

BTI 2014 | Armenia Country Report

Status Index	1-10	5.71	# 62 of 129	
Political Transformation	1-10	5.35	# 70 of 129	➔
Economic Transformation	1-10	6.07	# 48 of 129	➔
Management Index	1-10	4.84	# 69 of 129	
	scale	score	rank	trend

This report is part of the Bertelsmann Stiftung’s Transformation Index (BTI) 2014. It covers the period from 31 January 2011 to 31 January 2013. The BTI assesses the transformation toward democracy and a market economy as well as the quality of political management in 129 countries. More on the BTI at <http://www.bti-project.org>.

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Key Indicators

Population	M	3.0	HDI	0.729	GDP p.c.	\$	6645.2
Pop. growth ¹	% p.a.	0.2	HDI rank of 187	87	Gini Index		31.3
Life expectancy	years	74.3	UN Education Index	0.763	Poverty ³	%	19.9
Urban population	%	64.2	Gender inequality ²	0.340	Aid per capita	\$	89.2

Sources: The World Bank, World Development Indicators 2013 | UNDP, Human Development Report 2013. Footnotes: (1) Average annual growth rate. (2) Gender Inequality Index (GII). (3) Percentage of population living on less than \$2 a day.

Executive Summary

Since the Armenian government largely weathered a serious post-election crisis in 2008, the Armenian political landscape has been altered by two significant developments: a parliamentary election in May 2012 and the reelection of President Serzh Sarkisian in February 2013 (just after the period under review) to a second and final five-year term. The 2012 parliamentary vote was particularly significant for the election of several new opposition deputies, although each election was marred by voting irregularities, thereby diminishing the country's democratic aspirations and credentials.

Generally, the passage of time has helped to alleviate the deep tension and polarization from the country's 2008 post-election crisis, which ended in the deaths of 10 people and wounded many more after police and security services forcibly confronted and dispersed opposition demonstrations. The destabilizing potential of that crisis was also lessened by both the failure of the political opposition to unite against the Sarkisian government and by President Sarkisian's dialogue with key opposition leaders.

Despite the fairly successful weathering of the 2008 crisis, the Armenian government has yet to fully address and overcome a number of deep-seated challenges, ranging from a still politically polarized population to a pronounced degree of general distrust and unpopularity among much of the population. Moreover, the government remains beset by challenges from serious economic problems and structural deficiencies, including limited foreign investment, entrenched corruption, and, most notably, the burden of powerful cartels that dominate the export and import of core commodities. This issue has not only fostered a closed market by serving as a barrier to entry and an obstacle to competition, but has become so powerful that it now undermines the credibility and efficacy of the state itself, failing to pay its share of taxes and monopolizing several sectors of the Armenian economy.

More broadly, the country continues to suffer from widening disparities in wealth and income, with one-third of the Armenian population now officially living in poverty. But there has been some notable progress in reform, and Armenia has performed well in specific policy areas: fighting inflation, maintaining monetary stability and garnering success in its negotiations with the European Union over a new association agreement and a Deep and Comprehensive Free Trade Agreement (DCFTA), set to be concluded in November 2013. Thus, the coming challenge centers on the government's commitment to carrying forward the next generation of reform. This will entail tackling both vested interests endowed with economic power and political influence, and the threat posed by the close relationship between business and politics in Armenia.

History and Characteristics of Transformation

Even during the decline of the Soviet system in the late 1980s, Armenia faced two significant challenges. In February 1988, the majority Armenian population of Nagorno-Karabakh, an autonomous region in neighboring Azerbaijan, voted to unite with Armenia. Although the move conformed with existing Soviet legislation and constitutional avenues, and backers supported the reforms initiated by the Soviet leadership, Azerbaijan rejected the vote and the political conflict rapidly escalated into outright war. A second unexpected challenge came in December 1988, when Armenia was struck by a devastating earthquake. Both of these challenges imposed inordinate burdens on the Armenian leadership that emerged with the sudden independence of the country when the Soviet Union collapsed.

Although Armenia, as in the case of each former Soviet state, was unprepared for independence, the ongoing Nagorno-Karabakh conflict and the imperative for earthquake recovery only exacerbated the struggle for statehood. In the wake of some seven decades of Soviet rule, the newly independent Armenia struggled to create resilient institutions necessary for statehood and sovereignty, introduce market-based economic reforms, and contain the paralyzing effect of a near total collapse of industry and a related breakdown in trade and transport routes.

Against that backdrop, Armenia's political and economic transformation was largely defined by the specific circumstances of the time, which greatly impacted the trajectory of reform. More specifically, these factors included politics defined by strident nationalism that imposed informal limits to political discourse, debate and tolerance, and which tended to reinforce a trend toward authoritarianism. A second factor was an economy deformed by "conflict economics," in which the closed borders and blockade of the country led to a severe scarcity of goods, which, in turn, fostered widespread corruption and distorted market-based prices and economic activity.

Within this closed economic system, and without much state oversight or regulation, several commodity-based cartels emerged, bolstered by a powerful combination of criminal links and political influence. Their power also stemmed from the opportunities for power and profit inherent in exploiting "conflict economics" through monopolistic positions controlling scarce

commodities, such as gasoline and heating oil, and basic staple goods. These cartels and semi-monopolies quickly eliminated competitors and secured dominant positions over the import and export of key consumer goods, raw materials and foodstuffs.

The emergence of these cartels was initially a consequence of the “conflict economics” of the Karabakh war, and they garnered political influence by generally supporting a feeble and war-weary state. The Armenian government was largely preoccupied with economic measures in other areas, ranging from the successful implementation of sweeping land reform and privatization to the introduction of a stable national currency. The power of these cartels quickly expanded beyond commodities, however; similar to those in other post-Soviet states, they leveraged their links with political power to acquire inordinate wealth and assets during the privatization process.

In political terms, the war years of the 1990s also thwarted early attempts at building democratic institutions and bolstering political reform, and the ongoing state of war shaped an already rigid political discourse, as a new vibrant nationalism crowded out more moderate voices within the Armenian political arena. This lowering of political discourse was matched by a second trend involving the transformation of the country’s political hierarchy, as a new elite from Nagorno-Karabakh gained power and consolidated top leadership positions in Armenia proper.

The BTI combines text analysis and numerical assessments. The score for each question is provided below its respective title. The scale ranges from 1 (worst) to 10 (best).

Transformation Status

I. Political Transformation

1 | Stateness

Since independence, the Armenian state has enjoyed sound authority, with no challenges to the state's monopoly on force. This trend has generally been strengthened by a powerful degree of ethnocentric nationalism within a highly homogenous society, matched by a consistent degree of respect for and popularity of the armed forces, which has never directly intervened in politics and is subordinate to civilian state control and oversight. Moreover, the state's unquestioned monopoly on violence is bolstered by stable civil-military relations and the general absence of weapons in the possession of private citizens or groups.

Although the state's monopoly on the use of force faces no real threat of revolution or civil war, the potential for internal unrest or political instability has increased in recent years. More specifically, the police force and security services are unpopular and enjoy very little trust, driven by a record of abuse of power and cases involving the excessive use of force against detainees and civilians. Moreover, there is a growing risk that fundamental socioeconomic discontent will emerge as a challenge to state authority, especially if popular demand for reform remains unaddressed.

