

## 5. PROPERTY REFORM: HOPES AND DISAPPOINTMENTS

The 90's decade was characterized by massive privatizations in Europe and Latin America countries. Economic theory suggests, that private enterprises are more efficient than the state run ones, having higher factor productivity, producing competitive goods. Profitability, measured as net income to sales, as well as output, sales, dividends –all are higher, while leverage decreases. The major objective of corporate management is maximization of shareholders' wealth, expressed in increased value of equity – capital gains and increased dividends. Pressure factors on the management, which force them to strive for superior profitability, are: threat of bankruptcy, threat of job losses as a result of underperformance, threat of hostile takeovers.

Several types of privatization are known: restoration, direct sales and public offers, management and employees buyouts. The Washington Consensus recommended the voucher privatization through investment funds as the best policy approach to the property reform in transition economies.

### *The stages of privatization*

In 1990 the Parliament of the Republic of Moldova approved the concept, and in 1991 the Law on Privatization. The voucher model (National Patrimony Bonds) was adopted, a "fast privatization track" being accepted. Particularities of the Moldovan model were: nominal bond, distributed exclusively to Moldovan citizens, not subject to trade; nominal value being determined according to individual's employment record plus the equivalent of 5 years for everyone, including the children; the bond entitled its bearers to a share of public property. In March 1993 the Mass Privatization Program, along with other standard acts, which constituted the framework of the privatization process, were adopted. In order to ensure the equity of distribution, 50% shares of processing enterprises were transferred to the main suppliers of raw agricultural products. The employees were allowed to purchase at preferable prices up to 20% of their enterprises' shares. TACIS and USAID technical assistance programs helped during the creation of the privatization framework. Price Waterhouse Company assisted all the stages of privatization and helped with the establishment of the securities market.

15 shares subscription auctions were organized, where citizens and Privatization Investment Funds could participate. 1142 enterprises were privatized. Out of 3,067,164 filed applications, 471,690 had been presented directly to collection centers, 2,585,549 had been presented through investment funds of trust companies, 9,925 applications had been declared invalid. Circa 1093 small enterprises were privatized through 94 traditional auctions and 11 open offerings. According to the Department of Privatization and Administration of State Property (DPASP) data 93% processing units, including 78% - winemaking, 82% - light industry, 96% - commercial units, 95% - social services enterprises, and all sugar processing, canning, dairy products, repairing enterprises have been privatized in such a manner. 90% of issued bonds have been utilized in this process.

On May 5<sup>th</sup> 1995 the State Privatization Program for 1995-1996 was adopted. The program stipulated: extension of privatization, including the assets of state owned enterprises, rented spaces, adjacent territories; elaboration of new mechanisms for privatization – individual projects, public offerings; diversification of means of payment; homologation of shareholders' rights. Almost 100 laws and standard acts were elaborated, 115 centers for bonds collection have been instituted; licenses for 53 investment funds and fiduciary companies have been issued.

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The Program stipulated the privatization of 1553 units, the number of which increased to 2065 as a result of de-monopolization of some enterprises. These objects were included in 4 lists: 1306 – for privatization bonds, 190 – for cash, 457 – unique enterprises and individual projects, 99 – premises under construction. 93.9% enterprises included in the 1<sup>st</sup> list have been privatized for bonds. Only 9 unfinished constructions were sold for 632 thousand lei.

Privatization Program for 1997-1998 was adopted on July 25, 1997 and its implementation started on September 11. The following have been declared as major objective the modernization of State's role in the economy: withdrawal from productive activities; modification of regulatory functions in order to create a favorable environment for

entrepreneurship; development

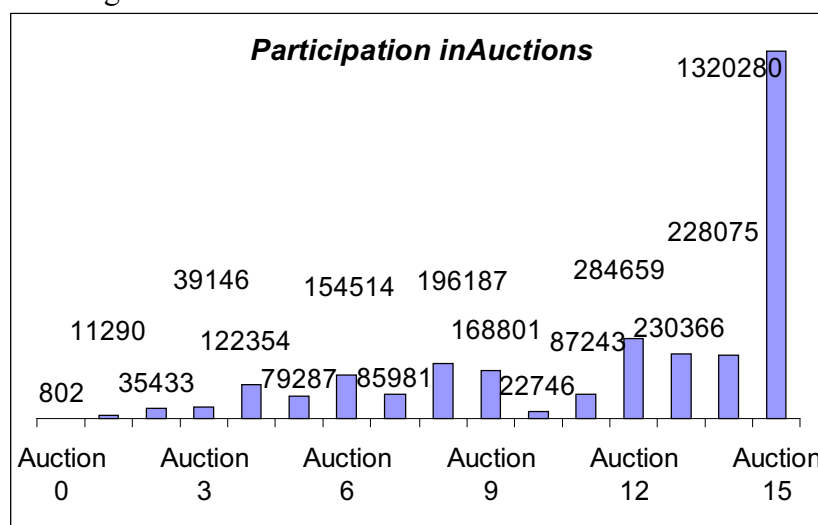
of the capital market, initiation of the cash privatization; concentration of efforts for solving social problems – education, medicine. The objects to be privatized were included in 3 annexes, which specified – 554 typical items, 28 enterprises that required individual privatization projects, approved by the Parliament, and 130 unfinished premises. Also, the shares of 797 previously privatized joint stock companies were supposed to be sold through the Stock Exchange. The nominal value of those stocks, still held by the State, was estimated at 373.8 million lei.

The implementation of the Program was delayed by eight months, 148 enterprises, 9 unfinished premises, and 15 unique companies being privatized during the specified period. Therefore, on December 12, 1998 the program was prolonged for the years 1999-2000. In order to attract a large number of investors some modifications were introduced: the payment of 75% of the cost could be spread out over a period of 5 years, which allowed for additional investment into the productive potential at the yearly stages of reconstruction; sales of illiquid state enterprises at the symbolic price of 1 leu, with the imposed obligation on the buyer to pay off the arrears; sales of equity through the Stock Exchange, which would lead to the formation of the equilibrium price and strengthening the infrastructure of the capital market.

JSC “Bălțeanca“, acquired by Steilmann Group for DM 1,750,000, was the first enterprise to bring in real money as a result of privatization. Other companies sold to foreign investors in 1998 were “Ciment”, “Agro-Petrol”, „Farmaco”. Beside the acquisition price, investors additionally were committed to invest in the production process and assumed a part of the debt of privatized enterprises to the State budget and to suppliers. Overall, in 1998 87 million lei, DM 82 million, US\$ 57.7 million were invested.

A unique, interesting experiment is under way at the JSC “Ionel”. The State share of 64%, estimated at 1.8 million lei, is being bought out by employees (circa 2000 people) and management over a three-year period. 225 thousand lei have been already paid, another 1.6 million lei were invested in production. “Ionel” is a light industry enterprise, producing clothes and outwear based on contracts with Italy, Canada, Russia. The net income in 1998 constituted 2.3 million lei. Over the first semester of 1999, the output of “Ionel” increased by 51% compared to the same period of 1998.

Figure 5.1



Source: National Commission on Securities Market

The Moldovan-Irish Company Listmore Investment was declared as winner of the tender for the privatization of "MoldCarton". They offered 11 million lei also promising to invest US\$ 10 million and to cover arrears of 36 million lei. At the moment the enterprise functions at 15-20% capacity mainly because of the lack of raw materials. There are contracts signed with German firms for the delivery of paper waste. *In December the Economic Court of Moldova canceled the transaction.*

According to DPASP data in the first 9 months of 1999, 80 out of 128 objects have been sold for 18.3 million lei. For one unfinished premise were received 395 thousand lei. 300 rented premises were privatized for a total of 26.4 million lei. 783 adjacent territories with an area of 208 hectares were sold for 13.6 million lei. At 22 investment tenders 17 objects, valuing 78 million lei, were privatized. Besides, 390 million lei were committed for investment.

Following the decision of selling state shares through the Stock Exchange, in 1997 equity in 198 enterprises has been sold for 2.6 million lei. In 1998 shares of 104 enterprises were sold for 5 million lei. In 1999 the remaining shares in 53 companies were sold for 13 million lei. Till September 1<sup>st</sup>, 1999 the shares of 322 out of 855 enterprises were sold for a total of 20.9 million lei. The biggest transaction was registered with 28% shares of the largest brewing Company "Vitanta-Intravest". DPASP expects to sell in 1999 the shares of another 69 companies through the Stock Exchange. One could argue, that commercial enterprises face the highest demand, and the price is determined according to the financial state of the company and to the amount of shares put up for sale.

***The social implications of privatization*** were barely discussed in the Republic of Moldova. Although the long-run effects of privatization are supposed to be positive, in the short run severe social costs are observed. First of all, *fringe benefits* were reduced – industrial employees used to have some of the following benefits: kinder-gardens, general and vocational schools, sport and cultural premises, summer camps, specialized clinics and hospitals, subsidized food and transportation. The worst decline was observed in capital spending – housing building and maintenance, social infrastructure development. The amount of fringe benefits differed by localities and by sector of industry, benefits being correlated with the size of companies. The benefits, received by Center subordinated enterprises, were by one third higher than the ones received by state employees. Rural population was receiving the least benefits, motivation being their ability to grow their own food. The average fringe benefits by sectors in 1991 in Moldova were estimated at 20-25% of the wage fund. In the conditions, when limitations on the size of the salary were imposed, non-salary benefits served as a bargaining tool in attracting the most qualified labor. The Western companies are also offering some benefits in form of pension funds payments, life and medical insurances.

The official unemployment rate in Moldova is 2.1%, but the surveys, organized by the WB reveal a 9.4% rate, while independent experts estimate it at 12-13%. Common practices in Moldova are un-paid, forced leaves. A partial explanation of the hidden unemployment in Moldova is the existence of the above fringe benefits. The management of enterprises did not want to fire the employees, because they could maintain soft budget constraints – subsidies, guaranteed credits, fiscal arrears.

It is commonly accepted, that in order to increase competitiveness, companies should be absolved from the responsibility of providing social services. The public and private sectors have different, distinct sets of problems. The state, however, can contract private firms to fulfill certain tasks, but the attribution and financing of these tasks should be carried out in a transparent way, which is impossible to achieve in the conditions of existing unfounded governmental mandates, while both sides can escape the hard budget constraints<sup>11</sup>.

<sup>11</sup> Sewell, David, *Shifting Responsibility as Enterprises Privatize in Belarus*, WB Policy Research Working Paper 1719.

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Although social service objects are considered as assets, they constitute a burden for the enterprises. Their administration distracts management's attention from the achievement of their direct obligations – implementation of an efficient production process. One should complete the transfer of social objects from balance of enterprises to the balance of local budgets. Unfortunately the set of acts, defining the functions and responsibilities of local administrations was adopted only in 1999.

Other short-run negative social implications mentioned in the literature are: increase in unemployment; diminished salaries; worsening of working conditions; rise in the consumer goods prices<sup>12</sup>. State enterprises are likely to employ extra labor force, pay excessive salaries and have low factor

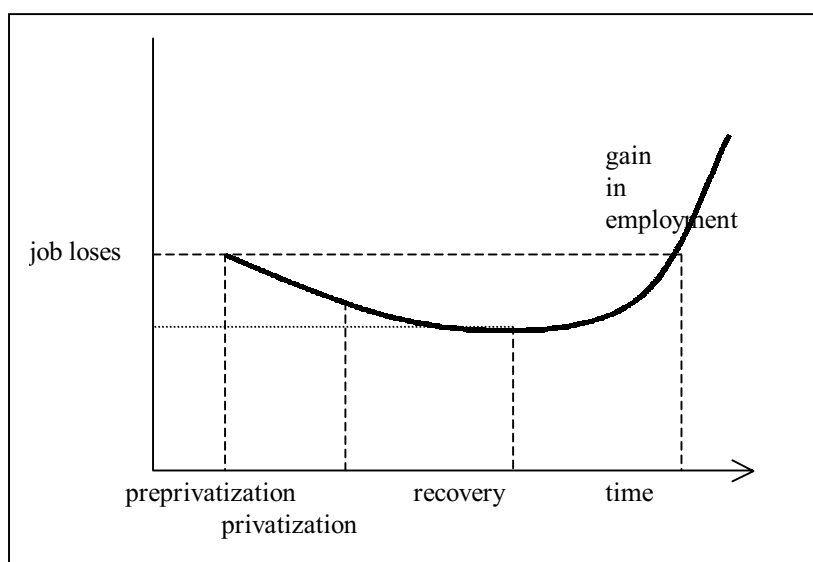
productivity. Studies on privatization suggest that employment tends to evolve on a U-curve. If the company is viable over in time as a result of investment, followed by enhanced production, it would increase operation, and, as a result, the initial employment level will be attained. Also, increased efficiency, resulted from privatization, should bring about lower prices. The fact, that former state companies were heavily subsidized, resulted in higher price for goods, and particularly, for consumer goods. CPI in 1999 constituted 4890 (1990=1), while the salary index was only 880. The real salary in 1998 constituted only 17% of the 1990 level. Distribution of income also deteriorated, the Gini coefficient evolving from 0.29 to 0.44 over the given period of time.

The private sector also tends to pay higher wages. Current data from the Department of Statistics and Sociological Analysis (DSSA) as of November 1<sup>st</sup>, 1999 support that argument in the construction, education, medicine, and real estate sectors. The agricultural, industry, trade data show a different picture, but lower salaries in the private sector are explained by underreporting of income levels. The salaries in the mixed property sector (without the participation of foreign capital) are higher in virtually all the areas, except fishing and trade.

### *Aspects of privatization*

The previous Parliament deferred inadmissibly the land reform, which occurred in 2 stages. Initially, each family was entitled to at least 0.3 ha, with additional 0.1 ha for each member of the family (starting with fifth person). During the second stage, launched after the adoption of the Land Code on January 1<sup>st</sup>, 1992, the outside-built over areas started being distributed. In February 1995 the allocation of equivalent land plots has been stopped as a result of the adoption of the Law on Modification and Completion of the Land Code. On January 25<sup>th</sup>, 1996

**Figure 3.2**



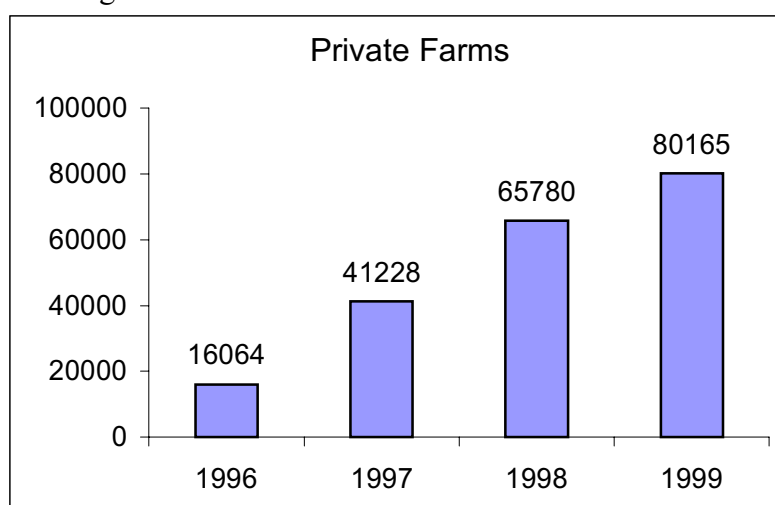
Source: Stanjeev Gupta, Christian Schiller, and Henry Ma, *Privatization, Social Impact and Social Safety Nets*, IMF Working Paper 1999

<sup>12</sup> Stanjeev Gupta, Christian Schiller, and Henry Ma, *Privatization, Social Impact and Social Safety Nets*, IMF Working Paper 1999.

the Constitutional Court declared those modifications unconstitutional, which accelerated the distribution of land.

