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INSTITUTIONAL BARRIERS TO INVESTMENT CLIMATE OF ARMENIA
AND RUSSIA'S ROLE IN IT

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INTRODUCTION

Starting from the late 1990s the literature on investment attractiveness has been widely renewed by focusing on the role of the quality of domestic institutions as one of the key factors explaining the inequality in investment levels among countries (see Kraay and Zoido-Lobaton 1999, Agnès Bénassy-Quéré et al. 2005). From the one side the rule of law, government effectiveness, efficient enforcement of property rights and contracts as well as the legal system in general and from the other side the proper operation of informal networks, low level of corruption and political risks have been specifically demonstrated to be associated with higher investment levels.

Another important fact about investments this study refers to is that the productivity of the investments on the host country's economy is significantly influenced by the country of origin of the investments (Fortanier 2007). The characteristics of the investors acquired in some specific country decides the form of FDI particularly whether or not the investments tend to concentrations in the host country's economy, which has a negative effect on the host economy (Mathis 2005) particularly on transition economies (Mencinger 2003). These negative effects also negatively influence the attractiveness of the country as an environment for foreign investment and hinder the level of investments to the very economy.

This study is concentrated on Armenia's case and tries to demonstrate the real investment climate in the country which is in an acute contradiction with the officially presenting characteristics. Though the official position of Armenian government towards foreign investment seems completely sufficient in reality the aspects stated officially are implemented not efficiently, with major gaps and failures or are not implemented at all.

"The concept of Investment policy of RA" (Government of Armenia 2005) expressing the general approaches and strategy of investment policy of Armenia notes the significant role of investment and particularly foreign investment for Armenian economy and as a way for rising the country's attractiveness for a foreign investors in the line with other factors importance is also given to the institutional quality with a focus on the enforcement of the rights of investors and investments. This means that Armenia officially supports the idea of

foreign investment and would like to have investment inflows to the country, however, to what rules of the market - mostly unofficial - these investments should follow and how it affects the level of investments and attractiveness of Armenian investment market is of much discussion that this study refers to.

Indeed, the recent data from the National Statistical Service of Armenia (NSS) indicates that the foreign direct investment (FDI) in the Armenian economy has demonstrated a sharp decrease in 2013 for a second consecutive year (Ministry of Economy of Armenia 2013). The data shows that the FDI in Armenia during 2013 was just over \$271 million which is less by over 52 percent from that of 2012. Similarly, in 2012 the FDI inflows into Armenian economy were equal to nearly \$567 million which is 10 percent less than in 2011. This declining tendency of the foreign investment in the state has started from 2007 and though the domestic economy started slowly to emerge from the crisis starting from 2009, the level of FDI in Armenia has been still decreasing. Armenian governmental officials refer this ongoing tendency to external factors, particularly the slow economic growth of developed countries.

However, the politicians representing opposition and other independent analysts attributed it to the various barriers, flaws and gaps in Armenia's business environment. The lack of an acting field for the majority of investors has also been stated as such factor. Many believe that foreign investors are not willing and in some sense are scared to act in an environment where the government-linked entrepreneurs enjoyed a full patronage from the officials. Under the control of this kind of entrepreneurs are many sectors of large-scale and profitable businesses. Indeed, the report made by the World Bank (WB) on November 2013 states that de facto in Armenia monopolies control over 20 percent of economic performance, thus making Armenia the most monopolized economy on the post-Soviet space (WB 2013).

The study is concentrated on the role of formal and informal institutions of Armenia in causing barriers that hinder foreign investment inflows into Armenia. Taking into consideration both political and economic role of Russia for Armenia the study is also discussing Russia's role as an external actor that may influence the operation of those very

institutions. Taking into account the mentioned two research questions are formulated in the scope of this thesis.

The Research Question 1 is the following: What are the barriers to investment market of Armenia which cannot be reflected in the macro-economic figures - particularly the institutional ones? This question gives a rise to the Hypothesis 1 which is the following: Informal networks of Armenia and governmental decisions on securing dominant positions of specific companies are generally acted as barriers to investment market of Armenia.

The Research Question 2 of this thesis is formulated in the following way: What is Russia's role in causing institutional barriers in Armenia's investment market? This question gives a rise to the Hypothesis 2 which is the following: Russia stimulates the rise of the institutional barriers in the investment market of Armenia.

The study will respond to these questions mostly through the transaction cost approach of the institutional analysis. This approach of institutionalism has been widely discussed particularly by Douglas North (1990) intending to concentrate on the linkage between the operation of institutions and transaction costs. The latter influences the behavior and decision making of the investor (Fazzari et al. 1988, Whited 1992, Schaller 1993, and Faroque and Ton-That 1995) which in its turn is one of the decisive factors determining the investment levels. The analysis of the hypothesis will be based on the case studies of the 3 sectors of Armenian economy.

Another perspective of proving the hypothesis is the analysis of the primary data acquired through the interviews which have been conducted with Armenian politicians (political analysts) and economists. The outcome of the interviews is further elaborated and analyzed with a correspondence to the research questions and hypothesis of this study. The analysis of the interviews has been mostly focused on the Hypothesis 2 that is on Russia's role in stimulating institutional barriers to the investment market of Armenia.

The study shows that the informal institutions, particularly the powerful informal networks acting in Armenia influence the investment market of the country, create an environment where the investors are obliged to hold the interests of these informal networks particularly through corruption practices, which increase their transaction costs.

The study also finds that there are formal institutions, particularly governmental acts that are acting as barriers to investment climate of Armenia.

The study shows that Russian investments tend to concentrate and monopolize Armenian market through the levers concentrated on Russia's hands. The concentration of the economic environment leads to a situation where the investors need to spend additional resources to get access to the market or for continuation of their activities in the market. This again leads to the increase in transaction costs. As throughout the literature review it is demonstrated that higher transaction costs lead to the decrease in investment levels, the study finds that both Russia and informal networks arise barriers for foreign investment inflows to Armenia, thus negatively affecting the investment climate of Armenia.

This research benefits the literature in several ways. It is of high importance to mention that Armenian literature and literature in general lack to provide similar researches that is a comprehensive study of institutional gaps and their role in Armenia's attractiveness as an investment market. Although various articles, reports – especially by international organizations – and media publications wrote about those institutional failures, these gaps and failures are as a rule used to demonstrate the violations in the work of this or that officials and criticize the weak rule of law in the country and rarely link it to the behavior and decision making process of the investor and entrepreneur.

The existence of this kind of study rise awareness about Armenian investment market and can be a good supplement for any investor, especially for the ones who have little or no knowledge about this market. There is a significant need to make the findings of this research public as an alternative to official reports. What is more taking into account today's strict pro-Russian attitude of the Armenian Government it is doubtful whether or not the official reports reflect Russia's negative effects on Armenian economy.

Other than the mentioned this research may indirectly benefit the literature in the scope of today's one of the most discussed topics in Armenia, that is the inclusion of Armenia to the de facto Russian-dominated Customs Union. The findings about Russia's role in the operation of institutions of Armenia may be of high importance if further elaborated in a right way.

The thesis is organized as follows. Firstly will be demonstrated the background where the institutional background of investment market of Armenia is characterized. In the next section will be demonstrated the theoretical basement of the research, the review of existing literature related to this study, and the methodology of the analysis. The following section will present the case studies and analysis of 3 sectors of Armenian economy. The answers to questionnaire are conceptualized and discussed in the next section named – Analysis of the Interviews. The last section concludes.

BACKGROUND

Armenia in the past 23 years has had, has, and in the foreseeable future will probably have the major problems hindering faster economic growth, the level and quality of life, which, undoubtedly, affects the investment environment in the country. These problems are both objective and subjective. The objective is low capacity of the economy, shortage of resources and, ultimately, the history of Armenia. Subjective ones are of exogenous nature, that is, the causes and issues that do not depend on officials, but which, nevertheless, has to be considered.

Fear of risk is a result of ineffective activities over the past all the years of independence, when Armenians in a wide sense failed to create an effective state. However, effective state in the comprehensive sense of the term, in the sense of creating institutions of economic regulatory institutions effective equalization of incomes of the population, institutions, creating a system of protection of rights and freedoms of citizens, institutions, providing feedback in the process of democracy, had to provide the best results of the formation of power structures, based on checks and balances based on constitutional values. Here should be added the lack of work in terms of international cooperation, particularly weak integration into the world economy and political processes.

The government of Armenia, by and large, has done and continue to do errors that accumulate and cumulative continue to create new quality problems, which, in principle, could not be. If there was an effective government, already achieved a high level of life, mastering high technologies and was more or less competitive economy, the solution of the question on attraction of investments would be easily undertaken. All of the mentioned has lead to an environment which is reflected in the rankings and reports made by different international organizations.

The Index of Economic Freedom 2014 (The Heritage Foundation 2014) gave a 68.9 score to Armenia thus naming Armenia as “moderately free” and ranking as the 41st freest among 186 countries (For the methodology of the index see Appendix 1). The report about Armenia indicates that the overall score comparing to the previous year has declined by 0.5 point mostly due to “combined deteriorations in investment freedom, business freedom, and

fiscal freedom”. According to the Index of Economic Freedom 2014 some aspects have improved their scores (Labor Freedom, Monetary Freedom) while the others have worsened or demonstrated no change. Particularly, Business Freedom, Investment Freedom, Government Spending and Fiscal Freedom have worsened their positions comparing to the year 2013.

The report points out that the bureaucratic barriers and non-transparent regulations are the main factors that restrain foreign investment. What is more, if believing the report, significant challenges still exist, specifically in implementing deeper institutional and systemic reforms, which have a crucial role in strengthening the bases of economic freedom. Moreover, the Index indicates the weak legal framework of Armenia, high level of corruption and low level of protection of property rights. Particularly, the corruption covers such important areas in Armenia as tax and customs operations and law enforcement. The report notes that it is mostly common to face with a petty corruption and that anti-corruption regulations have not been enforced properly which leads to weak rule of law and poor protection of intellectual property rights.

The 2013 Corruption Perception Index (Transparency International 2013) presented by the Transparency International (For the methodology of the index see Appendix 2) gave score 36 to Armenia thus ranking Armenia 94th (in the line with Algeria, Djibouti, Suriname and others) among 177 countries in terms of corruption level. Although Armenia has improved its position slightly since 2012 and got some better scores for 2013, it is still considered as highly corrupted country with a corrupted business environment which hardly can be attractive for a foreign investor.

Another ranking called Freedom in the World 2013 (Freedom House 2013) introduced by the Freedom House gave a “Partly Free” status with a Freedom Rating of 4.5 to Armenia in a wide sense in terms of “Political Rights” and “Civil Liberties” (For the methodology of the index see Appendix 3). In the report on Armenia the research, here again pointed out the widespread corruption practices, bribery and nepotism which are also common among the government officials, who however, are rarely prosecuted or removed for abuse of office. The law enforcement is also believed to be struggled by high levels of corruption.

The report underlines that in Armenia “The judiciary is subject to political pressure from the executive branch and suffers from considerable corruption”. Although it is legally allowed to own a business in Armenia the report make a focus on factors hindering business activities, particularly the corrupted and inefficient court system, and what is not less important the unfair competition in the business environment. As stated, the main industries are in the hands of a group of entrepreneurs better known in the society as oligarchs who as a rule have received preferential treatment during the early periods of privatization. Illegal expropriation of private property by the state is also one of the problems hindering business activity in the country.

Another important factor that the report of the Freedom House writes about is the press freedom. The freedom of press in general is a significant contributor for investor. During the market research and information collecting process the media may be one of the least resource consuming sources of information for the investor and as high is the level of press freedom as unbiased will be the information presented there and vice versa, meaning that in case of not free media environment the investor will probably spend more money for getting information from more reliable sources.

All of the mentioned characterizes Armenian business environment and investment climate of Armenia. Some of the aspects and problems mentioned above by those international organizations are further discussed and elaborated in this study.

CHAPTER 1. THEORETICAL FRAMEWORK AND LITERATURE REVIEW

Classical macroeconomic studies generally describe positively the increase in the levels of investments for the host economy. However, these studies mostly overlook the institutional background of the host country of investments. Taking into account the institutional characteristics of Armenia demonstrated in the section of Background, particularly high corruption rates, state patronage, highly monopolized market, the weak rule of law, these characteristics can have a decisive role on the effect of for instance FDI on economic development of Armenia. However, a number of studies addressed institutions, their role in attracting investments, the effect of host country's institutions on the levels of investment inflows, the role of those institutions in determining the spillover effects. In this sense, this study is going to observe through institutional analysis the role of institutions of Armenia in attracting (hindering) investment inflows given in mind already mentioned institutional specificity of Armenia.

Institutions serve to constrain and guide human behavior. They are systems of established and embedded social rules that structure social interactions (Hodgson 2000). Institutions provide stability and guidelines for action which are necessary because individuals lack information on the current position and on alternatives and because people suffer from insufficient capacity to make rational choices under complex conditions. "Institutionalism also argues that structures (institutions) create greater regularity of human behavior than would otherwise exist and therefore enhance the explanatory and predictive capacity of the social sciences" (Peters 2000). However, a lot depends on the institutional approach chosen for a study or research. Further in this chapter it is demonstrated the theoretical base and the approach used for the analysis of this thesis.

