AMERICAN UNIVERSITY OF ARMENIA

A STUDY EXAMINING FOREIGN DIRECT INVESTMENT IN ARMENIA: INCENTIVES FOR FDI

A MASTER'S ESSAY SUBMITTED TO

THE FACULTY OF THE GRADUATE SCHOOL OF

POLITICAL SCIENCE AND INTERNATIONAL AFFAIRS

FOR PARTIAL FULFILLMENT OF THE DEGREE OF

MASTER OF ARTS

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JANUARY 2007

SIGNATURE PAGE

Faculty Advisor Date

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American University of Armenia

January 2007

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LIST OF ABBREVIATIONS

ADA-Armenian Development Agency

AMCHAM-American Chamber of Commerce in Armenia

AMD-Armenian Dram

ARCS-Administrative and Regulatory Costs Survey

BIT-Bilateral Investment Treaty

BSC-Business Support Council

CIS-Commonwealth of Independent States

DTT-Double Taxation Treaty

EBRD-European Bank for Reconstruction and Development

EUCCA-European Union Chamber of Commerce in Armenia

FDI-Foreign Direct Investment

FSU-Former Soviet Union

FIAS-Foreign Investment Advisory Service

IMF-International Monetary Fund

IT-information Technology

MLN-Million

MNC-Multi National Corporation

MTED-Ministry of Trade and Economic Development

NAFTA-North American Free Trade Agreement

NPV-Net Present Value

ODA-Official Development Assistance

OECD-Organization for Economic Cooperation and Development

ROA-Republic of Armenia

TNC-Transnational Corporation

TRIM-Trade Related Investment Measures

WTO-World Trade Organization

UNCTAD-United Nations Conference for Trade and Development

US-United States

USA-United State of America

USD-United States Dollar

USSR-Union of Soviet Socialist Republics

VAT-Value Added Tax

ACKNOWLEDGMENTS

The work on my Master's essay was empowered and facilitated by effort of several people.

I want to express a special gratitude to my faculty adviser Dr. Arthur Drampian for his professional approach in advising and revising this Master's essay during the whole process of its development. Dr. Drampian's high professional and human qualities were accompanying me along this way and helping to finish the work I had undertaken.

I would like to thank all those organizations which had provided me with the information imperative for the realization of the goals of the study. Among them are Ministry of Trade and Economic Development, Armenian Development Agency and Ministry of Statistical Services of Armenia. Especially I would like to thank the head of the Secretariat of the Armenian Development Agency Mr. Girair Aramyan for advising to select an appropriate scope of the study and providing valuable information.

My special thanks to Dr. Lucig H. Danielian, Dean of School of Political Science and International Affairs, who has enormous impact on my professional development as a graduate student of AUA.

ABSTRACT

The aim of this Master's essay is the examination of Foreign Direct Investment (FDI) in Armenia. Particularly the essay was focused on investment incentives created by Armenian government to attract FDI as well as identification of other factors positively or negatively affecting the inflow of FDI in Armenia.

The essay consists of the following major parts: ***Introduction, Theoretical Part, Analyses of Armenian Legislation on FDI, Conclusion and Recommendations.***

Introduction includes general information about the inflow of Foreign Direct Investment and its possible effects on the world economic development as a whole. Then the focus narrows down to the countries of the Former Soviet Union and Armenia. Most importantly, introduction includes ***hypothesis****,* ***research questions*** *and* ***methodology*** *of the study.*

The next major part of the essay is theoretical one which includes the following information: (1) definitions of types of FDI and factors affecting the inflow of FDI into a country, (2) literature review of studies concerning FDI.

The essay also refers to the agencies responsible for FDI promotion as well as provides analyses of Armenian legislation on FDI and investment in general. Evaluation of investment climate as well as business environment in Armenia is also discussed. Based on all these examinations and analyses ***findings*** *and* ***recommendations*** *were presented.*

Findings mainly present answers to the research questions. It is interesting to find out that, in spite of implementation problems, legislation in Armenia is very attractive including many policy incentives for foreign companies to locate their firms in Armenia and feel protected. In addition to appropriate legislative environment, there are also other factors such as skilled labor force, favorable privatization opportunities, attractive sectors of economy, comparative advantage in certain sectors of economy, which can promote FDI in Armenia.

Besides positively affecting factors, obstacles constraining FDI were also identified. These obstacles have been classified into controllable, semi-controllable, and uncontrollable ones. Among controllable obstacles are those that can be corrected by policy intervention (government intervenes by creating appropriate legislative field in the country). Semi-controllable factors include political instability and unresolved Karabagh conflict. But most importantly, there are factors which are out of the control of the government such as small market size, landlocked location and remoteness from major markets.

Final part of the essay contains conclusions and recommendations. As the scope of the study did not allow to develop specific recommendations for the government, they were grouped into several general clusters, where we thought positive changes would improve overall attractiveness of the country for FDI. Recommendations mainly include the following: (1) Armenian tax legislation and tax administration should be amended to provide increased transparency and efficiency of tax administration, improve fairness of treating business entities, etc, (2) the Law on Foreign Investment needs to be revised to decrease the number of inconsistencies and omissions, (3) private sector should be engaged in the process of drafting laws and government decisions to reduce policy instability and uncertainty in the business environment, (4) major attention should be paid to the improvement of rural roads, irrigation and telecommunication infrastructure, (5) clear strategy should be defined for FDI promotion, such as identification of new sectors and their promotion in international forums to potential investors, etc, (6) the process of privatization should be continued to attract even more FDI, and finally (7) the corruption should be more aggressively combatted to curtail shadow economy and increase the competitiveness of all companies doing business in Armenia.

INTRODUCTION

One of the most notable features of economic globalization has been the increased importance of foreign direct investment around the world. Over the past two decades, the international flow of FDI has increased considerably. In 2005 they rose by 29% (to reach $916 billion). “Inward FDI grew in all the main subregions.... In percentage terms, the share of developed countries increased somewhat, to 59% of global inward FDI. The share of developing countries was 36% and that of South-East Europe and the Commonwealth of Independent States (CIS) was about 4%.” (FDI from Developing and Transition Economies: Implication for Development 2006). Reasons for such an increase especially for developed countries are high level of cross-border mergers and acquisitions. The expansion of Transnational Corporations (TNCs) also showed an increase in undertaking FDI. According to UNCTAD estimations “…the universe of TNCs now spans some 77,000 parent companies with over 770,000 foreign affiliates [which] generated an estimated $4.5 trillion in value added, employed some 62 million workers and exported goods and services valued at more than $4 trillion.” (FDI from Developing and Transition Economies: Implication for Development 2006).

The importance of FDI as a source of capital to developing countries and countries in transition, such as Armenia, is expressed in acquiring technologies, management skills, goods and services from developed countries, thus avoiding the necessity to invent. This statement is in concordance with the broader phenomenon defined by Alexander Gerschenkron as “advantages of backwardness” in his seminal work “Economic Backwardness in Historical Perspective.” (Gerschenkron 1962). Gerschenkron’s point is that developing nations can learn from the experience of already advanced nations and this will help them to achieve development goals faster than if they would learn through their own path of trials and errors. These advantages are in the area of science, technology, management of enterprises, national economic policymaking etc. Economic growth theory holds that developing countries can be successful if they manage to catch up advanced levels of technology and management expertise available in developed countries (Shiells 2003). FDI is one of the channels through which technologies can be transferred. According to Blomstrom and Kokko (2003) “foreign direct investment can play an important role in raising a country’s technological level, creating new employment, and promoting economic growth.” (20). Through positive externalities FDI promotes new knowledge and technology (technology spillover) to host countries (Shiells 2003).

The collapse of the Soviet Union and introduction of market economy in the countries of the former Soviet Union can be considered as a starting point for intensification of foreign capital inflow to the region. Break-up of the USSR paralyzed the national economies of its former republics, affecting especially smaller nations much dependent on Russian markets. There was an understanding in these newly independent countries that inflow of foreign capital accompanied by all advantages mentioned above could help them to quickly revive their economies, address social needs of population (poverty, unemployment). As a result most of these countries started to receive foreign investment, including but not limited to official development assistance (ODA), official nonconcessional finance and private finance. However, not all countries managed to succeed in attracting FDI into their economies. This is mainly due to quality of investment climate which depends both on policies and institutions of every country (Shiells 2003). In spite of weak institutional and policy arrangements, instable political regimes, poor democracy and ethnic conflicts, countries with reach resource endowments and energy transportation infrastructure were more successful then others. Nevertheless, the countries with less or no natural resources tried to attract FDI by large privatization transactions or settlement of energy debts (Shiells 2003, 5).

Armenia, being a landlocked country with persisting ethnic conflicts and little natural resources could, however, record foreign capital inflow increase in the period from 2000 to 2005. In the process of attracting foreign capital inflow into the country, Armenian government pursued a number of investment policies.

As a result of the investment policies pursued by the government of Armenia, the volume of foreign investment in the real sector of Armenia's economy (exclusive of the funds received through the public sector and banking system) during 2000-2005 amounted to **USD 1465.7 MLN**, of which direct investment was **USD 961.5 MLN.** In the period from 2000 to 2005, the average annual increase in foreign direct investment was about 31.3%." (Investments 2006, 62).

What kinds of policies were pursued by the Armenia government to attract FDI? Are there any other factors affecting FDI inflow into Armenia?

The objective of this study is to examine investment incentives pursued by the Armenian government to attract FDI. In addition to this it is interesting to examine whether other factors also could have impact on the increase of FDI in Armenia in recent years. For this purpose, the following hypothesis and research questions will be considered.

HYPOTHESIS AND RESEARCH QUESTIONS AND METHODOLOGY

Hypothesis: Inflow of FDI in Armenia is positively affected by the following major factors:

a) government policy to provide investment incentives and eliminate investment obstacles,

b) comparative advantage in certain sectors of economy,

c) natural endowments (resources),

d) low cost of labor force.

Research questions:

1) What are the factors affecting FDI in Armenia?

