



POLICY
FORUM
ARMENIA

STATE OF THE NATION

CORRUPTION IN ARMENIA



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This Report in Perspective

This is the third *State of the Nation Report* by Policy Forum Armenia and the eighth one in total, all focused on issues of critical importance for Armenia. Yet the impact of a subject such as corruption on the society and economy is so profound that this Report may well be the most significant one. It is certainly timely, given the recent domestic and international developments that are bringing Armenia to an unavoidable brink of a systemic change. In our view, the release of this Report at this time is particularly opportune.

Ironically, while corruption is at the crux of many of the challenges we have addressed in our previous reports, it is the most difficult one to analyze using the methods of inquiry and measurement common in social science research. This is because corruption by its very nature is intended to be concealed. Moreover, without the political will to investigate cases and judicial systems to prosecute them, it is even more difficult to provide concrete quantifiable examples and clear evidence in a document such as this one.

Nevertheless, this Report employs the latest quantitative techniques that can help effectively gauge the extent of corruption and bribery taking place at the macroeconomic, enterprise, and individual levels. It also uses case studies to highlight patterns of corruption in various segments of public life.

That said, the Report does not try to duplicate the efforts of various local and international agencies engaged in monitoring corruption (in their different forms) in Armenia. Instead, the Report adds to this body of evidence by presenting a series of sector-level studies that examine the nature of relevant corrupt practices and providing quantitative measures of large-scale corruption and bribery. It also offers a new anti-corruption

framework that will help address the implications of large-scale embezzlement and mismanagement observed in Armenia and put the country on a path to development and progress.

This Report is structured as follows:

- ▶ **Chapter I sets the stage and builds the case for fighting corruption and related phenomena head-on.** It puts Armenia in the context of its peers and details the specific channels through which corruption impacts economic development in Armenia. It shows that despite the recent advances on the legislative front, the *de facto* situation on the ground remains dire.
- ▶ **Chapter II provides an overview of survey-based perceptions of corruption in Armenia.** It sheds light on how residents of Armenia view and interpret acts of corruption and offers a strategy for reducing corruption in Armenia. The strategy is built on a platform for boosting individuals' opportunities and freedoms, otherwise restricted by corruption.
- ▶ **Chapter III examines specific sectors with high corruption risks.** These include law enforcement, military, public procurement, health, education, and money laundering. It describes in detail how the provision of public services in each of these sectors is affected by the corruption observed in those sectors. Finally, it provides detailed recommendations on how to fight corruption and mismanagement in these sectors.
- ▶ **Chapter IV analyzes corruption and poor governance at the macroeconomic level.** It builds a compelling case that the design and implementation of public policy in Armenia often serve the interest of the entrenched elite and not the country as a whole. Finally, the chapter provides estimates of *foregone growth* in Armenia due to corruption and mismanagement at the wholesale level.
- ▶ **Chapter V estimates the extent of bribery received by public sector employees.** It uses nationally-representative household expenditure survey collected by Armenia's National Statistical Service. Comparing the differences in income between public and private sector

THIS REPORT IN PERSPECTIVE

employees, the regression analysis shows that there is a statistically significant difference between wages in these two sectors, which can be attributed to bribery. However, the relatively small magnitude of average bribes (roughly 10 percent of income per year) confirms that bribery in Armenia is low among most low- and mid-level public officials and instead is concentrated in the hands of a few high-level officials, as conjectured in previous chapters.

- ▶ **Chapter VI employs a survey of large enterprises in Armenia to measure the impact of corruption on their operations.** Using data collected by the World Bank, the analysis shows that corruption has become more of a problem over the years for businesses operating in Armenia and is now one of the top three problems faced by those firms. The chapter shows that with an estimated cost to large enterprises of approximately 5 percent of sales per year—the highest among the comparator countries—corruption in Armenia erodes productivity and competitiveness of firms and by extension also of the economy as a whole.
- ▶ **Finally, Chapter VII lays out a blueprint for the *Stolen Asset Recovery Initiative*.** It is modeled on the experience of other countries in recovering assets acquired by illegal means as well as on the international laws and regulations that govern this area. In doing so, the chapter offers a framework for: (1) identifying illegally acquired assets held both in and outside of Armenia, (2) seizing those assets, and (3) holding and redistributing those assets (or the proceeds from their sale). The chapter intends to jumpstart a public debate on the issue and remind corrupt officials that civil society organizations are ready to help identify and recover stolen assets—irrespective of their location—and return them to their rightful owners.


...

The overarching message of PFA (2012a) is more pertinent now than ever before: the effective handling of challenges facing Armenia should begin by forming a

legitimate authority to oversee the new policy course on behalf of the people. This can be achieved only by a political power with incentives and capacity to spearhead a systemic change. At the moment, the feedback mechanism between power and people is broken in Armenia. This makes the country's ruling regime immune to any pressures from the electorate to perform better and fundamentally changes the incentives of individuals at the top of the ruling pyramid. The *crony capitalism*, therefore, remains the name of the game in Armenia for the time being, ever entrenched in the high-level politics at the expense of growth, public health, education, and national security.

In addition to corruption, in many of its forms, the US State Department's Human Rights Report (2012) mentions limitations on *the right of citizens to change their government* as the most significant human rights problem in Armenia. This is why the regime's signaling of the intention to keep Serge Sargsyan in power beyond his current term (as Prime Minister, following amendments to the Constitution) must feel like a bad dream not only for most in Armenia but also for Armenia's friends around the world.

The change appears inevitable in Armenia, but it can no longer come from the top. The ruling Republican Party has effectively turned itself into a neo-Communist party, only this time money—not an ideology—holds it together. The Communist regime lasted 70 years. While it remains to be seen how long the Republican-led regime would last, the first signs of distress—not unlike those observed in late-1980s when things began to unravel in the Kremlin—are already apparent. This Report details the structural underpinnings of that distress and offers a way forward.

The background of the slide features a photograph of several US dollar bills hanging from a clothesline. The bills are held in place by several wooden clothespins. The bills are slightly crumpled and appear to be drying, with some showing signs of wear and discoloration. The lighting is soft, highlighting the texture of the paper and the wood of the clothespins.

**“[P]OOR COUNTRIES ARE POOR BECAUSE THOSE WHO HAVE
POWER MAKE CHOICES THAT CREATE POVERTY. THEY GET IT
WRONG NOT BY MISTAKE OR IGNORANCE BUT ON PURPOSE.”**

PROFESSORS DARON ACEMOGLU AND JAMES A. ROBINSON

WHY NATIONS FAIL: THE ORIGINS OF POWER, PROSPERITY, AND POVERTY

I. Introduction and Motivation

¹ PFA's report on "[Armenia: Averting an Economic Catastrophe](#)" (PFA, 2012a) describes the implications of Armenia's governance regime on the quality and conduct of economic and social policies.

² In a 2009 [interview](#), Vahram Nercissiantz, Robert Kocharyan's chief economic adviser, said this about the degree of *state capture* in Armenia:

"Businessmen holding state positions have turned into oligarchs, who have avoided paying sufficient taxes by abusing their state positions, distorted markets with unequal conditions, breached the rules of competition, impeded or prevented small and medium-sized business' entry into manufacturing and thereby sharply deepened social polarization in the republic."

While rather bold and unprecedented, this view shields the country's political leadership from the responsibility of tolerating—if not leading—this process, portraying it as a victim rather than a villain.

Setting the scene

Corruption in Armenia directly benefits the very top layers of the country's ruling regime. This is public knowledge in the Armenian society and in much of the outside world. Since independence, many individuals at the very top of the ruling pyramid have amassed significant wealth, some of which is rumored to have been transferred abroad. These individuals use their wealth to maintain a grip on power and further consolidate their already formidable positions in the economy. They do this through maintaining a sizable apparatus of loyalists ranging from relevant government officials to criminal "bosses". The current status quo has until recently not been challenged in any meaningful way by stakeholders in or outside the system. This has a profound impact on how the Armenian economy and the society function.¹

This Report discusses the nature of corruption in Armenia and its repercussions. Following Hellman, Jones, and Kaufmann (2000), it distinguishes between two types of corruption: *state capture* and *petty crime*. The former obtains when an entrenched elite group is capable of shaping the rules of the game to its advantage using their control of economic and social policies and massive illegal and non-transparent provision of private benefits to its members. Examples of such behavior include influencing fiscal or monetary policies, controlling legislative votes, or obtaining favorable executive decrees and court decisions. The term "governance" is used in the Report

to indicate the ability and willingness of the ruling elite to control corruption and reduce the *state capture*. The latter and a much less important form of corruption in Armenia—the petty crime—is referred to as bribery (or kick-backs) and defined as an "abuse of public office for private gain."

The ruling regime in Armenia maintains its grip on power through a system, which for a casual observer, may appear to be at least a quasi-democracy. However, upon a closer examination, the system involves elements that are neither threatening to the regime's existence nor are easily reversible. Modeled on Russia's political system, the Armenian political regime uses every ploy, as described in Andrew Wilson's book, "[Virtual Politics: Faking Democracy in the Post-Soviet World](#)," to create a pretense of legitimacy and hold its grip on power. In the context of countries with similar characteristics, such as Russia and Ukraine, Wilson (2005) accurately describes the use of fake political parties, phantom political rivals, and "scarecrow" opponents, while exposing the paramount role that mass media plays in projecting these creations and effectively presenting a false picture of the entire political process.

Nevertheless, independent media reports of corruption at the highest level of government and political establishment abound in Armenia. They involve allegations of top government officials having acquired most lucrative retail businesses, mining interests, real estate, and import licenses² (See Box 1 for examples).

BOX 1. NOTABLE CASES OF HIGH-PROFILE CORRUPTION

Among high-level officials of the current and previous administrations, who allegedly have been involved in large-scale embezzlements and criminal conduct, the former president Robert Kocharyan knows no rivals. A recently-formed **“Anti-corruption” NGO** put him on the top of the list of the most corrupt individuals in Armenia. **Media reports** place him on top of a sizable financial and economic conglomerate with assets both inside and outside Armenia, which he amassed during his two terms in office in 1998-2008.

Another famous case involves the former Minister of Natural Resources, a ruling Republican Party MP and the chairman of Parliament’s standing committee on Economic Issues, Vardan Aivazyan. According to an international **award-winning series of reports** by Investigative Journalists of Armenia, during 2001-07 this individual issued several lucrative mining licenses to his family members. He **was found guilty** by the Southern District Court of New York for demanding a kick-back from Global Gold Mining, LLC and was ordered to pay the company a \$37.5 million fine. Another high-level official, who **allegedly owns** lucrative mining interests is the Speaker of the Parliament, Hovik Abrahamyan.

Recently, the same group of investigative journalists **revealed facts of ownership** of a Cyprus-based off-shore entity by the current Prime Minister, Tigran Sargsyan. Finally, **media reports** have linked Head of the State Tax and Customs Agency, Gagik Khachatryan, to massive wealth through the ownership of a major Internet and cable TV service provider, two food-importing companies, one supermarket, a car dealership, a luxury watch store, and a company that has a legal monopoly on supplying paper for cash registers, among other assets.

However, such high-profile corruption cases rarely, if ever, lead to investigations and are even less likely to result in arrests or any serious punishment.³ Despite ample anecdotal evidence to this effect, no cases of financial fraud or money laundering have been brought to the public’s attention in recent years. When independent media outlets do expose these violations, they are often harassed with phony law suits. Much of the anti-corruption measures that are formally initiated by the authorities (including **the Corruption Council**) are either purely of legislative nature or, if they have the ability to change the existing status quo, are dead from the start.⁴

³ The International Crisis Group (2012) echoes this point.

⁴ Interestingly enough, instead of encouraging law enforcement action against corrupt government officials, Serge Sargsyan **publicly rebuked** the head of the Parliament’s Audit Chamber for publishing numbers that “don’t make sense.”

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⁵ Serge Sargsyan **recently admitted** that the regime is able to manipulate the election outcome in its favor.

⁶ The **closing press conference** of the OSCE-ODIHR monitoring group for the February 2013 presidential election was interrupted suddenly by young/progressive activists, who took over the event and read out their own statement listing the fraud and manipulations that took place during the election. This was a major act of defiance against what was seen as the OSCE-ODIHR rubberstamping an otherwise fraudulent election, which was well received by the Armenian society as a whole.

State capture is especially pronounced in Armenia when it comes to nation-wide elections. Our detailed research (contained in PFA's 2008a, 2009, 2012b, and 2013 reports) describes the well-oiled election fraud machine employed by the country's political elite. Election fraud in Armenia has taken new forms and reached new heights in recent years, and the growing sophistication of electoral mechanisms makes it difficult for international observers to notice it.⁵ However, the use of public funds to benefit the incumbents, the wide-spread employment of illegal tactics to intimidate voters, and massive manipulations of election outcome leave no doubt about the degree of coordination and the source of these illegal activities.

Figure 1 puts Armenia's corruption and governance indicators in the context of the world average across time. It shows that, on the most critical issues, such as, Control of Corruption and Voice and Accountability, Armenia is ranked among the bottom deciles of the world and has recorded a trend decline. Unfortunately, most international observers judge Armenia's corruption-related compliance from a *de jure* as opposed to a *de facto* perspective.

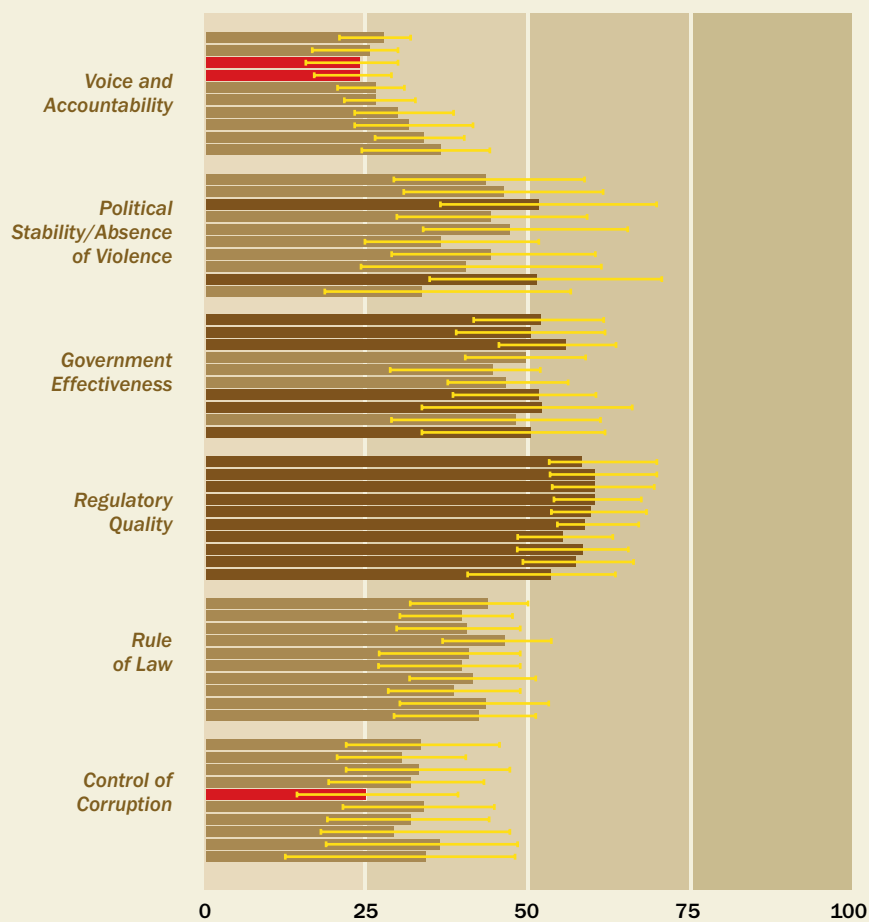
This adds practically no value to the process of anti-corruption and may have actually reduced the incentives of the authorities to improve governance. This approach, however, is likely to backfire and undermine the credibility of Armenia's international partners.⁶

This report does not deal with issues of laws and regulations related to anti-corruption and crimes. However, a number of points are worth making in this regard. While further improvements can be made, the legal framework is generally considered adequate. The problem, in our view, is how that framework is implemented. Indeed, the **Global Integrity Scorecard for Armenia** shows the stark contrast between the legal framework and its actual implementation. While the former is classified as "strong", the latter gets a "very weak" score, rendering an overall combined score as "weak". Armenia is doing poorly on the legal framework of an anti-corruption agenda. Figure 2 shows Armenia's ranking in relation to a select country grouping on the implementation of the overall legal framework (Panel 1) as well as the anti-corruption elements of the legal framework (Panel 2). Armenia lags behind in both dimensions.

FIGURE 1. THE DYNAMICS OF ARMENIA'S CORRUPTION INDICATORS, 2002-11

Armenia

Comparison between 2011, 2010, 2009, 2008, 2007, 2006, 2005, 2004, 2003, 2002 (top-bottom order)
(relative percentile vis-à-vis the world)



Country's Percentile Rank (0-100)

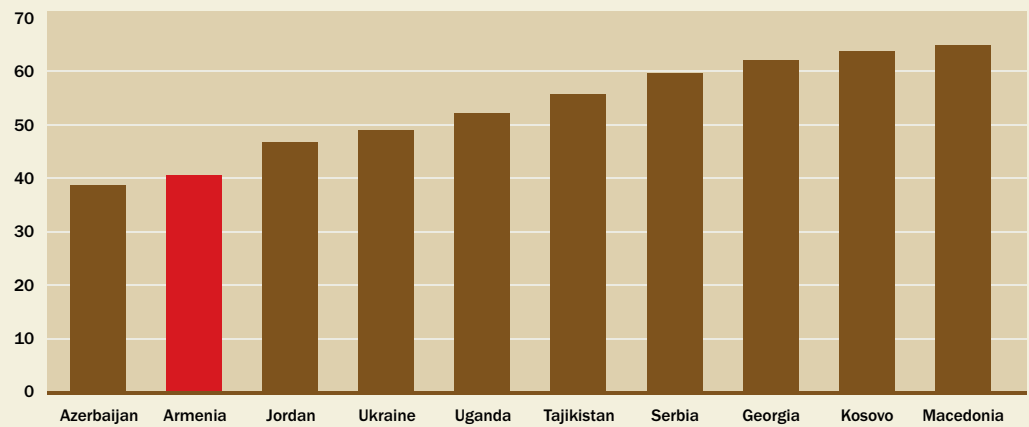
Source. Kaufmann D., A. Kraay, and M. Mastruzzi (2010), The Worldwide Governance Indicators: Methodology and Analytical Issues

Note. The Worldwide Governance Indicators (WGI) are a research dataset summarizing and expert survey respondents in industrial and developing countries.

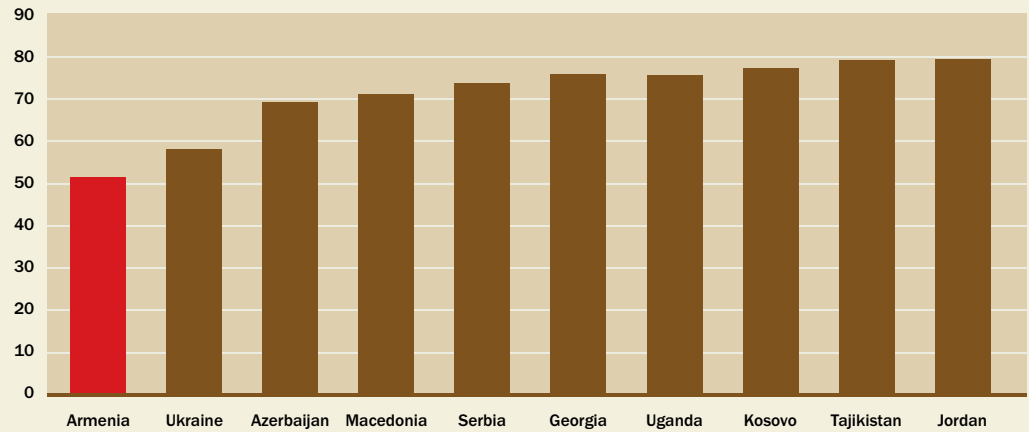
These data are gathered from a number of survey institutes, think tanks, non-governmental organizations, international organizations, and private sector firms.

FIGURE 2. GLOBAL INTEGRITY SCORES (SELECT COUNTRIES)

Actual Implementation (of Overall Legal Framework)



Anti-Corruption Legal Framework



Source. Global Integrity Report, 2011.

Implications of corruption in Armenia

The following is a partial list of channels through which corruption hurts economic development in Armenia:

- ▶ The rent-seeking motives of top-level officials have profound structural and distributional implications for the economy. Since “taxing” a large number of economic agents—producers and consumers—for one’s own enrichment is increasingly difficult due to transaction costs and the potential for social discontent, the regime has moved to monopolize more of the economic activity in the country and extract rents from it more easily.⁷
- ▶ The lack of political will to subject these monopolistic structures to formal rules and taxation. This results in under-collection of taxes accrued to the budget and, in turn, the inability to adequately allocate resources to social and developmental projects.⁸
- ▶ State capture in Armenia has prevented a true economic integration between Armenia and the Armenian Diaspora. It has become a serious barrier to harnessing Diaspora’s capital, both human and physical.
- ▶ Corruption in the judicial system and law enforcement violate fundamental human rights and weaken property rights. These in turn increase the uncertainty and the transaction costs associated with doing business.
- ▶ Many top level public officials are also directly engaged in business activities, which is illegal. By doing so, these officials are able to give their enterprises unfair advantage over the competition.⁹ It also undermines the ability of officials to carry their public service-related duties properly.