The pilot-project „Pământ” – “Land”, which stipulated the privatization and reorganization of agricultural enterprises, was launched in 1997 and permitted the privatization of 72 enterprises. The National Program of Privatization and Reorganization of Agricultural Enterprises “Pământ” took off afterwards. Private companies, licensed by the Cadastre, Land Resources and Geodesy Agency, were involved in the project. By January 1<sup>st</sup>, 1999 contracts with 650 enterprises were signed. By April 1<sup>st</sup>, 1999,

Figure 5.3.



Source: DPASP

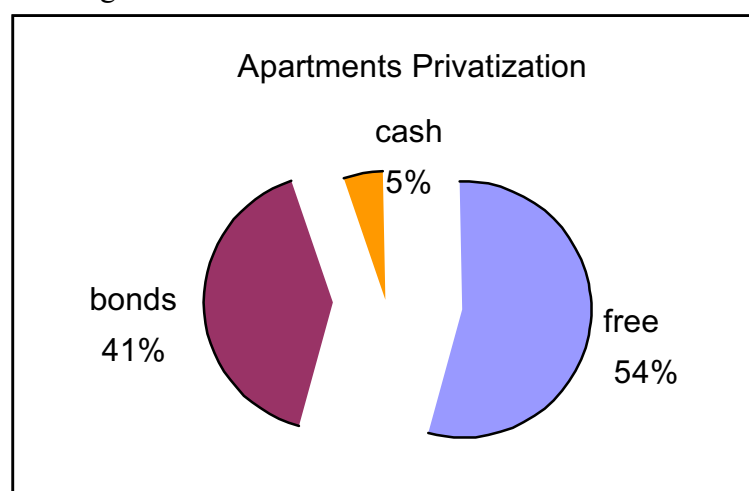
95.8% of citizens entitled to equivalent land plots, received the titles certifying their rights. 36 thousand people were put in possession of land. By the 3<sup>rd</sup> trimester of 1999 circa 1200 former agricultural enterprises have been restructured. Up to date 874 enterprises applied for the participation in the “Pământ” project, 778 contracts being already fulfilled. Over 160 thousand citizen already received land titles.

For equity proposes, caused by the difference in land quality, each person received several plots, even within the enterprises reformed by “Pământ” program. In the end a family could end up having more than 4 plots, bearing additional production costs. The international practice shows, that only large-scale agricultural enterprises can be profitable. A more lucrative method of distribution could be in conferring a coefficient, correlated with the size of the plot, quality, and proximity to the settlement, and distribution of land according to that coefficient.

Adoption of the Law on Restructuring Agricultural Enterprises under Privatization, which specifies the postponement and cancellation of debts of agricultural enterprises, is a measure that will help create the owners’ class in the countryside. The cumulative debt of agricultural enterprises as of January 1<sup>st</sup>, 1999 amounted to 2 billion lei.

One of the few aspects, positively appreciated by the population is the privatization of state housing. A family could obtain for free their apartment if the combined length of service constituted 35 years as of March 10<sup>th</sup>, 1993. One had to pay 25% of the apartment’s cost if the length of service was between 30-35 years, and 50% if the length of service was between 25-30 years.

Figure 5.4.



Source: Department of Privatization and Administration of State Property

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Patrimonial Bonds could have been used for the privatization of housing. As of January 1<sup>st</sup>, 1999, 89.4% of the state apartments have been privatized (225600). During January-September 1999 another 5270 (4900 in the city of Chişinău) apartments have been privatized. As a result, 490 associations of residents were formed. The budget received 26.3 million lei. The situation with dormitories is more difficult. One could privatize them only if 60% of residents would have agreed on that. The dormitories of educational institutions were not subject to privatization. A manifestation of social inequity was the decision, prohibiting rural inhabitants to privatize their housing for bonds.

Privatization of apartments helped to create the real estate market, which is essential for economic development. It was estimated, that a quarter of unemployment in transition economies is caused by labor force immobility, resulting from the lack of housing. The real estate investment is considered to be profitable almost everywhere. Some residents, which are unable to pay the rising utility bills, would like to exchange their apartments for smaller ones. After the 1998 crisis, according to the "Lara" real estate agency, the dollar prices for apartments in Chişinău City were falling by 10% monthly, reaching a slight stabilization in the summer of 1999. The prices of 2-3 room flats are converging to the 1-room ones, so the investment turned out to be not as profitable as expected.

The problem of the Moldovan patrimony on the territory of other States has not been completely solved. As of January 1<sup>st</sup>, 1999 the list of objects situated on the territory of Ukraine was not updated. In April 1998 a draft of a treaty between Ukraine and Moldova for the mutual recognition of rights and regulation of property relations upon the objects of one side located on other side's territory was elaborated. There have been also elaborated modifications to the inter-Governmental Treaty from August 11<sup>th</sup>, 1994. The enterprises in Russia have been restructured and transformed into JSC. The wine bottling enterprises of Moldova, located in Russia have been priced in rubles, which contributed to their increased attractiveness after the ruble devaluation in summer-fall of 1998. But this diminished the amount of revenues, which Moldovan budget was supposed to receive. Besides, the funds for the acquired enterprises haven't been transferred yet.

The problem of adjacent territories was a determinant for the process of privatization. The Cadastre Agency started functioning only in 1998, a wide geodesic map of Moldova has not been elaborated yet. The normative prices for land, which was too high, ranging from 10 thousand to 1 million lei, was utilized. The completion of transaction with "Lafarge" was delayed for some time, because the normative price of the land was higher than the price, the firm paid for SA "Ciment". The Department of Supervision within the Prosecutor's General Office reported, that, as a result inactivity of local governments, for 1500 plots sold (with the surface of 333,000 ha) instead of 30 million lei were received 12 million only. Lately fewer enterprises are purchasing adjacent plots because of hard financial conditions.

### *Perspectives for privatization*

The pace of privatization in Moldova is heavily influenced by politics, the latest developments being a concluding example. In accordance to the World Bank's SAC-2 agreement, the Parliament adopted in the first reading the individual projects for the privatization of 5 wine making enterprises, 6 tobacco fermentation plants and of the JSC "Tutun-CTC". In October 1999 the Parliament halted the privatization of these units. The arguments of the right-wing political forces were based on the corruption in the Government, which is unable to carry on an efficient privatization. The forces from the left argued that the companies are still profitable, the budget receiving revenues at the moment. However the financial reports show, that "Aroma", "Struguraş", "Vismos" companies, as well as the fermentation plants from Ciadâr-Lunga, Făleşti had registered losses. The dynamics of sales

present a catastrophe, caused partially by the fall of demand in Eastern markets. The underlying reason for the delay in privatization is group interests. There were set up small firms near the main enterprises, through which the profits, by transfer pricing are siphoned off.

The MoldTelecom Company has a long privatization history. On September 11<sup>th</sup>, 1995 the Government adopted a decision to reorganize and privatize this enterprise. The first plan, designed in July 1996, asked the strategic partner to pay and commit US\$ 120 million. The winner of the tender – OTE Telecom offered US\$ 46.4 million, and the Government canceled the tender.

On October 14<sup>th</sup>, 1998 the individual privatization Plan for the State Company MoldTelecom was adopted. By January 5<sup>th</sup> 1999 MoldTelecom became a JSC. The first draft of the project offered a 5-years exclusive license to the buyer, but the Constitutional Court considered the monopolistic provision as being anti-constitutional. The winner is required to increase the density of phone lines to 25 per 100 inhabitants. Tariffs will be fixed, with a possibility to adjust them every May to the inflation rate. On May 31<sup>st</sup>, 1999 a contract with Price Waterhouse Coopers was signed for the accomplishing of an audit for MoldTelecom. The Government seeks an Investment Bank for the management of the MoldTelecom Privatization. For that purpose presentations in the UK and in the US have been organized.

The winner of the tender will automatically receive a license to render mobile telephony services on the territory of Moldova. The French Company VOXTEL monopolized the Moldovan market. The Moldavian-Turkish company MoldCell purchased recently a license for mobile telephony, but because the process was not transparent enough, the Prosecutor's Office declared the transaction illegal.

One cannot delay any further the privatization of such a strategic sector. Modern technologies – mobile telephony, Internet, Internet Telephony, will lead to a drop in the demand on the international market. The price evolution on the world market is evident. Due to the technological revolution, telecommunications may not be considered natural monopolies any longer. Econometrical analysis suggests that increased competition as a result of privatization is positively correlated with increased number of phone lines per capita, increased number of public phones, a superior connection capacity, reduction of tariffs for local calls. But exclusive licenses delay the benefits of privatization; therefore one should note the Government decision to institute an Independent Regulatory Agency. Besides, the practice reveals that privatization without a regulatory agency leads only to an increase in the number of public phones<sup>13</sup>.

On August 2<sup>nd</sup>, 1999, the Government announced an open International Tender for the privatization of electric distribution companies. In April Parliament adopted the Law on the Debt Restructuring in the Energy Sector. Credit Comerciale de France was selected as consultant for the privatization of energy sector. The privatization of distribution network should be accomplished by the end of 1999, of the generating enterprises – by March 2000. According to the Law on Energy Sector Privatization, the State assumes the historical debts, which amounted to 1.5 billion lei by mid-1999, therefore, the amount received is expected at least to cover a part of the sum. The major cause of privatization of that vital sector is the technical deterioration of the distribution network, major investment being needed. Permanent energy disconnections, caused by insufficient supply of fuel, resulted from arrears, affect the production process. Also, it generates an additional problem – stealing of hi-voltage cables for base metals.

<sup>13</sup> Wallsten, Scott J., "An empirical analysis of competition, privatization, and regulation in Africa and Latin America", May 1999

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The 100% state share is supposed to be transferred into private hands in three stages, based on the geographical principle. The winning company is supposed to have experience in the field and to have sales of at least US\$ 100 million per year. 5 Companies out of 8 withdrew their offers as a result of political instability in Moldova, caused by Government's resignation. The Russian Company RAO UES lost its license, and the Ukrainian Company Luganskoblenergo's offer was rejected because it did not comply with the requirements. The only company left in the contest is the Spanish "Union Finosa", which offered for: "RED-Chisinau" SA - US\$ 20,200,000 plus the promise to invest US\$ 42.9 million over a 5-year period, "RED-Nord" SA - US\$ 15,300,000, "RED-Sud" SA - US\$ 5,100,000 and investment in the amount of US\$ 13,268,000. The winning company is also supposed to additionally invest US\$ 32.9 million into the re-launch of the distribution network.

A hard decision is expected – the acceptance of the offer or the organization of a new tender in the condition when the foreign financing is ceased for a uncertain period, and Fitch IBCA agency downgraded Moldova's rating from "B" to "B-".

Other enterprises that could be privatized by the end of the year are:

The largest cosmetics producer SA „Viorica”, the deadline for offers being set for October 25, 1999. The market share of the company is 30%, and continuously growing as the leu depreciates. State share is 96.12%, the remaining belonging to individual shareholders.

November 30, 1999 was fixed as deadline for the tender for „Zorile” privatization – the largest foot-ware producer in Moldova, which accounts for a 20% domestic market share. Statutory capital is estimated at 19.2 million lei, the State holding 60% shares, the employees – 20% shares. „Zorile” has its own distribution network in Moldova. This fall the enterprise launched a product line, with 170 new models.

The Parliament accepted in the first reading the Project of privatization of the Company „Tirex-Petrol”. In November the NCSM issued the approval for the reorganization of the enterprise into 3 components: „Tirex-Petrol” with a statutory capital of 41 million lei, „Zidpetrocon” with a statutory capital of 2.55 million lei, and „Combustibil” with a statutory capital of 33 million lei. The Moldovan side is negotiating with the Romanian Company CONEL about the transfer of 51% shares of „Tirex-Petrol” for the outstanding debt for energy to the Romanian partner.

The process of preparation of documents for the privatization process is extremely slow, some investors being discouraged by these procedures. A similar case happened with „Moldova TUR”, the largest travel-agency in Moldova, which is considered to be privatized now. The company experiences at the moment some difficulties, caused by a 3-time drop in tourist's flow compared to the last year.

One should consider the privatization of the State monopoly – Moldovan Rail Roads Company. It operates at loses at the moment, while several transporting and freight companies are flourishing around it.

By the end of December the DPASP expects to privatize another 16 enterprises.



### *Corporate governance*

It was argued, that *voucher* privatization was the only possible way of privatization in Moldova, the main arguments being social equity, political support from the population, and lack of local finances for the carrying out of privatization. The problems, common for a mass privatization program, are linked to the disperse structure of shareholders, partially solved by the cartelisation of shareholders through investment funds and trust companies.

A brief review of other privatization models suggests, that from the point of view of morality and public confidence in the intentions to pursue the property rights principles, the *restitution* is the best solution. But this process is selective and may take too long, delaying privatization. *Direct sales* to investors bring new technologies and knowledge; result in higher privatization proceeds in the conditions of an underdeveloped capital market. The investor, which values the enterprise the most, will guarantee its most efficient use. But the wide population strata consider them as inequitable. Another drawbacks of the method are shortage of local capital, lack of interest from the foreign investors, insufficiency of information, considerable expenses on advertising and supervision of the process. *Management-employees buy-outs* are one of the preferred methods, and one of the fastest ones. The costs of this method are weak corporate governance and efficiency losses. The enterprises tend to keep high employment levels and wages above the market ones, underinvesting in production. They also lack the skills and abilities for restructuring. Employees have to gain the most, while the large masses do not benefit from such privatization. It was estimated, that outside dominated firms outperform the insider dominated ones, but the most prosperous are *de novo* – green field companies<sup>14</sup>. To support that, department of industrial policy data show, that while during the first semester of 1999 the industrial output had fallen by 25.2% on average, SA "Farmaco" increased its output by 21%, SA "Moldagrotehnica" by 42%, SA "Ionel" by 51%, SA "Floare-Carpet" by 8%. It was observed that food processing and wine-making enterprises are the fastest to restructure. During the same period the output of sugar-beet processing plants increased by 61%, of meat producing enterprises by 26%.

It was formulated the idea of rapid privatization, which will not allow the old nomenclature to regain control, therefore the creation of investment funds, which will carry on the restructuring process, was seen as imminent. The Privatization Investment Funds (PIFs) were created in Moldova according to the President's decree. They constituted a hybrid between mutual funds and holding companies, having several restrictions imposed on them. Overall they concentrated 70% of the value of all the Bonds emitted to population. Individuals, who invested their bonds into fiduciary companies, become shareholders of the enterprises, were the fiduciary company acted as an intermediary, while the individuals who invested in PIFs, become shareholders of the fund. The investment funds, which received the shares of enterprises in return for the Bonds they collected, are considered one-man holders, which entitles them to dividends and to the right to participate in the corporate governance. The income of investment funds is proportionally linked to the performance of enterprises, which influences the dividends paid by the funds.

Aggregate assets of PIFs and trust companies accounted for 1,148 million lei (US\$ 225 million, 98% of total value of the securities) their portfolios including the shares of major Moldovan perspective companies. As of January 1, 1999, the book value of investment funds' assets constituted 864 million lei, the estimated market value being 827 million lei. Statutory capital was 622 million lei. But the assets owned by the funds did not have a real market quotation – "junk shares".

<sup>14</sup> Oleh Havrylyshyn, Donald McGettigan, *Privatization in Transition Countries: A Sampling of Literature*, IMF working Paper, January 1999.

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Some experts argue that the funds did not have the incentives, power, expertise, and capital to carry on the restructuring of enterprises<sup>15</sup>. The lack of incentives was primary determined by restrictions, imposed on the shares, held by a fund in one particular enterprise, at 25%, which determined the creation of twin funds as Exiton-Bon, Exiton-Inverst. Even when the fund is committing time and efforts to the restructuring of a company, the benefits will be captured by the remaining shareholders. If the fund holds 50-60% of the enterprise's shares, the free rider problem emerges. Besides, the remuneration of managers is limited by a fixed amount, a fraction of the assets they administrate (5%), and is not directly linked to performance. Even if, as a result of good management team efforts, the assets of the fund would grow considerably, the remuneration could increase only by the share stipulated in the law. Having a spread structure of shareholders, the funds' management does not face any credible threats, in order to increase their performance. Therefore, they find it more lucrative the shares trade operations, transfer pricing, non-transparent transactions. In 1998, 29 investment funds declared revenues (or losses) from transactions with securities. In order to optimize the portfolio structure, they engage in SWAPs. The aggregate revenues from dividends of investment funds for the first 9-months of 1998 accounted for 2,529,100 lei, while the revenues from transactions with shares amounted to 10,424,600 lei – 70% of all revenues.

