INTERNATIONAL CENTER FOR AGRIBUSINESS RESEARCH AND EDUCATION

PROMOTING INVESTMENTS INTO AGRICULTURAL SECTOR OF ARMENIA

POLICY RECOMMENDATION

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ABBREVIATIONS

ADA	Armenian Development Agency
CBA	Central Bank of Armenia
DFA	Development Foundation of Armenia
EEU	Eurasian Economic Union
EU	European Union
FDI	Foreign Direct Investments
FEZ	Free Economic Zone
FSCN	Food Security Concept Note
GoA	Government of Armenia
HBS	Harvard Business School
IDF	Industrial Development Foundation
MoA	Ministry of Agriculture
MoE	Ministry of Economy
MoEDI	Ministry of Economic Development and Investments
NCFA	National Competitiveness Foundation of Armenia
NSSA	National Statistics Service of Armenia
SARDS	Sustainable Agriculture and Rural Development Strategy
WB	World Bank

INTRODUCTION

Agriculture in developed countries has undergone dramatic transformation as the result of introduction of automation, mechanization and new production and post-harvest technologies. Modern livestock farm is entirely managed by machines; having automatic on-farm feeding, milking, packaging, labeling and quality control operations. Chicken farms use standardized size production, slaughter, freezing and packaging. Fruit orchards and greenhouses, formerly labour intensive industries, are now using machines to plant, irrigate, fertilize, collect, sort, grade and package fruits and vegetables. These technologies not only minimize human work, but make farming very efficient and resource-intensive (Ford: 2015). Former Prime Minister of Israel Shimon Peres in his Nobble Lecture stated "Israel, essentially a desert country, has achieved remarkable agricultural yields by applying science to its fields, without expanding its territory or its water resources" (Peres: 1999). In this context, Armenia does not have any alternative to developing agriculture through investing in knowledge, science and new technologies.

Furthermore, due to interdependence and further market liberalization, inadequate reaction on global dynamics can be fatal for growth and development. The best illustration of such a risk could be policy adopted by Russian government toward promoting development of agrarian sector, along with import substitution strategy announced and promoted by the president of Russian Federation Vladimir Putin (Путин: 2015). It can pose long-term threat, since large share of Armenian agri-food exports goes to Russia. Moreover, further investments into agriculture in Russia and other states may not only influence on exports from Armenia, but later may also result in tougher competition for local market.

Nevertheless, due to concern over global food security, as population grows, agriculture and food production has a great potential. Global dynamics and forecasts demonstrate increase in demand for basic agricultural and food products. According to a study implemented by the McKinsey & Company, food and agribusiness form a $5 trillion global industry that is only getting bigger and the trend continues; by 2050, caloric demand will increase by 70 percent, and crop demand for human consumption and animal feed will increase by at least 100 percent (Lutz Goedde; Maya Horii; and Sunil Sanghvi: 2015). Another study conducted by the HBS stated that food demand is expected to increase anywhere between 59% and 98% by 2050 (Elferink; Schierhorn: 2016).

Taking into account all threats and opportunities, it is obvious that Armenian agriculture has a good potential to benefit from growing markets, through attracting foreign investments in the sector. The new government should focus on creating and promoting investment-friendly environment by strengthening investment support institutions and implementing a number of policy reforms. Foreign investments can become an excellent source not only to attract capital, but also knowledge, technologies, experience and new markets. In addition, local population may benefit not only from investment by additional workplaces, but likewise by accessing broader selection of products, higher quality, and better safety and pricing.

General framework of this policy recommendation paper is built on the fact that attracting local and foreign investments in agriculture goes beyond sector specific strategy, and a number of other considerations should be made. The first section of the report focuses on the main challenges and issues, and the second section focuses on recommendations for attracting foreign investors in agricultural sector.

1. BACKGROUND AND SITUATION ANALYSIS

1.1. STATE OF AGRICULTURE

Contribution of agriculture to gross domestic product in Armenia averaged about 20 percent during the last five years (WB: 2016). It composed of large number of small, fragmented, and subsistence farms. Altogether there are 317,000 farms, and most of them have very low labour productivity and lack of application of new technologies. Land parcels are small, with average size of land constituting 1.4 hectares (NSSA: 2014). Education and extension system does not play a role of transfer of knowledge and technology, since these institutions do not possess the necessary capacity. In many parts of Armenia farmers still use traditional cultivation methods. Transformation from delicate crops to more robust crops is slow, which in turn slows down automation process in many sectors. Limited use of technologies and low sophistication level of sector poses serious long-term risks.

1.2. AGRICULTURAL PROGRAMS AND STRATEGIES

Government funding to the agricultural sector is low. In 2016 it constituted around 10.86 billion AMD (The Law on the State Budget: 2017). Government support measures do not target on technology transfer, but rather aim at subsidizing costs for inputs (water, diesel fuel, fertilizer, wheat seeds, loan interest rate) and implementing regular operations such as vaccinations, chemical analysis of land and other similar activities. Most of subsidies are provided to small farmers. The credit interest rate subsidies program aims at supporting small producers. The maximum size of these loans is 3 million AMD, provided for three years.

There are number of strategic documents designed by the MoA aiming at developing the sector. Two main documents are the SARDS 2010-2020" and the FSCN. MoA has informed that new strategic documents are circulated in the government, titled SARDS 2016-2025". There are also policy documents aiming at developing specific sectors. As the result of analysis of these documents, there are several notes to consider: a) MoA presents large number of priorities having no funding available to implement them b) some activities in the action plan do not entirely comply with problem definition c) there are no activities targeted on attracting investments. A fundamental problem with the strategy is that it demonstrates that the MoA does not have very clear understanding of sector priorities. For example, it may consider during the design of the new policy to concentrate on 5-7 priorities, and design specific set of activities and government support measures in accordance with these priorities.

Furthermore, neither of policy documents have a mechanism for attracting foreign investments. Only recently in cooperation with international development organizations, it prepared an agro-investment guide, sample investment project on greenhouses, and investment teasers for aquaculture.

To summarize, on strategic level, MoA does not have any concept or any documents aiming at promoting foreign investments. MoA usually refers that it is ready to support investors but it does not have any structured approach, rather it attempts to help upon specific request. At the same time, no specific assistance mechanism is adopted. MoA does not have any structural department which designs policy in investments, and the investment function is led by the MoEDI. New government renamed the MoE to MoEDI to highlight importance of investments. Furthermore, more than two years ago, government has created an investment and export promotion agency, the DFA.

