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Institutions, Entrepreneurship, and Post-Soviet Development: An Assessment of Moldova's Entrepreneurial Climate (1991-2009)

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Abstract

This paper explores the relation between Moldova's institutions, entrepreneurship, and poor economic performance 18 years after socialism. The prevailing local institutions determine the direction of entrepreneurship in society (North, 1990; Baumol, 1990; Olson, 1996; Boettke, 1998). Societies with a mix of institutions favorable to productive entrepreneurship experience sustained growth. Conversely, societies with institutions rewarding unproductive and destructive entrepreneurship experience economic stagnation. Using the conceptual frameworks of new institutional economics, Austrian market process theory, and interviews with local entrepreneurs, I explore the link between Moldova's institutional context and the local entrepreneurship and underdevelopment. For a better understanding of Moldova's poor economic performance after socialism, scholars and policy makers must investigate the existing underlying gap between the *de jure* and the *de facto* institutional barriers to productive entrepreneurship.

Keywords: alertness, arbitrage, corruption, entrepreneurship, informal rules, institutions, opportunity discovery, post-Soviet economies, red tape

1. Introduction

Throughout its first 18 years of independence following the collapse of the Soviet Union (1991), Moldova retained the title of Europe's poorest economy (Note 1). Despite of its proximity to more prosperous Central Europe and, more recently, the formation of the eastern border of the European Union (EU) (Note 2), Moldova remains a lower-middle-income economy, lagging significantly behind the rest of the comparable countries in the region. This paper explores the underlying attributes of Moldova's institutional context and their effects on entrepreneurship and economic performance. Why has Moldova performed so poorly after independence? To answer my research question, I follow a four-step approach. First, I look at the literature explaining the concepts of entrepreneurship and institutions, and their interaction and implications for economic growth and development. Second, I briefly review Moldova's economic history. Third, I investigate Moldova's present institutional and entrepreneurial environment in light of my qualitative interviews and the theoretical insights developed in the fields of entrepreneurship and institutional analysis. Finally, I conclude with general directions for policy reform in post-Soviet Moldova.

According to my preliminary findings, Moldova's indigenous institutions persistently encouraged socially destructive and unproductive forms of entrepreneurship. The economy failed to perform because the process of the ongoing conflict between two sets of forces—1) the productive forces of market entrepreneurs, and 2) the unproductive forces of political entrepreneurs—results in the diversion of entrepreneurial action from productive to unproductive and destructive forms of investments.

The conceptualization of entrepreneurship used in this paper is based on the cognitive approach to entrepreneurship as advanced in Austrian market process economics, in the theory of entrepreneurship and competition developed by Israel Kirzner (1973) from earlier, foundational works on human action and societal knowledge developed by Ludwig von Mises (1949) and F.A. Hayek (1948). I take the link between entrepreneurship and institutions from the historical analyses of William Baumol (1990), and the crucial role of institutions for growth from the works of Douglass North (1990), Peter Boettke (1998), and Mancur Olson (1996), who find that crucial for a nation's economic performance is not the supply of entrepreneurship, but of the quality of its prevailing local mix of policies and formal and informal institutions. I further combine my theoretical analysis with my fieldwork findings in Moldova, as well as with studies and publications measuring

Moldova's institutions; studies issued by national and international organizations, such as The World Bank, the Heritage Foundation, The Central Intelligence Agency, Transparency International, and The National Bureau of Statistics of the Republic of Moldova.

2. Research Method

2.1 Theoretical Framework: Entrepreneurship, Institutions, and Development in Theory

Academic interest in the role of entrepreneurship for economic development dates back to the end of World War II, when economists studying growth theory turned their attention to entrepreneurship to help explain the persisting gap between poor and wealthy nations (Boettke et al., 2006). In contemporary development studies, the role of entrepreneurship in economic development is widely acknowledged: entrepreneurs are depicted as "the driving force of the market" (Kirzner, 1992, 2000), or "the engine of economic growth" (Minniti, 2006). Similarly, the present public discourse in many countries considers the role of entrepreneurs for growth and the search for ways of fostering entrepreneurship in their societies. However, although on the surface it is widely agreed that entrepreneurship matters, disagreements persist with respect to what entrepreneurship is and how it matters for growth: "The entrepreneur, is one of the most intriguing and at the same time most elusive characters in the cast that constitutes the subject of economic analysis" (Baumol, 1968, p. 64).

It is the elusiveness surrounding the concept of entrepreneurship that has led to the formation of two conflicting views on the function of entrepreneurship in market changes: 1) one view emphasizes the *behavioral* aspect of entrepreneurship, and 2) the other view insists on the *cognitive* aspect. Because different theoretical approaches determine different policy implications, it is vital to understand their differences.

According to *the behavioral approach*, the supply of entrepreneurship in a society is a function of talent, skills, ingenuity, and other remarkable qualities associated with successful entrepreneurs. In this view, it takes a particular kind of individuals to act entrepreneurially, to innovate.

According to *the cognitive approach*, entrepreneurship is omnipresent. In the Austrian market process perspective on entrepreneurship, it is in every individual's innate inclination to pursue what is in their best interest to pursue, at each moment in time, in accord with his or her subjective interpretation of and response to changes in preferences, technology, resource availability, and market knowledge (Mises, 1949; Kirzner, 1992). As Ludwig von Mises put it: "In any real and living economy, every actor is always an entrepreneur" (Mises, 1949, p. 253). This entrepreneurial inclination innate to every individual was further conceptualized by Israel Kirzner (1973, 1979, 1985, 1992, 1996) as "an element of entrepreneurship" manifested through one's "alertness to pure profit opportunities." Kirzner famously wrote that entrepreneurs react to costless arbitrage opportunities, or "pure profit opportunities," of both short-run or singleperiod type (short-period, current profits), and long-run, intertemporal or multiperiod type (long-period, future profits) opportunities (Kirzner, 1996, p. 50). Long-term or multiperiod arbitrage includes innovation—a form of intertemporal arbitrage exploited by individuals acting within firms to capture profits that involve a multiperiod production structure (Sautet, 1999, p. 63). Singleperiod arbitrage activities lead to a more efficient allocation of existing resources, while the intertemporal arbitrage activities push a country's entire production possibilities frontier (PPF) outward and involve Research and Development efforts towards the discovery and production of new products and/or new processes of production.

