

ISSUES RELATED TO PROMOTING A COMPETITIVE BUSINESS ENVIRONMENT IN ARMENIA

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Abstract: *Despite the apparent growth of the Armenian economy, there is widespread concern that the lack of competition within Armenia could threaten the long term sustainability of growth and that it has been a contributing factor to the existing wealth polarization in Armenian society. The paper examines the scope for anti-competitive behavior, which sectors are the most affected, what relevant work has been done on these issues, what policy options are available to deal with the problems, and what additional work is needed. The analysis points at the three main areas: (1) regulated sectors, where there are natural monopolies or where competition is inherently limited, such as utilities, telecommunications and transportation; (2) sectors of the economy that in Armenia are generally viewed as being controlled by a small number of incumbents and (3) barriers to entry into economic activities. Ultimately, the paper suggests policy options for promoting a competitive business environment in Armenia.*

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I. INTRODUCTION

The Armenian economy has registered sustained rapid growth over the past decade, especially in the last few years. In 2003, GDP increased by 14 percent in real terms, after having increased by 12.9 percent in 2002. The government is committed to economic reform, and the economy is gradually being transformed. Private sector development is the main pillar of its growth strategy and it has been working to improve the business environment through a reduction in regulations, improving the bankruptcy law, improving customs administration, strengthening the banking system, and reducing the capacity of officials to hamper businesses. In this process, it has received substantial support from donors. Nevertheless, per capita GDP remains low. Although the extreme poverty rate has fallen, there are still large numbers of poor in Armenia, especially in the rural areas and urban centers outside the capital, Yerevan. Unemployment statistics still show large number of unemployed, although the informal sector, which currently accounts for the equivalent of 46 percent of GNI,²² probably has absorbed a substantial number of those who are recorded as being out of work. The “trickle down” impact of the high growth rates on poverty alleviation has been disappointing and there has been slow progress in reducing the unequal distribution of income – Armenia’s Gini coefficient²³ is 0.45, which is the highest in the Former Soviet Union (FSU), though household survey data put the coefficient at a much more reasonable 0.27, possibly due to unrecorded informal sector and remittance income.

Although the economy’s growth performance has been strong, the government is anxious to ensure that it is sustainable. In this regard, there is concern that the lack of competition within Armenia could threaten the long term sustainability of growth and that it is a contributing factor to the apparent failure of the recent economic expansion to benefit a larger proportion of the population.

The aim of this paper is to come to a preliminary judgment on the importance of this issue for the development of the Armenian economy. The paper examines the scope for anti-competitive behavior, which sectors are the most affected, what relevant work has been done on these issues, what policy options are available to deal with the problems and what additional work is needed. It also touches on the political economy issues related to areas of the economy where competition is lacking and suggests policy options for the government.

The paper is organized as follows: we look at three main areas where competition issues are important in Armenia. In the first section, we discuss briefly those sectors that are traditionally regulated, *i.e.* where there are natural monopolies or where competition is inherently limited, such as utilities, telecommunications and transportation. Then, in the second section, we look at sectors of the economy that, in Armenia, are generally viewed as being controlled by a small number of incumbents who either singly or in cartels dominate distribution of particular products. These include gasoline, wheat, cut flowers, and sugar. In this section, we also discuss some of the methods that appear to be used to maintain market dominance and make some suggestions. In the third section, the paper looks at barriers to

²² Source: World Development Indicators 2003.

²³ The Gini index of income is a measure of the degree to which income among a population is unequally distributed. The Gini coefficient ranges from 0 to 1. If the income is perfectly even distributed, the Gini coefficient is 0. If the income is perfectly concentrated, the Gini coefficient is 1.

entry into economic activities more generally – the higher the entry barriers, the less likely growth is to trickle down to the population more generally and the greater the long run constraints on growth. The final section of the paper provides some conclusions and policy implications.

II. EXISTING ANALYSIS OF COMPETITION ISSUES IN ARMENIA

Several pieces of work on Armenia touch on issues this paper raises, but, to date, there has been little specific analysis of the issues related to competition. The Trade Diagnostic Study (World Bank, 2002) examined constraints related to further integration of Armenia's foreign trade into the world trading system. It touched on some of the issues related to promoting competition, particularly in the customs area, as well as some of the constraints on private sector development of foreign trade. A recent USAID Report, prepared by Nathan Associates, J.E. Austin Associates, (2004) on competitiveness provides quite detailed descriptive analysis, though without any further consideration of real issues related to lack of competition that constrain the Armenian economy. A study of financial markets in Armenia by Mu, *et al.* (2004) sets out issues related to financial market underdevelopment. A very recent report (Schiffman, 2004) on bank corporate governance and creditors' rights analyzes recent changes in laws related to collateral and finds that little has been done. There is currently underway an analysis of Armenia's trade in services within the context of the General Agreement of Trade in Services. It will examine in greater depth some of the issues raised in this paper, particularly with respect to landing rights at Yerevan airport. Additional relevant work includes an analysis of competition law reform (McArdle, 2001). None of these studies, however, address the issues related to promoting an effective environment for competition in Armenia.

III. COMPETITION POLICY IN ARMENIA

This section examines some of the issues related to sectors that are traditionally regulated in most economies. These include telecommunications, power, water, natural gas, transport, and airports. The Armenian Parliament is in the process of legislating a telecommunications Act that, once passed, will bring telecommunications regulation under the jurisdiction of the Public Service Commission. The Commission also regulates power, water, and natural gas.

Other sectors are regulated differently. The Civil Aviation Service (CAS) regulates air traffic. Yerevan airport operates under a concessional agreement between CAS and a foreign company owned by an Argentinean-Armenian, which is an important step in creating favorable initial conditions for successful air transportation regulation. The Ministry of Transport regulates other transportation. The national railway company is still state owned, and unfavorable practices have been reported in this sector. In addition, the Commission for the Protection of Economic Competition (CPEC) also has jurisdiction to the extent that companies' practices in these sectors are deemed to harm the consumer. So far, it has not exercised this authority, though the CPEC is adamant that it could do so in the future.

The Public Services Commission has been the recipient of substantial support from donors, both in the area of technical assistance to upgrade skills and in improving its operating infrastructure. As a result, the capacity of the Commission to regulate the industries under its jurisdiction has improved.

A. Telecommunications

After independence, Armenia inherited a relatively extensive but low quality telecommunications network. The design of the network was not commercially driven, leading to misallocated lines and low call volumes. These elements combined with politically driven low local tariffs (subsidized by high international call rates) resulted in low revenues per line. The outcome was outdated equipment, poor network quality, and a slow digitalization rate due to chronic under investment in the sector.