In terms of state identity, there is a generally accepted consensus on the issue of citizenship, mainly stemming from the country's homogeneity and mono-ethnic Armenian society. There is little or no record of ethnic division or discrimination facing native, non-Armenian minorities (Kurds, Russians and some Jews). However, the ethnic minorities have limited representation in Armenian government. For example, the largest ethnic minority in Armenia, Yezidis, as of 2012, still has no representation in the National Assembly. In theory, all citizens are endowed with the same civic rights, and the Armenian state ensures equal access to education, the courts and public welfare. In practical terms, however, there are continued contradictions with legal safeguards, as there are signs of a growing discrepancy in rights between certain groups. This discrepancy manifests itself, for example, in both political polarization between supporters of the opposition and government, and on a class

Question
Score

Monopoly on the
use of force

9

State identity

9

basis, with an obvious, widening division between a small, wealthy and politically connected elite and the larger, more impoverished general population.

The Armenian Apostolic Church holds a strongly entrenched position of dominance within Armenian society, mainly based on two factors. First, the church holds an informal but powerful relationship with the Armenian state, endowing the authorities with a degree of legitimacy and support. This legitimizing support has been especially helpful for the rather unpopular government, which has also sought to leverage the church's regard among the ordinary population as one of the least corrupt and most respected institutions in Armenia. Formally, Armenia observes a policy of separation between church and state, with religious dogma barred from any direct role in politics. Over the past two years, however, the church has adopted a much more assertive role in political discourse, ranging from debates over "family values" and other cultural issues to state-related issues of urban development and foreign-language education.

No interference of
religious dogmas
9

The second factor contributing to the dominant position of the Armenian Apostolic Church, to which nearly 95% of the country's religious believers belong, is rooted in its historical standing as a defender of Armenian identity and cultural norms. However, according to the Caucasus Research Resource Centers (CRRC) 2011 survey, over 60% of Armenia's population, despite emphasizing the importance of religion in their daily life, attends religious services only on special holidays or less often.

The church has traditionally kept a distance from partisan politics, but that distance has begun to narrow in recent years. Calls have emerged over the past two years for the church to play a greater political role, most notably in combating economic injustice and the country's widespread corruption.

The protection of the fundamental freedom of religion is incomplete in Armenia, and over the past two years, there have been repeated cases of discrimination against nontraditional religious groups and sects such as the Jehovah's Witnesses and the Mormon missionaries active in the country. All formal churches and religious groups outside the Armenian Apostolic Church are required to register officially with the government, and proselytizing is forbidden by law.

In terms of basic administration, the Armenian system is fairly well-developed, with generally competent administrative structures operating on many levels of government. In 2011-2012, some improvements took place in law enforcement, in particular the adoption of a Criminal Procedure Code in 2012. Also worth mentioning is the introduction of e-government services in 2011, which can be seen as a positive step toward reducing low-level corruption.

Basic
administration
7

Despite a series of recent civil service reforms, corruption within administrative structures remains a serious challenge. Administration remains hindered by the legacy of Soviet-era practices, many of which are grossly inefficient and overly

bureaucratic. Administration of justice functions reasonably well, although adjudication remains subject to political, personal or financial interference. This is largely related to a fairly weak and arbitrary rule of law, matched by a flawed system of law enforcement and a sometimes checkered record of justice.

The inherent lack of professionalism and lower level of efficiency are especially prevalent throughout the less developed rural regions of the countryside, but such shortcomings are also evident in larger towns and cities. Similarly, the lack of an independent judiciary tends to weaken the efficacy of state administrative bodies and foster a general public mistrust in the system. Other areas of administration in specific need of reform include customs and tax revenue monitoring and collection, water and electricity utilities, and healthcare.

2 | Political Participation

Armenia's first election in the early 1990s was the country's last free and fair balloting without restrictions. Moreover, for much of the last decade, the Armenian population has grown accustomed to flawed elections, and has become increasingly disengaged from politics.

Free and fair
elections

5

Despite some electoral reforms, the country's political system remains rigid, closed and seriously impeded by entrenched corruption and political patronage. In 2011, the National Assembly adopted amendments to the electoral code. The key characteristic of the new code was that the Central Elections Commission and district commissions would no longer be formed by political parties. Instead these commissions, with the approval of executive, would be organized by an ombudsman and the Chamber of Advocates.

The electoral campaign for the May 2012 parliamentary elections although dominated by controversy over the proposal to eliminate constituency seats in favor of a fully proportional system, which was eventually rejected by the parliament was fairly smooth and uneventful. After some modest improvements in the parliamentary elections, the campaign for the 2013 presidential elections was marked by a number of irregularities: hunger strikes, an assassination attempt on a candidate, and appeals to postpone the election. These incidents present a rather negative contrast with the smooth 2008 electoral campaign.

The elections themselves, although they took place after the period under review, continued this negative trend, as the vote was marred by widespread irregularities and a broader problem of voter fraud and vote-buying. The deeper problem stems from the usual practice of the incumbent authorities' instinctive reliance on vote-buying and voter intimidation. And under the conditions of low voter turnout, the authorities generally succumb to the temptation to resort to the traditional practice of leveraging

the so-called administrative resources of incumbency, coercing public servants to create an un-level playing field.

Moreover, in what was widely perceived as Armenia's least competitive presidential election, the February 2013 election returned incumbent Serzh Sarkisian to office. Yet the severity of discontent and the appeal of second-place finisher Raffi Hovhannisian were both seriously underestimated. Though Hovhannisian has sought to become an agent of change in Armenia, much of the country's diverse and divided opposition failed to unite behind him. But this post-election crisis was defined less by support for Hovhannisian personally than by opposition to the government. The crisis affirmed the weakness and immaturity of the main opposition parties, which were unable or unwilling to unite, suggesting that the political landscape will only continue to be defined more by general opposition to the government, but without any unified or credible opposition leader or party.

Thanks in part to fundamental flaws in the country's closed political system and the absence of free and fair elections, the Armenian authorities have typically held virtually unchallenged power and authority, despite public demands for change. Such power is often harnessed at the expense of democratization.

Effective power to govern

2

The incumbent president, Serzh Sarkisian, a chosen successor of the previous president Robert Kocharyan, came to power after the flawed 2008 elections and solidified his rule with brutal crackdowns on opposition and the political dissent. Despite the government's efforts to establish a political dialogue with the opposition in 2011, and despite a range of government concessions, in 2012 the ruling regime continued relying on autocratic methods of rigging elections and intimidating the opposition.

In light of that, the ruling political elites, particularly the executive, could be described as veto players standing in the way of democratic reform. However, provided that Armenian political representatives were democratically elected, they could enjoy effective, constitutional power to govern, virtually unchallenged by other veto players such as the military or clergy. Therefore, the fundamental problem lies with elites who hinder democratization in favor of Soviet-style modes of governance. Hence, the Armenian ruling elites under Sarkisian could be defined as a veto power blocking democratic processes.

Although Armenia has a vibrant civil society, comprised of a wide array of civic groups and NGOs, only several modest improvements in state attitude toward the rights of assembly occurred in 2011 2012. Apart from the removal of the ban on rallies in Yerevan in 2011, a series of civil demonstrations that took place from February to November, in part inspired by the Arab Spring, secured a number of concessions from the government. First, a law on freedom of assembly was passed by the parliament in 2011. Second, in 2011, environmental campaigners succeeded

Association / assembly rights

6

in persuading the government to cancel the construction of a hydroelectric power plant, which could endanger the famous Trchkan waterfall.

Despite some progress on civil liberties in this period, including the lifting of restrictions on opposition rallies, the country's authoritative approach to civic freedoms and civil rights requires more resolute reform. Although the constitution guarantees freedom of association and assembly, there has been a pattern of intimidation of civic and political groups, including such normally politically neutral groups as environmental activists and even groups fighting abuse in the military and defending historical monuments and architecture. Overall, the protection of civil rights in Armenia has remained incomplete and far too arbitrary, with deficiencies mainly due to the weak and arbitrary application of the rule of law. In some cases, for example, several incidents of blatant violations of civil rights have only reaffirmed the need for proper oversight by an independent judiciary. One exception has been the institution of the human rights ombudsman, which has actively challenged the state's lack of protection and even violation of civil liberties.

