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A STUDY OF THE DEMOCRATIZATION PROCESSES  
AND ECONOMIC DEVELOPMENT  
IN THE REPUBLIC OF ARMENIA

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## LIST OF ABBREVIATIONS

ADA	Armenian Development Agency
AEPLAC	Armenian European Policy and Legal Advise Center
ARDEP	Armenia Regional Development Project
APRSEP	Armenia Public Sector Reform Programme
BSTDB	Black Sea Trade Development Bank
CBA	Central Bank of Armenia
CIS	Commonwealth of Independent States
CMEA	Council for Mutual Economic Assistance
CSP	Country Strategy Paper
DAC	Development Assistance Committee
DFID	UK Department for International Development
EBRD	European Bank of Reconstruction and Development
ENP	European Neighbourhood Policy
EC	European Commission
ECHO	European Commission for Development and Humanitarian Aid
EU	European Union
EUR	Euro
GDP	Gross Domestic Product
GoA	Government of Armenia
GTZ	Gesellschaft fur Technische Zusammenarbeit (German Overseas Development Agency)
JPY	Japanese Yen
IBRD	International Bank for Reconstruction and Development
IDA	International Development Association
IFC	International Finance Corporation
IFI	International Financial Institution
IMF	International Monetary Fund
INGO	International Non-Governmental Organization
INOGATE	Interstate Oil and Gas Transport to Europe
KfW	Kreditansalt fur Wiederaufban

MDG	Millennium Development Goals
MCA	Millennium Challenge Account
MTEF	Medium-term expenditure framework
NGO	Non-Governmental Organization
ODA	Official Development Assistance
OSCE	Organization for Security and Cooperation in Europe
PHARE	Poland and Hungary: Assistance for Restructuring their Economies
PRGF	Poverty Reduction and Growth Facility
PRSP	Poverty Reduction Strategy Paper
PSMP	Public Sector Modernization Programme
PSRC	Public Services Regulatory Commission
RTI	Research Triangle Institute International
SME	Small-and Medium-size Enterprise
TACIS	Technical Assistance for Commonwealth of Independent States
TRACECA	Transport Corridor of Europe-Caucasus-Asia
UNDP	United Nations Development Programme
UNHCR	United Nations High Commissioner for Refugees
USAID	United States Agency for International Development
USD	United States Dollar
USDA	United States Department for Agriculture
USSR	The Union of Soviet Socialist Republics
WHO	World Health Organization

## ABSTRACT

This paper is based on the results of the Policy Internship Project conducted at the UK Department for International Development, represented in Armenia, DFID/Yerevan.

When in early 90s the countries of Central and Eastern Europe and the post-Soviet states introduced the new economic system, they simultaneously changed their political system and introduced democracy. For post-Soviet states the transition was more complex as they underwent for the first time in their history the processes of state building, democratization and the introduction of a market economy simultaneously.

Armenia, as one of the former Soviet Union republics, had to face all the hardships of this simultaneous transition, aggravated with a natural disaster, military conflict, and transport blockade from the beginning of the reforms.

This paper is aimed at studying the relationship between the democratization processes and economic development in Armenia during the transition period. Another purpose of the study is to see how the international donor agencies, represented in Armenia, consider supporting democratization while implementing economic development oriented programs in the country. The paper suggests the appropriate priority in this regard via policy recommendations to donors in Armenia.

The results of the research revealed little correlation between economic development and democratization in Armenia, but illustrated the importance of donors in facilitating the efforts and advancing the reforms in these areas.



“The crucial moment in any passage from authoritarian to democratic rule is the crossing of the threshold beyond which no one can intervene to reverse the outcomes of the formal political process. Democratization is an act of subjecting all interests to competition, of institutionalizing uncertainty. The decisive step toward democracy is the devolution of power from a group of people to a set of rules.”

*Adam Przeworski*

“Without democracy, we cannot expect development of a genuine market economy under fair and transparent rules of competition. I have long believed economic growth achieved under conditions of political repression and market distortion is neither sound nor sustainable. I believe democracy and a market economy are like two wheels of a cart, and that both must move together and depend on each other for forward motion.”

*Korean President Kim Dae-Jung, opening address, Conference on Democracy, Market Economy and Development, 1999.*

## INTRODUCTION

The process of global democratization during 70s, named by Samuel Huntington (1991) “the third wave of democratization”, regained its momentum in late 80s and early 90s with unprecedented changes in the post-communist world and emergence of new democracies.

For a large number of countries the transition to democracy often coincided with economic crises. Many of these new democracies faced simultaneously an urgent need to consolidate the nascent political institutions and overcome the economic collapse. That was why at the end of the 1980s and the beginning of the 1990s a radical change took place in the world economy as well. The countries within the former Soviet block abandoned central planning and switched over to a market economy approach. They had to -- and to some extent they still have to -- rebuild their economic system and adapt their economies to the new conditions. This transition is

distinguished with drastic and radical political changes. When the countries of Central Europe and most of the post-Soviet states introduced the new economic system, they simultaneously changed their political system and introduced democracy. Smith (1999) states that for post-Soviet states the transition was more complex as they underwent for the first time in their history the processes of decolonization, democratization, and the introduction of a market economy simultaneously. Though Smith (1999) accepts that prospects for democratization can be mainly influenced by the economic liberalization, he doubts the idea, popular in the West, that economic liberalization is integral to facilitating both democratization and geopolitical stability. Democracy is not necessarily a major cause of the economic success and even can have a contrary effect, as the radical and rapid economic reforms can cause social crises and poverty, thus, affecting the people's correct perception of democracy (Smith 1999). However, many cross-country studies (Fidrmuc 2003, Frye 2006, Knack 2004) demonstrate that democratization in transition countries, though being weakly correlated with growth, fosters favorable conditions for promotion of market-oriented economic reforms, to much extent, with the help of IFIs and international development organizations (donors).

Armenia, as one of the former Soviet Union republics, had to face all the hardships of this simultaneous transition, aggravated with a natural disaster, military conflict, and transport blockade from the beginning of the reforms.

This research, conducted within the Policy Internship Project, studies the economic development in Armenia, mainly focusing on the economic reforms and patterns of growth and their influence on the process of democratization in the country, aiming to see to what extent these processes are correlated. Because democratization and economic reforms were initiated almost simultaneously, it was considered to be worth studying them in one integral context.

Another purpose of this study is to see how the international donor agencies, represented in Armenia, consider supporting democratization while implementing economic development oriented programs in the country. The reason of focusing on this issue is that international donor organizations are among the major actors sustaining and promoting development and reforms in the countries undergoing transition, helping out the national governments to strengthen democratic institutions, overcome challenges of structural adjustment and social consequences of reforms.

The main purpose of the research is to determine the priorities in the policies of the donors aimed at economic development and democratization, and propose policy recommendations in this regard.

This study is aimed to answer the following research questions that could help to reveal the correlations and issues described above:

Research questions:

1. Is there a correlation between the processes of economic development and democratization in Armenia?
2. How does the economic development of Armenia depend on support and technical assistance provided by international donor organizations?
3. Are the democratization processes considered by donors during the implementation of economic development policies in Armenia?
4. What role do the international development agencies play in mediating the relationships between democracy and economic development in Armenia?

## REVIEW OF THE LITERATURE

### Transition to Market Economy

In the process of transforming a centrally planned economy into a market one, three main areas of reform can be distinguished: (i) the creation of new institutional framework, (ii) macroeconomic stabilization, and (iii) the adjustment of the firms and sectors on the microeconomic level (Yeager 1999, Balcerowicz 1995).

The rules and incentives of centrally planned economies have to be replaced by institutional arrangements that allow market transactions and let firms decide on their production and their investments autonomously. Institutional arrangements are needed for “*systemic transformation*” - for instance, privatization of state owned enterprises, tax reform, protection of property rights, reform in the banking sector or even the creation of new institutions, like the stock exchange. A legal framework is of utmost importance, particularly for ensuring contract enforcement, or for property rights guarantees. Property rights are responsible for long term effects being taken into account in economic calculations and are also a crucial incentive for individuals to do business. Legal and institutional reforms are needed to redefine the role of the state in the economy, establishing the rule of law, and introducing appropriate competition policies (Balcerowicz 1995).

During the transition from a centrally planned economy to a market economy, macroeconomic instabilities arise. The macroeconomic policy is aimed to create stabilizers for normal functioning of the economy such as controlling inflation, reducing budget deficit, stabilizing the value of currency, opening foreign trade, attracting investments, and providing general growth (Yeager 1999, Balcerowicz 1995). Yeager (1999) notes that there is a debate as to whether or not macroeconomic stabilization is necessary for economic growth as these

processes are painful requiring such unpopular “remedies” as cuts in expenditures or increases in taxes. However, many leading IFIs, such as IMF, require that countries undergo stabilization before any funds will be lent to the country.