How Institutions Attract FDI and Determine Its Growth Effect

The earlier studies on finding the role of institutions in attracting Foreign Direct Investment (FDI) were not that successful. The research carried out by Mody and Wheeler

in 1992 can be an example. With the use of the first main elements of 13 risk factors which in the line with corruption, the legal system and political instability contains also factors as inequality and the environment of expatriates which are not directly linked with the quality of institutions the research was carried out. The outcome was that they fail to demonstrate a significant impact of the quality of institutions on the location of American foreign affiliates.

However, the later studies were more successful in demonstrating that institutions matter for FDI. A study by La Porta; Lopez-de-Silanes et al. (1998) demonstrate that shareholder rights, risk of repudiation of contracts by government as well as the risk of expropriation are significantly effecting FDI. The study by Kaufmann, Kraay and Zoido-Lobaton (1999) find out that political instability and violence, rule of law, government effectiveness, regulatory burden and bribery are also matter for FDI. The role of political instability in the investment climate of the country has been studied further. Ok (2004) indicates political instability in the line with economic instability as the most substantial barrier to foreign investment. He observed a dataset obtained through a survey of managers and expatriates of companies who have foreign capital in Turkey (2004). The level of political risk also has a negative impact on the level of inward FDI of a specific country (Harms and Ursprung 2002).

When discussing institutions, it should be mentioned that institutions can be both formal and informal (North 1990). "Informal institutions are socially shared values, usually unwritten, that are created, communicated and enforced outside officially sanctioned channels" (Helmke and Levitsky 2006, P 286), such as conventions and codes of behavior (North 1990). Formal institutions include judicial, economic rules, and contracts that are created through official channels (executive, legislative) and communicated and enforced by state agencies (Helmke and Levitsky 2006; North 1990). "Although formal rules may change overnight as the result of political or judicial decisions, informal constraints embodied in customs, traditions, and codes of conduct are much more impervious to deliberate policies" (North 1990, P6).

One of the main differences between formal and informal institutions is that, while the latter are shared expectations established and enforced outside officially sanctioned

channels, the former are rules or procedures which are created and enforced through official channels (Belay Seyoum 2011). However, in both cases the violation of the rules assumes some form of sanctions.

The duration of registering a business is a good example of the operation of formal institutions which have may cause significant barriers to investment in this or that location. For instance, De Soto (2000) indicates that almost 2 months is needed for registering a business in West Asian countries, whereas in Organization for Economic Cooperation and Development (OECD) countries only half of that duration. The role of formal institutions in attracting investments is relatively obvious if comparing with informal institutions. The latter in the scope of its influence on FDI and economic growth has received limited attention in the literature.

One of the studies focused on the typology of informal institutions that is increasingly used in the literature (Bratton 2007; Estrin and Prevezer 2010) is the study carried out by Helmke and Levitsky (2006).

As stated by Bush (1987) the institutional structure of any society combines 2 systems of value, namely the instrumental and the ceremonial. The characteristics of the ceremonial values include the standards of judgment through referring to traditions, ideologies and myths rather than to any test of refutability. In contrast to the mentioned, the standards of judgment of instrumental values for correlating behavior are based on tools and skills. They are based on the standards such as efficient cause meaning that these values are not immutable and they will be replaced by better standards if they lose their ability of problem solving (Veblen 1904). In general, both ceremonial and instrumental values are laid on the bases of this or that institution. A large portion of ceremonial dominance would point out a low level openness of the institution to technological changes and vice a versa if the ceremonial values are replaced by instrumental values this would lead to institutional progress (Adkisson 2010; Bush 1987).

There are different reasons for emerging of informal institutions, such as the consequences of a specific historical experience that generates particular socially shared expectations. Another factor favoring the rise of informal institutions is the gaps in the formal institutions. Here informal institutions come to address norms procedures not

considered by the formal rules (Helmke and Levitsky 2006). Informal rules also may be established in order to circumvent the formal ones and thus to get engaged in activities that may be illegal.

A mechanism of the transmission and enforcement of informal rules is personal networks, often operating through organizations (Belay Seyoum 2011). “Although the formal organization describes authority lines, much of the influence (Knoke and Burt 1983) and the actual work (Bums and Stalker 1961; Strauss 1962) is accomplished through the informal structure of friends, contacts, and accidental communications” (Krackhardt and Stern 1988) that form these personal networks or informal networks which in their turn are considered as informal institutions. These informal networks have a decisive and vital role in the investment climate of Armenia. As stated earlier the main industries are in the hands of a group of entrepreneurs better known in the society as oligarchs who as a rule have received preferential treatment during the early periods of privatization. These oligarchs among who are also high level officials constitute the strongest networks the goal of which is to follow the common interests with the use of the levers concentrated in their hands. The function of these informal networks will be further elaborated and discussed in the section of Case Studies of this research.

Another interesting argument is demonstrated by Stiglitz (1999) who indicates that institutional failures are restraining the supply response of many developing countries thus decreasing their absorptive capacity for investment. Taking this argument into account Belay Seyoum (2011) mentions that that is why it is important to strengthen not only formal institutions but to put an emphasis on informal institutions as well, such as trust and reputation. In high trust societies, trust increases impersonal market exchanges, reduces the need for external enforcement, which in its turn gives a rise to the gains from specialization and international division of labor (Keefer and Knack 1997; Putnam 1993).

Seyoum (2011) indicates several reasons why the countries with informal institutions which are based on high level of trust and reputation are likely to attract FDI. He notes that reliable informal networks in general provide efficient mechanisms for contract enforcement with both suppliers and customers; they provide reliable information which may be vital in making business decisions and also reliable informal networks

decrease overall transaction costs by decreasing the cost of information, screening and monitoring potential partners and suppliers.

Seyoum (2011) also adds that although informal institutions may have particular ceremonial implications like enhancing someone's social status in the community, they also may demonstrate the instrumental function of decreasing transaction costs and providing effective mechanisms of contract enforcement. In the study made by Bernstein (1996) it is demonstrated that American merchants usually prefer to solve their disputes without referring to the expensive legal system of the country.

Kerr (2010) explains about the business climate of the Middle East as an environment with one largely based on trust and reputation and many challenges faced by foreign companies in navigating complex political systems, patronage networks and unclear legal environments. Much of the behavior in the market that is related to giving preference to this or that market is conditioned by reputational concerns (List 2006). Business partners follow their commitments as they want to secure their reputation and get involved in future business interactions. A lot of contracts in the business world have many gaps and incompleteness however business partners tend to follow the initial agreements as their reputation is valuable. "Reputation is an intangible asset and a significant source indicating the firm's competitiveness" (Seyoum 2011).

There are different reasons why the quality of institutions may have a role in attracting FDI (Agnès Bénassy-Quéré et al. 2005). One of the reasons is that poor institutions may yield extra costs to FDI. The case of corruption can be considered as an example (Wei, 2000). Another reason is that the rise of productivity prospects may attract foreign investors (Agnès Bénassy-Quéré et al. 2005). The next reason is that FDI is specifically sensitive to any form of uncertainty, including uncertainty stemming from poor government efficiency, policy reversals, graft or weak enforcement of property rights and of the legal system in general (Agnès Bénassy-Quéré et al. 2005). What is more, one of the early studies on the institutions (Krueger 1974) states that when the quality of institutions is low, the legal system also works with low effectiveness and in such situations the regulatory burden in the hands of bureaucrats operates as revenue seeking tool acting through red tape and other harassment tools. In this sense, corruption is a main element of

the regulatory burden of bureaucrats who are collecting bribes and producers or consumers who are paying bribes. In the first case it works as a rent collecting device, while in the case of paying bribes it is considered as a device to limit or bypass the regulatory burden (Philippe Kohler 2010).

Another perspective of institutional determinants of FDI is the democratization process. There is no single view on the role of democratization in the FDI inflows. The later studies on the topic that came to replace the unclear outcomes of the ones before – particularly by Li and Resnick (2003) – mostly show that democratic institutions have positive effect on FDI (Kolstad and Tondel 2002; North and Weingast 1989; Harms and Ursprung 2002). However, Doytch and Eren (2012) indicate that the democratization process can also have a negative effect on FDI, since foreign investors may be in position to receive better incentives from autocratic regimes than from democracies (Doytch and Eren 2012, P.3). Also Asiedu and Lien (2011) argue that democratization has positive impact on FDI in states where the proportion of natural resources in total exports is relatively low and has negative impact on FDI in states where the proportion of natural resources in total exports is high.

Since the corruption is a sign of unfavorable institutional environment (Doytch and Eren 2012, P4), the effect of corruption on FDI has been also widely studied in the scope of institutional determinants of investment. However, the situation here is very much alike as with the democratization process, in the sense that the researches carried out through the time have led to 3 different outcomes. That is, some studies indicate no significant relationship between corruption and FDI inflows (Akçay 2001), others indicate a significantly negative impact of corruption on FDI (Stein and Daude 2001; Habib and Zurawicki 2001; Smarzynska and Wei 2000). Moreover, there are studies that prove that corruption can be also an inducement for FDI (Egger and Winner 2003, 2005). In their study Doytch and Eren (2012) explain this kind of outcome with the opportunity to circumvent regulatory and administrative restrictions, and what is more they highlight the fact that in low-income countries these are used frequently in order to allow government officials to share in the profits that come from foreign investment.

The operation and functioning of institutions along with other factors design the investment climate of a specific country. Investment climate has also been analyzed in the framework of its attractiveness for FDI. Kinda (2010) detected that constraints which are linked to the investment climate including institutional and physical infrastructure problems as well as financing constraints are barriers for FDI. What is more, the same study noted that the firms that supply the domestic market are less constrained in their functioning by physical infrastructure barriers than the foreign firms.

Veganzones-Varoudakis and Sekkat (2007) evaluate the impact of openness and investment climate on FDI. The outcome of this research is that infrastructure availability as well as solid political and economic conditions raises the attractiveness of developing countries for foreign investors. One of the few studies on the sector-level analysis of FDI with a focus on sector of services is handled by Golub (2009). Based on the indices of barriers to operational restrictions on foreign firms and foreign ownership, the study notes that the most restricted sectors of industry are the sectors which are related to national sovereignty considerations and national security. Telecommunications, electricity, transportation and finance are considered as such. However, this statement has little to do with Armenia, where the mentioned sectors are fully or partly owned by foreign companies or given to foreign firms on the bases of a long term concession management. Thus, the claim made by Golub (2009) can be arguable in the sense that the mentioned sectors may not be that restricted to foreign firms if the sovereignty of the host country is under question or the sovereignty of the country has already been violated and/or the guest company is a state-owned company representing a country which has different levers with the use of which can have a solid pressure on the host country. These all mentioned is further studied in the scope of Armenia – Russia relationship.

Generally, policies rely on the idea that FDI leads to the economic development of the host country. However, there is a weak empirical evidence for the positive impact of FDI on economic growth leading to the conclusion that the FDI effect is determined by the local conditions such as education level of the country, financial markets, etc. (Alfaro et al., 2009). Some studies find that FDI causes economic growth, while others find that there is no such effect, moreover, in some cases the effect can be negative. Furthermore,

differences in the host country also matter in a way that the investment, trade and competition policies of the host country play a key role in the effect of FDI on the growth (Moran et al. 2005). Also with regard to transition countries, the relationship between FDI and economic growth is not significant for the sample of transition economies (Lyrroudi et al., 2010).

To continue the discussion of the local conditions of the host country, it can be argued that beyond the purely macroeconomic factors such as openness, inflation, GDP growth and real effective exchange rate, institutional and development factors can also be important for generating the positive effect of FDI on the growth. In this regard, institutional development factors include legal system efficiency, judicial independence, infrastructure quality, etc. (Walsh and Yu, 2010).

Moura and Forte (2010) review theoretical and empirical studies, and find that the impact of FDI on growth depends on the internal conditions of the host country. These conditions can be economic, political, social, cultural, etc. Macroeconomic theory suggests that FDI can increase the economic growth through capital accumulation and total factor productivity. More specifically, FDI increases the stock of knowledge, and once the knowledge spreads over, the factor productivity rises. Furthermore, FDI contributes to the increasing competition, formation of human resources, integration with the global economy, transfer of technologies, firms' development and restructuring, and difficulty of the implementation of economic policies. These factors can be regarded as channels through which the FDI generates growth in the host country. However, it remains unclear if these channels cause negative or positive effects. For instance, the effect can be negative if the firms transfer inappropriate technologies. Also in case of advanced technologies labour force has to be contracted generating unemployment in the country. What is more, FDI may affect imports more than exports, and as a result the balance of payments is negatively impacted. Increased competition, in its turn, may lead to the disappearance of the domestic firms, because they may be found to be weak to resist the competition. Finally, as far as it is extremely hard to predict the inflows of the FDI, instabilities in the economy may hinder the implementation of the right economic policies.

What stands out from the theoretical discussion above is that the absorptive

capability of the technologies of the host country is the most important factor in determining how the FDI impacts the economic growth (Borensztein, 1998). However, it is extremely hard to analyze the effect of FDI on the growth through this particular channel suggested by the macroeconomic theory for the case of Armenia, primarily, due to the data and information limitations caused by the government. Therefore, this study turns to the institutional analysis, which seems more plausible considering the current situation in Armenia with respect to corruption practices, monopolies and weak institutions.