2) What are the obstacles constraining FDI inflow to Armenia?

3) Which are the major sectors of economy attracting FDI in Armenia?

4) Why some sectors are more attractive than others?

5) Are there any government policy incentives to attract FDI in Armenia?

6) What additional incentives could be suggested to attract FDI?

The Methodology of this study is analysis of statistical data from the National Statistical Service of Armenia, analysis of Armenian legislation (Law on Foreign Investment, Laws on Taxation), analysis of data of studies done by international organizations and by the Government of Armenia. Two interviews have been conducted--one with the head of the Secretariat of the Armenian Development Agency (ADA) and the other one with the head of the Investment Policy and Market Infrastructure Development Department at the Ministry of Trade and Economic Development.

Based on results of above mentioned analyses advantages and disadvantages of Armenian investment environment have been identified and some recommendations were presented.

THEORETICAL PART

Theoretical Concepts Defining and Explaining Foreign Direct Investment

From the outset it is important to define foreign direct investment and explain the difference from other forms of foreign investment. Foreign capital penetrates into national economy in many different ways, specifically in the form of direct, portfolio or other investments. Originally, it was accepted to think of investment as FDI when "…a company from one country makes a physical investment into building a factory in another country." (Graham and Spaulding 2004). However, recent developments broadened the definition to include "…acquisition of a lasting management interest in a company or enterprise outside the investing firm's home country." (Graham and Spaulding 2004).

"According to IMF and OECD definitions, direct investment reflects the aim of obtaining a lasting interest by a resident entity of one economy (direct investor) in an enterprise that is resident in another economy (the direct investment enterprise)." (Duce and Espana 2003, 2). Both, IMF and OECD consider 10 or more percent ownership in a company's capital as direct investment. However, this is not a clear cut rule, "…as [they] acknowledge that [even] smaller percentage may entail a controlling interest in the company." (Duce and Espana 2003, 2). But in order to have clear understanding in shareholding IMF recommends using this 10% dividing line to differentiate between direct investment and portfolio investment. Consequently, any investment less than 10% should be considered as portfolio investment (Duce and Espana 2003).

In general it is accepted that changes in trade and investment policies such as policy and tariff liberalization, easing the process of foreign investment and acquisition in many nations and privatization of many industries catalyzed the expansion of FDI globally (Graham and Spaulding 2004). It is obvious that there is tendency of farther increase of FDI in the world. But what are the forces that foster international flow of capital, particularly FDI? According to Robert Garbaugh (1992) "…productive factors flow in response to difference in returns (e.g., wages and yields on capital) as long as these are large enough to more than outweigh the cost of moving from one county to another." (244). According to economic theory FDI "…is conducted in anticipation of future profits." (Garbaugh 1992, 247). However, future profits are only one factor among all others (market demand conditions, trade restrictions, investment regulations, and labor cost advantages) that can influence FDI decision-making. There are two sets of factors: *demand and cost,* discussed by Garbaugh (1992) to have influence on the flow of FDI. Acquisition of new profits encourages multinational corporations (MNCs) to search for new markets and sources of demand. Demand incentive is very strong because there are local differences in taste and design. It is very important to be familiar with local demand for conducting a successful marketing program (Garbaugh 1992, 247). This kind of strategy is usually called *market-seeking FDI*, which is oriented toward selling in domestic or regional markets (Shiells 2003, 15). Because the driving force for *market-seeking FDI* is "…to better serve a local market by local production, market size and market growth of the host economy are the main drivers." (Kinoshita and Campos 2003, 2-3).

Another factor having its impact in decision-making for FDI is the cost of production. A major goal that any company pursues is to maximize its profit and one way of doing it is by reduction of production costs. There are different ways of cost reduction. First is concerned with acquisition of cheaper raw materials or agricultural commodities. "Natural supply advantages such as resource endowments or climate conditions may indeed influence a company's decision to invest abroad." (Garbaugh 1992, 249). Another way of cost reduction for MNCs is difference in labor cost around the world. "Labor costs as well as other production costs tend to differ among national economies. MNCs may be able to hold costs down by locating part or all of their productive facilities abroad." (Garbaugh 1992, 249). *Resource seeking or export oriented* FDI can be attracted by "…natural resources, raw materials, or low cost inputs as labor…. Availability of low-cost labor is one prime driver for export-oriented FDI." (Kinoshita and Campos 2003, 4). According to Shiells, "direct investment in CIS countries has mainly resource seeking or export oriented FDI, whereas FDI into countries that are more advanced in the transition process has been more often efficiency seeking…" (2003, 15). *Efficiency seeking is* "…when the firm can gain from the common governance of geographically dispersed activities in the presence of economies of scale and scope." (Kinoshita and Campos 2003, 3). EU Accession prospective seems to attract efficiency-seeking FDI. "All these suggest that the countries that possess a large market, low-cost labor, abundant natural resources, and are close to the major Western markets would attract large amounts of FDI inflows." (Kinoshita and Campos 2003, 4).

Armenia is a country with a well-educated and relatively low-cost labor force. The country is endowed by certain natural resources such as molybdenum, aluminum, zinc, gold, stone, mineral water etc. At the same time being one of the CIS countries Armenia, through regional cooperation[1], can remove "…trade and transport impediments… and raise the attractiveness of the smaller CIS markets." (Shiells 2003, 28).

Finally, besides demand and cost considerations, government policies may play an enormous role in attracting FDI. Potential benefits from foreign direct investment make developing countries, which are short of capital and need to boost their economies, to attract FDI by granting foreign investors subsidies such as preferential tax treatment, tax holidays, etc. Usually, import tariff barriers may have impact on FDI. For example, very high tariffs may serve as an obstacle for importers making them to locate production facilities in a country instead of exporting (Garbaugh 1992, 249). In short, whether the production should occur at home for export abroad or whether manufacturing facilities should set up abroad is determined by the following important factors: "(1) import tariff structures, (2) the size of the foreign market in relation to the company's most efficient plant size, (3) comparative labor productivity, and (4) the amount of capital used in the production process." (Garbaugh 1992, 250).

In order "…to achieve country's development objectives, the host government should devise policies that are based on a logical analysis of the perspective benefits and costs of the foreign investment." (Meier 1980, 348). From the standpoint of hosting country the core idea for encouraging FDI is that "…real income resulting from the investment is

[1] Armenia has free trade regimes with Georgia, Kyrgyzstan, Moldova, Russia, Belorussia, Turkmenistan, and Ukraine (Sandoyan 2005).

greater than the resulting increase in the income of the investor." (Meier 1980, 349). According to Meier "it would be rational for the host country to allow the entry of the foreign investment as long as its benefit/cost ratio is greater than unity."[2] (1980, 349). For example, "if the value added to output by the foreign capital is greater than the amount appropriated by the investor, social returns exceed private returns." (Meier 1980, 349). When we consider social benefits and social costs from the FDI, host country should be interested to allow inflow of foreign investment whenever "…the social net present value (NPV[3]) of the project is greater than 0, but insist on… divestment when the NPV becomes less than 0 or when NPV of a substitute domestic investment becomes greater than the NPV of the foreign investment." (Meier 1980, 353).

In the process of encouraging FDI host governments should be cautious not to provide extra concessions. All the benefits coming from FDI should be weighed against costs which governments incur by providing concessions to attract foreign investment. Sometimes several countries compete among themselves to attract foreign capital which can lead to excessive concessions. Thus, in order to escape extra concessions capital receiving countries should agree upon maximum concession that will be made (Meier 1980, 352).

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[2] By saying unity is meant domestic investment or domestic economy without foreign intervention.

[3] "Algebraic sum of net present value of the project is the total value of output less the total value of inputs." (Meier 1980, 353).

Literature Review of Relevant Empirical Studies on FDI and Economic Growth

According to Blomstrom and Kokko the literature on FDI can be classified under two categories. The first category is concerned with the *effect of FDI on macroeconomic factors* such as growth, technology, and labor productivity. It is achieved through its technological spillover effects as mentioned before (Blomstrom and Kokko 2003; Kinoshita and Campos 2003). The second cluster of studies investigates *the determinants of FDI*, which include the size of the domestic market, the degree of protection of the domestic market, geographical location of the host country, the degree of economy's openness, and the provision of fiscal incentives by the recipient country (Blomstrom and Kokko 2003; Kinoshita and Campos 2003). This paper focuses on the second set of variables to study the factors affecting FDI inflow to Armenia.

Richard Beilock has conducted a study on factors inhibiting the growth of Armenia. According to him there are, in general, several determinants of investment and trade, which are closely interrelated (See Figure 1). Resource Endowment and Geographic Factors (REGF) which includes: "…mineral endowments, climate, soil quality, proximity to large markets, and the availability of harbors and navigable rivers or the presence of natural barriers, such as mountain chains. Clearly, these factors impact on trade opportunities and, in turn, investments." (Beilock 1999). Other factors "…are primarily in public sector or subject to close regulation." (Beilock 1999). These factors are Infrastructure and Government Institutions (IGI). "Infrastructure includes roads, railroads, water system, and… telecommunications." (Beilock 1999). Government institutions include "…those units which directly interact with the business community, such as tax and licensing authorities, customs, police, and the judiciary. Like REGF, the quality and the nature of IGI impacts on trade opportunities and investments." (Beilock 1999). Third factor is Domestic Political Situation impacting "…upon the performance of Government Institutions and investment incentives."

(Beilock 1999). Finally, the International Political Situation is also very important factor affecting Investment and Trade and REGF.

> "The Domestic Political Situation impacts upon the performance of Government Institutions and investment incentives. If there is political instability domestically, government agencies are likely to operate poorly. This, along with security and other problems normally associated with political instability, can raise the cost of doing business, thereby lowering investment incentives. Finally, the International Political Situation impacts on Investment and Trade and REGF. For example, risk of war can lower prospects for trading and jeopardize the security of investments. Trade embargoes and blockades can alter the effective or usable resource and geographic endowments." (Beilock 1999).

