Introduction

The recent trend towards globalization and worldwide integration strengthened growing interdependence among nations and nation-states in the world. Being a consistent engine of growth and development, this interdependence, both political and economic, makes states to continuously develop in order to not to be alienated by the outside world. In other words, integration creates competition among states to survive which constant economic and political development is needed.

As a basis for economic growth and development and a force fostering economic integration, foreign direct investment (FDI) recently started to gain more importance, especially for developing countries. Being an old phenomenon for developed countries, FDI inflow (and outflow) today became a desirable goal for developing ones as well. Governments of developing countries today look at FDI promotion in their states as a number one priority issue. This is because "…many developing countries now desire to extend the market-price system and the private sector and to mitigate the external debt problem by attracting more private foreign investment." (Meier, 1995, p.1)

Each investment procedure has in itself elements of trade because, like trade, investment is closely connected with capital, technology, skills, etc. inflow (importing) to the host economy and with final production's share (exporting) with the outside world. According to the study on "Investigation of Factors Inhibiting FDI in Armenia" (Report, 1999), trade leads to investment, and vice versa. In other words, "FDI is an extension of international trade by other means." (Ibid., p.101).

> FDI is international investment …[with] the objective of obtaining a lasting interest by a resident entity in one economy in an enterprise resident in another economy… This interest is

defined by the IMF as involving the ownership of 10% of the shares of the target enterprise or equivalent (such as share in an unincorporated unit or branch).[1]

The role of FDI for states' economic growth and development is huge. This is the main explanation of the fact that FDI flows not only from developed countries to developing ones, but also among developed states. Moreover, because of growing global integration, FDI will flow wherever it finds an environment open to it. So, the fact is that FDI flow is desired worldwide as it benefits both investors and hosts in the long-run and, hence, "…it is not a zero-sum game."[2] According to Meier (1995), for FDI investors the main benefits from the deal are the profit brought by investment made and the expansion of their business market elsewhere in the global economy beyond the investment project itself. For a developing country, the inflow of FDI brings much more benefits (brings in new technological and managerial skills, fosters domestic investment, reduces unemployment level, etc.), and as a direct result of them the international flow of capital serves as an alternative to labor migration from the poor country. (Ibid.)

So, FDI does much more than just providing countries with financing for their growth. Therefore, since 1980-1990s developing countries, understanding the cost of being locked out of the global integration, have strictly changed their attitude towards FDI and started to liberalize their economies in order to attract them. As a result, among the main four sources of external finance flows to developing countries, the share of FDI remains the largest one (nearly 40%). (See Figure 1. and Appendix A) According to Meier (1995), there are some relative advantages of FDI over foreign loans. Whereas loan provision requires payments of debt irrespective of the state of the economy, FDI requires payments only when it earns a profit. Moreover, with private

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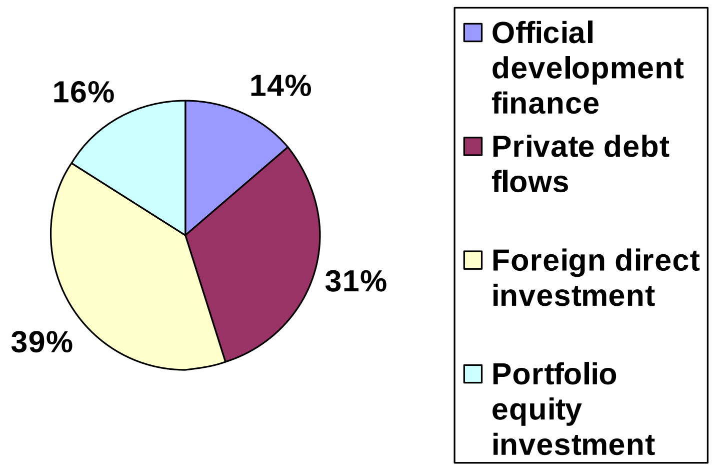
[1] Balance of Payments Manual, 5th Ed. 1993. Washington, DC: IMF, 1993. Pp. 86-90.
[2] Foreign Direct Investment. 1997. Lessons of Experience Series, No5. (Joint report by IFC and FIAS). Washington, DC: USA, p.4

FDI, "…both the commercial risk and the exchange rate risk are passed on to the investor rather than having to be borne by the host government." (Ibid., 1995, p.2).

Figure 1. External Finance Flows to Developing Countries, 1996[3]

100% = $284.6 billion



Source: World Bank Debtor Reporting System. 1996 Preliminary data.

Therefore, foreign investors look at all pros and cons of their future business with the host country before investing in it. In order to have FDI experience, the country must, at least, pursue market-oriented and export-oriented policies. (Ibid.)

Today the FDI flow is very unequal. It flows freely among industrial countries, from developed to the "…more advanced developing…" countries, and to a much lesser extent to the societies in transition. (Ibid.) Moreover, the level of FDI flow among these societies fluctuates as well. (See Table 1 and Figure 2)

Table 1. FDI in Central and Eastern European countries.[4]

	Cumulative inflows 1989-98 (million dollars)	**Cumulative inflows Per capita 1989-98** (million dollars)	**Inflows per capita 1998** (dollars)
Albania	384	103	12
Bulgaria	1,352	163	48
Croatia	2,086	464	190
Czech Republic	8,053	782	120
Estonia	1,467	1,005	387
Hungary	14,508	1,429	94
Latvia	1,645	666	111
Lithuania	1,566	422	249
Macedonia, FormerYugoslav Republic of	175	80	25
Poland	14,680	380	159
Romania	4,489	199	90
Slovak Republic	1,331	247	56
Slovenia	1,199	603	83

Sources: IMF, *International Financial Statistics,* and *World Economic Outlook*, various years (Washington: International Monetary Fund).

