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Overcoming Barriers to Investment

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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 Energy under the TRANSFORM programme and its successor. Our publications are publicly available at our website (www.get-moldova.de).

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Overcoming Barriers to Investment

Executive Summary

There is widespread agreement that Moldova needs more investments – both real investment and Foreign Direct Investment (FDI) - in order to create jobs and to increase living standards. While - with 23% of GDP in 2013 – the so-called investment ratio was quite comparable to other countries; being in line with its peers is simply not enough if Moldova wants to improve economic development.

The level of Foreign Direct Investment (FDI) in Moldova is relatively low compared to other countries. In Romania, for example, the FDI stock per person is four times higher. In other words, Moldova would need to attract FDI worth USD 11 bn in order to pull alongside with Romania. With a current FDI inflow of around USD 200 m per year, there is still a long way to go.

What is holding investments and FDI back? Our research suggests that **labour, access to finance and the relationship to state bodies** are three areas where potential investors face unnecessary risks and costs which subsequently reduce investment activity. Low labour costs are one of the main competitive advantages Moldova has to offer. However, severe **deficiencies in labour regulation** reduce this advantage for investors. Parental leave, for example, is too restrictive. Instead of protecting young women, it excludes them from the labour market and makes life difficult for investors. Additionally, proper regulation for allowing a meaningful trial period (probation periods), a very important feature for any investor wishing to increase employment, does not exist in Moldova. In combination with an overly strong protection against dismissals, the outdated labour regulation acts as a major deterrent for investors.

Additionally, **labour qualification is not demand-oriented**. Investors often do not find staff with the right professions, job profiles are outdated and some new job profiles simply do not exist. The underlying reason is a too centralistic vocational training system with too little involvement of companies. Instead companies should play a much larger role in all aspects of vocational training: Providing practical training, consulting on content of training and enrollment planning.

Furthermore, **the relationship between businesses and state bodies needs to be improved**. Firstly, implementation is sometimes not effective. This is to a large degree caused by weak institutions which are not as independent as they should be. Another aspect is the circumvention of arbitration courts, one of the few means investors have to protect their interests amidst a dysfunctional justice system. Additionally, business - state body relations could be improved for all businesses, not only large ones, if they could appeal to an Ombudsman office with the legal powers to stop wrong-doing by state institution.

Finally, investments would increase if access to finance would be improved. Weak competition among banks leads to unfavourable interest rates, restricted supply of loans and lack of innovative products. Given the crucial importance of those three factors – labour, financing and the relationship to state bodies – for any type of investment, reforming these fields would provide a boost to investments and FDI and in turn increase living standards for the population.

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1 Investment in Moldova: Current situation

1.1 General view on investment climate

In the past years, Moldova has taken several steps to improve the business climate and to encourage domestic and foreign investors to invest in Moldova. Both types of investment are crucial for job creation and economic development. Especially the attraction of FDI plays an important role offering technology and know-how transfer to the domestic economy. This boosts productivity and in turn supports the competitiveness of Moldovan products on international markets.

In the latest Doing Business Report by the World Bank, Moldova gained 19 places and is now ranked 63, similar as Russia and Cyprus and in line with the regional average. This is the result of several changes made to ease the administrative burden for enterprises. For example, registering a business has been simplified. Following the changes, all information that is necessary for the registration has to be provided to only one registration office which then forwards the information to the tax authorities, health and social insurance, statistical office and others. Before, each state body had to be visited separately.

Furthermore, to improve and facilitate the interaction with government bodies, the project e-Governance was launched in 2011. By allowing companies and individuals to make administrative procedures electronically not only the scope for corruption is reduced but also time consuming administrative procedures are facilitated. This includes submitting tax statements and obtaining licenses for business activities and customs clearance. Especially the latter one should provide a considerable relief for export-oriented companies which rely on on-time deliveries.

Finally, transparency of inspections has been increased. Facing a total of 33 different types of inspections, those checks are a particular disturbance for running a business in Moldova. To limit this negative effect somewhat, the schedule of planned inspections is now available online to inform individual companies. Additionally, the duration of inspection is limited with labour inspections, for example, only allowed a total of ten days to inspect an individual enterprise.