Based on this theoretical background Beilock came to a conclusion that even though Armenia is endowed with some natural resources such as gold, iron, copper, these are not sufficient for investment growth. According to him investors in Armenia focus on low labor costs and high labor force qualifications as the two most important incentives for investing in Armenia.

Furthermore, geographically Armenia is also disadvantaged, having landlocked location and considerable distance from major markets in Europe, East Asia and North America. Russian market is the closest but reaching it incurs high transaction costs. Internal political situation is negative due to blockade imposed by Turkey and Azerbaijan. The blockade, consequently, raises transaction costs. Georgia and Iran are the only transportation routes. Georgian government, recognizing these limited options for Armenia, increases transportation costs by imposing unreasonably high transit tariffs.

When it comes to domestic political stability, the possibility of political upheavals is currently lower than five years ago, which makes the businesses feel to some extent confident. Similarly, infrastructure, in spite of need for maintenance and upgrading, is operating and its physical condition is not a critical factor impeding economic activities. The most important factor, which impacts investment climate, is government institutions. "Unlike other factors, such as resource and geographic endowments and international politics, the performance of its government institutions is entirely under Armenia's control and ability to change." (Beilock 1999). According to 90 % of respondents to the survey[4] (sample of foreign investors in Armenia) the most important factor inhibiting business activity in Armenia is bureaucratic red tape, irregular additional payments to government officials to get things done, unexpected changes in business related laws and corruption.

Garibaldi et al (2001) have conducted a study analyzing capital flows to transition economies. Their purpose was "…to document the magnitude and composition of capital flows to the transition economies of Central and Eastern Europe and the former Soviet Union from the early 1990s until 1999." (Garibaldi et al. 2001, 110). They mostly wanted to highlight the difference between countries receiving FDI and portfolio investment as a source of financing. This study was the first to have such a broad view in a larger sample of 25 transition economies that include the countries of former Soviet Union. According to the results of the study inward flow of FDI into transition economies can be well explained by economic fundamentals which include "…macroeconomic stability, the level of economic reforms, trade liberalization, natural resource endowments, the privatization method, direct barriers to inward investment, and a measure of government "red tape" that reflects obstacles to investment and entrepreneurship and is closely related to corruption." (Garibaldi et al 2001, 137).

Another very interesting study was conducted by Kinoshita and Campos (2003). They have used panel data set for 25 transition economies of the former Soviet Union between 1990 and 1998. The main purpose was "…to investigate the importance of institutions and agglomeration[5] vis-à-vis initial conditions and factor endowments as determinants of the choice of location by foreign investors…" (2003, 1). Thirty countries

[4] A 1998 survey of current and potential foreign investors in Armenia and of government and non-government experts on the Armenian economy.

[5] Presence of agglomeration economies allow new investors to mimic past investment decisions made by other investors in choosing the location. (Kinoshita and Campos 2003, 5)

with different institutional settings, initial conditions, income levels provide variations allowing "…comparative analysis in a unique situation akin to a natural experiment…" (Kinoshita and Campos 2003, 1). Kinoshita and Campos tried to contribute to the literature dedicated to locational determinants of FDI. "The basic notion is that lower level of corruption, a fair, predictable and expedient judiciary and efficient bureaucracy will help to attract FDI." According to their findings "…the most important determinants for FDI location are institutional and agglomeration economies that override the importance of other economic variables." (Kinoshita and Campos 2003, 22). They also found that the inflow of FDI is motivated by abundance of natural resources and labor cost. Quality of bureaucracy and rule of law was found to be important determinants of FDI in transition economies. In addition to these "…foreign investors prefer transition countries that are more open to trade and with fewer restrictions on FDI as the destinations of their investment." (Kinoshita and Campos 2003, 22).

Another study done by Mariya Aleksynska (2003) also dedicated to the investigation of "…the role of FDI in the economic growth process for economies in transition." (2). The study investigates whether countries in transition benefited from FDI. Furthermore, she was interested in whether foreign and domestic investments have complimentary or substitute relations. Another aspect of her study was to see whether there is one-way impact of FDI influencing growth, or reverse relationship is also possible: prospects of economic growth of recipient country attracting FDI inflow. Empirical results for 18 countries in transition provide evidence in support for the statistically significant positive effect of the FDI on economic growth of the recipient country. Moreover, the results suggest that the higher the level of human capital in the country, the more effective the impact of FDI. This means that in a country with high educated workforce it is easer to inject foreign knowledge and technology transferred by means of FDI. This is called “…absorptive capacity of the host economies.” (Aleksynska 2003, 56).

According to Aleksynska interaction between foreign and domestic investment is also very important. Findings suggest that both are important for prosperity of countries in transition; they are complementary to each other. “Foreign injections are more effective when the host economy injects a certain amount of domestic investment as well; and domestic investment is more effective whenever there is a presence of foreign investment in an economy.” (Aleksynska 2003, 58).

Finally, double causality of FDI and growth. The data suggest that FDI has short lived effect in a host economy and the effect does not go beyond the period in which it was received by the host country. It is interesting to mention that it is not the growth and even not the prospect of growth that make investors to invest in transition economy. Many studies showed that FDI can be motivated by many factors other than prospects for growth (e.g. creation of good investment climate). The study conducted by Aleksynska (2003) suggests that transition countries should give a priority to incentive programs attracting FDI.

Finally, study conduced by Tytell and Yudaeva (2005) in four countries of Eastern Europe was intended to identify the spillover effect of FDI on domestic companies. “Using data from Poland, Romania, Russia, and Ukraine, [they] demonstrate that not all FDI have positive spillover effects on domestic firms.” (2005, 1). This implies that effect of FDI is positive “…if the investor has an advantage over local firms either because of superior technological knowledge or because of better managerial techniques, distributional network, etc. As a result, firms with FDI should usually be more productive than domestic firms.” (Tytell and Yudaeva 2005, 2).

TREATIES FOR FDI PROMOTION

Bilateral Investment Treaties

So far we have spoken about factors attracting FDI and creating favorable environment for investment. However, there are many impediments for safer investment in the CIS countries, causing investors to be skeptical toward investing in these regions. One of the main steps that each country fulfils to guarantee protection of the rights of investor is signing Bilateral Investment Treaties (BITs) with major investing countries. "Bilateral Investment Treaties guarantee certain standards of treatment that can be enforced via binding investor-to-state dispute settlement outside the domestic juridical system." (Neumayer and Spress 2005, 1). According to Neumayer and Spress countries tend to accept some restrictions on their sovereignty in the hope that the protection from political and other risks leads to increased levels of FDI. Nevertheless, there is a concern whether BITs fulfill their function. Different scholars think that political and economic climate is much more decisive then creation of a legal structure for protection of FDI (Neumayer and Spress 2005, 4). For example, major hosts of FDI -- Mexico and Brazil -- for a long time were reluctant to sign BITs (Neumayer and Spress 2005, 4). However, BITs seem to be the main instrument of protection to foreign investor. There is no much legal alternative to BITs. Some regional free trade agreements like North American Free Trade Agreement (NAFTA) and Agreement on Trade-Related Investment Measures (TRIMs Agreements) provide some rudimentary investment protection, which are not as comprehensive as provisions contained in BITs (Neumayer and Spress 2005, 11).

Neumayer and Spress (2005) have conducted a panel study over the period 1970 to 2001, covering up to 119 countries. They found a positive effect of BITs on FDI inflows. According to their findings the effect is sometimes conditional on institutional quality, but is always positive and statistically significantly different from zero at all levels of institutional quality.” (2005, 5). This study was the first to provide hard evidence about the willingness of developing countries to incur the costs of negotiating BITs and accept restrictions on their sovereignty (Neumayer and Spress 2005, 5). After demonstrating that BITs are really important parts in the process of attracting FDI, the study was concerned with another question of whether BITs can be substitutes or serve only as compliments to good institutional quality. The results showed some limited evidence that BITs can become substitutes for institutional quality. This “…would suggest that they are most effective where such quality is low and that they are most successful where they are needed most.” (Neumayer and Spress 2005, 5).

Vast majority of BITs were signed between developed and developing countries. “The web of international agreements of relevance to FDI continued to expand. By the end of 2005, the total number of bilateral investment treaties had reached 2,495…” (FDI from Developing and Transition Economies: Implication for Development 2006). Armenia has signed 42 BITs[6] so far (Sandoyan et al. 2005).

Double Taxation Treaties

Double Taxation Treaties (DTTs) are another tool for protecting foreign investment. They “…serve to avoid double taxation in situations in which a taxpayer could be taxed twice, once by the country in which the income arises and once by the country where the taxpayer resides.” (Hakobyan and Joulfaian 2006).

[6] The following countries has signed BIT with Armenia: USA, Argentina, Austria, Australia, Belgium-Luxembourg, Belorussia, Bolivia, Brasilia, Bulgaria, Germany, Egypt, Ecuador, Turkmenistan, Ireland, Spain, Israel, Italy, Iran, Lebanon, Canada, Cyprus, South Korea, India, Holland, Jordan, Greece, Hungary, Kazakhstan, Kyrgyz Republic, Malaysia, Great Britain, Sweden, Switzerland, Czech Republic, China, Romania, Syria, Slovenia, Vietnam, Georgia, Ukraine, and France.

Usually "…income taxes have built-in provisions to avoid the double taxation of the income of a resident earned in a foreign state by granting them a foreign tax credit or exempting foreign source income altogether." (Hakobyan and Joulfaian 2006). However, there are situations when the built-in provisions fail to provide protection. Double taxation is not avoidable for example "…when residency and the determination of taxable income are not well defined. Should [for example] the profits of Austrian Airlines from serving Armenia be taxed in Austria or Armenia? At what point or length of time does a foreigner residing in Armenia become an Armenian taxpayer?" (Hakobyan and Joulfaian 2006). In order to avoid confusions and double taxations, tax treaties are signed to include the following:

- **Clarity rights of each country:** treaties provide clarity, for instance, where the income should be taxed, in which country.
- **Provide for problem resolution mechanisms:** taxation treaties provide for mechanisms for resolving disputes in case there are ones and most importantly define the competent authority to deal with the resolving the dispute.
- **Prevent tax evasion and avoidance:** this includes exchange of information on taxpayers between authorities and provides protection of tax base for countries.
- **Provide concessions to developing countries:** "some treaties provide for some concessions or tax preferences in the tax treatment of income and profits from investment in low income developing economies." (Hakobyan and Joulfaian 2006).