Transition economies also have to deal with microeconomic issues on their way of replacing the planning system with a market system supported by an institutional framework that allows low-cost transactions (Yeager 1999). The process in general deals with price liberalization and privatization again under the correspondent institutional framework described above.

Among the others, Roland (1999) says that the reforms can be realized in one big step or gradually. At the beginning of the economic reforms in post-Soviet countries there was a dominant idea, which became known as “Washington Consensus” elaborated by international financial institutions (IMF, World Bank, etc), suggesting the transition countries to copy the western economic system by liberalization, stabilization, and privatization, and implement it at, though a painful, but fast rate; so called “shock therapy” (Roland 1999).

It has been intensively discussed in the literature whether the “shock therapy” (i.e. rapid economic reforms and marketization) or rather the gradual reforms approach promises to be more successful (Roland 1999, Blazyca 2003). Psychological aspects and political economy arguments speak well in favor of “shock therapy” approach. After the collapse of the centrally planned economy people are prepared to try a new approach and to make sacrifices for it. For example, real wages in Poland in 1990 and in Czech Republic in 1991 fell by more than 30% within one year (Blazyca 2003). The quicker the necessary painful steps of adjustment are carried out, the quicker the country will get out of the crisis. When the countries of Central Europe introduced the new economic system, they simultaneously changed their political system and introduced democracy. This is another important argument in favor of the “shock therapy”

approach: there is a narrow window for reform. If the fundamental social consensus for reform loses momentum, the government can be replaced; then the consistency of the reform approach can be lost. That was the main argument that led to the predominance of “Washington Consensus” model among the post-communist transition countries.

As an alternative, a gradual approach was discussed in the literature on the transformation (Roland 1999, Blazyca 2003). The argument in favor of the gradual approach implied that the transformation process would turn out to be less hard, if the steps of reform were stretched over a longer period of time. But this requires a “deep breath” for the transformation, particularly a prolonged willingness of people to stand the necessary reform steps. If the willingness to reform is lost in the course of time, the transformation process can come to a halt. The growth rates of Poland (more than 5% after 1993) and the comparatively lower budget deficits of around 3% after 1992, compared to Hungary (deficits of more than 5% in the period of 1993-1995), seem to confirm the advantages of the “shock therapy” (Blazyca 2003). This is all more valid in comparison with the many successor states of the Soviet Union, like Russia, where the reforms were tackled only hesitantly and where the collapse of production was, nevertheless, sizable. Yet, experience of the Czech Republic with the financial crisis in 1997 suggests that the “shock therapy” may lose the support of the voters (Blazyca 2003).

In terms of gradual reform evolutionary-institutionalist perspective was discussed and proposed by academic circles. The main difference of it from the vision of proponents of the “shock therapy” lays in “the attitude towards uncertainty with respect to the outcome of reforms” (Roland 2001, p. 33). The “Washington Consensus” emphasizes with a strong confidence that the reforms will be effective and successful, while the evolutionary-institutionalist perspective

underlines the aggregate uncertainty of transition outcomes meaning that even copying the best economic models, the things may go wrong, given such large-scale changes (Roland 2001).

### Democracy and Economic Development

Socioeconomic development has long been believed to be conducive to the emergence and survival of democracy, so changes in democracy may be related to changes in per capita income. For example, according to the study of A. Przeworski, M. Alvarez, J. Chieub, and F. Limongi (2001) based on the data of World Bank that covered 266 observations, dispelled over time for 84 countries, the level of economic performance and growth makes the probability that democracy will survive very high. For instance, democracy is expected to last about eight years in a country with annual per-capita income of 1000 dollars; and 100 years-between 4000 and 6000 dollars (Przeworski et al 2001). Unfortunately, the study did not cover the new post-Soviet democracies, although it demonstrates in practice a correlation between income per capita and democratization, thus suggesting economic reforms be the major factor promoting democratization.

Yet, there are opinions that the economic reforms should be postponed until the democracy is consolidated, as they bring up social crises (Bunce 2000). Indeed, instead of a short J-shaped growth, most transition post-communist countries in the beginning of the reforms experienced deep recessions. Nevertheless, most of these countries succeeded in sustaining at least a moderate level of democracy despite of sharp economic and political upheavals, military conflicts, and coup attempts. This intensive democratization process is prompted, together with the citizens' wish to live in democracy, by the encouragement and pressure of Western governments, international organizations, and especially EU, which preconditioned their

financial assistance and accession negotiations with the rate and effectiveness of democratic developments within the transition countries. (Fidrmuc 2003).

Many authors, drawn on the experience of Latin America and East Asia, where economic reforms were successful under the authoritarian regimes, were skeptically predisposed to the capacity of the new democratic governments to manage both political and economic reforms without sacrificing one to another (Frye 2006, Maravall 1995). As Haggard and Kaufman (1995) state, “It was thought that either reform would undermine democracy by placing undue strains on fragile polities, or democratic politics would undermine the coherence of policy, generating a downward economic spiral.” (Haggard and Kaufman 1995, p.1). The idea whether “democracy is a requirement for efficient economic markets”, while the latter are “necessary but not sufficient condition for democracy” became a source for many controversies (Maravall 1995). The skeptical approach is based on the hypotheses that authoritarian regimes are the best for economic reforms, which must be introduced before political reforms, and only given a successful economic development, favorable conditions for democracy emerge (Maravall 1995). One of the public expressions of this concept was the speech delivered at the Europe-East Asia Economic Forum in Hong Kong in 1992 by Datuk Seri Mahathir bin Mohamad, prime minister of Malaysia:

“In the former Soviet Union and East European countries democracy was introduced along with the free market. The result is chaos and increased misery. Not only have the countries broken up, mainly through bloody civil wars, but there is actual recession and more hardship for the people than when the Communist ruled...In a number of East Asian countries, while democracy is still eschewed, the free market has been accepted and has brought prosperity. Perhaps it is the authoritarian stability which enabled this to happen. Should we enforce democracy on people who may not be able to handle it and destroy stability?” (Maravall 1995, p.13).

Maravall (1995) explains the strength of the pro-authoritarian arguments with the greater political capacity of dictatorships and higher level of “insulation from pluralistic demands” as



compared with the ones of democratic regimes. The vulnerability to the “demands of immediate consumption” because of a “collective-action<sup>1</sup>” is a major problem for new democracies, as “the short-term interest of social groups in turning economic policies into a distributive game would prevail at the expense of long-term benefits that would eventually have accrued from cooperative sacrifices” (Maravall, 1995, p. 14). This brings to an ineffective distribution of income, an increase in consumption and a corresponding decline in savings and investments, expanding budgets, and increasing fiscal deficits. The political result is instability and even a fall of the regime (Maraval 1995, Sorensen 1994).

Due to the fewer dependants on popular support and even less concerns of the elections, the potential of authoritarian regimes is seen to be greater in implementing unpopular policies. However the success of these policies will be conditioned by the right decisions of the “enlightened” ruler, which in their turn will be the right ones, if the ruler is responsive to the “enlightened” outside pressures (such as international institutions) (Maravall 1995). Alternatively, if the authoritarian regime is corrupt and not “enlightened” it may bring the country to collapse.

In contrast with an authoritarian regime, democracy gives a number of advantages during economic reforms, which speak well in favor for choosing democratic path. For instance, democracy provides mechanisms of feedback when bad governments can be easily replaced. Political pluralism is a guarantee of more and better information that can be used in economic decision-making; democratic institutions provide capacity to reduce transaction costs of economic reform; free press and political opposition are seen as an “early warning system” to

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<sup>1</sup> The issue of “collective action” relates to the difficulty of getting individuals to pursue their joint welfare, as contrasted to individual welfare, and was developed by Mancur Olson in his book *The Logic of Collective Action* (1965). The author argues that a large enough group of rational, self-interested individuals **will not** act to achieve their common interests or group interests.

correct policies. Dependence on the voters promotes “opportunistic and self-serving behavior” of the policy-makers; legitimacy of the government enables to expect more cooperation of the citizens, as far as economic hardships are concerned, and provides greater independence from the economic performance, unlike authoritarian regimes (Maravall 1995).

In general, economic history shows that democracies tend to outperform authoritarian regimes in the long term, because: (i) in democracy property rights are guaranteed, (ii) representative governments have a greater “encompassing” interest in the development of economy than authoritarian rulers, therefore, delivering policies favorable for sustaining growth and prosperity, (iii) democracy promotes higher growth because it lowers economic uncertainty, delivers better institutional outcomes and results in better response to adverse shocks (Fidrmuc 2003).

