hand, given the small size of Armenian economy one might even expect a relatively larger proportion from large enterprises in the economy.

The industries that are mostly dominated by large companies both in number of people employed and turnover are the capital-intensive ones, where there has been either a monopoly or oligopolistic competition (mining, energy, logistics, water supply, telecommunications) for many years. From SME point of view those sectors of the economy are not much relevant as access to finance and core capabilities developed by these players in the market is somewhat hard to compete. (Exhibit 20).

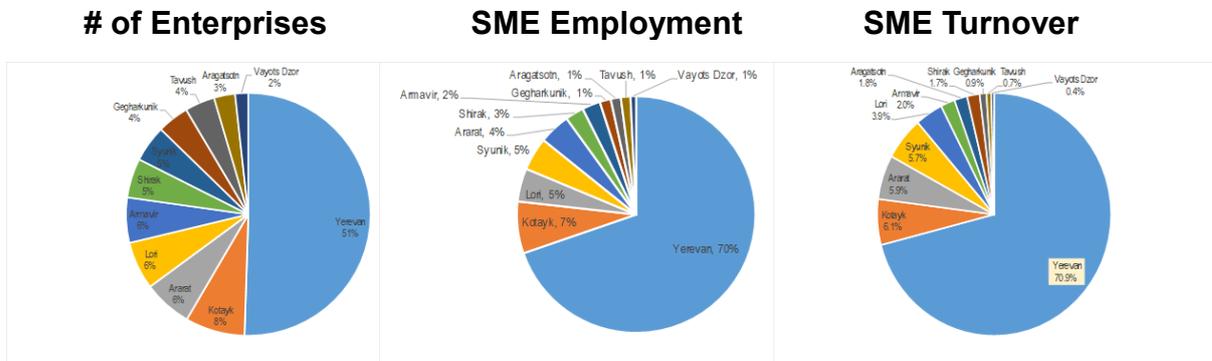
Exhibit 20 Turnover by size and industry



Source: OECD Compendium of SME Indicators of Armenia 2018 – Not Published as of writing

SMEs are heavily concentrated in Yerevan, with 70% of the turnover in the capital city. The government’s objectives²⁶ of sustainable development of the overall economy this issue needs to be tackled.

Exhibit 21

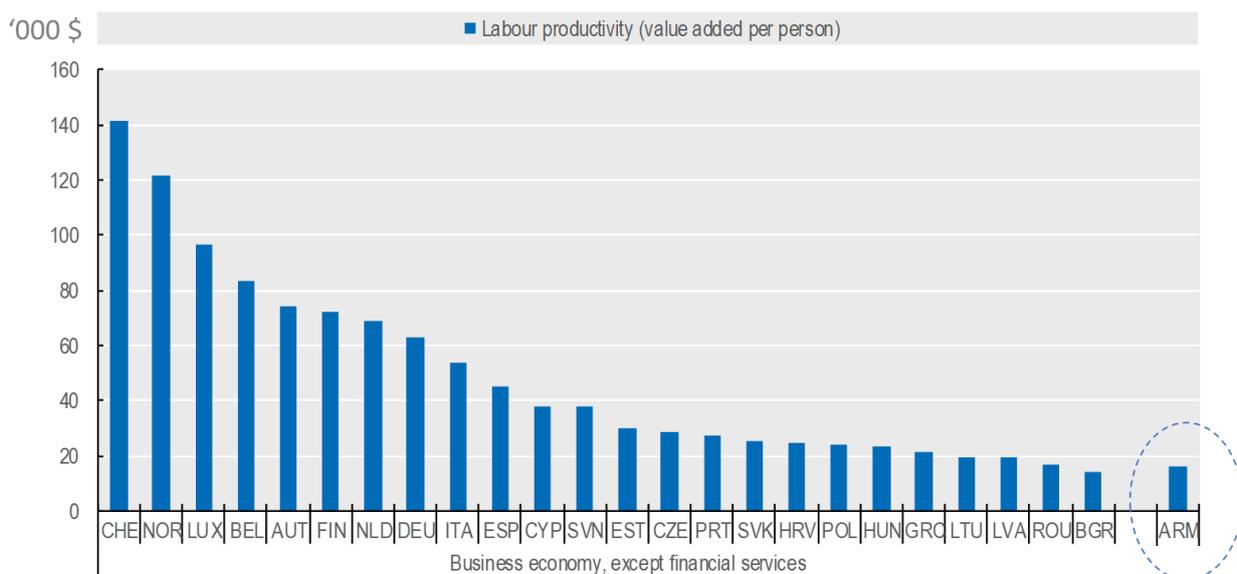


Source: OECD Compendium of SME Indicators of Armenia 2018 – Not Published as of writing

Lastly, the low productivity in the Armenian economy has been an issue for many years and continues to be an important one going forward. The labour productivity is at the low end of many eastern European countries (Exhibit 22).

Looking at industry specific productivities in Armenian economy being extra small or small (0-49 employees) makes those enterprises relatively more productive in such industries as transportation, energy, real estate as well as in professional and administrative services. This can be the result of a more agile business models for those small enterprises. In addition, medium firms have higher output per labour in accommodation sector. On the other hand, as one would expect large enterprises have advantage over SMEs in such sectors as mining, manufacturing and ICT, where

Exhibit 22

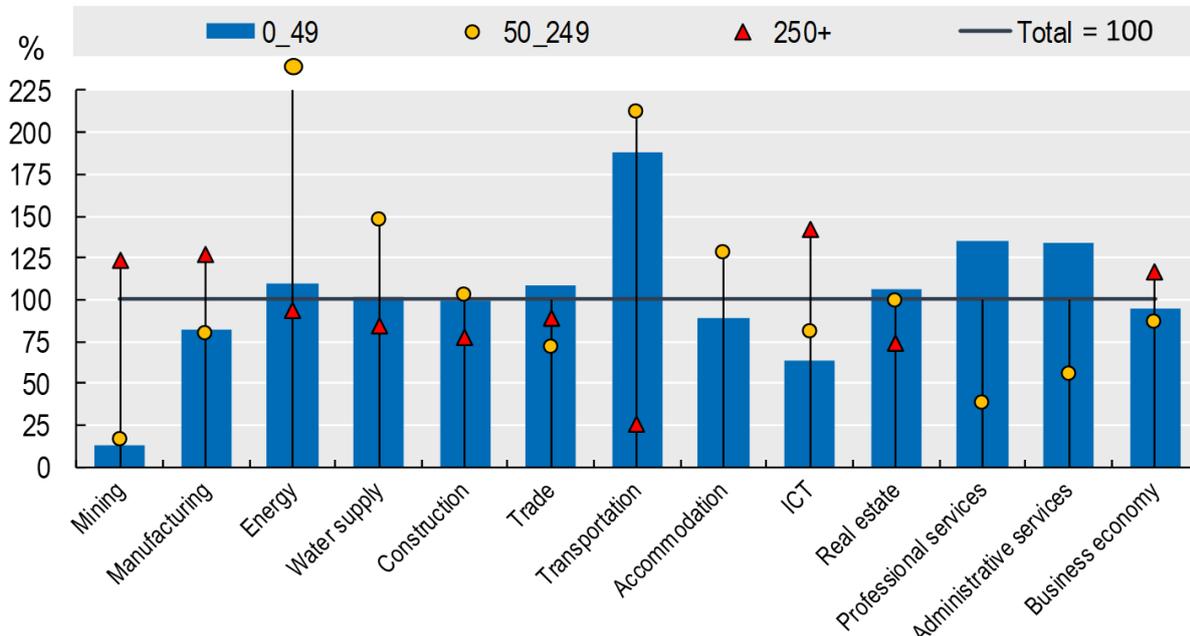


Source: OECD Compendium of SME Indicators of Armenia 2018 – Not Published as of writing

²⁶ Armenia Development Strategy 2014-2025

economies of scale, large capital investments and distinctive technologies are the driven forces in productivity levels.

Exhibit 23 Labor Productively by Industry



Source: OECD Compendium of SME Indicators of Armenia 2018 – Not Published as of writing

Key insights:

- Armenia has a higher percentage of micro and large enterprise and lower medium ones compared to OECD countries;
- Even though number of small firms are over 95% are micro and small, large ones dominate the turnovers and employment stats (~38%);
- Compared to OECD countries, Armenia has higher turnover from large ones, and lower from micro and medium ones;
- As expected traditional capital intensive and historically monopolistic/oligopolistic sectors are dominated by large companies both by turnover and employment statistics,
- Compared to OECD countries, Armenia is at the lower end of productivity, even vs the Eastern European countries. Small and Medium enterprises are more productive in such industries as transportation, energy, real estate as well as in professional and administrative services, medium firms have higher output per labour in accommodation sector and large enterprises have advantage over SMEs in such sectors as mining, manufacturing and Information, Communication and Technology (ICT).

5. ASSESSMENT OF SME STRATEGY 2016-2018



The SME Strategy 2016 – 2018 evaluation exercise conducted in the framework of the current Study was conducted in 2 stages:

- Firstly, the assessment of SME Strategy and Action Plans Design including the assessment of its structure, components, content, legal compliance as well as procedure and processes was assessed and respective recommendations were brought forward (the results are presented in the sub-chapter 5.1);
- At the next stage a pillar analysis of SME Development framework was conducted. The pillar analysis incorporating all key aspects of SME development under the following four pillars:
 - o Legal & Regulatory framework
 - o Access to finance
 - o Access to markets
 - o Innovation, competitiveness & human capital

Under each pillar the Consultant conducted desk research as well as market analysis in order to identify key issues and come up with relevant recommendations for each pillar.

5.1. ASSESSMENT OF SME STRATEGY DESIGN

Based on an in-depth review of the literature in respect to the strategy design and implementation by countries such as Ireland, Georgia, Moldova Eastern and Central European countries, as well as interviews and consultations with an international expert²⁷ specifically on the development of country SME Strategy, an SME Strategy Design Assessment Framework was prepared (see Exhibit 13) and a Gap Analysis of the Armenian SME Strategy (2016-2018) as well as respective Action Plans was prepared.

The SME Strategy Design framework suggests (see Exhibit 13) a roadmap through which it is recommendable to perform a walkthrough in order to ensure consistency and adequacy of the SME strategy.

²⁷ Dr Ricardo Pinto (Pinto Consulting GmbH and GIZ expert) was consulted on good practice in developing SME strategies and action plans in general and the framework for assessing existing SME strategies and Action Plans.

Exhibit 24 SME Strategy Design Framework

In-Depth Analysis	Mission/Vision	Strategic Objectives	Activity Measures	Monitoring & Reporting
<p>1 Macroeconomic analysis, incorporating top-down and bottom-up approaches with data driven insights.</p>	<p>4 Clear mission: e.g. to increase the competitiveness of the SME sector, providing jobs for the economic and social benefit citizens of Armenia.</p>	<p>7 Clear Strategic Objectives The strategy should contain clear objectives, serving the achievement of the mission stated in the strategy.</p>	<p>10 The Strategy should have consecutive annual action plans which will describe the steps on the implementation of the set objectives</p>	<p>13 The activities planned under the Strategy and action plans should be periodically monitored.</p>
<p>2 Business environment analysis, highlighting data-driven changes and key insights.</p>	<p>5 Clear vision which should be connected to the Mission: e.g. Increase the share of SMEs in the Value Added of Economic Growth to X%, Reduce the Poverty Rate in the strategic period to Y%</p>	<p>8 The objectives should be specific and contain quantitative and qualitative e.g. for number of job creation, number of investments, share in GDP, productivity targets by the end of the specific time period</p>	<p>11 The action plans should have Specified Key Performance Indicators (KPIs) in place in line with pre-defined objectives.</p>	<p>14 Corrective measures should be if there is misalignment in any given period in progress status of action plans.</p>
<p>3 SME sector & competitiveness analysis, including SWOT analysis.</p>	<p>6 It is recommended that the Strategy is ideally connected to the country's economic development or other overarching strategies. e.g. people-centric economic development, digitalization throughout the economy</p>	<p>9 The objectives can have sub-goals (optional)</p>	<p>12 The action plans should include resource planning, taking into account donor funding.</p>	<p>15 At least yearly mandatory reporting on specific measures of key performance indicators and their impact should be done.</p>

Source: ADWISE analysis

GAP Analysis of SME Strategy 2016-2018

Based on research on strategies already implemented by many states (Ireland, Georgia, Ukraine, Moldova, Eastern European countries) and multiples interviews with different stakeholders, including development experts with extensive experience, a GAP analysis was conducted.

Exhibit 25 SME Strategy 2016-2018 GAP Analysis

Pillar	Criteria	Inclusion	Existing Strategy Assessment	Recommendations
In-Depth Analysis	Statistical Analysis	X NO	Time series data is not included, no baseline for comparison therefore limited trends and forecasts	Detailed statistical analysis of births, deaths, GDP, value added, export, etc. Disaggregation by gender, region and sectors
	SME institutional analysis	X NO	Lack of mapping of different entities involved in the strategy, with no clear roles	The overall SME institutional framework should be detailed (incl. diagram)
	SWOT Analysis	X NO	Strengths, weakness, opportunities and threats are not analyzed, summarized and highlighted	Summary of statistical and qualitative analysis of SME sector in the form of a SWOT analysis
Mission/Vision	Vision	X NO	Explicitly vision is not included, but the Strategy highlights poverty reduction, job creation, which are overarching results.	Short vision statement encapsulating strategy – e.g. <i>For the benefits of the Armenian economy we will strive to become the most successful SME development among OECD Benchmarked countries.</i>
	Mission	X NO	The document does not explicitly state a mission. Neither there is a connecting statement made with the overall country strategy*	e.g. <i>increase the competitiveness of the SME sector, providing jobs for the economic and social benefit to citizens of Armenia</i>
Objectives and Targets	Term of the Strategy	X NO	3 years is a relatively short period for a strategy, compared with international good practice.	Good practice is 5-10 years and legal requirement (Government of Armenia Protocol Decision N. 42) in Armenia is 5 years
	Link to wider national and international policy framework	X NO	There is no link between the Armenia 2014-2025 sustainable development strategy or any other overarching strategy, although it is linked to SBA	SME strategy should be linked both to SBA and overarching economic policy framework, including the sustainable development strategy and the new economic development framework being prepared by the government
	Strategic Objectives	V YES	7 objectives are highlighted, but the scope is very wide, and with limited specificity and focus	Limited number of overall strategic objectives (ca. 5) to make the efforts more focused.
	Targets	X NO	The strategic objectives lack specific targets (quantitative indicators) e.g. creation of xx number of jobs in 2-3 year time etc.	SME specific indicators/targets need to be selected (baseline and end target) e.g. <i>net SME jobs, value added in GDP, number of women entrepreneurs, etc.</i>
Activities and Measures	Activities/Measures	V YES	Specific measures backed by analysis are not included for each strategy objective	Specific measures should be identified and prioritised based on analysis, which are further developed in the action plan (refer to Action Plan recommendations)
	Public Private Dialogue	X NO	The document does not explicitly state anything related to public-private dialogue	<i>PPD related details such as defining relative stakeholders, frequency of meetings and coordination should be stated</i>
	Inter-Ministerial Coordination	X NO	Even though SME DNC is mentioned as the main implementor of the state policy there is no description of the inter-ministerial coordination with other government related entities*	Since SME development is horizontal in nature, regular cooperation must be in place for effective decision making - check progress, resolve bottlenecks, etc.
Monitoring & Reporting	Monitoring	X NO	There is no description of process of monitoring, including the frequency, responsible parties, etc.	To ensure effective implementation (see action plan), progress needs to be monitored regularly (quarterly, bi-annually, annually)
	Reporting	X NO	There is no description of process of reporting, including the frequency, responsible parties, etc.	To ensure effective implementation (see Action Plan), the results of the monitoring should be reported regularly (quarterly, bi-annually) and sent to the respective government bodies / Parliament
	Mid Term Evaluation	X NO	There is no description of process of mid-term evaluation	To assess progress and recalibrate the action plans, there should be a midterm evaluation (e.g. if the strategy is for 10 years, then the evaluation should be done in year 5) and optimally by an independent body/evaluator
	End of Term Evaluation	X NO	There is no description of process of end-term evaluation	To assess progress and recalibrate the action plans, there should be an end of term evaluation by an independent body/evaluator

Source: ADWISE Analysis based on SME design framework suggested by Dr. Ricardo Pinto.

*Business Armenia, Export insurance Agency, Armenian Territorial Development Fund, Development and Investments Corporation of Armenia, etc.

Legal Compliance Gap Analysis

The SME Development Strategy 2016-2018 is not fully compliant with the legal requirements that existed when it was adopted and does not fully meet legal requirements currently in place.

Back in 2015 the Strategy should have complied with “Methodological guidelines for drafting concepts, strategies, projects” (“Guidelines”) adopted by the protocol decision No. 2 of the RA Government dated January 22, 2015.

As defined in the Guidelines, a strategy is a document describing in general the main directions and initiatives aimed at implementation of the targeted purposes.

Below is the analysis of the Guideline requirements which are not fully met by the Strategy:

- 1) Requirement to stipulate the **actions** to be taken and **services** to be provided is not met. The SME Development Strategy 2016-2018 does not set forth any specific actions or services, and instead merely states that the relevant actions will be determined via annual action plans. Moreover, the actions specified in the action plans for relevant years (including services to be provided) are not clearly linked to the Strategy.
- 2) Requirement to stipulate **performance indicators** is not met, as the SME Development Strategy 2016-2018 does not set forth any specific performance indicators.
- 3) Requirement to stipulate procedures for **project management, monitoring and assessment** is not met, as the Strategy is silent on such matters.
- 4) Requirement to stipulate **implementation stages, implementation timelines and expected results per each stage** is not properly met, as the Strategy only mentions vague results.

