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# **SME Regulation in Moldova: Recommendations from an Economic Perspective**

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# **SME Regulation in Moldova: Recommendations from an Economic Perspective**

## **Executive Summary**

The government of Moldova plans to create a single common SME framework law that is the fundament of the legal and regulatory framework concerning small- and medium-sized enterprises (SME). This paper contributes to the preparation of the new SME framework law by discussing economic issues of SME regulation. The papers addresses some of the most important economic issues of the current situation of the SME sector in Moldova as well as some formal regulation matters, and it derives concrete recommendations that can be used as background for drafting the new SME framework law.

The following list highlights the essence of our recommendations.

1. State the assurance of free and efficient competition as clear policy objective
2. Provide simplifications for tax calculation and accounting, but prevent tax evasion
3. Facilitate self-regulation of liberal professions that helps to increase quality and transparency of professional services, but prevent self-regulation that undermines efficient competition
4. Ease restrictive labour market regulation for small enterprises
5. Ensure non-discrimination in access to SME state support programmes, prevent misuse
6. Abolish exceptional regulations for special types of economic agents
7. Harmonise the Moldovan SME classification criteria with the EU classification system
8. Improve statistical data collection and evaluation regarding economic data of the SME sector

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## 1. Introduction

The government of Moldova considers a change of the legal and regulatory framework concerning small- and medium-sized enterprises (SME). The currently most preferred option is the establishment of a SME framework law. Such a SME framework law is not yet in force in Moldova.

The central legal norm that regulates matters of SME in Moldova is the "Law on support of the sector of small and medium sized enterprises No. 206-XVI as of 7 July 2006". This law should, according to the plans of the Ministry of Economy, be transformed into a SME framework law.

The paper aims to support the reform process by providing some recommendations for the new legal and regulatory SME framework from an economic perspective. In order to accomplish this task, we adapt international experience to the specific challenges of Moldova.

The paper is organised as follows. Firstly, we sketch SME policy objectives that are generally applicable and can be used as guidelines for policy formulation. Secondly, we address some specific regulation issues that have impact on the economic SME sector development. Instead of providing a comprehensive framework, we point to some of the most pressing economic issues that we have identified during our research and advisory work in Moldova. Thirdly, we discuss formal issues of general regulation matters.

## 2. Objectives of SME policy formulation from an economic perspective

### **Recommendation 1:** SME policy objectives

- Ensuring fair competition, preventing economic and structural distortions
- Facilitating company creation
- Facilitating company growth and innovation
- Harmonising with EU Small Business Act

#### *Explanation:*

The core objective of SME policy is the facilitation of economic dynamics. That is the stimulation of venture creation and the facilitation of growth. Since small and young companies are most vulnerable to economic changes or even crises, the sector of micro and small enterprises form the Achilles' heel of the economy. Therefore, policy must support the quick transformation of small and young companies into companies with sustainable sizes. In other words: Small companies of today are the possible big companies of tomorrow.

A vital economy is characterized by many start-ups, many climbers from the SME sector into the big enterprise sector and many market exits. On the opposite, an inflexible SME sector is the digging shovel of the economy. The best SME policy is, therefore, the securing of efficient competitive markets with low barriers on market entry, on growth and on market exit. A policy that provides incentives for SME to stay small and/or helps big companies to combat potential competitors (climbers from SME sector) harms the economy.

Additionally, we recommend preparing for possible future EU membership negotiations to implement the EU SME policy objectives laid out in the "Small Business Act".<sup>1</sup>

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<sup>1</sup> European Commission 2008: "Think Small First". A "Small Business Act" for Europe. COM(2008) 394 final.

### 3. Selected fields of regulation

#### 3.1 Taxation and tax accounting

##### **Recommendation 2:**

- No systematic tax advantage for any kind of economic agents
- Common tax rates for all kind of personal income generated from economic activities
- Simplifications in tax calculation and accounting

##### *Explanation:*

There are currently different tax regulations for special types of individual entrepreneurial agents in Moldova, for instance lawyers have different income tax rates. Furthermore, there are schemes of simplified taxation such as "entrepreneurship patents". The recommendation is to dispose different tax regulation and apply a single taxation framework.

