

REPUBLIC OF  
MOLDOVA **2014**

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**REPORT**

STATE OF THE COUNTRY REPORT

**REPUBLIC OF  
MOLDOVA  
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**2014:  
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COUNTRY REPORT**

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# Key Policy Messages

*In 2013, the Republic of Moldova experienced an impressive economic performance: the 8.9% growth in the gross domestic product (GDP) was the highest in its modern history and places the country as one of the best economic performers in the region. Nevertheless, this improvement was primarily due to cyclical factors (recovery in the agricultural sector after the severe drought of 2012), with limited progress taking place regarding the main driving engines of economic growth. Investment activity and exports remained tepid, while the employment rate was low, revealing that the Moldovan economy reflects an unsustainable and non-inclusive development model. Economic growth is therefore expected to be rather slow in the coming years as the cyclical factors cited will dissipate in 2014 and, most likely, will not be replaced by structural growth factors. In addition, the uncertain situation in Ukraine and the economic difficulties in the Commonwealth of Independent States (CIS) and the European Union (EU) will exert additional pressures on the Moldovan economy in the near future. In this context, the authorities' top priorities should be to improve the business climate, thoroughly monitor the banking system, boost the efficiency of state-owned enterprises and reform the education system. These measures will eventually boost the three main production factors on which the competitiveness of an economy depends: capital (investment), the labour force and technologies that influence the efficiency/productivity.*

- ❑ In addition to domestic economic difficulties, **there are certain risks stemming from Moldova's high exposure to the external environment in the face of the unstable economic and political context in the region.** Thus, the inflow of foreign direct investment and remittances and the volume of exports are all expected to be volatile in the short-term, due to the uncertainty in the region (especially in Ukraine), volatile foreign demand (especially from CIS countries) and the trade restrictions imposed by the Russian Federation. These risks are heightened by Moldova's low level of competitiveness, poorly diversified sales markets and the limited capacity of most of the country's public institutions. **These constraints are likely to undermine the benefits of the Association Agreement with the EU during the next three to five years.**
- ❑ In addition to the traditional channels through which a country can be exposed to external shocks (investment, exports, remittances, weather conditions), **two additional sources of potential disruption have taken shape in Moldova in recent years: (i) foreign grants, and (ii) placements and portfolio investments in the banking sector.** Though in the short-term these have positive effects (grants help improve the infrastructure and stabilize public finances, while placements and portfolio investments foster banking system capitalization and liquidity), they impose a series of potential risks in the long term. First, an eventual decline in foreign grants, which account for about 10% of the state budget, could double the budgetary deficit, which is already relatively high (an expected 2.6% of GDP for 2014, as against a maximum sustainability threshold for Moldova of only 1%). Considering the extent of the informal economy, poor tax administration and restricted access to foreign sources to fund the budget deficit, such a high exposure to foreign grants is hazardous – it should be scaled down as soon as possible, by broadening the domestic tax base. Second, placements and portfolio investments in such an opaque banking system as Moldova's generate additional risks related to their eventual withdrawal and make banking surveillance more complicated.
- ❑ **Domestic vulnerabilities, along with low immunity to potential external shocks, will tend to undermine economic growth in the coming years.** Core economic growth (controlled for any cycle effects) is estimated to oscillate at around 3-4%, which is not enough to ensure Moldova



keeps up with its regional neighbours. Moldova needs an average annual growth of 7% so that the next generations will experience a standard of living at least equal to half the level obtained in the emerging and developing European countries. Only annual income growth of 10% will ensure full closure of the gap between Moldova and its regional neighbours by 2040. Consequently, without a comprehensive structural modernization, economic growth will not generate decent jobs and enough economic opportunities in order to achieve a substantial improvement in people's living standards. Given that Moldovan society is becoming increasingly polarized, social cohesion needs to be strengthened around the national idea of reviving the Moldovan economy, which can be achieved by ensuring economic growth of 7-10%. Irrespective of their (geo)political preferences, political leaders must come together and combine their efforts in order to attain this objective and in order to bring living standards closer to the level of Central and East European countries.

- ❑ Qualitative and quantitative estimates, as well as the natural trends in Moldova's external relations, suggest that Moldova's association with the EU is compatible with the objective of economic modernization. However, **the association process, and even European integration, will only bring benefits as a result of far-reaching cultural, structural and institutional reforms.** Such reforms must particularly involve strengthening the fundamental democratic institutions, focusing on: (i) transparency of political parties' financing; (ii) transparency and public control over the income and interest of public dignitaries; and, (iii) public control over lobbying. Other priorities are: educating a more enterprising young generation and eliminating business constraints; redefining the role played by the Government in the economy and eliminating inappropriate functions; promoting an industrial and educational policy which will provide more support to innovation and which will ensure transition of the labour force from less productive sectors (agriculture, the public sector) to the most efficient ones (industry, high value-added services).
- ❑ **The quality of Moldova's human capital is still one of the main constraints undermining economic development.** Despite the fact that the educational sector is oversized in terms of infrastructure and financing, **the quality and efficiency of education investments are among the poorest in the region.** The reason for this is that crucial structural reforms have been delayed, which has resulted in the education system being decoupled from the economic, demographic and social realities. Accordingly, the Government's immediate priorities should be to match the educational supply with employers' needs, and to adjust the sector in the light of budget constraints. The unprecedented reforms initiated by the Ministry of Education need to receive widespread support from other key ministries (the Ministry of Economy, the Ministry of Finance, the Ministry of Labour, Social Protection and Family etc.), as well as from political leaders. Last but not least, the quality of education should be improved, by changing people's mentality. Currently Moldovans focus more on *access* rather than on the *quality and relevance* of their studies. In this respect, a wide information campaign is necessary in order to develop respect for education and for the possibility of achieving success in life through studies and skills.
- ❑ **The quality of human capital is also affected by poor health.** Life expectancy at birth is one of the lowest in the region, being caused by an unhealthy lifestyle, as well as by limited access to high quality medical services. As in the case of the education system, the health system is very expensive for the public budget and does not generate the expected results because of its excessive size, which is at the expense of quality. The unfavorable economic and social situation is another important factor that affects people's health status. Thus, the incidence of diseases that are caused by social factors (HIV, tuberculosis), as well as alcoholism rates, remains at alarming levels. **In order to improve this situation a set of systemic measures, complemented by preventive actions, is necessary. In particular, health policies should reflect quality rather than quantity objectives:** it is necessary to continue to streamline the hospital network in order to free up resources so that these resources can be used to equip health care facilities with technical devices, consumables and equipment, as well as provide medical staff with periodic training. At the same time, it is necessary to intensify the state policy against practices that are injurious to health, such as smoking, and alcohol and drug abuse. Political leaders should provide maximum support to this end.



- ❑ The Government has rapidly advanced association with the EU, signing and ratifying the Association Agreement at a fairly rapid pace. However, the authorities have not paid sufficient attention to the fact that **European integration is not only about foreign policy: it is also about domestic matters**. Thus, despite the unprecedented support from the international community, in particular the EU and the USA, the Government does not enjoy the same support from the population, which is polarized more than ever with regard to strategic development. An essential reason behind this phenomenon is the stark fact that **European integration remains a project for elites rather than for “ordinary people”**. Unfortunately, the population is not only misinformed about the essence and the implications of the EU Association Agreement, it is also manipulated by several media institutions and by domestic political forces in this regard. As a result, a great part of the population (about half) is either against or confused regarding Moldova’s path towards the EU. This reluctance has also been caused by frequent cases of corruption in state institutions, domestic political instability, and limited job opportunities, which have amplified the population’s lack of trust in the country’s political elites. To improve the situation, the **Government and local public authorities should communicate more actively to the population and to business entities regarding the tangible improvements that will arise from the EU Association Agreement**. It is also important for the Government to show a clear commitment to the reforms that will allow the country to benefit from the association. It is crucial that this communication to be inclusive, covering also the Russian speaking population, the rural population and those with a lower educational profile (the most Eurosceptic categories of the population).
- ❑ **The communication strategy of the Government regarding European integration should be balanced and should be based on realistic messages**. It is important to take into account that the benefits of the EU Association Agreement are conditional upon a set of complicated structural reforms, as well as on significant inflows of foreign direct investment into the economy. Given the uncertain situation in Ukraine, and the weak administrative and financial capacities of most public institutions in the country, there is a high probability that in the coming years the reforms will progress slowly, the business climate will remain unpredictable, and the investment inflows will remain modest. In this context, any exaggerated promises regarding the EU Association Agreement will eventually be undermined by what may be a harsh reality in the coming years. **Thus, exaggerating expectations regarding the Association Agreement today could compromise European integration in the future, fueling the risk that at the next electoral cycle Eurosceptic political forces could gain a larger stake in the Parliament**. Therefore, the communication strategy regarding Europe must involve explaining to people that the benefits of the Association Agreement and of the coming transformational processes will be noticeable only after a certain period of time and not immediately. In the context of an election year, where shortsightedness tends to prevail, this task is extremely difficult; it is not, however, impossible. Thus, instead of focusing on messages that will generate high expectations (which would be typical during an electoral run), the communication strategy should involve constant interaction with the population, regardless of the electoral cycle or of the political context. This interaction can take place through the press, through experience exchange among farmers, through training workshops, at different cultural events, at public debates, in the form of classes/workshops at educational institutions of all levels etc. At the same time, the messages should not be propagandistic. They should instead be based on balanced arguments and statements. **The effects of such an approach will not be noticeable right away, but in several years the outcome will be more sustainable, and the risks of “disappointed expectations” – of which the population has grown tired – will be avoided.**
- ❑ **Another fundamental issue that may produce a time bomb effect is related to the unsustainable public pension system**. Despite the fact that this issue is common to most European countries, in Moldova it is worsened by migration, the size of the informal economy and the lack of a multi-pillar pension system. For the most part, the public pension system does not fulfill its basic functions and is inefficient and unsustainable, to such an extent that significant reform is vital. Reform measures must contain a series of parametric adjustments (equalizing the retirement age of women and men, streamlining calculation formulas and pension indexation) which should eventually be complemented by structural reforms (development of the second and third pension pillars, scaling down informal employment and remuneration and strengthening the equity of, and trust in, the pension system).

# Summary

## Economy: Rapid but Insufficient Growth

In 2013, the Moldovan economy registered economic growth that, in the last 20 years at least, was unprecedented. It was ranked among the top-10 highest growth rates in the world. However, in the coming two to three years the agricultural sector will not be able to achieve the same level of performance as was achieved in 2013. At the same time, consumers are becoming more vigilant and foreign markets are vulnerable because of geopolitical conflicts. The economic growth is still decoupled from the labour market, where employment indicators have remained at rather low levels. Maximum attention will have to be paid to the revitalization of the financial sector, which is currently the greatest source of danger – even greater than the embargo imposed by the Russian Federation – to sustainable economic development. Recoupling the production sector to the labour market and financial stabilization are indispensable in order to ensure the acceleration of the positive trends of modernization and economic convergence that have been noticed in recent years. Moldova needs a long period of macroeconomic and financial stability and an inclusive growth model that is able to generate an annual growth rate of at least 7% so that during the next generation's lifespan it will close at least half of the gap that currently exists between living standards in the country and those in Eastern European countries. During the coming decades, economic modernization will partially involve the continuing release of the labour force from the traditional sectors. For this reason, economic policies need to focus on facilitating labour force transition towards modern sectors. Politicians must keep in mind the fact that easy reforms belong to the past, while achieving accelerated and socially inclusive economic growth will require reforming several fundamental aspects of the state: strengthening democratic institutions, educating a more enterprising young generation, eliminating inappropriate functions of the Government (including those related to economic management), reducing the economic presence of the Government through state-owned enterprises, supporting innovation and labour force skills and stabilising agricultural markets.

## Labour Market: An Example of Incomplete Structural Transition

The situation in the labour market reflects the development trajectory of the national economy and the vicissitudes of structural reforms. The Republic of Moldova entered the transition period from a Soviet-style planned economy to the free-market economy with an economic structure that was typical of underdeveloped countries, where the agricultural sector played the dominant role in terms of labour force employment. In the past decades, intensive redistribution of the employed population among different sectors of the national economy occurred more as an effect of natural structural changes in the economy rather than due to qualitative systemic reforms. The share of the population working in the agricultural sector has thus diminished, the labour force surplus shifting either towards the service sector or emigrating due to the lack of demand in the industrial sector. However, after the crisis of 2009 the labour market restructuring processes came to a halt: the service sector developed exclusively as a result of labour productivity, but was unable to generate sufficient jobs. Therefore, given the labour force orientation to higher productivity sectors, the labour market has reached a balance that is sub-optimal for sustainable growth of the national economy. Additionally, the extent of informal relations in the economy affects the quality of the labour market, decreases the efficiency of sectoral policies and supports the sub-optimal equilibrium. In order to unlock labour market mechanisms it is necessary to continue implementing structural reforms, which focus on creating quality jobs in sectors of higher labour productivity, such as services and industrial sectors. In order to reduce the severity of informal relations and their repercussions, it is also imperative to improve the quality of the institutional framework and the business environment.

## Human Capital: Making the Transition from Quantity to Quality

Moldova continues to allocate a substantial share of GDP to education (about 7.2% estimated for 2014), and this is primarily due to the need to maintain an over-extended education network, which, for a long time, has not reflected the demographic realities. The Government has undertaken a commitment to streamline school infrastructure. However, its attempts are facing tremendous resistance from local communities that experience an obvious “value short-sightedness”: for a great part of the population the physical existence of educational institutions matters more than the relevance of the knowledge acquired by pupils. The extremely bad results in the baccalaureate in 2013 and 2014 unquestionably prove the poor quality of education. The Education Code and the draft Education 2020 Strategy, the former approved in 2014 and the latter recently drafted, are documents of the utmost importance which will guide the development of the education system throughout the coming decade. However, the education system has been neglected to such an extent that no short-term qualitative changes of any significance should be expected. The most important route for improving the quality of education lies in investing in teacher training and substantially increasing their salaries, to return the profession to the level of prestige it once possessed. This applies to both general education and vocational education, where one of the most acute issues is that teachers and instructors have generally no practical experience in actual industry. It is not surprising that about 70% of enterprises consider that vocational, secondary specialized and higher education does not generally meet their needs. The limited relevance of vocational education is also reflected by the professions preferred by students (and universities), with a strong bias towards “easy” and “prestigious” fields. Thus, more than one third of enrolled students still prefer social sciences, business and law, even though the Moldovan economy is in the middle of a structural transformation and is acquiring new technologies and equipment, and therefore needs more skilled persons in engineering, technology and construction. Certain issues

in the health care sector also affect the quality of human capital negatively. Although now rather neglected, the proliferation of drug addiction is one of the most disturbing issues of the past two decades and continues to have the potential, along with alcoholism, to undermine the attempts of Government and the private sector to promote a modern labour culture.

## Environment and Energy Efficiency: How Sustainable is Economic Growth from the Environmental Standpoint?

The Republic of Moldova depends critically on its natural capital. It is not rich in natural resources, but a quarter of the population is employed in sectors that depend directly on natural capital, while one third of energy resources are imported. This situation highlights the importance of using domestic and imported natural assets as efficiently as possible. Irresponsible use of the main natural capital (water, forests, soils), as well as of imported resources, affects the sustainability of economic growth and has a negative impact on the country's economic competitiveness. The Republic of Moldova is facing a set of issues related to the use of environmental resources, such as: shrinking forest areas, soil erosion, limited water resources, irrigation system degradation, relatively high intensity of use of natural resources and energy. These issues place additional pressure on the sustainability of economic growth. At the same time, air and water pollution, and poor access of the rural population to water sources and sewerage services affects the quality of life in the country. Given these challenges, it is necessary to focus efforts on public policies that aim to improve the environment and achieve a more efficient use of natural resources.

## Domestic and External Politics: Momentum towards Europe on the Outside, Imitating Reforms on the Inside

During the period covered by this report, domestic politics experienced a period of relative calm after the key political leaders (the Liberal Democratic Party and the Democratic Party), who have been used to confronting each other, left their positions in the government and moved to the "back office". Nevertheless, their influence on political events occurring in the country was not lessened, which also caused reforms (in such areas as justice, fighting corruption, reform of the prosecution office etc.) to be implemented more slowly. There appears to be an internal consensus among the coalition parties, who are concerned about their political survival. On the other hand, domestic politics is dominated by the foreign agenda, with less attention being paid to vital reforms, initiated along with the European integration process. The governing forces did not pass the "exam" on quality of governance, in particular as a result of the non-transparent concession of the Chisinau Airport and the flawed privatization of the Banca de Economii. Generally, the domestic agenda has been marked by a series of trends, such as: creating alliances outside the governing coalition (at central and local levels); activation of separatist manifestations (Gagauzia, Balti municipality); reviving discussions on federalisation of the country; diminishing pro-European sympathies in public polls; and the emergence of pro-Customs Union preferences. Insignificant results in combating corruption (especially in the field of justice), the sluggish justice reform and the polarisation of state institutions have been among the major failures of the pro-European government. In terms of foreign politics, considerable progress has been made as far as relations with Western partners are concerned. EU-Moldova relations have experienced their highest ever level of development. At the same time, the crisis in Ukraine and Russia's actions have

provided the EU with a reason to increase its presence in the region, leading to a speeding up of the liberalisation of the visa regime and of the signing of the Association Agreement. In addition, transatlantic relations improved significantly, with the USA supporting Moldova's European trajectory, a development that was also affected by Russian activities in Eastern Europe. Even though European integration progressed significantly during 2013–2014, the sustainability of this trajectory will be tested by the “geopolitical vote” that will be made by the country's citizens at the time of the parliamentary elections. In any case, the acceleration of European integration will depend not only on the success of Moldova's reforms, but also on the EU's actions in response to the situation in Ukraine and Russia's behaviour.

## Pension System: Risks and Options for Reform

The pension system in Moldova is an old-fashioned redistributive (Pay-As-You-Go) system, that consists of only one pillar (the second pillar (mandatory cumulative) does not exist, and the third (facultative cumulative) is non-functional) and this pillar does not fulfill its functions appropriately. Thus, the average old-age pension covers only about 70% of the subsistence minimum, and the replacement rate is only 27% (the conventional minimum is 40%). In spite of this, the pension system runs a continuous deficit that increases from one year to another, financed from the state budget. The viability of the public pension system is undermined both by *pressures on the revenue side* (a narrower tax base due to informal employment and the widespread practice of under-the-table salaries, low levels of confidence in the pension system and emigration of the working age population), and by *pressures on the expenditures side* (the aging population, the increase in life expectancy at birth, a large number of privileged pensions). Failing to resolve these issues promptly poses a serious risk of system collapse, which may have repercussions for the stability of public finances. However, declaring the system unsustainable is a diagnosis rather than a death sentence. The issue can be fixed by a comprehensive reform of the public pension system. This reform should involve both parametric measures, the goal of which will be to strengthen the short-term system sustainability (equalizing the retirement age of women and men, adjusting calculation formulas and pension indexation, rebalancing social contributions paid by employers and employees) and structural measures aimed at strengthening the long-term sustainability of the system (eliminating privileged pensions and enhancing the system transparency, decreasing informal employment and developing the second and third pension pillars). Last, but not least, reform of the pension system requires the mobilisation of competent public institutions and broad support from political elites.



# Economy: rapid growth, but modest development

*In this chapter, the main economic growth factors in the recent period are identified and their sustainability is assessed. The current statistics are reviewed to identify long-term trends, with a major focus on structural and institutional changes in the Moldovan economy. The chapter concludes with a series of recommendations for accelerating economic growth and making growth more socially inclusive.*

## Current Economic Situation: Key Trends

After the stagnation of 2012, which was caused by a severe drought, the Moldovan economy registered an impressive recovery in 2013, with 8.9% growth in GDP (Table 1). This was the first time in 20 years that Moldova has registered such a high growth rate, with the country being ranked among the top ten countries worldwide as regards GDP growth.<sup>1</sup> On the supply side, half of this expansion was driven by the recovery of production in the agricultural sector and related industries. On the demand side, it was particularly the result of a growth in household consumption, of about 6.5%.