Jude and Levieuge (2013) find that the institutional quality could determine the effect of FDI on growth in developing countries. The institutional quality affects the capital accumulation and total factor productivity, which are the channels of FDI impact on growth as suggested by the macroeconomic theory. In case of strong institutions the domestic firms can preserve their existence next to foreign firms, in other words domestic investment will not decline. Besides the institutional quality, the FDI effect on growth is determined by law enforcement, bureaucratic quality, corruption, and property rights. According to institutional theory, institutions set market rules and ensures the compliance of the economic actors with these rules. Thus, the institutional quality affects the relationship between the domestic and foreign firms, and the degree of the technological spillover. In contrast, bad institutions increase the transaction costs. Another important aspect is the quality of FDI. For instance, in case of weak institutions of the host country, it is more likely that the country will attract low-technology leaving the country without the growth prospects. Furthermore, weak institutional environment affects also the mode of entry in a way that the foreign firms may enter the domestic market through mergers and acquisitions leading to concentration, and again limiting the growth potential. Finally, strong institutions may ensure the elimination of the information asymmetries, in other words, the information will be transmitted to the market participants more effectively. However, if less transparency is involved in the system, then it becomes uncertain where the financial resources stemming from the FDI go. If the latter occurs, then the chances for the growth decrease substantially.

Country of Origin as a Factor of Foreign Investment Effect

The effect of FDI on the growth of the host economy has been widely studied in the literature. However, the outcomes of the studies differ from research to research. While many researches (De Mello (1999), and Xu (2000), etc.) point out the positive effect of the FDI on the growth of the host country's economy, other studies (Carkovic and Levine (2000), Djankov and Hoekman, (1999); Mencinger, 2003, for CEE countries etc.) indicate that the rise in the levels of FDI mostly negatively affect the growth.

Fortanier (2007) argues that one of the factors that significantly affect the productivity of the FDI on the host economy is the country of the origin of the FDI. The influence of the country of origin on TNCs has been extensively documented, especially from an institutional theory perspective. The nature of the domestic market, business system and institutional backgrounds influences a wide range of strategic and organizational characteristics of transnational corporations (TNCs) (Fortanier 2007, P46).

The theory of the country of origin of the investment will be used in this study in the scope of the investments that are made in Armenia by Russia. As mentioned the nature of the domestic market, business system and institutional backgrounds affect the characteristics of TNCs. This study also argues that this effect has a place to be in the case of firms and companies other than TNCs. The institutional background of Russia as well as the business market in Russia is characterized by the 2014 Index of Economic Freedom (The Heritage Foundation 2013). The low levels of investment freedom, financial freedom, business freedom, monopolized environment and property rights as well as highly increasing corruption levels throughout the whole economy are putting Russia in the line with the countries considered "mostly unfree".

It is argued that the characteristics of the firms acting in Russia are acquired from the environment where they act. For instance as the firms working in Russia in an environment where the monopolization of the market is one of the usual goals of each firm, it is believed that the kind of goal will tried to be achieved in a host country in this case in Armenia, if the firm invests there and tries to enlarge. And taking into account the problems in the institutional background of Armenia already mentioned earlier like high rates of

corruption and weak rule of law gives possibility for such a company to monopolize this or that market, meaning bringing bad practices to Armenia.

Mathis (2005) states that “for FDI effects on competition – like trade, inward investment allows service providers to challenge the domestic market and stimulate competition. However, FDI can also lead to concentrations (mergers and acquisitions) which, if not addressed, can raise prices by reducing supply and holds back development” Mathis 2005, P 11). What is more, Mencinger indicates “that the negative relationship between FDI and growth in transition economies could be explained by the form of FDI, which had been predominantly through acquisitions rather than greenfield investments” (Fortanier 2007, P46). Given in mind that Armenia is considered as a transition economy this kind of negative effect may have a place to be there. However, it should be also mentioned that in Armenia the concentrations of the market are mostly realized through monopolization rather than acquisitions or mergers.

It is of high importance to attract investment and to get high portion of FDI, however, as mentioned earlier if the entrance of the foreign firm is realized with acquisitions or the acting of the firm in the host economy creates monopolized environment the possible negative effects should be taken into consideration as well. In order to avoid the monopolization of the market and thus the negative effects of FDI, appropriate competition policies and strong enforcement of the very policies are needed. Competition policy is not always the priority policy, however, in the absence of competition law or in case of violating this law there will be no lever for the government to exercise this policy when it is needed (Mathis 2005).

In Armenia the gaps in the competition law as well as the improper enforcement of the law has lead to a monopolized environment where the monopolies as was mentioned earlier are controlling the 20 percent of the economic performance of Armenia. The study is going to argue that the concentration of the environment in Armenia is tightly conditioned with the presence of entrepreneurs or so called oligarchs who may have significant influence on the functioning of the State Government, generally through the established informal networks or corruption practices. This in its turn lead to an environment where the

government or the officials are not motivated and in some sense are limited in improving the competition law or at least in proper enforcement of the existing law.

The thesis argues that the investments coming to Armenia from Russia tend to concentrations of the environment and that there is a non appropriate respond from the government to these actions, which as this study believes are also linked with political incentives that are presented in Armenia – Russia relationship which will be observed further in the thesis. The thesis argues that these political linkages foster the increase of a kind of Russian investment that monopolize the market, usually through legal acts – which may be also an outcome of blackmail and/or pressures – thus raising new barriers for the new investments in the market.

Thus, another argument of this study based on the concepts mentioned is that the country of origin of investment should be taken into consideration as one of the factors determining the positive or negative effect on the host economy, then the characteristics of the investments coming from that specific country should be taken into consideration particularly whether or not the investments tend to concentrations and monopolization of the host country's economy.

If the concentration of the market is realized as a result of state patronage through not proper enforcement of competition law this hinders the entries of other investors, who in order to get access to the market also needs patronage which is generally acquired through corrupt practices and which in its turn increase the transaction costs of the investor.

The Role of Transaction Costs in Attracting Investments

The level of transaction costs is believed to be one of the decisive elements in the decision making process of the investor or entrepreneur. Furubotn and Richter (1997) argue that if considering various connections that get revealed during the production process, then the transaction costs account for 60% of the product final price. Another study carried out by Wallis and North (1988) assesses the transaction costs of USA economy in 1970. The study finds that the transaction costs account for 55% of Gross Domestic Product (GDP).

The literature has extensively discussed how the transaction costs affect investment. The studies by Fazzari et al. (1988), Whited (1992), Schaller (1993), and Faroque and Ton-That (1995) specifically assess this effect. It follows from the conclusions that the transaction costs negatively affect the investments in particular industries of different countries, meaning that an increase in transaction costs will lead to decrease in the level of investment.

Benjamin and Phimister (1997) provide similar findings. They argue that the transaction costs constrain the market that stops working efficiently, and as a result, that the market failures affect investments negatively. Thus, countries where the share of transactions costs is high tend to have more restrictions in their credit market, which leads to low investment rates.

Maher (1997) attempts to evaluate the relationship between transaction costs and contracts in a given environment. The author finds out that in the sense of decreasing transaction costs, the market provides the best mode of governance. Hence, the opportunism, which is the primary transaction cost, is mitigated (Maher 1997). Although here a different approach has been used, the outcome of the research again suggests that the low level of transaction costs stimulates higher level of investments, where the opposite is also true.

Dunning (1994) states that during the 90s, the companies in various countries implemented a number of structural changes for the purpose of attracting more FDI. These structural changes imply the implementation of extensive privatization programs that aim at contracting the bureaucracy and expanding the market of goods and services. The mentioned changes finished with promoting the reduction of transaction costs. As Dunning (1994) states, those changes would enable more capital flows.

However, there are also a few studies (Macaulay 1963, 1985) which state the non significance of the transaction costs for the investment levels and for the economy as a whole. In order to clarify this, Williamson (1985) points out the fact that the investments are being affected only by those transaction costs that are peculiar to the given sectors of the economy. Otherwise, the market functions efficiently.

Due to the findings of the literature, this study believes that the role of transaction

costs does not have to be underestimated, and as mentioned earlier the transaction costs will be considered as factor affecting the decision making process of the investor, thus stating that high transaction costs affect the investment climate of a country negatively, whereas the low level of transaction costs has a positive influence on the investment climate of a country.

Transaction Cost Approach

The theory that Douglas North considers as relatively close for transaction cost approach to be based on is the neoclassical theory of institutional economics. Although, the neoclassical theory has been a major investment to understanding and works in the analysis of markets in developed countries it has significant problems and gaps - particularly there is a big contrast between the logical implications of the theory and the performance of economies in reality - that are not able to connect the transaction cost approach to the very theory without making changes in the assumptions made there.

Namely “the neoclassical theory is based on the fundamental assumption of scarcity and hence competition; its harmonious implications come from its assumptions about a frictionless exchange process in which property rights are perfectly and costlessly specified and information is likewise costless to acquire” (North 1990, P11). The scarcity and hence competition assumption has been solid, whereas the other assumptions have not survived nearly so well. Specifically the other assumptions are made on a zero transaction cost approach. In a zero transaction cost world, the strength of bargaining has no influence on efficiency however in real life where as a rule positive transaction cost exists it does affect the efficiency. In his book (1990) North tries to fit the positive transaction cost approach to the neoclassical theory of institutions given the changes that should be made in the theory and state that only taking into account the transaction costs the theory may work in a better productivity.

In the book by North and Thomas (1973) transformations of property rights in labor as well as in land are discussed with a notion that this kind of transformations lead to

changes of transaction costs applying to the organization of factors of production, which in its turn will lead to new institutional configurations. This very approach is set in the base of North's newer book (1990). North (1990) indicates that the way institutions affect transaction and production costs, is the key to much of the institutional analysis. "Institutions affect the performance of the economy by their effect on the costs of exchange and production. Together with the technology employed they determine the transaction and transformation (production) costs that make up total costs" (North 1990, Series Editor's Preface).

"It takes resources to transform inputs of land, labor, and capital into the output of goods and services and that transformation is a function not only of the technology employed, but of institutions as well. Therefore, institutions play a key role in the costs of production" (North 1990, P61). "The total costs of production consist of the resource inputs of land, labor, and capital involved both in transforming the physical attributes of a good (size, weight, color, location, chemical composition, and so forth) and in transacting - defining, protecting, and enforcing the property rights to goods (the right to use, the right to derive income from the use of, the right to exclude, and the right to exchange). Thus the costs of production are the sum of transformation and transaction costs" (North 1990, P28). North (1990) highlights the fact that substantial resources and efforts are devoted to the measurement and enforcement of agreements. Warranties, guarantees, trademarks, the resources devoted to sorting and grading, time and motion studies, the bonding of agents, arbitration, mediation, and of course the entire system of judicial process all reflect the ubiquity of measurement and enforcement (North 1990, P31). So far in his book North also indicates that, it is, however, measurement plus the costliness of enforcement that together determine the costs of transacting (North 1990, P32). Throughout the discussions North (1990, P66) emphasizes that the cost of transacting reflects the overall complex of institutions - formal and informal - that make up an economy or, on an even greater scale, a society and that overall structure ultimately shapes the cost of transacting at the individual contract level.

The very approach corresponds to the research question in several ways. Other than just revealing the institutional barriers to the investment climate of Armenia, the

transaction cost approach of the institutional analysis provides understanding on how exactly these barriers may affect the investor's behavior and decision.

However, the measurement of institutions and their changes pose perhaps the biggest challenge in the use of institutional analysis. However, the transaction cost approach is not called for measuring the level of effect the investor's behavior is exposed to, rather it tries to shed a light on structures of both formal and informal institutions and predicts how the functioning or changes in that structures relates to the behavior of the investor. It is assumed a priori that institutions make sense as an explanatory variable.

Methodology

The research is going to answer two main questions. The first research question is the following; what are the barriers to investment market of Armenia which cannot be reflected in the macro-economic figures - particularly the institutional ones?

The hypothesis 1 of the first research question that the thesis is going to prove is the following; Informal networks of Armenia and governmental decisions on securing dominant positions of specific companies are generally acted as barriers to investment market of Armenia.

The methodology for responding to this research question is based on the practical usage of the transaction cost approach of the institutional analysis. The formal and informal institutions of Armenia with their functioning and operation are affecting the transaction costs of the investor and/or entrepreneur making the transaction costs dependent from the working of institutions.

The theory and literature review point out that low level transaction costs attract more investment whereas high level of transaction costs has negative effect on the investor's decision, hinder the investment level of a country and thus negatively influence the overall investment climate of the state. Taking into account the mentioned, one of the core concepts of the thesis is constructed, in a way that the operation of institutions that lead to

an increase in transaction costs, finally negatively affect the investment climate of the country.

The analysis of institutions will be implemented through case studies of 3 sectors of Armenian economy (Retail Sector, Energy Sector, Public Procurement Sector) which are assumed to be of high importance for the state economy. Through the analysis of these case studies, this study tries to demonstrate how the gaps in the functioning of formal and informal institutions of Armenia are affecting the change of transaction costs of the investors to Armenian market.

Particularly the fails in the functioning of different institutions may generate corrupt practices. As was highlighted by Wei (2000) poor institutions may yield extra costs for the investor for instance through the corrupt practices. The corrupt practices are increasing the expenses of the investor, thus increasing the transaction costs of the latter. In this sense corruption will be used as one of the indicators assessing the change in the transaction costs.

The rule of law is another indicator demonstrating the increase or decrease of transaction costs. As stated by Krueger (1974) the poor institutions of the country lead to weak rule of law. This may put the investor in a situation where in order to defend his rights or in order to stick his counterparts to the legislation of the country, or to the rules of this or that contract the investor spends additional amount of money on the legal system of the country. This spending increase the overall transaction costs of the investor.