The government added substantially to the problems of the telecommunications sector by awarding a long term monopoly (granted until 2013) to ArmenTel, the local telecommunications company owned by the Hellenic Telecommunications Organization, a Greek company. The monopoly, which also encompasses cellular and “last mile” internet services, has allowed ArmenTel to provide low quality services at high prices, further hampering growth in telecommunications and related sectors. The process of privatization was poorly handled, was not transparent, and occurred without an adequate regulatory framework. Its costs are still being born by the private sector of the Armenian economy.

The impact of the high costs of telecommunications are especially severe given that Armenia is remote from Europe and the United States – the need for low cost communications is acute in small remote economies. One of the rapidly expanding areas of the economy is the IT sector, which relies on communicating easily with the outside world.

The result was very high telecommunications costs that severely exacerbated Armenia’s geographical disadvantages. One indicator of the inefficiencies arising from the monopoly is that mobile phone cards, issued by ArmenTel itself, sell at a high premium on a secondary market. ArmenTel does not issue sufficient quantities of calling cards to meet demand and the price is bid up to 3 or 4 times the face value of the cards. It is quite possible that these cards offer ArmenTel employees substantial opportunities for corruption, because they have an inside track to obtaining the cards, which they could resell if so disposed.

In spite of this, the internet sector of the Armenian economy has thrived and there are a large number of internet service providers. However, they all have to go through ArmenTel to connect to the Internet, which results in unreliable connections and a limit on their ability to compete in price. Service is also limited to modem connections only – ArmenTel maintains a monopoly on high speed connections and charges prices that are 20 to 30 times more than those in countries where there is competition in the telecommunications sector. The government recently has taken ArmenTel to arbitration in a London arbitration tribunal on the grounds that it has failed to fulfill its contractual obligations to invest in the telecommunications sector.²⁴ It has also announced that, regardless of the outcome of the arbitration, it will open the cellular and data transfer portion of the sector to other providers.

These statements have not materialized in concrete outcomes. There appears to have been a settlement of the dispute and a new license has been issued to another service provider; however, Armentel maintains its monopoly of internet services and has banned VOIP.

²⁴ Though there is some concern that the investment issues are less clear cut than they otherwise would be because ArmenTel also has a business in Armenia selling telecommunications infrastructure equipment.

Although details are not yet available, the initial outlook for promoting competition does not appear promising.

The need for regulation is probably intensified by the forthcoming changes, and it is important to put in place a coherent and competent regulatory structure. To ensure this, continued donor assistance to the Public Services Commission to enhance its capabilities to regulate the telecommunications sector is warranted.

B. Utilities

The electricity sector has been restructured substantially over the past few years. First, the distribution system has been privatized, an effort that appears to have been very successful. Whereas prior to privatization, inefficiencies and large arrears strained the system to the point where it was breaking down, arrears have now been eliminated, electricity bills are collected on time, and the system functions reliably. This is one of the success stories of Armenian privatization.

The power generation sector consists of five large generators, one of which is nuclear, two of which are thermal, and the remaining two of which are hydro-electric. One of the hydro generators and one of the thermal generators are operated by the Russian government, which acquired the generators from the Armenian government in a debt-for-equity swap. Russians government also operates the nuclear station under a management contract. In addition to the large generators, there are a substantial number of small private hydro producers who supply the grid, which is compelled to purchase any power that they produce.

The Public Services Commission also regulates the natural gas distribution sector – in which many of the same issues appear to apply—and there is no indication that distribution occurs ineffectively. The Russian-Armenian joint-stock company “ArmRusGasProd” has invested intensively in developing a gas-distribution network in the country.

The Commission regulates the producers²⁵ on a rate of return basis. While it is possible to quibble over the efficiency of this rate of return regulation, a brief review indicates that it appears to be done competently, though a much more in-depth study would be needed to confirm this.

C. Transport

There are several issues in the transport sector that warrant further investigation. The Ministry of Transport regulates rail traffic. In the railway sector, there were reports that price setting is non-transparent and opportunistic – there were ongoing negotiations with the Gold Mining Company regarding new rates that the Ministry tried to approve. Realizing that the Gold Mining Company needed to connect its mining facilities (situated in the North-East part of the country) with its melting facilities (located in the South-West of the country), and the fact that using other means of transportation other than the only existing railway are economically inefficient, the state-owned railway company attempted to abuse its naturally dominant power in the sector by proposing high rates for transporting ore so that it could extract extra-high profits from the transaction.

²⁵ Except for the small ones, which can sell at a predetermined price until 2007.

Issues relating to air traffic are also grounds for concern. The national flag carrier, Armenian Airlines, went bankrupt and was liquidated in 2003. A local company, Armavia, bought the liquidated Armenian Airlines and thus acquired bilateral landing rights in flights to and from Armenia. Armavia, and its the landing rights, was in turn purchased by Air Siberia, a Russian airline company. There have been reports that whenever foreign airlines operating in Armenia want to increase the number of their flights and apply for permission to do so from the CAS, the CAS has in turn sought the agreement of Armavia which owns the bilateral rights. In effect, therefore, a private company that has no interest in seeing competition increase because it reduces the value of the landing rights that it holds indirectly controls access to Yerevan by foreign airlines.

This clearly substantially disadvantages Armenia. A small, remote economy that implements policies resulting in increased cost of communications, whether telecommunications, or transportation, exacerbates the effect of its smallness and remoteness. The Armenian national interest requires that the government take as bold a policy towards air transport as it appears to do with the telecommunications monopoly. An open skies policy should be implemented without delay. Moreover, in this context, the operating infrastructure of the CAS should undergo the necessary changes to maintain an open skies policy.

IV. LACK OF COMPETITION IN DISTRIBUTION

Many private sector participants in Armenia operate in ways that would otherwise be unusual in many industrial countries. As is common in many countries with weak institutions, facilitation payments are frequently used as a means of ensuring that dealings with the public sector proceed without undue delay. Unlike other countries in which facilitation payments are common, however, the system has so far not degenerated into one where massive corruption is pervasive, although undoubtedly there is corruption that extends to the highest levels. Rather, it has evolved into one in which interlocking obligations arising from favors and interventions govern much of the interaction among the business community, as well as between businesses and the legal system. A person who acts to intercede on behalf of another becomes a *roof*, and the benefactor incurs an obligation to return the favor in one form or another at some point in the future. In Armenia, there appear to be few rules that cannot be modified or adjusted through the intervention of a *roof*, even within the judicial system. In sectors where a powerful *roof* exists, the incumbents seem to have the power to make life extremely difficult for new entrants.

It is also noteworthy that foreign investors often do not have the network which would provide them with a *roof* and so are frequently more likely to have difficulty navigating their way through the various bureaucracies and judiciary, something which has been mentioned in all the surveys that have been done on foreign investment in Armenia. In addition, companies that are only exporters claim they are singled out for unfavorable treatment, especially with respect to VAT refunds.