As shown in the remainder of this Report, the economic impact of corruption in Armenia is fairly substantial. In fact, it puts in place insurmountable barriers for the economic development and progress in the country. No development plan could succeed in Armenia without credibly addressing the underlying systemic corruption and high-level rent seeking.

Going forward: A call for bolder action

The lack of political will to reduce corruption and improve governance in Armenia is the main obstacle to overcome. There is also the lack of effective mechanisms and often genuine interest from international community to see Armenia reform. In addition, powerful local vested interests represented in the highest echelons of power continue to conspire against—and effectively block—potential improvements in governance.¹⁰ Constrained by these factors, the progress in Armenia will not take place without political change. Hence, much of the recommendations contained in the remainder of this Report are conditional on this requirement.

SUPPORT FROM OUTSIDE ARMENIA IS KEY

Assistance from the international community and the Diaspora would be required for the people of Armenia to succeed in improving the governance while forcing the entrenched corrupt elite to either reform or leave.

⁷ The logic of this is discussed in more detail in Charap and Harm (2002) and papers cited therein.

⁸ See Chapter IV for a detailed discussion on this issue.

⁹ These government officials and parliamentarians, who are known to be very wealthy but declare only small fractions of their income and wealth, stay off of the radar screen of Armenia’s tax collectors.

¹⁰ In conclusion to his comparative study of corruption in Armenia and Georgia, Stefes (2003) notes the following:

“In Armenia, it is rather unlikely that honest reformers are able to move their way up through the corrupt apparatus to top positions. Without the support of patronage networks, Armenian politicians are unlikely to gain power, but relying on these networks also means to become part of the corrupt system. Change needs to come from the top.”

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¹¹ PFA (2010a) outlines these requirements in detail.

The international community could assist by:

- ▶ Conditioning aid to Armenia on tangible improvements in anti-corruption and, particularly, its *state capture* component.
- ▶ Supporting civil society organizations and key players outside the establishment.
- ▶ Assisting independent local think tanks to allow them to play a more active role in analyzing the outcomes and proposing alternatives.

The Diaspora can act as a partner for change by:

- ▶ Achieving closer integration with the civil society in Armenia and better understand Armenia's developmental and geopolitical needs.¹¹
- ▶ Sending stronger signals to the ruling regime in Armenia on what is and is not acceptable.
- ▶ Being more vocal in "naming and shaming" public officials accused of large-scale embezzlements and crime. The criticism of rogue behavior could be effective if it were unequivocal and unapologetic.

NEED TO PROSECUTE SENIOR LEVEL ABUSES

The grand-scale corruption observed in Armenia has names and addresses. It is a fairly concentrated practice, which includes people high up in corridors of formal power. A credible anti-corruption agenda should begin by prosecuting a critical number of these senior government officials, who have used public office for personal wealth accumulation.

CREDIBLE REFORM IN THE JUDICIAL SYSTEM

This, in turn, depends on far-reaching measures to clean up the top levels of the law enforcement agencies: the Prosecutor General's office, the Ministry of Justice, and the courts.

MECHANISMS FOR RE-CLAIMING STOLEN ASSETS

Restoring stolen or embezzled assets by these individuals should be part of the any anti-corruption agenda of any future government in Armenia. This would send a strong signal that the overall reform effort is credible and translate into a better business environment fairly quickly.

II. Public Perceptions of Corruption in Armenia

In Armenia—as in any other country where traditional norms and national customs play an important role in social relations—it is difficult to evaluate any aspect of life without taking into account the underlying social perceptions and interpretations. This evaluation approach pertains to the study of a country's corruption problem too. This Chapter sheds light on local perceptions and interpretations of corruption. It then proposes measures aimed at reducing corruption in Armenia in the context of a plan of action that focuses on the human development dimension, that is, increasing an individual's opportunities and freedoms that are typically restricted by corruption.

Evaluations and perceptions of corruption

Outlining their reasoning for relying on perception-based data for constructing a set of corruption and governance indices, Kaufmann, Kraay, and Mastruzzi (2010) write:

...perceptions data have particular value in the measurement of governance. First, perceptions matter because agents base their actions on their perceptions, impression, and views. If citizens believe that the courts are inefficient or the police are corrupt, they are unlikely to avail themselves of their services. Similarly, enterprises base their investment decisions - and citizens their voting decisions - on their perceived view of the investment climate and the government's

performance. Second, in many areas of governance, there are few alternatives to relying on perceptions data. For instance, this has been particularly the case for corruption, which almost by definition leaves no "paper trail" that can be captured by purely objective measures."

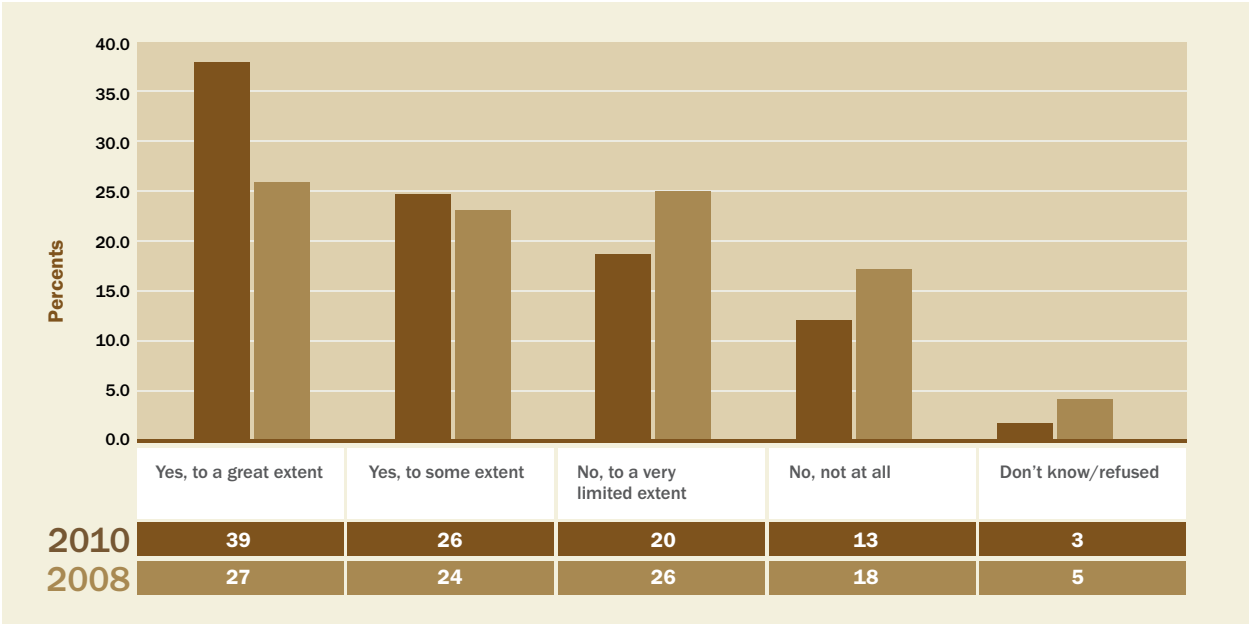
The remainder of this chapter shows that perception of corruption plays a key role in the Armenian context too. The present analysis is based on Armenia Corruption Household Survey 2010 database implemented by the **Caucasus Research Resource Center**.

Indeed, data reveal that corruption is one of the five most important problems of concern for residents of Armenia, even outranking emigration. 57.8 percent of those questioned cited corruption as a serious problem, which was reported across the board in Armenia with little statistical variation: Yerevan (60 percent), regional urban residents (62 percent) and regional rural residents (51.7 percent).

It is important to note the extent to which people consider high levels of corruption as a fact of life. 39 percent of those surveyed regarded corruption as normal and another 26 percent regarded it as somewhat normal (see Figure 3). In other words, a significant percentage of respondents regard corruption as a normal aspect of daily life in Armenia. A similar survey implemented in 2008 shows that the ratio of those who consider corruption as a fact of life has since increased significantly (from 27 in 2008 to 39 in 2010).

PUBLIC PERCEPTIONS OF CORRUPTION IN ARMENIA

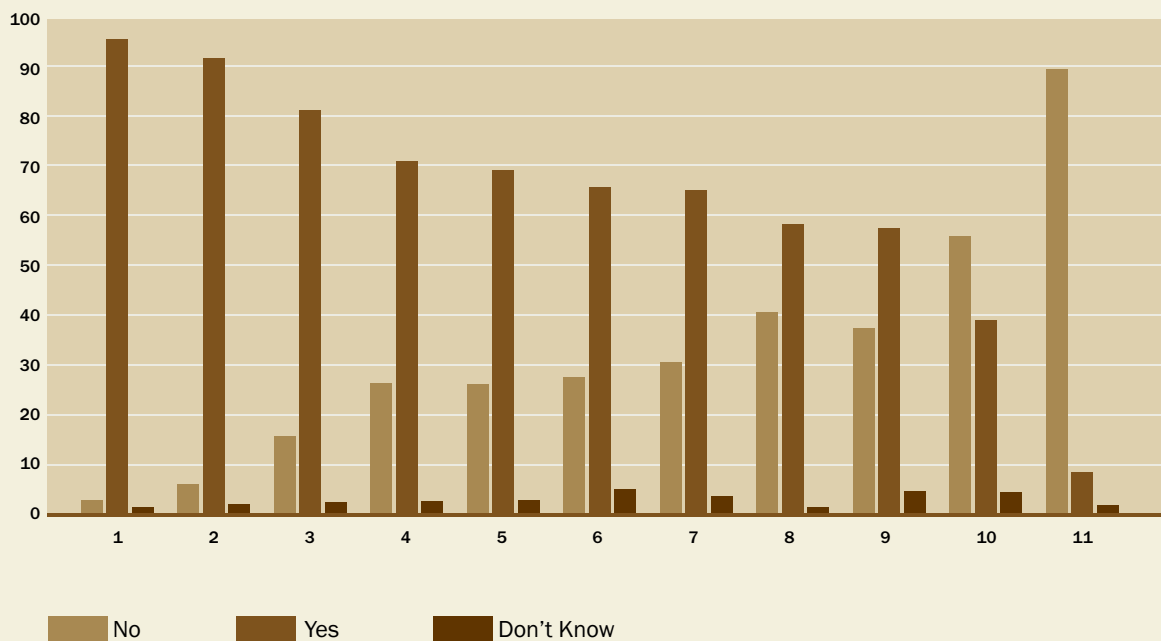
FIGURE 3. DO YOU AGREE WITH THE STATEMENT THAT CITIZENS OF ARMENIA CONSIDER CORRUPTION AS A FACT OF LIFE?



It is important to clarify from the onset how people define corruption. Figure 4 shows most respondents surveyed have a clear idea of what corruption is and is not.

PUBLIC PERCEPTIONS OF CORRUPTION IN ARMENIA

FIGURE 4. PLEASE INDICATE WHETHER YOU THINK THAT THIS ACTION IS AN INDICATION OF CORRUPTION



- 1 Paying a judge in exchange for favorable treatment
- 2 Giving cash to a police officer to avoid revocation of your driving license
- 3 A student or a student's parent giving a professor a gift on the day of exams
- 4 Using connections to exempt someone close to you from military service
- 5 Making small, unofficial payments to ensure delivery of pension payments
- 6 Abuse of an official position for private business purposes

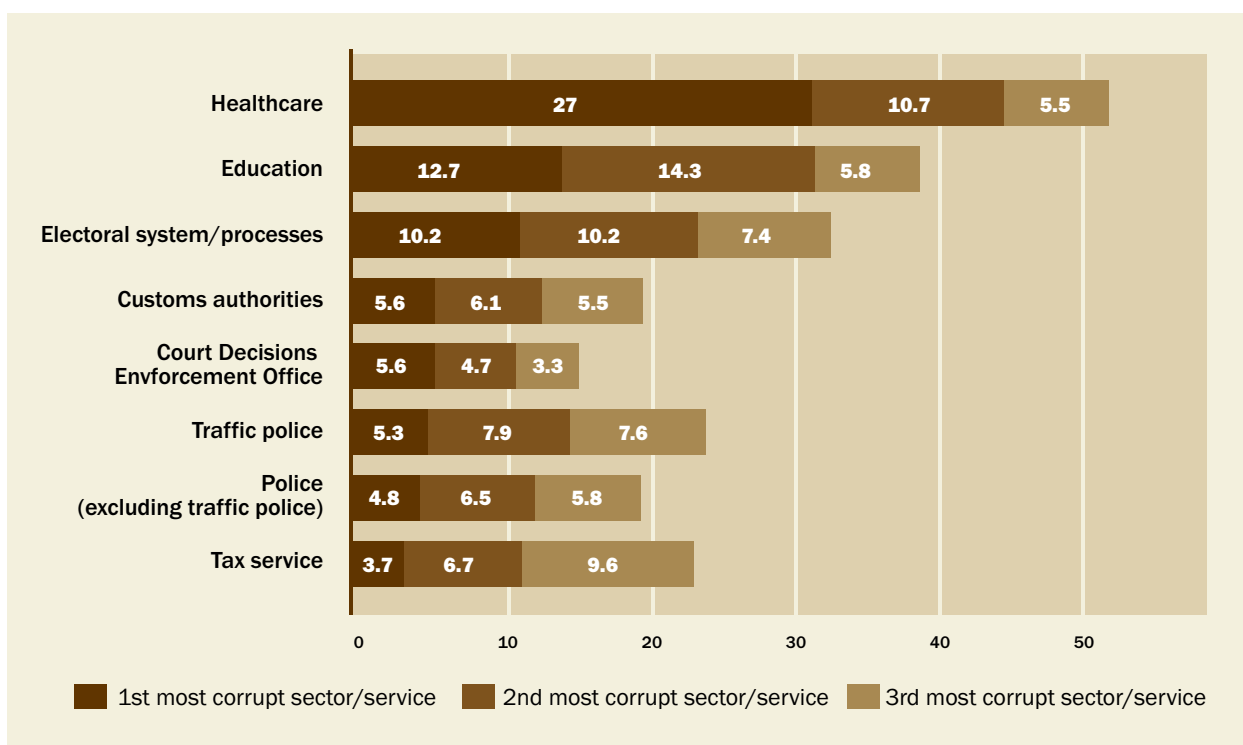
- 7 A public official helping a relative to gain acceptance to a university
- 8 Giving a gift to a doctor in exchange for special care and services
- 9 A public official recommending a relative for a position in a Ministry
- 10 A government employee using an office car for private purposes
- 11 Picking flowers or fruit from a neighbor's garden without permission

PUBLIC PERCEPTIONS OF CORRUPTION IN ARMENIA

When asked to identify the first three most corrupt sectors (Figure 5), respondents named healthcare (27 percent), education (12.7 percent), electoral systems/processes (10.2 percent), and the customs authorities and Court Decision Enforcement Office (5.6 percent each). The sectors that were identified as *second most corrupt* were education (14.3

percent), healthcare (10.7 percent), electoral systems/processes (10.2 percent), and traffic police (7.9 percent). The sectors that were chosen as the third most corrupt were tax service (9.6 percent), traffic police (7.6 percent), electoral systems/processes (7.4 percent), and police (excluding traffic police) and education (5.8 percent each).

FIGURE 5. PLEASE NAME THE THREE MOST CORRUPT SECTORS OR SERVICES, AND RANK THEM FROM HIGHEST TO LOWEST



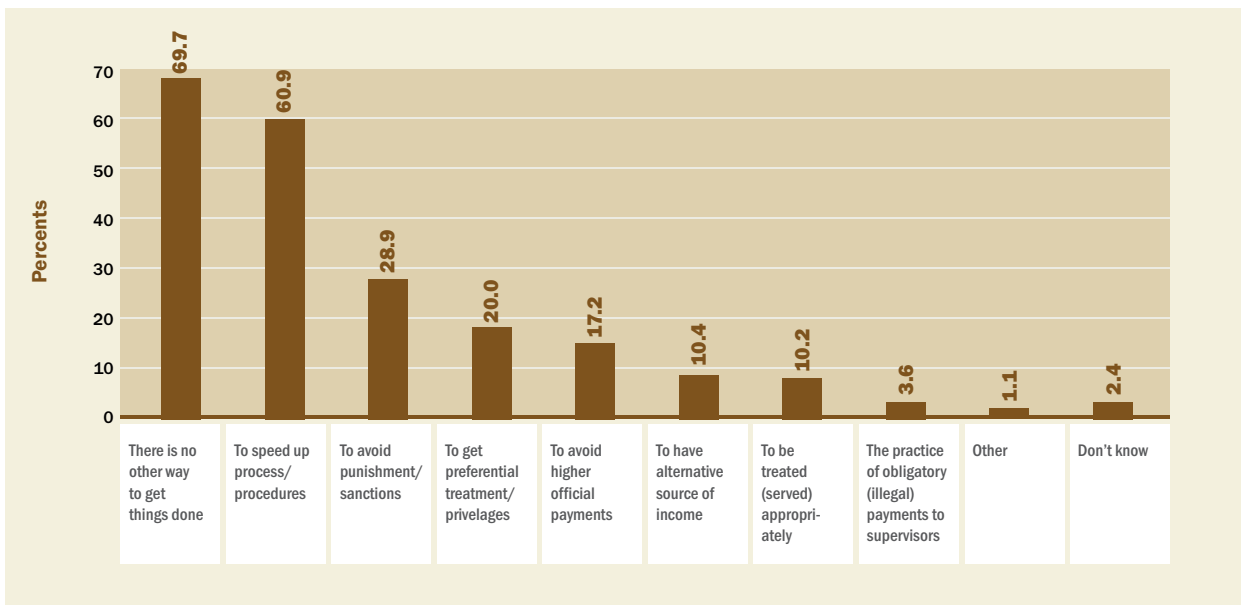
PUBLIC PERCEPTIONS OF CORRUPTION IN ARMENIA

Public perception of the root causes of corrupt conduct

Interesting to note that citizens perceive corruption/bribery justified as the most effective method to resolve problems. The answers demonstrate the ways by which people generally cope with the reality of corruption. The results also show general acceptance of engaging in corrupt behavior in order to resolve problems with others in positions of authority.

Figure 6 provides some of the most common reasons why people engage in corrupt behavior. It shows that 69.7 percent of respondents believe that the most common reason that people engage in corruption is that there is no other way to “get things done” while 60.9 percent believe that engaging in corruption speeds up processes and procedures. In addition, 28.9 percent feel that it is a way to avoid punishment and sanctions and 17.2 percent regard corrupt practices as a way to avoid higher official payments.

FIGURE 6. IN YOUR OPINION, WHICH OF THE FOLLOWING ARE THE PRIMARY REASONS THAT PEOPLE JUSTIFY THEIR PARTICIPATION IN CORRUPT PRACTICES?

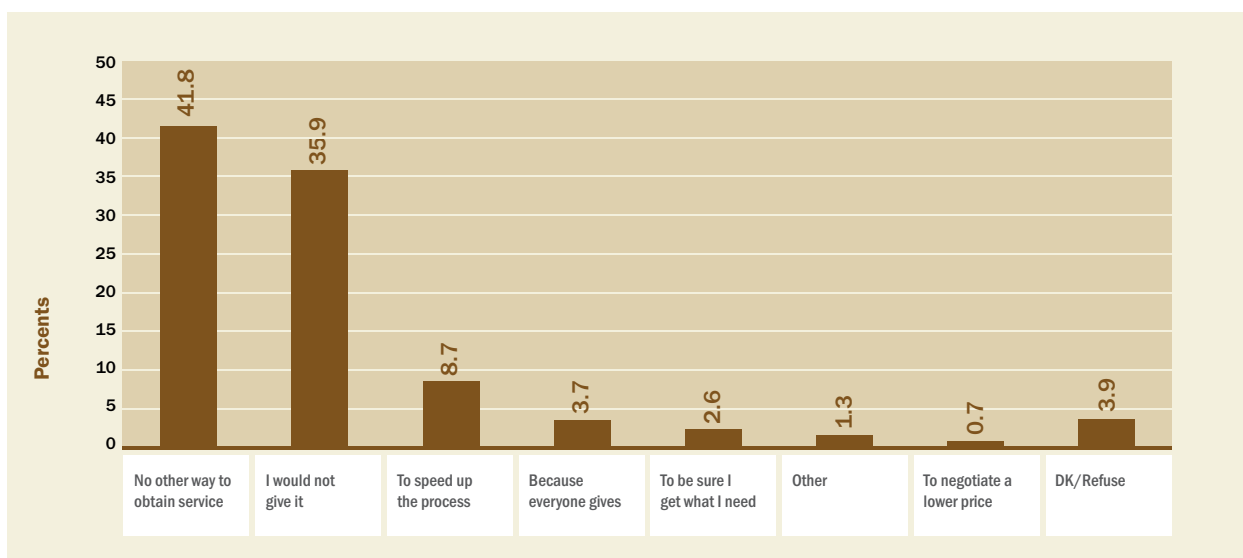


PUBLIC PERCEPTIONS OF CORRUPTION IN ARMENIA

The data also reveal that many people in Armenia reject the idea that there may be a connection between their own corrupt practices and the ever-deepening level of corruption at the national level. Thus, individuals contribute to corruption despite the fact that they consider corruption to have a negative impact on society. Most respondents do not believe that they have a role to play in the fight against corruption, rendering them passive against corruption.