Simplified taxation schemes and tax advantages for small and micro enterprises create growth barriers, because disproportionately low tax burden work as an incentive to stay small.

Tax accounting standards can be simplified for SME. International experiences show that such simplifications can contribute to the development of SME. Examples of such simplifications are cash basis taxation and simplified profit calculation, as for example in Germany. Box 1 sketches the simplifications of tax calculation and accounting for individual entrepreneurs in Germany (see below).

There is already regulation regarding simplified accounting in place in Moldova: Simple entry accounting system and simplified double entry accounting system. The recommendation is to review this regulation, to harmonize the eligibility criteria with SME classification criteria and to base it on the SME framework law.

The World Bank report "Doing Business in Moldova" shows that the average time needed for tax declaration is less than in other Eastern European and CIS countries – although still above OECD average; Moldova should follow this positive path and reduce the administrative burden further. However, the number of tax payments per year is relatively high, leaving much room for improvement of the tax administration system.<sup>2</sup>

##### *Opportunities and possible advantages:*

- Reduction of administrative burden and accounting costs for SME
- Reduction of administrative costs for tax authorities
- Improving the entrepreneurs' liquidity
- No economic and structural distortions
- No major losses in public revenues, prevents tax evasion

##### *Challenges and possible disadvantages:*

- The disposal of the system "entrepreneurship patent" might result in higher administrative and tax burden for the current patent holder; this might further cause worries and irritations for some of the entrepreneurship patent holder
- The disposal of special regulation for specific economic agents could mean that privileges are abolished

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<sup>2</sup> World Bank 2010: Doing Business 2011 - Moldova.

**Box 1**

Simplifications for income taxation and income tax accounting of individual entrepreneurs in Germany

Who is eligible?	Individual commercial entrepreneur with a yearly turnover < 500,000 EUR and a yearly profit < 50,000 EUR
What is the (optional) simplification?	<ul style="list-style-type: none"> <li>• Simplified profit calculation: profit is a simple revenue surplus, i.e. profit = yearly revenues minus yearly expenses</li> <li>• Profit is liable to Personal Income Tax (not to Corporate Income Tax)</li> <li>• Cash basis taxation: Profit is calculated on the basis of settled accounts, i.e. only paid invoices are considered</li> <li>• Exempted from the obligation to keep double entry accounts</li> <li>• Simplified records: a simple cash receipts and disbursement statement on a pre-printed official form</li> </ul>
Why is it more simple?	<p>For corporations and for "big" commercial entrepreneurs: Profit is calculated as the difference between the assets at the end of the respective years. Therefore a balance sheet accounting is needed, which is more complex and means higher accounting costs and higher auditing costs.</p> <p>For corporations and for "big" commercial entrepreneurs: Profit is calculated on the basis of invoice amounts, regardless of payment of invoices. When income tax payment is due before outgoing invoices are paid, a liquidity problem can occur.</p>
What is the German experience?	The simplifications proved to be an effective and cost-efficient policy measure for supporting the development of small entrepreneurship in Germany. Therefore, the German government changed the eligibility criteria for the simplifications several times (2003, 2008, July 2009), allowing a growing number of individual entrepreneurs to benefit from those provisions.

### 3.2 Special regulation for liberal professions

#### **Recommendation 3:**

- Allow professional associations to define self-regulation frameworks regarding
  - Organisation
  - Qualification and competence of the members of the profession
  - Professional ethics / conduct of members
  - Impartiality
  - Supervision
  - Liability and consumer protection
- Prohibit self-regulation that undermines free and efficient competition, especially reg.
  - Price fixing and recommended prices
  - Advertising regulations
  - Entry restrictions and granting of exclusive rights to perform certain services
  - Regulations governing business structure (restrictions on the scope for cooperation) and multi-disciplinary practices (restrictions on the setting up of inter-professional services)

*Explanation:*

There is currently no framework law that regulates liberal profession in Moldova. On the other hand, a tremendous variety of self-regulation frameworks of professional associations exist.

