

Chapter Three

INVESTMENT CLIMATE AND ITS IMPACT ON ENTERPRISE PERFORMANCE

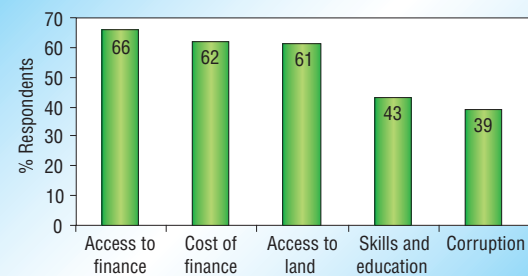
3.1 Introduction

The assessment of the business climate and its impact on enterprise performance in Maldives is based on standard ICA methodology comprising both subjective and objective variables. The subjective measures provide a first step in understanding the preferences and perspectives of firms on constraints that affect the growth and expansion of business sector activities, while the objective measures provide additional information for carrying out the analysis, paying particular attention to industry-specific and country-specific factors. A proper blend of these two aspects allows us to assess the burden imposed by these constraints on enterprise performance.

3.2 An Efficient Taxation System; Weaknesses in Access to Finance, Land, and Skilled Labor

The empirical evidence from the ICA survey¹⁹ reveals that there are significant differences in the perceptions of opportunities and barriers for investment and growth among Maldivian entrepreneurs, depending on sector-specific issues (figure 3.1). Irrespective of the intersectoral differences among investor perceptions, there are a number of areas that represent major obstacles to all three sectors. These include: (i) access to finance; (ii) cost of finance; (iii) access to land; (iv) skilled labor; (v) corruption; and (vi) legal framework. A detailed assessment of these issues based on a sector-specific approach would be more interesting and policy relevant (figure 3.2).

Figure 3.1
Overall Top Five Constraints



Source: World Bank, Maldives, ICA, 2005

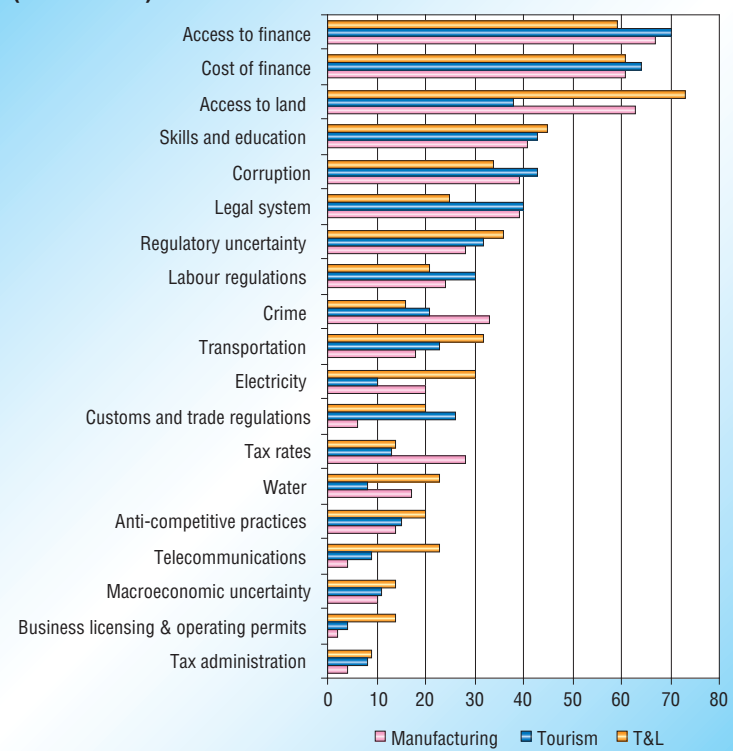
Entrepreneurs in all three sectors identified access to finance as the most important and most severe constraint affecting enterprise performance. There is, however, a high degree of diversity across the three sectors with respect to the relative significance and severity of other constraints affecting enterprise performance. For example, entrepreneurs in tourism and transport-logistics identified the cost of finance as the second-most severe problem, while their counterparts in manufacturing ranked it as third. Similarly, entrepreneurs in the transport-logistics sector identified access to land as the most severe constraint, while their counterparts in manufacturing and tourism

¹⁹ Using the standard ICA methodology, manufacturing, tourism, and transport and logistics sector enterprises were asked to rate 19 predetermined factors and any other factor that may affect their business performance on a 0 to 4 scale.

ranked it second and sixth, respectively. Interestingly, entrepreneurs in the tourism sector identified the relative significance of a lack of skilled labor as the third-highest constraint on investment decisions, while their counterparts in manufacturing and transport-logistics ranked it at the fourth-highest position.

The explanatory factors underlying these findings are discussed in the remainder of this chapter. The next section describes the overall success story of reducing bureaucratic obstacles to doing business and identifies specific factors leading to barriers to entry. This is followed by sections on the legal system, governance structure, finance, land, labor, and infrastructure, and an analysis of the impact of the prevailing investment climate on firm performance.

Figure 3.2
Different Constraints in the Investment Climate in Maldives
(% of firms)



Source: World Bank, Maldives ICA Survey, 2005

3.3 Minimum Administrative Obstacles to Business Startup

Maldivian businesses do not appear to suffer from entry barriers as so many other South Asian countries do, and DBI 2006 ranked it 31 among 155 countries. Official procedures required to do business, such as registering a new business, obtaining licenses, paying taxes, etc., are often viewed as negative factors affecting the investment climate. These procedures can slow down the growth and expansion of business activities and retard the graduation of the informal economy into the formal sector. The existing body of empirical evidence on the business climate in South Asian countries—except for Maldives—points to heavy government regulation and unpredictability as key constraints to private sector development.

As noted in chapter 2, Maldives' performance is better than South Asia's overall performance and also relative to that of comparable small-island economies. In dealing with licenses, Maldives records the lowest cost relative to some of the island economies of similar income levels. Only 9 steps of licensing procedures need to be followed and the time required is about 131 days, while the regional average is much higher. Maldivian performance is better with respect to payment of taxes in terms of frequency of payments, time to comply, and tax rates. In the ICA survey, less than 10 percent of the firms cited licensing and operating permits and tax administration as constraints to doing business. As reported in DBI 2006, the Maldives and Hong Kong are the only two countries who collect taxes once a year. In Hong Kong, however, it takes 80 hours per year

to collect taxes and the total tax payable is 14.3 of gross profits, as against 5.5 percent of gross profits in Maldives with no extra time taken.