Both the *behavioral* and the *cognitive* views recognize the importance of entrepreneurship for growth. Promoters on both sides would like to see more entrepreneurship taking place in the developing world. However, unlike the behavior-focused theorists and policy makers who ultimately seek to increase the supply of entrepreneurs by capturing and replicating a presumed unique set of psychological qualities observed in successful entrepreneurs' behavior, the market process theorists point out that entrepreneurship is omnipresent—it is a manifestation of economic growth present in every human society—and, therefore, something else must explain why some countries perform worse/better than others. In the market process view, productive entrepreneurship is a consequence and not the cause of development; it is the institutions that determine the incentives for entrepreneurship, and thus institutions cause development, not the reverse (Boettke et al., 2003).

A clearer link between entrepreneurship and institutions is expressed in the works of William Baumol (1990), who argues that, historically, entrepreneurs responded to the prevailing "structure of payoffs" or "rules of the game" in a society. According to Baumol's hypothesis (Baumol, 1990, pp. 898-99), the general direction of entrepreneurship will be determined by the highest paying activities, whether productive (causing growth), unproductive (stagnation), or destructive (retrogression). An extension of this framework includes "evasive entrepreneurship" (Coyne & Leeson, 2004). Evasive entrepreneurship characterizes informal markets where entrepreneurs succeed in engaging in unproductive activities in order to avoid the burdensome fiscal and regulatory systems. Consequently, crucial for a nation's economic performance is not the supply of entrepreneurship, but the quality of its institutions and economic policies (Olson, 1996, p. 16) guiding the allocation of entrepreneurship. The underlying institutional arrangements (formal and informal) in a society determine its prospects for economic progress: "Institutions are the rules of the game in a society or, more formally, are the humanly devised constraints that shape human interaction" (North, 1990).

Yet a more succinct chain of arguments linking economic performance, entrepreneurship, and institutions comes still from the perspective of Austrian economics on the entrepreneurial process and economic growth:

- Economic performance (i.e., growth) depends on capital accumulation.
- Capital accumulation is the result of entrepreneurial profit discoveries.
- Entrepreneurship is a function of the institutional makeup of a society.
- Institutions (or rules) will foster entrepreneurship if their adverse effects on: (a) the noticeability and (b) the exploitability of profit opportunities are limited over time.
- In order to limit the effects on the noticeability and exploitability of profit opportunities, institutions must constrain the government from the possibility of reneging on its commitments (Sautet, 2008, p. 41).

Argument 3 reinforces that it is the quality of institutions that matters for entrepreneurship to flourish. Argument 4 sets the two types of incentives affecting entrepreneurial actions: a) Incentives that affect the noticeability of undiscovered courses of action and b) incentives that affect the exploitability of discovered profit opportunities (Sautet, 2008, p. 41).

It follows that there are two major policy measures that could help foster economic development: the first is to secure entrepreneurs' freedom to discover pure profit opportunities, and the second is to eliminate the insecurity related to entrepreneurs' freedom to exploit discovered profits. Freedom to discover pure profits required the protection of property rights. Freedom to exploit discovered profits requires limiting government's abuse of private property.

The protection of private property rights of the means of production enables market exchanges and the formation of prices. Existing differences in prices, as well as expected changes in prices, stimulate entrepreneurs to engage in arbitrage activities. Arbitrage activities lead to a better allocation of resources and enhance growth. However, entrepreneurs will only explore arbitrage plans as long as they will have incentives to do so (i.e., as long as they can rely on the security of their property/profits). Therefore, private property rights must be properly enforced and protected.

Eliminating government's discretion to interfere in entrepreneurs' activity (interference by means of official and unofficial use of taxation and regulations) encourages productive entrepreneurship. The heavier the burden of taxes and regulations applied to economic activities, the lower entrepreneurs' incentive to pursue profit recognized in a) already perceived courses of action (Kirzner, 1985, p. 95), and b) in other existing, not yet discovered, entrepreneurial courses of action (Kirzner, 1985, p. 97). The double disincentive effect of government interference with individuals' ability to notice and exploit pure profits causes the neglect of existing, greater gains from trade. Overlooked gains from trade are detrimental to economic growth as they imply decreased capital accumulation. Moreover, the government effect stimulates productive entrepreneurs to use part of their capital in wasteful activities (i.e., evading the formal institutions and legal system). To sum up, the government inhibits productive arbitrage activities which increase the efficiency in markets' use of resources and which, in a good institutional environment, would lead to an outward shift in Moldova's production possibility frontier (Kirzner, 1985). More precisely:

1) When corrupt public servants using unofficial taxation and overregulation ex-post making certain policy commitments toward their constituencies, entrepreneurial alertness (i.e., entrepreneurs' ability to calculate existing gaps in prices, qualities, markets) is hindered, and productive and innovative entrepreneurial processes necessary for sustained economic growth become reversed or stalled. The high likelihood of a corrupt government's ex-post failure to honor their economic policy commitments represents a disincentive for existing entrepreneurs to exploit discovered entrepreneurial opportunities, and for other potential entrepreneurs to enter the market.

2) A corrupt government's interference in the entrepreneurial process through discretionary regulation and taxation is undesirable for productive entrepreneurship and growth for four major reasons: a) the impossibility to assess what paths productive entrepreneurs would have taken in the absence of discretionary regulations, b) lack of a *mechanism of profit and loss* due to lack of market prices and competition in regulatory action removes the *entrepreneurial process* and the associated signal and

incentives, making it impossible for policy makers to discover the actual opportunities for improved regulatory actions, c) regulations inhibit desirable discovery processes brought about by productive entrepreneurs, and d) regulations change the rules guiding individuals in their entrepreneurial decisions, therefore changing the direction of entrepreneurship toward different types of discoveries that would have been generated by unconstrained markets, as well as changing the distribution of gains (Kirzner, 1985, p. 137; Sautet, 2002, pp. 134-135).