Despite all these efforts, there is still need for further enhancing the business climate in Moldova. While the Doing Business ranking has improved due to better legislation and administrative procedures, even long-term investors notice only small changes in their daily work. A further decrease of the bureaucratic burden as well as a sound implementation of measures will help to improve the conditions for investors.

As such, the objective of this report is to identify the main barriers to investment in Moldova and to propose measures on how to overcome them. It is important to note, that reducing those investment barriers is of high importance for any type of investment, foreign and domestic ones.

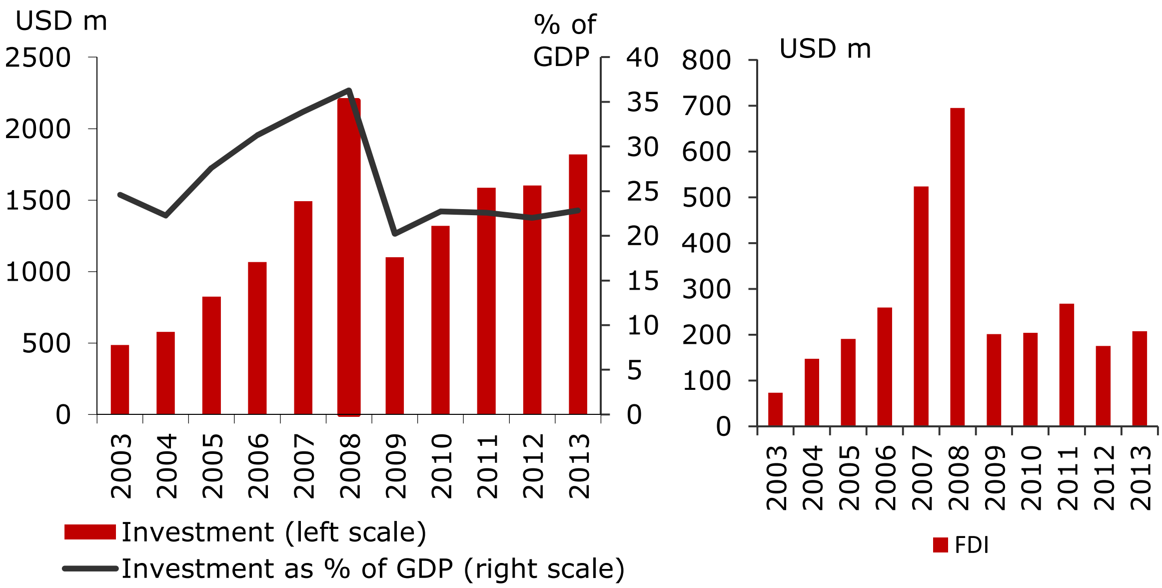
1.2 Investment facts and figures

Investment dynamics until today

In this paper we concentrate on two variables investment and foreign direct investment (FDI). FDI is not an equivalent to new investments by foreign firms, it is a financial balance-of-payments concept; while investment is a real national account variable. FDI may not become investment in real sense as it could be mere transfers of ownership of existing assets from domestic to foreign firms. Therefore the variables are different but we choose to focus on both of them, because of their importance for economic development in Moldova.

Until 2008, Moldova saw strong growth in both foreign and domestic investments. Investments expanded considerably, not only in absolute terms but also as share of GDP and peaked in 2008 with the investment to GDP ratio reaching 36%. The financial crisis, however, brought an abrupt end to this development. Total investments collapsed from around USD 2.2 bn in 2008 to USD 1.1 bn in 2009. Since then, the investment to GDP ratio stagnated between 20% and 23%. This suggests that investments grow at the same pace as the economy (Figure 1.)