Regulations of liberal professions occur in every OECD country.<sup>3</sup> In some of the EU member states, there is even a confusing mass of self-regulations of professional associations that has evolved historically. However, traditionally restrictive rules are in many aspects not adjusted to current economic challenges. Such out-dated regulation entails the serious economic dangers of limited competition between service providers and thus reduced incentives for professionals to work cost-efficiently, to lower prices, to increase quality or to offer innovative services.

The EU, therefore, provides a set of clear recommendations for the deregulation of sectors of liberal professions for EU member states.<sup>4</sup> Considering that Moldova follows the long-term objective of EU integration, the recommendation is to apply the EU policy guidelines on liberal profession deregulation right from the beginning.

*Opportunities and possible advantages:*

- Increased capacity for innovation and competitiveness of professional services
- Availability of better and more varied professional services
- Increasing demand for professional services
- Positive impact on job creation in the professional service sector
- In EU member states with deregulated sectors of liberal professions: Higher number of entrepreneurs, higher sales volume per entrepreneur, higher generated value of the sector<sup>5</sup>

*Challenges and possible disadvantages:*

- Resistance from professional associations to new regulation could emerge
- Fierce competition and high volatility in the sector of professional services in the short-term is a possible, but not definite, side effect

### 3.3 Labour market regulation

#### **Recommendation 4: Ease of labour market regulation for small enterprises**

*Explanation:*

Company growth paths require different human resources and capabilities in different growth stages. At the beginning of a firm's life cycle, product development and market penetration are the most important tasks; during market maintaining phase, customer relationship management and supply chain management are main success factors. Companies must be able to change the personnel easily according to the challenges of their respective growth stage. Furthermore, companies must be able to balance the personnel workload according to the market requirements. The current labour market regulation of Moldova forms barriers, especially for growth oriented companies.

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<sup>3</sup> OECD 1999: Competition in Professional Services.

<sup>4</sup> European Commission 2004: Report on Competition in Professional Services. COM(2004) 83 final; European commission 2005: Professional Services - Scope for more reform. Follow-up to the Report on Competition in Professional Services COM(2004) 83 of 9 February 2004. COM(2005) 405 final; European Parliament resolution on follow-up to the report on Competition in Professional Services (2006/2137(INI)).

<sup>5</sup> Paterson/Fink/Ogus 2003: Economic Impact of regulation in the field of liberal professions in different EU Member States. Institute for Advanced Studies, Vienna.

*Opportunities and possible advantages:*

- Accelerated growth of SME sector
- Positive impact on job creation
- Compliance to EU principle of "Flexicurity": Balance between entrepreneurial flexibility and job security

*Challenges and possible disadvantages:*

- Higher labour market volatility is a possible, but not definite, side effect
- Accelerated unemployment increase during crises is a possible, but not definite, side effect

### 3.4 State support

#### **Recommendation 5:**

- Ensure non-discrimination in access to state support
- Introduce cap for subsidies per company

*Explanation:*

This chapter concerns direct SME policy. SME direct policy is the sum of measures that provide individual support for founders, entrepreneurs and companies. Typical direct SME policy instruments are: Business development services, subsidies, loans, loan guarantees, facilities and specific infrastructure. In contrast to that, indirect SME policy is the sum of measures that aim to improve general conditions for the development of the SME sector, such as the improvement of business climate and framework conditions, fostering entrepreneurial interest and talent, and building a positive image of entrepreneurship.

Direct SME policy measures are only in exceptional cases recommendable for Moldova, because they are, in contrast to indirect measures, very expensive and thus have a negative impact on public finances in the short term, they entail the danger of corruption, misuse and structural distortions and they require sophisticated institutional capacity for the implementation. On the positive side: The impact of direct SME measures can be seen often immediately whereas effects of indirect SME policy come with a time lag.