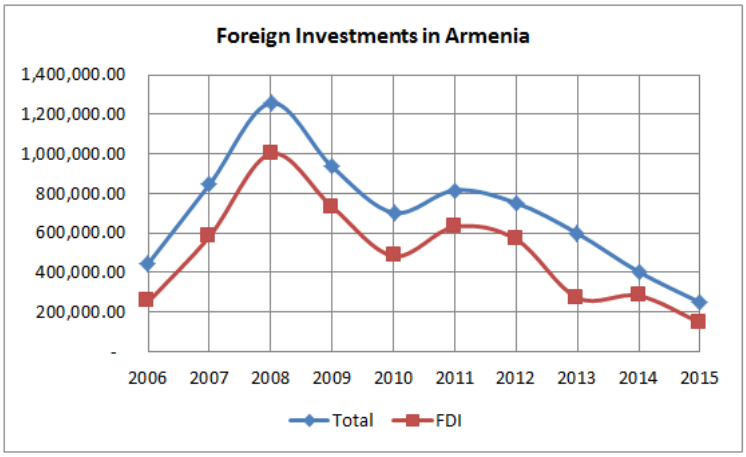
1.3. INVESTMENT DYNAMICS

During January-December 2015 the net flows of foreign investments into the real sector was 247.7 million USD. Major investing states were Argentina (98.5 million USD), Switzerland (90.2 million USD), Russian Federation (66.9 million USD), Luxemburg (59.5 million USD), Germany (56.2 million USD), UAE (25.4 million USD), and USA (23.8 million USD). The sector composition of the investments were mostly directed to the mining industry (134.9 million USD), electricity, gas (106.8 million USD), transportation and storage (72.8 million USD), wholesale and retail trade (33.7 million USD), and agriculture, forestry and fisheries (26.2 million USD). (MoEDI: 2016)

Foreign Investments in Armenia 2006-2015 (Thousand USD)

	Total	FDI
2006	444,120.00	250,727.00
2007	845,377.00	582,314.00
2008	1,257,643.00	1,000,911.00
2009	935,485.00	732,118.00
2010	702,661.00	482,999.00
2011	816,272.00	631,420.00
2012	751,804.00	567,409.00
2013	597,375.00	271,160.00
2014	402,582.00	281,790.00
2015	247,759.00	145,268.00

Source: NSSA, 2016

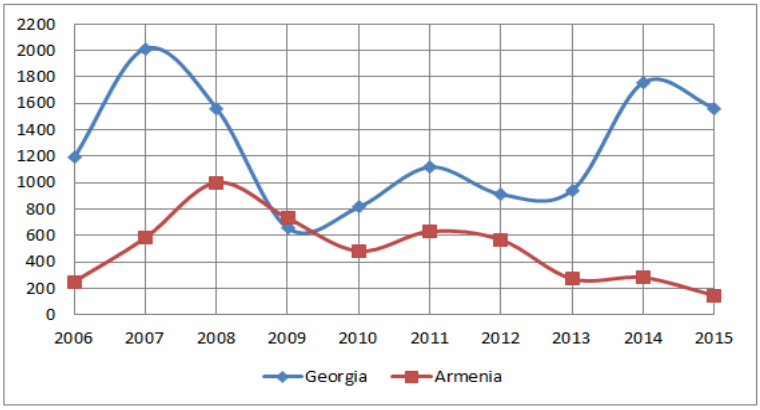


Investments dynamics and size should express concern of GoA, since it clearly demonstrates a decreasing slope in both total and foreign direct investments, which has reached its minimal point in 2015. Some may argue that due to the global financial crisis, investments in general suffered decrease all around the world, but the next chart is a good demonstration that in neighbouring Georgia situation is much different.

Foreign Direct Investments in Armenia and Georgia 2006-2015 (mln USD)

	Georgia	Armenia
2006	1190	251
2007	2015	582
2008	1564	1001
2009	658	732
2010	814	483
2011	1117	631
2012	912	567
2013	942	271
2014	1758	282
2015	1564	145

Source: NSSA, 2016



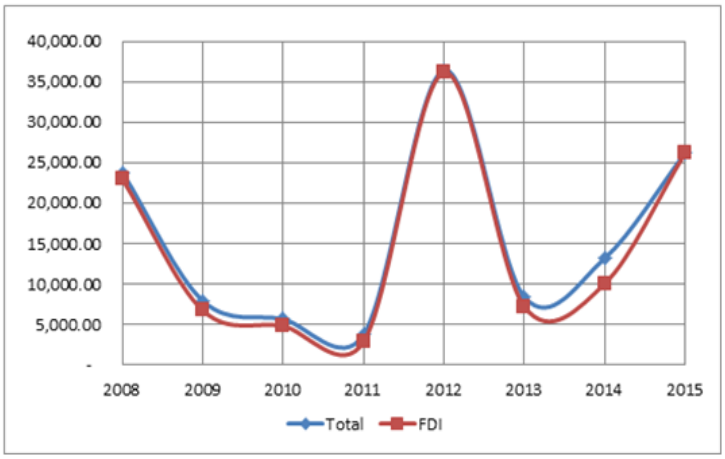
The investments into Georgia's economy are significantly higher, and after global financial crisis the foreign investment is dynamically growing (GeoStat: 2016). It is also important to note, that in Georgia most of FDI, over 50%, goes to transportation and construction sectors and about 9% in 2015 went to agriculture and manufacturing. In other words, around 50% of investments are flowing into building better infrastructure, which is one of critical factors of development, and one which has direct influence on investors.

There are some investments made during the last five years in agricultural sectors such as modern greenhouses, dairy farms, orchards, fish production. Most of these investments are local or made by Diaspora.

Foreign Investments in Agriculture of Armenia 2008-2015 (thousand USD)

	Total	FDI
2008	23,745.00	22,923.60
2009	7,893.70	6,700.00
2010	5,639.20	4,784.00
2011	3,742.90	2,835.20
2012	36,407.90	36,126.30
2013	8,371.00	7,171.00
2014	13,179.20	10,047.70
2015	26,181.20	26,163.80

Source: NSSA, 2016



Among these investments most recent case is the viticulture and winemaking sector. Currently, there are also some projects in the pipeline, particularly large scale investment into walnut production. There is a positive sign for the agricultural sector.

Entities established with foreign capital

Countries	Share (%)
Iran	38.2
Russia	21.8
USA	8.3
India	3.2
Syria	2.8
France	2.8
Lebanon	2.7
Georgia	2.1
Other	18.1

Source: State Register of Legal Entities, 2016

While total investments in Armenia are decreasing, the agriculture sector has demonstrated increase in foreign investments since 2013. The sector has a large potential for attracting foreign investments, and flow of investments can be significantly increased. Nonetheless, the size of investment is low at the moment, and government needs to implement reforms which would ensure interest of investors in the sector. In general, if we explore dynamics of investments in agriculture since independence, it has been historically very low. Tracing back diaspora activities in Armenia, ethnic Armenians living in the U.S., France, Lebanon, Russia, mostly preferred to provide development assistance rather than investing in economy. We believe that if government minimizes uncertainty and works on continuous improvement of investment environment, investments in the agricultural sector may significantly increase.