Figure 1: Investment (left side) and net FDI flows (right side) in Moldova



Source: IMF and National Bank of Moldova

International comparison

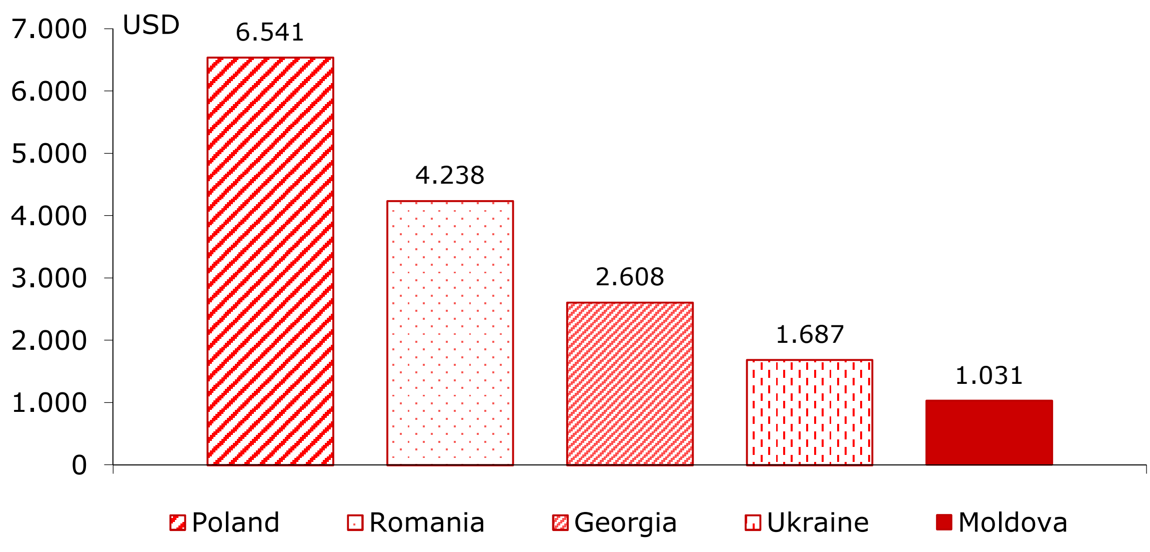
A comparison of Moldova's investment ratio with other countries shows that investment activity is in line with the global average and similar to its peer countries. In Ukraine, for example, the investment to GDP ratio in 2013 was only 16% (amidst a stagnating economy), in Poland it stood at 21%, in Romania at 23% and in Georgia at 27%. However, unlike its peer countries Moldova has a very low GDP per capita and, as such, needs a higher investment ratio to catch up with richer economies. Only being in line with regional counterparts is not enough. Indeed, rapidly developing economies typically feature a much higher investment to GDP ratio – for example China had an investment ratio of 48% in 2013.

Performance of FDI

A look at FDI development supports this view that Moldova lacks attention of investors. After the collapse of the Soviet Union and the ensuing crisis, Moldova attracted only modest FDI inflows. Annual inflows were mostly below USD 100 m. However, since 2003 FDI inflows saw a continuous increase until the global economic crisis of 2008/2009 brought this development to an end. The most dynamic years were 2007 and 2008 with inflows peaking in 2008 at USD 700 m. In fact, a large part of today's FDI stock in Moldova is based on this period.

Since 2009, the FDI inflows remain at the level of about USD 200 m, annually. FDI inflows are also relatively low in regional comparison. According to UNCTAD, the average FDI inflow per capita in the past three years was USD 65 in Moldova, in Ukraine it was USD 137, in Romania USD 147, in Poland USD 178 and in Georgia even 221 USD. This backlog becomes even more apparent if FDI stock per capita is compared (Figure 2).

Figure 2: FDI stock per capita, 2013



Source: UNCTAD and World Bank

With an FDI stock per capita of USD 1,030 in 2013 Moldova has the lowest value in the peer group. Georgia`s stock of foreign investment is more than twice as high and Romania’s more than four times higher.

Conclusion 1: Moldova’s total investment relative to GDP is too low to close the income gap with peer economies.

Conclusion 2: Moldova has substantial unrealised potential for foreign direct investment (FDI). Investment per head in Romania is more than 4 times higher even so the two countries starting point was roughly the same.

2 Barriers for Investment

2.1 General Barriers

The general barriers to investment in Moldova are well-known. The main obstacles are widespread corruption, severe deficiencies in the rule of law and the high administrative burden. For example, almost half of the companies in Moldova claim that they are expected to pay bribes in order to get a (re-)construction permit. As a result, investments are delayed or are not undertaken at all.

While those remain major obstacles, the focus of the paper lies on more specific barriers which may not have gotten that much attention, specifically:

- Labour market: Regulation and qualified labour
- The relationship between state bodies and businesses
- Access to finance.