Some studies show that the countries that are democratized subsequently grow faster than similar countries that shied away from democratization. In contrast, empirical studies based on large cross sections of countries suggest that the relationship is negative (Fidrmuc 2003, Sorensen 1993). Many authors conclude that democracy boosts growth because of its favorable effect on the accumulation of human capital and by reducing income inequality. On the other hand, democracy hinders growth because it negatively affects the accumulation of physical capital, and because democratic countries tend to have greater governments. The overall effect then is moderately negative (Fidrmuc 2003, Sorensen 1993)

This inconclusiveness of theory and empirical evidence raises more questions and leaves a lot of space for further research. Nevertheless, according to the existing studies, the direct impact of democracy on growth is ambiguous, while democracy has a positive effect on progress in implementing market-oriented reforms. As Fidrmuc concludes, “Democracy is clearly not a necessary condition for high growth...as the examples of Chile and China illustrate.

Nevertheless, as the experience of the post-communist transition countries illustrates, democracy results in policies and institutions that facilitate economic reforms and create an environment that is favorable to growth.” (Fidrmuc. 2003, p.602).

Economic liberalization, in turn, has a strong positive effect on growth. It is thus because of this reinforcing effect on economic reforms that democracy indirectly improves growth performance (Fidrmuc 2003, Diamond and Plattner 1995, Frye 2006).

### International Aid in Promoting Democracy and Economic Development

The idea of aid, as it exists now, takes its origin from the post World War II events, when the US Marshall Plan, named after US Secretary of State George C. Marshall (1947-1949) was launched in Europe. It was to endow the economic recovery of war-torn Europe by a massive financial injection into the economies of 16 Western-European countries. This initiative was continued when the newly independent states (former colonies), having discovered how economically weak they were, and realizing that the only way for their development could be foreign aid, applied for help to the developed countries. The latter were ready to supply aid but on their own terms. However, that differed from the Marshall Plan by its longitudinal character: Marshall Plan was “once-for-all” operation (Arnold 1994). Later, with the establishment of bilateral and multilateral agreements between countries on aid, the major donor countries created different agencies like USAID (USA), DFID (UK), and so forth, aimed at providing assistance to the developing countries. The western nations, for example, formed Development Assistance Committee (DAC) in 1960, which coordinated the aid flow. The Soviet bloc created The Council for Mutual Economic Assistance (CMEA) for assisting socialist counties (Arnold 1994).

As far as modern international aid is concerned, authors mention that international actors seeking to promote and support democracy have a number of tools at their disposal to assist

countries. In particular, Knack (2004) distinguishes three ways of assistance: (i) technical assistance, focusing on electoral processes, the strengthening of legislatures and judiciaries as checks on executive power, and the promotion of civil society organizations, including a free press; (ii) conditionality (i.e. providing aid at certain conditions); and (iii) efforts, aimed at improving education and increasing per capita incomes.

Larry Diamond (1995) also underlines three types of donor assistance: (i) political, that may be of a financial or technical nature, but its goal is political: to develop democratic institutions, practices, and capacities; (ii) economic, which can also make a difference, if one presumes that (market-oriented) economic development ultimately encourages democratization, and that economic improvement is at some point necessary to legitimate and sustain a new democracy; and (iii) diplomacy, aid conditionality, and sanctions.

Currently majority of developing countries and countries in transition consider foreign saving as an important factor in their development efforts and they receive it in the form of foreign aid, foreign investment and foreign borrowing. Foreign aid is provided on concessional terms and technically is called official development assistance (ODA). A major form of aid is financial assistance that includes a variety of forms of support: IMF and World Bank loans, EBRD loans and investments<sup>2</sup>, grants from the EU under the PHARE<sup>3</sup> and TACIS<sup>4</sup> programs, initiatives of the G-7<sup>5</sup> and bilateral support, trade credits, humanitarian aid, debt rescheduling and reduction

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<sup>2</sup> IMF, World Bank, and EBRD provide concessional loans (i.e. at much lower interest rates and for much longer time than commercial loans) to developing countries to sustain their economies.

<sup>3</sup> PHARE is one of European Union initiatives to help consolidate the economic and political transitions in Central and Eastern Europe. Originally created in 1989 as the “Poland and Hungary: Assistance for Restructuring their Economies”, PHARE has expanded from Poland and Hungary to currently cover ten countries.

<sup>4</sup> TACIS is technical assistance to CIS countries.

<sup>5</sup> G-7 is a club of seven richest countries. The members are Canada, France, Germany, Japan, Italy, UK, and USA.

agreements with the Paris and London clubs<sup>6</sup>, and others. Also private capital flows play a very important role.

Many foreign aid donors include the promotion of democratic government as a major goal of their aid programs. USAID alone spends more than \$700 million annually on democracy-related programs, including elections support, the strengthening of parliaments, judiciaries and political parties, and fostering the growth and power of “civil society organizations” such as labor unions and women’s and human rights groups (Carothers 1999).

Another effective aid instrument that donor states and IFIs are increasingly inclined to use is conditionality -- “tying desired forms of aid to democracy or political liberalization” (Diamond 1995). Donors often condition grants or loans aimed at general budget support on both economic performance and fostering favorable conditions in the areas of civil liberties, the conduct of elections, and respect for the rule of law. For example, in 1975, section 116 was added to the Foreign Assistance Act, conditioning U.S. aid on respect for human rights and civil liberties (Knack 2004). Albeit, major aid is intended to improve economic growth, most donor nations and numerous multilateral institutions sponsor democracy programs as well. The World Bank, for instance, that do not explicitly promote democratization, commit sizeable resources to “good governance” programs intended to strengthen accountability and the rule of law in recipient countries (Knack 2004).

Despite the fact that many aid recipients have become more democratic, studies generally find that conditioning aid on reform in recipient nations is largely ineffective. For example, Friedman (1958) has argued that foreign aid can undermine democratic government, as most aid goes to governments, thus, strengthening the role of the government sector in general economic activity relatively to the private sector. Democracy and freedom, Friedman (1958) and others have

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<sup>6</sup> Paris and London clubs are the clubs of creditor countries.

argued, are less likely to emerge and to survive where most economic activity is organized by the public sector (Knack 2004). Other scholars argue that aid potentially weakens governmental accountability, as with high levels of aid, recipient governments are accountable primarily to foreign donors rather than to taxpayers, “those with the loudest single voice on revenue and expenditure decisions are international lending agencies.” (Brautigam 1992, p.11).

According to a number of cross-country empirical studies on effectiveness of aid in promoting economic development, the impact of aid on income growth is higher in more democratic nations, as measured by the Freedom House indexes<sup>7</sup> of political rights and civil liberties (Knack 2004). Furthermore, countries with higher scores on the Freedom House indicators have higher economic rates of return on World Bank-financed government projects (Isham et al 1997). Knack (2004) examined the impact of aid on democratic development in a large sample of aid recipients, finding no evidence that aid has promoted or undermined democracy in recipient nations.

## METHODOLOGY

For the purposes of the internship project the content analyses of the official documents and reports, statistical data, internet publications, and political facts, as well as publications in recognized periodicals have been conducted. Particularly, the data of economic performance of Armenia were explored via various sources including Armenian National Statistical Service and reports of IMF, World Bank, and EBRD, concerning economic development of Armenia. Opinions of such INGOs as Freedom House or World Audit were examined with the purpose to get data concerning democratic developments in Armenia and compare them with economic

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<sup>7</sup> Democracy index of countries is based on indicators of political rights and civil liberties reported annually by the Freedom House with the scale of 1 as highest, and 7-the lowest level of democratic reforms.

development indexes of the country. The exploration of the political upheavals connected with the democratization and their influence on the economic performance in Armenia during different periods after the independence have been done.

For collecting other necessary data, the research also included the review of the activities of the major IFIs and bilateral donors, represented in Armenia. In addition, interviews were conducted with the relevant experts and other competent people, who had long-term experience of working in Armenia in the areas of foreign assistance and development programs. The interviews were conducted with the experts from AEPLAC, APRSEP, DFID, RTI International, and UNDP.

## ECONOMIC DEVELOPMENT OF ARMENIA

Armenia was one of the republics of former Soviet Union with highly developed industry. It used to supply the USSR as well as foreign markets with defense and space electronics, electric power, chemicals, fertilizers and pharmaceutical products, rubber and tires, machinery, tools and nonferrous metals, construction materials and stones, textile and apparel, wine, brandy and preserves, and other manufactured goods. Approximately 60% of Net Material Production was industrial, 95% of which was exported. However, after the catastrophic earthquake in 1988 (when nearly 40% of production capacity was lost), the following break-up of Soviet Union in 1991, and military conflict with Azerbaijan for Nagorno-Karabakh, combined with the collapse of its trade, payment and financial systems the Armenian economy was paralyzed. It was the time when Armenia regained independence and declared its intention to start transition towards democratic governance with market economy.