In 2017 the Guidelines have been replaced by the Government protocol decision No. 42 dated October 5, 2017, which introduced the “Methodological instruction for preparation, submission and monitoring of strategy documents affecting state revenues and immediate expenses” (hereinafter the “Instruction”).

It has been approved which sets forth general requirements to the content of strategy documents, management of preparation and submission of strategy reports, registration of strategy documents. According to the Instruction, strategy documents shall contain the description of ways, actions or measures aimed at implementation of objectives prescribed by the document, justifying the precise connection between those actions and envisaged results. The Instruction distinguishes comprehensive strategies, mid-level strategies and strategies of budgetary projects.

Below is the analysis of the Instruction requirements which are not fully met by the Strategy:

- Requirement to cover a period of **at least 5 years** is not met, as the Strategy only covers a 3-year period.
- The requirement to stipulate expected **mid-term** and **direct results** (outcomes) is not met, as the Strategy does not set forth any such results.
- The requirement to perform **monitoring** and **assessment** is not fully met, as the Strategy does not contain any performance indicators to be monitored and assessed.
- The requirement to indicate the **implementing authority** is not fully met, as the Strategy only mentions the role of the MEDI in the development of the Strategy, but not in the implementation, which shall also be specified in the strategy.

Conclusive Observations:

- The Strategy term is too short (3 years), and does not allow for mid- to long-term planning and thus can result in short-term / “quick wins” approach;
- The Objectives stated in the Strategy are many (7), broad and thus lack focus;
- The Strategy does not have any link/connection to the overarching country development framework (Sustainable Development Strategy 2014-2025) or to the Support to SME Sector Yearly Action Plans. This means that it operates in a vacuum in terms of implementation;
- The Strategy implementation mechanisms and approaches (implementing bodies, coordination, resources, etc.) are not clearly stated in the document.

GAP Analysis of SME Action Plans 2016-2018

A similar approach indicated above was applied to evaluate the yearly action plans that have been in place and implemented by SME DNC in the strategic period. The analysis is presented in Exhibit 26 below.

Overall assessment

The yearly action plans (2016, 2017 and 2018) have not been linked to 2016-2018 Strategy and have been executed in isolation from the SME strategy. The reasons among many other factors can be divided into three core issues:

1. As highlighted above the existing Strategy lacks specificity in key components (e.g. vision, mission measurable targets, etc.) of effective strategizing.
2. Based on the interviews conducted with executives of DNC, the Action Plans and respectively the activities of the SME DNC have been driven by supply side (donor funding) as opposed to the desired approach of SME Strategy and Action plans driving funding through donor coordination.
3. Lastly, the targets connected to the objectives of the Strategy should be clearly identified with quantitative data²⁸.

²⁸ As a good practice example in the case of Ireland, IDA (the development agency of Ireland) has clear numerical targets of employment, investments R&D in its five-year strategy, which are renewed, the last time being in 2015

Exhibit 26

Action Plan GAP Analysis

Criteria	Inclusion	Existing Action Plan Assessment	Recommendations
Term of the Action Plan	✓ YES	Annual Action Plans produced for 2016, 2017 and 2018 have only 1 year horizon	When the strategy is created, good practice is to have 3 - year action plan
Activities/Measures	✓ YES	Specified activities and measures highlighted in actions plans are detached from the strategy objectives and targets	Activities should be derived from the SME Strategic objectives and be specified clearly
Deadlines & Budget	✗ NO	No deadlines and budgets for specific activities mentioned	The deadlines (by quarter) should be stated, the resources needed should be specified (state, donor, IFI, other)
Responsibilities	✗ NO	Although the key implementor, SME DNC is defined, distribution of responsibilities among government related entities is not defined	The lead/responsible organisation should be stated, as well as others to be involved
Key Performance Indicators	✗ NO	Key Performance Indicators are not present	The expected KPIs should be stated, connected to the SME strategy (e.g. new law by xx date; xxx SME owners trained, etc.)

Source: ADWISE Analysis based on SME design framework suggested by Dr. Ricardo Pinto.

Exhibit 27 Sample Template for Target Monitoring

SME Target Indicators	Target (2019-2023)	Change % from 2018 Baseline
Investments(AMD)	XXX	XXX
Gross Jobs (#)	XXX	XXX
Portfolio of Companies (#)	XXX	XXX
Economic Spillovers/Expenditures (AMD)	XXX	XXX
SME Births/Startups (#)	XXX	XXX
SME Export Share (%)	XXX	XXX
SME Value Added (AMD)	XXX	XXX
SME Productivity (%)	XXX	XXX

5.2. ASSESSMENT OF SME SECTOR DEVELOPMENT FRAMEWORK

5.2.1. LEGAL & REGULATORY ENVIRONMENT

Overall Regulatory Environment and Institutional Framework

The Armenian Ministry of Economic Development and Investments (MEDI) is responsible for developing SME policy, in line with the Law on State Support of SMEs, which stipulates a broad list of the ways of government support to SMEs, namely:

- Development of a favourable regulatory framework;
- Financial and investment support, granting of guarantees;
- Promoting the creation and development of supporting infrastructure;
- Information and consulting assistance;
- Fostering exports;
- Supporting the introduction of innovative activities and modern technologies;
- Conducting a favourable tax policy;
- Human resource developments;
- Creation of simplified statistical reporting and tax accounting systems;
- Assistance within the scope of public procurement process.

According to the law, state support of SMEs shall be performed in accordance with annual SME development programmes (action plans), and the SME Development National Centre (SME DNC) is the agency responsible for implementing the annual SME development programme. While formally SME DNC is an independent agency, its *ex officio* chairperson is the Minister of Economic Development and Investments so, in essence, it is informally integrated into the MEDI.

The law does not require a mid-term SME strategy to be in place. However, the Government of Armenia Protocol Decision N. 42 dated 02.10.2017 requires that, if there is such a strategy (or any other strategy with a budgetary impact), it is to meet the following criteria:

- The Strategy shall generally cover a period of 5 years or more;
- The power to authorize the drafting and review of the belongs to the Prime Minister, upon the initiative of the functional minister(s);
- The Strategy shall stipulate at least mid-term and direct results (outcomes) expected, as well as the links between them (i.e. explain which direct outcomes are expected under each mid-term outcome, and which final objectives are served by each mid-term outcome). Each direct outcome serves as a basis for a separate budget programme;
- The implementing body should be mentioned, which generally should be the same as the body which develops the strategy (i.e. in this case the MEDI);
- Overall control of the implementation is conducted by the Strategic Planning Unit of the Government staff;

- Starting from year 2, there has to be an Annual Progress Report, and the Strategy shall stipulate the requirements towards the report;
- The budgetary impact as per direct outcomes shall be assessed.

Recommendations:

- Ensure the SME Development Strategy complies with the requirements of the Government of Armenia Protocol Decision N. 42 dated 02.10.2017 in terms of implementation period, content, reporting, monitoring and evaluation.

The 2016-2018 SME Development Strategy (SMEDS) recognized the need to make the regulatory environment predictable for SMEs in the mid-term perspective²⁹.

Frequent changes in the regulations (especially tax), vagueness/ambiguity of existing regulation, as well as low level of public consultation in relation to the drafting of regulations, are historically among the key challenges facing the SMEs (as well as business in general) in the regulatory sphere, especially in the field of tax regulations³⁰.

While the key role in remedying these issues rests with the Government, one of the key ways to overcome these challenges is improving the public consultation through increasing the engagement of SMEs in the discussions of draft regulations and policies which affect SMEs, as well as fostering the lobbying and advocacy capacities of SMEs.

It is intrinsically difficult for SMEs to individually engage in public consultation and especially lobbying and advocacy directly, mainly due to lack of appropriate mechanisms, capacities as well as resources. Thus, SME participation in public consultations is relatively low, and generally they are not satisfied with how their concerns are taken into account. According the on-line survey conducted among 131 SMEs, only 7.3% actively participate in the public consultations on draft legislation (Exhibit 28). Moreover, 79% of those who participate in the discussions consider that their proposals and concerns are not properly taken into account.

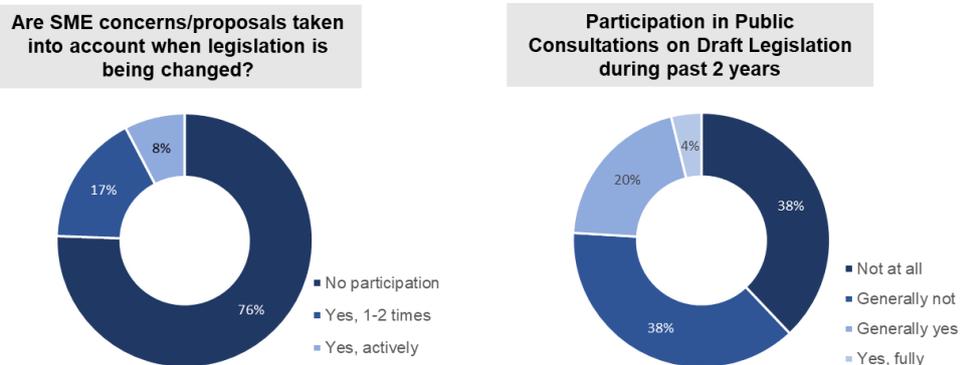
²⁹ 2016-2018 SMEDS, para. 36

³⁰ Over 1/4 of phone interviews indicate ambiguity of tax legislation as a key challenge. Tax regulations were also by far the most cited challenge in the qualitative comments of the online survey. See also European Business Association, Main Business Impediments in Armenia, Exploratory Study, September 2016, p. 8; Republican Union of Employers of Armenia, The Main Business Obstacles in Armenia, SME Situational Comprehensive Survey at Macro and Micro Levels, September 2015, p. 7; BMO Sector Study Report within the scope of the Business Membership Organisations (BMOs) Development Initiative in Armenia for GIZ SMEDA Programme, July 2017, p. 21

Online survey results on the SME satisfaction with public consultations

Exhibit 28

% of respondents*, n = 131



Source: Online survey, * Figures may not sum to 100% due to rounding

In our opinion, the key role in this regard falls on the Business Membership Organisations (BMOs) to coordinate their members' views and ensure effective lobbying and advocacy on their behalf. However, BMO representatives have also expressed dissatisfaction with the extent SME concerns are taken into account in drafting regulations³¹.

The key institutional role in facilitating the consultation aimed at fostering the overall business environment for SMEs is placed on the SME Development Council (the Council), which was established in 2011³². The Council historically included government officials, along with a few representatives of international donor organizations and local BMOs. Despite the requirement to hold quarterly meetings, Council meetings were held only 1-2 times a year (with most of the agenda items relating to taxation), and the last meeting up to date was held in July 2017³³.

On October 1st 2018 the Prime Minister of Armenia approved a new regulation for the Council, which introduced a Sub-Council (to include majority of the Council members excluding the Deputy Prime Minister and MEDI Minister) which must now meet at least monthly, and which shall include up to 7 BMO/BSO representatives on rotation basis, as well as representatives of donor international organizations with relevant projects. The new regulation introduces specific requirements and assigns responsibilities to MEDI and SME DNC for reviewing regulations affecting SMEs, and for organizing public consultations. If properly implemented, the new regulation should substantially improve the effectiveness of the Council.

In 2017 the government launched the www.e-draft.am web-platform for publication of draft regulations, which includes the option for the public to place their comments in relation to the drafts. The law requires all draft legislation to be published on the platform for at least 15 days and requires the government entity responsible for the draft to record all comments and suggestions³⁴. However, there is no requirement for the government

³¹ As per face-to-face interviews with representatives of most representative BMOs

³² Government of Armenia decision N 638-N dated 07.07.2011

³³ See: <http://www.bso.am/hy/what-we-do/assistance-to-sme-development-council/council-minutes>; according to the members of the Secretariat at the Council, absence of meetings since 2017 was due to political changes throughout most of 2018

³⁴ Government of Armenia decision 296-N dated 25.03.2010 (<http://www.arlis.am/DocumentView.aspx?DocID=109364>)

to consider, respond or provide feedback on comments from the private sector, or to justify why a specific comment has or has not been taken into account. Moreover, there are no statistics or data on how many comments are considered and/or acted upon, making it impossible to assess the efficiency of the platform.

The new SME Support Council regulation should generally allow remedying this issue through the activities of the Council, by providing for a more structured and proactive role of the Council in public consultations.

Additionally, the law provides for (but does not mandate) public discussions of the drafts via hearings, meetings discussions and other means³⁵, but in practice this does not occur systematically.

Recommendations:

- Ensure proper implementation of the new SME Development Council regulations.
- Ensure ministries consistently perform public discussions of draft regulations.

Regulatory Impact Assessment (RIA) and Simplification of Regulations

It is an international best practice to perform Regulatory Impact Assessments (RIA) to assess the impact of draft regulations on key stakeholder, including specifically SMEs. RIA is one of the factors subject to assessment within the scope of the OECD SME Policy Index.

RIA was applied in Armenia since 2011, and was expected to include cost and benefit analysis and consultations with the private sector. One of the seven assessment frameworks was the economic impact of regulations, including specifically impact on SMEs³⁶. The impact assessment should include the stages of preliminary assessment, cost and benefit analysis, and regulatory impact assessment results. Consultations with the business (including specifically SMEs) are required.

While MEDI had been sending draft legislation to main BMOs and businesses for comment and input, in practice this process has not been regularized, and the SME Development Council was not properly engaged in the process. Moreover, while on paper the cost and benefit analysis should be based on quantitative criteria, it was impossible to evidence any such analysis apart from assessment of direct budgetary impacts.

The economic impact assessment was required to focus on the possible impact on economic growth, new jobs created, investments made in general, as well as improvement of the business environments as per the WB Doing Business study and the SME development index (as per UN methodology), but there was no clear requirement

³⁵ *Ibid*

³⁶ Introduced under Government of Armenia decision 1159-N dated 15.10.2009 (<http://www.arlis.am/DocumentView.aspx?DocID=54381>)

to apply the “**think small first**” principle³⁷, as per the EC’s Small Business Act. Moreover, since the 2015 constitutional reform the above-mentioned RIA framework is no longer in force³⁸, and a new procedure for RIA is yet to be adopted. The draft RIA framework currently in circulation does require certain analysis as per the impact on the SMEs, but it is generally limited to impacts in the sphere of competition and state support, as well as social issues, and does not envisage a general economic impact assessment as per SMEs. Once again there is no clear requirement to apply the “**think small first**” principle.

During 2012-2015, a “regulatory guillotine” programme was applied for the elimination of obsolete business-related legislation and simplification of remaining legislation, which resulted in the elimination and simplification of regulations across the board. In this regard, a separate entity has been established (the “National Centre for Legislative Regulation” foundation) to make appropriate suggestions for the complete implementation of the “regulatory guillotine” programme. While the programme itself has ended, the National Centre for Legislative Regulation is still in place, and is charged with performing RIA for selected regulations (which at least includes an impact analysis on SMEs for some sectors), but formal criteria for the selection are not available. Moreover, it is not clear whether charging the Centre with a key role in the RIA process is the most effective approach, as opposed to assigning that role a dedicated structure within the Government, which could be better positioned to deal with all stakeholders in implementing the RIA.

Recommendations:

- Ensure that the new legal framework for Regulatory Impact Assessment is adopted;
- Ensure that it requires a mandatory assessment of impacts on the SMEs (SME Test) based on international good practice, including the application of the “think small first” principle, along with the use of Common Commencement dates (limited number of fixed dates when business-related legislation comes into force).
- Consider the possibility of assigning the key role in the RIA process to a dedicated structure within the Government or the MEDI.

Interaction with government services (e-government)

In addition to the e-draft platform discussed above, Armenia has developed and introduced a number of e-services, including e-filing for filing tax reports and social security contributions, e-pension, e-procurement system (for participating in public

³⁷ The “think small first” principle requires a preliminary assessment of impacts on the SMEs (involving consultations with SMEs and their representatives, and a cost-benefit analysis), as well as the use of specific provisions in legislation avoiding disproportionate burden on SMEs, and the use of Common Commencement dates - business-related legislation comes into force on a limited number of fixed dates, making life easier for SMEs

³⁸ The underlying law was replaced by a new law as a part of the constitutional reform, and the new regulations have not yet been adopted based on the new law.

procurement tenders), e-cadastre, e-register, e-filing for submitting intellectual property related applications, e-visa, e-payments (for performing payments for all state duties, state and municipal service fees, as well as fines), e-auction system for participating in auctions by the State Service for the Enforcement of Judicial Decisions. All the systems are integrated in the www.e-gov.am online portal, which provides links and access to all available e-services to the users.

The most recent functionality included on the e-gov.am platform is the possibility to submit online applications for licenses, mandatory declarations required for performing certain activities (certain types of production, import of certain goods etc.), as well as applying to receive certain qualifications (those within the purview of the MEDI). Moreover, the Government has a platform for online registration of collaterals of movable property has been introduced, a platform (www.trade.gov.am) for performing online declaration of goods for export and import procedures online via the platform situated on www.trade.gov.am website (please see more detailed information under below sections), as well as a mechanism for electronically (via e-mail) submitting statistical reports.

It should be noted that not all the e-services are functioning smoothly, the main underlying issue being lack of interoperability of different systems (e.g. e-register and the platform for online registration of collaterals, e-payments and e-filing of intellectual property related applications).

Moreover, to this date e-services (apart from e-payments) are not available for services (particularly various permits) provided by municipalities.

Recommendations:

- Ensure continuous improvement of the e-governance tools, particularly through ensuring interoperability of existing databases.
- Continue broadening scope of e-services, particularly in relation to services by municipalities.