The cases are taken from various reports carried out by international organizations (e.g. World Bank, U.S. Department of State and etc.) and from different announcements and publications by mostly Armenian media, particularly from the ones which during the time of their existence and activity have demonstrated more or less unbiased and trustworthy information and are considered as reliable sources of information by the society of Armenia.

The second research question is the following; what is Russia's role in causing institutional barriers in Armenia's investment market?

The hypothesis 2 of this research question is that Russia stimulates the rise of the institutional barriers in the investment market of Armenia.

In order to pursue more in-depth information as well as solid viewpoints about Russia's role in the institutional barriers of investment market in Armenia and to prove the hypothesis 2, structured interviews are carried out. Although the interviews are structured upon the receipt of the answers to the questions stated in the questionnaire, the interviewees have been contacted again if the answers to the questions were not clear or were there was a need of some more explanation in order to have clearly formulated responses. The questionnaire includes 4 questions which are discussed below:

- 1) Is there observed a tendency of market concentration, monopolization in Armenia by Russia's investments?

The question tends to reveal the general form of investment inflows to Armenia coming from Russia. The positive outcome of the question that is if the investments tend to concentrate the market, as discussed through the theory has a negative impact on the investment market of the state. What is more, the concentration of the market may raise new barriers for the new investors overcoming which may increase the transaction costs of the latter. The negative answers of the respondents to this question will mean that the investments from Russia to Armenia do not tend to concentration, thus raise the competition in the market and positively affect the market.

- 2) What are the main reasons for the existence of Russian companies in Armenia that have dominant positions in the state's economy?

The aim of this question is to demonstrate whether the dominant positions of Russian companies in Armenian market is acquired as a result of free competition or as a result of various informalities that lead to such situation.

- 3) Is the problem with high shares of monopolies in Armenian economic market more conditioned with the gaps in the law itself or with not proper enforcement of the law?

If the responds point out that the problem is in the proper enforcement of the law the answer will benefit the idea that the concentration of the market is occurred in order to secure the interests of the informal networks of Armenia which are tightly linked with Armenian Government and officials, are limiting the legal activities of competent

authorities. Otherwise, if the main problem is in the failures of the law itself, this will firstly mean that the concentration of the market is acquired through legal channels and the law is not violated, and secondly that the solution of the problem is linked with adoption of a better law and other formal processes rather than with informal institutions.

- 4) Do Russia's investments into Armenian economy hinder domestic and other foreign investment inflows to Armenia?

The negative answer to this question will point out that Russia has no visible role in stimulating institutional barriers to investment climate of Armenia, whereas the positive response will benefit the Hypotheses 2.

The questionnaire has been presented to respondents in two languages - Armenian and English (As long as mostly the responses have been carried out in Armenian, the answer sheets are not included in the paper, but are ready to be presented upon request.). The number of interviewees is 9 (For the details of the respondents see Appendix 4) and includes past and present officials, politicians and political analysts as well as economists. The politicians among the respondents have been chosen in the way to have people from different political camps and thus to try to secure the existence of different viewpoints.

The data collected through interviews are called to prove the hypothesis 2 through the theory in a way that the country of origin of foreign investments matter, meaning that there is an importance to take into account the investments to Armenia from Russia. The data will try to prove that the way how Russian investments enter Armenian economy also matters, particularly meaning whether these inflows lead or tend to lead to concentrations and monopolization of the market. The answers of respondents will be referred to in order to test the hypothesis 2.

CHAPTER 2. CASE STUDIES

RETAIL SECTOR

The first sector of Armenian economy that is going to be observed in the scope of these case studies is the retail sector of Armenia. The latest statistics (2013) show that the share of the retail sector in the whole trade realized in Armenia during 2013 is almost 68 percent (Armenian Statistical Service of Republic of Armenia 2013) which makes the discussion of this sector of high importance for Armenian economy.

Here, the role of State Commission for the Protection of Economic Competition of the Republic of Armenia (SCPEC) is vital for both attracting new investors and for the companies that are already functioning. The goals of SCPEC include but not limited to protection and promotion of economic competition, creation of appropriate environment for fair competition, contribution to the development of entrepreneurship (SCPEC 2007). Even taking into account only the goals of the SCPEC it is obvious that the role of this state organization in the state's investment climate is essential. In contrast to the law (SCPEC 2007) in the scope of which the SCPEC acts, the decisions made by the SCPEC are not always clear and unbiased which is believed is the effect of informal networks operating in the country.

Informal Institutions in the Retail Sector of Armenia

The latest statistics (Year 2013) show that 89% of computer users in Armenia are in the use of unlicensed software (A. Barseghyan 2013). Although compared to 2006 this number decreased by 7 percent, it still remains very high. This high percentage is closely linked to the fact that absolute majority of the shops sell computers with already unlicensed software installed there. Today in Armenia, de facto the main company that is interested in the fight against the usage of unlicensed computer programs is the representative office of "Microsoft" company in Armenia. As long as the very company is responsible for the provision of programs for absolute majority of computers used in the country, it is logical

that Microsoft Armenia tends to act in an environment where the rules of fair competition and intellectual property rights (IPR) are protected and what is not less important honored and respected. Undoubtedly, this will increase the volume of purchases of the licensed products supplied by the very company, which in its turn will increase the company's profits. The Microsoft copyright infringement by the shops selling computers or software in the country get opportunity to sell their products in lower prices, where the difference in the price is formed merely from the usage of non licensed software.

The gaps in the implementation of SCPEC's direct functions lead to barriers that hinder investment. These barriers are presented in the form of insufficient enforcement of IPR. It is known that the strengthening of IPR in most developing countries has resulted in an increase in investment inflows (Samuel Adams 2000). If the organization responsible – in this case SCPEC – for this or that reason fails to realize its functions, which in this case is the creation of appropriate environment for fair competition through strengthening of IPR then the announcement of Microsoft Armenia's CEO that, no company is making major investments for creating a product that can be distributed and sold in the local market (Ibid), can be easily explained.

However, here the main reason of insufficient enforcement of IPR is not the gaps in the legal system, rather than the existence of informal institutions. Some chains of computer shops which in the line with other sellers violate IPR are owned by powerful politicians or their relatives who in reality limit the functioning of authorities liable for the protection of property rights. Another problem here is the high level of corruption, bribery and corrupted court system. Even when the cases of illegal usage of intellectual property is revealed – which is actually not that difficult task – only in very rare cases these trespassers are bring to justice due to paying bribes to authorities and even if they are fined as a rule they continue their illegal activity.

The gaps in the functioning of SCPEC are not limited to those mentioned earlier. It is clearly stated that the SCPEC should protect and promote economic competition as well as create an appropriate environment for fair competition. For Armenia's case these functions are implemented only on case by case bases regarding whose interests – primarily economic and/or political – the implementation of the law may touch. It is not a secret

among the population of Armenia that there is no clear segregation of business and politics in the sense that high level officials for instance members of National Assembly are generally engaged in business activities, despite the fact that it is prohibited by the law. These tough links between politics and business /as well as between politicians and businessmen/ is a decisive factor negatively affecting the majority of institutions functioning in Armenia. This, in its turn has a negative effect on the investment climate of the country.

Here the main problems are the informal constraints rather than the formal ones. “Although formal rules may change overnight as the result of political or judicial decisions, informal constraints embodied in customs, traditions, and codes of conduct are much more impervious to deliberate policies” (Douglas North 1990, P 6). In Armenia it is far well known that there are some sectors of economy where no one is able to transact there without any patronage by several powerful members of state government or even by President of RA himself. This kind of political patronage as a rule violates formal laws, because as a rule nepotism and cronyism has a place to be there.

Among many cases, the best example could be the accession into Armenian market in 2011 by the French hypermarket chain “Carrefour”. Probably it would be better to say the decision of the entry into market, as till today the market chain has not started its functioning due to one or more barriers raised as a result of failures in the work of SCPEC and not only. The case of “Carrefour” is interesting in the way that it is one of the biggest hypermarket chains in the world and widely known brand (“Carrefour” homepage 2014). Thus, one would probably assume that such a company will not face institutional barriers, particularly the informal ones taking into account its well known reputation.

In 2011 an agreement was reached between “Carrefour” and one of the Armenian malls on providing 10 thousand square meters area to “Carrefour” for opening the hypermarket (“Carrefour” supermarket chain 2013). However, this agreement was canceled by the representatives of the mall and what is more “Carrefour” failed to get any other place for its activity – with no logical explanation – in other parts of the city too. It is obvious that such an attitude towards the investor was directed and managed by the representatives of high echelon and as some analysts argue it was directly linked to the “Carrefour’s” will

to import the products that should be sold in the hypermarket. The initial computations showed that it will lead to lower prices in “Carrefour” than the average prices in the retail market of Armenia. This would for sure influence entrepreneurs acting in Armenia, especially those whose businesses have dominated or monopolistic positions in the market. So as can be observed if function “Carrefour” will be a solid competitor not only for other supermarkets/hypermarkets but also it will be a strong competitor for importing companies, many of which have monopolistic or dominant positions in the country.

Thus, the motivation that drives the formation of such barriers becomes obvious. These kinds of barriers are a function of the existence of informal networks involving Armenian political elite – that have evolved during the time and recently has become probably the most powerful decision making institution, though informal – and non-functioning or functioning with many flaws of appropriate bodies, including SCPEC. The heated debates on the case of “Carrefour” lead to a situation where even the US Ambassador to Armenia John Heffern referred to the question, particularly highlighting his desire to see “Carrefour” in Armenia (John Heffern 2013). However, when the ambassador of a country like US even states its wish – especially when it is out of his direct responsibilities and functions – it is seen more as a call – in this case to let “Carrefour” function in the country – rather than just a personal desire. One can also consider this as a result of informal networking between the representatives of “Carrefour” and US Embassy as one of the most powerful foreign representation in the country.

On April 2013 after several months of negotiations The National Secretary of the RA National Security Council (NSC) informed that the Armenian market accession process of “Carrefour” is assumed to be finished by the end of the year 2013 (The “Road Map 2013”). Some analysts argue that the very agreement was reached due to “Carrefour’s” interest in Armenian supermarket chains. Specifically, the owner of the biggest Armenian supermarket chain “Yerevan City” announced that “Carrefour” demonstrated interest in buying his supermarket chain if operating in Armenian retail market (Samvel Aleksanyan 2013).

Here the main point that arises is that de facto the accession of Armenian retail market by one of the biggest hypermarket chains and reputed brand is followed by various

barriers which as a rule arise from the private interests and desires of Armenian businessmen and politicians or often both in one person. However, the announcement made by the NSC has not come true. By the first quarter of the year 2014 “Carrefour” has not started its functioning in Armenia yet. Although, from time to time various state agencies announce that no barriers exist for the functioning of “Carrefour” and that the very chain would start its activity very soon, this cannot be admitted as given. It is a fact that an entry of a supermarket chain lasts almost 3 years and what is more, it is still nothing exact. These kinds of experiences definitely have a great negative effect on the prestige of a country as an investment market.

The existence of the import monopolies in Armenia is another reason hindering foreign investment. It is barely possible even to imagine a de jure democratic country with a de jure free market economy where the 44.3 percent of the foodstuffs markets and 83.3 percent of the markets for household items are represented by import monopolies (Hrayr Maroukhian Foundation, 2013). However, the problem of import monopolies is not something new for Armenian markets. The roots of this problem is dated back to the early 1990s when the economic policy makers of Armenia, after Armenian independence, have failed to declare the economic policy of Armenia as well as its long-term goals. As objective reasons that have not allowed the policymakers to declare and define a long-term economic agenda of the country can be mentioned the war, the rapid privatization of the post soviet era as well as financial and political tension of the time. However, the main problem is that even after 23 years after Armenian Independence, unfortunately, no significant changes have been occurred in either the institutional economic structure of Armenia or the principles of governance system.

However, it should be stated that these monopolies have arisen due to a strong patronage of high level politicians rather than by the excellent operation of their businesses, free market competition, introduction of something innovative. Starting from the independence of Armenia in 1991, groups of people on the head of the country have made an enough clear division of sectors of business and economy of Armenia among each other, which continues till today, and any new investment, entrepreneurship in these sectors has

always been accompanied by many artificial barriers unless these actors are the new players pointed by the powerful political and economic informal networks of Armenia.

As a result, now in such a small market as is Armenia, where the presence of import monopolies has a vital role in economic development, many monopolies and oligopolies operate. When speaking about import monopolies it is worth to mention the sugar market, which fairly can be ranked as the most widely known one in Armenia. During the previous decade the granulated sugar market has become the most discussed monopoly by economists, policymakers, media and shopkeepers alike. Although, the company managing this monopoly has changed different names through the time, it has had an absolutely dominant position in the market since the establishment of SCPEC, hence, since the implementation of the legislation on economic competition. The sugar market is the most concentrated market in Armenia. SCPEC demonstrates the characteristics of the market and the key indicators of the sugar market can be observed in the Table 1 below.