3.4 Weak Legal Framework and Enforcement Capacity

According to the ICA survey findings, confidence in the rule of law also varies among entrepreneurs across sectors. Only about 41 percent of the entrepreneurs in manufacturing and tourism were confident that the judicial system would enforce contractual rights in business disputes and that figure was about 27 percent among transport and logistics sector entrepreneurs. Similarly, only 43 percent of entrepreneurs in tourism were confident that "government officials' interpretations of regulations affecting establishments are predictable," while it was 39 and 20 percent among entrepreneurs in the manufacturing and transport-logistics sectors.

Major problems still remain with respect to enforcing contracts and closing a business, creating severe exit barriers. According to the DBI 2006, the procedures for starting a business is relatively better in Maldives, with only 6 stages, compared to a regional average of 7.9; the time required is 12 days, compared to the regional average of 35.3 days. The cost is much less also, at 12.4 percent of income per capita, while the South Asian regional average was 39.7 percent. To enforce a contract, it takes 434 days, compared to a regional average of 385 days, even though the cost-at 8 percent of the debt-was much less than the regional average of 36.7 percent. Since there is no insolvency or bankruptcy law, the time taken for closing a business can be as long as 6.7 years, compared to a regional average of 4.2 years; the cost is about 4 percent of the estate. (Refer Box 3.1)

The perception of corruption in the Maldives is better than the South Asian average (Star Graph 3.1). The score was 4.2 according to the Corruption Index of Transparency International, but lags behind Singapore (9.2). In the World Bank Governance Indicators 2005, Maldives ranked second in South Asia and is only behind Bhutan in control of corruption. However, the performance under overall governance indicators deteriorated in the Maldives in 2004 compared to the ranking of 2002, as can be seen in the Star Graph 3.2. This perception has been supported by increasing print and electronic media exposure on perceived conflict of interest, which will affect the business environment in the medium term. More attention needs to be given to this aspect to ensure that the situation does not deteriorate further, despite the fact that Maldives' performance relative to the other countries in the region may still be better. This perception was further supported by the empirical evidence of the ICA. Fifty-two percent of the firms surveyed reported making informal payments to conduct typical business activities; this amounted to 6 percent of the share of sales.

Box 3.1 : Legal and Judicial System in the Maldives

The Maldivian judicial system is based on Islamic Shari'ah law. The Urf or customary law in the community is accepted, as the conventions do not contradict the Shari'ah or the legislative framework. In 1997, reforms brought four categories into the court system: civil, criminal, family, and juvenile law. All of the island courts come under the Ministry of Justice, while the high court is independent of the lower courts. However, there is also a right of appeal to the president if the litigants are dissatisfied with the decision of the High Court. The Maldives is already a member of the Multilateral Investment Guarantee Agency (MIGA).

Civil courts handle cases relating to property, commercial, and summary matters. Unlike the other countries in South Asia, where the legal system has been well developed over the past three centuries, the legal and judicial system in Maldives is still at a very preliminary stage. The members of the Bar are drawn from graduates of Common law, Islamic law as well as from qualified graduates who follow the diploma course in Shari'ah law in Maldives. The government has recognized the need to introduce major reforms in the legal and judicial system especially in the commercial law to provide a better legal framework to further induce investors.

Source: Year Book 2003

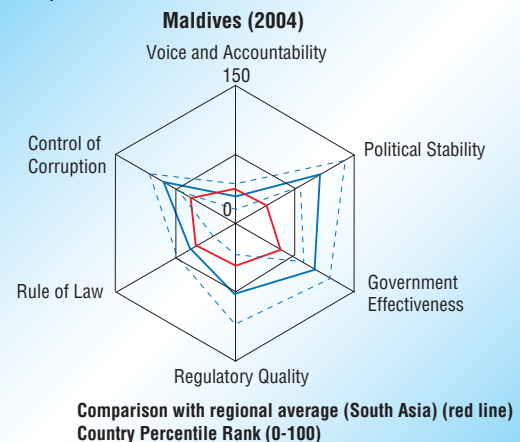
Confidence in the legal system that contracts will be honored and disputes will be handled fairly and efficiently is important for attracting investments. The ICA study revealed that investor confidence in the judicial system is low at 38 percent, compared to Sri Lanka (69%) and India (71%). Another concern raised by investors is the unclear demarcation between public and private sector roles. This is an emerging concern for most of the small countries, including Bhutan and Sri Lanka. The Maldives was rated 31 out of 155 countries in DBI 2006 for ease of doing business, ahead of all South Asian countries; however, to consolidate its position, it needs to improve public disclosure, transparency, and accountability in its public policy matters and better manage conflict of interest. Having recognized that a more modern legal and judicial system needs to be introduced, the government has already initiated reform efforts in the legal and regulatory framework to facilitate investment

and private sector development. However, these efforts need to be expedited.

During 2005, the government introduced several reforms, including the setting up of a separate body for monitoring compliance with enforcement of court decisions in the Attorney General's department. The government also announced that it would introduce an examination for practicing lawyers and that it plans to establish a Bar Association and draft a Code of Ethics for judges. The Attorney General's department is in the process of preparing a three-year civil-justice action plan. Training has been provided to the staff in Malaysia and Singapore. Currently civil court procedures, banking law, labor tribunal law, and arbitration acts are being drafted. The AG's

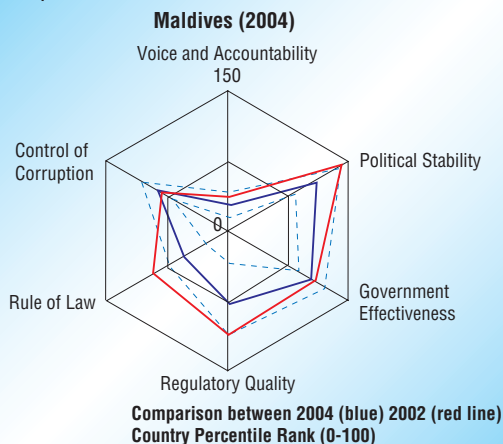
department is in the process of amending the foreign investment law, which will be presented to the parliament shortly. A treasury bills law and an audit law are also being drafted. The government also has initiated efforts to strengthen the Public Procurement Bureau with assistance from the World Bank (see annex 1).