3) Because violations of entrepreneurs' property rights are the result of a dishonest government's action, reforms must start by addressing Moldova's constitutional deficiencies, which encourage a predatory state, and slow down the country's growth and development.

2.2 Interviews with Local Entrepreneurs

Qualitative data from local entrepreneurs helps to assess the gap between perceived, seen, or *de jure* institutions, and the prevailing, unseen, or *de facto* realities affecting entrepreneurial activity. In conducting my field research, I aimed at gaining access to local knowledge relevant for the understanding of the problems faced by entrepreneurs in Moldova. Insights from local individuals' institutional experience are vital in identifying the real sources of frustrations discouraging entrepreneurship; barriers to entrepreneurship not captured anywhere in know national and international databases.

This paper investigates the *de facto* institutional impact on Moldovan entrepreneurs. My field research consisted of in-depth interviews with entrepreneurs from the municipal area of Chisinau conducted in June 2009. As part of the standard interview structure, I asked entrepreneurs about their difficulties with starting their businesses, doing business, their experience with government authorities, and what they consider to be major threats to their activity. My findings illustrate how various aspects of the institutional context affect entrepreneurial endeavors. According to my interviews, the main barriers to entrepreneurship in Moldova are (a) formal and informal taxes, tariffs, restrictions, fees, and fines on profitable activity, (b) frequent changes in rules and regulations, (c) lack of transparency and accountability in public bureaus, and (d) public officials' ability to abuse their position for personal interests. The interviews did not cover all types of entrepreneurial activities. Nonetheless, I contend that these are the key institutional barriers for productive entrepreneurship in Moldova.

3. Overview of Moldova's Economic History

3.1 Moldova: Institutions, Entrepreneurship and Growth in History

A historical perspective on Moldova's economy can help us understand the events that have shaped the local institutional system and how changes in its structure of payoffs influenced the allocation of entrepreneurial activities (Baumol, 1990). The latter provides valuable insights into Moldova's path to economic development. In this section, I provide a brief overview of Moldova's economic history.

In late Middle Ages, the present-day territory of Moldova formed the Eastern half of the principality of Moldavia—one of the three distinct principalities of Latin origin in Eastern Europe to have been united in 1859 to set the basis of modern Romania. Later, between the 15th and 20th centuries, despite fighting back for independence with its small military power, Moldova's territory had been successively conquered by the rising hegemonic empires: the Hungarian Empire (1390), the Ottoman Empire (1512), the Russian Empire (1812), and reunited with Romania (1861, 1918) throughout the interwar period.

At the end of World War II, under the Ribbentrop-Molotov Pact (1939), it was annexed by the USSR. As a Soviet Socialist Republic, Moldova experienced the abolition of private ownership of means of production and the apathy that dominated every centrally planned economy. Scarcity, expropriation, deportation, forceful work on Soviet collective farms (kolkhoz (Note 3)), and the Soviet police state have lead individuals to pursue unproductive entrepreneurship in form of shirking, extortion, stealing, crime, and spying—an inefficient allocation of resources, leading to a declining economy. Although most economic activities took place in a centralized form, de facto economy included small self-sufficient economic activities that complemented individuals' earnings from working in collective enterprises (i.e., Soviet agricultural land, mills, mines, etc.), as well as other economic activities such as underground trade, exchanges of imported goods, and inter-industry trade (i.e., managers or workers of Soviet-owned industries would accumulate subtracted goods and later barter them on covert markets). The informal trade between industries changed the allocation of resources in favor of one group or another according to their hierarchical position and their access to common market resources; all this led individuals aim at high positions in the union knowing there is an easier way to get around scarcity by extracting rents from the others, by stealing or accepting bribes. Thus, contrary to conventional depiction of central planning, the Soviet system was rather driven by rent-seeking incentives, instead of alleged ideological incentives (Boettke & Anderson, 1997).

3. Moldova's Institutional Environment and Its Effects on Entrepreneurship and Development

3.1 Moldova's Institutional Environment in 18 Years of Independence

Moldova is a small ex-Soviet developing country in Eastern Europe, between Romania and Ukraine. Its population counts 4.3 million of which 60 per cent live in the rural areas, 30 per cent live below the poverty line, and an estimated third of the population lives and works abroad (CIA, 2009). Economic activity in the rural areas is primarily agrarian, with most households living of subsistence and remittances sent by relatives from abroad.

The fall of the Soviet Union in 1991 opened the chance for Moldova to move from a centrally-planned economy to a market-driven economy. But although it took only a few moments for the new elites to settle in, agree on a new constitution, and declare independence, the change from a Soviet Republic to an Independent Republic did not bring with itself prosperity. According to the IBRD's income group classification in 2009, Moldova is one of the 55 lower-middle-income economies of the world (Note 4).

Compared to most of the former Soviet Republics that have changed their income status from lower to middle and higher-middle groups not long after the break-up, Moldova's small leap comes after a long period of stagnation within the lower-income limits, and is rather modest and fairly recent. Moldova's GDP (purchasing power parity) per capita in 2008 was of $2,925, more comparable to Kyrgyzstan, Uzbekistan, and Tajikistan—the three least developed Central Asian members of the Community of Independent States (CIS)—than to any of its neighboring ex-communist countries: Ukraine, Romania, Bulgaria, and Russia (see Table 1). Unlike Romania, for instance, its upper-middle-income neighbor and EU member, Moldova has fallen behind, trapped in a continuous transitional cycle. The gap between Moldova's and Romania's GDP per capita is truly remarkable (Table 1 shows how Romanians earned $11,139 on average more than Moldovans did in 2008).

Compared to the first decade after the USSR collapsed, when inflation reached 945 per cent (1992) and 860 per cent (1993) in response to persistent de facto institutional barriers to market liberalization, more recent annual price changes stayed at a relatively stable level. However, double-digit inflation remains a problem, and in 2007, it was approximately 16 per cent (World Bank, GDP deflator, annual percentage).