1.4. INSTITUTIONS

The main institution in charge of investment policy making in Armenia is the MoEDI. Under this Ministry, the government has formed the DFA in 2015 as a result of a merger between the ADA, IDF, and NCFA. Recently, a new foundation was formed, "Hayastani Iravazorutyun", whose goal is to increase attractiveness of Armenia to foreign investors. The Board of Trustees of the foundation is to be led by the Chief Advisor of the President of Armenia (Armenpress: 2016). Currently, the only operating agency to support investors is the DFA. The DFA provides services to foreign investors including information on business climate, investment opportunities and relevant legislation, ground support in organizing site visits for investors, management of post-visit support, assistance in investment project implementation, business introductions, etc. They also provide after-care investment services to investors already established in Armenia. Services provided by the DFA to investors are free of charge and tailored to the specific needs of each investor: support to investment, expansion, and re-investment projects; providing linkages with the Armenian business community; providing assistance on discussions with local authorities, state administration bodies, and public institutions; assistance in seeking suitable industrial zones and business properties; providing support in human resources to find specific skills and promoting cooperation between investors and universities (MoEDI: 2016). It is difficult to make an assessment of institution yet, since it has been established only recently.

1.5. LEGISLATION AND INTERNATIONAL ARBITRATION

Armenia has adopted an "open door" policy since 1994 and has passed laws on "Free Economic Zones" and "Foreign Investment". No other investment related legal or sub-legal act has been adopted afterwards. In other words, no serious attention was paid to improving investment environment. The Law on Foreign Investments provides the types and forms of foreign investments, guarantees securing protection of foreign investments and additional privileges to foreign-owned entities, as well as procedure for settlement of disputes. In June 2011, Armenia adopted a Law on Free Economic Zones (FEZ) and developed several key regulations at the end of 2011 to attract foreign investments into FEZs: exemptions from VAT, corporate income/profit tax, customs duties, export tax and property tax. MoEDI has designed new draft of the Law on Foreign Investments, and soon it will be presented to foreign investors and other stakeholders for their feedback (Yerkir: 2016).

According to the Article 24 of the RA Law on Foreign Investments (1994), all disputes that arise between a foreign investor and the Republic of Armenia must be settled in Armenian courts. Commercial disputes are heard in courts of general jurisdiction. The specialized administrative courts adjudicate cases brought against state entities. Final judgments may be appealed to the Court of Appeal and Court of Cassation, the highest judicial authority in Armenia.

A new law on Commercial Arbitration was enacted in 2007, which provides investors with a wider range of options for resolving their commercial disputes. The US-Armenia BIT provides that in the event of a dispute between an American investor and the Republic of Armenia, the investor may take the case to international arbitration. As an international treaty, the BIT supersedes Armenian law, a point which Armenia's constitution acknowledges and which holds in actual practice. While there have been a few investment disputes involving U.S. and other foreign investors, there is no evidence of a pattern of discrimination against foreign investors in these cases (UDS BEBA, 2016).

It is worth noting that beginning from October 16, 1992 Armenia has been a member of the International Centre for the Settlement of Investment Disputes and acceded to the Convention on the Settlement of Investment Disputes between States and Nationals of Other States signed in Washington in 1992 providing facilities for the resolution of legal disputes between eligible parties, through conciliation or arbitration procedures (GTA: 2016). Armenia is also a member state to the International Centre for Settlement of

Investment Disputes (ICSID Convention) and convention on the Recognition and Enforcement of Foreign Arbitral Awards (1958 New York Convention). The stipulations of the New York convention have been incorporated into Article 6 of the Armenian Constitution which requires domestic courts to recognize foreign arbitral awards.

Armenia has had plans to develop an alternative dispute resolution (ADR) mechanism that will include mediation and arbitration. ADR is expected to be used not only in commercial matters, including those involving mobile property and secured transactions, but also in cases involving family and labour disputes. While ADR options are available for those who seek alternatives to litigation, they currently are not widely used (UDS BEBA, 2016).

1.6. POLITICAL SITUATION, MACROECONOMIC STABILITY AND STRUCTURAL DIFFICULTIES

Political and economic stability are among fundamental indicators for foreign investment. In this context there are several issues that may hamper investments in the sector. Particularly, recent short war outbreak (April, 2016) amid Armenia and Azerbaijan had a negative influence on trade and investments. Among major risks for the investors, are the insecurity issue and possibility of physical destruction of production facilities; partial or full elimination of operations; possibility of imposing sanctions and trade barriers during war and after war; non proper operation of trade logistics, etc. Therefore, political risks influence on willingness of foreign investors to invest in agricultural sector of Armenia. Therefore, continuing efforts to resolve the conflict is of utmost importance.

Economic stability is playing a big role in attracting foreign investors. After the global financial crisis the Armenian economy had plummeted by 14 percent in 2009, and recovery is very slow. In the third quarter of 2016 Armenia has registered decrease of GDP by 2.6%, in the first and the second quarters economic performance was 4.3% and 1.6% respectively (NSSA: 2016). Although the data on the last quarter is not published yet, it is obvious that GDP growth will be negligible.

Due to fluctuations of local currency as a result of devaluation of Russian rubble, many exporters depending on traditional Russian market had carried serous losses and difficulties. Negative balance of payment and negative trade deficit is another issue, since the difference is usually funded by either government debt or remittances. The government debt is increasing and remittances are decreasing due to devaluation of ruble and general economic difficulties in Russia. Moreover, to moderate impact of devaluation of ruble, the Central Bank of Armenia has increased the refinancing interest rate during 2015, which also had a negative impact on businesses. Only recently, CBA has decreased the refinancing rate.

Nevertheless, the most important issue of the Armenian economy is structural. Inefficiency and corruption at public institutions, in particularly those that have regular contacts with the businesses is an issue. According to Heritage foundation assessment, bribery and nepotism are reportedly common among government officials, who are rarely prosecuted or removed for abuse of office. The judiciary suffers from a lack of independence and transparency (Heritage Foundation: 2016). Corruption remains a significant obstacle: although the government has introduced a number of reforms over the last few years, and the overall investment climate seems to be incrementally improving, corruption remains a problem in critical areas such as the judiciary, tax and customs operations, healthcare, education, military and law enforcement. Since 2004 Armenia has adopted various anti-corruption strategies. Despite this, no tangible progress has been registered. According to a recent study by Abdih and Medina (2013), the informal economy accounts for over 40% of GDP in Armenia.