Armenia, since its independence, has signed tax treaties with 27 countries[7] 25 of which have been ratified by Armenian parliament. It is worth mentioning that Armenia has not signed tax treaty with USA. In 1973 USA signed tax treaty with USSR and "…this treaty

[7] Austria, Belarus, Belgium, Bulgaria, Canada, China, Estonia, France, Georgia, Greece, Iran, Italy, Latvia, Lebanon, Lithuania, Moldova, Netherlands, Poland, Qatar, Romania, Russia, Syria, Tajikistan, Thailand, Turkmenistan, UAE, Ukraine.

remains in force and governs tax relations with Armenia as a successor state to the Soviet Union." (Hakobyan and Joulfaian 2006).

Overall it is apparent that DTTs (the total number of which around the world had reached 2,758) along with BITs have FDI promotion effect for all participating parties (FDI from Developing and Transition Economies: Implication for Development 2006).

PUBLIC AGENCIES AND MINISTRIES RESPONSIBLE FOR FDI IN ARMENIA

Ministry of Trade and Economic Development

The Ministry of Trade and Economic Development (MTED) deals with "…the review and development of investment policy… coordinating state agencies in their activities in this field." (Umurzakov 2003, 17). One of the department of the MTED: the Investment Policy and Market Infrastructure Development Department, is involved in many investment-related issues. The functions of MTED are:

> "(1) formulation of the national investment policy and monitoring its implementation… and drafting amendments to the existing investment legislation; (2) consideration of proposals on possible accession to multilateral conventions and drafting bilateral investment agreements; (3) implementation of the country's policy on foreign investment attraction through economic policy instruments." (Umurzakov 2003, 18).

Armenian Development Agency: What is Done to Foster FDI Inflow into Armenia?

"The Armenian Development Agency was established in April 1998 by the Government of the Armenia to facilitate foreign direct investment and promote export." (ADA Official Site). The Board of the ADA is chaired by the Prime Minister. The role of the ADA is to assist investors in setting up their business in the country, to help with project implementation, to provide information on investment opportunities in the country, as well as investment-related regulations and laws (ADA Official Site).

Overall, for attracting FDI into Armenia ADA has conducted a) research of the competitive spheres, b) discovery of potential investors, c) creation of database of more then 7000 potential investors, and finally, d) organization and implementation of three international country promotion companies. ADA successful activities fostered some changes in ROA laws; for example, new law on “Electronic Signature” was passed in February 2002. In addition to these accomplishments, where ADA had either a direct role or support, around 20 meetings were organized during three years, where 58 questions concerning different spheres of economy were discussed and all of these questions were given positive solutions. The “Bank of Problems” was created, 95% of problems were given solution. From years 2000 to 2006 ADA has organized more then 60 international exhibitions in Armenia and abroad. The most vivid example is an exhibition organized in Japan in 2005. ADA has organized business conferences with participation of businesses from different countries, like Russia, Latvia, Japan, Canada etc. More than 60 companies have visited Armenia and ten organizations decided to invest in Armenia (What is Done and What is Achieved 2006). ADA was also the initiator of conducting international campaigns. This practice is recognized as having positive effect for attracting investment. There were three campaigns conducted so far and three more are planned to be held. As a result more than 30 American, European, and Scandinavian enterprises were interested in contacting with ADA representatives to discuss opportunities in making investments in Armenia. As a consequence of different international exhibitions and business forums organized by ADA the impression was created in the market that Armenia is a country with ecologically clean and health agricultural production (What is Done and What is Achieved 2006).

Business Support Council

The Business Support Council (BSC) was established by the President of Armenia on December 31, 2000. It has an evenly balanced private/state membership which represents a powerful instrument to improve the business and investment environment. The Board members of the Council are representatives of the public sector and business community of Armenia. The Council is chaired by the Prime Minister of Armenia, the Vice Chairman is the Chief Economic Advisor to the President of Armenia, and the Secretary of the Council is the General Director of the Armenian Development Agency which has been operating based on the decree No. 112, 2002 of the Prime Minister of Armenia (ADA Official Site).

The main objective of the Council is to ensure a favorable environment for investment and business in Armenia. Objectives of the Council include:

- Promotion of investment and fostering of the business activities,
- Development of measures aimed at elimination of administrative constrains related to investment and business,
- Coordination of interrelations between the businessmen and state bodies, designing an efficient cooperation mechanism,
- Ensuring business community’s participation in the process of elaboration of the economic policy of the Republic of Armenia., and lastly,
- Fostering the formation of a legislative framework favorable for the regulation of investment and business environment (The Role and the Achievements of the BSC in the process of Improvements of the Business Environment and Investment Climate in Armenia 2006).

The secretariat of the Council mainly prepares materials related to the Council sessions and agenda, follows implementation of the Council decisions, provides the Council with recommendations on issues related to the elimination of the administrative and investment promotion constrains, ensures the dissemination of the information regarding the activities of the Council, keeps records of special opinions submitted in written form by the members of the Council, and distributes the decisions of the Council to the relevant ministries and state agencies (ADA Official Site).

Since its establishment BSC had 31 meetings where some 90 questions concerning different spheres of the economy have been discussed and positive solutions were found. The following are some indicators of BSC's successful activities:

1. The index of the economic openness in Armenia has increased since 2000; among 175 countries, it moved from 84th place to 44th in 2004 and consequently to 34th place in 2006.
2. The registration of a firm, firm name and a trademark is conducted by the principle of one window by the State Register.
3. The number of days for company registration decreased from 27.3 days in 2000 to 7 days in 2005.
4. The cost of company registration has declined from equivalent to US109 dollar in 2000 to US75 dollar in 2004.
5. The average cost of licensing has declined from US 660 dollar in 2002 to US361 dollar in 2005.
6. From 2001 the time of VAT refund from state budget has declined about three times (The Role and the Achievements of the BSC in the process of Improvements of the Business Environment and Investment Climate in Armenia 2006).

As a result of the BSC's successful performance in 2004 representatives of other small and medium size as well as non-profit organizations expressed willingness to join the Council. The President decision No. NH-768 was amended, and by the resolution No.NH-104-A the Council was enlarged form previous 28 members to 46 members which was later called “Club of 46.” (The Role and the Achievements of the BSC in the process of Improvements of the Business Environment and Investment Climate in Armenia 2006, 8).

OVERALL LEGAL FRAMEWORK

In general Armenian legal framework has undergone significant changes and reforms since gaining independence in 1991. A huge effort was made to acquire WTO membership. “WTO membership requires that domestic policies be consistent with international practice; the legal framework of the country has been substantially improved, introducing better legal standards.” (Umurzakov 2003, 19). (See Figure 1). To become a member of WTO Armenian government among others took obligation to “…reduce the role of the Government in the economy.” (Umurzakov 2003, 19).

Nevertheless, introduced legislative changes need further actions for enforcement and implementation. “The inconsistency, especially in terms of the implementation and interpretation of laws, adds yet another layer of uncertainty when potential foreign investors undertake their investment appraisal.” (Umurzakov 2003, 14).

Law on Foreign Investment of the Republic of Armenia

Law on Foreign Investment of the Republic of Armenia was adopted on July 31, 1994 as a sign for recognizing the importance of protecting foreign investor rights. According to the analysis of the Law done by the American Bar Association analysts (Duffy et al. 1998), it is among the most liberal and progressive direct foreign investment laws within transition economies. The Law “provides for non-expropriation, currency convertibility, the right to repatriate funds, guarantee of stability in the legal regime, and some custom privileges and tax incentives." (Umurzakov 2003, 14). The law provides protection from nationalization or expropriation of property, except for extreme cases of state emergency. But even in those cases the Law requires for full compensation. It provides custom duty exemptions for imports of property if it is used for its own production needs (raw materials, spare parts, etc.). There are no export duties as well no quotas and licensing on imports (Armenia. Investment Climate 2006).

Altogether, the law is a strong pro-investment legislation which "minimizes non-commercial risks of doing business in Armenia and, unlike some of the other laws in the region, does not discourage foreign investors form investing in Armenian enterprises." (Duffy et al. 1998).

However, next to all these provisions "the legislation lacks procedural details and legal standards needed to safeguard such investments. Without these procedures and standards, the rights set forth in the law amount to little more than a series of precatory statements on which investors may be unwilling to rely." (Duffy et al. 1998). It is interesting to note that many guarantees provided in the law are subject to other legislative regulation. As a result foreign investors should be aware of up-to-date versions of Armenian laws to know their rights and responsibilities. For example, Article 6 says that "the legislation of the Republic of Armenia may define those areas of the Republic of Armenia, wherein the activities of foreign investors and enterprises with foreign investment are limited or prohibited due to requirements of national security." The law does not provide the list of activities which are prohibited forcing the investor to spend time in finding out the list of prohibited activities to avoid waste of its capital, time and effort. Similarly, Article 24 does not provide information about the court which will settle the dispute between the investor and Republic of Armenia, though it provides in details the procedures for resolving disputes. Of course, the court that is meant in the law shall be an Armenian court ruling of which may be unacceptable for most of the foreign investors. It will be more favorable for foreigners if Article 24 be amended to shift dispute resolution responsibility from local courts to more neutral body. (Duffy et al. 1998).

> "The Armenian Law on Foreign Investments touches upon most provisions typically included in foreign investment legislation and under international model guidelines; however, the law is not as specific as most institutional investors demand. The lack of specificity may leave many matters subject to vague interpretations or prone to government abuse and, in turn, undermine any effort to attract foreign capital in the current competitive global environment in which investors require certainty in procedures and conditions." (Duffy et al. 1998).