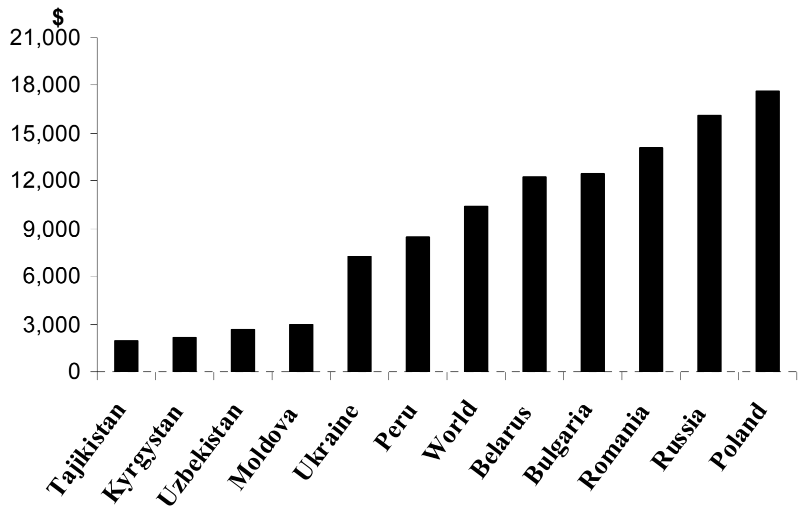

Figure 1. GDP (PPP) per capita in Moldova and selected economies in transition in 2008

Market reforms started after gaining independence have been slow in making sustained progress. On one side, the Moldovan government has liberalized most prices and has phased out subsidies on most basic consumer goods, and several smaller companies and industries were privatized in 2004. On the other side, privatization of most larger-scale state enterprises and state-owned assets is ongoing and controversial, with some cases associated with fraudulent deals involving government officials and their relatives. Most of former collectively owned land and housing units are privately owned (Note 5). In 2005, the private sector employed 43.3 per cent of the labor force in services, 40% in agriculture, and 16 per cent in industry (CIA, 2009). In short, Moldova's post-Soviet transition was dominated by sporadic and ineffective enforcement of the law, political uncertainty, and abusive interference that continue to discourage local and foreign entrepreneurs from pursuing productive profit opportunities.

In the 2009 Heritage Foundation Index of Economic Freedom, Moldova has been categorized as “mostly unfree” every year since their independence. Moldova’s institutional environment is a constant impediment for productive entrepreneurial activities. Foreign entrepreneurs face barriers ranging from tariff and non-tariff burdens to complete restrictions. There is significant corruption in most areas of the bureaucracy and an inefficient public sector suffers from a bloated payroll and ever-rising salary increases (Heritage Foundation 2009).

Moldova is a unitary parliamentary representative democratic republic. In 2001, Moldova became the first former Soviet state to elect a communist president. Despite his authoritarian ruling style, Vladimir Voronin and the Party of Communist of Republic of Moldova (PCRM) have succeeded to win the electorate for two successive mandates (2001–2009). Although the reformed Communist Party supported European Integration and has not reversed market reforms instituted in the early 1990’s, political corruption, regulatory inefficiency, and lack of accountability and transparency have been the dominant features of Moldova’s modern institutions. The current state of political blockage follows the violent civil street protests against PCRM accused of electoral fraud and media monopolization in the parliamentary elections of April 6, 2009.

3.2 What Causes Persistent Underdevelopment in Moldova?

In addition to limiting entrepreneurs’ economic freedom, institutions in developing societies generate incentives for some agents to exploit the productive outcomes of others through socially destructive forms of entrepreneurship. In this section, I will focus on the types of entrepreneurship generated by Moldova’s current institutional framework and its effect on the two types of productive entrepreneurial activities identified by the market process theorists: type 1—simple arbitrage, with no production structure, and type 2—complex process arbitrage, within firm, with production structure (Sautet, 1999).

My field research findings in Moldova indicate an institutional environment dominated by corrupt governance in the form of excessive government interference in individuals’ entrepreneurial actions. Formal and informal government barriers to productive entrepreneurship are the main cause for Moldova’s poor economic performance. Informal barriers to entrepreneurship are a particular problem as they come to counteract legitimate efforts of positive institutional reform and widen the gap between de jure and de facto institutional reality. At the heart of this problem lies a weak rule of law stimulating ex-post opportunism in form of informal arbitrary taxation, corruption, and deficient governance.

Table 1. Governance indicators for selected transition countries in 2008

Country	Percentile Rank (0 – 100)	Score (-2.5 to +2.5)	Percentile Rank (0 – 100)	Score (-2.5 to +2.5)	Percentile Rank (0 – 100)	Score (-2.5 to +2.5)
Armenia	52.6	-0.07	42.6	-0.36	34.8	-0.54
Bulgaria	58.3	0.1	51.7	-0.12	52.2	-0.17
Croatia	69.7	0.52	55	0.08	61.8	0.12
Czech Republic	82.5	1.07	77	0.85	66.7	0.37
Estonia	84.4	1.15	84.7	1.05	79.2	0.94
Georgia	61.6	0.18	44	-0.34	50.7	-0.23
Latvia	70.1	0.56	71.3	0.73	64.7	0.29
Lithuania	71.6	0.64	67.5	0.58	63.3	0.18
Moldova	23.7	-0.76	40.7	-0.46	30.9	-0.64
Poland	68.2	0.48	65.1	0.49	67.6	0.38
Romania	50.2	-0.14	53.6	-0.05	57	-0.06
Russia	45	-0.32	19.6	-0.91	15.5	-0.98
Slovakia	77.3	0.76	67	0.52	68.6	0.43
Slovenia	82.9	1.09	82.3	0.91	79.7	0.95
Ukraine	32.7	-0.6	31.1	-0.62	28	-0.72

Source: World Bank, World Governance Indicators, Governance Matters 2009.

As presented in Table 1, with regard to the governance and anti-corruption dimension of the institutional environment, Moldova scores lower than most comparable transition economies in the region. For all three governance indicators, Moldova ranks at the bottom. In "governance effectiveness", Moldova is the fifteenth of all the fifteen countries. In "rule of law" and "control of corruption", Moldova is the thirteenth out of fifteen. Indeed, these poor scores are confirmed by my field research findings. The institutional framework providing individuals with entrepreneurial incentives is more favorable to unproductive activities.

