БИЗНЕС-СРЕДА

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THE DETERMINANTS OF CORRUPTION IN ARMENIA

Introduction

Armenia, like the majority of post-soviet states, suffers from the destructive heritage of corruption. Conceptually, the shift of the economies from planned to market basis could foretell the liberation of post-soviet states from the chronic corruption of a deficit economy (Levin, Satarov, 2012). However, the studies by Osipian (Osipian, 2010), Stefes (Stefes, 2008) and Lazarev (Лазарев, 2010) claim that the corruption present in the majority of post-soviet states is structurally and functionally identical to the Soviet original. Consequently, the literature cultivates a myth that post-soviet states, Russia especially, possess unique type of corruption, which is impossible to eliminate. Particularly, there is a theory of *distributive economy* (раздаточная экономика) by Bessonova (Бессонова, 2008) where corruption is set to be a state-building institute, which is a unique cultural-historical experience of Russia. Similarly, there exist theories of *low-income trap* (Todaro, Smith, 2012) prescribed for corrupt African and Asian states that feature permanent high corruption and *familism1* (Monte, Papagni, 2007). However, these institutional concepts of corruption inevitability are disproved with the prominent experience of economic miracle of the Singapore, South Korea, Israel and so forth.

Theoretically, all of the listed theories are applicable for the evaluation of corruption and its transformation in Armenia, however, there are notable negative factors like the protracted war in Nagorno Kharabakh, emigration and the economic and political blockade, which make the study of corruption in Armenia essentially attractive for the economic research. Tsaturyan and Bryson (Tsaturyan, Bryson, 2009) explored the effect of corruption on the integration of Armenian economy in the global and found a strong negative relation between the foreign direct investment (FDI) and corruption, however they did not find evidence that corruption hinders the international trade. Furthermore, Stefes (Stefes, 2008) found that the corruption in Armenia, unlike neighboring Georgia and Azerbaijan, had positive smoothening effect on the political and economic transition of 1990s. However, notwithstanding the encouraging reforms of 1990s and the two-digit grow rate of 2000s (Mitra et al., 2007), Armenian economy stays in recession since the crisis of the 2008. Moreover, despite the studies of the harmless corruption in Armenia, the latest three governments since 2008 declared corruption the core hindrance for the economic growth.

Notwithstanding the listed negative outcomes for the Armenian economy and risks for the state vitality, there are practically no sensible steps by the political leadership for eliminating corruption. The fact of awareness on corruption existence and the inactivity of the political leadership expose fair questions "Why everything goeswrong?" and "How should Armenia get to the right path?". Current paper aims to answer these questions by exploring the dynamics of corruption for past 25 years, outline the institutional-political

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[1] Familismis a social structure, where the family maximizes material and short-run advantages of the group rather than the needs of individual members (Monte, Papagni, 2007).

transformations that made the corruption persistent and find core economic problem that generate corruption. The first section of the paper exposes the political, economic and cultural causes of corruption and outlines the transformations that were fostered during the transition from the Soviet state. The second section explores corruption impact on the political-institutional structure and the economy of modern Armenia. The third section discusses the efficiency of the measures taken against corruption. The final section is the summary of the study and some implications of the analysis.

1. The causes of corruption

1.1. Soviet political heritage

The chronic deficit of the Soviet economy formulated a strong vertical party hierarchy over the economy, which transformed the everyday corruption caused by the chronic deficit into an essential component of the political system (Levin, Satarov, 2012; Osipian, 2010). The wave of political and economic reforms in the second half of 1980s handled by Mikhail Gorbachev in the USSR, which became known as perestroika (перестройка), aimed to release the state from corruption. However, the reforms were not completed (as the country collapsed). The last years of the USSR were qualified with the loss of political stability, impotence of the state institutions and the growing rate of anarchy and violence. The listed facts of the political crisis of the central state in late 80s and early 90s reflected among the Union members in the form of nationalistic movements, rise of the criminal and the growth of grey and black markets, which naturally demolished soviet institutions except corruption.

