FDI Attraction to Moldova: Facts, Potential and Recommendations

Ricardo Giucci, Jörg Radeke

Berlin/Chișinău, April 2012
About the German Economic Team Moldova

The German Economic Team Moldova (GET Moldova) advises the Moldovan government and other Moldovan state authorities such as the National Bank on a wide range of economic policy issues. Our analytical work is presented and discussed during regular meetings with high-level decision makers. GET Moldova is financed by the German Federal Ministry of Economics and Technology under the TRANSFORM programme and its successor. Our publications are available at our website (www.get-moldova.de).

German Economic Team Moldova
c/o Berlin Economics
Schillerstr. 59
D-10627 Berlin
Tel: +49 30 / 20 61 34 64 0
Fax: +49 30 / 20 61 34 64 9
E-Mail: info@get-moldova.de
http:www.get-moldova.de
**FDI Attraction to Moldova: Facts, Potential and Recommendations**

**Executive Summary**

Competition for foreign direct investment (FDI) is tough as many potential investment locations try to attract scarce and increasingly footloose foreign capital. The data on Moldova’s FDI inflows and stock suggest that the country has only been partly successful in attracting foreign investors. The level of foreign capital invested per capita lags behind other peer economies and the structure of FDI is biased towards services. Manufacturing industries – which are usually more capital intensive and require thus a higher commitment from investors – are yet underrepresented and agriculture almost completely failed to attract FDI.

Talking to investors, business associations and other stakeholders reveals that there are a number of issues that inflate the cost and/or increase the risk of investing in Moldova. Thus, removing such problems is the key for increasing FDI to Moldova. We structure our recommendations in three categories.

Firstly, there is a need to improve legislation. Since this general issue has been widely discussed and covered for Moldova, we focus in this paper on selected urgent legislative issues. One of such issues is the ban of land purchasing for foreign investors. While there are many workarounds for insiders and established investors, this ban is deterring new potential investors and increases the cost, and the risk, of doing business for existing ones. Indeed, given the many ways of circumventing the ban, aligning legislation with reality would be quick win and low cost recommendation for improving the FDI climate. More complex, nevertheless important, is the issue of labour laws. Despite high headline spending on education investors have difficulties to find and retain skilled workers. A major problem is a lack of options to tie workers to the company and, thus, provide the incentives for employers to invest in training and education. Consequently, know-how transfer, a crucial aspect of FDI, is severely inhibited. Furthermore, curricula and methods of further education are partly outdated.

Secondly, the problematic relationship between government and business is a major barrier for FDI. The risk of investing in Moldova is particularly high due to the frequent arbitrary implementation of legislation by state bodies. Furthermore, often and sudden changes in legislation, which are not consulted with stakeholders, increase the cost and risk of running a business.

Thirdly, the current “personalised approach” of attracting investment, where high level policy makers would champion investors, is not without problems. While policy makers have a role to play in facilitating FDI, an “institutional approach” centred on a well-resourced MIEPO would reduce the risk for potential investors.

Most of our recommendations (see overview below) could be implemented in the short term and at a very low cost. This means that Moldova could in fact significantly improve its investment climate soon and inexpensively, thus inducing higher FDI inflows.
Overview of recommendations

Legislation

1. There is an urgent need for reforming labour legislation, in particular with regard to investment of employers in further education and training of employees.

2. The education system should be overhauled in order to take into account the needs of a modern, technology-based economy. While a complete overhaul might require many years, the reform of some educational fields should start as soon as possible and might be used as pilot projects for other fields.

3. Legal persons with foreign capital participation should be allowed to purchase, or long term lease, land as part of their investment plans. This measure is of crucial importance for attracting foreign investment into agriculture and manufacturing, thus creating a strong export basis.

Relationship government-business

4. Improvements in legislation should be accompanied by progress in the behaviour of state bodies vis-à-vis business and by focusing on implementation issues. This is particularly true for tax legislation.

5. When preparing new legislation the relevant state institutions should conduct consultations with different stakeholders, including business.

Approach to FDI attraction

6. Moldova needs an institutional approach to FDI attraction. Policy makers have an important role to play by supporting MIEPO, however, not by taking over its tasks. For this approach to work, MIEPO needs to be set up and equipped according to best international practice.

7. Policies that aim at attracting foreign investors should address general barriers and should not follow a sectorial approach. Promoting certain industries and ‘picking winners’ is not the role of the state.