3.3 Corruption

As it is typical for all CIS countries, complex and non-transparent laws and regulations dominate Moldova's institutions. Lack of transparency and clarity in the legislative acts are the source of incentives for empowered authorities to exercise bureaucratic discretion in interpreting or implementing the legislation. This is particular to regulatory agencies, such as Fiscal Inspectorate, Customs Departments, Technical Inspectors, Quality Control Agencies, Environmental Agencies, and Labor Safety. The complexity and ambiguity in their content present themselves as a profit opportunity for control authorities, whose position in negotiating the transactions terms is more favorable. Extracted rents, in this case, are a premium cost of transacting with law makers paid by confused/ignorant entrepreneurs who are willing to pay the demanded bribe instead of risking incurring higher costs in form of blocked merchandise in customs depots, or seizure of entrepreneurial activity for the time required to run fiscal or technical inspections. One start-up entrepreneur in Chisinau said: "It is impossible to keep up with so frequent and complex changes in laws and regulations. Paying the man in charge with enforcing them is an easy way to get out of trouble." Widespread corruption, a weak rule of law, inefficiencies in the legislative and judicial systems, and the regulatory burden form together a costly environment for productive entrepreneurship.

The problem of corruption in Moldova is systematically documented by Transparency International. In the organization's annual Corruption Perception Indexes, Moldova has never scored higher than 3.3 out of 10. Local entrepreneurs complain about corruption associated with lack of institutional transparency, accountability, and predictability. Like entrepreneurship, corruption is omnipresent in human nature; it is a form of entrepreneurship guided by inefficient institutional arrangements. However, unlike entrepreneurship within an efficient set of institutions, which leads to a superior allocation of resources and increases a country's production possibilities frontier (PPF), corruption is a response to institutions rewarding socially destructive and unproductive activity and leads to lower than a country's full potential for gains from trade. In a corrupt institutional environment, some unproductive agents exploit the profits gained by other, productive agents. Moreover, apart from being a mere redistribution of wealth from productive to unproductive entrepreneurs, it also diminishes the supply of productive entrepreneurs, because a tax on pure profits works as a disincentive toward individuals' ability and willingness to discover future profitable avenues. Not only is corruption an unproductive activity, but it also discourages the realization of other potential gains from trade. Thus, corruption is damaging Moldova's prosperity.

When discussing corruption, several interviewees remembered two Soviet-times sayings: "If you don't steal from the union, you steal from your family" and "They who divide, make their own share first". These popular sayings illustrate that corruption was a common and socially accepted activity in Soviet bureaucracies. It also shows that in present democratic Moldova, corruption did not vanish; today's bureaucracies provide perverse incentives just like the old Soviet ones did. The owner of a small logistics firm from Chisinau told us: "I was lucky when I started my business six years ago, a good friend of mine was in charge of license procedures, I received my license in 2 days with a privileged pass in his offices." Having relatives or friends connected with public institutions or the government can make things easier for productive entrepreneurs. The same entrepreneur continued: "Whenever I need to deal with unfamiliar public authorities, I always do my homework upfront to find out who is at the top of their office, what are others saying about his practices, how much or how to propose as bribe, etc. this is the only way to save on time and money, otherwise they will keep delaying your or refusing your requests at infinitum." Time is scarce, and as long as entrepreneurs keep their relatives happy, they do not have to wait in overcrowded public offices to get their business approved. Otherwise, building a personal relationship with the person in charge of a public office, such as the registration office, is necessary before dealing with public bureaus.

3.4 Excessive and Redundant Regulations

In both Economic Freedom Index 2009, and Doing Business 2010, Moldova appears as a top fiscal and regulatory reformer, accomplishing significant reductions in taxes and regulations. As of January 1, 2008, the top income tax rate was reduced to eighteen percent and the corporate tax was eliminated. However, this internationally recognized accomplishment conflicts with the lack of local endorsement. Valeriu Lazar, Minister of Moldova's Economy, agrees, "Zero tax shares don't necessarily mean liberalization. On one side we have the zero tax shares, on the other we have a very restrictive tax administration, that annihilates the whole effect of this improvement." (Note 6) Not all entrepreneurs are better off in their activity with a zero percent corporate tax. Construction companies report prohibitive transaction costs in the process of opening a construction site. Indeed, by the World Bank's experts' evaluation, the procedures authorizing construction activities in Moldova are highly prohibitive to businesses. Many entrepreneurs said they prefer the cancellation of the zero corporate tax rates in exchange of eliminating the technical and administrative barriers, as it is highly onerous to wait for construction authorizations for years ex-post investing resources in local land and capital.

The World Bank and the USAID addressed the problem of regulatory inefficiency in Moldova in 2002. The two organizations have help implement a regulatory reform—"The Guillotine"—aimed at eliminating unnecessary procedures from laws imposed on entrepreneurial activity. As a result, improvements can be noticed in the IBRD's "Doing Business 2010" where Moldova is found among the top ten reformers (Note 7), ranking thirteen positions higher than in the previous year. Property registration was simplified by eliminating the requirement for a cadastral sketch, reducing procedures from six to five, and days from 48 to five. An expedited registration service eased business startup. Registering a firm takes an entrepreneur officially only 15 days, compared to the Eastern Europe and Central Asia's average of 17 days, and corporate tax rates have been eliminated. However, Moldova ranks worse in all other reform domains that are essential for entrepreneurs' decision making in arbitrage opportunities of type 2. Obtaining a construction license, for example, requires 30 procedures, 292 days, and cost 120 (percent of income per capita) more than the OECD average of 15 procedures and 152 days, and 56% in cost. Enforcing contracts requires following 31 procedures, takes at least one year, and costs 30% of the claim. Dealing with the tax administration is onerous because of time spent paying taxes (228 days), number of payments (48), and their cost (31% profit) per year.