The noticeable decline in basic civil freedoms in recent years has been matched by efforts to constrain the Armenian media, leaving the sector increasingly subject to a troubling pattern of state control and intimidation. In the period under review, there were signs that the state was retreating from more assertively restricting the media, despite a continuing pattern of self-censorship in which the media has backed away from producing bolder journalism.

Freedom of
expression

5

The Committee to Protect Freedom of Expression (CPFE), an Armenian NGO, reported that violence against journalists decreased in 2011. There were fewer incidents of violence against media personnel in 2012, according to the CPFE. In addition, a Council for Information Disputes was established in 2011.

In terms of negative developments, the decriminalization of libel in 2010 resulted in higher fines for insult, and the number of court cases against mass media on insult and defamation charges increased.

In a broader context, lingering domestic tension rooted in political crises, sometimes accompanied by violence and intimidation, lessened in this period. Although the protection of civil rights in Armenia has remained incomplete and far too arbitrary overall, there have been signs of progress. The human rights ombudsman has actively challenged the state's lack of protection for journalists, and even its violations of civil liberties and free expression.

3 | Rule of Law

Given a lack of any effective checks and balances or any clear separation of powers, Armenia's democratic transformation remains both incomplete and inadequate. Moreover, there has been no progress in the past two years, with no attempt to reform or revise the current model of a strong presidency at the expense of a subservient judiciary and an ineffective parliament.

Separation of
powers
4

This structural deficiency is compounded by the weak state of the rule of law. The closed nature of the system and the lack of an independent judiciary also tends to weaken the efficacy of the state administrative bodies and foster a general public mistrust of the system.

In the face of a dominant presidency, with the executive remaining unquestionably the strongest branch of government, the judiciary can best be described as overly compliant with the demands of the executive.

Independent
judiciary
4

Officially, an independent judiciary does exist in Armenia, but it is still largely subordinate to the executive, and its effectiveness is undermined by widespread corruption and general incompetence. Nevertheless, several positive transitions took place in the period from 2011 to 2013. For instance, the World Bank started its Second Judicial Reform Project in Armenia in 2011, and a new Criminal Procedure Code was adopted in 2012.

A pattern of an abuse of power among Armenian officials remains rampant and unchecked. Such abuse manifests partly as entrenched corruption within state institutions. Over the past two years, however, there were several more cases of arrests and prosecution of officials and even law enforcement personnel for corruption-related crimes and abuse of power, confirming a trend toward at least seeking to limit and reduce the severity and number of more flagrant abuses of office.

Prosecution of
office abuse
5

In 2011, several senior police officials were arrested on abuse of power and corruption charges. These included the head of the criminal investigations unit, the road police chief and the second-in-command of the police department. However, most of these purges are a result of internal power struggles and do not represent a long-term strategy.

The protection of civil rights in Armenia remains incomplete, with deficiencies mainly due to the weak and arbitrary application of the rule of law. Over the past two years, blatant violation of civil rights by the state have reaffirmed the need for proper oversight by an independent judiciary.

Civil rights
6

The 2011 amnesty for political prisoners and investigations into the 2008 deaths of opposition members could be seen as state concessions on civil rights resulting from

a political consensus between the government and opposition in the aftermath of 2011 opposition-organized rallies. The 2011 lifting of the ban on rallies in the capital city constitutes a modest improvement.

However, the lack of any real accountability for the abuses and excessive force by the police and security forces, as well as the dubious judicial processes and questionable investigations subsequently conducted by the authorities, magnifies an environment of public fear.

4 | Stability of Democratic Institutions

In theory, democratic institutions exist in Armenia. In practice, paternalism of ruling elites, corruption and patron-client networks make them inefficient. While most of the state's ministries and departments are in hierarchical subordination to the executive and have little room in practice for independent institution-building, relatively liberal institutions exist at regional and municipal levels of administration. As of 2011, there were over 915 self-governing communities in Armenia. Although in reality many of the community heads depend on patron-client relations with regional governors and other higher-ranking state authorities, self-governing communities hold potential for future democratic institution-building.

Performance of
democratic
institutions
3

In 2011, the Armenian government started the process of merging self-governing communities in order to increase their budgets and improve organizational structure. In addition, an e-government system was launched in 2011 and 2012. However, most of Armenia's institutions still remain under the patrimonial control of the executive, which continues to pose a challenge for democratic reform and institution building.

Armenia's commitment to democratic institutions is limited and largely superficial. More crucially, the deeper flaws in the political system itself, most notably the weak rule of law, a compliant judiciary and an ineffective parliament, suggest that the current political system is incapable of sustaining itself in the face of mounting pressure from an unresolved political crisis and a lingering crisis of confidence. More specifically, since a post-election crisis that culminated in a violent confrontation between the Armenian authorities and the opposition on 1 March 2008, Armenia has been plagued by lingering political tension driven by a profound degree of political polarization and exacerbated by widening economic disparities.

Commitment to
democratic
institutions
3

The authorities have also been hindered by a lack of legitimacy and a crisis of confidence that have undermined its political mandate and impeded its reform program. For the past several years, the Armenian government has remained fairly unpopular and unable to fully overcome these challenges, and neither the authorities nor the opposition was able to resolve the political crisis or to reach any constructive compromise.

As a result, the function of democratic institutions is impaired by both the government's lack of legitimacy and the continuous interference of the executive branch in the work of institutions.

5 | Political and Social Integration

Overall, the main political campaigns (both presidential and parliamentary) in this period were dominated by contests of personalities, with no real choice between party ideologies or policies. The presidential campaign was also marked by a rather primitive, low level of political discourse, with little debate and even less of a choice among the candidates between competing visions or strategic alternatives. A related criticism of the campaign was its affirmation that politics in Armenia is unprofessional, with little in terms of campaign tactics and even less political strategy. The opposition's use of boycotts and hunger strikes did not represent commonly accepted political campaign tactics.

But the situation is changing. Armenian politics faces a new era of dynamic change, driven by a fundamentally different period of political conflict and transition. A serious division among the ruling political elite has emerged that is tied to the deep rivalry between President Sarkisian and his predecessor, Robert Kocharian, which is matched by a proxy battle between Sarkisian's dominant Republican Party and its junior coalition partner Prosperous Armenia, the country's number two party, widely seen as Kocharian's political creation. The Republican Party was intent on weakening Prosperous Armenia in each of the two elections in this period.

Over the past two years, there has been a strengthening of Armenia's civic and community-based organizations. This has been sparked by a political awakening among interest groups and other politically active groups such youth and student clubs, which are no longer content to be politically disenfranchised. This period has also seen the emergence of assertive issue-based interest groups, ranging from environmentalists to social and youth campaigners.

In 2011, there was an increase in human rights activism, in particular against abuses in the army.

The overwhelming majority of the population seems in principle to be strongly committed to democratic norms and procedures. According to the CRRC 2011 survey, 62% of Armenians approve of democratic governance. However, the institutions of the state are mostly distrusted; 49% distrust courts, 50% distrust the parliament, and 42% distrust the president.

Commitment to democratic norms and procedures has remained stable despite widespread political apathy, frustration at the flawed 2013 presidential election, and growing disillusionment associated with the slow pace of democratization. Despite

Party system

6

Interest groups

6

Approval of
democracy

n/a

the country's evident political shortcomings, the public seems more committed to the constitutional system than most of the political parties do. However, this confidence in and approval of democracy as a system has not translated into public faith or trust in specific Armenian institutions.