Company registration and deregistration

Armenia stands at 15 in the ranking of 190 economies on the ease of starting a business as per the WB 2018 Doing Business report (in 2017 Armenia ranked 9th and in 2015 it was the 4th, so in comparison with 2015 data Armenia is down by 11 points in the category of ease of starting a business). This is due to the fact, that as per WB 2017 and 2018 Doing Business reports, the number of days required to register a company and the applicable procedures have significantly increased, but this is due to change of the report methodology/inputs (VAT registration and registering employees were counted in 2017 and 2018, but not in 2015, although those processes existed in 2015 and have become easier since then). Although the 2018 WB report estimates the number of days required for company registration at 4.5 days, but in practice individual founders can establish an LLC and complete all administrative steps within just 1 day.

A Ministry of Justice agency (State Registry of Legal Persons) acts as a one-stop-shop for company registration (including for the company name) and tax registration. Furthermore, the registration can be performed online (however, the online system is not fully functional yet, namely, company registration still requires a visit to the registering agency to finalize the filing and registration).

Starting from late 2016 the postal offices and branches of several banks started to act as one-stop-shops for company registration too, making this service available throughout the regions. It should be, however, noted that the processing through those one-stop-shops is significantly more time-consuming, as they cannot perform the registration on the spot.

Overall, there are no notable obstacles or challenges for SMEs for registering a business.

De-registering a company is more complicated and involves 3 administrative steps, one of them being a tax audit by the tax authorities. The duration of the process is at least 2 months and may take longer if outstanding tax obligations or unsatisfied debts are involved. At the same time, the Tax Code allows for suspending business activities with a simple written application to the tax authorities, in which case all tax and reporting obligations cease, and the company becomes moot without going through a deregistration (liquidation) process.

Recommendations:

- Ensure full functionality of the online company registration process (including acquiring the registration documents).
- Consider options for optimising the company deregistration process by simplifying and/or streamlining the tax audit.

Bankruptcy procedures and second chance

Armenia ranks 97th out of 190 economies in the “Resolving Insolvency” dimension of the World Bank Doing Business report 2018 (down by 28 points since 2015, and 19 points since 2017 – due mainly to adjustments of replies as to availability of electronic case-management tools, which do not reflect any real change in the insolvency proceedings). It has the second-best performance among EaP countries for bankruptcy time (1.9 years) and costs incurred through bankruptcy proceedings (11% of the estate’s value). However, the recovery rate for creditors is just half the OECD average (36.4% and 73% respectively) (World Bank, 2017), which is most likely due to the insolvency proceedings being wired towards sale of assets as opposed to financial rehabilitation and restructuring.

Bankruptcy procedures are governed by the Law on Bankruptcy of 2006. Separate legal frameworks are in place for banks and other financial institutions, which is however irrelevant for SMEs. The 2006 Law was extensively amended in 2016, with regulations being introduced for threatened bankruptcy (including introduction of a moratorium of

creditor claims and late payment penalties), as well as several administrative improvements in relation to bankruptcy managers. The amendments also generally remedied issues related to provision of material information to creditors.

Recent judicial reforms have allowed for the introduction a specialized bankruptcy court with the view of improving court proceedings in bankruptcy cases, however, it will only begin operating in 2019.

Despite the implemented reforms the bankruptcy framework is still geared towards liquidation with a sale of assets, as opposed to recovery (financial rehabilitation and resuming operations). Namely, the legal framework does not incentivize bankruptcy managers to aim for recovery, but rather to pursue sale of assets, resulting in eventual liquidation of the insolvent business. Particularly, the Republic of Armenia Law on Bankruptcy currently in force provides for potentially larger remuneration for the bankruptcy manager when the insolvency results in a sale of assets as opposed to the recovery. Moreover, the remuneration for the sale of assets is particularly large when the amounts recovered are relatively small, thus making sale of assets preferable in the case of SMEs. Other issues identified in past assessments (namely the OECD 2015 SBA assessment) include lack of incentives for post-petition financing, lack of early-warning systems to identify financially distressed companies, and absence of regulations and platforms for dealing with cross-border insolvency cases. The latter issue was partially remedied by the new Civil Procedure Code, which introduced a requirement for recognizing foreign judgments in civil cases based on the principle of reciprocity, which substantially increases the potential for recognizing foreign bankruptcy judgements in Armenia.

Recently extensive legislative amendments to the Republic of Armenia Law on Bankruptcy have been initiated introducing a wide scope of improvements to the existing regulations. The draft amendments are aimed, among other things, at incentivizing bankruptcy managers towards financial recovery, by ensuring relatively higher remuneration in case of recovery as opposed to sale of assets and bankruptcy. Moreover, the bankruptcy manager is guaranteed an additional bonus for speedy recovery. The draft law has not been adopted by the National Assembly of the Republic of Armenia yet. However, given the fact that the bankruptcy management system has been favouring sale of assets over recovery, merely introducing financial incentives may prove insufficient, and capacity and skills of bankruptcy managers need to be assessed, and potentially capacity building measures (e.g. training of bankruptcy managers) might be necessary.

Recommendations:

- Ensure the planned amendments to the Republic of Armenia Law on Bankruptcy (aimed at incentivizing bankruptcy managers towards financial recovery) are adopted.

- Assess the needs for capacity building among bankruptcy managers as per implementing financial recovery, implement capacity binding measures as needed.

Social Entrepreneurship

Currently there are no tailor-made Social Enterprise legal forms in place in Armenia, and more generally there is no legal framework for social entrepreneurship in Armenia.

There are several regulations which potentially benefit *de facto* social enterprises:

- Donations received by Non-Profit Organisations are tax exempt, as are donations made by such organizations to individual beneficiaries;
- There is an allowance to deduct 150% of remuneration paid to handicapped employees from corporate income tax (profit tax or CIT), potentially incentivizing inclusion. It is however not likely to benefit many social enterprises, as they are likely to be relatively small enterprises which use the turnover tax taxation regime and do not pay CIT;
- There is an allowance to deduct charity expenses from CIT, capped at 0.25% of the revenue. As with the previous allowance, it is not likely to benefit many social enterprises, as they are likely to be relatively small enterprises which use the turnover tax taxation regime and do not pay CIT;
- Non-Profit Organisations are allowed to establish commercial subsidiaries;
- Starting from 2017 amendments to the NGO regulations allowed NGOs to engage in business activities (with the profits to be used for their charter non-commercial purposes).

At the same time the ability for NGO to engage in business activities does not create clear benefits for social entrepreneurship, since NGOs engaging in such activities fall under the general taxation framework as per their business activities (i.e. effectively have to pay VAT and CIT on their commercial activities), and moreover are effectively forced to conduct two-tier accounting – 1 for non-profit and 1 for commercial activities, which implies higher compliance costs as compared to business entities and pure non-profits.

While there is no generally supported approach as to whether to provide special tax exemptions to businesses operating as social enterprises or else to establish separate organizational forms for social enterprises, it is clear that the current framework does not incentivize social entrepreneurship, and introduction of such incentives should be considered (including by introducing mechanism for micro and small enterprises to benefit from benefits analogous to the existing inclusion and charity related CIT deduction allowances).

Recommendations:

- Consider defining the social entrepreneurship and introduction of tax incentives or special tax regimes for social entrepreneurship.

Customs Issues

Armenia joined the Eurasian Economic Union (EAEU) in 2014, which eased import and export formalities with Russia and other EAEU countries. At the same time Armenia is a beneficiary of the GSP+ scheme³⁹, and since 2018 benefits from the REX system⁴⁰. However, even the GSP+ system is still not fully utilized, while the REX system is highly under-utilized, with only 21 companies having registered as of mid-September 2018⁴¹. The main issue appears to be lack of awareness among businesses, which results in them missing out on an opportunity to save time and minimize costs.

In 2017 Armenia introduced electronic filing for customs declarations (via www.trade.gov.am), allowing importers and exporters (upon registering with the customs authorities) to file declarations and supporting documents remotely⁴². This system establishes strict deadlines and allows for process tracking, thus minimizing the time needed for customs clearance procedures. Although there is no official statistics on how many businesses use the electronic declaration system, continuing concerns from SMEs and qualitative feedback indicate that many businesses are not aware of this system.

Overall Armenia has significantly improved its *Trading Across Borders* ranking (up from 110th in 2015 to 52nd in 2018), mainly by cutting down time to import. The online survey shows customs administration still remains a source of concern for SMEs (Exhibit 29), however, this can at least partially be attributed to low awareness of the improvements mentioned above.

It should be noted that there have been no significant improvements as to the time to export as per the WB Doing Business report, but lack of detailed comments makes analysing the causes difficult.

³⁹ The GSP+ is an advanced option of the Generalised Scheme of Preferences, which grants economically vulnerable countries (including Armenia) particularly large exemptions from import duties for import to the EU, on the condition the respective countries adhere to key international agreements on human rights, environment and good governance

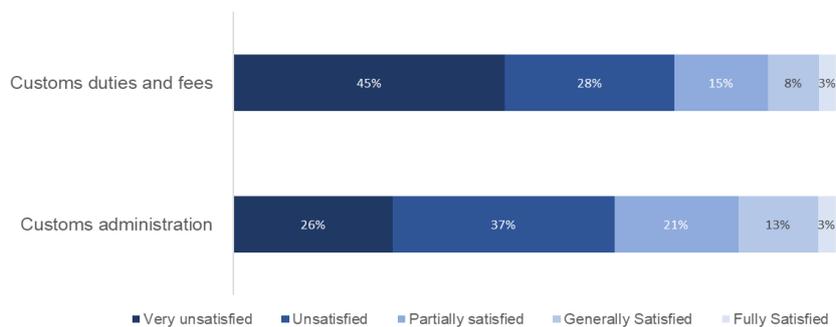
⁴⁰ The Registered Exporter System allows exporters (including Armenian ones) to benefit from GSP+ benefits without acquiring certificates of origin for each shipment, by simply registering in the REX system once (which is generally quicker, and unlike the certificates of origin implies no costs).

⁴¹ As per data provided by MEDI

⁴² Government of Armenia No. 546-N dated 30.03.2017

Online survey results on the SME satisfaction with customs-related factors (impacts)

Exhibit 29 % of respondents*, n = 131



Source: Online Survey, * Figures may not sum to 100% due to rounding, respondents who answered "no exposure" are not shown

While generally exports procedures pose fewer issues than imports, exports of agricultural products are susceptible to negative impacts resulting from the duration of required phytosanitary inspections, which increases proportionally to the assortment of goods being exported by the given business. With the recent trend being towards the increase of such exports by SMEs,⁴³ this could prove an obstacle to development, however the inspections cannot be phased out, and the process length is dictated by objective factors. Nevertheless, adequacy of the inspection capacity should be monitored to avoid creating unjustified delays during high season (summer months), and potentially capacities for phytosanitary inspections should be introduced in the regions (especially those further away from the Georgian border), to allow for pre-export inspections.

Armenian law allows for the creation of *Free Economic Zones*, with 2 such zones having been established only within the last year in regions of Armenia (Meghri and Hrazdan), in addition to the 2 zones already operating in Yerevan. The entities operating the Free Economic Zones are exempt from VAT, corporate income tax and property tax, which creates a highly favourable legal framework for export-oriented businesses.

Two of the zones (one in Yerevan and one in Hrazdan) are focused on IT and innovative technologies, one (located in Yerevan) is focused on gold products, and the last one located in Meghri on the border with Iran is focused on agriculture, manufacturing, electricity supply, trade, transportation and economy storage, professional and technical activities, culture, tourism, entertainment and rest. In essence all the zones can potentially be used by export-oriented SMEs.

Recommendations:

- Consider targeted support to SME development in regional free economic zones.

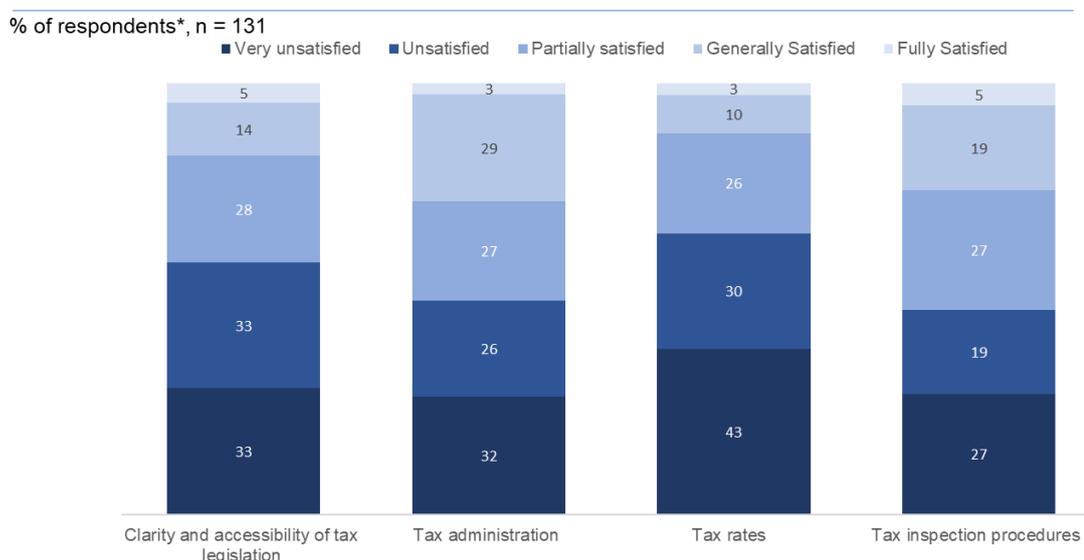
⁴³ No official statistics available, information collected during the face-to-face interview with the head of the State Service for Food Safety as well as SME representatives

- Increase awareness among SMEs (e.g. via advertisement campaigns) on opportunities within EAEU, GSP+, REX, as well as optimal application of customs procedures
- Introduce capacities for phytosanitary inspections in the regions (especially those further away from the Georgian border).

Tax Regulations and Administration

Frequent changes in the tax regulations and ambiguity of the existing regulations, along with tax administration, remain among key problems for business⁴⁴ (Exhibit 30).

Exhibit 30 **Online survey results on the SME satisfaction with tax-related factors (impacts)**



Source: Online survey, * Figures may not sum to 100% due to rounding, respondents who answered "no exposure" are not shown

The introduction of the Tax Code in 2017 has partially remedied the ambiguity issue, however, regular changes continue to persist. Within less than 2 years since entry into force, the Tax Code has been already amended 10 times, including 2 major sets of amendments in December 2017 and June 2018, both of which entered into force within just 10 days from adoption. This has major implications for compliance, especially for smaller firms which typically do not have lawyers and accountants to help them.

⁴⁴ Over 1/4 of phone interviews indicate ambiguity of tax legislation as a key challenge. Tax regulations were also by far the most cited challenge in the comments from online survey as well as face-to-face interviews. See also European Business Association, Main Business Impediments in Armenia, Exploratory Study, September 2016, p. 8; Republican Union of Employers of Armenia, The Main Business Obstacles in Armenia, SME Situational Comprehensive Survey at Macro and Micro Levels, September 2015, p. 7; BMO Sector Study Report within the scope of the Business Membership Organisations (BMOs) Development Initiative in Armenia for GIZ SMEDA Programme, July 2017, p. 21

Recommendations:

- Ensure effective use of the SME test for all amendments in tax regulations;
- Ensure longer periods for substantial changes in tax regulation to come into effect;
- Implement ongoing awareness-raising campaigns on tax legislation and administration especially during the transition.

Regarding tax administration – the introduction and gradual improvements in the online invoicing and reporting systems should be noted. A significant recent improvement is the automated pulling of input data in the turnover tax reports, but in practice the input is in most cases inaccurate, making businesses unable to rely on it⁴⁵.

Recommendations:

- Continue improvements of electronic tools for tax reporting.

At the same time taxation of SME remains complex, with 4 different tax regimes⁴⁶ involving 9 types of taxes⁴⁷, not to mention mandatory social payments, which are generally perceived as a form of taxation, and also several industry specific permit-related payments, which too are often perceived as analogous to taxes⁴⁸. Moreover, although 2 of the existing tax regimes (such as the turnover tax and family enterprise taxation regimes) are intended specifically to simplify the tax accounting and administration (and in some cases also the overall tax burden) for SMEs, in practice they both are subject to relatively small turnover limits (the limit is currently approximately 115 mln AMD for turnover tax, which is set to decrease by about 50% from 2019, and approximately 18 mln AMD for family enterprises), and thus in essence only apply to micro businesses.

On the up side it should be mentioned that the scope of services in relation to tax administration available electronically had been increasing, and substantial progress has been made in relation to VAT returns⁴⁹.

⁴⁵ Confirmed via brief phone-interviews have been conducted with several leading tax advisory managers (including 2 Big4 companies).

⁴⁶ General taxation regime (the business pays VAT and CIT), turnover taxation regime (with a fixed tax on turnover substituting for VAT and CIT), patent tax regime (with a fixed-fee tax substituting for VAT and CIT, mandatory for a defined sets of activities), and family enterprise taxation (relieved of almost all taxes)

⁴⁷ VAT, excise tax, profit tax (CIT), income tax, environmental tax, road tax, turnover tax, patent tax.

⁴⁸ For example: quarterly duties for restaurants and other food-service providers, or quarterly duties for alcohol and tobacco sales.

⁴⁹ Brief phone-interviews have been conducted with several leading tax advisory managers (including 2 Big4 companies), who confirmed significant improvements and lack of serious issues, provided VAT returns are filed regularly (filing returns infrequently results in the need for complicated adjustments and a large scope of review by the tax authorities)

Recommendations:

- Move towards making simplified taxation schemes (turnover tax or similar) available to small and medium enterprises.