General recommendations

8. Moldova needs to realign obsolete legislation to reality. By doing so, it will make a huge contribution for improving the perceived investment climate at practically zero cost.

9. Special attention should be devoted to the failure for attracting FDI to agriculture and food processing. After identifying the reasons in a systematic way, a strategy for higher FDI into agro-food industries should be developed and implemented.

Authors

Ricardo Giucci       giucci@berlin-economics.com       +49 30 / 20 61 34 64 0
Jörg Radeke         radeke@berlin-economics.com       +49 30 / 20 61 34 64 7

Acknowledgements: The authors would like to thank the Word Bank, the American Chamber of Commerce, the Foreign Investors Association (FIA) and a number of anonymous sources for their kind assistance.
# Contents

1 Introduction .................................................................................................................. 1

2 FDI to Moldova: Facts .................................................................................................. 1
2.1 Aggregate view ........................................................................................................... 1
2.2 The structure of Moldova’s foreign direct investment holdings ......................... 2
2.3 Assessment of FDI attraction to this date: Significant upward potential .......... 5

3 How to increase FDI: Recommendations ................................................................. 7
3.1 Selected legislative barriers .................................................................................... 8
   3.1.1 Human Resources ............................................................................................ 8
   3.1.2 Land ownership ............................................................................................... 9
3.2 The relationship between government and business ....................................... 11
   3.2.1 Arbitrariness of state administration and corruption ..................................... 11
   3.2.2 Lack of ex-ante consultation with business .................................................. 12
3.3 From a personalised towards an institutional approach of FDI attraction ........ 13

4 Conclusions ............................................................................................................... 14

References .................................................................................................................... 16
1 Introduction

Foreign direct investments are important for a number of reasons. Firstly, they constitute import of capital – a scarce resource in any country, but in particular in transition and developing countries. Secondly, foreign direct investments allow knowledge transfer from the source country to the investment destination. Indeed, foreign investors would often seek to transfer business models and products that have been successful in one country to another country thus spreading product and process innovations. This is also true for investors that seek to take a significant interest in a foreign company as they would typically also try to influence management and business practices. Furthermore, foreign direct investments enable access to foreign markets and business networks.

Foreign direct investments (FDI) typically describe a number of different types of investments such as equity capital (actual ownership stakes in a business), reinvestment of earnings of a foreign investor that has already established operations and portfolio investments (for example bonds and other financial instruments) (World Bank 2012).

As with any other business the main objective of foreign investors is to receive a high return on their investment – that is, achieving high profitability. Therefore, the decision if and to what extent to invest in a country depends to a large degree on how an investor assesses the expected profitability of potential investments. This expected profitability is determined by the level of risk and the actual cost of doing business. The higher the risk and cost the higher the return on investment an investor will demand. If a country cannot offer these returns investors will be deterred and invest their capital in alternative destinations.

This rationale provides a good basis for the assessment of Moldova as an investment destination. We will start this assessment by analysing the trends and structure of foreign direct investment to Moldova in section 2 of the report. This will provide us with a first indication of Moldova's performance in attracting foreign capital and may highlight any shortcomings. We then immediately proceed with analysing any potential barriers to attracting FDI in section 3. There, we also put forward recommendations how to overcome these barriers. In the final section 4 of the analysis we provide our conclusions.

2 FDI to Moldova: Facts

The main goal of this chapter is to illustrate the trend and nature of foreign direct investment flows and holdings (i.e. the stock of foreign direct investment) in Moldova. This assessment will form the basis for any further analysis.

2.1 Aggregate view

A review of historic foreign direct investment inflows into Moldova over the past decade shows a volatile picture. Foreign direct investment activity can be roughly divided into three phases (see Figure 1 below). Firstly, following the decade-long recession after the collapse of the Soviet Union, the Moldovan economy attracted only modest foreign direct
investment inflows. Annual inflows ranged between USD 100 and 200 m until 2005. Only late in the global economic cycle – around 2006 – did the Moldavian economy start to attract and increase inflows of money from foreign investors. This second phase was characterised by a steep increase of foreign direct investment into the country with inflows peaking at USD 700 m in 2008 at the height of the global economic cycle. Indeed, most of Moldova’s stock of foreign investment is stemming from this period.

**Figure 1**
Net foreign direct investment flows

![Graph showing net foreign direct investment flows from 2000 to 2010.](image)


However, the global financial crisis put an abrupt end to this period of rapid foreign direct investment growth with inflows collapsing to a mere USD 130 m in 2009. Furthermore, 2009 was a year of political turmoil and a transition of power adding a large degree of uncertainty for investors. Recovery since has been only moderate and inflows in 2010 are yet well below their pre-recession levels.