1.2. Political and institutional transition

Initially, the key factor, that affected the political transformations in Armenia, was the war in Nagorno-Kharabakh. The society and the ruling political elite did not set at the first place the long-term task of transition from authoritarian regime to a democratic one (like in Russia did), but was forced to take a short-term goal of surviving. Despite the fact that the surviving strategy had positive effect of political consolidation and stabilization, it did not enclose such goal as the establishment of efficient and productive political institutions. The smooth transition of the power from the communist party to the Armenian National Movement did not have revolutionary effect on political system, as many of communist bureaucrats switched sides already in late 1980s (Stefes, 2008). Technically, the early Armenian political system imitated the institutional-functional properties of the soviet formation as well as the chronic corruption. The Armenian political leadership and high rank executives rapidly developed intensive patronage networks with the emerging business. The access of the new type of state-business relation, which (Levin, Satarov, 2012) call western type of corruption, assisted the small group of businesspersons in overcoming bureaucratic barriers and sustaining galloping growth of the newly creating capital. The persistence of corruption was beneficial for both sides, the state elite for ensuring the economic demand of its power and for the business, which could achieve state privileges and economic rents. Following the example of the executive power, the judicial power also gradually infected with corruption and passed under the control of the leading elite. The process bypassed the approval of majority of the society and did not cause social discontent, as the mass media (the Fourth Estate) did not have adequate power and resources to inform the society (there were intensive electricity blackouts). Ultimately, the concentration of the power furtherly generated a series of corrupt elections and made the elites practically non-accountable. Subsequently,

the banal copying of the institutional structure of the western type did not provide adequate *rules of the game* for the democratic development of Armenia. The primary property rights functioned only for distinct elite groups and the demand for property rights protection (so called *krysha* (крыша)) fostered the development of corruption networks. Finally, the soviet type of corruption transformed into an eastern type of patronage, which, with the development of the business capital, furtherly evolved into the western type of corruption. Thereby, with the evolution of corruption, the institutional status of the state transformed from the superior of the economy to the supplier of patronage service for the business elite, rather than the anticipated role of the installer of the fair rules in the economy.

1.3. The social-cultural impact of corruption

The theft of the public property or the use of public position for the private gain, i.e. socialistic corruption, transformed into a cultural norm of soviet society (Levin, Satarov, 2012). Hereinafter, that social illness was expected to eliminate with the collapse of the Soviet formation, however the institutional changes in Armenia supported corruption development largely. With the loss of the credibility of the rules and the state support, the society implemented the culture of *familism* and informal social agreements. The natural mechanism of the state regulation by laws and law enforcing bodies failed to affect the social transformations. Everyday corruption rooted in the culture in the forms of obligatory gift-giving to public employees like teacher, doctors and etc. Consequently, the excessive corruption in the country shifted the social development to an eastern type of ingrained forms of social positions with weak social lifts, which turned to be just the opposite of the social liberalism that was declared by the elite.

1.4. The economic transition

The Armenian economy inherited the collapsed economy of the soviet period both figuratively and literally. The Armenian economy was isolated from the previous union member and did not have capabilities to integrate in the global economy. The economic isolation by Azerbaijan created logistic crisis (it was the major gateway for Armenia). The situation would not seem so tragic for the economy, if the 1988 Spitak earthquake would not liquidate the 30% of the industrial power of the economy and create destructions, which Armenian economy is not capable to recover until 2016. Another fatal impact had the closure of the chemistry industry (partially) in 1987 and the nuclear plant in 1989 for ecological and safety reasons, which overwhelmed the industry and energetic system. Similarly, the human capital got a hit in the form of the Spitak earthquake victims[1] and 400 000 refugees (Data, 2016) from Azerbaijan.