The country's GDP decreased by more than 50% between 1991 and 1993 from its 1989 level. The national currency, the dram, suffered hyperinflation for the first few years after its

introduction in 1993. The economic situation got worse during the military conflict in Nagorno-Karabakh (1992-1994) and the following transportation blockade imposed on the country by Turkey and Azerbaijan. Unsustainable public expenditures and falling revenues together with financial chaos resulted in the budget deficit to be of 55% of GDP in 1993 (Gelbard et al. 2005, IMF 2006).

The country began to recover in 1994, with the adoption of a comprehensive IMF-sponsored economic program that has resulted in positive growth rates in the following decade. Primary steps for economic reforms were taken such as price liberalization, establishment of openness in foreign trade, privatization of state-owned enterprises-- steps that are inherent to the “shock therapy” effect. These processes were further complicated by a lack of experience in entering and positioning in foreign markets, legally regulating market competition and preventing creation of monopolies, and strengthening socioeconomic hardships. Nevertheless, beginning from 1994, possibilities arose for stopping the country’s economic decline and ensuring macroeconomic stability. Armenia also managed to slash inflation and to privatize land and most small and medium enterprises. New sectors, such as precious stone processing and jewelry making, information and communication technology, and tourism are beginning to supplant more traditional sectors of economy such as machine-building and chemical industry. Overall, reforms covered medium-and large-scale privatization, the tax and banking systems, the business environment, and the energy and water sector (Gelbard et al. 2005).

This steady economic progress has earned Armenia further and increasing support from international financial institutions. The IMF, World Bank, EBRD, as well as other IFIs and foreign countries are extending considerable grants and loans. Total loans extended to Armenia since 1993 has reached USD1 billion. These loans are targeted at reducing the budget deficit,



stabilizing the local currency; developing private businesses; reforming the energy, water and municipal heating systems; the agriculture, food processing, transportation, and health and education sectors; and ongoing rehabilitation work in the earthquake zone.

Although starting from an exceptionally low base, Armenia's turn-around has been remarkable. Economic growth has averaged about 8% per year for the past eight years, reaching nearly 14% during 2003, one of the highest in the world (see table 1). Government institutions have been restructured, and the basic institutions of democracy have helped to reorient relations between the public and private sector (Gelbard et al. 2005).

**Table 1: Real GDP Growth in Armenia (percent change over the previous years)**

Year	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
%	5.4	6.9	5.9	3.3	7.2	3.3	6.0	9.6	12.9	13.9

Source: National Statistical Service.

Despite the impressive economic progress, poverty remains widespread throughout the country. Armenia's fifteen-year transition to a free market was characterized by a dramatic decline in living standards with growth benefiting few and income disparities widening; about one third of Armenians live in poverty (see table 2). Even after several years of strong growth, output is still low; per capita GDP was USD1135 in 2004, for the country's estimated 3.2 million residents. Much of the growth that has occurred has been narrowly based and has not had significant employment effects. These issues, among the others, were included in Poverty Reduction Strategy Paper (PRSP) adopted by the government in 2003<sup>8</sup> (IMF 2005).

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<sup>8</sup> The PRSP was elaborated with the wide participation of all stakeholders (governmental agencies, private sector, civil society, and donor community)

**Table 2: Poverty and Inequality in Armenia (1996-2003)**  
(Percent of total population, unless otherwise noted)

	1996	1999	2001	2003
<b>Overall poverty rate</b>	56.7	56.3	47	32
<b>Rural poverty</b>	49	47.7	46	33.9
<b>Extreme poverty</b>	27.7	26.1	16.2	5.5
<b>Gini coefficient (income)<sup>9</sup></b>	0.6	0.59	0.54	0.44
<b>Gini coefficient (consumption)</b>	0.4	0.37	0.38	0.33

Source: IMF

By the end of 2004 EBRD transition indicators (see table 4) positioned Armenia ahead of other CIS countries on all dimensions of structural reforms<sup>10</sup> (Gelbard et al. 2005). In accordance with the Heritage Foundation data, Armenia's general index of economic freedom for 2006 is 2.26, ranking 27<sup>th</sup> and is qualified as mostly free (Heritage Foundation 2006).

**Table 3: EBRD. Transition Indicators of the CIS countries, 2005 (1 little or no progress, 4 advanced progress or similar to the one in developed countries).**

Countries	Enterprises			Markets and Trade			Financial Institutions		Infrastructure
	Large scale privatization	Small scale privatization	Governance & enterprise restructuring	Price liberalization	Trade & foreign exchange system	Competition policy	Banking reform & interest rate liberalization	Securities markets & non-bank financial institutions	Infrastructural reforms
<b>Armenia</b>	<b>4-</b>	<b>4</b>	<b>2+</b>	<b>4+</b>	<b>4+</b>	<b>2+</b>	<b>3-</b>	<b>2</b>	<b>2+</b>
Azerbaijan	2	4-	2+	4	4	2	2+	2-	2
Belarus	1	2+	1	3-	2+	2	2-	2	1+
Georgia	4-	4	2+	4+	4+	2	3-	2-	2+
Kazakhstan	3	4	2	4	3+	2	3	2+	2+
Kyrgyzstan	4-	4	2	4+	4+	2	2+	2	2
Moldova	3	3+	2	4-	4+	2	4-	2	2+
Russia	3	4	2+	4	3+	2+	2	3-	3-
Tajikistan	2+	4	2-	4-	3+	2-	2	1	1+
Turkmenistan	1	2	1	3-	1	1	1	1	1
Ukraine	3	4	2	4	3+	2+	3-	2+	2
Uzbekistan	3-	3	2-	3-	3-	2-	2-	2	2-

<sup>9</sup> Ranges from 0 (perfect equality) to 1 (total inequality)

<sup>10</sup> The progress in implementing economic reforms is measured by the progress-in-transition indicators published by the European Bank for Reconstruction and Development (EBRD).

However, it must be noted that economic development has many other dimensions than merely growing GDP and progress of reforms. It includes such components as poverty rate, income distribution, social equity, demographic trends, and others. Thus, the overall picture of economic development is not that encouraging as the one of economic growth, because the poverty rates, though decreasing, are still high, and the gap between the poorest and richest population is huge (see table 2). The country is facing declining population growth due to falling birth rate and high emigration rates in 90s.

Nonetheless, despite of the above mentioned factors, some progress in economic development can be stated and, in our opinion, it is in more noticeable than democratic achievements, described below.

#### DEMOCRACY IN ARMENIA

After the declaration of independence, in the beginning of the 1990-s in Armenia as well as in all other parts of the former Soviet Union, mass national movements and the political structures they formed, first of all replaced the centralized authoritarian ruling model with a democratic, representational form of governance. The implantation of new social ideas took place as a result of devaluation of the communist ideology on the one hand, and the desire to acquire the experiences of Western free markets and democracies with all their social **liberties** and economic aspects, on the other.

Overall, it can be stated that democratic reforms fell onto a well fertilized soil of discontent with authoritarian communist regimes; people were prepared for such reforms and there was social consensus on the necessity to move away from anti-democratic traditions of the past (this consensus varied from country to country, the influence of Communists still being strong in Russia and Belarus).

In the past decade and a half Armenia has made significant progress in moving away from authoritarian rule towards more democratic governance. At the same time, serious drawbacks have accompanied the process of reforms. As it was described above, the independence of Armenia in the beginning led to disintegration of regional economic ties which, among other factors, contributed to increased unemployment and the impoverishment of many people. The withdrawal of total state control and supervision in many areas provided a fertilized soil for flourishing of corruption and fraud. On the other hand, people were not prepared to such a fast retreat of state from delivery of many benefits which were taken as granted in the past (free medical service, guaranteed job, low subsidized prices for food and utilities etc.)

Significant steps have been taken towards establishing a legal framework for the foundation of democratic practices and values in the country. For example, the adoption of the Constitution (1995), and the laws on local self-government (1996, new law passed in 2002), non-profit organizations (2001), political parties (2002), professional associations (2001), and others have laid a firm ground for democratic development in Armenia. International treaties and conventions signed by Armenia -- including the Universal Declaration of Human Rights and the European Charter of Local Self-Government -- have played a key role in establishing standards for the relevant legislation. Armenian political system includes more than 100 registered political parties; nearly 3,000 non-profit organizations and foundations; 26 professional unions with affiliated branches; the mass media in the form of more than 120 printed publications, about 20 private television channels and 12 creative unions in radio; more than 50 registered religious organizations; the offices and representatives of international organizations; and many others (IDEA 2003).