2.2 The structure of Moldova’s foreign direct investment holdings

Looking at the structure of foreign direct investment holdings suggests that foreigners’ money has been benefitting a wide range of industries (see Figure 2). Financial services – having received 22% - were the largest recipient of foreign capital. However, processing industries, retail and wholesale trade as well as the property sector all accounted for similar shares of the foreign direct investment stock of around 20% respectively. As such, foreign direct investments reasonably balanced among the industries. This is an important aspect as large inflows into only one industry – for example property – could lead to unwanted side-effects such as overheating.

Agriculture, however, accounted for only 1% of the foreign investment stock and thus plays only a minor role as a destination for foreign direct investments. This is somewhat
surprising given the sectors development prospects. Indeed, the World Bank has identified the ‘Agro-Food’ sector as one of Moldova’s growth industries (World Bank 2011). Furthermore, the sector accounts currently for around 13% of gross domestic product which should be reflected in its foreign direct investment share.

The data on foreign direct investment holdings in Moldova also suggest a preference of investors for the services sector. Indeed, investment in services accounted for almost 70% of the FDI stock in 2010 while only contributing to 50% of Moldova’s GDP. This suggest that investors do not yet feel confident enough to invest in manufacturing industries which tend to be more capital intensive than services and hence require a larger commitment of investors. While all investments are valuable, services tend to be consumed domestically and hence add little to export growth – some services such as retail and wholesale may contribute to growing imports. Manufacturing industries, on the other hand, can support the balance of payment as goods produced here are more likely to end up on international markets (German Advisory Group Ukraine 2007).

However, there are exemptions to this notion. Professional services such as finance and information technology and communications are often exported. The latter is an area in which Moldova has been remarkably successful. This may be an additional explanation of the dominance of the services sector visible in the FDI statistics.

**Figure 2**
Foreign direct investment positions by sector in 2010

![Pie chart showing foreign direct investment positions by sector in 2010](image)

*Source: Moldovan Investment and Export Promotion Organisation (MIEPO) (2010)*

Our analysis of the structure of foreign direct investment to Moldova suggests also that Russia accounted for almost a quarter of the foreign direct investment stock – making it the origin country with the largest investment share. Lukoil, one of the largest Russian
investors, can be put forward as an example here. Given the large number of Moldavians working and living in Russia it is easy to see the strong links between the two countries that are reflected in foreign direct investments. Secondly, there is the country’s strong dependence on energy from Russia which serves as an additional explanation for the large share of Russian capital.

If taken together, however, investors from the European Union easily exceed Russian investors with around 60% of the foreign direct investment holdings originating from the European community. Indeed, the second largest investment position is from Dutch investors which accounted for 14% of the investment positions. Danube Logistics – a subsidy of Easeur Holding B.V. which operates a harbour and trades oil and petroleum products – is one of the largest investors with Dutch origins. Other important investment origins are France – with Orange being a visible telecommunications provider –, Romania and Spain.

The sizable share of investors from Cyprus reflects the island’s status as a tax haven, with its residents not liable for capital gains tax, which is being used to re-route cash to Moldova.

**Figure 3**

Foreign direct investment stocks by country of origin, 2010

![Pie chart showing foreign direct investment stocks by country of origin, 2010](chart.png)

*Source: IMF Data Warehouse (2012)*

The examination of the structure of foreign direct investments provides generally a reasonably balanced picture in terms of countries of origins and industries that benefit from the foreign capital.
Conclusion 1: The sectorial structure of the foreign direct investment holdings suggests a bias of investors towards the services sector. While any kind of foreign direct investment is valuable, this raises some question marks why manufacturing seems to be yet underrepresented. Indeed, while being more capital intensive, processing industries are typically also better sources of export growth compared to services which tend to be consumed domestically. Professional services which are often exported are a notable exemption here.

Conclusion 2: Agriculture has been widely shunned by foreign investors. Given the sector’s contribution to the economy and potential of the industry as a driver of future growth and exports, identifying what inhibits foreign investments here is important.

2.3 Assessment of FDI attraction to this date: Significant upward potential

To put Moldova’s foreign direct investments into perspective it makes sense to compare it internationally. An important indicator that allows such a comparison is the stock of foreign direct investments per person. As per end of 2010 the value of foreign direct investment positions in the country was around USD 2,770 m. This is the equivalent of USD 778 per capita.