Indeed, labour, capital and the relationship with state institutions are possibly three of the most important aspects when running a business. As such, it is necessary to understand which problems investors face in this regard and how they can be addressed.

2.2 Labour regulation

One of the main reasons for companies to invest in Moldova is the comparably low labour cost. Indeed, especially companies with labour-intensive production are interested in investing in Moldova. For them it is fundamental to work in an environment with a working and balanced labour regulation. Unfortunately, businesses report that hiring, maintaining and dismissing employees in Moldova is not as straight forward and can involve a lot of time and costs. Considering that a large part of investments are labour intensive – especially in terms of foreign investment, this creates a substantial barrier for investment.

Some issues are rather small and can be managed with a good human resource department. For example, the employer has to inform the employee about the start of the vacation. Also the end of a fixed term contract – which per definition already includes a specific date for the contract to expire – has to be announced to the employee a sufficient time before. If the employer does not fulfil this obligation, the contract will be silently prolonged. As such, this is a problem that affects in particular small and medium sized companies. Additionally, there is good reason to believe that the restrictive labour regulation is also a main cause for widespread informal employment.

In the following, some specific problems shall be looked into in more detail including (1) dismissal during trial periods, (2) parental leave and (3) protection against dismissal.

Dismissal during trial periods

Trial periods are a very important feature of work contracts. They are meant to give employee and employer the possibility to test the new work relationship and also the freedom to cancel the working contract without any commitments at any time. Having a well-working trial period system is important as it substantially reduces the risks for employers when deciding to invest in an employee or not. While Moldovan labour legislation theoretically allows arranging trial periods, the system does not work in practice for several reasons:

First of all, trial periods can be arranged for a duration of only 15 days and therefore are too short to fulfil their main purpose of getting to know the employee. Regulation in many other countries trial periods are of at least three months, often longer.

Additionally, dismissing employees during the trial period requires a detailed explanation of the employer. This defies the main principle of a trial period. In addition, such an explanation is also often used by the employee before court in order to enforce the right of employment or some other kind of compensation. In short, the lack of a genuine trial period increases the cost and risk for investors and acts as a main barrier for more investments.

Parental leave

There is also strong indication that the regulation regarding parental leave causes high risks and costs for investors. One of the problems in this context is the length of parental leave. The regulation in Moldova foresees that mothers can take leave until the child is six years of age. The maximum period for maternity leave is therefore six years. In international comparison that regulation is very generous as in many countries the leave can only be up to three years.

Table 1: Parental Leave – International Comparison

Country	Months of parental leave (in months)
Czech Republic	36
Estonia	36
Germany	36
Hungary	36
Lithuania	36
Moldova	**72**
Poland	36
Slovakia	36
Slovenia	8,6

Source: Moss, P. (2014) International Review of Leave Policies and Research 2014.

Besides indicating a maximum period, there is no restriction on how long each period of leave or the working time between the leaves must be. Furthermore, the parental leave can be partitioned into as many parts as wished. The final day of returning to work has not to be agreed upon before taking the leave. As a consequence, the employer has to be very flexible to find a solution to fill the vacant position, as the return to work and start of leave can be announced with a few days of notice.

Again, this is particularly costly for small companies as shifting personnel to different positions or hiring employees with limited contract may not be a solution. Moreover, there will be little effort to invest and train the staff on limited contracts, as the person on parental leave will return at any time and reclaim the position.

On top, according to the regulation, the returning mother is entitled to work in the exact same position upon return. So the employer has to keep this exact position and make it available once the employee returns. A similar position that requires the same skills and provides the same salary can be refused by the employee. In particular, for cases of long-term parental leaves that can be a serious and insolvable issue. For example, if there has been restructuring in the firm or if the skills are no longer needed due to technological improvements, it can be impossible to fulfil this requirement. With some financial flexibility, a position can be artificially recreated. However, such a solution may not be feasible for smaller companies.

Faced with those risks, employers think twice before hiring young female staff in the first place. Consequently, the labour regulation acts against the interests of females and young mothers by reducing job opportunities for them.