Laws on Taxation

In general there are different concessions and preferential treatments in Armenian tax customs legislation[8] applied both to local as well as to foreign investors. There are incentives "…to channel and stimulate domestic and foreign investment. Tax concessions may vary by sector, type of assets invested in, and discriminate among domestic and foreign investors." (Joulfaian and Melikyan 2004, 216). Speaking of tax holidays for foreigners it is worth mentioning that "through 2007, foreign companies investing $850,000 (500M AMD) are fully exempt from the profit tax for two years." (Joulfaian and Melikyan 2004, 216) According to Article 39 on Profit Tax

> "if the share of a foreign investor in the statutory capital of a resident is at least dram 500 million, after January 1, 1998, the following reductions are made: a) 100% of profit tax within the next two years after the investment is made; b) 50% of profit tax starting from the third year and until the tenth year after the investment."

[8] Tax legislation includes Law on Income Tax (personal income tax), Law on Profit Tax (corporate income tax), Law on Property Tax, Law on Land Tax, Law on Value-Added Tax (VAT), Law on Excise Tax, Law on Simplified Tax, Law on Presumptive Tax (Fixed Tax) and other laws. Customs legislation is consolidated in customs code.

In general, for all investors (domestic and foreign) zero profit tax rate is applied for firms involved in agricultural production. Generally "uniform profit tax rate of 20 percent is among the lowest in the region." (McHugh et al. 2005, 61). In addition, there are accelerated depreciation allowances for several types of equipments and structures such as computers and hotels. "The cost of acquiring computers can be expensed; hotels may be depreciated over a period of ten years. [Also] the tax code provides preferential treatment for investment in the earthquake zone…" (Joulfaian and Melikyan 2004, 216).

From1997 to 2000, tax legislation was repeatedly revised and even new laws were adopted. For example changes made at the end of the year 2000 created two types of taxpayers: fixed and simplified taxpayers. Taxpayers can choose to "…be subject to simplified tax instead of income tax, profit tax and VAT, if their total net turnover of goods and services supplies during the previous year does not exceed 30 million Armenian drams…" (Umurzakov 2003, 16).

Concerning the VAT refund "the government amended the VAT law in November 2005 allowing companies to delay VAT payments for one to two years on certain imported goods used in production and manufacturing." (Investment Climate Statement – Armenia 2006).

In order to give accurate description of Armenian tax legislation and problems associated with it, it is interesting to examine the study[9] done "…by Arlex International Ltd., on behalf of the American Chamber of Commerce, in conjunction with the European Union Chamber of Commerce in Armenia concerning the Armenian Tax System." (Reform of the Armenian Tax System: The Foreign Investors' Perspective 2003, 2). As was mentioned in the White Paper (2003) presented by the above mentioned entities (AMCHAM and EUCCA) the

[9] The study was done based on surveys of 34 members of the American and European Union Chamber of Commerce in Armenia, mainly international investors, who are in a better position to make comparison of Armenian tax system with other countries.

aim of the study was "to present the aggregated views of the foreign business community in Armenia on the legislative and administrative functioning of the current Armenian Tax System and how it compares to that of other countries, particularly those in transition, as a factor of Armenia's country competitiveness." (Reform of the Armenian Tax System: The Foreign Investors' Perspective 2003, 2).

Generally speaking the study revealed that "…while Armenia's rates are higher…than those in many other countries, the overwhelming problem with the Armenian tax system… is unpredictability and difficulty of compliance." (Reform of the Armenian Tax System: The Foreign Investors' Perspective 2003, 3). Most of the respondents stated that even though laws are in the same line with other CIS countries, "…they fall short in precision and consistency when compared with advanced legal systems…. They are significantly less practical than the tax laws in the Baltic States, Russia or in Eastern European countries." (Reform of the Armenian Tax System: The Foreign Investors' Perspective 2003, 3). In addition "…the tax administration and the implementation of the tax system in Armenia on the part of the tax authorities is inefficient, inequitable and unprofessional, with widespread corruption and harassment of foreign investors and corporations that try to abide by the laws." (Reform of the Armenian Tax System: The Foreign Investors' Perspective 2003, 3). As a result FDI into Armenia is affected negatively.

In summarizing the most illogical aspects of Armenian tax system[10] the following four points were identified: (1) laws are changed frequently causing confusion without providing mechanisms for replacing old laws with new once; (2) laws are taken from other foreign legal systems such as France, United Kingdom, and Russia, and adopted without proper adjustment considerations with local specificities; (3) activities of tax authorities are

[10] Sixty seven percent of respondents revealed that Armenian tax system is illogical at least in part; a third found it to be reasonably logical (Reform of the Armenian Tax System: The Foreign Investors' Perspective 2003).

corrupt impeding proper application of laws in practice; (4) laws are inconsistent with internationally accepted business practices. (Reform of the Armenian Tax System: The Foreign Investors' Perspective 2003).

> "A particularly negative aspect of the Armenian tax system in comparison to other transition economies is the frequent change in applicable laws, with new laws often being adopted in December when most foreign investors are absent for application on January 1st. This effectively precludes them from public participation in the law-making process and makes it difficult for companies to prepare for legal compliance. Moreover, old laws are not always amended to harmonize with new legislation following such changes, resulting in conflicts between laws and legal uncertainty that ultimately increases companies' compliance issues." (Reform of the Armenian Tax System: The Foreign Investors' Perspective 2003, 4).

According to 75% of respondents "refunding of credit, especially VAT, demands of prepayments, [and] extra-legal activities of the tax authorities" are the most common problems that businesses deal with concerning the tax system in Armenia (Reform of the Armenian Tax System: The Foreign Investors' Perspective 2003). Sixty five percent of respondents mentioned about excessive paperwork/bureaucracy and unclear regulations.

> "Many respondents explained that these procedures demanded excessive information that was unnecessary and hence burdened businesses with increased operational expenses without apparent benefit to any party. The VAT system was particularly unpopular in this respect as tax payers are required to present a multiplicity of documents to the tax authorities." (Reform of the Armenian Tax System: The Foreign Investors' Perspective 2003, 6).

Law on Privatization

Law on Privatization of State Property also contains provisions for foreign investors. Article 5 says that "foreign persons have the same rights of participation in privatization as physical and legal persons of the RA."

Privatization contracts are usually made having performance requirements such as "…paying back wages, implement renovation programs, and meet certain production targets. Foreign investors are not required to purchase from local sources or export a certain share of output. There are no legal requirements for employment of host country national as well." (Umurzakov 2003, 16).

INVESTMENT CLIMATE IN ARMENIA

Despite Armenia's failure to be perfectly integrated into the global economy due to its geography (landlocked location and subsequently high transaction costs) and regional political conflicts, the country does have the potential for greater export-led growth and foreign investment. Armenia's free trade regime with the rest of the CIS countries, a liberal trade policy and attractive investment legislation, minimum non-tariff barriers, few control on exports, a stable currency, a well educated workforce, and a worldwide Diaspora of Armenians providing access to investment and links to international markets are important indicators for such an optimistic conclusion (Armenia Trade Diagnostic Study 2002, i). According to UNCTAD Armenia is a country with low FDI potential and with above-potential performance. This means Armenia's real investments could exceed expectations based on its low investment potential. At the same time, Armenia ranked as mostly free by the assessments of Wall Street Journal and Heritage Foundation. Assessments of economic freedom and prosperity were based on the following criteria: "trade, fiscal burden, government intervention in the economy, monetary policy, black market, banking and finance, foreign investments, regulation, etc." (Armenia. Investment Climate 2006, 9). (See Table 1).

Table 1: Economic Freedom Index for 2002-2006

Rank For The Year Among 161 Countries	Overall Score	Trade	Foreign Investment	Banking & Finance	Government Intervention	Informal Market
27th place for the year 2006	2.26*	2.0	1.0	1.0	2.0	3.5
42nd place for the year 2005	2.58	2.0	1.0	1.0	2.5	4.0
44th place for the year 2004	2.63	2.0	1.0	1.0	3.0	4.0
44th place for the year 2003	2.65	1.0	2.0	2.0	3.0	4.0

Source: Armenia. Investment Climate (2006)
*1 is the best and 5 is the worst.

Many developing and transition countries with poor trade performance mostly exercise overvalued exchange rate, protectionist trade policy, and restrictions on foreign investment. Policy recommendation that can be proposed are straightforward: reduce tariff rates, remove export taxes; allow market forces to determine a competitive exchange rate; and open borders to foreign investors. These recommendations constitute first generation policy reforms which are already in place in Armenia. In spite of these improvements the level of foreign direct investment in Armenia, compared to other countries in the region, is the lowest. In general the total amount of investment in Armenia is not very large if we consider the amount of assistance to the country. "As a percent of GDP, Armenia receives more Official Development Assistance than any other nation in the Former Soviet Union (FSU) and Eastern Europe…. In addition, Armenia receives large cash infusions from the Diaspora and remittances from Armenians working abroad." (Beilock 1999). Majority of this money are being used for current consumption… rather than being used for investment, which explains inconsistency between money received and money invested. (Beilock 1999). In the period from 1991 to 2000 the total FDI in Armenia was about $ 600 million, 80 percent of which was attracted after 1998 mainly due to large scale privatization of state owned enterprises. The inflow of FDI in Armenia has increased since 1991. "From 2000 to 2005 in

Armenia total sum of FDI made more than 1.5 billion US dollars…. According to official statistics 3,102 companies with foreign investment have been established during 1991-2005." (Armenia. Investment Climate 2006, 10). After 2005, the time when major privatization processes had finished, FDI continues to evolve as a capital of the new small and medium enterprises as well as re- investment (Armenia. Investment Climate 2006).