The attitudes of respondents regarding willingness to pay bribes are consistent with the general findings that people engage in corrupt behavior to ensure the completion of a given transaction. Figure 7 shows that the primary reason for the vast majority (71 percent) of those stating they are willing to pay bribes is the absence of other options in order to receive services. This clearly indicates that the forms of relations forced upon society by the authorities motivate residents to respond by resorting to corruption and bribery.

FIGURE 7. THE LEVEL OF READINESS TO PAY BRIBES AND MAIN REASONS FOR PAYING BRIBES

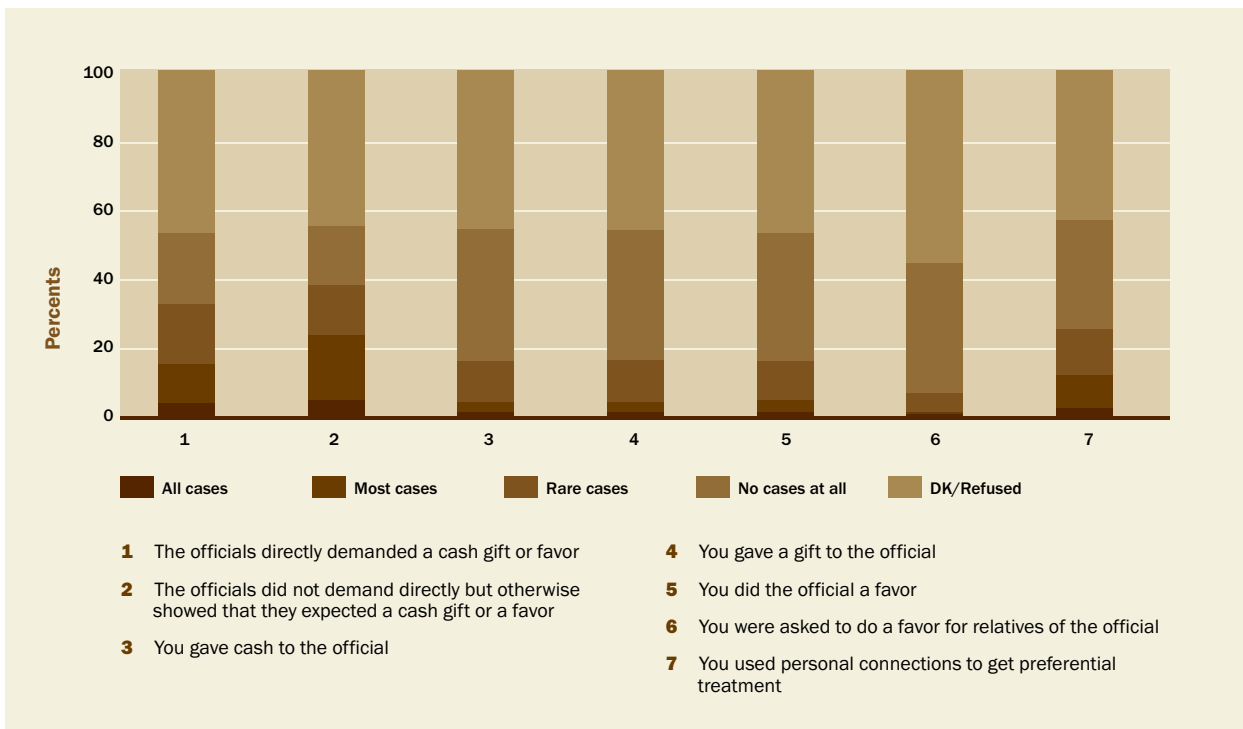


When asked “Whenever you have contacted officials in the public sector, how often did the following happen?” respondents cited the following scenarios as occurring “in all” or in “most cases” (Figure 8): (a) 23.6 percent of respondents indicated that “the officials did not demand directly but otherwise showed that they expect a cash gift

or a favor”; (b) 15.3 percent responded that “the officials directly demanded a cash gift or favor”; (c) 12 percent answered that they “used personal connections to receive preferential treatment”. Only a very small percentage of respondents (2-5 percent) indicated that they voluntarily gave cash and/or gifts to the official or did a favor.

PUBLIC PERCEPTIONS OF CORRUPTION IN ARMENIA

FIGURE 8. WHENEVER YOU HAVE CONTACTED OFFICIALS IN THE PUBLIC SECTOR, HOW OFTEN DID THE FOLLOWING HAPPEN?

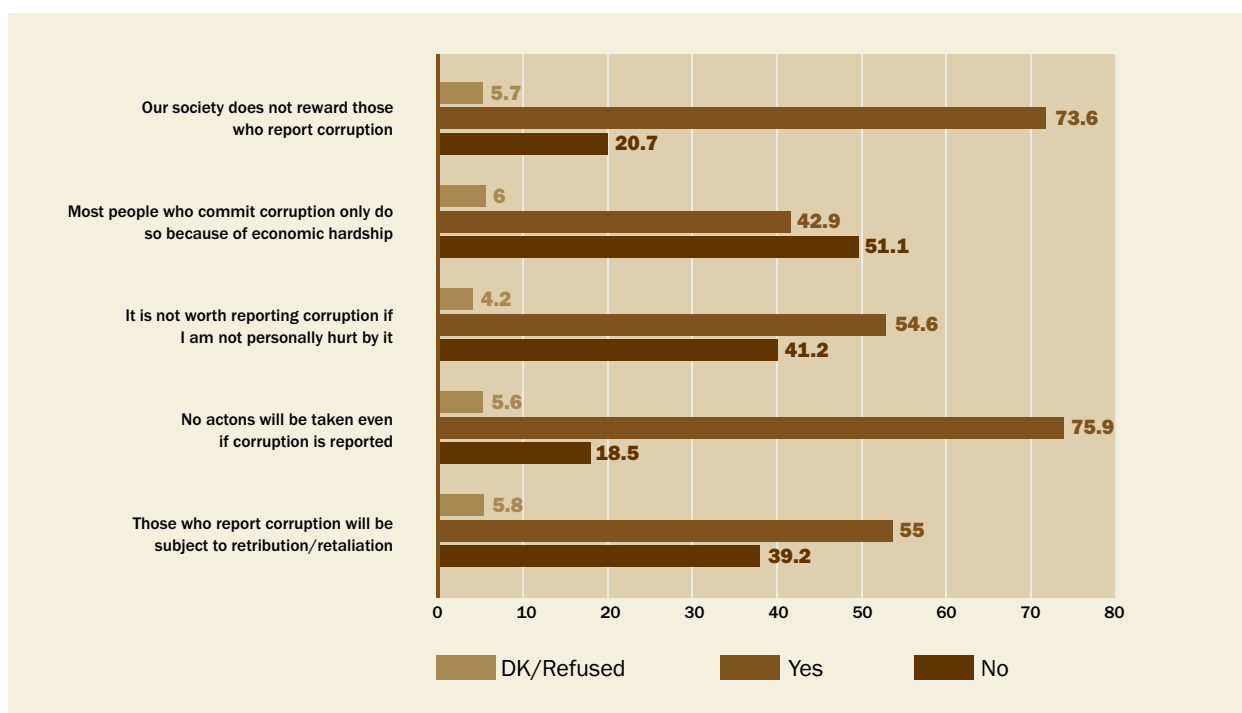


Interestingly, the reported views regarding corruption at large and the need for anti-corruption behavior indicate that most respondents have not only accepted that corruption exists in Armenian society but that there is no need to prevent its continuation. This sentiment is depicted in Figure 9 below. Results indicate that there are several factors that collectively

prevent the widespread adoption of anti-corrupt behavior throughout society. Specifically, a majority of respondents (73.6 percent) indicated that “society does not reward those who report corruption.” Additionally, a large segment of respondents (54.6 percent) felt that there was no need to report corruption if it did not personally harm them.

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FIGURE 9. WHICH OF THE FOLLOWING YOU PERSONALLY CONSIDER AS A REASON FOR NOT REPORTING CORRUPTION TO THE RELEVANT AUTHORITIES?



The survey also shows that 55 percent of respondents agreed that another reason that corrupt behavior is underreported is that “those who report corruption would be subject to retribution/retaliation.” This rather widespread perception that whistleblowers will be punished is a strong indication of ineffectiveness of all past anti-corruption efforts by the government.

Responses also indicate that the majority of respondents accept corrupt behavior because there is no effective enforcement of anti-corruption measures. Three in every four respon-

dents noted that “no actions will be taken even if corruption is reported.” This clearly demonstrates that most people have no faith in the institutions tasked with enforcement of anti-corruption measures. This may also point to a common basis for the generally passive attitude towards corruption demonstrated by the respondents.

Despite the fact that salaries of government employees are low, potentially resulting in bribe-taking (see Chapter VI for a discussion on this), most (51 percent) of respondents do not believe that economic hardship is the only

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factor behind corrupt practices. This may also be related to how people on the lower end of the corruption scale view what is happening on the upper end of the scale. It is conceivable that, because ordinary civil servants are aware that higher-ranked officials are involved in corrupt activities on a larger scale (and are not prosecuted for their crimes), they take the attitude that “since everyone is on the take, why not me?” and justify their own activities as “small potatoes” compared to what is taking place on a larger scale. Thus, they engage in corrupt activities because they do not think they will be punished for doing so.

The data indicate a general tolerance of, and even an inclination to engage in, corrupt behavior despite all of its negative connotations. One reason for this attitude may be rooted in traditional norms dating back to the Soviet era. However, the study suggests that this attitude is also, at least partially, a result of severe lack of political will on the side of state authorities to address institutional corruption.

Survey results also show that the existing stereotypes of obeying to both written and unwritten laws in Armenian society contribute to:

- ▶ Emergence of inconsistencies between respondents’ stated opinions about corruption-related matters and their actions;
- ▶ Preventing the formation of a social milieu conducive to an anti-corruption campaign;
- ▶ Hindering the formation of anti-corruption social movements.

In a political environment described above, individuals belonging to the “elite” class are disinterested in ending corruption and are able to cause additional problems. Such individuals

can cast an (anti-patriotic) shadow on the anti-corruption agenda by labeling those promoting transparency and better governance as foreign agents infringing on national security and “our” way of doing things.

This survey shows that the danger for such possibilities developing in Armenia over the long term is great. Luckily, there are some comforting signs in the data. For example, although a relatively large percentage of people note that they would not take part in an anti-corruption campaign (given the negative public stereotyping such people are subjected to), they will consider doing that in the future. This leaves room for the use of effective social technologies and/or important events to encourage these individuals to join an anti-corruption campaign. If we recall that a large percentage of respondents expressed an outright negative opinion regarding corruption, such societal involvement becomes even more likely.

Conclusion

This review reveals that anti-corruption efforts should first directly target perceptions of corruption. Removing barriers to human development will strengthen the effectiveness of such efforts. Perceptions of corruption must be targeted first.

Individual freedoms should be at the core of the struggle against corruption, because the latter restricts individual opportunities and freedoms. A new approach should emphasize the view that corruption runs counter to individual interests and is a barrier to human development, and not merely that corruption

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is an impediment for social, societal, and economic development. Such a modified perception could have a major influence on the review and redrafting of anti-corruption policies, as well as policy implementation and monitoring processes.

The ruling elite in Armenia has an overriding stake in maintaining the current level of corruption and in particular, the state capture. As such, the government is unwilling to implement an effective anti-corruption campaign and therefore cannot be considered a reliable participant in overcoming corruption. The civil society remains the most interested and legitimate actor in promoting transparency and adapting anti-corruption measures. Making it effective requires strong civil society institutions (e.g., think tanks, anti-corruption

watchdogs, independent media outlets, etc.) to develop and implement well-organized and concrete anti-corruption strategy. Such organizations must be able to influence both the government's actions as well as the societal norms governing/underlying corruption perceptions.

The adoption of a new conceptual approach in overcoming corruption is urgently needed. A new campaign must be aimed at neutralizing restrictions currently obstructing the development of individual freedoms. Projects that facilitate “open” social capital formation can help create civil structures in which corruption is not tolerated. New civil society initiatives should include expanded human rights protections to offer viable alternatives to engagement with corrupt public officials to “get things done.”



III. Selected Topics on Corruption in Armenia

This chapter uses expert testimonies and publicly available information to explore specific manifestations of corruption within various sectors of the Armenian economy. These short case-studies are intended to highlight relevant corruption patterns while specifying the way in which corruption affects the provision of public service in each sector. They also offer detailed sector-specific recommendations to reduce corruption and embezzlement of public resources.

Corruption in Law Enforcement

BACKGROUND

Armenia's legal system remains stagnant and unable to reform its judiciary, law enforcement, and compulsory enforcement sub-branches. During twenty-two years of independence, the legal system has failed to achieve any tangible results in tackling corruption. Bribery and patronage are two rampant forms of corruption within the legal system. *Telephone justice* is used extensively by the executive branch to intervene and goes beyond the reach of public oversight. Moreover, officials in the judicial/legal system often use their positions for personal and/or clan interests. As noted in the TI (2010a; p.17), "...the Armenian judicial system as a whole is significantly influenced by the president of the country and other political and non-political actors."

UNDERLYING REASONS

Corruption in the judicial/legal system stems from the following interconnected reasons:

- ▶ The judiciary and law enforcement agencies tasked with the enforcement of judicial acts are largely Soviet holdovers both in form and content.
- ▶ Criminal court proceedings, similar to their Soviet prototypes, continue to function as a system serving the interests of the regime. The essential function of guaranteeing rights of Armenian citizens is mostly neglected. Consequently, courts do not exercise their duty of securing justice and have instead been turned into an accessory of the investigative-prosecutorial systems. The punitive system cooperates with the prosecutorial system; however, it only fights crimes that threaten their own existence. As a rule, these courts merely endorse the actions of the punitive system in the name of "justice". The system allows the investigator to assume the role of the court of the first instance, the prosecutor to assume the role of the appeals court, and the chief prosecutor to assume the role of the cassation court.
- ▶ The two structures on the accusing side—the preliminary investigative body and the prosecution—continue to control the judiciary. As in Soviet times, the prosecutor predetermines the conduct of the court, which results in neglect of basic legal principles, particularly the presumption of innocence and equality of sides before the court, and eventually violates the principle of preeminence of the judicial process over the pre-trial process.
- ▶ Preliminary investigative bodies were set up as a consequence of the recent round of reforms in the pre-investigative system. This has resulted in an increased risk of departmental corruption and further deepened the ineffectiveness of the judicial system.¹²
- ▶ The courts remain an inseparable component of the executive branch of government subject to arbitrary intervention and pressure. The establishment of an independent and unbiased court system is impossible given these conditions.

¹² This is because the functions of launching and carrying criminal proceedings are now separated and are carried within the prosecutor's office and the pre-examination body, respectively.

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- ▶ The interim function of the court system is reserved to the appeals court, making the system bloated and essentially superfluous. The cassation court has become a judicial elite cut off from real life interventions within the justice process in individual cases. The parameters of this intervention are unclear and severely discretionary, causing them to become ineffective.
- ▶ The extensive powers given to general jurisdictional courts significantly impact the quality of the case investigations and the effectiveness of justice. Given the lack of adequate judiciary expertise in Armenia, widespread arguments regarding verdicts and decisions are common. As a result, a greater workload is left for the higher courts.
- ▶ In its present form the Ministry of Justice reduces the effectiveness of governance, facilitates the entrenchment of corruption, and provides an additional tool for the executive branch for discretionary action and intervention in judicial matters.

In conclusion, the justice system in Armenia is in critical condition. There are prospects of disastrous consequences including the mass exodus and the irreversible plunge of social viability, which in turn is threatening the existence of the state itself.

RECOMMENDATIONS

Implementing the following measures would be a function of political will:

- 1 Organize a broad public discussion to create a blueprint of a new judicial system or a major overhaul of the current system.
- 2 Create new judiciary and law enforcement systems, centered on the principle of sanctity of individuals' rights and freedoms.
- 3 Conduct a comprehensive study of human

capital and personnel resources across the entire legal/judiciary system. The drafting and incorporation of an effective legal mechanism is required to ensure generational change.

- 4 Guarantee the independence of the courts and their functioning according to the law. This requires the following:
 - ▶ Incorporate mechanisms that rule out the intervention of the executive branch.
 - ▶ Incorporate control mechanisms that ensure individual/citizen rights through the courts.
 - ▶ Reserve a role of impartial arbiter for the courts.
 - ▶ Enable the citizens to freely launch legal challenges against acts and actions of the state and its bodies.
 - ▶ Guarantee in practice the equality of parties before the court and the presumption of innocence in practice.
 - ▶ Rule out the implementation of justice in the pre-trial phase of criminal proceedings and/or in out-of-court cases. Move from the Soviet formulation of "charges and acquittal" to one of "charges and denying the charges".
 - ▶ Broaden the knowledge base and professionalism of staff in the judicial system.
 - ▶ Guarantee the independence, inviolability, and immutability of judges.
 - ▶ Form a jury system to adjudicate cases involving particularly serious crimes.
- 5 Improve the organizational, structural, and functionary aspects of the enforcement sub-system and placing it under the supervision and control of the judicial system.
- 6 Improve efficiency of the law enforcement system, including aspects, such as, transparency, accountability, and structural optimization.
- 7 Ensure a strong role for the research component in the activities of the judicial and law

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enforcement sectors by creating research institutions and other state and non-state systems/mechanisms for monitoring and expert guidance.

- 8 Limit the operation of investigative bodies solely to law enforcement (tasking these bodies with uncovering evidence of crimes and presenting it to the state body issuing indictments) and eliminate the present investigative system that operates as the body responsible for administering pre-trial/justice.

Corruption in the Military

BACKGROUND

During recent years, the Armenian government has taken steps to reduce corruption in the defense sector. While not resulting in system-wide improvement, these measures have led to some progress. Nevertheless, the situation is far from satisfactory. The defense sector remains one of the most closed and corrupt institutions in Armenia and the public's distrust toward it is getting deeper. Forms of corruption permeating the defense sector include the embezzlement of state resources, bribery, patronage, and **procurement fraud**.

Corruption in the defense sector runs deep and is multilayered. What follows is a list of interconnected reasons explaining why corruption flourishes in the defense sector:

- Amid continued weaknesses of the state, a culture of corruption has formed that has elements of Ottoman-era dictatorial and Soviet totalitarian rule.
- A cynical attitude toward the state by the Armenian citizens, and conversely, a disregard of the right of ordinary citizens by the Armenian

government together form a unique layer in the culture of corruption.

- An ineffective management system from the perspective of structure, inner rationale, and mechanisms of governance and management. This system is essentially a Soviet replica which is outdated and obsolete.
- Inadequate transparency, accountability, and oversight of the actions of the army's top brass.
- Lack of adequate checks and balances over the use of the defense budget.
- A critical shortage of qualified, high-caliber personnel, who can act as agents of change in the fight against corruption.

CONSEQUENCES AND THE IMPACT ON NATIONAL SECURITY

The systemic corruption in the defense establishment has resulted in:

- The inefficient use of state resources allocated to defense. This includes large-scale embezzlement and waste.
- Poor management of the Armed Forces.
- Nepotism and resulting flawed selection of personnel, causing the formation of special interest groups that subordinate public and national interests to personal and clan interests.
- The formation of a governing criminal-oligarchic system under a disguise of democracy; the unconstitutional use of armed forces for cementing power and/or threatening to employ such forces to usurp authority.

As a consequence of corruption, the preparedness, security capacity, and wherewithal of the state defense are greatly diminished. Given the characteristics of the region in which Armenia finds itself, such a situation not only endangers national interests but also threatens

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the survival of the Armenian statehood.

RECOMMENDATIONS

As in the previous section, the implementation of the following measures would require a significant amount of political will:

- 1 Form a modern system of governance within the defense sector;
- 2 Motivate quality personnel to reject the culture of corruption;
- 3 Establish a merit-based personnel selection system;
- 4 Apply effective mechanisms for civilian monitoring of the Armed Forces;
- 5 Dismiss the most corrupt personnel—primarily the top-ranking circle—and implement real generational change within the ranks;
- 6 Include effective legal reform mechanisms via appropriate constitutional reform.

Corruption in Public Procurement

BACKGROUND

In his **televised address** to the members of the cabinet, Serge Sargsyan characterized the corruption in state procurement as endemic and encouraged the Prime Minister to fight corruption by going after the “bigger fish.” Many interpreted this as a move by Sargsyan to distance himself from the large-scale embezzlement taking place in the country which is regularly brought to the public’s attention by independent media outlets, think tanks, and the parliament’s Chamber of Audit. Regardless of Sargsyan’s statements, one thing was

clear—speaking about the large-scale embezzlement of public resources in Armenia is no longer a taboo.