Protection against dismissal

Last but not least, employees are highly protected against dismissal. As mentioned above, this is already the case in the trial period. Following trial periods, for members of a union it is almost impossible to be fired. This request has to be brought in front of the trade union and requires their approval. In any case, employees in Moldova – like in most other countries – can bring their claim before court. Given the unbalanced labour law, it is very likely that the court then rules in favour of the employee. As a consequence, employer and employee have to come to an agreement or the employee has to be encouraged to search for a new position. This is both risky and costly for employers and can act a serious burden to more investment.

Naturally, it is important to protect the rights of employees, but only to a certain extent that does not distort investment and hiring decisions. The high protection of employees may have as well an adverse effect on the labour market, e.g. in respect to hiring women or older persons. Hence, modernizing the labour regulation should be of high priority. Below we outline our recommendations for some of the most pressing reform areas.

Proposed measures for improved labour regulation

Trial periods

Recommendation: Trial periods should be at least three to six months allowing companies to test employees for a sufficient period of time. Within that period dismissal without explanation should be possible.

Parental leave

Recommendation: In order to not to disadvantage young women and mothers on the labour market, it is necessary to bring the length and conditions of maternity leave in line with international practice. That includes to reduce the leave to three years and to set up requirements concerning the partitioning of the leave and the announcement of the period in advance. Furthermore, it has to be sufficient to provide a similar working place with the same conditions and similar skill requirements to the returning mother. Having to provide the exact same position is not practical.

Protection against dismissal

Recommendation: The government needs to review current legislation regarding protection against dismissal. While protection against arbitrary dismissal is a relevant concern, the law should allow dismissing employees if justified on economic grounds or individual performance with reasonable notice periods.

2.3 Qualified labour

The current system of vocational and educational training (VET) in Moldova is entirely dominated by the government, whilst companies have little or no influence over how vocational training is organised and provided. As a consequence, the current VET system fails to meet market demand. The lack of demand orientation is especially visible in three areas: (1) The VET system fails to provide enough trained people with the right professions; (2) the qualifications trained are outdated; (3) and there is a general lack of praxis orientation in the training provided.

Lack of demand-orientated VET

Empirical evidence confirms a lack of demand orientation vocational training. Vacancy rates for positions that require a vocational training background are much higher than the average of the economy, as companies struggle to find suitable skilled workers. At the same time, unemployment among people with a vocational training background is higher than for the rest of the economy.

In addition, companies also criticise the fact that the content of the training is outdated, and some newer professions are not trained at all. Indeed, of the over 340 existing professions, only about one quarter are currently trained in Moldova, suggesting that the list of nomenclature for professions is largely outdated.

Finally, even the graduates that are trained by the VET system show a serious lack of practical skills. The practical vocational training takes place on outdated equipment and is conducted by teaching staff without practical knowledge, with the result that graduates enter the job market with a severe lack of practical working skills.

Strategy for addressing the problems

To address these short-comings, vocational training needs to become a shared task of companies and the state, as is the case in many countries with a well performing VET system. Any reform concept for Moldova's VET system needs to reduce the role of the state and increase the role of companies. The long-term objective should be a Dual Apprenticeship System in which state and companies jointly organise and provide vocational training, which would automatically result in more market orientation. However, creating such a system cannot happen overnight. Since it takes time to provide the prerequisites, the route towards implementing a Dual Apprenticeship System cannot be a revolution, but the government should pursue a gradual approach.

The benefits of a system in which companies and the state jointly organise and provide vocational training can be huge. If the strategic vision of a Dual Apprenticeship System is fulfilled, companies will shoulder some of the cost of providing vocational training. Furthermore, since the skills trained would be much better correspond to their demand, companies' costs of retraining would be reduced and the productivity of the staff would be higher from the start. This is likely to improve the attractiveness of Moldova as a location for doing business. As such, the reform of the vocational training system could provide an enormous boost to the economy.

Below we outline specific recommendation on how to implement such a strategy:

Proposed measures for improved labour qualification

Introduce apprenticeship contracts

One of the most important incentives would be apprenticeship contracts that allow companies to tie students to their company until the end of the training period, which will then motivate them to invest in people.