Hence, although the "Regulatory Guillotine" might have helped improve Moldova's score in IBRD's annual "Doing Business" publication, in reality, simplified procedures don't necessarily equal better quality procedures to start businesses. Simple, non-customized simplification may lead to an increase in large firms' transaction costs and thus damage entrepreneurship and growth (Arrunada, 2007). Moreover, in the Doing Business methodology it is assumed that entrepreneurs have perfect knowledge and public agencies are incorruptible. Given that corruption remains a significant problem in Moldova, this rigid assumption underestimates de facto barriers to entry.

On the good side, the elimination of bureaucratic procedures is normally accompanied by a reduction of corrupt transactions in public agencies, which leads to lowering de facto barriers to entry for productive entrepreneurs. However, as the executive director of a pro-democracy think tank in Chisinau disclosed, the Regulatory Guillotine did not have the desired effect. On the contrary, it merely revealed how many inspectorates and how many redundant regulations and instructions existed, but did nothing to eliminate any (Note 8). The "guillotine" approach to business deregulation reforms is a top-down approach based on the IBRD and the USAID schemes of rewarding governments' performance in eliminating existing regulatory barriers. The Moldovan government managed the entire process of the guillotine: the scope, the instruments used, the approval process, and the implementation. Promoters of this approach argue that reversed incentives in the reform process overcome barriers that have slowed or blocked broad-based regulatory reforms in the past. These barriers include high political and administrative costs, intense and passive insider resistance to change, and lack of planning on how to sustain change into the future (Jacobs, 2006, p.16). The problem with this approach, however, is that it assumes that governments' gains from these short-term reform programs are greater than both short-term and long-term gains from keeping the current arrangements unchanged.

3.5 Unofficial Taxation

Lack of institutional transparency in public administration arranged by the communist government during its eight years of authoritarian regime, have made it profitable for political entrepreneurs to adapt to attempts of institutional changes without losing their power to extract rents from market entrepreneurs. As a result, the guillotine failed on two fronts: first, only trivial regulations were eliminated, and second, new forms of government predation were developed. I found out that of greater danger for entrepreneurs in Moldova is the "unofficial taxation". In this respect, the majority of my interviewed entrepreneurs explained similar situations to the one of a restaurant owner in Chisinau: "If your business is flourishing, you should expect them to knock on your door any day and ask you to sell it to them below the market level. Sure, you can refuse the deal, but then, be prepared to face tens of their unexpected controls for whatever invented reason, hunting you day and night, until, eventually, you will have no choice than to give up or go bankrupt."

Unofficial taxation in Moldova appears to be a form of government adapted predation to positive regulatory reforms the effect of which reduces: 1) the size of the formally collected public budgets through taxation, and 2) the size of informal budgets acquired through rent-seeking transactions stimulated by previously inefficient administrative and regulatory systems. In essence, the unofficial taxation is a manifestation of government ex-post opportunism for quasi-expropriation and consists of local authorities' power to use the legislation to extract rents from entrepreneurs in the name of the public interest. Entrepreneurs are constrained by the local authorities to contribute with donations to various government-led events or projects (Munteanu et al., 2006), or worse, to accept full expropriation at imposed terms (Prohnitchi, 2003). According to Article 46 of the Moldovan Constitution, these activities are illegitimate. The constitution text guarantees individuals' "Right to private property and its protection", but at the same time, it explicitly states, "no one can be expropriated unless for a matter of public necessity, under the law, against a fair previously determined compensation." (Note 9) Thus, the pretext of "public necessity" matters seems to offer local authorities an unintended opportunity for discretion in coercing entrepreneurs to sponsor various social projects unaccounted anywhere in public registers.

Moreover, according to my further research findings, the formal "rules of the game" guiding entrepreneurial activity are set in the Moldovan Business Laws established as early as 1991 (property laws), or as recent as 2001 (labor laws). However, in addition to formal basic laws, each regulatory agency has the power to emit special letters of interpretation, which give them discretion in identifying opportunities for quasi-expropriation. This inconsistency comes from complex and ambiguously formulated acts and laws. For instance, according to a decision emitted by the Licensing Chamber (Note 10) one of the requirements to obtain a license reads, "as long as the licensed activity is conducted in conformity with the legislative and regulative framework currently in force." This phrasing is so open-ended that it leaves room for regulators to consider any minor deviation, not necessary related to entrepreneurial activity (Note 11), a genuine violation of the "legislative and regulative framework currently in force" (Prohnitchi, 2003).

As a result, a firm can expect inspection or control visits from regulatory agencies at its headquarters based on both the business laws, and according to letters of interpretation and disposition which, in themselves, are arbitrary and distort the basic legislation text. This gives each empowered inspector or control officer the opportunity to interpret a given case in a way favorable for money extortion on "legal grounds". It further becomes in the interest of the Fiscal Inspectorate in Chisinau to collect as many fines as possible from businesses to achieve the "fiscal plan" established each year and report to the top of their hierarchy their annual performance. The same think tank executive told us: "I once counted 64 of them (control and inspection agencies) in total… Under these circumstances, firms have two alternatives: either closure, or double booking. These are the only real alternatives, you can try to resort to judicial power but you risk losing money and years of time in courts and there is no guarantee of success." To understand the extent and damage of government interference in entrepreneurial activities through regulatory agencies, in 2006 the highest number of controls firms received per year was 35. From a firm's perspective, approximating the average time of a vertical control to a week-long, this practically leaves entrepreneurs with no time to run a business (Munteanu et al., 2006). Moldova's "Guillotine" reformers originally estimated that its 67 inspectorates had created 300 to 500 regulations for businesses. The actual number revealed through the guillotine was more than 1,100, many of them illegal and never published (Jacobs, 2006, p. 3). Regarding firms' possibility to take legal action against abusive public servants, so far, there was no recorded case in Moldova in which a lawsuit against the state has actually won in court, except for a few cases resolved at Strasburg, at the European Court for Human Rights (ECHR).