If several funds decide to join their effort and to control a particular company, they cannot succeed, unless they are totally committed to it and have a unity of views. However, if a company is heavily indebted and close to be liquidated, the control passes to creditors. Therefore, the shareholders do not have enough power to continue the restructuring. The funds also lack the expertise in pursuing the restructuring process. CEEC experience showed, that foreign experts are usually lawyers, accountants, financial analysts, but had little experience in management, industry or technical expertise. The shares have been accumulated in non-cash transactions, but at the initial stage the funds spent vast amounts of money on organization, salaries, and advertisement. Now the founders are trying to earn return on their investment the minor shareholders remaining without the long-promised dividends. Aggregate spending of the investment funds in the first 9 months of 1999 constituted 6,925 thousand lei, while the spending for managers' remuneration amounted to 4,579 thousand lei. This happened when revenues from dividends accounted for 1,928 thousand lei, while the financial results from sales of assets revenues from sales of assets comprised 11,999 thousand lei. The social and political pressure is increasing, the citizens feeling that the "national patrimony" is slipping away to that new financial caste.

The Law on Joint Stock Companies ended the era of administrative control, opening a new era, of corporate governance. Also the investigations reveal, that enterprises controlled by strategic investors are more efficient than the ones controlled by institutional investors, investment funds, which bear large shares (over 25%) of enterprises, and could significantly influence the activity of JSCs in different legal ways, mainly through corporate governance. They are more organized and have more expertise than ordinary shareholders. They boosted the economic activity and investment of several enterprises, promoted new, competent managers. The management staff of enterprises, which found a common language with the investment funds, continues their activity for the benefit of both sides<sup>16</sup>. The representatives of IF are members of administrative teams at virtually half of the enterprises, but sometimes they are acting like bystanders, or engage in non-partner relations with the management of the companies. The role of the State representatives at the partially State-owned enterprises is the active participation in the management process, striving for benefits and transfer of dividends to the budget. But the representatives are not always up to the task because of lack of expertise in

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<sup>15</sup> David Ellerman, *Voucher privatization with Investment Funds: An Institutional Analysis*, The World Bank.

<sup>16</sup> Sergiu Certan, *Fondurile de investiții în Moldova. Structura caracteristică generală. Masă rotundă : Piețele de capital în Republica Moldova, iunie 1999.*

managing such enterprises, lack of responsibility for the taken decisions, lack of proper remuneration. In 1998 dividends of 4.5 million lei were transferred to the State budget (0.9 million more than in 1997). However, the managers of some enterprises cannot accept the idea, that someone is actually the owner of the company, and is willing to engage in restructuring. They would prefer the existence of atomized shareholders, unable to exercise control.

The performance of investment funds was heavily influenced by the overall economic situation. The managers of the investment funds consider the lack of cash, excessive cost of services on the capital markets, extreme dissemination of shares, and burden of arrears as being the major problems in the activities of investment funds. There are recommendations to create holding companies, based on the current investment funds. The experience also shows, that closed-end structures do not have enough incentives to struggle for efficiency and maximization of their portfolios' values. This structure allows inefficient management to stay in the market without a threat of job loss, therefore all the companies, which employ attracted funds, should be open-end structures.

The solution of the principal-agent problem is crucial for Moldova. It appeared as the shareholders are not admitted to the administration of enterprises' patrimony process, the managers considering themselves as big bosses, profiting from undefined relationships with the shareholders, the local administration, with other manufacturers. As the shares of investment fund are distributed to a large mass of people, and enterprises' managers act as agents for the funds, the principal-agent problem is even more acute.

Several obvious mistakes appeared at the stage of creation and design of their regulatory framework. There are some problems with the organization of general meetings, with the completion and registration of shareholders' lists, with proper informing of shareholders. NCSM discovered several law violations in the activity of IFs and holding companies. Not everyone received their titles; the mechanisms of collaboration with the shareholders of initiation of general meetings are not defined yet. Privatization and transformation into JSC was a new task for managers and for the employees. Also the JSC passed the privatization process, some of them did not register their shares. Some of them had already sold the shares to outsiders. The procedures with the NCSM are widely unknown, therefore the organization of new shares issuances, necessary for the attraction of new capital, are not very often. Several enterprises, which attempted to register new issuances, accumulated insufficient funds, and some issues had been canceled, because not even a single share was sold. All the 299 additional issuances in 1998 were closed ones. As a result of reorganization of JSC, which attempted the increase of their statutory capital, 2000 enterprises, which did not managed to accumulate sufficient funds, are subject to liquidation.

The dividends received for 1998 accounted for 3.396 million lei, the net income being 8.553 million lei. The dividends paid by only six investment funds to their shareholders constituted 4.5 million lei. According to NCSM data the situation in 1996-97 was similar. In 1996 the dividends received by the investment funds amounted to 2 million lei, while their total spending was 4.6 million lei.

Aggregate financial results of investment funds in 1998 show a net income of 2,841,233 lei, which constitutes a 0.3% own capital profitability, 15 funds declaring losses. The legislative framework of privatization was quite liberal, allowing for consolidation of property and access to the secondary market. In order to optimize their portfolios, the investment funds engaged in share trading and SWAP operations. Trust companies registered aggregate losses of 154,413 lei, "Mobiastrest S.R.L." being the only trust company with a positive financial result.

The role of investment funds in the launch of the capital market is also exaggerated, because there were no massive flows of capital from savings into investment— the shares were distributed for free. Foreign investors are looking for productive assets, and are not particularly

## 5. PROPERTY REFORM: HOPES AND DISAPPOINTMENTS

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interested in shares; therefore investment funds had little impact on foreign investment. Foreign investors in Moldova are more interested in the establishing joint-capital enterprises than in privatization.

***Privatization contributed to a continuous modification of property relationships,*** according to DPASP, and to the modification of the structure of the national economy through transparent and accessible mechanisms. Privatization has brought in foreign investors for the privatization of strategic companies, created conditions for the post-privatization functioning – financial recovery of enterprises, implementation of modern management, financial analysis and marketing techniques, new production lines, national accounting system and conditions were created for the privatization and restructuring in agriculture, for the establishment of start-up firms.

However not everything can be viewed in such a positive way. Initially, one intended to privatize property worth 10 billion rubles, circa 2/3 of the industrial patrimony. The Bonds were issued in the same amount. Some of the most valuable assets were excluded from the privatization process (through “spontaneous” privatization, which preceded the official schemes, or through elimination of some enterprises from the lists). “Privatization became a *fire sale* to which only the selected few were admitted”<sup>17</sup>. This created a misbalance between the value of Bonds and the value of patrimony. One could feel that already during the third bonds auction.

In the early 90s many enterprises started functioning on lease-contracts basis. The Accounting Court discovered over 120 violations of the process of transformation of those companies in JSCs. The lease product was overvalued, sometimes estimated at a higher value than the enterprise itself. Some documents were counterfeited – the year of enterprise creation, the exclusion of some assets during the estimation of enterprises’ value, erroneous indexation of funds to the inflation rate. The employees contributed to the statutory capital, so the share of the state was deliberately diminished. The contribution of new partners was sometimes overestimated. Assets were sold by managers at symbolic prices – the cars, fridges, office furniture. All that diminished enterprises’ attractiveness for foreign and domestic investors. In order to obtain the lowest possible price, one practiced price fixing techniques, the potential buyers were not informed about the auctions or were prevented their participation.

Inexistence of a serious legislative basis became a serious barrier. Although the Privatization Program took off in 1994, the errors occurred in other transition countries were not taken into account. The legal framework, which would define the property right is not perfect, the Law on Collateral and the Law on Bankruptcy have been just recently adopted, the Civil Code is not adapted to the realities of market economy.

One of the fundamental errors of the privatization process was the existence of an unique scheme, with small modifications, without the specification of strategic companies. The pace of reform was severely hampered by the opposition of enterprises’ management, which could have been avoided by employment guarantees or stock offers. Inclusion of social objects into the cost of the company sometimes artificially overvalued the statutory capital.

The rights of minor shareholders are practically ignored in Moldova. Major shareholders of some enterprises opted for the division of the company into several smaller ones, they acquiring the most valuable assets (downtown buildings or office spaces, for example). One admitted to the investment tenders the affiliates of some well-known firms, which were not

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<sup>17</sup> Vito Tanzi, *Transition and the Changing Role of Government*, Finance and Development, IMF, June 1999, 36(2)

serious partners by themselves. One failed to supervise the strict fulfillment of obligations assumed by the investors, the assets bought from the state being sold to a third party.

Lack of transparency on the capital market deepened the social inequity. Brokers all over the country for a tiny price collected a large amount of shares received by population during the early stages of privatization. An existence of stock quotations at the Stock Exchange would have prevented such an outcome. The NCSM decision to limit the over-the-counter transactions will eliminate some deficiencies and will lead to a single price creation mechanism.

During the late privatization processes several mistakes were also committed. The fiscal inspectorates sequestered the assets of selective indebted enterprises with ulterior sales of the confiscated patrimony, diminishing the attractiveness of the company. Recent evolutions show, that some perspective small-scale enterprises (mills, oil-mills) are confiscated for their debts to the State budget and then sold through auctions, where the “close” persons are invited.

One should carefully reexamine the banks’ privatization process, where the share of the state was underestimated in virtually all the cases. The history of often ownership changes in the Savings Bank, with its ulterior “nationalization”, is quite suspicious. The banking sector was severely affected by the overall performance of the economy, a huge stock of non-performing credits was accumulated, some of them issued under implicit state guarantees.

Serious impediments to privatization are arrears to the budget and to suppliers. Virtually all the enterprises have accumulated historical debts. Government decision to sell enterprises for the symbolic price of 1 leu will not contribute to a boost in privatization. It is imminent to reschedule those arrears, or in the case of debts to the budget, to consider their cancellation.

The purchasing power of local investors is extremely small. It was estimated, that local finances could cover only 25% of the value included in the privatization programs. A large share of output is produced in the shadow economy. It is observed a slight increase of lei-priced objects privatization due to leu devaluation. The latest capital inflows, according to NCSM, are coming from the offshore zones.

*The results of privatization* should be assessed not only from the viewpoint of the amount of disseminated state property, but it should be estimated the extent of development of the real private property, of the opportunities created for the functioning of entrepreneurs. As of mid-1999, private sector accounted for circa 60% of the economy and employed 66% of the labor force. The mixed property sector employs 8% of the labor force. The chosen privatization model had to and actually did solve the problem of transfer of property from the state, but could result in the creation of “social property”, when every citizen owns a tiny share of property, but is unable to influence its utilization. „Voucher privatization with investment funds is a *de facto* ‘industrial policy’ of real sector decapitalization in favor of short term rent-seeking by fund managers through financial sinecures and lucrative side deals”<sup>18</sup>.

Moldova couldn’t avoid all the problems faced by the ECEC, but in some cases it performed even worse. A possible explanation is seen in the fact, that CIS countries were more integrated in their input-output markets. Foreign trade was done through a Central network; therefore the managers did not have serious incentives for foreign marketing or quality control<sup>19</sup>.

Privatization alone, without the creation of market institutions, of a legal and judicial framework, which would lead to a reduction in corruption, does not lead to immediate results. One thought that macroeconomic stability – low inflation, price and trade liberalization, and enforcement of hard budget constraints will be a sufficient incentive for the

<sup>18</sup> David Ellerman, *Voucher privatization with Investment Funds: An Institutional Analysis*, The World Bank.

<sup>19</sup> Simeon Djankov, *Ownership Structure and Enterprise Restructuring in Six Newly Independent States*.

enterprises to restructure. But these measures distracted the attention from a favorable climate for Greenfield enterprises. International financial institutions should be partly responsible for the unsatisfactory results of privatization, as they pursued the governments to privatize rapidly and extensively, under the general assumption that private property will be sufficient for the enhanced performance of enterprises.

Macroeconomic stability is vital for the prosperity of the private sector. Inflation pushes up the wages and the interest rates, resulting in higher operational costs. Exchange rate volatility causes the uncertainty of foreign trade. Companies, subject to hard budget constraints, are more aggressive in collecting the arrears, are switching from quantitative to profitability goals. Competitive markets, and first of all a labor market, are vital for the diversification of production and services, for improved quality.

One did not take into account the secondary – fiscal impact of privatization, estimated as the difference between privatization proceeds and the present value of revenues obtained as dividends from the state controlled enterprises. One should have also accounted for capital transfers, credits, subventions, but also for increased budget spending for social protection.

The State failed to implement the policies, meant to alleviate the social impact of privatization: creation of temporary jobs, of agencies assisting in job search, training institutions, introduction of targeted subventions to the most vulnerable.

Some would call for a re-nationalization of the patrimony, and for a new, more equitable privatization. Good performance of some privatized firms is being explained by the fact, that better enterprises were privatized in the first place (cherry-picking).

This is not an alternative. One should account for the past mistakes in the process of further privatization, and to elaborate more transparent mechanisms, and performance criteria for the already privatized firms. The solution of property problems in the best interest of owners will result in enhanced efficiency, the State having a unique role in the protection of the large mass of shareholders.

## 6. REAL SECTOR DEVELOPMENT: TACTICS WITHOUT A STRATEGY

**Indicators and problems.** At the beginning of the 90s, especially in the period of “struggle” for macro-stabilization, the real sector was placed on the second plan. The disintegration of economic relationships, the decline in demand for goods and services, the liberalization of business activity, prices and foreign trade, the competition of the foreign producers, all these “attacked” the real sector and first of all the industry.

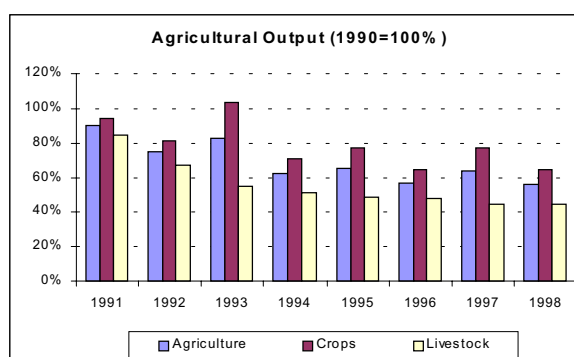
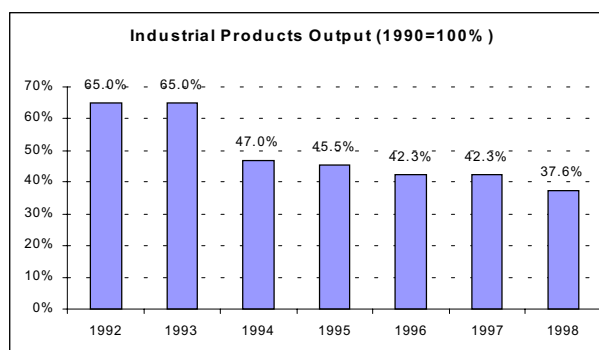
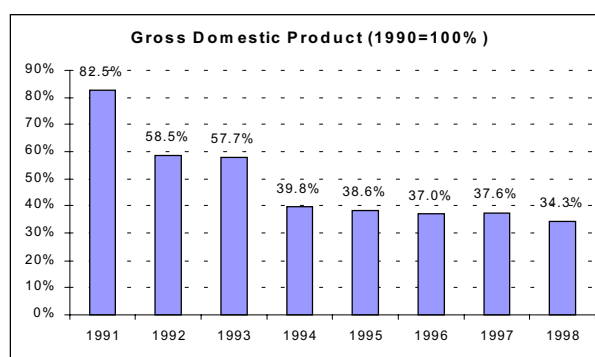
There was no state strategy for industry. The majority of enterprises was “self-rescuing”. “The concept of new industrial policy of the Republic of Moldova to year 2000” has been finally ratified by the Government in October 1996.