This phenomenon can act, however, as a substantial barrier to entry in the Armenian economy, both on the part of foreign investors as well as for new local businesses that attempt to compete with well-established companies and individuals operating in the Armenian economy. Despite recent improvements, subtle methods are used to impose

severe operating constraints on new competition, ranging from problems in clearing goods through customs, to inspections of various types by government officials, to outright sabotage of operations. Furthermore, such behavior is difficult to identify clearly because it is protected by all the members of a particular *roof*.

There are numerous, widespread anecdotes that a few powerful groups dominate the economy and maintain tight control on certain activities, particularly imports of petroleum, sugar, flowers and wheat.²⁶ It is, however, difficult to obtain hard evidence regarding these allegations, and the deeper the investigation, the greater the contradictions. *Roofs* do appear to operate in these sectors though, on their face, there is some competition. On the other hand, there are also widespread allegations that companies in these sectors are anonymously owned by interlocking share-holdings, so that a small number of people effectively control who can extract large profits and who engages in extremely conspicuous consumption.

A. Petroleum Products

Since Armenia has no oil or natural gas resources, it totally depends on imports. Imports of fuel products constitute about 20 percent of total imports. Imports of petroleum products (which include gasoline and diesel) and natural gas imports are the largest types of fuel products in terms of volume.

Statistics on imports of petroleum products appear to have been underreported. Data largely exclude imports by the Defense Ministry, Internal Affairs and the Nuclear Power Station, so it is not possible to determine the total imports of these products. Furthermore, in spite of very rapid growth, statistics on gasoline and diesel imports into Armenia show that in 2000 there was a sharp drop in the import volumes, and only very modest growth afterwards. This occurred in spite of a sharp increase in automobile imports, which rough statistics indicate exceed 14,000 vehicles per year, compared with 1,200 per year in 1999. Though fuel prices rose in 2000 oil prices rose, depressing demand, recently imported automobiles are more fuel efficient, and some motor vehicles have been converted from gasoline to natural gas, it seems unlikely that in the face of such rapid economic growth, fuel consumption could go down. Some observe that smuggling of petroleum is one explanation for the flat fuel imports.

The structure of market concentration underwent changes in the 1999-2000. In 1999, there was only one gasoline importer in Armenia, so that market power was located completely inside the borders of the country. In 2000 and 2001, the number of importers into the country increased so that, looking only at the number of operators within Armenia, the market could not be defined as uncompetitive. Analyzing the import chain reveals, however, that there is only one supplier who provides the bulk (88 percent) of imported gasoline to importers. While the concentration of direct importers has declined, the virtually single-sourcing of supply for gasoline importers means that the supply chain remains highly concentrated. Even though it has been reported that one more company started to supply importers with gasoline in 2002, the share of the incumbent supplier firm remained dominant at about 70 percent of total import supply.

²⁶ In this section, we based our analysis on the data and the information obtained from IMF Armenian Country Office and National Statistical Service (NSS). Reliable information on petroleum products and vehicle imports has been provided by the IMF Armenian Country Office. Data on sugar, wheat and cut flower is obtained from NSS.

Box 2.1. Welfare Impact of Non-competitive Behaviour in the Gasoline Market

To stress the negative impact of non-competitive behavior in gasoline market we made a very simple calculation of welfare losses (Table 2.1; for the explanation of the terms used in the analysis below one is referred to Tirole (1988)). We assumed a linear market-specific demand curve and estimated its slope and intercept considering price-increase vs. demand-decrease scenarios during 1999-2000 (such a decrease in demand is mainly explained by price increase in the international oil prices in contrast to the observed non-price impact (such as increased imports of cars after 2000) on the demand during later years).

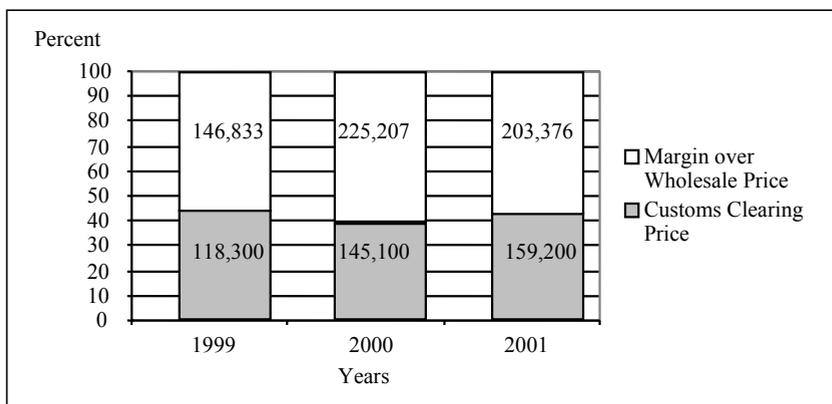
Table 2.1. Welfare Calculations in the Petroleum Market

Year	1999	2000	2001
Retail Price (Thousand AMD per Ton)	265,1	370,3	362,6
Customs Clearing Price (Thousand AMD/Ton)	118,3	145,1	159,2
Quantities Consumed (Thousand Tons)	258,1	181,4	187,5
Total Profit (Mln. AMD)	37,897,8	40,852,6	38,133,0
Estimated Slope of the Demand Curve	-1.4	-1.4	-1.4
Estimated Intercept of the Demand Curve	626,473.7	626,473.7	626,473.7
Quantities under Customs Clearing Price	362,981.2	343,838.4	333,766.9
Deadweight Loss (Mln. AMD)	7,700,0	18,291,2	14,873,6
Deadweight Loss (Mln. USD)	14,5	33,3	26,1
GDP (Mln. USD)	1,845.5	1,911.5	2,118.4
DWL as a percentage of GDP	0.8	1.8	1.3

It turns out that welfare loss, as a result of non-competitive behavior in the gasoline market alone, was averaged on 1.3 percent of GDP. This loss figure can be even higher if we consider that there is a double marginalization (we have not include in the calculations the deadweight loss, which can occur as a result of monopoly power of one supplier of importers) and that the same situation dominates in many other similar markets (such as in diesel market).

Moreover, the fact that concentrated rather high gasoline market profits (about 3.7 percent of GDP) have not contributed to reducing unequal distribution of income in the country accentuates the importance of liberalizing the petroleum oils market.