Social capital has been an increasingly significant factor in the last two years of Armenia's transformation. Armenian society is characterized by high levels of social capital "bonding" and low level of "bridging," which means that most social capital remains "locked" within family and close social groups. As a result, popular participation in organized civic activities is low. The Caucasus Research Resource Centers (CRRC) 2011 survey reported that 97% of the Armenian public does not participate in civic volunteerism or other social organizations. Trust in people is similarly low. For instance, the CRRC 2011 survey found that only 10% of Armenians trust other people. By contrast, over 40% said that they have enough people to rely on.

Social capital
6

II. Economic Transformation

6 | Level of Socioeconomic Development

Question
Score

Although Armenia's record of economic reform in recent years has been fairly impressive, most economic assessments warn of the dangers posed by overemphasizing statistical growth, while not doing enough to address overall poverty, the closed nature of the market and widening disparities in wealth and income, which have led to a serious socioeconomic divide.

Socioeconomic
barriers
4

The economy has still not fully recovered from the deep recession resulting from the global financial crisis in 2008 when GDP fell by 14.1%. Although the Armenian economy showed modest growth rates in 2010 and 2011 (2.2 % and 4.7%) and a rather significant GDP grow of 7.2% in 2012, it still has not reached its pre-crisis level.

The steep economic decline in 2009 has been the key factor behind the increase in the poverty rate that was reported by the Armenian State Statistical Service for the previous years. According to the newest official data, total poverty increased by 17.4% between 2008 and 2012. Although in 2012, only 32% percent of the population below the national poverty line compared to 35% in 2011, the poverty rate was still at a higher level than in 2008 (28%). In real terms, more than 1.2 million Armenians are now impoverished, living on approximately \$3 a day. In comparison, the minimum basket of consumer goods and foodstuffs is estimated to cost an average of 165,000 drams (or about \$170) a month, with prices for food and utilities steadily

rising. Also, there was a drop in the gross ratio of school enrollment from 102% in 2010 to 84% in 2011.

The economy's structural weaknesses including a decline in investment, over-reliance on the inflow of remittances, and a sporadic recovery of economic activity. These weaknesses have been aggravating social discrepancies in recent years. According to official national statistics, consumption inequality measured by the Gini coefficient increased from 0.242 in 2008 to 0.269 in 2012. Gross income inequality increased from 0.339 in 2008 to 0.372 in 2012. In addition, socioeconomic barriers are exacerbated by increased social pressure driven by rising costs for food, basic goods and energy. The state budget, while reflecting concern for the socioeconomic situation by increasing public spending, lacks adequate budgetary measures to counter widening wealth disparities and deepening poverty.

The socioeconomic divide also has a rural-urban geographic aspect, marked by an over-concentration of economic activity and opportunity in urban centers and the capital. This division has fostered more pronounced regional and rural income inequalities, and has been exacerbated by the wide variance in the quality of and access to essential public goods such as healthcare, education and other social services. The infrastructural divide between regions and urban centers has also encouraged greater migration to urban capitals from outlying rural areas.

Economic indicators		2009	2010	2011	2012
GDP	\$ M	8648.0	9260.3	10138.1	9910.4
GDP growth	%	-14.1	2.1	4.7	7.1
Inflation (CPI)	%	3.4	8.2	7.7	2.6
Unemployment	%	-	-	-	-
Foreign direct investment	% of GDP	9.0	6.2	6.5	4.9
Export growth	%	-10.4	21.7	5.0	-
Import growth	%	-19.2	13.8	-3.5	-
Current account balance	\$ M	-1369.5	-1373.2	-1136.4	-1052.2
Public debt	% of GDP	34.1	33.7	35.5	39.5
External debt	\$ M	5023.5	6240.7	7383.3	-
Total debt service	\$ M	423.6	968.2	925.6	-

Economic indicators		2009	2010	2011	2012
Cash surplus or deficit	% of GDP	-7.6	-5.0	-2.8	-
Tax revenue	% of GDP	16.5	17.1	17.2	-
Government consumption	% of GDP	13.3	13.3	11.9	-
Public expnd. on edu.	% of GDP	3.8	3.2	3.1	-
Public expnd. on health	% of GDP	2.0	1.8	1.6	-
R&D expenditure	% of GDP	0.27	-	-	-
Military expenditure	% of GDP	4.2	4.3	3.9	3.9

Sources: The World Bank, World Development Indicators 2013 | International Monetary Fund (IMF), World Economic Outlook 2013 | Stockholm International Peace Research Institute (SIPRI), Military Expenditure Database 2013.

7 | Organization of the Market and Competition

For much of the last two years, the foundations of a market-based, competitive economic system have continued to develop and strengthen, as can be seen in the steady growth of the private economy, which accounts for over 80% of GDP. Armenia is consistently rated as having one of the most open economies among the former Soviet states, and it is praised for its positive trade and investment policies as well as its lack of restrictions on capital.

However, over the longer term, the country faces a daunting set of problems, stemming from the powerful influence of several commodity-based cartels and monopolies that restrict free trade and market-based competition. The inherent dependency on the informal market and the involvement of political actors in business continue serving as obstacles to a free market.

The Armenian parliament has underperformed in this area, having rejected a proposal from the opposition to introduce new sweeping antitrust measures to curtail monopolies and improve competition. The proposed legislation would have required a new government strategy to implement “urgent measures aimed at the elimination of illegal monopolies” by imposing a new ban limiting companies from owning more than one-third of shares “in all areas of economic activity other than public utilities.” A second element would have imposed fines on any company determined to hold a “dominant position” in any specific sector of the economy.

Commodity-based cartels and monopolies continue to pose a serious problem for the country’s economic development, especially as the government has failed to

Market-based
competition
7

Anti-monopoly
policy
4

introduce a more effective application of antimonopoly mechanisms, as well as for reduced administrative costs for small and medium-sized enterprises.

Despite having one of the most advanced regulatory systems among the former Soviet states, Armenia needs to improve transparency. As things stand, Armenia lacks the necessary combination of critical laws and effective enforcement, particularly in the area of antimonopoly and antitrust law. This weakness is exacerbated by excessive state control over some key sectors of the economy.

Against the backdrop of generally weak state regulatory institutions and a pronounced lack of political will to confront corruption and break up cartels and semi-monopolies, the entrenched power of the oligarchs now stands as a direct threat to reform and an indirect threat at least to the state itself. The oligarchic system has had a devastating impact on Armenia, eroding the authority of the state, which can neither tax the oligarchs nor police their business interests. The state faces an uphill battle to regain control of the economic system.

The real danger for Armenia stems from complacency. For Armenian business, especially given the small size of the national economy, there is a serious need for the state to tackle monopolies and to further open the economy through transparency and competition. Although the emergence of monopolies in the Armenian business sector has not been as profound or as powerful as it has been in other former Soviet states, the net result is an overall weakening of economic growth, a barrier to competition and a serious disincentive for foreign investment. The second economic impact of these commodity-based cartels or monopolies is their role in obstructing the rise and expansion of new firms and businesses. This too harms overall job creation and maintains the closed and limited nature of the national economy. In Armenia's case, this not only reinforces the landlocked and blockaded limits on the Armenian economy, but creates a reinforcing cycle in which the monopolies become vested interests in maintaining closed borders in order to reinforce their control over key sectors of the economy. The only effective way to tackle this problem has been to introduce antitrust legislation strong enough to counter and contain the monopolies and cartels. But here, as demonstrated in the experience of other countries, it is the implementation and enforcement of the laws that matter most.

Armenia has been a WTO member since 2002. Despite its liberalized trade regime, the country has several very serious economic vulnerabilities. Closed borders and limited links to the broader global economy produce a kind of incubation effect, but an inherent structural vulnerability can be attributed to three elements: the country's dangerous dependence on the influx of remittances from Armenians working abroad; its narrow reliance on the country's service, commodity and construction sectors as the main drivers of economic growth; and, most distressing, the closed oligarchic

economic network centered on several informal commodity-based cartels and semi-monopolies.