Such an unequal distribution of FDI flows to developing countries is a direct result of the economic conditions and investment environment there. These include factors such as healthy legal field and proper law enforcement, favorable tax policies, labor skills, potential for export-import, etc. And the unequal flow of FDI to developing countries is mainly explained by these factors' unfavorability in some of them, which lowers their attractiveness for investors. The existence of such inhibiting factors in developing countries is a consequence of their governments' protective policies. For a long time, the governments of developing countries were

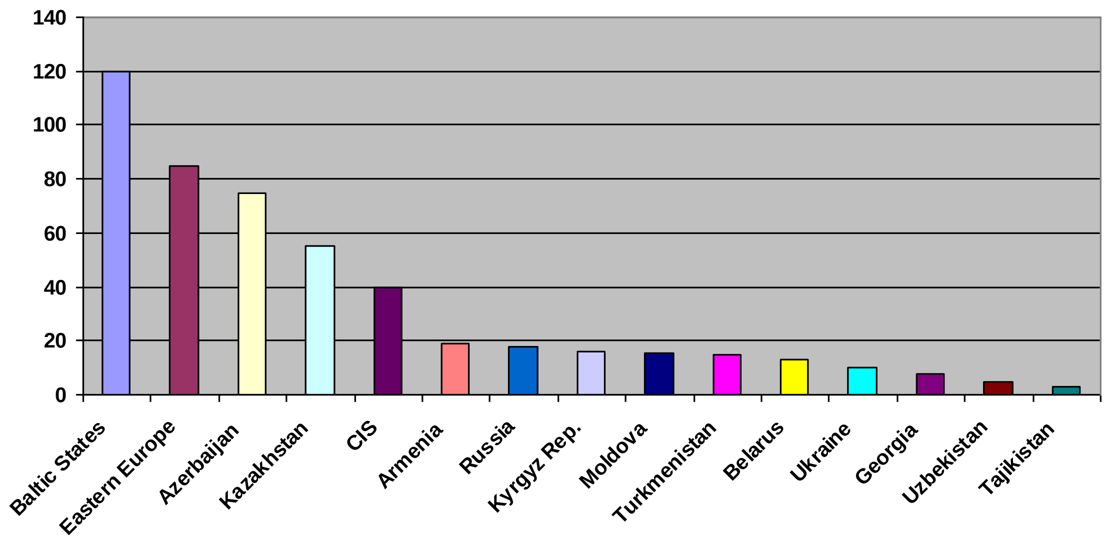
[3] Ibid.

against any kind of FDI inflow to their states, as they considered it as a sharing of control over the state with the outsiders, as giving up of their power. (Meier, 1995, p.13)

However, given the recent trend towards globalization and growing integration, and the big positive role that FDI plays in their joining to the world economy, these governments realized the importance of changing their policies and attitudes towards foreign investments. Moreover, as FDI is the main source of economic growth and development, today's challenge is not only how to attract them, but also how to increase their inflow level to the state's domestic economy. This is also the case for the Republic of Armenia (ROA).

Today the ROA that has high rates of unemployment, an 'uncoverable' budget deficit, and a huge external debt and trade deficit, needs FDI as a breathing air. However, *the overall level of FDI inflow to Armenia stays low compared to other CIS countries.* (See Figure 2)

Figure 2. FDI inflow to Eastern Europe and Central Asia
(Annual Average FDI per capita, 1993-99)



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[4] Economies in Transition, 2000 (September). Finance and Development. IMF Publications (p.29).

As Figure 2 shows, the level of FDI flow to Armenia is just about $19 per capita annually. The reasons for this are important to be examined and eliminated by state's government.

Thus, ***the Purpose of this Essay is to investigate the role of FDI for Armenia during its transition to market economy and democratic rule, and to examine the reasons for such a low level of FDI inflow to the country.*** The essay also examines feasible policies needed to mitigate existing investment barriers and to create a secure, healthy, and attractive investment climate in Armenia by raising the overall comparative advantage of doing business in this country rather than anywhere else. Here, special attention is given to the overall improvement of the legislative-judicial environment in Armenia, which is the main guarantor of business's security. Thus the main focus of the essay is on the minimization of risks through maximization of security, which serves as a good example of the way to increase a comparative advantage of investing in Armenia.

For that reason I used the data on the state of FDI in ROA covering the whole period since its independence up today, and investigated the reasons for its still low level (barriers to investment) by examining all existing laws and policies on FDI that the ROA implements today. Hence, *the main research question* arises and needs to be investigated:

- Why is Armenia receiving such small amounts of FDI today?

For this end, the ***Research Design*** looks at the following factors:

(1) What is the role of FDI for Armenia?

(2) What are the factors facilitating/inhibiting FDI in Armenia?

(3) What policies might be feasible to use in order to reduce the inhibiting factors?

(4) What problems exist in today's law on investments and in their implementation?

(5) How to increase FDI in Armenia? How to increase the comparative advantage of doing business in Armenia?

This research study serves an explanatory purpose, as it aims to explain the reasons for such small inflow of FDI to Armenia. ***The Methodology*** of this Master's Essay is an unobtrusive research method – content analysis – combined with the review and analysis of the secondary sources, and some personal interviews taken from major foreign companies that had invested and are doing their business in Armenia (Armentel, Diaspora investors, etc.).

Content analysis is helpful in examining a number of statistics, social artifacts, laws on FDI, and other official documents on correspondent issues. Some major official documents – laws, licences – on investment are examined in this essay and the results of surveys and interviews are analyzed according to them. For this end, the context of the "Law on Foreign Investments" of the ROA (1994), The Constitution of Armenia (1995), Land Code (1991), and Civil Code (1999), as well as some tax legislation are analyzed throughout the essay.

Review and analysis of the secondary sources is useful in reviewing researches and surveys done already on the concerned issue by the staff of some international organizations functioning in ROA (UNDP, USAID, IMF, WB, IFC and FIAS reports). The reports prepared by these organizations are worth examining and analyzing. The following reports are included in this study: (1) Report on "Investigation of Factors Inhibiting FDI in Armenia" prepared in 1999 by UNDP and the Ministry of Industry and Trade of the ROA, and (2) Report on "Administrative Barriers to Investment" in the ROA conducted in 2000 by the joint endeavors of FIAS and IFC. These two reports are important in that they present findings on the main impediments to FDI in Armenia and on the overall investment climate here. These reports are based on the surveys and interviews taken by the researchers from the correspondent company owners, potential investors, and experts.