3.6 Informal Barriers to Trade and Enterprise

According to "World Tariff Profiles 2009", Moldova's trade weighted average tariff rate was 13.9 %, with MFN duties ranging from 0% to 141% (Note 12). The cost added by import tariffs discourages local entrepreneurs from engaging in international arbitrage opportunities, thus affecting firms' profitability, capital accumulation, and therefore the country's economic growth. However, what adds to the cost of trade the most are a variety of additional non-tariff barriers: import and export restrictions and bans, import taxes and fees, burdensome trade regulations, and an inefficient and non-transparent customs process that is prone to corruption (Note 13). For example, with respect to the two main administrative barriers—customs evaluation and certification—Moldovan laws do not establish precise time for custom clearance. Such as for agricultural trade, a primary economic activity of rural entrepreneurs, because import-export transactions with fresh fruit and vegetables require the fastest customs clearance as possible, entrepreneurs are often forced to pay unofficial extra fees to customs officers to get through without risking spoiling their merchandise before it even gets on the destination market. For Moldovan entrepreneurs whose primary markets are CIS countries, corruption is bad news; Russian and Ukrainian customs officers are not less "entrepreneurial" than their Moldovan counterparts. One entrepreneur-exporter in Russia spoke: "They can clear our products in 2 days, but at the same time the law allows to clear products within 10 days. But fresh peaches cannot wait so long. So, we pay to get the clearance in 2 days." Another importer said: "Ukrainian customs are always a problem. They tried to make us pay extra, and we were forced to do it. It's one of the reasons we prefer to deal with European exporters." Bureaucratic ineffectiveness and constant changes in import-export regulations and procedures required by their own and by the foreign customs authorities, are perfect examples of perverse institutional opportunities incentivizing individuals to engage in unproductive entrepreneurship in Moldova.

3.7 Regime Uncertainty

Political aspects on both national and international levels influence the growth potential of any entrepreneurial activity. The more unstable the internal and international political situation is, the more unstable the "the rules of the game", the more volatile the trade policies, the greater the "regime uncertainty" (Robert Higgs, 1997). Both local and international frequent and chaotic changes in the institutional regimes divert or inhibit entrepreneurial activity from taking place. Regime uncertainty confuses entrepreneurs about the rules of the game, making it impossible to "play the game." When government changes, creates, and removes rules, the exploitability of discovered pure profits becomes uncertain. Entrepreneurs' willingness to exploit discovered arbitrage opportunities diminishes. The lower is investors' confidence in governments' credibility to commit, the lower their expectations regarding the exploitability of future profits, and thus the fewer will be their investments: 1) "We have dealt with Abkhazia, but now, after the region blast up, we have switched to Turkey," 2) "There was some tension with China, and in spring business terms and conditions of dealing with Chinese companies were restricted. That's how the state transforms politics into economics." (Note 14) Thus, the recent civil turmoil against the ruling Communist Party and its authoritarian governance, as well as the prolonged political blockade that followed, succeeded in crowding out potential foreign investment plans or pre-negotiated foreign commercial deals and partnerships with local entrepreneurs (under political pressure of risking losing their businesses).

3.8 Labor Migration and Local Entrepreneurship

Most Moldovan entrepreneurs working abroad spend their earnings in the country, renewing their homes, buying apartments and cars, and moving from rural to urban areas. Others, however, choose to save their earnings with the goal of pursuing a business opportunity that will make them rich upon settling back home. Unfortunately, few succeed to see their licenses, much less see their businesses growing; a Moldovan immigrant in Italy complained: "I worked in Italy for two years and saved money to start a small business, a driving school. But, after two months of striving to get my business license, I have given up. I plan to go back and hope the regulations will treat businesses better next year." The cause, again, is the institutions discouraging productive entrepreneurs. Annually, nearly 2.6 million Euros from remittances are spent on Moldova's monopolized markets of products and services.

3.9 Restricted Access to Land

Agriculture is still central for the Moldovan rural economy and foodstuffs, wine, and animal and vegetable products are important exports. However, Moldovan landowners have a limited bundle of rights that comes with their title. One long-lasting restriction on land transaction is selling to foreign buyers. Such a limitation on the bundled rights inhibits entrepreneurs from taking advantage of both the available, perceived arbitrage opportunities (type 1 entrepreneurship, such as buying low from locals and selling high to foreigners), as well as of the unperceived, yet to be discovered profit opportunities (type 2 entrepreneurship, e.g., foreign entrepreneurs buying land with the aim of capturing gains from innovating the production process, bring a new product on the market, etc.).

The consequence of criminalized foreign ownership of agricultural and forest lands was the monopolization of Moldovan agricultural markets by the creation of privileged conditions that benefited a special group, ex-brigadiers (ex-brigade leaders in the soviet collective farms, kolkhozy), with the effect of limiting the scale of land markets, their derivative markets, and the opportunities for innovation and discovery of other potential markets (the more profitable present entrepreneurial activities, the greater the opportunities for future entrepreneurial discoveries of both type 1 and 2). As a result, agricultural markets experienced decreases in the degree of specialization, low efficiency, and slow entrepreneurial growth.

4. Conclusions and Recommendations for Institutional Reform

In this paper, I argued that Moldova is stuck in underdevelopment because of prevalent unproductive entrepreneurship in spite of its 18 years of democratic institutions. My general findings confirm and extend previous research conducted in other the ex-socialist countries like Romania (Leeson & Coyne, 2007). Moldovans respond to incentives emitted by "bad institutions" inherited from the past that continue to constrain their decisions in the present. This unfortunate institutional context is what guides individuals to engage in socially destructive entrepreneurial activities, such as corruption, extortion, expropriation, taxation, and evasion. Thus, Moldova's economy fails to perform because of the enduring tension between two sets of institutions-driven forces: 1) the productive forces of the market entrepreneurs, and 2) the unproductive forces of the political entrepreneurs.

Moldova's specific institutional situation helps to explain its unusual divergence from a successful growth path. My assessment of the entrepreneurial environment in Moldova exposes the underlying causes of underdevelopment. According to my findings, Moldova is poor due to the persistence of formal and informal barriers to entrepreneurship: (a) formal and informal taxes, tariffs, restrictions, fees, and fines on productive activity, (b) frequent changes in rules and regulations, (c) lack of transparency and accountability in public bureaus, and (d) public officials' ability to abuse their power. Moreover, the qualitative data indicate that it is government predation that threatens the activity of current and prospective entrepreneurs the most, and not lack of entrepreneurial ideas, skills, money, etc. These unfortunate institutional arrangements present themselves with incentives to engage in profit opportunities that are limited to specialized predatory groups and are unproductive for the whole economy.