But there is significant promise, as the Armenian government has remained firm in its commitment to completing and signing an association agreement with the European Union, which would offer an important new opportunity to overcome Armenia's geographic isolation and closed borders by offering an important new deepening of trade and investment ties, including expanded access to European markets. In addition to the broader negotiations with the European Union over a Deep and Comprehensive Free Trade Agreement (DCFTA), the Armenian government is also actively promoting bilateral commercial and investment ties with several European countries. Armenia also has a relatively good standing in terms of trade tariffs: According to the Global Competitiveness Index (GCI), it occupies 38th place among 144 countries. The GCI also assigns Armenia 8th place in the world for ease of starting a business.

For the past two years, the Armenian banking system has remained both stable and secure, building on its positive reputation. According to the Global Competitiveness Index (GCI), Armenia's banking system experienced some positive transformations in 2011 2012. These include better availability and affordability of financial services, ease of access to loans, and venture capital availability.

Banking system
6

Nevertheless, the sector remains in need of serious reform and development, as the banking and financial services sectors are fundamentally limited by the small size of the country's financial sector (total assets are still well below 20% of GDP), with small and undeveloped capital markets. Although there have been some advances in terms of strengthening creditor rights, improving banking supervision and increasing minimum capital requirements for existing banks (from \$2 million to \$5 million), there is still a lack of adequate corporate governance.

8 | Currency and Price Stability

The Armenian Central Bank has consistently followed a strict policy of fiscal discipline, and has continued to maintain prudent monetary policies aimed at ensuring macroeconomic stability. The 2013 state budget includes an almost 10% increase in state spending, set at 1.15 trillion drams (\$2.84 billion), and projects a fiscal deficit of almost 120 billion drams, roughly equivalent to some 2.6% of Armenian GDP, with a deficit-to-GDP ratio of 2.8% for 2012. According to the state budget, the government has also pledged to reduce the deficit by increasing the level of overall tax collection by a planned 13%, targeted at a total of 993 billion drams in new tax revenue. The 2013 budget is based on a projected 6.2% rate of growth in the Armenian economy, following the government's 2012 forecast of 7%.

Anti-inflation /
forex policy
8

Yet there are some unresolved problems, as Armenia has been subject to increased money demand and a flexible exchange rate regime, which requires steady capital infusions, although it has been important for mitigating the adverse impact of external shocks. Over the past two years, the steady appreciation of the national currency (the dram) has raised questions about how appropriate it was for the state to intervene in supporting the currency's value well beyond normal market considerations.

Despite some problems, Armenia's economic performance has strengthened in 2012, and is expected to remain stable in 2013, with more than 6% in growth, low inflation, a declining fiscal deficit, and improvements in the agriculture, food processing, mining, and services sectors. But there are vulnerabilities, as Armenia's external current account deficit remains high, making Armenia significantly exposed to external shocks, such as a decline in exports and remittances. Armenia's general government debt decreased in 2012 2013 to 35.1% of GDP, as compared to 39.4% in 2011 2012.

But there is a deeper structural problem in the Armenian taxation system. Specifically, state revenue has traditionally relied on proceeds from the value-added tax (VAT), most of which is generated from imported goods. Accounting for a little more than half of all state revenue, the VAT has now become the leading source of state revenue, far beyond the meager level of corporate profit tax collection. Yet after several years of double-digit economic growth, such a discrepancy between a dangerously high reliance on the VAT and a meager rate of corporate tax income is worrisome for two reasons. First, such an over-reliance on the VAT for overall tax collection is not sustainable over the long term and, as the low level of corporate tax revenue shows, has only deferred more serious budget shortfalls while tax evasion and underreporting has gone unpunished. In addition to that structural problem, the high dependence on VAT-related tax revenue, rather than more significant corporate and import taxes, tends to impose an unfair tax burden on the country's lower and still-emerging middle classes, as individual consumers are increasingly forced to endure even higher sales and value-added taxes than medium- and large-scale business enterprises.

Even more significant, in terms of the dangerous linkage between the state budget and tax collection, the Sarkisian government already faces a new, looming economic crisis. The crisis stems from the combination of a possible downturn in economic growth with a potential rise in inflation set off by the onset of dramatic price rises for food, gas and other basic commodities as part of a global crisis that is only expected to worsen.

Macrostability

6

9 | Private Property

Armenian property rights and the regulation of property acquisition are adequately defined and soundly defended. This stems from an initial focus on private property during the country's early stages of privatization and transformation, although incidents of privileged control and corrupt practices undermined the efficacy and integrity of the overall privatization program. The government has continued to make progress by reducing state interference in business formation and strengthening property rights. For instance, Armenia's procedures to start a business and to register a property have been further simplified in 2012: Now it takes only three procedures and eight days, in contrast to six procedures and 15 days in 2011.

Property rights
8

Armenia has a flourishing private sector that has expanded over the last two years. The government has recognized the role of the private sector as the engine driving sustained growth, and has improved the business environment by reducing regulations, improving the bankruptcy law and the administration of customs, and strengthening the banking system. However, burdensome bureaucratic procedures still tend to hamper private-sector commerce.

Private enterprise
8

The Armenian government also approved a set of amendments to the tax code during this period that will significantly simplify tax reporting requirements for small business. The changes offer important incentives for smaller firms with an annual revenue of less than 58.3 million drams (\$144,000), including a reduction in the number of financial reports that they are required to file with the State Revenue Committee. Under the new law, those smaller businesses will have to file only four financial reports, rather than the current 16, thereby cutting administrative expenses and overhead for the firms. The smaller firms will also be offered a new option to have their profit tax calculated on the basis of turnover rather than earnings. The new tax amendments follow an earlier round of simplifying modifications, including a 50% reduction in the number of annual payments for corporate income, property, and land taxes, as well as for pension contributions.

10 | Welfare Regime

Although the state provides the basic elements of a social safety net, the general overdependence on external remittances and serious appreciation in the national currency's value (which by extension lowered the exchange value of the dollar, the euro and the ruble, the most common currencies used for remittances) have reduced the value and adequacy of the social safety net for most families. Structurally, social assistance in Armenia is based on the provision of limited cash benefits as well as some limited state subsidies for energy (e.g., the "lifeline" utility tariffs). Social insurance (e.g., unemployment and pension pay) are both flat-rate benefits. In

Social safety nets
6

Armenia, social safety nets are also based on family and kinship structures, on which individuals often rely for support in moments of emergency and need.

Over the last two years, inequality of opportunity in Armenia has worsened. Social divisions distort access to state benefits and services and result in uneven availability of opportunity. Although some elements of the country's economic reform and poverty-reduction strategies seek to correct this inequality, there are no practical or direct avenues for doing so. Moreover, the return of a significant number of migrant workers after the onset of economic crisis in Russia has exacerbated the lack of economic opportunity.

There is also a geographic aspect of this socioeconomic divide along urban-rural lines, which is marked by an over-concentration of economic activity and opportunity in urban centers and the capital. This division has fostered more pronounced regional and rural income inequalities and is exacerbated by a wide variance in the quality and accessibility of essential public services, such as healthcare and education.

11 | Economic Performance

Following the launch of economic reforms, Armenia's economy posted an impressive record of double-digit economic growth over the last seven years, making Armenia one of the fastest-growing former Soviet states. This growth was matched by low inflation and an increasing level of real per capita income. Investment levels also continued to rise, accompanied by a substantial expansion of the private sector, which currently accounts for over 80% of GDP.