Table 1 (Ibid)

Year	Concentration	Number of Economic Entities	Economic Entity Having a Dominant Position	Retail Price in Armenia, AMD	Price Increase/Decrease over the Previous Year, in Armenia	Global Price Increase/Decrease over the Previous Year, in Armenia	AMD to USD	Retail Price in Armenia, in USD
2011	High	5	Lusastgh Sugar: 99,0	432.8	125.1	109.9	372.5	1.16
2010	High		Alex Grig LLC: 77,5	346.0	114.4	111.8	373.6	0.93
2009	High	6	Alex Grig LLC: 99,9	302.5	123.2	151.5	363.3	0.83
2008	High	21	Salex Group LLC:91,4	245.4	96.2	116.6	306	0.80
2007				255.2	79.6	64.3	342.1	0.75
2006	High	21	Salex Group LLC: 91,4	320.4	129.6	144.8	416	0.77
2005	High	21	Salex Group LLC: 91,4	247.2	96.3	94.8	457.7	0.54

2004	High	23	Fleetfood LLC: 99,4	256.7	97.6	93.0	533.4	0.48
2003	High	7	Astghatsolk LLC: 81,6%	262.9	101.9	131.8	578.8	0.45
2002	High	11	Astghatsolk LLC: 94,8%	257.9	99.4	79.9		
2001	High	9	Astghatsolk LLC: 79,8%	259.4	112.7	111.6		

From 2001 to 2003, the same company has controlled 79-95 percent of the sugar market of Armenia, having both rises and falls in the volume of the market control. However, it can be easily observed that starting from 2004 the very company has continuously controlled more than 90 percent of the sugar market, reaching 99.9 percent in 2009 and 99 percent in 2011.

Table 2 (Ibid)

Commodity Market	Number of Participants in Commodity Market		Concentration in Commodity Markets			
			Percent		Extent	
	Previous study	Recent study	Previous study	Recent study	Previous study	Recent study
1 Wheat Floor	43	51	78.9	87.6	High	High
2 Sugar	21	6	99.9	100.0	High	High
3 Butter	23	20	84.1	67.6	High	Medium
4 Chicken eggs in the shell	12	6	85.9	80.6	High	High
5 Frozen fish	11	20	72.3	62.3	High	Medium
6 Rice	19	28	66.6	62.8	Medium	Medium
7 Unused tires of passenger cars	60	36	46.6	66.7	Medium	Medium
8 Gasoline	7	5	89.9	93.9	High	High
9 Diesel fuel	11	7	76.3	95.1	High	High
Total number of competitors in commodity markets	207	179				

It also should not be overlooked the fact that as shown on Table 2 the number of importer companies has demonstrated a drastic decrease reaching from 21 firms to just 6 in 2011. It is interesting that another 0.1 percent of the sugar market is controlled by 5 other firms. This is mainly done for avoiding to have just a single importer and to artificially make the “Lusastgh Sugar” firm, a company with a dominant position rather than monopolistic position. However, even in such artificially constructed market the 3 of the other firms are not selling the sugar as it is; these companies are confectionery producers, so the sugar they import is mainly used in their products and is not sold as a pure sugar by itself. The activities of the other 2 companies are not clear, but in fact, one should not overlook the possibility that these companies can also belong to the very monopolist, though not registered under the same name.

However, de facto there is just one importer in the sugar market and whenever the question on this issue is raised in the National Assembly by the opposition - who are minority there - the government as well as SCPEC behaves themselves like a dedicated server and advocate of the systemic corruption and monopolies of the country. What is more, if even theoretically assume that another company after many barriers faced starts importing sugar to the national market, there is a high probability that the very company will not be able to realize its product due to unfair competition.

Particularly, the “Lusastgh Sugar” firm belongs to an oligarch who is simultaneously a deputy of Armenian National Assembly and a friend of the president himself. Thus, having such levers and using informal networking his firm(s) somehow avoid full payment of taxes which means that the very company will be able to supply sugar with the lowest price in the market thus driving out from the market all other contestants, as has actually been done.

Almost the same situation is with the wheat flour, butter and chicken eggs markets and etc., though with lower concentration. This kind of market economy led to the today's reality of Armenia, where the wealth of trade flows into the coffers of the already dominant businessmen-politicians, strengthening their position, weakening the state parliament, and contributing to the tilted balance of political power, which persisted and support the lack of economic and political development in the country.

Transaction Cost in the Retail Sector of Armenia

The cases related to the retail sector of Armenia discussed show that in Armenia informal institutions work for enhancing the benefits of the representatives of local elites rather than a tool for new investors in overcoming complex political systems, patronage networks and unclear legal environments. In this sense, in Armenia informal networking is mostly used as a mechanism for giving birth to informal constraints, which in its turn increase the transaction costs, pushing the investor to find more reliable information for making business decisions, use the expensive legal system of the country, due to the low level of trust and reputation of the country. As Kerr (2010) argues it would be possible to overcome complex political systems and unclear legal environments for foreign investors if the level of trust formed by the informal networks was high.

The case of “Carrefour” is one of the classic cases where the increase in transaction costs is clearly demonstrated. The supermarket chain during the latest 3 years has spent money for accessing the retail market of Armenia; however, these costs are more related to overcoming the artificially raised constraints mentioned earlier which in the end lead to the decision of buying the existing supermarket chain in the country in order to get access to the market. The procurement of this supermarket chain should be considered as a price for acting in the very sector. This increases the transaction costs for “Carrefour”. It is obvious that the transaction costs would be much less for “Carrefour” if the informal networks which as was already mentioned are formed from powerful members of the State Government as well has been willing to see the supermarket chain in the country.

In the retail sector of Armenia one probably will come up with one of the most significant problems of the investment climate of Armenia that is the company that decides to invest in the country in the line with its personal gains should take into consideration the interests of the elite or the informal institutions on behalf of informal networks. Indeed, de facto the operation of the company is decided by these elites rather than by the free market economy. And from several examples mentioned earlier in this chapter it is obvious that relying on the formal institutions in overcoming the raised barriers is naivety. This in its turn led to some environment where the investor in order to realize his business ideas

should find other ways mostly informal to overcome the existing barriers like giving bribes which as Wei (2000) believes leads to extra costs for the investment.

It is obvious that this kind of behavior, particularly engagement in corruption processes again increases the transaction costs of the investor and as suggests the theory high transaction costs negatively affects the investment climate in the retail sector of the country (Fazzari et al. 1988). The experience also suggests that giving bribes for transacting in the market by a certain company or investor do not limit to a single case, when it becomes obvious that the investor is ready to have high transaction costs that is to give bribes, during their activity they are usually being put in situations when they have to continue to pay bribes in order to continue their activities thus having additional costs.

Any new investment, any new undertaking or business startup in the country should consider these gaps as a factor that probably will have a negative impact on its activity. Though institutions in general are called for decreasing the transaction costs, just vice versa happens when the very institutions do not carry out their functions or function with major omissions. Protection and enforcement of IPR – which along with other factors that form the transaction costs – in Armenia are not being ensured due to the improper function of the organizations responsible for it. As Merges argues (1995) intellectual property rights lower transaction costs. The gaps in the enforcement of IPR in Armenia lead to an increase in the transaction costs of a company that would like to make an investment as it takes some additional resources firstly to define and then also to protect the IPR which in this kind of environment should be realized mostly by the investor himself due to the weak rule of law. Otherwise as in the case of Microsoft Armenia the company loses or the same to say does not make the profit it should.

The increase in the costs of investor particularly the increase of the share of transaction costs is a factor that mostly negatively influences the decision of the entrepreneur whether or not to act in some specific sector of economy. Although there will be and are for sure investors who will be willing to act in such an environment, as mentioned by Doytch and Eren (2012) this will take place if the investors are in the position of receiving better incentives from the situation in the market, however, many of them may find it not profitable deal giving in mind the increase in transaction costs that in the retail

sector of Armenia is merely formed as a result of bargaining with informal networks and as an outcome of satisfying the interests of these networks or of some individuals in that networks.

The cases discussed in the retail sector of Armenia with a notion on existence and operation of informal institutions in that sector directly or indirectly affect the transaction costs for new investments, influence the decision making of investors and thus affect the level of investments in the retail sector of Armenia.

ENERGY SECTOR

In this chapter the focus is made on the latest events in the framework of Armenia's energy sector and Russia's role in the energy sector of Armenia. This will be discussed in the framework of formal institutions particularly with a notion on the agreements and contracts between Armenia and Russia related to the sector. When studying the energy sector of Armenia, one firstly comes up with discussions on the role of natural gas in the country. This seems logical if taking into account that the consumption of natural gas is accounting for almost the half of the total energy consumption in Armenia (M. Grigoryan 2008).

Formal Institutions in the Energy Sector of Armenia

On December 19th of 2013 the Constitutional Court of the Republic of Armenia declared that the agreements on the supply of natural gas signed up between the Republic of Armenia (RA) and Russian Federation (RF) – which later have been also ratified by the National Assembly of Armenia – are in the scope of the Constitution of Armenia (Armenia's parliament ratifies 2013). This specifically applies to the agreements named “The conditions of “ArmRosGazprom” Closed Joint-Stock Company's share trading and future activities”, “About the regulation on the price formation of natural gas supplied to the Republic of Armenia”, “About the cooperation on the supply of gas, oil and natural rough diamonds to the Republic of Armenia”. These agreements, especially the points stated in the agreement “The conditions of “ArmRosGazprom” Closed Joint-Stock Company's share trading and future activities” (Government of Russia 2013) /hereinafter “the Agreement”/ have become a subject of heated discussions in the scope of Armenia's political lifecycle. Many analysts and members of National Assembly of Armenia, in contrast to the decision of the Constitutional Court of Armenia, pointed out that this Agreement contradicts the Armenian Constitution and is degrading for Armenia and Armenians as well.

The Ministry of Energy and Natural Resources of Armenia – in the way prescribed by the Agreement – gave its 20 percent share in “ArmRosGazprom” CJSC to “Gazprom” OJSC for 63,334 billion AMD (Nearly \$153,026,000, converted by Oanda, 19.05.2014), thus making “Gazprom” OJSC the owner of 100 percent of authorized capital of “ArmRosGazprom”. What is more, as prescribed by the Agreement, the acquisition of this 20 percent of shares by “Gazprom” OJSC was realized through direct sales method, that is without any agreement and permit required by RA legislation including the agreements required by the SCPEC. The kind of decision not to involve SCPEC in the sales process seems doubtful given in mind that by this operation “Gazprom” OJSC de facto acquires a monopolistic position in gas supply to Armenia. However, it is worth to mention that this is not the only point of the Agreement that makes the whole deal look not that beneficial for Armenian side.

The Article 3 of the Agreement states that the Russian side guarantees the delivery of natural gas by “Gazprom” OJSC to Armenia in amounts sufficient to fully meet the internal needs of the RA and the Armenian side ensures that the gas delivered from Russia to Armenia, which is intended for consumption in the domestic market of Armenia, will not be exported.

What is more the Article 5 of the Agreement stipulates that “ArmRosGazprom” CSJC possesses the exclusive right to import gas from Russia to Armenia. This means that it automatically prohibits Armenia from getting any amount of gas from Russian company other than “Gazprom” OJSC, regardless whether or not the conditions offered by the other companies are or will be better in the future.

As about the duration of the Agreement, here comes one of the key points of the very Agreement. The last article of the Agreement –that is the Article 11 – states that the Agreement is signed for an indefinite period of time, meaning that it theoretically may be in operation till both sides decide to cancel the Agreement. Taking into account the fact that at least in the near future it stems from Russia’s interests to sell as large amount of gas as possible, it becomes obvious that the Agreement will be cancelled whenever Russia on behalf of “Gazprom” OJSC will have a desire or need to do that.

However, the mostly discussed part of the Agreement among Armenian politicians and political analysts is the Article 7. The very Article of the Agreement states that the Armenian side guarantees that the rights and interests of “Gazprom” OJSC, “ArmRosGazprom” CSJC and their respective successors, are not subject to change, amendment withdrawal or reductions without Russia’s consent till 31st of December 2043. Armenians and Armenian analysts believe that 30 years for this kind of agreement is a very big period of time. It is believed that signing a kind of agreement for 30 years in the framework of very drastic global changes in the research and development, in a world where many companies rise and others “die” in a very short period, where offers, interests, and obligations of companies and countries are subject to radical changes, this is a short-sighted project putting Armenia in a dependency from one country and/or even a company.

Moreover, the Article 7 also indicates that the Armenian side guarantees that until 31 December 2043 no future laws, decrees, orders and other normative legal acts will change and/or cancel and/or in any other way violate the rights and interests of “Gazprom” OJSC, “ArmRosGazprom” CJSC and their respective successors as stated in the Agreement. This assumes that during the next 30 years, regardless what political and/or economic situation will be in the country, in the region or worldwide, no legal act amended by Armenia should affect the very Agreement. The Agreement goes even deeper by noting that if by 2043, December 31 inclusive, the RA amend any legal act that will repeal, change or in any other way violate the rights and interests of “Gazprom” OJSC, “ArmRosGazprom” CJSC and their respective successors as stated in the Agreement, it will not be applied to these companies. The ex Minister of Foreign Affairs of Armenia Alik Arzumanyan indicates that the very Agreement completely restricts all the rights of one of the sides and ensures all the rights of the other side (The details 2013). Mr. Arzumanyan also noted that the very Agreement contradicts the Armenian Constitution in many ways and as an addition states that this kind of agreements are called capitulation acts rather than agreements between 2 partner countries.