Star Graph 3.1



Source: D. Kaufmann, A. Kraay, and M. Mastruzzi 2005: Governance Matters IV: Governance Indicators for 1996-2004 (<http://www.worldbank.org/wbi/governance/pubs/govmatters4.html>)

Star Graph 3.2



Source: D. Kaufmann, A. Kraay, and M. Mastruzzi 2005: Governance Matters IV: Governance Indicators for 1996-2004 (<http://www.worldbank.org/wbi/governance/pubs/govmatters4.html>)

3.5 Access to Finance, a Growing Concern

Access to finance is the most serious constraint affecting the investment climate in the Maldives. As noted in chapter 2, only one-third of the business community uses bank loans for business activities. Survey data also reveal that firms in the Maldives heavily depend on internal funds for

meeting their working capital and investment capital requirements (Table 3.1). On average, the contribution of domestic commercial banks and international commercial banks to working capital requirements is as low as 11 and 3 percent, respectively. The contribution to new investments, however, is 17 and 5 percent by domestic and foreign banks, respectively. Use of credit cards, equity, family and friends, and leasing as alternative sources of financing are also relatively less significant in Maldives. Further investigations into low dependency on bank loans by business sector enterprises revealed that more than 75 percent of the respondents in all three sectors have not applied for a bank loan. Twenty-five percent in tourism, 19 in manufacturing, and 17 percent in transport stated that their last application was turned down by a bank.

| Working capital - % | Manufacturing | Tourism | Transport & Logistics |
|---|----------------------|----------------|----------------------------------|
| 1. Internal funds | 73 | 67 | 56 |
| 2. Domestic commercial banks | 13 | 10 | 13 |
| 3. International commercial banks | 2 | 4 | 2 |
| 4. Trade credit | 5 | 8 | 12 |
| 5. Other | 7 | 11 | 17 |
| Total | 100 | 100 | 100 |
| New investments - % | Manufacturing | Tourism | Transport & Logistics |
| 1. Internal funds | 48 | 65 | 44 |
| 2. Domestic commercial banks | 13 | 16 | 13 |
| 3. International commercial banks | 1 | 10 | 7 |
| 4. Leasing arrangement | 6 | 1 | 3 |
| 5. Other | 32 | 8 | 13 |
| Total | 100 | 100 | 100 |
| Source: World Bank, Maldives ICA Survey, 2005 | | | |

The financial sector of the Maldives is very narrow and is dominated by the banking sector, which consists of one locally owned commercial bank, branches of three South Asian state-owned commercial banks, and a branch of a widely known international bank. The nonbank financial sector in the country consists of a government provident fund, a finance leasing company, a housing bank, two insurance companies registered in the country, and some agents for overseas insurance companies. The government recognizes the importance of a well-functioning financial sector to making further progress on the path of development and has taken measures to increase competition in the financial sector, including facilitating the expansion of the banking sector, and supporting the creation of a leasing finance and a housing finance institution, which have somewhat deepened the market.

Of the commercial banks, Bank of Maldives (BML), the only domestic bank, is jointly owned by the government (51%), island communities (25%), and other government agencies. The BML has 18 branches (three of which are located in Male) and 5 mobile branches (dhonis). It is undertaking development-banking activities whereby credit is extended to the private sector for various income-generating activities. Of the foreign commercial banks, all of which are based in *Male*, three are South Asian banks. These banks provide credit especially for the tourism sector. Although they continue to mobilize deposits and provide foreign exchange to the private sector, they cater primarily to the corporate sector.

Banks hold a substantial part of their assets in the form of reserves (the minimum reserve requirement is a high 30 percent), which constrains their ability to increase lending. Commercial banks invest in Certificates of Deposits of the MMA (Maldives Monetary Authority); residents are

Table 3.2 : Loans and Advances in Commercial Banks, 2002-2004 (%)

| Sectors | 2002 | 2003 | 2004 |
|---------------|--------|--------|--------|
| Fishing | 5.50 | 6.80 | 6.30 |
| Tourism | 55.60 | 56.00 | 58.20 |
| Agriculture | 0.50 | 0.50 | 0.30 |
| Construction | 6.50 | 7.60 | 6.80 |
| Manufacturing | 0.70 | 1.80 | 1.40 |
| Commerce | 25.40 | 22.00 | 20.70 |
| Others | 5.70 | 5.40 | 6.30 |
| | 100.00 | 100.00 | 100.00 |

Source: Maldives Monetary Authority - (2002 - 2004)

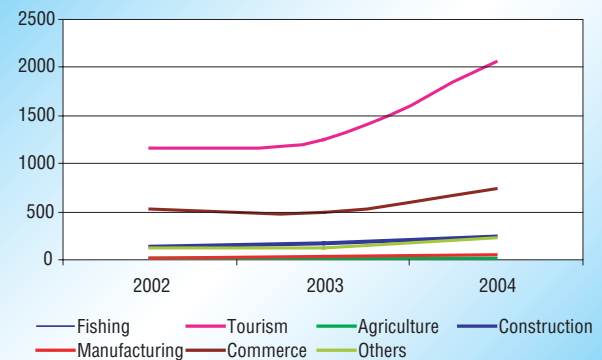
allowed to maintain foreign currency accounts and both current and capital accounts have been liberalized. Banks are generally reluctant to extend loans with longer-term maturities (more than 3-5 years) and the spreads remain high. Bank-to-bank credit ceilings were removed in 2001. Prior to July 2001, there were aggregate credit limits on commercial banks, which served as a cap on the growth of credit to the private sector.