Although Armenia is not considered as a country with very attractive economy for FDI there are some success stories proving that the country offers some advantages to foreign investors. Among the major investors are Russia (461.411 thousand USD), Greece (433.9), USA (203.4), France (158.6), Germany (138.9), Canada (137.1), Lebanon (71.2), United Kingdom (70.1), Argentina (52.2), Cyprus (40.3) (Armenia. Investment Climate 2006, 10). All these countries have signed BIT with Armenia in early 1990s. Therefore the question arises what Armenia can offer to foreign investors. Below we will discuss the advantages and disadvantages of the Armenian economy from foreign investors' perspective.

Advantages of Armenian Economy

First: *easy access to CIS and Middle East markets.* Armenia as a member of CIS enjoys the advantage of free trade regime with the members and has easy access to their markets. Moreover, better knowledge of the region, people and business ethics, sometimes similar historical patterns and same level of development are important preliminary conditions for successful business establishment (Armenia Trade Diagnostic Study 2002, 44).

Second: *liberal trade policy and attractive investment legislation.* In general, Armenian legislation is 'investment friendly' providing sufficient incentives and

[11] The Inflow from 1991-2004 for all the above mentioned countries (Armenia. Investment Climate 2006).

opportunities for FDI. Almost all the laws regulating economic development in the country were adopted in late 1990s. The Law on Foreign Investment was the first piece of legislation providing some tangible rights to the foreign investors. Subsequently, different laws continued to provide additional incentives to foreigners to direct FDI into Armenia. The legislation is very liberal and a lot of improvements were made to meet international standards. According to Mr. Gnel Mayilyan, the head of the Investment Policy and Market Infrastructure Development Department of the Ministry of Trade and Economic Development most of what was required to be done by the government in the sphere of legislation adoption and improvements is almost done and very little extra improvements are needed.

The Constitution of Armenia also provides "…equal rights to private ownership and its free management for both local as well as foreign investors, with the exception of the land property rights…. Foreign citizens can make use of land only on leasing bases." (Sandoyan et all 2005, 23).

Third: *well educated skilled and easily trainable workforce* (Armenia. Investment Climate 2006). Armenian population is almost 100% literate. Comparative advantage is guaranteed for investors as the qualified workforce is available for low cost.

Forth: *developed infrastructure.* At the Soviet times Armenia developed comparatively strong industrial base. Part of this infrastructure has survived and can be utilized. Some new infrastructure has been developed in the years following establishment of independence.

Fifth: Diaspora which provides links to international markets brings in business experience and management skills, tax discipline and high ethical standards of doing business (Armenia Trade Diagnostic Study 2002, 45).

Sixth: m*embership in the World Trade Organization (WTO).* In 2003 Armenia became a member of WTO and took an obligation to liberalize trade and investment providing for more attractive environment for inflow of FDI. It is apparent that WTO membership will not create a rapidly growing FDI in the country but "…over time, freer access to the import of production inputs could help to improve the cost-quality conditions of manufacturing, and increase the attractiveness of economy as a place for efficiency-oriented manufacturing FDI." (Armenia. Investment Climate 2006).

Limitations of Armenian Economy

Side by side with favorable conditions there are also factors limiting investment in the country. Some of these factors are "…under control and some are out of the control of the Government of Armenia." (Armenia Trade Diagnostic Study 2002, 46). Among non-controllable factors are global trends in international investment (only a small share of total FDI goes to emerging markets), general perception about the region as a whole (as a zone of conflict). The most important ones are the landlocked position of Armenia, the small size of domestic market, and lack of significant natural resources (Armenia Trade Diagnostic Study 2002).

Another set of factors called controllable factors include:

> "(1) weak institutional capacity, limited incentives, and the lack of a clear strategy for FDI promotion; (2) the lack of a clear separation of responsibilities for FDI promotion among government ministries; (3) administrative barriers for investors and businesses in general, e.g., large and very poorly paid bureaucracy, widespread corruption, in general absence of the "Rule of Law"; (4) the high cost of doing business, including costs of business inputs, transportation, energy, skilled labor, and the brain-drain, especially among younger generation." (Armenia Trade Diagnostic Study 2002, 47).

In spite of all these limitations Armenia has a potential to become a place for many successful investment projects, which could encourage farther FDI promotion (Armenia Trade Diagnostic Study 2002).

Today Armenia needs "…to upgrade its commercial laws to standards that are generally acceptable internationally and… to make those laws fully effective… through strengthening the court system, tackling corruption, and the adoption of… measures to strengthen the rule of law." (Commercial Laws of Armenia 2006, 1).

CONSTRAINS FOR DOING BUSINESS IN ARMENIA

In 2000 *Foreign Investment Advisory Service* (FIAS), a joint service of the International Finance Corporation and The World Bank, was invited to conduct a study on the Administrative Barriers to Investment in Armenia and give recommendations. In 2004 FIAS was requested by the government of Armenia to assess the status of implementation of the recommendations made in 2000. The project was launched in 2004 in cooperation with the Ministry of Trade and Economic Development. Findings were encouraging; but at the same time they revealed areas which are still malfunctioning. In general there were improvements in administrative procedures like business registration and licensing. However, some areas like "…efficient and fair tax and customs administration, transparent privatization and lease of public land and construction coordination remain to be tackled." (Armenia: Assessment of Administrative Procedures for Doing Business in Armenia 2004, x).

In addition to FIAS study Armenian government in partnership with the World Bank has launched a project called *Administrative and Regulatory Costs Survey* (ARCS) to assess procedures and institutional arrangements on private Armenian firms on an annual basis[12]. The ARCS captures the experiences of businesses in undergoing administrative

[12] Surveys were conducted in August – November 2000, September-November 2001 and October-December 2002 respectively, and October-November 2003. These surveys were carried out based on a nation-wide representative sample of private enterprises (N = 300 enterprises).

procedures in Armenia for the past 3-4 years. According to the last ARCS in some areas there is no progress registered. The top five constrains affecting the operations and growth of private Armenian businesses are: t*ax and tax administration/regulation* (with 83.7% of respondents judging that to be a serious problem), *policy instability/uncertainty* (with 76.0%), *infrastructure* (with 74.0%), *financing* (with 69.7%), and *corruption* (with 66.4%) (Armenia: Administrative Barriers to Investment 2004). (See Table 2.).

Table 2: Evaluation of the Most Problematic Constrains

REGULATORY OR PUBLIC SERVICE PROVIDING AREA	%**	AVERAGE RATING*
Tax and Tax administration	83.7	3.26
Policy instability/uncertainty	76.0	2.93
Infrastructure (telephone, electricity, water, roads, land)	74.0	2.95
Financing	69.7	2.93
Corruption	66.4	2.84
High tax rate	59.4	2.70
Anti-competitive practices by government or private firms	55.6	2.54
Functioning of the judiciary	53.3	2.33
Price instability/inflation	41.0	2.31
Complexity, non-transparency of government policies	37.0	1.99
Exchange rate	34.7	2.03
Documentation requirements (accounting forms, etc.)	29.4	1.90
Customs/foreign trade regulations	27.3	1.43
*The evaluation of the most problematic areas on a four-point scale, where 1 stands for no obstacle, 2 – for minor obstacle, 3 – for moderate obstacle and 4 – for major obstacle. **Percent of firms judging the particular area specified to be a moderate or major obstacle to their operations/growth. (Source: Armenia: Administrative Barriers to Investment 2004)		

From the table above it is apparent that "tax and tax administration" is the most obvious obstacle for growth and development. "Among the various components of tax administration, Armenian respondents have identified *the extra-legal requirement for advance payment of taxes*[13], and *frequency of changes in rules and rates* as having significantly more negative impact on businesses as compared with other components." (Armenia: Administrative Barriers to Investment 2004, vi).

[13] "Occurring mainly at the beginning and end of financial years as well as during the times of big budgetary gaps." (Armenia: Administrative Barriers to Investment 2004, vi).

The second major obstacle identified by the ARCS study is *policy instability and uncertainty.* Predictability of laws is very low. More than half of the firms (61.8%) participating in the study state that "…businesses are not notified in advance about changes in rules and legislations that materially affect their activities; 58.2% indicate that when developing new rule or legislations affecting their business activities the government does not take into account their concerns." (Armenia: Administrative Barriers to Investment 2004, 63). In addition, 50.5% of companies believe that "…the changes in laws, rules, and legislations affecting their business activities are unpredictable; and to 46.9% of respondents interpretations of laws and regulations are inconsistent and unpredictable." (Armenia: Administrative Barriers to Investment 2004, 63). There is a provision in the Law on Foreign Investment protecting foreigners from unexpected changes in laws. According to Article 7, "in the event of amendments to the foreign investment legislation of the Republic of Armenia, the legislation which was effective at the moment of implementation of investments shall be applied, upon the request of a foreign investor, during a five years period from that moment." This means that changes made in the legislation will not be applied to foreigners for five years. This is a very important provision/protection for foreign investors in case they are not satisfied with changes or additions in the legislation. Among respondents 11.7% of companies mentioned they can rely on trade associations or lobby group when they try to affect the formation of new laws or regulations affecting their business. Almost 23% of respondents stated that it is more reliable to have direct ties with public officials (Armenia: Administrative Barriers to Investment 2004, 64).

It is worth mentioning about the seriousness of problems caused by insufficient infrastructure in the country, although Armenia is generally considered as a country with strongly developed infrastructure inherited from the Soviet era. The results of ARCS study show that 74.0% of firms mention infrastructure as the major constraint after taxes and tax administration (Armenia: Administrative Barriers to Investment 2004, 72). Well-developed infrastructure is an important factor for inward flow of FDI. Telecommunication is one of the most important branches of infrastructure. In Armenia "…internet connections are slow and expensive. This restricts the country's communication with the outside world and reduces the competitiveness of important exports such as computer software." (Armenia Trade Diagnostic Study 2002, iv). This problem makes government to undertake reforms in telecom system.

The next major obstacle for business growth is corruption. Almost half of the companies complain about corruption. "About 49.4% of firms agree that it is common for companies in their line of business to make some informal payments to get things done… 37.3% of all respondents also state that they know in advance how much informal payment to make to get things done." It is surprising, that "only 47.0% (or 82.4% of those who think it is common to use informal payments) of all surveyed firms believe that after making such payment, the service is delivered as agreed." (Armenia: Administrative Barriers to Investment 2004, 68).