Figure 2.1. Gasoline Price Structure for the Period 1999-2001; AMD per Ton



More interestingly, though the large number of retail companies operating in Armenia ensures retail competition, the retail mark-up price was substantially higher than the imported (wholesale) price (which we treat as the customs clearing price). The gross profit mark-up, most of which probably occurs at the wholesale level, constituted more than half of the retail price in 2001 (Figure 2.1). Since competition at the retail level is strong, it is very unlikely that retailers earn excess returns – most of the returns probably accrue to the wholesalers. These rough calculations indicate that there appears to be large welfare losses arising from the concentration of the petroleum market that could amount to the equivalent of over one percent of GDP. This loss figure may be even higher if we take into consideration that there is a further profit margin earned by the single source monopoly supplier of imports. This is not included in the calculations of the deadweight loss, which can occur as a result of monopoly power of the one supplier of importers and that the same situation dominates in similar markets (such as in the diesel market).

B. Sugar

A single importer supplies the vast majority of Armenian sugar imports. Various rumors, many of them dark, surround the business practices of sugar distribution believed to be controlled by this single “oligarch”. The Commission on the Protection of Economic Competition investigated the sugar-importing company, but before a judgment could be reached, the importing company was dissolved and a new one created with the same shareholders. As a result, the original case did not proceed – whether a new one will be brought is yet to be determined. Trade data indicate that imported sugar comes mainly from the United Kingdom (U.K.). For the considered period the import share of U.K. averaged around 70 percent. Other countries that have a notable share in Armenian sugar importing: Iran, Russia, Turkey, and Ukraine.

Figure 2.2. Sugar Price Decomposition (US dollars per Kilo)



The monopoly in the sugar market is reflected in Armenian sugar’s price and mark-up data. Figure 2.2 shows that the difference between the customs clearing price and the retail price of sugar is substantial – the retail margin is 47 percent, very high by any standard. Like petroleum, there is substantial competition at the retail level, so excess profits are unlikely to be earned at this stage.

Table 2.2 reveals the patterns of the mark-up. Sugar has a very low demand-price elasticity, which allows a high-profit-seeking importer with dominant power to hinder potential entrants. During the period under consideration, the returns in the sugar market profit were, on average, approximately US \$14 million.

Table 2.2. Sugar Market Data

Year	1999	2000	2001	2002
Mark-Up (USD/KG)	0.185	0.176	0.222	0.205
Percentage Annual Change of Mark-Up	-	-4.650	25.933	-7.349
Import of Sugar (Metric Tons)	69,836	69,422	73,485	68,400
Percentage Annual Change in volumes of imported Sugar	-	-0.592	5.853	-6.921

Some in Armenia argue that there are not large welfare issues arising from the importation of sugar. They point out that the market is small and the main supplier can use his dominant position to purchase large quantities of sugar at a low price. Therefore, even if there are some monopoly rents being extracted, the welfare losses are offset by lower wholesale prices than would exist if there were several importers buying at higher prices in the exporting countries. The flaw in this argument is that if the current importer had concerns about new entrants, it would not exploit its market dominance to the same degree and would extract lower rents. In addition, the large numbers of businesses operating in areas where there is no restriction of competition illustrate the potential dynamism of the economy. Companies in the IT area, restaurants, retail outlets and building are being created in large numbers. Restricting competition harms the Armenian economy's entrepreneurial and dynamic element as well as consumers.

C. Wheat and Cut Flowers

Gathering data in other markets proved to be more difficult, and it was not possible to undertake an analysis as detailed as that for petroleum and sugar. Armenia imports approximately 50 percent of its wheat and the majority of its cut flowers. There are widespread reports of concentration of distribution in both these products, with potential competitors being harassed at the borders by customs who used many non-tariff restrictions – health standards, quality standards, and valuation prices - in order to delay imports to the point where costs arising from dealing with the delay eroded any potential profit. These issues are discussed at greater length in the section on the customs service.

D. How Monopolies Are Maintained

Corruption and rent sharing with state officials are a pervasive reality of doing business in Armenia. These practices affect the competitive environment in many ways. Market incumbents make illicit payments to, or enter into collusion, with governmental officials and agree to share rents, which are generated as a result of collusion. There are reports of state officials being given shares in incumbent companies, which distorts the incentives associated with increasing public welfare through greater competition. Instead, the incentive for officials who are also shareholders in the incumbent companies is to maintain the *status quo*. As a result, the abuse of state power is a tool for maintaining monopolies in the market. Although illicit and sometimes violent “private methods” have been used to

maintain a dominant position in one specific market, the abuse of state power remains the most effective and widespread method for maintaining monopoly power.

The Customs Office

Armenia has made great strides in attaining compliance associated with World Trade Organization (WTO) access; however, this has not prevented the Customs Office from remaining one of the predominant instruments for hampering or eliminating potential competitors, particularly in the distribution sector. Customs clearance and valuation procedures are far from transparent and standardized, with substantial discretion being applied in the licensing of brokers, storage, and freight transporters and in the operation of the free trade zone. In addition, the continued widespread use of reference pricing in contravention of WTO commitments is another method of delaying imports. Since customs also has some responsibility for enforcing product standards, the number of potential administrative barriers are legion, particularly since some of these standards are also under the jurisdiction of the Ministry of Health. There are, therefore, numerous opportunities to delay imports for a large number of reasons. Some of these issues are discussed in greater detail in the following sections.

Limiting the Number of Customs Brokers and Associated Activities

The Customs Office controls “unwanted” private enrolment in customs operation through widely reported unfair and discretionary licensing of customs brokers.²⁷ The Customs Office appears to limit strictly the number of brokers through customs examinations. Each year there are examinations for customs brokers – even incumbents must take annual exams.²⁸ There is anecdotal evidence that, in 2003, 30 out of 36 applicants allegedly passed the examination but after internal review the Customs Committee declared that there were only 5 successful applicants. One of the unsuccessful applicants (an operating broker) apparently was able to get another Minister to call the Chairman of the Customs Committee on his behalf, so finally there were 6 successful applicants.

On its face, the procedure appears valid: a written examination subject to scrutiny and appeal. In practice, however, the results of the examination are subject to internal review and adjustment at the whim of the Customs Committee. This “informal review” procedure is not written down anywhere. With such subjective discretion, the Customs Committee can strictly control the number of brokers and restrict their independence.

Clearing Procedures

The Customs Office has introduced electronic clearing procedures to expedite the clearance of goods. Customs brokers, however, do not have access to the computer system and, therefore, must deal with paper documentation that nullifies many of the advantages of computerized clearance and that provides inadequate information about the status of the goods that they are attempting to clear. The result is uncertainty in the process and delays for which importers incur substantial costs, especially since they are charged for storage of the goods that are held up.

²⁷ Customs brokers were only legalized 3 years ago.

²⁸ Licensing fees are US\$500 per year, very high in a country where civil servants salaries rarely exceed US\$100 per month.