The sustainability of this record growth rate is, however, uncertain, since during 2014–2015 the agricultural sector will not reproduce the growth performance of the previous year. The conditions in foreign markets are less attractive for exporters, partly because of the conflict between Ukraine and Russia, but also due to the sanctions imposed by Moscow on Moldovan exports as a result of the fact that Chisinau rapidly signed and ratified the EU Association Agreement. Moreover, the fundamental economic issues in Russia (effects of the international sanctions and sclerotic economic growth during the past decade) and the EU (a high unemployment rate and the slow recovery of the financial sector) make a strong growth in remittances less likely. This will be the case not only in 2014, but at least during 2015–2016 as well.

There are signs that indicate that consumers will be more cautious in 2014: in Q1-14, households' final consumption expenditure had practically not changed, after a growth of almost 4% in Q1-13. Anticipating the 2014 general elections, a slight improvement in consumers' attitudes may be expected due to "electoral" increases in pensions and salaries in the public sector, which have already been approved. These increases do not seem, however, to be sustainable, and the granting of such increases, coupled with undeserved tax privileges, is a significant departure from the financial discipline carefully promoted by the Government from 2010 to 2012.

The increase in equity investment was quite modest during 2012 and 2013 (1.8% and 3.3%, respectively). Foreign investments are also not a great reason for joy, as their net inflow is still at the modest level of 2–3% of GDP, which is not enough for the country to feed its need for technologies, which are instrumental for boosting the competitiveness of the country. The fact that most foreign investments went into sectors generating exportable products is quite reassuring, even though the investors' inputs occurred mainly as the deliberate effect of attracting

<sup>1</sup> <https://www.cia.gov/library/publications/the-world-factbook/rankorder/2003rank.html>.

large producers in free economic zones and not due to sectoral improvements in the investment climate. We should not overlook the fact that in 2013–2014 at least three large investors already present in Moldova – WNICEF (the owner of Glass Container Prim), Grawe (Grawe Carat Asigurari) and Draexmaier Automotive – stated their intention to leave Moldova as a result of particular investment disputes. One single case of this kind would be enough to compromise the efforts of the industrial policy, no matter how creative it may be.

The key socio-economic indicators have also not shown consistent improvement over the past two years. Considering investors' cautiousness, the employment rate is still at an extremely low level of less than 40%, although matters did improve in geographic areas that give investors the possibility of carrying out business in free economic zones. Another key indicator, the poverty rate (computed by reference to the national poverty threshold), continued to decrease in 2013 (12.7%, compared to 16.6% a year earlier<sup>2</sup>) and, apparently, dynamics in this area will remain favourable in 2014. The mechanism that allows for the accurate “targeting” of persons who need help applied recently is an essential factor in providing social aid and one that has enabled greater poverty reduction. However, the relatively low incidence of poverty is the outcome of a quite generous national poverty threshold (i.e. the government declares people to be not in poverty when in fact their circumstances imply that they are). Applying a comparison based on the international poverty threshold may actually reveal a worse situation: at the threshold of USD 5 per day (PPP) more than 50% of the country's population was poor in 2011 compared to 25% in Central and East Europe.<sup>3</sup>

**Table 1. Main Indicators Monitored regarding the Economy of the Republic of Moldova**

	2011	2012	2013
GDP, change over the previous year, %	6.8	-0.7	8.9
GDP per capita, % of Central and East European countries' average	22.2	21.7	23.3
Agricultural production, change over the previous year, %	5.0	-22.3	38.3
Industrial production, change over the previous year, %	9.5	-1.9	6.8
Volume of services provided, change over the previous year, %	5.0	2.7	6.0
Volume of construction work, change over the previous year, %	1.8	0.7	5.1
Household consumption, change over the previous year, %	9.4	1.0	6.5
Gross fixed capital formation, change over the previous year, %	13.0	1.8	3.3
Foreign direct investments, net inflow, % of GDP	3.5	2.1	2.7
Exports of goods and services, % of GDP	44.1	42.5	43.8
Imports of goods and services, % of GDP	86.6	84.5	81.5
Producer Price Index, change over the previous year, %	7.8	4.1	5.2
Total commercial bank loans, % of GDP	36.2	39.6	42.2
Unemployment rate, % of the economically active population	6.7	5.6	5.0
Employment rate, % of the population aged over 15 years old	39.4	38.4	39.0
Current account/GDP, %	-11.2	-6.8	-4.8
Budgetary deficit/GDP, %	-2.4	-2.1	-1.8
Average bank lending rate, %	14.4	13.3	12.3
Average bank deposit rate, %	7.5	7.6	7.2

Source: National Bureau of Statistics (NBS), National Bank of Moldova (NBM), Eurostat and EXPERT-GRUP calculations

<sup>2</sup> Ministry of Economy, “Information Note. Poverty in Republic of Moldova 2013”, Chisinau, July 2014.

<sup>3</sup> International Monetary Fund (IMF), “Republic of Moldova. 2014 Article IV consultations and first Post-Program Monitoring Discussions”, Staff Report, IMF Country Report no.14/190.



The impressive growth of the banking sector penetration rate, from 36.2% of GDP in 2011 to 42.2% in 2013, should be regarded with the utmost caution. Flawed governance and low transparency in the financial sector give rise to great problems for the Government and the National Bank of Moldova (NBM). They also pose national security risks that are worth considering. The general quality of the bank loan portfolio is unsatisfactory, and a considerable part of the newly provided loans, especially in 2013, are suspicious placements in banks from the Russian Federation which are not necessarily favorable to the Moldovan economy. On the contrary, these placements increase the geopolitical vulnerability of the Republic of Moldova as far as relations with the Russian Federation are concerned, as Russia has threatened Moldova with the “consequences” of signing the EU Association Agreement.

## Is Economic Modernisation Taking Place? A Quick Look at Key Indicators

An analysis of the main statistical data compiled during the past two decades leaves a mixed impression. From a historical perspective, it seems that there are some reasons to be happy, including the fact that during 2011–2013 the level of GDP exceeded the 1992 threshold, as a result of the launch of economic reforms. However, a geographical comparison makes the situation appear a good deal less positive. For that matter, the entire economic history of the country is marked by contradictory developments, which do not leave too much room for unambiguous analysis.

In terms of the temporal aspect, between 1995 and 2013 the average annual GDP growth rate was about 2.8%. This does not seem very high. However, if maintained this rate would mean a doubling of national income every 25 years. Without wishing to oversimplify things, it may be presumed that with such a rate, children would enjoy living standards twice as high as their parents. The fact that between 2000 and 2013 – despite all external shocks – the average annual economic growth rate in Moldova was 4.9% provides another reason to be optimistic: maintaining such a rate would mean that every new generation would have the chance to enjoy a level of income 3.4 to 3.5 times higher than that of the previous generation.

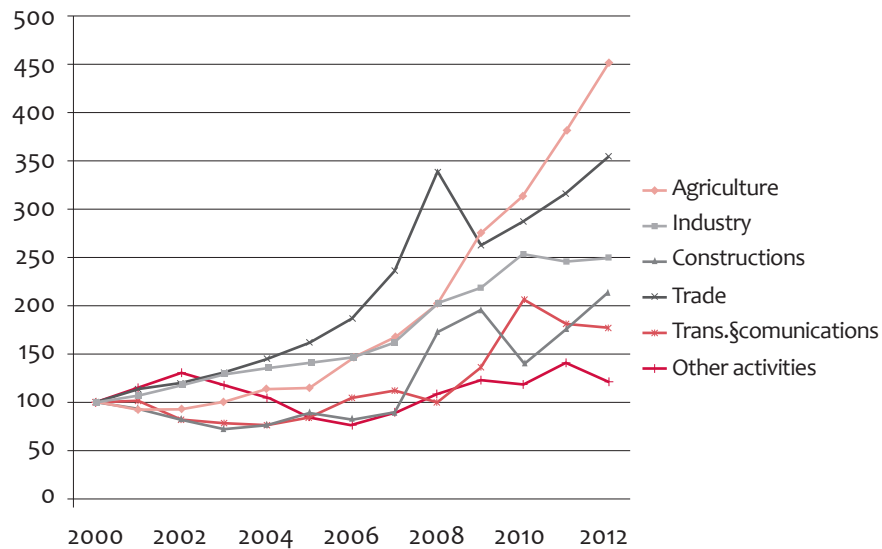
However, if one draws a geographical comparison, the growth achieved is not impressive at all: during 1995–2013, the emerging and developing countries of Europe<sup>4</sup> grew, on average, by 3.8% annually, which is one percentage point more than Moldova’s performance. An annual GDP growth rate of 5%, which the Government counts on in its medium-term forecasts, will not enable Moldova to attain convergence with the living standards in the emerging and developing countries of Europe for at least a generation: considering that currently in Moldova the income per capita is about 22% of the average for European countries (by 2014 the ratio will be 31%). This is not enough to discourage emigration and to provide immediate and real reasons for the younger generation to be optimistic. Moldova needs average annual growth of 7% in order for the next generation to reach at least half of the standard of living that will exist in the emerging and developing countries of Europe, and only 10% of annual income growth or more will ensure a full closure of the gap by 2040. The task of achieving this convergence during the lifespan of one generation is so monumental that it implies resetting the entire socio-cultural, political and economic model of the country. At the same, this task is so ambitious that it could very well be accepted as a national idea by Moldova’s extremely fragmented society.

<sup>4</sup> An economic and geographic category defined by the IMF, that includes 13 countries: Albania, Bosnia-Herzegovina, Bulgaria, Croatia, Hungary, Kosovo, Lithuania, Macedonia, Montenegro, Poland, Romania, Serbia and Turkey.

Our State of the Country Report for the year 2009 pointed out that overcoming the economic development handicap implies an essential structural modernisation of the Moldovan economy. Half of Moldova’s population lives in rural areas, and depends – in one way or another – on agriculture, which is why it is natural to make modernising this sector a top priority. Agricultural modernisation can be carried out both under the influence of active policies (such as providing access to cheap and long-term financing sources, technological training of farmers, rational subsidy policies), and of reactive forces which imply the outflow of idle resources, (i.e. decreasing the number of persons employed in this sector), as well as because of demographic changes.

It is obvious that the reluctance to change on the part of rural society seriously hampers agricultural modernisation. Nevertheless, an analysis of the long-term evolution of particular key indicators reveals certain encouraging changes in Moldovan agriculture. The reduction of the share of GDP accounted for by agriculture, from 25% in the mid-1990s down to about 10–11% at present, is a positive evolution (despite the political criticism that has been leveled at this reduction): as a result, the entire economy has become less vulnerable to climatic vicissitudes. As a result of equity investments (an active factor) and labour force outflow (a passive factor), agriculture registered during 2000–2012 the highest gains with regard to the capital/employee indicator (Figure 1). This achievement automatically triggered important gains in terms of agricultural labour productivity: during the same period the agricultural sector registered the highest productivity growth (about seven times higher, while the national average for other large sectors – industry, construction, trade, transport and communication and other services – was 5.8 times higher, in 2013 compared to 2000). Nevertheless, the average productivity in agriculture represents only 40% of the average of the other large economic sectors. It is thus clear that the convergence process is still far from being completed. The aging of employees working in the agricultural sector is the greatest impediment preventing sector modernisation: in 2013 about 52% of the employed population in this sector was aged over 45 years old (compared to 43% in 2000). This is caused primarily by the fact that the number of employees aged under 24 years old decreased by four times. The casual evidence suggests that few farmers’ children wish to continue the job of their parents who are employed in agriculture.

**Figure 1. Evolution of the Capital-to-Employee Ratio by Main Sectors**  
constant prices, 2000=100%

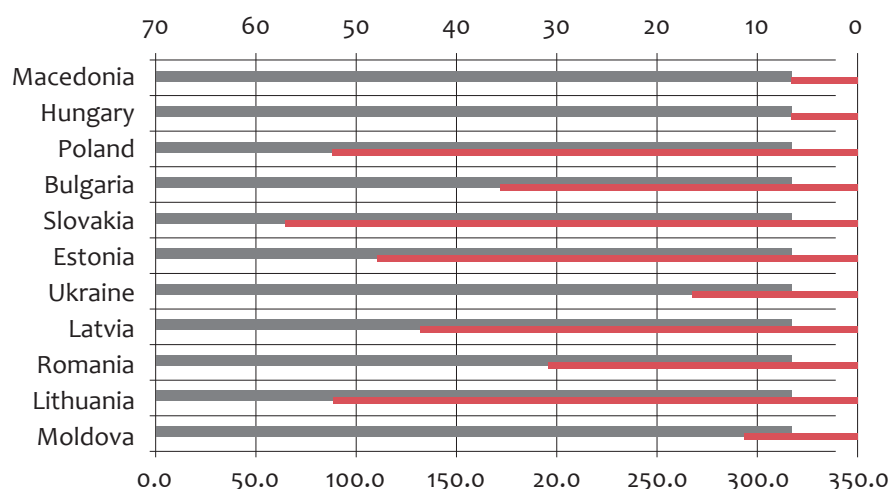


Note: capital = fixed assets at book value

Sources: The authors’ calculations on the basis of NBS data.

Besides agricultural productivity growth *per se*, development acceleration also implies an efficient transition of the labour force towards sectors characterised by a higher intrinsic productivity – In Moldova’s case this would primarily be industry, because the service sector cannot function as a valve in a very small economy with a poor population. However, we do not notice a sufficient absorption by the industrial sector of the labour force surplus from the agricultural sector (see “Labour Market” chapter). A large part of the population chooses to emigrate, while others find jobs in low productivity areas, especially in those related to informal trade and construction. The slow transition from traditional sectors to modern ones hampers labour productivity growth at the level of the entire economy. At first glance, the productivity differences compared to other countries, noted in State of the Country Report 2009, appear to be insurmountable (Figure 2).

**Figure 2. Labour Productivity Gains (2013/2000, %, left axis) and Labour Productivity Level (2013, GDP/employee, USD at Purchasing Power Parity, right axis)**



Sources: The authors’ calculations on the basis of NBS, State Committee of Statistics of Ukraine and Eurostat data

Figure 2 provides a more important message, however: out of the 11 countries included, Moldova yielded the greatest labour productivity gains during 2000–2013. Calculations show that active factors (investment and labour force training) have played a central role compared to passive ones as far as this productivity growth is concerned.

## How to Accelerate Economic Growth? What should be done in Order for More People to Benefit from it?

“Easy” reforms in the Moldovan economy already belong to the past. The available estimates suggest a relatively small gap between actual and potential economic growth, which in recent years has varied within  $\pm 1\%$  of potential GDP.<sup>5</sup> A significant increase in the country’s productive potential will be possible only as a result of deep cultural, structural and institutional reforms. Such reforms would include a series of key aspects:

<sup>5</sup> IMF, 2014.

- ❑ **Strengthening of the key democratic institutions.** Relatively recent economic research<sup>6</sup> clearly proves that democracy is a meta-institution that provides the necessary framework for building the basic institutions of a market economy: property rights, independent regulatory institutions, institutions for macroeconomic stability, social security and institutions for overcoming social conflicts. There are three key democratic institutions in the Republic of Moldova, the strengthening of which, by separating politics from the economy, will play an essential role in long-term economic development. They include the following: 1) ensuring transparency of political parties' financing; 2) transparency and public control over the income and interests of public officials; and, 3) public control over lobbying, through full compliance with the law on the transparency of decision-making.
- ❑ **Educating a more enterprising young generation.** Entrepreneurial spirit – the source of innovation and new jobs – is an intrinsic part of the real wealth of nations. In the early and mid-1990s, Moldova witnessed an extraordinary burst of entrepreneurial activity, with ordinary people standing for days in queues by the State Registration Chamber to register their own companies. In the years that followed, the entrepreneurial enthusiasm of Moldovan citizens diminished in the face of the local business environment. Only one-third of the roughly 60,000 sole proprietorships registered with the tax authorities are actually running. Moldovan citizens gave up assuming the risks of running their own businesses and instead preferred to assume the risks of emigration. With markets very inert and affected by a lack of competition and innovation, the economy needs what Joseph Schumpeter has called “creative destruction”.
- ❑ **Redefining the Government's role in the economy and eliminating its inappropriate functions.** In this respect, the legislative framework regulating the activity of the Government as a whole, and of some ministries in part, calls for important interventions. Public property administration functions should be given a secondary priority while policy functions should become the number one priority. Today, priorities have switched places in most of the Government institutions. How hard will the Ministry of Agriculture work on agricultural policies when it has under its authority about 55 enterprises, of which 11 are insolvent? Or, does the Ministry of Culture really need as many as five state-owned enterprises that specialise in publishing and printing? Or, what is the connection between the mandate of the Ministry of Regional Development and Construction and the popular culture center “Veselia” or the sanatorium “Constructorul”?
- ❑ **The Government must reduce as much as possible its active economic presence, as exerted through state-owned enterprises.** This aspect overlaps with the idea of the Government giving up inappropriate functions it has undertaken. In addition to the fact that state-owned enterprises generate conflicts of interest, the Government simply does not own enough resources to operate such a huge sector, which consists of about 400 state-owned enterprises – most of which are at the nod of the directors who are subordinated to the main political figures. At the same time, those enterprises that will have to remain state-owned, for certain objective reasons, must be managed by professionals who receive wages comparable with the private sector. Sufficient remuneration of state-owned enterprises' managers, along with the professional supervision of the executive body by Administration Councils, are two indispensable preconditions for ensure high-quality management of public enterprises.

<sup>6</sup> Rodrik Dani, “Institutions for high-quality growth: what they are and how to acquire them?” National Bureau of Economic Research (NBER) Working Paper Series, Working Paper 7540 available at <http://www.nber.org/papers/w7540>.

- **The structural transformations of the past 20 years have been positive but slow, and they need to be significantly pushed forward.** The transition of the labour force from the agricultural to the industrial sector needs to be supported both by industrial policies that are more sustaining of innovation, and by educational policies. Rapid industrialisation in free economic zones or industrial parks, without the essential improvement of fundamental elements – human capital and institutions – can only generate short-lived growth episodes, not long-lasting ones. The main reason why industrialisation is so important is that industry creates products that can be sold on international markets. The economic miracle that the country needs can happen only as a result of sustainable modern export-oriented sectors – not subsistence agriculture, not enterprises in free economic zones and not by way of value-added services. Agriculture and services can, of course, deliver many economic opportunities for a certain number of employees, but these sectors will not ensure a sustainable convergence of the income level across the entire society to Central and East European standards.
- **Agricultural policies should be oriented towards agricultural sector stabilisation.** Industry-based development does not imply under any circumstances the denigration of agriculture. However, despite the equity investments that have already been made, agriculture still needs to go through a long period of significant capitalisation. The investment decisions in this sector will be favorable only when the predictability of agricultural product prices increases. Price stabilisation does not, however, exclusively or necessarily imply only Government market interventions. The Government can make an essential contribution to the stabilisation of agriculture through the development of the insurance sector, the promotion of vertical integration with upstream and downstream sectors, and through the development of post-harvest infrastructure and the promotion of long-term purchase contracts.

# Labour Market: an Example of Incomplete Structural Transition

*Labour is a crucial factor for sustainable and quality economic growth, particularly in countries that lack other factors of production. Efficient exploitation of the labour force directly influences economic growth and poverty reduction, resulting in positive dynamics of labour productivity and a high employment rate. In this chapter, we will analyze – from the perspective of the labour market – to what extent Moldova’s economic growth over the past decade has contributed to the optimal exploitation of the labour factor and to the sectoral transformation of the national economy.*

## Analysis of Key Developments and Trends

Despite the robust economic growth outlined in Chapter 2, the Republic of Moldova is still dealing with structural adjustments, being characterized by a labour surplus (mainly of a poor quality), and by an imbalance between labour supply and demand. This is a development challenge, affecting optimal utilisation of the labour force, poverty reduction and the creation of decent jobs in the national economy. In particular, the labour force sectoral distribution directly influences productivity aggregate dynamics at a macroeconomic level, the competitiveness of the economy and the sustainability of the economic development process. Thus, in economies with a high concentration of labour in low productivity sectors (agricultural and public sectors) – the Republic of Moldova being one of them – there is a vicious cycle whereby a slow increase of labour productivity leads to poor competitiveness, which in turn causes economic specialisation based on static comparative advantages and on the investments which are channeled to these branches (especially based on labour), thus renewing the cycle.

