PAPER

The Small and Medium Size Enterprises and the Middle Class Evidence of the Republic of Armenia

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Abstract This paper analyzes the importance of small and medium enterprises (SME) development in the context of middle class enlargement in the Republic of Armenia (RA). The paper first describes the relationship between the relative size of the SME sector and the living standards by country groups classified by the income-based criterion of the World Bank. We then show that the shares of middle class and SMEs increase as countries grow richer and societies less unequal. We also found that despite some improvements in SMEs in RA for the last years its size remains still insignificant and the impediments restricted the future development of the sector are specified.

Introduction

The middle class is typically identified with a large range of occupations and professions and includes people holding professional degrees such as academics, lawyers, engineers, doctors as well as clergymen and lower-level occupations different from manual workers[1]. Besides being a typical public employee, middle class is also identified as an owner (as well as employee) of micro, small and medium size enterprises. That is why, the sector of small and medium size enterprises is often assumed to be a source of employment and incomes for the middle class, which, in its turn, is considered as the provider of innovations and the source of skilled labor force. In fact, based on cross country and panel econometric regressions, Easterly (2000) has shown that a higher share of income for the middle class are empirically associated with higher income, higher growth, more education and other favorable development

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1 Solimano A. "The Middle Class and the Development Process", p.1 - http://www.andressolimano.com

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outcomes[2]. Moreover, some recent empirical evidence shows that, (in relative terms), the SME sector is larger in higher income countries than in middle and lower income countries[3]. This paper comes to prove the aforementioned using a wider range sample of indicators included in the analysis as well as to determine the main causes of small middle class in Armenia and find the possible ways of its enlargement.

Cross-country analysis of the correlation between income distribution, standards of living and the share of SME

Economies were grouped according to their level of per capita income using the definition of the World Bank (Low-Income, Lower-Middle Income, Upper-Middle Income and High-Income) and estimated for each group of countries the following averaged for the period 2007-2012 indicators: GDP per capita, share of poor, middle and rich classes, income GINI Index, percent of SME's employment in total employment and percent of SME's output in GDP (see table 1).

Table 1 Country groups by several indicators

Country group (income-based criterion of the World Bank)	GDP per capita (PPP adjusted, US$ year 2000)	Poor (Deciles 1 and 2, % of GDP)	Middle class (Broad definition, Deciles 3 to 9, % of GDP)	Rich (Top Decile, % of GDP)	Income GINI Index	SME's Employment (% of Total Employment)	SME's Output (% of GDP)
Low-Income Economies	1220	6.04	60.41	33.55	0.422	36.19	24.00
Lower-Middle-Income Economies	3339	5.54	59.94	34.51	0.438	38.76	29.41
Upper-Middle-Income Economies	9506	5.69	61.21	33.10	0.423	51.14	40.79
High-Income Economies	36959	7.47	66.67	25.85	0.330	63.93	48.77

Source: Own elaboration based on World Bank database – www.worldbank.org

Table 1 shows the tendency of increase in the share of middle class while moving towards higher level of per capita income. Also we found that the income share of the rich (top 10 percent) is smaller in high-income economies (on average 25.8 percent) than the corresponding share in low-income economies (33.5 percent). So, income distribution is less concentrated in high-income economies than that is in middle and low income economies. The same results are considered while analyzing GINI index. Such results allow to confirm the presumption that countries with high Gini index (that is more unequal societies) have relatively smaller middle class than more equal economies. Moreover, high-income economies have substantially higher share of SME in employment and output than other groups. Micro enterprises play an important role for any economy as it provides self-employment and small family business.

2 Easterly, W. (2000). "The Middle Class Consensus and Economic Development", The World Bank, Policy Research Working Paper # 2346 – www.worldbank.org
3 Ayyagari, Meghana, Thorsten Beck and Asli Demirgüç-Kunt (2005). "Small and Medium Enterprises across the Globe", p.36 - http://www.tilburguniversity.edu

It is a labor-intensive activity and the important source for family income growth. Among the main obstacles for development of private business, especially SME worth for mentioning is the limited access to external financing. Development of the majority of Armenian enterprises is financed from own resources, which consists about 89%, perhaps, the highest among CIS and Baltic states. Financing from formal sources consist only 11.4% of overall financing directed for establishment and development of private companies (see table 2).