Another issue frequently cited by importers is the continued use of reference pricing by Customs Office unless extensive documentation accompanies shipments.²⁹ If any of the documents are missing, then Customs applies reference prices to the shipment, a practice that is contrary to WTO rules. In other countries, goods can be cleared with partial documentation under surety bonds that provide a guarantee in the event that the declaration was incorrect; however, the lack of financial system development in Armenia implies that surety bonds are difficult to obtain and, even when they are not, the cost is high. The problem of reference prices is further compounded by the relatively high VAT rate (20 percent) and the extreme difficulty in obtaining drawbacks of VAT payments upon the export of any goods that use imports as inputs.

E. The Role of the Commission on the Protection of Economic Competition

Should the Commission on the Protection of Economic Competition (CPEC) be one of the pillars of policy to promote competition in Armenia? There are understandable concerns that it could become yet another layer of bureaucracy that leads to “inspections” and the ability of businesses to function without undue interference of officialdom, which in turn can be used to harass entrepreneurs and to protect incumbency. Arguments in favor of strengthening the Commission are based on the recognition that it could be a means to resist the restrictions on competition that abound in several sectors of the economy.

In our view, CPEC’s present form means that it is not a significant bulwark against anti-competitive behavior. It has neither the necessary skills, nor the staff, nor the facilities, to operate effectively. Though it has succeeded in a limited number of cases,³⁰ it is not a force in areas where competition is obviously restricted. Its report on the petroleum market is deficient in terms of depth as well as analysis³¹.

Does this mean that attempts to assist the Commission should be abandoned? We do not believe so. Over the longer term, it could be one of the instruments for promoting competition in Armenia. CPEC warrants modest technical assistance and perhaps some help with improving its IT resources. It is unrealistic, however, to perceive it as useful in the shorter term. CPEC needs several years to evolve into any sort of instrument against restrictions on competition. Nevertheless, its continued existence is assured and it is in the interest of the private sector lie to its technical competence.

V. BARRIERS TO ENTRY

Formal barriers to entry have been reduced. For example, the cost of registering a business is now negligible and occurs with few delays. The Armenian authorities are determined to eliminate delays altogether; however, reducing the costs of formalization does not address

²⁹ Importers are required to present original documents, including the invoice, the contract covering the import, the certificate of origin, and an export declaration from the country of origin.

³⁰ The Commission has investigated a number of recent cases among, which was the successful elimination of a monopoly granted by the airport operator to a taxi cab company. There have been also several hearings concerning the abuse of monopoly power by ArmenTel. The company had cut-off the telephone lines of some internet service providers without prior notification, suspecting them of providing Voice-Over IP service in Armenia. In almost all cases, the Commission made decisions in favor of the ISPs and fined ArmenTel to cover the losses incurred by ISPs.

³¹ A four-page analysis concluded that there is competition in the distribution of petroleum because several wholesalers/importers exist within Armenia. The paper does point out that there is only one supplier/seller to the wholesalers but appeared not to view this as a problem.

the many issues related to the benefits of being formal. As the next sections will point out, public goods related to the business sector are still inadequate. The main reasons for formality are access to finance and access to a system of formal contracting. In Armenia, financial markets function poorly, and the system of contracting and dispute resolution is haphazard at best so that even under normal circumstances it is not effective. Armenian businesses have little incentive to formalize, and the current system also allows petty officialdom to target formal businesses with inspections that have payoffs as their aim.

There has been some progress in reducing these payoffs. For examples, tax officials can now conduct only one audit per year, but they are still allowed to undertake “fact finding”, which is not classified as an audit. Nevertheless, businesses report that information obtained during fact finding, which can occur as often as requested, is used in annual audits. The restriction on auditing is insufficient to limit official inquiries.

A. Financial Markets

Financial markets play a key role in intermediating between savers and investors. In addition, the financing of new projects enhances openness and competition by ensuring that profitable investment opportunities do not go untapped. The pressure of potential competition that well-functioning financial markets bring ensures that monopoly profits are limited. Since financial markets in Armenia fail to play this role, the disincentive on incumbents not to exploit their position is severely weakened.

Financial Underdevelopment

Financial markets in Armenia are severely underdeveloped and finance effectively neither local production nor foreign trade.

Figures 2.3 and 2.4 show the level of financial market development in Armenia compared to that in other countries at various stages of development³². Even by the standards of low income countries – those with per capita incomes of less than US\$1,000 – the ratio of credit to the private sector is very low – only one-fourth that of the average credit to GDP ratio in other low income countries. The lack of finance to business acts as a severe barrier to entry. Potential competitors cannot finance their businesses, either in the form of working capital or to finance foreign trade. The result is that incumbents’ market dominance is rarely threatened by new entrants and that wealth remains concentrated among those with resources.

In spite of the low amount of credit to the private sector, there does not appear to be an excess demand for loans. On the contrary, at current rates of interest, there is an excess supply of loanable funds. For example, the largest bank in Armenia (HSBC) lends a much

³² The data for Armenia appears as percentages superimposed on the charts. For the countries in the sample, the chart is based on the ratio of credit to the private sector from deposit money banks and other financial institutions. For Armenia, it is the ratio of credit to the non-government sector. According to a sample of 47 countries: high income countries are defined as countries where GDP per capita in 1999 was higher than US\$10,000; upper middle income countries are defined as countries where GDP per capita in 1999 was between US\$3,000 and US\$10,000; lower middle income countries are defined as countries where GDP per capita in 1999 was between US\$1,000 and US\$3,000; low income countries are defined as countries where GDP per capita in 1999 was lower than US\$1,000. *Source: International Financial Statistics Database and World Development Indicators Database.*

smaller proportion of its liabilities (ten percent) to private business than it does in other countries in which it operates, where it lends 60 to 70 percent of liabilities.