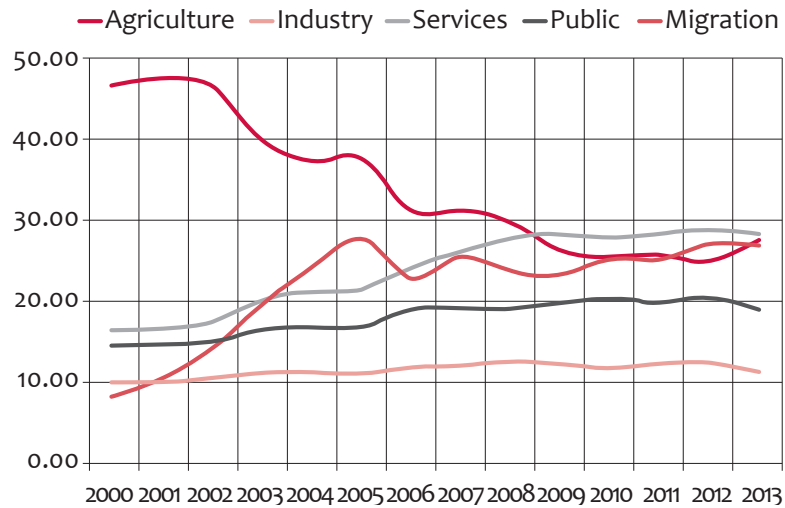
Moldova entered the transition period not only as an economy with a centralised planning system, like the rest of the former Central and Eastern European socialist bloc countries, but also with an economic structure much closer to third world countries. Unlike most of the countries from the former Central and Eastern European socialist bloc, the Moldovan economy was the least industrialised, with a high concentration of the labour force in the agricultural sector, while the economic decline of the 1990s only worsened the economic imbalances.

Over the past decade, respectable economic growth has been registered, which at a first glance seems to also have helped overcome the structural issues. Figure 3 shows that the number of people employed in the agricultural sector has decreased significantly and has been surpassed by the number employed in the services sector. However, with the economic slowdown in recent years, the situation has become static, with the intersectoral distribution of the labour force losing its velocity, thus contributing to a medium-term sub-optimal balance in the Moldovan labour market. This balance is the result of concentrating the labour force in less productive sectors (the agricultural and the public sector), highly informal contractual relations between employers and employees, reduced flexibility of domestic migration and growth of external migration. These rigidities and imbalances have led to an artificial “deficit” in the labour force, resulting in real wage growth rates that are greater than the labour productivity growth rates.<sup>7</sup> Thus, solving domestic structural bottlenecks is needed to allow labour to move towards higher productivity sectors like the industry and service sectors.

<sup>7</sup> Expert-Grup, “MEGA – Moldova Economic Growth Analysis”, Q1–2014 (#10).  
<http://www.expert-grup.org/ro/biblioteca/item/947-mega-x-2014&category=178>.



**Figure 3. Distribution of Employed Population by Sectors (% of the active population)**



Source: NBS

The key labour market indicators (the unemployment rate, the employment rate and labour force distribution by sector) are not the only fundamental factors that influence the performance of the labour market. In the Republic of Moldova the importance of the unemployment and employment rate is less relevant for sectoral policy analysis, due to external migration and because there is a significant informal sector. Thus, a more important indicator for estimating the processes that take place in the labour market is the *elasticity of employment with respect to growth*. This may provide valuable information regarding this market. Elasticity is the extent to which the number of the employed population varies as a result of one percent GDP growth. This indicator, thus, denotes the intensity of labour force exploitation and the structural changes in the economic growth process (see Annex 1 on the connection between the elasticity coefficient and GDP dynamics).

**Table 2. Elasticity Index by Economic Sectors in Relation to GDP Dynamics (average value for the corresponding time period)<sup>8</sup>**

ε	2001 – 2004	2005 – 2008	2009 – 2013
GDP (average per time period Δ%)	7	5.8	3.2
Total labour force	-0.16	-0.06	0.24
Salaried employees	-0.16	0.02	0.01
Informal employees	-0.15	-0.21	0.73
Migration	1.37	-0.08	0.44
Agriculture	-0.42	-0.38	0.69
Industry	-0.03	0.02	0.12
Services	0.14	0.24	0.01
Public sector	0	0.04	-0.11

Source: EXPERT-GRUP calculations based on NBS data.

<sup>8</sup> The formula for calculating the labour factor elasticity is as follows:  $\epsilon_i = \frac{(E_{t+1} + E_t)/E_t}{(Y_{t+1} + Y_t)/Y_t}$ , where E represents the employed population, and Y - the GDP or gross value added (GVA), depending on the type of the computed index.



In order to analyze how economic growth in the past decade has impacted labour force exploitation, as well as how recent structural developments have done so, we have computed the elasticity of employment for the Republic of Moldova dividing the period 2001-2013 into three sub-periods. Also, for a better understanding of the relationship between economic growth and the labour market, the given index has been computed both for the total employed labour force and for each sector separately.

Table 2 reveals the slowdown of the national economic growth rate in the past decade, followed by the change in the elasticity index in most of the sectors, (thus representing structural changes). It is very easy to see that economic growth up until 2008 was based on productivity growth and recovery of the losses from the previous decade, with the employment rate decreasing in most sectors, while the labour force surplus turned towards emigration. Internally, it was the service sector that benefited from the inter-sectoral labour force distribution, with one percent GDP growth leading to an increase of 0.14% and 0.24% of employment in this sector during the respective periods.

Importantly, since 2010, economic growth has been based both on labour productivity growth and on higher employment. This dynamic has occurred, however, at the expense of the structural quality of the labour market. The slowdown of the migration outflow was, thus, offset by growth of employment in the agricultural sector (0.69%) along with the expansion of informal relations (0.73%), this process being explained by the high share of migrants from rural regions (about two-thirds of the total number). At the same time, the service sector lost its capacity to absorb the labour force surplus labour (only 0.01% growth), while the growth in the agricultural sector occurred primarily as a result more of a higher employment rate and less as a result of productivity, thus highlighting the modest structural achievements in the past decade.

**Table 3. Elasticity Index by Economic Sectors in relation to the Dynamics of the Gross value added (average value for the corresponding time period)**

$\epsilon$	2001 – 2004	2005 – 2008	2009 – 2013
Agriculture	-1.09	-1.29	1.12
Industry	0.02	0.01	-0.03
Services	0.15	0.18	0
Public sector	-0.03	0.02	-0.16

Source: EXPERT-GRUP calculations based on NBS data.

Considering that during all of the specified periods the gross value added from each sector had a positive dynamic, it may be noted that the agricultural sector moved from growth that was based exclusively on productivity to growth based on an intensive use of the labour force. The indices of the industrial, service and public sectors evolved in an opposite direction to the agricultural sector, with a more efficient use of the labour force but no improvements in terms of employment.

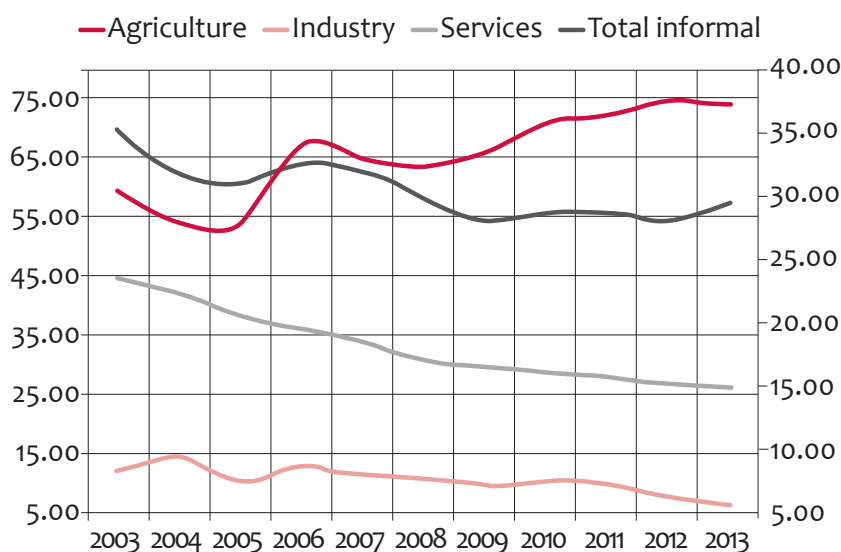
## Wider Implications and Risks

The economy of the Republic of Moldova entered the transition period with a labour force surplus in the primary branches of the economy and a higher population density in rural areas than in urban ones. This provided the chance to combine intensive and extensive economic growth through the accumulation of fixed capital and significant inter-sectoral redistribution of the labour force, mainly into the industrial and service sectors. These sectors are characterised by higher productivity compared to the agricultural sector and, by absorbing the surplus labour

force from rural areas, augur well for strengthening the country's competitiveness. As a result, a critical point has been reached ("the Lewis Threshold"): when most of the labour force is located in urban areas and is employed in the industrial and services sectors, with economic growth being based only on the intensive use of production factors.<sup>9</sup>

The structural adjustment process has evolved quite quickly during the past decade, both in terms of quantity and quality. Thus, besides the redistribution of the labour force from the agricultural sector to higher productivity sectors, the number of employees in the informal economy has also decreased. As revealed by Figure 4, after the 2009 crisis, economic growth ceased to exert a direct impact on the informal sector, with the share of the population employed in the informal sector stabilising at around 30% of the total employed population. The sectoral dynamics show that the share of informal relations in the agricultural sector increased continuously up to 74% of the total population employed in this sector, being the main source of informality in the national economy. These trends, as well as the structure of external migration (about 72% of migrants come from rural areas) confirm the structural bottleneck, labour market rigidity and the deterioration of the quality of Moldova's economic growth.

**Figure 4. The Dynamics of the Share of Employed Population in the Informal sector in Total (% right axis) and the Share of each Sector (% left axis)**



Source: NBS

In the case of Moldova, the lack of a viable demand for the labour force in the industrial and service sectors fostered external migration to the detriment of domestic migration. The increased external migration contributed in the first place to a significant reduction in poverty: according to World Bank estimates, the share of the population living with less than USD 2 a day halved during five years, reaching 4.4% of the population in 2010. This migration process has, however, a double impact on the national economy: it decreases incentives for structural reforms and, at the same time, increases the vulnerability of the economy due to the asymmetric distribution of migration flows. Thus, about 67% of the total population working abroad is employed in the Russian Federation, which makes the dynamics of remittances pro-cyclical and highly dependent on the evolution of bi-lateral relations. The signing of the EU Association Agreement by the Republic of

<sup>9</sup> Ross Garnaut, "Macroeconomic Implications of the Turning Point", University of Melbourne, 2010.

Moldova drew attention to this sensitive aspect for the national economy.<sup>10</sup> At the same time, the differences between the migration flows to EU and Russia show that the European market cannot serve as a short-term alternative to the Russian market: the Russian labour market complements rather than replaces the European one. Therefore, considering the recent sectoral dynamics and the structure of the migration stock (Moldovans who live as migrants) in the Russian Federation, there is a risk that if an external migration shock occurs, most of the repatriated migrants would look for jobs in the informal sector (mainly in the agricultural sector).<sup>11</sup> Thus, the migration that has recently increased draws attention to the incomplete structural transition within the national economy, and the need to speed up the relevant reforms.

## Policy Recommendations

Sustainable economic growth is possible only if structural adjustments and development of the quality of the labour market are moved in the following directions:

- ❑ Reduction of the informal sector and decent job creation are important for quality economic growth and for labour market performance. To progress in this area, it is crucially important to improve the quality of the institutional framework and to reduce corruption, as the enhancement of these components will stimulate the formalisation of the grey economy. Reducing informal relations will help to increase the number of quality jobs, aid labour productivity growth and, lastly, increase wages.
- ❑ Because of the significant external migration, as well as the incapacity of the national economy to absorb the labour surplus, it is essential to develop and implement an effective medium-term regulatory mechanism for migration flows. Geographical diversification and the formalisation of the migration process will help reduce exogenous risks and ensure macroeconomic stability, as well as anchor the migration framework in economic development planning and management.
- ❑ In order to minimise structural adjustment costs related to external migration and low employment, it is important to focus institutional and legislative efforts on attracting investment and technical assistance in high productivity sectors. In the short-term, giving a high priority to labour quality against jobs quantity at all costs will foster structural adjustments and strengthen economic growth sustainability.
- ❑ The imbalances between labour demand and supply in the labour market may be reduced by comprehensively reforming the education system. Curricula adjustment and the involvement of business entities in the process of professional training will contribute significantly to the reduction of the imbalances between demand and supply, a reduction of the unemployment rate among the young, and a reduction in the level of underemployment (see chapter on “Human Capital”).

<sup>10</sup> A. Fală, I. Morcotilo, “Aspectul migrațional în securitatea economică a Republicii Moldova: Analiză instituțională” (“Migrational Aspect for the Economic Security of the Republic of Moldova: Institutional Analysis”).

<sup>11</sup> <http://www.expert-grup.org/ro/activitate/item/912-problema-migran%C8%9Bilor-moldoveni-%C3%AEn-contextul-%C3%AEn%C4%83-spirii-legisla%C8%9Biei-migra%C8%9Bionale-%C3%AEn-federa%C8%9Bia-rus%C4%83&category=5>.

**Table 4. Main Indicators Monitored regarding the Labour Market**

Statistical Indicators	2011	2012	2013
Employment rate (%)	39.4	38.4	39.3
- men	42.1	40.6	41.8
- women	37.1	36.5	37.0
Unemployment rate (%)	6.7	5.6	5.1
- men	7.7	6.8	6.0
- women	5.6	4.3	4.1
Nominal wage growth (%)	11.6	8.9	8.3
External migration growth (%)	1.9	3.6	1.3
The share of the population living below the national absolute poverty threshold (absolute poverty rate %)	17.5	16.6	NA
Remittances growth rates (%)	21.5	13.3	9.1
Share of remittances in GDP (%)	22.8	24.6	24.5
Nominal average wage RM/CEE in USD (%)	20.4	22.9	NA

Source: NBS, NBM, World Bank

### Annex 1. Relationship between Elasticity Index and GDP Dynamics

Labour force elasticity – $\epsilon$	GDP dynamics	
	GDP growth	GDP decrease
$\epsilon < 0$	(-) employed population dynamics (+) labour productivity dynamics	(+) employed population dynamics (-) labour productivity dynamics
$0 \leq \epsilon \leq 1$	(+) employed population dynamics (+) labour productivity dynamics	(-) employed population dynamics (-) labour productivity dynamics
$\epsilon > 1$	(+) employed population dynamics (-) labour productivity dynamics	(-) employed population dynamics (+) labour productivity dynamics

Source: International Labour Organisation (ILO)<sup>12</sup>

<sup>12</sup> Steven Kapsos, “The Employment intensity of growth: Trends and macroeconomic determinants”, ILO, 2005/12.

# Human Capital: Making the Transition from Quantity to Quality

*This chapter analyzes the current state of human capital, assessing education, professional training and health care – which are the three key factors that influence the quality of human capital. The chapter ends with a series of recommendations for enhancing human capital formation.*

## Education: General Aspects

As disclosed in the State of the Country Report for 2013, in Moldova a record-share internationally of GDP is used to finance the education system, but the results of this level of funding are rather modest. It was, obviously, impossible for the situation to change quickly during one year (Table 5). Relying on the official macroeconomic forecasts, and on the national public budget planned for 2014, we estimate that about 7.2% of the expected GDP for the current year will be used to fund formal education at all levels. This structural indicator, uncommonly high even for OECD countries, camouflages a very low level of funding per pupil which is the result of the very small GDP produced by the Moldovan economy. It is important to note here that a great part of the money is used to maintain a network of over-extended elementary and vocational schools that does not meet the current demographic realities (being designed for twice as many pupils as are actually enrolled today, a figure that is continuously decreasing). While during 2000/2001 about 750,000 pupils and students were enrolled in all educational institutions, during 2013/2014 that number was down to 490,000. For purposes of comparison, in 1994 the school population was 780,000 persons. In the case of secondary vocational institutions, only 50% of the enrolment capacity is exploited in the almost 70 institutions. Streamlining these networks would release huge amounts of funds that could be used to improve the quality of education.

**Table 5. Main Indicators Monitored regarding Human Capital Development**

	2011	2012	2013
Public expenditure on education, % of GDP	8.3	8.4	7.1
Share of population enrolled in all education levels, % of the total population	18.5	18.1	17.7
Net enrolment rate in preschool education, %	78.3	80.6	81.6
- male	78.9	81.3	82.0
- female	77.7	79.9	81.2
Net enrolment rate in primary education, %	87.9	87.9	87.1
- male	88.2	88.1	87.5
- female	87.6	87.6	86.8
Net enrolment rate in secondary education, %	82.9	82.3	82.6
- male	83.3	82.6	82.9
- female	82.5	81.9	82.9
Graduates from secondary vocational educational institutions, per 10,000 inhabitants	34	29	29
Graduates from colleges, per 10,000 inhabitants	20	21	21
Graduates of higher educational institutions, per 10,000 inhabitants	78	75	70
Average salary earnings in education, % of the average salary per economy	87.8	87.0	79.9
Public expenditure on health care, % of GDP	5.2	5.2	4.9
General morbidity of the population, registered patients diagnosed for the first time, per 10,000 inhabitants	3537.9	3309.8	3343.9
Patients taken under observation in curative and preventive institutions, diagnosed with alcoholism and alcohol-related psychosis, per 100,000 inhabitants	1308.1	1317.2	1303.1
Patients taken under observation in curative and preventive institutions, diagnosed with drug addiction and toxicomania, per 100,000 inhabitants	265.4	278.2	292.8
Mortality rate, %	11.0	11.1	10.7
- men	12.0	12.1	11.6
- women	10.1	10.2	9.8

Source: NBS, Ministry of Health and authors' calculations

Concerning education policy, certain improvements made from 2013 to 2014 are worth bringing to the forefront. The courage shown by the Ministry of Education in promoting reforms has proven to be a very uncommon one in the context of a political climate that is not friendly to reform. Use of anti-fraud mechanisms in baccalaureate exams during two consecutive examinations sessions has disclosed high corruption levels in the educational system and a poor quality of education in secondary and high schools. Considering the extent to which the issues have worsened in the education system, the signals sent by the Ministry to the population that it will not tolerate any more corruption will not bring better baccalaureate results for another two to three years.

Since 2013, all institutions of general primary and secondary education have been funded on the basis of a standard cost per pupil. This new funding method offers the possibility of balancing the expenses per pupil, of simplifying and strengthening the budget forecasting process, of increasing transparency with regard to school financing and of expanding school autonomy. Under circumstances of school autonomy, school administration bodies may decide, within the approved limits, to redistribute the financial resources depending on the school's needs, including in investment expenditure.

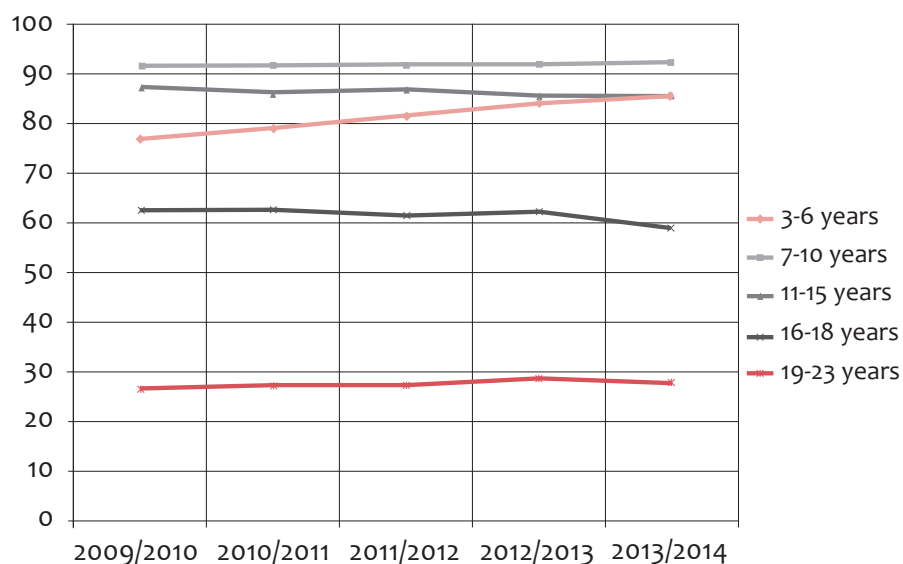
Ensuring Parliament's approval of the new Education Code would be one sign of progress. This is on the verge of failure, as evidenced by the Minister of Education's threat that she will tender her resignation. As a result of several intensive rounds of negotiation within the governing coalition the Code has partially lost the ambition it reflected when it was first drafted, but it still provides a clear and consistent framework for the development of the education system for at least the next decade. Besides the approval of the Education Code, another important policy evolution will be the Ministry of Education's approval of the draft comprehensive sectoral strategy for education development.<sup>13</sup> The strategy states that education quality is the most significant issue in the sector. Along with education quality, two other issues officially recognised as being important are access to education and the relevance of studies.