In order to support his belief Mr Arzumanyan calls the Article 6. The Article 6 of the Agreement states that in the territory of Armenia, any property belonging to “Gazprom” or to persons affiliated with “Gazprom” enjoy a full and unconditional protection by the RA

and cannot be exposed to direct or indirect expropriation, nationalization or requisition, as well as to other changes that may lead to consequences that are tantamount to expropriation, nationalization or requisition. It also states that if contrary to the terms of the Agreement such expropriation nationalization, requisition or other deprivation of property, rights or interests take place then the Armenian side will promptly reimburse the value of such property, rights or interests in full market value and in U.S. dollar. This in the line with other Articles of the Agreement mentioned earlier indicates that during the next 30 years anything that will affect negatively “Gazprom’s” property and in general “Gazprom’s” interests as stated in the Agreement, will be totally covered and/or reimbursed by the Armenian side, however, nothing is mentioned about the sanctions that will be applied to the other side for not actualizing its duties and obligations.

The Price and Quality of Armenian Gas and the Possible Alternative Supplier

Another important side of natural gas supply is the price. Here, even the price at which Russia supplies gas to Armenia is a question under dispute. Many times the Armenian Government has indicated that the price at which Armenia gets natural gas from Russia equals to \$189 for 1000 cubic meters of gas (Russia to supply 2013). However, in reality no one in Armenia gets gas at the very price. That is the price at which “ArmRosGazprom” CJSC is getting gas from “Gazprom” OJSC. Thus, after “Gazprom” OJSC becomes the sole owner of “ArmRosGazprom” CJSC, this means that “Gazprom” OJSC is selling gas just to himself in the face of its subsidiary “ArmRosGazprom” CJSC. The real price at which the consumers in Armenia get gas is \$391 /AMD 158,000/ (Hrant Bagratyan 2013).

Here, logically a question arises, whether or not Armenia can get natural gas on better conditions. This question has especially become widely discussed after the Ambassador of Iran to Armenia declares that Iran may distribute gas to Armenia with cheaper prices than it does to other countries, though the Ambassador did not state any concrete price (N. Bulghadarian 2013). Armenian government on behalf of the RA Minister

of Energy and Natural Resources Armen Movsisyan has announced that Iran suggests Armenia gas for more than \$400 for 1000 cubic meters, thus stating that it cannot be considered as a profitable deal for Armenia. Afterwards, however, Iranian Ambassador put under doubt the announcement made by Mr. Movsisyan, which means that it is still under doubt the price at which Iran is eager to sell Iranian gas to Armenia.

It is worth to mention, that today, Armenia gets Iranian gas which however, is used solely in combine heat and power stations. The official data presented by the RA State Revenue Committee shows that Iran delivers gas to Armenia at the price \$181 for 1000 cubic meters (Mr. Pashinyan 2013). This price, even if comparing to the price at which “Gazprom” OJSC sells the gas to “ArmRosGazprom” CJSC is \$8 less. It is obvious that if Iran is exporting gas to Armenia at the very price, there is no difference for them whether this gas is used in the heat and power stations or by other subscribers as well.

The reasons why Armenia did not import Iranian gas for internal needs before the signing of the Agreement with Russia are also matter of discussions. The main barriers for the importing Iranian gas was/is Russia, United States of America (USA) and European Union (EU). They all have been against the import of Iranian gas by Armenia and each of these geopolitical units has their own reason for that. However, the recent progress in the relations between the West and Iran may drastically change the situation. If Iran and the West achieve a long-term settlement, both USA and EU will be for importation of Iranian gas by Armenia, thus reducing the dependency of Armenia from Russia. What is more, the export of Iranian gas to Europe through Iran Armenia Georgia transit way may be of great interest, taking into account Europe’s will to have alternative natural gas routes bypassing Russia and Turkey, and as a transit country Armenia would definitely get gas with far lower price.

The kind of pressure from Russia’s side is not something new. After the completion of Iran-Armenia natural gas pipeline in 2008, the Armenian Ministry of Energy announced that Armenia does not need Iranian gas yet. Here again many analysts linked this with Russia’s pressures on Armenia (Op. cit. M.Grigoryan). What is more, Russia possesses not only all the natural gas pipeline network within Armenia that supplies Russian gas, but the Armenian part of the Iran-Armenia pipeline is also owned by Russia in the face of

“ArmRosGazprom” CJSC, which is an additional warranty that through the pipelines existing in Armenia will flow exclusively Russian gas.

Moreover, natural gas has a big role in Armenia’s electricity production. Armenia's thermal power stations (which supply approximately 24% of Armenia's electricity needs) run on natural gas. Talking about the electricity of Armenia, here comes out another significant fact. The “Electric Networks of Armenia” CJSC (“ENA” CJSC) was founded in May of 2002 as merger of four state regional companies (“Yerevan Electric Networks”, “North Electric Networks”, “South Electric Networks” and “Central Electric Networks”) distributing and selling electric energy (“ENA” CJSC homepage). The company is mainly engaged in regulated distribution and sales of electric energy. Overall spread of its grid is 36 thousand km. The company provides service to about 935.000 customers.

What is more, the company is also a monopoly and has an exclusive license for distribution of electric energy within the Republic of Armenia. In addition to the above mentioned, "Electric Networks of Armenia" CJSC is a subsidiary of Russian “INTER RAO UES” OJSC. “INTER RAO UES” OJSC is a functioning operator of electricity exports and imports on the territory of Russia. As can be seen the electricity of Armenia also belongs to Russia/Russian company which even deepens the dependency of Armenia from Russia. These monopolies also restrain the technological progress in the sphere and make super profit by reducing the quality of the production. The latter has largely been discussed in Armenia recently, in the framework of the quality of supplied natural gas. Many analysts argue that the calorific value of natural gas used in Armenia is much less than the standards state.

In addition the ex Prime Minister of Armenia Hrant Bagratyan has indicated that even if one consider that the calorific value of natural gas used by Armenian consumers satisfies the standards, those standards are much lower than the ones used in EU countries, and in order to compare the prices of natural gas among countries the calorific value of the gas must be taken into account. The calculations made by Dr. Bagratyan led to the conclusion that in order to compare the gas supplied to Armenia and the gas supplied to Europe one should multiply the price at which Armenia gets gas by 1.27, which in its turn

makes Armenia a country that gets one of the most expensive gas in Europe, as noted by Dr. Bagratyan (Op. cit. Hrant Bagratyan).

Although the companies like “ArmRosGazprom” CJSC and “Electric Networks of Armenia” CJSC are enjoying the advantages of their monopolistic position, these companies are largely managed in an inefficient way. The tariffs of these monopolies are mostly affected by their investment levels, and it is worth to mention that the very companies fail to realize the investment obligations that were assumed under concession or privatization contracts. The energy sector has not benefited from significant investment projects or any visible modernization of the infrastructure. This in a broad sense comes from the inefficient work of the governmental institutions of Armenia and the absence of the civil society as an institution.

Transaction Cost in the Energy Sector of Armenia

Due to different objective and subjective problems existing in the functioning of Armenian Government - which will be discussed later in this study - Russia gets opportunity to acquire monopolistic positions in the energy sector of Armenia in this very case through de jure legal channels, formal institutions, that is through signing agreements and contracts that serve its interests, however, leading to an environment where no other actor can operate, de facto without Russia’s permission.

This is assumed from the Agreement and particularly from the Article 3 of the agreement stated earlier. It actually means that till the end of the Agreement Armenia will not be able to get gas from other suppliers. Although it is not prohibited by the Agreement, but taking into account the fact that in the scope of the Agreement Armenia will get the full amount of gas that is needed for the domestic use and will not be able to export that gas, there is no need and logic to get additional gas from other exporters. So this is one of the formal constraints that both directly and indirectly hinder the future investors/suppliers

from operating in the very sphere and raises almost insurmountable barrier for accessing the market.

Taking into account the fact that the Agreement is signed for the indefinite period of time (Article 11) this situation will continue until Russia sees any interest in ending it. This means that for instance if Armenia would like to get Iranian gas, taking into consideration that the latter is willing to supply that gas and taking into account that it may be economically even more profitable for Armenia as mentioned earlier, it is becoming obvious that without ensuring Russia's no matter economic or political interests this kind of project is almost impossible after signing of the Agreement. In this case the question is whether Iran or Armenia (or maybe both) should pay for getting "permission" of the supply of Iranian gas to Armenia. If the Iran as the investor party in order to supply gas to Armenia will be willing to ensure Russia's interests in order to get access to Armenia's energy market it can be considered as an added expenditure which increases the supplier's transaction costs.

Particularly the monopolization by "Gazprom" OJSC on behalf of "ArmRosGazprom" CJSC in Armenian energy market is a demonstration of concentration of the sector. As stated by Mathis (2005) the concentration of the market may yield to negative effects for the host country in this case for Armenia particularly holds back development and raise prices about which the case study discussed.

Taking into account today's geopolitical situation it is assumed that Iran can make a political/economic suggestion to Russia, which should rise firstly from Russia's interest which theoretically may lead to permission for Iran - Armenia gas delivery. However, as said this should primarily ensure Russia's interests meaning having additional spending for Iran which will be demonstrated as a supplement to transaction costs.

Depending on the level the transaction costs are increased that is the terms at which Russia may agree to change the Agreement or cancel it thus giving an opportunity for Iran to supply gas to Armenia, the supplier that is Iran will decide whether or not it worth to operate in Armenia's energy market, whereas in the absence of the Agreement it would be completely another situation where the permission from Russia will not be needed, therefore no increase in transaction costs would be made. As it can be seen in the energy

sector of Armenia formal institutions lead to barriers that hinder any foreign actor who would be eager to act – in this situation particularly Iran – in the market and lead to a situation where there is practically little or no possibility to alter the main gas supplier that is to alter Russia.

PUBLIC PROCUREMENT SECTOR

In the report “2013 Investment Climate Statement - Armenia” (U.S. Department of State 2013) U.S. Department of State also turns to the question of public procurement in Armenia, particularly to the tender processes. The report highlighted the existence of unfair tender procedures presented in the country and preferential treatment stating that the existing barriers are complicating the seemingly open legislative framework and Armenian Government’s visible effort in attracting foreign investment. These examples, in addition with the state’s failure in providing fair investigation of abuses have put under doubt the Government’s claims of equal treatment and transparency.

In Armenia, the public procurement system seems to suffer from a perception of lack of transparency and integrity. The weaknesses in the public procurement system particularly in the area of integrity and transparency are a result of improper and weak framework, non-observance with norms, manipulation of the market, or as a result of malfeasance by key players. In the “Country Procurement Assessment Report” of the RA introduced by the World Bank from various reports are collected and presented the issues in the procurement system of Armenia which are related to: “weaknesses and overreliance on and abuse of restricted tendering (mainly sole sourcing); a lack of confidence in the independence and effectiveness of the complaint review mechanisms; numerous reports of poor quality of works and services and instances of non-delivery or non-performance; deficient rules on conflict of interest and codes of conduct; indications of anti-competitive agreement prior to submitting bids (eg. collusion); abuse of the qualification and evaluation process to favor pre-determined bidder; faulty specifications that favor certain suppliers; lack of significant participation and oversight by civil society groups and other stakeholders; deficient mechanisms for transparency, information access and feedback systems; unclear and overlapping audit systems with no significant follow-up of findings; lack of integration with overall national anti-corruption strategy and reference to the appropriate criminal legal framework; abuse of use of “monopoly” privileges; dismally low

level of tender participation; and general lack of capacity of procuring entities” (WB 2009, P 37-38).

The existing barriers and difficulties for accessing information and the weak implementation of appropriate information systems and the obstacles in the freedom of information regimes are also factors hindering transparency.

Informal Institutions in the Public Procurement Sector of Armenia

There are many cases when ministries other than violating tender procedures, make purchases from only one organization, which in fact contains corruption risks, especially when those organizations are not chosen within tender procedures. This kind of violations in general leads to two main negative effects. Firstly, the state pays much higher prices than the real prices for the goods, labor and services that are being purchased for the country’s needs. And secondly, even when paying higher than the real price of the product, labor or service, the state does not get the outcome that was supposed initially, meaning that the state gets no result or partial or poor quality result.

And another major problem that will be further elaborated is the negative effect of this kind of environment on investors. The problems and gaps in the public procurement sphere exist in almost all stages of planning, management, bargaining and enforcement processes. Another major problem is that this kind of attitude towards public procurement and tender processes in general hinder the rise of new actors, including the foreign ones. Corruption and political patronage through informal networking are the main barriers to free and fair tender processes. In the scope of this chapter some of the most apparent cases of violations in the public purchase sphere will be discussed.

Particularly one of the government procurement cases made by Compulsory Enforcement Service of the Ministry of Justice of RA (JACES) is worth to mention. JACES as a client has bought a large number of Chinese BYD cars from a specific LTD. However, it turns out that the client that is JACES on behalf of the chief of the JACES and the agent of the very LTD on behalf of its founder is the same person Mihran Poghosyan

(Systematic, Widespread Corruption 2013). In other words, a high level governmental official de facto bought those cars from himself by serving the state budget resources for the prosperity of his own business. Violations specifically in the procurement of cars are quite common in Armenia. For example, the Prosecutor General's Office of the RA (PGO) is purchasing cars from the company belonging to the head of the PGO or the Police of the RA are purchasing cars from the firm belonging to the Vice Prime minister of the RA, if believing many publications made by the media during the last years (Public procurement of cars 2013). This actually demonstrate the division of the car importing companies among public agencies meaning that any new investor or representative of any other car company is pulled out of the game and has practically no opportunity to get engaged into public procurement processes.

In the scope of public procurement it is also risky when the product or service is purchased from one company or individual, especially when that kind of agreements has a long term nature. Purchases from a single source are especially very common in the regions other than the capital of Armenia. Usually the public agencies explain their kind of behavior by pointing out that there were no other bids for tender, however the studies have revealed many cases when that single source purchases were realized using a company that has been directly or indirectly affiliated with the official responsible for the public agency making that purchase.