Public procurement in the developing world accounts for a significant percentage of public expenditure and these systems are widely believed to be the main source of leakage from government budgets. Armenia is no different. Here, corruption in public procurement translates itself through:

- ▶ **Direct bribery:** kickbacks from suppliers to public officials;
- ▶ **Kickback brokers:** kickbacks from suppliers to middlemen or middle-companies, local agents of international firms, acting on behalf of public officials;
- ▶ **Front companies:** awarding contracts to companies owned or controlled by government officials either because of rigged bids (see below) or because all bidders are colluding so that the designated front company wins. Since there is no true competition, the prices for goods and services are exorbitant;
- ▶ **Bid rigging:** manipulating the bidding process by government officials to ensure that the contract is awarded to a designated bidder. This manipulation could include a pre-designed scheme such as, selective short-listing of suppliers, single sourcing through complex justification, restrictive specification, unrealistic delivery schedules, etc.;
- ▶ **Official-owned enterprises:** participating in a bid process and awarding contracts to companies owned by public officials.

Public Procurement accounts for over 60 percent of public expenditure of Armenia’s budget. According to the World Bank (2009), the sectors with the largest budgets (i.e., defense,

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health, and education) in Armenia utilized non-competitive procurement methods (single source and/or quotations) for over 80 percent of their purchases.¹³ For comparison, in a good public procurement practice, single source/selective procurement method levels do not surpass 5 percent of the total procurement budget. It has been established through international good practices that non-competitive procurement methods present an estimated 25–30 percent opportunity loss compared to competitive procurement methods.

The 2005 Public Procurement Law of Armenia established two procurement processes—open and restrictive—with various methods including selective and single source procurement. In treating the two processes of open and restrictive equally, the Procurement Law does not establish the open competitive process as the preferred method. Thus, it provides equal access to procuring entities to

utilize the restrictive methods, albeit under certain conditions, thus opening the door to inherent abuses.

The limited data available on the government's procurement [website](#) indicates that these methods are still in use for a sizable majority of all procurement-allocated budgets. The site should contain more contract-related, detailed data. At a minimum, the site should include data for each awarded contract, the bid announcement date, the venue for advertisement, the bid submission date, the procurement method utilized, the number of bids received, their respective prices, the name and coordinates of the winning bid, the amount and date of the awarded contract, the number of extensions (if any) with their relevant dates, the amount of extensions, and the final contract amount. Table 1 offers some insights into the extent of procurement-related opportunity losses in Armenia.

¹³ TI (2010b) paints a similar story.

TABLE 1. PROCUREMENT-RELATED LOSSES IN ARMENIA

| (in millions of US dollars) | FISCAL YEAR | | |
|--|-------------|-----------|-----------|
| | 2009 | 2010 | 2011 |
| Total budgeted expenditures | \$2,932 | \$2,498 | \$2,623 |
| Estimated procurement expenditures | \$1,759 | \$1,499 | \$1,574 |
| Estimated level of single source procurement | \$1,407 | \$1,199 | \$1,259 |
| Opportunity loss (25-30 percent) | \$352-422 | \$300-360 | \$315-378 |

Note: The following exchange rates were used for conversion: AMD306/US\$1 in 2009, AMD363/US\$1 in 2010, and AMD374/US\$1 in 2011.

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¹⁴ The accounting system applies to both budgetary institutions and most NCOs.

Two more issues undermine the integrity of the budget procurement in Armenia:

- ▶ **A coverage problem** has arisen because more than 80 percent of budgetary institutions were converted into Non-commercial Organizations (NCOs) and are outside the budgetary system. Although transfers to NCOs are subject to control by the budgetary system, their final expenditures—which constitute a large proportion of final general government expenditures—are not.
- ▶ **The accounting system** remains fundamentally unchanged since independence in 1991.¹⁴ The lack of any meaningful upgrade means that its effectiveness is likely to have progressively eroded over time. The authorities have announced plans to reform the system and introduce International Public Sector Accounting Standards (IPSASs) but little if any progress has been registered to date. These losses coming from the *use-of-funds side* are obviously large for an economy the size of Armenia's, and compared to the financial flows that the country receives in official assistance, including through Diaspora-led/facilitated efforts.

RECOMMENDATIONS

To signal a credible intention to eradicate corruption in public procurement legal proceedings should be initiated against those high-level officials who have been implicated in wrong-doings and subsequently dismissed from their positions. Letting those officials go unpunished only reinforces the atmosphere of impunity and encourages further theft.

To help monitor and limit the extent of corruption and mismanagement in the public sector, we propose the creation of a *region/marz*-level index within Armenia that would estimate the difference between public spending and the actual measures of infrastructure development and social services provided (see Golden and Picci (2005) for such an indicator constructed for Italy's 95 provinces and 20 regions). The larger the difference between the allocations and the reality on the ground (measured by the proposed index), the greater amounts of money would be expected to be lost via corruption and mismanagement.

Corruption in the Health Sector

BACKGROUND

As discussed in Chapter II, corruption in the health sector is high and is considered to be in the top four most corrupt sectors in Armenia. Armenia's health sector is a holdover from the corrupt sectors of Soviet times. The rise of corruption risks was furthered by insufficient funding, an inefficient management system, wasteful use of resources, and the lack of effective mechanisms for control. The concentration of ownership in the health sector combined with a short planning horizon undermines the possibility of the sector's success.

In Armenia's health sector the observed corruption can be divided into three levels: (1) state;¹⁵ (2) administrative; and (3) operational.

Corruption risks at the **state level** affect state resources:

- ▶ Corruption in public procurement, notably, the manipulation with public funds allocated to health services;
- ▶ Privatization of medical institutions at insignificant prices and hence with insignificant benefits to the budget;
- ▶ Monopolies in the pharmaceutical and medical supplies' industries;
- ▶ Distribution of financial resources for the benefit of a small elite controlling the sector;
- ▶ Successful lobbying and adoption of legislation that promotes the interest this elite;
- ▶ Conflict of interest (some high level public officials regulating the healthcare sector are also large players in the healthcare business).

The most commonly observed forms of corrup-

tion at the **administrative level** are:

- ▶ Rollback of public fund usage;
- ▶ Individual payouts from medical staff to owners and managers;
- ▶ Payouts from large and small entrepreneurs for the right to conduct business on the premises of a medical institution or bribes from vendors;
- ▶ Illegal manipulation of financial flows including assignment and overpay of wages;
- ▶ Unregulated procedures for recruiting and nepotism;
- ▶ Deliberate suppression of medical information;
- ▶ Unofficial "taxation";
- ▶ Administrative fraud.

Operational corruption is the most widespread one and takes the following forms:

- ▶ Manipulation with official and unofficial payments within the medical institution;
- ▶ Bribery;
- ▶ Improper usage of pharmaceutical and other resources;
- ▶ Provision of subsidized medicines to patients for additional payments;
- ▶ Requiring additional payments in exchange for providing "better quality" services.

The low wages of medical staff and the delays in payments creates fertile ground for these risks.

RECOMMENDATIONS

Corruption impacts the public health sector at all levels. Some officials and doctors enrich themselves illegally at the expense of the state, while others do so at the expense of patients. It may not be possible to eradicate corruption completely, but the following mea-

¹⁵ State level is also called bureaucratic or political corruption for the purpose of self-profit.

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¹⁶These surveys include: (1) **2010 Armenia Corruption Survey of Households**; (2) OSCE: Student's perception on Corruption in Armenian Higher Education System, Yerevan 2010; (3) Government of the Republic of Armenia, "The Republic of Armenia Anti-Corruption Strategy and Its Implication Action Plan for 2009-2012"; Yerevan 2009; and (4) H. Aleksanyan, "Cases of Corruption and its Prevention in Armenia's Education System; Yerevan 2012."

¹⁷Armenia signed the Bergen Communiqué of the Ministers of Education from the Bologna participating countries on May 19, 2005.

sures will likely dramatically reduce the extent of it:

- ▶ Improvement of legislation in the public health sector;
- ▶ Strengthening the state and public control while monitoring the state public procurement sector;
- ▶ Improvement of the compensation system for medical staff;
- ▶ Establishment of professional medical associations to protect the public and ensure health care standards;
- ▶ Development of independent public control by both the medical community and civil society to promote effective mechanisms to overcome corrupt practices while reducing corruption the risk.

Corruption in the Education System

BACKGROUND

According to surveys, the education sector is considered among the most corrupt sectors in Armenia.¹⁶ Corruption in the education system is widespread in all domains, especially in general and higher education. While there have been attempts to improve the situation through reforms, these efforts have also resulted in the creation and exploitation of new loopholes. The Bologna Process—the driver behind Armenia's educational reform, to which the country became a signatory of in 2005¹⁷—has become largely a smokescreen producing no tangible results.

Regarding university education, the internationally funded and accredited universi-

ties—the American University of Armenia, the French University, the Armenian-Slavonic University, and the German University—are somewhat immune from problems described in this section (to various degrees), but it is unclear how they are integrated into the overall system and whether or not they contribute to the education and human capital development in the country in the long run. Given the economic and human rights conditions in Armenia, the degrees received from these universities—which are less expensive to receive than in the host countries—may be seen as convenient launching pads for seeking job opportunities abroad.

The sector is highly politicized. According to a **2012 study conducted in Gyumri and Vanadzor**, the second and third largest cities of Armenia, principals of the schools are overwhelmingly members of ruling Republican party. Many of these principals are also involved in elections as members of electoral committees and for their political services often being allowed to conduct the affairs of their schools as they please.

The sector remains heavily underfunded. Salaries and compensation of teachers and faculty are part of the story, creating a fertile ground for bribe-taking (see Chapter V for a discussion on this). A study conducted in 2012 by the Center for International Higher Education (and **reported by New York Times**), Armenian professors on average are the poorest paid among the 28 countries studied in the report, one of the poorest on the global scale. Interestingly 10 major universities in Armenia are among top taxpayers: for example, Yerevan

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State University was **80th top taxpayer in Armenia** for the first half 2013.

There are no open recruitment procedures for hiring. Instead, anecdotal evidence suggests that bribing school principals to get hired is common practice. In such circumstances, the quality of staff hired is often overlooked. Bribing is also rumored to be common in the higher education system, where bribes are paid for university admission and for fixing grades during exams. In addition to this, academic fraud, favoritism, and career advancement based on party affiliations are among the most common manifestations of corrupt behavior at universities.

The illegal “fundraisings” at schools remains one of the most resonant corruption practices. The law permits parents’ assistance to schools on a voluntary basis.¹⁸ Despite the attempts of the Ministry of Education to address the issue (particularly by setting up a phone hotline), the teachers are forced to collect money for school funding which then goes to the school principals and other higher-level officials.

The oversight of budgetary resources remains poor and under the complete control of

school principals who manage the money with full discretion. School Boards (comprised of teachers, parents, and students) charged with this oversight are mostly ineffective and rarely fulfill their functions.

RECOMMENDATIONS

Any meaningful reforms in the education system in Armenia would require political will and significant financial resources. The latter hinges by and large on advances in economic conditions and would require time to secure. Measures proposed below, however, would be necessary for any systemic change to take root:

- ▶ De-politicize the top-level administrators in public schools, especially in universities;
- ▶ Ensure more transparent and merit-based recruitment policies;
- ▶ Institute a more effective management of public funds allocated to institutions of learning;
- ▶ Offer attractive compensation packages for school teachers and university faculty;¹⁹
- ▶ Reduce discretion and opportunities for human intervention in university entry exams;
- ▶ Set up a system of ratings and quality control in public educational institutions.

¹⁸ Law of the RA on Education, adopted by the National Assembly on April 14, 1999.

¹⁹ In the short run this can be done with resources freed up as a result of more transparent and effective managements of funds and by reducing the tax burden of universities. In a **recent interview**, a rector of one of the local universities reveals that better management of funds enabled 40 percent increase of salaries for teaching staff without any additional funding.

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²⁰ Annual Report on 2011 Activities
in the Field of Combating Money
Laundering and Terrorism Financing
in the Republic of Armenia.

Money Laundering

BACKGROUND

The current political and economic environment has created fertile ground for corrupt public officials and oligarchs to evade the laws of the country and launder the proceeds of crime and tax evasion without detection. Despite a growing banking sector and applicable laws which have been introduced to combat financial crime, the country still faces challenges in the fight against money laundering. The continuing hold of monopolistic power within the economy is linked to high-level government officials and a growing number of cash intensive businesses (such as, grocery chains, restaurants, hotels, brothels, and casinos). These powers have created more opportunities for corrupt politicians and their front men to hide proceeds of their illicit activities.

The Central Bank of Armenia (CBA) is responsible for regulating the financial and banking sector. The Financial Monitoring Centre (FMC), which sits within the CBA, is Armenia's Financial Intelligence Unit responsible for receiving, analysing, and disseminating financial intelligence. Financial intelligence is often submitted by financial institutions regulated by the CBA to law enforcement agencies for further investigation. Armenia is a member of the Committee of Experts on the Evaluation of Anti-Money Laundering Measures and the Financing of Terrorism (MONEYVAL).

Money laundering in Armenia is criminalized in conjunction with the requirements of the Financial Action Task Force (FATF). Some offenses

listed in Armenia's Criminal Code include bribery, embezzlement, extortion, forgery, and terrorist financing.

OPERATIONAL REGIME

In 2011, approximately 150,000 reports were filed on transactions above thresholds. These reports were subsequently subject to mandatory reporting and were then filed with the FMC, bringing the total number of reports contained within the FMC database to approximately 625,000.²⁰ Only 184 disclosures have been based on suspicious activity reports. As a result, only ten criminal cases were instigated in 2011, which resulted in five convictions on charges relating to production of counterfeit bank cards, embezzlement, and legalization of criminal proceeds.

While relevant legislation has been enacted, law enforcement authorities have conducted a low number of follow up investigations and convictions. This suggests that the implementation and collection of financial intelligence is a matter of form but not in spirit. This is further evidenced in a [recent article](#) published by Investigative Journalists that discusses a money laundering case involving Nairit Factory.

The legislative Anti-Money Laundering and Combating of Terrorist Financing (AML/CTF) measures adopted by the authorities resulted in little, if any, change on the ground. They are generally well received by international monitoring agencies, thus their substandard results are concerning to the (generally well-informed) Armenian public. [The U.S. State Department Money Laundering Report 2012](#) stated that while Armenia is not facing a high risk of

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money laundering for terrorist financing, other factors such as governmental corruption, the presence of organized crime, and a large shadow economy make the country vulnerable to the risk. Despite the warning, prosecutions and convictions remain low even with the 625,000 cases held with the FMC. Even with the wealth of financial intelligence material available with the Financial Intelligence Unit, authorities have only pursued a handful of investigations.

The lack of investigations in these areas stifles the willingness and ability of the government and law enforcement to instigate investigations regarding corruption, especially for public officials, oligarchs, and those closely associated with the ruling elite. The following is a list of reasons for this phenomenon:

- ▶ The Republic of Armenia Law on Combating Anti Money Laundering and Terrorism Financing, Article 3, defines a Politically Exposed Person (PEP) as 'An individual, who is or has been entrusted with prominent state, political, or public functions in a foreign country or territory'. From this definition, the current requirements do not extend to domestic political individuals or their family members and associates, which would allow banks to consider high risk domestic political clients in their risk based monitoring.
- ▶ Despite the shortcomings of the PEP definition, banks may not actively report suspicious activities with respect to domestic PEPs due to intimidation, fear of punishment, and retribution from authorities who themselves would be the subject of the suspicious activity report. This is also evidenced in the OECD report on "Anti-Corruption Network for Eastern Europe and Central Asia" (OECD, 2011), which highlighted that a particular attention should be paid to

PEPs, since no suspicious transactions reports relating to such persons have been identified so far (p. 29).

- ▶ Lack of transparency associated with ultimate beneficial ownership of legal persons which are linked to, or owned by, PEPs. This creates operational and due diligence barriers for financial institutions and law enforcement to identify the real owners of businesses.
- ▶ Senior Management and Compliance officials responsible for monitoring AML compliance risks are likely to be prevented from filing suspicious cases because certain banks' ownership/shareholding structure includes individuals²¹ who may themselves be accused of corruption and embezzlement. Conflicts of interest may also exist due to political, personal, or family loyalties and/or connections.
- ▶ Dissemination of cases by FMC to law enforcement authorities are biased and used as a tool against high profile political opponents.²²
- ▶ The FMC is not independent, thus it is unable to freely obtain and deploy its resources without undue interference or influence from a political party or the government.
- ▶ Law enforcement authorities do not request the FMC to provide materials related to corruption for the purpose of instigating investigations, which means that law enforcement bodies are not interested in pursuing corruption cases, especially against high profile PEPs.
- ▶ Lack of staff to deal effectively with the increasing number of disclosures from financial institutions (IMF, 2010; p.85).
- ▶ Pursuant to Article 176 of the Criminal Procedure Code, if the competent authority receives statements or mass media reports on or discovers information about crimes, there are "reasons" to instigate a criminal case. However, despite ample media reporting on activities with potential implications for money laundering by Armenian oligarchs, top govern-

²¹A recent report published by a Russian newsletter Versia (translation by Masis Post) alleges that Robert Kocharyan has shareholding of 30-50 percent in Converse Bank Armenia and over 50 percent in Ardshinvestbank. The same report states that Serge Sargsyan recently sold his shareholding in VTB-Armenia Bank for \$28 million.

²² Ex-foreign minister of Armenia, parliamentarian from Prosperous Armenia Party Vardan Oskanyan is accused of money laundering and misappropriation basing on Articles 179 and 190 of the Criminal Code. The case against the Civiltas Foundation concerns a \$2 million transaction for the sale of Huntsman Building Products, an Armenia-based company owned by US-based Polymer Materials and Huntsman International. The Ombudsman called the case "politically motivated".

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ment officials, and members of the National Assembly, no such criminal cases have been instigated by the National Security Service.

The IMF (2010) states that the low number of money laundering criminal investigations compared to the number of criminal investigations for proceeds-generating crimes, as well as the high standard of proof applied by the courts to establish that assets originate from crime, indicate an issue of effectiveness in the implementation of the money laundering criminal provision.

RECOMMENDATIONS

In addition to suggestions contained in the IMF (2010), implementing the following recommendations would provide a stronger defense against money laundering in Armenia:

- ▶ Ensure that the authorities are endowed with the responsibility for pursuing financial investigations that are independent and free of any political pressure and political association, while maintaining high standards of confidentiality, ethics and integrity.
 - ▶ Assign adequate financial, human and technical resources to law enforcement and prosecu-
- torial authorities.
 - ▶ Request that the authorities take a proactive approach and investigate accusations of corruption, money laundering or any form of illegal activity appearing in media reports, regardless of the affiliation of media channels to certain political movements.
 - ▶ Expand the current definition of foreign PEPs and include 'Domestic' PEPs in the law.
 - ▶ Ensure effective implementation and ongoing compliance with the 2012 recommendations of FATF.
 - ▶ Make the establishment of relationships with PEPs subject to CBA/FMC's review and approval (instead of approval of only the Senior Management of reporting institutions). This will allow the authorities to maintain a tight grip on monitoring of financial dealings of politicians and identify suspicious activities in a timely manner.
 - ▶ Identify emerging techniques and threats of money laundering which are being used by domestic PEPs to launder proceeds of corruption and communicate such typologies to the financial community in order to develop appropriate countermeasures in identification and reporting of suspicious activities.

IV. Effects of Corruption at Macroeconomic Level

A THEORETICAL PERSPECTIVE

Olson (1982), North (1990), and Clague and Rausser (1991) were among the first economists to reiterate the vitality of building adequate legal foundations and proper functioning institutions in promoting economic growth. Perhaps the grand summary argument brought forward in favor of doing so is that markets are less likely to exist when property rights and contract enforcement are absent or inadequate. Early empirical research was supportive of this assertion and found strong correlation between various determinants of institutional quality and legal framework on the one side and growth, investment, and the size of capital markets on the other side. A recent volume edited by prominent economists Douglass North, Daron Acemoglu, Francis Fukuyama, and Dani Rodrik (2008) offer ample reasons why the link between governance and macroeconomic growth exists and why it is important.

During the past decade, applied social science research has made substantial progress in measuring different types of corruption using different methods, such as, the implementation of specialized surveys of firms and individuals. There have also been advances in the theoretical literature that enhances our understanding of how political and economic systems function. In their groundbreaking book *“Why Nations Fail: The Origins of Power, Prosperity, and Poverty”*, Professors Daron Acemoglu and James Robinson put forth a thesis that nations with inclusive political and economic institutions are capable of sustained growth, while nations with extractive political

and economic institutions are not. Even when an authoritarian regime appears to engineer economic growth for some period of time, it cannot maintain this expansion because human creativity, human inventiveness, and the dismantling of old ways of doing things are lacking in authoritarian environments. By the virtue of always being ahead of the rest of the society, the vested interests are able to block competition, both political and economic, and often brutally so. Specifically, Acemoglu and Robinson note:

“Nations fail today because their extractive economic institutions do not create the incentives needed for people to save, invest, and innovate. Extractive political institutions support these economic institutions by cementing the power of those who benefit from the extraction. Extractive economic and political institutions, though their details vary under different circumstances, are always at the root of failure.” (p. 372)

The authors argue that success is circumstantial and is possible only when the regime has the right leadership and governance. The overarching prescription is thus to build inclusive, strong political and economic institutions to allow for the right circumstances to form that have the potential to lead to progress.