As regards access, it is important to note the fact that enrolment rates in educational institutions have developed unevenly during the past five years (Figure 5). On the one side, we there was an essential improvement in enrolment ratios at the upper and lower limits of the typical age for education (three to six years old and 19–23 years old), but on the other side, there was stagnation or even a slight worsening of the situation with regard to the lower age segments, where the dropout rate is very high. The decreasing enrolment is highly alarming as regards children from secondary education institutions, where the net enrolment ratio in education decreased from 84% in 2009/2010 to 82.6% in 2013/2014, continuing a ten-year trend (in 2001/2002 the net enrolment ratio in secondary education was 87%). The decrease in the number of children enrolled in education has become noticeable: if in 2000/2001 the net enrolment ratio in secondary education in urban areas was about nine percentage points above the net enrolment ratio in the rural areas, in 2013/2014 the gap increased to up to 15 percentage points. This dynamic can partially be explained by measurement errors caused by the definitive emigration of children together with their parents, who were already living abroad, and by the fact that many children from sub-urban settlements prefer to go to school in the nearby town or city. However, the enrolment decrease is too deep to be explained solely by such "technical" causes. The decrease in the number of children from rural areas enrolled in education occurs not only among ethnic groups or in certain geographic areas, it is an all-inclusive issue which is not strictly about access to educational services per se, but rather reflects a deeper social and economic degradation of rural life.. Despite the modernisation process of the 21st century, which has also encompassed Moldovan society as a whole (the opening of borders, internet penetration etc.), it must be admitted that the conservative rural society in Moldova does not regard education with due respect: most pupils consider school to be an eternal torture rather than an opportunity. It is this attitude that, probably serves as the main explanation for the high rate of school dropout.

<sup>13</sup> "Education 2020", draft Sector Development Strategy for 2014–2020, Ministry of Education, 2014, available at: [http://www.eu2005.lu/en/actualites/documents\\_travail/2005/04/06Patientsafety/Luxembourg\\_Declaration\\_on\\_Patient\\_Safety\\_05042005-1.pdf](http://www.eu2005.lu/en/actualites/documents_travail/2005/04/06Patientsafety/Luxembourg_Declaration_on_Patient_Safety_05042005-1.pdf).



**Figure 5. Evolution of Education Enrolment Ratios, by Education Years and by Main Age Groups**



Source: NBS, Education 2014.

However, it is important to highlight that the quality of the education sector is more important than access. The extremely bad results of the baccalaureate in 2013 and 2014 – with about half of the candidates failing at least one test – make clear the poor quality of education. The causes behind this state of affairs are systemic in nature: they include an outdated methodology and curriculum, and poor endowment of equipment and teaching materials. However, even if these issues were relatively quickly overcome with appropriate investments, one issue will remain: the issue of teaching staff who do not have the necessary skills to apply new standards and methods. Thus, before reforming the school system, the teacher training system should first be reformed, and teachers’ wages should be increased significantly in order to create a set of proper incentives for professional dedication. Currently, teachers’ salary levels do are below the national average (Table 5).

## Vocational Education and Training

As a result of the emigration of highly qualified staff from different areas, but also due to the fact that young people leave the educational system at an early age and lose their interest in vocational studies at all levels, the economy has, for several years, experienced a constant shortage as regards a skilled labour force. A recent study conducted in 2013 by EXPERT-GRUP at the request of the National Confederation of Employers of Moldova (NCEM), shows that over the past three years almost half of companies encountered difficulties when hiring the staff with the skills and competences desired by the employer.<sup>14</sup> Relatively large enterprises and those established in the provinces suffer the most because of the deficit in terms of a skilled labour force.<sup>15</sup>

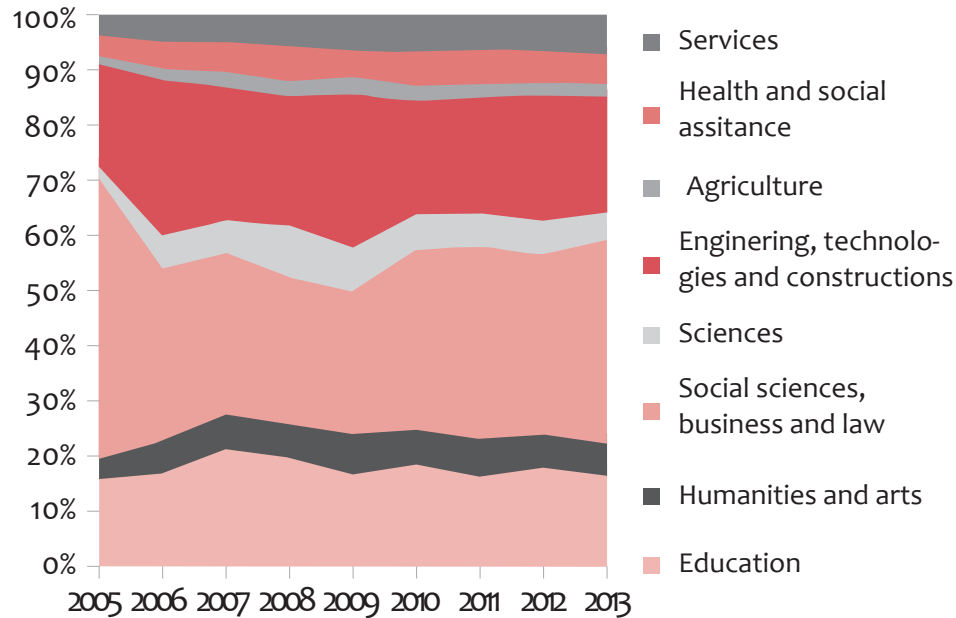
The relevance of the vocational education acquired by young specialists is also increasingly questioned by investors and business people. The survey conducted during the aforementioned study showed that about 70% of business people consider that vocational, secondary, specialised

<sup>14</sup> NCEM, 2013.

<sup>15</sup> Idem.

and higher education do not generally meet enterprises' needs. The curriculum is overloaded with irrelevant theoretical aspects, internships are perfunctory, most of the teaching staff lack practical experience in the real economy, and the knowledge assessment methods are not reliable. The system does not provide pupils with general skills that are indispensable in the modern economy, such as using information technology, communication skills, work culture etc.

**Figure 6. Structure by Fields of Study Chosen by Undergraduate Students Enrolled in Higher Education, % of the Enrolled Students**



Source: Authors' calculations on the basis of NBS Education 2009 and NBS Education 2014

Another issue that is frequently discussed in society is the extent to which the range of specialisations provided by universities meets the needs of the real economy. There has been a surge in the labour market of undergraduates and higher education “specialists” in “prestigious” areas: economy, law, administrative sciences, political science – while there is a shortage of professionals in teaching science, technology and engineering. Contrary to the Government’s policies (such as closing programmes teaching law in colleges) “prestigious” specialities are still preferred by young people (Figure 6).

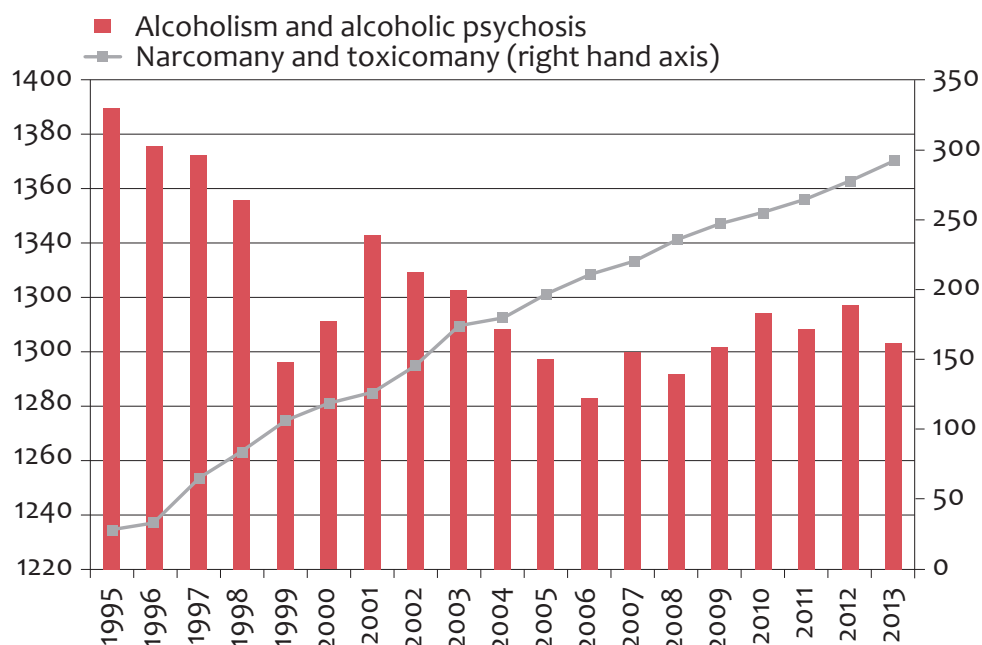
## Health Care System

As is the case regarding education, the Government invests a relatively large share of GDP in the health care system (about 5.3%). Again, as in the case of education, one of the reasons behind such an “expensive” health care system is the over-extended network of health care facilities, which are inefficient from an energy consumption viewpoint and irrational in terms of geographic location or institutional affiliation. It is true that during the past two decades there has been a clear trend of reducing the number of state-owned health care facilities (from 293 in 1997 to 72 in 2013) while private hospitals have emerged (growing from one to 13 health care facilities). The outpatient care sub-sector shows an even greater development in this regard. However, as revealed by estimates made by specialists, the public system is still too extended in terms of number of health care facilities and the volume of physical infrastructure, which prevents the

proper endowment of health facilities, especially at the local level. Some district hospitals are experiencing a large deficit as regards basic endowments, such as appropriate sanitary points, medical gloves and masks. The health care system is still marred by several hazardous practices, including improper methods of medical and biological waste management. Private informal payments are still a reality, one that it is hard to fight off, and primary health care is not yet able to efficiently fulfill the tasks of sorting and regulating the flow of patients towards specialised health professionals. Finally, non-communicable diseases and those caused by social factors (HIV, tuberculosis) continue to spread at a great speed.<sup>16</sup>

All these features exert a negative impact on the quality of human capital, population morbidity and mortality indicators which remain very high (Table 5). Many diseases and disorders continue to affect the quality of human capital in the long run unless they are promptly addressed. Alcohol and drug addiction are two such flaws that are often overlooked when the state of the human capital of the country is analyzed – despite the fact that they have a major impact on the quality and the culture of labour. In the case of alcohol addiction, a positive trend was outlined during the past two decades, with a slightly lower prevalence being detected. The prevalence nevertheless remains very high. Employers, especially those at the local level, complain that alcohol addiction is one of the toughest barriers preventing the development of a modern labour culture. As regards drug addiction, the situation is fairly alarming as there has been a swift growth in the number of patients under observance in curative and preventive institutions (Figure 7). While a decade ago drug addiction was usually associated with deviant behaviour among youngsters, now drug addiction affects other age groups as well, including the economically active population.

**Figure 7. Patients under Observation in Curative and Preventive Institutions, per 100,000 Inhabitants**



Source: NBS Databank, "Population morbidity by cause of narcological disorders, persons with morbidities by age, indicators and diseases".

<sup>16</sup> World Bank, "The Republic of Moldova. Programme for Results. Health Transformation Operation. Environmental and Social Systems Assessment", document no.E4490, Chisinau, March 20, 2014.

## Policy Recommendations

Alongside increasing economic growth and improving firms' technological sophistication, local employers and foreign investors, as well as the society as a whole, urgently need to see a development in the country's human capital. Meeting these requirements will require important changes in public policies.

- ❑ Moldovan society esteems perfunctory access to education in high esteem (“a child should go to school”), rather than the quality and relevance of the education. It is precisely this attitude that explains the community's, and certain politicians', reticence regarding closing schools in rural areas that do not meet the minimal enrolment standards. The Government should launch strategic coalitions together with non-governmental organisations (NGOs) and media institutions in order to achieve a change in the mentality in Moldovan society: teaching respect for education and the possibility of achieving success in life due to studies and skills.
- ❑ Government needs to pay significant attention to ensuring access to pre-school education in rural areas, where the enrolment rate is significantly lower than in urban areas. Greater access to pre-school education in rural areas will lead to a higher rate of women's participation in the labour market.
- ❑ The poor performance of the Moldovan education system, especially as regards vocational education, is mainly explained by the lack of a real competition between universities regarding the enrolment of the best students. It is, therefore, recommended that Government facilitates the opening of local extensions of European universities and vocational schools. Such an action, coupled with the financial autonomy and greater public responsibility of universities, will create the incentives of university managers to care more about the efficiency of their institutions.
- ❑ Absolute priority should be given to strengthening institutions that have a central role in ensuring quality education – such as an independent agency that will accredit education institutions and ensure the quality of the education process, both in vocational schools and universities.
- ❑ Although a Strategy on Vocational/Technical Education has been adopted for 2013–2020, its implementation has been delayed because of a lack of funds. The EU has offered Moldova nearly EUR 25 million for its implementation. The most difficult aspect of implementing this strategy will be reorganising the network of vocational/technical education institutions, not least because of the huge internal resistance from managers and teaching staff. A strategic coalition should be created between the Government and employers, parents and students, and the conditions of employment and promotion of the managers and teachers of vocational institutions should be enhanced in order to overcome this resistance.
- ❑ It is necessary to strengthen the relationship between the relevant educational institutions, employers and research institutions. These connections are currently limited to providing internship opportunities to students: they should also allow for vocational training opportunities for teachers (masters), as well as for employers' opinions to be taken into account concerning the strategic surveillance of educational institutions.

- ❑ The Government should sponsor or directly assess the relevance of teaching programmes, both at the level of vocational schools and at a systemic level, and the results of this assessment should be made public. It is necessary to introduce a system of evaluation indicators of school performances, including by evaluating such indicators as the employment rate of graduates during predefined time periods after graduation, employers' levels of satisfaction, and graduates' salary level.
- ❑ Continuing hospital network rationalisation is imperative in order to release resources to equip health care facilities with the technical means, consumables and equipment, as well as to ensure periodic training of medical staff. These elements play a much greater role in ensuring a population's health than the number of available hospital beds.
- ❑ The Government policies for discouraging such practices as smoking, and alcohol and drug abuse, should be more active and need to be given the necessary support at the parliamentary level. During 2013–2014 the Government's efforts in implementing anti-smoking policies were not supported adequately by Parliament. Within these policies it is particularly necessary to target the categories that are the most vulnerable i.e. children and young people. It is these people who are the bearers of the future human capital of the country.

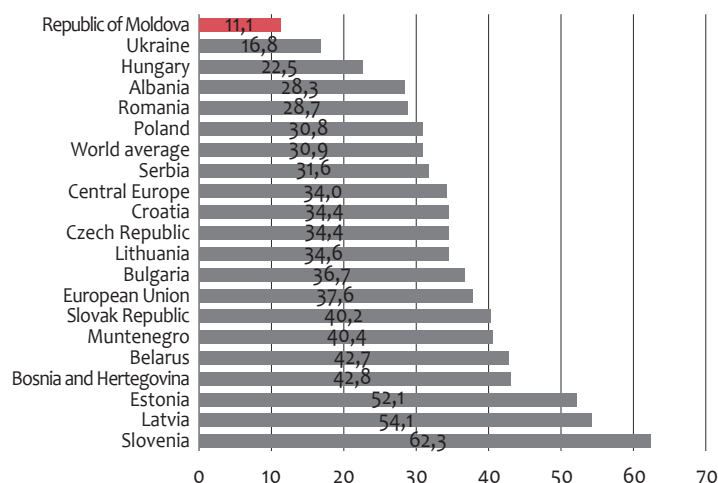
# Environment and Energy Efficiency: How Sustainable is Economic Growth from the Environmental Standpoint?

*The Moldovan economy is very vulnerable to extreme weather conditions and has a very low adaptation capacity. In this context, natural capital and the efficient use of environmental resources plays a crucial role in enhancing adaptation capacities and in ensuring the country's sustainable development. Taking this as a starting point, this chapter will focus on the analysis of the relationship between economic development and environmental conditions. The analysis will focus on three dimensions: the natural capital of the Republic of Moldova, the productivity and efficiency of environmental inputs and the impact of environmental constraints on the quality of life.*

## Natural Capital

**Forest Resources.** The forest resources of the Republic of Moldova consist of forestry and of forest vegetation in the surrounding grounds. According to the Land Cadastre, the forested area is 418.9 thousand ha.<sup>17</sup> The land area covered by forests is 374.5 thousand ha, while the forest vegetation outside the forest fund covers about 44 thousand ha.<sup>18</sup> Currently, the percentage of forest cover in the country is 11.1%, which is very low compared to other countries in the region (Figure 8). This level of forest coverage is under the minimum required threshold of 15% for ensuring an ecological balance. Moreover, afforestation rates are quite slow: over half a century, the forest cover percentage has increased by only 5.6 percentage points. At the same time, the expansion of forested areas has been achieved by species that are not appropriate to the country's conditions (e.g. the locust tree) and that go against the traditional species (e.g. oak).<sup>19</sup>

**Figure 8. Forest Cover Percentage in Various Countries, % of the land area**



Source: World Bank

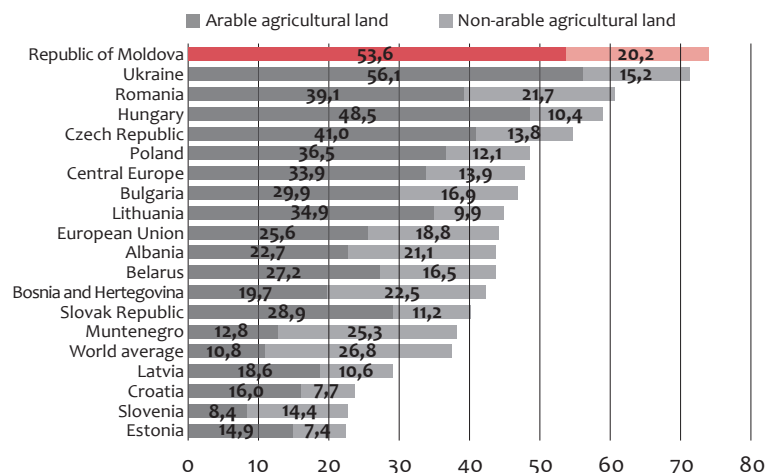
<sup>17</sup> Ministry of Environment, Academy of Sciences of Moldova, Institute of Ecology and Geography, "State of Environment in the Republic of Moldova during 2007-2010" (National Report), 2011, p. 21.

<sup>18</sup> Ibidem, p. 21.

<sup>19</sup> United Nations Development Programme (UNDP), "The Third Millennium Development Goals Report. Republic of Moldova", Chisinau, 2013.

**Land resources.** The total land area of the Republic of Moldova is 3384.6 thousand ha.<sup>20</sup> The predominance of black soil (chernozem), which accounts for 73% of the land surface structure, enables active exploitation of the land. Due to this fact, the Republic of Moldova has one of the highest shares of agricultural land, not only in the region, but also worldwide (Figure 9). Thus, judging by the way the lands are used, about 74% of this is agricultural area.