Personal interviews are a source of most updated information that will be useful for this essay. They are taken in order to find out whether there is a change of attitudes towards the overall investment climate in ROA today.

Literature Review

Growth and development require sound investment, which in its turn, be it domestic or foreign, requires a favorable investment climate. The basic provisions regulating the investment climate in the ROA are set by the Bilateral Investment Treaty (BIT) signed by the USA and the ROA in 1992, and by the Law on Foreign Investment adopted by ROA in 1994, July 31st. [5]

According to the Law, under the term *Foreign Investor*, the law understands "…any foreign company, a citizen, a person without citizenship, an Armenian citizen permanently residing outside of Armenia, or an international organization which invests in Armenia." (Ibid., p. 69). *Foreign Investment* means "…any type of property including financial means and intellectual property which is invested by a foreign investor directly in the territory of Armenia" to gain profit or other beneficial result in any economic or other area. (Ibid., p. 69). And *Foreign Investment Company* is an enterprise of "…any legal form recognized under Armenian Law which is founded by a foreign investor", or in which the investor is a participant. (Ibid., p.69)

There are two main types of foreign investment:

a) FDI – founding a foreign company in the host country or buying host company with a maintenance of a say in the management of the enterprise (IFC and FIAS Report, 1997);

[5] Armenia: Investment and Business Guide, 1998, Washington, DC – Yerevan: International Business Publications, USA

b) Foreign (indirect) portfolio investment – acquisition of bonds, stocks, T-bills by investor in the host country. (Ibid.).

As discussed earlier, FDI is a main source of the worldwide development and growth. Hence, the fostering of its inflow is one of the main aims of development strategies worked out by transition countries. Evidence shows that the level, location, and reasons of foreign investment in the transition countries are all strongly associated with progress in transition. (www.worldbank.org). [6] And the greater the progress in transition made by the given state, the higher its worldwide credibility rate and, hence, the more is its attractiveness for potential investors. (Ibid.)

So, the credit rating of the host country is used to measure the investor's perception of the country specific risk. "This rating gives weight to economic, political and institutional performance…" and, *thus, it can be concluded that it is the reform process that opens opportunities for profitable investment, and "…which through its impact on returns and risks, motivates investors to take advantage of them."* (Ibid., p.7)

Another important, though independent, determinant of FDI inflow to the transition countries is the current or expected EU membership of these countries. It increases the country's credit rating as it implies that the given country already attained or is in the process of attaining major reforms contributing to the establishment of democratic rule and market-oriented economy in the state. "This was certainly the case for Portugal, Spain, and Ireland, which all experienced rapid growth after becoming EU members."[7] According to the same source, model-based simulations for EU prospective members from Central and Eastern Europe already established a sound growth climate there. For example, in Poland as a result of growth it is expected by 2003

[6] Stern Nicholas (Chief Economist and Special Counsellor to the President, EBRD). "The Future of the Economic Transition". July 1998. *EBRD Working Paper No 30* (p.7)

to bring to balance the general government's budget, and the inflation rate will drop below 4%, thus, the Polish GDP growth will result "…of about 5% annually, fueled primarily by exports and investments." (Ibid., pp. 14-15).

So, "…the bulk of the gain from EU membership for transition economies will derive from increased investment coming from both reduced domestic risk and increased FDI flows." (www.worldbank.org, p.8) In addition, ultimate EU membership implies guarantees in terms of macroeconomic stability, institutional and legal environment, and political stability, which together strengthen the investment climate. (Ibid.)

Macroeconomic stability is measured by the indicators of the inflation rate, the government balance, the external debt stock, extent of privatization, the industrial sector share, etc. (Ibid.) However, though the necessity of favorable economic conditions cannot be neglected, there are other factors that are not less important in determining the country's attractiveness for FDI. As Meier (1995, p.29) mentions, "Established property rights, transparent regulatory and legal regimes, economic stability, and political stability are of first consideration to a prospective investor."

There are other factors determining flow of FDI as well. These are country's physical infrastructure, its natural resource base, the general degree of industrialization, and cheap and skilled labor force. And the last, but not least, determinant – supporting tax policies – made up by the host governments also worth consideration.

Generally, the investment's flow and their level in the given state are indicators of outside reliability on the hosts' tax policies and institutional framework. Liberalization of policies (such as open-door policy adoption in Armenia) and major legal-institutional

[7] Economies in Transition, 2000, Finance and Development, IMF Publications, p.28

restructuring has led to significant increases in FDI flows. (IFC and FIAS joint report, 1997) The brightest example of investment growth as a result of this is China.

Moreover, in order to attract foreign investments favorable tax policy is needed. Tax holidays and exemptions from some kinds of taxation guarantee preferential treatment of investors by the host state, hence attracting more investments.

As a result of successful implementation of privatization programs, some Eastern Europe and Central Asian republics of the Former Soviet Union (FSU) have emerged as important FDI hosts during their economic and political transition. Among them Poland, Hungary, and the Czech Republic deserve special attention. (Ibid.) For example, "FDI in Poland has risen from \$11 mln in 1980 to \$4.2 bln in 1996" (Ibid., p.18). (See Table 1.) South Asian republics showed lower FDI levels, which reflects the long history of restrictive policy environments there. (Ibid.)

Among the main disincentives to investment such as - corruption and governance problems – still are rooted in some countries, while being far less prevalent in others. States where these problems exist (like in Armenia) today lack to develop, and cannot derive benefits from foreign and domestic investment.

All in all, the recent decades saw a great increase of FDI flows worldwide, and only FDI flow to developing countries since the mid 1980s grew by almost 10% annually in real terms. (IFC and FIAS report, 1997) According to the same report,

> Real FDI in 1980-89 was 50 % more than in the previous ten years, and two fifths of that in the next seven years. FDI now averages 1.7% of developing countries' GNP and accounts for nearly 40% of all global FDI flows to developing countries.[8] Developing countries now receive one third of global FDI. (Ibid., p.15)

[8] See Figure 1.

This all is what the theory says about the direction of FDI flow to transition countries and about the ways to increase it. Let's see how this all works for Armenia – the brightest example of a transition country.