Figure 2.3. Interest Rate Spreads (lending rate minus deposit rate)

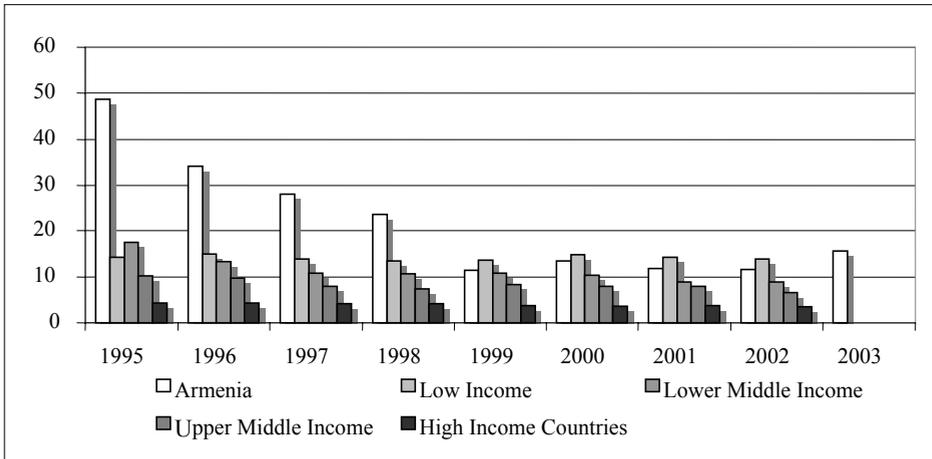
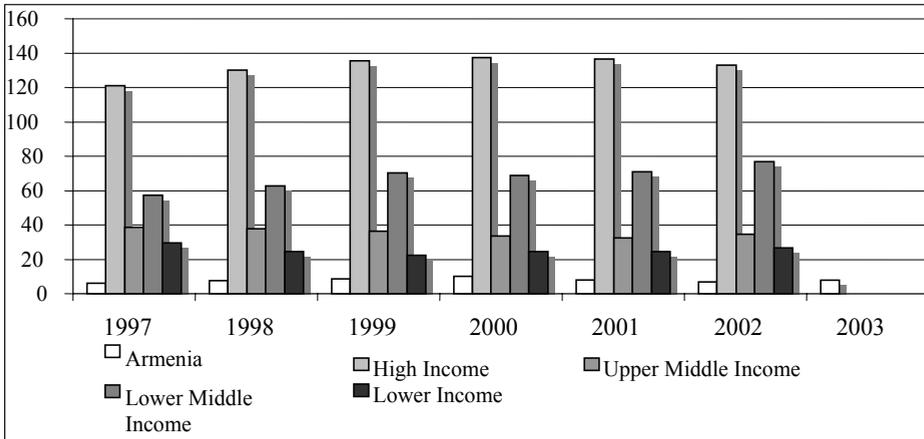


Figure 2.4. Domestic Credits to the Private Sector (percent of GDP)



Although interest rate spreads between borrowing and lending rates have fallen, they remain higher than in other low income countries. Financial activity in the foreign trade sector is limited. Some importers do use the banking system of raise letters of credit but the practice is not widespread. There is little export financing. The practice of using irrevocable letters of credit as basis for providing funds to fulfill export orders appears to be non-existent. As a result, the financial system cannot be said to support the growth of trade that in turn is the key to promoting more competition in Armenia. Essential skills in raising letters of credit are confined to a small number of banks. Before exporting under letters of credit can occur, training in the minutiae of the procedures will be required for most banks in Armenia.

Secured Transactions Framework

In Armenia, movable property cannot be used effectively as collateral to secure loans. There are numerous problems with the secured transactions framework. Floating pledges are not allowed, and there are no registries that allow pledges to be perfected. Repossession is time consuming and costly. A particular problem with financing exports is that there is no provision allowing the use of future production as collateral, so that financing against export orders is not feasible. A similar problem arises with imports. Because there is no provision for pledging goods that are not possession of the borrower, imported goods paid for by letter of credit cannot be seized in the event of default. The effect of the inadequacies of the collateral framework extend throughout the economy, with the result that banks correctly perceive lending as extremely risky.³³ To understand what is necessary to establishing a framework for secured transactions, it is essential to understand the four economically important stages of any secured-transactions system. They are:

- *Creation.* The process by which the creditor establishes a security interest in a specific property (the collateral.)
- *Priority.* The process by which the lender establishes the priority of the security interest.
- *Publicity.* The process that makes public the priority of the security interest.
- *Enforcement.* The process by which, upon the debtor's default, the creditor will seize and sell the collateral to satisfy his claim.

Each of these stages must function effectively for collateral-based lending to occur. Currently, in Armenia, none of them work well.

There is an ongoing USAID project to assist in the reform of the collateral framework. The implementers of the project reported that a law had been drafted by a prominent Canadian expert but that the Ministry of Justice had redrafted the law to include many undesirable features. There is also World Bank assistance in this area through further review of the law. In our view, neither approach will be successful. Comprehensive collateral reform requires reviewing and changing the whole process for pledging of property. While rewriting the laws governing the ability of property to serve effectively as collateral is an integral part of this process, it is a long way from being all that is needed. Without a thorough revision of the whole system, collateral reform will remain elusive.

There have been many attempts at such reform in other countries, most of them unsuccessful. Legal analysis, without corresponding analysis by economists of suggestions for reform, has failed in most countries that have attempted it. Established international legal models may not be the best economic practice to reform the collateral framework.

It is our opinion that a good project on collateral reform requires close coordination between the economists, international legal experts, local lawyers, and technical experts. Local lawyers perform crucial functions both at the first stage, in research, and at the second stage, explaining the work to other local people. Failing to integrate the local and international legal experts can only produce poor results. The international experts cannot

³³ Some advocate “relationship lending”, by which banks make loans on the basis of analysis of business plans and the borrower’s history as an entrepreneur. This is unlikely to happen. First, most lending to businesses in the United States is secured by collateral, unlike Armenia. Second, the skills available for drawing up business plans are scarce. Third, those who have run businesses successfully are often the entrenched interests in Armenia, so that they, who have tight control of the business sector, are the most likely to receive loans.

make sensible recommendations without considerable input from the local lawyers. Furthermore, economists and technical experts should be involved from the outset of the project, collaborating with lawyers in a diagnosis of the issues and elaborating drafting options.

Examples of successful reform do exist and serve as a model for Armenia. A recent reform of the secured transactions framework in Romania has transformed Romania's lending environment by facilitating the use of collateral as security for lending, not only from the banking system, but also from equipment suppliers, wholesalers, and agricultural suppliers. There were many similarities between the Romanian financial sector before this reform and that in Armenia – severe financial underdevelopment, inability of a large sector of the economy to access credit, and a distrust of banks. Romania is also a civil code country. Use of this model could have significant potential for the development of the Armenian financial system that could substantially reduce barriers to entry.

The secured transactions reform in Romania tightly integrated diagnosis, drafting, and regulations, which is one of the main reasons for its success. Such methodology has rarely been followed in reform efforts elsewhere. Even in the United States, reforms of the collateral framework have proved to be much more expensive than they needed to be.³⁴

Credit Bureau

There is a new initiative in Armenia to establish a credit bureau. The progress of this effort is an interesting illustration of the difficulties of doing business in the country and why it still possesses a much less competitive environment. Initial contacts indicated substantial enthusiasm for obtaining credit information on potential borrowers. There was support from banks, microfinance institutions, and utilities, all of whom promised to supply information.