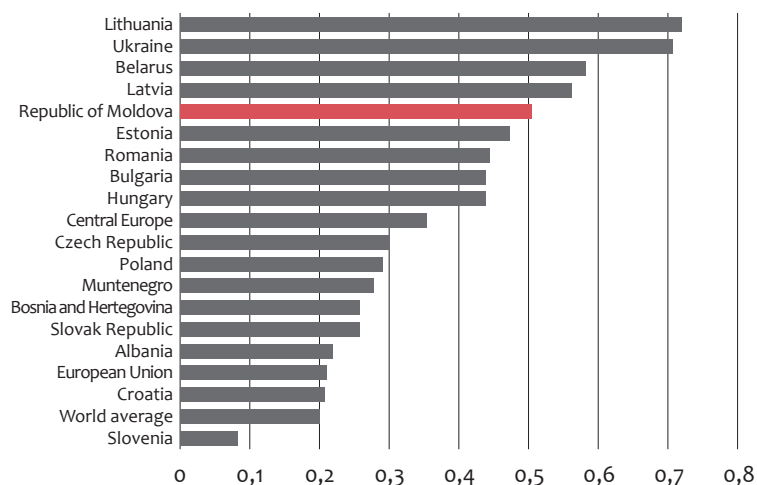
**Figure 9. Agricultural Land, % of the Total Land Area**



Source: World Bank, NBS

Providing the population with arable land is also a good prerequisite for agricultural development, including for the purpose of obtaining economies of scale. Thus, in the Republic of Moldova there are 0.5 ha of arable land per inhabitant, which is one of the highest values in the region (Figure 10).

**Figure 10. Arable Land Per Capita, ha per capita**



Source: World Bank, NBS

<sup>20</sup> Ministry of Environment, "Environmental Protection in the Republic of Moldova"



This incontestable advantage of Moldova is not, however, exploited, and the land has instead been exposed to advanced erosion processes. During 2000–2010, the area of non-eroded soils decreased by 41 thousand ha. The area of eroded soils increased during the same time period: the lightly eroded areas increased by 500 ha, the moderately eroded ones by 1600 ha, and the highly eroded areas have increased by 12,500 ha. Apart from the economic losses in the agricultural sector produced by this erosion, erosion has other consequences – such as the siltation of ponds, pollution of soil, destruction of communication lines etc.

**Table 6. Soil Erosion**

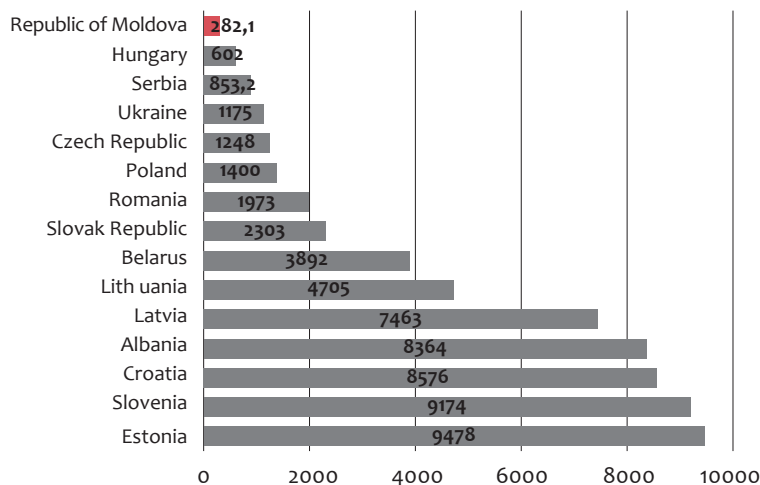
	2000 (thousand ha)	2010 (thousand ha)	Absolute change (2010-2000) (thousand ha)
Uneroded lands	1685	1644	-41
Lightly eroded lands	504.2	504.7	0.5
Moderately eroded lands	257.7	259.3	1.6
Highly eroded lands	101.7	114.2	12.5

Source: Yearbook of State Environmental Inspectorate, 2010, authors' estimates

**Water Resources.** The water resources of the Republic of Moldova consist of 3,621 rivers with a total length of 16 thousand km, 4,143 natural and artificial water basins extending over an area of about 41.7 thousand ha, groundwater in the form of 4,810 artesian wells, and 166.5 thousand wells supplied from the shallow water table.<sup>21</sup> The surface water of the Republic of Moldova originates mainly from the river basins of the Nistru (68.46%) and Prut rivers (31.48%). The country also has about 3,500 artificial water reservoirs, with a total storage capacity of 1.5 billion m<sup>3</sup> of water. It also has about 50 natural lakes, with a 60 km<sup>2</sup> in total area. The volume of groundwater is estimated to be about 1.3 billion m<sup>3</sup>, and its evolution in time is more stable than that of the surface water.

The total volume of water resources that Moldova possesses is about 15.8 billion m<sup>3</sup>. The water resources originating in the territory of the country represent, however, only 1 billion m<sup>3</sup>, which means 272.1 m<sup>3</sup> per capita of the population, being among the lowest in the region (Figure 11).

**Figure 11. Domestic Water Resources, m<sup>3</sup> per capita**



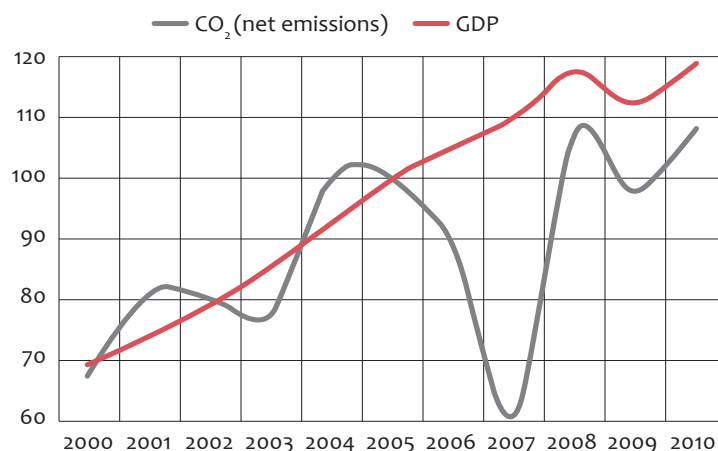
Source: <http://knoema.com/FAOQST2013/fao-aquastat-2013>

The main source of supply is surface water (85%), while groundwater accounts for only 15%. Of the surface water resources, the most important supply source is the Nistru River, which covers about 83% of consumption. The Prut River plays a less significant role and its share in water supply is only 1.8%, while other surface waters accounts for a 0.2% share of the water supply.<sup>22</sup> During 2000–2012, the annual average quantity of abstracted water from all the resources was 859.5 million m<sup>3</sup>. After the dramatic reduction in the 1990s, the evolution of the volume of abstracted water was relatively stable, the recorded variations being insignificant.

## Use of Natural Resources

**CO<sub>2</sub> emissions.** CO<sub>2</sub> emissions have a crucial impact on the environment as they cause an increase in temperature and increased intensity and frequency of extreme weather events. CO<sub>2</sub> emissions dropped significantly during 1990-2000. The main factor that caused this decline in emissions was the economic downturn registered during this period. The decreasing consumption of fossil fuels (in particular, coal and fuel oil) and reorientation towards the less polluting natural gas<sup>23</sup> also led to decreasing emissions. However, since 2001, following economic resurgence, an increase in CO<sub>2</sub> emissions has been recorded. Economic growth after 2000 has, nevertheless, been faster than the increase in CO<sub>2</sub> emissions: a partial decoupling of economic growth from the CO<sub>2</sub> emissions being recorded (Figure 12). This economic growth occurred on account of the development of sectors characterised by low CO<sub>2</sub> emissions, such as trade and services. At the same time, the evolution of CO<sub>2</sub> emissions was characterised by structural changes. The share of the energy sector decreased, but it is still the primary generator of emissions. On the other hand, the share of transport has grown continuously and now this sector ranks second in terms of CO<sub>2</sub> emissions.

**Figure 12. CO<sub>2</sub> Emissions versus GDP growth, 2005=100, %**



*Note: computed for the entire territory of the Republic of Moldova*

*Source: NBS, Central Bank of the Left Banks of the Nistru River, Climate Change Office, authors' estimations*

During 1995–2010, the productivity of CO<sub>2</sub> emissions (calculated by reporting the net CO<sub>2</sub> emissions to GDP on the basis of the *production-based CO<sub>2</sub> productivity* approach) witnessed a volatile evolution. Nevertheless, a general trend of increasing CO<sub>2</sub> emissions was recorded. Thus, CO<sub>2</sub> productivity in 2010 increased by 7.6% as compared to the 2000 level. In spite of this

<sup>22</sup> Ministry of Environment, SEI, the SEI yearbook – 2010 “Environmental Protection in the Republic of Moldova”, p. 36.

<sup>23</sup> Ministry of Environment, Low-Emissions Development Strategy of the Republic of Moldova by 2020 (draft), 2011, p. 7.

increase, the ratio of productivity to CO<sub>2</sub> emissions remains quite low in the Republic of Moldova, if compared with the EU, OECD or the average efficiency at the international level (Table 7). This means that in the Republic of Moldova one kg of CO<sub>2</sub> emitted corresponds to the production of a lower volume of value-added than in other countries. The gap is caused by the relatively low GDP in the Republic of Moldova coupled with increasing emissions as a result of a higher number of vehicles in use, the endowment of enterprises with outdated equipment, and a considerable stock of poorly insulated buildings.

**Table 7. Comparative Aspects as regards CO<sub>2</sub> Productivity, GDP in USD 2005/kg CO<sub>2</sub>**

	2000	2010	Changes 2010/2000, %
EU	3	3.6	19.1
OECD	2.4	2.8	16.5
World average	1.6	1.6	-1.6
Republic of Moldova	0.4	0.5	7.6

*Note: computed for the entire territory of the Republic of Moldova*

*Source: NBS, Central Bank of the Region on the Left Bank of the Nistru River, authors' estimations*

**Energy.** During 2005–2012 the supply of primary energy decreased significantly, from 56.2 thousand terajoules (TJ) to 46.1 thousand TJ. The reduction occurred due to the decrease in gas consumption, which in 2012 decreased by 22.8%, compared to 2005.<sup>24</sup> An important factor that determined the reduction of gas consumption was the continuous increase in the average domestic tariff (the tariff increased 5.3 times in 2012 compared to 2005): this increase was prevalently determined by the increase in import prices, which increased 5.2 times during 2005–2012.

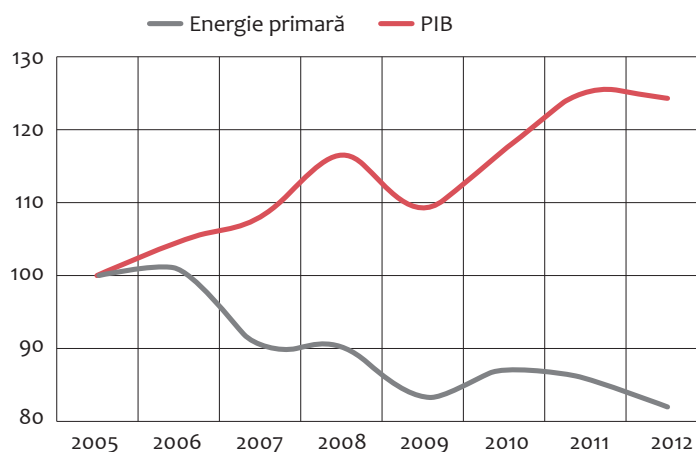
The two main issues for the Republic of Moldova as far as energy use is concerned are the strong monopolisation of imported energy resources and the low energy efficiency. Over one-third of energy resources are imported. Domestic production does not cover even a fifth of the country's energy consumption: gas is fully imported from the Russian Federation, and 70% of the electricity is procured either from Ukraine or from the left bank of the Nistru River. Outdated and inefficient equipment, old infrastructure and housing cause the low efficiency with low energy saving potential,<sup>25</sup> while declines in energy consumption are a defining characteristic of the national energy system. During 2005–2012, the share of losses in energy consumption decreased slightly (from 7% to 5.6%). Though the ratio of electricity losses to electricity consumption is still high, it dropped during 2005–2012 from 18.7% to 13.7%.

During the same period, the Republic of Moldova reached full decoupling because the decrease in the primary energy supply was accompanied by robust economic growth (Figure 13). However, this phenomenon should be treated carefully, because the decoupling did not result from higher energy efficiency in the production process, but thanks to the economy's orientation towards energy non-intensive sectors and negative developments in some branches of industry.

<sup>24</sup> National Agency for Energy Regulation in Moldova, Activity Report of 2009 and 2012

<sup>25</sup> Ministry of Environment, Low-Emissions Development Strategy of the Republic of Moldova by 2020 (draft), 2011, p.7.

**Figure 13. Primary Energy versus GDP Growth, 2005=100, %**



Source: NBS, authors' estimates

**Water.** Since 2001, the volume of water consumed in the Republic of Moldova has demonstrated volatility. Yet, a slight decreasing trend may be distinguished. In 2012, 786 million m<sup>3</sup> of water was consumed, which represents a decrease of 7.4% compared to 2000. The decrease in the consumption of water can be explained partially by more efficient consumption patterns in households (consumption decreased by 19.2% during 1990–2012). Due to this fact, the intensity of water use in the economy (water consumption/GDP) dropped. On the other hand, the ratio of volumes of water lost to water consumption has not changed significantly, accounting for about 8% (Table 8).

**Table 8. Indicators regarding the Use of Water in the Economy**

	2000	2005	2010	2011	2012
Water consumption, million m <sup>3</sup>	849	785	785	785	786
Water consumption/GDP, l/1000 USD int., 2005=1	34.9	22.4	18.9	17.9	18.0
Water losses/consumption, %	7.5	8.5	8.4	7.9	8.1

Note: \* - computed for the entire territory of the Republic of Moldova

Source: NBS, Central Bank of the Region on the Left Bank of the Nistru River, authors' estimations

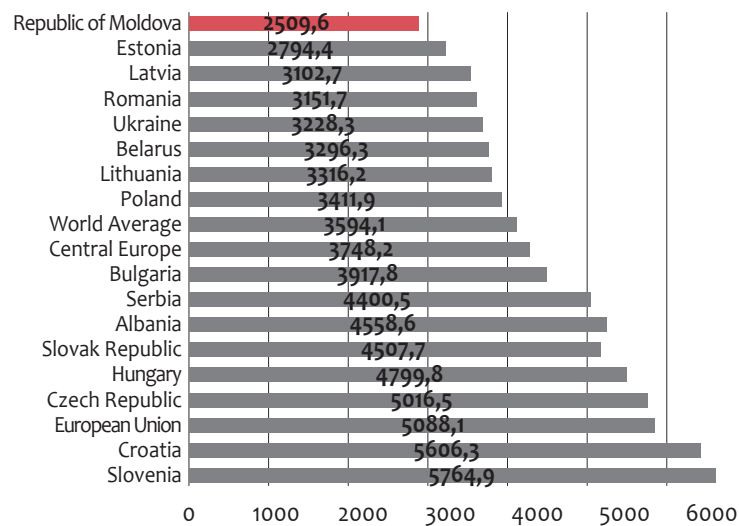
It should be noted that in the agricultural sector water consumption has decreased significantly. In 2012 the irrigated lands accounted for 6.7% of the total land area. The area of irrigated land was 228.3 thousand ha; compared to 1995 it has declined by 26.2%. The irrigated area has decreased due to several factors, including outdated pumping stations, deteriorating equipment, and higher energy costs (which have made pumped water unaffordable for some farmers).<sup>26</sup>

**Soil.** The low level of crop rotation and declining use of organic and mineral fertilisers, has led to a decrease in the humus content and bio-elements in the soil, and to its biological degradation.<sup>27</sup> The decrease in soil quality is a crucial problem in the country, as it leads to lower crop yields. A comparative analysis shows that the soil yield in the Republic of Moldova is one of the lowest in the region (Figure 14).

<sup>26</sup> Ibidem, p. 54.

<sup>27</sup> Ministry of Environment, Low-Emissions Development Strategy of the Republic of Moldova by 2020 (draft), 2011, p.53.

**Figure 14. Average Grain Harvest for 2008-2012, kg/ha**



Source: World Bank

Also, it should be mentioned that Moldova’s agriculture is heavily dependent on weather conditions. This causes large variability in agricultural production, leading to anaemic growth in the agricultural sector.

## Risks to Quality of Life

**Air pollution.** Air quality is, largely, unsatisfactory. One risk that has a major impact on the population’s health is exposure to air that is polluted by solid fine particles  $PM_{10}$  and  $PM_{2.5}$ . Despite the trend of a reduction in the concentration of solid particles in the air, their level is higher than the safe limit. The concentration of solid particles  $PM_{10}$  varies, at the national level, at around the level of 33-36  $\mu g/m^3$  and exceeds the level of 20  $\mu g/m^3$  set by the World Health Organisation (WHO). Likewise, the share of the population exposed to  $PM_{2.5}$  concentrations that are above the WHO norm of 10  $\mu g/m^3$  is between 30–40%. There is no clear sign of this share being reduced.

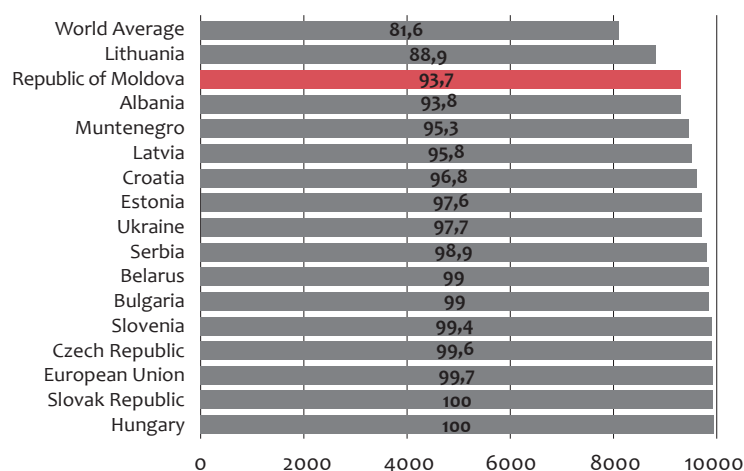
Air pollution from non-stationary sources has increased and has become the main source of atmospheric poisoning. Air pollution from stationary sources has reached a stable level: during 2001–2013, the volume of emissions varied at around the level of 16.5 thousand tons. On the other hand, vehicle pollution increased by 73.4% in 2013 compared to 2001.

**Access to water and sanitation.** The Republic of Moldova lags behind with regard to the access of the rural population to improved sources of water. In 2012, the share of the rural population with access to improved sources of water was 93.7%. This result places the Republic of Moldova among the last countries in the region (Figure 15). A significant share of the water used by households does not comply with sanitary requirements. The water in over 40% of water pipes investigated by the National Center for Public Health does not comply with sanitary-chemical requirements. In rural areas, the situation is particularly severe, with 75% of the population being supplied by water from wells while 84% of wells do not comply with sanitary-chemical standards, and 30% of wells do not comply with macro-biologic parameters.

The share of the population with access to improved sanitation has increased continuously, from 32.3% in 2000 to 56.6% in 2012. Thanks to this progress, the Millennium Development Goals (MDG) target of 50%, set for 2010, was achieved. A new target of 65% was set for 2015, but accomplishing this

target seems unrealistic. At the same time, there is a large gap between people's access to sanitation services between the rural and urban areas. Thus, in cities between 70% and 80% of households are connected to sewerage services, while in the rural area the connection rate varies between 3% and 7%.

**Figure 15. Access of Rural Population to Improved Sources of Water, % of the rural population**



Source: World Bank

**Waste.** The increasing stock of waste leads to a higher release of harmful substances into the air, soil and water, affecting people's health, as well as decreasing the area of land that can be used for other activities. The Republic of Moldova is characterised by a rapid growth of waste. Thus, during 2005–2012 the volume of household waste increased by 91% (Table 9). During the same period, the area of solid waste neutralisation sites increased only by 14.9%, decreasing areas that can be used for other activities.

**Table 9. Household Waste in Urban Settlements**

	2005	2006	2007	2008	2009	2010	2011	2012
Solid waste, thousand m <sup>3</sup>	1268.5	1353.6	1790.6	2130.8	2210.2	2302.6	2350	2421.1
Liquid waste, thousand m <sup>3</sup>	23.9	27.8	28.9	42	57.4	56.9	51.9	48
Area for solid waste neutralization, ha	166.9	180.2	195	190.1	199.2	206.5	210.7	191.8

Source: NBS

## Policy Recommendations

The Republic of Moldova faces a complex set of issues associated with the use of environmental resources. In order to improve environmental quality and efficient use of natural resources, it is necessary to take actions in various areas.