Wilson (2005) also argues that the main barriers for developing meaningful democracies are not the economic problems. He further notes that it is “the unique post-Bolshevik culture of ‘political technology’” that is the main obstacle to better governance in the region, to real popular participation in public affairs, and to the modernization of the political economy

²³ See Kormendi and Meguire (1985), Scully (1988), Brunetti, Kisunko, and Weder (1997), La Porta et al. (1997), Grigorian and Martinez (2001), among others.

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²⁴They document this evidence using a set of worldwide governance-indicators covering 175 countries and use the results to interpret the relationship between incomes and governance focusing on the Latin America and Caribbean region within a worldwide empirical context.

²⁵Poverty has grown steadily since 2008. The official statistics put 35.8 percent of population below the poverty line in 2010, compared to 27.6 in 2008 (NSS, 2011). However, given the rather low official poverty threshold (\$89.7 per adult per month), these statistics are likely understating the true number of people experiencing hardship. The overall social safety net remains inadequate. Official data on unemployment is notoriously unreliable, but anecdotal evidence points to a massive increase in the number of people left without jobs since the beginning of the crisis in 2008.

²⁶With a dramatic decline in FDI between 2009 and 2012 (see IMF, 2013, Table 2) and pervasive migration, it is not entirely clear what would drive the aggregate economic growth in Armenia.

²⁷Another area where state capture is pervasive is the management of country's natural resources. PFA (2010b) discusses corruption in mining and the use of resources (see Box 4).

in the longer term. On a similar note, Scully (1988) writes that “life, liberty and property are not additively separable attributes; the diminution of one diminishes all.” Setting up institutions and pushing the boundaries of freedom is not just an end in itself. This becomes the foundation upon which inclusive economic institutions that drive sustainable development are built.

But perhaps most important finding of the empirical research linking growth with governance is that while governance leads to higher growth and per capita income, (higher) income does not by itself lead to improvements in governance. Kaufmann and Kraay (2002) broke down the correlation between growth and governance between: (1) a strong positive causal effect running from better governance to higher per capita incomes, and (2) a weak and even negative causal effect running in the opposite direction (from per capita incomes to governance). The first result confirms existing evidence on the importance of good governance for economic development. The second result is new and suggests the absence of a “virtuous circle” in which higher incomes lead to further improvements in governance.²⁴ They explain the presence of the negative effect between income to governance by the presence of special interest and entrenched elites.

THE REALITY ON THE GROUND IN ARMENIA: THE POLITICAL ECONOMY DISINCENTIVES

It is this presence of special interest groups and rent-seeking entrenched elites that makes the reality on the ground in Armenia very bleak. A remnant of what was known as

the “silicon value of the Soviet Union”, the economy is presently held hostage by the political leadership and oligarchs connected to it. This is a **crony capitalist** system where a select few are given disproportionate access to power and influence over economic decision-making for their personal gain at the expense of the rest of the population. All of this is effectively protected by law enforcement agencies and judiciary, which act as guarantors of the regime’s safety and block any challenges that could be launched by people.

Economic policy choices made by the regime clearly reflect this *modus operandi*. Public policy—with its fiscal, monetary, social, and structural components—is implemented with a singular objective in mind: to enrich the ruling elite (see PFA (2012a) for a detailed discussion on this). Not surprisingly, most often the manifestations of this behavior hurt the poor, sick, underage, and elderly as well as the country’s national security and military preparedness. As a result, Armenia’s income inequality has increased and a significant portion of population is left in poverty.²⁵ Migration has reached catastrophic proportions with several bus loads of people leaving the (small) country on a daily basis for good. By manipulating macroeconomic data—specifically, by overstating real growth and understating price increases—the regime presents a favorable picture on both growth and poverty sides.²⁶

Nowhere else are the implications of *state capture* in Armenia as evident as in the process of formulating and implementing fiscal policy.²⁷ The fundamental function of redistribution of wealth to provide equal access to public ser-

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vices—explicit in the role of fiscal policy in any country in the world—has been turned upside down in Armenia, and here is how.

On the **revenue side**, the government does not sufficiently tax its friends—the oligarchs and top politicians with sizable business holdings—and instead harasses the remaining entrepreneurs and businesses by imposing excessive fines and advance payments on future tax liabilities and extorting bribes. This asymmetric treatment of enterprises puts independent business owners in very difficult conditions (and eventually makes them uncompetitive), helping the oligarchs and politically-connected “elite” in their pursuit of consolidating their hold on the economy. This makes a few individuals very wealthy and also reduces competition, restrains innovation, and limits growth and economic progress in general.

Recent empirical research provides some interesting insights into the magnitude of tax under-collection in Armenia. Studies conducted at the IMF (see Davoodi and Grigorian, 2007) and World Bank (see Le, Moreno-Dodson, and Rojchaichanthorn, 2008) show that Armenia’s potential tax-to-GDP ratio stands at 21 percent excluding social contributions. Taking into account that the *actual* tax-to-GDP ratio was 16.1-16.7 percent in 2009-11 (see IMF, 2013, Table 6)—higher only to that of Tajikistan’s from among the Commonwealth of Independent States—Armenia’s budget under-collected 4.3-4.9 percent of GDP per year in taxes.²⁸ In nominal term, this shortfall amounted to \$450 million in 2011 alone.

Interestingly, Davoodi and Grigorian (2007) also show that much of this shortfall in tax

collection is due to non-payment of corporate profit tax, a category under a direct control of oligarchs.²⁹

On the **expenditure side**, the government allocates very little funding to education, social safety net, and infrastructure investment. World Bank (2011) confirms this assessment by providing the following specifics:

- ▶ Public spending on health as a percentage of GDP is one-half of that in CIS and one-fifth of that in Europe and has fallen consistently below official projections (p. 49);
- ▶ While life expectancy in Armenia in 1970 was about two years behind Western Europe and ten years ahead of East Asia, it is now about eight years behind Europe and on par with Asia (p.50);
- ▶ Low public spending on health and the resulting high out-of-pocket health care payments cause households to fall below the poverty line (p. 52);³⁰

Only 30 percent of country’s roads are considered to be in good or fair condition (p. 67).

This, in no small part, is because constituencies that would typically be the main beneficiaries of public expenditures in these areas have little, if any, political weight. As a result, these expenditure categories are left grossly underfunded without any consequence for the government or the political leadership. In fact, further reductions are unlikely to have any political costs for the regime.

While the budget’s expenditure envelop in principle is restricted to the amount of revenue the government collects and how much it can borrow, provision of public goods and services in Armenia is also constrained by corrup-

²⁸ Tax collection has improved in 2012.

Part of this improvement, however, came from increased income tax rates for high-income earners and collection from the small and medium sized enterprises, most of which have already been subjected to advance tax withholding and other unorthodox collection practices.

²⁹ It is important to note that the low tax collection is not due to lower statutory tax rates. In fact, most tax rates in Armenia are at par with, or higher than, the rates in countries in the region and other comparators that have a higher tax-to-GDP ratio (See table on page 8 of PFA (2012a) for a comparison).

³⁰ Bribery actually penalizes the poor twice: acting as a regressive tax and discouraging access to basic services. Kaufmann, Montoriol-Garriga, and Recanatini (2008) show that for some basic services, low-income households pay a larger share of their income than wealthier ones do, making the corruption/bribery tax regressive. In addition, low-income individuals are more likely to be discouraged and not to seek a service than wealthier ones especially when in need of a basic service (i.e., education, water, and the police).

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tion and mismanagement in public procurement. The latter impose extensive *economic* and *social* costs. The *economic* costs involve the waste and misallocation of resources, efficiency losses, and higher transaction costs. The *social* costs accrue via the proliferation of non-transparent, unregulated patronage of networks and special interests. These networks weaken the rule of law and government authority, thus diminishing the government's mandate for accountability, and eroding the effectiveness of governance institutions and public service provision.

Estimates provided above (see Table 1 in Chapter III) provide a sense of overall budgetary leaks. Combined with losses from the revenue side, **the total budgetary losses in Armenia will be an excess of \$750 million per year**, or

in excess of 7 percent of 2012 GDP. This is a formidable sum, which could have otherwise been spent on education, health care, public investment, or national security.

Implications of these and other fraudulent activities and policy choices at the macro level are sizable. Box 2 below offers a simplified framework for calculating the foregone growth due to mismanagement and corruption in Armenia. It shows that corruption is costing Armenia 2 percent of real GDP annually. To put this in the context of time, Armenia's GDP could have been 55 percent higher than it is today—or \$16.4 billion instead of \$10.5 billion—if it consistently had a level of governance comparable to that observed in some of the well-governed economies in Sub-Saharan Africa, Botswana and Namibia.

BOX 2. FORGONE GROWTH IN ARMENIA DUE TO CORRUPTION: USING CROSS-COUNTRY EVIDENCE

This section poses a simple question: “how much would Armenia's growth rate and aggregate income have been, if the country had lower levels of corruption and better governance, holding other factors unchanged?”

To answer this question, we turn to published cross-country empirical studies that estimate the impact of corruption and economic growth. Differences in specifications notwithstanding, a typical equation that looks at the impact of corruption on growth could schematically be presented as follows:

$$Growth_{it} = \alpha + \beta \cdot Corruption_{it} + \gamma \cdot Controls_{it} + \varepsilon_{it} \quad (B-1)$$

where $Growth_{it}$ is growth of per capita GDP in country i at time t , $Corruption_{it}$ is a measure of corruption, and $Controls_{it}$ is a set of policy and control variables measuring countries' characteristics and other factors that may influence the growth of per capital GDP. Finally, ε_{it} is the model error. Estimate of β (or $\hat{\beta}$) provide a magnitude of the impact of corruption on income growth.

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With this in mind, we define a variable Foregone Growth in Armenia (i.e., difference in Armenia's per capita GDP growth due to corruption, holding all other factors unchanged) as follows:

$$\text{ForegoneGrowth}_{\text{Armenia}} = (\text{Growth}_{\text{Armenia}} | \overline{\text{Corruption}}) - (\text{Growth}_{\text{Armenia}} | \text{Corruption}_{\text{Armenia}}) \quad (\text{B-2})$$

where $\overline{\text{Corruption}}$ is a benchmark level of governance, better than that presently observed in Armenia. Using equation (B-1) and taking expected value of both sides of equation (B-2)³¹ results in the following simplified relationship:

$$E(\text{ForegoneGrowth}_{\text{Armenia}}) = \hat{\beta} \cdot (\overline{\text{Corruption}} - \text{Corruption}_{\text{Armenia}}) \quad (\text{B-3})$$

To get the value of $\hat{\beta}$ and estimate the foregone growth for Armenia using the above specification we utilize the following cross-country empirical studies that measure the impact of corruption on growth of per capita GDP:

- **Study 1:** Pellegrini and Gerlagh (2004);
- **Study 2:** Hodge et al. (2011); and
- **Study 3:** Mendez and Sepulveda (2006).

Table below summarizes the relevant statistics based of these studies and also reports quantitative estimates for Armenia. As benchmark comparators for Armenia, we chose Botswana and Namibia, two of the relatively well-governed countries in the Sub-Saharan Africa (exc. South Africa). The results would obviously be much stronger if countries of Eastern Europe (e.g., Estonia and Slovakia) were used as comparators.

TABLE 2: SUMMARY STATISTICS

| | STUDY 1 | STUDY 2 | STUDY 3 |
|--|-----------------------------|-----------------------|--------------------------|
| Measure of corruption | Corruption Perception Index | ICRG Corruption Index | ICRG Corruption Index 1/ |
| Estimated coefficient on corruption ($\hat{\beta}$) | -0.38 | -0.34 | -0.013 2/ |
| Armenia's value of the index 3/ | 2.9 | 1.5 | 1.5 |
| Average value of the corruption index for Botswana and Namibia 3/ | 5.2 | 3.25 | 3.25 |
| Expected annual Foregone Growth in Armenia (based on Equation B-3) | 0.9 percent | 0.6 percent | 1.3 percent |

1/ The index was rescaled in the study. 2/ Based on the quadratic specification (3) in Table 6 of the study. Coefficient on Corruption-squared is accounted for in estimation. 3/ Most recent available.

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³⁴Doing so would nullify the modeling and prediction errors.

The final row in the table suggest that if Armenia improved its governance to the level currently observed in Botswana and Namibia, its GDP per capita could have grown approximately 1 percent faster than it has grown in the past. In terms of aggregate GDP growth, this—after assuming an average annual population growth of 1.1 percent in the studies, equal the rate of growth of world population—implies foregone growth in excess of 2 percent annually.

While this may not appear much at the first glance, if looked at in terms of the cumulative impact, the findings are striking. They suggest that Armenia's GDP would have been 55 percent larger than its current level, if the country's governance had consistently been at the level of that in Botswana and Namibia for the past 22 years (since independence). In nominal terms, this suggests than instead of approximately \$10.5 billion, Armenia's GDP would have been \$16.4 billion in 2013.

While these estimates are arguably rough and cannot possibly account for all the complex factors that are at play when measuring the impact of rampant corruption on growth, they nevertheless provide good ballpark estimates of losses due to corruption and are likely to be at the lower bound of Armenia's foregone aggregate wealth and output since independence.

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RECOMMENDATIONS

A hypothetical political power that is in a position and has the will to “right the wrongs” should start by a complete revamping of the cabinet. What is required is a *true government of national unity* that would lay out a workable agenda and reach out to all constructive forces in Armenia and the Diaspora to help accomplish that. These efforts would require adequate professional skills, presently absent in the government, and the air-cover of a truly national and clean political leadership to be successful.

Some specific policy measures pertaining to problems discussed in this Chapter include:

- ▶ Leaks from, and corruption within, the budget should be curtailed. A much larger share of budget procurement should be handled through competitive bidding, and safeguards should be instituted to reduce the participation of firms connected to government officials. The Prosecutor’s Office should initiate legal proceedings against violations identified in the latest report by the Audit Chamber. The public

should be regularly updated on the progress on these proceedings.

- ▶ Under-collection of tax and customs revenues should be addressed without delay. This should begin with sweeping management and staffing changes in the state tax and customs agency, which, in addition to being seen as corrupt, is also used as a tool of political score-settling by the ruling regime.
- ▶ Tax and customs rules and regulations should be made clearer, less subjective, and less prone to rent-seeking. It should be noted that increasing statutory tax rates and tightening tax administration for individuals and businesses that are already under a substantial burden will further depress economic activity and reinforce the widely held notion that taxation in Armenia is unjust.

If undertaken, these measures may potentially free up hundreds of millions of dollars annually for investment in public infrastructure, education, research and development, social security, and defense and may result in faster growth, higher per capital income and more equal opportunities for all.

V. Estimating Bribery from Microeconomic Data

³² A study by Ul Haque and Sahay (1996) shows that public sector wage cuts beyond some point may reduce the government tax collection since they increase corruption.

³³ For example, when wages in police are low, the temptation for a traffic policeman to solicit a bribe from a driver for a speeding infraction (in return for not issuing a traffic citation) is strong.

General Hypothesis

There is a sizable body of empirical research linking the private-public wage gap with bribery. A study of 31 developing countries by van Rijckeghem and Weder (2001) finds a robust negative relationship between aggregate corruption indices and relative civil service pay.³² At an individual country level this should indicate that the lower the civil service wages relative to a country-specific benchmark, the higher the corruption.³³

It turns out that the private sector wage level is a useful benchmark to compare the public sector wages at a country level for making inferences about corruption. There appears to be an interesting difference in the pattern between private and public pay across countries. Although Gregory and Borland (1999) found that public sector employees generally receive higher average earnings than private sector employees in developed countries, a series of recent papers on transition countries have showed the opposite: public sector employees receive much lower wages than their private sector counterparts in Poland (Adamchik and Bedi, 2000), in Russia (Brainerd, 2002), in Ukraine (in Gorodnichenko and Sabrianova Peter, 2007), and Yugoslavia (Lokshin and Jovanovic, 2003). In the context of Armenia, World Bank (2011) states that “civil service salaries tend to be about 60 percent lower than reported earnings by non-public entities, which is a significant difference” (p. 45) and that “pay levels in Armenia appear to be sufficient for a reasonable standard of living only for the top two civil service groups (senior and chief)” (p. 44).

While several factors can explain why an employee would accept a relatively smaller pay by taking a public sector job, these factors can largely be accounted for in a regression framework. However, irrespective of the nature of those factors, and other things being equal, lower pay should translate into lower expenditures. Therefore, if after holding expenditure patterns the same there still remains a gap between private and public earnings, it could be concluded that unreported income of some kind is at play.

This Chapter explores these matters further. It follows the innovative research on measuring bribery in application to Ukraine published in the Journal of Public Economics by Gorodnichenko and Sabrianova Peter (2007). Authors argue that bribes received by the public sector employees are the most likely explanation for the difference between private and public wages in transition countries. This explanation in the Armenian context will be consistent with much of the evidence of widespread bribery and abuse of public office discussed earlier in this Report.

The analysis of Gorodnichenko and Sabrianova Peter is based on estimating the gaps in public-private sector employees’ expenditures and reported earnings to identify the size of unofficial compensation (i.e., bribes) received by the public sector employees. In this framework, bribery—as any other form of non-labor compensation—equals the difference between public-private wages after expenditures are accounted for. To follow the authors’ model and controlling for all labor market character-

ESTIMATING BRIBERY FROM MICROECONOMIC DATA

istics, the wage equilibrium with bribes can be presented as follows:

$$W_{private} = W_{public} (1 + b) \quad (1)$$

where $W_{private}$ is the earnings of a representative/average employee in the private sector, W_{public} is the earnings of a representative/average employee in the public sector, and b is the proportion of annual earnings received in the form of bribes by employee in the public sector. Since b is not observed, we use the estimate of b (denoted as \hat{b}) from the following equation to compute the proportion of earnings received in bribes as $(\exp(\hat{b}) - 1)$.

$$\ln W_i = b \cdot D_{private\ i} + Controls_i + \varepsilon_i \quad (2)$$

where $\ln W_i$ is the natural logarithm of monthly wage of worker i , $D_{private\ i}$ is a dummy variable that takes value of 1 if the person is employed in the private sector, and 0 otherwise and $Controls_i$ is a set of workers' characteristics, such as, age, gender, marital status, education, family size, geographic location, etc. Finally, ε_i is the error term.

The main assumption in this method is that there are no informal payments in the private sector. If, however, private sector employees do receive informal payments (which they do not report during survey interviews), then the estimate of bribery provided using this method will be understated.³⁴

Data Description

The data used for this analysis were collected by the National Statistical Service (NSS) of Armenia using a combination of interviews and self-reporting. These surveys are conducted every year and cover nearly 8,000 households (over 30,000 family members) from across the country. The Chapter uses household survey data for 2010. Table 3 below provides a summary of relevant indicators.

A more detailed list of variables used in the analysis below—both at the individual as well as the household level—is reported in the Appendix to this Chapter. The final (regression) analysis is

³⁴ For a detailed discussion on this issue see the end of this Chapter.

TABLE 3. DESCRIPTIVE STATISTICS FOR SELECT INDICATORS, 2010 (AVERAGES ACROSS GROUPS)

| | PRIVATE SECTOR | PUBLIC SECTOR |
|----------------------------------|----------------|---------------|
| Monthly wage (dram) | 81,596 | 73,892 |
| Hours worked (per week) | 46.1 | 39.7 |
| Paid benefits (percent) | 23.7 | 94.0 |
| Happy with current job (percent) | 58.8 | 73.5 |
| Number of observations | 3,521 | 3,044 |

Note: Employees categorized as working for central government and municipalities were treated as public sector employees for the purpose of this analysis. The sample contains only non-agricultural private sector employees.

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³⁵ The baseline conditional regression, in addition to D_private, includes the following variables: respondent's age, age squared, dummy variables for gender, marital status, full time employment, paid (i.e., leave and sick) benefits, 6 dummy variables for various education levels, and 11 dummy variables for marzes/regions.

³⁶ One more result of this analysis is worth noting. As reported in Table 5, the regressions suggest a very large wage differential between men and women in Armenia, ranging from 55 to 65 percent (with estimated coefficient for Female of -0.45 and -0.5), after controlling for other factors. This result is consistent with Mhitaryan and Oganessyan (2004), who report that the average monthly wage of women in Armenia is only 39 percent of the wage of men.

³⁷ Including this dummy variable intends to control for other factors that could determine job satisfaction (and, therefore, an employee's choice between a private vs. public sector job) but are otherwise difficult to measure.

based on a large sample containing 6,300 employed individuals and over 5,500 households (with at least one employed individual).