Dynamics of CPI score in Armenia

Year	2015	2014	2013	2012
Armenian CPI score and place	35 (95th)	37 (94th)	36 (94th)	34 (105th)
Georgian CPI score and place	52 (48th)	52 (50th)	49 (55th)	52 (51th)

Source: Transparency International, Corruption perception index, 2016

The new government has undertaken an agenda of optimization with the aim to increase efficiency of the state institutions; however, there is still no specific measure undertaken. In addition, it is not clear if optimization will lead to ability of state institutions to provide better services. Recently the Prime Minister stated that he will rename optimization process to drastic cuts (Armenpress: 2016). What it means and how it will impact economy is difficult to evaluate; however, it increases the uncertainty.

The public debt does not focus on resolving fundamental issues in the economy. An example is the way public funds are allocated. Large amounts (percent of budget) are allocated for social and defense needs of the country, while education, healthcare and other critical public goods receive very little attention. Today, when many countries are struggling to build intellectual and technology-based economy, Armenia is still on the verge of moving from agrarian to industrial society. Without structural changes and professional public institutions, this task would be difficult to implement.

In general, the approach should be oriented on eliminating unnecessary burdens and facilitating contacts amid foreign investors and state institutions. This means first of all review of laws and regulations, enforcement of property rights, predictable legal environment, and supportive institutions. In this case, for example, the government may need to review and define rights over renting pastures, create a land register and make it accessible online, regulate and maintain better land market mechanisms, strictly define roles of central and local governments. Similar activities should be implemented in water management sector to ensure that an investor has stable water supply without interruptions.

1.7. LABOUR MARKET, EDUCATION AND INNOVATION

The amended Labour Code came into force in June 2005 and is considered to be largely consistent with international standards. The law sets a standard 40-hour work week, with 20 days of mandatory annual paid leave. The current legal minimum wage is AMD 55,000 (USD 112) per month. Entry-level skilled professionals (such as software engineers) command wages of about USD 500-600 per month. Wages in the public sector are often significantly lower than those in the private sector (UDS OIA, 2016).

Armenian law protects the rights of workers to form and to join independent unions, with exceptions for personnel of the armed forces and law enforcement agencies. The law also provides for the right to strike, with the same exceptions, and permits collective bargaining. The law stipulates that workers' rights cannot be restricted because of membership in a union. Labour organizations remain weak because of employer resistance, high unemployment, and poor economic conditions; collective bargaining is not common in Armenia (UDS BEBA, 2016).

During the investment forum in the New York City, many investment presentations referred to cheap and qualified labour as an advantage of investing in Armenia. According to the global competitiveness index picture looks differently. Although human capital is mentioned by the Armenian side as relatively cheap and qualified, Armenia is ranked 109 and 102 places amid 138 states on its ability to retain talents and attract talents (WEF: 2016). In other words, Armenia has a negative balance for talent flow. This is extremely concerning given the current transformations in the global economic system.

Nowadays, we can observe that some post-industrial states are moving into direction of intellectual economic system, based on creative ideas, innovation and new technologies; where human capital is critical. Although Armenian has the potential in this direction, many talented people have been migrating to find better use of skills and knowledge. Armenia positioned 93 and 71 levels accordingly in the quality of primary, higher education and training (WEF: 2016). If we analyse the data in details, it is quality of management of schools as well as extent of staff training that are defined as weak. In many other indicators Armenia positioned somewhere in the middle.

In Armenia, agricultural education is particularly weak and inefficient, it has no link to research and science and it does not meet requirements of industry. Moreover, in agricultural sector the situation is the worst. Most of greenhouse owners that we have talked with, mentioned limited number of professional greenhouse agronomists as one of the critical issues. Local professional higher education and vocational schools are not meeting the demand.

In regard to cheap labour force, the global economy is slowing from locating their production in countries with cheap labour force, due to replacing most labour intensive agricultural activities with machines and automating many operations. Therefore, the role of affordable labour force would be diminishing for the investors. Furthermore, it is important to train not only professional agronomists and food processing specialist, but development technology oriented institutions. The same index, for example, ranked Armenia on the 100th place in quality of scientific research institutions and 92nd in spending of companies on research and development as well as university industry collaboration (WEF: 2016). This demonstrates that there is no serious attention on technology development.

1.8. ECONOMIC INTEGRATION AND FREE TRADE AGREEMENTS

Membership of Armenia to the EEU is presented by the government as an opportunity for investors to access large market of 180 million without any barriers (EEU: 2016). Armenia´s membership in the EEU since January 2015 is a major challenge for the economy. It should be noted that taxes in Armenia are higher when comparing to Russia, Belarus and Kazakhstan and lower than average in EU. Armenian companies face a number of difficulties after the implementation of new EEU customs procedures. Although the government promised to promote small and medium-sized businesses, the authorities approved a set of amendments to the tax code that will significantly strengthen the regulation of tax reporting by small enterprises (Bertelsmann Stiftung's Transformation Index (BTI) 2016).

The reference is made to the fact that EEU space and Russian market in particularly is the largest export destination for Armenian agricultural products. In addition, Armenian products have good awareness and high quality perception. One of the key messages is that Armenia has a small market, low consumer sophistication level but as a result of joining to EEU it can become a bridge amid non-member countries and EEU. This coin has two sides. On the one hand, if the product meets country of origin requirements, it can access to EEU markets without any barrier. However, benefits of EEU are underutilized, and Armenian companies seem to continue working only in the direction of export to Russia, while trade pattern with Kazakhstan, Belarus and Kyrgyzstan has not been affected.

Despite not signing the Deep and Comprehensive Free Trade Agreement (DCFTA) with the European Union, Armenia still enjoys a preferential generalized system of preferences (GSP+) trade status with the EU and some Armenian companies are successfully exporting into the EU. Other than benefits of joining to the EEU, government officials also refer to preferential trade regime, GSP plus with the European Union, and GSP United States, Japan and Canada as well as bilateral free trade agreement with Georgia and CIS countries. In addition, they also refer to the growing importance of trade with Iran.

Nonetheless, membership possesses risks for potential investors. At first, many experts and pundits point out that integration is not only economic, but foremost political project, which means that member states may extend their sphere of regulation and decision making which may create some uncertainty. In other words, in most of trade related issues the decision is made on the EEU level, rather than national level. At second, the Russian economy is hit by crisis and it has direct influence on trade.