Case of the ROA – Barriers to Investment in Armenia

Since 1991 the newly independent ROA had entered a very difficult stage in its history – a stage of transition, which strengthened the necessity of major political and economic reforms in the country. As the primary source of economic growth and, hence, political stabilization for all developing countries, FDI started to gain growing importance for Armenia.

Being one of the most industrialized republics of the FSU, which had high production and export rates and which had never practised poverty before, ROA starting from 1990s faced a completely reverse situation. Its highly educated and skilled workforce is unemployed today and is begging on the streets, its industries are closed and it has huge budget and trade deficits (imports exceed exports four times). On the contrary, if one takes into account that only starting from the end 1994 economic development of Armenia began, the hope remains that all these problems are temporary and will be overcome one day. To this end it was identified by the ROA that attracting and increasing FDI inflow to the country is and will be its main development strategy. As USAID report puts it,

> By virtually any measure, investment levels are poor in Armenia. As a percent of GDP, Armenia receives more official development assistance than any other nation in the FSU and Eastern Europe.[9]…Armenia's external trade performance is also poor. But …Armenia's poor natural resource base does not, in itself, condemn its people to poverty and dependence…[It only means that] …*development depends upon having high investment rates and fully exploiting the skills and initiatives of the population* – i.e. human resources – to compete in world markets.[10]

[9] See Appendix A.

[10] Armenia: Investment and Business Guide, 1998, Washington, DC – Yerevan: International Business Publications, USA (pp.185-190).

In other words, to increase its FDI inflow levels, Armenia has to identify and develop its comparative advantages through creation and improvement of an internal favorable investment climate. Therefore, it is needed to see what has already been done by the ROA for this end in order to identify what remains to do.

"Armenia is one of CIS member-countries that implements liberalized foreign investment policy aimed at attracting foreign investments."(www.cba.am). The basic points of this policy are reflected in 1) the Law of the Republic of Armenia on Foreign Investments adopted on July 31st, 1994 and 2) the Bilateral Investment Treaty (BIT) signed by the US and ROA on September 23rd, 1992. (Armenia: Investment and Business Guide, 1998) Below it is discussed what major incentives they brought and to what extent they improved the overall investment climate in the ROA. According to document "Law of the ROA on Foreign Investments" (1999),

> The law shall establish the legal, economic, and organizational basis for the implementations of foreign investments in the territory of the ROA and shall be directed at the provision of protection of the rights, lawful interests and property of foreign investors, along with the creation of necessary conditions for attraction of foreign material and financial resources…(www.planetnoah.com).

The Law provides some major guarantees and incentives to foreign investors:

- *It prevents confiscation and nationalization of investments.* Confiscation with full compensation can occur only by a court decision "…as an extreme means in case of emergency declared in accordance with the legislation of the ROA…" (Ibid.) Investors are entitled to full compensation through a court order for damages caused to them by the government officials or for government bodies' illegal actions towards investors. (Ibid.) Moreover, independent auditors should determine the size of prompt compensation at current market prices, and if compensation payment is delayed, interest will be added. (Ibid.)

◆ *The Law guarantees full repatriation of assets and profit* that result from their investment after all due taxes (profit tax, value-added tax, excise tax, etc.) and fees are paid. (Ibid.) There are also no transfer limitations. Foreign investments are entitled to "…freely export their property, profits and other means legally gained as a result of investments or as a payment for labor…" or as a compensation got according to the Article 9 of this law. (www.planetnoah.com).

◆ The law says that *the legal treatment of foreign investors cannot be less favorable than that of domestic ones.* Moreover, a five-year grace period is granted to foreign investors if the legislation effective at the time of initial investment is amended. (Ibid.)

◆ Law *establishes procedure for resolution of disputes between investors and the ROA* according to the legislation of the ROA and, only in cases when ROA is not a party to the dispute, the use of some international mediation courts is allowed. (Ibid.)

◆ And the final legal incentive provided says that *foreign investments are exempt from customs duties* on property (such as raw materials, supplementary items, etc.) imported for use in the production process. (Ibid.)

But, as law says, all these privileges apply to those foreign investment enterprises where "…investment is no less than 30 (thirty) percent at the moment of foundation." (Ibid.) There is no clarification in law on what if later this percentage shortens or fluctuates.

The other document signed earlier between USA and ROA – BIT – went into effect only in September 1995 after being ratified by the Parliament and signed by ambassador Peter Tomsen and Minister of Foreign Affairs Vahan Papazyan. (www.bisnis.doc.gov).

> The BIT sets forth investment conditions for investors of each party to be no less favorable than for national investors. It protects investment against expropriation and nationalization, and regulates dispute settlements between foreign companies and governments of each party. Armenia does not have a bilateral taxation treaty with the US. (Ibid.)

So, basically these documents set a good ground for foreign investors and provide their equal as well as favorable treatment by the ROA. However, the joint report by UNDP and Ministry of Industry and Trade (MIT) of the ROA revealed that among the factors indicating the business climate in Armenia the existing legal/regulatory regime was rated by foreign investors and experts as "generally adequate".[11] (See Appendixes B and C) Moreover, a number of other factors such as unproper law enforcement, red tape and corruption, and investment law's inconsistency with the other Armenian laws create disincentives for investors (this all is discussed later in the "Analyses and Findings" chapter).

Another major step forward towards improving the Armenian investment climate since 1994 was general reform of the Armenian tax policy and tax laws, which continues up today. The taxation system in Armenia is based on periodically amended "Law on Taxes and Duties" first adopted by the ROA in April 19th, 1992.[12] That law provided some tax incentives to foreign investors such as:

- *Profit tax holiday* for two-year period is granted to investments (no less than 30%). (Ibid.)
- If the foreign share in company is more than 50%, from the third up to tenth year of operation *50% of the tax liability can be deducted.* (Ibid.)
- And, *the income tax reduction* of the given resident applies from January 1st, 1998 "…if the total value of investments made by the foreign investors in the statutory capital of the resident (excluding banks) makes up 500 mln dram…" (www.cba.am).