Total assets in the commercial banking sector as of 2004²⁰ were MRf 7.1 billion. Total credit to the private sector increased from MRf 2.2 billion to MRf. 3.5 billion in 2004. As reflected

in table 3.2, almost 60 percent of the credit is for the tourism sector. It was followed by the commerce and fisheries sectors, with all three sectors accounting for more than 85 percent (figure 3.3). The expansion of credit in 2003 was significant and 70 percent of the credit was for the private sector in that year. This trend was endorsed in discussions with the individual banks. The deposits amounted to MRf 5.7 billion in 2004 and there is an increasing tendency for the foreign currency deposits to grow. However, it was notable that 69 percent of the deposits were short-term deposits.

Deposit rates vary from 1.5 percent to 3.0 percent for savings deposits, while time deposits range from 1.5 percent to 6.5 percent for maturities of 6 months to over 5 years. The lending rates vary from 8-13 percent for domestic currency and 7.75-13.0 percent for foreign currency; the same rates apply for the government. The rates of return on deposits had been negative, given the high inflationary trends in the past two years (6.5 and 8.0 percent, respectively). In addition, Maldivians enjoy other attractive investment opportunities in neighboring countries, which require the banks in Maldives to be more competitive and innovative.

From the analysis given in table 3.3, it is evident that large-scale entrepreneurs are dominant in the utilization of bank loans in tourism. In contrast, small-scale entrepreneurs in manufacturing and transport and logistics account for more than 50 percent of the bank loans utilized for business development. However, it is evident from the supplier side as well as the demand side that access

Figure 3.3 Commercial Bank Credit (Rf millions)

Source: Maldives Monetary Authority, 2005

to credit is a major constraint, especially for the medium and small enterprises, given that more than 50 percent²¹ of bank credit is for the tourism sector. In addition, the banks rely on collateral more than cash-based lending and, given the limited availability of land ownership in the country, the SMEs find it difficult to raise funds for new business ventures.

Table 3.3 : Use of Bank Loans by Firm Size (%)

| Size | Manufacturing | Tourism | T & L |
|---------------------------|---------------|---------|-------|
| Small (50< employees) | 61.5 | 37 | 57 |
| Medium (51-100 employees) | 30.5 | 5 | 21 |
| Large (employees 100 +) | 8 | 58 | 21 |
| | 100 | 100 | 100 |

Source: World Bank, Maldives, ICA Survey, 2005

With the entry of the Maldives Finance Leasing Company (MFLC) in 2002, enterprises have access to medium- and long-term capital-equipment financing for various economic sectors. This was one of the government's initiatives to strengthen and introduce more sophistication and depth into the financial sector. The company was established with assistance from International Finance Corporation (IFC), with the National Development Bank (NDB) of Sri Lanka as the technical partner. It has provided leasing finance for capital equipment, of which 79 percent is for the tourism sector—speed boats, live-aboard safari and fishing vessels, dhonis, computers, and excavators. The lease periods range from 12-60 months, with the majority being at the upper end. Given the proactive role played by the leasing company, greater expansion in leasing facilities can be expected.

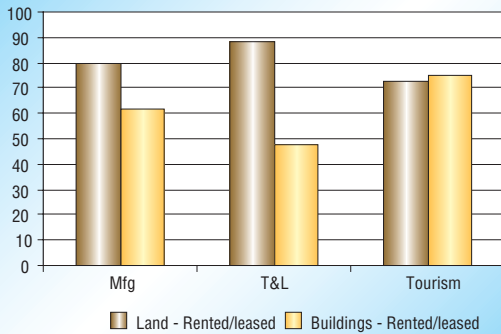
Another positive initiative was the commencement of capital market operations in April 2002, with the opening of securities trading; this remains, however, at a very nascent stage. Only three state enterprises that have been quoted on the stock exchange—the BML, State Trading Organization (STO), and the Maldivian Transport and Construction Company—and have limited secondary market activities. Total market capitalization was MRf 662 million in 2002 with only three state-owned enterprises listed, but there is potential for high growth with government plans to list more enterprises on the stock exchange. That will encourage corporate governance as well as more transparency for the state-owned enterprises. Currently, the investment instruments are extremely limited, and if other private sector companies—especially in tourism, trading, and commerce—are also encouraged to list on the stock exchange, the economic linkage with the rest of the economy can be strengthened. The government may also explore the feasibility of Maldivian companies listing on emerging stock markets in the region, including those of Colombo and Mumbai.

3.6 Access to Land, a Critical Constraint to Further Expansion

Access to land has emerged as one of the biggest obstacles to business growth. In fact, the majority of business operations are being carried out in rented/leased out land and buildings (figure 3.4). The average contract length for land varies from 7 years in transport and logistics to 10 and 14 years in manufacturing and tourism, respectively. Similarly, the average contract length for buildings varies from 7 years in transport and logistics to 8 and 11 years in manufacturing and tourism. The financial terms of the lease are primarily (90 percent) based on the rental value.

21 Maldives Monetary Authority, Economic Statistics, June 2005.

Figure 3.4
Rented/Leased out Land and Buildings (% of firms)



Source: World Bank, Maldives ICA Survey, 2005

According to the survey evidence, more than one-third of the firms in tourism and transport-logistics and about 26 percent in manufacturing have made an attempt to acquire rights to new land or buildings. However, as reported by the respondents, such efforts have been unsuccessful (62% in manufacturing, 44% in tourism, and 47% in transport-logistics). The entrepreneurs believe that this is primarily due to high prices and a lack of interest on the part of the government. The other reasons include failure to get zoning approval, lack of infrastructure facilities, and absence of clear titles.

One of the major challenges for the government is how to attract investments within the structure of an increasingly competitive market economy while protecting the vulnerable groups, particularly women, the poor, and the elderly. This is endorsed by the government's Vision 2020. Land and housing markets are an integral component of a dynamic market economy, which was recognized in the Sixth National Development Plan. This will require a paradigm shift in the role of the government from being a direct provider to being a facilitator and a regulator by allowing the development of housing, land, and property markets in the private sector and local communities.