Furthermore, import substitution policy which has been adopted by Russia would enforce competition on Russian market, as well as possess longer term risk of import of Russian agricultural products to Armenia. There is also a risk with regard to Georgian market access: since Georgia has signed an association agreement, in the midterm perspective it may also have more stringent regulation of trade, which may hamper access of Armenian food products to that country. Ultimately, preferential trade regimes are reviewed within the certain time period; therefore, there is an uncertainty in this matter as well. There is no guarantee that EU, US and other states would regularly maintain preferential treatment for Armenia.

In May 2015, Armenia signed a Trade and Investment Framework Agreement (TIFA) with the United States. The TIFA establishes a United States-Armenia Council on Trade and Investment to discuss bilateral trade and investment and related issues and examine ways to strengthen the trade and investment relationship between the two countries.

The U.S.-Armenia Bilateral Investment Treaty (BIT) provides that if a dispute arises between an American investor and the Republic of Armenia, the investor may choose to seek remedy through binding international arbitration. Although Armenian legislation complies with the Trade Related Aspects of Intellectual Properties (TRIPS) Agreement and offers protection of intellectual property rights (IPR), enforcement efforts need improvement (UDS BEBA, 2016)

1.9. STABILITY

During discussions, many of local agribusiness owners mentioned stability as the main issue for investors. In other words, uncertainty is the major enemy for the country that hampers attracting investments. Although some producers mean political and economic stability that have been mentioned above, there are many issues raised that have to do with the trust and commitments of the government. Investors are interested to know that rules of game are static and do not change regularly. An illustration could be the cost of natural gas, which is important for those, who invest in modern greenhouses. At the moment government has decided to lower the cost of natural gas for greenhouses. It can be observed as a good stimulus, if there is a specific commitment for some certain period. An example could be that the government guarantees the price for at least 5 years. Similarly, investors are interested to see stability in tax policies, and little changes in tariffs for imported raw materials. Due to membership to the EEU, by 2020 many tariffs on import of equipment and raw materials from third countries are rising thus creating risks for those investors relying upon import of some inputs and equipment. Exchange rate fluctuation is also a risk factor.

CBA has consistently followed a strict policy of fiscal discipline, and has continued to maintain prudent monetary policies aimed at ensuring macroeconomic stability. However, interest rates remain very high. The sector needs serious reforms and development, as the banking and financial services sectors are fundamentally limited by the small size of the country's financial sector (total assets are still well below 20% of GDP), with small and undeveloped capital markets.

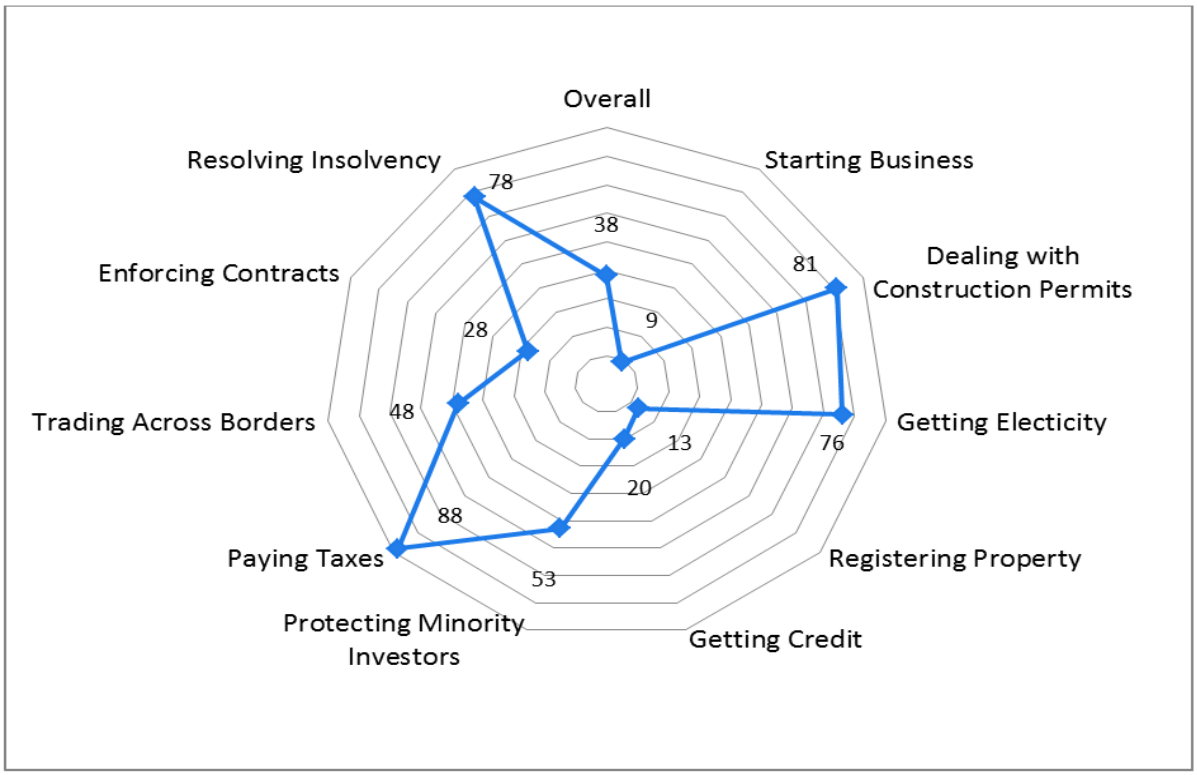
The traditionally open and liberalized Armenian economy must adopt the higher tariffs and more protectionist policies of the other EEU members. This move will not only likely spark price increases, but may also mandate a serious renegotiation over Armenia's membership in the WTO.

Internal political situation and stability is another important implication. New government has announced a

serious reform agenda, which includes a more effective way of fighting corruption and resolving issues of monopolization in some sectors of the economy; it promises to enforce law and ensure facilitated tax administration as well as equal right for every tax payer; it is addressing the issues at the customs agencies and working toward forming more professional and effective public institutions. Although these processes create positive expectation, there are several political events ahead, such as parliamentary election in 2017 and transition from semi-presidential to parliamentary state in 2018.