For instance, the administration of one of the regions of Armenia has made a single source purchase through a company that belongs to the brother of the head of that administration (Transparency International 2013). In a Vanadzor city, similar case was detected, when the municipality was making single source purchase, using a company that belongs to the mayor of that very city (Op. cit. Systematic, widespread corruption). What is more, in major tenders for single source procurement, are taking part and win such companies that even have no electronic data available including their contacts and description about their activity. Although informal networking helps these high ranked officials to avoid sanctions, in order to be more protected they generally used another scheme for bidding too. The idea of this scheme is that an owner of several firms presents individual packages for every firm he owns for the participation in tender, by setting

different prices for the same activity. As a result, in any case the winning company belongs to him and what is more in official documents there will be clearly stated that de jure several firms were competing for the tender. These officials relying on corruption and on their networking feel themselves protected in the sense that no inspection will go deep enough or will be eager to go deep enough to reveal these violations.

As a rule violations in the public procurement sphere are revealed through the investigations realized by more or less free media representatives or by international organizations acting in Armenia. However, even when such violations are discovered by media or international organizations, it is very rare when anyone is brought to justice, including the officials mentioned earlier in this paragraph. Here becomes obvious another significant problem that hinders foreign investment, which is the weak rule of law.

Another case is the fuel supply to farms and farmers by the state. During 2012 the State Government in the framework of the assistance to farmers program has allocated to them more than AMD 620 million subsidy for a fuel purchase. In 2013 this subsidy was equal to almost AMD 595 million. Thus during these 2 years the overall amount of the subsidy was nearly AMD 1.2 billion. However, this subsidy was not provided to the farmers for instance through some special coupons, rather it is delivered to a single particular fuel supplier (Op. cit. Systematic, widespread Corruption). It is obvious, that the plan used by the Government for farmers subsidizing is strengthening the positions of a specific supplier in a market, gives him an illegitimate advantage over both the other suppliers acting in the market and the possible new competitors. Those advantages not only foster that very company's enrichment at the expense of the state budget but also strengthen the monopolistic position of the company, increase the prices related to it and inhibit the economic development even more. In such environment it is hardly possible to compete with this kind of suppliers. In general, Armenian market is very small and limited due to a small number of population and thus consumers. And this kind of advantages that are illegally given to some particular suppliers make almost impossible for any other especially foreign actors to operate in the same field. The amount of subsidy mentioned earlier is a huge "assistance" to that firm and the very firm having such a big demand can just by decreasing the prices on the fuel for a while oust any newcomer from the market.

Transaction Cost in the Public Procurement Sector of Armenia

The foreign investor after the investigation of the local market, after collecting the needed information will probably become aware about the “unwritten rules” of the market, as these barriers and the behavior of officials towards these barriers are so obvious and ubiquitous that the barriers the investor will face to will be visible already on the first stage of his activity. This means, that the investor’s behavior and future decisions particularly whether or not to enter into Armenian market is conditioned mostly by his readiness and willingness to pay bribes, or to pay some constant percentage from the future profit or to use other means to get patronage from high level officials, which means to get engaged in a corruption process.

As discussed through the theory the corrupt practices will yield additional costs to investor which means that the investor will have higher transaction costs. In the public procurement sector of Armenia the increase in transaction costs is more visible during the bargaining process that is when the investor needs to spend money on bribes as well as spend more time and efforts to sign an agreement that will allow him to supply the public organizations. But it is not fact that it will be always possible to get market access for a foreign investor through informal channels as people acting in that way are linked tightly among each other for a long period of time and not in every sphere there will be market access or the transaction costs – the price to be paid for entering the market – may be so high that it will be financially not efficient to act in the framework of such conditions.

What is more, as in many other cases in order to be considered or chosen as a winner of a tender the firm should take into consideration the personal interests of the decision makers that is the officials. Taking into account the cases demonstrated earlier related to the public procurement sector of the country, it again becomes obvious the corrupt system which again enriches the corrupt politicians from the one side and increase the transaction costs of the entrepreneur from the other side.

In many public purchase cases and in the mentioned cases particularly related to public procurement of cars, it should be taken into consideration that other than the corruption processes that increase the transaction costs, there are also presented political

risks which as noted by Harms and Ursprung (2002) decrease the level of inward investment. Although the suppliers of the state organizations in general serve for a long term, from time to time these suppliers are subject to change as a result of political changes which lead to changes in the office of the head of this or that state organization. However, even during that time the supplying companies that are coming as an alternative to the previous ones as a rule, are not chosen in a fair tender processes either. This means that any car importing company that would like to be a supplier of any public organization should take into account not only the corruption risks but also the political risks as the decisive factor in determining the start and end of cooperation with public agencies, rather than the quality and prices of the products supplied.

Even if for instance the foreign company wins a tender and serves for this or that public agency, due to the weak rule of law the firm should spend money to be sure the other party sticks to the terms and conditions of the agreement. These costs are also considered as transaction costs (Dahlman, Carl J. 1979). And the company should take appropriate actions whenever violations are revealed, which means again to spend money this time for enforcing the other side to stick to the terms. These actions in general assume acting through legal system. As stated Krueger (1974) mentions when the quality of institutions is low, the legal system also works with low effectiveness and in such situations the regulatory burden in the hands of bureaucrats operates as revenue seeking tool acting through red tape and other harassment tools. This in the end leads to a corrupt practices and again increases the transaction costs of the investor.

However, here from the one side there is a weak legal system of Armenia with a weak rule of law and what is more from the other side there is a party on behalf of a state agency. Here if the violations by the state agency arise it is extremely difficult to achieve justice using the biased courts that are tightly linked with other state organizations in the scope of informal networking. And again if the foreign firm wants to continue its functioning and needs to overcome the created barriers needs to spend money on sticking the other party to the terms that is to have higher transaction costs that would not exist if the legal system works in an appropriate way without the negative influence of powerful informal institutions.

Taking this into account the case studies related to the public procurement sector, the operation of informal institutions there, and their affect and control on the sector the entrepreneur that is eager to provide services to state organizations or act in a field where some specific company enjoys the state's sponsorship, like in the fuel consumption case, the newcomer should in advance ensure him with at least some fixed demand of his services or products which can be done by signing agreements and contracts with the state organizations. Here we come to the thing from which we have started that is from case studies it becomes obvious that in order to become an agent for a public procurement organization in Armenia it is essential to consider high transaction costs that arise merely from the functioning of informal institutions.

CHAPTER 3. ANALYSIS OF THE INTERVIEWS

In this chapter the data acquired through structured interviews is analyzed. The analysis takes into account the theory and methodology of the thesis when responding to the research questions and hypothesis. Particularly the Russia's investments to Armenia are discussed in the context of the importance of country of origin of foreign investments as highlighted by Fortanier (2007). The country of origin of the foreign investment is one of the factors affecting the form of foreign investments which has a great importance for the host economy (Mencinger 2003), particularly whether or not the investments tend to market concentrations which in their turn rise barriers for other investors overcoming of which lead to increase in transaction costs. The questions to interviewees are elaborated further.

- 1) Is there observed a tendency of market concentration, monopolization in Armenia by Russia's investments?

The 7 out of 9 respondents have pointed out that there is a clear tendency of the major investments from Russia into Armenian economy that tend to monopolize the sector of economy where they are going to function and act. This is firstly conditioned with the will to get super profits and depending on the sector of economy the monopolization of the environment can be also used in order to deepen the dependency of Armenia from Russia. The sectors that have been mentioned by the respondents as the ones where there is a high concentration of the market by Russian companies include energy sector, transport and communication sector and manufacturing sector. Russia is the sole owner of the national railway network of Armenia (South Caucasus Railway 2014), 2 of the 3 telecommunication companies are fully or partially owned by Russian firms ("Beeline Armenia" and "VivaCell Mts") and other than the earlier stated facts about energy sector of Armenia it worth to mention that Russia owned all of Armenia's hydroelectric and nuclear power stations with the exception of two (K. Sargsyan 2014).

The respondent Mr. Karen Pashayan has also noted that the tendency of monopolizing different sectors of Armenian economy by Russian firms and companies through investments is being continued. And as a particular example is mentioned the inclusion of Armenia into Customs Union one of the main economic goals of which as Mr.

Pashayan believes is even more concentrating and monopolizing the Armenian market by Russian entities.

The other 2 respondents believe that the entry of Russian investments as well as any other investment coming from any other country is stimulating higher competition rates and have indicated to see no monopolization of the environment by Russian firms, however, they agree in a way that there are sectors of economy in Armenia where Russia owned or Russian companies have dominant positions.

- 2) What are the main reasons for the existence of Russian companies in Armenia that have dominant positions in the state's economy?

Here, all of the respondents agree at least with the point that there are Russian firms that possess dominant positions in different sectors of Armenian economy. However, the reasons of the existence of these firms vary from respondent to respondent. However, the answers of the respondents can be divided into two groups – the answers in the first group indicate this kind of reality as an outcome of many factors mostly negatively influencing Armenian investment market and institutional background and the answers in the second group state the existence of sectors dominated by Russian firms as a positive factor for Armenia.

Here the majority of respondents belong to the first group, who have pointed that it is the outcome of pressures by Russia on Armenia, corrupt practices, informal networking, personal interests of high level officials of Armenia that lead to an environment where monopolies and/or dominant position possessing Russian firms operate. In addition, the improper enforcement of competition law is mentioned as another factor fostering the rise of such companies. Although the function of such companies is being ensured through legal acts or formal institutions, the ways this kind of agreements are reached are not rising from the idea of productivity for Armenian economy.

For instance, taking into account the highly disputable results of presidential elections of Armenia (A. ISHKANIAN 2008) that officially have been won by Serzh Sargsyan, today the main foreign support force for Mr. Sargsyan personally is Russia on behalf of Kremlin. This leads to the fact that in order not to lose this support – thus his presidential position – the President of Armenia formally secures the undertakings and big

investments of Russia in Armenia through legal agreements, like for instance giving them exclusive rights to act in some particular sectors. This can be considered as a place where personal interests of individual affect the monopolization of Armenian economy by Russian firms. In this context it is important to refer to Doytch and Eren (2012) who indicate that the democratization process can also have a negative effect on FDI, if foreign investors are in the position of receiving better incentives from autocratic regimes than from democracies. This is how Russia benefits from the failures in the democratization process of Armenia.

It is also the pressure of Russia on Armenia that may lead to the monopolization of Armenian market. One of the most significant factors that are used by Russia for having a pressure on Armenia is the fact of being Armenia's chief security supplier. Taking into consideration the unresolved conflict of Armenia and Azerbaijan over Nagorno Karabakh as well as other elements that make the region sensitive to military actions it becomes obvious that any security blackmail used by Russia against Armenia can hardly be resisted by Armenia. Many believe that Armenia's choice to join Customs Union is also the outcome of the security blackmail and serious pressures by Russia. And as stated earlier one of the respondents strongly believe that one of the economic missions of Customs Union related to Armenia is monopolizing the Armenian economic market.

However, few of the respondents suppose that the dominant positions of Russia owned or Russian companies in Armenia is conditioned with the high productivity of these companies, low prices of their services or products, or the innovative approaches used by them. It has been also mentioned that the dominant positions acquired by these firms is the result of the absence or weak interest of domestic firms to operate in the same particular field.

- 3) Is the problem with high shares of monopolies in Armenian economic market more conditioned with the gaps in the law itself or with not proper enforcement of the law?

Surprisingly or not all the responses to this question in this or that way suggest the idea that although the competition law in Armenia is not ideal and some gaps exist there, it is of far greater importance that the law is not enforced properly. The improper

enforcement of the competition law in its turn leads to monopolization of the environment and low level of competition. The proper enforcement of the law in its present condition will hinder the concentration of the market as the respondents believe.

The weak rule of law in Armenia that gives possibility for the enforcement of competition law only case by case bases is a significant factor that let the monopolization of the economic environment. Both the domestic and foreign investment, including the investment inflows coming from Russia to Armenia would not lead to concentrations or monopolizations of the economic market of Armenia if the competition law is appropriately used.

As Mathias (2005) mentioned, in the absence of competition law or in case of violating this law there will be no “lever” for the government to exercise this policy when it is needed. In Armenia’s case the problem is the violation of the law as indicated by the majority of the respondents the gap is not in the existence of the law but in the proper enforcement. This lead to a situation where the government of Armenia does not using the levers that are legally stated through the competition law, which lead to the monopolization of the market.

It can be inferred from the mentioned that the investor should take into account the weak rule of law, thus be ready to spend money to stick the other company to terms of the competition law if the one is violating them. If there would be a strong rule of law in Armenia the competition law would be enforced without the actions of individual investors in the legal system of the country in order to defend their interests, rather any violations in the scope of competition law would have been prevented by the competent authorities. However, in this reality due to the weak rule of law, the investor as was already said may be forced to stick the other party to the competition law by spending some money, meaning having increased transaction costs that otherwise would not occur.

- 4) Do Russia’s investments into Armenian economy hinder domestic and other foreign investment inflows to Armenia?

6 out of the 9 respondents have indicated that the way Russia’s investment inflows to Armenia are actualized today is fostering the rise of the barriers for other investors. Firstly, due to the goals and missions of the Russia’s investments, concentration of the

market occurs after Russia companies are investing in Armenian economic environment. This becomes possible through the usage of various levers concentrated on the hands of Russia. Concentrated economic environment decrease the attractiveness of the market for any other investor, thus negatively affecting the investment climate of the country.