As Figure 4 suggests this value compares dismally with peer-economies in the region. Romania, for example, has attracted foreign direct investments worth USD 3,200 per person. Other former communist economies, which had a similar starting point as Moldova, also have performed better. Poland shows a stock of foreign direct investment of about USD 5,300 per person. The value of investments from foreign destinations in Estonia even exceeded USD 11,000 as of end 2010, making it one of the top performers under former communist countries. However, it is fair to say that the high inflow of foreign capital, and its sudden removal during the financial crisis, has not been without problems for the Estonian economy.
Admittedly, Moldova’s performance in attracting foreign investors looks better when comparing the stock of foreign investments to the size of its economy. The data suggest that Moldova’s stock of foreign direct investments amount to 48% of its gross domestic product – higher than most other former communist countries. However, this is as much reflection of the country’s low level of economic activity (visible in a low gross domestic product) than of vibrant foreign investment activity.

As such, the international comparison suggests that Moldova has attracted less foreign investments than its peer economies. Having had a similar starting point as other former communist countries the stock of investments in Moldova is even lower than in Belarus and Ukraine – two economies that have been avoided by investors due to an unreliable political climate.

Moldova’s dismal record in attracting foreign direct investments is somewhat surprising given that a number of factors speak in favour of Moldova as an investment destination. Moldova offers good access to both the European Union and the CIS markets. It has a comparatively well-educated population and spends a high a share of its, albeit low, income on education. Educational attainment is also visible in good language skills with foreign languages such as Russian and English widely spoken. Additionally, the country features wage costs well below other economies in the region.

Sources: IMF Data Warehouse (2012), Eurostat (2012)
Conclusion 3: While FDI attraction to date lags behind, Moldova could attract significantly higher foreign investment. Comparing it with other more successful investment destinations in the region suggests that there is significant upward potential in store for the country. However, the key question is how this potential can be realised.

How competitive is Moldova?

International competitiveness depends on a large number of factors. The importance of individual factors differs from one investor to the next and depends on the actual business model. Reflecting this, there are many studies and attempts to assess and compare international competitiveness. The Word Bank’s Doing Business Indicator is one of them (World Bank 2012). It ranks Moldova 81 among 183 countries on the ease of doing business.

The Global Economic Forum provides another ranking, the ‘International Competitiveness Indicator’, which uses economic indicators as well as questionnaires to assess a country’s international competitiveness. Here Moldova ranks 93 out of 142 in the latest ranking (World Economic Forum 2011). Thus, both studies suggest that Moldova is not yet perceived as a top location for doing business.

Despite this sober reading, Moldova has actually a number of favourable economic factors. Firstly, wages are low making it an ideal location for labour intensive industries. However, low wages partly reflect low productivity (for example measured as output per employee). As such foreign capital could help to improve productivity and hence the country’s attractiveness. Finally, Moldova compares favourably in terms of education spending, a crude yet valid indicator for the educational attainment of the workforce.

Table 1. Selected measures of Moldova’s competitiveness

<table>
<thead>
<tr>
<th></th>
<th>Monthly wage in manufacturing (USD/employee)</th>
<th>Productivity (GDP/person engaged)</th>
<th>Education spending % of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Moldova</td>
<td>249</td>
<td>11,807</td>
<td>9.1</td>
</tr>
<tr>
<td>Romania</td>
<td>470</td>
<td>11,019</td>
<td>4.3</td>
</tr>
<tr>
<td>Ukraine</td>
<td>237</td>
<td>9,564</td>
<td>5.3</td>
</tr>
<tr>
<td>Belarus</td>
<td>335</td>
<td>28,465</td>
<td>4.5</td>
</tr>
<tr>
<td>Poland</td>
<td>899</td>
<td>25,873</td>
<td>5.1</td>
</tr>
<tr>
<td>Germany</td>
<td>3,008</td>
<td>43,050</td>
<td>4.6</td>
</tr>
</tbody>
</table>

Sources: Own analysis based on ILO (2012), Eurostat (2012), World Bank (2012)

Moldova’s international competitiveness has room for improvement and doing so will be a long term process. Indeed, the euro crisis underlines that better off economies have to constantly monitor and maintain their international competitiveness.