1.10. INVESTMENT AND BUSINESS ENVIRONMENT

In 2017, Armenia has slightly improved its position in the doing business index and was ranked 38. Nonetheless, there are serious issues that need to be addressed by the government to improve attractiveness for foreign investors. According to the index, Armenia is still lagging behind in many indicators, such as construction permits, access to electricity, protection of minority investments, payment of taxes and resolving insolvency. However, if we complement this data with the enterprise survey, then it is obvious that there are several other issues that need to be addressed. Among these issues, access to finance is important. Armenia has significantly improved its position on getting credit indicator, from 42 to 20, but enterprise survey reveals some serious issues, which makes credit affordable and available to few. In this context one of the issues is the value of collateral needed for a loan. In other words, it is difficult to raise money to finance a good program or to implement an idea; you need to have valuable collateral to get the credit. Since equity market is not developed in Armenia, banks are usually the only source of funding. In doing business index, one of the issues that have to be resolved is tax, which also reflected in the enterprise survey, around 37% of firms identifying tax rates as a major constraint. Government is usually paying a lot of attention on these indicators, and a regular works needs to continue to create a better investment environment. The neighbouring Georgia, for example, where foreign investment flow is much bigger, now outperforms Armenia in the index and is positioned 13 (WB: 2016).



Source: WB 2016, Doing Business Index.

The IMF has warned of the need for a "radical improvement" in tax collection and the business environment, noting that doing business in Armenia continues to be difficult due to the country's geopolitical isolation and

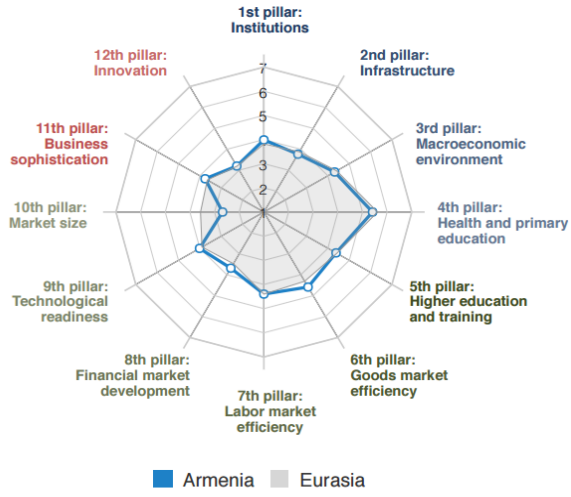
closed borders, governmental corruption, and an overall absence of clear and predictable government regulations. The IMF also remains concerned about the government's failure to reduce tax evasion and enhance competitiveness. The government needs to neutralize the unfavourable external factors through the implementation of major structural reforms.

The competitiveness index of the World Economic Forum is another important document that should be carefully reviewed by the government, because it refers to some fundamental issues of little investments. The chart below represents the weakest points, and therefore, government needs to think about the ways to improve them.

The market size was among the worst indicators, where Armenia ranked 120 among 138 states (WEF: 2016). This means, that an investor should clearly see export opportunities and clearly define markets. Little investors may consider opportunity to focus on local and very competitive markets. Moreover, the market itself in many cases is not efficient. Therefore, investors will be looking for access to potential export markets. In particularly, after joining the EEU, Armenia can negotiate free trade agreement only as part of EEU, and therefore, at the moment the only markets where Armenia has free trade agreements are CIS countries and Georgia; it is a member of customs union with Russia, Kazakhstan, Kyrgyzstan and Belarus and it also benefits from GSP+ preferential trade regime with the European Union, and GSP regime with the United States, Canada and Japan. In addition to this, recently EEU has completed negotiation with Vietnam on free trade. At the moment EEU is negotiating free trade agreements with other states, in particularly, China, Israel, Singapore, Iran, etc.

	Rank / 138	Score (1-7)	Trend	Distance from best
Global Competitiveness Index	79	4.1		
Subindex A: Basic requirements	83	4.4		
1st pillar: Institutions	66	4.0		
2nd pillar: Infrastructure	82	3.8		
3rd pillar: Macroeconomic environment	88	4.3		
4th pillar: Health and primary education	93	5.4		
Subindex B: Efficiency enhancers	80	4.0		
5th pillar: Higher education and training	71	4.4		
6th pillar: Goods market efficiency	45	4.6		
7th pillar: Labor market efficiency	55	4.4		
8th pillar: Financial market development	90	3.7		
9th pillar: Technological readiness	71	4.0		
10th pillar: Market size	120	2.7		
Subindex C: Innovation and sophistication factors	81	3.5		
11th pillar: Business sophistication	81	3.8		
12th pillar: Innovation	87	3.2		

Edition	2012-13	2013-14	2014-15	2015-16	2016-17
Rank	82 / 144	79 / 148	85 / 144	82 / 140	79 / 138
Score	4.0	4.1	4.0	4.0	4.1



Source: WEF, GCI 2016.

Armenia is also demonstrating poor performance in judicial independence and protection of property rights, indicator which is very important for companies that will be investing in research and development. In general, other than these two indicators, Armenia is still lagging behind many states in efficiency in legal framework, efficacy of corporate boards. Another investment related indicator is infrastructure, where Armenia has many positions for improvement. Some of these indicators are critically important for investors in agriculture; an example is the quality of roads, and in particularly rural roads; railroad infrastructure.

The Armenian Government and the CBA should also pay more attention to financial market development. In particularly, according to the index, it ranked 99th amid 138 states in the category of financial services meeting business needs; 87th in affordability of financial services; 119th in financing through equity market.

Armenia also was placed 54th in the world by Economic Freedom Index. In general, Armenia ranked 79th amid 138 states in all competitiveness indicators, and Government should pay close attention to those issues that are most important for the investors. Poor performance on infrastructure, macroeconomic environment, education, public institutions, and technology and innovation, are among most important ones (WEF: 2016).

Armenia ranks as one of the highest in the Logistics Performance Index: 3rd in the CIS region and with excellent performance in customs and logistics quality. Armenia has 2 Free Economic Zones with NO profit tax, VAT and property tax. Armenia allows 100% foreign ownership of local business entities and provides equal opportunities for local and foreign investors. Armenia has no restrictions on remittances and repatriation of profits. Sustainable banking system working in accordance with international standards, free currency exchange, stable local currency and finally the country offers special incentive schemes for investors, specifically for IT companies and start-ups, as well as border regions and large exporters (DFA: 2016).

Armenia currently offers incentives for exporters (no export duty, VAT refund on goods and services exported) and foreign investors (income tax holidays, the ability to carry forward losses indefinitely, and temporary import regimes for raw material imports without VAT and customs duties). The GoA amended the VAT law in 2005 to allow companies to delay VAT payments for one to two years on certain imported goods used in production and manufacturing. After the 2008 global financial crisis, the government made further amendments to the same law, and VAT payments for capital investment-related imports may be deferred for up to three years. In 2015, the GoA exempted from customs duties investment-related import of equipment and raw materials from non-Eurasian Economic Union member countries. Also, in accordance with the Law on Foreign Investment, several ad hoc incentives may be negotiated on a case-by-case basis for investments targeted at certain sectors of the economy and/or of strategic importance to the economy.