The Central Bank proved to be less than enthusiastic, however, apparently because the credit bureau would compete with information that it sells. Commercial Banks supply full details to the Central Banks on all the loans that they make that exceed US\$3000. These records are sold to commercial banks that ask for information on potential borrowers that have applied for loans. The Central Bank has taken the position that it intends at some point to privatize the sale of this information and is, therefore, unwilling to make it available to the credit bureau. The lack of support by the Central Bank has, in turn, led to a waning of enthusiasm by the commercial banks for the new credit bureau and only one has signed up for its services. In other countries with successful credit bureaus, it has usually been necessary for the Central Bank to insist that the commercial banks share information on their customers. The fact that Armenia's Central Bank is almost a competitor not only bode ill for the new credit bureau, but also sends an ambiguous message to potential entrants in this area. In our view, the Central Bank should cooperate to encourage the entry of credit information systems rather than act to hinder them.

³⁴ The State of Maryland reformed its secured transactions law, but left in the unnecessary condition that original documents had to be filed. This necessitated the development of a very expensive scanning system for the system to be accessible on-line. The final cost was over US \$10 million, compared with substantially less than US\$1 million for the Romanian reform.

B. Commercial Law and Contracting

The law governing commercial transactions is inadequate, with the result that contracts tend to be informal and take place between people who know each other well. The effect is a barrier to entry – arms-length contracting is a requirement of a well-functioning economic system. Non-arms-length contracting also has the effect of increasing incentives for informal behavior, which occurs widely in Armenia. Problems include:

- Basing decisions on issues related to commercial transactions on an agglomeration of civil code laws, which makes the applicability of contract provisions uncertain.
- Basing contractual agreements on “unless otherwise governed by law” rather than “unless otherwise stated in the contract” provisions. Since many commercial transactions are subject to a wide range of laws, rather than a more unified commercial code, this provision requires a full knowledge of all the laws and implementing regulations that may apply to an agreement, which is compounded by the problem of unavailability of translations.
- Not only the lack of precedent in courts’ decisions, but also of the absence of a system to report cases, though a World Bank legal reform project has partly addressed this issue.
- in addition to the uncertainty arising from the commercial code, the view that judges are incompetent and corrupt. As a result, businesses have little recourse if they are the victims of anti-competitive behavior.

Notaries and Formal Contracts

The role of notaries in Armenia adds to barriers to entry and the incentives for informal behavior. Notaries are government employees and are required to validate most contractual documents. Procedures are antiquated and slow. Notaries also act as judges and determine the validity of documents (and in many cases insist on preparing the documents). Notary fees and stamp fees are high and are based on the value of the transactions covered by the contract being notarized. The result is that many contracts remain informal due to the high cost of notarization and that incumbents favor those with whom they have experience working.

C. Bureaucracy

A further problem for businesses in Armenia is the failure of the government to issue VAT refunds to those companies that are primarily or solely engaged in export. For example, a company that exports smelted copper is owed large refund amounts that stretch over more than twelve months. Similar problems are reported by one of the major hotels in Yerevan that is having difficulty getting VAT refunds on the cost of building. While this is not necessarily an issue that impinges directly on competition in Armenia, it is another illustration of the failure of the state to protect property rights and the rights of businesses, and it is a further example of the limited benefits of formalization.

A recent FIAS Report (2004) also highlights the role of the tax authorities in raising transactions costs. Over 80 percent of respondents indicated dissatisfaction with their dealings with the tax administration. They cite most problematic areas in tax regulation and administration as the “extra-legal requirement for advance payment of taxes”, “frequency of changes in rules and rates”, and “availability of information regarding the laws and

regulations”. While these data must be interpreted cautiously – Armenian businesses are not known for their compliance with the tax codes – the widespread dissatisfaction with the lack of transparency of the process is indicative of the extent to which taxation can be used as an instrument for harassing entrants into areas that are dominated by incumbents.

VI. CONCLUSIONS AND POLICY IMPLICATIONS

There is little doubt that some sectors of the Armenian economy face a serious lack of competition. The preceding analysis indicates that in several sectors, particularly those related to imports and distribution, monopoly profits are being earned by a small group who are profiting greatly and imposing welfare losses. Therefore, concerns regarding lack of competition in Armenia are warranted. This paper identifies three separate areas of the economy where competition, or its lack, is an issue. These are:

- the traditionally regulated sectors – utilities and natural monopolies;
- areas where competition is widely perceived to be restricted, especially petroleum, sugar, wheat and flowers; and
- barriers to entry that maintain the position of market incumbents.

Nevertheless, it is important to recall that Armenia has been among the fastest growing economies in the world for several years. This rapid growth is all the more noteworthy because has taken place against a backdrop of closed borders and the threat of renewed hostilities with Azerbaijan over Nagorno-Karabakh.

Lack of competition, however, has long-run efficiency implications as well as the danger that the apparent concentration of wealth could reduce political support for reform and limit the benefits of rapid growth. There is ample evidence of poverty in Armenia, even in Yerevan – outside the capital it is far worse. Poverty reduction requires that the benefits of growth “trickle down” to a substantial number of people, because even at current growth rates, it will be some time before Armenia can afford adequate social safety nets. The more competition is restricted and commercial activities are reserved for incumbents, the less likely it is that the benefits of growth will be widespread.

There are additional unfortunate consequences of the dominance of the oligarchs in some sectors. The concentration of wealth provides substantial ability to grant “favors” to officials and to subtly (and, sometimes, not so subtly) hinder competitors entering the market. The phenomenon of “*roofs*”, discussed in the section on business practices, is one manifestation of the way incumbents maintain their market power. In other cases, it appears that there are direct attempts to prevent competition. Widespread subversion of the “rules of the game” by the rich and powerful sends strong messages to those who are on the outside. It contributes to a general attitude that taxes should not be paid, officials should be bribed and goods smuggled. This does nothing to develop the foundation for a modern competitive economy.

A. Geography and Competition Policy

The Armenian economy is small and remote. One of the aims of policy should, therefore, be directed at ensuring that nothing exacerbates these geographic facts of life. In particular, policy should ensure that communication and transportation are as low cost as possible. In the past, policy has not adhered to this principle and almost appears to have been designed

to intensify the disadvantages of Armenia's geographic limitations. The ill-conceived awarding of a telecommunications monopoly to ArmenTel has substantially raised the cost of communications. The policy regarding regulating flights into and out of Yerevan raises that cost of traveling to and from the country. There is no valid economic reason for these restrictions. The government has started to do something about the telecommunications issue. It should take similar measures with regard to air transport and declare an open skies policy, allowing any airline that wishes to fly to Armenia to land at Yerevan.