Until about 2002, there was no housing and urban development strategy in the Maldives and development took place within an ad-hoc regulatory framework. Residential densities in *Male* Island are extremely high. A survey in 2002 revealed an average net density of 913 persons per hectare, with some areas even higher. Estimates of demand for housing indicated that between 2003 and 2020, additional dwellings would be needed for about 600 households annually for the next few years. More would be required in order to reduce existing levels of overcrowding and replacement of obsolete or substandard housing on *Male*. Since there is no prospect of increasing the area of land available on *Male*, the only significant option for meeting future housing and urban development needs exists through the development of Hulhumale, which has already begun. According to the 2002 study, even that may not be adequate in the long term, so policymakers need to be efficient and sensitive in allocations.

A regulatory audit carried out in 2002 concluded that existing planning standards and regulations, together with land-use planning and zoning regulations, are generally flexible and accommodate needs within the available resources. For example, although government authorities have proposed land-use zoning for major land uses, their application has not inhibited the development of small-scale economic activities within residential areas or housing within institutional areas. However, there is considerable inconsistency and duplication in the application of the regulatory framework by government departments, most of which lack the capability to enforce the regulations and standards for which they are responsible. In addition, administrative procedures are complicated and there is a lack of transparency in providing information in a coordinated, comprehensive manner. This makes it extremely difficult for private developers or individuals to conform to these regulations, standards, and procedures.

According to the available studies, no comprehensive and transparent regulatory framework for housing and urban management currently exists in the Maldives. Planning and building standards and regulations have been developed in an ad-hoc manner in response to individual needs and circumstances. According to the 2002 study, neither the *Male* Municipality nor Ministry of Housing possesses a single list of regulations or standards to which individuals or developers must conform in order to obtain planning or building permission. This lack of a clear framework does not appear to have inhibited a substantial increase in building activity during the last two decades. A large number of multistory buildings have been developed in *Male*, even though regulations concerning set-backs from adjacent properties for window openings and ventilation were not formally introduced until May 2002.

Procedures for obtaining building permits in the *Male* urban region are perceived as lengthy, but are in fact extremely quick compared to most countries. For example, it took only 17 days in 2002 to obtain building permits for private buildings of one or two stories; 24 days for private buildings over two stories, and 40 days for government buildings. However, the procedures in the atolls were much lengthier, since many more institutions are involved.

Several agencies are developing regulations on similar issues, which has led to duplication in some cases and gaps in others. In many cases, the regulations that do exist are not readily available to the general public or potential developers. This inhibits the development of a formal property market. Finally, the lack of a condominium or strata title system, together with the regulation permitting plots to be subdivided into separate buildings, has resulted in excessive subdivision and inefficient plot use.

Land Use and Urban Form. Land use in the reclaimed area of *Male* is less efficient than in the older parts of the city. This is partly due to the segregation of land uses and the lack of residential uses in the reclaimed area, which is less than 7 percent of the total area reclaimed. This is ironic, since the stated objective of reclaiming this area was to increase space for residential use. The layout of blocks in the reclaimed area does not achieve the flexibility or efficiency of the traditional layouts. The allocation of large blocks to single government users has also resulted in the inefficient development of block frontages onto roads, raising the unit costs of infrastructure provision and resulting in an urban environment that lacks the social vitality, economic efficiency, and visual interest found throughout the older areas of *Male*.

Management of Public Non-residential Property. In 2002, government departments paid only a nominal monthly rent of MRf 0.5 per square foot for land they occupied. Public enterprises (PEs) paid a fixed monthly rent of MRf 1.0 per square foot (MRf 10 square meter) compared to notional market rates of MRf 5.0-8.0 per square foot, which represented an opportunity cost of between MRf 4 and MRf 7 for every square foot of such land every month. There is no regular land market in *Male*, since all land has been developed and the tradition by which government allocates land free to selected applicants makes estimates of market rates difficult to obtain. However, the recent policy discourages public sector agencies from realizing the full value of their property portfolios. It also encourages them to claim larger areas of land than may be strictly required to fulfill their mandates, and in several cases has enabled public enterprises to generate considerable income from renting out surplus space to private sector companies, thereby further inhibiting the development of a transparent land market.

The development of Hulhumale' provides an opportunity for the spatial decentralization of economic activity and population as part of a national housing and urban development strategy. While the government of Maldives has identified Hulhumale as the means of achieving this objective, the key issue is the nature and extent of incentives that may be required to achieve it. This also raises the possibility of relocating inappropriate land uses on *Male* to Hulhumale' or Thilafushi and releasing land for additional residential development and social facilities to reduce densities and improve the urban environment in *Male*.

3.7 Inadequacies in the Skills Mix

| Award | Male | Female |
|----------------------|------|--------|
| Certificate | 61 | 13 |
| Advanced Certificate | 138 | 128 |
| Diploma | 93 | 152 |
| Degree | 14 | 18 |
| Foundation Studies | 80 | 165 |
| Sub Total | 386 | 476 |
| Grand Total | 862 | |

Source: Maldives College of Higher Education, 2004

Educational attainment in Maldives has improved over the past several years, but other elements for a strong human capital base are missing. In 2004, the graduate output of Maldives College of Higher Education was 862, representing certificate, diploma, degree, and foundation study programs (table 3.4). Although most workers (67 percent) are involved in some on-the-job training, it is often not enough to enable them to adjust to major changes in technology or to move across different jobs (table 3.5). Despite certain improvements, the lack of local skilled labor continues to be a major problem in Maldives. Moreover, the quality of education has not kept pace with enrollment. This has led to a dysfunctional labor market and creates reliance on migrant labor from neighboring countries. Since there is no statutory minimum wage, cheap labor in the region, especially from India, Sri Lanka, and Bangladesh, further depresses the market.

| Type of training | Manufacturing | Tourism | Transport & Logistics |
|------------------|---------------|---------|-----------------------|
| Internal | 57 | 63 | 57 |
| External | 28 | 43 | 36 |

Source: World Bank, Maldives ICA Survey, 2005

According to the 2000 Population Census, the country's domestic labor force stands at about 87,442. The labor force participation rate is 47.7 percent. The local labor force is supplemented by the employment of a significant expatriate labor force. In 2004, 38,413 expatriates were employed in the Maldives, up from 33,765 employed at the end of 2003. Youth is the largest cohort among the Maldivian population (35 percent)²² and the extent of nonparticipation by youth in national development is disturbing. Unemployment rates have risen significantly in the Maldives, especially in the Atolls and among youth. As shown in the figure 3.5, access to employment opportunities is much lower for young women than for youngmen. This trend is attributable to cultural issues and the restricted mobility of women in the atolls, as well as to increasing income and education levels, which result in high expectations among youth for professional and remunerative jobs.