In addition to the soviet heritage the early Armenian economy was burdened with the excessive legislation and regulations on the economic activity, which would not attract FDIs. Consequently, the functioning of the economy was possible only with an excess of bureaucratic corruption, which would gradually expand the shadow economy. Consequently, the state not only lost the common leverage of the economy (i.e. taxing, had chronic budget shortfalls and high inflation), but could not provide basic social responsibility against citizens. In the scope of excessive risks, the economy shifted to the mode of short term business projects, despite that the gains were not proportional to the risks. The widespread corruption and patronage did not support a free market competition; the winners would rather be the ones with better connections.

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[1] There were estimated 130 000 people with disabilities.

1.4.1. The economic cannibalism

In the isolation, the only source of income for the Armenian economy was the sale of public property, which was feasible only in case of corruption (the privatization started only in 1993 by the law № 3P-58). If initially the corruption was a tool for the survival, furtherly, with the growth of both foreign trade and the economy, it became a form of business for the high-rank official. Subsequently, the public position became a reasonable form of investment project for early entrepreneurs: practically, almost all public positions could be obtained by bribe. Remarkably, the corruption became so common that the pricing of each position (police officer, judge, minister or deputy) was publicly known and the market mechanism of power distribution was widely acceptable.
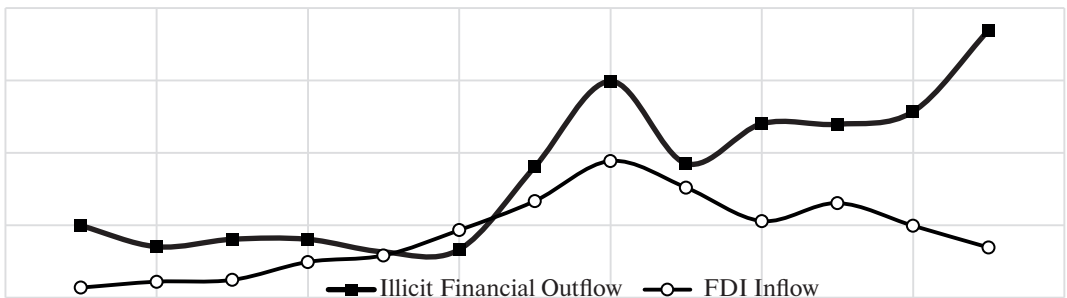
1.4.2. The reforms of 1990s and the backwards of 2000s

The economic anarchy of the state office partially finished with the reforms of Bagratyan 1993–1995, with the restart of the nuclear plant and certain industrial powers. As the result of 1993 privatization, the socialist corruption transformed into the western type of corruption, which was more preferable for the economy (it promoted small and medium scale entrepreneurship). However, the corruption did not grow as fast as the economy did, because the economic policy changed to deregulation and the support of competition in previously monopolized fields (example, electricity generation and distribution). Another notable factor for corruption reduction was the eradication of criminal syndicates, the result of which was the notable increase of the property right protection and the willingness of the business for large investments (only after 1993 Armenia achieved positive DGP growth[1]).

The result of the reforms was the stable positive growth of the Armenian economy till 2008, however during that time corruption had structural transformations, which did not have evolutionary character. The centralization of the power during Kocharyan's presidency created a corruption vertical similar to soviet one. The state transformed into an enterprise of the ruling elite, which exploited its powers for enhancing corrupt financial flows. Subsequently, the systematization of corruption had a twofold effect for the economy:

The property rights protection became guaranteed by the state vertical vitality for both legal and illegal properties, which diminished the risk in the economy and promoted FDI inflow.

The share of the shadow economy was increasing at the expense of the official economy.