Quantitative Results

INDIVIDUAL-LEVEL ANALYSIS

Table 4 below summarizes the results of Ordinary Least Squares (OLS) regressions reported in greater detail in Table 5.³⁵ All regressions specifications show very good statistical fits

and economically meaningful signs of coefficients (*a la* Mincer, 1974). Estimates point to a difference in earnings between private and public sector of approximately 8.5-11 percent of public sector wages and confirm that there exist conditional differences between private and public sector earnings.³⁶ Interestingly, these results show a smaller private-public wage gap than that reported on Ukraine by Gorodnichenko and Sabirianova Peter (ranging from 24 to 32 percent). We explore this cross-country difference below.

TABLE 4. SUMMARY STATISTICS FOR WAGE DIFFERENTIAL

| | UNCONDITIONAL | CONDITIONAL | | |
|-------------------------------|---------------|---------------------|------------------------------|-------------------------|
| | | Baseline regression | Controlling for hours worked | Controlling for "Happy" |
| Estimate of b (\hat{b}) | | 0.105 | 0.080 | 0.091 |
| Percent difference 1/ | 10.4 | 11.1 | 8.3 | 9.5 |

1/ For conditional differences this is calculated as $(\exp(\hat{b})-1)$. Unconditional difference is the percent difference between average private and public sector wages as reported in Table 1.

To check for the robustness of the baseline results, the next regression added hours worked per week to account for the difference between sectors in hours worked. The estimate of the gap between sectors is somewhat smaller (0.08 vs. 0.105) but remains sizable and statistically very significant. Finally, the last column reports the result of the regression that replaced the dummy for benefits for a dummy variable that takes a value of 1 if the person is overall happy with his/her job.³⁷ Doing so reduces the wage gap only slightly but maintains its statistical significance.

HOUSEHOLD-LEVEL ANALYSIS

Unfortunately, factors such as prestige and risk aversion are difficult to account for in a regression framework. While in principle, these factors could explain why individuals may prefer public over private sector employment (and therefore determine the wage difference between the two), lower wages must translate into lower consumption expenditures irrespective of this. In other words, if public sector employees (choose to) receive lower wages for any reason, then they should spend less than their counterparts from the private sector (af-

ESTIMATING BRIBERY FROM MICROECONOMIC DATA

ter individual characteristics are accounted for). To see whether this holds in practice, the analysis was extended further to look household income and expenditures/consumption.

Column (1) in Table 6 presents the details of household-level OLS regressions using the following equation:

$$\ln(\text{Totalincome})_{HH} = a \cdot N_{private\ HH} + \text{Controls}_{HH} + \theta_{HH} \quad (3)$$

Where *Totalincome* is the combined wage and non-wage income of the household, $N_{private}$ is the number of household members employed in the private sector, and *Controls* is a large set of control variables describing the household, and θ is the error term.³⁸

Similar to results reported in Table 5, the regressions show remarkable fits and economically meaningful signs of all coefficients. Estimated income equation (see column 1) is consistent with the previous findings (see Table 5) and indicates a significant earnings gap between the public and private sectors employees. Total household earnings go up nearly 5 percent when a household member is employed in the private sector instead of being employed in the public, other things equal. The increase becomes 10 percent, if two member of the household are employed in the private instead of public sector, and so on.

The next step is to examine the possibility of a difference in expenditures between households with private and public sector employees. Total food and non-food expenditures (i.e., current expenditures) reported by household were thus regressed on the same set of

household characteristics as follows:

$$\ln(\text{Expenditures})_{HH} = \gamma \cdot N_{private\ HH} + \text{Controls}_{HH} + \delta_{HH} \quad (4)$$

where *Expenditures* is the total current expenditures of the household. The results based on OLS are reported in column (2) of Table 6. As expected, the difference in household expenditures of public and private sector employees (measured by the coefficient on $N_{private}$) is statistically zero (i.e., non-existent). This is an important consistency check both for the data as well as for the analytical framework used in this Chapter.

Having the same set of control variables in both income and expenditure equations (3 and 4) allows a direct estimation of the expenditure-income gap

$$\ln(\text{Expenditures})_{HH} - \ln(\text{Totalincome})_{HH} = \mu \cdot N_{private\ HH} + \text{Controls}_{HH} + \vartheta_{HH} \quad (5)$$

Figure 10 summarize the findings reported in Table 6.

Controlling for the size of assets would be another way to ensure the households are not running down their savings to finance their current expenditures. While this was not the focus of the survey, one indicator is very useful nevertheless: the self-assessment of housing condition—the main asset for many households in Armenia—as a proxy for household's total assets.³⁹ The results based on *ordered logit* regressions are reported in column (4) of Table 6.

Interestingly, private sector employment is negatively correlated with the quality of hous-

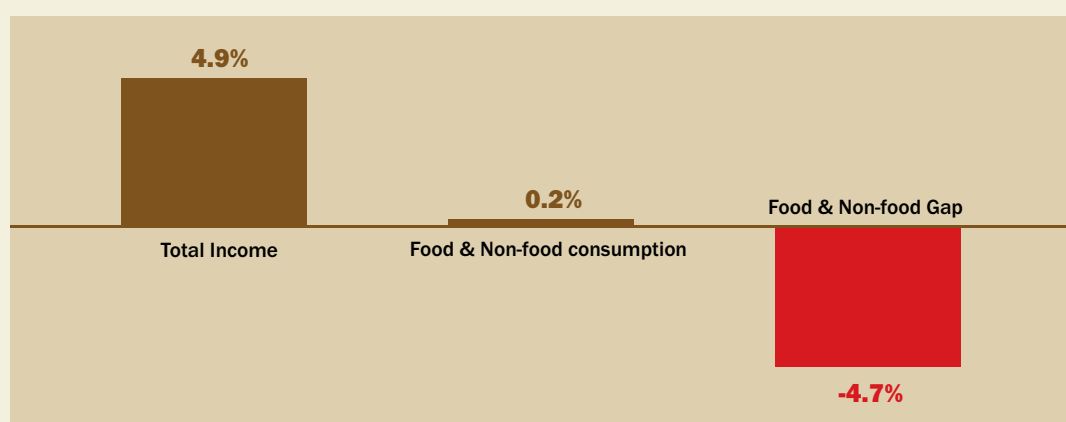
³⁸ This set includes the number of total wage earners, number of total household members, number of children under 11 years of age, the highest education level attained by any members of the household, the age of the household head (itself and squared), dummy variable if the household head is female, dummy variable if the head of the household is married, education level of the household head, and geographic location within Armenia.

³⁹ The variable takes values from 1 (very bad) to 5 (very good).

⁴⁰ For this comparison, the ranking for Ukraine was taken as of 2003 (i.e., the final year of Gorodnichenko and Sabirianova Peter's study) and for Armenia as of 2010 (i.e., the year when the survey data used in this study was collected). To compare at one point in time, Ukraine was ranked better than Armenia in 2003 and only marginally worse than Armenia in 2010.

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FIGURE 10. PRIVATE-PUBLIC HOUSEHOLD INCOME AND CONSUMPTION GAPS (PERCENT)



Note: Percentage point difference between private and public variables per every additional member of the household working in the private sector.

ing (suggesting that other things equal, employment in the public sector is associated with better quality housing), thus rejecting the hypothesis that public sector employees are financing their current expenditures by dipping into assets.

Sample Bias and Its Implications

This Chapter estimated the residual wage differentials between the public and (non-agricultural) private sectors using an extensive household survey from 2010. Comparing these differentials with the differences in household expenditures and assets the analysis showed that there is a statistically signifi-

cant difference between wages in private and public sectors, which is attributed to bribery. Specifically, the estimates point out that there is 8.5-11 percent difference between private and public sector wages once most measurable characteristics of individual employees and accounted for. Interestingly, these results suggest a difference, which is about one third of that in Ukraine, a country that was rated better than Armenia by Transparency International's **Corruption Perception Index**.⁴⁰

As startling as these estimates may seem, there are reasons to believe that these results understate the true extent of bribery at the aggregate (i.e., country-wide) level. The main reason is that the official household

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surveys conducted by the NSS are not representative of the entire population in terms of earnings and consumption patterns.⁴¹ In fact, Minasyan (2010) states that “there is a worrying disconnect between Household Surveys and National Accounts...” and goes on to show that depending on the measure of income, the average income reported in the survey is only 32-45 percent of total disposable income taken from the National Accounts.

Failure of the survey to capture the top income earners is the main reason behind the relatively small scale of the gap. If the top income group holds a disproportionately large part of national income, not accurately capturing this group may result in a substantial deviation from the aggregate (i.e., national income) data. Minasyan (2010) contrasts the income figures obtained through the surveys with the average income calculated from the national income accounting to arrive at this conclusion.⁴² In addition, she compares the car ownership data obtained from the NSS survey (which is difficult to hide/underreport) with that obtained from the state automobile registry (which is considered reliable). Results of this analysis too support the hypothesis that the NSS surveys fail to include all income groups in a representative fashion.⁴³ Finally, by referring to significantly different outcomes between the job-based surveys and household surveys conducted by the NSS, the World Bank (2011) indirectly confirms this finding (p. 45).

Perhaps more importantly for the above analysis, the NSS surveys are likely not capturing

the top government officials (and their families) among the excluded top income earners. The list of categories not captured in the survey includes government ministers and deputy ministers; heads of agencies, permitting departments, procurement offices, schools, state-owned medical clinics, and local municipalities; chiefs of police and tax inspectorates; and other categories of public employees that are typically accused of (and sometimes convicted for) large-scale/massive bribery and corruption. This will undoubtedly bias the estimates of individual (as well as aggregate) bribery downwards and thus should be treated strictly as the lower bound of the true extent of bribery in the country.

Conclusion

The above analysis offers both good and bad news. The bad news is that bribery in Armenia is widespread, as it is statistically significant and robust to various model specifications. However, the good news is that the scale of bribery is relatively small among most low- and mid-level government officials. This offers hope that a public sector reform that targets removal of top corrupt government officials and offers meaningful wage adjustment for the remainder of the public sector may be successful in eliminating bribery in Armenia. However, as Svensson (2005) points out, the effectiveness of anti-corruption policies based on wage increases hinges on the existence of an honest third party that can monitor the agencies involved.

⁴¹ Underreporting is likely to be another reason behind the relatively low estimates of bribery. However, when it comes to reporting official income there is going to be a difference between private and public sector employees. Private sector employees are likely to underreport their earnings because some of it may include unofficial payments, made by employers in cash to avoid social security payments/taxes on them. In contrast, public sector employees have their end-of-the-month payroll statement as a reference point when answering survey questions and are likely to report their official salary more accurately. This difference in reporting patterns is likely to understate the reported wage gap between private and public sector, leading to lower empirical estimates.

⁴² The author shows (based on the NSS survey from 2007) that only top 5 percentile of the surveyed households had income above GDP per capita; only top 3 percentile of population have consumption higher than national average; while top 1 percentile has consumption only double of national average, all pointing out that high income individuals are not represented in these surveys. Given Armenia's highly concentrated wealth structure, the missing super rich could easily account for a chunk of the 50+ percent gap between the survey and the national accounts.

⁴³ Furthermore, comparing the car ownership pattern across time—in 1999, 2004, and 2007—and contrasting it with the aggregate growth numbers, the author concludes that the official HH surveys have missed a growing share of well-off households: in 2004 more than in 1999, and in 2007 more than in 2004.

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TABLE 5. OLS ESTIMATES OF WAGE EQUATION (INDIVIDUAL-LEVEL REGRESSIONS)

| | DEPENDENT VARIABLE: NATURAL LOGARITHM OF MONTHLY WAGE | | | |
|--------------|---|---------------------|----------------------|----------------------|
| | Baseline (1) | w/ Hours worked (2) | Benefits=YES (3) | w/ Happy (4) |
| Dprivate | 0.105 (5.71)*** | 0.080 (4.45)*** | 0.103 (5.23)*** | 0.091 (6.52)*** |
| Age | 0.036 (9.77)*** | 0.034 (9.42)*** | 0.03 (6.33)*** | 0.04 (11.16)*** |
| Age-sq/100 | -0.043 (10.00)*** | -0.040 (9.58)*** | -0.036 (6.68)*** | -0.048 (11.43)*** |
| Female | -0.5 (35.12)*** | -0.45 (32.04)*** | -0.503 (29.90)*** | -0.498 (36.18)*** |
| Married | 0.019 (1.16) | 0.021 (1.30) | 0.004 (0.20) | 0.005 (0.31) |
| Fulltime | 0.09 (5.21)*** | 0.14 (8.24)*** | 0.101 (3.52)*** | 0.057 (3.45)*** |
| Benefits | 0.065 (3.47)*** | 0.075 (4.10)*** | | |
| Hours worked | | 0.009 (19.97)*** | | |
| Happy | | | | 0.282 (21.15)*** |
| Educ 6 | 0.457 (1.84)* | 0.488 (2.03)** | 0.411 (1.25) | 0.465 (1.94)* |
| Educ 7 | 0.39 (1.50) | 0.474 (1.88)* | 0.389 (1.15) | 0.399 (1.59) |
| Marz dummies | Yes | Yes | Yes | Yes |
| Constant | 10.287 (40.30)*** | 9.797 (39.40)*** | 10.524 (31.16)*** | 10.099 (40.91)*** |
| Observations | 6,265 | 6,265 | 3,568 | 6,265 |
| R-squared | 0.26 | 0.31 | 0.31 | 0.31 |

Note: Absolute value of t-statistics in parentheses. *- significant at 10 percent; **- significant at 5 percent; ***- significant at 1 percent levels. Categories of employment were not included in regressions as they were almost perfectly aligned with private vs. public sector categories/dummies. Regression 3 is run as a robustness test only for individuals that report having both health and leave benefits. The results are consistent with those of other regressions. Only education dummies with statistically significant coefficients are reported.

ESTIMATING BRIBERY FROM MICROECONOMIC DATA

TABLE 6. OLS ESTIMATES OF TOTAL INCOME AND CONSUMPTION (HOUSEHOLD-LEVEL REGRESSIONS)

| | DEPENDENT VARIABLES: | | | |
|----------------|------------------------------|--------------------------|---|-----------------------|
| | Total Income (1) | Current Expenditures (2) | Gap (Current Expenditures minus Total Income) (3) | Housing Condition (4) |
| | Ordinary Least Squares (OLS) | | Ordered Logit | |
| Nprivate | 0.048 (5.74)*** | 0.002 (0.22) | -0.048 (4.72)*** | -0.164 (1.74)* |
| Nwearners | 0.347 (38.61)*** | 0.142 (14.61)*** | -0.205 (18.99)*** | 0.276 (4.53)*** |
| Mempresent | 0.069 (15.32)*** | 0.111 (22.55)*** | 0.041 (7.59)*** | -0.111 (3.68)*** |
| Maxeduclev | 0.068 (10.39)*** | 0.105 (14.72)*** | 0.037 (4.63)*** | 0.269 (5.34)*** |
| Headage | -0.028 (9.05)*** | -0.001 (0.33) | 0.027 (7.21)*** | -0.159 (0.78) |
| Headage-sq/100 | 0.029 (10.61)*** | 0.000 (0.08) | -0.028 (8.74)*** | -0.011 (0.34) |
| Headfemale | -0.091 (3.62)*** | -0.053 (1.96)** | 0.039 (1.30) | 0.010 (0.29) |
| Headmarried | 0.137 (5.40)*** | 0.112 (4.08)*** | -0.022 (0.73) | -0.950 (4.48)*** |
| Nchildren | 0.031 (1.37) | -0.014 (0.58) | -0.045 (1.64) | 0.354 (2.54)** |
| Educ 6 | 0.180 (4.81)*** | 0.115 (2.82)*** | -0.068 (1.51) | -0.873 (0.63) |
| Educ 7 | 0.261 (2.26)** | 0.087 (0.69) | -0.178 (1.28) | 0.342 (0.23) |
| Marz dummies | Yes | Yes | Yes | Yes |
| Constant | 11.113 (123.08)*** | 10.278 (105.06)*** | -0.830 (7.65)*** | ... |
| Observations | 5,546 | 5,541 | 5,539 | 2,391 |
| R-squared | 0.54 | 0.43 | 0.15 | 0.08 |

Note: Absolute value of t-statistics in parentheses. *- significant at 10 percent; **- significant at 5 percent; ***- significant at 1 percent levels.

Appendix: Description of Variables

| | |
|----------------------|--|
| Dprivate | Dummy variable=1 if respondent works in the private sector and 0 otherwise; |
| Nprivate | Number of HH members employed in the private sector; |
| LnWage | Natural logarithm of individual worker's monthly wage (in dram); |
| Educ 2-7 | Dummies for 6 education levels; |
| Edumax | Highest education level attained in the HH; |
| Fulltime | Dummy variable for full-time employed; |
| Hours | Total number of hours worked in the past week; |
| Benefits | Dummy variable=1 if the respondents receives paid sick and vocation leave; |
| Happy | Dummy variable=1 if the respondent is happy with the current job; |
| Age | Age of the respondent (in years); |
| Age-sq | Age of the respondent squared; |
| Headage | Age of the HH head (in years); |
| Headage-sq | Age of the HH head squared; |
| Nwearnors | Number of wage earners in the HH; |
| Female | Dummy variable for females; |
| Marz2-11 | Dummy variables for 10 marzes (regions). Left-out region is Yerevan; |
| Totincome | Natural logarithm of total monthly income (wage and non-wage) of the HH; |
| Mempresent | Number of present HH members; |
| Nchildren | Number of children below 11 years of age; |
| Consump | Natural logarithm of total monthly HH current consumption; |
| Housing Cond. | Dwelling condition taking values of 1 through 5, with 1="very bad" to 5="very good". |

VI. Corruption and Business Activity: The Experience of Entrepreneurs

Introduction

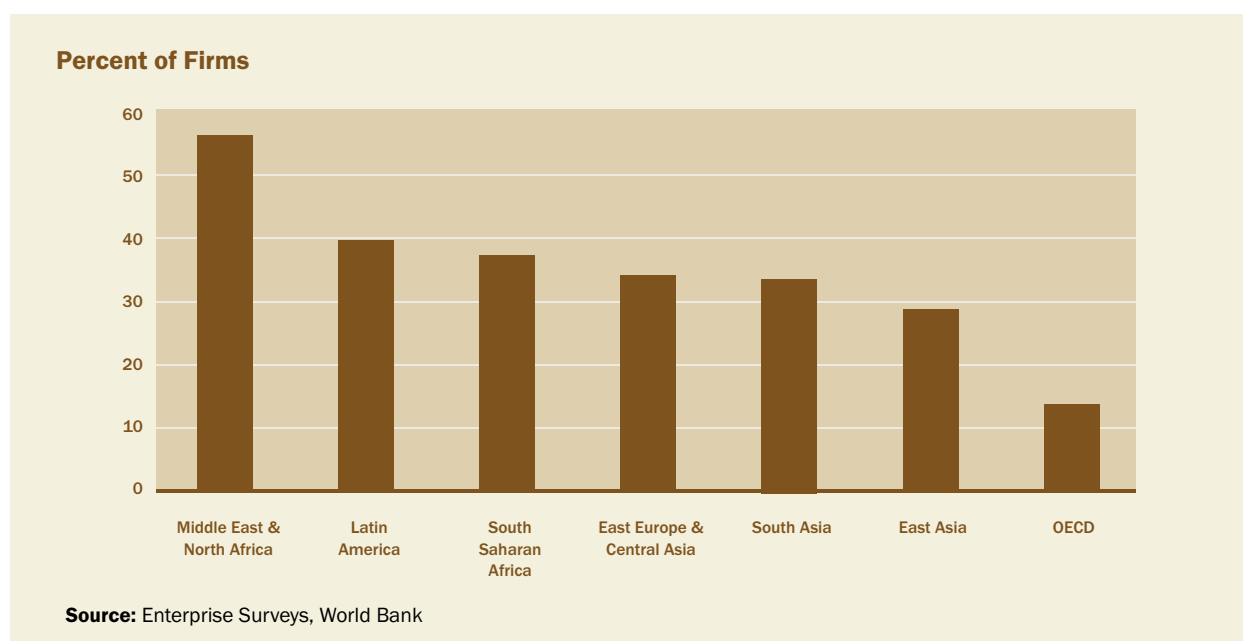
This Chapter assesses the extent to which corruption is perceived as a problem by the business community in Armenia and the actual cost of illegal payments for enterprises operating in Armenia.

The data used allow us to not only measure the degree of prevalence of corrupt behavior in a number of business activities (e.g., paying taxes, requesting licenses, obtaining permits, etc.), but also to estimate the corresponding value of informal payments. Furthermore we show the evolution of these corruption related dimensions of the business environment over time.

The results of this analysis are based on two sets of data. One set, at the macro level, is

represented by the Corruption Perception Index (Transparency International), the Doing Business Ranking (World Bank), and the Competitiveness Index (World Economic Forum). The second set, at the micro level, consists of three enterprise surveys of approximately 300 Armenian entrepreneurs conducted in 2002, 2005, and 2009. These surveys are part of the Business Environment and Enterprise Surveys (BEEPS) initiative and are periodically collected by a joint effort of the World Bank and the European Bank for Reconstruction and Development. Results are benchmarked against a set of economies in East Europe with similar characteristics to Armenia, with particular emphasis on neighboring Georgia, where anti-corruption efforts in recent years were the most talked about.