The analyses of the activity and the dynamic of developments of the Armenian political parties and other actors demonstrate that political field is not yet fully developed in Armenia. If in 1991–1994 the process of the emergence of political parties was comparatively democratic and open, since 1994 parties started to form not on the basis of ideology or political preferences but rather on the basis of the personal goals of their founders, in most cases lacking any kind of real ideology (IDEA 2003).

A range of civil society organizations have become rather active during recent years. Currently almost all Armenian interest groups are registered as non-profit organizations. Activities of NGOs are mainly focused on providing social services and assisting the socially disadvantaged sections of the population rather than on stimulating democratic processes or protecting human rights. For the most part, they are financed by international or foreign organizations and foundations and, therefore, tend to be directed by these organizations. Few of them manage to maintain their independence or ability to act in accordance with their missions (Freedom House 2006, IDEA 2003).

The first parliamentary elections of independent Armenia took place in 1995 as formally the 1990 elections of the Supreme Council were held under the jurisdiction of the Soviet government. Regardless of the different evaluations, those elections were unique for Armenia: parliamentary elections were combined with the referendum on the first Constitution of independent Armenia. As a result of a referendum the Constitution was adopted, and a new legislative entity was formed -- the National Assembly. People's will was expressed freely and had not encountered any pressures. Subsequent elections to the National Assembly in 1999 and 2003 were strongly criticized by the international community, independent experts and opposition for being held with numerous violations and for not corresponding to the international

standards. The presidential elections in 1996, then (after resignation of President Levon Ter-Petrosyan) in 1998, and 2003 were also conducted with numerous violations and falsifications and confirmed the opinion of independent observers that Armenian government still fails to conduct fair elections. The referendum on the amendments to the Constitution held in 2005, though expressed the will of the majority, was also criticized by observers for violations.

The situation, however, is believed to improve due to such initiatives of the government as membership to the Council of Europe together with the declared intention to join EU and to adhere to the European standards.

Overall, the democratic development of Armenia has proceeded unevenly during the post-independence years. In accordance with the opinion of many leading international organizations such as Freedom House or IDEA, the absence of an effective system of checks and balances, the concentration of power in the presidency, weak and corrupt judiciary power, and the centralized system of government have fostered weak governance and widespread corruption in the country. This has been strengthened by the close links and growing merger between the country's political and business elites, which have impeded the development of a more transparent political system. Elections have generally failed to meet international standards, contributing to public cynicism toward the authorities and skepticism about the value of participating in political and civic activities (Freedom House 2006, IDEA 2003). The election process requires “legislation improvement, reinforcement of implementation mechanisms, and mature public awareness” (UNDP 2001 p.11). Despite of the legal framework for democratic governance was established during these years, the implementation of democratic practices remains weak. Armenia has not yet turned into a state ruled by law. According to the democracy index of Freedom House for 2006, Armenia has a score of 5.14 (see table 4), which corresponds to a country with “semi-

consolidated authoritarian regime” (Freedom House 2006). This is in line with another estimation of democracy in Armenia, done by the World Democracy Audit, according to which Armenia is 105th out of 150 countries (see table 5) on democratic development (World Democracy Audit 2006).

**Table 4: Democracy Scores of Armenia**

<b>Years</b>	<b>1997</b>	<b>1998</b>	<b>1999</b>	<b>2001</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>
<b>Electoral Process</b>	5.50	5.75	5.25	5.50	5.50	5.50	5.75	5.75	5.75
<b>Civil Society</b>	3.50	3.50	3.50	3.50	3.5	3.50	3.5	3.50	3.50
<b>Independent Media</b>	5.25	5.25	4.75	4.75	4.75	5.00	5.25	5.50	5.50
<b>Governance</b>	4.50	4.50	4.50	4.50	4.5	4.75	4.75	n/a	n/a
<b>National Democratic Governance</b>	n/a	n/a	n/a	n/a	n/a	n/a	n/a	5.00	5.00
<b>Local Democratic Governance</b>	n/a	n/a	n/a	n/a	n/a	n/a	n/a	5.50	5.50
<b>Judicial Framework &amp; Independence</b>	4.75	5.00	5.00	5.00	5.00	5.00	5.00	5.25	5.00
<b>Corruption</b>			5.75	5.75	5.75	5.75	5.75	5.75	5.75
<b>Democracy score</b>	4.70	4.80	4.79	4.83	4.83	4.92	5.00	5.18	5.14

The ratings are based on a scale of 1 to 7, with 1 representing the highest level of democratic progress and 7 the lowest. The Democracy Score is an average of ratings for the categories tracked in a given year.

Source: Freedom House

**Table 5: Most recent World Democracy Audit scores and rankings achieved by Armenia (Lower scores are preferable)**

	<b>Range</b>	<b>Results</b>
<b>World Democracy Audit overall ranking</b>	1-150	105
<b>Political Rights</b>	1-7	5
<b>Civil Liberties</b>	1-7	4
<b>Press Freedom</b>	0-100	100
<b>Corruption</b>	0-100	76

Source: World Democracy Audit.

## THE MAIN IFIs, MULTILATERAL AND BILATERAL DONORS IN ARMENIA

A large number of donors and some major IFIs have extensive programs in Armenia, many of them being started since the first years of reforms and transition (see the Appendix, tables 1 and 2). The following are the main international organizations, operating in the country.

### Major International Financial Institutions

#### *International Monetary Fund (IMF)*

Armenia received the membership of the IMF in 1992. Since then, the IMF has provided programs to support macroeconomic stabilization and structural reforms in Armenia, including the Poverty Reduction and Growth Facility (PRGF). Following successful resolution of the IMF's discussion with the government on reform of the tax system, a new USD 34 million program under PRGF was approved by the IMF Board in June 2005 (EBRD 2006).

#### *The World Bank (WB)*

The World Bank is the largest multilateral donor in Armenia. The scope of its activity -- the widest in the country, spreads over natural resource management and poverty reduction, foreign investment and export promotion, information technologies, infrastructure, education, health, social sector, agricultural reform, municipal development, transport, and judicial reform. Armenia joined the IBRD in 1992 and the International Development Association<sup>11</sup> (IDA) in 1993. The IDA lending has helped to finance infrastructure rehabilitation, including support for earthquake reconstruction, irrigation, power, road maintenance, and municipal water. The IDA also provided credits to support the social safety net and improve access to social services, including operations in health, education, and helped to establish Social Investment Fund, aimed

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<sup>11</sup> These two institutions are collectively known as the World Bank. IDA provides soft loans on concessional terms to the poorest countries in the world and only to governments. Its loans are usually for 50 years and without interest.



at improving basic social and economic infrastructure in communities. The WB has committed to Armenia about USD 900 million, divided among 40 projects. Armenia has been a member of the International Finance Corporation<sup>12</sup> (IFC) since 1995. The IFC is mainly providing donor-funded technical assistance to improve the investment climate by promoting modern corporate governance practices, including legislative amendments (WB 2004, EBRD 2006).

#### *European Bank of Reconstruction and Development (EBRD)*

EBRD concentrates on private sector development through a line of credit for SMEs, a Business Advisory Program, and trade facilitation.

#### *The Black Sea Trade Development Bank (BSTDB)*

The BSTDB started operations in Armenia in February 2003 by launching an SME financial program together with Izmirlyan Foundation<sup>13</sup>. The programme provides loans to SMEs with up to 5 year maturity, in the amount of up to USD 500,000 to finance capital expenditures and working capital. The main priorities of the BSTDB in Armenia for the forthcoming years remain SME financing with emphasis on transport, food processing, and manufacturing (EBRD 2006).

### Main Multilateral and Bilateral Donors

#### *UNDP*

UNDP supports a broad range of activities in Armenia, and works closely with IDA on many of its programs. It has a major program, helping the government to develop systems to monitor development results. Another key area of focus is improving delivery of public services at central and local levels, including governance, judicial reform, local government strengthening and improvement of social protection administration. UNDP also promotes support infrastructure for small and medium size enterprises. In rural areas, it has a program to promote agriculture-

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<sup>12</sup> IFC is the affiliate of the WB aimed at providing support to private sector.

<sup>13</sup> A Swiss-Armenian investment and charity organization

based employment opportunities and agricultural services, as well as helping protect Armenia's biodiversity. UNDP programs help to rehabilitate community infrastructure, build capacity for monitoring quality of drinking water, and improve energy efficiency. The total volume of UNDP programs in Armenia for 1993-2004 amounted to USD21 million, which included UNDP core resources and donor cost-sharing (UNDP 2006).