1.11 CAPITAL MARKETS AND PORTFOLIO INVESTMENTS

The banking system in Armenia is sound and well-regulated, but Armenia's financial sector is not highly developed. IMF estimates suggest that banking sector assets account for about 90 percent of total financial sector assets. Financial intermediation is poor. Because Armenian banks charge service and other fees, the actual interest rate paid by the customer may be higher than the nominal interest rate quoted by the banks. Nearly all banks require collateral located in Armenia, and large collateral requirements often prevent potential borrowers from entering the market. This remains the main barrier for SMEs and start-up companies.

The GOA has a welcoming attitude towards foreign portfolio investments, and there is a system and legal framework for investments in place. However, Armenia's securities market is not well developed and has only minimal trading activity through the NASDAQ-OMS exchange. Liquidity for the transfer of large sums can be difficult due to the small size of Armenia’s financial market and overall economy. The GOA is hoping that as a result of the 2014 pension reform, which brought two international asset managers (Amundi and C-Quadrat) to Armenia, the capital market will play a more prominent role in the financial sector of the country. Armenia respects IMF Article VIII by refraining from restrictions on payments and transfers for current international transactions. Credit is allocated on market terms and foreign investors are able to access credit locally. (UDS BEBA, 2016)

2. RECOMMENDATIONS

a. **Strengthening capacity of investment promotion agency.** Strengthening capacity of the investment promotion agency, DFA has to better address needs of sectorial investors. DFA has two investment departments, one aiming at development of investment programs and one on promotion. A mechanism is necessary to ensure that those two departments have capacity to provide investors with agriculture related services. It should design mechanism of cooperation with the MoA on the regular basis. At the moment this mechanism is either absent or weak.

   The agency maintains the website that provides necessary information for prospective investors, however the website in not very informative at the moment. In the websites of similar agencies in Georgia and Chile, for example (www.investingeorgia.org/en) (www.investchile.gob.cl), an investor can explore a lot more information, than what DFA proposes. The web site should be designed in the way that it is regularly based on recent inquiries from investors. A dedicated person in the MoA should be recruited and trained to work with the DFA.

   In this context, the agency and MoA should work together to define the best local investment practices and design an investment program catalogue, which should define specific projects, investment size, basic information on potential markets, risks and main financial indicators such as Internal Rate of Return and Net Present Value of a project in comparison to other available forms of investment. This information should be available printed and online at MoA and the Agency. If someone is interested, these data can be articulated in details. Usually, these tools can better attract prospective investors, rather than demonstrating strength of a specific sector in theory. Existing as well as newly created foundation have to offer foreign investors with the business services therefore. It should also initiate dialogue amid banks and donor organizations.

b. **Defining target investors.** Better targeting at specific countries and prospective investors may be helpful during preparation and implementation of investment policies. Therefore, it is recommended to prepare a list of potential countries and potential investors that may have interest in investing in agricultural sector.

   In the agricultural sector, ethnic Armenians from diaspora communities can be considered as potential investors or it could be states having growing population and limited agricultural resources. These countries and businessman may be interested in filling supply gap. Armenia is located nearby many oil and gas rich Arabic states that have limited potential and resources for developing agriculture. These states can be a good source of investments in agriculture and food production. An example could be a lamb production, where neighbouring Iran and other Gulf countries have high interest. If government design proper pasture management plan and pasture leasing scheme, it may attract investors.

c. **Designing specific investment programs.** An investment portfolio should be designed to ensure a) investment flow into priority sector b) to provide investors with profitable investments opportunities c) develop potential public private partnership projects d) define specific government support tools and mechanism. We have attempted to find such a portfolio at the website or by visiting MoA and the DFA; however they have only a few business plans, in most of cases prepared by businesses or by international development organizations. Although, these projects do not follow the same format, but can complement this works. DFA should work closely with the MoA to identify and design a few realistic investment project portfolios, which ideally should have high internal rate of return. Most of investors will be looking at the projects with the shortest return and high profitability, and the support by the government that can have many forms, starting with some guarantees and finishing with co-funding. The projects

should be therefore profitable in comparison with basic return of financial portfolio. A risk minimization strategy should be also designed.

d. **Creating regularly updated land bank and facilitating land market.** Land market and land availability is among top issues that many investors are facing, in particularly those who need larger parcels of land for orchards, feed production, etc. The first issue is that investor in many cases has to visit villages and regions to explore availability of proper land. Therefore, primary task for government should be creation of land information system, which can be accessible to investors. Land information system has to have proper information on current land condition and history of land use. Mapping of land, as well as recommendations on the best use of the land can be also added. This database would be also very useful for other types of investors, in alternative energy sector, for example. This function can be performed by the regional institutions of the MoA. In particularly, NSSA completed agricultural census and data is now widely available, it can be complemented with new technologies for regular data collections, and groundwork of the MoA on quality of land. MoA has referred that it works with the WB to start a satellite analysis program to better address the issue of land use and availability.

   In addition, government should clearly map all community lands and decide upon flexible mechanism of land renting or leasing to foreign investors or selling to local investors. To overcome the problem with the land register, government may consider long-term leases, which can boost investments. It could protect ownership rights and provide no tenancy rights to the lessor to ensure that the land reverts automatically to the owner when the lease period expires. In parallel with land bank and register, the similar works should be implemented for unused property (such as production facilities, old factories, etc.).

   In order to promote use of land, progressive land taxation should be adopted. Furthermore, the land market mechanism should be developed and government may consider or create brokerage service in rural communities to facilitate the process. These services can also be delegated to existing public institutions in the field, such as regional agriculture support centers, where staff should be recruited and trained. Many investors are mainly concerned about inefficiency of land market, difficulty in finding larger land parcels and difficulty in finding land owners.

   Ultimately, to increase effective operation of land market, government should facilitate procedures, reduce or eliminate payments associated with the land purchase or lease, and ensure protection of ownership rights.

e. **Invest in basic rural and agricultural infrastructure.** Needless to mention that the investors would like to see some basic infrastructure such as road and water supply systems to ensure that they can reach production facility and they can have access to water. These investments can be a good source for creating short term employments during the economic slowdown and optimization of government, where many employees will leave their jobs. In the long run perspective, infrastructure would attract investment in real economy which would result in inclusive economic development. Infrastructure is public good that in most of the cases is provided by government. Availability of proper infrastructure is also very important for investors, including those interested in agriculture. Among most important are the roads, water storage and distribution systems, and alternative energy. In particular, investments into infrastructure at this moment have also importance in stimulating economy. We recommend, due to high level of ineptness of the country, not to rely upon new loans, but rather reallocate resources to strategic infrastructure development, which will aim at sectors like tourism, agriculture, etc.

f. **Human Capital Development:** Human Capital is critically important for all sectors of the economy, but especially for agriculture, because agriculture-related professions are not very popular in the society for

many different reasons. However, knowledge is critical in transformation from traditional to technology and knowledge oriented sector. Low interest in and low quality of education result in absence or very little number of good agronomists, animal health and food safety specialists and many other professions. The problems exist at many different levels, in vocational schools, higher education institutions and extension system. Availability of skilled labour force would not only trigger economic development and improve livelihood and social conditions, but also boost innovation. The system of technical education and vocational schools is particularly important.