Moreover, recent improvement in the Law on Taxes and Duties occurred on January 2001 that added some more incentives. Among them the most encouraging one is the strengthening of the

[11] "Investigation of Factors Inhibiting FDI in Armenia." 1999. Joint report by UNDP and MIT of the ROA. (30 January). IRIS Caucuses Center. Yerevan. (p.55)
[12] Armenia: Investment and Business Guide, 1998, Washington, DC – Yerevan: International Business Publications, USA

security and protection of the rights of taxpayers. The new legislation says that a juridical person can apply to court and win the case when finding any contradictions and confusions in tax laws, and when court founds out that those contradictions are really there.[13] So, the risk of the taxpayer is reduced and security is raised as law (court) protects his/her/its rights.

The other two major incentives that were added by the new legislation are "…a substantial cut in two taxes – income tax and compulsory social security payments (CSSP)" (www.eurasianet.org). Before that the income tax rate varied progressively from 15 to 30 percent of gross wages, and the CSSP rate varied from 28 to 22 percent under a regressive scale. (Ibid.) So, the employer formerly paid about 50% of its wage to the state. (Ibid.) New legislation cut down this percentage up to 28% (income tax and CSSP together), which is paid starting with monthly salaries of 20,000 drams ($36 USD) or higher. (Ibid.) Moreover, this value now is not ranging, it is fixed and stable. (Ibid.) This adds a new incentive to potential taxpayers (one of them is a foreign investor) and makes them more confident in the Armenian business field. As one of my interviewees pointed out, "…widely fluctuating tax rates increase the uncertainty and decrease the confidence level of potential investors."[14] The Government of Armenia declared that these new tax rates would be maintained for, at least, next three years. (www.eurasianet.org). Government officials hope that "…the new legislation may lead to some reduction in the shadow economy and …will specifically foster the growth of small businesses and a rise in wages." (Ibid.) So, previously high and fluctuating tax rates had prevented the growing of small businesses in Armenia that could have employed a significant part of the labor market and had discouraged the investments' flow to ROA. (Ibid.) And the effective implementation of the new

[13] Karayan, S. (2001) "About the tax law reforms." Karavaroum (Management) (January): 34-40.
[14] From my personal interview with Avetis Seferyan, a Research Associate at the Center for Business Research and Development of AUA, and an administrative adviser at the "Diaspora Investors"Ltd.

tax legislation may lead to increase in salaries, encourage small businesses and investors to start their deal in Armenia, and may result in the long-run in successful revenue collection here.

However, the overall tax optimization and tax collection mechanisms' adjudication are deficient yet and need improvement in order to encourage business activity in Armenia. As the study on "Investigation of Factors Inhibiting FDI in Armenia" found out, the overall evaluation of the tax administration in Armenia is rated very low (1.7 - 2.1) on the scale of 1 – 4, where 1 is very unfavorable and 4 is very favorable. (See Appendix C)

Among the major incentives for investment flow to Armenia is its *highly specialized and qualified* <u>*cheap*</u> *labor force.*[15] It is the main comparative advantage of Armenia today, which despite many inhibiting factors continues to attract investors.

> There is a significant supply of qualified specialists both in research/engineering and production in the following domains: electrical and electronic components; …software electric motors and generators; optics; apparel production; chemistry; …jewelry; architecture and construction; arts and crafts; and food processing. (Armenia: Investment and Business Guide, 1998, p.85).

Moreover, this supply now exceeds demand in Armenia, as unemployment rate is too high (38-40% according to non-official data).[16] This is the main reason that besides being highly skilled and educated, Armenian labor is also a very cheap one. "Currently, the official average monthly salary is 20,612 drams or $37 in USD per month" (www.eurasianet.org).

So, as it was identified by the study on "Investigation of Factors Inhibiting FDI in Armenia" (1999, p.44) on the scale of 1 (disadvantage) to 7 (advantage), "…only three factors received an average rating of over 5", which are: a) labor force costs (5.8), b) labor force qualifications (5.2), and c) popular attitudes toward foreign investors (5.0). (See Appendix B)

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[15] Personal interviews with Avetis Seferyan and Mr. Lumakis (Chief administrative manager at the Armentel-OTE) also prove this statement
[16] Ibid.

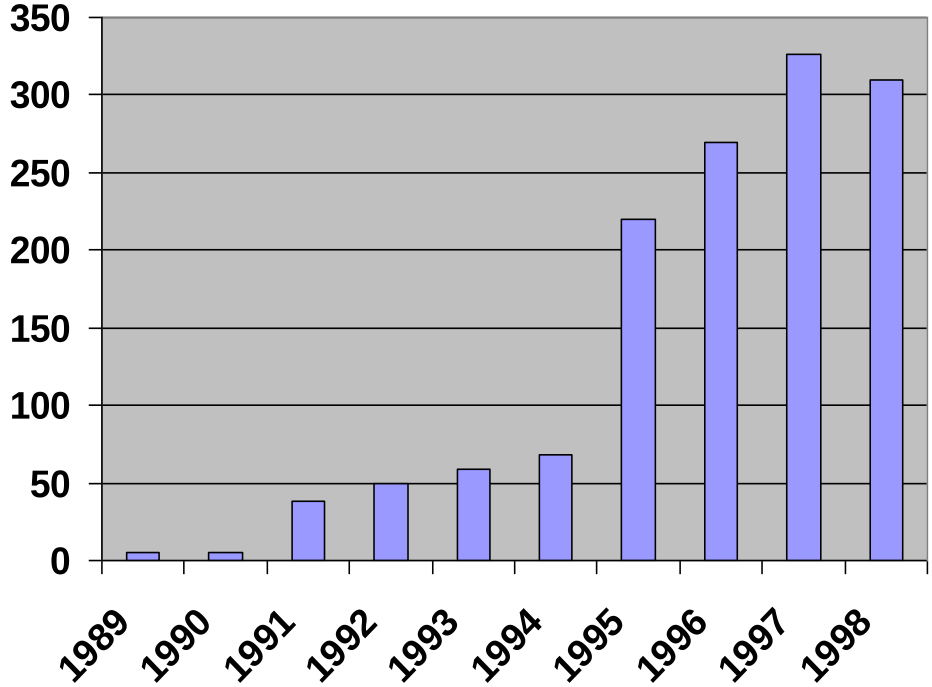
Other factors such as access to land/real estate (4.2), natural resources (4.0), geographical location (4.0), and banking/accounting (4.0), etc. were rated by both investors and experts on the average as neutral or not in so bad condition compared to other CIS countries. (Ibid.) (See Appendix B) However, when asked what, after all, prevents them from more investments or reinvestments, these people indicated the main disadvantages/barriers to FDI inflow in Armenia. These are: Armenian infrastructure base, its political instability, prevalence of red tape and corruption, not transparent laws and unproper legal enforcement, low insurance mechanisms, and poor servicing, etc. (Ibid.) These factors must be the main policy objectives for our government today to take into consideration, the sooner the better.