Judiciary/court system is another major problem in spite of on-going reforms in the country. Almost half of respondents believe that court system affects the operations of their businesses. This can explain the reason why BITs are so important for foreign investors to feel protected from voluntarism of local judiciary system.

The survey results showed improvements in business start-up in Armenia. The registration of company name and trademark is carried out by the same agency -State Register- according to which time spent on company registration, is decreased from 15.6 days in 2002 to 14.5 days in 2003. Moreover, the total cost of licensing also decreased: while it was 377,178.2 AMD in 2002, it went down to 205,691.2 AMD in 2003. (Armenia: Administrative Barriers to Investment 2004).

The project on the *Assessment of Administrative Procedures for Doing Business in Armenia*, organized by FIAS and Government of Armenia, was one of the major attempts to assess the constrains for doing business in Armenia.

In October 2000 findings and recommendations were discussed in a workshop with participation of Government, the private sector and the donor community and it was decided to create a high level Business Council chaired by the Prime Minister which was established in 2000 by the president of Armenia. The main objective of the council is "…to promote improvements in the business and investment climate with broad participation of local and foreign companies." (Armenia: Assessment of Administrative Procedures for Doing Business in Armenia 2004, 1). An action plan was developed based on recommendations of the FIAS report. The aim of the government was to improve the business environment to increase the level of domestic and foreign investment. Areas to be improved are *customs and, tax administration and licensing.* Ministry of Trade and Economic Development was the main government counterpart for the project, and the Business Council was the Steering Committee of the Project. The project was carried out by close cooperation between FIAS and its counterpart in day-to-day operation was the *Investment Policy and Market Infrastructure Development Department of the Ministry of Trade and Economic Development.* (Armenia: Assessment of Administrative Procedures for Doing Business in Armenia 2004, 2).

It is essential to consider findings of FIAS assessment reports and ARCSs as these are the projects where official information was provided by the government and at the same time that information was cross-checked by information from other sources, including opinions of businesses.

FACTORS POSITIVELY AND NEGATIVELY AFFECTING FDI

There are not too many factors affecting FDI inflow in Armenia. The most important factors are liberal trade and economic policy, favorable investment legislation, and willingness of the government to implement policy reforms. One of such intentions was Prime Ministers decree No. 509-N issued on July 9, 2005. The decree was "On reduction of number of reports submitted by economic operators was accepted, specification of their flows and ruling out of duplications of reports submitted to various agencies." (Government Official Site).

In August 2003 Government of Armenia adopted "Poverty Reduction Strategy Paper" by the Order No. 994-N. This strategic document stated that one of the most important ways of combating poverty in Armenia was the improvement of investment climate in the country. This fact also shows Armenian government's readiness and willingness to improve the environment for foreign investors.

Numerous legislative initiatives has been fostered by Business Support Council, including the following: (1) the draft Law on Investment of the RA was prepared and discussed (after discussions in the government, the draft was returned for revisions and changes to the MTED about two years ago); (2) new legal act on VAT refund has passed; (3) the Law on Electronic Signature was passed; (4) with the effort of BSC some changes were made in legal acts which regulate activities of state agencies responsible for audit. The focus was on decreasing and even eliminating the need for doing additional inspections and compliance checks (The Role and the Achievements of the BSC in the process of Improvements of the Business Environment and Investment Climate in Armenia).

There is no doubt that business environment has improved since 2000 due to the effort of government. These advancements were recorded by several international organizations' research results (FIAS studies). Repeatedly conducted FIAS studies' (2000 and 2004) were the biggest evidence of the government's intention to identify and remove constrains inhibiting business growth and barriers for investment inflow form other countries.

However, in spite of apparent advancements the business and investment environment in Armenia needs farther improvements. This becomes apparent when the comparison is made with other countries. (See Figures 2 and 3).

In addition to favorable legislation there are other essential factors having positive impact on FDI.

- It is essential to mention that **privatization** of state-owned enterprises offered significant opportunities for foreign investors as the value set for privatizing enterprises was very low by international standards.

> "The largest foreign investors in Armenia are those who purchased interests in valuable Soviet-era state assets. Privatization of Yerevan's largest hotels, two historic brandy factories, the Zvartnots International Airport, the telecommunications network, several mining assets and much of the energy generation and distribution system accounts for the bulk of foreign commercial presence in Armenia." (Investment Climate Statement – Armenia 2006).

According to official statistics almost half of FDI comes from privatization for the period from 1998-2005. (See Table 3).

- **Skilled and affordable workforce** is another important determinant for FDI inflow to Armenia. Armenia is a country with high rate of literacy. Education is a priority for Armenian people stemming from ancient times. "Armenia's human capital is one of its best resources. The labor force is well educated, particularly in the sciences. Almost one hundred percent of Armenia's population is literate." (Investment Climate Statement – Armenia 2006). The qualified workforce is available for relatively low cost.

- Armenia has comparative advantage in several **sectors of economy,** which make them quite attractive for foreign investors. Some strategic sectors, such as energy production, mining industry, telecommunications, organic farming, food and beverage production, diamond processing may become the sectors, where the country produce can become competitive in the international markets.

Obstacles constraining FDI inflow to Armenia: As it was revealed above, there are still problems for doing business in Armenia, mainly overall corruption. **Political instability and unresolved conflict** between Karabagh and Azerbaijan create impression of Armenia, as a region of persistent conflict. More importantly, it is the small market size, landlocked location, and long distance from major markets of the world, which cause restrained FDI inflow to Armenia.

Currently the **appreciation of Armenian dram and depreciation of the US dollar** has a negative impact on sectors of local economy, exporting their produce. This will make production in the country less profitable also for foreign countries, which intend to manufacture good and export them to foreign markets.

Reasons for attractiveness of certain sectors of Armenian economy for FDI: Armenia is a small country but the structure of its economy is much diversified. This is important as the country is not dependent upon one or two sectors of economy. Government supports development of certain sectors of economy. According to Mr. Karen Chshmarityan, Minister of Trade and Economic Development, "special attention is accorded to so-called priority sectors like information technologies and tourism without, however, providing particular incentives." (Ministry of Trade and Economic Development Official Site). For the future he pointed out to the sectors, including mining, diamond cutting, construction, chemical industry and processing of agricultural production. According to the data of the National Statistical Service, sectors like energy, gas, and water supply, post and telecommunication, food and beverage processing are the most attractive for foreign investment and most investments are located there (See Table 3). There can be different reasons for these sectors' attractiveness. One of the major reasons was low value of privatization in strategically important sectors, which would become quite profitable, if developed and improved. Another reason for attractiveness of food and beverage processing is centuries-old tradition of wine-making and brandy production, clean and genetically not modified food production.

In addition to above mentioned sectors there are two other attractive cluster of economy. IT and diamond processing sectors are attractive, because they have almost no transportation cost. Moreover, diamond cutting is attractive because of skilled labor force and a long-standing tradition of artisanship in jewelry-making.

Some FDI was also channeled into tourism development in Armenia. The sector is attractive as the country has ancient history, beautiful nature and historical monuments.

It is surprising, however, that IT and tourism sectors have attracted much less FDI compared to energy, gas and water supply infrastructure and post and telecommunication. According to the numbers provided by the National Statistical Service of Armenia, IT has attracted rather less than expected (1-3 percent of total FDI from 1999 to 2002; in 2003 it grew to 5.1 percent, after which it again went down to 2-3 percent). Low share of FDI in this sector can be explained by the fact that IT development does not require much investment, like, for example, energy sector, which needs to repair old infrastructure to make the system operate.

Finally, it is interesting to mention that construction, which seems to boom in Armenia, attracted very low percentage of FDI. According to the data provided by the National Statistical Services of Armenia, the largest FDI in construction sector was observed in 2002 and made up only 6.1 percent of all investment done in this sector. But in general from 1999 to 2005 the percentage of FDI in construction varied from 0.5 to 4.5 (See Table 3). Overall, general investment in this sector is not very large, so is FDI.

Table 3: FDI from Overall Foreign Investment (thousand USD)

Type of activity	1999	2000	2001	2002	2003	2004	2005	Total
Privatization	70000	42000	26455	53995	67199	69936	44408	310996
Energy, gas and water supply	50673	42000	24855	42376	3769	32282	120	196077
Post & telecommunication	11642	37415	13322	9242	10069	43178	56067	180936
Food and beverage production	376782	7793	3851	13597	12914	34728	26401	476069
Mining Industry	8500	228	95	244	17	39555	97537	146178
IT	620	1488	2189	5235	7869	4945	6849	29199
Hotels and restaurants	6756	4551	1145	2104	1410	3098	6555	25622
Construction	1160	720	3449	8619	5259	1031	4353	24592

Source: Socio-Economic Status of the Republic of Armenia 2000-2005.

CONCLUSIONS AND RECOMMENDATIONS

As it was presumed in our hypothesis, there are several factors positively affecting inflow of FDI in Armenia. Hypothesis of the study is proved. Government policy to provide investment incentives and eliminate investment obstacles proved to be the most important factor for FDI inflow. Similarly, it is apparent that there is comparative advantage in certain sectors of economy. Natural endowments (resources), although not very abundant and diverse, also are proved to attract foreign investment. Lastly, low cost of labor force provides incentive for foreign investment.

Based on analyses of statistical data, studies done earlier and our own findings the following recommendations are developed as the outcome of this paper:

- In order to improve the environment for doing business in Armenia tax legislation should be amended and tax administration improved to provide the following: (1) increase transparency and efficiency of tax administration, (2) ensure fairness of treating business entities, (3) make the tax legislation more consistent with the best international practices, (4) harmonize tax legislation, eliminate inconsistencies and contradictions between various laws and regulations. The attention should be directed also to the implementation of the laws.