Graph. 1. FDI Inflow and Illicit Financial Outflow, million USD

1.4.2. The neo-cannibalism of the modern Armenian economy

During Sargsyan presidency, Armenia adopted the strategy of decentralization of the power. However, the process passed not in the scope of institutional decentralization, but it became a transformation to an oligarchy. The corrupt integral of the state weakened, as

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[1] See table.

the business capital preferred investing in the economy rather than in a public position, which did not provide sufficient corrupt financial flow because of the economic downfall. Moreover, Armenia adopted various anti-corruption grants of increasing the control over corruption, which targeted primarily corruption in grassroots. Consequently, a public position (especially low-rank) became a less desirable investment project in Armenia, as the central power diminished the resource of corruption extraction and increased the risk of being caught for the inferiors. The result of the programs was the shrink of the population with middle-income, who joined the poor[1]. With the political transformation, the corruption decreased in the periphery of the power, while in the central state it transformed into a more "legal" form of government favors for the business. Sargsyan's government adopted a protectionist policy for the big business by making taxes exemptions in purpose of stimulating FDIs. This policy had temporary positive effect, but for long time horizon, it became catastrophic for the economy. In the result, the domestic big business started exploiting deliberately generated legal rents, which is another manifestation of the economic cannibalism of the early 90s.

2. How big is the problem of corruption in Armenia?

2.1. The political threats of corruption

Over 25 years of independence, Armenian state merged with corruption so strongly, that the latter became one of the key factors of political life. The initial "fair" demand for corruption as the foundation of the state building process, transformed into the major threat of the national security. Corruption weakened the state in main three stances:
- The loss of functionality of the election mechanism, which is the cornerstone institution of a competitive political system. The very first case of corrupted elections of 1996 generates so much mistrust of citizens, that there was no incentive[2] for the ruling elite to organize following elections fairly. As a result, corruption increased the internal political tension and generates excess of political instability, which not only discourages FDI-s, but also stimulates emigration and the outflow of the domestic capital (see Table 1).
- Ordinarily, the insufficiency of the internal legitimacy of the leadership is compensated with the third party (IMF, USA, EU, Russia and so forth) in exchange for economic or political concessions from Armenian side. For instance, Armenia was forced to sign contracts of loans with high interest rate, cheaply privatized public property and other non-beneficial international contracts (Hetq, 2016).
- The systematic corruption in the state hierarchy generates the dysfunction of human capital distribution in the forms of nepotism and negative selection (when higher ranked officials employ inferiors with lower intellectual and professional qualities). Here, the intensive manifestation of nepotism generates extensive growth of the public office, which becomes a burden for the economy and decreases the efficiency of the state functioning. Commonly for Armenia, as a treatment for the efficiency problem, the leadership is forced to rule in the *manual mode*, which may transform the sophisticated state institutional organization into a degraded elementary apparatus.

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[1] This statement is not directly registered in statistics, but it can be indirectly derived from other figures. During 2006–2012 the average salary in Armenia grew from 141 USD to 283 USD (for government employee 200 USD in 2012), which is very low wage for living in Armenia (for example monthly expenses for living in capital Yerevan is 500 USD for one person). Rationally, one may assume that there is huge black market of bribes and the increase of wages should have targeted the decrease of corruption deals.

[2] The public memory of past corrupt elections will prevent the legitimation of the results of a fair election.

Table Content

	Illicit Financial Outflow, million. USD	*FDI Inflow, million USD*	*FDI Outflow, million. USD*
2001	497,5	69,9	-
2002	351,9	110,7	0,0
2003	403,5	122,9	0,4
2004	403,0	247,1	-0,4
2005	315,9	292,1	4,9
2006	332,7	466,5	21,9
2007	904,4	667,7	13,8
2008	1494,0	943,7	18,7
2009	926,0	760,0	50,4
2010	1201,0	529,3	7,9
2011	1197,0	653,2	215,9
2012	1285,0	496,6	15,8
2013	1848,0	346,1	26,6