Flexible enrolment planning

Another severe shortcoming of the current system lies in the field of enrolment planning. As of today, the Ministry of Education decides how many students can be enrolled for each profession. Instead, the decision of how many students are needed should be the responsibility of the companies, and in the future apprenticeship contracts should become the main instrument with which to determine skills demand. The planned sectorial committees should provide the main input on demand and enrolment planning, but the role played by this enrolment planning should be to ascertain the overall capacity of the system, whilst still having enough flexibly to react to economic shocks or changes in demand.

Funding per student approach

To achieve this VET, schools and colleges should have much greater flexibility in accepting students. This would require a funding-per-student approach, as planned in the Vocational Training Strategy 2013-2020.

Involve companies in updating professions

Finally, companies should have a much bigger say in updating professions and developing the curricula. The proposed sectorial committees are a good starting point, but for companies and their representatives to get earnestly involved, a legally binding process that makes sure their recommendations are followed is necessary. Additionally, new investors should be allowed to train their own qualifications.

2.4 Relationship between state bodies and business

As the recent Doing Business ranking suggest, there has been some progress in the regulations and legal framework affecting investments in Moldova. A regulatory impact assessment for all draft laws that are related to business activity has been introduced to avoid unnecessary or improper changes to regulations. For ensuring higher transparency, all court rulings are to be published. However, those legal changes are often not noticed among businesses as (1) Implementation is often not effective, (2) arbitration is ignored, and (3) Institutional support for small and medium sized investors does not exist.

Combined, this makes government-business relations costly and risky for business and consequently acts as a main deterrent for investments.

Ineffective Implementation

The implementation process of new laws is not well defined and therefore takes longer than necessary. The communication of changes and the cooperation between agencies is lacking efficiency so that, despite having a new law in place, the internal orders and processes may not correspond to the changes made. As a consequence, the change of laws is not effective. In addition, this frequently causes disagreements between companies and civil servants as each deal with different information.

Furthermore, the rule of law is impeded not only by corruption but also by a too flexible interpretation of laws. Individuals e.g. members of the administrative staff may decide differently on the basis of the same law. In this context, long-term practice can suddenly change due to a new way of interpreting the regulation and result in an unforeseen penalty for the business in regard. Other consequences can be the withdrawal of a licence for certain business activities or setting up new rules and requirements that may be in the boundaries of the law but significantly affects the business activity of a company.

Such varying interpretation is often the result of weak institutions. Some implementing bodies are not as independent as they should be. Indeed, it can be seen that the person at the head of implementation bodies and regulatory institutions is often changed following elections.

Arbitration courts

Since those problems exist, it is crucial for investors to receive objective legal support. One way to circumvent dysfunctional Moldovan courts and to assure the rule of law is by making use of arbitration boards. However, Moldovan courts fail to accept arbitration clauses in contracts or overrule decisions made by arbitration boards. That way, investors have no safety net against arbitrary interpretation of laws and the deficiencies in Moldova's justice system. Having to operate in an uncertain environment with risk of penalties, disturbance of their business activity e.g. by the withdrawal of licences or other abusive actions is likely to have a negative impact on their investment decisions.

Institutional support for all investors

While all companies irrespectively of their size are subject to legal uncertainty, small and medium sized companies appear to be more vulnerable. Compared to large and foreign investors they lack public attention and therefore do not receive the same level of support from government institutions. Domestic investors cannot appeal to embassies and have less access to business associations or political stakeholders in order to get support on legal matters.

Proposed measures for improved state-business relations

Effective implementation

For better implementation of new laws and for ensuring continuity of regulation, two changes have to be made. First, inspectors and other civil servants have to receive systematic training once new legislation is coming into force. This must be supplemented by a transparent implementation procedure for new laws.

Independent institutions

And secondly, a stronger institutionalization is needed by creating strong and independent rule-based institutions. Any external influence must be prevented by setting up clear and understandable instructions that can be followed and limit the possibilities for interpretation of regulations and discretionary ruling. The head of implementation bodies should be technocrats and remain in their position even after a change of government.

Respect arbitration and other dispute settlement mechanisms

To ensure rule of law, the practice to publicly announcing court ruling must be maintained. This is an important step to combat bribery or extortion of judges. Above that, an efficient and well-functioning support and conflict resolution system for businesses of all sizes must be provided. The law on Investments in Entrepreneurial Activity already supports a dispute settlement system which allows the involved parties to address an arbitration board. In practice that has proven to be problematic and time consuming which can ruin especially small companies.