3 How to increase FDI: Recommendations

The question on how to increase FDI inflows into a country has been widely discussed. The standard procedure to deal with this question is to revise current legislation and to identify the critical pieces of legislation that inhibit inflows of FDI. Based on such an
analysis, recommendations are derived, taking into account best international practice. In the case of Moldova, this exercise has been conducted in a very professional manner at least a few times. The Foreign Investors Association (FIA 2009) regularly updates its “White Book” and UNCTAD is about to publish its thorough review of Moldova within the international series “Investment Policy Reviews”. Consequently, there is not really a need to produce yet another thorough review of legislative impediments to FDI in Moldova. Furthermore, FDI attraction is not only about legislation but also about other important issues.

Following this line we decided to structure our recommendations in the following way. Firstly, we look at selected problems regarding legislation which are of crucial importance. Secondly, the relationship between government and business is analysed, a topic often neglected when dealing with FDI attraction. Thirdly, we assess the current “personalised approach” to FDI attraction in comparison to a more “institutional approach”.

The insights for these recommendations were gained through several in-depth interviews and discussion with entrepreneurs, financial institutions and other relevant stakeholders in Moldova about their first-hand experience on doing business in the country. We also reviewed some of the relevant international literature on the topic.

3.1 Selected legislative barriers

Labour and land are two key production factors in any economy. In Moldova, both factors face severe legislative barriers which inhibit actual or perceived profitability for investors and thus reduce investment activity.

3.1.1 Human Resources

The situation regarding human resources is rather difficult to grasp. On the one hand, Moldova spends a lot of money on education - 9.1% of its national income and thus a higher share than many other countries. It also has a well educated population with particular advanced language skills. On the other hand, foreign investors often complain about the difficulties of finding personnel with the appropriate qualifications. As we were repeatedly told, this seems to be one of the major problems for foreign investors. So, how to explain this complex situation? Two related factors are to blame for this unsatisfactory situation: The current education system and the labour market regulation in the country.

The education system is outdated. In particular, it is not directed towards the needs of a market economy based on modern technology. Students and apprentices often use outdated textbooks and practice their skills using outdated technology. As a result, they

---

1 See UNCTAD (2012).
cannot fulfil the requirements of modern job descriptions as required by foreign and domestic companies.

While this is a big problem, there are ways to address these shortcomings. As shown by international experience, foreign investors often hire local degree holders and invest in their further education. In many cases, local employees are sent to conduct higher studies in universities and colleges abroad or spend some time at the headquarters of the mother company. In fact, this is a crucial part of the often cited and extremely positive know-how transfer which takes place in the context of FDI. Needless to say, companies will only invest in further education of their local employees if they can be sure that this investment will have a positive return. Therefore, there is a need for long-term work contracts, including a clause concerning the repayment of the investment in further education in case the employee decides to terminate the contract prematurely. Furthermore, the company must be sure that such a contract is enforceable in case the employee does not fulfil his obligations after having received the further education.

However, such an approach is not practicable in Moldova since the current labour legislation does not allow for such schemes. In an apparent attempt to protect employees, the extremely outdated labour legislation does in fact preclude young professionals from getting a better education and improving their skills sets. On top, it reduces the know-how transfer for existing FDI projects and is a significant detriment for the attraction of fresh FDI into the country.

**Recommendation 1:** There is an urgent need for reforming labour legislation, in particular with regard to investment of employers in further education and training of employees. Since such a reform is not costly in term of time and money, it should be implemented in a timely manner.

**Recommendation 2:** The education system should be overhauled in order to take into account the needs of a modern, technology-based economy. While a complete overhaul might require many years, the reform of some educational fields should start as soon as possible and might be used as pilot projects for other fields. While drafting and implementing such a reform it is of paramount importance to maintain a tight dialogue with business, including foreign investors.

### 3.1.2 Land ownership

Land is an important factor of production. As such, regulation of land ownership is of crucial importance for investment and for economic growth. Furthermore, the regulation of land is of particular importance for agriculture companies and for the manufacturing industry, i.e. for two sectors which could contribute to export growth and import substitution. Given Moldova’s huge trade deficit which amounted to ca. 40% of GDP (IMF 2011) this aspect should not be neglected. An appropriate regulation of land is important for the economic development and for the improvement of the balance of payments of the country.
In Moldova foreign investors are not allowed to purchase land. However, this prohibition can, to some extent, be circumvented. For example, if a company wishes to buy land from a legal or physical person\(^2\) it can provide to the person a mortgage loan using land as collateral. Once the person stops servicing the debt, and certain legal steps are taken, the company as the creditor becomes the legal owner of the land. The existence of such schemes is often used as an argument against the practical importance of the ban on land purchase by foreign investors. Indeed, some observers view the issue of land ownership as only a modest problem.