- Policies on energy use should target three dimensions: (i) geographic de-concentration of sources of imports; (ii) development of alternative forms of energy; and, (iii) streamlining of the use of energy resources. Progress in these directions will improve the environmental

situation both by implementing non-polluting sources of energy, such as wind or sun energy, as well as by decreasing CO<sub>2</sub> emissions. Another dimension relates to continuing to adjust tariffs to reflect the costs of energy production, which will streamline consumption. Likewise, energy saving measures should be applied at the construction stage. Useful policies to this effect would encompass not only requirements for building designs, included in the National Energy Efficiency Programme, but also raising public awareness of simple saving opportunities, most of which are unknown to most people. In this respect, the Energy Efficiency Agency has capacity to promote energy savings. However, it needs additional assistance in training the public on the appropriate use of energy.

- ❑ In the Republic of Moldova there are difficulties regarding access to quality water. The irrigation system is also damaged. Policies should be focused on three dimensions: (i) strengthening the institutional capacities of the structures in charge of managing the water resources; (ii) ensuring financial support for policy implementation (to this end the possibility of adjusting tariffs might be considered); and, (iii) strengthening the infrastructure by building new reservoirs, extending the network of channels and abstracting groundwater.
- ❑ During recent years, organic agriculture has been insufficiently supported in the country, mainly through small subsidies. To improve the situation, the relevant policies should focus on providing support for trade, information on sales opportunities in the domestic and external market, and a system of efficient and transparent subsidies. The support may be provided through grants for investments in organic agriculture, processing and marketing projects, organisation of organic farmers groups, and financial support for converting to, and maintaining the status of, organic farming.
- ❑ In order to reduce environmental pollution from motor vehicles, green transport policies of the kind that are actively promoted in most developed countries should be promoted. Policy measures could include financial support for the construction of special lanes for cycling, free parking lots (park-and-ride) on the outskirts of cities in order to make it possible for people to travel by trolleybus within the town, bypasses for heavy transport, modernisation of the vehicle fleet to make public transport more attractive and quicker, and raising public awareness regarding green means of transport.

**Table 10. Main Indicators Monitored regarding Environment and Energy Efficiency**

Statistical indicators	2011	2012	2013
Forests, % of the total land	11.1	11.1	-
Agricultural land, % of the total land	73.8	73.8	73.8
Arable land, % of the total land	53.6	53.5	53.6
Arable land per person, ha per capita	0.51	0.51	0.51
Domestic water resources per person, m <sup>3</sup> per capita	-	281.2	-
CO <sub>2</sub> productivity, GDP IN USD 2005/kg CO <sub>2</sub>	-	-	-
Energy productivity, GDP in USD 2010/MJ	0.25	0.23	-
Water use intensity (water consumption/GDP), l/1000 USD 2005	17.9	18.0	-
Population with access to improved sewerage, % of total population	54.6	56.6	-



# Domestic and Foreign Politics: Momentum towards Europe on the Outside, Imitating Reforms on the Inside

*This chapter provides an assessment of both domestic and foreign politics, and presents the most important developments during 2013–2014. The analysis includes an in-depth look at the risks related to the peculiarities of the European course, pressures caused by future elections, and complications associated with the cold relations with Russia. It is argued that there is an inconsistency between foreign policy and the reforms actually undertaken, particularly in regard to justice and combating corruption. Additionally, authorities have failed to use fully the benefits of the European agenda and to enhance citizens' support. This failure has allowed an increase in the public sympathy for Eurasian geopolitical projects, which have further deepened the polarisation of society. The recommendations presented at the end of this chapter aim at speeding up reforms and strengthening internal cohesion, resizing the relations with certain external partners, as well as setting up more sensible external politics.*

## Analysis of the Main Trends and Developments

### Domestic Politics

For the first time since the pro-European forces came into power, after the elections of July 2009, there have appeared real chances, in 2013, to stabilise domestic policy. Compared with 2012, the intensity of animosities has diminished; it is nevertheless the case that some conflictual stakeholders have been excluded from the political stage but not from governance. In fact, the offices of the ruling parties (the Liberal Democratic Party of Moldova (PLDM), the Democratic Party of Moldova (PDM)) have become centres of power, around which all political decisions in the country are taken. The reforms initiated by the previous pro-European governments (until May 2013) resulted, by 2014, in concrete actions concerning the EU, particularly the EU visa liberalisation.<sup>28</sup> Visa liberalisation was accelerated by several circumstances, including the political crisis in Ukraine and the development of Russia's hostile position towards the extension of the EU's influence in the region. Domestic politics has been dominated by the consensus that has been reached by the coalition parties, a consensus guided primarily by their desire for political survival – commitments to external partners have been secondary. At the same time, internal politics has been dominated by external politics, which has had the effect of drawing attention away from crucial reforms (justice, combatting corruption). During 2013–2014, several trends were noticed that have influenced the domestic agenda, including:

- ❑ **Removal of party leaders from top governance, but not from the act of governance.** The leaders of PLDM and PDM gave up their main positions in the state but this was a temporary compromise, necessary to overcome the political crisis and requested by European partners. The involvement of PDM and PLDM leaders in the act of governance has not disappeared, however. It has taken a more subtle and unobtrusive form, being achieved through subordinated political stakeholders who maintained their office after the establishment of the new Government (May 30, 2013). Thus, rivalries have often been noticed among ministers from the two political groups (eg the Minister of Economy versus the Minister of Agriculture and Food Industry).

<sup>28</sup> European Commission, Commissioner Malmström on visa-free travel for Moldova, April 3, 2014, [http://europa.eu/rapid/press-release\\_STATEMENT-14-101\\_en.htm?locale=FR](http://europa.eu/rapid/press-release_STATEMENT-14-101_en.htm?locale=FR).

- ❑ **Non-transparent governance and incomplete justice.** The cold peace established between the ruling parties (PLDM and PD) has relied on a balance of power between these two groups. Keeping the law enforcement institutions (Prosecutor's Office, Anti-Corruption National Center etc.) in their "subordination" has ensured political immunity to justice for both political groups. The level of impunity has not changed as compared with the situation in previous years. Therefore, there are no pending cases against any high officials.
- ❑ **Alliances outside the ruling coalition.** Both at the central and local levels, the ruling parties voted with the Communist opposition. The votes by PLDM and the Party of Communists of the Republic of Moldova (PCRM) that have been in common related to crucial aspects regarding the democratic process of governance, such as: not to allow uninominal voting, to extend the prerogatives of the acting Prime Minister, to bring back the National Anticorruption Center under the subordination of the Executive, and to raise the election threshold up to 6%. PDM has allied itself with PCRM at the regional level.
- ❑ **Non-transparent or inefficient transactions involving public goods.** The concession of Chisinau Airport and the vicious privatization of the commercial bank "Banca de Economii" show that private interests have dominated over national ones. Both objects are of strategic importance for the national economy, but also for the country's security. Although they were contested by the opposition parties and created confusion for Moldova's European partners because of the non-transparent procedures, the results of these transactions were not reviewed.
- ❑ **Attack on the Constitutional Court.** Through its deliberations, the Court has become an essential element for verifying the constitutionality of laws and acts. Therefore, this institution was used to cancel the possibility of organising local referenda on issues of foreign policy and to reject the Prime Minister who was accused of corruption. Although the Court has made it possible to overcome some crisis situations, its behaviour has sometimes been inconsistent – for example in the case of the Chisinau Airport concession – or has increased the tension in society (for example the decision on the status of the Romanian language). The fact that the Court's weight has increased is proved by the legislative initiative (PCRM, PLDM) regarding the revocation of Court judges, augmenting with the loss of credibility.
- ❑ **Delimitation of symbols.** The ruling political parties have cut domestic symbolist rhetoric. PLDM has comprehensively focused on the European issues and on a moderate "Romanism" – an issue where PL and PLRM are rivals. On the other hand, PDM supports the Moldovan rhetoric, which is very close to the left-wing parties (PCRM and PSRM).
- ❑ **Conversion to federalism.** The idea of federalising the country has reappeared in the public eye, in connection with the events in Ukraine. Some Russian officials have emphasised an interest in this subject. However, Russia does not have the necessary background to resuscitate the "Kozak Plan" which was rejected in 2003 by the PCRM.
- ❑ **Extensive separatism.** Transnistrian separatism has been reinforced because of Tiraspol's insistence on enhancing its control over the property on the left bank of the Nistru River, which is still subordinated, though weakly, to Chisinau (Latin-script schools, lands of the inhabitants from the Dorotcaia commune). The annexation of Crimea by Russia has been used to revive discussions about the annexation of the region by Russia. Weak domestic support from the pro-European governance, in tandem with Russia's actions in the region, have created appropriate conditions for the activation of separatist tendencies in Gagauzia. As evidence, one may refer to the referendum held in Gagauzia region, where most Gagauz people (98% out of 70 thousand) voted for the Customs Union Russia-Belarus-Kazakhstan (CU RBK). Subsequently, some Gagauz officials have voiced more loudly their separatist intentions to seek secession from the country if the EU Association Agreement is signed.

The general, public opinion on the development of the country remains negative. The underlying reasons are not only the maintenance of oligarchic groups in government, which are seen as subordinating state-owned institutions, but also the lack of political alternatives represented by the current opposition. According to the Public Opinion Barometer, about 70% have pessimistic

views concerning the direction in which the country is headed (68% in April 2014 and 69.4% in November 2013). In addition, other polls show that most people see Moldovan democracy as being in a deadlock (86% of respondents are not satisfied with the level of democracy, by 6 p.p. more than the survey held in August, 2014).<sup>29</sup>

During 2013, the European objective became the top priority in both foreign and domestic politics. A perception was created that any actions taken by the authorities were part of a European agenda. However, communication on the EU topic started too late and was mainly motivated by Ukrainian events and less due to the internal information vacuum. In fact, European integration remains an elitist project, rather than a mainstream one. The Government has not ensured effective dissemination of the European idea from the Government to ordinary people, especially in rural areas and among monolingual groups. In fact, Eurosceptic views are determined by a lack of communication and by the awareness of costs and real sacrifices that will be involved in signing the Association Agreement. At the same time, the proximity of two regional integration projects has led to an ongoing polarisation of society. Opponents and supporters of the EU and CU accession are divided behind barricades of almost identical strength.

Even if the European dimension has materialised in projects that have focused on concrete objectives (social infrastructure, public service quality, etc.), and also on strategic objectives (good governance, judicial reform, etc.), support for this has declined (see Figure 1). At the same time, a lot of citizens continue to support the Eurasian trajectory (CU: 40%, versus EU: 44%<sup>30</sup>). Ukrainian events have produced additional arguments in favour and against the two integration options, influencing public perception in the country. In the EU's view, Russia's actions regarding extending the CU are related to pressures<sup>31</sup> aimed at hindering the signing of the Association Agreement with the EU (Ukraine, Moldova). At the same time, according to Moscow, the EU will force the Eastern Partnership (EaP) countries to choose between the CU and the Association Agreement. The information war between West and East concerning the situation in Ukraine has created additional pressure on local public perceptions. The population uses as a source of information not only local sources, but also Russian ones that are fully controlled by the Russian authorities.

## Good Governance and the Rule of Law

During 2013–2014, no significant results were obtained in the justice reform and combating corruption. Instead, attempts were made to imitate, rather than implement, reforms. According to Transparency International, the level of corruption perception has increased by eight points, positioning Moldova as 102 out of 177 countries. Although corruption is pervasive in Government institutions and in society, National Anticorruption Centre filed only 374 criminal cases of corruption, and many cases were closed without any sentence. Thus, 310 or 65% of criminal cases (of a total of 479) were closed. In most cases, the accused persons were rehabilitated (296 cases). The Ministry of Internal Affairs also achieved insignificant results. To put it another way, the National Integrity Commission (NIC) has reported about 50 files (up to October 2013), of which about 20 were closed. Furthermore, no high official was accused of corruption, although the former Prime Minister was accused of corruption, as confirmed by the Constitutional Court and by other political leaders (eg Vlad Plahotniuc). The performance of institutions (NAC, NIC) is extremely low because of: dependence on political factors; weak and/or insufficient institutional

<sup>29</sup> European Commission, EU Neighbourhood Barometer Eastern Partnership, [http://euneighbourhood.eu/wp-content/uploads/2014/05/RapportENPI\\_wave4\\_East1.pdf](http://euneighbourhood.eu/wp-content/uploads/2014/05/RapportENPI_wave4_East1.pdf).

<sup>30</sup> CEPI, Sociological survey "Widening the European Dialogue in Moldova", November 19, 2013, [http://www.cepolicy.org/sites/cepolicy.org/files/attachments/survey\\_results.pdf](http://www.cepolicy.org/sites/cepolicy.org/files/attachments/survey_results.pdf).

<sup>31</sup> European Commission, Ștefan Füle, European Commissioner for Enlargement and Neighbourhood Policy, Statement on the pressure exercised by Russia on countries of the Eastern Partnership, September 11, 2013, [http://europa.eu/rapid/press-release\\_SPEE-CH-13-687\\_en.htm](http://europa.eu/rapid/press-release_SPEE-CH-13-687_en.htm).

capacities; overlapping responsibilities of NAC and MHA; lack of interest and efficiency of NIC that depends on prosecution activity, which remains unreformed because of contradictions within the ruling coalition (PLDM, PDM).

In general, justice reform is proceeding slowly; even though the Moldovan side has met certain preconditions for which it received the first installment (EUR 15 million) of an EU grant (EUR 60 million). The package of anti-corruption laws, which were voted on in December 2013, has not led to the confiscation of illegally obtained assets or in other relevant sentences.

Deficiencies in the judiciary caused by the corruptibility of courts have been apparent in constraints on certain strategic sectors of the economy, such as banking. In 2013, new “raider attacks” occurred, resulting in the theft of several shares of the commercial bank “Moldova Agroinbank” and their transfer to offshore companies. This fact has raised concerns within the European Bank for Reconstruction and Development (EBRD), which demanded cancellation of fraudulent transactions. However, NBM intervention was stopped by a court decision. In this way, new evidence appeared showing judicial corruption and legal gaps that allow the limiting of the powers of the NBM. The IMF has suggested the review of the national legal framework to strengthen the supervisory and regulatory functions of the NBM,<sup>32</sup> in order to define the level of judiciary involvement. Another unresolved issue is ensuring the transparency of bank shareholders, which causes additional risks for the sector. In addition, the impunity of judges involved in “raider attack” schemes remains an issue. This has diminished confidence in the judiciary and in the process of property rights protection and guarantees.

Moreover, Moldova has regressed in terms of transparency in Government decision-making, along with the increase of non-transparency indicators by about 6% (from 45.1% to 51%).<sup>33</sup> The most prominent cases of non-transparency are related to: failure to consult the State Budget Law for 2014 with the civil society, Decision on Duties of the Prime Minister and Deputy Prime Ministers, Draft Law on Agricultural Tax etc. To put it another way, although in 2013 the availability to draft decisions increased, through their posting on the official websites of the Central Public Authorities or on [www.particip.gov.md](http://www.particip.gov.md) (up to 97% of cases), the consultation of citizens has diminished (-5% in 2013 versus 6% in 2011). Additionally, in the field of open governance, monitoring reports<sup>34</sup> show an incomplete development of the open governance measures for 2013 (only 50% of actions). In particular, the transparency of public expenditure was at a level of 70%, while the involvement of citizens in the decision-making process and the increase of the transparency of that process was at only 47%.

## Foreign Policy

During 2013–2014, significant improvements in foreign policy took place, except for relations with Russia. The strengthening of the dialogue with external development partners was focused on preserving the European trajectory. In this respect, we noticed a substantial progress in relations with the EU, as stated by the visits of key European officials: the President of the European Council, Herman Van Rompuy, and the President of the European Commission, José Manuel Barroso. Compared with other EaP countries, which regressed in this area, the Republic of Moldova qualifies as the leader of EaP process. However, this does not represent a success story. The EU regards the progress of reforms as being rather slow.<sup>35</sup> Analyzing the evolution of relations with the EU and the Member States, these can be divided into two distinct phases: “pre” and “post” initiation of the Association Agreement:

<sup>32</sup> Consultations of Consultation Mission, IMF, April 30, 2014, <http://www.imf.md/press/pressw/press-140430ro.html>.

<sup>33</sup> The data provided by NPC for comparison of data of April 18, 2012 – February 27, 2013 and respectively June 5 – December 5, 2013, <http://cnp.md/ro/produse/monitorizarea-politicilor/general/item/1864-rezolvarea-caren%C8%9Belor-transparen%C8%9Bei-decisionale-a-guvernului-republicii-moldova>.

<sup>34</sup> <http://soros.md/files/publications/documents/raport%20PAGD%202012-2013.pdf>.

<sup>35</sup> Czech Ambassador in the Republic of Moldova, Jaromír Kvapil: “Moldova is modernising slowly, but I hope in the future they will spend less time and will be more assiduous in doing it”, <http://www.europalibera.org/content/article/25409255.html>.



- ❑ **In the pre-initiation period**, the European factor was invoked in order to solve the political crisis, taking into consideration the delicate situation of the Government after the case of “Padurea domneasca”<sup>36</sup> and the collapse of the Government after the former Prime Minister was charged with corruption. Subsequently, attention was focused on preparation for Association Agreement initiation. At the same time, visa liberalisation entered the final phase of implementation – at the technical level all the necessary conditions were met.
- ❑ **In the post- initiation period**, the main focus of the European partners shifted to the mediation of conflicts within the Government, and on deepening and improving reforms. They focused on establishing a beneficial context for signing the Association Agreement, and at the national level on the preparation of the agenda for Association Agreement implementation. The country’s diplomatic efforts were oriented on the European states’ coalition to take a favourable decision regarding the visa liberalisation. The Ukrainian crisis and the Russia retort against intensification of the EU’s influence in the region by signing the Association Agreement with EaP countries accelerated the elimination of the Schengen visa. Russia clearly disputed the sovereignty principle of EaP countries that fueled pro-European political movements in the Eastern proximity. This contributed to an early signing of the Association Agreement, on June 27, 2014 (it had previously been scheduled for late autumn 2014). The European Parliament resolution of April 17, 2014 recognises the eligibility of EaP states (including Moldova) to EU accession. Pro-European forces have given the date of EU accession as 2019, when Romania will take over the EU presidency. However, this calendar looks purely political and is not supported by reasonable calculations. Croatia became a member of the EU in July 2013, 10 years after its submission of its membership application to the EU, and 12 years since the EU Stabilisation and Association Agreement was signed.

The bilateral dialogue with the EU has taken on a new dimension with the involvement of European factors in the popularisation of the European idea at the local level. This need has arisen because of incomplete interaction between the authorities and citizens, a sophisticated and misleading information about the EU, and the difficulty of translating the European agenda into accessible language for the public. Another additional factor has been the failure of EU diplomacy in Ukraine and the emergence of a pro-CU message in the country and region. As a result, an active involvement of European officials in local debates on the Association Agreement’s benefits and costs was observed. This has also expanded outside the capital (Comrat, Balti, Ialoveni etc.), and has involved students, farmers and business women. The short-term effects of these actions are insignificant, but for the medium and long term they can have a significant impact. At the same time, in order to support the European course, the authorities have launched some actions to mobilise the Moldovan diaspora.

**Relations with neighbouring countries.** Despite the political complications in Ukraine, and small disruptions in the Moldovan-Romanian dialogue, the relations with neighbouring countries remained positive. Chisinau chose to support the new pro-European government in Kiev, treating the subject with caution, using various tools, aligning itself with the EU position and with the international community concerning Russian actions. The efficiency of the Bucharest dialogue has materialised in concrete projects (technical assistance, an energy dimension, support of the European course). However, interpretations concerning “unionism” promoted by certain political factors in Bucharest has caused small episodes of tension in bilateral relations (e.g. disputes between T. Basescu and I. Leanca).

**Transatlantic dialogue.** An upward trend could be seen relations with other Western countries. The transatlantic dialogue has evolved extremely positively. Thus, Washington–Chisinau relations were strengthened as a result of numerous mutual visits, which led to political and economic results. The launch of a Strategic Bilateral Dialogue, formation of the Working Group on energy

<sup>36</sup> Analysis: Boar hunt shooting tragedy triggers Moldova crisis, <http://www.reuters.com/article/2013/04/24/us-moldova-crisis-idusbreg3nopa20130424>.

security, and the initiation of negotiations on trade and investment have created a favourable context for accelerating transatlantic relations. Also, the USA has supported the country's European trajectory. It was possible to establish the transatlantic vector thanks to the opening of a diplomatic mission in Canada, a host country for Moldovan immigrants, and political articulation of bilateral relations. The beginning of a dialogue with the North Atlantic Treaty Organisation (NATO) concerning security was possible due to the tense geopolitical context.