SME regulation can contribute to diminishing the danger of structural distortions of direct SME support measures: The recommendation is to assure that all economic agents have the same fair chances to access state support programmes. If budgets and/or the number of companies, that can be supported, are limited, the selection criteria should be transparent, non-discriminative and based on economic reasoning only. In other words: It must be prevented, that state support flows to those companies with that have the biggest lobbying power.

To accomplish this task, a cap on subsidies per company could be used additionally. This means that the total value of direct support measures, that a company receives during a specific time period, is limited.

*Example "de minimis" rule of European Union:*<sup>6</sup> A companies receives business advisory support, worth 20,000 EUR, subsidies of 100,000 EUR, and subsidised premises, worth 80,000 EUR. The sum is 200,000 EUR. The limit on state aid for a company is 200,000 EUR for a 3 year period, independent of company size. Result: This company would not be eligible for further state support during the next three years.

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<sup>6</sup> European Commission 2006: Commission Regulation (EC) No 1998/2006 of 15 December 2006 on the application of Articles 87 and 88 of the Treaty to de minimis aid.

*Opportunities and possible advantages:*

- Helps to prevent structural distortions of state support programmes
- Helps to prevent corruption and misuse of state support programmes

*Challenges and possible disadvantages:*

- Definition of cap value
- Implementation, enforcement and monitoring of administrative procedures for realising non-discrimination and cap on subsidies

## **4. Formal aspects**

### 4.1 Area of application

**Recommendation 6:** Abolishment of exceptions in the single common framework regarding special types of economic agents

*Explanation:*

There are currently different regulations for special types of entrepreneurial agents in Moldova. One example for a special type of entrepreneurial agents is the so-called "entrepreneurship patent holder". Furthermore, economic activities of liberal professions are regulated in separate frameworks (see above). The recommendation is to abolish separate and parallel regulations and instead apply a common framework to all economic entities. Specific regulations, that apply to certain types of economic agents – such as for liberal professions - should be based on the comprehensive SME framework law.

*Opportunities and possible advantages:*

- A single SME framework law can increase the transparency and visibility of the regulation.
- A single SME framework can facilitate company growth. Regulative and administrative simplifications such as "entrepreneurship patents" create growth barriers, because disproportionately low overhead costs for "entrepreneurship patent" holders work as an incentive to stay small.
- Many areas of regulation are applicable independent of the business purpose. Among those: Taxation, accounting, reporting. There is, for instance, little economic reason for different income tax rates for different types of economic activities.
- A single SME framework can enhance economic dynamics, because economic agents can easily change and/or diversify their products and services without needing to build up competencies regarding special regulation. Examples: Small traders can offer additional services etc. Such flexibility enables entrepreneurs to react quickly to changing national and international markets.

*Challenges and possible disadvantages:*

- The disposal of the system "entrepreneurship patent" might result in higher administrative and tax burden for the current patent holder. This might cause worries and irritations for some of those individual entrepreneurs, which may hazard the acceptance of the new regulation.
- The disposal of special regulation for specific economic agents could mean that privileges are abolished and may thus hazard the acceptance of new regulation.

#### 4.1 SME definition

##### **Recommendation 7:** Harmonisation of SME classification criteria with the EU classification

*Explanation:*

The current definition of SME in Moldova differs from the EU classification system<sup>7</sup>.

**Table 1: SME classification criteria Moldova<sup>8</sup>**

<i>Enterprise category</i>	<i>Average annual number of personnel</i>	<i>Annual turnover <b>AND</b> annual balance sheet total, m MDL, (m EUR)<sup>9</sup></i>
Micro enterprise	1 – 9	≤ 3 (≤ 0.19)
Small enterprise	10 – 49	≤ 25 (≤ 1.54)
Medium enterprise	50 – 249	≤ 50 (≤ 3.08)
Big enterprise	> 249	> 50 (> 3.08)

According to the Moldovan classification, a company has to meet all three criteria ("No. of employees" and "turnover" **AND** "annual balance sheet total") for qualifying as SME.

Example: Company with 249 employees, 100 m MDL turnover, 40 MDL total annual value of assets = "big" company according to Moldovan classification, because it does not meet all of the three criteria for the "medium" category.