Another important issue (particularly considering the large share of agriculture in the overall GDP structure) is that the current tax treatment of agriculture disincentivizes centralization of farming, formalization of the sector and formation of agricultural cooperatives. Namely, individuals producing agricultural produce are exempt from all taxes, while companies and individual entrepreneurs engaged in the same activities are subject to VAT for turnover in excess of approximately 58.35 mln AMD, which, with the VAT rate of 20%, places them at a relative disadvantage against small individual producers, and largely cancels out the benefits that can be achieved through economies of scale (in essence, the significance of the VAT impact means only significant economies of scale can set it off, in essence meaning only relatively large businesses can benefit thereof). While certain tax planning (for example, cooperatives selling members' produce on commission, rather than reselling on their own behalf) can be used to mitigate this disadvantage, in practice those are relatively complex and require input of professional services (tax and legal), to which the potential cooperative members normally have no access.

Recommendations:

- Consider awareness raising and professional services (tax and legal) to agricultural cooperatives, to allow them to structure their activities in a tax-efficient manner (for example, perform on-commission sales of member produce).

Rule of law and the justice system

Armenia's rankings per rule of law have been improving, with Armenia advancing from 111th place among 193 jurisdictions in 2015 to 92nd in 2017. Armenia now ranks second-best among the six EaP countries.

As per the Transparency International index on perception of corruption Armenia's score remained stable from 2015 to 2017 at 35, but Armenia's rank has dropped from 95th to 107th place among 180 countries during the same period (again the second best among EaP countries). It should be noted that the strong anti-corruption measures following the "Velvet" revolution in May 2018 are not yet factored in any such assessment.

There have also been improvements in the court system. A 2016 survey within the scope of the EU's "Justice Monitoring" Project identified a gradual increase in the predictability of court decisions for the lawyers and individuals dealing with courts (mainly due to the increasing case-law of the Court of Cassation and improving adherence to the case-law of the European Court of Human Rights), but a significant degree of unpredictability

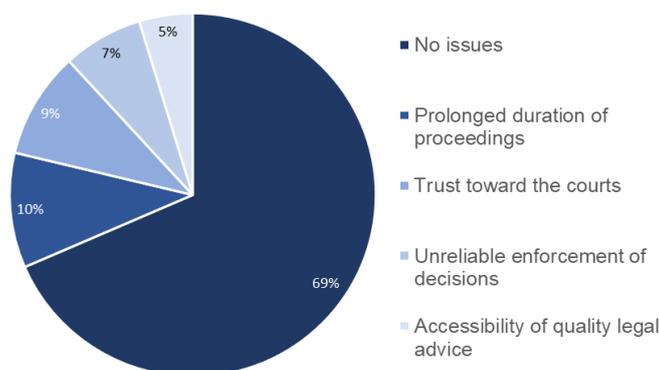
remained, mainly due to factors such as corruption, lack of objectivity, ambiguity and flexibility of legislation⁵⁰.

The same survey has identified issues with independence of judges, which have been partially remedied by the 2015 constitutional reform, which however did not result in significant changes among the appointed judges, thus leaving previously non-independent judges in office⁵¹.

Another issue identified by the “Justice Monitoring” Project survey is that of public trust towards courts. The trust among the general public is substantially lower than among legal professionals, which could be indicative of lack of awareness about improvements among the general public, in addition to possible objective reasons for low trust. Both indicate a need for increase of publicity, transparency of judicial procedures, better access to judicial acts, and increase in legal awareness⁵².

Exhibit 31 Online survey responses on issues related to judicial procedures

% of respondents*, n = 131



Source: Online survey, * Figures may not sum to 100% due to rounding, respondents who answered “no exposure” are not shown

Generally, the duration of court proceedings in Armenia is reasonable (570 days as per WB DB report 2018, compared to the 490 days average for Europe & Central Asia). Proceedings in administrative courts (handling administration-related disputes between businesses and government agencies) are particularly reasonable, however the excessive case burden in the Administrative Court of Appeals currently results in a gap of over 1.5 years between the appeal and the first appeal hearing, indicating a clear need to increasing the capacity of the court.

Armenian legislation has been recently amended to introduce mediation proceedings for civil disputes (which can only be mandated by the court in very limited cases, but otherwise remain purely voluntary), and the arbitration legislation has been substantially amended in 2016 to strengthen this channel of alternative dispute resolution.

However, apart from the financial arbitration (established by the Union of Banks and relatively often used by financial institutions in disputes with their clients), the use of

⁵⁰ Peoples’ Justice Needs and Expectations in Armenia, Monitoring Report, 2017, pp.64-71

⁵¹ *Ibid* pp. 30-36

⁵² *Ibid* pp. 90-100

mediation and arbitration in Armenia is underdeveloped, with mediation being mainly limited to marital and inheritance cases, and hardly any business disputes. While there are no surveys regarding the reasons for this, our experience combined with interviews with practitioners in the area of arbitration and mediation identified among the main reasons the lack of awareness among SMEs (for mediation), gaps of the legislation (the most serious issue being impossibility to enforce injunctions imposed by arbitral tribunals) and lack of reputable arbitration tribunals (for arbitration), which normally are formed around the chambers of commerce and industry.

Recommendations:

- Consider options for awareness raising on alternative dispute resolution (arbitration and mediation).
- Improve the legal framework for arbitration, particularly by ensuring enforcement of injunctions.
- Consider possibility of capacity building for arbitration, possibly within the framework of the ArmCCI.

Protection of FDI

While generally FDI-related regulations are a key issue for Multi-National Corporations, rather than SMEs, in the case of Armenia there appears to be potential for small and medium size investments from the Armenian diaspora, which makes FDI protection relevant for SMEs.

Foreign investments are currently protected in Armenia by the Law on Foreign Investments, which establishes a national treatment regime (i.e. treatment on par with the treatment for local investors) for all foreign investors, protects the foreign investment against nationalization, guarantees compensation for damages caused by the State, guarantees freedom to repatriate profits, and contains a “grandfather” clause, which grants the foreign investor protection from any unfavourable regulatory changes within 5 years following the investment (which is a relatively short period considering FDIs are often long-term endeavours).

There is a pending draft by MEDI for amending the Law on Foreign Investments. These amendments effectively rewrite the existing regulation in its entirety. Based on the current draft published on the official MEDI website (<http://www.mineconomy.am>), the draft introduces many significant improvements in line with international best practices⁵³.

However, the draft removes the “grandfather” clause, which has been effectively used by foreign investors to protect their investment.

⁵³ Such as introducing principles of most favoured nation treatment, fair and equitable treatment of foreign investors, and the minimum standard requirement, introducing the possibility of arbitration.

Recommendations:

- Consider retaining the grandfather clause in the new FDI law, potentially extending its protection beyond 5 years.

Public Procurement

New public procurement regulations (a new Law on State Purchases) have been adopted in 2017. The current regulation does contain certain developments which work better for the SMEs. The law allows for the tenders to be divided into lots (which increases the opportunities for small/specialized businesses to participate in tenders for specific lots) and minimizes the options for direct procurement (i.e. procurement without a tender). Information on public procurement opportunities is openly available and free of charge. Moreover, once the business registers in the public procurement portal, it starts receiving e-mail notifications on all tenders fitting its registered profile. The new law introduces requirements for the tender appeals to be heard by an impartial and independent authority.

The main criterion for awarding tenders remains the lowest price only. Combination of lowest price and non-price criteria (e.g. value for money) can be used, but there is no specific guidance/procedure for introducing and evaluating such non-price criteria (which makes the use of such method unlikely), and they are not required to relate to the actual value of the products/services.

Provisions benefiting SMEs include the exemption from qualification requirements for tenders under 5 million AMD. The down side is that the regulations require the tender participants to submit a bank guarantee or a cash guarantee in the size of 10% of the contract upon being awarded the contract, which is retained until full performance of the contract. Data collected during face-to-face interviews with SMEs and BMO representatives indicate that this requirement acts as a significant deterrent for SMEs. Not only does it represent an extra cost, in the case of long-term (e.g. 1 year) contracts, smaller firms are often unable to freeze the corresponding amount of funds for the whole duration of a contract. Accordingly, it is advisable to consider exemptions or alternative solutions (e.g. assistance in acquiring bank guarantees).

Recommendations:

- Ensure the application of value-for-money evaluations in awarding contracts during public procurement.
- Consider removing or easing the guarantee/deposit requirements for SMEs during bidding/contracting.

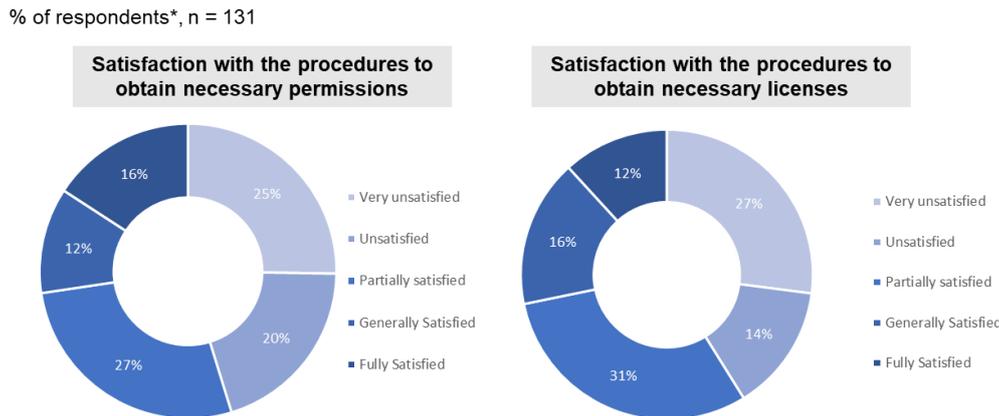
Licenses and permits

Generally, the number of activities requiring licensing in Armenia has been reduced (mainly within the scope of the Regulatory Guillotine programme), and currently mainly includes activities directly involving safety or other high areas of risk (namely, specific activities related to explosives and weapons, pharmaceuticals and medical care, FX trade, financial institutions, energy sector, education, communications, nuclear energy, hazardous waste, gambling, public transport, construction), as well as import/export of certain categories of goods as per EAEU regulations. Electronic filing for licenses is available on the e-gov.am platform, facilitating the process.

For several activities in the field of agriculture and trade licensing has been replaced by unilateral declarations (notifications) by the business (which exclude any waiting periods and administrative procedures), also available on the e-gov.am platform.

Administration of other permits relevant to SMEs (mainly permits issued by municipal authorities in relation to trade, advertising, hospitality, etc.) remains paper-based. There is room for improvement through introducing e-services for acquiring such permits.

Exhibit 32 **Online survey responses on the SME satisfaction with licensing and permit procedures**



Source: Online survey, * Figures may not sum to 100% due to rounding, respondents who answered "no exposure" are not shown

Construction permits remain relatively burdensome. While the overall system has been optimized and requirements towards low risk construction have been reduced, construction permits are still required not only for full-scale construction, but even for internal remodelling which does not anyhow affect structural strength of buildings. As a result, businesses most often proceed with such works without permits, against the risk of administrative penalties.

Recommendations:

- Further streamline acquisition of various permits by making e-filing available for municipally administered permits.

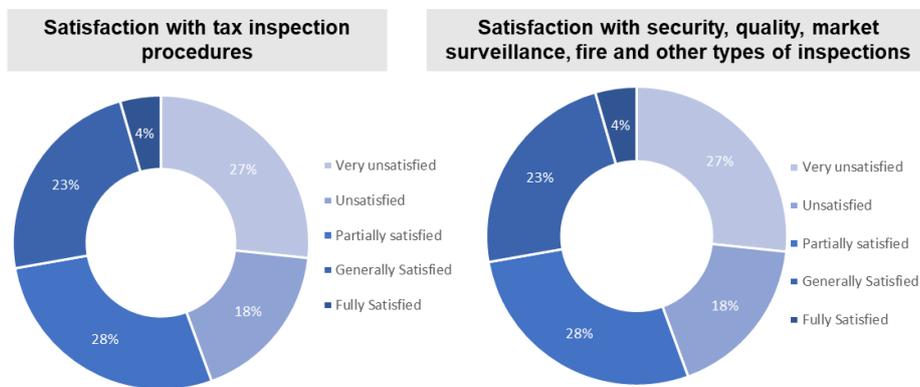
- Consider removing or further easing the construction permit requirements for internal remodelling which does not affect structural strength of buildings.

Inspections

While in general several dozen agencies are authorized to conduct inspections of businesses, the inspections most frequently facing SMEs are, first of all, inspections by the tax authorities, and also inspections by food safety, market control, fire safety and sanitary inspections, as well as several other sector-specific inspections, which generally are a burden for SMEs (Exhibit 33).

Exhibit 33 **Online survey responses on the SME satisfaction with inspection procedures**

% of respondents*, n = 131



Source: Online survey, * Figures may not sum to 100% due to rounding, respondents who answered "no exposure" are not shown

A risk-based approach is mandated for the selection of businesses to be inspected (with narrow exceptions for several subject matters, where inspections can be based on *ad hoc* indicators). The law on Organizing and Conducting Inspections mandates that no less than 75% of the inspections are in high-risk enterprises, and no more than 5% are in low-risk ones. Risk assessment factors vary greatly from one area to another, but in terms of targeting SMEs those are either neutral (i.e. it is neither more nor less likely for SMEs to be characterized as high risk), or are favourable towards SMEs (smaller size, operations and personnel of the SMEs make them less likely to be characterized as high risk).

Recommendations:

- Consider revising inspection risk-assessment methodologies to ensure inspections of SMEs are minimized, particularly by setting different risk thresholds for SMEs.

Standards and technical regulation

Between 2014 and 2016 Armenia has become gradually integrated into the technical regulations framework of the EAEU, and currently majority of technical standards applied in Armenia are EAEU standards. While overall the number of technical regulations has increased (there are around 40 new technical regulations within the framework of the EAEU, approximately half of them regulating areas previously not regulated by local technical regulations), the administrative burden of compliance has decreased, since for most products the technical certification and registration requirements (which involved costs and administrative procedures) have been replaced by voluntary self-declaration. Face-to-face interviews with regulators, SMEs and BMO representatives indicate that the down-side of this deregulation is decreased incentives for businesses to comply with quality standards, which in the long-run may create compliance and reputational risks.

Recommendations:

- Consider options to strengthen product quality control without undue administrative burdens.
- Increase awareness of SMEs regarding the technical and related regulations.

Labour market regulations

Generally, the labour code and related regulations are socially oriented and excessively burdensome in terms of compliance, especially for SMEs. The key issues include complex regulations pertaining to benefits, excessive documentation requirements and limited options for termination of labour contracts.

Regulations relating to benefits (supplementary payments, additional vacations, shortened working time, early retirement, etc.) for certain professions include a total of 4 lists of works (containing several thousand of positions/professions, which are not synchronized between the lists), which makes it excessively difficult to assess whether a given employee is entitled to a given benefit.

Documentation requirements require a business to have internal regulations pertaining to often superficial issues (such as payment of salaries, rights and obligations of employees, retention and termination procedures – all of which are sufficiently regulated by the law), adopt and notify individual orders on essentially operational issues (e.g. each case of vacation and overtime).

The most challenging issue is, however, termination of employees. Termination without cause by the employer is not allowed (except for a 3-month probation period), at the same time the legislation significantly limits the ability of employers to hire employees under fixed-term contracts, requiring indefinite term employments contracts as the default. The causes for termination are furthermore limited, effectively preventing

termination in several cases when there is good cause for termination,⁵⁴ and sometimes excessively difficult to implement.

Recommendations:

- Amend the employment regulations to reduce compliance requirements at least for SMEs;
- Allow reasonable termination options for employers with the focus on SMEs.

Summary

As can be seen from the preceding analysis, many aspects of the Policy and Regulatory frameworks have been changing, incorporating simplification and therefore a better environment for SMEs for doing business, while others (such as unpredictability of Tax & Customs Administration, rule of law, factors affecting second chance (bankruptcy) for SMEs, rigid labour regulations, as well as absence of specific requirements (term, targets, monitoring, etc.) from the Armenian law on 2016-2018 SME strategy), continue to have a negative impact⁵⁵ on SMEs operating in the country. Going forward, the specific issues highlighted with relevant recommendations should be tackled, to increase the competitiveness of Armenian enterprises in general, especially the SMEs.

⁵⁴ For example, there is no option to immediately terminate an employee for misconducts such as harassment, causing reputational damage to the employer, misuse of company resources short of theft, gross negligence endangering human life, or even alleged crimes other than theft of company property.

⁵⁵ ADWISE's desk research highlighted in this section compared to in-depth interviews.

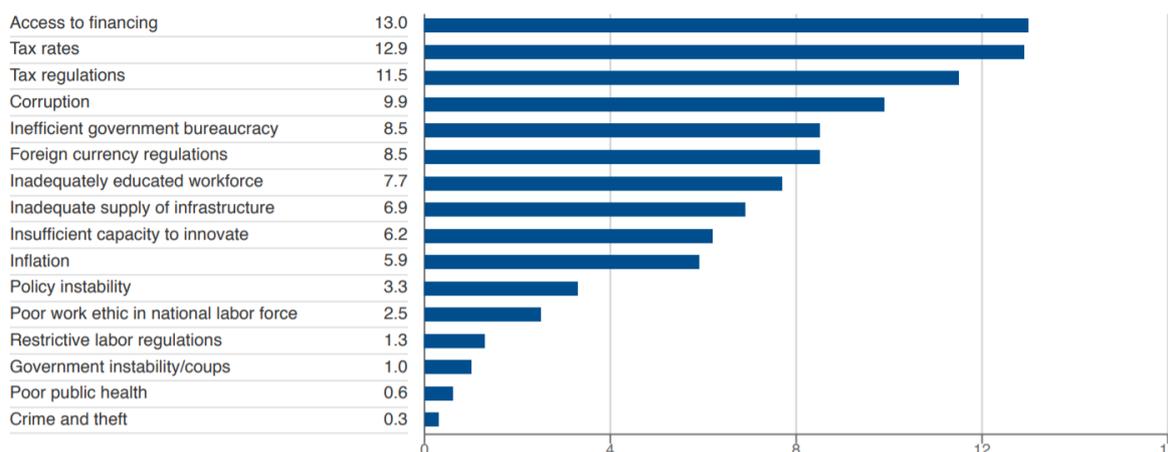
5.2.2. ACCESS TO FINANCE

SMEs' No.1 Problem

SME access to finance is one of, if not, the biggest obstacles for doing business in almost all countries. The results of several studies and surveys come to prove that the access to finance is the biggest point of concern for SMEs in Armenia, as illustrated below:

- According to the Global Competitiveness Report 2017-2018⁵⁶ access to finance is the biggest obstacle for doing business followed by 'tax rates' and 'tax regulations'.