**Relations with Russia.** Advancing the dialogue with the EU on the signature of the Association Agreement has generated difficulties in relations with Russia, which is interested in its own integration projects. Russian officials' unfriendly political rhetoric, distrust of pro-European forces, as well as application of restrictive measures against domestic products, along with tightening of the migration conditions, has short-circuited the bilateral dialogue. The authorities' attempts to relaunch this dialogue at the highest level were rather unilateral. At the same time, communication via Foreign Ministries has allowed dialogue to remain afloat. With the signing of the Agreement on the Eurasian Economic Union (May 29, 2014), pro-CU messages will become more attractive to the local public and to pro-Russian advocates. This will increase competition among electoral offers proposed by pro-European and pro-Russian forces. In addition, in the context of Ukraine's request to quit the CIS, which is important for Russia, similar messages have gained visibility in the local public discourse in Moldova. However, the Chisinau executive has said there is compatibility between membership in CIS and the signing of the EU Association Agreement.

## Wider Implications and Risks

The rhythm and the depth of reforms is the main source of concern for the current Government, which must report its results both to its own electorate and internationally. In particular, justice reform and combating corruption are among the most problematic areas, where the results achieved by the authorities were below the people's, and the European partners', expectations.<sup>37</sup>

Indicators on the corruption level show that the situation has not changed at all: on the contrary, it worsened (102<sup>nd</sup> place in 2013, which means eight positions lower compared to 2012, according to the Corruption Index). This problem may be explained by the political dependence of the NAC, as well as by its low effectiveness, similar to the NIC. Moreover, there is an overlapping jurisdiction between the NAC and the Ministry of Home Affairs, which prevents a comprehensive approach to combating corruption. In a related matter, the fulfillment of the actions planned for 2013 in the Justice Sector Reform Strategy looks unlikely: only about 56% have been achieved. Thus, justice reform has been implemented mainly on paper; actual implementation of the approved anti-corruption legislation has thus far failed.<sup>38</sup>

At the same time, the internal gaps arising from the confrontation of two regional integration projects (Association Agreement with EU and CU/Eurasian Economic Union), will increase, implying a range of political risks in the short and medium-term, including:

- **Conducting a “geopolitical ballot”:** The elections of November 2014 could lead to a turnaround. The electoral options will be assessed from the perspective of the external orientation of political parties. Hence, the external agenda will supervene upon the domestic one, and the electorate will vote for East or West. In the short and medium-term, the European integration will be affected, taking into account the Eurosceptic (PCRM) opposition's promise to initiate a review of the Association Agreement.

<sup>37</sup> Ziarul de Garda, Cecilia Malmström: “We are concerned about areas that need to be reformed”, May 22, 2014, <http://www.zdg.md/stiri/cecilia-malmstrom-suntem-ingrijorati-de-domeniile-care-necesita-sa-fie-reformate>.

<sup>38</sup> Euromonitor: Synthesis of the Main Developments, January – December 2013, <http://www.e-democracy.md/files/sinteza-euromonitor-2013.pdf>.

- ❑ **European agenda and “protest vote”.** The elections of November 2014 are a challenge for the continuity of the European agenda. They may represent a potential protest vote against the present Government which will be interpreted as voting against European integration. From this point of view, voters will experience difficulties when evaluating political parties apart from geopolitical affiliation. This aspect represents a “life buoy” for pro-European forces, in the context of electoral competition, by benefiting from the transfer of positive image from European stakeholders. However, in the context of anti-European attitudes, (at least 32 myths about the EU have been presented) and anti-Association Agreement stereotypes,<sup>39</sup> which imply “anti-union” messages, circulated in the local public space, the European factor could equally be an “Achilles heel” for parties associated with the EU public.
- ❑ **Activation of separatism.** The population divide on the geopolitical principle has been exploited extensively by certain political forces to create public visibility, but also to set the electorate against the current Government. The appeal to carry out a referendum to choose between the Association Agreement and joining the CU was a part of the rhetoric of the Eurosceptic opposition parties. Moreover, the anti-constitutional referendum organised by the local authorities of the Gagauzian region, with a predictable result in favour of the CU, reveals the fragility of the legal framework and its ineffectiveness in preventing separatist manifestations.

Regarding the external dimension, the lack of effective dialogue between Government and citizens on European integration has reduced the level of cohesion. The anti-European campaigns and pro-CU platform of the pro-Russian forces, as well as an absence of an active civil society at the local level, have deepened the existing cracks. Public diplomacy conducted by the EU remains weak: the communication process with the public has not yielded significant results so far, as is proved by the low EU support in the polls. In a related matter, relations with other countries have varied according to the different geopolitical circumstances. The main risks that hover in this area are related to the following aspects:

- ❑ **The appearance of a vacuum in EU–Moldova relations, generated by the membership of the EU institutions.** Thus, two key European leaders, supporters of European integration in Moldova (Van Rompuy and Barroso), will conclude their mandates by the end of 2014. In addition, European Commission composition will change and European parliamentary elections indicate a certain momentum of Euroscepticism in several European countries,<sup>40</sup> as well those considered as supporters of the country’s European vector (the United Kingdom, France, Italy, and Austria).
- ❑ **Inefficient use of the financial assistance provided by foreign partners.** Direct contradictions between various ministries for European assistance on the ENPARD funds dedicated to regional development and agriculture<sup>41</sup> has indicated clear attempts to politicise the process of managing the European funds. At the same time, political interference has caused disputes between governing and opposite parties concerning the final beneficiaries of technical assistance provided by Romania.
- ❑ **Indeterminacy in relations with Russia.** The authorities came up with an initiative to inform Russia on EU Agreement, including translating it into the Russian language, in order to reduce Russia’s fears concerning adverse effects of the Association Agreement on bilateral commercial relations. Contrary to these efforts, Russian officials have stated that trade liberalisation between Moldova and the EU represents a risk for Russian commercial

<sup>39</sup> According to BOP of April 2014, the top five myths against the Association Agreement are the following: 1) loss of the CIS sales market; 2) loss of the Russian market; 3) introduction of visas for CIS countries; 4) destruction of local producers; 5) loss of the Transnistrian region, [http://ipp.md/public/files/Barometru/Brosura\\_BOP\\_04.2014\\_prima\\_parte\\_final-rg.pdf](http://ipp.md/public/files/Barometru/Brosura_BOP_04.2014_prima_parte_final-rg.pdf).

<sup>40</sup> The Economist, Eurosceptic party seats, May 26, 2014, <http://www.economist.com/blogs/graphicdetail/2014/05/daily-chart-16?fsrc=scn/fb/wl/dc/acertainideaofdisunion>.

<sup>41</sup> Europa Libera, the Republic of Moldova risks to lose European funds for agriculture, May 6, 2014, <http://www.europalibera.org/content/article/25375518.html>.



interests. At the same time, Russia has a number of levers they can use to influence the behaviour of Moldova from outside (seasonal workers, trade measures, Transnistrian separatism and the “Gagauz factor”).

- ❑ **“Ukraine test”.** Top priorities for the new Ukrainian President Piotr Poroshenko are to combat separatism, diminish the constraints arising from Russia, and to keep the European agenda. Delays in performing of these tasks might cause certain problems for the Chisinau authorities, for whom the stability and Europeanisation of Ukraine means a strengthened regional security, a regional synergy for the consolidation of democratic institutions, “Europeanisation” of Ukrainian minorities in their country, and predictable partnerships that are necessary to settle the Transnistrian conflict.

## Recommendations:

### Domestic Politics

- ❑ Establish both sectoral and extended platforms with the involvement of mass media and the representatives of civil society, in order to maintain the dialogue between Chisinau, Tiraspol and Comrat. Such platforms can be developed in the context of the European integration process – in the case of Comrat – and in the context of confidence building measures – in relations with Tiraspol.
- ❑ Ensure a clear, efficient and systematic communication strategy, in order to enhance EU visibility, provide clarity regarding the purpose of the Moldova-EU relations and the benefits and costs of European integration.

### Good Governance and the Rule of Law

- ❑ Use tools for monitoring the policies aimed at fighting corruption and Justice Reform implementation. Develop national campaigns based on “zero tolerance” for corruption, by presenting (in figures and images) the adverse consequences of corruption for the national budget and the welfare of every citizen. Consolidate the banking sector by strengthening the duties of the regulator (NBM), and by ensuring shareholders’ transparency.
- ❑ Ensure transparency of law enforcement bodies and increase the citizen’s confidence; develop an interest in the integrity of civil servants, by sanctioning the failure to submit Income and Property Statements, and subsequently monitor and make them public. In addition, it is required to: separate the responsibilities of the institutions involved in combating corruption (NAC and MHA); ensure full functionality of NAC by depoliticising the institution; improve the National Integrity Commission’s activity by limiting the number of monitored subjects and focusing on senior officials (MPs, ministers, etc.); implement prosecution reform by increasing transparency, internal independence of prosecutors, and institution depoliticisation.

### Foreign Policy

- ❑ Develop a set of external actions that reflect the new realities in the European institutions, but also in Europe, after the parliamentary elections. In this respect, the potential of the European Action Group of the Republic of Moldova (GAERM) could be used, which represents an informal platform that can be used for increasing the country’s visibility at the European level. Strengthening the efforts aimed at intensifying the economic diplomacy and attracting European investments is another significant point (this depends of the quality of the local reforms).

- ❑ Advance the relations with neighbouring countries. It is important to develop a regional agenda of European integration of Ukraine to include concerted action related to the Ukrainian minority in the country and to the Transnistrian conflict. The relations with Romania should be based on pragmatism, with the emphasis on multilateral interconnection of the countries (in terms of energy, economy, etc.), excluding subjective elements (“unionism”) which are harmful to the country’s European agenda.
- ❑ Ensure a balanced foreign policy that will combine dynamic political relations with economic ones. Enhancing economic dialogue involves focusing on signing of economic and trade agreements, i.e. investment attraction and job creation.
- ❑ Renew the dialogue with Russia regarding the European dimension of the external policies of both parties that in different forms and speeds provide strategic relations with the EU. The evaluation of Eurasian integration projects, of their impacts and constraints, is an urgent need for the Chisinau authorities, given the emergence of the Eurasian Economic Union and EU-Russia disputes which have been intensified by the background of the Ukraine crisis.

**Table 11. Main Indicators Monitored regarding the Political Situation**

	2011	2012	2013
Number of corruption-related sentences in all files (CNA)	9767.2	8220.2	-
Number of laws and regulations, developed by the Government, consulted with the public <sup>1</sup>	-	-	169 of 479
Decisional transparency in CPAs	-	83.4%	79%
Corruption Index, Transparency International	77%	-	97%
Media Freedom (World Press Freedom Index)	112	94	102
Peace Index (Global Peace Index)	75 (2010)	53	55

# Pension System – Risks and Reform Options

The current situation, as well as the short- and long-term forecasts, confirm that the pension system of the Republic of Moldova is in trouble. The pressures stem both from the expenditure side, as a result of the increasing number of retirees, and the revenue side, given the narrowing of the tax base. Thus, amid a worsening of the demographic situation, the pressures on the pension system are fueled by low employment, informal remuneration and migration of the working age population. As a result, the system experiences a structural deficit that is expected to grow in the coming years, while the average pension does not even cover the subsistence minimum. Taking into account the inability of the system to ensure a subsistence minimum for retirees and the sustainability risks in the long run, parametric and structural reforms are strongly needed. In this analysis, we will present the main concerns about the viability and efficiency of the pension system and propose a set of key policy measures aimed at consolidating the system resilience.

## Analysis of Key Trends

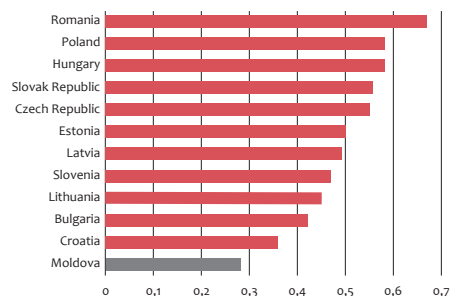
People are by definition short-sighted, the present being more valuable than the future. This is reasonable behaviour, given the high level of uncertainty regarding the future, especially in the case of a small and unstable country like Moldova. However, this does not motivate people to make long-term savings for old-age, when the capacity to generate income strongly declines. In this context, the role of a mandatory social insurance system is crucial. Thus, a functional pension system should provide at least a subsistence minimum for retirees and additionally a level of pensions linked to contributions made, to prevent the worsening of living standards once reaching the retirement age. In the case of the Republic of Moldova, neither of these tasks are fulfilled, which reveals serious vulnerabilities in the pension system.

**Figure 16. The Average Pension and the Subsistence Minimum, MDL**



Source: National Bureau of Statistics

**Figure 17. Replacement Rate in Regional Profile, %**



Source: EUROSTAT, World Bank, Lupusor and Benchman, 2014

Two problems should be highlighted about the Moldovan public pensions' system. First, the current system is unable to ensure an average pension that will cover at least the subsistence minimum: in 2013, the average old-age pension covered only 74% of the subsistence minimum (MDL 987 versus MDL 1326.9 monthly). Second, the system does not ensure a proper correlation between the level of contributions paid and the pension received, so that the pension does not allow a level of living at least close to that during the economically active period to be maintained. This is proved by the extremely low level of the wage replacement rate: in 2013 the average pension covered only 26% of the average salary (conventionally the minimum threshold is 40%).

Despite paying very low pensions, the system records a persistent structural deficit, which, since 2009, has been increasing continuously. Thus, in 2009 – a year of severe economic crisis – the difference between social security contributions and social security benefits amounted to 942 million MDL. This increased to 1.13 billion MDL in 2013 and in 2014 it is expected to be about 1.25 billion MDL. These differences are covered from the state budget. Therefore, the bill for the system's inefficiency and for the delayed reforms in this regard is paid by taxpayers who are taxed twice: (i) paying social security contributions on wages, and (ii) paying other taxes (e.g. income, VAT, excise duty) which are used to cover the deficit of the Social State Insurance Budget (SSIB).

The fact that the pension system records a constantly growing deficit, whereas the average pension does not cover even the subsistence minimum, reveals acute weaknesses in the system. The main factors responsible for this are related to the pressures on both the revenue and expenditure sides of the public pension fund.

### **Pressures on the public pension fund's revenues:**

- ❑ The main source of financing for the public pension fund is mandatory state social security contributions paid by employers and employees, which are calculated based on salaries (99% from own income and 73% from total income of SSIB<sup>42</sup>). As long as the system is based on the redistributive principle (Pay-As-You-Go), the ability of the SSIB to pay pensions to the current beneficiaries (retirees) depends directly on the amount of contributions collected from employers and employees. Currently, wage under-reporting (salaries “paid under the table”) and informal employment significantly affect the SSIB revenues. According to estimations by the Ministry of Labour, Social Protection and Family and the World Bank, the extent of under-reporting is approximately 50%–60%. Eradication of this phenomenon would bring to SSIB an additional MDL 3-4 billion – enough to cover the deficit and to align the average pension to the level of subsistence minimum.
- ❑ Acceleration of migration trends also exerts major pressures on the tax base of the public pension fund. Thus, during 2000–2013, the number of the population employed or looking for a job abroad increased 2.4 times (from 138.3 thousand up to 332.5 thousand people), with the highest growth (about three times) recorded for the age group of 25 to 34 years, which accounts for about one-third of all migrants.
- ❑ Low coverage of the social security system and the diminishing number of the insured population also undermines the tax base of the public pension fund. Thus, in 2013, only 33% of the working age population was insured, its share being in a continuous decline during the past years (in 2006 it was 46%). Besides the important share of informal employment, this phenomenon is also caused by the decrease in the employment rate (in 2013 it was 39.3%, decreasing continuously from 42.9% in 2006).

<sup>42</sup> According to the Law on State Social Insurance Budget for 2014.

- The low confidence level in the system represents a major factor underlying people's motivation to avoid social security system by accepting informal employment (EXPERT-GRUP, 2014). People's reluctance to contribute to the system is caused both by the system's incapacity to guarantee an acceptable level of living after retirement, being unsustainable in the long run, as well as by the low level of its transparency. Currently, SSIB pays not only old-age pensions, but also disability pensions, unemployment and maternity allowances and other types of social benefits, but the taxpayer does not know what share of its contributions are directed to one or other payment (23% for employer and 6% for employee). The reluctance to contribute to the system is also fueled by the multitude of privileged pensions (e.g. for MPs, Government members, prosecutors, judges etc.) which, despite having a modest share in the total pension fund expenditure (2.7% planned for 2014), undermines the equity of the system. The pension computing formula is another factor underpinning people's distrust in the public pension system. In particular, the formula introduced in 1999 takes into account the nominal rather than real salary, excluding in this way the erosion of purchasing power as a result of inflationary processes during economically active periods. This affects the correlation between the future pension level and the salary size, contributing to the deterioration of the wage replacement rate.

### **Pressures on the public pension fund's expenses:**

- During recent years, the number of beneficiaries of old-age pensions increased, while the number of taxpayers in the system decreased. Thus, taking into account the solidarity and redistribution principle of the current pension system, in 2013 about 1.8 taxpayers maintained one retiree (decreasing from 2.3 in 2006), while the minimum ratio required to maintain the stability of the system is about 4 to 1. Moreover, the ratio of 1.8 taxpayers to one retiree is a rather optimistic estimation, because it does not take into account the multitude of exemptions and facilities to the payment of social security contributions enjoyed by many categories of the population, which could effectively lower the ratio to one-to-one. The deterioration over the years of the dependency rate has been the main reason that the SSIB deficit increased. The deficit is expected to be at about 1.2% of GDP for 2014.
- The increasing number of pension beneficiaries is caused by the population aging. Thus, in early 2014, the share of the population aged over 60 years in the total population (aging coefficient) was 15.7%, being on a continuous upward trend during the past years (13.6% in early 2001). This is expected to accelerate in the future (in 2020 – approximately 20%).
- The increase in life expectancy at birth is another factor that creates additional pressures on the expenditure side of the public pension fund. In 2000 this indicator was 67.6 years; in 2013 it increased to 71.9 years. Although this is a positive trend and reveals improvements in life quality, it also implies certain risks regarding the redistributive pension system.

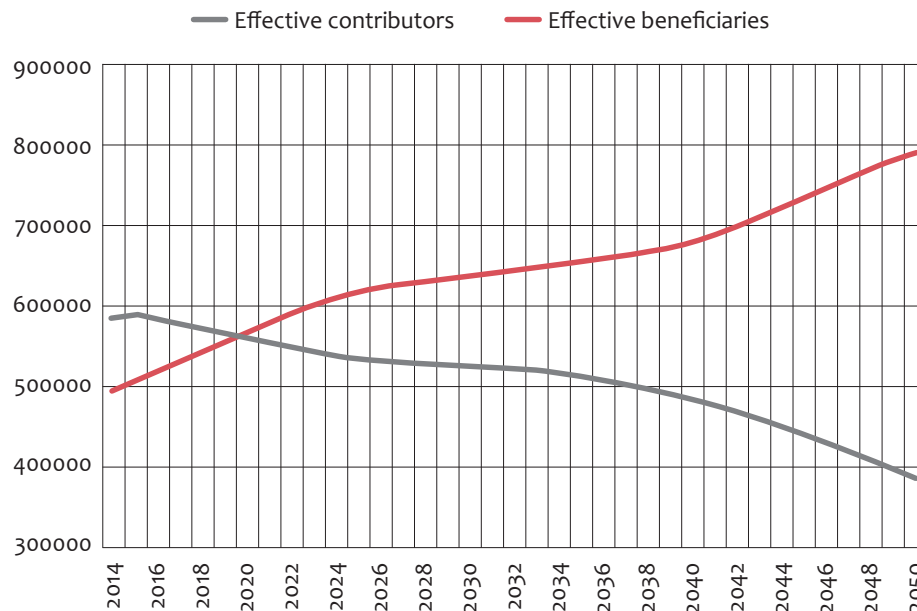
These problems have affected people's confidence in the public pension system. According to the survey conducted by EXPERT-GRUP in June, 2014, about 75% of the population do not trust the pension system; this share is even bigger among the elderly (80% for 45–59 years and 78% for 60 years and over). At the same time, 69% of the population believes the pension system is not fair, which correlates with the low level of trust, the most negative perception being again among the elderly (73% for 45–59 years and 74% for 60 years and over). One of the major causes of mistrust and negative perceptions towards the pension system derive from the weak link between the size of pension and the contributions made to the budget. Thus, only 59% of respondents said that the amount of retirement pension depends on the amount of contributions to the budget. It also denotes a low level of information on how the public pension system works (formula, the redistributive principle etc.), which motivates people to accept informal forms of employment and remuneration.