Ombudsman offices

For a more direct approach it could be considered to create an ombudsman office which can be addressed by businesses with legitimate problems. Such kind of office needs to have the legal powers and influence to challenge institutions if concerns of a business are found to be relevant.

2.5 Access to finance

Access to finance is a major prerequisite investments and economic growth. However, there is strong indication that companies find it difficult to access finance. Below we explore the underlying reasons and make suggestions to improve the situation.

With a lack of foreign and domestic investors in the finance sector, competition is severely restricted. As in any other market, a lack of competition will always lead to higher prices, reduced choice and poor quality. All those symptoms are also evident in Moldova’s financial sector.

Interest rates on deposits are not attractive and therefore fail to attract deposits. At the same time borrowers need to pay higher interest rates than in a system with stronger competition among banks. Moreover, there is a lack of innovative products for both savers and borrowers. With little foreign investment, the choice of financial products is limited. For example corporate bonds do not exist and life insurance is its infancy. Finally, the supply of loans is restricted and the criteria for loan approvals are not always transparent. Some loans are given to debtors with dubious background. As a result, the share of non-performing loans is high. This restricts loans supply for companies with sound criteria.

Lack of trust leads to lack of long-term deposits

Long-term loans a generally difficult to obtain due to the maturity gap between deposits and loans. In the first half of 2014, almost 90% of all new deposits had a maturity of one year or less with an average interest rate of about 5%. Only 5% of the new loans handed out in the first semester 2014 had a maturity of more than five years. Often the banks use their share capital to finance long-term loans. In addition to unattractive interest rates, people do not have enough trust in order to invest significant amounts for longer periods of time. Following various scandals and raider attack, this lack of trust is another direct result of the inadequate regulation of the banking sector.

In addition, the deposit protection scheme may not be sufficient to inject enough trust for savers. The amount protected (currently only up to 6000 MDL are covered) is simply too low to protect a critical mass of saver in case of a confidence crisis in the banking sector.

Crowding out of small and medium sized companies

The lack of financing is especially problematic for small, local or new enterprises. Instead of drawing a loan, these companies mostly rely on their own savings or e.g. microfinance institutions. Large companies have more diverse options to access long-term financing, like equity fund options. However, due to bad experience with joint ventures or other collaborations, these companies prefer to take out a bank loan. With large collateral, the interest rates are acceptable. As a consequence, small and medium sized enterprises face even higher difficulties as they are crowded out by the large companies.

Proposed measures to improve access to finance

The pre-requisite to improve the constrained access to finance is to steer up competition and improve the trust in the banking sector by providing sound regulation and transparency. Increasing its attractiveness for investors and foster competition will help to overcome the problems like unattractive interest rates, the lack of loans and innovative financial products.

In addition, more trust in the banking system will also encourage the savings behaviour. For a better protection of savings, an increase in the level for insured deposits of the Deposit Guarantee Fund should be considered.

To address the maturity gap, the government could improve incentives for long-term savings e.g. by providing an adequate legal framework for life insurances.

3 Conclusive remarks and outlook

In the past, the Moldovan government has taken several steps to improve the business climate. This included reducing the cost and time involved for administrative processes or the support of the dialogue between companies and educational institutions for a demand-driven VET.

However, these changes have so far had little impact on the investment activity in Moldova. Indeed, our research indicates that substantial barriers for investors remain. Therefore, it is important to hold up the effort for improving the business climate. A main focus should be on the three crucial areas labour, access to finance and good relations between state bodies and businesses.

While carrying out those reforms will proof challenging, it also offers great opportunities. By improving the investment climate, Moldova would be in a much better position to catch up in terms capital invested with its regional peers. Indeed, attracting the same level of FDI stocks per head as Romania – which is in our view not an unfeasible objective - would see an inflow of capital worth 140% of Moldova's gross domestic product. It is clear that this would go in line with a proportional increase of living standards.

Further research is needed to identify the sectors that exhibit a lack of investment and to investigate the underlying reasons for underinvestment. Additionally, in addition to addressing the barriers, it should be explored if the Moldovan government should provide additional incentives to attract investments.

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