Due to the patronage by Armenia even if some specific Russian company does not possess an exclusive right to operate in this or that sphere, usually it is of great efforts and expenditures to any other investor to act in the same sector and to become a competitor. Many artificial barriers may be raised by the officials till the new investor will be pulled out from the market or will try to secure the interests of these high ranked officials. This again means that the investor will be mostly obliged to pay bribes in order to stay and operate in the market. However, the bribery will increase the transaction costs of the investor and it is obvious that an environment with high transaction costs will most probably impede the investment levels.

However, the other 3 respondents have highlighted that investments from Russia has no role in stimulating barriers in the investment market of Armenia or raising barriers for investments from countries other than Russia. They have pointed out that the existence of the institutional barriers that hinder foreign investments into Armenian economic market is solely the outcome of the inefficient state regulation of the country.

While the majority of the interviewees stated that in a broad sense Russia has a negative role in the functioning of institutions in Armenia, the others find no Russia's influence in the existence, formation or stimulation of institutional barriers to investment market of Armenia. However, the interviewees who support the idea that Russia plays no role in stimulating institutional barriers in Armenia has an important congeniality in the way that they all represent either Armenian governmental organizations which has strict pro-Russian attitude or have leading position in the organizations sponsored by Russia. The study believes that the answers of these interviewees have subjective bases rather than objective ones meaning that these responds should be considered as biased.

The data collected through interviews and analysis of this data lead to the outcome where the role of Russian investment into Armenian market in stimulating the barriers for other entries into the same market becomes obvious. The answers of the respondents give

opportunity to believe that the investment inflows from Russia to Armenia tend to concentrate and monopolize the market using already noted levers, thus fostering the rise of the barriers for other investors when investing into the same sector of economy of Armenia.

Particularly, in order to act in a sector where Russian company enjoys full or partial patronage by Armenian Government or powerful informal networks of Armenia, the newcomer is put in a situation where the way to start operating in the market is possible by securing the interests of these networks. This in its turn put the investor in a situation where if willing to start its activity the investor is being engaged in corrupt practices, which as was mentioned increases the transaction costs of the investor.

From the other side, if Russian firm enters into this or that sector of Armenian economy where various companies already act and try to monopolize the sector mostly by violating the competition law, due to the weak rule of law of Armenia and patronage of Russian firms by government of Armenia mostly the other companies are not being protected by the competent authorities. These firms by spending money and time with using the expensive legal environment or by engaging in corrupt practices try to protect their rights. In both ways these lead to an increase in transaction costs of the entrepreneur. And the increase in transaction costs lead to a decrease in the levels of investments coming from countries other than Russia.

CONCLUSION

In this thesis the institutional barriers to investment climate of Armenia and their role in the level of investment inflows to Armenia is studied. The main theoretical argument of this study is that the functioning of both formal and informal institutions of Armenia affects the transaction costs of the investors which as demonstrated through the theory in its turn has a significant impact on the level of investment inflows. Whether or not the operation of Armenian institutions increases the transaction costs is analyzed through the case studies covering 3 sectors of Armenian economy. Another theoretical argument of the paper is that the country of origin of foreign investment matters as depending on it the investment inflows may lead to concentrations in the host economy, where the entrance for other investments will be limited and the overcoming of that kind of problems will in its turn lead to an increase in transaction costs of other investors. In this sense the investment inflows to Armenia from Russia is studied through the primary data acquired from the interviews.

The specificity of Armenian institutional background particularly high level of corruption, negative effects of informal networks, weak rule of law, state patronage and monopolized environment form the investment climate of the country. In this sense the usage of institutional analysis is important as it looks beyond the macroeconomic figures, particularly demonstrating that the increase of foreign investments is not always beneficial for the host economy due to weak institutional background of the country. Specifically the most flagrant cases have been studied to highlight that the gaps and failures in the work of institutions and insufficient institutional changes in Armenia makes the investment climate in the country unfriendly and unfavorable for investors or at least for those investors who do not possess some kind of patronage thus hindering the rise of the overall investment levels of the state.

This study concludes that the informal networks of Armenia which are highly discussed in the scope of this study are functioning for securing their interests which in general negatively affect the investment climate of the country. Particularly, the concentration of the market by the companies belonging to the powerful members of these

informal networks or to the companies which are acting under the patronage of these informal networks lead to an environment where any new investor should secure the interests of these informal networks in order to be able to act in the same environment. By ensuring these interests the investor spends additional resources meaning having higher transaction costs.

This study also concludes that there are also decisions adopted by the government of Armenia the adoption of which hinders the investment opportunities of others. Particularly in the case study of the Energy Sector of Armenia is discussed the adoption of an intergovernmental contract between Armenia and Russia which as this study believes increases the transaction costs of another party specifically Iran for acting in the environment.

The analysis on Russia's role has been further elaborated through the analysis of the data obtained from the interviews. While the majority of the interviewees stated that in a broad sense Russia has a negative role in the functioning of institutions in Armenia, the others find no Russia's influence in the existence, formation or stimulation of institutional barriers to investment market of Armenia. However, as already stated, the interviewees who support the idea that Russia plays no role in stimulating institutional barriers in Armenia has an important congeniality in the way that they all represent either Armenian governmental organizations which has strict Pro-Russian attitude or have leading positions in the organizations sponsored by Russia. The study believes that the answers of these interviewees have subjective bases rather than objective ones meaning that these responds are biased and cannot be admitted as given and concludes that Russia plays a negative role in the functioning of various institutions in Armenia, and stimulates the rise of new barriers or strengthen already existed barriers in the investment market of Armenia particularly through concentration and monopolization of the market, which lead to an environment where the new investor needs higher transaction costs for acting in the field.

The study throughout literature review has demonstrated that the increase in transaction costs negatively affect the levels of the investment inflows to the host economy. Taking into account this key factor, the study concludes that the function of the informal networks of Armenia, particular contracts securing dominant positions of specific firms

adopted by the government of Armenia negatively affect the institutional climate of Armenia as this factors increase the transaction costs of the other investors. What is more, the study concludes that Russia has a negative role in the investment climate of Armenia, as the investments coming from Russia tend to market concentrations which lead to an increase in the transaction costs for other investors.

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APPENDICES

Appendix 1. Index of Economic Freedom 2014

What is economic freedom?

Economic freedom is the fundamental right of every human to control his or her own labor and property. In an economically free society, individuals are free to work, produce, consume, and invest in any way they please. In economically free societies, governments allow labor, capital and goods to move freely, and refrain from coercion or constraint of liberty beyond the extent necessary to protect and maintain liberty itself.

How is measured economic freedom?

The economic freedom is measure based on 10 quantitative and qualitative factors, grouped into four broad categories, or pillars, of economic freedom:

Rule of Law (property rights, freedom from corruption);

Limited Government (fiscal freedom, government spending);

Regulatory Efficiency (business freedom, labor freedom, monetary freedom); and

Open Markets (trade freedom, investment freedom, financial freedom).

Each of the ten economic freedoms within these categories is graded on a scale of 0 to 100. A country's overall score is derived by averaging these ten economic freedoms, with equal weight being given to each.

Which components of economic freedom are most important?

The Index of Economic Freedom considers every component equally important in achieving the positive benefits of economic freedom. Each freedom is weighted equally in determining country scores. Countries considering economic reforms may find significant opportunities for improving economic performance in those factors in which they score the lowest. These factors may indicate significant binding constraints on economic growth and prosperity.

What is the period of study?

For the 2014, most data covers the second half of 2012 through the first half of 2013. To the extent possible, the information considered for each factor was current as of June 30, 2013. It is important to understand that some factors are based on historical information. For example, the monetary policy factor is a 3-year weighted average rate of inflation from January 1, 2010, to December 31, 2012.

How can the Index of Economic Freedom be used?

The Index of Economic Freedom is a helpful tool for a variety of audiences, including academics, policymakers, journalist, students, teachers, and those in business and finance. The Index provides an objective tool for analyzing 186 economies throughout the world. Each country page is a resource for in-depth analysis of a country's political and economic developments. Historical Index data can provide vital long-term insights. Furthermore, the 10 economic freedoms provide a comprehensive set of principles for those who wish to understand the fundamentals of economic growth and prosperity.

Appendix 2. Corruption Perceptions Index 2013

What is the Corruption Perceptions Index (CPI)?

The CPI scores and ranks countries/territories based on how corrupt a country's public sector is perceived to be. It is a composite index, a combination of surveys and assessments of corruption, collected by a variety of reputable institutions. The CPI is the most widely used indicator of corruption worldwide.

What is the difference between a country/territory's rank and its score?

A country/territory's score indicates the perceived level of public sector corruption on a scale of 0-100, where 0 means that a country is perceived as highly corrupt and a 100 means that a country is perceived as very clean. A country's rank indicates its position relative to the other countries/territories included in the index. Ranks can change merely if the number of countries included in the index changes.

Is the country/territory with the lowest score the world's most corrupt nation?

No. The CPI is an indicator of perceptions of public sector corruption, i.e. administrative and political corruption. It is not a verdict on the levels of corruption of entire nations or societies, or of their policies, or the activities of their private sector. Citizens of those countries/territories that score at the lower end of the CPI often show the same concern about and condemnation of corruption as the public in countries that perform strongly.

Further, the country/territory with the lowest score is the one where public sector corruption is perceived to be greatest among those included in the list. The CPI provides no information about countries/territories that are not included in the index.

Can the score of a country in the 2013 Corruption Perceptions Index be compared with the previous year?

Yes. As part of the update to the methodology used to calculate the CPI in 2012 we established the new scale of 0-100. Using this scale we can compare CPI scores from one year to the next. Because of the update in the methodology last year, however, CPI scores before 2012 are not comparable over time.

Appendix 3. Freedom in the World 2013

Methodology Summary

The Freedom in the World survey provides an annual evaluation of the progress and decline of freedom in 195 countries and 14 related and disputed territories. The survey, which includes both analytical reports and numerical ratings, measures freedom according to two broad categories: political rights and civil liberties. Political rights ratings are based on an evaluation of three subcategories: electoral process, political pluralism and participation, and functioning of government. Civil liberties ratings are based on an evaluation of four subcategories: freedom of expression and belief, associational and organizational rights, rule of law, and personal autonomy and individual rights.

Each country is assigned a numerical rating from 1 to 7 for both political rights and civil liberties, with 1 representing the most free and 7 the least free. The ratings are determined by the total number of points (up to 100) each country receives on 10 political rights questions and 15 civil liberties questions; countries receive 0 to 4 points on each question, with 0 representing the smallest degree and 4 the greatest degree of freedom. The average of the political rights and civil liberties ratings, known as the freedom rating, determines the overall status: Free (1.0 to 2.5), Partly Free (3.0 to 5.0), or Not Free (5.5 to 7.0). Freedom House also assigns upward or downward trend arrows to countries which saw general positive or negative trends during the year that were not significant enough to result in a ratings change. The survey assigns the designation of electoral democracy to countries that have met certain minimum standards. The numerical benchmark for a country to be listed as an electoral democracy is a total of 7 points or more (out of a possible 12) for the 3 political rights subcategory questions on electoral process, as well as a total of 20 points or more (out of a possible 40) for all 10 political rights questions.

Freedom House does not maintain a culture-bound view of freedom. The methodology of the survey is grounded in basic standards of political rights and civil liberties, derived in large measure from relevant portions of the Universal Declaration of Human Rights. These standards apply to all countries and territories, irrespective of geographical location, ethnic or religious composition, or level of economic development.

The survey does not rate governments or government performance per se, but rather the real-world rights and freedoms enjoyed by individuals. Freedoms can be affected by state actions as well as by non state actors, including insurgents and other armed groups.

The findings are reached after a multilayered process of analysis and evaluation by a team of in-house and consultant regional experts and scholars. The survey, which has been published since 1972, enables an examination of trends in freedom over time and on a comparative basis across regions with different political and economic systems. Freedom in the World's ratings and narrative reports are used by policymakers, leading scholars, the media, and international organizations in monitoring the ebb and flow of freedom worldwide.

Appendix 4 .Names, Positions and Academic Degree of Interviewees

Name, Surname	Former or Present Position	Academic Degree
Alexander Arzumanyan	Member of National Assembly of Armenia, Former Minister of Foreign Affairs of RA (1996-1998)	
Bagrat Asatryan	Lecturer at Yerevan State University, Former President of the Central Bank of RA (1994-1998)	PHD in Economics
Edward Sandoyan	Director of the Institute of Economics and Business at Armenian Russian Slavonic University, Former Minister of Finance and Economy of RA (1998-1999)	Doctor of Economics, Professor
Grigor Kirakosyan	Adviser to the Rector at Armenian State University of Economics	Doctor of Economics, Professor
Karen Pashayan	Lecturer at Yerevan State University of Economics	PHD in Economics
Stepan Mnatsakanyan	President of the National Statistical Service of RA	PHD in Economics, Docent
Tatoul Manasserian	Founder and Director of the Research Center “ALTERNATIVE”	Doctor of Science in Economics, Professor
Vahagn Khachatryan	Former Mayor of Yerevan (1992 to 1996)	Economist
Vahe Mikaelyan	Vice Dean of the Finance Department at Armenian State University of Economics	PHD in Economics, Docent