## Wider Implications and Risks

At the beginning of this chapter, we spoke about people's myopia and their perception about the present as being more valuable than the future. In fact, this is exactly what motivates the existence of a functional pension system. However, we have to keep in mind that politicians have the same perception: they make plans for periods that most often do not go beyond one election cycle (four to five years). This explains the delays in reforms for which the advantages can be seen in the long run (over five years), and which imply short-term electoral risks. The delaying of Moldovan pension reform proves this hypothesis in a plausible way. However, the reform cannot be delayed forever, given that the demographic, migration and economic trends will put increasing pressure in the near future on the SSIB.

The process of aging will be fueled in the near future by the rapid growth of the number of retirees as a result of the aging of those born during the "baby boom" after the Second World War. Thus, already in 2020, one in five people will be over 60 years old and in 2050, about one third of the population will be aged. At the same time, the model of urban reproduction is characterised by low birth rates, while migration processes will lead to the narrowing of the tax base to the public pensions' fund. As a result, the ratio of taxpayers to retirees will progressively deteriorate such that in 2020 the number of retirees will exceed the number of taxpayers and the gap will increase exponentially (Figure 18).

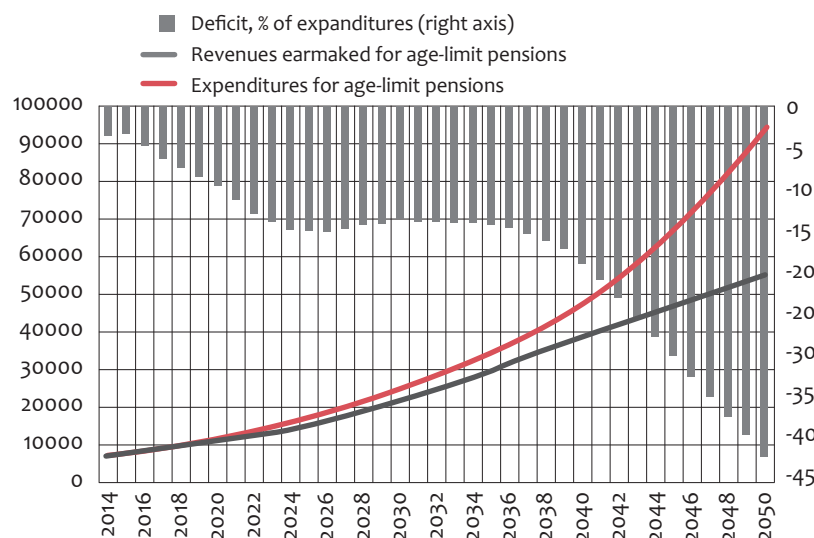
**Figure 18. Forecast Number of Taxpayers and Actual Retirees, persons**



Source: Lupusor and Benchman, 2014

Given the increasing SSIB expenses, in tandem with decreasing revenue, the risks for the sustainability of the public pension system are serious. According to estimations, the gap between revenue and expenses forecast for the coming years will grow continuously, and after a temporary stabilisation during 2024–2034, the deficit will grow exponentially (Figure 19).

**Figure 19. Forecast Dynamics of the Revenue, Expenses and Deficit of the State Social Insurance Budget, MDL million**



Source: Lupusor and Benchman, 2014

The inability of the pension fund's revenues to cover the payment obligations to pension beneficiaries, coupled with the expected growth of the deficit, show that the system is not sustainable over time. Delaying reforms will increase each year the cost of maintaining the current system, and the main losers will be both retirees, who will receive small pensions, poorly correlated with previously received salaries, as well taxpayers because the deficit is covered from the state budget (taxes and fees collected from population and enterprises).

## Policy Recommendations

The verdict of the long-term unsustainability of the public pension system is not a death sentence, but rather a diagnosis of an illness that can be cured. As shown by the experience of other countries in the region that have faced similar problems, a range of measures can include a set of parametric adjustments that should be complemented with a set of structural adjustments. We believe that a comprehensive reform has to combine the above policy measures:

### Parametric Measures

Parametric measures can be applied immediately and their effects will be visible during the course of several years. These measures consist of:

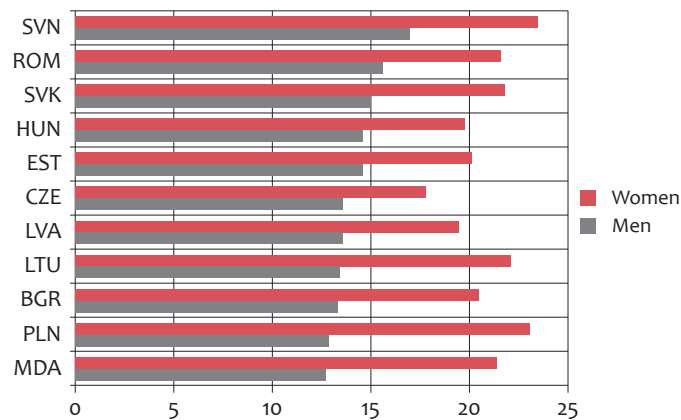
- (i) equalising the retirement age of women and men (raising the retirement age of women from 57 years to 62 years);
- (ii) changes in the pensions computation formula to motivate taxpayers to remain in the system and to ensure a closer link between the calculated pension and the level of salary previously received;
- (iii) rebalancing of a part of the quantum of social security contributions from the employer to the employee.



### Equalising the retirement age of women and men

Raising the retirement age is probably one of the first reform measures that governments resort to in order to balance pension systems. In the case of the Republic of Moldova, the retirement age is one of the lowest in the region (57 years for women and 62 for men), which, at first glance, would justify an upwards adjustment. However, the retirement age cannot be raised without taking into account the retirees' life expectancy. Thus, comparing the difference between life expectancy of the retirees and retirement age, it is obvious that retired men live a relatively shorter period of time in regional comparison, while the length of retired women's lives is near the average in the region (Figure 20).

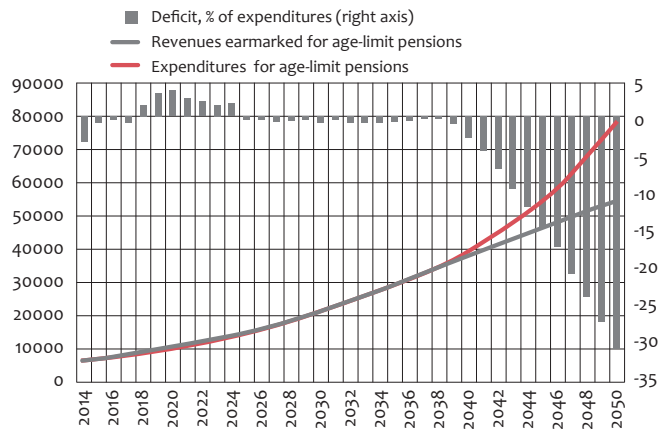
**Figure 20. Difference between the Life Expectancy at 60 Years Old and the Official Retirement Age**



Source: Lupusor and Benchman, 2012

Therefore, it is not appropriate to raise the retirement age of men unless their life expectancy increases. The only option, then, is a gradual increase (e.g. during 10 years) of the retirement age of women up to the men's level. The estimated effects of such a measure are significant because it allows balancing the SSIB for a certain period of time (Figure 21). However, this does not solve the problem completely, because the deficit will still start to grow exponentially from 2038.

**Figure 21. Effects on SSIB of the Increase over 10 Years of the Women's Retirement Age to 62 years, MDL million**



Source: Benchman and Lupusor, 2014  
Changes in the pensions' computation formula

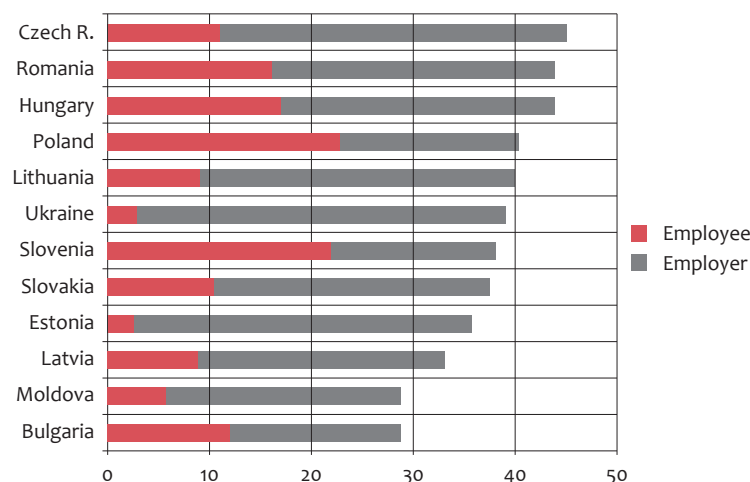
The age pension computation formula, implemented in 1999, contains a number of shortcomings that undermine the connection between previous contributions and pension received, and thus affect public confidence in the pension system. Therefore, this formula should be adjusted in several areas:

- ❑ The pension computation formula must take into account the real wage rather than the nominal one, in order to control the effect of the money purchasing power erosion over time. Currently, the formula is based on nominal income, which does not allow for estimating objectively the pension and practically undermines the link between income and pension.
- ❑ The multiplication coefficients (accrual rate) in the pensions' computation formula should be changed to motivate taxpayers to remain as long as possible in the system. Currently, the formula uses the coefficient of 1.4% for the minimum number of years worked (30 years) and a slightly higher coefficient (2%) for persons who have contributed for more than 30 years and the same coefficient of 2% for people who remained employed after reaching retirement age. A fixed coefficient for such a long period (30 years) does not create the necessary motivation to remain in the system. Instead, if the multiplication coefficient increased every five years, taxpayers would be interested in remaining in the system because they would be remunerated for each extra year worked.
- ❑ Although it is not related directly to the pensions' computation formula, the pension indexation mechanism contributes directly to the decrease in the employment rate: the annual pension indexation coefficient is calculated on the basis of the average of the growth of nominal salary and the Consumer Price Index (CPI). However, due to the fact that CPI is often lower than the growth of the nominal wage, pensions will always increase at a lower rate than salaries, which automatically reduces the salary replacement rate. Therefore, it is necessary to ensure a proper indexation of pensions to a specific basket of consumer prices for goods and services consumed by the elderly, without taking into account the nominal salary.

#### ***Rebalance a part of the social security contributions rate from the employer to the employee***

Although the rate of social security contributions is low compared to the region, it will not be appropriate to raise it, given the high share of informal employment and remuneration (about 50%–60%). However, it is possible to rebalance the rate of social security contributions between employers and employees. Currently, most social security contributions are paid by employers (23% of the total of 29%), which motivates many companies to pay a portion of salaries “under the table”. At the same time, a relatively small contribution of employees (6% of 29% total) does not sufficiently motivate them to ask companies to pay formal salaries. This largely explains the widespread informal economy, as companies have greater bargaining power in relation to employees. The rebalancing of social contributions between employer and employee is motivated by the experience of other countries in the region, where the burden on employers is slightly smaller (Figure 22).

**Figure 22. Distribution of the Social Insurance Contributions between the Employer and Employee, %**



Source: Lupusor and Benchman, 2012

Thus, without increasing the rate of social security contributions, it is recommended that the contribution paid by the employer be gradually decreased and to increase proportionally the contributions paid by the employee. As an indication, the current ratio of 23% to 6% could be rebalanced to 20% to 9%. This would allow a fairer distribution of the tax burden between the employer and employee and will create preconditions for diminishing informal employment.

## Structural Measures

The parametric adjustments mentioned above will not achieve the expected effect unless they are complemented by a set of structural measures. These are more difficult to implement, but the strengthening of the long-term sustainability of the system will depend on these reforms.

- ❑ Improve the equity of the pension system by reducing the privileges. Privileged pensions financed from the pension fund (e.g. pension for MPs, Government members, prosecutors, judges, etc.) negatively affect the confidence in the system and fuel taxpayers' dissatisfaction. Hence, privileged pensions should be diminished and some even eliminated in order to restore the system's equity.
- ❑ Strengthen the transparency of the public pension system. Based on the experience of most countries in the region, it is necessary to ensure clarity regarding the use of paid contributions. Currently, the 29% social security contributions paid by employers and employees are not used only to pay age pensions, but also to pay disability pensions, survivor's pensions, privileged pensions and various social benefits (for children, temporary disability, maternity, disability, unemployment etc.). Therefore, it is necessary to make the social contribution (consisting of 29%) earmarked for the main financing directions: old age pensions, other pensions (disability, survivors), for the unemployment fund and for maternity allowances. This will allow taxpayers to understand better how the pension fund resources are spent. At the same time, it will streamline the management of SSIB resources, because transferring money among categories of expenses will not be allowed.

- Develop the second pension pillar<sup>43</sup>. Conceptually, a second pension pillar could be implemented after parameter adjustments, after strengthening the sustainability of the first pension pillar (the current one). The second pension pillar is of crucial importance because it is based on a cumulative principle and not on the distribution principle specific to pillar one. Thus, the contributions under pillar two are invested in financial instruments and the pension amount will be equal to the amount of contributions plus investment income, which ensures a better correlation between income until retirement and pension. At the same time, as the taxpayer has property rights over these resources, it ensures a greater public confidence in the system and creates greater motivation to contribute. This measure can be implemented gradually after five years by reallocating 0.5 p.p. from social security contributions paid by the employer and employee until they reach 3% paid by the employer and 3% paid by the employee to pension pillar two. The deficit that could result from the reallocation of 6 p.p. from the total of 29% of pillar one to pillar one could be covered by privatization and the additional resources obtained after raising the pension age for women.
- Decrease informal employment and remuneration. Eradication of this phenomenon could release the necessary resources to fully cover the pension fund deficit and align the average pension to the subsistence minimum level. Therefore, a fundamental objective is to bring money from the informal into the formal flow. Some of the measures already mentioned above could help in this regard (e.g. rebalance the social security contributions, increase transparency of the public pension system, adjust the formula for pension computation), because they provide more incentives for employees to contribute to the system. Other measures in this regard could be: active informing of employees about the negative effects of informal employment and remuneration and the importance of contributing to the pension system, elimination of the practice of calculating penalties for enterprises based on the amount of the wage fund, sharing responsibility for the informal employment and remuneration between employer and employee (both the employer and the employee must be fined), increasing the fines, and increasing the monitoring capacity of authorities in charge.

**In conclusion**, the public pension system faces serious problems that can be eliminated by a comprehensive set of complex measures, consisting both of parametric adjustments and structural reforms. Importantly, the pension system problem is not related to the line ministry only (Ministry of Labour, Social Protection and Family), because it requires a consolidated effort of several ministries and institutions (e.g. Ministry of Finance, National Social Insurance House, Ministry of Economy, and Labour Inspection). Last but not least, broad political support is needed, as well as the capacity of political elites to undertake a comprehensive reform of the pension system in the Republic of Moldova.

**Table 12. Main Indicators Monitored regarding the Public Retirement Scheme**

	2010	2011	2012	2013
Average age pension, per month, MDL	800.8	836.6	900.6	987
Ratio between the average age pension and the subsistence minimum, %	67.6	64.1	69.1	74.4
Replacement rate (ratio between average age pension and the average monthly salary per economy), %	26.9	26.2	25.9	26.2
Dependency rate (ratio between the number of taxpayers to SSIB and the number of age pension beneficiaries)	1.8	1.8	1.7	1.7
Coverage ratio (share of the number of taxpayers to SSIB related to the number of the working age population), %	36.4	36.2	35.1	33.1
Structural deficit of SSIB (difference between income from social security contributions and expenses related to social insurance), MDL million	-1038.6	-1013.8	-1110.0	-1132.0

*Sourc e: NBS, National Social Insurance House*

<sup>43</sup> The second pillar of the pensions' system implies that the contributions are accumulated on individual accounts of each contributor, rather than redistributed immediately to pensioners.

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# About EXPERT-GRUP

## WHO WE ARE

Expert-Grup is a Moldovan non-governmental and not-for-profit organisation that specializes in economic and policy research. Expert-Grup does not represent any economic, corporate or political interests. An independent organisation, Expert-Grup reflects the ideals of young Moldovan intellectuals who have created the institution with the purpose of contributing to Moldova's development. Among other types of organisations in Moldovan civil society, Expert-Grup positions itself as a politically and ideologically neutral think-tank.

## OUR ACTIVITIES

Our core activity is economic analysis, forecast and policy research. In this area, we offer a wide range of analytical products and services helping our beneficiaries to take decisions that will support Moldova's development path. Our key competence consists in the ability to provide professional, high-quality and objective research in such broad areas as:

- ❑ Macroeconomic analysis and forecasts;
- ❑ Political economy;
- ❑ Public finance;
- ❑ Human development and poverty reduction;
- ❑ Labour market and consumer behavior;
- ❑ Foreign trade;
- ❑ Financial markets;
- ❑ The economy of European integration;
- ❑ Economic analysis by sectors;
- ❑ Regional and local economic development;
- ❑ Energy and the economy of the environment.

## PARTNERS AND DONORS

During 2006–2014 Expert-Grup implemented over 60 research and advocacy projects in various areas related to economic research and public policy. Over 100 experts, both affiliated and not affiliated to our institution, from Moldova and abroad, were involved in these projects. We have worked with such donors as Soros Foundation Moldova, East Europe Foundation, Konrad Adenauer Stiftung, Balkan Trust for Democracy, Black Sea Trust, Friedrich-Ebert-Stiftung, UNDP Moldova, UNICEF, European Commission, Council of Europe, Open Society Foundation, Swiss Agency for International Cooperation, and United Kingdom Department for International Development. In 2010 and 2012 Expert-Grup was selected as member of the National Participation Council. Since 2008, Expert-Grup has been a member of the Policy Association for an Open Society – an international network consisting of 56 think-tanks from various European countries.



Friedrich-Ebert-Stiftung (FES) is a German political social-democratic foundation which aims to promote democracy, peace, international understanding and cooperation. FES fulfills its mandate in the spirit of social democracy and devotes itself to public debates and finding social-democratic solutions to current and future issues of the society.

## FES IN MOLDOVA

In the Republic of Moldova, FES aims to foster European integration, democracy, peace and social justice through political dialogue, education and research. Our main areas of activity are:

### **Democratization and Political Participation**

Moldova faces the challenge of consolidating its democratic institutions and developing a democratic culture that brings the country fully in line with standards of the EU. FES contributes to this process by promoting political participation in civil society organisations, political parties and local self-governing bodies. A particular focus of FES' activities in this area is on empowering citizens in the regions. Citizens need to be empowered to be able to critically follow public debate, monitor political stakeholders, articulate their views, and act on behalf of their interests. Therefore FES has engaged in activities to promote participatory democracy and the enhancement of citizens' civic and political culture at the local level.

### **European Integration**

Moldova is part of the European Neighborhood Policy and the EaP. FES supports the European integration process of the country. Through a series of instruments, such as radio debates, news bulletins, policy papers, publications and conferences, FES focuses on the main challenges related to the European integration process, facilitating the public's access to up-to-date and reliable information on the topic, improving the dialogue between civil society and decision-makers on the requirements for successful European integration, and contributing to strengthening the European integration efforts of the Moldovan authorities. Additionally, FES supports NGOs in contributing to a peaceful resolution of the Transnistrian conflict as a prerequisite for successful European integration in the long run.

### **Economic, Social and Environmental Policy**

In this area FES supports its partners in developing and implementing policies for a functioning market economy which is sustainable, socially balanced and able to address the needs of all citizens. Input and projects in the area focus on topics such as reforming social security systems, improving working conditions and labour market opportunities and fostering sustainable development. Additionally, FES runs programs which aim to promote social-democratic values.