### *The European Union (EU)*

Cooperation between the EU and Armenia has focused on development of political institutions, the rule of law and human rights, regional stability, economic and social reforms, including gradual participation of Armenia in the EU market. In 1991-2003, the EU provided Armenia with EUR331.9 million in assistance (not counting member states' bilateral programs), primarily through TACIS, Food Security Programme, and ECHO. In 2004-2006 the EU assistance to Armenia is estimated at EUR55 million. Co-operation between the EU and Armenia should further increase with the inclusion of Armenia in the European Neighbourhood Programme (ENP).

Armenia has benefited from regional programmes such as TRACECA and INOGATE. The current framework for EC assistance is the Country Strategy Paper (CSP) 2002-2006 which is based on the objectives of the Partnership and Cooperation. The budgetary support of around EUR10 million per annum provided by the EC Food Security Programme is contributing to the implementation of key structural reforms in the agricultural and social sectors and to improved delivery of certain government programmes in line with PRSP orientations. Within the framework of the CSP, the TACIS Indicative Programme 2004-2006 has been adopted by EC in September 2003. The main pillars of the programme are (i) support for institutional, legal and administrative reform (including legal advice, assistance to customs and statistics, energy policy

reform, local government decentralization/reform and regional development, and civil society) and (ii) measures to address the social consequences of transition (focusing on poverty alleviation via agricultural and social protection policies, education and vocational and technical training). The EC's budget for Armenia for 2004-2006 is EUR20 million (AEPLAC and DFID 2006, EBRD 2006).

### *United States*

Since the opening of the U.S. Mission in 1992, the United States has provided over USD 1.7 billion dollars worth of assistance to Armenia. The government assistance from United States is provided primarily through the US Agency for International Development (USAID). The USAID mission in Armenia has a strategic program for 2004-2008 that covers seven strategic objectives: cross-cutting, education, democracy and governance, healthcare, private sector, social protection, and water and energy. Current programs include economic restructuring, energy sector reform, healthcare, democracy and government, and agricultural support.

USAID mission in Armenia has an office for democracy programs that, particularly, aim to increase citizen participation in local and national government, develop NGOs and independent media, promote civic education in secondary schools, strengthen local government and the legislature, and support legal reform. USAID plans to achieve more democratic governance by implementing the programs in the following areas: (i) Citizen Awareness and Participation, (ii) Independent Media, (iii) Civic Education Program, (iv) Local Government Program, (v) NGO Strengthening Program, (vi) Legislative Strengthening, and (vii) Legal and Judicial Reform.

In 2004, Armenia, among the other 16 countries, was selected by the US Government as eligible to apply for Millennium Challenge Account (MCA). Armenia has applied to the

Millennium Challenge Corporation for USD 235 million in assistance to support development of rural infrastructure (roads and irrigation) and received an approval (EBRD 2006, USAID 2006).

### *Germany*

The main directions for assistance provided by the federal government of Germany to Armenia are the projects implemented by GTZ, and KfW, which first opened its office in Armenia in 1998. The main focus of CTZ is on technical cooperation, including local government reform, promotion of rule of law, and promotion of SME activities. GTZ-sponsored current projects in Armenia are estimated total EUR14.3 million. KfW has provided assistance to SMEs through local banks via the German-Armenian Fund (EUR19 million). Other ongoing projects total EUR38 million, and include rehabilitation of water and wastewater systems in selected regions (EUR14.5 million), rehabilitation of power transmission (EUR8.9 million), and a credit guarantee fund (EUR6.8 million) (EBRD 2006, WB 2004).

### *United Kingdom*

The main implementing agency for direct UK Government assistance to Armenia is the Department for International Development (DFID). Starting its activities since 1996, DFID has implemented a variety of programs and projects on public sector reform, sustaining social initiatives, and on integrated regional development in two marzes (Tavoush and Gegharqunik). It has supported both PRSP and MTEF processes. In 2003, DFID and the government of Armenia launched the Armenia Public Sector Reform Programme (APSREP). This project, implemented by PricewaterhouseCoopers (PwC), is called to improve the efficiency, effectiveness, accountability, transparency, and responsiveness of public administration in Armenia. APSREP is one of the directions of a wider programme of donor assistance to the GoA, which includes the DFID Armenia Regional Development Project (ARDEP) and the World Bank's Public Sector

Modernization Programme (PSMP), designed to contribute to poverty reduction in Armenia and to increase the capacity of individuals and groups to participate in, and shape the transition to a democracy and market economy. One of the project goals is to help ensure that citizens, the media, and civil society organizations can contribute to the effectiveness of public sector policy formulation through increased participation in policy debates, especially in the three APSREP counterpart ministries, the Ministry of Health, the Ministry of Education and Science, and the Ministry of Labour and Social Issues.

Currently ongoing projects of DFID in Armenia have a combined budget of GBP11 million (DFID 2006).

#### *Japan*

Government of Japan began its bilateral assistance (ODA) to Armenia in 1991. Over USD 30 million has been disbursed at the end of 2003. The priority areas of Japanese assistance are (i) consolidating the basic economic structure, (ii) the energy sector, (iii) transport infrastructure, (iv) improvement of the irrigation and water supply systems, and (v) the social sector (health and medical care, education, and mitigating hardships faced by the unemployed and the low-income population).

Implementation of a JPY 5.4 billion loan for an electricity transmission and distribution network project began in 2001. A loan of JPY15.92 billion was made in 2005 to finance the Yerevan Combined Cycle Co-Generation Power Plant project (EBRD 2006).

#### *The Netherlands*

The priorities of bilateral assistance of the Netherlands to Armenia mainly focus on strengthening public sector reform and good (economic) governance (EBRD 2006).

## INTERVIEWS WITH EXPERTS

As it was mentioned above, with the purpose of getting necessary information for the study, in-depth interviews with the experts from relevant fields were conducted. In order to have a variety of opinions, it was decided to have interviews with experts from the agencies representing different countries and being different in nature (ex. bilateral and multilateral). Interviews were conducted in the following agencies: AEPLAC, representing EU, APRSEP – one of the projects of DFID, DFID – representing UK, RTI International – one of the programs of USAID, and UNDP – representing a multilateral donor. The issues, discussed during the interviews touched various aspects of donors' activities in Armenia, namely concerning the democratization developments in the country in light of economic development, the role of donor agencies in these processes, their own evaluation of these developments, and many others. Below, the summary of the interviews is presented.

*Interview with Samuel Coxson, Chief of Party, Local Government Project Phase 3, USAID/RTI International.*

Concerning the relations between democracy and economic development, Mr. Coxson noted that economic growth can be a necessary condition for democracy but not sufficient. Progress in economy requires a certain level of democracy, albeit does not necessarily support the democratic progress like, for example, in China, Russia, and other countries. Mr. Coxson considers the balanced approach to democracy and growth to be the best outcome.

Regarding the international donors in Armenia, Mr. Coxson thinks that the major ones like the IMF or World Bank commit a lot of financial resources to the government, but people mainly do not benefit from that aid. Other donors (USAID, DFID, GTZ, UNDP, and others) mostly focus on specific programs, providing incremental, day to day, assistance, which is closer to the

needs of people. Their role in democratization is at this daily work level, not at the level of big theories. The contribution of donors to the democratic process in Armenia can be demonstrated by the following:

- increasing degree of participation of citizens in decision-making
- increasing their capacity to use their rights and power
- acquired knowledge on how to use new resources and opportunities given to local governments by the Constitution
- improving economic and social conditions.

Mr. Coxson underlines that there is a big drive and willingness on the side of the representatives of local governments towards democratization.

*Interview with Stephen J. Avalyan Newton, Project Team Leader, APSREP*

Mr. Newton underlined the primary role of economic development during transition rather than democratization, as, unless the basic socio-economic needs are satisfied, people will not be ready to accept and apply democratic values. Yet, the private sector is still weak in Armenia, despite of the overall economic growth, which is mainly due to remittances. There are many problems in developing the private business, particularly, imperfect tax system that favors the black market. Mr. Newton emphasized the capacity of the government to regulate properly its policies in this regard. When economic hardships are behind, democracy will be forced by people. However, a lot has to be done in Armenia, and not to a less extend by means of donors, to establish the correct perception of democracy by people and their expectations from the government. This depends on the citizens' awareness of their rights and opportunities and their capacity to use them. In this regard donors should concentrate more on strengthening the rule of law and introducing publicity via proper education and trainings.

Regarding the appropriateness of applying conditionality by donors, Mr. Newton underlined that the vision and strategic objectives of donors should not be imposed on but agreed with the recipient government, without much interference into the domestic policies. Otherwise, there would not be effective cooperation, “donors have got to sell their ideas, instead of enforcing them”, concluded Mr. Newton.