The necessity of eradication or, at least, mitigation of barriers to investment in Armenia is even more strengthened if one takes into account Armenia's biggest comparative advantage – its diaspora. Armenian diaspora, which is spread worldwide today and makes up about double, if not more (~5.5 mln), of the number of Armenians in ROA, composes the huge source of potential investors that are eager to invest and do business in their motherland. Moreover, this kind of investment is also desired by ROA as it can better negotiate and sign contracts with its native people than with foreigners. (Ibid.)

So, reforms are already there and are continuously made by the ROA. This attracts both old and new investors to Armenia. However, the overall FDI rate is still low, which strengthens the need for doing something more to improve the internal investment climate.

As Figure 3 shows, the overall trend of FDI in Armenia has strictly changed starting from 1995 as a result of the ROA's open-door policy.

Figure 3. Trends of Foreign Private Investments (FDI) in Armenia (in million of US $)[17]



Today, according to official statistical data, there are about 1860 companies with foreign capital that established their business in Armenia. (“Hayatsk Tntesoutian” newsletter, 2001).

. (Ibid.) (See Table 2.) Among them 48% is in the service sector, 41% is in industry, and 11% is in the trade sector. (Ibid.) (See Table 2.)

[17] “Investigation of Factors Inhibiting FDI in Armenia.” 1999. Joint report by UNDP and MIT of the ROA. (January 30) IRIS Caucuses Center. Yerevan (p.13)

Table 2. The Size and Distribution of FDI in Armenia by sectors in 1999 and 2000 (January – September) (thousands of US $)

FDI Size	1999	2000 (January – September)
Total Foreign Investments	156 053	140 649
Amount of FDI	138 913	99 718
Other Investments	17 140	40 931
FDI as a Result of Privatization	70 000	
FDI Distribution by Sectors		
Service Sector	79 809	82 183
Industry Sector	62 445	41 755
Trade Sector	13 798	16 711

Source: Center for Information and Analyses of the Economic Reforms at the Government of ROA (2001) "Hayatsk Tntesoutian" newsletter. September 21: 9

Among major investments done in Armenia the latest most important ones are:

- Greek "OTE" telephone company acquired more than 90% of the share in the "Armentel" (Armenian Telephone Company) in 1997 by signing a fifteen-year monopoly contract with ROA and promising to invest about 400 mln USD. (Ibid.)
- French "Pernod Ricard" company that bought Yerevan Brandy Company. (Ibid.)
- Another French "Castel" firm invested 18 mln USD in Abovian Beer Factory. (Ibid.)

◆ Armenian-Russian joint “Armenal” firm was established on the base of former Kanaker Aluminium Factory, and the Russian “Sibirski Alumin” group promised to invest for the coming next three years after investment for about 20 mln USD. (Ibid.)

Other investments were done in the tobacco production, gold and other precious metals’ mining and extraction, banking and accounting, tourism (hotel construction), etc. Today, Armenia’s major investors are Russian Federation, USA, Greece, Syria, France, Canada, etc. (See Table 3.).

Table 3. FDI by Countries, 1998 – 2000 (percentage of 100)[18]

	1998	**1999**	**2000**	**2000/1999(change in %)**
Total FDI	100	100	100	92.1
Russia	18.6	32.9	35.9	100.7
Greece	33.5	9	32.3	3.3 times
USA	15.3	4.3	6.3	134.6
France	7	19.6	2.5	11.8
Canada	13.4	8.3	9	99.5
United Arab Emirates	1.7	6.7	0.4	5.9
Netherlands	0.2	0.4	0.7	156.7
Luxembourg	3.6	8.3	2.3	25.6
Italy	0.2	3.7	4.1	102.6
Cyprus	2.9	2.4	1.4	52.8
Other Countries	3.8	4.3	5.3	

[18] Source: Center for Information and Analyses of the Economic Reforms at the Government of ROA (2001) “Hayatsk Tntesoutian” newsletter. September 21: 9

Source: ROA National Statistical Service (2000)

What is more difficult is to attract new potential investors (mainly diaspora) to Armenia, as they consider the investment climate here as, at least, unreliable and uncertain.

Analyses and Findings – Attractiveness of ROA's Internal Investment Climate Today

It is obvious that this/that factor's favorability or unfavorability in the given country can affect motivations for investment. But, whatever motivations are the main goal of each investor is to get profit from the business he/she/it does. In other words, "The primary goal of any investor is to realize the highest possible return at the lowest necessary risk." (Report on "Investigation of Factors Inhibiting Foreign Direct Investment In Armenia", 1999, p. 13)

So, for the sake of business any investor analyses in deep detail the investment environment in the given country before making final investment decision. Hence, this part of the Essay does the same type of the analysis for Armenia to find out whether its current business climate is attractive or not for foreign investors.

Though being a small and landlocked country with poor natural resource base and slowly but steadily recovering economy and industry, Armenia, taken as a whole, has a potential to become in the near future a magnet for its worldwide diaspora and other foreign investors.