Exhibit 34: Most problematic factors for doing business in Armenia



Source: World Economic Forum, Executive Survey 2017

- Similarly, according to BEEPS V (2011 – 2014)⁵⁷ access to finance is the major obstacle for doing business by SMEs, followed by tax administration and political instability. SMEs in Armenia face constraints when asking for credit.

Exhibit 35: SME Access to Finance Seen as Obstacle



■ Complex procedures ■ Collateral ■ Interest rates ■ Did not expect approval ■ Other

Source: BEEPS Survey

⁵⁶ World Economic Forum Executive Opinion Survey 2017

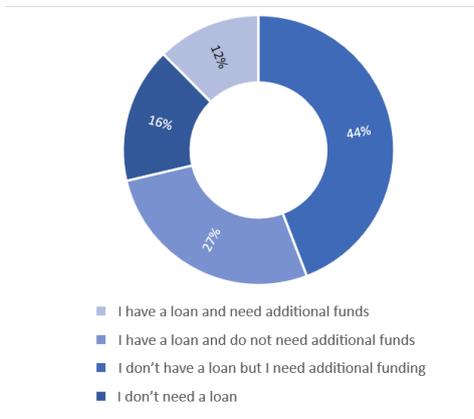
⁵⁷ Business Environment and Enterprise Performance Survey, BEEPS V (2011-2014), European Bank for Reconstruction and Development, dataset available at <http://ebrd-beeps.com>

- According to the SME Policy Index for the Eastern Partnership countries (2016), Dimension 6 (Access to finance) has a score of 3.53/5 (5 being best). It is worth mentioning that the score in 2016 only improved slightly compared with the score in 2012 (3/5).
- In addition to the surveys and studies conducted by international institutions discussed above, the Consultant, in cooperation with different partners, has conducted surveys and interviews among SME representatives which reinforce the conclusion that access to finance remains N 1 issue among SMEs. For example, according to the online survey conducted among 131 SMEs from different regions of Armenia, 83.7% of the respondents need additional financing (Exhibit 36).

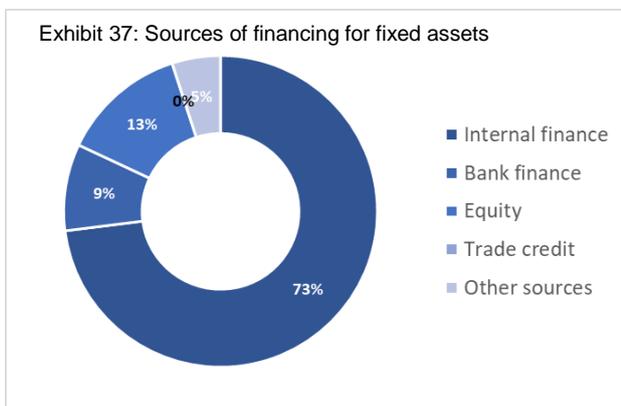
Demand Side of the Story

According to different sources of information SMEs in Armenia are in constant need for funding. For example, according to BEEPS report (2014), more than 83% of SMEs use credit, while according to the online survey conducted among 131 SME respondents within our study only 16% of the respondents do not need additional financing (Exhibit 36).

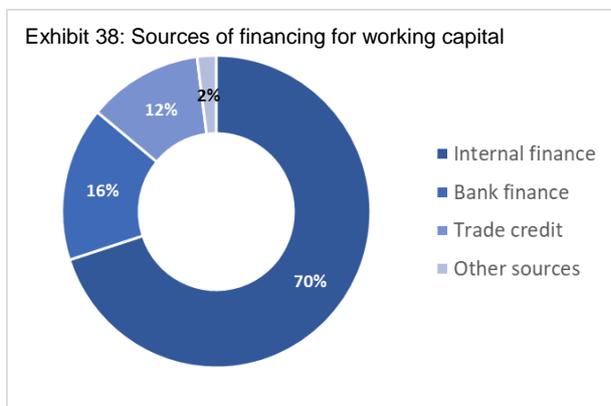
Exhibit 36: Which of the following best describes the current situation of your business financing?



The SMEs conventionally need funding for either financing investments in fixed assets or working capital. However, according to the BEEPs report as shown in Exhibits 37, 38, bank financing is not their primary source of funding. The primary source for financing both for working capital and fixed assets are internal. This (further supported by the interviews with SMEs conducted within our Study) mainly indicates that having issues in accessing formal financing sources (mainly banks) the SMEs heavily rely on their internal sources (mainly extra liquidity generated within the business cycle) which is generated much slower and respectively slows down the investments



Source: BEEPS report



Source: BEEPS report

into working capital and especially fixed assets and thus negatively influences the growth and development of the SME sector companies.

The reasons for underutilizing the banks funding are manifold. According to the BEEPS report (as well as supported by the opinions collected during face-to-face interviews with SMEs within the current Study) many SMEs having been exposed to negative experiences with financial institutions (especially within the lending process) are discouraged to apply for financing to financial institutions the several reasons such as complex procedures (38%), high interest rates (32%), heavy collateral requirements (10%) etc. The Exhibit 39 depicts the reasons discouraged firms do not apply for funding:

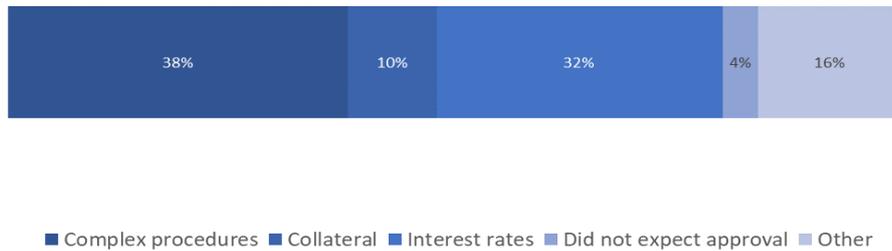


Exhibit 39: Reasons discouraged firms do not apply for a loan

According to the online survey conducted among 131 SMEs the level of satisfaction by the terms of credit (interest rates, other fees and commissions) provided by financial institutions is quite low (43% of respondents are very unsatisfied with the terms of business financing and a further 29% are somewhat dissatisfied) (Exhibit 40). The survey also illustrates that the biggest sources of dissatisfaction are: interest rates (62%), guarantor (53%) and collateral requirements for providing financing (49%).

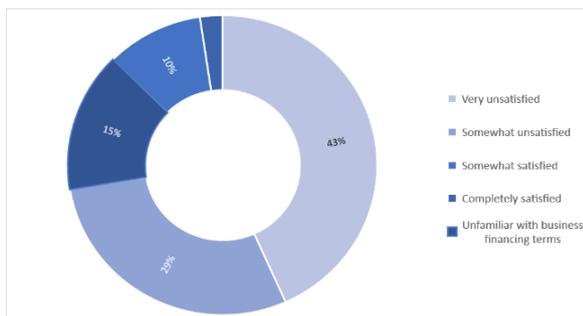


Exhibit 40: How satisfied are you with the existing business financing terms of the market?
Source: online survey, n=131

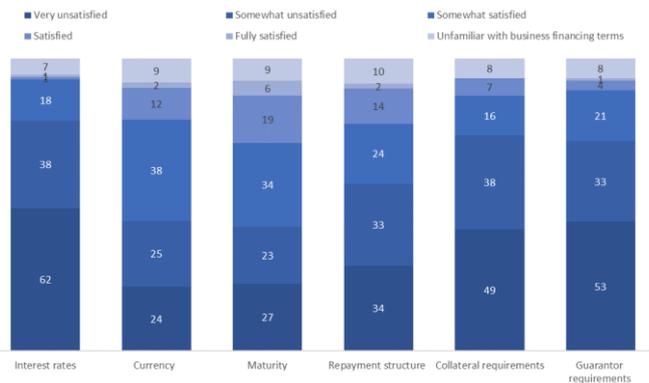


Exhibit 41: the key concerns with business financing terms of the market?
Source: online survey, n=131

According to the EIB Bank Lending Survey (2016), the availability of majority of debt instruments (except for leasing) in the market is not considered an issue as such. However, leasing is considered seldomly and very seldomly available by 30% of respondents and private equity is considered seldomly or very seldomly available by 70% of respondents. It should be highlighted, however, that as a result of the phone and

face-to-face interviews conducted among SMEs in the framework of the current Study, it becomes obvious that there is low level of awareness and understanding of other financial instruments (especially equity) among the SMEs, which might be the reason of high level of satisfaction with the existing set of available products.

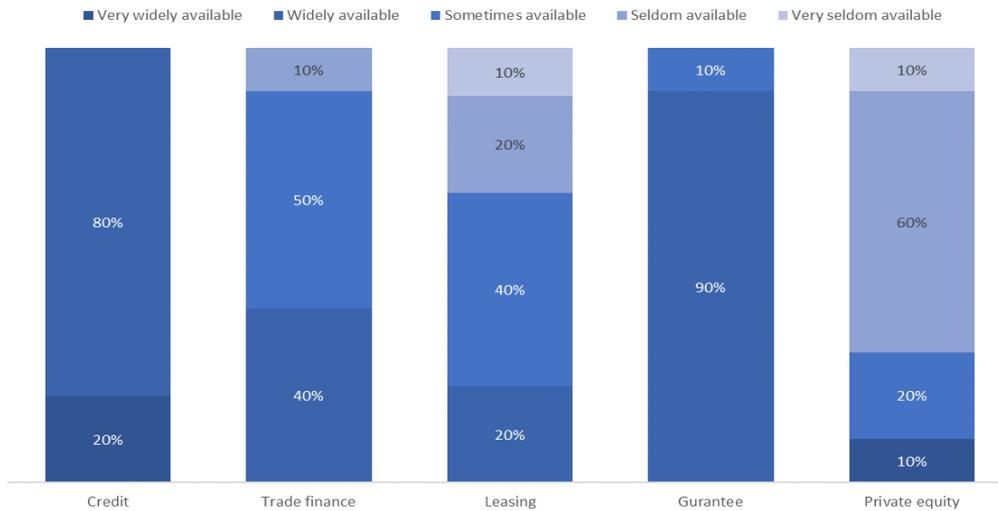


Exhibit 42: Availability of financial instruments in the market

According to the EIB Bank Lending Survey (2016), in the view of financial institutions the SMEs have limited access to financing because of certain significant constraints such as 1) issues with creditworthiness and/or good credit history (50%), lack of capacity to prepare business plans (i.e. to properly communicate the viability and feasibility of the business project for which financing is required (50%), lack of acceptable collateral (meaning collateral with high enough value, liquidity level, preferably immovable) (40%), local (30%) as well as global (20%) macroeconomic environment related issues, other (see more details in Exhibit 43).

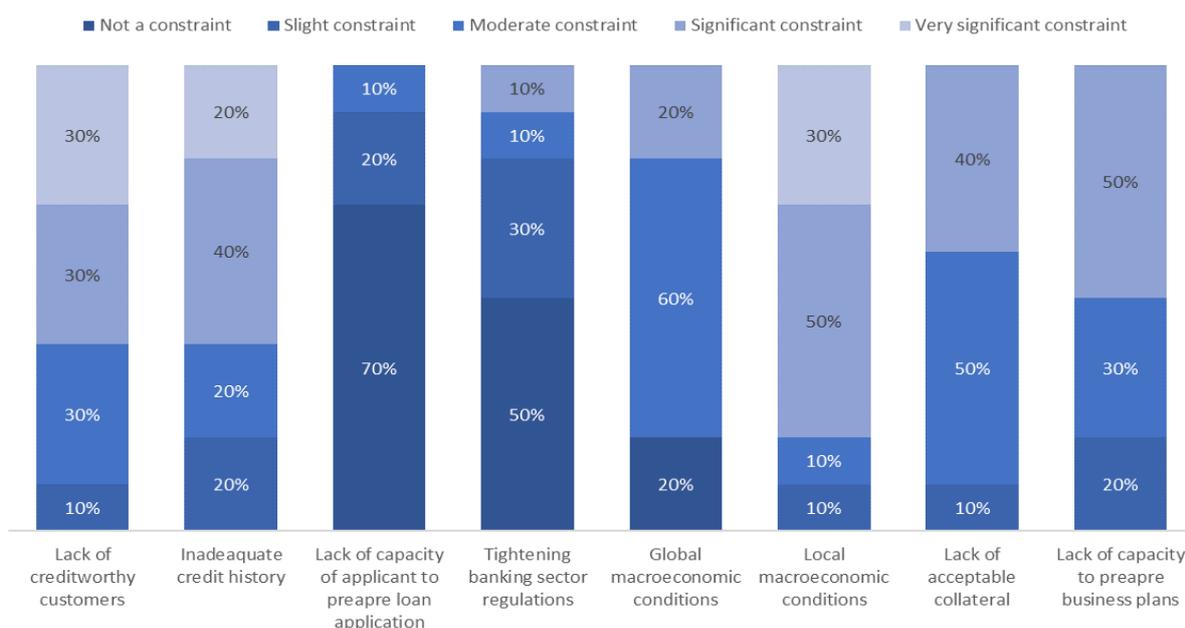


Exhibit 43: Macro-environment and customer-related issues limiting SMEs access to credit

Supply Side of the Story

Financial sector

Financial intermediation into the economy of Armenia has been increasing over the years. As of end of 2016, banking sector assets made up 79% of GDP, while loans made up 46% of GDP) (Exhibit 44).

%	2010	2011	2012	2013	2014	2015	2016
Total assets of banking system / GDP	45.1	54.7	61.8	69.0	70.3	68.5	78.7
Total loans of banking system /GDP	27.4	33.6	40.2	42.1	42.7	39.8	45.8

Exhibit 44: Banking sector assets to GDP, banking sector loans to GDP.

As of the August 2018, the financial system of Armenia consisted of 17 commercial banks, 39 universal credit institutions, 9 insurance companies, 3 insurance brokers, 10 investment companies, 3 investment and pension funds, as well as multiple pawnshops, exchange bureaus, money transfer companies. However, the financial system is strongly dominated by the commercial banking sector (85.4% of financial sector assets belong to banks).

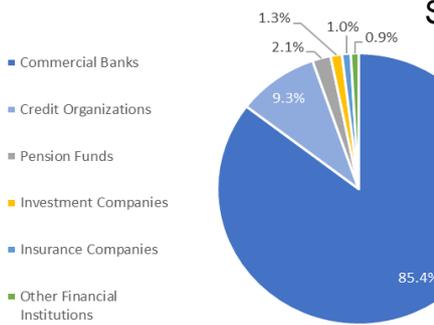


Exhibit 45: Structure of financial system assets, by financial institutions, 2017
Source: Central Bank of Armenia

Since there is neither regulatory nor practical differentiation of target clients of financial institutions by size as well as due to the dominance of financial sector by commercial banks we can state that the SME sector is predominantly financed by commercial banks merely because of an overwhelming size of the commercial banks, their universality and interest in SMEs. The involvement of commercial banks in the SME lending business became even stronger after the increase of capital requirements in 2017, as a result of which the liquidity levels of commercial banks increased and competition increased.

It should be noted that the number of financial institutions, especially banks is still quite high (the number of banks decreased from 21 to 17 since 2015, because of the increase of minimum regulatory capital level requirements by the Central Bank of Armenia (CBA)) for the size of the country's economy, and thus the competition among banks and credit institutions is quite strong.

The loans of commercial banks account for 91% of the financial sector loans (commercial banks and credit institutions), as of August 2018. Moreover, there is a high level of concentration of assets (around 50%) in the top five banks of the country.

The banking sector remains well capitalized. As of August 2018, the regulatory Capital Adequacy ratio indicator of the commercial banks was 17.8% against the required 12%. It is also very liquid: the liquid assets/total assets ratio is 28% against the required 15%.

On the other hand, the dollarization of the economy and the banking sector remains high. Local currency deposits are the main source of local currency for the banks, however, the local currency deposits are scarce. As of August 2018, 60% of banking sector deposits were in foreign currency, which results in high share of foreign currency loans in the portfolios of the banking sector (46% of banking sector loans are in FX). Moreover, more than 33% of local currency deposits are demand deposits, while the term deposits maturities are relatively low, which is another reason that banks are relatively limited in lending to SMEs in local currency: it should be noted that the consumer loans to private individuals must be extended in local currency only according to the CBA regulation, which reduces the allocation of local currency loans to companies even further. This contains a notable risk to the economy and especially to the SME sector, as such companies are more prone to different economic shakeups (as soon as there is a fluctuation in local currency due to different macroeconomic factors in the country and region) thus quickly translated into losses to SMEs and credit risk to the financial institutions. The gap in local currency is partially met by a CBA subsidiary, the German-Armenian Fund⁵⁸, which channels international funds to the commercial banks by taking-up the foreign currency risk and on-lending to commercial banks in local currency and specifically targeting SME sector financing under its programmes.

⁵⁸ www.gaf.am

The profitability of the banking system has gradually decreased in recent years due to several reasons, such as quality of loan portfolio, decreasing margins due to high competition, etc. As of end of 2017, the Return on Investment (RoE) in the banking sector was 5.6%.