The 90s in Moldova were described as a slump in GDP and in public welfare. Comparing to 1990, GDP accounted for 34 % in 1998, agricultural production – 55.9%, and industrial production – 37.6%. In dynamics of GDP downward trend should be mentioned three important stages.

The first stage (years 1990-1992) was characterized by the disintegration of the single USSR market, the lack of legal basis for the market, galloping inflation, and as a result – the rapid fall of circulating assets of enterprises, the rise in the price of power resources and an increase of energy costs (expenses) in the structure of production costs. Between 1990-1992, GDP decreased with 41.5%, the agricultural production - with 24.9%, and industrial production – with 35.0%.

Between 1993-1994, in Moldova took place the liberalization of prices and foreign trade. The goods of Moldovan producers confronted the tough competitiveness of foreign producers, on internal as well as on the traditional markets of Russia and other FSU countries. Moldovan producers were not able to hold out against the competition, since the hyperinflation deprived businesses of financial resources required for their restructuring. Comparing to 1990, the index of industrial products accounted for 47%, and agricultural – 62.5%.

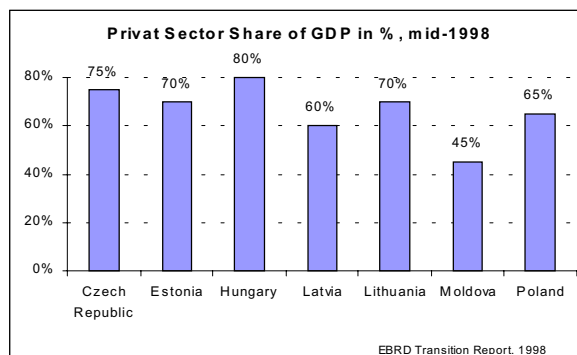
In the absence of industrial strategies and transparent legislation, the managers of the enterprises tried to transfer the administrated assets to some private, controlled by them, entities. As a consequence, the enterprises didn't restructure, and the debts were hiking.



## 6. REAL SECTOR DEVELOPMENT: TACTICS WITHOUT A STRATEGY

Such a situation didn't threaten the managers of the enterprises with any problems due to the lack of legal mechanism on bankruptcy and lack of development of corporate governance system.

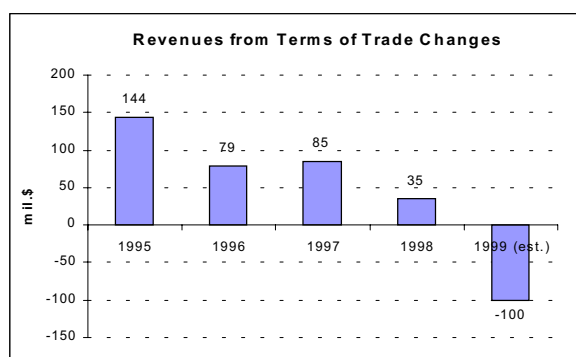
Since the state didn't practically have the control over its property, the created situation was possible to positively change only through privatization. By the way, the weight of private sector in GDP was and continues to be smaller in Moldova comparing to other countries with economic transition, where the economic growth already started.



Starting with 1995, the real sector enters into a period of depression. In order to get out of this situation, it was necessary to create a favorable investment climate for small and medium enterprises, for investments and restructuring, based on a transparent legislation that regulates the activity of enterprises. Unfortunately, the quality of legislation, the environment for institutionalization and the application of Courts' decisions in Moldova continue to be at a very low level. Until the mid of 1998 in Moldova took place the mixed privatization (for vouchers and money), after which from the state property started to be privatized the most important and appealing enterprises. These have slowed down the creation of a favorable investment climate in the country.

The slight growth that was registered in 1997 was lately annihilated by the financial crisis from Russia – this showing a significant dependency of Moldovan producers of Russian market (import of energy resources, sales of products).

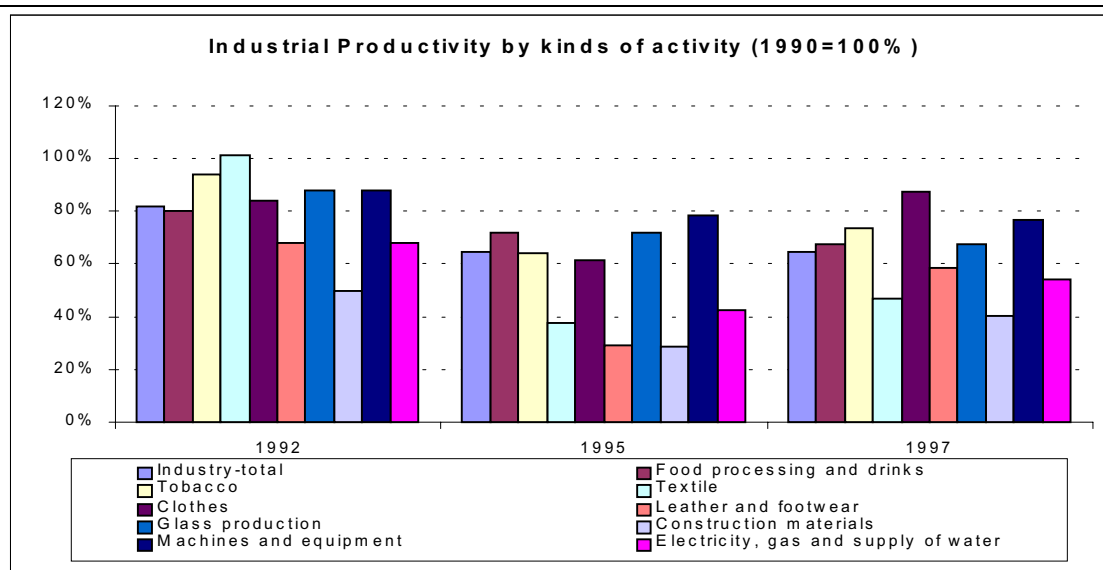
The regional crisis had worsened the macroeconomic environment for the Moldovan producers: depreciation of national currency, the rise of inflation, cut backs of exports. After the introduction of local currency, 1999 was the first year that registered substantial losses (around US\$100m) that were a consequence of the changes of commercial conditions.



The lack of state strategy on promotion of Moldovan products on new markets, was conditioned by personal and collective interests of Moldovan managers for the FSU markets. Scarcity of financial resources for the restructuring of enterprises didn't let the raise of competitiveness rates of these enterprises – productivity of work in industry decreased and lowered to 82% in 1992 comparing to 1990, and continuing to lower in 1995 – to up to 65%. A little better is the situation in light industry: thus, between 1995-1997 the productivity of work in textile enterprises increased by 26%, in clothing industry – by 42%, in leather and footwear enterprises the productivity of work doubled.

A significant decline agricultural output took place before 1994. Starting by 1994 agricultural production stabilized (regardless to unfavorable climatic conditions).





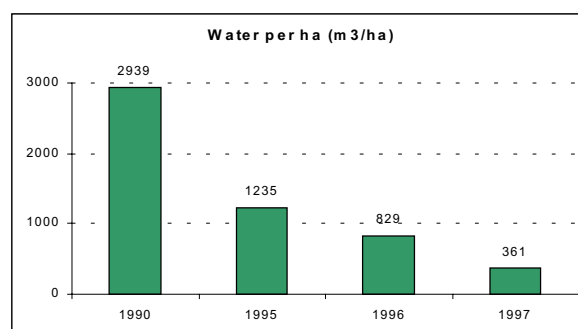
Reasons for the decline of agricultural output are:

- scarcity of financial resources;
- high price of credits (interest rates for credits);
- incapability to renovate the machinery park;
- undefined property rights for the agricultural enterprises;
- the old system of supply and selling of agricultural products was destroyed, and the new one was not created yet;
- inefficient and not transparent system of subsidies in agriculture;
- decline of purchasing power of the population, diminishing demand for agricultural production;
- loss of sales market after the breakdown of SU market;
- lack of competitiveness of production of food enterprises caused a decline in food processing industry, and reduced the demand for agricultural raw materials;
- presence of different kinds of barriers (tariff and non tariff based ones) for Moldovan agro-industrial production on the markets of other countries.

A decline of the agricultural production in 1994-1998 in comparison with 1981-1990 took place for goods which are not tradable at commodity exchange (vegetables, fruits, and grapes), a biggest part of their production had to be directed for final consumption and processing inside the country. As a rule, the production of these goods needs essential material and financial expenditures. For goods which could be sold at commodity exchange (grains and sunflower seeds) the decline of production was not essential.

The volume of investments in agriculture and food industry declined essentially during last years, because the unfavorable investment climate in the country. On the base of total investments there were modernized only 18% of the fixed assets of the agro-industrial sector, the remaining 82% are out of date.

Irrigation is vitally important for the agriculture of Moldova due to low level of precipitation in much of the country and its variability. The situation of the watering means is worse. As a result of a "wild" actions in the agrarian sector during the first half of '90th it became incomplete: from 2.5 thou of sprinkling-machine today are able to work in reality not more 500. In comparison with 1990 consumption of

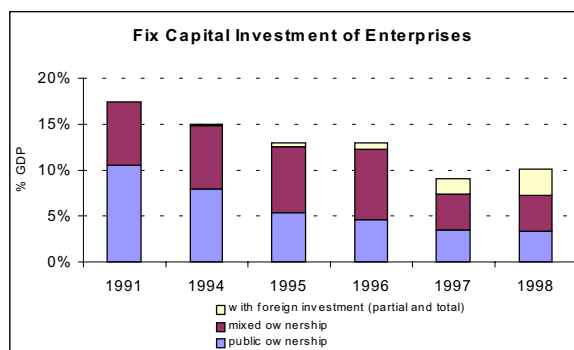


water for irrigation per ha declined 7-8 times.

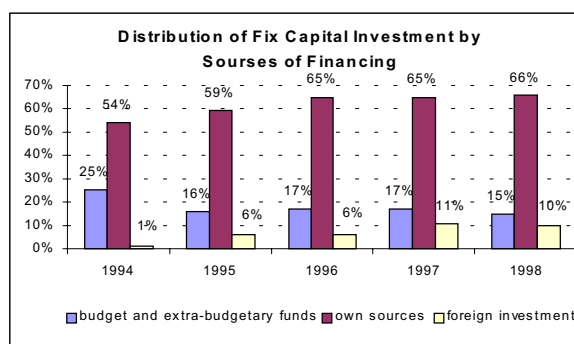
It is well known that not use of fertilizers leads to the decline of harvest per ha by 30-40%. In Moldova a large massive of land under grains was not fertilized during last 10 years. The use of chemical fertilizers per ha felt down by almost 19 times (from 136 kg in 1990 to 7 kg in 1998). The use of local natural fertilizers per ha (from 5.6 tons in 1990 to 0.1 ton in 1998) is decline in 56 time. If the situation evaluates the same way, the fertility of the well-known Moldovan black soil will decline catastrophically.

Plant protection is one of the most important part of the technological process of agricultural crops growing. According to distributors, the supply of pesticides in 1998 declined 1.4 – 2 times as a result of VAT and special custom tax. Many enterprises sow untreated seeds, spray the gardens 2-3 times instead of 8-9. Only 11% of surfaces are treated with herbicides.

**Investment climate.** Investment resources are important restructuring components of the national economy, prerequisites for raising the bid of production growth and for social improvement. One of the reasons the lack of GDP growth the transition period, is the scarcity of investment sources.



In the 90<sup>th</sup>, on the general background of the economic crisis, the investment activity has suddenly declined. Thus, in the GDP structure after final expenditures, the investments in the rough set up of the fixed capital have decreased from 17.5% in 1991 to 10.2% in 1998. A growth of the volume of investments (in four years–100%) was registered only at the enterprises with foreign capital. At the same time, the composition of financial sources modifies dramatically – the share of resources from the state budget and extra budgetary funds diminishes (from 25% in 1994 to 15% in 1998). The weight of the own resources of the enterprises varied from 54% in 1994 to 66% in 1998. The mechanism of accumulation of resources from the population is far from being perfect. The efforts to attract the foreign investors have not been very successful (from 1% of total investments in 1994 to 10% in 1998). The outcomes of the mass privatization didn't make more active the flow of investments.



The budgetary crisis, arrears taxes and the use of more than a half of budgetary expenses for social purposes have unexpectedly diminished the volume of investments from the state budget: in 1995 – 132.8 million lei; in 1996 – 155.0 million; in 1997 - around 130 million lei, and in 1998 – 70 million lei. As a result the incoming credit lines assisted by the international organizations, the share of banking credits in the structure of investments in the set up of fixed capital, increased from 0.8% in 1997 to 7.3% in 1998.

To encourage the investments is to develop the economic potential of a country. Consequently, in order to overcome the crisis, the share of investments in GDP should be increased to at least 25-27%, that is the lowest level in the European countries in transition. The destination of investments should be first of all the restructuring of the products and of

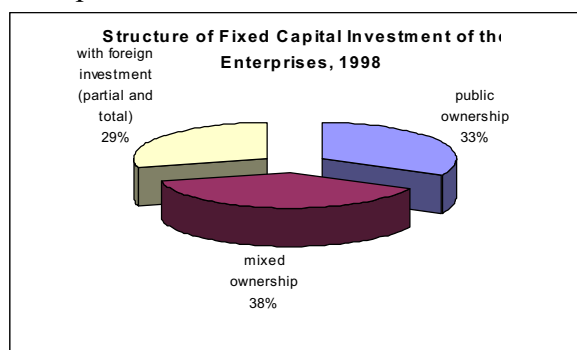
infrastructure capacity, since at the initial stage of the set up of Moldovan market economy, they have been mainly concentrated in area of services.

The main direction of the long-term investment policy is the mobilization of multiple extra-budgetary sources that shall be used in at least 90% of the capital investments. There are three such sources: own means of economic agents, the resources of population and foreign investments. In the next years, in the economic development, especially the domestic accumulations shall become the main catalyst of the investment activity. From this perspective, it is necessary to elaborate and to implement the “state economic policy”, that would let the businesses and population to cumulate resources and to turn them into investments. This will require amendments in fiscal policy, in crediting, in incomes policy and insurance against risks.

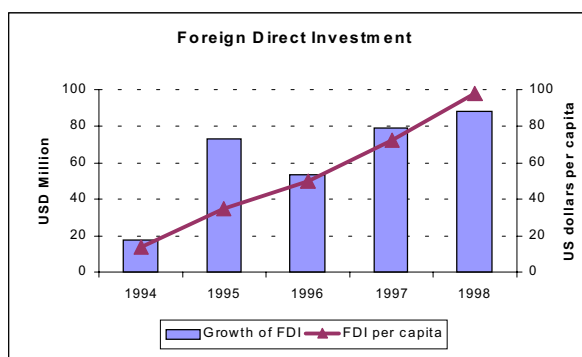
The survival of Moldovan enterprises depend on the incoming foreign direct investment (FDI), that in a relatively short period of time allows:

- to achieve the mainly new competitiveness level of the enterprises by using new technologies, know-how, introducing new operating management principles and training of personnel;
- to push up the volume of investments, to raise their share in GDP up to the level required to complete reproduction on a progressively enlarging scale;
- to promote the degree of integration of Moldova in world economy system based on the increase of potentiality of the export;
- to increase the income of the population and to cut unemployment.

Foreign direct and portfolio investments are an important source of financial resources for the restructuring of enterprises. In 1998, the enterprises with fixed investment ratio including the foreign funds amounted to 29% of their total volume. These investments have been much more efficient from the point of view of modernization and re-equipment of production (referring to “Knauf”, “Vitanta”, “Zicos” enterprises in 1997, in 1998 about three quarters of the foreign investment has been allocated to the Giurgiulesti terminal, “Lukoil”, “McDonalds”, “Green Hills”).