Despite the possibility of circumvention schemes, the prohibition of land purchases for foreign investors has to be seen as a major problem for FDI attraction in Moldova for two main reasons. Firstly, circumventing the prohibition increases cost in terms of time and money. As a consequence the profitability of FDI projects in Moldova drops. So does then the likelihood of investors choosing Moldova as an investment destination. Regional and international competition for the attraction of FDI is tough and any drop in profitability has a negative impact on investment activity.

Secondly, circumventing the prohibition of land sale to foreigner increases the risk of FDI. Even if a foreign investor knows that he can “somehow” get land, he will question if it can be retained if challenged in a court in the future. Thus, the real and the perceived risk of FDI increase significantly. As a consequence, investors need to include a sizeable risk premium into their investment plans, which in turn lower the expected profitability of the investment and may deter some investments altogether.

A different aspect of the prohibition of land purchasing concerns the structure of FDI. While the prohibition has a negative impact on practically all foreign investors, the impact is particularly strong on small and medium sized as well as on new potential investors. With respect to the size of companies, big enterprises can deal in a better way with the risks attached to circumvolving schemes to purchase land. They have better professional advice and the local administration is less likely to confront them with unfounded claims. In case of problems with local authorities, they can launch a much more effective campaign for defending their rights. Similarly, established companies are also in a better position to deal with the risks of land ownership than potential new investors. They have better information and can assess the risk better. Due to their networks they might be able to defend themselves more effectively.

In the consequence Moldova is likely to deter two important groups of investors – small and medium sized companies and those that have not yet any business links with the country. Furthermore, by only talking to big and already well-established foreign investors the magnitude of this burden will be underestimated. Instead, it is necessary to talk with potential new investors and to small and medium sized businesses. The structure of FDI in Moldova, with a significant bias towards big companies and towards

\(^2\) Moldovan citizens (natural persons) and companies (legal persons) with no foreign capital participation are allowed to purchase land.
investments by already established companies seems to support our thesis on the issue of land ownership\(^3\).

**Recommendation 3**: Legal persons with foreign capital participation should be allowed to purchase land as part of their investment plans. This measure is of crucial importance for attracting foreign investment from new companies and from small and medium sized enterprises, thus correcting the current bias towards FDI from big and established companies. Furthermore, land ownership is especially important for attracting FDI into agriculture and manufacturing and, thus, creating a strong export basis. The reform should be conducted in the near future given its low cost of implementation in terms of time and money. Indeed, given the manifold ways of circumventing the ban, changed legislation would largely reflect realities on the ground.

Please note that this recommendation refers to the sale of land for industrial purposes – i.e. ground to set up production or other business facilities. We acknowledge that the sale of agricultural land is politically more sensitive and many countries choose to restrict land sale to foreign investors.

3.2 **The relationship between government and business**

The content of legislation is without doubt of great importance for investors, both local and foreign. But, beyond these content issues, also the style of behaviour of government bodies is of great concern to investors – as was revealed in the several meetings conducted in Moldova. In our view, the discussion about FDI attraction has so far neglected this crucial factor of the relationship between government and business. Here we will focus on two main problems

- the high level of arbitrariness of state administration when dealing with business and
- the lack of ex-ante consultations with business when drafting new legislation.

3.2.1 **Arbitrariness of state administration and corruption**

As reported by businesses in Moldova, there is a wide discrepancy between written legislation and its implementation. State bodies often try to extract either official fines or unofficial bribes for no apparent reason – in contradiction and disregard of current legislation.

Without doubt this style of behaviour has a negative impact on the investment climate. It is not just the fact of an additional financial burden on business it also involves a significant increase in risk. As such, it negatively affects the return on investment in two

\(^3\) Additionally, small companies are more adaptable and may overcome some of the problems larger investors face. SME can use smaller, up to now untouched, geographical pockets of the country where there are less problem to attract small numbers of employees but were bigger enterprises would not invest. This, in turn, would also contribute to a more unbiased regional development.
ways. Furthermore, confronted with such arbitrariness, how can an investor rule out that the amount of this additional burden will not double by tomorrow?