Table 2 The main sources of investment financing in fixed assets in Armenia and several other countries, 2010%

Country	Own resources	Shares and other securities	Banks	Non-bank financial institutes	Public resources	Leasing	Suppliers credits	Other
Armenia	67.3	1.0	3.2	0.4	4.9	0.9	1.0	21.3
Georgia	69.6	0.7	7.2	1.3	6.8	3.4	5.2	5.8
Azerbaijan	63.4	0.2	1.9	0.4	14.4	0.8	3.4	15.5
Russia	69.6	0.9	5.6	1.3	4.0	3.5	8.7	6.4
Ukraine	69.1	2.2	6.4	1.7	4.9	1.1	7.0	7.6
Estonia	35.5	15.9	20.0	5.6	2.3	8.5	3.8	8.4
Poland	39.6	30.5	15.1	3.9	1.4	4.3	3.5	1.7
Hungary	42.1	11.0	18.1	5.7	4.2	2.4	4.1	12.4
Czech Republik	43.6	8.8	20.2	7.9	6.0	3.4	3.5	6.6
Bulgary	48.2	7.4	16.4	9.6	4.4	3.6	5.5	4.9

Source: Data of Investment Climate Around The World, WB, 2011, p. 122.

For comparison, in Estonia it consists 55.5%, in Georgia – 24.6%, in Poland – 56% and etc. Financial sector provides only 6.5% of resources, 3.2% of which is provided by banking sector. For example, in the same Poland this number consists 54.6%, in Estonia - 53.5%. This evidences of financial market underdevelopment as well as low level of financial discipline and mutual trust in business environment which would become a serious impediment for private sector development in the nearest future. Current credit policy and crediting procedures actually restricted the opportunities especially for poor people to get credit, necessity of which for this category is highest5. It emphasizes the importance of credit expansion and easiness for getting credit for reducing the poverty and income inequality and therefore for enlargement of the middle class.

Middle class and SME sector in RA – current state and the revelation of the main development problems

Meanwhile, in spite of certain improvements in the main indicators of SME sector development in Armenia for the last years (see table 3), the future development of given sector is restricted mainly due to high monopolization of economy.

Table 3 Main indicators of SME sector in RA, 2004-2012.

	2004	2005	2006	2007	2008	2009	2010	2011	2012
SME's output (% of GDP)	38.6	39.8	40.3	41.0	41.7	42.5	27.2	25.9	27.1
SME's employment (% of total employment)	32.9	34.0	35.1	40.7	42.1	42.2	-	-	-
Labor productivity in SME sector ($)	1104.4	1513.0	1996.0	2844.0	3689.0	2686.0	-	-	-

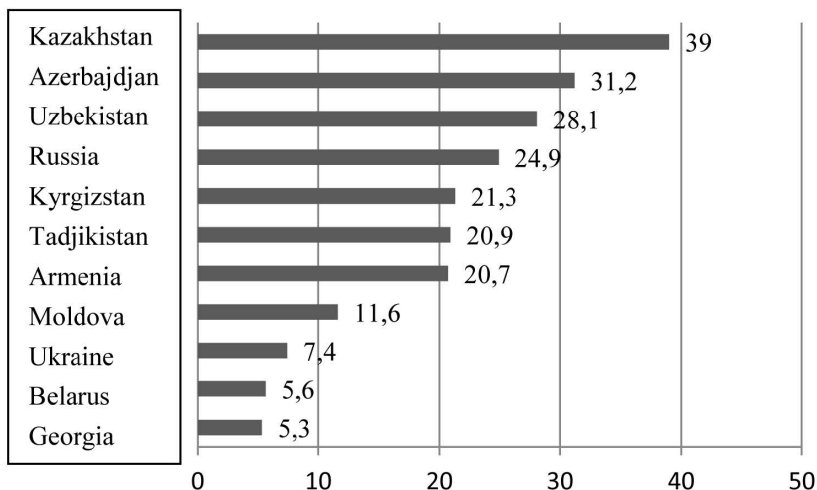Source: Data of National center of SME development in Armenia – http://www.smednc.am/

According to data of National center for SME development in Armenia, the share of the SME sector in GDP consists 27.1% in 2012, while the share of SME sector production in overall export structure consists only 15% that is 200-300 million. USA dollar. The measures for supporting SME sector implemented during last years, for example, tax benefits for VAT, simplification of tax and custom administration (prolongation of the term of custom regimes "interim export", "interim import" for the imported by these regimes goods, three-year deferment of VAT payment for the goods which value exceeds 300 million. AMD, as well as the assignment of public guaranties for credits and direct business crediting (150 million. AMD annually for the last years), have certain positive influence on the state of SME sector.