FIGURE 11. PERCEPTION OF CORRUPTION AS A MAJOR OBSTACLE



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⁴⁴ World Economic Forum (2009); Iarossi and Clarke (2011); and Batra et al. (2003).

⁴⁵ Doing Business 2012, International Financial Corporation.

Corruption in the Private Sector in Armenia: a Macro View

Generally, firms around the world face a number of obstacles to their operation. Among them corruption is often cited as one of the most important. Across the developing world as little as almost one third and as high as almost two thirds of firms complain about corruption (Figure 11).

Empirical research has clearly shown the negative effect of corruption both at the aggregate level (as discussed in Chapter IV above) as well as on the micro level. From a micro perspective, the negative impact of corruption is significant: it undermines competition, lowers productivity, and hinders firm growth. Illegal payments have been shown to increase the cost of doing business. Estimates of such costs are hard to come by, but they range from 2 percent to as high as 4.5 percent of sales.⁴⁴

Opportunities for illegal payments are created by the interaction between private and public sector. This is more so when regulations are not transparent and the rule of law is unevenly applied. The need for firms to obtain licenses and permits, to request clearance and public services provide a fertile ground for informal payments. Data from 170 countries show a

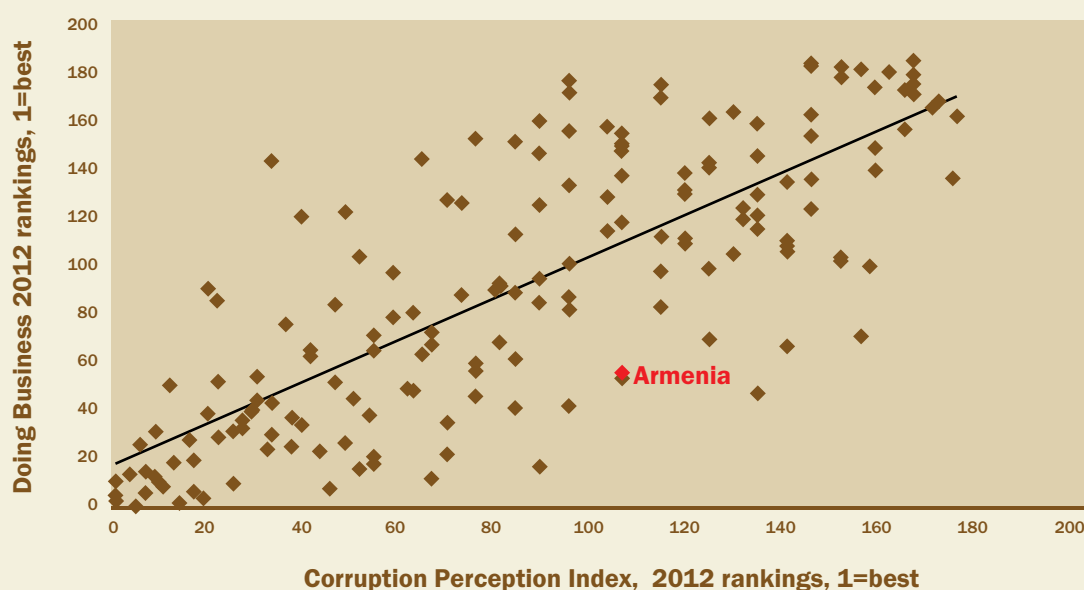
clear and strong positive correlation between the level of corruption and the ease of doing business around the world (Figure 12). The complexity of the regulatory environment represents a breathing ground for illegal behavior. In this scenario Armenia performs worse than what the average correlation would indicate. In fact, given its level of regulatory complexity, the level of corruption observed in Armenia should be half as high.

Armenia was one of the first former soviet republics to make a painful but necessary transition to a market economy through a number of reforms in the early-1990s, including the privatization of land and of state-owned enterprises. In recent years improvements were made in the delivery of electricity and other services, such as ease of paying taxes and resolving insolvency. In 2012, Armenia was ranked number 55 in the world in terms of ease of doing business.⁴⁵

Despite this progress, however, the prevalence of corruption in Armenia seems to have increased in the last decade. According to the Transparency International's Corruption Perception Index (CPI), in 2011 Armenia ranked 129 out of 182 countries in the world, much worse than its ranking in 2003 when it was ranked 78 (Figure 13).

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FIGURE 12. EASE OF DOING BUSINESS AND CORRUPTION PERCEPTION RANKINGS IN 170 COUNTRIES



Source: Transparency International and Doing Business Surveys

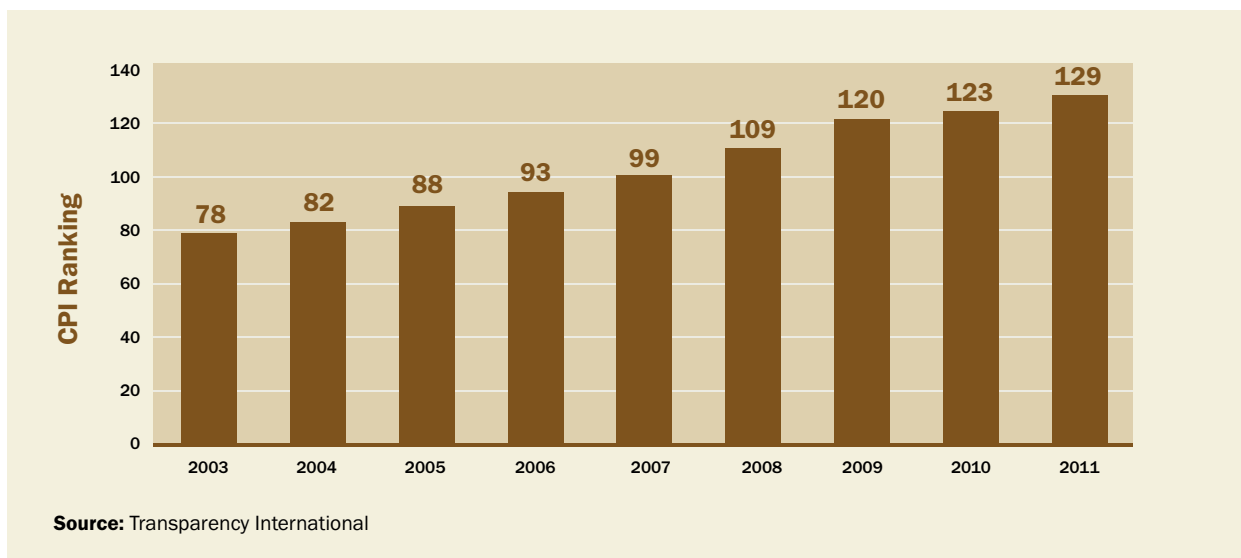
Corruption at the Micro Level: Views of Entrepreneurs

Several firm-level surveys over the last decade have shown that paying taxes, accessing infrastructure services, and obtaining credit are among the top constraints faced by firms around the globe. In 2002, Armenian firms followed this general trend by identifying tax rates and access to finance among the top five obstacles faced by entrepreneurs. Since

then, however, a unique phenomenon has characterized Armenia's business environment. Access to credit is no longer a major obstacle while corruption has become virtually the top constraint. As a matter of fact, while corruption was identified by Armenian entrepreneurs as the sixth most important obstacle in 2002, it became the fourth most important in 2005, and rose to the enviable second place in 2009, the latest year for which data is available. This is in sharp contrast with what has been happening in Europe and Central

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FIGURE 13. ARMENIA'S RANKING IN THE CORRUPTION PERCEPTION INDEX (2003-11)⁴⁹



⁴⁶ Because Transparency International changed its methodology in 2012 we could not use the CPI value for 2012.

Asia where corruption has always remained around the eight most important problem with a declining trend over time.

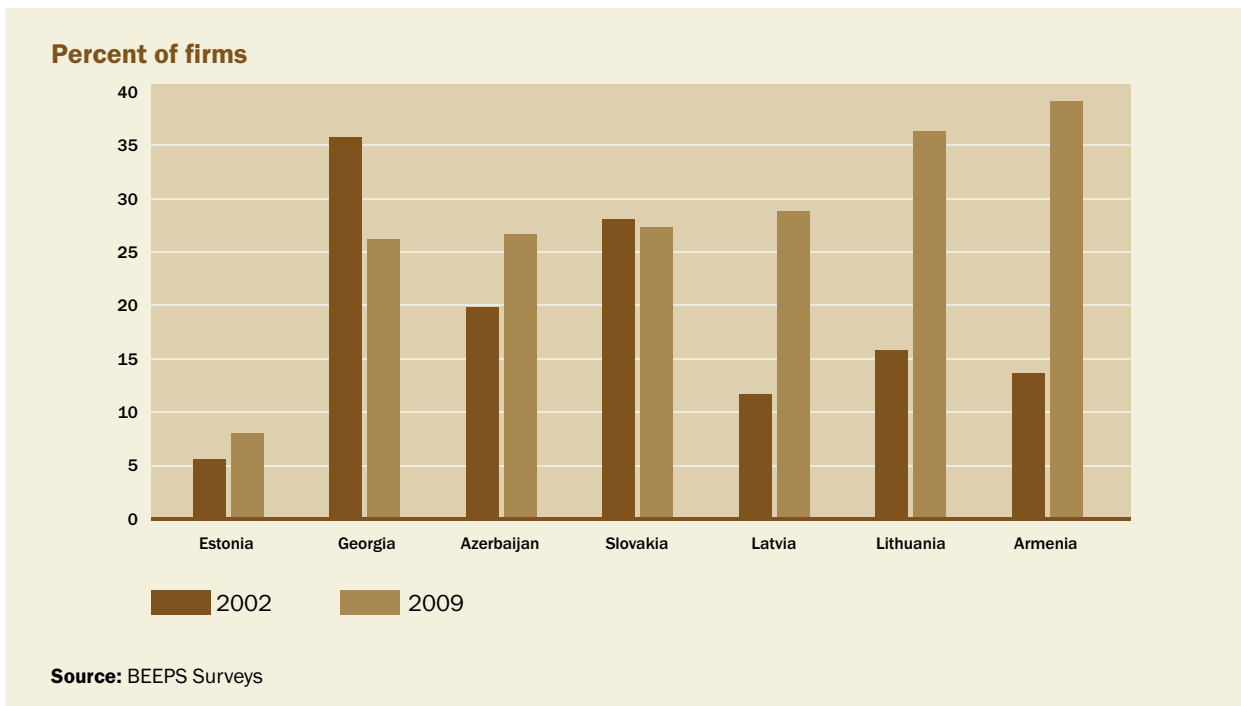
In Armenia, on the contrary, an increasing share of firms complained about corruption over time. In 2002, only 13 percent of them identified corruption as a major obstacle. This number increased to 20 percent in 2005 and reached 39 percent in 2009, three times as high as in 2002. No other country in the region has seen such a rise. Among a group of comparator countries represented by Georgia, Azerbaijan, Estonia, Latvia, Lithuania, and Slovakia, Armenia was the country with one of the lowest level of complaints about corruption in 2002, but became the country with the highest percentage of complains in

2009 (Figure 14).

Since most incidents of corruption occur when entrepreneurs interact with public officials (to obtain licenses, permits, authorization, or government contracts), we look more in detail at such events in Armenia and benchmark them with Georgia, a neighboring country that has been praised for its fight against corruption. In 2009, existing regulations required 43 percent of Armenian businesses to obtain compulsory certificates, 22 percent to obtain permits, and 21 percent to obtain an operating license. The corresponding values for Georgia were half as high at 21 percent, 18 percent, and 6 percent, respectively. Similarly, when requesting such certificates and permits, Armenian managers were asked for bribes 28 percent, 38 percent,

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FIGURE 14. PERCEPTION OF CORRUPTION AMONG BUSINESSES: (SELECT COUNTRIES)



and 11 percent of the times while no Georgian firm involved in such procedures reports being asked to pay bribes.⁴⁷

Overall, if we take into account all licenses, permits, and certificates, two out of three firms in Armenia were required to obtain at least one of them every year, and more than half of the firms reported being asked for bribes to get things done with regard to customs, taxes, licenses, regulations, etc. Again these values are approximately half for Georgia, at 36 percent and 24 percent, respectively.

Obtaining licenses and permits, however, is

not the only way firms interact with government officials. Business inspections represent another channel of interaction and possibility of illegal behavior. In Armenia, 84 percent of firms are inspected, compared to just 46 percent in Georgia. On average companies in Armenia receive inspectors more than three times a year, while their counterparts in Georgia receive inspectors less than once a year on average. Of the firms that are inspected 53 percent pay a fine (or bribe) in Armenia, compared to 63 percent in Georgia, perhaps indicating better targeting of companies for inspection in Georgia than in Armenia.

⁴⁷A recent volume published by the World Bank (2012) offers a details discussion on the anti-corruption effort in that country (based on a series of case studies) and why it was successful. "From these case studies, ten themes emerge that help explain Georgia's success story: having strong political will and vision; establishing credibility early; undertaking a frontal assault; attracting new staff; limiting the role of the state; adopting unconventional methods; coordinating closely; tailoring international experience to local conditions; harnessing technology; and using communications strategically" (as stated by the World Bank).

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Similarly, tax inspections are more frequent in Armenia than in Georgia, 81 percent of firms versus 43 percent, respectively. On average Armenian firms are visited more than 3 times a year, while Georgian firms are visited a little over once a year. Armenian firms were asked

for informal payments by tax inspectors 12 percent of the times, compared to just 2 percent in Georgia (Table 7). In terms of tax inspections and bribes, Armenia perform worse than all comparator countries, only second to Azerbaijan.

TABLE 7. INSPECTIONS AND INFORMAL PAYMENTS REQUESTS, 2009

| | GENERAL INSPECTIONS | | TAX INSPECTIONS | |
|--|---------------------|---------|-----------------|---------|
| | Armenia | Georgia | Armenia | Georgia |
| Average number of inspections last year | 3.1 | 0.7 | 3.2 | 1.6 |
| Share of firms inspected | 84 | 46 | 81 | 43 |
| Share of firms inspected that pay fees and/or bribes | 53 1/ | 63 1/ | 12 2/ | 2 2/ |

Source: BEEPS surveys. 1/ Share of firms that paid fees and/or bribes (not possible to separate). 2/ Share of firms that paid bribes.

⁴⁸ Overall Armenian entrepreneurs lose approximately 13 percent of sales per year, taking into account the losses from bribes, security measures and theft. These losses are in addition to losses of about 1.2 percent and 3.3 percent of sales per year due to transportation disruptions and power outages, respectively.

Dealing with regulations is costly for firms. This cost is represented by the time spent to follow procedures as well as by monetary outlays in the form of fees assessed and informal payments requested. Even with respect to these objective indicators of corruption Armenia performs poorly. In 2009, Armenian managers spent 12 percent of their time dealing with bureaucratic procedures, four times as much as in 2002 and the highest share among all comparator countries. This trend is the opposite of what has happened in Georgia over the same period of time (with a decline

of 11.6 percent and 2.5 percent of the time spent dealing with bureaucratic procedures).

Furthermore, while in 2002 Armenian firms paid approximately 1 percent of sales in bribes, this figure reached 5 percent in 2009 – a 400 percent increase. This adds significantly to the cost of doing business in Armenia, cuts productivity, and reduces the competitiveness of the country's private sector.⁴⁸ Cross-country evidence in fact shows a clear negative correlation between the level of competitiveness of a country and its level of corruption (Figure 15).

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FIGURE 15. CORRUPTION AND COMPETITIVENESS



Empirical Estimation

Some researchers have pointed out that corruption is not necessarily an obstacle to firms' operations.⁴⁹ They argue that informal payments could be beneficial to firms as long as they facilitate businesses' operations by increasing the speed with which government officials issue permits. We attempt to see if there is such evidence in Armenia by investigating the impact of illegal payments on at the amount of time needed to obtain licenses.

Survey data show that irrespective of whether firms are required or not to renew licenses and permits, an approximately equal share of them (38 percent) complain about corruption. This seems to be consistent with the view that corruption is more of an obstacle than a business facilitator. However, since it is possible that this result is influenced by the composition of the sample, we test the same hypothesis within a regression framework. This will allow us to control for a number of behavioral factors (e.g., paying a bribe, spending more time following

⁴⁹ Vial and Hanoteau (2010); Méon and Sekkat (2005); Beck and Mahler (1986); Lien (1986); And Méon and Weill (2010).

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the procedures, etc.) as well as fixed factors (e.g., being a small firm or a domestic company, etc.) that might influence the results.

Our hypothesis is that paying a bribe speeds up the process by which firms in Armenia obtain a license. We include in our estimation all firms that are required to obtain a mandatory certificate, a license or a permit and control for a number of firm-specific factors (e.g., firm size, export orientation, domestic ownership, and age). The model can be presented as follows:

$$Days_i = \alpha + \beta * Gift_i + \gamma * Controls_i + \varepsilon_i \quad (6)$$

Where $Days_i$ represents the number of days it takes a company i to obtain a license; $Gift_i$ represents a dummy variable that takes a value of 1 if the firm paid a bribe and 0 otherwise; and $Controls_i$ represents a set of control variables. Results of this regression are reported in Table 8 (column 1). The coefficient of interest, β , is significant but has the “wrong” sign, indicating that—contrary to our initial hypothesis—paying a bribe is associated with lengthier bureaucratic processes.

However, it is possible that the length of the

time needed to obtain a license depends on the effort put by the manager (or its staff) in dealing with the procedures related to the license. So we control for the number of days the firm’s staff spent dealing with the regulatory process (column 2). Doing so turns both the coefficients on bribes and the number of days insignificant, suggesting that neither paying a bribe nor spending more time to follow the regulatory procedures have any impact on the speed of obtaining a license. Again, these results do not support the initial hypothesis.

The next step is to add the amount of fees and bribes paid to the model (especially if this includes bribes, as the case in the data), as this may have an impact on the speed of obtaining a license. The results are reported in column 3. In this specification both staff days and the amount paid appear statistically significant, but the coefficient on paying a bribe remains insignificant. This appears contradictory: on the one hand, the variable on paying a bribe seems to indicate no impact on the dependent variable. On the other hand, the amount paid shows a positive association with the days to obtain a license.

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TABLE 8. REGRESSION RESULTS OF NUMBER OF DAYS TO OBTAIN A LICENSE

| | (1) | (2) | (3) | (4) | (5) |
|--|----------|---------|-----------|----------|-----------|
| Dependent Variable: Days to obtain license | | | | | |
| Gift (dummy) | 15.74* | -1.258 | 0.162 | -9.083* | -9.350*** |
| | (8.503) | (11.36) | (5.386) | (6.568) | (7.272) |
| Staff days spent | | 0.109 | 0.133** | 0.116* | -0.029 |
| | | (0.117) | (0.062) | (0.061) | (0.082) |
| Fees and Bribes | | | 0.0038*** | 0.003*** | 0.0004 |
| | | | (0.0007) | (0.0007) | (0.002) |
| (Gift dummy) *(Fees & Bribes) | | | | 0.004** | 0.008*** |
| | | | | (0.0018) | (0.002) |
| Permits (dummy) 1/ | 13.82* | 16.86** | 8.558* | 7.615* | 12.15** |
| | (7.148) | (8.336) | (4.369) | (4.319) | (6.026) |
| License (dummy) 1/ | -8.629 | | | | |
| | (9.868) | | | | |
| Constant | 13.58*** | 10.82* | 5.204* | 6.863** | 8.708** |
| | (4.248) | (5.586) | (2.940) | (2.976) | (4.020) |
| Observations | 330 | 200 | 151 | 151 | 61 |
| R-squared | 0.020 | 0.026 | 0.243 | 0.272 | 0.476 |

Standard errors in parentheses; *- significant at 10 percent; **- significant at 5 percent; ***- significant at 1 percent levels. The results with control variables are qualitatively identical. 1/ Compulsory certificates is the omitted category.

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⁵⁰ As mentioned earlier, the available data on payment includes both fees and bribes, hence we are unable to identify which firms are assessed a fee and which ones are assessed a bribe. With this sample restriction we try to filter only those payments in which we are certain that an actual bribe is involved.

To further clarify this relationship, we observed, surprisingly, that more firms that are not visited by inspectors (47 percent) complained about corruption than firms that were indeed inspected (29 percent). This fact made us suspect of a potential link between inspections and illegal behavior. To test this, we postulate that the coefficient on paying bribes in the above model depends on the occurrence of inspections. So our augmented model becomes:

$$Days_i = \alpha + \beta * Gift_i + \delta * (Inspection_i * Gift_i) + \gamma * Controls_i + \varepsilon_i \quad (7)$$

The modified model shows significant results and of the expected sign. Paying a bribe during an inspection has the effect of reducing the number of days needed to obtain a license. Furthermore this effect seems to disappear as the amount of the fees and bribe increases (column 4). Because of data limitations and due to the sensitive nature of the survey question on admitting to pay a bribe, we finally run the same model on a restricted sample of managers that report corruption as a problem.⁵⁰ The earlier results are confirmed. For these firms even the number of days spent by staff has no impact on the speed of obtaining a license, while paying a bribe in connection with an inspection remains an effective way to speed up the process (column 5).