This arbitrary behaviour has also a negative impact on the structure of FDI. Similar as with the issue of land ownership (see section 3.1.2) the arbitrariness tends to be a bigger problem for smaller companies and for potential new investors since bigger and already established investors have “learned” how to deal with the issue. Thus, the described problem seems to be supported by the observed FDI bias towards big and established companies. Furthermore, some countries have tough rules on national companies paying bribes abroad. Companies from these countries find it difficult to invest in such an environment as they would face legal prosecution at home.

**Recommendation 4**: Improvements in legislation should be accompanied by progress in the behaviour of state bodies vis-à-vis business and by focusing on implementation issues. This is particularly true for tax legislation (see policy paper PP/01/2011 by GET Moldova).

3.2.2 **Lack of ex-ante consultation with business**

Another issue related to the style of government concerns the process of adoption of new legislation. Without doubt, the government has to avoid converting particular business interests into legislation when this would not be beneficial for the society as a whole. But this does not preclude conducting ex-ante consultations with stakeholders, including businesses, before new legislation is adopted.

As reported by investors in Moldova, businesses are rarely consulted before taking decisions and thus important aspects might be overlooked. On top, the period to adapt to new legislation is quite often short thus creating severe difficulties for companies. In some cases, new regulation seems to have been introduced retroactively.

For both foreign and local investors such style of government has to be identified as a major source of risk with a resulting negative impact on FDI. Again, even if a particular business is doing well today, investors cannot exclude sudden regulatory shocks with little or no time to adapt. Consequently, investors will be reluctant to engage in any long-term investments that cannot be exited on a reasonable notice. This is often true for manufacturing businesses which require typically higher capital expenditure than other, more services-orientated sectors. As such it may explain the observed bias of foreign investors towards the services sector.

**Recommendation 5**: When preparing new legislation the relevant state institutions should conduct consultations with different stakeholders, including business.⁴

---

⁴ This general recommendation also applies to the reform of the education system, as expressed in section 4.1.1.
3.3 From a personalised towards an institutional approach of FDI attraction

Foreign investors, both potential and actual ones, need the support of government institutions for several reasons. They need information and data about the country, about sectors and regions of the economy and about legislation. Also, companies need help for identifying their counterparts at the level of local government and other government bodies. Such “investment facilitation services” are typically provided by national and local investment promotion agencies.

As of today, MIEPO acts as the investment promotion agency of Moldova. However, there are many problems. First, the agency has little room for taking own decisions. Instead, it is very much dependent on government officials. Best practice would demand an institutional set-up which would place it high in the governmental hierarchy. Second, since the end of an European Union project to support MIEPO it faces a critical lack of resources. Third, partly as a result of the above mentioned problems, the agency has difficulties in attracting and retaining appropriate experts. The fluctuation of personnel at the agency is reportedly high.

In order to improve the situation at MIEPO, one could put forward legislative recommendations on the autonomy of the agency, on its budget and on its personnel. However, just by adding more written rules the situation will not improve. The described problems are just symptoms of a more fundamental problem: The “personalised” approach to FDI attraction pursued by high level policy makers. As widely observed in Moldova and in other countries of the region, high-level policy makers prefer to make direct arrangements with foreign investors instead of delegating this task to agencies such as MIEPO.

From the point of view of potential foreign investors this personalised approach is rather problematic. Having the support of a high-ranking official is without doubt an advantage as of today since many obstacles might be put aside with this support. But investors have by definition a long-term perspective and they do not only care about today. In the future, however, the high-level policy maker who facilitated the investment process might not be in power anymore. Even worse, his party might not be in power anymore or even a political enemy of his former political supporter might be in office. Thus, potential investors will wonder whether their investment will be safe after the departure of the “partner”. Again, with the long-term prospects of the investment in limbo the investor will demand a high risk premium or might decide not to invest in Moldova. This is especially the case for long-term investment projects involving significant investment amounts.

Thus, high-level policy makers should delegate powers to MIEPO. That way, a modern institutional approach to FDI attraction can replace the current outdated personalised approach. For this to work it is important though that MIEPO’s institutional and financial set up reflect best international practice.
It should be noted that also within an institutional approach there is much room for support from high-level policy makers, especially when it comes to sizeable investment projects. Consequently, an institutional approach to FDI attraction does not question the merit of having internal policy advisors – for example those advising the Prime Minister on FDI attraction. Indeed, well-qualified experts within the Prime Minsters' office are essential for evidence-based, best practice policy making. However, high-level policy makers and their advisors should complement, not substitute, the work of MIEPO.