Although Armenia's record of economic reform in recent years has been fairly impressive, most economic assessments warn of the dangers posed by an overemphasis on statistical growth, without sufficient attention paid to overall poverty, the closed nature of the market, and widening disparities in wealth and income, which have led to a serious socioeconomic divide. According to the official data, Armenian GDP posted an increase of 7% for 2012, with Finance Minister Vache Gabrielyan noting a continued low level of inflation and promising a decrease in poverty of between 2% and 3% for 2013. The official national poverty level is now estimated at 34%, compared to 36% in 2010 and 24% in 2008. The minister also reported that tax collection for 2012 is expected to reach 21.66% of GDP, and total external debt stood at nearly \$4.38 billion for 2012, up roughly \$252 million from the 2011 level of \$4.128 billion.

According to official statistics, economic growth for 2011 was 4.7%, but the government set a new 7% GDP growth target for 2013 (most economic forecasters see a 6.2% increase in GDP as more realistic for 2013). Separately, officials announced a new \$11 million Chinese aid package, with most funding directed at

Equal opportunity

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Output strength

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reform and modernization of the customs system, with other Chinese assistance directed at the agriculture, healthcare and transportation sectors. But the International Monetary Fund (IMF) has warned of the need for a “radical improvement” in tax collection and the business environment, noting that doing business in Armenia continues to be difficult due to the country’s geopolitical isolation and closed borders, governmental corruption, and an overall absence of clear and predictable government regulations. The IMF also remains concerned about the government’s failure to boost tax revenue and “strengthen the legal framework, improve governance, and enhance competitiveness,” and has warned that “Armenia remains well below all its comparators regarding its tax revenue-to-GDP” ratio. The IMF praised the government for granting more power to the State Commission for the Protection of Economic Competition (SCPEC), although the state has yet to effectively reform the customs service, the source of “some practices that could lead to unfair advantages for some players in the market.”

During this period, as the IMF has noted, robust growth in 2012 has reflected a stronger performance across a range of sectors and industries. As fiscal consolidation has continued, inflation and public spending have both been kept in check, although pressures are growing for increased budget allocations (for infrastructure, health and education, pension reforms, etc.).

12 | Sustainability

Over the last two years, environmental considerations have been increasingly taken into account as part of the government’s overall reform program. The government has identified specific concerns relating to overexploitation of natural resources, including the depletion of the water supply, soil erosion and the loss of biodiversity. The Armenian constitution mandates that the state protect the environment and ensure the rational use and exploitation of natural resources. Yet despite this overall record of environmental recognition, the trend has been toward policies promoting growth rather than policies of conservation.

More specifically, the Armenian government’s priority of developing and even expanding the country’s mining sector will pose coming challenges to the balance between economic growth and environmental planning, with little practice of conducting environmental impact studies. The government reported a significant 10% increase in the aggregate output of the mining sector for 2012. Despite a fall in global prices for key metals, including copper, molybdenum and other base metals, the volume of Armenian exports of metals and metal ore concentrates, which now account for the country’s main export item, also increased by 36% for the same period. The government also confirmed a 27% decrease in the level of tax payments by mining firms in 2012.

Environmental
policy
6

Armenia has three main challenges in developing its education and R&D sectors: an inability to sustain adequate levels investment and state spending, aging facilities, and the severe effects of the country's brain drain during the early to mid-1990s. The decline in state investment in education has predictably led to a decline in the overall quality of education. Nevertheless, Armenia has succeeded in maintaining its system of universal basic and secondary schooling. Enrollment rates at both levels remain high, and over 99% of the population is literate. The Global Competitiveness Index (GCI) placed Armenia at 111th place among 144 countries with the regard to quality of scientific research institutions. It also reported a reduction in brain drain in Armenia in 2012.

Although R&D has long been recognized as an area of strategic importance in Armenia, annual state funding for this purpose has rarely surpassed a ceiling of 1% of GDP. The government has created a strategic plan for research and innovation focusing on the following sectors: information and communications technologies (ICT), life sciences, food security and quality, environment and energy, and nanotechnology. The information technology sector has also attracted some investment and continues to serve as a strategic priority for the state. The only exception for this period was the development and leveraging of R&D in the pharmaceuticals sector.

Education policy /
R&D

5

Transformation Management

I. Level of Difficulty

Since the collapse of the Soviet Union, independent Armenia has struggled to forge new institutions of statehood and overcome a daunting set of economic, political and social challenges. Economic and political reform has been especially difficult, as the country experienced a severe earthquake, a war with neighboring Azerbaijan and the imposition of a virtual blockade. Armenia still faces serious challenges today, including incomplete democratic reform and uneven economic development. Yet it is the lack of overall good governance that remains the most fundamental obstacle to political and economic transformation.

Structural
constraints

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Over the last two years, the Armenian government has been unable to sustain its traditional reliance on economic growth as the sole source of legitimacy. Internal weaknesses due to a lack of popular support and an unresolved domestic political crisis have made it increasingly difficult for authorities to manage the country's structural fragility. Entrenched corruption and incomplete reform now threaten the economic system, compromising its ability to sustain itself in the face of mounting challenges.

More serious is the emergence of cartels and monopolies that flourish within closed economies, averting the transparency and competition that dominate more open marketplaces. These cartels and monopolies also become entrenched through their negotiations with state actors. In Armenia, given the small size of the national economy, transparency and competition are rather easy to avoid. And despite the most well-intended antitrust legislation and bodies empowered to limit or breakup monopolies, without a strong rule of law, and political will, very little can be reasonably expected. In larger economies, such as in the East Asian region, such cronyism has resulted in state policies aimed at restricting foreign and domestic competition, in return for providing an avenue for lucrative shares to the state elite.

In both cases, however, there is a high transaction cost to such arrangements. It fosters and promotes widespread corruption, even to the point of actually weakening the state by depriving it of much-needed tax revenue. It also limits economic growth in the short run, and constrains competition in the long run, which, in turn, leads to higher prices and slower innovation. Thus, the cumulative effects are devastating for

the national economy and the society. For Armenia, with its small, infant economy still engaged in a difficult transition, such a situation threatens to further destabilize and isolate the country.

The influence of Armenian civil society is generally constrained by the state's failure to engage it in constructive dialogue or to grant it a role in public debate or the formulation of policy. There is also a second challenge, stemming from a demonstrable lack of equal opportunity. While there has been continued progress in both the number and activity of civil society groups, with a greater breadth of civic and non-governmental organizations (NGOs) dealing with a wide range of issues, only a handful of these operate with any consistency.

Civil society traditions

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More than seven decades of communist rule resulted in virtual elimination of most pre-Soviet forms of civil association in Armenia. As a consequence, present-day Armenia has no deeply rooted civic traditions. Formal civil society, represented by the NGO sector, is a post-communist phenomenon. Although Armenian society is characterized by vibrant social capital, the formal civil association, in particular membership in civil society organizations, continues to be unpopular. The public trust toward civil society, according to recent surveys, remains markedly low, and NGOs are often associated with political actors. Levels of interpersonal or social trust are also fairly low.

Internally, there is no real evidence of ethnic, religious or social conflict. Yet over the last two years, confidence in the government has eroded to the point of political crisis unprecedented in Armenia's recent history. In this way, the Armenian government's most basic challenge stems from a distinctly new political context, insofar as the population has emerged from years of apathy to voice fresh and insistent demands for change. This is rooted, at least in part, in the opaque nature of the Armenian political system, in which dissent is seen as a direct threat to the state rather than as a characteristic element of a healthy democracy.