	Freedom house score (0−7, lower is better)							*Transparency insternational*	
	Electoral Process	*Civil Society*	*Independent Media*	*National Democratic Governance*	*Local Democratic Governance*	*Judicial Framework and Independence*	*Corruption*	*CPI index (0−10, higher is less corrupt)**	*country ranking*
2006	5,75	3,5	5,5	5	5,5	5	5,75	2,9	93
2007	5,75	3,5	5,75	5,25	5,5	5	5,75	3	99
2008	5,5	3,5	5,75	5,25	5,5	5,25	5,75	2,9	109
2009	5,75	3,75	6	5,75	5,5	5,5	5,5	2,7	120
2010	5,75	3,75	6	5,75	5,5	5,5	5,5	2,6	123
2011	5,75	3,75	6	5,75	5,75	5,5	5,5	2,6	129
2012	5,75	3,75	6	5,75	5,75	5,5	5,25	3,4	105
2013	5,75	3,75	5,75	5,75	5,75	5,5	5,25	3,4	94
2014	5,75	3,75	5,75	5,75	5,75	5,5	5,25	3,4	94
2015	5,75	3,75	5,75	5,75	5,75	5,5	5,25	3,5	95

*Corruption Perceptions Index

Nevertheless, if the political distortions of corruption listed above mainly generate excessive inefficiency of the economy, in case of economic downfall, corruption may additionally cause the failures of the corruptive integral and further political instability.

Subsequently, there would not be any economic incentives for engaging in a corrupt activity, but the state would stay in the trap of political corruption at the expense of public welfare. See CPIA and Freedom House PR indexes during the economic downfall of 2008−2011 (see Table 2).Ultimately, the political threats of corruption do not limit with the internal drawbacks (which are more or less controllable for the Armenian state), but there is an additional risk of corruption growth fostered[1] externally by the Eurasian Union members.

2.2. The core economic threat of corruption

The economic literature mainstream debates more than two decades on the question if corruption puts a spoke in the wheel of development, but still there is no distinct answer. The definition of this problem furtherly evolved into a more practical question "If corruption stimulates foreign investments to the country?". The prevalent answer is "No", but on practice, it is a multifactor process with different manifestations in each country. The data on Armenia shows that FDI inflow (see table 1.2), contrary to mainstream theory, is positively correlated with the spread of systemic corruption of 2000s, which increased the share of shadow market in the economy. Consequently, there occurs another question "Did FDIs promote economic growth in Armenia?". Unfortunately, the structure of FDIs is unknown, but it is highly probable that the main portion of FDIs are large investment projects targeting rent extraction[2] (mining, monopoly acquisition). In short run the investments would generate some GDP growth (new jobs creation, the increase of demand in some markets), though the gained rentsare not pending to be reinvested in the economy and would generate negative net outflow of capital from Armenia in long run. Consequently, the classical concept that "FDIs are the key drivers of economy" is not applicable to Armenia, even if the investments are done for long-term projects.

More interesting is the underestimated problem of the effect of corruption on domestic investments (DI) of the economy. The World Bank statistics shows that Armenia makes suspiciously moderate investment outflows (see table 1). On the other hand, the 2015 Report of Global Financial Integrity showed that the illegal finance outflow (see table 1) from Armenia was much more than the official investment outflows. Consequently, it is likely that the capital earnings of residents in Armenia are almost illegal and the profits are reinvested either in the shadow economy or invested in a foreign market or are simply kept *under the pillow*. In any case, the profit generated in the shadow economy harms the official economy with the deficit of investments and cash, which turned out to be a robust tendency in Armenia since 2008 world crisis. (see Graph 1)

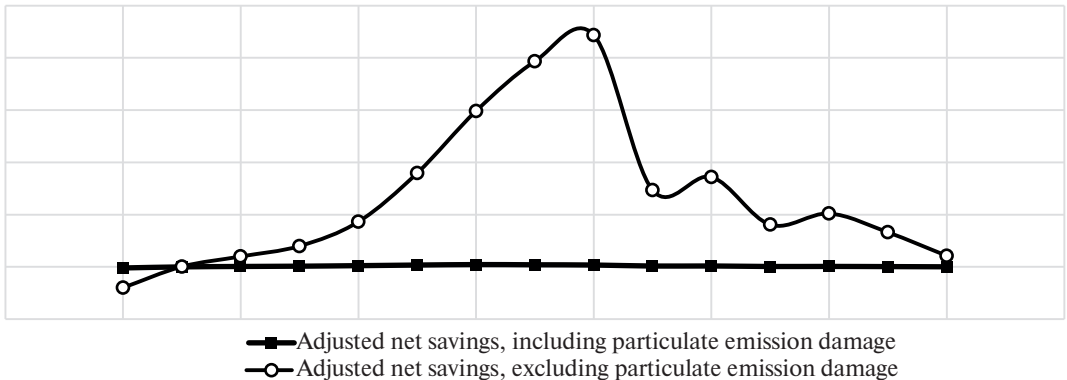### 2.3. The uncompetitiveness of the Armenian economy