Perception of SMEs by the Financial Sector

The EIB bank lending survey (2016) demonstrates that almost all banks provide loans to SMEs in both domestic and foreign currencies. 90% of the surveyed banks in Armenia indicated that they offer loans, as well as trade finance products to SMEs. However, the financial sector has certain challenges in dealing with SME sector. According to the same survey, the financial institutions indicate under significant and very significant concerns regarding financing the SME sector the following factors: low profitability of SMEs (60%), lack of local currency funding (50%), lack of long-term funding, interest rates (30%) (see more details in exhibit 46).

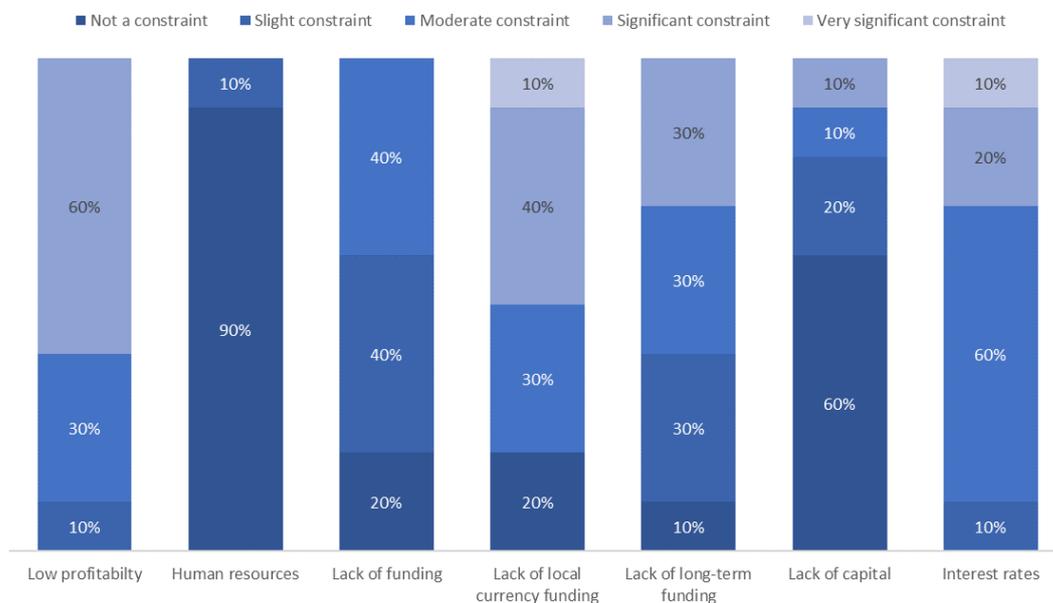


Exhibit 46: Bank specific factors limiting SMEs access to credit
Source: EIB banking sector survey

In addition, according to the empirical evidence as well as results of expert and SME sector interviews, the SME sector continues to lack several preconditions and capacities to be able to gain greater access to affordable financing, such as:

- Lack of formality and transparency in terms of the financial track-record (the financial statements of SMEs are often neither available nor disclosed, let alone audited) creating significant information asymmetry problems;
- Lack of awareness of financial products, as well as certain capacities and skills, such as financial literacy.

As a result, the financial institutions heavily rely on collateral, mostly immovable collateral such as real estate, which is one of the biggest issues in terms of access to finance, as the SMEs and especially micro and small companies do not usually possess any or

enough immovable collateral. The situation with registering and thus having more control over the pledged movable collateral has improved: the newly adopted law on Registration of Secured Rights towards Movable Property stipulates a creation of a register for movable property and it is practically being implemented. However, this has not yet materially shifted the preference of banks towards movable collaterals. Moreover, the banks apply high haircuts to the collateral value due to high volatility and low liquidity of the real estate market.

Non-banking Financing

Based on our interviews and published studies of the SMEs sector an unavoidable conclusion is that most SMEs being financed by the commercial banks are SMEs at the expansion or maturity stage, usually with a well-established financial track-record and possessing adequate collateral. There is an obvious gap of financial instruments for other SMEs (e.g. family businesses, subsistence farms, etc.), as well as start-ups, innovative companies, fast-growing companies and other companies that lack collateral. It is a well-known fact, however, that the latter types of SMEs are not often subject to traditional financing via commercial banks and other financial institutions and thus require access to alternative mechanisms and/or sources of financing.

Below we present an analysis and assessment of non-loan financial instruments availability in the market:

Type of instruments:	Status:
Grants	Grants are a very common form of SME finance support in Armenia overall, often used in conjunction with TA. Majority of grants are distributed via intermediaries, such as civil society organisations, whereas grant programmes whereby SMEs receive direct financial input are fewer. There are cases of blended instruments (e.g. Grant+TA in case of SMEDA to start-ups, or Regional Business Startup Grant and follow up loan guarantee by SME DNC, but blending generally is not often used).
Non-cash flow instruments (guarantees and insurance)	NCFIs are not widely used in Armenia, current examples are Government of Armenia initiatives of limited scale and impact – very popular (but limited in resources) SME DNC Revolving Guarantee Fund as well as Export Insurance Agency of Armenia.
Leasing, factoring, trade finance	Leasing and factoring products are offered by financial institutions particularly in agricultural sector (leasing of machinery), but these tools are underdeveloped. There is growing use of such instruments by commercial banks, but these are constrained by low levels of financial literacy among SMEs.
Crowd-funding, seed funding, business angels, venture capital, mezzanine finance.	Use of these instruments in Armenia are in their infancy. Some of the first examples are Granatus Venture. There are emerging players also in the pre-seed/seed Venture Capital are (e.g. SmartGate, Hive Venture Capital).

Private equity funding	Private equity funds are underdeveloped either. It is expected that in early 2019 an EBRD co-funded Private Equity Fund will be set-up with the target to finance SME sector projects. Amber Capital will manage this private equity fund for expansion and maturity stage SMEs.
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Public Programmes in SME financing to SMEs and its Institutional Aspect

The role of state-supported public financial programmes, mechanisms and instruments is to bridge the financing gap that exists in the market. The role is first and foremost to assist SMEs to become bankable and then to ensure that the commercial financial sector takes over in terms of providing access to finance.

In the framework of the current Study (interviews and empirical observations) the Consultant came to the conclusion that there is a lack of strategic and systematic approach to SME financing topic including but not limited to coordination of institutions and instruments involved in SME financing (donors, public sector financial institutions) resulting in uneven distribution of financial instruments across various SME segments.

The SME finance function is very fragmented across government (PanArmenian fund, SME Investments, SME Revolving Guarantee Fund within SME DNC, Export Insurance Agency of Armenia, other funds (e.g. Freda) and investment vehicles in agriculture, regional development etc.) – this historically has been a common problem across Central and Eastern Europe.

Specifically, the following institutions are the key public players in the field:

- **SME DNC:** in addition to its primary mission of implementing the SME Strategy of the country by supporting SMEs in different aspects⁵⁹, SME DNC operates the Loan Guarantee Provision programme, which facilitates the access to finance of existing SMEs via providing guarantees of up to 70% of the loans. The guarantee amounts cannot exceed 15 million AMD and is provided to 8 commercial banks. Start-up companies also have access to the Loan Guarantee Provision programme (if they are participants of ‘Support to Start-up’ program of SME DNC), they can have access to 100% of guarantee at 10% interest rate up to 5 mln AMD up to 5 years.
- **Development and Investments Corporation of Armenia (UCO - former SME investments UCO):** The company was established in August 2009. It is a classical credit institution (Universal Credit Organization) regulated by the CBA and established by SME DNC and Ministry of Finance of Armenia. The mission of the institution is to develop SME sector entrepreneurship by financing the sector. Since recently (2018) UCO also manages the Pan-Armenian Fund (former Pan-Armenian Bank, which was reorganized in early 2018). As of December, 2017 (according to the audited financial statements of 2017) the institution has a loan portfolio of 7.6 bln AMD and the annual net profit is 399 million AMD. It is worth mentioning that the

⁵⁹ www.smednc.am

administrative expenses of the institutions (including salaries) make up more than 500 mln. AMD. According to the interview with the CEO of the DICA the institution perceives itself as a market player (meaning, it is basically a full-fledged market player competing with other commercial financial institutions) as well as has profitability expectations.

- **Export Insurance Agency of Armenia CJSC:** The company was established in late 2013 and its mission is to promote export of the country by offering exporters insurance against the non-payment risk of their overseas buyers, as well as to contribute to the creation of accessible and affordable financial resources for SMEs and the development of private market of commercial credit insurance. The institution has 2 main products: 1) export insurance and 2) pre-export financing insurance. As of August, 2018 the institution has around 340 insurance policies and 3 bln. AMD of sum insured. According to the audited financial statements of 2017 the administrative expenses of 2017 were slightly above 150 mln AMD. The net profit of the institution in 2017 was 139 mln AMD.
- **Fund for Rural & Economic Development of Armenia (FREDA):** the company was established in January, 2009 in the framework of the “Rural finance” component of the “Farmer Market Access Program in Armenia”, which is a joint activity between the Government of Armenia and the International Fund for Agricultural Development (IFAD). FREDA a fund with a rural focus that makes investments in rural SMEs by providing financing instruments and capital and management assistance, thus enabling the enterprises to improve their competitive position and thus contribute to accelerate rural development. As of December, 2017 (according to the audited financial statements of 2017) FREDA has 191 mln. AMD investments in projects (equity) and 1.2 bln AMD extended loans. The administrative expenses of 2017 were 434 mln AMD, while the net profit for the year was 153 mln AMD.

Financial Literacy

Financial literacy and business skills is one of the key issues in the SME sector. This becomes obvious from different meetings and interviews conducted among SMEs. In 2012, the Central Bank of Armenia introduced a general financial literacy assessment leading to a “National Strategy on Financial Literacy Action Plan”, approved by the government in 2014. The capacity building and training projects conducted by SME DNC directly or indirectly touch upon the topic of financial literacy and business skills of entrepreneurs. The inclusion of financial literacy as part of the education system is planned, but is not yet been implemented. Financial literacy is very tightly connected with the access to finance topic, as it is very often challenging to SMEs to assess 1) whether their business needs additional funding or not, and if yes, then how much 2) which financial product or service is more relevant for their specific situation (resulting in very high demand for loans, and very low demand for non-loan products, such as leasing, factoring, trade finance instruments, equity instruments etc.).

Recommendations:

- Consider merging & consolidating the public sector financial institutions (namely, Development and Investment Corporation of Armenia, Export Insurance Agency of Armenia, Fund for Rural & Economic Development of Armenia) and the financial intermediation functions of non-financial institutions (the Loan Guarantee Provision programme function from SME DNC) under one institution/holding/umbrella with the main objectives to:
 - Create a one-stop shop for SMEs to access different types of financial instruments and solutions;
 - Have clear strategic alignment (e.g. if the country's strategy is to foster the start-ups, or innovative companies, it will be easier to navigate the single institution in the same strategic direction);
 - Establish synergies and economies of scale (pooling experience, information accumulation, saving considerable overhead cost).
- All the above-mentioned financial institutions pursue profitability as one of their main targets, which, in our opinion, is the reason of deviation from their key missions. Thus, consider removing the profitability expectation from those institutions.
- The above-mentioned financial institutions (as a public sector support instrument) must intervene ONLY into those SME segments which are underserved by the commercial sector. Thus, elimination of competition possibilities can be considered.
- Merging of the above-mentioned institutions would release budgets and capital for extending/enlarging the financial intermediation to those SMEs that are underserved by the commercial sector as well as introducing products which are not active in the market yet. Thus, consider introducing leasing, factoring, venture capital/mezzanine financing and similar instruments to the underserved SMEs.
- Consider introducing/co-funding venture funds, pooling business angel networks, seed and crowd funding platforms.
- Consider introducing capacity building and awareness raising programmes targeting financial literacy of SMEs.
- Consider introducing capacity building and awareness raising programmes targeting financial sector employees with the purpose of increasing understanding about SMEs, their needs and specifics.
- As awareness level of SMEs regarding the availability of different programs is quite low, consider establishing a platform/portal where information on all public as well as other (donor, NGO) SME financing tools and instruments is available. Consider the Latvian example: <https://www.altum.lv/en/>

5.2.3. ACCESS TO MARKETS



Exports as a Growth Priority

The experience of the severe economic crisis in 2009 demonstrated, once again, that an important precondition for sustainable development of the Armenian economy is to diversify and adjust the economic structure, for example, through the development of export-oriented economic sectors. Over the years, the Armenian government has focused on export growth and strongly prioritized⁶⁰ the development of an export driven economy with direct interventionist elements aimed at job creation.

It has also engaged in a continuous effort to implement business environment reforms, simplifying the legislative and regulatory framework and enhancing its business support infrastructure to maximize exports. As a result, the exports in 2017 grew YoY by 19.7%⁶¹ and made up approximately 38% of GDP, while the same indicator ten years ago was ~15% (Exhibit 18). As can be seen from the Exhibit 47, the exports' share in GDP continued to grow in the period of the SME strategy 2016-2018 as well.

Georgia's outperformance in exports in recent years (as a share of GDP) can be attributed to a few factors. Firstly, it has signed the Association agreement with EU in 2014 (entered into force in 2016), secondly, the reopening of Russia (the largest export market for Georgia in 2017⁶²) as an export market as many Georgian products were not permitted to import to Russia due to political tensions, and thirdly, a clear focus on export-oriented sectors such as agriculture, transport, tourism⁶³ and Hydro Power⁶⁴. Lastly, there seem to be a coordination between the sector strategies and country strategy (Georgia 2020⁶⁵).

⁶⁰ Armenian Development Strategy for 2014-2015

⁶¹ World Bank Databank

⁶² MOF Georgia Outlook, 2018

⁶³ From 2007 foreign visitors to Georgia has increased over 6x, from close to 1 million to over 6 million in 2018, MOF Georgia Outlook, 2018

⁶⁴ Georgia the outlook 2018. MOF of Georgia

⁶⁵ Three main pillars are private sector competitiveness, human capital development and access to finance. MOF Outlook, 2018

Armenia’s exports as % of GDP has high correlation with that of Georgia’s, given the similarities between the economic structures..

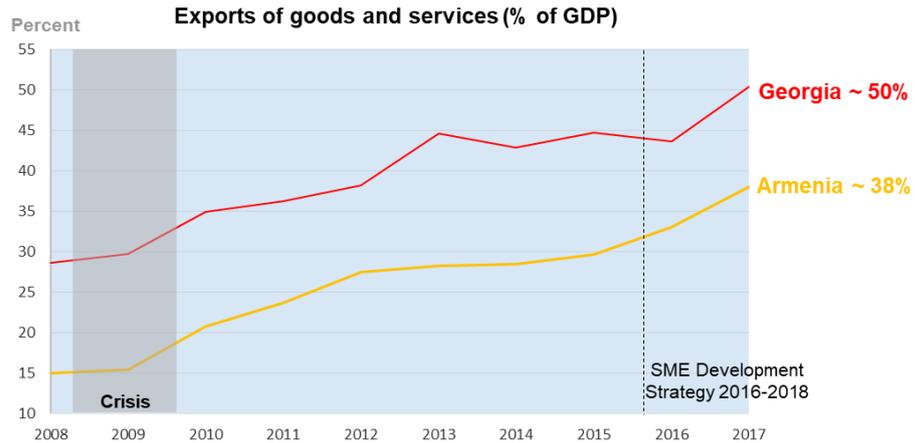
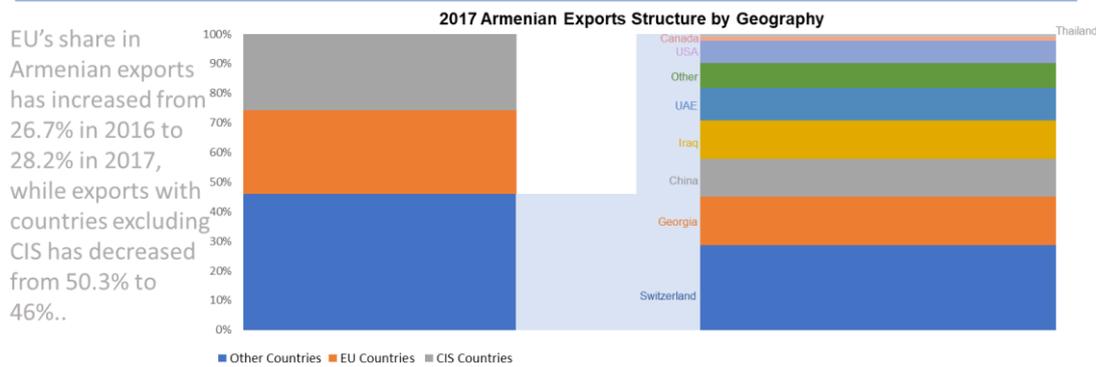


Exhibit 47

Source: World Bank

In terms of geographical structure, the largest export markets of Armenia have historically been the Commonwealth of Independent States (CIS), dominated by Russia, EU countries, while “other countries” represents the largest category of the three (Exhibit 48).

Exhibit 48



Source: www.armstat.am, ADWISE analysis

The breakdown of the largest export category shows that the top three markets in 2017 were Switzerland (jewellery, gold products, watches and other expensive jewellery related products are imported from Switzerland, processed in Armenia then reexported to Switzerland⁶⁶), Georgia and China.

In terms of the dynamics, it is interesting to highlight that EU’s share in total exports has increased from 26.7% in 2016 to 28.2% in 2017, while the share to CIS countries has decreased over the same period by ~4% in spite of the fact that Armenia is a member of Eurasian Economic Union (EAEU).