22 Based on 2000 Census data, age group 15-35 years.

With the growth and expansion of business activities, however, expatriate labor has recorded a steady increase over time. As can be seen from table 3.6, the presence of expatriates is very high at the unskilled level. Some surmise that the immigration of "guest workers" and the concomitant decline in the birth rate might lead to non-Maldivians being a majority in 50 years.

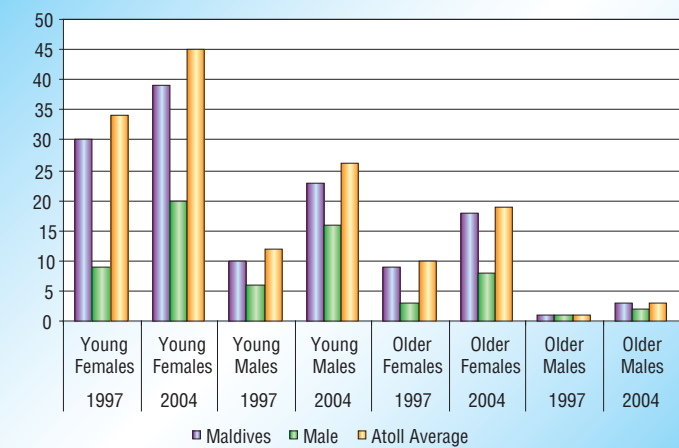
Survey data indicated that existing labor regulations act as a constraint affecting enterprise performance, particularly in employing foreign

labor. As argued in the literature, liberalizing temporary contracts while leaving in place strict regulations on regular contracts reinforces the inequity in the labor market. It also creates distortions in the labor market. According to industry sources, an unskilled worker from a foreign country collects an average monthly pay of MRfs 2,000 while a local person needs to be paid at least MRfs 2,500 per month. Hence, firms will have greater incentive to hire foreign workers at an entry level and employ them for a limited period, without giving them a regular position thereafter. This does not necessarily increase overall employment or productivity because at the end of the contract, there will be little or no development of human capital.

The survey also highlighted the lack of availability of the right skills. Most schools only offer commerce subjects and the average pass rate is 25 percent. The pass rate for English was 6 percent. However, the pass rate for chemistry, physics, commerce, fisheries, and science ranges from 25-45 percent. Difficulty in access to gainful employment increases the incidence of drug use, pessimism, and delinquency. An investment climate that benefits all members of society confronts the challenges of creating opportunities for the unemployed and young people joining the workforce for the first time. Labor market policies that meet this test play a vital role in the investment climate by helping to connect people to opportunities.

Maldives has no labor law in place, and issues relating to labor are governed by the labor regulations and numerous procedures set out by the Ministry of Labor and Employment. According to the current labor regulations, those intending to work in the Maldives must acquire a work permit issued by the Ministry of Employment and Labor. Employers intending to employ foreign nationals in the Maldives are required to apply for work permit numbers prior to the prospective employees' arrival in the Maldives. A completed work permit application is processed within one to three working days.²³ Wages and working hours in the private sector are largely determined by negotiations between the employer and prospective employees. However, the public

Figure 3.5
Unemployment by Broad Age Group and Gender (1997 & 2004)



Source: World Bank, Maldives ICA Survey, 2005

| Occupation | Employed - Local* | Employed - Foreign" | Total |
|---|-------------------|---------------------|----------------|
| Legislators, Senior Officials & Managers | 3,815 | 801 | 4,616 |
| Professionals | 7,604 | 4,072 | 11,676 |
| Technicians & Associate Professionals | 6,363 | 1,941 | 8,304 |
| Clerks | 4,611 | 258 | 4,869 |
| Service workers and shop and market sales workers | 10,554 | 4,717 | 15,271 |
| Skilled Agricultural & Fisheries Workers | 11,565 | 107 | 11,672 |
| Craft & related Trade Workers | 14,518 | 5,329 | 19,847 |
| Plant, Machine Operators Assemblers | 5,079 | 2,422 | 7,501 |
| Elementary Occupations | 6,158 | 14,118 | 20,276 |
| Armed forces | 1,433 | | 1,433 |
| Not stated | 14,545 | | 14,545 |
| Totals | 86,245 | 33,765 | 120,010 |
| Source: * Census 2000 - Ministry of Planning and National Development " 2003 data - Ministry of Employment and Labor | | | |

sector has standardized working hours and salary scales. Labor strikes and other work disruptions are nonexistent in the Maldives, which is a positive sign compared to the unhealthy trends in the rest of South Asia.

There seems to be a lack of relevant training, which leads to a mismatch in demand and supply. The demand is primarily in the "blue collar" category while the supply is more for "white collar" jobs (Box 3.2). According to a study conducted in 2003, every year about 10,000 non secondary-qualified youth join the labor force. The employment age is specified as 18 years, but there is no mandatory schooling age as in the case of some of the other South Asian countries (e.g., Sri Lanka). It has also been revealed that 56 percent of the youth join the labor force unprepared for the demands of the labor market.²⁴

Box 3.2 : Higher Education in the Maldives

The Maldives College of Higher Education consists of the Faculty of Health Sciences (established in 1973, caters to nursing, pharmacy, and paramedics), the Faculty of Engineering Technology (1975, caters to engineering and other technical courses); the Faculty of Education (1977, caters to teacher training); the Faculty of Hospitality and Tourism (1987), the Faculty of Management and Computing (1991) caters primarily to the lower administrative services such as clerical, accounting, and business studies); the Centre for Maritime Studies (1987), the Centre for Open Learning (1999, distance learning), and the Faculty of Shari'ah and Law.