**Table 2: SME classification criteria EU<sup>10</sup>**

<i>Enterprise category</i>	<i>Average annual number of personnel</i>	<i>Annual turnover m EUR</i>	<i>Annual balance sheet total m EUR</i>
Micro enterprise	1 – 9	≤ 2	≤ 2
Small enterprise	10 – 49	≤ 10	≤ 10
Medium enterprise	50 – 249	≤ 50	≤ 43
Big enterprise	> 249	> 50	> 43

According to the EU classification, a company has to meet the criterion "No. of employees" and one of the criteria "turnover" **OR** "annual balance sheet total".

Example: Company with 249 employees, 100 m EUR turnover, 40 m EUR balance sheet total = "medium" company according to EU classification because it meets two of the criteria for the "medium" category.

Adopting the EU classification without any adjustment is not advisable, because

- The level of value generated per employee of Moldova is much lower than the EU average
- Following to the EU classification, almost all companies in Moldova would be SMEs. There are only 29 companies in entire Moldova that exceed the SME thresholds of the EU definition (4 big private domestically-owned companies, 14 big state companies and 11 big foreign-owned companies).

Considering this, we recommend to

a) Harmonise the Moldovan SME classification rules with the EU classification system, which means that a company has to meet the criterion "No. of employees" and one of the criteria "turnover" **OR** "annual balance sheet total"

<sup>7</sup> European Commission 2003: Commission Recommendation of 6 May 2003 concerning the definition of micro, small and medium-sized enterprises (2003/361/EC).

<sup>8</sup> Law on support of the sector of small and medium sized enterprises No. 206-XVI as of 7 July 2006.

<sup>9</sup> Underlying exchange rate 1 EUR=16.2 MLD, exchange rate as of 22 Nov 2010.

<sup>10</sup> European Commission 2005: The new SME definition - User guide and model declaration.

b) For the quantitative criteria “annual turnover” and “annual balance sheet total”, use a conversion factors that transforms the EU criteria into Moldovan criteria. This conversion factor should takes into account the different level of economic development in Moldova and the EU. A possible conversion factor could be GDP per capita of Moldova divided by GDP per capita of EU.

*Opportunities and possible advantages:*

- Statistical data of Moldova are easier to compare with statistical data of EU member states
- The impact of SME policy is easier to monitor and to benchmark with EU best practice experience

*Challenges and possible disadvantages:*

- Definition of conversion factor
- Changing statistical methods means that future and past statistical data of Moldova are difficult to compare with each other

#### 4.3 Statistical reporting

##### **Recommendation 8:**

- Review existing standards of statistical reporting
- Common standards of statistical reporting for all kind of economic agents

*Explanation:*

There are currently different regulations regarding statistical reporting for special types of individual entrepreneurial agents in Moldova.

The statistical data of the National Bureau of Statistics of the Republic of Moldova do currently not provide a complete picture of the SME sector. As an example: 40% of the micro, 10% of the small and 10% of the medium enterprises report no activities; that could mean that those companies are either not operating or they operate only in the informal economy. Furthermore, Entrepreneurship patent holders are not included in the statistics.

Fragmented statistical data complicate SME policy formulation, SME policy monitoring and SME policy impact assessment.

It must be mentioned that the EU Commission has currently recommended to lower standards of statistical reporting for SME. However, EU member states have additional instruments for SME sector analysis and SME sector development monitoring, such as panel data of (private or state) research institutes. Since Moldova’s SME policy formulation relies solely on official statistics and no other statistical research data is available in Moldova, the recommendation is to advance statistical standards of SME in Moldova.

*Opportunities and possible advantages:*

- Statistical data of Moldova are easier to compare with statistical data of EU member states and transition countries
- Improved SME sector analysis and SME sector development monitoring
- Impact of SME policy is easier to monitor and to benchmark with international best practice experience

*Challenges and possible disadvantages:*

- It should be assured that the changing statistical reporting requirements do not increase administrative burden on SME

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