The feedback from multiple interviews conducted with policy makers at government agencies, BMOs and trade associations, combined with the economic realities of Armenia (landlocked, low productivity, small scale, etc.) the possible future policy direction could be to export small scale but high priced⁶⁷/premium products to foreign

⁶⁶ Chamber of Commerce and Industry of the Republic of Armenia

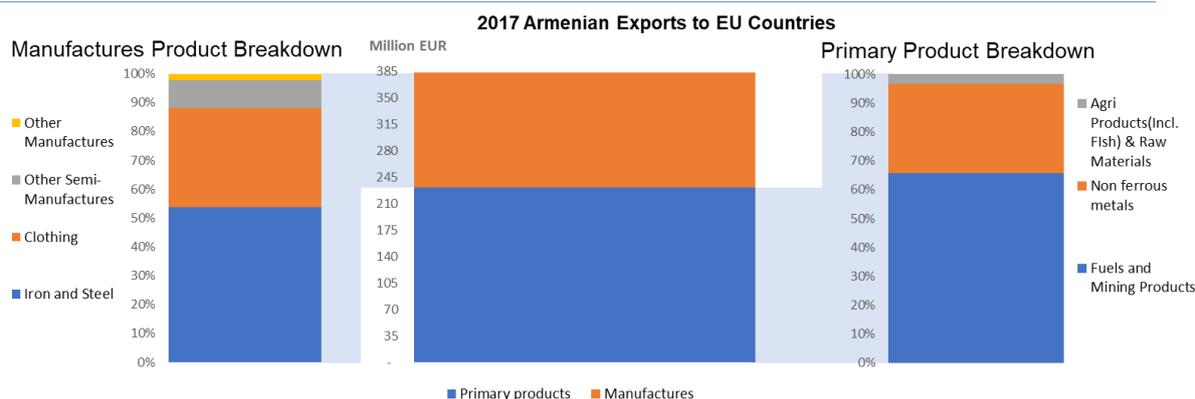
⁶⁷ For some high-value added products

markets. The majority of those interviewed highlighted that the EU should be considered as a primary market in the future, given the greater willingness to pay for “Made in Armenia” premium products. Consequently, in order to better understand the potential offered by the EU market the next part the analysis focuses on exports to EU.

As can be seen from the Exhibit 49 below, out of EUR 382 million worth of exports to EU countries in 2017, there are two major categories of products: primary and manufactured products according to Eurostat data.

The first category is dominated by mining-related products, accounting for over 60% of exports. The rest is made-up of non-ferrous metals exports, which accounts for approximately 35% and only 11 million euros worth of agriculture products were exported, making only 4.7% of the overall primary products. Those agriculture-related products were 100% made of food products. Even though the export of these food products grew by 12.7% YoY, there is a very large potential to increase exports further. Moreover, as highlighted in our macroeconomic analysis, agriculture still dominates GDP and many SMEs involved in this sector can potentially access EU markets given the right diagnosis and relevant assistance (highlighted below in recommendations).

Exhibit 49



Source: Eurostat Comext, ADWISE analysis

At the same time, for less sophisticated (but export-ready) SMEs, it is likely that the CIS⁶⁸ market will remain a priority market in the medium term.

From an SME development perspective, given the fact that the dominant sectors of EU exports remain mining-related products⁶⁹ (Exhibit 20), diversifying the share of traditional products and services offered by SMEs would be an asset. To address this issue, the government has created initiatives to support the export driven agenda, for example by establishing several government related agencies, the major ones being:

- **Pan-Armenian Bank** was established as a development bank in 2011, to support export-oriented SME companies but the institution did not succeed in achieving its mission and in 2018 it was transformed into a fund, currently managed by the

⁶⁸ Interviews with multiple stakeholders has shown that exporting to CIS countries requires less regulation and compliance compared to EU, as well as being less costly

⁶⁹ Cronimet Mining AG owns and operates Zangezur Copper Molybdenum Combine (ZCMC)

- Development and Investment Corporation of Armenia (for further details on the institution and its role in SME development see the “Access to Finance” pillar);
- **Export Insurance Agency of Armenia ICJSC** was established in 2013 by the decision of the Government of the Republic of Armenia in the framework of export-oriented industrial policy (for more information see the “Access to Finance” pillar).
 - In 2015, the Armenian government created new export promotion body - Development Foundation of Armenia later rebranded as **Business Armenia**. As of March 2018, it has 36 representatives in 25 countries who present Armenia’s investment incentives and export potential during business meetings. Business Armenia has created the Business Support Club, whose services facilitate the process of exporting. The member companies⁷⁰ of the Club provide consulting and other services to exporters and foreign direct investment companies on exclusive terms.

According to the latest (2016) OECD SME Index Policy report by dimension 10 (internationalization of SMEs) Armenia performs above average among the EaP countries, however, the initiatives highlighted above remain limited in scope, as overall scores for this dimension remain low across all EaP countries, reflecting a limited level of development of financial and non-financial support for SME internationalization.

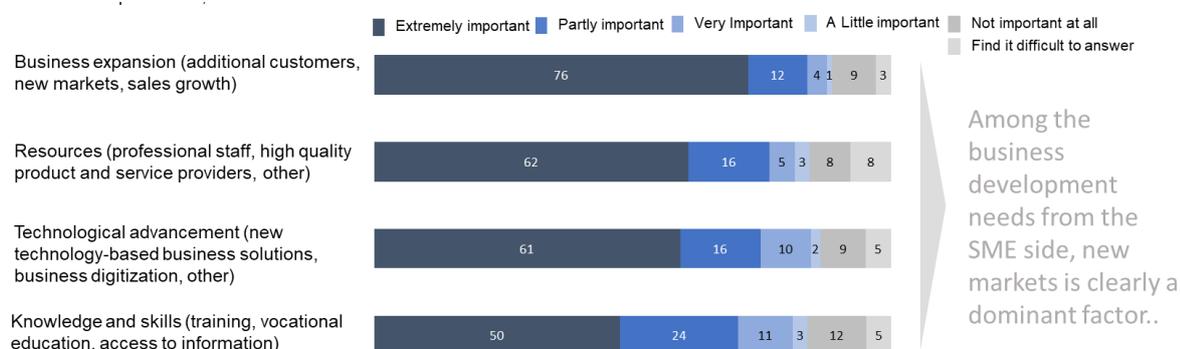
Dimension 10: Internationalization of SMEs

Dimension 10	Armenia	EaP average
2016 average	3.37	2.79
2012 average	2.50	2.30

SME Survey Data

Despite the progress highlighted in this section, export promotion efforts are still nascent and small in scale. The difficulties SMEs face in achieving the necessary economies of scale to produce for international markets and build relevant networks and the relatively small size of the domestic markets means that the natural next stage of development is to expand abroad to become sustainable in the long run. This is highlighted in Exhibit 50 based on the survey of SMEs⁷¹, which identify new markets and customers among their

Exhibit 50 **The main challenges of business development**



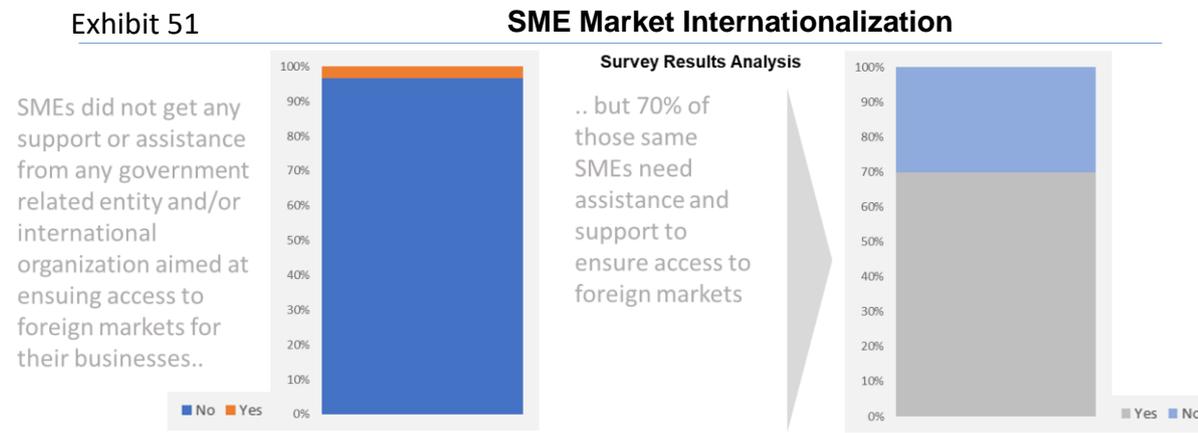
top priority (76% find it extremely important), surpassing other challenges such as

⁷⁰ As of June 2018 the club had 16 members, www.businessarmenia.com

⁷¹ Online survey conducted among 131 SME respondents

resources, technological advancement and knowledge and skills, for which 62% find this factor as extremely important.

Over 98% of the SMEs participating in the survey responded that they did not obtain support which would help them to access to foreign markets from any government related entity. However, the demand for such services is close to 70% among the SMEs surveyed.



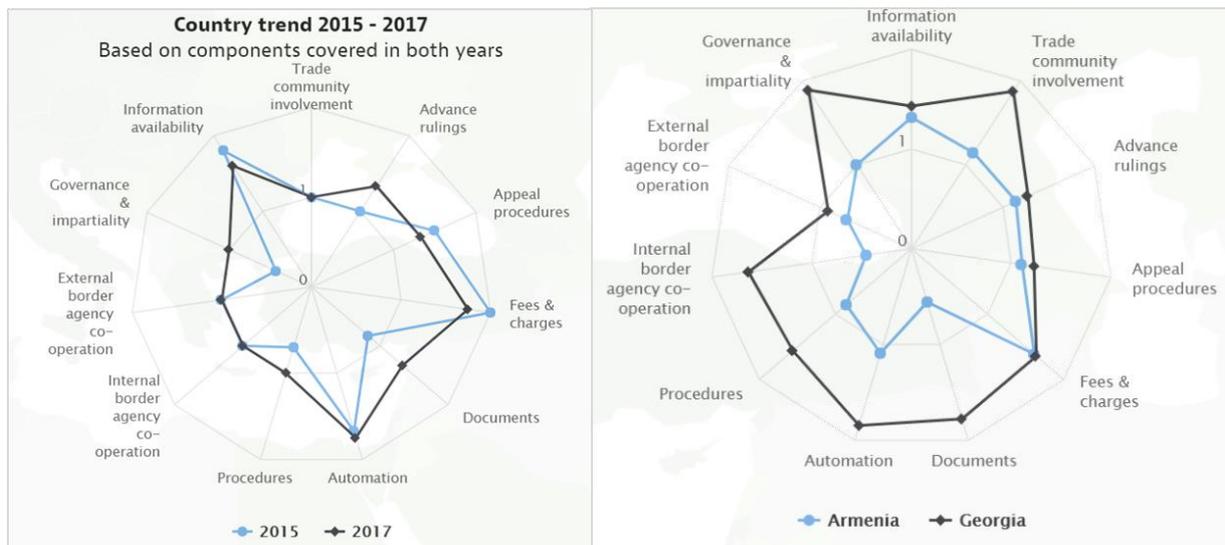
Source: online survey, n = 131

Even though Armenia has made some progress in increasing exports share in GDP and diversifying export markets⁷², it is evident from the preceding analysis that the internationalization for the SMEs is a key policy area to focus on in the future. Moreover, the benchmark report on SME development in EaP countries conducted by the OECD⁷³, will include in its third publication new factors such as trade facilitation and use of e-commerce in calculations of rankings for the access to markets pillar. Therefore, the trade facilitation performance of has been mapped as shown in the Exhibit 52 below.

The Exhibit 52 shows that the largest gaps are in procedures (single window submission), automation (use of automated risk management), documents (harmonization in accordance with international standards) and trade community involvements (structures of consultations, exitance of notice-and-comment frameworks) components. Furthermore, a benchmark analysis with Georgia, given the similarities in economic structure, shows significant differences in performance. Georgia has an average ranking across 11 components of 1.55, as opposed to Armenia, which has an average ranking of 1. As can be seen form the Exhibit 52 below, even though there is an improvement on procedural front for Armenia, from 2015 to 2017, the large gap vs Georgia needs to be tackled to solve the issues of complication for exporting enterprises (see the tax regulation and administration part in regulatory environment analysis of the Report). This issue can be more effectively solved when there is a strong coordination among the export driven priority industries and the country's strategy objective of raising competitiveness of the enterprises.

⁷² As discussed above, the share of export to the EU has grown compared with the traditional markets of CIS, which has decreased

⁷³ OECD SME Policy Index Report (2016)

Exhibit 52 Trade Facilitation Performance*


Source: OECD TFI Database, * Best performance that can be achieved =2

Recommendations:

- To increase the exports as well as the share of exports in GDP, the alignment to the country's development strategy at the level of SME Development Strategy should be targeted. This means that if the country strategy⁷⁴ highlights key sectors with export potential, for example, Agriculture, Food Processing and ICT then the new SMEs strategy should incorporate and target solving the primary issues for SMEs within those sectors.
- Taking into account the small size of the market and thus low capacities of SME sector, consider setting up or supporting cluster-type approach with regional or industry-specific members and partners to meet the quality and quantity demands of the international markets. This scaling up approach may help the SMEs to share cost, meet volume requirements, strike better deals, share promotional and marketing costs as well as share knowledge and experience.
- Capacity building and awareness raising activities for improving skills and knowledge of export-oriented SMEs on the following topics: export procedures, standards, quality and document requirements of the target export market, information and analysis of key export markets (demand trends, market intelligence etc.)
- Support and facilitation of participation in targeted trade fairs and exhibitions.
- Facilitate (via subsidization or similar) access to specific financial instruments such as export insurance, trade finance instruments.
- Target digitalization of export-oriented businesses via supporting them in establishing e-commerce solutions.

⁷⁴ In the process of development as of the writing of this Report

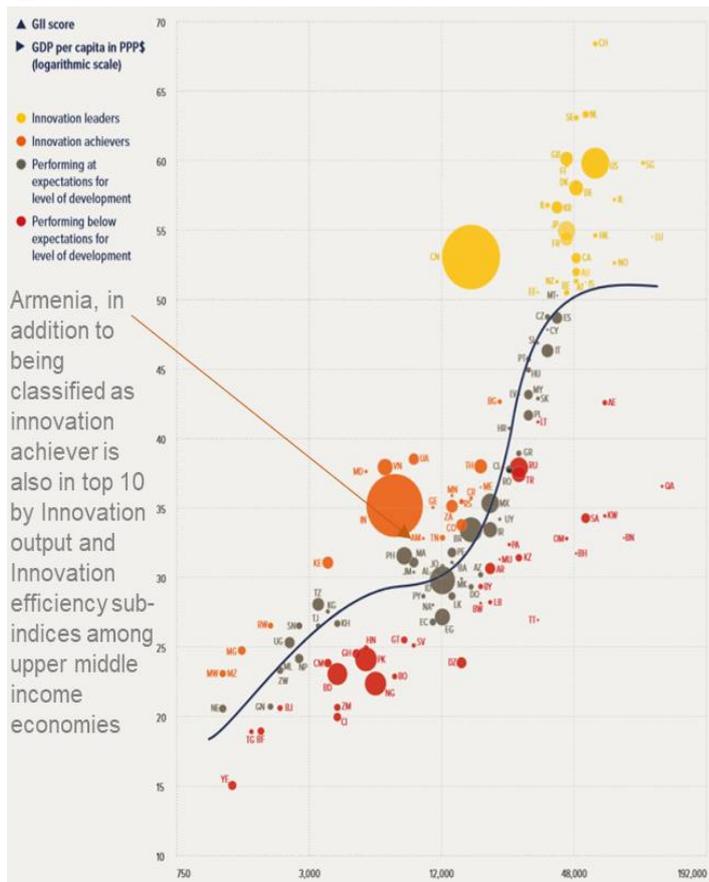
5.2.4. INNOVATION, COMPETITIVENESS & HUMAN CAPITAL



Innovation

Taking into account the fact that the SME development is horizontal, the analysis of the overall environment for innovation is analysed in this part of the report. The Global Innovation Index 2018 (GII) is one of the most cited benchmarks and is therefore an

Exhibit 53 Global Innovation Index



appropriate starting point. GII seeks to

improve the understanding of the innovation ecosystem with a view to facilitating evidence-based policy-making. The GII is calculated based on the ratio of Innovation Output, index, which is a mixture of knowledge technology and creative outputs and Innovation Input sub-index, which in its turn is a combination of five other components, ranging from institutional environment, human capital and research to infrastructure (ICT & economical), as well as market and business sophistication.

Armenia has been classified as an “innovation achiever⁷⁵” for the last 7 years, starting from 2012; only Moldova from EaP countries has been named as such more often than Armenia (8 times). By contrast, Georgia⁷⁶ has only

Source: The Global Innovation Index 2018

⁷⁵ Economies that perform at least 10% above their peers for their level of GDP are called 'innovation achiever'

⁷⁶ Given Georgia's similarities in economic structure, geographical location, income per capita, country credit ranking, correlated growth rates, export growth rates and structures, similar banking and demographic indicators, etc.