The volume of foreign investment per capita was of 98 US dollars. It is necessary to underline that comparing to other countries in economic transition, this volume is obviously



**Foreign Direct Investment, per Capita (USD)**

	Cumulative 1989-1998	1997-1998
Albania	132	27
Bulgaria	155	104
Croatia	349	174
Czech Republic	968	367
Estonia	947	480
Macedonia, FRY	97	72
<b>Moldova</b>	<b>98</b>	<b>48</b>
Hungary	1652	331
Latvia	634	286
Lithuania	422	346
Poland	389	250
Romania	200	144

insufficient. We have to note that only a small percentage of these investments come to constitute the fixed assets (in 1998 not more than 30-40%), the most significant part being spent on credits and increase of statutory funds.

The foreign direct investment is closely linked to the liberalization of foreign trade, to the adoption of free trade conditions with EU countries. Thus, the Association Agreement for Poland, Hungary, Czech Republic, Romania and Bulgaria came into force in 1995. Estonia and Latvia have ratified this agreement in 1995, and Lithuania – in 1996. In the frame of this agreement, the mentioned countries, have ratified some social conditions in order to create the free trade zone, that would allow a more intensive foreign direct investment: if in 1994, the foreign direct investment in Central and Eastern Europe and Baltic Republics constituted 3.8 billion dollars, then already in 1995, they increased to 9.7 billion dollars. According to EBRD experts, in 1998 the incoming flow of foreign direct investments in this zone constituted more than 16 billions of dollars.

The largest part of the foreign investment in Moldova is directed to the agro-industrial complex and services, mainly in small and medium enterprises. Strategically important are the investments in machinery production, cement and gypsum, infrastructure objects - terminal on Danube River, Chişinău airport, electrification of Razdelinaia-Ungheni railroad and reconstruction of the main highway.

For the renewal of enterprises equipment the future will be leasing, the creation of financial institutions assisted by foreign investors - co-owners of the Moldovan enterprises that receive equipment and its services in leasing.

In order to neutralize its temporarily and speculative nature, portfolio investment (the purchase of shares of Moldovan enterprises by foreign banks and companies) is welcome to be directed to the financing of these enterprises in exchange of shares from the statutory funds.

Energy sector, restructuring of the agricultural farms, the infrastructure of the transportation, of public municipal services, of the constructions and the social areas are considered as the areas of priority for the implementation of the Public Investment Programme.

Other areas such as telecommunications, public transportation, industry, trade – should constitute the area of private sector investments. The first PIP was designed for 3 years - 1995-1997; the new programme is designed for years 1998-2000. PIP is financed from the own country resources, from external credits and donations. The government has selected 36 investment projects for the Second PIP. Over 60% of the total volume of financing reverts to energetic, transportation and municipal economy services projects that has a purpose the country modernization.

Improvement of investment climate creates the main premises for the positive changes. From this perspective, it is necessary to reduce the political risks and to forecast the changes in political economy, legal protection of ownership rights, facilitation of free circulation of funds, development of land market and of dwelling space, improvement of management on the market of capitals.

The concrete measures for the amelioration of the investment climate from the European experience based critical years are:

- encouraging the commercial banks in providing long-term credits to the real sector (subsidizing the interest rates of the loans, differentiation of shares of allocations into the reserve funds of banks);
- development of the organizations' network specialized in financial investment – bank investments, leasing companies as well as the orientation of the non-banking financial institutions towards investment activity (privatization investment funds, insurance companies, pension funds);

- authentication of the repatriation of capital – funds, that even if considered foreign, may be used as a large financial source in the economy of Moldova;
- facilitation of tender procedures for the individual projects of privatization for money, as well as of procedures for the portfolio investment and procurement of shares of Moldovan business by the foreign investors;
- development of investments insurance system.

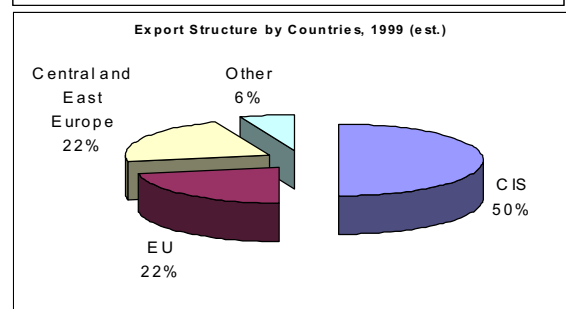
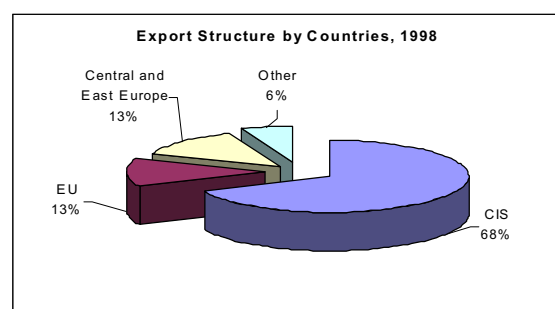
One of the possibilities of improving the investment climate is the development of investment advantages to be better than in neighboring countries. The problem is however that Moldova's neighboring countries – Ukraine (with a total population of 52 millions) and Romania (22 millions) present a much more interest for foreign investors, due to the considerable larger markets and higher domestic demand. It is inefficient to invest in a large project in Moldova, with a small sales market and to export products in the neighboring countries. That is why, it is vitally important to create conditions for investments that would be more attractive than in neighboring countries.

**Liberalization of foreign trade.** The free external trade policy contributes to the economic development. This is relating primarily to the transfer of advanced technology and know-how to the business management. Moldovan producers could adopt the innovations embodied in imported goods. In order to have a healthy competition on the international markets, an Economical policy oriented to export will stimulate the modernization of local firms. On a domestic protected market such incentives practically don't work.

International trade assures to Moldova the access to large markets. This is important because in a small economy, the potentiality of the growth depends on the capacity of enterprises to compete on the large markets, gaining from quantity of production. For small economies it is vitally important to reduce the barriers in foreign trade operations. International experiences show us that in a short-run a tough protectionist policy could have positive results for the country. However, in the long run such a country usually confronts much more difficulties as a result of the decline of competitiveness of its goods. The politics of professionalism has only negative effects for a country as small as Moldova, because Moldova can not be sure that the politics promoted by other countries will be the same, as a consequence Moldovan producers losing more that they would have gained.

The accession of Moldova to various unions and trade organizations, that would reduce the barriers of the reciprocal trade between the countries, is, nevertheless, an important tendency of the external economic policy that would allow the improvement of the situation in the real sector of economy.

The re-created on the post-soviet territory the economic structure of FSU, proved to be less efficient. The shrinking internal market of these regions, the informal obstacles and the level of prices had a destabilized influence on the Moldovan enterprises. Search for new markets lead to the increased rate of non-FSU countries in the turnover of external trade of Moldova – 40%. Actually, we have to note that the FSU countries, first of all Russia, continue to be the main market for the Moldovan products – that is approximately 70%.



The same is notable in other areas. In trade of Moldova with foreign countries it is time to already to move forward from the tactics of survival to the strategy of development. The state shall make some efforts in order to facilitate the access of Moldovan producers on the European markets, to reduce the tariffs and not-tariff barriers. This would be one of the reasons of speeding up the adhesion of Moldova to WTO, the accession that will be followed by the conclusion of the agreements with European Trade Unions (CEFTA, Baltic Union, Agreement of Free trade with European Union). The Liberal economic external policy, based on the reduction of trade barriers of Moldova with European Union countries it is a good possibility to sign the Agreement of association as a member of European Union.

The possibility of concluding the free trade agreement of Moldova with the European Union countries will be discussed by the European commission after the adhesion of Moldova to WTO. The agreement calls for a more liberal trade conditions between the signatory countries in the framework of fulfillment of requirements of WTO.

From the experience of other signatory countries to this agreement, it can be expected the following:

- the free trade will bring significant profits to the real sector if there is the proper economic environment where the firms and people are free to choose the possibility of doing their business;
- reduction of the trade barriers as a component of the free trade agreement that not necessary to be advantageous in the short run for the members. In the long run, the decrease of commercial constraints will contribute to the optimization of the placement of enterprise resources, thus will contribute to the competitiveness of production;
- to make decisions of signing the free trade agreement, first of all we shall draw the attention to the barriers such as bureaucracy, corruption etc. The reduction of these obstacles will lead to the rise of government's income from the real economic sector and practically will compensate for the fall of the imported fee;
- the membership of WTO will be the pretext of signing the free trade agreement with the European Union and will facilitate the countries' participation in the future multilateral commercial negotiations;
- the country will receive social dividends as a consequence of economic development that will be the result of the incoming foreign direct investment and advanced technology. The investment and modernization of business are the key elements of the contemporary free trade agreements;
- the free trade agreement will play an important role in the speed up of the structural reforms in transition period. However, the agreement will not have any positive influence if the internal restructuring process will be inconsistent.

Finally, in the activities of the President, Parliament and Government, the attention to the situation in real sector is intensified. This gives us hopes.

## 7. BUSINESS CLIMATE: FROM AN INVESTOR'S PROSPECTIVE

Although the Moldovan economy has shown signs of recovery throughout 1999, it still remains very fragile. Most of Moldovan companies experienced a severe drop in their business activities, primarily in volume sales. All businesses had to face a shortage of external financing even for the working capital purposes and consequently had to finance their activities through internal, very scarce cash flows.

The year of 1999 has been a period of a very short political stability: two governments have been ousted by the opposition forces. The short ruling of the government led by the reformist Ion Sturza has brought some early positive trends into economy. That was also a period of a dynamic collaboration with international and bilateral investors and donors, characterized by an accelerated pace of privatization.

As a result of increased risk after the regional financial crisis and climbing political instability, the local banking system raised effective interest rates in 1999 and more than ever was cautious in providing credit to businesses. In aggregate, the Total Investment dropped at the beginning of 1999 both in real absolute terms and as percentage of GDP.

The high cost of capital discourages domestic investment. Tight monetary policy is usually cited as a main explanation to this. However, other two "hidden" factors should be brought to the light: 1. The massive borrowing by the public sector, especially in order to support energy providing companies, which drag huge arrears and generate new debts. 2. Inefficient domestic banking system that has high operational costs and applies thus huge spreads.

The banking sector clearly needs to be consolidated.

The whole business investment infrastructure remains week and half way between centrally planned and market oriented and perhaps is the main impediment to the investment both domestic and foreign.

The following key incentives have been provided to business in 1999 to encourage foreign investments:

- Exemption from customs tariffs on goods (including office equipment, machinery, other equipment and raw materials) which represent a contribution to the formation and increase of the statutory capital of an enterprise with foreign capital.
- Exemption from customs tariffs on goods (raw materials, semi-products, etc.) imported by an investor to be used in the production of articles for export.
- Enterprises enjoy a 50% reduction in income tax for five years, with no obligation to sell their hard currency income, provided that the share of foreign capital in the statutory fund exceeds US\$ 250 thousand and that the income received from sale of its own products (goods or services) constitutes 50% of the total income.
- Enterprises are exempt from income tax for three years if the share of foreign capital in the statutory fund exceeds US\$ 1 million.

However, these incentives provided to foreign investors could not compensate for all inherent risks: macroeconomic and political instability, constantly changing regulatory framework. The annual amount of foreign investment in Moldova's economy stood at a very low level of about US\$20 per capita. Foreign investors are complaining about red tape, corruption of

## 7. BUSINESS CLIMATE: FROM AN INVESTOR'S PROSPECTIVE

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Moldovan authorities, especially at lowest operational level. The investors would rather give up this privileged tax treatment in exchange for clear, transparent “rules of the game”.

Another constant subject of complains of all export-import companies are the customs regulations which are frequently changed, rising confusion among the business community and different officials who apply different treatments and are often not familiar with different product codes. Additionally, exporters are faced with complex set of administrative rules designed to regulate the flow of hard currency into and out of Moldova. Under these conditions, corruption is a major problem for foreign investors. Exporters are also obliged to register foreign exchange received from the export of goods with their commercial banks.

The main inefficiencies are created in Moldovan economy by so-called **groups of interest**. These groups of interest, which have been striving to maintain their overall control over the economy and hostile to foreign investment and private ownership in such key sectors as wine-making, energy, transportation, telecommunication, agro-processing, tobacco industry, hotels. In this respect, the peculiar role of privatization investment funds (PIFs) should be mentioned. The PIFs were supposed to become a channel for investment into Moldovan companies, but instead, the vacuum of public and regulatory control over PIFs activities, lack of own resources, lack of financial experience, etc. transformed PIFs in one of main impediments to foreign investment in Moldovan economy. Presently, PIFs try to consolidate their ownership in companies, which is usually associated with fighting out existing management.

The foreign investors realized the importance to organize an institution, a “foreign investors club”.

The Foreign Investors Forum was created at the initiative of Mark Horton, former IMF Resident Representative to Moldova in August 1999. The purpose of this informal meeting is:

- assess the recent economic developments and prospects of the country;
- summarize experience of the well established companies in view of helping the new-comers via sharing information on the major obstacles/business problems;
- organize meetings with local officials;
- discuss ways to attract more foreign investments to Moldova.

As of December 1999, three meetings have taken place which included representatives of International Finance Corporation, Western NIS Enterprise Fund, EBRD, Africa-Israel Fund, Coca-Cola, IPC of Germany, SIIF of France, Voxel, Sudzucker (Germany), Esastampa (Italy)-Piele, Eurofarm (Romania)-Farmaco.

A free access to land is a critical issue for foreign investment especially in an agricultural country like Moldova. Yet, the big foreign investment has mostly remained limited to the capital. International institutions try to facilitate the investment in rural areas by setting different programs, e.g. Rural Finance Corporation, through providing technical assistance. However, the big difference would make the attraction of big, specialized agricultural investors who would come with money, technologies, experienced people.

Unfortunately, the investment climate, after a short uphill in spring-summer 1999, has significantly deteriorated. Moldova is seriously jeopardizing its reputation and runs the risk to pass in the category of “neglected” countries, slipping away from the list of priorities of investors.



## 8. SOCIAL COSTS OF REFORMS

The decade of transition is characterized by profound social and economic degradation. Transformations, which occurred, did not meet people's expectations. To the contrary, they resulted in a dramatic deterioration of living standards, increasing inequality, fragmentation of society and lack of social cohesion. Reform imitation and chronic political instability has undermined the basis of human development, amplifying poverty, unemployment, criminalization of power, and the disruption of the moral and institutional fabric of society. The development of transitional processes poses the following fundamental question: is the reform worth, while such painful social costs, and how much time will people enduring them?

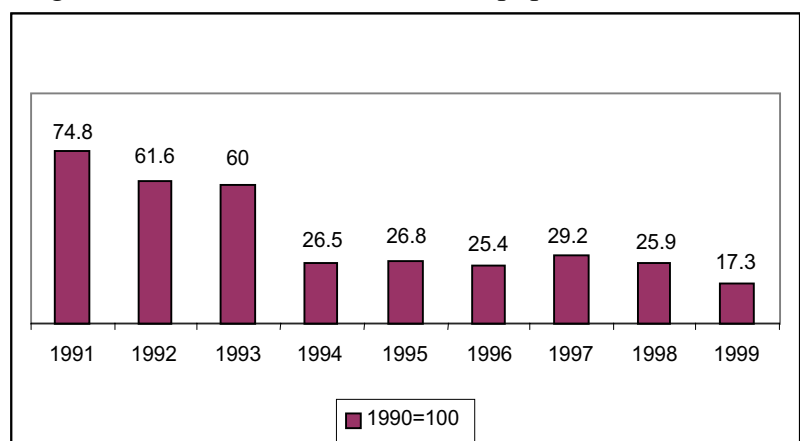
The fall in output, which was accompanied by lack of political will in promoting genuine reforms have implied severe social costs that grew up during this period of time. The number of people living below the subsistence level was about 1.7 million at the end of 1999 or 45% of the total population. Income dispersion reached uncontrollable dimensions: the index of quintile income distribution is 14.7 while in 1991 it did not exceed 7. Unemployment continues to spread at high rates, capturing at the moment about 10% of economically active population. Well-being, health care, and education, which are the components of human development index (HDI), have shown a deep regress throughout the transitional period. As a result, Moldova ceded 30 positions in the UNDP ranking of *human development index* falling down to the 104<sup>th</sup> place in 1998.