The earlier described economic problems, despite their depressive effect on the economic efficiency, mainly have occasional character and, from institutional perspective, are rather easy to overcome. However, there are core specific factors of Armenia, that discourage any productive activity and in a couple with corruption formulate the underdevelopment trap since 1990s.

The Nagorno-Kharabakh war diminishes the risk sensitivity of domestic entrepreneurs and cultivates excessive risks in the domestic market, which increases the feasible

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[1] According to the Transparency International ranking of 2015, Armenia is the least corrupt Eurasian Union member, therefore, the economic integration of the 2015 may only promote the growth of the shadow economy in Armenia.

[2] On practice, in the economies with a systemic corruption there are no incentives for innovation and the investments are targeted on rent extraction.

threshold of corruption and discourages foreign entrepreneurs. The partial isolation, i.e. the burden of accessing neibour markets, ruins the potential of development of the agriculture and non-technical industries, (i.e. full integration to the global market). High energy and transportation costs[1] make the production of any non-technological product unprofitable, despite the low labor cost. Another core reason of the economic downfall is the emigration of the human capital[2]. Moreover, regardless the population downfall since 1990, the statistics does not track the real figures of population, which is estimated to be 30%[3] lower than the official report. Consequently, for an isolated economy even the basic forms of business, in case of decreasing demand, i.e. population decline, would become unprofitable[4]. Ultimately, if Armenia does not overcome corruption, create institutionally favorable environment and property rights protection, which would return domestic capital and bring effective FDIs, the negative trend will not have any alternatives.

—■— Adjusted net savings, including particulate emission damage
—○— Adjusted net savings, excluding particulate emission damage

Graph. 2.Adjasted Net Savings, million USD

3. The necessary measures against corruption

3.1. What should be done?

The core reason of corruption persistence (besides the systemic corruption) would probably be the cultural-civic addiction towards it. But the Policy Forum Armenia 2013 Report survey shows, that there is high corruption awareness and unwillingness of the population to engage in a corrupt deal. Moreover, the 69,7% of survey participants believe that "there is no other way things done". Subsequently, for Armenian case it is practically

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[1] Let us compare the export costs from China and Armenia, 823 USD and 3240 USD (it is summation of costs from Armenia and Georgia, as Armenia does not have a sea port) respectively. If we take the average value of goods loaded in one container 40 000 USD, agreeably the transportation cost is 2% and 8.1% of the value of goods in container. Meanwhile, if we compare the energy prices in the region, the gross prices (including taxes and licenses) in Armenia are 40% higher than in Georgia or Azerbaijan. It means that practically there are no opportunities for Armenian producer to compete in the global market.

[2] According to the interview of an Armenian parliamentary, since 1991 13 000 people with PhD degree and higher degree emigrated from Armenia (0,43% of the population in 2010).

[3] This figure could be derived from the data of fixed telephone subscribers. If one subtracts from the latter figure the numbers of commercial organizations (80 000) and multiple the figure with the amount of average family size (3—4 person), may get for 2014 year the real permanent population of 1 478 316—1 971 088; which is lower than the official number by at least 30%.

[4] By the classical theory of Adam Smith on work division in a closed economy, the smaller the population, the less intensive work division would be. This means that the Armenian economy would shrink if it does not get sufficiently free access to the global trade.

preferable[1] to limit the possibilities of state connections with the economy, rather than trying to improve corrupt verticals.