4.1 Recommendations for Institutional and Policy Reform

Economic growth relies on higher degrees of coordination achieved through the market process of discovery and exploitation of existing arbitrage opportunities. Entrepreneurs' alertness to profit opportunities is not sufficient for growth to take place. A prerequisite for economic growth is a context of legal and political institutions conducive to productive entrepreneurship—a system of payoffs that is responsive to gaps in growth (i.e. pure profits that have not been yet recognized).

An ideal institutional context includes well-defined property rights, freedom of contract and its enforcement, and limited interference from government authorities with market outcomes (Kirzner & Sautet, 2006). Thus, generally, reforms should aim at eliminating the sources of institutional uncertainty and inefficiency. In Moldova, my study indicates that it is government corruption and abuse of power that threaten active and prospective entrepreneurs the most, and not their lack of ideas, skills, money, etc. Thus, removing the source of incentives for these types of socially destructive entrepreneurial activities would lead to an improvement in the country's economic performance.

Before making further policy suggestions, I concede that the reality of markets is beyond policy makers' grasp (just as is the process of productive entrepreneurial discoveries) and that growth is the result of a spontaneous order that cannot be engineered (Hayek, 1948). In Moldova's case, I contend that improvements in the quality of institutions will foster entrepreneurial activities directed toward more capital accumulation and, therefore, increased economic growth. Following, I list three general guidelines for policy reform in Moldova.

First, reformers should aim at reducing legal direct and indirect barriers to entry by: eliminating tariff and non-tariff barriers to trade, removing state-favored monopolies caused by restrictions on foreign investors' ownership of Moldovan land, liberalizing labor movement, privatizing inefficient state-owned enterprises, and de-monopolizing media channels. Moldovan government's commitment to free trade policies can be secured by establishing a trade constitution that would guarantee entrepreneurs' freedom to trade internationally.

Second, reforms should aim at limiting governments' ability to renege on policy commitments (Boettke, 2001, p. 157) on both official and unofficial grounds. Reform must constrain public officials' power to serve privileged interest groups, or to distort the reading of legislation for extortion or expropriation purposes. A particular lesson from prevailing unofficial practices of taxation and extortion in Moldova is that reforms must reduce the payoffs of ex-post opportunities for private property predation. One solution to this problem consists in increasing government's transparency and accountability by allowing competition on the information markets and channels (Coyne & Leeson, 2004), such as media, press, internet, and postal services. Another solution is to establish constitutional constrains on government taxation and regulation by means of: 1) a fiscal constitution: to limit taxation and balance the budget; and 2) a regulatory constitution: to limit industry regulation (including competition law) and to require compensation for regulatory takings (Sautet, 2008). Yet of additional crucial importance is to remove the vagueness in Moldovan business legislation texts so that it leaves no room for legislators' discretion in distorting the law for rent-seeking purposes.

Third, top-down institutional reforms like "The Regulatory Guillotine" are failing to achieve positive change in Moldova because of the freedom enjoyed by the public officials' to extract significantly higher rents from productive entrepreneurs in the future. Their short-term gains from implementing good reforms are insufficient to offset the loss of their future flows of pay-offs facilitated by maintaining the current institutional arrangements. Thus, regulatory reforms need to take into account bottom-up knowledge as well, and must be accompanied by accountability and transparency mechanisms.

In order to overcome the problem of underdevelopment, Moldovan policy makers must look for ways to improve the quality of the institutions. Only an institutional context of well-defined and enforced property rights will foster productive entrepreneurial activities. Economic freedom and protection of private property from both private and public predation are prerequisites for a society driven by the allure of increased profits from trade.

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Notes

Note 1. Beginning 2008, CIA reports a $2,300 GDP/capita in the newly independent Kosovo, compared to $2,500/capita in Moldova.

Note 2. Romania joined EU on January 1, 2007; Moldova borders Romania in the West.

Note 3. Kolkhoz, collective farm in the Soviet Union, formed from “kol” (collective) and “khoz” (farm).

Note 4. The World Bank divides economies into four income groups according to 2008 GNI per capita, calculated using the World Bank Atlas method. The groups are: low income, $975 or less; lower middle income, $976 - $3,855; upper middle income, $3,856 - $11,905; and high income, $11,906 or more.

Note 5. A program started in March 1993 has privatized 80% of all housing units and nearly 2,000 small, medium, and large enterprises. Other successes include the privatization of nearly all of Moldova's agricultural land from state to private ownership, as a result of an American assistance program, "Pamint" ("land"), completed in 2000. A stock market opened in June 1995.

Note 6. Interview with Valeriu Lazar, Minister of Moldova’s Economy, in Jurnal.md, retrieved 25 November 2009.

Note 7. World Bank, 2009. Top 10 Reformers from *Doing Business 2010.*

Note 8. The list of all regulations included in the “Guillotine” reform, see Moldovan Government page http://www.economie.guvern.md/Default.aspx?noutateID=32

Note 9. The Constitution of the Republic of Moldova states in Article 46. The Right of Private Property and Its Protection:(1) The right to possess private property and the debts incurred by the State are guaranteed.

(2) No one may be expropriated except for reasons dictated by public necessity, as established by law and against just and appropriate compensation made in advance.

Note 10. Regard to the approval of licensing requirements for types of entrepreneurial activities no. 38-g of 09-16-2002, Official Government Gazette of Moldova no. 146-148, of 10-31-2002

Note 11. For instance, the conformity for fire extinguishers.

Note 12. Most Favored Nation applied maximum duties on some beverages and tobacco products. Source: the 2009 WTO World Tariff Profiles.

Note 13. The Heritage Foundation & Wall-Street Journal, Economic Freedom Index 2009, accessed November 20, 2009.

Note 14. Interviews from the GFK survey, 10 November 2009 “Moldovan Agricultural Products on the Russian Market.”

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