The whole population felt the negative impact of social costs but most badly it were the elderly, the disabled, the large families, and other social-vulnerable groups. Thus, the majority of people with low income, who in fact are the most needy of social protection, carry the burden of social costs. Consequently, the vulnerability and social exclusion of people has been growing. This fact is confirmed by the results of an opinion poll carried out in Apr. '99 by CISR and Foundation Soros-Moldova. The findings showed that reform brought benefits only to 5% of the population; while for 70% of them living standards have worsened dramatically.

The social costs of transition have eroded considerably *human security* many indicators of which have approached their respective critical limits. The scope of this process is very broad and it may have adverse consequences in the long run. That is why public awareness of the fact that human security is in big danger has been growing in the country. According to findings of some opinion polls, population considers its top concerns to be the problem of "*human insecurity*", stressing particularly such components as economic security, threats for health care, and personal security. At present the aggregate index of human security in Moldova represents only 1/3 of its "pre-transition" value, being one of the lowest among countries in transition.

High inflation and substantial declines in output, which occurred at the initial phase of reform, having being accompanied further by tax evasion and corruption, caused a significant deterioration of real incomes of the population. Throughout the decade in transition the synergic effect in devaluation of liquid assets was minus 83%. At the end of 1999 the real value of personal income has only 17% of that

Figure 8.1. The fall in real income of population



Source: CISR/author calculations

## 8. SOCIAL COSTS OF REFORMS

registered in 1990. It should be noted that the depreciation of real income took place at rates higher than the decline in output. This fact spurred the spreading of poverty.

Distributional asymmetries caused by wage imperfection provoked an income inequality never known before. Growing *disparity in real incomes and social differentiation* is due mainly to the following processes:

- liberalization of wage structure as a consequence of removing the bureaucratic impediments in wage policy and increasing the role of non-traditional sources of income;
- reduction and partial cancellation of state subsidization of public goods and services;
- private sector development and improvement of labor market flexibility;
- privatization and formation of financial intermediaries.

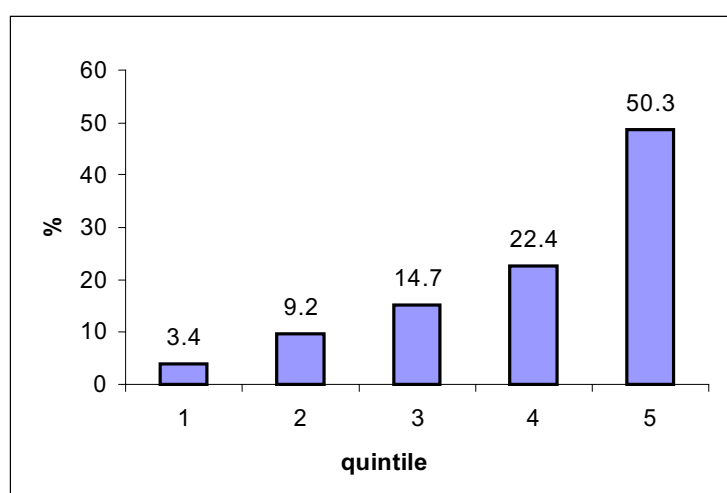
Income inequality of “*the new rich*” and “*the new poor*” is getting wider. Comparable with the 1990 Gini coefficient, which shows the degree of uneven distribution of disposable income, grew 1.7 times reaching in 1999 the level of 44.1. This is one of the highest rates of social stratification that have been recorded by now among countries in transition.

It is symptomatic that due to “distributional metamorphose” mainly the socially vulnerable groups of population have suffered, like the families with dependent children, the elderly, the unemployed, and the disabled who usually are placed in the lowest quintile and who are the poorest.

For instance, when national currency, the Moldovan leu, was introduced in November '93, the first quintile had the personal income accounting for 4.9% of total disposable income of the population, while the fifth quintile held 44.8% of it. Today the correlation between the poorest and richest groups is 3.4% and 50.3% respectively. Thus, the rich become richer and the poor become more marginalized. People with the medium level of income who constitute the main part of society hold only 46.3% of total disposable income. This is conclusive evidence that the middle class in Moldova is too fragile and cannot serve as a shock absorber to social costs of reform.

Fall in the purchasing power of population has led to a significant decline in individual consumption that obviously spurred malnutrition. From a society with profound deficit in the commodity market as was the case of Moldova at the outset of reform, now this country became a society with limited consumption. The decline occurred to all *components of consumption* (services, food stuff, and industrial goods), but sharper it was to the basic food products, like meat-minus 57%, milk-minus 49%, and fish-minus 84%. Consumption deterioration has approached dangerously to the critical limits, threatening normal human development. According to CISR findings based on household budget survey data, today less than 10% of population (mainly the richest layers of the society) are able to keep the level of consumption similar to that registered in 1990. Meanwhile almost 10% of population consume less than 1500 kcal per day that according to FAO represents the critical threshold of

Figure 8.2. Income inequality in 1999



Source: CISR/author calculations

malnutrition. The average consumption level in Moldova was 1980 calories comparable to the threshold of 2500 calories established by FAO. It should be noted that malnutrition affects today not only social groups with low level of income but also those with medium income who are employed in the public sector (mainly teachers, social workers, and nurseries) due to incidence of delays in paying salaries.

Malnutrition has affected directly *demographic indicators and the status of public health*. The exponent of life quality, life expectancy, continues to worsen substantially.

Comparable to 1991 life expectancy has shrunk by

9% being at the present

70.7 years for women

and 63.2 years for men.

The incidence of chronic and infections deceases is growing up. Now

Moldova is on the eve of explosion of epidemics of VIC and tuberculoses. A precarious situation is reported with the health

care of children. Due to

a serious insufficiency in breeding and a poor

nutrition value of food

(which covers only 40%

of the required daily

minimum of the energy

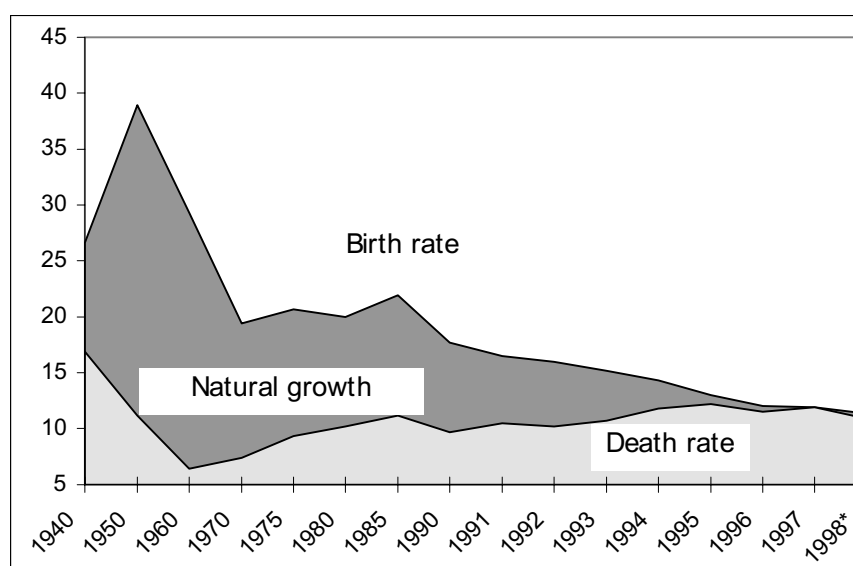
value) the number of

pathologies is growing up significantly. To date almost each fifth child suffers from some serious physical or mental dysfunctions.

Having not got sufficient financial resources to cover the cost of medical treatment the main part of population is imposed to abandon costly medical services, which are provided by the specialized medical institutions. Instead of them the poor have to treat themselves at home taking traditionally popular medicines. As a result, about 60% out of the total number of deaths and 30% of children deceases are registered at home. This fact led to the situation when the death rate stands at high level-11.1 per 1000 inhabitants being 3 folds higher than European median. Quite alarming is the trend of rising death rate among active population. Compared to 1993 death toll soared 1.1 folds capturing at present 41.6% of the total number of deceases.

One of the most important factors of human development crisis in Moldova is the lack of financial resources that are allocated for social needs. Though the share of social expenditure is pretty high, 22% of GDP, (that is comparable even with the level of some western countries), keeping unchangeable the nature of social security net has undermined the viability of social finances depriving it for a sustainable support. Additionally to that, misusing of funds, which has being accompanied by a low rate collection of social contributions, has expanded the disparity between financial possibilities and social commitments. If in 1990 the scope of this phenomenon was 15%, when in 1998 the lack of finance amounted for 44%. This is a signal that the viability of social finance is on the verge of crisis.

Figure 8.3. Demographic Trends



Source: findings of HCC under the MH

## 8. SOCIAL COSTS OF REFORMS

Despite robust attempts to make some changes social security net is not efficient and equitable yet. The implicit nature of social facilities has made them more dispersed. More frequently social groups with high and medium level of income get these benefits. According to a study, which was done by the World Bank in the first semester of 1999, close to 1/3 of the total social assistance benefits went to the welfare people. In general, the current system of social protection is extremely inefficient and costly for the whole economy. Overlapping and unclear eligibility criteria led to a significant increase of social facilities. Moldova like other states of NIS has a large spectrum of social facilities for certain layers of population considered “worthy” of social support, but in fact they are not the needy. Overall there are almost 1.3 million who got some sorts of social assistance facilities. In spite of energetic actions, which were undertaken towards reducing the number of social privileges, this bulk still remain to be significantly large. By the middle of 1999 they accounted for 8% of GDP.

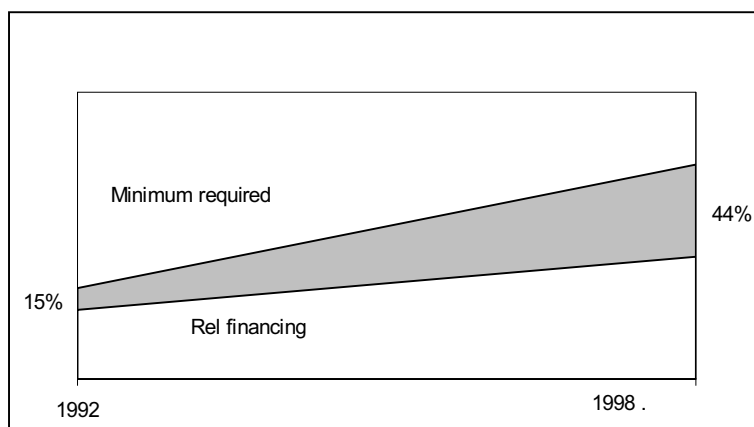
Government failure to fulfill social commitments has caused an explosive growth of *arrears*. It became a norm

delays in paying wages, pensions, social indemnities. Social arrears to public servants, pensioners, and suppliers of energy resources has registered a constant increase since the mid of 90's, reaching at the end of 1999 almost 13% of GDP. During the last five years the situation worsened because of the combination of planning overestimated revenues, the lack of reserves for unexpected shocks, and the lack of monitoring public expenditures. The synergic effect of these factors has shaped the situation of “planned arrears”.

Although during the decade of transition some attempts to change the existing social security net were undertaken, in fact it remains unreformed, keeping its pre-transitional nature. Misallocations of funds, implicit subsidy of social benefits, and the operational rigidity of social institutions attest that social protection is disintegrated and insolvent. Unfair privatization of medical and education services has undermined the assets of social sphere, limiting the access to these kinds of services only to a small number of welfare people who can afford themselves such a luxury.

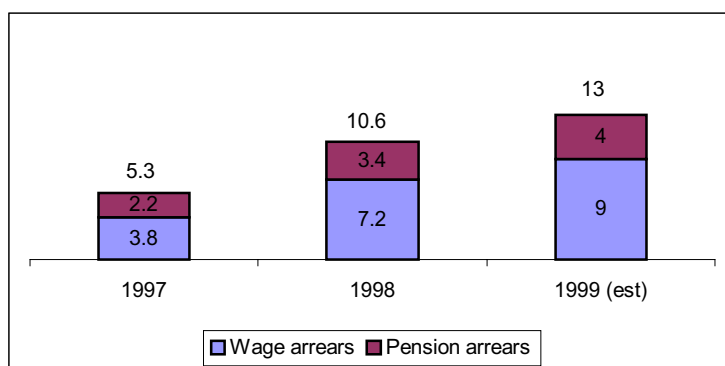
Family allocations and indemnities are provided implicitly and in a manner almost similar to that of universal social benefits. Cross-subsidization of thermal and energy tariffs was the

Figure 8.4. Disparity in social finance



Source: CISR/author calculations

Figure 8.5. Social arrears, as % of GDP



Source: CISR/authors calculations

most vulnerable point in the social security system. These subsidies absorb almost 20% of the public budget revenue and are convenient only to providers (distributors) of energy resources. Cancellation of subsidization may be hindered by serious institutional impediments, which makes this rather a political issue than social.

The administrative capability of the social institutions is too weak and this fact might be a serious impediment to performing social protection reform. Besides that the lack of public information regarding the aim and scope of social reform led to strengthening the position of opponents and intensifies the hesitance in promoting reform.

The cumulative effect of profound deterioration of living standards has been materialized in the *massive pauperization* of population. The incidence of this phenomenon became more frequent covering new social strata. According to some estimations completed by the UNDP-Moldova today more than 80% of the population have the daily income less than two dollars. Regardless the fact that there is no an official estimation of poverty threshold so far, as a preliminarily benchmarking of poverty might be used the estimations provided by the household budget surveys. According to that in 1997 circa 35% of population was living below the absolute poverty line of 82.1 lei monthly income per person. The 1998 regional crisis, which contributed significantly to the output decline, has intensified poverty escalation. Using the same poverty line yet at the beginning of 1999 almost 46% of the population was poor. Therefore we can conclude that poverty is growing at high rates that might undermine seriously the effectiveness and viability of social policies.

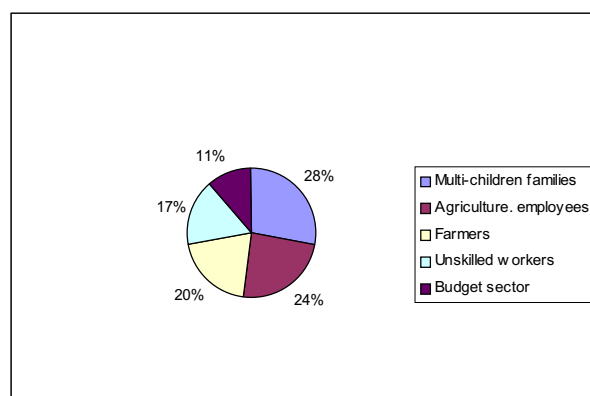
The situation is becoming more difficult due the fact that poverty, which was considered at the beginning of reforms to be temporary and short lasting, now seems to change into a long run phenomenon, capable to accompany the reality of Moldova for many years. The arguments for this statement might be the following reasons:

- fragile and unsustainable income basis;
- high extent of vulnerability of Moldova's economy of its external environment;
- significant decline in employed labor force ;
- insignificant capability of economic units to absorb the excessive labor force;
- insolvability of current social security net.

From the perspective of macroeconomic policy, poverty in Moldova is a labor market phenomena spurred by the limited opportunities to find a paid job. The incidence of poverty among employed people, particularly those in agrarian sectors, demonstrates the imperfection of wage and employment policies. Preliminary estimations reveal that some 7% of GDP are needed to reallocate for poverty eradication programs. This task is hardly achievable in condition of a profound economic recession.