*Interview with Ashot Iskandaryan, AEPLAC*

Concerning the successful economic growth of Armenia, Mr. Iskandaryan does not tend to link it with any specific factor; he thinks that this growth is natural, and it should have taken place anyway, according to the market laws. Of course, the growth probably would not have been so much remarkable without the endeavors of the government with the help of donors to slash inflation, cut the budget deficit, and improve the general macroeconomic performance, which in turn positively impact the private sector.

Albeit Mr. Iskandaryan does not have illusions regarding the success of democratization in Armenia, he is sure that the process of integration into the European structures like the possible membership to the Council of Europe and involvement into the ENP may have positive effect on the development of democracy in the country. Armenia is looking for economic and political benefits from the integration into the EU market. However, integration into European structures is conditioned by numerous requirements that the EU imposes upon our country. Following the requirements of EU, which are not focused on specific sectors but have broad and comprehensive approach, the country has done a big step towards the democratization as well. Particularly, in terms of National Program<sup>14</sup> a large number of legislative amendments are being

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<sup>14</sup> In 2003 the Armenian government initiated the elaboration of the Partnership and Cooperation Agreement (PCA) implementation National Program, with the aim to plan and organize the process of legal approximation and other relevant processes of institution and capacity building in accordance with the obligations under the PCA signed with the EU and the EU member countries, which entered into force in 1999.



prepared by the experts of AEPLAC to be implemented in Armenia that along with widening economic opportunities will strengthen democratic principles in the country.

*Interview with Victoria Gevorgyan, Programme Officer, DFID.*

Regarding the dependence of Armenia on donors, Mrs. Gevorgyan noted that there is a quality change in providing aid now as compared with the early years of donor's activity in the country. Initially, the aid was more of humanitarian character; and Armenia highly depended on it. Then, due to the conditionality, it took a mandatory, supply-driven characteristic, when the government had to follow the donor's requirements in order to get aid. Today the patterns of international aid are different, and the aid is becoming demand-driven, i.e. based on the demands of the country. The nature of the aid has also changed from specific problem-oriented projects to comprehensive programs. However, the dependency still exists as the sources of current economic growth – constructions and some industrial sectors like diamond processing – cannot be sufficient for general growth without well-developed industry, which is growing very slowly today. Mrs. Gevorgyan considers the assessment of growth based on the indicators of a particular sector to be incorrect, as it leads to erroneous conclusions.

As far as democratization is concerned, Mrs. Gevorgyan is sure that the programs of donors carry a positive impact on democratization, as they are originally based on democratic values, which are transferred to the Armenian society through these programs. Mrs. Gevorgyan underlined the role of NGOs that, to a great extent, have become very active with the help of donors and are able to contribute much to democracy building. Unfortunately, the results of overall development can be seen mainly in Yerevan and its suburbs, while other marzes are still lagging well behind in all dimensions of development. Donors have the potential to improve the situation via more coordination and cooperation. Albeit some efforts, are being made, like Donor

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Coordination Group monthly meetings, carrying mostly informative character, the donors still do not come up with effectively coordinated actions. The role of the government in managing the flows of development assistance and coordinating the donors is very important, but unfortunately the government is not proactive in this sense

*Interview with Alla Bakunts UNDP*

Mrs. Bakunts confirmed the opinion of the other experts that have been interviewed concerning the role of donors in democracy building in Armenia. She particularly noted that despite donors' activity in this regard, yet the lack of coordination from the side of the government impedes the process. Donors cannot coordinate their activity without the support of the government, and therefore sometimes the programs overlap, wasting their valuable time and resources. The creation of donor coordination database would be of great use.

UNDP conducts its programs with close collaboration with the government and is very flexible, always finding alternative for reaching consensus. Mrs. Bakunts sees the role of donors in promoting democratic values in Armenia via increasing the sense of national ownership and overcoming the apathy and disappointment that many citizens have. It can be done through more active involvement of people in decision-making process and participation in adoption of governmental projects.

To conclude the opinions and remarks of the interviewed experts it can be stated that donors consider democratization as one of the key aspects for overall development of Armenia and have a capacity for supporting democratic initiatives. However, lack of a proper coordination of their efforts, especially from the side of the government, hinders this process, particularly, and overall donors' activity, generally. The experts also emphasized the problems that Armenia faces currently on its way to prosperity and democratic governance and underlined the necessity of

integrating the society into the solution of these problems with an active assistance of donor agencies.

## FINDINGS

As a result of this study, during which an analysis of various official documents, statistics, reports, publications, etc. have been done together with in-depth interviews with the relevant experts, the following has been revealed.

Armenia experienced dramatic contraction of economic activity at the outset of economic reforms and reached the bottom of transformational recession during the disastrous period from 1992 to 1994. Afterwards, the country started to recover at rather impressive rates of GDP growth due to the economic and political reforms.

However, democracy can hardly account for this progress in economic growth, or at least affected the growth indirectly. Albeit the government has succeeded in creating appropriate legislative framework and establishing the basic democratic institutions, the implementation of democratic practices yet remains weak in the country. According to the democracy index of Freedom House, Armenia has very low democratic progress and is categorized to be a country with semi-consolidated authoritarian regime. The comparison between the Freedom House scores of political rights and civil liberties and annual rates of economic growth indicates that there is no direct relationship between democracy and economic growth in Armenia.

What democracy can account for in economic development of Armenia is the progress in implementing market oriented reforms. As it was discussed above, Armenia initiated almost simultaneous transition to democracy and market economy. However, chronologically, political changes (moving from communist regime to democratic governance) preceded economic liberalization. Democratically elected government started economic liberalization, aiming to quit

central planning economy and move towards market economy, choosing a “shock therapy” model of transformation. Later on this brought to full-scale structural reforms, including privatization, price liberalization, openness of foreign trade, etc. For example, in accordance with the transition indicators of EBRD for 2005, Armenia was positioned ahead of other CIS countries in all dimensions of structural reforms (see table 4). Economic freedom of the country is also progressing, according to the data of Heritage Foundation.

This suggests that democratization, though being in embryonic state in early 90s, became a driving force to push forward economic reforms in the country.

However, in order to conclude that democracy promotes economic reforms, it is important to find out why this relationship exists. Analysis of the developments of both democratization and economic development illustrate that these processes are, to a large extent, driven by another common factor -- international donor agencies operating in Armenia. The intention to join the Western community and enjoy all the benefits (mainly economic) promised by such cooperation is largely responsible for driving forward both economic and democratic reforms. Bilateral cooperation between Armenia and international community takes its start from the very beginning of existence of the Republic of Armenia as a sovereign state. Donor agencies have been very active in supporting the country in its development efforts and played a significant role in sustaining both democracy and economic development of the country. Comprehensive economic reforms, initiated in 1994, were sponsored by one of the major donor in Armenia – IMF. Donors supported the reforms and provided various kinds of assistance (technical, financial, humanitarian, etc) to all efforts of Armenian government to establish democratic institutions in the country. For example, from the period from 1991 to 2006 more than USD2.5 billion of ODA was transferred to Armenia (see the Appendix, table 2). ODA comprises a

considerable percentage of GDP and per capita income (see table 6). This proves that Armenia is still dependent from international aid, though not so much as during 90s. The participation in US government's MCA program is a vivid evidence of confirming the importance of international aid for Armenia.

**Table 6: Total Net ODA in Armenia (1997-2000)**

<b>Year</b>	<b>1997</b>	<b>1998</b>	<b>1999</b>	<b>2000</b>
<b>USD millions</b>	151	119	98	103
<b>As % of GDP</b>	9.3	6.3	5.3	5.4
<b>Per capita (USD)</b>	39	31	26	27

Source: UNDP

The review of the programs, implemented by donors, illustrates that the main sectors of their focus are: improvements of macroeconomic performance, good governance, including public sector reforms, assistance to some sectoral reforms (energy, water), regional and local governance development, SME support, etc. These all are aimed at improving economic development (see appendix).

However, there are such activities in the agendas of donor organizations, which are called to sustain and enroot democratic principles in Armenia, namely considering the rule of law, protecting human rights, promoting citizens' participation and awareness, decentralization and strengthening of local government. This implies that democratization is considered by donors as an integral part of implementing economic development oriented programs in Armenia.

## ANALYSIS

Findings of this study enable to reach the following conclusions in response to the research questions. Concerning the correlation between the democratization processes and economic

development in Armenia, no direct correlation was found between the economic development and democratization in the country. Despite of the remarkable growth rates democratic index of Armenia is still very low. However, democratization processes had positive effect on the economic reforms in the country due to the economic liberalization, initiated by the democratically elected government. Yet it must be mentioned that this conclusion is done based on the analysis of general process of democratic and economic developments. The picture could be different if the regression analysis is done in this regard to show the statistical significance of this correlation, taking into account such factors like the impact of neighbour countries or the level of political stability in the region.