The first basic step would be the commercialization of the public services, which would foster the competition of the public service market and increase the efficiency of the state (at least, the volume of corruption market would). The entrance of the private firms in the public service market would improve the human capital distribution between the public and private markets, which would increase the legal salaries and discourage public officials from taking bribes.

An alternative method of eliminating corruption on the grassroots is the implementation of the electronic government system, which could diminish the chances of public and private entities to collude for an illegal activity. The electronic system of tenders and the limitation of cash clearings would maximally decrease the inefficient public spending, which turned out to be more than the 70% (Armenia, 2013) of the Armenian state budget.

Furthermore, corruption in the executive power may be confined with the delegation of the powers from the central state to the local authorities[2]. In case of Armenia, there is a trend of increasing the local governments' independence in the form of city mayor elections, however, the local budgets are still formed by the distribution of the central government. Consequently, the local election institute may not support sufficient accountability of the executive power and the redistribution of the powers may not have any practical effect for diminishing corruption and improving state effectiveness.

Conceptually, the persistence of the anticorruption reforms in Armenia may be guaranteed only in case of the liberation of the judicial system[3]. In addition to the legislative independence from the executive power, the judicial system should have reasonable salaries and a competitive internal labor market, which would support the efficient human capital allocation. Ultimately, the state should promote the practice of arbitrage courts to avoid the inefficiency of these judicial reforms and further corruption opportunities.

Finally, corruption may be turned down only with the support of the civil society. The engagement of the civil society in all levels of the state office (including the police and the army) may significantly diminish the corruption grassroots and uncover corruption networks. Similarly, there should be an easy access not only to the internet, but to all types of mass media.

Conclusion

The historic survey shows that Armenia had practically no chance of escaping the soviet corruption heritage due to the soviet government construction that it implemented in early 1990s. However, it was believed that with the economic growth sustainability the country would shift to a democratic government by the establishment of the market economy. The rationale of the hypothesis was that corruption puts spokes in the wheel of the social development and the social awareness of the problem would motivate the society for the right decision.

In case of Armenia, corruption was not generally the economic manifestation of the market mechanism in a deficit economy, but it was also politically prominent tool for the

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[1] According to the Transparency International and Freedom House reports, Armenia did not noticeably improve its institutional environment in the period of 2006–2014. Despite the convictions of international donors (USAID, EU), the programs of fighting corruption by improving the state institutions turned out to be extremely inefficient. For instance, the improvement of the TI CPI index from 2.9 (2006) to 3.4 (2013) costs a net development assistance of 4 186 000 000 USD (Data, 2016), which is more than 40% of 2013 GDP!

[2] According to Levin end Satarov (Левин, Сатаров, 2012) observation shows that an ordinary election of local road policy by the local government may significantly decrease corruption in the field.

[3] See the Transparency International 2013 Report.

state building process. The key problem is that corruption became *too effective*[1] tool of government to be rejected by the elite. As a result, modern Armenia suffers with dysfunctionality of core institutions of a democratic society (independent judicial system, election mechanism, etc.). Moreover, there is an urgent requirement of restoring the channels of state-society feedback, which is generally realized by the assistance of the civil society. A good basis for the restore of the political institutions may be the extension of the reforms of economic liberalization started in 1990s. In particular, an adequate institute of private property would separate the economic powers from the political institutions and maintain a proper political mechanism which would serve the economy, rather than exploit it.

The primary purpose of this paper was to make a theoretical analyzes of corruption and outline the effect of the factors that shaped uniqueness of the phenomenon in Armenia. It turned out that there is too much speculation on the soviet origin of corruption and the myth of corruption to be a social norm in Armenia. Modern Armenian corruption is generally politically driven process where the economic methods of fighting are not sufficient for the achievement of long lasting effects.

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[1] Both politically (political stability) and economically (the creation of corruption vertical increased FDIs).