However, the institutional environment of economy, particularly, the monopolization, lack of cheap financial resources etc. don't allow SME sector in RA develop in full and become the pillar of the economy as in the West. In such conditions a wider range of the supporting mechanisms has to be implemented and provide its addressness. For this purpose, in the context of SME development and middle class enlargement we offer to introduce legally a new business classification for micro, small, middle and large. To micro business it should be referred individuals with annual turnover up to $20000 who doesn't use hired labour force. This class of business must be free of any tax and inspections. Business with annual turnover up to $50000 must be free of paying VAT (20%). In current law this limit is fixed at the level of 58 million. AMD, however it is currently being revised at the National Assembly of RA to the toughening up to 30 million. AMD. Concerning small business this category must include enterprises with annual turnover below $100000, significantly reduce the profit tax for up to 5%. Implementation of these mechanisms will contribute for the development and enlargement of SME sector in RA and consequently the formation of middle class, which in its turn is a necessary precondition of economic, political and social stability.

According to investigations of the Center of business information, sociological and marketing researches, the share of middle class in RA consists about 21% (see figure 1). Taking into account that the estimation involved only urban population and the standards of leaving in rural areas significantly yields to urban ones, consequently, the given percent would be even lower for the whole population. Meanwhile in developed countries the middle class consists the largest share of population - 70%, in developing - 45-50%. There is a great difference between
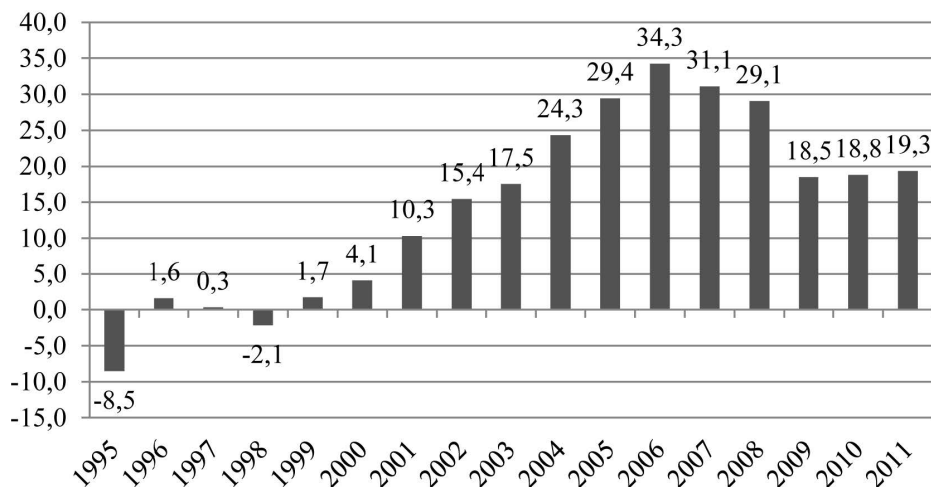
what we mean under the middle class and what it's meant in abroad.

Figure 1 Percent of middle class in selected post-soviet economies

Country	Percent
Kazakhstan	39
Azerbajdjan	31,2
Uzbekistan	28,1
Russia	24,9
Kyrgizstan	21,3
Tadjikistan	20,9
Armenia	20,7
Moldova	11,6
Ukraine	7,4
Belarus	5,6
Georgia	5,3

From the other side, the enlargement of middle class is the guarantee for sustained economic growth as middle class is traditionally concerned as the main source of savings. Macroeconomic theory emphasizes the level of national savings as the predictor of economic growth rates.

Figure 2 The dynamics of gross savings in RA (% of GDP)

Year	% of GDP
1995	-8,5
1996	1,6
1997	0,3
1998	-2,1
1999	1,7
2000	4,1
2001	10,3
2002	15,4
2003	17,5
2004	24,3
2005	29,4
2006	34,3
2007	31,1
2008	29,1
2009	18,5
2010	18,8
2011	19,3

Source: World Bank: World Development Indicators, 2013 - http://devdata.worldbank.org/dataonline/

As it is presented at the figure 2, during 1995-2000 gross savings in RA remained insignificant. The level of national savings started to grow from 1999 and reached its peak in 2006 (34.3%), than it considered the decline of the given indicator. In 2011 the value of gross savings was 19.3%.

Conclusion

Taking into account that more than 35% of armenian population lives in poverty and in a very pure conditions, every extra dram (armenian national currency) will be spent, but not saved. If the present rates of saving still continiou which means modest rates of economic growth, the problem of eradication of poverty and inequality in RA can not be solved in the nearest future, in short-term period, and the problem of formation of middle class will be postponed for years as well.

Thus, the results of aforedone analysis prove that the outrunning of SME sector development is the necessary (but not the only one) precondition of eradication of the poverty and inequality as well as of the middle class enlargement. On the other side, the large middle class means higher level of national savings which is more stable internal source of economic growth in conditions of unpredictable external financing.

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