According to a tracer study of the Faculty of Engineering Sciences, 75 percent of the students were employed, of which 70 percent in the private sector; 92 percent in the field of training had found jobs within 41 days at an average. One-third of the enrollments of the 5,584 in 2003 were females, and 32 percent in Law, 80 percent in Education, 67 percent in Health, 64 percent in Accounting, and 26 percent in Hoteliering were female students. Ten percent of the courses are degree courses, 10 percent diplomas, 13 percent advanced certificate courses, and 65 percent are certificate courses. Most of the students qualify in health, maritime, and tourism, compared to the other sectors. In 2004, the completion rate was 25 percent. Annual budget for MCHC was MRF 61 million.

Source: Profile - MCHC 2005.

3.8 Among Infrastructure Facilities, Sea Transport appears to be the only Major Constraint

Transportation

In stark contrast to the above, the provision of infrastructure services does not appear to be a serious constraint from the perspective of the Maldivian entrepreneurs. Transportation problems seem to be a bottleneck only for tourism (23 percent) and transport-logistics (32 percent) sector businesses. In fact, this could be viewed as an important factor affecting the growth of business

24 Memo on Youth Employment: Real Issues by Dr. H. Hamid, May 2003.

activities in other atolls. In an island economy, transportation involves land, air, and maritime transport. As shown in table 3.4, only a small percentage of firms have their own transport and the majority of them are dependent on the services provided by public and private sector service providers. In manufacturing, about 55 percent of the transport requirements are met by maritime transport, while the rest is shared by land (29 percent) and air transport (16 percent) facilities.

The high cost of transportation in Maldives has major implications for business progress. Improvement of the transportation facilities will promote business activities in all sectors of the economy. It will also facilitate the decentralization initiative of the government and allow economic activities to develop outside *Male*. During field visits entrepreneurs complained strongly about the high cost of transport between atolls. Transport has also been identified as a major factor affecting poverty.

Road transport is important in *Male* and the large islands have paved roads and easy accessibility. Motorcycle (14,200 in 2002) is the popular vehicle in *Male* and the island and motor car is more of a status symbol, with about 1,950 (2002) in *Male*; a very efficient taxi service for reasonable rates is also available in *Male*. Sea transport is crucial for the Maldives and visible growth in domestic aviation is evident, with the setting up of domestic airports and the establishment of floating platforms for sea planes (30 in 2002).

| Indicator | Atoll Average |
|---|---------------|
| More than 100 people per vessel | 43 |
| Dhoni traveling 3 time or less a month to Atoll capital | 26 |
| Dhoni traveling 3 time or less a month to <i>Male</i> | 36 |
| Island not always accessible | 40 |
| Source: World Bank, Maldives ICA Survey, 2005 | |

Sea transport is the largest mode of transport, especially between *Male* and the islands. With the exception of a few ferry services among the islands of the greater *Male* region and very few in the atolls, the Maldives is without regular interatoll and interisland boat services (table 3.7). In the islands, people are required to arrange dhonis for themselves for travel and the cost of hire is very high. Fishing dhoni is the all-purpose

vessel in Maldives in addition to the ferries; they are primarily owned by the tourist resorts or by ferry companies who provide transport to islands on individual requests. Problems include a lack of harbors and jetties, sometimes due to shallow waters and coral reef, weather conditions, and visibility at night (markers are not available). The problem of sea transport is assessed based on: (i) the number of people per vessel; (ii) the frequency of transport to the atoll capital; and (iii) the accessibility of the island.

According to the recent VPA,²⁵ during the past seven years, from 1997 to 2004, limited changes have taken place in interatoll and interisland transport. With the exception of the ward islands of *Male*, a limited number of islands and primary atolls, a large number of islands are without regular ferry or boat services. One reason is the increased size of a typical dhoni. The same can be seen with transport to *Male*. In 1997, 29 percent of the population had a dhoni traveling less than three times a month; in 2004, however, the percentage had increased to 36 percent.

25 Vulnerability and Poverty Assessment, 2005.

Accessibility has also improved significantly during the period 1997-2004. By now, there are no islands without accessibility due to coral reefs. The number of people who live without a harbor or jetty are half the number they were in 1997. The population who live on islands that are always accessible has risen from 30 percent to 60 percent.

Electricity

Similar to the findings for transportation, only about 20 percent of the firms in manufacturing thought that electricity represented a major constraint, while it was 23 and 10 percent in transport-logistics and tourism sectors. State Electric Company Ltd. is generating and distributing electricity to commercial and residential customers, government departments, and mosques in *Male* and 23 other inhabited islands in the Maldives. The commercial and industrial sector accounts for about 31 percent of its revenue, while the rest is generated by residential (48%) and public and government institutions (21%). The tariff rates for business sector enterprises vary from MRf. 3.15 to MRf. 3.75 per unit depending on the level of power consumption. On average, the frequency of power outages was 2.8 days as against 6 days in the Philippines and 14.5 days in Pakistan. The delay in obtaining an electricity connection was 5.5 days in Maldives in comparison to 8.2 days in the Philippines and 81.6 days in India.

Similar to India, 64 percent of business enterprises in Maldives reported having their own generators. However, contrary to international experience, the use of generators in the island economy of Maldives appears to be a low-cost operation in carrying out business activities. As noted during field visits, having their own generators is more advantageous to business enterprises in *Male* as the unit cost of electricity is less relative to STELCO (the STELCO cost per unit for business-purpose customers varies from MRfs. 3.15 to 3.75, while they incur a much lower cost per unit with the use of a generator). On average, the cost of a generator varies from MRf. 0.61 million among businesses in the manufacturing sector to MRf. 1.75 million for those in tourism. This is equivalent to 5 percent and 7 percent of the total fixed assets of the manufacturing and tourism enterprises. These resources could be employed more productively in the core business areas of firms.

STELCO²⁶ is the only company that supplies electricity. Due to the geographical structure, supplying electricity from one island to another is more expensive than installing individual power stations in the islands. *Male* was the first island to have a 24-hour power supply, but this has now increased to more than 20 islands. In addition, the government has provided financial assistance for developing both private and community-based power stations in the remaining islands. Fifty islands have community power and another 6 islands have private providers for 24-hour power supply. The remaining 119 islands have at least 5-12 hours' power supply (table 3.8).