Conflict intensity

3

II. Management Performance

14 | Steering Capability

Question Score

In 2011, the key strategic priorities of the Armenian government were centered on preparation for the 2012 parliamentary elections. The main political development of the year was the dialogue between the government and the Armenian National Congress (ANC), an alliance of opposition parties. Although the dialogue resulted in

Prioritization

5

a number of concessions offered by the president, the opposition failed to achieve most of its goals.

In 2012, on consolidating its victory in the May 2012 parliamentary elections, the ruling Republican Party began preparations for the February 2013 presidential elections. However, no notable transition in the government's strategic priorities occurred during that period.

Main long-term priorities of the Armenian government, frequently reiterated during the 2012 campaign, were focused on strengthening the economy and regional security. Remarkably, none of the opposition's presidential candidates prioritized long-term goals, instead emphasizing the need for immediate political change. Overall, the last two years were marked by the absence of long-term government strategies beyond the immediate concern of dominating parliamentary and presidential elections. Sarkisian's administration maneuvered between rapprochement with the opposition and attempting to implement changes to the electoral code and judicial system.

Although Armenia has established the basic framework for a modern market economy and has demonstrated sound macroeconomic policymaking, the sustainability of these previous achievements now depends on carrying out the next generation of reform. If sustainability is to be attained, a greater degree of political commitment to the implementation of these reforms must be shown, with the government demonstrating it can withstand short-term political pressures in pursuit of strategic economic development and reform. The two areas most glaringly in need of further reform are the banking sector and the social sector, each of which demands policies designed to correct widening disparities of income and wealth. Also critical are improvements in the judicial sector that would foster greater efficiency and effectiveness in enforcing contracts and regulating commerce.

In 2011-2012, the Armenian government was rather effective in implementing its policies. The key developments of this period include the adoption of the electoral and criminal codes, the establishment of a Council for Information Disputes, the reorganization of self-governing communities, judicial reform, and the fight against corruption.

One of the most startling lessons of the past two years is the fact that the Armenian state can no longer maintain its economic system. If the state is to weather the current economic crisis, it must put an end to its reliance on the twin evils of corruption and oligarchic cartels and monopolies. Faced with an already apparent shortage of political legitimacy, the Armenian state can no longer sustain the closed economic system that has deformed and distorted the country in recent years.

The government's response to the 2011 opposition rallies significantly differs from its approach to its 2008 post-election response. Rather than violently suppressing the

Implementation

5

Policy learning

4

opposition-organized street protests, Sarkisian's government chose to open a dialogue with the opposition. In part due to his low popularity, the incumbent's strategy in the wake of 2012 parliamentary and 2013 presidential elections was a softer approach to the political dissents. In 2011-2012, the Armenian government worked closely with the European Union and the World Bank on anticorruption campaigns and on reforming the judiciary.

There were several signs suggesting a newfound political will within the Sarkisian administration, however, aimed at reforming and bolstering the tax and customs services and seeking to combat the oligarchs' permissive approach to tax evasion. Both President Sarkisian and Prime Minister Tigran Sarkisian have reiterated their commitment to defeating the power of the oligarchs by attacking the economic monopolies and cartels that fuel and finance the oligarchic system. Generally, such cartels and monopolies flourish within closed economies, averting the transparency and competition that dominate the more open marketplace. But in addition to the need for greater antitrust legislation and stronger state regulatory bodies empowered to break up monopolies, stronger rule of law and political will are needed to overcome this cronyism. Thus, the closed nature of the political system, infected by a clan-based and oligarchic elite, has significantly eroded the state's most important asset of legitimacy.

The last two years have also seen a significant increase in the government's efforts to tackle corruption. For instance, the adoption of several anticorruption laws in 2011-2012 shows some commitment by the regime to reduce the embezzlement and theft of the state budget by officials.

15 | Resource Efficiency

In 2011, the Armenian state budget deficit, still struggling with residual effects of the economic crisis, began to slowly decline. On reaching its average of 1.5% of the country's GDP, the budget deficit stabilized in 2012. However, positive trends in budget spending were offset by an increase in government debt, which reached its highest level since independence at 35.5% of GDP in 2012. With no significant improvements in the organization of public administration, the government has similarly made no notable progress in the decentralization of state institutions.

Positive developments in public organization include policies to merge self-governing communities with the goal of increasing their financial and organizational potential. Another notable development was the adoption of the Law of Public Service, which requires all government officials to regularly submit statements on income and property. This law is to be regulated by the new Commission on Ethics of Senior Public Officials.

Efficient use of
assets

6

Although the Armenian government has developed a fairly effective resource base and has made some gains over the past two years in implementing broad civil service reforms, the state must utilize a new generation of dedicated and skilled personnel more effectively. To date, the most fundamental shortcoming in resource management has been the lack of merit-based advancement. Positions and benefits have flowed to those with connections, and an inadequate pay scale has fostered greater cronyism, which together limit the state's ability to effectively utilize its resources.

The closed nature of the system is offset by fairly well-developed administrative competence at many levels of government. Despite some recent reforms in the last four years targeting the civil service, corruption within these structures remain a serious challenge, however, and civil administration remains hindered by a legacy of inefficient and burdensome Soviet-era practices. Additionally, although there is a reasonable administration of justice, adjudication remains contingent on political, personal or financial interference (such as bribery). This is related to a fairly weak rule of law, matched by a flawed system of law enforcement and a sometimes checkered record of justice, primarily in the less developed regions of the countryside, but not excluding incidents in the major cities. Similarly, the lack of an independent judiciary also tends to weaken the efficacy of state administrative bodies and fosters a general public mistrust of the system.

Dominated by hierarchical bureaucracy and high reliance on informal power networks rather than formal institutions, the Armenian government is not very efficient at reconciling conflicting objectives. During the review period, one of the most glaring deficiencies in policy coordination has been the lack of a coherent government policy in the face of a new domestic political crisis and the onset of serious external economic pressure. For the Armenian authorities, the past two years have only reaffirmed the overwhelming need for good governance, including better transparency, ethics and accountability and more competent administration. These prerequisites are notably lacking today, exacerbating the danger of the fresh crisis.

Policy
coordination
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Shortcomings in Armenia's anticorruption policies have been most clearly demonstrated by the powerful role of Armenia's small, wealthy political elite, the so-called oligarchs, who exercise not only commercial and economic power through commodity-based cartels and virtual monopolies, but who have also acquired political power after becoming parliamentary deputies. Left unchecked, their ill-gotten wealth and political power threatens democratization and the rule of law and allows them to further consolidate and protect their informal networks of power.

Anti-corruption
policy
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Nevertheless, a number of notable improvements in the fight against corruption took place during the observation period. In 2011, the Law on Procurement and a new criminal code were adopted. The same year, e-government services were launched to reduce low-level government corruption. Procedures for issuing business licenses

were also simplified in an effort to tackle corruption. In 2012, the government approved the Anti-Corruption Strategy and Action Plan for 2009-2012.

Apart from directly tackling corruption, the government also introduced measures overseeing the ethical and financial status of high-ranking state officials. For instance, the Law on Public Service, which took effect in 2012, requires all state officials to submit declarations of their income and assets. Indirect efforts at reducing corruption also included the establishment of the Commission on Ethics of Senior Public Officials, which is tasked with monitoring declarations on income submitted by high-ranking officials.

16 | Consensus-Building

While no significant distinctions exist between the government's and the major opposition parties' views on market economy, their positions on democracy slightly differ. For instance, the ANC, a coalition of opposition parties, emphasized democratic values as the core of its 2012 campaign. Democratic reforms were also the priority for the presidential candidate, Raffi Hovannisian.

Consensus on goals
6

In contrast, the ruling Republican Party, regardless of its formal adherence to democratization, has so far failed to implement significant steps in facilitating the democratic transition. Despite the 2011 dialogue between the Republican Party and the opposition, which resulted in amnesty for political prisoners and improvements in assembly rights, a general lack of consensus on democracy between the government and opposition still prevails. Electoral irregularities and claims of fraud repeatedly emphasized by the opposition further reduce the credibility of the incumbent in promoting democratic reforms.