Conclusion

Over the years, corruption has become more and more of a problem to entrepreneurs operating in Armenia. Both macro level evidence and firm level data confirms that corruption is now one of the top three problems faced by Armenian firms. It imposes a significant cost on Armenian firms, both in terms of time spent and sales lost. With an estimated cost to firms of approximately 5 percent of sales per year—the highest of all comparator countries—the ultimate impact of this is undermining the productivity and competitiveness of Armenia's economy.

Analysis conducted in this Chapter shows that inspections and other administrative barriers are used to extract rents from entrepreneurs. This confirms once again that barriers for progress and development in Armenia are man-made and therefore can be reduced, if not eliminated, in the presence of political will.

VII. Going Forward: Setting a Credible Anti-Corruption Agenda

To bring about social cohesion, fairness, and economic efficiency in Armenia, a credible approach to identifying, securing, and disposing of illegally acquired assets would be required. This Chapter provides a framework based on international experience that addresses issues of identification, repossession, and redistribution of illegally acquired assets. In addition to spurring a public debate, this Chapter intends to remind corrupt officials that there is no safe haven for their stolen assets. Civil society organizations and watchdogs, such as, Policy Forum Armenia, are focused on exposing corruption that results in large-scale embezzlement and are ready to help prosecute the perpetrators and recover stolen assets, irrespective of their location.

In doing so, the Chapter answers the following four questions:

- ▶ How should the illegally acquired assets held both in and outside of Armenia be identified?
- ▶ Who should be responsible for seizing the assets?
- ▶ Where, how, and for how long should those assets be held?
- ▶ How should the assets (or the proceeds from their sale) be re-distributed?

The problem of stolen assets entered the domain of bilateral and multilateral politics only recently. In recognition of a growing problem, a joint Press Release issued in 2010 by the World Bank (WB) and the United Nation Office of Drug and Crime (UNODC) entitled “Creative International Cooperation Can Help Developing Countries Recover Stolen Assets” stated:

“Developing countries lose between \$20 billion and \$40 billion each year to bribery, embezzlement, and other corrupt practices.”

As discussed earlier in the Report, Armenia is no exception in this regard. In fact, the aggregate amount embezzled since independence is likely to exceed Armenia’s GDP, requiring a special mechanism or approach to be handled properly.

Legal provisions in International Law

Several international instruments (regulations and standards) clarify how to administer and regulate the disposal of proceeds of crime or property:

- ▶ The United Nations Convention against Corruption, Article 31(3), and the United Nations Convention against Transnational Organized Crime, Article 14, stipulate that states should make provisions to regulate the administration and disposal of confiscated property in accordance with their domestic law and administrative procedures, which they are encouraged to adopt. The Legislative Guide to the United Nations Convention against Transnational Organized Crime and the Protocols Thereto states that for most confiscation systems, a key objective is to “restore to victims property taken from them by criminals and it is extremely useful to provide for a procedure under domestic law to enable sharing of confiscated assets with domestic and foreign victims” (page 152). Article 57(1) of the United Nations Convention against Corruption states that confiscated property be returned to its prior legitimate owner.

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⁵¹Interestingly, Armenia ratified both treaties with reservations.

- ▶ According to the Council of Europe report “Combating Organized Crime: Best Practice Surveys of the Council of Europe”, in some states, confiscated proceeds do not go to the state but instead go to activities such as law enforcement, police training, or prevention activities (page 71). The Council of Europe report stresses the importance of transparency of expenditure, so the public knows where the funds end up. In the case of trans-border criminal offenses, as set out in Article 14 of the United Nations Convention against Transnational Organized Crime, the state that has confiscated proceeds or property may consider sharing it with the other states or using it to cover costs of mutual legal assistance provided by the other state.
- ▶ Other relevant laws include: (a) Convention on Laundering, Search, Seizure and Confiscation of the Proceeds from Crime and on the Financing of Terrorism and (b) Criminal Law Convention on Corruption.⁵¹
- ▶ Building partnerships to increase legislative, investigative, judicial, and enforcement capacity in developing countries to enable them to successfully recover the stock of stolen assets while deterring new flows;
- ▶ Helping developing countries monitor the use of recovered assets, in the case of voluntarily agreement.

With the objective to “end safe havens for corrupt funds”, StAR provides governments of developing countries with technical assistance and advice on how to effectively detect, prevent and recover stolen assets. It strives to build strong international standards, collective responsibility and action plans, establish institutions, use proper legal tools and channels, and build skills and knowledge of practitioners. Although StAR does not investigate or prosecute cases, it helps countries launch and run cases, linking them with financial centers, law enforcement and financial intelligence practitioners in financial centers.

The initiative expects to have far exceeding benefits than the asset restitution itself. The program signals that ‘there is no safe haven for stolen assets’, embodying a powerful prevention effect. Additional benefits are expected as asset recovery effort are accompanied by institutional reforms.

Individual experiences of countries dealing with illegally acquired assets vary depending on the severity of the issue. Box 3 below provides some examples of that.

Multilateral Arrangements: Stolen Assets Recovery Program (StAR) Initiative

In 2007, the WB, in partnership with the UNODC, launched the Stolen Asset Recovery (StAR) initiative. The mission of this initiative was framed by the WB’s Governance and Anti-Corruption and the UN Convention Against Corruption, the first global anticorruption agreement that entered into force in December 2005.

The WB-UNODC partnership thus aims at:

- ▶ Enhancing cooperation between developed and developing countries on StAR and convincing all countries to ratify and implement UNCAC in partnership with other agencies;

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BOX 3. COUNTRY EXPERIENCE WITH STOLEN ASSET RECOVERY

Nigeria: During his rule of Nigeria from 1993 to 1998, General Sani Abacha was estimated to have looted from \$3 billion to \$5 billion. His death in 1998 prompted the opening of investigations and then campaigns to recover the assets stolen by him and his associates. The embezzled funds were laundered through a complex web of banks and front companies in several countries and localities. The Nigerian government engaged the Swiss authorities and a Swiss law firm to assist with tracing and recovering of monies held abroad. Nevertheless it took Nigeria five years to obtain a repatriation decision from the Swiss authorities due to numerous appeals brought by the Abachas, who employed large numbers of lawyers to block or slow the case. A total of \$505.5 million was repatriated in 2005 and 2006. The World Bank was selected as a bona fide third party for the monitoring of recovered assets. The Nigerian civil society organizations were also mobilized to participate in the review and analysis of the use of the looted funds. The funds have generally been used to increase budget spending in support of the Millennium Development Goals, as promised.

Peru: During the presidency of Alberto Fujimori (1990–2000), the intelligence police chief, Vladimiro Montesinos, methodically misused his position, bribing judges, politicians, and the news media. More than \$2 billion was allegedly stolen from the state. For laundering the proceeds, Montesinos and his cronies used shell companies based in tax haven jurisdictions, managed by trustees.

The new president, Alejandro Toledo, put in place a new anti-corruption system, including prosecution agencies and anti-corruption courts, fundamental to the dismantling of the prevailing corruption network and the repatriation of the stolen assets. Montesinos was captured in Caracas and extradited to Peru. As a result of the international cooperation, nearly \$33 million was repatriated to Peru from Cayman Islands, \$77.5 million returned by the Swiss authorities, and \$20 million by the United States. The repatriated assets went into a special fund, which was managed by a board of five members appointed from different government ministries.

Tunisia: After the revolution of 2011, hundreds of assets previously owned by members of Tunisia's Ben Ali regime were put on sale to the public. The Committee for the Management of Confiscated Assets was formed and became responsible for the sale and organization of these assets. It marked the beginning of a long process of making the private holdings of the former regime public.

Germany: In 2008, in unprecedented move to fight tax evasion, the German authorities bought a DVD with stolen data on German clients suspected for tax evasion from an employee of Liechtenstein Global Trust. The information was used to investigate more than 700 citizens and most importantly the former head of the German Post Office, Klaus Zumwinkel. In the wake of these events, the German tax officials embarked on a campaign calling for Switzerland to be blacklisted as an uncooperative tax haven. In 2009, the OECD put Switzerland on its "grey list" of tax havens and removed it from the list only after Switzerland signed new

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tax agreements with 12 countries. The same year Switzerland accepted OECD standards on information exchange related to tax evasion and fraud, under the pressure from G-20.

In 2010, Germany announced plans to buy a CD containing customer data of HSBC bank in Switzerland, a move that created a stir among tax evaders. To avoid prosecution, thousands of people lined up to confess that they had dodged their taxes. The Swiss government was forced to undertake serious reforms in the banking sector and declare that it would no longer accept untaxed money.

Ukraine: In 2005, Ukraine revoked the privatization of the Krivoriizhstal steel factory, which had been sold to a group of domestic investors for \$800 million, and subsequently sold it in a fair tender to Mittal Steel for \$4.8 billion, in what is generally viewed as Ukraine's most transparent major privatization to date.

United Kingdom: The confiscated assets and goods in the UK are subject to auctions organized by the police. After the sale, the police have to decide on the disposition of the proceeds. The vast majority of this money goes to the Home Office, so that it can continue to improve its service. According to the UK laws and regulations, the criminal justice system is also likely to receive a large injection of funds to help with the funding of local courts, the police service, prisons, and the work of probation officers. Recently a small proportion of the funds have been placed in projects called "community cash bank". People of the community often vote on how the money should be spent.

Presently, significant scrutiny is being applied to off-shore centers, where much of the money that avoided taxation by high-net worth individuals is believed to be hidden. Recently, the International Consortium of Investigative Journalists (ICIJ) **announced** that they are in a possession of information that links top country officials from 170 countries to assets in off-shore centers. Interestingly, the European Council's High Level Working Party on Taxation **has formally requested** the ICIJ to release the data.

Identification of Criminal Property

This issue is perhaps the most difficult for the following reasons. First, information transparency and disclosure standards around the world remain poor, making identification difficult, especially in Armenia. Some cases, such as off-shore jurisdictions, are different than others and complicate the matter further. In these cases information disclosure and transparency rules

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are often sub-standard. Second, the accuracy of information—the difference between the records and facts—adds another layer of complication. This includes issues such as “hidden” connections between the property ownership and its final holder—a practice widely used in Armenia. Finally, restating justice and fairness requires that no mistakes be made in the process of identifying the improperly acquired assets. The process needs to be handled in a way so that it is accurate, fair, and transparent.

Considering that there are already established channels to transfer funds and acquire property/invest in assets through specific mechanisms (including networks of several holding companies and off-shore registrations with confidentiality and secrecy requirements), identifying “stolen” assets could be a challenge.

However, the secrecy surrounding the issue of asset ownership can be unveiled with the help of public action. Specifically, a database of stolen property can be established, using both publicly available information and leads from “whistle blowers”.⁵² Diaspora communities in countries that typically receive stolen assets could be enlisted for support. Internet and social media outlets could be used extensively for the purpose collecting and verifying this information. This will prepare a necessary ground for vetting the collected information and its use. The latter could be done by a special commission to be created specifically for this purpose (see below).

Confiscation/nationalization and subsequent denationalization of property acquired via illegal means

The process of identification of stolen property both in and outside Armenia should be conducted by the Preparatory Commission (PC) to be established for that purpose. The PC will prepare the legal grounds for the nationalization and (a temporary transfer of ownership of those assets to the Republic of Armenia, in coordination with relevant government non-government agencies, if/when appropriate. Finally, the PC should prepare the necessary legislative changes for a smooth transition from nationalization to the eventual de-nationalization of stolen assets.

The PC should strive to have a wide-based support of the civil society, the media, Diaspora, and other stakeholders. It should consist of high-caliber finance and legal professionals from Armenia and the Diaspora, who have previously not held executive, legislative, or judicial appointments in Armenia. The PC should make public its annual reports of activities and report to the Parliament.

Once the tasks of identification of assets and preparation of legal grounds for their nationalization are completed, a National Commission on Management of Confiscated Assets (NCMCA) should be created (instead of, or in addition to, depending on circumstances) to proceed with the rest of this process towards the final denationalization of the assets.

⁵² Information collected by some state agencies (e.g., National Security Service, Police Department, and the Central Bank) since Armenia's independence too can be used for this purpose.

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⁵³ It is important to involve the victims of corruption in the process and ensure that the public knows how the funds are allocated and to whom.

⁵⁴ The latter could involve utilities and some strategic enterprises. In most of these cases, however, private management contracts should be considered.

⁵⁵ The Corporate Governance Center Foundation (CGC) www.corpgov.am is currently attempting to create an Institute of Corporate Directors in order to produce well trained and certified specialists being able to act as a director in any company's board. Individuals attending the CGC training sessions will be sufficiently professionally prepared and might be chosen (via a rigorous exam/interview process) to become directors. These specialists could be well used in the process of governance/management of these "big" companies, as they could be nominated by the NC for this purpose.

The general principles to be applied for the NCMCA functioning should be:

- ▶ Adequately safeguarding the resources;
- ▶ Securing transparency of transfer of ownership;⁵³
- ▶ Securing uninterrupted functioning of the tangible and non-tangible assets (i.e., factories, import and distribution channels, etc.); and
- ▶ Guarantee the transfer of ownership in such a way that strikes an appropriate balance between fairness and economic efficiency considerations.

The NCMCA will be mandated to have a short life (3 to 5 years), during which it will be obliged to transfer the ownership of assets under its control to the private sector and, in some exceptional cases, to the state.⁵⁴ The general tasks of the NCMCA are the follows:

- ▶ Create a database of assets under management and make it public;
- ▶ Conduct a case-by-case management of transferred assets (as different types of assets/funds will need different approaches and management);
- ▶ Secure information-sharing across relevant domestic and international agencies;
- ▶ Ensure transparent process of tenders, auctions, and other transactions as well as of the use of funds;
- ▶ Subject to the overall policy (to be set by the Parliament), distribute the funds while ensuring fairness and transparency as well as compliance with Armenia's international obligations;

Having identified the assets, the NCMCA should organize their secure, transparent, and fair transfer to custody of new owners through different methods depending on the type of assets. Different type (and size) of assets would require

different treatments along the following lines:

- ▶ **Small-size** assets (such as, houses, cars, small shops, etc.) can be disposed of through auctions. The funding raised through this could be initially deposited into a designated account (to ensure transparency and ease of monitoring), to be later transferred to either the State Pension Fund, individual retirement/wealth accounts of residents of Armenia, or a Sovereign Wealth Fund (see below).
- ▶ In the case of **medium-size** assets (such as, small/mid-sized factories, supermarkets, etc.), individual sales through tender should be pursued. In some cases, consideration should be given to distributing a certain level of equity/shares in those companies to certain categories of stakeholders (e.g., existing shareholders that may have been wronged, employees, etc.) to secure a better and more efficient functioning of those enterprises in the future.
- ▶ In the case of **large-scale** assets (such as, large enterprises, banks, etc.), the NCMCA should use specific care and attention. In such cases, the NCMCA should take over the rights and responsibilities of the confiscated properties and act as the owner of the shares in the governance system of these companies, while preparing the public sale of the company. In doing this, it can outsource the governance/management of its part to specialized management entities, or nominate directors to sit on the board of those companies, until the divestment is completed.⁵⁵ In this case too, part of the shares could be distributed to existing shareholders and workers/employees as compensation.

Safeguarding and Redistribution of Stolen Assets

Proper handling of the recovered stolen assets would require a well-defined structure and trans-

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parent mechanisms. To this end, at least two (not mutually exclusive) methods can be implemented at various stages and for different types of assets.

The first method (which was implemented in Armenia in the beginning of the 1990s) is “voucher privatization”.⁵⁶ Under this approach, recovered assets are put into a holding company, which will issue shares—vouchers—to all eligible citizens. The initial value of the vouchers would be determined by the asset size of the holding company and the number of citizens eligible to receive a voucher. Following a pre-agreed timetable, the holding company would sell some of its assets (to local and foreign investors) and buy back the vouchers (i.e., give the citizens cash equivalent to the value of the voucher at that point in time). The citizens thus have the benefit of a direct cash transfer but not the benefit of the potential upside (i.e., the future profits from the functioning of the assets). The life of the holding company will be as long as it is necessary to dispose of assets under its management without undermining their prices on the market.

Another method of safeguarding the nationalized assets is via a (state-run) Asset Management Fund. This fund could be managed as a Fund for Future Generations (a Sovereign Wealth Fund) with the aim of maximizing economic returns for future citizens of Armenia. Sub-funds (of the main Fund) could be created to manage different types of assets depending on their size and category. The main Fund would be subject to a rule, whereby a certain portion of its earnings would get transferred to the budget earmarked for education, social projects, and infrastructure investment. While citizens would not receive a direct cash transfer, the society as a whole will benefit via increased budgetary spending and accumulating assets. The Fund will have a long-term horizon and its establishment may eventually lead to a better outcome from the society’s point of view than the voucher privatization method. Professional asset managers—including from the Diaspora—could be retained to enhance transparency, strengthen public buy-in, and improve efficiency of management of the Fund.⁵⁷

⁵⁶ This method was a dominant one in Armenia and in other transition countries for transferring the state-owned assets to its rightful owners, the people. It was thought to be a fair method that should bring together some other positive effects, such as the creation of securities market.

⁵⁷ More information about the functioning of common Sovereign Wealth Funds can be obtained via Sovereign Wealth Fund Institute at <http://www.swfinstitute.org/>.

Appendix: Extracts from some international instruments and mechanisms

⁵⁸ Adopted by the General Assembly on November 15, 2000 and open for signature on December 12-15, 2000 in Palermo (Italy).

⁵⁹ Adopted in Strasbourg on November 8, 1990. Signed by Armenia in 2001 and ratified in 2003.

The United Nations Convention against Transnational Organized Crime⁵⁸

The UN Convention foresees that States Parties shall adopt, to the greatest extent possible within their domestic legal systems, such measures as may be necessary to enable confiscation of:

- ▶ proceeds of crime derived from offences covered by this Convention or property the value of which corresponds to that of such proceeds; and
- ▶ property, equipment, or other instrumentalities used in or destined for use in offences covered by the Convention (article 12, paragraph 1).

For the purposes of article 12, on “confiscation and seizure” and of article 13, on “international cooperation for the purposes of confiscation”, each State Party shall empower its courts or other competent authorities to order that bank, financial or commercial records be made available or be seized. States Parties shall not decline to act on the ground of bank secrecy (article 12, par. 6).

The disposal of confiscated proceeds of crime or property is covered by article 14 according to which proceeds of crime or property confiscated by a State Party pursuant to the Convention shall be disposed of by the State Party in accordance with its domestic law and administrative procedures.

Council of Europe “CONVENTION ON LAUNDERING, SEARCH, SEIZURE AND CONFISCATION OF THE PROCEEDS FROM CRIME”⁵⁹

Article 15—Confiscated property: Any property confiscated by the requested Party shall be disposed of by that Party in accordance with its domestic law, unless otherwise agreed by the Parties concerned.

DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL On the freezing and confiscation of proceeds of crime in the European Union (adopted in 2012)

Article 10—Management of frozen or confiscated property: This provision intends to facilitate the management of property frozen in view of possible later confiscation. It requires Member States to introduce measures aimed at ensuring an adequate management of such property, notably by granting powers to realize frozen property, at least where it is liable to decline in value or become uneconomical to maintain.

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Testimonials

“Some say that Armenia is doomed to fail economically because of its geography or location in the world. But like so many other countries around the world and throughout history, its failure is due to corruption, unscrupulous politicians and weak institutions. It's not lack of opportunities but squandered opportunities that are at the root of Armenia's ills, and it can make progress only by confronting this fact and holding accountable those responsible for the failures. This wonderful report is a first step.”

DARON ACEMOGLU

ELIZABETH AND JAMES KILLIAN PROFESSOR OF ECONOMICS

MASSACHUSETTS INSTITUTE OF TECHNOLOGY

AUTHOR OF *“WHY NATIONS FAIL: ORIGINS OF POWER, PROSPERITY, AND POVERTY”*

“This data-rich study penetrates the realities of governance in Armenia—realities that have long been obscured. It confirms that political reform is essential to the national economic and social development”

ANNALEE SAXENIAN

DEAN AND PROFESSOR IN THE SCHOOL OF INFORMATION AND PROFESSOR IN THE DEPARTMENT OF CITY AND REGIONAL PLANNING AT THE UNIVERSITY OF CALIFORNIA, BERKELEY,

AUTHOR OF *“THE NEW ARGONAUTS: REGIONAL ADVANTAGE IN THE GLOBAL ECONOMY”*

“This comprehensive report is an important tool for Diaspora's understanding of the systemic corruption and viable solutions for Armenia's continuing economic and social deterioration. Those solutions, to have any chance of success, must be rooted in the establishment of a truly independent judiciary with a strict adherence to the rule of law, and an unwavering respect for civil rights.”

GARO GHAZARIAN

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