B. Regulated Sectors

In the sectors that have traditionally been the object of regulation, progress is being made. Actions are being taken to deal with the ArmenTel monopoly, and telecommunications regulation will come under the jurisdiction of the PSC once Parliament passes the pending legislation, as noted above. Regulation of power generation and distribution, as well as natural gas, has advanced. Both industries are also regulated by the PSC. The Commission's function appears to have improved – for example they reversed price increase in the energy sector. Although it is possible to quibble about the methods used, as well as some of the details of regulation, there is no doubt that in this area significant progress has been made.

There are concerns regarding regulation in sectors that are still state-dominated, especially the railway, which is a vitally important industry given Armenia's transport problems. The Ministry of Transport currently both administers and regulates the railway. Transport-intensive industries, such as mining, complain that attempts are being made to raise tariffs without any apparent justification. This is an issue that needs further investigation as well as the development of a system for setting tariffs. No options should be dismissed *a priori*, including privatization of the railway and bringing regulation under the purview of the PSC. Regulatory capabilities are scarce in Armenia and consolidation under one body, which can then be the recipient of intensive technical assistance, could be the best policy option.

C. Areas Where Competition is Restricted

This paper examines sectors of the economy that are widely regarded to suffer from lack of competition through monopoly and restriction of competition in the distribution chain. It concludes that there is evidence that prices are higher than they would be if there were more competition, and that welfare losses are significant. Most of the sectors discussed in the paper are involved with the distribution of imported products. In one sense, the problem would disappear immediately if it was possible to import freely; however, the paper points out that customs have become an instrument for maintaining the monopoly position of incumbents. There are several things that can be done about this.

The first is to increase the transparency of the process. When examination sheds light on irregular practices, they tend to decline. Two steps are possible in the short run: first, make the computerized customs database available to brokers, including the clearance of all goods, so that restrictions on shipments must be explained; and second, make the customs exams more transparent by following the letter of the law in this regard. All examination papers and the marking of the papers should be available for inspection.

Whether this is feasible from a political economy perspective is another matter. Donors have recommended customs reform almost from the time of the country's independence.

Some progress has been made, particularly with respect to the procedures related to Armenia's WTO accession. Nevertheless, there is still a long way to go, and the current process clearly maintains monopoly positions. Since the number of access points to Armenia is limited as a result of closed borders with Azerbaijan and Turkey, the effectiveness of restricting certain imports is enhanced. In addition, the use of reference pricing is still widespread, in contravention of WTO undertakings. Although customs and revenue officials claim that it is necessary to check invoices to ensure that there is no cheating on VAT payments, there are alternative procedures that allow goods to be cleared pending a check on prices that are used successfully in other countries. There is no reason why these methods could not also be used in Armenia.

One further issue hinders the customs process. By any standard, Armenia's VAT rate of 20 percent is high and provides incentives for smuggling and for evading duties. It is understandable that the authorities and donors are reluctant to reduce the rate when the overall tax take is equivalent to only thirteen percent of GDP. Nevertheless, taking into account incentives faced by the private sector is a key to the successful long term development of the Armenian economy and the need for reform of the tax system is part of this.

Perhaps another avenue is open to the authorities to improve competition in the petroleum market. They could insist that at least 50 percent of the petroleum imported into Armenia come from one of the large western petroleum companies and that the invoices supplied with the shipment be made available for public inspection.

D. The Commission on the Protection of Economic Competition

In its present form, the Commission can do little to ensure competitive markets in Armenia. It lacks the resources and the skills to be effective, and it has no power to enforce its own judgments except through the court system, which itself is arbitrary and open to outside influences. The policy question is, therefore, whether devoting resources to strengthening CPEC is warranted. Such assistance would take the form of upgrading the Commission's resources, particularly in the IT area, upgrading the skills of the Commission, and perhaps giving it the power to enforce its judgments. Currently, an USAID project is underway that will partly achieve the first two objectives, though the extent to which it will do so will be set out in a report that is so far unfinished.

Concerns regarding strengthening CPECrest on the understandable desire to avoid that yet another layer of bureaucracy that could be used as an instrument to harass business. The Commission is not going to disappear, however. Its existence is enshrined in law and it appears to have powers that have so far been untested. Upgrading CPEC's resources is necessary to prevent it from turning into the very institution that some fear it could become. The more professional the Commission, the less likely it is to turn into an instrument for restriction rather than promotion of competition.

E. The Long Term Promotion of Competition and Development

In the long run, promoting competition in Armenia is inseparable from promoting private sector development in the country. The ability to restrict competition frequently arises because the institutions that normally support private sector activity are underdeveloped, providing strong incentives for informal behavior. In Armenia, the public goods that provide the foundation for private sector development are weak. The court system does not

function effectively and arms length contracting is risky, so that transactions tend to take place between those who know and trust each other. This gives powerful advantages to incumbents. Similarly, the financial system remains extremely underdeveloped even by the standards of low-income countries. Hence, those who have substantial financial resources are in an especially strong position in maintaining and strengthening their market dominance. The development of institutions supporting the private sector is the only long-run solution to promoting a competitive market environment. Legal reform and the reform of the secured transactions framework are two measures that will greatly enhance private sector activity. In addition, it is necessary to upgrade government institutions. They need to be of positive assistance to the private sector, rather than the instruments for maintaining anti-competitive behavior that they now are. In particular, reform of the customs service is the key to promoting competition.

F. Shorter Term Measures

Several of the suggestions in the preceding sections could be implemented with little delay. The announcement of an open skies policy would signal the government's commitment to establishing a more competitive business environment. An immediate change in the examinations for customs brokers would signal a commitment to transparency in customs procedures as would giving access to brokers the computerized clearing system. Insisting that a certain percentage of imports of petroleum be purchased from one of the large international petroleum companies and that the documentation be made publicly available would also promote competition.

G. Suggestions for Further Work

A number of areas require further work to suggest more detailed reforms. The most important of these are:

- A thorough review of the commercial code to identify areas that are inimical to modern commercial practice and to suggest reforms. This review should not only be undertaken by lawyers but also by economists to ensure that the incentives inherent in the code are identified from an economic as well as a legal perspective.
- A similar review of the consumer protection law to take stock of the system for consumer protection that underlies the role of the CPEC. Such a review will ensure that the commission does not become an instrument for the harassment of businesses and that the incentives in the law make sense from an economic perspective. This review could also look into the feasibility and desirability of establishing a small claims court where consumers and producers who have been harmed by anti-competitive behavior could sue the perpetrators.
- stocktaking stock and reviewing the regulatory framework to determine how well it is now functioning, where further strengthening is needed, and how the PSC can be further supported in its work.
- A thorough review of the issues related to secured transactions reform, from an economic as well as a legal perspective. This should include the feasibility of using a similar approach to that taken in Romania.

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