A number of studies have shown positive correlation of level of education and economic development. A latest book, "East Asian Development: Foundations and Strategies", highlights positive correlation between education and economic growth (Perkins: 2013). Education and ability to attract skilled labour force, also demonstrate the strength of US economy in terms of innovations and technological advance. According to authors, American leadership was linked to the level of investments into human resources, which led to economic growth (Acemoglu and Autor: 2012). Therefore, it is critical to support developing countries to modernize the system of primary and higher education. Armenia is certainly not a destination of cheap labour force, and it should therefore concentrate on professionalism.

The agricultural extension system should be designed from the scratch and proper quality of extension can accommodate a number of services for investors. First, they should have knowledge and full understanding of priority investment fields to articulate to potential investors. The extension system also needs to play the role of technology and knowledge transfer. Extension specialists can also be trained in maintaining land register and assisting investors in obtaining land. Low salaries are the main barrier which hampers attraction of better specialists.

g. **Assess priority investment sectors and ensure preferential custom regime and tax operations.** If government would like to focus on development of a selected sector, then its policies should aim at facilitating transfer of technologies, import of equipment with either extended value added tax and no import tariff or other preferential treatment. In some cases, government should also consider preferential treatment for some input for some time, depending on the internal rate of return and breakeven of the business. Tax policies should be simplified.

   Another issue for investor is import of equipment, machinery and other capital goods form outside EEU. The main risk is associated with tariffs for capital goods are high. Therefore, based on priority sectors, Armenia should negotiate within EEU preferential treatment of these products. This is important to ensure that investors do not have to increase the cost of investments due to these payments.

h. **Identifying and removing unnecessary paperwork and procedures.** In general, approach should be oriented on eliminating unnecessary burden, and minimizing unnecessary contacts amid foreign investors and state institutions. This means first of all review of laws and regulations, enforcement of property rights, predictable legal environment, and supportive institutions. In this case, government may need to ensure friendly environment.

i. **Natural born disaster risk management.** Since agricultural sector also is the riskiest one, it is proper to think about ways of how to minimize those risks on the state level. The main risks in Armenia are frost and hail damage, droughts, strong winds, and floods. Each risk has a unique solution, and in some cases large investments. In addition, there is also possibility of introducing agricultural insurance. In general, the best practice is to ensure that all risks with probability of occurrence equal or higher than 5 years can be qualified for insurance. If a probability is less than five years, then it is better to adopt physical measures of protection, such as hail nets against hail, better storage and management of water resources to address the issue of drought. The government is working with the German Development Bank and

may start a pilot project in 2017. In addition, it should consider support measures for those that would like to adopt any tool to minimize the risks, such as tax and tariff exemption of hail nets.

j. **Labour Legislation:** The existing labour legislation also should be changed. Particular attention should be paid to measures that will increase the labour productivity, while ensuring that the proposed changes are in line with internationally recognised principles and standards on employment and industrial relations. Reducing informality of employment would not only bring substantial benefits to Armenia's economy, but would also protect workers, increase labour and product market efficiency and productivity.

k. **Ensuring Readiness for Equity Financing:** In Armenia, many companies rely on banks and credit organizations as the sole source of funding, in addition to own capital. Nonetheless, there is a growing opportunity for developing of equity financing. Many international banks and development organisations have raised interest toward application of this tool in the agribusiness sector. IFAD, for example, has designed an equity financing mechanism in Armenia implemented by the Fund for Rural Economic Development of Armenia (FREDA, www.freda.am). During the workshop organized by the European Investment Bank (EIB), regional representatives expressed interest of EIB in extending this tool in agricultural sector. However, there are number of issues to be resolved before these tools can become widely available for the agricultural sector. Among the main issues, is lack of corporate management culture, unwillingness of many companies to allow equity investor to participate in management of the organizations and ensuring access to accounting and finances of organizations, and finally little interest in high quality external audit. Usually, chief accountant takes a role of Chief Financial Officer (CFO), and there is a low level of application of the function of financial manager.

   In order to create a favourable environment for equity investors, and ensure interest in investing into agricultural operations, companies should better address the issue of corporate governance, and fully understand and apply best financial practices. But the main issue also remains preparing better financial managers, and ensuring availability of business schools and training centers. At the same time, government should ensure that companies do not experience double accounting practices and do not afraid of allowing foreign companies to fully engage in management of organizations. This is critically important, because those companies can play a critical role in improving management of organizations.

l. **Legislation and International Treaties.** Albeit the fact that Armenia has a favourable investment environment, the government should take into consideration that many other states are struggling to protect investors and provide them more preferential treatments. In this context, it is recommended to join OECD Declaration on International Investment. The OECD Guidelines for Multinational Enterprises (OECD Guidelines), which form a part of the OECD Declaration on International Investment and Multinational Enterprises, are recommendations on responsible business conduct (RBC) addressed by adhering governments to businesses operating in or from their jurisdictions. The Guidelines set out principles and standards in all major areas related to good business practices, including information disclosure, human rights, employment and industrial relations, environment, bribery and corruption, consumer interests, science and technology, competition, and taxation. Additional obstacles to FDI in agriculture include uncertainty and time of judiciary processes which, according to interviews and statistical data from Doing Business and Global Corruption Barometer, are seen as one of the most corruption prone areas in Armenia.

   Investment treaties are another policy area to help contribute to a sound investment climate for both existing and new investors. In some sense, Armenia has very limited options as signing bilateral agreements are subject for mutual agreement clause among countries of Eurasian Economic Union. A first valuable step could be for Armenia to follow to the UN Convention on Transparency in Treaty-Based Investor-State Arbitration. The review provides useful information on the temporal validity of

Armenia's international investment agreements, which could inform the country's timetable to engage with its treaty partners. Finally, Armenia's newly established body responsible for strategic investments could serve as a valuable vehicle for bringing about policy coherence on a wide range of issues that affect the quality of the investment environment, including, for example, labour relations and corporate governance in which Armenia has relatively low scores according to GCR. A robust investment promotion body, should have the potential to shape the quality of incoming investments.

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