For this end, the Government of the Republic of Armenia needs to continue reforms aiming to improve the overall business climate in the country and to identify and develop the comparative advantages that attract businessmen from the outside. A big step towards this was already done – *government's openness to changes/reforms* and its firm commitment to make Armenia a country with a democratic society living in a state of free market economic relations where the rule of law prevails. As it is put in "Armenia: Investment and Business Guide" (1998),

> The need for investment in its idle research and manufacturing industries, its delicious agri-products, its large pool of underemployed and highly qualified specialists, its inexpensive labor force, its historically entrepreneurial spirit, and its close ties with the many countries through its Diasporas and at the governmental level, offer attractive prospects for businesses interested in investment and partnership opportunities in such areas as power generation, aviation, construction, electronics, apparel, tourism, food-processing, industrial property acquisition, banking, and other areas. (p. 54)

So, there are certain advantages that bring investors to Armenia, but in order to not to discourage current investors and to attract new and existing potential ones, Armenian government's main objective is to eliminate certain gaps and shortcomings that are there in investment climate and improve it more. Below the Essay concentrates on some of them – the most important ones and those of primary consideration.

"Motivation for FDI involve market considerations, its size in terms of potential sales and profits, and the comparative advantages of the target country in terms of resources …in sectors of concern to investor."[19] *Armenia's local market potential for sales and profit is too low* – low wages of its labor, high unemployment and poverty rates, and lack of market related skills – this all limits the possibility of selling production within the state. Moreover, Armenia's poor infrastructure bases – no water roads, railroads are not fully exploited – that is impeded by its neighborhood (Turkey, Azerbaijan), and difficulties in customs procedures complicate the export of this internal production. This is one of the explanations why is *Armenian exports' level is so low* despite the fact that exports in Armenia are tax exempted. Currently, Armenian exports, especially those to the non-CIS countries, are relatively concentrated. (Ibid.)

[19] "Investigation of Factors Inhibiting FDI in Armenia." 1999. Joint report by UNDP and MIT of the ROA. (January 30) IRIS Caucuses Center. Yerevan (p. 12)

The most important export destiny for Armenian goods and services – Russian Federation – is still open for them. Moreover, the recent celebration of Russian-Armenian relations' holiday and the consequent visit of Russian government officials and the President V. Putin to ROA were followed by signing of some additional Russian investment projects with Armenia – mainly in sectors of energy supply and electronics.

Armenia also exports to other CIS countries and the West.

> Its diamonds and jewelry is frequently exported to Europe … Roughly 20 % of exports is precious or semiprecious stones and precious metals (largely exported to Belgium). About 40-50% of exports goes to CIS countries, some part through joint ventures. [And only] …roughly 30% of exports goes to other countries [such as Iran, United Arab Emirates, etc.] (Ibid., p. 53)

However, for all investors the number one inhibiting factor is the *'strange' business environment in Armenia,* which exists today and is a direct result of legal/regulatory deficiencies.

Though "laws themselves are generally adequate, their implementation and enforcement are often less so." (Ibid., p. 55) This is the direct result of the fact that most of Armenian laws are vaguely worded and often contradict each other. This lacks their transparency and opens the door for their manipulation.

It is known that any investor before making his/her/its decision to invest and do business in the given country gives a special attention to the prevalence of the rule of law and transparent regulatory mechanisms there. This is because to feel secure and be sure they will make profit, investors want to be certain that their rights will be protected by the legal-judicial system in the given state. Moreover, every investor needs clear-cut information on mechanisms of registration/establishment, taxation and customs procedures, and dispute settlement ways to do efficient business.[20] Currently, none of the above requirements is completely met by the ROA. And the main reasons for this are *laws' inconsistency and their contradictory character*.

One such contradiction arises around customs duties of investors. The current law on investments as well as none of the bilateral and multilateral investment treaties signed by the ROA does not clearly distinguish the line between FDI and portfolio investments. (Ibid.) Article 15 of the Law on Investments says that law provides exemption from customs duties of any property that might be used by investors for production purposes. (Ibid., 2000) At the same time, Article 8 of the Law on Customs Duties requires payment on property invested by foreign investors. (Ibid.) As Armenian laws have equal power, the investor's property treatment will be left in this case to the custom's office consideration, which of course will not hesitate to take payment.

Another source for uncertainty refers to the right of foreign investors to own land. Both the Constitution of the ROA (Article 28) and the Land Code (Article 4) prevent investors from owning land on the territory of the ROA. (Ibid.) However, Article 167.3 of the Civil Code provides this right to own land to "…'some' juridical persons." (Ibid., p. 35) Again, inconsistency arises on what law should apply, or clarification is needed on exactly what juridical person can own land and how.

Uncertainty is there also over legal procedures for appealing against Government actions by foreign investors. As it is put in Law on Investments, "…only Armenian courts should consider such disputes where the Government of Armenia is a party." (Ibid., p. 36) On the contrary, investment promotion treaties (bilateral and multilateral) signed by Armenia allow the use of internationally established tribunals for disputes where Armenia is a party to them. (Ibid.)

[20] "Administrative barriers to investment in Armenia." (2000) Joint report by FIAS and MIT of the ROA. May. Washington, DC: USA

These and many more examples show the need for clarification and readjustment of existing laws and for adoption or readoption of new ones.

Another shortcoming in the Armenia legislation is *the absence of an Antimonopoly Law*. (Ibid.) This prevents many businessmen from starting business in ROA as this lacks the competition among foreign and domestic firms and lacks their belief in the prospectus for the development of market economy here.

The major legal shortcoming that needs immediate solution is the fact that *laws and legal norms in ROA are passed too frequently*, which creates inconsistency among them and complicates their implementation. (Ibid.) So, as a kind of resolution, some type of legal catalogue or guide should exist to show the dates of this/that law's adoption, in order to put in a little clarification on what law was established later and, hence, should prevail over others, etc. (Ibid.) Moreover, open forums must be organized before adopting new laws, that must include all persons or firms on which that law will have an effect (government bodies of the ROA, judges, business community, etc) (Ibid.). The latter will help to improve our judicial branch of the government, which is not so reliable source to come to in search of justice and security. (Ibid.) Armenian judicial branch, which is still dependent on executive one, is not considered by both domestic and international business communities as a way of dispute settlement and as a place of equal and just treatment, as courts are highly corrupt and poorly skilled to perform their functions. (Ibid.)