Since the incumbent government is mostly satisfied with the status quo, it shows no determination to jumpstart the country's stalled democratization process. The ruling elites' failure to hold free and transparent elections make it the strongest veto power to democratic reforms.

Anti-democratic actors
6

Although there are no real antidemocratic actors present in the country, a power competition is underway between political and economic elites. This struggle may devolve or expand to include some new form of actor capable of confronting the reformers outside the confines of the existing system.

Armenia's ruling regime showed only limited efforts to depolarize the political landscape from 2011 to 2013. Brief and largely ineffective dialogue held in 2011 between the government and opposition has failed to build a consensus between the political actors. Existing cleavages were further exacerbated by the May 2012 parliamentary elections, which were described by the opposition as illegitimate. Furthermore, dominated by the incumbent and marred by the intimidation of

Cleavage / conflict management
5

opposition candidates, the 2013 presidential campaign deepened cleavages between the largely unpopular president and polarized opposition actors.

Over the last two years, Armenia has slipped into a political crisis rooted in deadlock between the authorities and the opposition. The deadlock is driven by an unpopular government that refuses to recognize the country's new political reality and an opposition movement that seems devoid of any clear policy alternatives. The government's lack of legitimacy and absence of any popular mandate have exacerbated its tendency to favor authoritarian rule over accountable governance, and it has retained a myopic view that sees dissent only as a direct challenge to its authority. Similarly, the opposition is limited by its internal conflicts and its inability to offer substantial alternatives.

While the government does not overtly impede civil society organizations, it continues excluding civil society from participation in political processes. Although civil society in Armenia has been both vibrant and vocal for many years, the new upsurge in civic activism stems from a wave of grassroots youth-led momentum over issues including the environment and urban planning.

Civil society
participation
5

This activism was capped by a successful campaign by environmentalists against the construction of a hydroelectric plant in the northwestern Shirak region. It was also evident in a wave of angry street protests sparked by the fatal beating of a military doctor in 2012 at a Yerevan restaurant owned by a notorious businessman, Ruben Hayrapetian, who was later forced to resign as member of parliament. That incident only exacerbated an already deep-seated sense of outrage at the arrogance and abuse of power and position by the class of so-called oligarchs, and businessmen-turned-politicians.

Nevertheless, the role of civil society in political participation remained limited throughout the period under review. The government largely ignored civil actors' criticism of electoral fraud during the 2012 parliamentary elections and irregularities in the 2013 presidential campaign.

The Armenian-Turkish reconciliation process remained stalled between 2011 and 2013, and no significant progress was achieved on the Nagorno-Karabakh issue between Armenia and Azerbaijan. However, anti-Turkish sentiment and calls to recognize the independence of Nagorno-Karabakh were often exploited by both the incumbent and opposition during the parliamentary elections, as well as in the 2012 presidential campaign. The government and the opposition also favored the failed bill criminalizing the denial of Armenian genocide passed by the French parliament in 2012.

Reconciliation
4

17 | International Cooperation

Over the last two years, Armenia has made notable progress in reform, and Armenia has performed well in specific policy areas, in terms of fighting inflation, maintaining monetary stability and garnering success in its negotiations with the European Union over a new association agreement and a Deep and Comprehensive Free Trade Agreement (DCFTA), set to be concluded in November 2013. Armenia's cooperation with the European Union also included the signing of the Visa Facilitation Agreement in 2012.

Effective use of support

7

In addition, Armenia stepped up its cooperation on anticorruption efforts and judicial reform with both the European Union and the World Bank. Armenia's collaboration with the Council of Europe was focused on electoral reforms. Yet, due the uneven and slow pace of reform, Armenia's cooperation with international partners on democratization remains inconsistent.

Armenia has signed a new visa liberalization agreement with the European Union, easing visa requirements for Armenians planning to visit EU countries. Signed in Brussels in a session of the EU-Armenia Cooperation Council, the new agreement provides easier access for Armenian citizens to the so-called Schengen zone; grants new categories of travelers, such as university students, academics and state officials, easier eligibility rules for long-term and multiple-entry Schengen visas; and brings Armenia and the European Union a step closer to a wide-ranging association agreement. For its part, Armenia has also unilaterally lifted its visa requirements for EU nationals, effective 1 January 2013, offering EU citizens a visa-free regime good for up to 90 days per visit to Armenia.

The Armenian government's commitment to democratic reforms, albeit not always transferred into practice, is recognized by international actors. For instance, Armenia continues to actively cooperate on democracy-building projects with USAID, U.N. agencies and other international promoters of democracy.

Credibility

7

However, the irregularities observed during the 2012 parliamentary elections have caused international concern on the part of the European Union and the Organization for Security and Co-operation in Europe (OSCE), among others. The lack of judicial independence and violations of human rights and freedom of speech were also highlighted in the European Neighbourhood Policy progress report on Armenia.

In terms of cooperation with neighboring countries and regional organizations, there has been no real change in the last two years. Although Armenia seeks greater cooperation, seeking to overcome the effects of external isolation and a blockade that is particularly damaging for the landlocked country, the unresolved Nagorno-Karabakh conflict has led to frozen relations with both Azerbaijan and Turkey. Armenia faces further isolation as a result, and needs a normalization and restoration of regional trade and transport links.

Regional cooperation

7

Strategic Outlook

In general, through much of this period, domestic Armenian politics was dominated by a pre-election jockeying for position and power among the country's leading political parties. At the same time, there was a significant shift in the nature of political competition, moving from the traditional conflict between government and opposition to a new, much more significant clash within the ruling pro-government elite. This conflict pits the ruling Republican Party, Armenia's largest party, led by President Serzh Sarkisian, against junior coalition partner Prosperous Armenia, a party led by businessman Gagik Tsarukian, who openly supports former President Robert Kocharian. The Republican Party seems intent on marginalizing Prosperous Armenia. But now that the elections have passed, there is an important new opportunity for the Armenian government to overcome a legacy of mistrust and a pronounced lack of legitimacy and provide President Sarkisian an opportunity to build on his own reelection free from the shadow of his predecessor. The president should be allowed a fresh start with a new parliament in order to more accurately respond to Armenia's political reality.

But the Armenian government must be able to meet these expectations, and demonstrate a new sense of political will and commitment to reform. The government has moved to resolve the lingering political crisis and has sought to ease the deadlock between the authorities and the opposition. Indeed, it has exhibited a degree of statesmanship previously lacking in Armenian politics. But public discontent remains, driven by years of widening disparities in wealth and income, a deeper trend of increasing poverty, and a pronounced lack of economic opportunity.

Despite political gains, this undercurrent of economic discontent is only increasing. Although the record of economic reform in recent years has been fairly impressive, it has not sufficiently addressing the paradox whereby several years of double-digit economic growth have resulted in such uneven dividends with respect to wealth and living standards nationwide. In a broader context, a second serious obstacle to Armenia's democratic development is rooted in the structural deficiencies of the political system, including weak rule of law, a compliant judiciary and an ineffective parliament. Most crucially, these structural flaws demonstrate that the current political system is incapable of sustaining itself in the face of mounting pressure and suggest that the only viable avenue toward democratic development in Armenia is through reforming and forcing open the inherently closed nature of the country's political system.

In order to attain lasting gains in the political and economic transformation of Armenia, the country must focus on overcoming internal threats to statehood. Armenia needs leaders who govern, rather than simply rule, and who will rise to the challenge of defeating the "cancer of corruption." Legitimacy is the key to stability.