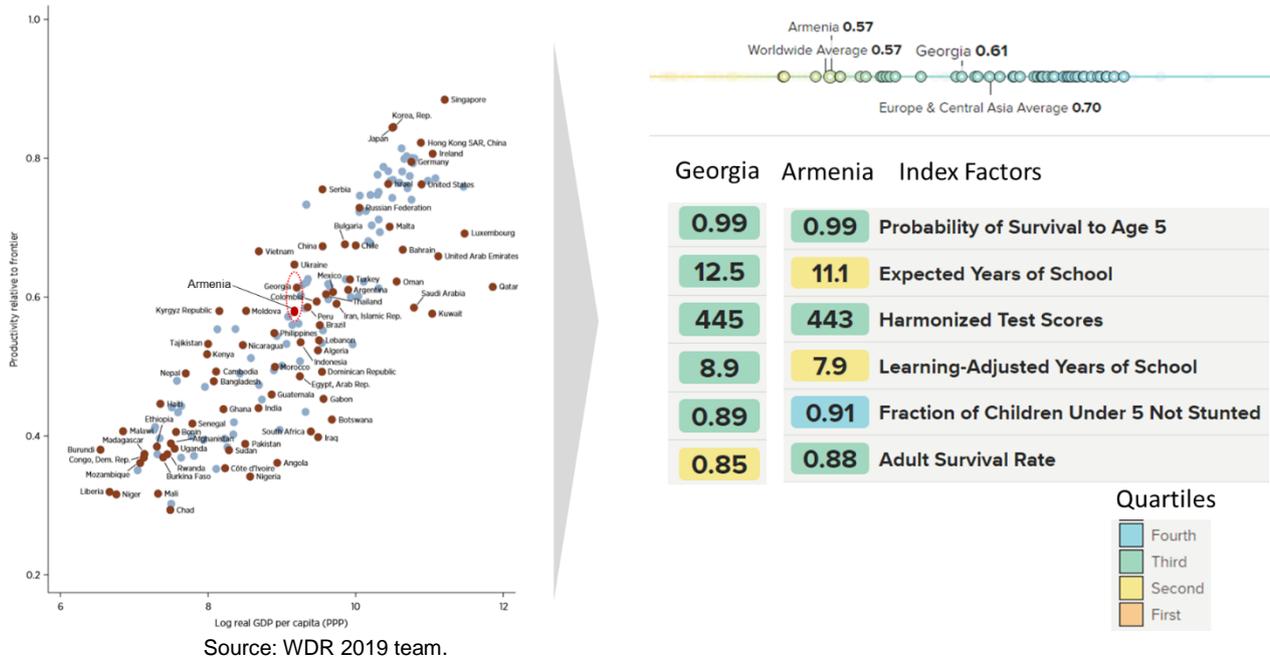
reached this level 4 times. However, Armenia's GII ranking in 2018 decreased markedly from 59th in 2017 to 68th, whereas the reverse has happened with Georgia's ranking (improved from 68th to 59th). The main reason for this trend is Georgia's strong performance in the areas of input sub index (Georgia ranked 53rd vs Armenia's 94th).

To understand the structure of Armenia's GII ranking we have done a component analysis (80 variables) for each of seven pillars mentioned below (for both Armenia and Georgia). Some of the main strengths and weaknesses of the pillars are worth highlighting:

1. **Human Capital & Research:** Armenia displays clear weaknesses such as the low percentages of GDP spent on education and graduates in science and engineering (11.3% of the overall graduates), which results in the 90th rank. Moreover, both Armenia and Georgia share two weaknesses in low local university global rankings, as well as R&D done by global companies. But in contrast to Armenia, Georgia performs well in terms of the pupil-teacher ratio in secondary education.
2. **Infrastructure:** Armenia has strengths in ICT access and usage but weakness in both logistics performance and gross capital formation in GDP, whereas Georgia has strengths in infrastructure indicator due to higher gross capital formation as a percentage of GDP over the past years.
3. **Business Sophistication:** Armenia's strength is knowledge-intensive employment in the overall labour market participants but a weakness is the low percentage of firms offering formal trainings (also an issue in Georgia). Georgia has additional strengths in females employed with advanced degrees, number of deals with joint venture alliances and FDI net inflows in GDP.
4. **Knowledge and technology outputs:** This is one of the two pillars (the other is discussed below) that Armenia has more strengths than Georgia. Strengths include knowledge creation, patents by origin, scientific and technical articles and share of ICT services exports in total trade. Georgia has strengths in the number of new business and FDI net outflows in GDP. Common weaknesses here are the limited ISO quality certifications and medium high-tech manufacturers.
5. **Creative Outputs:** Armenia's strengths include trademarks by origin, share of printing and other media in overall manufacturing, online creativity, including Wikipedia edits. This is the only pillar that Armenia does not have any weakness mentioned.

An analysis of the Human Capital Index by World Bank, which gives Armenia a score of 0.57⁷⁷ (significantly lower than Georgia, which has a score of 0.61), shows that the main underperformance for Armenia’s ranking is connected to the relatively poor quality of primary and secondary education⁷⁸. This in turn will result in low productivity levels as the younger generation enters the workforce.

Exhibit 54 Human Capital Index Armenia’s Ranking vs Georgia



Moreover, the lack of highly qualified workforce is already one of the key challenges to the SME sector,⁷⁹ indicative of both the quality of education and a mismatch between skills supplied and market demand.

Accordingly, it is necessary to improve the quality of education and improve the match between skills supplied and market demand. Ensuring an active role of SMEs in the design of educational programmes is one of the necessary measures to achieve this end.

Another important aspect is strengthening capacities for Vocational Education and Training (VET) and ensuring cooperation of private and public actors to improve the labour-market relevance of VET are also considered best practices in this regard. SMEs will in turn benefit from improved human capital and an increase in productivity.

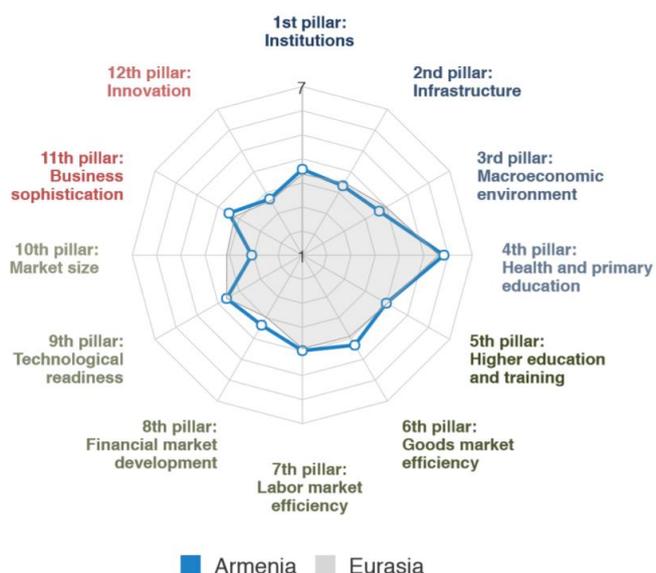
⁷⁷ The human capital index ranges between 0 and 1. The index is measured in terms of the productivity of the next generation of workers relative to the benchmark of complete education and full health. An economy in which the average worker achieves both full health and full education potential will score a value of 1 on the index.

⁷⁸ As per the WB Human Capital Index when years of schooling are adjusted for quality of learning, Armenian children only receive an equivalent to 7.9 years of school education (with the non-adjusted average schooling time of 11.1 years)

⁷⁹ Republican Union of Employers of Armenia, The Main Business Obstacles in Armenia, SME Situational Comprehensive Survey at Macro and Micro Levels, September 2015, pp. 8-9; BMO Sector Study Report within the scope of the Business Membership Organisations (BMOs) Development Initiative in Armenia for GIZ SMEDA Programme, July 2017, p. 21

The other two pillars that need to be addressed are business and market sophistication - the state needs to facilitate collaboration between university research and businesses, firms need incentives to train their staff on regular basis⁸⁰, the state needs to better manage clusters that it already has prioritized (technology, media and telecom) and create new clusters and/or value chains (manufacturing as an example). The government also needs to help with access to foreign markets due to lack of scale in the economy (see Access to Markets Section), which will give extra incentives to entrepreneurs to come up with products that can be exported. Lastly, in order to increase

Armenia's Competitiveness Across 12 Dimensions



market sophistication level, the government needs to create attractive business environment to attract foreign capital, including venture capital which will also have a spill over effect on technical expertise in addition to improving access to finance.

Exhibit 55

Source: World Economic Forum Competitiveness report 2017- 2018

Competitiveness

According to World Economic Forum Global Competitiveness Index Armenia ranked 73rd (previously 79) among 137 countries in 2017. The ranking is calculated according to 12 pillars among which Armenia has the largest gaps versus the top-rated countries in areas of innovation, infrastructure, market size and business sophistication. The last two components have also been used in Global Innovation Index ranking calculations, which was discussed above. It is important to note that the factors highlighted are not only Armenia specific, but are largely common among the countries in Eurasian region. Although the overall trend is positive for most Eurasian economies, there is little sign of convergence within the region. Its most competitive economies, including the Russian Federation (38th, up five ranks), are maintaining their edge. This year's most improved Eurasian economy started from a low base; Moldova moved up 11 places to 89th, demonstrating that it is possible to make rapid progress. Others that had been catching

⁸⁰ Based on face-to-face interviews with representatives of the Republican Union of Employers

up in past years are slipping back, with Georgia (67th) and Kazakhstan (57th) losing eight and four places respectively.

According to the latest OECD SME Index Policy report, Armenia is above average of the EaP countries and has the highest score tied with Belarus. However, the issues related to the 12 pillars highlighted above continue to limit the competitiveness of the economy, since the overall scores for this dimension remain low across all EaP countries, reflecting a limited level of SME innovation and competitiveness. SMEs require institutional co-operation; a strategic approach to innovation policy that targets SMEs; and a broad range of infrastructure, technical and financial support services to be developed.

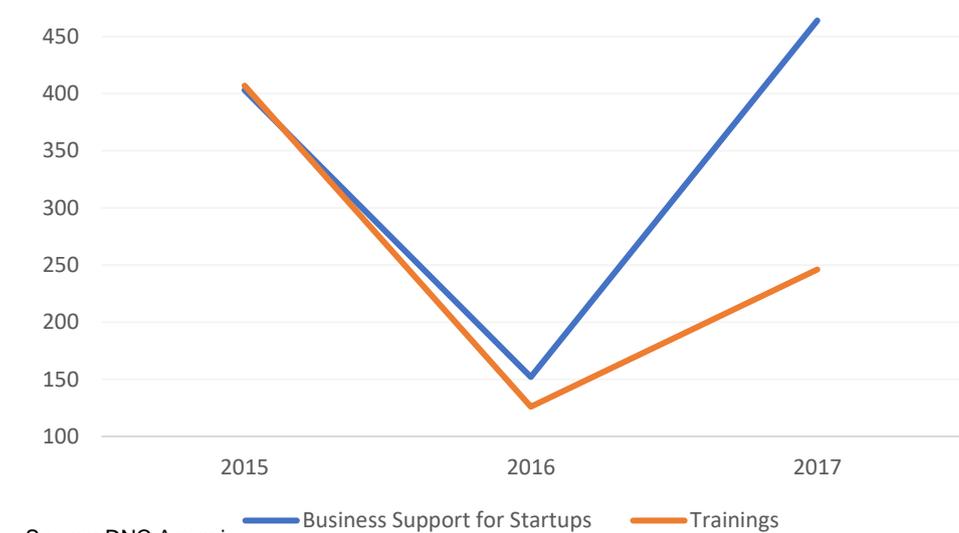
Dimension 8b: Innovation

Dimension 8b	Armenia	EaP average
2016 average	2.91	2.57
2012 average	1.79	2.05

Knowledge Base and Business Skills

As analysed in both innovation and competitiveness sections above, low level of investments in education sector, low engagement of youth in STEM related subjects⁸¹, low business sophistication and other factors have negatively affected the competitiveness of Armenian economy over the

Exhibit 56 **SME Support from Domestic National Center**



past years. As can be seen from the Exhibit above, the SME DNC has conducted on average 339 business support activities for start-ups and 259 trainings for SMEs (non-start-ups) over the last 3 years. The Exhibit above shows that both training business support declined markedly in 2016 whereas business support for start-ups has since exceeded the level of 2015, the training did not recover to the same extent in 2017. Our interviews with representatives of SME DNC have revealed that the initiatives involving start-ups are mostly located in the regions of Armenia, which don't have any other source of support. Taking into account the fact that there are over 78,000 SMEs in Armenia, only a fraction is currently in receipt of support. Taking into account the capabilities developed by SME DNC (over more than 16 years of operations, with presence in many regions) significantly more funding would be needed to scale up the business support functions going forward, enhancing entrepreneurship skills and therefore enterprise

⁸¹ Human Capital & research sub-component in in GII 2018

skills. However, the starting point would be to evaluate the effectiveness of such funding, as well as relevance of supplied trainings as per SME needs (as further analysed below), and implements adjustments and improvements, as may be necessary, prior to committing scarce state resources.

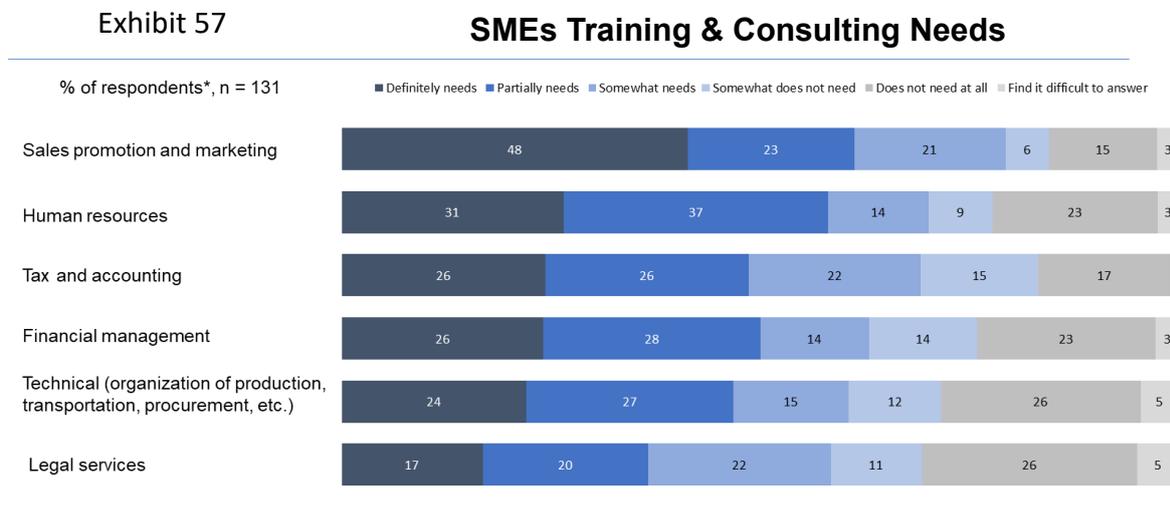
Green economy

A connected component to innovation, productivity and therefore competitiveness of SMEs is pillar that incorporates environmental issues. Moreover, account the OECD SME Policy index report⁸², takes also into account the SMEs in Green Economy, in its pillar of innovation and productivity, therefore, it is important to see what is the current situation in Armenia from the SMEs perspective. To absorb environmental requirements and to comply with them SMEs are often not aware⁸³ of the economic opportunities presented by green business practices. Therefore, government can offer support in the form of technical assistance, tax benefits (e.g. accelerated amortisation, reduced property or corporate taxes) and favourable financing terms for SMEs willing to invest in green technologies.

SME Survey Data

Online survey data shows that the number of SMEs that have received either financial, technical and/or training related to environmental is relatively low (22%) but not negligible. This basically highlights that there is engagement with these issues from the SME side, however, an awareness of their importance exists.

Turning to training and consulting needs, as can be seen from Exhibit 57, the SMEs the



ADWISE analysis, * Figures may not sum to 100% due to rounding

greatest demand concerns a perceived need for trainings and consulting on sales and marketing matters, followed by human resources topic. In terms of the supply, our in-person interviews with SME DNC’s executives as well as SMEs lead to a perception⁸⁴ that the focus for their trainings over the last years has been mostly in business planning,

⁸² A benchmark report on SMEs that many stakeholders -investors, policy makers pay close attention

⁸³ ADWISE survey data - online and in person interviews

⁸⁴ No Information is available for DNC’s training breakdown by topic in their annual reports

financial management, tax and accounting services (which are also in demand but not to quite the same extent), which appears to be driven by pre-existing focuses of donor funded projects as opposed to SME training needs assessments. There would appear to be a need for greater demand orientation in the delivery of SME DNC training and consulting support.

However, it cannot be expected that all such services will be delivered free-of-charge or indeed by public sector institutions such as SME DNC. There is a need for the future SME policy to ensure the development of reasonably priced, good quality, privately provided business development services (BDS) and to ensure that these are also available throughout the country.

Recommendations:

- Improve the quality of education and the match between skills supplies and market demand, particularly by ensuring an active role of SMEs in the design of educational programmes is one of the necessary measures to achieve this end.
- In order to foster innovation, consider fostering (by subsidizing or providing technical assistance) the cooperation between SMEs and academia (universities as well as R&D institutions). Different models of cooperation can be considered:
 - Establishment of companies with co-owners from the academia which will foster commercialization of inventions and intellectual property.
 - Foster cooperation of SME clusters or value chains with academia for a shared objective (e.g. specific research, establishment of a laboratory etc.)
- Consider providing targeted support to innovative SMEs in the form of:
 - Access to special financial products
 - Subsidization of investment in innovative technologies and equipment
 - Technical assistance at the stages of proof-of-concept and commercialization of new technologies.
- Strengthen capacities for Vocational Education and Training (VET) and ensure cooperation of private and public actors to improve the labour-market relevance of VET are also considered best practices in this regard.
- In the framework of capacity building and training activities of SME DNC it is important to:
 - Periodically conduct training needs assessment of the SME sector and thus relate the training activities to the identified needs.
 - Taking into account the scarcity of resources within SME DNC as well as targeting higher level of flexibility for SMEs consider designing and

implementing innovative approaches in training such as on-line training courses, webinars, e-learning applications and other e-learning tools.

- As not a big share of SMEs is fully aware of the activities conducted by the SM DNC, it is very important to increase the awareness on planned training and capacity building programs as well as their importance and relevance by different awareness raising campaigns.
- Introduction of voucher programs (providing vouchers to SMEs with the right to attend certain trainings and make use of other SME DNC services) can be considered.