At present poverty profile is much diversified and more complex than at outset of the transition. Apart from families with many dependent children, the elderly, and disabled who usually lived below poverty line, now this social illness has penetrated into employed groups in agro sector, the unemployed, and even low quality workers from budget sector. For all these social groups poverty line is much higher than the average poverty threshold of 45%. It is worth mentioning that the presence of children is close related to the probability to be affected by the poverty. This happens due to "dependency burden", i.e. the necessity to support on the modest sources of personal income several other members of household who do not gain money for life yet. As a result the process of emerging

Figure 8.6. Profile of the „new poor”



Source: Opinion pools and HDS'98

“poverty pockets” is intensifying and this could amplify social segregation and marginalization of population.

Situation is getting worse due to the fact when main part of the society barely manage to survive and cannot allow even the minimum living standards they had previously, in the actions of “new rich” an irrational consumption behavior takes place, which manifests itself in an arrogant exhibition of their welfare. This phenomenon (taking into account dubiously sources of income) cannot to no provoke disgust and protest of grass roots.

Thus when the mass pauperization has a large scope, and the main part of the society is located at the limit of biological subsistence, the fight for physiological surviving becomes the main challenge. Because the official employment is no longer a secure source of income and the chance to find a suitable job is less significant, untraditionally ways are used to secure the income. Among them are follows:

- small street trade (vending),
- leasing out dwelling houses,
- providing services by using personal cars,
- unofficial labor migration,
- trading with agricultural products.

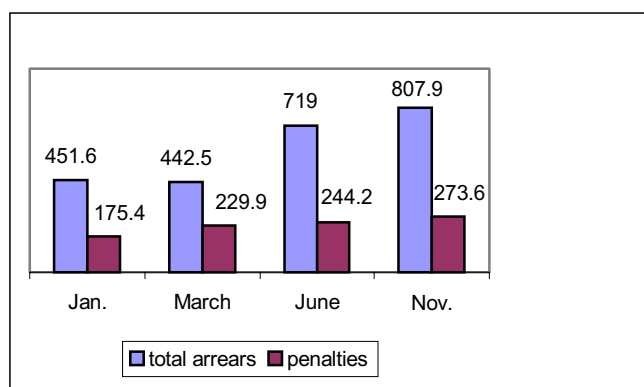
In a situation when state possibilities to meet people’s social needs are limited, *self-employment and entrepreneurship* are emerging as new factors in ensuring the human security, and as an approach of “self-protection” in this turbulent time. Property reform and private initiative have modified the structure of employment in Moldova: during the period 1995-1998 the share of employees in the public sector has shrunk from 34% to 26%. At the same time private sector’s employees increased from 60% to 66%, and for joint venture companies from 6.4% to 8% respectively.

The retrospective analysis shows that one of the most popular methods to gain means for life has become self-employment. During the past 5-7 years in Moldova a new social category has emerged which has been creating independently its labor sector and its new jobs. These are small enterprises that provide services and commodities, selfemployment in the social sphere (healthcare, education, culture), but mostly popular approach is the individual unorganized trade.

The data of opinion poll and analysis of household budget survey show that in the country almost 40% (but in the rural areas more than 60%) of individual income come from self employment, individual labor activities, and other unrecorded jobs. In many cases this is informal shadow economy.

*Small business* required insignificant resources from centralized public funds and is reported to be the *sector of physiological surviving* for those who were fired, demobilized from army, youth without professional training, the elderly. It is the sector of confirmation the professional abilities and practically is the only stable chance for welfare recovery. Entrepreneurs are less dependent on state finances and in this sense they might contribute significantly to job creation and to reducing unemployment. In transition period small business is aimed at ensuring conditions to vulnerable social groups of surviving mainly through self-employment and informal activities.

Figure 8.7. Accounts receivable of the Social Fund, 1999



Sources: CISR/author calculations



Despite the fact that the dimensions of small business and entrepreneurship are getting larger, this kind of activity is facing with a lot of economic, legal, financial, and administrative impediments like heavy fiscal burden, limited access to the foreign markets, long and controversial setting up procedures, bureaucracy, and corruption.

Like in other NIS countries *labor migration* has become the most rapid and often the riskier way of gaining means for life. Being unable to find opportunities to be hired in Moldova the most skilled and experienced people are going abroad looking for a temporary job. For many of them this is the only sources of income. The incidence of this phenomenon is becoming more frequent in nowadays getting significant dimensions. According to some estimations the scope of unofficial labor migration accounts for 250-300 thou persons annually. Only in Moscow and its skirts there are above 40 thou people from Moldova.

But the official number of labor migration is much smaller. In 1998 only 12.5 thou persons were registered as working abroad. Mostly of them, about 5 thou were employed in Russia, in Czech Republic-2 thou, Ukraine-500 persons. The contingent of those working abroad is quite varied, but predominantly are specialties of constructors, waiters, housekeepers, and drivers. Is not exception when physicians, PC, and researchers are demanded on the external labor market. In general circa 2/3 out of those who leave abroad for a job are people with high and medium professional education. The geography of labor migration is very various and includes Russia, Ukraine, Belarus, Hungary, Romania, Greece, Turkey and other states.

If labor migration does has an official and legal basis it can bring some benefits (familiarization with new technologies and labor approaches, advanced study of foreign languages, increase of hard currency inflow in Moldova). But in the case of Moldova those who are going abroad looking for a work are doing this without any legal support. Usually people are leaving using tourist visa and then employ themselves in the "black" labor market. This fact has adverse impact exposing people at diverse risks, and not ensuring any state social protection. Obviously it is necessary to lead labor migration into legal framework, formalizing it within interstates agreements. This process has already been started. Moldova has signed intergovernmental agreements on labor migration with many NIS countries. But this kind of activity should continue with regard to those state from Central and Eastern Europe where labor migration flows are more significant.

In the line of social events of transition period the 1999-year is marked as a year of contrasts. A mix of controversial results characterizes the situation registered at the end of 1999. On the one hand some tendencies of fragile macroeconomic stabilization has occurred, on the other hand living standards worsened. Performances achieved did not materialized in tangible benefits for the grass roots. For both government and population it became clear that the social burden accumulated throughout the decade in transition is too heavy to be eradicated in a short run period. "Big bang" in revitalizing economy did not happen.

The aggregate indicator of quality of life –people's real income – has fall deeply. According to some preliminary estimations in the current year '99 the real disposable income will be by 25% less than in the previous year. This phenomenon is caused mainly by the devaluation of income sources, and firstly of salaries (wages) and pensions. Statistical data show that the average wage in economy covers only 46% of the minimum consumption budget; while in 1998 its share was 53%. Low value of income sources and the uncertainty of paying them out attests the fact that income insecurity continues to aggravate.

Despite the fact that tax collection to the Social Fund has improved slightly during the '99 year their nominal value remain to be far behind the real necessities. For instance, to pay in time current pensions some 3 million lei are needed daily. Effectively the rates of daily collections do not exceed 2 million lei. The main reason of low fiscal discipline is the financial insolvency of economic agents to honor their duties to the Social Fund. Thus the overall stock receivable debts to the Social Fund accounted on 1<sup>st</sup> October '99 the sum of 770.7 million lei has

## 8. SOCIAL COSTS OF REFORMS

been increasing since the beginning of the year by 70.7%. It worth mentioning that 1/3 of them is penalties, which in fact are “dead money” due to low probability of collecting them.

In order to facilitate the partial pay off of pension debts the Government issued in July '99 a decision according to that farmers and other economic units from the agrarian sector were allowed to deliver sunflower, wheat, maize, oats, and sugar on the accounts of debts to the Social Fund. Today we can affirm that this intention is carried out so far unsuccessfully. Statistical data attest that economic agents are reluctant to this idea. By now in accordance to aforementioned governmental decision were delivered only 39 thou tons of wheat from the new harvest out of 104 thou tons envisaged. Also there were provided circa 3 thou tons of oats of those 8.7 thou tons planned and only 1.6 thou tons of sunflower from 22 thou envisaged. The quantities of sunflower and maize are even less: from 109.5 thou tons of maize were delivered only 863 tone, that accounts for 0.8%, and of 20 thou tons sugar Social fund received 7.6 tons or 0.004 %.

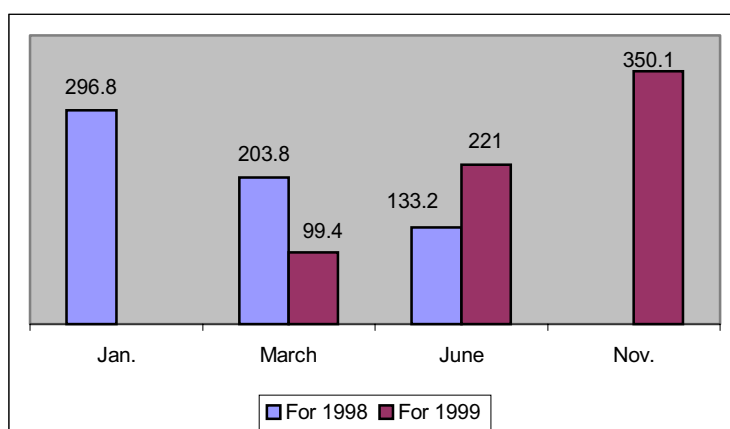
Pensions arrears, which continues to be at high level-8.4% of GDP- emerged as a derivate of unsustainable financial basis of Social Fund. It should be mentioned that throughout 1999 there were undertaken measures to reduce from the discrepancy of pension debts. It was combined pay off of debts in cash, in-kind, and on account of tariffs for the communal services. As a result the overall stock of outstanding pension debts decreased by 244.4 million lei. But the beneficial effect of these intensions was undermined by the significant increase in current debts. During the 1999 they soared 5.7 times. Thus the viability of social finance is too shaky leading to an unsustainable support.

A similar situation was reported and with regard to wage arrears. Even the overall stock of debts has shrunk by 12% during 1999 their value still remain to be impressive-14% of GDP that is much higher than in the previous '98 year. Wages debts to the budgetary institutions have risen 1.33 times comparable to the same period of 1998.

The analysis of processes, which engendered in the decade of transition and in 1999 have confirmed one more time the common rule: procrastination of social reforms and its politicization lead to a significant deterioration of living standards and to a profound human insecurity. Having being constrained by fiscal imbalances and by the excessive income stratification of the population, the decision makers gave preference to traditional scenarios that are less risky. In line with that one can remark that so far it has been putting into place the formula of piecemeal and partial changes, i.e. *quasi reform*, which is proved by practical evidences as one of the most painful and costly for the society.

Besides that social reform procrastination was influenced in main part by the environment they are implementing. High degrees of reform politization and populism, in concert with governmental frequent changes have eroded considerably the political will of decision makers in promoting deep and genuine social reform. As a result the conceptual framework of reform suffers from a unilateral approach (predominantly financial) without any coherency and consecutively. What happened in the social sphere during ten years of transition might be qualified as

Figure 8.8. Pension arrears for 1999, million lei



Source: CISR/author calculations



a mixture of palliative and fragmented measures, implemented sporadically and in an ad-hock manner.

It is clear that human security improvement depends on the efficiency of social security net. The mission of social protection must fit the new reality that shaped after ten years of transition and changes conceived should be promoted in accordance with the following three criteria: economic efficiency, social equity, and political feasibility.

The retrospective of transition decade shows that *social nihilism combined with the weaknesses of the governance* had adverse impact on social programs undermining seriously living standards. Economic reform does not limit itself only to reducing budget deficit, maintaining stable national currency, or making structural adjustments. Economic reform implies first of all the extension of opportunities for people to build up a decent living standard. An equitable and sustainable economic growth cannot be associated with poverty and human insecurity. Reform, which imposes high social costs to the population, would be deprived of social cohesion support and its outputs would be fragile.

Neglecting social and human component of reform has led to a significant drop of living standards. Poverty and income inequality endangered human security. Obviously, it is necessary a holistical approach in promoting economic reform, which will ensure a balance between macroeconomic and human aspects. Good economic policy should take into account social implications and to avoid mass pauperization.

In the context of unfavorable trends of transition period a predominantly attention on human development issue is required. Human being and its basic needs should be placed in the center of policy makers' attention, and to be considered as a major objective of economic reform. In this sense the agenda of social policy is demanded to ensure a more efficient and equitable provision of social services. The vector of further activities might be directed to the reduction of social costs of economic reform and not allowing living standards to drop below the level of human security.

Taking into consideration the scope of absolute poverty that covered more than 2/3 of the population, a priority attention should be given to the eradication of this social illness. Poverty reduction and social protection of most vulnerable groups of population might be the main concern of decision makers for short run period. Policies in this sense could combine two elements: active and passive measures. In the first case the accent will be placed on promoting the economic opportunities to the poor through job creation and diversifying social infrastructure. This could expend the possibilities of using more productively the only asset the poor have in abundance-their cheap labor force. In the second case a significant progress could be achieved by using more efficiently the social security net. Providing basic social services (access to elementary education, primary health care, and targeted indemnities and compensations) should lessen to some extent the burden of social costs on vulnerable groups. For the passive policy and especially for the social aid (cash or in kind) it is important to provide them on a means-testing basis improving the address ability of social benefits.

Simultaneously with measures of poverty eradication it is necessary to intensify actions of reforming social sphere, and firstly to relock pension program reform, and reform of education and health care system. The efforts should be centered on the rationalization of social expenditure, improving administrative capabilities of social institutions, and adjusting the portfolio of social services. This will allow to cushion to some extent social stress and to restore public confidence in reform.

## 9. LABOR DEVELOPMENTS IN MOLDOVA: ADJUSTMENT THROUGH PRICES OR THROUGH QUANTITIES?

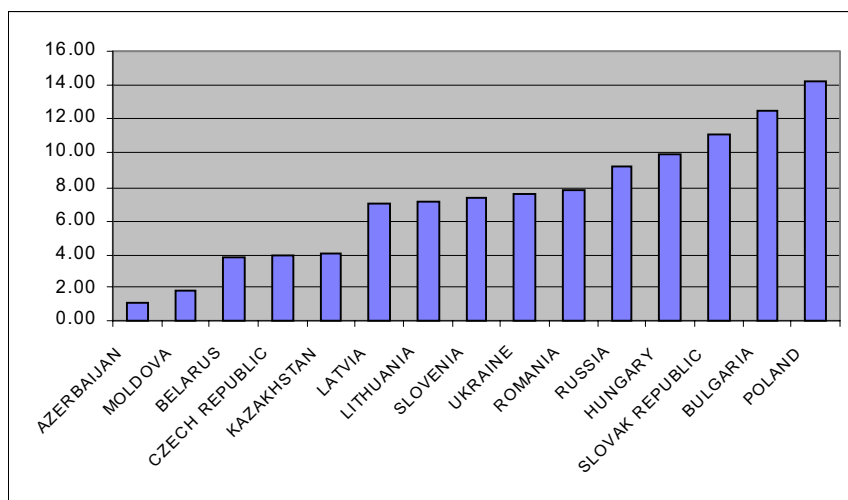
Moldova has seen one of the most drastic output decline in the former Soviet Union. Real GDP decline amounted to about 70% since independence, according to IMF estimates (IMF Staff Country Report, 99/110). The falling output, and hence falling demand for labor in the new market environment should have been reflected in the employment reductions (adjustment through quantities) or/and wages cuts (adjustment through prices). Such adjustments were especially needed as a result of earlier strategy of labor hoarding under the central planning regime. It has been widely argued that Moldovan enterprises failed to undertake the task of adjustment. In place of cost-reduction and restructuring, enterprises adopted the strategy of state aid seeking. This paper claims, however, that some adjustment does occur on the labor side. It takes forms of hindered unemployment and under-employment, and wage arrears.

In fact, established data sources (referred to as “Official” below) significantly underestimate occurred adjustments. In the paper official statistics has been accomplished with the results of Household Budget Survey (referred to as “Survey”)<sup>20</sup> to get more precise estimates of effective employment<sup>21</sup>. Wage data was adjusted for the stock of arrears.