There are about 5.7 MW of privately owned standby power systems in *Male* alone. A standby power system is used by the Maldives Water and Sanitation Authority for production of water. There are more than 20 private providers in the outer islands, primarily small private companies and family-run businesses.

26 Vulnerability and Poverty Assessment, 2005.

Even in 1997, only 7 percent did not have access to electricity, with 7 islands not having access to electricity at all. Two-thirds of the islands' supply was less than six hours. According to the VPA 2005, all have access to electricity, and only three islands, with populations of less than 150 people, had less than six hours of power supply. On the other islands, a very small number of the people had less than six hours, not due to supply but due to unaffordability.

Table 3.8 : Access to Electricity (% of population)

| | 1997 | 2004 | 1997 | 2004 |
|-------------------|-----------------------|-----------------------|-------------------|-------------------|
| | Access to electricity | Access to electricity | More than 6 hours | More than 6 hours |
| Maldives | 93 | 100 | 80 | 99 |
| Male | 100 | 100 | 100 | 100 |
| Atolls | 91 | 100 | 72 | 98 |
| Source: VPA, 2005 | | | | |

3.9 Growth in Telecommunications Leads to Greater Connectivity

Telecommunications do not appear to be a serious constraint to Maldivian entrepreneurs. Only 27 percent of the firms in transport and logistics thought that it represented a major constraint, while it was 18 and 4 percent in tourism and manufacturing. The telecom sector in Maldives appears to be one of the high-growth sectors in the economy. To a large extent, Maldives has performed well in terms of telecommunications, particularly during the recent past, as in the case of all South Asian countries. In fact, improved telecommunications has opened up new economic opportunities and contributed to growth and expansion of business activities in the Maldives. While the combined fixed and mobile phone penetration rate in Maldives is higher than that of its South Asian counterparts, it remains low compared to other countries in East Asia (e.g., Singapore), indicating significant scope for improvement. Similarly, with respect to use of the Internet, Maldives ranks far behind Singapore, in spite of its better performance by South Asian standards. As noted earlier, use of e-mails and Web sites for business purposes is high in tourism relative to manufacturing and transport and logistic (table 3.9).

Table 3.9 : Use of Telecommunications Facilities in Business Activities (%)

| | Manufac-turing | Tourism | T & L |
|--|----------------|---------|-------|
| Regular use of e-mails interacting with clients/suppliers | 96 | 98 | 84 |
| Regular use of Websites interacting with clients/suppliers | 45 | 93 | 59 |
| Source: World Bank, Maldives ICA Survey, 2005 | | | |

The rapid progress of communication has proved to be a backbone for socioeconomic development in the Maldives and it lessens the insular nature of the islands.²⁷ Further developments are envisaged. Traditionally, communication services were provided solely by Dhiraguu Private Limited, a joint venture between the government and a United Kingdom-based company. Creating more competition, the sector has been opened to a second player recently, with Wataniya, a Kuwait-based company commencing operations in 2004. Postal services are provided by the government. With the introduction of mobile telephones in 1997, the accessibility of the outer islands has improved significantly. About 150,000 mobile phones are available, while the fixed lines total up to about 60,000.

In *Male*, two-thirds of the population have a fixed-line phone at home and more than three-fourths have a mobile phone. In the atolls where fixed lines have been installed, one in six has a telephone in the house. Mobile phones have spread wider, and 50 percent of the population in the atolls have at least one mobile phone. Radio and television are quite widely used, with five-sixths of the

population having both these items. Regular newspapers are not available for more than 40 percent of the population.

The phenomenal progress seen in the telecommunications sector also widens the horizons for mobile banking, providing connectivity with the island communities and especially promoting income-generating economic activities that were not feasible earlier.

Water Supplies

Maldives Water & Sewerage Company Pvt. Ltd. (MWSC) is primarily responsible for providing water supply and sewerage services to the islands of *Male*, Hulhumale, Villingili, and Maafushi (in *Male* atoll). Its tariff rates for the institutional and commercial sectors have remained unchanged over the past three years, while the tariff rates for domestic customers have marked a declining trend during the same period. Interestingly, water service is the only sector addressed in the survey for which there are no complaints about service interruptions and resulting hours of productive time lost. Out of a total of 59 percent of enterprises in manufacturing, only 17 percent complained about the quality of water used in production.

3.10 Impact of the Investment Climate on Enterprise Performance and Investments

This section presents the results of our empirical analysis of the effect of various investment-climate indicators on enterprise performance: labor productivity, profitability, sales growth, employment growth, and investment rate. Our findings confirm that the investment-climate constraints discussed in the preceding sections affect firm performance. However, we are not in a position to highlight intersectoral differences of investment climates due to the small size of the sample. The methodological approaches used in the analysis are described in detail in technical appendix 2.

An assessment of investment climate- and industry- and firm-specific factors on enterprise performance brings out some interesting policy insights. First, foreign competition (as measured subjectively by entrepreneurs) is positive and significant as a determinant of productivity, profitability, and employment growth. It also indicates the negative impact of unskilled labor on profitability and productivity. Use of e-mail and Web sites in business activities is positive and significant as a key determinant of productivity. Similarly, the impact of training is positive and significant in promoting employment growth and the rate of investment.

Second, the impact of unskilled labor on productivity and profitability indicates the significance of human resource development in improving the investment climate in the Maldives. In addition, labor relations are also perceived to be negatively associated with value added and profitability. The negative impact of bank loans on value added, profitability, and sales growth confirms the relatively low utilization of bank loans by the firms. The evidence on investment climate and enterprise performance clearly confirm the negative impact of access to finance over labor

productivity. The cost of finance is also negative and significant as a determinant of labor productivity and investment rates.

Among governance and administration variables, total waiting days for import licenses appear to be negatively associated with labor productivity. The impact of the regulatory burden measured in terms of the number of government visits (inspections) per employee revealed a significant negative correlation with labor productivity, profitability, and investment rates. The impact of other investment climate constraints on business performance cannot be assessed due to the lack of robustness and the small sample size of the study.