As far as international donors are concerned, their contribution to the overall development of the country is significant, as the scope of their activity includes almost all the sectors of Armenian both political and economic performance. Despite the high growth rates, Armenia needs the financial, technical and other assistance of donors, given still lagging democratic development and depreciated infrastructure of the country. The participation to MCA and close integration into EU structures confirm the importance of such initiatives for Armenia on its way to become a fully developed (in both economic and democratic sense) country. On the other hand MCA funding is strongly conditioned by further progress in democratic reforms and may be even discontinued in case the government of Armenia is unable to demonstrate vivid progress in this area.

In light of the aforesaid and regarding the review of the programs together with the opinions of the interviewed experts, it can be concluded that donors are concerned with assisting in both economic reforms and democratization processes in the country and, hence, their role in mediating the relationship between these processes remains highly important.

## POLICY RECOMMENDATIONS

The issues discussed in this paper led to come up with the following policy recommendations to the donor agencies, operating in Armenia.

- As the review of the programs implemented by the donors in the county showed, a relatively large number of donors have large-scale programs in Armenia, with a number of overlapping ones, requiring active management and coordination. To avoid overlap in programs it would be useful to consolidate and harmonize the actions of donors in order to implement similar programs via coordinated actions. The role of the government in managing and coordinating donors has weakened since the late 1990s, when the office in the Ministry of Finance and Economy, designated to monitor donor activities, began to play a less central role in the process. UNDP and IDA are helping to strengthen this function. In the last few years, independently of the government, donors have been meeting regularly to share information, coordinate plans and programs, and reduce duplication. However, these meetings usually carry an informative character, remaining less effective in coordinating efforts.
- It is recommended to form and coordinate groups of donors with common experience and interest in a particular field or sector and pool their resources together. With united budgets and resources the overall outcome of the programs would be of greater effectiveness and wider scale.
- The issue of sustainability of implemented projects remains central in development assistance. Programs once started by donors and then transferred to beneficiaries (either central, local government, or NGOs) often become discontinued. As experience has showed, very often, many of these programs, claimed to be successful, had been closed

afterwards, becoming a waste of time and resources of donors. It would be useful if the party, benefiting from the program, would provide matching funds or any other type of contribution (in-kind, labor) to the financing of the project. This would increase the responsibility of beneficiaries and contribute to sustain functioning of the program.

- Monopolization of markets is one of the major problems in Armenia as it hinders the development of free market competition. Less tolerance to the monopolization efforts and more antimonopoly oriented programs will contribute to strengthening of democratic patterns of business through providing equal opportunities to all business entities.
- The huge gap in socioeconomic development between Yerevan and marzes should be filled. Substantial funds should be directed to the development of rural areas in order to provide even development throughout the country.
- People are passive in participating in the decision-making processes because of unawareness of their rights and opportunities, provided by the legislature or inability to defend their rights. More programs oriented to raising the awareness and civic activity of people are still of great need.

## CONCLUSION

In light of the issues discussed above, it can be concluded that economic development and democratization processes in Armenia, though being initiated simultaneously, did not develop in parallel directions and at similar rates. Economic development, having been prioritized during reforms, is at the higher level than progress in democratic reforms in the country. Yet, these processes have been pushed forward profoundly by a common driving force that played and keeps playing a big role in developing both economy and democracy in Armenia. This force is the Official Development Assistance received from international donor agencies, represented in



Armenia, which views democratization processes in the context of economic development programs, implemented by them in the country, thus becoming one of the major watchdogs for promoting democratic practices in the country within the scope of overall development of the republic.

However, the findings of the research show a general picture, without going into the details of all the sectors of both economic and democratic processes and comparing them, for example, via regression analyses. This could be a subject of a further research, taking into account many other variables like the regional development, or still continuing transportation blockade and other issues hindering further economic development in Armenia.

Larry Diamond, in his lecture at the Center for the Study of Democracy, University of California, in 2003, underlined the importance of economic integration and aid in democratization processes, particularly mentioning that:

“If we can manage more or less to sustain the process of global economic integration and growth, while making freedom at least an important priority in our diplomacy, aid, and other international engagements, I think democracy will continue to expand in the world. History has proven that it is the best form of government. And gradually -- probably not in my lifetime...-- virtually every country in the world may be democratic.” (Diamond 2003, p.26).

APPENDIX

**Table 1. Partnership between National Agencies and Donors in Armenia**

<b>Sector</b>	<b>Lead National Agency</b>	<b>Partners</b>
Donor Coordination	Ministry of Finance and Economy, PRSP Steering Committee	All donors
Poverty Reduction	PRSP Steering Committee	IMF, UNDP, USAID, UHCR, NGOs, EU, GTZ, DFID, UNICEF
Governance, Corruption	Public Sector Reform Committee, different ministries, agencies, National Assembly	IMF, EU, DFID, USAID, GTZ, UNDP, NGOs
Health	Ministry of Health	USAID, UNDP, WHO, UNICEF, UNHCR, GTZ, Global Fund
Transport	Ministry of Transport and Communications	Lincy Foundation, EU, UNDP, USAID, IFAD
Education	Ministry of Education and Science	UNICEF, EU, UNHCR, WFP, GTZ
Agriculture, Food Safety, Rural Development	Ministry of Agriculture, Ministry of Territorial Administration	EU, FAO, WFP, IFAD, USDA, GTZ, UNCHR, DFID, UNDP, USAID, UNIDO, NGOs
Decentralization	Ministry of Territorial Administration	USAID, EU, UNDP
Energy, Heating	Ministry of Finance and Economy, Ministry of Energy, PSRC	EBRD, JBIC, EU, USAID, GTZ, IMF, UNDP
Private Sector	Ministry of Trade and Economic Development, Armenian Development Agency	USAID, GTZ, UK, EBRD, EU, Eurasia Foundation, IMF, UNDP
Natural Resources, Environment (including water resources management)	Ministry of Nature Protection, Ministry of Territorial Administration (State Committee on Water Systems), PSRC, Ministry of Health	UNDP, EU, FAO, UNIDO, USAID, EBRD, GTZ, UNEP, NGOs
Financial Sector	Central Bank, Ministry of Finance and Economy, Securities Commission	IMF, USAID, USDA, GTZ, EBRD
Social Protection	Ministry of Labor and Social Issues	UNDP, UNHCR, USAID, EU, UNICEF, NGOs

**Table 2. Main IFIs and Donors in Armenia**

<b>IFI/Donor</b>	<b>Since</b>	<b>Scope of activity</b>	<b>ODA committed (aprox.)</b>
World Bank, including (IDA and IFC)	1992	Natural resource management and poverty reduction, foreign investment and export promotion, information technologies, infrastructure, education, health, social sector, agricultural reform, municipal development, transport, and judicial reform	1992-2006 USD 900 ml.
IMF	1992	Macroeconomic stabilization and structural reforms, including the Poverty Reduction and Growth Facility (PRGF)	1992-2004 USD 218 ml
UNDP	1993	Policy advice for people-centered development, advocacy, capacity building, institution building, coordination of external assistance, rehabilitation and direct support	1993-2004 USD21 ml.
EU via TACIS, ECHO, TRACECA, and INOGATE	1991	Development of political institutions, the rule of law and human rights, regional stability, economic and social reforms, including gradual participation of Armenia in the EU market. Support for institutional, legal and administrative reform (including legal advice, assistance to customs and statistics, energy policy reform, local government decentralization reform and regional development and civil society) and measures to address the social consequences of transition (focusing on poverty alleviation via agricultural and social protection policies, education and vocational and technical training).	1991-2006 EUR400 ml.
US government assistance	1991	Economic restructuring, energy sector reform, healthcare, democracy and governance, and agricultural support, and MCA.	1991-2006 USD1300 ml.
Germany via GTZ and KfW	1998	Technical cooperation, including in local development, promotion of rule of law, and promotion of SME activities, rehabilitation of water and wastewater in selected regions, rehabilitation of power transmission	Current activity EUR 60 ml.
UK via DFID	1995	Public sector reform, supporting social initiatives, and regional development in two marzes.	1995-2006 GBP 11ml.
Japan	1991	Consolidating the basic economic structure, the energy sector, transport infrastructure, improvement of the irrigation and water supply systems, and the social sector (health and medical care, education, and mitigating hardships faced by the unemployed and the low-income population).	1991-2003 USD 30 ml.

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