So, the general impression is that this lack of reliance in judicial system of Armenia is there because *judicial and legal systems are not traditionally developed in ROA.* As one lawyer described it in the study on "Administrative Barriers to Investment in Armenia" (2000, p. 20), "You have to understand that in Armenia to apply to court means weakness. It means, that you have no proper financial resources as well as no reliable or powerful nets (relationships) to directly solve your problems." And really, having enough money and good relations with 'some' officials or 'powers' in Armenia makes one's life much easier than if one decides to solve the same problems through court. Furthermore, it saves one's time and money, whereas in the court one can loose both of them by finally getting nothing. (See Appendix D)

Another, the most important, source of uncertainty for investors is the existence of *bureaucratic behavior and corruption* in Armenia, which results in lack of enforcement mechanisms and in inefficient work of judicial branch of the government.

Armenia has inherited the corrupt practices that were common throughout its being a part of the former USSR. (Ibid.) It was identified by many studies that the main causes of widespread corruption in Armenia are:[21]

a) Tradition – because corruption is inherited from the Soviet era and has a long-practice history, people are very tolerant and used to it today (Ibid.);
b) Low wages – because of high rates of unemployment and underemployment in Armenia today, bribery and corrupt practices are the main sources of income even for those who are employed as they get very low wages (Ibid.);
c) Low risk incurred to those engaging in corrupt practices – even if the salaries of bureaucrats were to be raised, the incentives for corruption would still remain (as political protection – 'krysha' is still there and is widely used by them).

So, a number of reforms is needed immediate implementation to cure such evils as corruption, use of political protection in the economy, etc. through civil service reforms, more effective legal prosecution of those who are corrupt, civilization of society, etc. (Ibid.).

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[21] Armenia: Investment and Business Guide, 1998, Washington, DC - Yerevan: International Business Publications, USA (pp. 249-252).

As it was measured by the study on "Investigation of Factors Inhibiting FDI in Armenia" (1999), the widespread corruption and bureaucratic behavior are considered the main factors inhibiting FDI inflow level to ROA. Moreover, they promote largely the informal economy sector, which is day by day increasing in ROA and makes up approximately 1/3 of the country's GDP.

> Of the current investors, 89.7% agreed that successful business in Armenia is frequently based on relationship with powerful political/economic groups in the country… 86.7% of current investors agreed that "businesses frequently have to pay some irregular 'additional, or facilitation payment'" to get things done. Moreover, according to 84.6% of current investors, if a business pays the required "additional payment" the services are usually delivered as agreed. (Ibid., 1999, p. 61)

So, the existence of all these factors creates and forms a kind of a ***strange*** business environment in Armenia, which is unknown and new to the outside international community. While it is already normal for current investors and is usual for domestic ones to pay "additional or supportive" payments or to use political protection (the so-called 'roof or krysha') to register their business, this climate prevents outsiders to come into and start a deal here.[22] Not only foreign investors but also diaspora ones are very much discouraged by this kind of situation in Armenia and, mainly, this is the real cause for their hesitation and uncertainty to make an investment decision. Moreover, even if they decide to get registered here, the fact is that they lack almost all kinds of nets and relations with powerful "krysha" and, hence, political protection is not available to them. (Ibid.) So, they realize it will take both their time and money to do a business here and, as a result, their costs will exceed their benefits. (Ibid.) (See also Appendix D)

So, again the general conclusion comes as following: as the current investment climate of ROA prevents foreign investors to make a profit from their business, they hesitate to start anything here and wait unless better time comes.

However, as study on "Investigation of Factors Inhibiting FDI in Armenia" shows (1999), there is a great interest by the outside world in investing in Armenia and most potential investors are planing for investment projects in the coming years in ROA. They only hesitate and wait for more reforms in the sphere of economy.

Finally, one additional sphere, if improved, may attract investments to Armenia – the creation of a single body that will provide general information on how and where to invest, on how to get registered, and on how to get profit from investment in Armenia. Currently, there is a similar body ADA (Armenian Development Agency) that provides some information on these kind of issues and is projected to be reformed in the near future into a single one-stop-shop. (Ibid.)

So, based on the above analyses and ideas, generally my **Findings** are as following:

◆ **Finding 1.** High level of corruption in Armenia decreases the confidence level of investors and promotes the growth of an informal economy sector here.

As a direct result of this comes the next Finding.

◆ **Finding 1a.** Poorly functioning and still not independent judiciary strengthens investors' uncertainty in fair treatment by law.

◆ **Finding 2.** The low level of FDI in Armenia is a direct result of contradictory laws passed by the ROA, of the lack of their transparency, and of unproper law enforcement mechanisms.

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[22] "Administrative Barriers to Investment in Armenia." (2000). Joint Report by FIAS and MIT of the ROA. May. Washington, DC: USA

◆ **Finding 3.** Creation and formulation of the new, correspondent legal field regulating the land leasing procedures will force more FDI to the ROA.

◆ **Finding 4.** Further tax policy optimization will add to security of investors and bring more investments.

◆ **Finding 5.** The absence of widely accessible information about current investment climate in Armenia lowers the overall credibility rating of the country in the eyes of potential investors. Therefore, potential investors are less optimistic about the Armenian investment climate than the current ones (only 66.7% of surveyed potential investors have in mind specific investment projects and amounts that will be put in ROA within the next 2-3 years). At the same time, 94.6% of surveyed active current investors is planning additional investments in Armenia. (Ibid., 1999, p. 49)

◆ **Finding 6.** There is a possibility for moving towards Import/substitution growth – high industrial potential of Armenia.

There are certain areas in state's industry which together with highly skillful and cheap labor force can raise Armenia's competitiveness in world markets – special importance here gain the development of IT (Information/Technology) industry, food-processing, optics, mining industry, jewelry, etc.

Conclusion

Though among CIS countries Armenia is perceived as a state where the liberalization/open door policy was most successfully carried out, Essay shows that gaps are still there and need a quick recovery. It is said that our government is generally open to reforms. But, as the proverb says, actions speak louder than words. So, this will, however, be proved only when reforms successfully undertaken by the government will foster investments and bring to the overall economic recovery and growth in Armenia.

By way of conclusion, for Armenia it is more than true that growth requires sound investment, which in its turn, be it domestic or foreign, requires a favorable investment climate. To achieve it, a number one goal for Armenia today is to minimize the risk through maximizing security – which can raise the overall comparative advantage of doing business in this country rather than anywhere else.