**Recommendation 6**: Moldova needs an institutional approach to FDI attraction. Policy makers have an important role to play by supporting, MIEPO, however, not by taking over its tasks. For that to work, MIEPO needs to be set up and equipped according to best international practice.

### 4 Conclusions

There are diverging views about the attractiveness of Moldova as an investment destination. On the one hand, *existing* foreign investors seem to consider Moldova as a satisfactory investment destination. While there is ample room for improvement of the business climate, those businesses largely maintain their presence and, in some cases, even expand their ventures.

However, the picture is rather different when talking to *potential* new investors who have visited the country. Those frequently point out to severe problems which clearly outweigh the positive factors such as good access to foreign markets, the well-educated population, language skills, low wages and good agricultural land. In their view Moldova is not a good destination for foreign investment.

Consider for example labour laws. Potential investors analyse the unsupportive labour legislation and, as a consequence, assess the investment climate as being poor refraining from an investment. While existing investors agree on the obstructing legislation, they know that workarounds exist. Indeed, there are legal (though complex and costly) ways to avoid at least some of the tough labour regulations. A similar story applies to land ownership. Potential investors learn about the prohibition of purchasing land and decide not to invest. Existing investors know the legal tricks to get around the ban and thus come to a more benign assessment of the investment climate.

These divergent views are not just interesting from an analytic point of view; they provide the basis for a fundamental policy recommendation for improving FDI attraction to Moldova. If in some cases labour legislation is *de jure*, on the paper, very tough but *de-facto* rather meaningless: Why not realigning legislation with reality? And if foreign companies are on the paper not allowed to purchase land but can de facto circumvent this ban, why not lifting the ban on land purchase by foreigners altogether?

---

5 Regarding the issue dealt with in section 3.1.1 (employer wants to invest in employees’ further education) legislation and reality are very much in line. Thus, in this case a change in policy and legislation is needed; the recommendation to realign legislation to reality does to extend to this and many other cases.
By merely realigning obsolete pieces of legislation to reality Moldova could improve its investment climate significantly. More importantly, potential investors will change their assessment of Moldova as an investment destination which is likely to be reflected in investment activity. This would also open Moldova up for new groups of investors including SMEs.

In fact, the recommended realignment of legislation to reality would be an ideal marketing tool for the country. The effect of road shows and investors conferences would be much higher than today when high-level policy makers have to give unsatisfactory answers to potential investors knowing that reality is better than legislation, but not able to say so publicly.

**Final recommendation:** Moldova needs to realign obsolete legislation to reality. By doing so, it will make a huge contribution for improving the perceived investment climate at practically zero cost. In such a way, new potential investors will become interested in the country, including SMEs.
References

Eurostat (2012). The European Statistics Office - Online Database.


ILO (2012). Laborsta Internet.


List of recent Policy Papers

- Options for a Deep and Comprehensive Free Trade Agreement between Moldova and the EU, by Matthias Luecke, Alex Oprunenco and Valeriu Prohnitchi, Policy Paper 02, May 2011
- Proposals for Reducing the Administrative Burden of Tax Regulations in Moldova, by Ricardo Giucci, Alexander Knuth, Natalia Cotruta and Ana Popa, Policy Paper 01, March 2011
- SME Regulation in Moldova: Recommendations from an Economic Perspective, by Alexander Knuth, Policy Paper 02, November 2010
- Electricity Sector in Moldova: Evaluation of strategic options, by Georg Zachmann and Alex Oprunenco, Policy Paper 01, September 2010

List of recent Policy Briefings

- Moldovan Carbon Credits beyond 2012, by Georg Zachmann, Policy Briefing 09, December 2011
- Comments on the Draft Law on Small and Medium Enterprises as of October 2011, by Alexander Knuth, Policy Briefing 08, October 2011
- Reform Proposals for Primary Documentation in Moldova, by Alexander Knuth and Natalia Cotruta, Policy Briefing 07, October 2011
- Reform Proposals for the Accounting Standards for Micro Enterprises in Moldova - Presentation of a Complete Draft and Discussion of Related Issues, by Alexander Knuth, Natalia Cotruta, Alexander Nederita and Natalia Tsiriulnikova, Policy Briefing 06, October 2011
- SME sector monitoring in Germany, by Alexander Knuth, Policy Briefing 05, July 2011
- Primary Documentation in Germany, by Alexander Knuth and Ilona Kaiser, Policy Briefing 04, May 2011
- EU Energy Strategy and its Implications for Moldova, by Georg Zachmann and Alex Oprunenco, Policy Briefing 02, July 2011