### *Quantities adjustment. Effective level of employment*

First look at data suggest that labor reduction has been done on a very small scale. Employment has shrunk only about 10% since 1991<sup>22</sup>. Moldova’s registered unemployment rate of 2% ranks among the lowest in the FSU, Central and Eastern Europe countries (Figure 9.1). Similarly Moldova’s labor force participation rate, estimated at 79.8% ranks among the highest out of a similar set of countries<sup>23</sup>.

Figure 9.1. Registered Unemployment Rate in the FSU and CEE countries (%), 1996.



Source: International Financial Statistics Data base.

<sup>20</sup> Moldovan Household Budget Survey has been started in April 1997, with the pilot study done in February, 1997. Apart from data on households’ budgets, it gives representative information on employment and unemployment. The number of adult respondents (aged 16 and over) exceeds 3600.

<sup>21</sup> Similar analysis was carried by (Lindauer, (1998)). At that time only results of the pilot study of the Household Budget Survey were available. This report is based on annual 1998 data, which is more robust and allows to account for seasonality.

<sup>22</sup> Data on GDP and employment here and below in the article excludes Transnistria region.

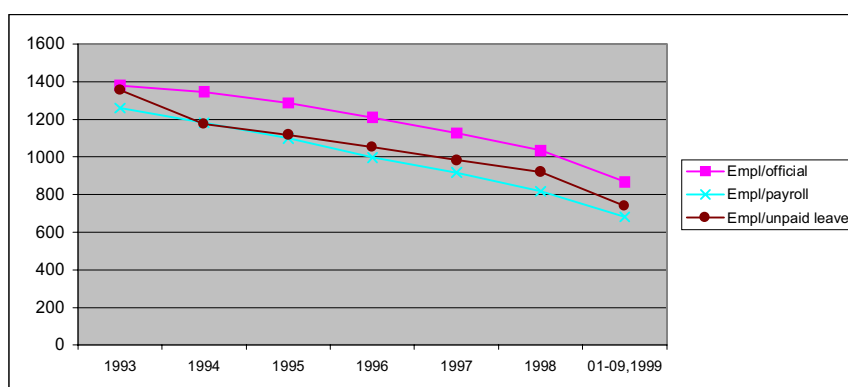
<sup>23</sup> OECD-CCET Labour Market Database, (Lindauer, 1998) and (Alisson and Ringold, 1996).

However, a closer look at data gives different conclusion. Actual level of employment and labor participation is much lower, with open unemployment rates appear well-above single digits.

The total number of employed in the economy in 1998 amounted to 61% of the adult population<sup>24</sup>, according to official statistics. The Survey data suggests that the number of employed ('those who had job during last seven days') in 1998 was 48%. Thus, the effective employment in 1998 was 13% of the adult population (or 347 thousand people) lower, making **employment reduction of 29% at least since 1991**.

Other information on employment available from official sources only covers enterprises with 20 or more number of employees. Thus, it does not reflect the employment situation in the whole economy, but gives some insights about who is effectively employed.

Figure 9.2. Employment Official, on Payroll and Adjusted for Unpaid Leaves (1995-01.09.1999, Thousand).



Source: Department of Statistics, own calculations.

Unpaid leaves (though statutory forbidden) are very common in Moldova (Figure 9.2). Though since 1995 the number of unpaid leave shows a declining trend, in 1998 it still amounts to 11% of the employment (at enterprises of 20 or more employees) or 120 thousand employees. This is similar to Russia, where unpaid leaves amounted to 11.5% in 1998 (Denisova (1998)). Employees prefer to be nominally affiliated with an enterprise, even it seizes its operations and they get no salaries because of benefits (housing, medical, etc) they might continue to receive. Employers also favor labor hoarding as to avoid social costs associated with firing together with financial costs of paying severance payments plus accumulated wage arrears. Labor hoarding also helps employers in aid-seeking bargaining. This tradition, in fact, goes back to the times of planned economy. Thus, those on unpaid leaves are effectively unemployed.

Payroll employment figures are smaller, as they include unpaid leaves, maternity and sick leaves. However, the gap between payroll employment and employment adjusted for unpaid leaves has been increasing since 1996 (See Figure 9.2). Given rather stable and small number of maternity and sick leaves, this could possible suggest that payroll figures are the more exact reflection of the effective number of unpaid leaves<sup>25</sup>.

In general, employment shows a declining trend. Since 1993 payroll employment shrank some 46%. This, however, indicates not only adjustment phenomenon *i.e.* employment reduction in response to negative external shocks, but also restructuring processes in the economy. The number of employed at medium- and large-scale enterprises shrank due to the relative growth of small-scale enterprises. Since 1996, the number of peasant farms, which represent the majority of small-scale enterprises has seen almost four-fold increase in the framework of the Land

<sup>24</sup> Here and below adult population include ages 16 and over.

<sup>25</sup> Inadequate methodology does not allow to determine the number on unpaid leaves at a given moment of time. Data is cumulative, those on unpaid leaves are registered throughout the year.

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programme<sup>26</sup>. In 1999 only 5062 enterprises were covered by the Official data compared to 7474 at the end of 1993. Thus, roughly 1/3 of the employment decrease can be attributed to the reduction in enterprises' coverage, while 2/3 or some **30% reflect adjustment processes**.

### *How much unemployment is there in Moldova?*

Official and survey data offer similar estimates of registered unemployment, roughly 1% of the adult population in 1998. Such a small number is explained by the fact that costs of being registered as unemployed outweigh the benefits. Unemployment compensations are small, difficult to obtain and are paid with a lag. As a result, only one out of four officially registered unemployed gets the benefit, which on average was equal to 80 lei in 1998 (US\$US 15). Adding workers on unpaid leaves, or 112 thousand on average in 1998, raises unemployment based on official data to 6% of the adult population for an unemployment rate estimated at 9%.

Survey results are more comprehensive in revealing the effective unemployed. In 1998 on average 280 thousand workers declared themselves without a job during last seven days. This is almost twice the level of unpaid leaves and registered unemployment. Adding up three categories of workers (those on leaves<sup>27</sup>, seeking for a job, and at enterprises which did not operate, Table 9.1) pushes unemployment to 10.5% of adult population, and unemployment rate to 17.9%.

Table 9.1. The Unemployed Out of the Adult Population by Job Status and by Area, in Percentage, 1998, 1Q and 2Q of 1999.

	%, Annual, 1998			%, 1Q, 1999			%, 2Q, 1999		
	Urban	rural	Total	urban	rural	total	urban	rural	total
On leave	3.3	3.9	3.7	2.4	4.3	3.5	2.4	2.8	2.6
Enterprise did not operate	1.8	3.3	2.8	2.3	7.1	5.2	1.2	1.6	1.4
Seek a job	7.9	1.4	4	7.3	1.4	3.7	5.8	1	2.8
Total	13.0	8.6	10.5	12	12.8	12.4	9.4	5.4	6.8

Source: Household Budget Survey.

The latest estimate is likely to be biased upwards, as it includes unemployed not actively engaged in seeking a job. However, calculating conventional unemployment rate (where unemployment is defined as working zero hours, wanting to work and seeking it) gives misleading results, as relatively small fraction of those considered as unemployed answered in the affirmative. As it is explained in Lindauer (1998), this is probably because the notion "looking for work" remains ill-defined in the society accustomed to state provisions of employment. Data on urban vs. rural unemployed who are looking for a job may suggest another explanation. Unemployed do not report they are seeking a job simply due to lack of any job opportunities, as it is the case in rural areas. In fact, in 1998 7.9% of urban adult population were seeking a job, while for rural it was only 1.4%. Thus, we argue that urban data can be a good approximation for estimates of conventional unemployment rate. Under this assumption, unemployment figure goes down to 7.9% of adult population, and the unemployment rate is equal to 14.1%.

**The open unemployment rate of 14.1%** is comparable to adjusted for seasonality unemployment estimates in (Lindauer, 1998). When placed in a regional context (Table 9.2), Moldova is situated at the upper end of open unemployment rates in Central and Eastern Europe which goes in line with the pace and the character of Moldova's transition experience relative to other countries.

Table 9.2. Open Unemployment Rates, Central and Eastern Europe, 1995.

<sup>26</sup> MET, Quarterly issue, August, 1999, p.53.

<sup>27</sup> Those are likely unpaid leaves.

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COUNTRY	Open Unempl. Rate, %
BULGARIA <sup>a</sup>	20.0
MOLDOVA <sup>b</sup>	14.1
POLAND	14.0
SLOVAKIA <sup>a</sup>	13.4
HUNGARY	9.4
SLOVENIA <sup>c</sup>	9.4
ROMANIA	8.0
CZECH REPUBLIC	3.5

a. 1994

b. Seasonally Adjusted.

c. 1993

Sources: Moldova, author's calculation. Other countries are all based on labor force surveys as reported in Lindauer (1998), Allison and Ringfold (1996).

Annual data suggests that unemployment is higher in urban areas, 13% of the adult population versus 8.6% in rural areas. It may be somewhat misleading, as annual rural data does not reflect peaks of unemployment due to seasonal factors. First quarter (which is a still season for agriculture) of 1999 has seen unemployment of 12.8% of rural adult population, while in the second quarter it was 5.4% (Table 1). In fact, unemployed agricultural workers reported in the first quarter that in most cases their enterprises were not operating, or they were sent on leaves.

### *Under-Employment*

Along with open unemployment, under-employment is another indicator of labor utilization. Hours worked are usually used to measure the extent of under-employment. According to Household Budget Survey, in 1998 almost 10% of the employed worked less than 20 hours last week and about 30% worked from 20 to 40 hours (Table 9.3). That is on average 40% of employees were not on full-time employment. Such a high level of under-employment in Moldova is driven in the first hand by the situation in rural areas. There 47.5% of employed reported to work fewer than 40 hours a week, although in the cities it is also high – 28% correspondingly.

Table 9.3. Under-Employment. Weekly Hours Worked, Total, Urban and Rural, 1998.

Hours Worked	Total		Urban		Rural	
	Nr.	%	Nr.	%	Nr.	%
< 20	609	8.7	140	5.0	469	11.2
20-29	932	13.2	232	8.1	700	16.7
30-39	1245	17.7	425	14.9	820	19.6
40-49	3176	45.1	1438	50.5	1738	41.5
>50	1077	15.3	612	21.5	465	11
Total	7039	100	2847	100	4192	100

Source: Household Budget Survey.

Observed under-employment is to a great extent involuntary, especially in rural areas. Widespread low-working hours coupled with double digit unemployment rate reflect lack of employment opportunities in Moldova resulted from poor performance of Moldavian economy.

### *Participation Rate*

Employment reduction occur either through increasing number of unemployed or those out of the labor force. Apart workers who are joining the latter group due to age, health and family reasons, there are also those who have given up trying to find work. Relative size of the labor force (*i.e.* employed and un/under-employed workers) and the remaining population of working age is measured by participation rate.

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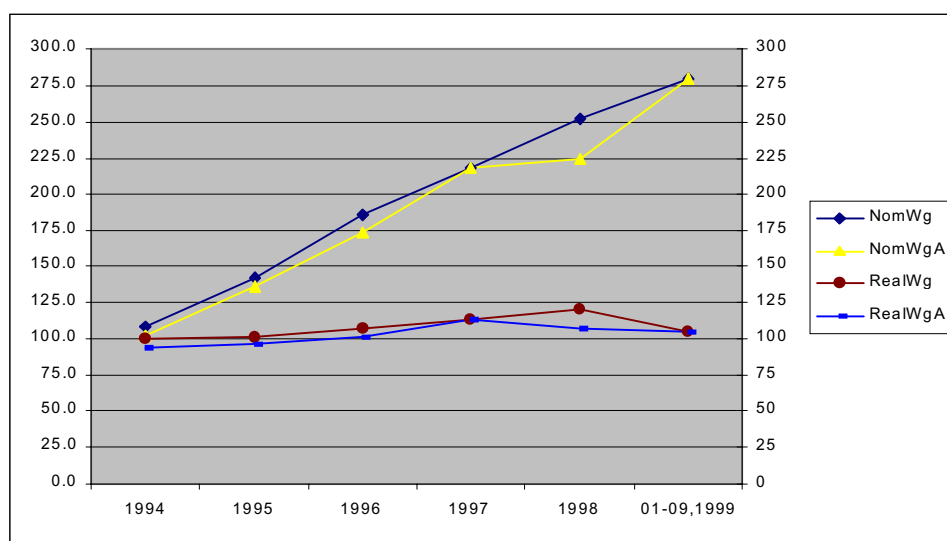
Moldova has high participation rate of 79.8% compared to other OECD economies. However, this rather reflects relatively small number of working population in the country due to low official retirement age coupled with distribution of population skewed to old ages<sup>28</sup>. Participation rate indicator measured as a percentage of the adult population is more comprehensive. According to official figures, in 1998 36.5% of adult population was out of the labor force, survey estimate it even higher - at 44.1%. For both men and women the dominant explanation why they are out of the labor force is age.

Thus, effective participation rate in Moldova is not high due to low participation of older workers. It results in a heavy burden on those who are employed<sup>29</sup>.

### *Prices Adjustment*

Since 1994 nominal wages in Moldova has seen 2.5 times increase. In real terms, however only slightly positive trend has been observed until 1998, which was upset by inflation in 1999 (Figure 9.3). Thus, real wages by the end of nine month of 1999 were only some 4% higher than in 1994.

Figure 9.3. Average Wages: Nominal, Nominal Adjusted for Arrears, Real and Real Adjusted for Arrears, 1994-01.09.1999.



If adjusted for widespread arrears, those developments look even poorer (See Figure 9.3). The harm of wage arrears is obvious. Though forbidden statutory, the state and enterprises borrow from their employees without their direct consent. This directly leads to worsening population welfare, contrary to the essential role of market reforms.

Official statistics is likely to understate actual wage levels. Under-reporting is common due to tax reasons, small-scale firms and self-employment with higher pay levels are not covered by official surveys. In any case, there is no indication that adjustment has been done through prices.

### *Conclusion:*

Moldova has experienced some adjustment through quantities. It took forms of widespread unpaid leaves, under-employment coupled with double-digit open unemployment rate. Employment has shrunk about 30% since 1991. Open unemployment rate is estimated at 14%.

<sup>28</sup> 22% of Moldova's adult population is in retirement age.

<sup>29</sup> On average, every 100 workers support themselves plus another 167 people (Lindauer, 1998).

Though such adjustments may be considered rather modest in the light of the output decline, they are sound outcomes on the Moldovan labor market. It indicates widespread under-utilization of labor resources and shortage of job opportunities.

However, due to a hindered character, occurred adjustments do not fulfill its role in catching up for productivity losses. Instead of jobs destruction at unproductive units and freeing labor for opportunities on the new markets, artificial level of employment is preserved. Due to soft budget constraint, enterprises continue to hoard excessive labor and provide social benefits. State subsidies result in losses during redistribution process and high inflation<sup>30</sup>. Closure and restructuring of unproductive firms is thus slowed down.

Low official unemployment rate results in weak and almost in-existent unemployment insurance system. It does not allow to protect vulnerable population group during the adjustment period. As a result workers on unpaid leaves *i.e.* effectively unemployed prefer to stay at enterprises in hope of some benefits and future opportunities, while currently surviving through dacha plots and street trade. Other workers have to accept arrears in wage payments and under-employment not to lose their jobs. Elder workers are squeezed out of the labor force increasing the already heavy burden for employed.

Observed negative tendencies on the Moldovan labor market mirror slow pace of structural and institutional reforms in the country. To create productive job opportunities, structural reforms must be fostered. Further restructuring of state enterprises, formal development of private sector and legal base together with macro-stabilization would necessarily lead to job creation and improving living standards.

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<sup>30</sup> The costs of redistribution are analysed in (Zaman and Radziwill, 1999).