- The Law on Foreign Investment should be revised to decrease the number of inconsistencies and omissions from the Law. The Law should be straightforward in depriving state officials from the opportunity to make subjective interpretations. It should be more detailed, explaining foreigners their rights and privileges.
- Policy instability and unpredictability should be overcome by engaging private sector in the process of drafting laws and regulations. Private sector should be viewed as a valuable source of information and a major stakeholder in policy making.
- Infrastructure improvements should be undertaken. There are places in Armenia which are deprived of basic infrastructure such as roads or telephone lines. Telecommunication should be provided to ensure country's all-around coverage. Major attention should be paid to the improvement of rural roads, irrigation and telecommunication infrastructure
- Armenian government should continue the process of privatization. Privatization in energy, water and telecommunication sectors proved to be efficient and improve the financial standing of former state-owned enterprises.
- There should be a clear strategy for FDI promotion, specifically:
    - new sectors of economy should be identified to be promoted in international forums to potential investors,
    - the role of Diaspora should be augmented to make use of its opportunities to promote the country abroad,
    - there should be a single agency responsible for FDI promotion in order not to confuse responsibilities. The role of ADA should be strengthened in this regard. According to World Bank, "MTED and ADA should have a clear mandate and

strategy, actively supported by the President. The focus should be on reducing the risks and costs of doing business in Armenia by improving the business environment, and offering selective incentives to foreign investors." (Armenia Trade Diagnostic Study 2002, 55). Both MTED and ADA should "…prepare specific investment projects, identify target investors, conduct initial negotiations with investors, organize investment tenders…, provide investors with pre- and post-investment support, and assist investors in dealings and negotiations with the Government." (Armenia Trade Diagnostic Study 2002, 55).

- better use of diplomatic channels, in particular appointment of trade/commercial attaches in the embassies, especially in those countries, which are the major source of FDI. Armenian Diaspora can also support this initiative. Professional associations and networks of Armenian businessmen could be a very valuable instrument for accelerating FDI in Armenia (Armenia Trade Diagnostic Study 2002).

- The government should more aggressively combat corruption in the country and reduce the size of shadow economy. These two are going hand in hand with each other. Corruption creates base for shadow economy, which serves as an obstacle for development of competitive markets. It endangers the competitiveness of business entities operating in compliance with laws and regulations.

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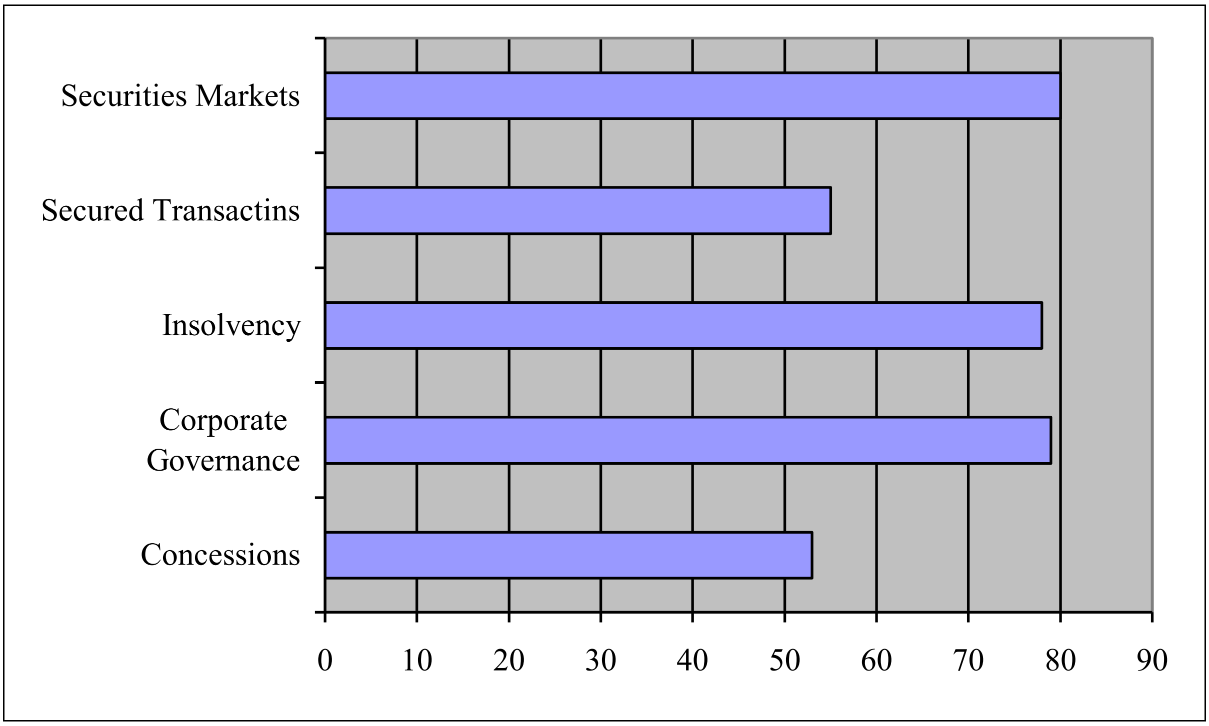
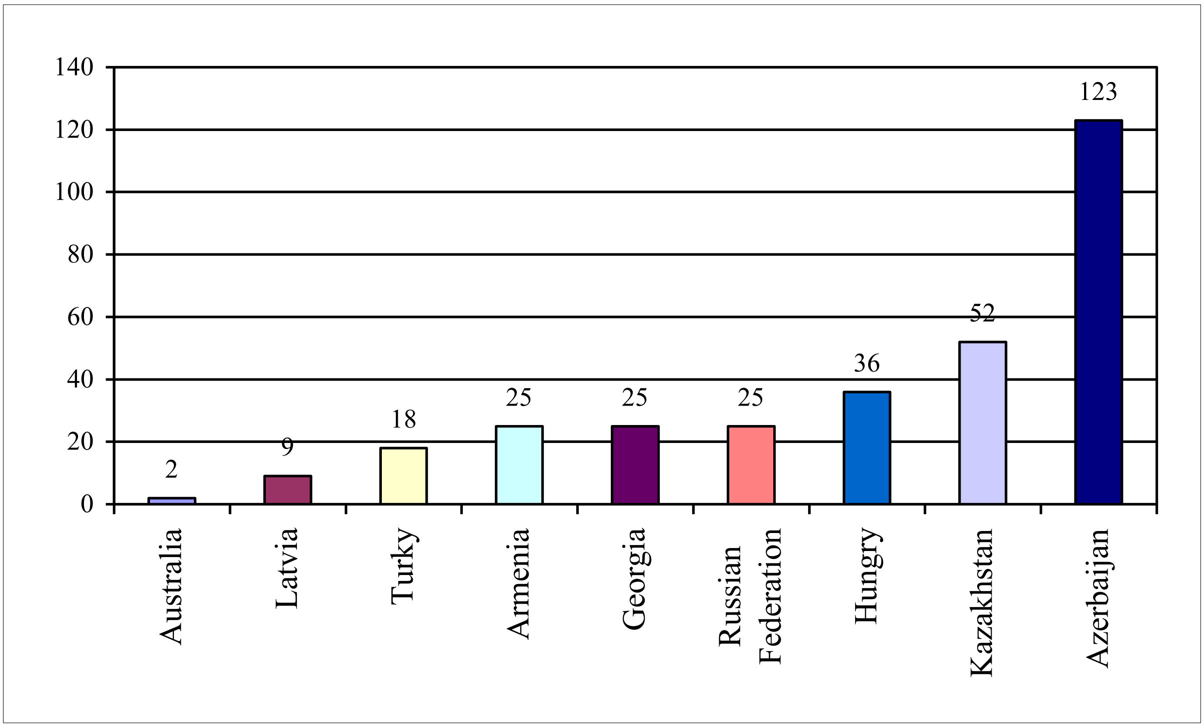
Figure 1: Snapshot of Armenia's Commercial Laws.



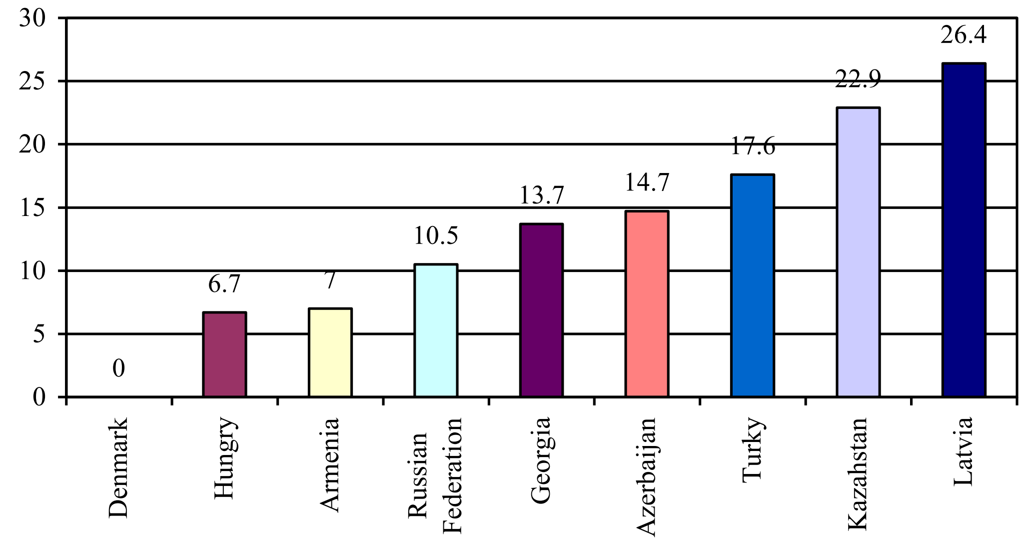
Source: Commercial Laws of Armenia 2006
*0: Does not meet international standards.
*90: Fully meets international standards.

Figure 2: Time to Start Business (Days



Source: Commercial Laws of Armenia 2006

Figure 3: The Cost to Start a Business



Source: Commercial Laws of Armenia 2006